

# BT Group - 1<sup>st</sup> quarter results - 27 July 2006

## Ben Verwaayen - Chief Executive

Good morning and thank you for coming. I know it is an extremely busy day. Many, many people reporting, but I think you have chosen the right one to come to because we have some good news to tell you. Now first I want to draw your attention to this slide, our lawyers have worked very hard on it as always and I am sure you will read it maybe during the coming weeks when you are at a place of leisure. So let's talk about the business.

I think this is a chart that I wouldn't mind to put up every single time. All the arrows are up and they are green and I think they tell the story of the strong momentum in the business. This is a story about not just growing the business, but growing the business in a profitable way. This is about confidence in continuation, it's about the ability to perform in a changing market and making the change happen in the company. I would like to draw your attention to the Free Cash Flow. It's £100 million better than a year ago. So I think we have done pretty well here. Now if you want to look to the balanced picture, this is an important one.

We have been talking about the EBITDA for a while and you see it's growing. It was positive in Q4 point 9%. It's now almost double that and I think it is a good line as it tells you a story. In the mix, where we know that if you replace existing traditional business with new business for a while you have to suffer on the EBITDA line, we have now mastered that art. Look to our revenue growth. It's now ten consecutive quarters of growth. It becomes almost a boring slide. It becomes predictable and it's a good thing. And more important if you look to the composition of the growth. Now you have seen the new wave business out-performing the fall in traditional now for a while and if you look to those numbers there are two remarks I would like to make. First of all the increase in absolute terms of the New Wave have been consistent over the last 9 quarters of approximately £250 million every single quarter. And the other observation I would like to make is that the decline in traditional was £123 million in quarter so that is half of the increase in New Wave. I'll say it differently. Our new wave business is growing twice the rate of the decline in our traditional.

Now change happens in the market and change happens in our mix and this slide has two change messages. The first message you have heard over and over and over again. That is that we are winning in the Enterprise market, we are winning in the B2B market and we are pretty consistent in where we are in the consumer market, 26% now, and profitable. But more important is the other message here. Look to new wave and the growth of New Wave and look to new wave in consumer business. It makes a jump from 8 to 14% and it is also now really, really important in our SME business. So the change is not just to whom we sell but what we sell.

Let's talk about our customer segments. Firstly, let's talk about corporate. I think it is a very strong message we have to give to you. In a market where you have seen many, many messages, our message is that we are in the right spot, at the right time, with the right product set. We are growing 6% in corporate which means that new wave has doubled digits and we have eaten our decline away so to say in our traditional business. It's important to see here is that we are adding customers, outside the UK, more than 200, to be accurate 230 branded companies, not being a BT customer before added to the list this particular quarter. It is important to note that our order intake of a billion is a good performance. Yes we have those big contracts, headline contracts, very hard to focus them on any particular quarter, they happen when they happen. But if you take that out, that 1 billion it's a

very strong number in the market. And there is consistency that we grow not just here in Europe we grow in America, we grow in Asia Pacific, we grow round the globe. 96 countries reached via MPLS we have added 17 cities over the last three months. I think we have a capability here that is pretty unique. Now instead of me trying to convince you, it's probably better to listen to what our customers have to say.

**Video clip (starts)**

**Visa** - "Our decision to go with BT has been vindicated. We have found them to be a very good partner, now, on average we are achieving 99.98% availability to all our members for Azerbaijan to Zambia. That is a totally different order of magnitude of customer service which can only enhance our reputation."

**Ministry of Defence** - "As a transformation partner we have leveraged a lot of the expertise from BT and certain process transformation we've continually involved and I think that is the success behind the partnership. Security is one of our prime considerations being the Ministry of Defence, therefore the key has been to pick a supplier that not only understands our business but also understands the security aspects of our business."

**InBev** - "Three or four years ago if you had asked within this company where is BT's strong end they would say yeah they can give you a network. BT has evolved a lot and is today very performing in delivering services. "When we address an issue, the issue will be handled and will be handled professionally and somebody will really own the problem until it is solved. We start trusting each other, which is also a very important topic within the outsourcing world."

**Video clip (ends)**

So from Azerbaijan to Zambia I really like that, and it's not just in the video that customers say that. If you look to the watchers of the industry, they all recognise that we participate in a market that is changing the face of our industry. It is convergence working in real time and if you look to where we get our accolades, it's not just from the strategy, it's on very mundane things as; Where do I get my service? Is there a local helpdesk? Can I get really good services that helps me to transform my business?

Now the transformation of the business is not just happening in the corporate world. It's also happening in the small and mid size markets and I think this is a great chart because in living memory we have not been able to tell you that we would increase our revenue in the SME markets. Well, here we are, it's happening. And I don't think that for the last couple of years that we could talk about stabilisation of our calls market in the SME. Well here we are, it's happening. Over 500,000 sites in the UK now having BT business plan. That's a great basis for doing much more with that customer base. And that's our story. Our story is the expansion into new areas that help businesses, small, mid size and large, to do much better in what they want to do. If you are a small company you don't want the hassle, you want to get on with your life, you are on the move, you are an agile organisation and what you want is to get a partner. Most of those guys, they have Bob. Bob lives around the corner and comes in with a big screwdriver and helps you at a time that's convenient to Bob. Well, we're going to complete with Bob because we have something in the box that helps you to do the job much easier, seamlessly and brings you all the great stuff downloaded.

**Video clip (outlines the services within our IT Manager solution for the SME market)**

Right, now in addition to what we do for corporates and what we do in the SME market, we have a whole bunch of specialised companies that deal with niche markets in the B2V market. We don't talk about it (BT Enterprises) too much, but if you add it all up your talking about the business of £700 million plus in revenue and over £100 million in profits and growing very nicely. So I thought why don't we take four out of those companies and talk about it a little bit.

**BT Conferencing**, Frost and Sullivan just recently announced to the world that BT Conferencing is the fastest growing conferencing business world-wide. We grew in quarter, 32%. 40% gross in the US. Over 300,000 customers in BT Conferencing.

**BT Exoedite** in the Retail market. We talk a lot about the financial markets if we talk about Andy's business. Let's talk about the retail business. What is the issue there? It is IT solutions on the work floor, real in shops. Where can we make a difference? How can we make a difference? Well, guess what? An electronic point of sales terminals and systems is what BT Expedite does and we are winning. We are winning great names and it gives a capability much further than just the point of sale. With new technologies like RFID, (those tags that you can put on stuff) a better, much more efficient and much more forward-looking inventory management capability. And we have household names, all European brands and we think that this is a market that has great promise. Not the first thing you think about if you talk about BT, but you should give it a thought.

Next time you see the Emirate Stadium and you will no doubt see that often and you see great football from Arsenal, what should you remember? You should remember that **BT RedCare** has the contract for the CCTV environment there. Many, many different markets, many, many different offers and great growth potential.

The latest addition, **dabs.com** has been terrific. Since they are on board they give us the ability to sell the combination of the BT service and the hardware through a web based channel to market. And I think you will see that that is a great way to reach part of the SME market that in the past we had difficulty to get at.

So it seems to me that everybody wants always to talk about the consumer business and I understand that. It is a great business, it is a great business for us, it's 26% of what we do as you have seen, but it occupies the mind. So let's talk about consumer market and we have great stories to talk about here as well. Let me start with the contracted element. This is longer an impulse business. 68% which is 3% higher than a year ago, 1% higher than last quarter, is under contract. And the second thing you see here is that the ARPU is up. If you do the calculation quickly you will see it's (new wave) 35% up over a year ago and that's important because the consumer market is not one blanket market. It is not one market, there are segmentations in the market. This Telecom market that we knew from the past is no longer there. People make choices based on very, very different appreciations of the various elements in the market. Yes there is a price market, and that's there. It's very crowded nowadays. There is a value for money market and we are, I think, occupying that part of the market.

As you have seen, when we talked about the SME market, we had a great performance in that market on Broadband and people buy the higher packages. The same is going on here in this particular part of the market. People look to BT for much more than a down-pipe. They want to have the services. And that's how we are positioned. I think we are positioned very well. First of all, know your facts. It's now official, the BT Retail Broadband Network is the best in the country. It's now official.

Independent research has brought that to bear. Now the packages that we have introduced, I would say are also very clear. This is all about added value. This is not just a pipe. This is the "so-what" of the pipe and what can you do with it. And we have communicated against price the word complete. You can have your solution, and don't worry about the rest. Every new service that will come along will be a software download. So no more hassle. It's all about services. And the service capability of BT Total Broadband, is second to none. And interesting to note, it's when we get engaged with the customers, there is a tendency, a clear tendency to go to the higher packages which is good for us and I think it's great for customers.

Now if you look to this picture, you've seen it before, we are adding new services as we speak every single time. And what we do is we take, every single time whenever we have this wonderful quarterly review we take a subject and talk about it a bit. Now Voice over IP has been for a long time an issue that if you were in that part of the room (left hand side) on the negative and if you were on the other side of the room, the positive. Now let me look to where the reality is. We're talking about getting a million customers in the next 12 months on VoIP because we think it is a great thing. It is a tool to combine services and to do something that is what customers really want. That's get the hassle out, making sure that I can really use what I want to use, when I want to use it and how I want to use it.

Now the other part of the explanation is in the introduction of the video element. Voice, Data and Video combined is what Broadband is all about. It's not high speed internet access, it's about added choices you have to bring whatever you want, on whatever terminal, in whatever way and form you want. That is what Broadband really is all about. Now BT Vision, we've talked about it and you've seen these wonderful additions, it's all about variety and choice and it will be an experience that is the next generation personalised TV. Yesterday we made an announcement and I would like you to look at the announcement.

***Video clip (starts)***

*"Broadband is going to change the way millions of people watch movies at home. Today's partnership offers the quickest route from the cinema to the home. Some of the great movies you will be able to see on BT Vision from Universal I am about to show you."*

***Video clip (ends)***

So what is the significance of this? I think there are three points, extremely significant. The first one is what you heard the guy from Universal tell us. We from the media industry he said reckon that Broadband is a transformational tool how we go to market. The second "so-what" of this is that it gives BT Vision access not just to your PC as it will from Monday, where you can download great movies just out on DVD at the same time that otherwise you had to go to a high street shop to get it, for a very attractive price. But you will also be able to take that download and bring it when we have BT Vision to a TV. So if you have to wait for Pay Per View, some of the other guys, you have to wait three months longer. The window is three months earlier through this mechanism. And what is important here is that it gives choice a different meaning. And where we start here with Universal it's great to have a brand like that choosing BT, because of our capabilities in streaming and the rest of the capabilities you need to bring that to homes. I guess that we all have thousands of titles in the months coming forward. So what you see here is an expansion. It's not just another side, it's an expansion of what the media and the communications industry are willing to do together.

So, if we continue to look at the markets how about Wholesale and Carrier. An important part of our customer base with fascinating trends there. First of all Openreach, it is open for business and I know that there was some suspicion in the market; Can we deliver? Can we do the stuff? I think Steve Robertson and team have done a tremendous job, recognised all over the industry we have delivered what we said we would and the business is a business. It is a very, deeply, intensely regulated business so everybody knows what to do and what to expect and I think this business is delivering. We have customers, real customers, more than 15.

We have now LLU in, if I'm not mistaken, 932 exchanges with an average of 7 in the exchange. They have plans to go to 1,240 exchanges and its all working. Mass migration will be working in September so we are delivering from a BT Openreach point of view what we said we would and it's done on an equivalent basis. And I think that's terrific because it takes a lot of stuff out of the market. I mean blaming, finger pointing and the rest. It is a normal market and it gives us all the certainty and security that we want. On the other side we get at the retail level our deregulation also delivered.

Now in Wholesale there is a fantastic, interesting move. It says here Managed Services. Basically what it does, it gives people now the state of mind that they say "Let's see what we really want? How do I want to go to the market? Should I do it myself? Should I make all the investment? Take the operational risk? Or should I go as Managed Services? And BT Wholesale is now in a much better position to be a normal partner to have those discussions. You will see going forward with 21CN where we are going to talk about it in a minute, that we will get an expanded capability in services to offer to the market, so if you are a new mobile player. You are a new Broadband player, or you are just the CPS player, you can now chose and say I'm going to do it myself, or, you know what, I'm not going for it. I'm going to Managed Services. This business will grow and it will be substantial business, where you will see competition on one side of the market when it comes through the consumer business and very much cooperation on the network part. Capabilities and the next generation of services will make this market more attractive.

Now look at the Broadband market and you will see where we are today is this summer 9 million. I just want to remind everybody that three years ago there was a big party here, you were part of it. You may not have noticed because we celebrated 1 million. And we had the big bet whether we'd reach 5 million or not. There were people who were saying no, read your own notes back please, saying "5 million, forget it, it won't happen." 9 million this summer and I think what you see is two things here; 40% of households in the UK have now Broadband. Two ways to look at it. 40% means 60% don't. Great market opportunity for us, or you can say 40% so there must be a slow down somewhere going in the market in the S curve. I think what you see is that this is a market as we said before driven very much driven by campaigns. Where the variety of offers will increase and Broadband will be no longer a single product in and by itself. People will get Broadband on the back of services that they buy and that is not the case if you really want to go for just a pipe. So there will be an interesting next phase in the market and I think this will be a growth market for some time to see.

Now, let's talk about the next subject, 21CN. Is it real? Many people have asked we thought it's good to give you some facts. The first fact is that over 3,000 people in BT full time now engaged in 21CN. It is really working. And over 23 million calls over the last couple of months have been done over the network configuration that we call 21CN the equipment that will be in 21CN. You haven't noticed a blip and that's very good news. It's working. Full IP, end-to-end, it's working, 23 million calls. We have a full consultation with the market and we expect in the coming weeks to have those streams resulting in work plans with the other suppliers in the market. Then we go to the next big thing, we go

to Cardiff, November, we are going to migrate 350,000 lines. I think we are making steps that will help us to deliver something much more important than just the core network.

Although that's very important to do, the converged core network also it gives us the savings that we talked about. It gives us the capability to have a streamlined portfolio. We have now adjusted 158 products in Voice and Data and we have been able to eliminate 30 products because we have better products, better new products than the old products. It is much more than that, and I want you to look at this because what's the relevance of 21CN?

We have talked about this part, building a new converged core network where Voice, Data and Video can go all over the way as you see fit, but the more important than the core infrastructure is the capability to bring new products to the markets very, very fast. Where we had months, you talk about weeks, and where we had weeks you talk about days. Because common purpose capabilities are in the process of being developed and we can add the know-how and the creativity of others to this and therefore it is important to have a core infrastructure. It is important to have the corporate willpower to create common capabilities that we use all across the business. But the most important thing is at the top (on this slide) and that is the customer integration. That is what we can do for customers by having a softer layer around it. Everybody who can programme, around the globe, in an open architecture, can put their creativity on top of it and bring services to our market place that can use 21CN just by clicking on an icon and bringing that capability into their programming. And that is working. I can demonstrate you today, by announcing that we have our first licensing agreement in the market around 21C. This is not hardware put together in a smart way. This is about our own capabilities, creativity, software development that will redefine how the world will look to this capability. 21C, in itself, is a guarantee for innovation.

It's great to talk about the market, great to talk about all that stuff. It will work better if you have a very good cost management. And we do have a very good cost management. We promised you over £400 million this year, we delivered that last year, we are very good at that and we have also delivered a Q1 that is in line with that. And the good news is, every single one of our businesses has contributed to that. I can dwell on it and give you all the examples. Let me take two just to give you a feel for where we are. First of all, when we talk about faults in the network, down 9% this quarter. That's a fantastic saving that is just more than a saving from a cost perspective. It's also a saving that you can make from a customer service perspective. The second example is what we do in Global Sourcing. We sell the world the capability to go wherever they want to go and we use that capability ourselves more and more and more and it will give us best in class performance and it gives us the flexibility that we need going forward. So we are on track on the costs.

Now, you know this chart because last time we used it as well. There are a few alternations here. First of all we have adjusted the numbers because 17 is better than 16, and 10 is better than 9, and 6 is better than 5, and I think you will agree with that. And the second thing is, that we said is, yes we have a strategy and we haven't shown you the strategy chart this time, I apologise for that, and we haven't said "trends are your friends" so I apologise for that - I've said it now! Yes we are consistent in winning business but, you know, how confident are we? We are confident. I think what you see is the business that has much more than one single product.

If you go through the numbers, and I think they are terrific numbers, and you dig and you dig and you dig, you can always have a debate about a certain number against a certain prospect and you can find yourself the evidence for feeling how you want to feel. It's sunny out there so why wouldn't you feel sunny? You can always find that. But then if you then take two steps back and say "Where's this

company going?" you can see that we do not depend on one single product. We do not depend on one single development. This company has now built itself the space, by great cost management, by growing our business, by having the capabilities to look to our margins, we have given ourselves the capability to deliver what we said we would and are not dependent on every single part of our business always to deliver. And that's great because it gives us the confidence to end this presentation, my part of this presentation, that Q1 results underpin what we said for the year. And we are very confident to deliver that. Hanif.

### **Hanif Lalani - Group Finance Director**

Thanks Ben. Good morning everyone. Our first quarter performance builds on the momentum from last year. These are strong results and underpin the confidence we have in the outlook that we provided to you on May the 18th.

Overall Group revenue rose by nearly 3% with declines in Retail and Openreach more than offset by strong growth in Wholesale and Global.

Group EBITDA pre-leavers grew by nearly 2% with each line of business EBITDA performance in line with what we shared with you last quarter.

Depreciation and amortisation were £6 million lower, resulting in an operating profit of £683 million pre-leavers. Operating profit margins increased by 0.2 percentage points on last year to 14%. This reflects high revenues, but importantly, improving cost management across all lines of business.

Leaver costs were £18 million higher than last year's very low levels. Net Finance costs were £96 million lower than last year. This was due to a number of factors. Firstly, stronger cash flow generation in the business resulting in lower net debt. Secondly, refinancing high coupon debt reduces our average interest rate. Thirdly, pension interest credit that I shared with you last quarter and fourthly, mark to market movement on derivatives.

So profit before tax and specific items were £615 million, an increase of 20%.

Our respective tax rate reduced by 0.7 percentage points to 24.5% resulting in an earnings per share, before specific items, increasing 24% to 5.6 pence.

Let's move on to cash. Free cash flow was more than a £100 million better than the first quarter last year, reflecting our focus on working capital, interest and tax management. These benefits were partially off-set by higher capital payments. The rise this quarter in those payments does not change our guidance on annual capital expenditure which remains at around £3.1 billion. Net debt at 7.7 billion is 5% lower than last year. Let's now move to each line of business performance.

Firstly, Global Services. Revenue increased by 4% to £2.2 billion driven by growth in New Wave services which now account for 55% of the total revenue.

Increased revenue and ongoing cost reduction programmes resulted in EBITDA improving by 3% year on year, to £228 million. Leaver costs were £15 million higher as the Board headcount was reduced resulting in an operating profit of £63 million, £4 million lower than the prior year.

BT Retail. Traditional revenue declined by 8% whilst New Wave revenue grew by 31% predominantly driven by broadband. New Wave now accounts for 19% compared to 14% at the same time last year. And although revenue fell by 2%, gross margin grew by 4% to £560 million, an increase of 1.8 percentage points compared to last year. This was driven by effective margin management and a focus on reducing our cost of sales.

After holding SG&A costs flat, our continued efficiency improvement EBITDA before leaver costs was 15% higher, the fourth consecutive quarter of EBITDA growth and despite the £6 million increase in depreciation, operating profit of £140 million was 16% better than last year.

Let's move onto BT Wholesale. Revenue of £1.8 billion increased by 2% driven by growth in external revenue of 3%. External revenue was boosted by a 21% increase in New Wave services. Internal revenue also increased to £850 million due to growth in broadband, more than offsetting the impact of lower prices and lower call volumes.

Gross variable profit at £927 million increased by 5% as a result of the change in sales mix and increased revenues. Network and SG&A costs rose by 8% as cost savings in the network efficiency areas were more than offset by opex investment in 21CN and a growth in broadband volumes.

Overall EBITDA before leaver costs increased by £10 million to £478 million. High depreciation due to shortening of the economic life of legacy transmission equipment has resulted in a £5 million decline in operating profit at £192 million.

This is the first time that we are reporting on Openreach separately. Revenue was £1.3 billion, a decrease of 3% on the prior year. This was driven by regulatory price changes to both of its key products, LLU and WLR. The impact of WLR price reductions will reduce throughout the year with the impact in the first quarter being £63 million. The volume shift from internal channels to external channels means that external revenue increases by 145% and internal revenue has decreased 9%.

Operating costs in Openreach at £787 million were held flat despite the increased infrastructure costs of supporting Openreach, volume increases in activities and inflationary rises. And this is due to the fact that Openreach itself has a variety of cost reduction programmes throughout its business.

Overall there was a £35 million decrease in EBITDA before leaver costs. Depreciation was £11 million lower due to the lengthening of the useful life of copper consistent with the OFCOM methodology. First quarter operating profit of £295 million was £26 million lower than last year.

Capital expenditure rose 5% to £271 million, driven by expenditure in systems to deliver equivalence.

Finally, earnings per share remains one of the ultimate measures of our performance and in Q1 we delivered our 17th consecutive quarter of year-on-year growth.

We have established a track record of delivering across a number of key financial parameters. These improvements have been underpinned by positive operational trends across the Group, both in the UK and abroad. We remain committed to extracting efficiencies through process improvements, through cost transformation programmes and our success in executing our strategy stems from our ability to be innovative and competitive and responding to customer needs. All of these combined with financial discipline gives us the confidence to say revenues, EBITDA and EPS and dividends will grow through this year.