# S Mobility Limited

## Earnings Investor/Analyst Conference Call Transcript
## November 15, 2011

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**Moderator** Ladies and gentlemen good day and welcome to the S Mobility Limited Q2 & H1 FY12 Earnings Conference Call. As a reminder, for the duration for 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 India. Thank you, and over to you Sir.

**Ravi Sathe** Good afternoon, everyone, and thank you for joining us on S Mobility's Q2 & H1 FY2012 results conference call. We have with us Chief Financial Officer of S Mobility -- Mr. Subramanian Murali. Before we begin I would like to state 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 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. Subramanian Murali to make his opening remarks.

**Subramanian Murali** Thank you, Ravi. Good afternoon, everyone. A very warm welcome to everyone present and thank you for joining us today to discuss S Mobility's operating and financial performance for the quarter-ended September 30, 2011.

Let me take you through a general overview of S Mobility's performance and the developments during the quarter. The company continues to strengthen its position in the Mobile Internet space through a fusion of offerings across Device, VAS and Retail. I am sure you are aware of S Mobility's recent Switch Initiative which was the first milestone on the road towards becoming a leading Mobile Internet company. Our strong presence and competitive position across Devices, VAS and Retail, combined with our understanding and passion for Mobile Internet, sets us apart from the rest in India and gives us a profile similar to some large international players. Through the implementation of such a strategy, customizing it for demography, S Mobility is establishing a solid foundation and an advantageous position to capture emerging opportunities in the Indian telecom and Mobile Internet segment.

During the quarter under review we executed two significant tie-ups with two companies namely Tinno Mobile Technology and Mediatek. Tinno is a young innovative provider for mobile communication products and services; known for its proven capabilities in developing fashionable, personalized, high scale content and imaginary products and services..

The second major tie-up which has been of great significance is our association with MediaTek. MediaTek, as you may be aware, is currently the world's largest chipset manufacturer and the fourth largest fabless semiconductor company for wireless communication and digital multimedia solutions in the world. It is also the second-largest of all worldwide semiconductor companies in the field of mobile phone chipsets. MediaTek has acquired in July 2011 10% stake in our VAS business, Spice Digital which I mentioned in the last conference call. These tie-ups will aid us in implementing similar strategies that have enabled S Mobility's product dominance in the international regions. The possibility for customizing handsets for our expanding geographies is almost limitless through which we can now appeal to a broad spectrum of an audience. As purchasing power parity of rural consumers increases due to higher disposable incomes, the demand for better feature rich phones in rural areas increases as well. Moreover, we are witnessing an upward trend in the usage of data networks such as 3G, aiding S Mobility to retain its position in this challenging economic environment.

You must be aware of the S Group's acquisition of certain companies outside India. These are not S Mobility but S Group's acquisitions. S Group's acquisition of Nexian will benefit us positively. Nexian has actually created a success story in reaching out to customers in Mobile Internet space in Indonesia. We will look to leverage the experience gained in a mature 3G market and replicate the same in India.

Operationally, S Mobility has evolved into a strong Company with an established market presence over the last few years. I talked about the cluster strategy in the last conference call. We are achieving considerable traction through our 7 cluster strategy which is enabling us to enter new geographies, especially in South India. We have seen significant success in the last couple of quarters with respect to our cluster strategy.

Internationally, we have expanded our presence in South East Asia and Africa, mainly in the Value Added Services space.

Coming to the numbers, we sold 2.1 million handsets during the quarter under review, up 21% compared to corresponding quarter in the previous year. Our new device launches have been well received, these include the Cappuccino music phones and a range of android-based smartphones. In fact we were the first to launch an android phone which has an extended battery life.

Value Added Services business has also done well with new offerings and products. Value Added Services achieved revenue of Rs 622 million during the quarter, up by 14% compared to the previous year in the same quarter.

Product and service agreements with major networking players, platform players like Google and Facebook will further strengthen the product service portfolio and market presence.

We are also encouraged by the performance of our retail business which I am glad to mention is now PAT positive. We are the first Company in the Mobile Retail space to have achieved this. We have currently 829 Spice Hotspot stores across 173 cities, smartphones constitute 55% of the retail sales, which is an indication of the growing market for smartphones. Our total revenue for Q2 FY2012 stood at Rs. 5,407 million as EBITDA amounted to Rs. 206 million while PAT stood at Rs. 120 million.

I want to draw your attention to the fact that the company is in the investment mode currently. It is investing in people, marketing and products. Hence, you will see that there is a higher cost, which has been incurred in the last couple of quarters as compared to the last year. This has actually resulted in diminishing profit for the current quarter and compared to the last quarter. We are however not really worried about the fact that the profitability has taken a dip, because we continue to believe that our strategy of investment in markets, people and brand will eventually augment our market share and enable us create considerable value.

I will conclude by saying that we are pleased with the way our business is evolving. Of course, the macro environment continues to be challenging. I do not discount the fact that there are more and more local brands, which are stepping into the market, hence margins are under pressure. However, I believe our sound business model, deep understanding of the Mobile Internet space and strong tie-ups will enable S Mobility to continue to grow and create value.

This brings me to the end of my opening remarks. I will now be glad to take your suggestions and questions and provide you with whatever answers I can. Thank you very much.

**Moderator** Thank you sir. We will now begin the question-and-answer session. We have the first question from the line of Shobhit Khare from Motilal Oswal. Please go ahead.

**Shobhit Khare** Good afternoon sir, and thanks for the opportunity. A couple of questions; one is on your Retail business. I am looking at the 7% same-store growth that you have reported. I was just wondering given that there has been a 3G launch, etc., has there been no momentum in the ASPs or in the volumes because of 3G? When do you think the growth can pick up because of 3G further increasing the demand in smartphones? Secondly with respect to VAS, there have been recommendations from TRAI from double confirmations and a lot of confusion. How is that going to impact our business? There is a lot of discussion with regards to increased insourcing by service providers. Any comments on that?

**Subramanian Murali** Let me address the first question with regards to Retail. As I said, Retail has achieved profitability at PAT level. Our focus in Retail is market share and profitability. In the last four quarters we have seen that the profitability has considerably improved. We achieved EBITDA breakeven three quarters before and now we have achieved PAT breakeven. So to some extent, there has been an impact on the same-store growth, but we will live with that because going forward we know that once we are a profitable company we will be able to catch up in terms of growth. The second reason is related to the quarter. The period July-August-September is also a lean quarter as far as the business is concerned. We will witness same store growth during the October-November-December period, which is the festival season. Having said that, we are looking at a 10% same-store growth. Our objective is to achieve same-store growth and increase the presence in Retail by increasing our reach from 800 stores to 2000 stores. This will give us a higher market share.

With respect to Retail ASPs, we have seen improvement in ASPs but not very significantly. For example, it I need to state numbers, it has gone up by about 5% compared to Q1, and up 5% in Q2. There will be some incremental increase in ASP as consumers shift towards feature rich phones.

**Shobhit Khare** If I may ask, if the same-store growth is going to be in the similar ball park or maybe lower, what is the store level EBITDA margin which we have in our existing stores which are reasonably mature?

**Subramanian Murali** In an established store, we look at a 2 to 3% EBITDA margin. Once the store is 12 to 24 months old, we can achieve a 2 to 3% EBITDA margin. With respect to your question on Value Added Services, yes, the TRAI regulations are going to have some impact on the revenues, because as you know, our operator business is completely driven via relationships with operators. We are seeing a lot of changes from the operator side. They are also concerned about the TRAI regulations. They are making a lot of internal changes to ensure that they fall in line with the TRAI regulations. It is likely to have some impact. If you want me to quantify this, I do not think I can, but it is likely to have some impact in the next two quarters. As and when the operators comply with all the guidelines, that is when we will witness a decline in revenues. One of our de-risking strategies is to also look at opportunities beyond India. As I have mentioned it in our previous calls, we have been expanding outside India into Africa. Currently, the revenues from outside India stand about 10-12%. As we move forward two years from now, we expect outside India revenues to be around 25-30%. That is one of the factors which will de-risk us from being affected by TRAI regulations.

**Moderator** Thank you. Our next question is from the line of Rajat Gupta from JP Morgan. Please go ahead.

**Rajat Gupta** Thanks for taking my question. Your handset shipments for Spice Mobility phones have actually declined quarter-on-quarter. So I was just wondering what the reason is? Is this directly co-related to the poor mobile subscription trend observed in Q3 or is it a company-specific issue?

**Subramanian Murali** It is not a Company-specific issue. The period during Q2 is a season of comparatively lower revenues. If you see last year too we saw a decline. This has been cyclical in nature. Having said that, yes, there is a lot of competition for the low end handsets. Currently, we are focusing on feature rich phones competing in the category of Rs. 1000 to Rs. 4000 handsets, which is where we witness maximum competition. This is why we are trying to create relationships and partnerships with MediaTek and Tinno where we can move up the value chain to smart feature rich phones and smartphones. We will then witness growth in terms of revenues.

**Rajat Gupta** Just a follow-up, so smartphone as a percentage of Retail sales 55% and this is down from 60% in the last quarter. If you look at the numbers, the absolute number of smartphones have actually declined but your ASPs have gone up. So do we see ASPs facing more pressure going forward or how do we see this trend going forward?

**Subramanian Murali** ASP pressure at the low end will always be there. For example, if I launch a phone at sub-Rs. 1000, then obviously ASPs are under pressure. We need to really balance it out with launching phones at the high end and moving up the chain in terms of smart feature phones and smartphones, which is not likely to happen within one or two quarters. It is going to be witnessed over a longer term. It is going to take a minimum of 4 to 6 quarters to observe the same. Hence, ASP pressure will continue to exist. I do not think smartphone sales in Retail are actually declining. If there is a decline from Q1 to Q2, it is a temporary phenomenon. Infact, we are currently witnessing an increase in smartphone sales. So if I have to give you some data on the industry, smartphone sales have increased in terms of volume, from a 3% market share to 6% in the last one year, and in terms of value it has increased from 10% to 21%. We will witness the impact of the same in our Retail business also.

**Rajat Gupta** Thanks a lot.

**Moderator** Thank you. Our next question is from the line of Srinivas Rao from Deutsche Bank. Please go ahead.

**Srinivas Rao** Thank you very much for taking my question. Firstly, could you throw some light on the replacement cycle of mobile phones in India? What is the rate for 2 – 3 years, or even higher than that? Secondly, when you mentioned 55% as smartphones, are these necessarily 3G phones? Thirdly, could you throw some light on your Spice branded handset margins versus third-party handsets? I will ask the rest of the questions after this.

**Subramanian Murali** The replacement cycle is actually reducing. Three years ago the replacement cycle of a phone used to be three years. When we look at the market in terms of the new subscribers and the replacement users, predominantly, it was the new subscribers which were a contributing factor for market size. But now things are changing. Now, the replacement cycle is less than two years, or I would say in some other phones it is 18 months. One of the projections we have when we did an exercise with McKinsey is that three years from now, more than 70% of the market is going to be replacement market. So the market is moving quickly towards the replacement market and mainly moving towards the smart phone category.

These are the two major changes which are happening. So we do observe a replacement cycle within our own segment, We predict that replacement period will soon reach one year per handset. As of now, it stands at 18 months.

With respect to smartphones comprising of 3G phones, I would say, no. The 3G phone is a sub-segment of smartphone. So when I say 21% value share of smartphone it includes 3G and 2G.

**Srinivas Rao** What is the margin on your Spice branded handsets and the share versus third-party handset margins at the store level?

**Subramanian Murali** The range is between 10 to 20%.

**Srinivas Rao** For you the Spice handset?

**Subramanian Murali** Yes, it is within that range.

**Srinivas Rao** Just taking on the point of replacement sales increasingly becoming important. With respect to that, have you seen any numbers or have you tracked as to how many people who buy a Spice handset come back and buy a Spice handset or upgrade it over one or two replacement cycles?

**Subramanian Murali** Is your question related to the repeat sales for Spice?

**Srinivas Rao** With respect to repeat sales of Spice and upgrades. What is the percentage of people who do that? And in that context, I assume that brand building becomes an important factor.

**Subramanian Murali** Currently, it is not too high because we are now consciously focusing on creating a CRM and then offering some loyalty programs to our customers.

**Srinivas Rao** With regards to your VAS strategy, as you said, you are a white label VAS provider in conjunction with the telecom carriers. How much of your VAS business comprises the same?

**Subramanian Murali** Currently, the entire VAS business is through white label with operators and that is why when I talked about MediaTek's investment in Spice Digital, it is to move this business away from an operator VAS to a device VAS business where we work with MediaTek and work on their platform, creating applications which will further be embedded on to our handsets. The person using the handset will be using Spice service with operator being a provider for the bandwidth. This is a long-term goal. That is the fundamental reason why MediaTek has invested in Spice Digital.

**Srinivas Rao** In that context, device-based VAS is what an Apple or a Google produce. They have large software platforms and have managed to succeed in that. What will make S Mobility's VAS succeed in terms of size?

**Subramanian Murali** Device VAS will be the key. It does not mean that we are moving away from the operators. I will give you an example. I talked about S Group which acquired Nexian in Indonesia. They have developed their own messaging system, which is equivalent to a BlackBerry Messenger, BBM. So they have a subscriber base of more than 10 million in Indonesia through this which is embedded into the handsets. And then there is an e-mail system which is again embedded into the handsets, similar to BlackBerry e-mail. Nexian also has a Facebook application which can be operated from a feature phone. So in today's technology it is possible for us to embed certain applications even in the feature phone. You do not need to upgrade to a smartphone. This creates differentiation amongst handsets. There are handsets which may have this feature and some handsets which don't. Though, they are still routed via operators. As far as the device is concerned, this is a clear differentiator.

**Moderator** Thank you. Our next question is from the line of Rajiv Sharma from HSBC. Please go ahead.

**Rajiv Sharma** Thank you for the opportunity. I have a couple of questions. First, I just wanted to understand the kind of traction you expect in the African VAS space. Basically, what are the products or what would be the typical services that you will sell? The operators are mostly dependent on the 2G VAS space. Can you also throw some light on Bharti specific markets, which is where you are associated with them? Secondly, I would also like to understand the current size of the replacement handset market and how much of this is now moving towards 3G, and what is your long-term, 12-18 month perspective on that?

**Subramanian Murali** As far as the VAS Africa business is concerned, what we are seeing is that it is similar to the Indian market. We've been present in Africa for 18 months now. We have observed that, what sells in India, sells in Africa too. The profile of the people and the demographic nature is more or less the same. Again, in Africa you divide the region into South Africa and the rest of Africa. South Africa is mostly a 3G market and has predominantly been one.. I believe that the penetration is very high. The rest of Africa can be compared to India. VAS services like PRBTs, mobile radio, social networking and live streaming sell well in Africa. . Music is a big business in Africa. Mobile Radio from Spice Digital is a big business. Music and CRBT in Africa also are the two of the top businesses currently. And as far as operators are concerned, yes, we are working closely with them in Africa. For example, we work with Airtel in Tanzania and Kenya. And then we provide similar services what we provide in India, whether it is Mobile Radio, CRBT, live streaming services and others.

On your second question with regards to the replacement market, I do not have the figures right now, but I think currently the replacement market stands at more than 25%.

**Rajiv Sharma** Can you please state the numbers?

**Subramanian Murali** My estimate of the overall market in India is almost 15 million handsets per month. The replacement market will range from 25% to 35%.

**Rajiv Sharma** Is it a 5 million handsets per month market?

**Subramanian Murali** Yes.

**Rajiv Sharma** A 60 million handset market, that is the annual size?

**Subramanian Murali** Yes. Around that number.

**Rajiv Sharma** Does the 15 million includes the replacement market?

**Subramanian Murali** That is correct.

**Rajiv Sharma** So the current market is 180 million, out of which 120 will contribute to new sales and 60 million will constitute the replacement?

**Subramanian Murali** That is correct.

**Rajiv Sharma** On the mix of handsets in the replacement market, what is your outlook on 3G-enabled phones?

**Subramanian Murali** People are not specifically demanding for 3G-enabled phones because 3G has not caught full momentum as yet in India. It is only the manufacturers who are producing 3G-enabled phones. As far as the customers are concerned, 3G is just an additional feature they opt for. 3G handsets currently are not demanded to that extent because of the 3G network which has recently been launched. We sell android phones which are also 3G enabled but customers still use 2G networks on them.

**Rajiv Sharma** Since you are focusing on Retail, is it going to hedge you from the stringent TRAI recommendation in anyways?

**Subramanian Murali** No, I think these are unrelated. The TRAI recommendation is on the Value Added Services business and the only hedging we can do against TRAI regulations is to coordinate with the operators and increase the usage of the services by the customers. We keep launching services which the user wants. I keep quoting this particular example of 'live aarti', for example, when we come out with a service where people can listen and see live aarti happening in Tirupati at 6 am, proves to be a great Value Added Service for a user. So hedging will happen by creating more and more services which will create customer stickiness amongst our consumers.

**Rajiv Sharma** Just one last question, and this is just to understand if video-based services, you mentioned like live aarti and video-based services, video is something which has no language barriers, and if 3G is to work in India. Do you think the Rs. 4000-5000 3G handsets will be able to really give a good video experience? You are also into the handset segment along with Value Added Services. So, just wanted to understand your outlook on the same.

**Subramanian Murali** My answer is eventually, yes, because the Mobile handset industry is witnessing similar trends to the PC industry where a consumer got more for the same price you paid for initially. Secondly, companies like MediaTek are manufacturing chipsets that offer features similar to a phone that costs Rs 25,000. Phones with Mediatek chipsets offer the same features in the range of Rs 6000 to Rs 7,500. Going forward, we see the trend moving towards sub-5K phones. With sub-5K phones you will get better experience not on video alone, but on various other services.

**Rajiv Sharma** Which means the cost of various inputs which are incorporated, will also eventually reduce?

**Subramanian Murali** That is correct.

**Moderator** Thank you. Our next question is from the line of Rahul Mehta from Lucky Securities. Please go ahead.

**Rahul Mehta** Just wanted to check on the growth prospects for traditional CRBT and radio services that you are offering on the networks. What are the growth prospects? Will it keep grow or is the industry already saturated?

**Subramanian Murali** It will keep growing, but will not grow at a substantial rate. It will primarily grow because of our penetration into the rural market which we strategize on by increasing our presence across the country.. Secondly, it will grow in Africa, like I said that we are offering the same services in Africa as well, But we need to launch more products for 3G,, like video services and handset embedded services which I have already spoken about. . This is not the end of the road for CRBT or Mobile Radio. At the same time you cannot build a business for the next 10 years only based on this. We need to keep rolling out more products. That is what we have continuously been doing.

**Rahul Mehta** So what is the growth rate currently in traditional products, about 15-20%?

**Subramanian Murali** The traditional products stand at about 20%. Yes.

**Rahul Mehta** What would be the penetration of mobile radio and CRBT services today?

**Subramanian Murali** It will not be more than 10-15%.

**Rahul Mehta** 10-15% of the carrier base?

**Subramanian Murali** Yes.

**Rahul Mehta** Would that be the same number in Africa?

**Subramanian Murali** No. We just recently entered the market.

**Rahul Mehta** So the penetration itself is very low out there right now?

**Subramanian Murali** Yes, for the VAS services.

**Rahul Mehta** Where will you be sourcing the content for that market?

**Subramanian Murali** We have exclusive tie-ups with various players in Africa, who are sourcing content for us exclusively. Whether it is music, CRBT or any other services that we supply, we have local players who we associate with. We either go and tie-up with a person who has content or sometimes we even tie-up with agencies who can create content for us. For example, in India, Jaipur, we have created separate content for the Rajasthan community in Bhojpuri. Similarly, we can create our own content using artists.

**Moderator** Thank you. Our next question is from the line of Vivekanand from MF Global. Please go ahead.

**Vivekanand** Thank you for taking my question. I had a query on the handset ecosystem. Right now we have been hearing key operators talk about tying up with handset manufacturers to launch 3G featured handsets and they mentioned that the key in enhancing penetration would be the price and features available for a sub-5K handset. So have you been involved with operators who have showcased interest in manufacturing customized phones?

**Subramanian Murali** You are absolutely right. When we keep talking to operators whether it is in India or in Africa, we do get similar demand from the operators in terms of launching phones around the sub-5K category, which could be smart feature phones exclusively for them. So we are working with few operators and then we keep launching a few phones for them. But, yes, you are right. That is one of the requirements from the operators.

**Vivekanand** Specifically, are you seeing any such phones getting launched in India right now?

**Subramanian Murali** We will be, yes, we are working on a few deals with operators.

**Moderator** Thank you. We have the next question from the line of Srinivas Rao from Deutsche Bank. Please go ahead.

**Srinivas Rao** I wanted clarity on margins for your VAS. It seems that the margins have declined. So could you throw some light on what kind of margins you have right now and the trends in your VAS business?

**Subramanian Murali** You are talking about reductions from the last year or last quarter?

**Srinivas Rao** Last year.

**Subramanian Murali** Yes, it is a fact that the margins have declined in the Services business. I think I mentioned in the last conference call, that from a 25% to 30% of EBITDA margins have declined to around 20%-23%. And a couple of reasons I think I mentioned in the last earnings conference call. There are three reasons; there have been attempts by TRAI in terms of regulating this particular industry in the past which has affected the top-line of the operators. Secondly, the content costs have been increasing, we source content, that is the reason why I mentioned in the last question that we want to create our own content as well. If content prices increase, that will reduce margins. Thirdly, we are investing in manpower and infrastructure in Africa. In the last 12 to 15 months we have ramped up our manpower strength in Africa. We have close to 70 people sitting in Africa right now. So these three reasons are the main drivers for the drop in EBITDA margins to 20 to 23%.

**Srinivas Rao** Just wanted content costs and agreements with regards to the same.

**Subramanian Murali** There are two types of agreements; one is the pass-through agreement where we just pass the content cost to the operators, but mostly our agreements enable us to enter into agreements with operators for revenue share where everything else is managed by us, including the content, infrastructure for the operator and managing the service end-to-end. So if there is an increase in content cost, we may not be able to pass on all the costs to the operators.

**Srinivas Rao** You had indicated last time that you are looking at M&As in the app space, so any progress on that or anything you want to share?

**Subramanian Murali** We have looked at a few companies in the VAS space, and I think last year we acquired one company in Singapore. We have not really finalized anything as of now. But we are continuing to look at M&A opportunities in this space, especially outside India.

**Moderator** Thank you. As there are no further questions I would now like to hand the floor over to Mr. Subramanian Murali for closing comments.

**Subramanian Murali** Thank you everyone for listening into this conversation and also asking the queries. I hope I have been able to answer most of your queries and in case you have any further queries you can always write into our Investor Relations and we will be happy to get in touch with you. Thanks for giving me the opportunity.

**Moderator** Thank you. On behalf of S Mobility Limited that concludes this conference. Thank you for joining us and you may now disconnect your lines.