S Mobility Limited

Investor/Analyst Conference Call Transcript
August 31, 2012

Moderator Ladies and gentlemen good day and welcome to the S Mobility's conference call. As a reminder for the duration of the conference all participants' 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 the conference 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 India. 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 period ended June 30th, 2012. We have with us on the call the CFO of the company Mr. Subramanian Murali, Mr. Sanjeev Mahajan, CEO of Spice Retail, Mr. Saket Agarwal, CEO of Spice Digital and Mr. T. M. Ramakrishnan, CEO of S Mobile Devices. 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 conference invite which was emailed to you earlier. We would begin the call with opening remarks from the management, after which we will have the forum open for an interactive question and answer session. I would now like to invite Mr. Subramanian Murali – CFO of S Mobility to share with you some perspective from performance and developments in the company. Thank you.

Subramanian Murali Good afternoon. I would like to welcome all of you on this call to discuss the financial performance of S Mobility for the quarter and financial period ended June 2012. I am happy to be present on this call to discuss the company's position and its endeavors going forward. As mentioned in the earlier call we are witnessing a noteworthy change in the mobile ecosystem. We are observing a change in consumer behavior as consumers become more data network dependent, we are looking at subscribers moving towards data network services on mobile phones which is auguring well for us. It will increase the internet penetration through mobile phones in a big way. The advent of 3G was initially not well received but we are confident of 3G becoming the subscriber's primary choice especially in major cities where we have a very good retail presence. One of the key factors driving consumer behavior is the introduction of 3G enabled handsets. The purchase of 3G enabled handsets can push a consumer, having paid for a 3G handset to subscribe to a 3G service as he wants to make the most of his purchase. Most of these 3G phones are smart phones and the smart phone segment backed by data services is growing at over 100% year on year along with the feature phone segment which is witnessing flat growth but still has a significant value share of the total market size of $10 billion for the mobile handsets market. On the retail side, organic retail is beginning to play a very important role in the sale of smart phones. Spice Retail being the largest organized retail chain in terms of revenues and reach, we are in a good position to take advantage of the shift that is taking place in the mobile industry. There are several initiatives that we have undertaken recently on the retail front. Primarily the establishment of Spice Version 2 retail stores, the advent of establishing these stores will aid us in driving higher ASPs and enhance brand recall consumer market share.

As for the performance for the quarter ended 30^{th} June, 2012 I am happy to mention that after two difficult quarters we are now on the road to recovery. If you look at the last financial year which is the 15-month period ended June 2012, we have had five quarters. In the first two quarters the company was profitable while, the third and fourth quarters have exhibited losses. I am happy to say that we are de-risking ourselves and gradually gaining control over the losses we have incurred over the past few quarters. We have faced challenges in the ecosystem which are primarily led by increased competition, high costs of operation, depreciation of the rupee versus the dollar over the last 12 months and other primary reasons for losses incurred during Q3-FY12 and Q4-FY12 which are currently under control. The product introduction and good marketing campaigns by many international players along with the evident exchange rate fluctuation had made it difficult for players to operate in the environment starting from Q3. But we have well addressed these issues since the last two quarters, focusing on bringing the Company back to profitability. We have invested in strengthening our product portfolio, our infrastructure, promoting our brand recall and also spreading our retail presence. Through these initiatives, we are on the right track of getting our business back to profitability.

With respect to the numbers, on the device business, S Mobility sold 1.17 million S-branded handsets during the quarter and an overall 6.7 million for the 15-month period ended June 2012. Our gross margins have improved sequentially. Again, these margins were good during the first two quarters. Q3 FY12 & Q4 FY12 witnessed a decline in gross margins but Q5 FY12 witnessed improved gross margins. This was driven by a strong line of new products that were added to the Company's portfolio during the quarter. The aberrations during Q3 FY12 and Q4 FY12 are hopefully over in terms of the dollar fluctuation and we have completed liquidation of stock which led to margin erosions in Q3 FY12 and Q4 FY12. On the product front, in the last quarter we were the first to launch an analog TV phone in India and also an Android 2.3 touch phone with anti-virus protection at less than 10K. We have also been focusing on Android devices such as MI 415 and M5 425 which have been well received. We expect these handsets to sell well as they are high quality devices which are sure to deliver performance at competitive price points. Our expectation of these devices catering well to the market is also backed by a change in the consumer behavior which I mentioned earlier, related to the user who now understands smart phone features, functions and high-end operating systems like the Android. The net results for the devices business is that the EBIDTA loss for the device business has reduced from Rs 153 million during the quarter ended March 2012 to Rs 56 million in the quarter ended June 2012. That is a significant reduction in loss and is an indication of moving towards profitability with regards to the S branded device business.

On the retail front, we have managed to garner stable growth in our multi-brand retail, volume-wise and value-wise. Our multi-brand retail ASP stands at Rs 5,020 which increased by 5% sequentially and 11% year-on-year, reflecting a positive trend in organized retail of high end products. Just to give you an illustration, uptake of 3G enabled handsets, is continuing to grow and stood at 60% value share during the quarter, up from 43% a year ago via our organized retail chain. Retail presence continues to grow as we have 869 Hot Spot stores across 149 cities as on 30th June, 2012 compared with 792 across 159 cities last year. This indicates that we are expanding our presence towards main tier-1 cities rather than focusing wholly on regional areas. I also want to mention that our retail business continues to be EBITDA-positive and retail revenues have grown from Rs 2,431 million in April-May-June 2011 to Rs 3,141 million in April-May-June 2012 showing a sequential year-on-year growth of 29%. Sequentially there has been a drop in revenue of 7% which is mainly due to the seasonal impact. January to March quarter is typically better.

Coming to the VAS business, our domestic 2G VAS services are witnessing slag and negative growth on account of regulatory changes which have occurred over the last 12 months. We are trying to de-risk ourselves by expanding into international markets and also introducing new services. Most of our handsets are also manufactured with S Apps planet pre-embedded into our devices. This we believe, will lead to higher download rates from consumers who purchase our products, which will give us an additional revenue stream going forward. With regards to the business performance of value added service business, there has been a 1% sequential growth in revenue compared to the quarter ended June 2012 as the revenue contribution from international operation has increased, standing at 22% during the quarter under review as against 17% in the previous sequential quarter and 11% in the same quarter last year. This is mainly due to the traction witnessed in Africa. We are now present in 12 countries in Africa but in terms of product range, our international VAS business comprises of products that are similar to the ones catered to people in India due to similar demographic profiles. These services mostly constitute of live streaming products, live FM, USSD services, banking solutions, music services and so on. One of our areas of focus is also on enterprise mobility solutions, mobile commerce and business to consumer services which are going to be the growth areas for VAS over the next 2 to 3 years timeframe.

In terms of consolidated financials, revenues for the quarter ended June 2012 stood at Rs 5,115 million translating to a 2.7% decrease over the corresponding quarter last year mainly due to lower volumes and ASPs. However if you look at the fiscal 15-month period ended June 2012, we reported an annualized growth of 9% with revenues at 27,421 million. With respect to our operational profitability in the quarter, as I mentioned earlier, I want to highlight that we have succeeded in constricting our losses and managing our margins better. Earnings before Interest Depreciation and Tax stood at a positive Rs 16 million as against a loss of 118 million in the last sequential quarter. Loss after Tax is 37 million for the quarter as against the loss of 198 million in the quarter ended March 2012. Thus, the losses during the quarter have been significantly reduced primarily due to reduction in operating costs, efficient management of manpower, optimization of costs, streamlining supply chain process and good control on the foreign exchange rates as we have now settled with foreign exchange rates at Rs. 55-56 per dollar vs Rs 48, Rs 50, and Rs 52 which we witnessed 2-3 quarters back. We continue to renegotiate prices with our vendors considering the current INR and USD exchange rates.

Just to sum it up, I would just want to state that there are several strategies that are currently under execution, which is expected to serve the company in recovering from its shortfalls which we witnessed in the last few quarters. The overall scenario in the industry is going through a challenging phase but yet holds ample of potential. We have entered new geographies, expanded our retail presence, and are constantly endeavoring to improve our operational efficiency. We are doing the right things. Challenges will exist and will never cease to confront us. We believe that we are well positioned to leverage this sector with great optimism and effectively cater to the dynamic demands that are constantly emerging within the industry. I will now like to discuss your queries and suggestions. Thank you very much.

Moderator Thank you very much Sir.

Ladies and gentlemen we will now begin the question and answer session.

Our first question is from the line of Srinivas Rao of Deutsche Bank. Please go ahead.

Srinivas Rao Could you please throw some light on footfalls in your stores? How has that been over the last quarter and the last six months? The context of this question is that we are seeing a slowdown in discretionary spending. Is that impacting Spice Retail? Is the replacement cycle of mobile phones increasing? Secondly, please state your thoughts on how 3G has not picked up as expected given that you said that smart phone sales have dramatically increased.

Sanjeev Mahajan We have a robust system of tracking footfalls in our stores. Last year we clocked 20 million footfalls across 900 Spice Retail stores PAN India. There has been a drop in the last one quarter, which has been rather marginal. We expect this to improve over the next two quarters as the festive season builds up. In many senses we are shielded from such shortfalls because we have expanded our presence cautiously, insulated from the overall numeration footfalls that you would have seen in the other retail sectors.

T M Ramakrishnan Regarding 3G, operators do not push handsets based on contracts. The percentage penetration for 3G handsets is low. There is enough opportunity for data to grow. Secondly, the reach of 3G is currently limited as consumers would like to have the availability of 3G in all locations when they are travelling. Thirdly, 3G is not affordable for everyone. Though, 3G devices that are being sold, is growing by 100% year-on-year and latest statistics indicate that by 2013 volumes of smart phones will exceed feature phones. Now consumers are using EDGE on their existing 3G devices. Once the affordability factor facilitates better data plan pricing, we will witness massive traction in the devices segment.

Moderator Our next question is from Pranav Kshatriya of Brics Securities. Please go ahead.

Pranav Kshatriya How do you define a smart phone and a feature phone?

T M Ramakrishnan The difference between a feature phone and a smart phone is mainly a data enabled touch phone with EDGE or an Android operating system which is referred to as a smart phone. There are different definitions by brands. People actually define this in terms of value or facilities provided to them. So as far as smart phones are concerned, any touch phone which has EDGE with Android, is a smart phone. The rest are feature phones.

Subramanian Murali May be even a simpler definition is, a phone that is used to make general calls and messages and has a close-ended operating system is called a feature phone. A smart phone is one with an open-ended operating system; generally has the ability to take advantage of 3G networks and multi-task with various applications via mobile internet, enabling VAS on the phone.

Pranav Kshatriya What is the average price of a smart phone? Is it declining in terms of percentage quarter-on-quarter or year-on-year?

Sanjeev Mahajan We have witnessed a significant growth and as retailers, we stock brands which are prominent in the country. In general, we have seen a drop in prices of 3G enabled smart phones by 15% to 20% in the last one year.

Pranav Kshatriya Can you be a little more specific? Your smart phone share has increased by 45% last year to 62% this year, whereas ASPs have increased by less than 10%. So I just want to know the average selling price with respect to smart phones. That will be helpful.

Sanjeev Mahajan For smart phones, the ASP within a store continues to be about Rs. 7000. We are talking with respect to Spice Retail's non-feature phones. We are witnessing two clear phenomena here. Firstly, we are witnessing the fact that 25% of individuals who walk into a store and use a feature phone aspire to move to a smart phone. Buying smart phones from our product portfolio could be (a) a phone which has got an open operating system (b) a 3G phone and (c) an android based phone. So we are witnessing ASPs increasing because we are observing that people want to upgrade from a feature phone to a smart phone. Secondly, in general, we find that most vendors, MNC and non-MNC vendors want to push more of smart phones because that is the future according to them. A combination of the increase in demand from the consumer side coupled with the aspiration of vendors to push more smart phones is leading to the increase in ASPs and the increase in the overall share of smart phones. You will also notice the fact that in general, the ASPs of smart phone will fall in the next one and half years and will stabilize going forward. Two years ago, retailers spoke of ASPs for high-end smart phones being close to Rs. 13,000. These days it is not unusual to find a fully functional, highly operational smart phone at price points which are slight around the Rs. 5,500 to Rs. 6,000 bracket.

Moderator Our next question is from Rajat Gupta of J P Morgan. Please go ahead.

Rajat Gupta With regards to retail sales, could you provide an ASP range in which the maximum numbers of your smart phones being sold? I would like to get a range between Rs 8,000 to Rs 12,000 and a percentage within that range.

Sanjeev Mahajan If you are talking specifically about smart phones, we are talking of 3G Android. The ASPs of 3G Android handsets stands at in excess of Rs. 8,000.

Rajat Gupta Are maximum percentage of your phones being sold in that range?

Sanjeev Mahajan The average ASP for phones being sold through Spice Hotspot is in excess of Rs. 5,000. 60% value would come from phones which cost about Rs 8,000 and the balance would come from phones which have an ASP of Rs 2,500 to Rs 3,000. With some calculation, you will arrive at a blended ASP of Rs 5,200- Rs 5,300.

Rajat Gupta Could you give us an idea of the top 4 leading brands here and its market share?

Sanjeev Mahajan Within a store, as a phenomenal market trend you will observe that Samsung would be a clear leader in the smart phone category and it would have a share of close to 40% within our outlets.

Rajat Gupta Who would be #2 or #3?

Sanjeev Mahajan Followed by Nokia, which even though it has lost market share, has had some success with the Asha series. Primarily Nokia models like Asha 302, 305 and 311. Nokia would have a market share of close to 30% within our outlets.

Rajat Gupta It would be great if you will give me the ASP range of these devices of Nokia phone especially if they are within the Rs 3,000 to Rs 4,000 range.

Sanjeev Mahajan For Samsung, the ASP would be around Rs. 7000. Nokia would stand at about Rs. 3600 or so.

Moderator Our next question is a follow-up question from Pranav Kshatriya of Big Securities, please go ahead.

Pranav Kshatriya Sir a few months back S Mobility mentioned of a manufacturing facility in Himachal Pradesh and I thought it will be quite helpful for the company to focus more especially in the scenario with regards to the depreciating rupee. So I just want to know what is happening on that front?

Subramanian Murali The manufacturing facility has not been ramped up because the rupee depreciation does not impact the manufacturing process with regards to boosting profitability. Whether we buy handsets as raw material or as a finished good, unless one indigenizes the components, it does not aid the Company with regards to profitability. The extent of indigenization is low in the mobile phone industry. So it does not really make any difference whether you import it fully or you get it manufactured here, except for the tax benefit which we can enjoy. So our focus is to grow our volumes and profitability. I don't think we are focused to ramp up the manufacturing facility. It is currently operational and it is producing may be 10% to 15% of the volume that we sell but we do not intend to ramp up its capacity as of now.

Moderator Our next question is from Srinivas Rao of Deutsche Bank. Please go ahead.

Srinivas Rao My question is on the VAS side, where you have continued to mention that domestic 2G VAS remains flat-to-negative. But you have described that regulatory issues have impacted it. The fact that regulatory issues have impacted VAS is probably a 4 to 5 quarter old phenomenon. So could you actually tell us exactly what is happening on that front? What regulation has impacted the growth? I have heard this particular so to say commentary from various managements, both the operators and VAS companies. So what exactly is the issue? It will be very helpful if you can let us know that.

Saket Agarwal Essentially, the regulatory body 'TRAI' has put in certain restrictions on activation of VAS services for consumers through the option of either using SMS, Email or Fax. This was effective September onwards last year. With regards to low literacy in India, a lot of 2G VAS services which are essentially meant for consumers who are on the other side of the digital life style and cannot access simple things through traditional mediums, be it access to music, direct commentary of cricket scores, devotional content from various sites across India. Low literacy levels, from point of view of SMSs, fax and email usage, will be a challenge in the short and long run. This will impact the subscribers on the system if they are not educated about advanced value added services due to lingual boundaries. A few operators also chose to focus on their own challenges with regards to their bottom-line by defocusing on services itself. This means that the telecom ecosystem in India which is adding close to 10 million consumers per month will not be informed of such value added services, even if operators have a service that can be subscribed, they will not be promoted due to which the uptake of services will reduce. Hence, through both forms – the mode of activation of services and information about certain services in the operators' portfolio available to new consumers will reduce over time. There is also a churn on VAS services as much as the natural churn in the telecom ecosystem. There is less uptake of the services, less promotion and high churn – so we will not witness much growth; muted growth or maybe de-growth for most of the companies will be evident. Thankfully targeting various geographies and reducing dependence on operator domain services has aided us in boosting revenue streams. Hence, we have been able to hold our revenue line. The industry overall, for both operators and most of the VAS companies has been a challenging one since the past 2-3 quarters.

Srinivas Rao As we mentioned with regards to the confirmation that comes via SMS, fax or email, is it difficult to get consent even on SMS?

Saket Agarwal Barring the metros, where SMS penetration or SMS usage is close to 40%; in states outside metros, the SMS uptake is not in an excess of 20% to 25% in major cities, and as we move further into rural areas, then it is as low as 10% to 15%.

Srinivas Rao Does TRAI allow consent by calling them or that is not allowed?

Saket Agarwal No, those who were involved in the same have stopped. Certain operators like BSNL have implemented and obeyed the law of the land and others are negotiating with TRAI because it is just becoming too difficult to get customers on board for value added services. Wherein for the same minutes of usage of 60 paise to Re1 the operator can make an earning between Rs 3 to Rs 5. This puts pressure on everybody who is associated with this ecosystem.

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

Subramanian Murali I would like to thank all the participants for taking their time to participate in this conference call. I hope we have been able to answer your queries and if you have any specific queries you can always write to us and get in touch with us and we will be able to answer that.

Moderator Thank you very much. Ladies and gentlemen on behalf of S Mobility that concludes this conference call.