Orange Polska

Q1 2023 EARNINGS CALL

Date: 26.4.2023

Participants:

- Julien Ducarroz, Chief Executive Officer
- Jacek Kunicki, Chief Financial Officer
- Leszek Iwaszko, Head of Investor Relations

Leszek Iwaszko:

Ladies and gentlemen, thank you for standing by. I would like to welcome you to Orange Polska first quarter 2023 results conference call. My name is Leszek Iwaszko and I'm in charge of investor relations. At this time, all participant lines are in a listen only mode. The format of the call will be a presentation by the management team followed by a Q&A session. Speakers for today will be Julien Ducarroz, CEO of Orange Polska and Jacek Kunicki, CFO. I pass the floor to Julien to begin.

Julien Ducarroz:

Good morning ladies and gentlemen. Welcome everyone on our conference summarizing first quarter of 2023. Let's start on slide five with the key message of this quarter. I'm pleased to say that this year started very well for Orange Polska. It is despite the environment continues to be challenging due to high inflation and slowing economy. Our commercial performance was solid. It reflects our focus on value in an intense market competition. ARPO continued to grow in all key services. This is our special focus and we are working to improve this dynamics further.

Our equipment revenue growth was very impressive in Q1. The key reason is shift of the demand towards higher value handsets. We don't sell more handsets, but the share of the more expensive brands in the mix increased the lot. We make it easier for the customer offering flexible installment plans. In Q4, we introduced 36 months installment scheme, which makes more expensive equipment more affordable and it is as well in line with our green strategy to increase the lifetime of the devices used by the customer. Our financial results were excellent with strong growth of revenues, EBITDAaL and net profit. It was despite inflation impacting our operating costs.

Q1 was also very relevant for our transformation. In .Grow strategy, we talked about phasing out of legacy technology and assets to release more of our potential. Q1 was particularly strong for disposal of our real estate that we no longer need. It decreases our operating costs and release capital. We have also announced a plan to gradual switch off of 3G technology that will start this year with a goal of completion by the end of 2025. This will lead to higher efficiency and make more room for 5G implementation.

Let's look on the next slide. Slide number six. Our financial results in Q1 were excellent. They illustrate well the strengths of our core business. More than 5% growth of EBITDAaL was generated by direct margin coming from strong performance of our key business lines. Our operating costs increase reflecting impact of inflation despite we partly mitigated with our actions. This is a healthy structure of growth, especially for inflationary environment, confirming our strong fundamentals.

In Q1, we have not yet seen full impact of inflation on our costs. Please also remember that last year in Q1 we had very high energy costs. We are satisfied with the results achieved in Q1 and they give us full confidence to achieve growth in the full year. Something that clearly is our ambition. Q1 eCapEx reflected higher year-on-year level of investment and very high proceed from disposal of assets, which I already mentioned. We sold more than in the entire 2022. Let's look on commercial activity on slide seven.

Our commercial performance in Q1 reflected continuous solid customer demand, our focus on value and intensive market competition. In convergence, we are pleased with 5% year-on-year growth of the customer base. It is healthy growth taking into account more intensive competition in this area. It confirmed that the customer appreciates the quality of our multiservice offer. Growth in convergence is supported by fiber where we continue to see good customer demand. Customer base increased more than 20% year-on-year. To complement our product portfolio on selected areas, we have launched fiber offer under our B-band Nju, which for the past 10 years has been very successful in mobile.

Our mobile customer base growth is also solid even if the pace of its increase has slowed down a bit. It's mainly due to slower results in B2B and high comparable base for Flex offer, which had a very strong last year due to demand from Ukrainians. ARPO continued to grow in all key services, which is obviously very important in the context of inflationary challenges. Our value initiatives for 2022 are gradually rolling into our customer base. Going forward, we will stick to our value approach in pricing. Thank you for now and I hand the floor to Jacek.

Jacek Kunicki:

Thank you, Julien. Good morning everyone. Let's start the financial review on slide nine where we present the highlight of our performance. Our financial results in Q1 were excellent with strong growth achieved in revenue EBITDAaL and the net income. Our top line continued to expand strongly. Solid performance of corw telco revenues was complemented by a 40% year-on-year increase in handsets sales.

Strong revenue expansion was the key driver of the five and a half percent year-on-year growth of EBITDAaL. A strong underlying performance enabled us to outgrow the headwinds from a challenging inflation environment. I am pleased that the EBITDAaL growth has consistently translated into the bottom line. Our net income of 270 million złoty has more than doubled year-on-year. It was driven up by the growth of the EBITDAaL but also by much higher gain on disposal of real estate assets.

The higher proceeds from asset disposals had also allowed us to lower the economic CapEx in Q1, which was 8% down versus the comparable period of last year. Finally, cash generation was impacted by timing of payments for CapEx and higher working capital requirements for sale of handsets in installments. Let's now review our results of Q1 in more detail. Starting with the top line.

We are very satisfied with the revenue performance in Q1. The key drivers of more than 7% year-on-year dynamics are largely consistent with prior quarters and based on sustainable demand for our services. Firstly, core telecom services continued their solid pace of growth benefiting from a simultaneous expansion of their respective customer bases and ARPOs. We are monitoring the volume of KPIs while relentlessly implementing the value strategy.

Secondly, the IT and IS area had another good quarter with revenue expanding at double digit rates. This is reached despite market slowdown that is stemming from higher uncertainty amongst our business clients. Wholesale revenues have increased by 15% as we continue to capitalize on the demand for our infrastructure. And finally, as Julien mentioned, equipment revenue's growth by an extraordinary 40% year-on-year, reflecting a shift of customer demand to higher value handsets.

The expansion of our core business was the key driver for operating profitability growth. Let's now look at this on slide 11. Our EBITDAaL in Q1 increased by a very strong five and a half percent year-on-year. It was a good quality growth resulting from excellent performance of our core business. The direct margin expanded by more than 5% year-over-year or 85 million. Translating the solid revenue growth into profits. I'm happy that the growth of the direct margin has accelerated versus the dynamics seen in the previous quarters.

Indirect costs have increased year-on-year but much less than the growth of the direct margin. First, as expected, our costs were affected by inflation mainly due to indexation of rental contracts and increase of prices of various external services. Secondly, we benefited from cost optimization and actions to mitigate the impact of inflation. For example, we achieved extra savings in property maintenance and very effectively hedged the prices of some utilities.

Third, we were able to reverse certain provisions, something which by nature is a non-recurring development. We are very satisfied with the EBITDAaL dynamics in Q1. This result and the trends behind it build our confidence to reach our ambition of growth in 2023.

Let's now take a look at cash flow on the next slide. Our cash flow generation, organic cash flow was negative in Q1 at around minus 120 million. There were two key factors that influenced this performance. Firstly, cash CapEx expenditures exceeded 700 million złotych. Over 400 million of this accounted for payments for high CapEx from the previous year. Last year, CapEx phasing was more backend loaded than usual, with Q4 accounting for 45% of the full year total and as consequence, the Q1 payments reflect this schedule.

Secondly, we have a higher need for working capital. This stems from very strong sales of handsets. We sell them in installments so we receive cash from customers during two to three years while we settle our payments right after the purchase. We are analyzing and plan to possibly extend the existing securitization facility to finance this demand and I'm confident that we can reduce the pressure on the working capital before the year end. Both of these factors are relating mainly to timing. Our underlying cash generation remains very strong. In particular we don't see any decrease, any deterioration of quality of our receivables. And obviously as the economy is slowing down, we are monitoring this indicator with great care.

Our balance sheet remains very sound with financial leverage at 1.3x and effective cost of the existing financing of just over 3%. Leverage was further decreased by another tranche received, as planned, from APG relating to the payment for the 50% shareholding of the FiberCo. That is all from me. Thank you very much for your attention and I have the floor back to Julien for the conclusions.

Julien Ducarroz:

So let me briefly summarize and present our focus for our next months. Our performance in Q1 was strong. We generated outstanding growth, especially taking into account that inflation affected our costs. We are confident on our full year objective. Our commercial result was solid, in the area where we see some slowdown, we have launched action to address it. We focus on relentless execution of our commercial strategy based on value and cost transformation especially needed in the current high inflation environment. 5G is obviously high on our agenda. We are looking forward to C-band auction, which according to the regulator should take place in Q4. Finally, we don't forget about our green commitment. We are planning new initiatives related to circular economy, after securing the CO2 emission reduction goal in scope one and two our focus is now on scope three, so including our value chain. That is all from us. We are now ready to take your questions.

Leszek Iwaszko:

Thank you. We will now be moving into a Q&A session. If you are dialed in via the phone and would like to ask a question, press star, two on your keypad and wait for your name to be called. You may also ask a voice or text question using the web platform. So once again, if you would like to ask a question, please press star, two on the keypad or press the question button on the web platform.

Question comes from Dominik Niszcz from Trigon. Dominik, your line is open. Please go ahead.

Dominik Niszcz:

Hi. Dominik here from Trigon. My question is about ARPO because we saw very stable dynamics in this quarter. On average it was the same as in the previous quarter, so plus 2% in convergence plus 3% in fixed internet, plus 4% in mobile. So the question is, how do you see it going forward? And would you say that it's fair to assume that in 2024 it could accelerate given the construction of your contracts? Thank you.

Julien Ducarroz:

Thank you for the question. Indeed, as you know we are rolling out and we started to increase our prices last year, but in the Polish context this is done on a way that is on the contractual basis. So only our new and people who extend their contract are subject to those reprises. So there is an effect of timing and we see it progressively on the base, but as you stated, that will impact over the time and the main effect will be next year. Now, I think we should as well be careful that next year is not set. The context might change and I will not necessarily be sure that there will be an acceleration. I think if there as today, mechanically it'll increase but 2024 is still one year ahead of us and there might be other factors that might impact ARPO. But you are right to say that mechanically the impact will be more visible next year than this year.

Dominik Niszcz:

Okay, thank you. And one more about real estate, you had a very good quarter, so the second quarter you expect to return to average or still a good one here?

Jacek Kunicki:

Well, thanks for the question. I guess when it comes to real estate, it's not something where we have a trend line or a clear pattern. It really depends on how many transactions do you close in a given period. I think there were about 21 transactions in Q1. We obviously have a good pipeline and we will continue to sell those real estates that we don't need to be using in the long term. But when it comes to the quarterly performance, it really will depend on how many transactions do we close in which quarter. But obviously we can see that last year, 2022 was much better than 2021. And by the way we've started this year you can see that we are aiming for a much better result in '23 than we've achieved in '22.

And this is definitely what is in our plans, what is in our ambitions, what is in our guidance for quite a low eCapEx guidance that we've given for this year. Now, after Q1 we can say we're confident to achieve it, but it's, I think, not that easy to tell you exactly what will be the expected amount in Q2. I don't think we'll repeat the good result from Q1 as we mentioned, it's really an extraordinary effort and a big accumulation of great successes from the team.

Dominik Niszcz:

Okay, I see. Thank you. And just the last one, I'm not sure if you commented but this high other operating income in this quarter, was it once off? If you could comment, thanks.

Jacek Kunicki:

Yeah, thanks. It's a relevant question. I guess first of all, it's fair to say when you look at other operating income and expense, the line by itself, it's not that recurrent. So Q1 of last year was quite low with plus 5 million. We had plus 34 million in Q2 of last year, then 17, then 21 million plus in quarter four, now it's 46. Different reasons and different, I would say, items that make this line go up or down every quarter. This line includes the activities that we do for the FiberCo. It includes copper sale, which usually is stronger in Q1 versus Q4. It wasn't so strong in Q4 and it's a bit stronger in Q1. Again, if you take a look at this line and if you're taking the year-on-year perspective, last year with just plus 5 million was quite low. We've been able to reverse some provisions and this is between 12 to 15 million impact which is non-recurrent but happens from time to time.

So in all honesty, always this line is usually made up of items which not all of them are recurrent. This is the situation that we've had throughout last year. We're happy every time that we do register a good result. We know that we have the inflationary environment to deal with and so every time that we get a positive in this line, whether it's a one off or recurring, we're happy to take it. I think it's important at the same time because your questions in the context of the EBITDAaL performance, I mean, if you think about what really, really made the five and a half percent, it's a very good growth of the direct margin. If you take a look at our presentations from the previous quarters, you will find that we are growing the direct margin this quarter by 85 million versus 50 million in Q4 or Q3, all of it is year-on-year. And versus 20 million growth on average per quarter registered in H1 of last year.

So this is really what has accelerated and this is what inspires our confidence to be able to outgrow the inflation this year. And this is the main plan and this is why we're happy with the structure of the EBITDAaL growth, not only the level of the EBITDAaL growth. But I hope that my answer also answered your question regarding the other operating income.

Dominik Niszcz:

Thank you.

Leszek Iwaszko:

Our next question on the phone is coming from Marcin Nowak from Ipopema. Marcin, your line is open, just go ahead.

Marcin Nowak:

Good morning. Thank you for the presentation. One question from me, given that you have repaid part of the loans in the first quarter, may I ask when do you expect to refinance the remaining part of the loans? And what is your prediction for the effective cost of financing including hedge, if you will pursue hedge after that? Thank you.

Jacek Kunicki:

Thank you very much. I see that you have been reading our balance sheet carefully. It's a very relevant question, so I would assume that the next drawing of increase of debt would be happening in the second half of this year. Now, in all honesty, a lot depends on how fast do we start the 5G auction and when do we finish the 5G auction because this is a material cash outlay that we will need to finance. So that will really depend on that. Obviously we are aware that there is a dividend payment coming along and we are happy to make this dividend payment.

At the same time, we do note that taking into account the EBITDAaL projection, quite low CapEx, we do expect quite good organic cash flow performance in the year to go. So that will help to finance the cash outflows that I have mentioned. I would assume that if the 5G auction is finalized and we need to pay, we will be drawing some debt in H2. When it comes down to the cost of the financing, it'll really depend on market conditions at that point in time. If I was to make the best guess today, it would be probably around 7%, maybe a bit less. And this is all in cost after hedge.

So as you will see, it's probably not going to be that relevant part of the net debt and it will not influence the overall cost of the debt that much.

Leszek Iwaszko:

Thank you. And then next question is coming from the line of Rohit Modi from Citi. Rohit, please go ahead, your line is open.

Rohit Modi:

Thank you for taking my questions. Some of them already answered, just two from my side. Firstly, on your revenue guidance, you have almost 6% revenue growth on your core service revenue growth in one quarter. If you could give us more color in terms of which are the areas where you see a slow-down in the rest the year and which are the areas where you see the growth will remain as stable as in Q1? Secondly, on the pricing environment given inflation is almost now 20%, are you looking for more index price increases? Are you in discussion with a regulator around this for any of the back book price increases? Thank you.

Jacek Kunicki:

Okay, so first of all, thank you for your questions. Again, both are very relevant. I think what's fair to say is when it comes to revenues, but in fact it goes both for revenues and for EBITDAaL, it's a very good start of the year. Coming back to your question, which specifically targeted revenues, I think what is particularly satisfying as factor is the five and a half percent growth of core telecom services. And this is really something that is key for us because this translates into the direct margin.

Then we have a number of revenue lines which are less subscription based and do tend to be a little bit volatile from one quarter to another. This includes IT and IS services and it also includes equipment sales. So the 7% top line headline that you see, it really was influenced also by this equipment sales which contributed in 132 million expansion year-over-year or 40% increase. And this is not something which is repeatable automatically. We will need to see how fast does this category continue on its growth path.

When it comes to the question of indexation, and this is something on which we have touched base a number of times before, obviously in Poland it is a bit more difficult to reprice the back book versus the Sales Acts. As we have mentioned before, we have not yet decided whether we are going to execute the inflation clauses that we have in some of the contracts. But we continue to seriously consider it because we are aware inflation is weighing in on our operating costs and ARPO growth is essential to protect the profitability. So no change on this point since February.

And then when it comes to more details on exactly when, exactly how much, you'll appreciate if we won't comments this specifically as this is commercially sensitive.

Julien Ducarroz:

Maybe just to add as well on the point of where do we see a slow down or when I commented that we are focusing on some areas, obviously there is a B2B market that given the economical context I will say is challenging. Not so much from, I would say, the competitor, but more at the general economy. We see some reduction of the fleet and the cost optimization on our client side. That's one area that we are looking and we take care of our clients helping them as well to go through those times, the same they are difficult on our side, on our cost, but the same way for our clients. So that's one area and the other area that we reported a bit lower, but it reflects more here the competition which is on the fixed broadband, that obviously we see more competition on the market of our competitors going as well on the convergence business. But this is an area that we are addressing and monitoring and continuously grow.

Rohit Modi:

Thank you so much.

Leszek Iwaszko:

Two questions that came online. First question from Piotr Raciborski from Wood&Co. "In Q1-23 you have recorded strong deceleration in fiber and mobile postpaid net additions. Do you see reduced commercial activity of consumers? Is it because of macro weakness or strong competition?" This is the first question. There are a couple of them so I will read one by one.

Julien Ducarroz:

Okay, so I think I touched a little bit in my previous comment related to mainly the B2B side on the macroeconomic, I will say, situation in Poland. What we have as well to keep in mind when we are looking at the contracted base of the post-paid. Last year we recorded the strong result, especially on flex and that was driven by the situation in Poland related to the start of the war where there was a higher influx of Ukrainians. So we had reported good net adds, but obviously now where the situation is different in terms of new customers, so this you will understand.

And regarding to the fixed broadband, I commented as well that yes, the market is obviously more competitive, more players entering the game. So on one side for us, given our experience, this is comforting that our strategy of convergence and FTTH has been the right one that we decided almost seven years ago. So to see competitors entering this, I will say it's reinsuring that we bet on the right direction. But as a consequence we see a competition here and we are keeping our value strategy. But at the same time, as I commented, we have launched as well our B-brand that in certain areas we are using to answer to some of customer needs when it comes to pricing.

Leszek Iwaszko:

The second question relates to FiberCo. "Are you satisfied with FiberCo performance? How do you rate competition environment in Polish fiber market?" Which partly was already touched.

Jacek Kunicki:

Okay, so we commented on the competition. With regards to FiberCo performance, we're satisfied with progress. The FiberCo is rolling out it's fiber in accordance with the plans and so this is giving additional footprint. We are, as Orange Polska, both happy as a shareholder and also regarding the commercial possibilities that this gives us because this is, on one hand additional footprint for us. And so when we expand, it's good that we do expand, and as a shareholder we are happy to see the network grow. We are happy to see the network of the FiberCo grow in the, I would say, very good profiled areas from the infrastructure perspective with not much of overlay of fiber overlay.

So this does really give us a shareholding in an entity that will profit from the wholesale margin over a very long time. And so yes, we're happy with the way that things are going. And what I commented during a discussion of the results is that we received another tranche of the payment that was still relating to the sale of shares in FiberCo. And this is again, underscoring that the company is progressing as planned and the rollout is progressing as planned. So yeah, we're very happy and we are very happy with both timing that we had with our ability to draw and secure the debt financing and to hedge when the time was right for these kinds of operations. And we do feel that this is a good robust engine for fiber deployment going forward.

Leszek Iwaszko:

The last question from Piotr is related to 5G auction. "Polish regulators increased size of the 5G frequency blocks from 80 megahertz, to 100 megahertz. If my understanding is correct, this increases capacity of the network utilizing 3.6 gigahertz spectrum and might imply lower CapEx related to 5G rollout. Do you have any estimates what can be impact of this decision on 5G rollout CapEx?"

Jacek Kunicki:

So first of all, we will not comment on the ongoing consultation and auction proceedings in detail. I think increasing the capacity that is offered is always a good thing and operators are satisfied with the fact that now the blocks are a bit bigger than they were. This will enable better utilization of the spectrum. This will enable better speeds. It should enable us as the entire market to offer better services, faster services with less congestion to our customers over the long term. And this is the comments that I would have as of today. I think more comments regarding the 5G auction and the plans are possible when conditions will be finalized and then when the auction will be done. Overall, we have clearly stated within .Grow strategy how much do we expect to spend on CapEx for mobile network, both renewable and the 5G rollout and these plans have not changed. They have shifted in time, but they have not changed. So nothing major to be added here.

Leszek Iwaszko:

The last question from Piotr. "You have pointed out that rentals and external services were the main drivers of indirect cost expansion in the first quarter. What growth do you expect in these OpEx lines in full year 2023?"

Jacek Kunicki:

Well, as we've mentioned when we were guiding for this year, we do expect quite an important impact of inflation. I think we see it in some of the numbers of Q1. It's not something which is, I would say, very different from our initial expectations. I think we did mention that this could be potentially comparable to the headwinds that we faced from the energy last year. So in and around 200 million złotych plus or minus Q1 doesn't change our position on this point. We're happy that for the first quarter, despite receiving the fair portion of those, but I'm speaking about all of the inflationary pressures, we have been able to offset them partly with the cost mitigation actions.

And these were quite important and partly with the super growth of the direct margin. The way that we will approach it going forward is every quarter we will have new and additional mitigation actions to limit the impact of this to the extent that is possible. But we are aware that what is really, really key for us is to outgrow inflation, which means achieving robust growth of the direct margin driven predominantly by simultaneous growth of the customer basis and of the ARPO in the key revenue lines. And this is what the commercial strategy is all about. This is why the value strategy that we are implementing is so vital for us.

Leszek Iwaszko:

We have the last question that came from Jakub Viscardi from BOS on the equipment revenue. "Equipment sells were exceptionally strong in Q1. Could you please explain the key factors standing behind such strong performance, especially given weak consumer spending and high inflation? Did you launch some aggressive promotional offers?"

Julien Ducarroz:

Yes. Thank you for the question. So first of all, obviously to achieve these growths of revenue, it's not on the back of aggressive promotion. I stated that the volumes were constant. So obviously the answer is that the average price of the handset has increased. And this is driven by the customer choosing higher handset type in terms of specification and the price. We have to say as well that on the overall market we see that Telco are taking back some shares to the open market. So this is as well for us a transfer of value.

But if you look at the total handset market, you might see a different picture than the result that we published. We are as well, as I commented, we came last year with a possibility for the customer to have a 36-month installment, which obviously this is helping the customer to pay less per month. So there are some customers that have decided to take a higher value handset thanks to this facility. So this is, I will say, the main comment and regarding a macroeconomic, I will say, purchasing power, I'm not in a position to comment.

Leszek Iwaszko:

This closes the Q&A session and this closes our today's conference. So thank you very much for your attention. If you would like to have any follow-ups with us, you know how to reach us. Otherwise, have a good day and see you in July. Bye.

Jacek Kunicki:

Thank you very much.

Julien Ducarroz:

Thank you. Have a nice day.