S Mobility Q4 & FY12

Investor/Analyst Conference Call Transcript
May 16, 2012

Moderator Ladies and gentlemen, good day and welcome to the S Mobility earnings conference call for the quarter ended 31st March 2012. As a reminder for the duration of this conference, all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions at the end of today's presentation. Should you need assistance during this conference call please signal an operator by pressing * and then 0 on your touchtone telephone. Please note that this conference is being recorded. At this time, I would like to hand the conference over to Mr. Ravi Sathe of CDR. Thank you and over to you sir.

Ravi Sathe Thank you. Good afternoon everyone and thank you for joining us on S Mobility results conference call for the quarter ended March 31st 2012. We have with us on the call the recently appointed CEO of the Company Mr. R.S. Desikan, the CFO Subramanian Murali, Mr. Sanjeev Mahajan, CEO of Spice retail and Mr. Saket Agarwal, CEO of Spice digital. Before we begin, I would like to add that some of the statements to be made in today's discussion may be forward looking in nature and a statement in this regard is available in the con call invite which was emailed to you earlier. We would begin the call with opening remarks from the management following which we will have the forum open for an interactive question and answer session. I would now like to invite Mr. R.S. Desikan to share with you some perspective from the performance and development in the Company.

R.S. Desikan A very warm welcome to all of you for joining us on this call. As you know I joined S Mobility about 3 months back. I am quite happy and very privileged to be a part of the S Mobility team. We are currently in a state of time where the entire mobile industry is undergoing a major change from 2G to 3G world-over. Of course in India it will take slightly longer than the other countries. The 3G shift has taken a significant leap forward in China. India is on the threshold; maybe it's a matter of time before we also move in to the 3G mode. Another important development in the sector is that a few years ago the average life cycle of a product used to be around 8 – 12 months. When we introduced a product, it used to last for about 6 – 8 months. Slowly this has started coming down. Today a product may last in the market for about 4 – 6 months. This throws different kinds of challenges in terms of inventory management, technology obsolesce, servicing and various other issues and we are gearing ourselves for the change in the entire business dynamics. The past quarters have been challenging and we are yet battling this tough ecosystem.

The 3G challenge what we mentioned earlier; the licenses were auctioned out some time back, the networks have not been fully rolled out, therefore all Mobile Internet applications and devices that we tried to bring in have witnessed slow momentum as compared to prior expectations. We believe in the Mobile Internet space and that is the way to go. We will definitely be able to encash our presence both in retail and distribution, in due course. Some of our models have really done well. Of course we also had a couple of product failures but that's a part of the learning curve. In terms of retail, we have actually embarked on a new venture what we internally call version 2 stores, which is to provide a better user experience compared to buying a simple feature phone from a normal store, where the buyer typically goes and buys a phone. The version 2 stores have store assistants who explain all the features, Apps and various other things. The entire user experience is slightly different which is what we are focusing on for our version 2 stores. With regards to our VAS business, there has been some significant development in terms of regulatory notifications, which has actually resulted in some amount of drop in revenue. However we are trying to compensate this by expanding aggressively overseas as well as developing new product offerings on various other services. I would now like to invite Mr. Murali to share with you the details on the business and the financials. I am now handing over the call to Mr. Murali.

Subramanian Murali Thank you Mr Desikan. A very warm welcome to everyone present and thank you for joining us today on the call, discussing S Mobility's financial performance for the quarter ended March 2012. I just want to begin by taking you through a general overview of key developments, which took place in the business as well as in S Mobility during the quarter. As Mr. Desikan pointed out, the sector has been facing significant challenges primarily as a result of the increasing competition, the movement from 2G to 3G, high input cost and above all, volatile exchange rates in the last 6 months. The increase in interest cost and the volatile currency has made it difficult for many small players to operate and as a result it is expected, the entities which foresee and adapt to changes and have presence across the mobile and Mobile Internet space will survive and grow. That is our outlook for the next 2 quarters. Fortunately S Mobility entity is a prime example of such an entity. Over the last 12 – 15 months, we have invested in strengthening our offerings and expand our infrastructure across the country from a northern centric company to an all India based presence. Hence we are perfectly positioned to direct the market with this kind of a potential. Our Pan India strategy has enabled us in increasing the Company's presence across the country. Now we are seeing growing revenues especially from the west and south. Our wide presence also provides more and more customers to enjoy personal experiences of our handset portfolio coupled with our retail and VAS offering**.** Our Company continues to build its presence not only at a state level but across the borders as well, internationally and VAS centric areas.

The strong and robust demand for data centric handsets and the increase of disposable income for consumers in rural areas is also gradually reflecting in our upward trend of purchases. Another factor contributing to our performance is our deep penetration in to the international market. During the quarter ended March 31st 2012, 95% of our international revenue for VAS was contributed by sales in Africa. We are present in 6 countries within the African continent. As we go forward and expand our capacity, we intend to focus more on international markets especially for the mobile applications space. Let me take you through business performance for the quarter and year ended March 31, 2012.

S Mobility sold 1.22 million Spice mobile handsets during the quarter versus 1.34 million units sold in the quarter ending December 2011. There has been a decline in the last quarter. Some of the products in like Mi 280 and Mi 250, which are basically android-based products, did well in the last quarter. We have realized that this is our area of focus with respect to devices. We will continue to focus on that.

Coming to the performance during the last quarter, we had to face severe impact of the dollar – rupee, a major part of the inventory, which we carried at the beginning of the quarter. We had to liquidate these inventories at a much lower margin, which has actually affected the overall gross margin of the devices. You may recall in the last conference call in the last quarter, I had mentioned about an impact of Rs. 20 Crore, which we witnessed in the December quarter due to the exchange rate of dollar and rupee. That was at an average of Rs. 50.83 for the quarter ended December 2011 and the average rate was Rs. 51.76 for the quarter ended March 2012. This has further resulted in higher cost of imports, which have further affected the margins. On the multi brand retail business, over Q4 of 2010-2011, ASPs grew from Rs 3,931 last year in the corresponding quarter to Rs 4,800 during the quarter ended 31st March 2012. This clearly reflects the trend in organized retail of high end products sale.

We continue to grow the number of stores, which currently stand at 887 across 147 cities as on 31st March 2012, compared to 786 stores in 172 cities last year. This indicates that we are surely moving towards bigger cities and just not being a regional player. I also want to mention that our retail business continues to be EBITDA positive, which we achieved four quarters before.

With regards to the Value Added Services business, we witnessed a 9% sequential de-growth in revenue for the quarter ended 31st March 2012 mainly due to reduced revenue share from one of our operators and also due to the TRAI impact. Revenues from the international operations have shown an increase in trend with almost 17% derived from international businesses as against 12% last year. We are now present in 7 countries across Africa through our own offices and 95% of the international revenue in VAS is contributed by our business in Africa. Live streaming products like RC**,** live FM, and USSD based m-banking solutions are few of the Value Added Services that continue to witness traction. Saket will talk about it more.

On a consolidated level, revenues for the quarter ended March 2012 stood at Rs. 5,543 million. This translates to a 5% increase over the corresponding quarter last year. With respect to operational profitability in the quarter ended March 2012, loss before interest depreciation and tax stood at Rs.105 million as against Rs. 150 million last quarter. Loss after tax was Rs. 198 million as against Rs 179 million last quarter. As we mentioned earlier and also in the last conference call, loss in the last quarter is primarily on account of the rupee depreciation against the dollar which resulted in higher input costs. During the period under review, we liquidated our inventory of products that were not very well received and did not do well as anticipated. Of course we continue to invest towards the enhancement of infrastructure and people, which we started in the first quarter of last year. This has also resulted in an increase of operation costs compared to 12-month period last year.

In summary I just want to say that the business is witnessing strong sales over the past year and we are continuing to grow. We have a diverse range of products and a diverse clientele across various geographies. We are optimistic that we can recover from the temporary issues related to the foreign exchange issues and liquidation of stocks. Challenges will continue to emerge but we are well prepared to face the same in due course. We believe that we are well positioned to enter the new fiscal and further drive growth. I will come to my remarks and we will now be happy to take your questions and answer them. Thank you very much.

Moderator Thank you very much sir. We will now begin the question and answer session. We have the first question from the line of Kumar Saurabh from Macquarie Securities, please go ahead.

Kumar Saurabh Why are handset sales reducing sequentially given that the industry is showing a double-digit growth? What could be the possible reason and how do we plan to address this?

R.S. Desikan If you compare the quarter ended 31st Dec 2011 versus the quarter ended 31st March 2012, yes certainly there is a drop but the prior period as you know is a festive season and seasonally every year, that quarter has always been slightly on the higher side as compared to the quarter ended 31st march 2012. Though on the overall trend, we have not moved in-line with the way the industry has moved forward. In this particular quarter there have been some challenges where we focused on some of the new products related to the Mobile Internet space.

Kumar Saurabh Is this because of the product mix or because of brand visibility? What is the problem and how do you plan to address this?

R.S. Desikan We don't think it's really a brand visibility issue. The problem is more related to the products per say.

R.S. Desikan We have had some bad products during the year.

Subramanian Murali If I can just add a few points, if you remember last year in the month of June – July we started this exercise of expanding across the country and also started being more Mobile Internet centric company. It's not an easy transformation. We will come across product failures because we are shifting our focus from low cost basic handsets to smart phone like handsets. This requires a lot of investment in selecting the right product. It is not an initiative which will execute instantaneously as this transformation will take time.

R.S. Desikan We are revisiting our product strategy, which needs fine-tuning, we are already in the process of doing the same.

Kumar Saurabh Okay makes sense sir.

Moderator Thank you. The next question is from the line of Pranav Kshatriya from Brics Securities, please go ahead.

Pranav Kshatriya Your retail sales growth has been quite good. I just want to know how much of that is coming from existing stores and how much of that is coming from the new stores?

Sanjeev Mahajan The same store sales growth is in the range of 5 – 7%, the balance would be from new stores.

Pranav Kshatriya Okay and one more question is pertaining to the Retail business. How much of percentage contribution is from Spice Mobile and how has it changed from last year to this year?

Sanjeev Mahajan I think we had a good trend there. For the year our value share for Spice Mobile within Spice Hotspots stands at a healthy 11%. From a volume point of view, every 5th phone sold at Spice Hotspot is a Spice Mobile. So therefore 20% volume share. Pertinent to note that in the top 3 cities where we operate in, which includes Delhi, Bangalore, Hyderabad and Kolkata, our handset shares will be in excess of 25%.

Pranav Kshatriya And how it has changed from let's say last quarter or last year same quarter?

Sanjeev Mahajan Over the last 2 years, we have almost doubled. So last to last year we were close to 4 – 4.5% moved to 6 – 6.5 – 7%, and now to 11%. Quarter on quarter we have remained stable but that's primarily because the quarter ended 31st Dec 2011 is a festive season where overall sales increase. To sum it up I think our strategy is clear. We find from a synergy point of view, it is desirable and easy to push a Spice product within the Spice Hotspot.

Pranav Kshatriya Big players like Samsung and LG are focusing lower end of smart phones pricing their Android phone in the Rs. 6,000 and Rs. 7000 category and is it really possible to give good quality handsets at a price which is lesser than that? Or how do you see the valid proposition for your smart phone as against the multinationals that are collaborating with Google and then launching their handset?

Sanjeev Mahajan I think we can answer this in 2 parts, one we can try and give a retail perspective to it. I ask my colleagues to add their perspective from a Spice Mobile point of view. The market is moving towards the price point that you talked about. So now you have a wide series of offerings for android phones in the range of Rs. 5,500 to Rs.6000. In India, if value is at the bottom of the pyramid, over time you will find the shift on the smart phone category towards a lower price point. Now having said that, I don't think there will be a drastic change. You would find smart phones at Rs.6,000 or so but in my assessment you will not find smart phones at about Rs.

3,000 – Rs. 4,000 at least not from a 9 month to 12 month perspective. As far the Spice strategy is clear, we have had pockets of success where we have launched phones like the Mi 350, Mi 280, Mi 410 and others which are small in number but yet we have found that we are able to position it rightly in the customer mind. We have witnessed traction with respect to these devices and as our overall strategy of products comes in to place, we will definitely move towards offering our own smart phones at the price points that we all talked about.

Pranav Kshatriya I want to know why a customer will opt for a Spice handset? What value can you add as compared to Samsung? Is there a differentiator like customer service or better specification or anything like that?

Subramanian Murali You know when you were to do an asset-to-asset comparison, I am going by the counter initiative. We offer our products from a spec point of view. Better spec phones at the same price point. Secondly from a service point of view we are in many senses clearly evolved. We have close to 450 – 500 service centers across the country. Thirdly, we realize where our strengths are. So we would not go in for mass catering by showcasing our smart phones across all retail counters. At Spice we would focus on key accounts, key counters and push our smart phone sales there. So it’s a combination of the previously mentioned things.

Moderator Thank you. The next question is from the line of Himanshu Shah from HDFC, please go ahead.

Himanshu Shah I have a question to ask. We are expecting the handset industry to double in size over the next 5 – 6 years from 180 – 185 million to almost 355 million. So what I am interested in is the handset industry. What would be the replacement demand and the new demand for handsets?

R.S. Desikan In terms of demand projection, your projection of 5 – 6 years for handsets doubling in such a short amount of time looks very aggressive because our own assessment indicates that it will take longer than 5 years as the total number of mobile subscribers currently stands at almost 900 million, out of which if you subtract unique ones and the dual SIM card category handsets, the real unique users could be at lets say 600 or 650 million. The past growth rate is unlikely to repeat for the next 5 years as far as the telecom operator is concerned. So therefore the total number increased may not be that significant. However, within the same segment, the proportion of smartphones as a percentage of the total is going to change significantly. For example, today smart phones sold in Indonesia amount to 20 – 25% of phones sold in Indonesia. The same stands at 40% in China, a 100% in Korea and Japan. Smart phones in India contribute to only 5% of total handset volume share. We believe that the growth is really going to come in this particular segment especially in terms of value. The second part of the question is the repeat customers are roughly about 30% and that we believe is going to double to about 60% over the next 5 years.

Himanshu Shah Is the replacement industry of the total handset volumes at 30%?

R.S. Desikan Yes. For 180 million total handset sales, 60 million accounts for replacement sales.

Himanshu Shah So that’s more like, near one-third of the replacement?

R.S. Desikan That will go up to 60% over the next 4 – 5 years.

Himanshu Shah What is the current replacement cycle of handsets and what is the trend with regards to that?

R.S. Desikan It earlier stood at 4 to 5 years. Now it is arriving at 2 – 3 years for the handset replacement cycle on an average. In fact, some handsets can be replaced within one year. For example, phones, which are typically used by the age group of 18 –

25, they get replaced in as low as 1 year. So depending upon the customer profile, the replacement cycle will vary. It will further reduce to 2 – 3 years as we are already witnessing the same.

Himanshu Shah Thirdly, I just want some clarification with regards to smart phones. Is every smart phone by default a 3G phone or will every 3G phone by default be a smart phone?

Sanjeev Mahajan As we see the market progressing, we know for a fact that phones and data are coming together. So in our assessment we find that phones which work with data plans in which the customer actually uses the phone for surfing the net, downloading data and being in the data mode tends to be smart phone. That phone could be a 2G phone or a 3G phone. But it is data dependent. Phones will surely be moving towards the 3G paradigm. To give you an example, our own set of outlets was a learning ground for watching the shift. 6 months ago, the 3G phones, from a value point of view stood at less than 15%. Now it stands at 57%. We expect the shift to continue.

Himanshu Shah Okay, one more clarification. Most of the handsets sold come under the data functionality category where you can access data through the browser. Is there a threshold in terms of processor or RAM of the handset? There may be network constraints from the operator, which may classify a device as a smart phone. Please throw some light on this.

Sanjeev Mahajan See if you look at it from an operator point of view, any phone that allows the customer to surf the net and download data at reasonable speeds is classified as a functioning smart phone.

Himanshu Shah In some research from Cybermedia I read that the smart phone volumes in CY11 was only 11 million. From that perspective it was less. Does this number seem modest for CY11 with regards to smart phones from your perspective?

Sanjeev Mahajan Along with research it is important to note trends. So whatever be the base line, one thing is clear that over a period of 3 – 6 months we will witness a 50 – 60% increase in Smartphone volume shares.

Himanshu Shah With regards to VAS, what's the trend on multi-SIM handsets? Are we witnessing growth in the multi-SIM category, or is the trend declining?

Sanjeev Mahajan Two interesting things are happening on the multi-SIM front. Over the last 2 years the share of multi-SIM handsets have stabilized between 35 – 38%. From an industry point of view, we are not seeing a major increase in the multi-SIM-phones as a share of the total market. Secondly, within multi-SIMs, we are noticing a shift in market shares, like Nokia by itself has been very aggressive and has emerged as the market leader within the multi-SIM category. We believe that the multi-SIM segment is an important large segment of the overall market and will continue to be fairly large from a 3G perspective for the next 1 – 2 years.

Subramanian Murali I may add one more point. Earlier you would have seen that, when the multi-SIM concept started 3 – 4 years back, it was basically limited to the low-end handsets, and they were basically feature phones. We were the first to launch android phones in 2010 with the multi-SIM capability. Now even the Android phones in the mid-end range are launching multi-SIM. That will continue to be there and grow at around 30 – 40% and this will be across the entire range.

Himanshu Shah The share of multi-SIM handsets, which have stabilized at 35 – 38%, is it in terms of number of models, volumes or value?

Subramanian Murali In terms of volume, number of handsets.

Himanshu Shah With regards to VAS and regulatory issues, has that impacted the numbers in the quarter ended 31st March 2012?

Saket Agarwal Based on TRAI directive, most of the operators have taken certain measures of in-sourcing the subscription request as a subscriber and putting a lot of restriction around it but more importantly because of various ecosystem challenges, telcos themselves went through some tough times and we have a business model where we have worked with telcos on a revenue share arrangement. So one of the pit falls of what overall telecom system went through was a moderation of revenue shares from an operator end. It was further compounded by the lack of promotion to for new acquisitions in the subscriber base. So to your point whether is it a bottom that we see in the revenue share front, we really cannot be too sure but yes we are operating at one of the lowest revenue shares worldwide.

Moderator Thank you. The next question is from the line of Rohit Jain from DBS Bank.

Rohit Jain I just want to continue asking the question about the multi-SIM category. if we generally talk about the Indian market, we know that MNP has already been launched and the regulators are also planning to get it launched nation wide to have ST numbers in the span of MNP. So is it advisable to invest from a manufacturer's point of view in this market?

Sanjeev Mahajan From an MNP point of view, the number portability has been a slow starter. Over the last 1 year the numbers have not exactly been healthy where despite the disturbed macro environment, churn from an operator point of view was limited. Secondly I will go back to what my colleague, Murali said, stating that the multi-SIM market will change its nature. We will notice that multi-SIM phones coming earlier stood in the sub Rs. 1,000 – Rs. 1,700 price range. We understand that from a trend point of view, you will continue to see multi-SIM growth in the Rs. 4,000 – Rs. 4500 price point range. As the ASP improves, multi-SIM players will witness that the value to the investor is slightly higher at the price point. So we are confident of the fact that this market will continue to increase. From an Indian customer point of view, it could be safe bet to go after.

Subramanian Murali Just to add to that, previously multi-SIMs actually were a success. Because everybody was carrying 2 SIMs one for incoming call and the other for outgoing calls with convenient rates. Telco rates are currently increasing. If that happens then again we are back to the same regime of 2 Telco's fighting for the airtime rates. So the demand for multi-SIM handsets will continue to grow. Our view is that it is not going to decline. The demand for multi-SIM handsets will increase for feature phones and smart phones. An individual may have 2 SIMs, one for 2G one and the other for 3G.

Rohit Jain If 4G has already been launched in 2 cities within India so from a manufacturer's point of view, 3G and 4G plans for a subscriber is almost comparable. But the speed with which a user gets for 4G is far ahead compared to 3G. So do you see a trend from the mobile handsets perspective moving more towards 4G in the next 1 – 2 years or will it still be in 3G areas?

R.S. Desikan I think it will take slightly more time for 4G to be launched on a full scale. In fact 3G has not been rolled out extensively in India. 4G is more of a promotional announcement by some operators, but the full rollout across the country is very unlikely in the next 1 – 2 years. We believe Mukesh Ambani's venture could be the first one to roll it out on a big time. These are rumors, but we will have to wait and watch.

Moderator Thank you. The next question is from the line of Amin Pirani from Deutsche Bank, please go ahead.

Amin Pirani The number of outlets on the retail front has increased but number of cities have decreased, so any particular reason why that has happened?

Sanjeev Mahanjan As we have evolved in our own retail learning curve, we have realized that in retail there is merit in terms of what we call 'network effect'. This means if you were to dominate one city by putting up a large number of outlets, it leads to better brand traction. It also leads to a higher market share. Being present in places like Delhi and Bangalore, for Delhi we have more than 250 outlets and in a place like Bangalore, we will have 60 outlets. We are pursuing the increase in market share. We have a higher market share in these 2 cities. Our value share in Delhi will be in excess of 20%. Therefore, what it appears is that it is more profitable to put more outlets in lesser cities than to spread ourselves too thin from a long-term point of view. Hence as a strategy, we have tried to keep the numbers of cities limited but we have tried to increase the critical mass of outlets in the city. We expect this shift to become cleaner in the next couple of years and so from a direction point of view, you will find that as we expand to 1,500 stores and 3,000 stores in the next 2 – 2.5 years, the number of cities will reduce as we concentrate more on profitable cities.

Amin Pirani Were the cities that have been excluded Tier-2 and Tier-3 cities? Were there some metro cities which were not feasible in terms of reaching the critical mass? Can you throw some light on that?

Sanjeev Mahanjan We mostly shut our stores in Tier-3 cities, which we had expanded to at an initial stage of expansion 3 years ago. Allow me to just to add to that, most of the cities that we dropped did not have more than 1 – 2 stores established within them.

Amin Pirani With respect to VAS, within India, could you just tell us what would be the share of traditional VAS products like CRBT, SMS and other services? Is there any significant pick up on the 3G driven VAS services or is that still very minimal at this stage?

Saket Agarwal With respect to the revenue share on services outsourced, we are dependent on the scope of the content. For CRBT with content, you could expect 25 – 30% revenue shares. If it is purely based on technology, it can be in the region of 10 – 15%. So the voice based services either could be pure technology, or it could be technology and content. Depending on the combination of the 2 it varies from 30% to 15%. On the 3G-uptake side, 3G is still at a very nascent stage with respect to VAS service offerings. Most of the 3G traction witnessed is through bundled ISP businesses that operators have engaged into, which is not an outsource-able business for VAS companies like us.

Amin Pirani Is CRBT right now around 25 – 30% of your revenue?

Saket Agarwal No 25 – 30% is what operators earn from VAS services.

Amin Pirani With respect to VAS revenues, how much does CRBT contribute to the Company's revenues?

Saket Agarwal For us it will be 5 – 7% of the total revenues.

Amin Pirani Are major revenue contributions still from SMS subscription VASs?

Saket Agarwal We are predominantly a voice based service Company. Our offerings constitute of voice services in 17 languages, data products that are SMS subscription and other services. We have few services like managing Indian railways enquiry system which is voice and SMS based services.

Amin Pirani The range of services that you do in Africa on the VAS side, are they significantly different from what you do in India or is it the same?

Saket Agarwal Most of the services are actually a replica to begin with but there is a huge traction around interactive TV game shows. Though that's still not something that is contributing to revenues, but traction for such a service in Africa is higher compared to the traction that we will witness in India.

Amin Pirani CRBT is a product which you would be deploying Africa as well?

Saket Agarwal Yes. Africa was a virgin territory for CRBT deployment. We are picking up a significant share of that market.

Moderator Thank you. As there are no further questions, I would now like to hand the floor over to the management for closing comments.

R. S. Desikan Thank you very much for joining us on the call and we will also see you exactly 3 months from today itself for the next quarter. By the way we have extended our financial year to the 30th of June. So the next quarter call will be covering our fiscal year '11-12, covering a 15 month period.

Moderator Thank you. On behalf of S Mobility that concludes this conference.