BT QUARTER 1 RESULTS: 29 JULY 2004

Ben Verwaayen - Chief Executive Officer (CEO)

Good morning. Thanks for coming. At the end of July and beginning of August it is always a surprise to see so many of you here and it is a very pleasant surprise.

You know that we have to give you this slide, it gives very interesting reading. Maybe you can see it in the back and let's go on to the real issue. This slide you have seen many times before but it is important to remind everybody that if you want to see how well BT is doing you only have to look to those five points.

It is:-

- How well we are doing in ICT;
- How are we doing in Broadband;
- How we are doing in Mobility;
- How well are we defending our traditional business and
- What about our cost leadership.

We will be going through all those five points during the presentation today.

If you look to Q1 I think you see a similar story as you saw in Q4. It is just the second quarter of growing our business; it is a quarter that you can see that our New Wave is again a quarter of over 30% growth and you see that our traditional business is declining but it is less of a decline this quarter than the quarter before and last quarter it was declining less than the quarter before that. So the story that we have on the revenue side is I think that we are on the right track.

To see how we are on the right track just look to the growth of our New Wave business. It represents now 20% of our revenue and this is business that we didn't do a few years ago. So that is I think a testimony for the right choices that we have made with our new growth business. Now let's look at that in more detail.

If you look at our New Wave turnover you see that we grow our ICT business by 15% and that is very good and to put that in perspective of what you have heard in the market so far over the last couple of weeks from our competitors. Now Broadband is growing at 102% and that is a good healthy number. Mobility – we will come back to that – also is becoming very very interesting and the fourth element and we love to show and never talk about but is now becoming an interesting 46% growth is the Classified Service and the Wholesale Managed Services. These are very good contributors to the overall 32% growth number we see in New Wave.

Now if we look to how we are doing in ICT. There are two things to look at, the revenue and how are we filling the pipeline.

Let's start with the pipeline, a £1.3BN order in-take is by any definition very good. Not only for the headline grabbers like the HP deal or Suffolk council ,those are very important long term deals, but I personally like very much that we are now building in all geographies and in all sectors of the business a breadth of contracts. 35 contracts are between £1M-£5M, giving a foundation that is much deeper than just a few single large contracts.

Global Services has performed in Q1 with a revenue growth number of 5%. If you would add to that Foreign Exchange it would be 6.5% in a challenging market. I'm just quoting all our competitors who say it is a challenging market and of course we understand that and we see that. But we have a product portfolio that is right at the heart of what our customers want.

Look for example at the growth in MPLS, 84% year on year, that is a very good number. If you look to the ICT business the solidity of that business it is really coming across, I think very well and it is a strategy that is working.

Another strategy that is working is Broadband. We have added in quarter a record 472,000 customers. That means that we installed more than 5,000 cusomters everyday, seven days a week and we are doing very very well here. Three million up and coming and I think this represents a strategy that is executed well with an absolute focus on making sure that we develop the market. We are now going to the next phase with not just the early adopters but you get the next round of customers on Broadband because of a whole raft of new services. Now that is the story if you look to the Retail Broadband part.

Market share 29% approximately the same as last quarter. Two things there that are important to note, first of all you see that the corporate market is now also interested in Broadband we have in this number approximately 50,000 Broadband lines for Corporate which is important. The second thing is that in the 29% we have to calculate the fact that there is now churn and the market is maturing. So of course with a large reinstall base you get even harder if you are the larger part of the reinstall base when it comes to churn. Nevertheless our response has been twofold.

First of all by launching new prices, on 1 July 2004 and early indications are very encouraging.

The second point is I think even more fundamental, it is the launch of BT Communicator. Even by itself is a fantastic product that gives you peer to peer communications, it is the first mass voice over Broadband product that I know of in the world. It is voice over Broadband not only peer to peer but also goes Off-net and you can call anyone for example in the UK free if you are BT Together Package 3 customers because it will use the prices of your relationship you have with BT anyway.

Therefore you can get the integration on your PC of all the ways you want to communicate, its web cam, its instant messaging and it is voice over Broadband. Quality wise, if you use it over Broadband it is absolutely the same quality as the best PSTN. If you use it over Narrowband it will probably be like the mobile phone. So this is a very good product, but it also shows that we are developing now from an access agreed price only type differentiation to a service differentiation which of course is the next phase that you need to have in the development of the Broadband market.

I can see a lot of attractiveness of these type of services that will tap into a whole new range of customer base. So that will not slow down the Broadband growth and secondly it will give a total different meaning to the word differentiation than simply just looking to price and that is also good. Because, if you look to price we are profitable in BT Wholesale Broadband, we are profitable for the BT Retail broadband for business that we sell to the business market. We have a road map to go into profitability on the consumer market but the real message here is that you need to have a broader differentiating opportunity in the market than price.

Now let's look to Mobility. 70,000 adds, that's not bad especially if you just compare it with well-established players for years in the Mobility market. You know we only play in the post-pay market. So reading this it is even better, just look to the numbers on the screen and you see that we have real credibility there in the way we have performed in the Mobility market. It is great to grow in the business 23%, it is absolutely fantastic to double your business in the consumer market and then on a relative scale you can see that this now becomes serious.

It is even more important to be honest to look to the innovation part of Mobility, project Bluephone. I think on Bluephone it has been a good launch of the product with a much better response from the market place in the sense that all kinds of credible operators around the world from Korea, Japan, Brazil and Europe came to us and said we absolutely agree with you. We think this is a fantastic innovative opportunity and can we please join forces and create what we have now made into an alliance to create an open global standard. That is important because that will create mass and critical mass is important to get a technology to market. Not only by the players that already signed up with us, Alcatel, Motorola, Ericsson but everybody else in the game. The price to pay for a couple of months delay in the launch of BT Bluephone was a no brainer. If you would compare that with the benefit that we now have, a truly world-alliance that is looking to converge services with the fixed and mobile. This will now take off very seriously and I think that is good news.

Now how are we doing in the traditional business is described here. Our performance is described in this waterfall chart. Now those of you who follow us quarter after quarter after quarter know that over the last year we have been talking about Private Circuits and we have promised you that the impact of the Private Circuits would go down after a year because that would work itself out of the numbers. You can see here that the traditional turnover declined in Private Circuits substantially less because of the PPC element that is now out of the numbers.

The real big number here to watch is calls and although it is a bigger number than it was the quarter before it is within the minus 4.9%. That is as you know much better than the quarter before and that was a better quarter than the quarter before that. Now let's look to that calls market and see what are the main factors. There are five factors and only one of them has to do with market share. Taking them bottom-up, you get the voice market which means fixed to fixed and that has declined 2%-3% and you can understand why people are using other methods to communicate and it is messaging they use mobile phones, they use e-mail for the rest of the stuff. Then we have an element that probably we don't understand fully yet and that is fixed calls to mobiles and that is going down probably for two reasons. Partly it will be CPS; people went to CPS are using that or it will partly be because the price perception was never as transparent as it is today, we think.

Talking about price, just read the papers and look to the TV ads. It is quite vibrant when it looks to different pricing and we are doing particularly well in our BT Together packages and that has an effect and the top one is of course basically what we want. We cannibalise ourselves dial IP and going over to Broadband.

If you look to market share, we discussed it last time, OFCOM is changing the total market and I want to repeat that our numbers have not changed. The total market numbers were last time when we talked about it about to be changed. The reality is that they will now publish by the end of August so what you see here is still based on conversations that we have with OFCOM. We have not published the numbers about Q4 but what you will see is probably where it is. The more telling trend is the second part of the chart here. This says how are we doing, the most asked question I believe, how are you doing on numbers of customers moving to CPS. There are two things that you see here. First of all that we are gaining more customers back than ever before you can see that in the yellow on top and that we are losing less to CPS and that is what you see in the blue. Therefore the red line is the plus and the minus combined and you can see that the trend is one that is less impacting for us than it was last quarter.

If you look to why are we doing so well then in those things here's the chart. It is BT Together. We are growing our option packages very well. Option 3, all you can eat, you remember that is a great offer and 34% growth in the quarter is really good. At the same time you can see that we have now abandoned the Standard Rate, so 9.2M customers are now on Option 1 and the contracted part of our Retail consumer business is now 59% and this is very very good.

Now in business, again if you look to market share bear in mind these are the numbers that we have been discussing with OFCOM and they have reclassified some we used to call consumer, that is now business. But given the same caution around it this is the trend that you see there. Now interestingly enough this chart shows our minutes that we use to lose to indirect access we are now losing to CPS. The red line here says that for BT in the minutes that we lose and you will see that it is coming to zero. So those two effects balance we lose less to indirect access than what we lost in the past to indirect access now to CPS has been zero.

Ian will talk a lot about our costs and what we are doing with the cost savings that we are making. Also the investment decisions that we take to choose to invest in our New Wave business. Having said all of that if you look to our operating margin, it is up. It was up the year before and the year before that and I think that is a good number. Even more important for our shareholders probably is this one that our Earnings per Share is up. I think what you can see is that we have a trend and the trend is best described if you compare how we are doing this quarter with last quarter. Because in many ways there are similarities between Q4 and Q1 Let's look at the big picture here. We are growing our business again. Our New Wave is the third consecutive quarter that we grow over 30%, it is now 20% of our business, it is a £4BN plus business growing 30%. In our traditional business, the decline is less than what we have seen before and I think if you look to the indicators we understand that business now very well.

If you look to what we have done on cost saving we are on track and we choose to reinvest in our new business. The mix in Q1 is slightly different than that of Q4 but if you take them together you get a six month period which is always better than a three month period. To get a look and eel for what it is, you can see that we have an understanding of our customer base and our top line and what we need to do. We have delivered on all those elements that we said we would deliver and we are able to translate that into a strong performance on the bottom line.

Ian Livingston: Group Finance Director (CFO)

Good morning everybody. Firstly the headlines.

As Ben said group turnover grew by 0.8% and that is after adjusting for Mobile Termination Rate reductions. As you will see from the release leaver costs are much higher this quarter than the same quarter last year as we have chosen to front-end load our programme of leavers.

In the quarter we spent over £100M on leavers which is approaching half of the expected spend for the total of this year. Now that is nearly ten times Q1 last year. So the variability of leaver costs between quarters does disrupt the trend. So I say this most quarters as normal I will focus on the pre-leavers numbers.

Total cost reduced by 1% this quarter. The reduction in costs helped operating profit grow 1% year on year. EPS before leavers grew by 10% to

4.6p as a result of the slightly higher operating profit, lower interest and reduced tax rate.

We generated £157M of free cash-flow this quarter and net debt reduced further to £8.3BN.

Now before I go into the detail of these numbers, we will look at the lines of business.

As you already know we have made some simplifications to internal trading which has reduced intergroup turnover by some £2.6BN per annum. The prior year has been restated to reflect this. I know that these changes do cause you to rework your models and I apologise for this but you will appreciate that this is a simplification and it will improve the clarity of our results going forward. I must stress that these changes have not impacted the group numbers.

So looking at BT Retail first of all. Turnover declined by 1%. The traditional business declined by 6% primarily due to the reduced call volumes you saw. This decline was largely offset by the 31% growth in our New Wave businesses.

Retail growth margin was slightly down. This is entirely due to the mix between traditional and New Wave business. In fact the gross margin retail for both traditional and for New Wave actually increased. Both the mobile and Broadband businesses have initial low growth margins due to subscriber acquisition cost and you should know that we do write them off immediately.

Our investment in New Wave activities and higher marketing costs resulted in a slight increase in Retail's SG&A. In the traditional business however SG&A costs declined by £13M. As a result of lower revenue our New Wave investment operating profit fell 8%.

Onto Wholesale. BT Wholesale's external turnover increased by 10% in the first quarter after adjusting for the effects of the cuts in Mobile Termination charges. The increase of 4% in traditional revenue was primarily driven by an increase in network volumes. New Wave has continued to grow strongly with Broadband being the key force behind the 81% increase in quarter 1. However internal turnover declined by 5% year on year.

Wholesale's network and SG&A costs fell by £28M in quarter 1. That was driven mainly by productivity improvements and the reduction in network costs. In total efficiencies in Wholesale delivered nearly £50M of savings in the quarter. This contributed to EBITDA being maintained. Although depreciation was slightly higher and that meant that operating profit was down just 1%.

Onto Global. Global Services turnover rose by 5% to £1.4BN. Syntegra posted 33% growth largely due to £40M of revenue from the NHS contracts.

Solutions achieved another quarter of double digit growth as they continue to convert the orders that you have seen into real billed revenue.

Turnover in Global Products and Global Carrier grew by 5% and 3% respectively. These two businesses were mostly affected by a £20M negative movement in Exchange Rates in the quarter. Excluding this turnover growth in Global Services would have been 6.4%. Converting that to a group level this actually would have added about a half percentage point to turnover growth making actually the underlying quarterly growth very similar to Q4 at 1.3%.

In a tough market the ongoing improvement in EBITDA was maintained. Savings on SG&A and network costs contributed to profit improvements in Global Products and Carrier. Whilst Solutions and Syntegra maintained their EBITDA despite early life investment in new contracts and the money they have invested in developing their businesses further. Overall operating losses were nearly halved year on year.

Now back to group matters. You have seen this slide last quarter. I think it helps to identify the reduction in costs that we have achieved each quarter. As I mentioned earlier the changing mix of our business has resulted in a reduced gross margin for the group and I think there is no surprises there. This has been partially offset by efficiencies in SG&A leaving EBITDA preleavers 2% lower year on year. However, the £31M reduction in depreciation more than compensated. This resulted in a 1% growth in operating profit pre-leavers and as Ben said a 0.2% increase in operating margins. That is very similar to the trend you have seen in previous quarters.

Despite the extra cost of New Wave activities total cost excluding leavers fell by £35M year on year. Part of this was due to the favourable effect of foreign exchange on our cost base.

Let’s look at these costs in a bit more detail now. I will deal on the next slide with the increase in other operating costs in a lot more detail. But keeping to this slide net pay within costs of sales increase by £29M versus the prior year. This reflects additional resources required to service recently won major ICT contracts. However net pay within SG&A reduced by £57M and that is a big change from last year. That was as a result of the leavers programme particularly in Q4. Overall pay reduced by £28M year on year.

Payment to Other Licensed Operators reduced by £51M due to the effect of Mobile Termination Rate reductions. Depreciation was lower due to efficiency of capital spend in recent years with some of our assets becoming fully depreciated.

As I said last quarter and I will re-emphasise it, we have chosen to reinforce our success in the New Wave business areas with further up-front investment. This of course does have an impact on our costs. It is clear from the chart that we are seeing increases in those areas we highlighted to you in Q4. First there was an £88M increase in cost of sales primarily for servicing ICT contracts but also reflecting the costs of acquiring new Mobile and Broadband subscribers. As expected in SG&A we also incurred a £21M increase in marketing costs. This extra expenditure was mainly for promoting Broadband and ICT. In addition R&D spend increased reflecting the extra work on 21CN and the Bluephone programmes.

As I said to you earlier in my presentation we have achieved quite significant savings in network costs both on Wholesale and Global Services and you see the number coming through there. We estimate that the cost reductions we achieved in our traditional business approached almost £100M in this quarter.

So to conclude the P&L. Interest costs reduced by 9% this quarter. Interest payable was slightly higher than some of you might have expected due to the increase in market interest rates and the fact that we are a net floating rate borrower. Effective Rate of tax at 26.5% is some four percentage points better than the equivalent quarter last year. The effect of the lower interest on one hand and the lower tax has helped group EPS pre-leavers grow by 10%. Given the higher leaver costs this quarter EPS post-leavers declined 0.4p to 3.7p.

On to CapEx. The rise of 26% in group CapEx was driven mainly by spend on our UK network. Key drives of this spend were the implementation of the next generation network, the hands off network access programme which we have talked to you about before and the rolling out of our Broadband footprint. In addition we spent around £40Mof capital on the NHS contracts. We also expect to have a more even phasing of spend across this year.

As we said in May we anticipate the group's capital expenditure for 04/05 will be higher than last year though it should remain within the £3BN envelope.

Now onto free cash-flow. EBITDA post-exceptional items reduced by £134M year on year primarily due to higher leaver costs. That of course does affect the cash-flow. As I mentioned at Q4 interest paid has been effected by the increased cash payments arising from the restructuring last year of our swap portfolio. Tax paid is higher than the prior year as the prior year benefited from the reversal of earlier overpayments. The worsening of working capital is largely due to partial reversal of exceptionally good quarter we had in Q4 and remember we beat the forecast by some large amount then. Capital expenditure is £113M higher year on year reflecting the rephasing I talked about earlier.

I expect that debt will be slightly higher at the end of Q2, you must remember in Q2 we pay our final dividend that is 5.3p in September. Our shares, to remind you, go ex-dividend next week. However we should see strong cash-flow in the second half of the year leading to a significant decline in debt by the end of the year.

So this quarter's performance closely mirrors as Ben said that which we saw last quarter. It very much reflects the actions that we said we were going to pursue and we highlighted these to you last quarter. We will continue to invest in our successful New Wave activities and we will drive the transformation forward. We have continued to deliver efficiency improvements. As we have said before our aim is on one hand to invest in the transformation of our business whilst we continue to produce solid financial results. I think we have continued that this quarter and that process will continue.