S Mobility Limited

Earnings Investor/Analyst Conference Call Transcript
17th February, 2012

Moderator Ladies and gentlemen good day and welcome to the S Mobility Limited Q3 FY12 Earnings Conference Call. As a reminder 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. If you should 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. I would now like to hand the conference over to Mr. Ravi Sathe from CDR India. Thank you and over to you sir.

Ravi Sathe Good afternoon, everyone, and thank you for joining us on S Mobility's Q3 & 9M FY2012 Results Conference Call. We have with us on the call, the recently appointed CEO of the company -- Mr. R. S. Desikan; the CFO -- Mr. Subramanian Murali; as well as the Head of Retail Business -- Mr. Sanjeev Mahajan and the Head of VAS -- Mr. Saket Aggarwal. 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 Concall invite which was e-mailed to you earlier. We will begin the call with the 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 of his perspectives of the performance and the developments of the company.

R. S. Desikan Good afternoon ladies and gentlemen. My name is Desikan. A very warm welcome to everyone on behalf of S Mobility. I am very delighted and honored to join this company and to be part of the team leading us to our next phase. Of course, this particular quarter has not been that encouraging as you might have seen from the results for various reasons which my colleague Murali will explain; However, we have a team which is very highly charged, has a strong belief in the brand that we have created and is focused on creating customer delight in the marketplace. It is just about a week since I have joined. Therefore, I may not be able to take any very specific questions though with regard to strategic direction, I would be happy to discuss. But now to take you into the details I will request my colleague Murali to take over. Over to you, Murali.

Subramanian Murali Thank you, Desikan. Good Morning everyone. A very warm welcome to everyone present in the call and thank you for joining us today to discuss S Mobility's operating and financial performance for the quarter-ended December 2011. I would also like to welcome on the call, Sanjeev Mahajan and Saket Aggarwal, the CEOs of Retail and VAS business, who will be sharing with you their perspectives of the respective business that they lead.

You may have also heard that Mr. Rajiv Makhni has been appointed as Additional Director of the Board of this Company. Rajiv is regarded to be India's Tech Guru - he anchors several TV shows on Technology including Gadget Guru, Cell Guru on the NDTV network. We are delighted with the joining of Rajiv and look forward to his insights and contribution in taking the Company to the next level.

Let me just briefly touch upon the performance of the Company during the quarter-ended December 2011. The consolidated revenue of the company grew from Rs. 5,393 million to Rs. 6,184 million, a growth of 15% quarter-on-quarter and from Rs. 5,279 million same quarter last year, a 17% growth year-on-year.

The Spice Brand Device sale witnessed a decline of 6% quarter-on-quarter from 1.4 million handsets in Q2 FY12 to 1.33 million handsets in this quarter. The ASP has marginally gone up from Rs. 1,475 last year to Rs. 1,508 in the current year same quarter.

The Company launched a series of Mobile Internet and Smartphones in the last quarter including a Tablet phone with a 2.6" Touchscreen and Blueberry series phone. Some of them did well, some of them did not.

The major point in the current quarter which ended in December 2011 was the dollar appreciation which happened during the quarter. As most of you are aware, the dollar appreciated by more than 10% during the quarter-ended December 2011, and this has adversely affected the margins of the Mobile Devices. So basically the cost of procurement has steeply gone up in the last quarter.

The market pricing has not really gone up commensurate to the increase in the input cost due to dollar appreciation because of competitive market conditions. This has resulted in loss for the quarter at a consolidated level of Rs. 179 million as against the profit of Rs. 120 million for the previous quarter. The main reason for this drop in profit was the Device business, where 100% of our phones are imported and the dollar impact is high.

Of course, the company is focused on introducing a new range of Mobile and Mobile Internet products and continues to invest in brand and manpower in the clusters. I talked about the seven cluster strategy in the last couple of conference calls and we are continuing to invest in those seven clusters and in building the brand and manpower. The benefit of these investments are likely to give results over the next few quarters in terms of increase in the market share revenues and profits. Of course, in the short-term, the market outlook continues to be challenging with competitive product offering at the low-end and margin pressure in the Mobile Internet category. However, a good point is that the dollar is coming back to less than Rs 50 level and that's an encouraging sign.

Regarding the Retail business, we have done quite well in the last quarter, growing at 31% during the quarter. Average Retail ASP has improved to 4,721 with 50% sale comprising Smartphones. We've expanded our presence with a number of stores increasing to 817 as compared to 777 last year. It is worthwhile to mention that the Retail business continues to be EBIDTA-positive and PAT-positive during this quarter also. In fact, Spice Retail, is today, the largest in Mobile Retailing category, in terms of revenues.

Moving on to VAS, the business saw a growth of 11% over the same quarter last year and sequentially it was a flat growth. EBITDA percentage has come down from 20% to less than 10% in this quarter. This drop is mainly attributable to an increase in content cost and reduction in revenue share in some of the operators.

The revenue from India has actually seen a flat growth year-on-year on the backdrop of implementation of TRAI guidelines by the operators. One of the positive development is that the revenue from international operations has contributed 16% this quarter compared to 9% same quarter last year . Our focus continues to be to open new offices outside India and we have offices in nine countries in Africa and have seven subsidiaries in Kenya, Nigeria, Zambia, Uganda, Tanzania, Ghana and South Africa. All our key offerings have showed encouraging traction.

We recently launched our own YouTube channel called “Spice” to showcase and monetize all in-house content. The channel has already registered two million views. We also launched an innovative service on our Mobile Radio called “Music Mania”, which allows customers to connect and share their music taste and preferences. In less than 100 days of the launch, we have a 45 million unique playlist being created with 2.5 million songs on only two major operators. Saket will take you through the details of this later during the call.

Operationally, S Mobility is evolving into a strong company with an established market presence. Although, there will be some near-time challenges as a result of our continued investment in manpower and market in an attempt to switch to be a Mobile Internet company. However, over the medium to long-term, we are quite confident that our presence across all three pillars of Devices, VAS and Retail and more importantly, access to several strengths and synergies of a global brand outside India will leverage growth opportunities in this exciting space. This brings us to the end of my opening remarks. We would now be glad to take your questions and try to give answers where possible. Thank you very much.

Moderator Thank you very much. Ladies and gentlemen we will now begin the question-and-answer session. The first question is from Srinivas Rao from Deutsche Bank. Please go ahead.

Srinivas Rao Firstly, is the loss relating to the Forex movement a part of your purchase of finished goods in your Profit and Loss statement?

Subramanian Murali Yes, that's correct. As you are aware, 100% of our phones are imported. During the last quarter the foreign exchange rates went up from Rs. 45 to almost Rs. 51; the average rate for the last quarter was Rs. 50.7. This has resulted in an upwards of 10% increase in input costs.

Srinivas Rao Do you think you can pass on the impact of fluctuation? Of course the rupee is plowing back now, but do you see any chance of increasing prices to compensate for this, or is the market too competitive?

Subramanian Murali Actually, if we look at the market scenario over the last couple of quarters, or let's say September to December, some brands like Samsung and Nokia tried to increase price while none of the local brands did so. We did once attempt to increase the price in the month of October, but our objective is not short-term and these fluctuations keep happening from time-to-time so we have largely kept prices the same. You yourself said now that the dollar has come back to less than 50 so things should now get better.

Srinivas Rao Are these costs not hedged or are these costs the net of hedging costs?

Subramanian Murali These are net of hedging costs. Also, our policy is to always hedge up to 90% of our exposure. It doesn't really make a difference because, firstly, you have to do mark-to-market. Secondly, for example, if I purchase in the month of December when the exchange rate is 52, my purchase cost is at 52. As a policy, we do not hedge future purchases.

Srinivas Rao Can I get a sense of the order cycle, typically, what is the lead time required, for the purchases which you put for your phones? Let's say, for the requirement in the current quarter, do you need to tell the suppliers one quarter in advance, how does it work?

Subramanian Murali The lead time is 45 days to 60 days. At the time of receipt of material, we try and hedge our positions.

Srinivas Rao And the pricing is based obviously on the date of the order, right?

Subramanian Murali That's correct. The pricing is on the date of the order, but the dollar rate is on the date of invoicing from the supplier, which is 30 days to 45 days from the date of order, That's when we try and hedge our positions because we also get 45 days to 60 days credit. So, we do not want to be in a situation wherein, at a time when payment is due, we may be subjected to exchange fluctuations. So, as a policy, we hedge 90% payable at any point of time.

Srinivas Rao And just wanted to know as per your presentation and also as you mentioned, details on the new category called "Smart-like Phones"**.** Obviously, you must appreciate that already there is a proliferation of definitions of Smartphones and most of these are fairly confusing to be honest, to understand exactly the underlying trends. Typically, globally, the standard definitions are Feature phones and Smartphones. Just wanted to understand what this is and purely talking from a consumer perspective, what does this mean, what is the underlying technology that is available? Is it the OS and the RF side, if you can just explain that will be great?

Sanjeev Mahajan Essentially, when you look at the unique nature of the Indian market, one can see that the domestic brands actually operate at an ASP which is lower than the MNC brands and we have found that at those price points, say, about Rs. 1,700 or so, there is a fairly large customer base which wants a phone with a capability of a number of features akin to a typical Smartphone, but they do not want to pay that kind of money.

To give you an example, people would want a surfing experience, but they will be quite happy if they do not get, in relative terms, speed which is as much as the Rs. 5,000 or Rs. 6,000 Smartphones. Hence we have seen the evolution of phones which though competent are not fully loaded and we noticed the fact that there is a large customer base especially in Tier B and Tier C cities who want those kinds of features. So, it is a definition which is evolved by default because when we operated at those price points, we have seen traction for these kinds of products which have come up.

Let me give you another perspective, when you notice phones in the range of Rs. 15,000 to 20,000, the number of applications found are humongous. 80% to 90% of these applications will never be used by an average customer. But what we have done is, we have tried to make sure that we build up customer traction at A) lower ASP and B) Phones which are capable of doing many things, but not really fully loaded. So our focus is on a Rs. 1,700- 1,800 kind of phone which has got some applications net surfing abilities, and has an OS which is capable of giving a basic performance, but not necessarily highly technologically evolved. It is a fine line, but as you notice the market is evolving and we believe we can do well in this segment.

Srinivas Rao The OS will be potentially Android in this case?

Sanjeev Mahajan Yes, Android 2. To give you a clearly specific example, we are in the process of launching Android phones at price points between Rs.4,000 and Rs.5,000, hopefully at price points close to Rs. 4,300 - 4,400. Now, these will be category killers, in a sense, because no one has attempted Android phones at these price points.

Srinivas Rao What version of android will be the OS? Not obviously, the Ice Cream Sandwich, not the latest one, right?

Sanjeev Mahajan May not be. Maybe three months down the line that too, but as of now may not be.

Srinivas Rao Will it utilize GPRS EDGE or W-CDMA? Because, essentially the surfing experience is a function of these two factors besides which you have said.

Sanjeev Mahajan Right! What could happen and that is a very interesting point the way you put it, is that the processor speed may be different and that’s a key component cost for increasing the price for a phone. Definitely, GPRS will be there.

Srinivas Rao W-CDMA will not be there, right?

Sanjeev Mahajan No W- CDMA will not be there. Instead of looking at phones which are at a price point of between Rs 10,000 - 15,000, which are totally loaded, you are looking at phones which are "reasonably priced" and capable of doing more, though not everything.

Srinivas Rao I will explain where I am coming from. The commentary which comes from the Telecom companies, obviously, after the launch of 3G, and everyone is excited that the Smartphone prices in India are falling. Thanks to obviously competitive efforts and innovation efforts from companies like you, we will get phones at Rs. 4,000 or thereabouts price points, but the key issue is, are these phones capable of a W-CDMA or not? Otherwise, the 3G investment by the Telecom companies will not bear any fruits from fall in pricing. That is where I am coming from. If the phone does not have an RF and the wave band which can do W-CDMA, then it does not matter whether the pricing of the phone falling. That is my basic question.

Sanjeev Mahajan Specifically, you are right. The Smart-like phones as of now do not have W-CDMA but we think in the next 3 to 6 months we see that coming in.

Srinivas Rao You will see W-CDMA capability being integrated over a 6 to 12 month period at these price points?

Sanjeev Mahajan Absolutely, and we have a clear line of sight to that. Essentially, we see Smart-like phones continue to build up volumes at the bottom-end of the pyramid.

Moderator Thank you. The next question is from Paras Mehta from Goldman Sachs. Please go ahead.

Paras Mehta Firstly, can you give us some color on the trends on the 3G Handset demand that you are seeing and in terms of incremental sales? Also what is the proportion of 3G versus non-3G? Secondly, what kind of demand are you seeing on 3G Handsets in Tier II and Tier III cities?

Sanjeev Mahajan Let's talk about the overall market then we will talk specifically about S Mobility. 3G while it has been a slow starter at the hardware side, we do not see a large number of phones which fall into the typical 3G category; however, having said that, this is a slow growing but high potential area. I think you will find the tipping point to happen in the next 9 to 12 months when you see 3G becoming much more popular and the price point for the basic 3G services coming down. As of now it is a very, very small nascent category but definitely a high potential category, say, 9 to 12 months from now.

Paras Mehta If I may ask, what makes you think that the 3G price points would come down? Because mostly the Telco operators, in a way are guiding that they will not be entering into competition in terms of 3G Data pricing. Anything else that gives us a confidence that these might come down?

Sanjeev Mahajan End-to-end from Devices to a retail company, we have found a clear customer feedback which suggest across cities, ABC tier towns consumers say that they are not happy with the kind of money that they would be paying for 3G services. An average bill for a 3G customer even now ranges at about Rs. 1,800 to Rs. 2,000, whereas if you notice the current ARPU, the number is extremely small. At an overall industry level I think the industry will have no choice but to make 3G more affordable. The flip side is that as 3G gets to be more affordable you will find that the net use of 3G gets higher. So real traction in volumes will only increase if the price point actually falls.

Demand in Tier II and Tier III towns for 3G, is again a slow starter, but surprisingly Tier II and Tier III towns are no longer that far behind Tier I, so we don't see a lag. Three years ago there used to be a lag in the adoption of handsets and technology between Tier A, Tier B and Tier C. So we notice the fact that when a product or service gets launched in Tier A there is a corresponding equal demand which comes in Tier B and Tier C. Our experience, again tells us that at an overall level, 3G is a slow starter but having said that it is a high potential area across Tier A, B, C and we should see traction in the next 9 to 12 months further.

Moderator Thank you. The next question is from Rajat Gupta from JP Morgan. Please go ahead.

Rajat Gupta My first question is on your investment plans going forward outside India. Can you just give us a brief pipeline of which regions you have planned to expand to in the next 6 to 9 months or may be one year?

Subramanian Murali Let me briefly share on investment opportunities in each of these three businesses.

With regard to the Device business, the investment opportunity that we are looking at outside India is in terms of design and possibly a manufacturing partner. On the Device side in India, it is about increasing the reach in India in terms of manpower and market.

On the Retail side, of course, it is an expansion in terms of number of stores in India from a current level of 800 to doubling this over the next couple of years. Also on the Retail side we are continuing to look at any good acquisition opportunity. You may be aware that we did two acquisitions in the last two years in India. Retail focus is fully in India.

On the Value Added Services side we are looking at an opportunity to acquire companies in the VAS space outside India and also in India. On the organic side in VAS we are looking at expanding in Middle East and Africa. Like I mentioned in my opening remarks, we already have a presence in Africa and we are also looking at LATAM as the next big opportunity. So these are the areas where we are looking at increasing our presence through either organic or inorganic ways.

Rajat Gupta In terms of design partnerships, right now, you are collaborating with MediaTek. I think that's around 80% to 90% of all your chips, is that right?

Subramanian Murali That's right. MediaTek is the largest chipset maker in the world. As I mentioned in a couple of calls before they have taken an equity in Spice Digital. They are a partner for us as far as the chipset is concerned. But apart from chipset, we are looking at an opportunity to partner with various ODMs for design also. So one is the chipset and the other is the design and manufacturing. So we are scouting for opportunities in the design and manufacturing areas also.

Rajat Gupta My next question is on your average retail ASPs. That has gone up substantially quarter-on-quarter. Can you just give a comment on how much is added due to the current situation, I mean the rupee depreciation or is it like just an increase in the number of high priced Smartphones or is it more due to the depreciation of the Rupee?

Sanjeev Mahajan Of the current number of 817 stores, 70-80 stores are new additions. So fairly large base of our stores are matured. And as we have matured we are reaping the benefits of modern trade actually - our repeat customer base has gone up from 25% to close to 50% over the last one year.

Secondly, multi brand vendors, Nokia, Samsung, Sony look at us as places where they can create the new Smartphones and expect to see traction. So we stand out because of a combination of the fact that we have matured in terms of age of stores, and secondly, vendors coming to us to push Smartphones because of the added advantage we offer in terms of manpower, expertise, locations, ability to invest in inventory and the overall look-touch feel that the kind of stuff that we have within outlets. We find that the average ASP of the phone continue to grow. In fact over quarter-on-quarter we have seen a fair amount of increase from close to 3,800 to 4,700. That is the number which is coming and we expect this trend to grow.

Subramanian Murali To add to that I don’t think Forex has got anything to do with this because we haven’t seen a significant increase in market prices due to Forex increase which is the point that I made during my initial comments, whereas the cost has gone up for all the manufacturers and Device vendors.

Moderator Thank you. The next question is from Srinivas Rao from Deutsche Bank. Please go ahead.

Srinivas Rao Firstly, I think the previous person asked, what is the share of 3G Phones as a percentage of total Handset sales that you are making? I think you have given a graph by value in your presentation.

Sanjeev Mahajan From an overall retail point of view the number would be close to 7%. Even though 50% of our sales are Smartphones, which goes back to the earlier statement that I made, that the Smartphone category continues to gallop, whereas 3G category per se is still to evolve.

Srinivas Rao My second question is actually on your VAS business where you have continued to mention about this TRAI impact. Now, the TRAI directive is almost a year old. It is not just you, but even the Telecom companies continue to hold that up as a point. What are we to make out of it? Basically, the conclusion at least from an outsider's point of view is that, a lot of the VAS that was essentially completely push-based and it does not seem to have that kind of pull we all expected. Otherwise, the TRAI directive should not have that big an impact, it is just a double confirmation. If a consumer is interested, one would take that service, right? It is not that big a barrier to have made such a big impact on the VAS growth is the point I am trying to make. Could you throw some light on that?

Saket Aggarwal The TRAI directive was implemented somewhere in September of last year. It is not for most of the VAS services and most of the things that are offered are not really basic necessity services. It is more to be able to communicate. Hence a lot of VAS spend is from disposable income, so there is need to do some of it through communication. So it is more led by entertainment though of late, there is some utility VAS which is coming into being.

Now TRAI has been rather harsh on operators and there have been many representations by both the operator and VAS companies. To be very specific, TRAI wanted that any customer wanting to get to subscribe to a service, will have to send an SMS or send a fax or e-mail. Now, that's the directive in true sense of it. I don't think it is implemented as yet because it is going to pull back the whole industry by a couple of years or more because where is fax in these days and how many people would be literate enough to be able to send an e-mail and how many people indeed use SMS?

So, while we continue to say the TRAI directive has impacted, it is not that it was just a push thing; it is that the operator has taken note of what TRAI is wanting and accordingly, really taken a back seat in even communicating the services to the consumer. In the last 3 to 4 months there has been no communication sent to new customers coming on board about the services. How would they ever know about the service? How would they ever get to subscribe? So it's just that at this point in time. There are no new acquisition happening. Literally, none and that is leading to a tough time for players like us and it is getting compounded by the fact that Telecom operators have also got into reducing the revenue shares which is typically a yearly exercise, so we are hit by both; the volumes have dropped and our predominant revenue business model which is around revenue share also starts coming under pressure. So volume and revenue share both coming down is impacting the overall profitability and turnover.

Srinivas Rao If I may add something here and may be I am playing a bit of a devil's advocate. As I said that TRAI directive says, you can send a SMS. I think whatever the constraints people will be able to send a SMS if they want the service. So it actually brings us back to the point what TRAI's initial worry was probably proving a bit true that the usage was being significantly led by a push. Secondly, I am curious to know why the Telecom operators would not push VAS services given that it is typically a higher margin for them

Saket Aggarwal I mentioned that there is a strong sense of imposition coming from TRAI to have this policy implemented and as I mentioned about e-mail, fax and SMS as the only means to subscribe. In letter and spirit it is fairly difficult to implement just that.

More importantly, as you are making a point, if somebody wants the service, he will do via sms. I would want to contest that for two reasons.

Firstly, you need to know about the service to be able to send the SMSes. So, one of the points that I am making is that, people are not getting any information whatsoever either through above the line promotion, the traditional electronic or print media or the most used outbound dialer or sms blast that were allowed and there is also penal action coming in if DND subscriber or any of the people are getting SMSes. So it is one about education about services which exist.

Secondly, no more than 40% of the people in the country know how to send a text. So that's also a big put off to get people to subscribe to the services.

So I think it is just that telecom operators have taken a back seat to get into promoting it in the manner it was being done,

Moderator Thank you. As there are no further questions from the participants I would now like to hand the conference back to the management for closing comments.

R. S. Desikan In conclusion, even though we had a slightly disappointing quarter, we do look forward to more exciting times in the future. We have all the enablers inside the Company in terms of technology, marketing, brand and above all, people and enthusiasm to take it to the next level. I am sure that we should be able to reach higher heights as is expected by the Board and the Shareholders. Thank you very much for attending this call.

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