Presentation Transcript
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City Telecom (HK) Limited
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Intro with Service Demo (slides 1-2)
In Hong Kong, we provide the world's fastest broadband residential service of symmetric 1Gbps at what we believe to be the best value in the World, at US$26/month. This is side by side download demo of a video of 1.5GB in size. On our Fibre service it takes about 15 seconds to download. On the incumbent's copper network it would take about 52 minutes. To put this in perspective, Verizon FiOS fastest plan runs at 50Mbps download and 20Mbps upload and costs US$140/month. What we're seeing now is more and more applications that can take advantage of this bandwidth, such as youtube in High Definition, movies on facebook etc. We're ahead of the curve in terms of having a cost effective commercial service to deliver this bandwidth.

Company Background (slides 3-5)
Our Company background… We were founded in 1992 by two cousins – Ricky Wong and Paul Cheung with about C$100,000 and with about ten people. Today, 19 years later, we're a US$500 million market cap Company with about 3,000 colleagues, listed in Hong Kong and NASDAQ. We're the fastest growing broadband service provider in Hong Kong and currently the second largest.

What I'd like to share with you is our corporate vision as it is different and unique to us. A lot of companies have vision statements on their website. Enron had a great vision statement set in marble in its lobby. With a lot of corporate vision statements, you can change the name of the Company and you wouldn't know the difference. But ours is very specific to us. If you look at our core value, it talks about "experience of the motion of competition, winning and crushing competition". We have set a 10 year Big, Hairy, Audacious Goal (BHAG) in 2006 to become the largest broadband provider in ten years time by 2016. And it ends with saying – "my children will say, "Dad, I love you as my father."" That means we want to make a positive lasting impact on society with the services we're delivering today. I think we've done that. In the last 19 years that we've been around in Hong Kong we've made communications a lot cheaper and a lot better by stimulating competition for the benefit of society in general, and at the same time, made a lot of money for our shareholders.

Fibre-To-The-Home is a Global Trend (slides 6-9)
Now, Fiber-To-The-Home is not unique to Hong Kong, it is happening everywhere. In the States you're seeing Verizon FiOS doing quite well. You're seeing FiOS and other Fibre subscriber take-up accelerate as copper is starting to see a sunset curve. In Japan you already have more Fibre users today than there are copper users since 2007. So, the Fibre take-up around the world is happening everywhere. The primary difference between the US experience and us in Hong Kong is cost. In Hong Kong we have 16,000 people per square mile versus 80 in the states. It is this super density of affluent people living on top of each other that allows us to build our Fibre network at about one-fifth to one-tenth of comparables around the world. It costs us about US$200 per home pass, versus I believe Verizon FiOS at closer to US$1,500.

So, in the US, consumers love the Fibre service but investors are concerned about the investment costs. In Hong Kong, we have the benefit of both. Our consumers love our service and the cost base is very low so that our shareholders can earn good returns. This is why we can afford to charge what we charge, less than one-quarter the cost of FiOS in the US and still have great returns.

Recently, last year, we were awarded the best fixed line carrier in Asia. This is across all of Asia, not just in Hong Kong.

Our Corporate Culture (slides 10-11)
To show you our corporate culture, I would like to play this video of our town hall meeting which is held every six months. We are very different to your traditional legacy telecom operator. We're a new kind of new entrant and our culture is very different with an entrepreneurial bias. We have over 3,000 colleagues spread between Hong Kong and Guangzhou. This is William, our CEO. He's a former policeman. We talk about going to war, about taking market share. We talk about crushing the competition.

Also, our executive compensation is very long-term. Our compensation is actually structured towards achieving our BHAG, so our BHAG is much more than a slogan that sounds cool on our website. I think a key difference in our Company is our ability to take a long-term view. Today, are harvesting the investment that we have made over the past decade. It took us seven years to hit positive free cash flow. We joke that ifwe our founders didn't maintain majority ownership in the company, they would have been fired and replaced well before inflection point was reached.

We started investing in Fibre in year 2000 when everybody else was cutting back on capital expenditure after the Internet bubble bursting. It took us seven years to hit positive cash flow after capex but ever since that inflection point our margins have been increasing. Not a lot of companies have the appetite to eat seven years of negative free cash flow before turning positive.

To give you an idea of the culture we have in the Company, we have a graduate trainee program called CXO of the future, with the "X" being a variable for CEO, CFO, CTO etc. Essentially, I'm looking for my upgrade in say 15 years time. We hire fresh graduates from university and then put them through very extensive 18 month program with the aim of eventually becoming a CEO, CFO, CTO, ete. We ask these new hires to read a book a month, to run a half marathon, to sit the CFA Level 1. This year we have 1,300 applicants and we are likely to take only two. That gives you an idea of the culture we have in our Company.

Introduction of Private Bank Style Account Management (slide 12)
We're also pioneering something on the Customer Engagement front. A lot of telecos have an ex-monopoly mentality. You call a service hotline, then you press one for English, two for Chinese, thee for mandarin etc etc. There's a long waiting period and then often you get passed around departments. We're moving away from this legacy model. We have moved to private account management where each one of our broadband customers has a dedicated account manager that will service you. In Hong Kong, if you wanted to open up a private bank account with HSBC, the leading bank in Hong Kong, it requires a minimum balance of US$150,000 to set up that account. In our case it's US$26 a month and you already enjoy the attention of a dedicated account manager. So, not only are we trying to differentiate on the service and the brand, but also on the Engagement with our Customers.

A Disruptive Impact … Never Me-Too (slide 13)

What we're trying to do is have a disruptive impact, i.e. change the rules of the game, and pull the rug away from underneath the legacy incumbents. I mentioned there are a lot of things we do that contradicts incumbent mindsets. I understand in the States, a lot of the incumbent telecos here talk about avoiding commoditization of bandwidth, avoiding over the top content providers like Netflix, Google, iTunes etc. US carriers have even proposed to impose bandwidth surcharge for high bandwidth users.

We think differently. We embrace over the top companies. We love people who burn up the bandwidth, because we have excess bandwidth. In an environment where a lot of people use a lot of bandwidth, we will shine with our Gigabit infrastructure. So, we think differently from the incumbent and proactively seek to make a disruptive impact. In short, we love being in the Fat Dumb Pipe business, because this is what we are good at doing. You can see similar disruptive changes like Netflix had on Blockbuster or Netflix on Comcast or Amazon on Barnes and Noble and in our case you can see our share price versus the incumbent over the last couple of years. It's a very similar kind of trend.

Free TV over Fibre (slide 14)
Free TV over Fibre is a new growth opportunity that we are chasing. We have applied for a Free TV license and we hope to get that in the next six months or so. If we do, we would deliver Free TV over Fiber. This would be an incremental revenue stream. This is different to Pay TV in the sense that you don't need a set top box. So, the addressable market would be a lot higher. By the end of the year, we should approach 2.0mn homes pass with our Fibre, and assuming 2 TV per home, then we will cover 4.0mn TVs, which is 4x more than the two leading legacy pay-TV operators. We hope to bring a lot of international content into Hong Kong to challenge the decades old status quo of dominance by two local terrestrial Free TV operators. This initiative will allow us to derive another revenue stream from our sunk Fibre investment.

Focus on Executing Well in Hong Kong (slides 15-17)
A lot of people ask us, as Hong Kong is a "small and matured" market, do we have ambitions to get into China? Do we have ambitions to go regional? Our focus right now is on Hong Kong. We do look around but we have very high hurdle rates. If you look at this chart, the small circle is us and the much larger pie is the incumbent. So, for us there's a lot room for us to grow by taking market share in Hong Kong. If we can get our execution right, I think there's a lot of upside. The incumbent enterprise value is US$8 billion versus our enterprise value at US$0.5 billion. If we execute well in the next three to five years, I believe we can get to a quarter or maybe even a third of the incumbent's enterprise value. This means a 4x to 5x bagger for us and as we are managers who own 53% of our company, this very much motives us. This is why we're so excited by the growth in Hong Kong and want to focus on execution.

Fibre is in a High Growth Era (slide 17)
Another point – many investors have a misconception about broadband growth potential in Hong Kong, considering the market as matured and saturated. Yes, 85% of households in Hong Kong have a broadband connection but only 35% have FTTH and we are the market leader with about 60% of the FTTH segment. So, we are in the middle of a growth era for Fibre. It's like looking at 3G or 4G today. The growth potential is very high because it's replacing 2G. Likewise, we are in the process of substituting copper for Fibre today.

Five Year Tend Shows Benefits of Operational Leverage (slide 18-19)

This is our five year trend. You can see a material turn around starting in about 2007 and since then our profit growth has been accelerating. This is because the operational leverage we have inherent in the business. Our guidance for this year, we're looking for about a 25% increase in EBITDA, driven by operational leverage in the business. We are now the price dictator in Hong Kong, so when we cut prices, the incumbent follows us and when we raise prices, the incumbent follows us, although they tend to be less aggressive on the way up. Three years ago, we were the fourth operator, the smallest of four operators in Hong Kong, but today we're the second largest and our market share is bigger than the next two combined.

So, we offer incredible value. Hong Kong is a very rich city similar to New York City. Yet the price we pay for our broadband is US$26/month all-in whether it's our 1Gbps to the home service or our triple-play with 100 Mbps. So, it's a very affordable service that we offer. Prices in telecoms in general are very, very low relative to the Hong Kong's GDP. Basically every family in Hong Kong can afford our services.

Structural Fibre Network Advantage (slide 20-21)
We have a structural advantage. The simple way of thinking of our network is we've built a local area network (LAN) similar to what you would typically have in a corporate environment but taking it to mass scale across Hong Kong. In this is hotel, when you go back to your room, your broadband is provided by an Ethernet port, rather than having an xDSL or Cable modem in each room as it will be prohibitively expensive to have a modem in each room. Our network is basically what you have at this Mandarin Orient hotel, scaled up to 1.8 mn rooms. This is why our costs per port is actually cheaper than a traditional telephone network yet our performance is much higher. We can do this because we've taken advantage of the density of Hong Kong.

Structure Operating Cost Advantage (slide 22)
Supplementing our structural Fibre network advantage is our structural cost advantage. Almost half our 3,200 colleagues are based in Guangzhou. Guangzhou speaks the same Cantonese dialect as Hong Kong and is a two hour train ride away from Hong Kong across the border. The salary cost in Guangzhou is about 1/3 of that in Hong Kong and the talent pool for call center executives is much deeper. So imagine you have New York revenue but Mexican cost base, that what we have. This allows us to scale very nicely over time because as we move from acquisition to retention, the cost base natural moves from Hong Kong to Guangzhou, as acquisition is done in Hong Kong but retention is down by our call center in Guangzhou. This is what is driving our margin expansion.

Dominating Growth in Hong Kong – 93% Market Share of Net Growth in FY2010 (slide 23)
If you look at this chart, there are four key operators. The top blue line is the incumbent's reported subscriber base which is showing a flattening trend. The red and the green, are our two other competitors and both are showing flat or declining trend. The orange is us. What's more insightful is if you look at the right-hand side of the slide, which shows the change in subscribers. You can see the incumbent is falling off a cliff in terms of the growth rate and we're the mirror image of that as we are taking their market share. This is why we're confident that we are on track to reach our BHAG to be bigger than the incumbent by 2016. Today, PCCW and us, dominate the market with nearly 80% market share, making the market dynamics duopoly like.

Competitor Analysis (slide 24)
PCCW is the incumbent. They actually enjoy great EBITDA margins. You want to compete with a profitable incumbent. You don't want to compete with an unprofitable incumbent because they set the

umbrella pricing. They enjoy 43% EBITDA margin on the core telecom business whereas we are on 30%. We'd be happy to meet the incumbent somewhere in between and enjoy 35-40% together as the two industry leaders. The other competitor Hutchison is mainly a mobile operator and residential fixed line is less than 8% of their group revenue base. So, their focus is not really on the residential space which is our key focus, as residential fixed is 85% of our revenue base and this is what we are good at and is what we are focused on. And our final competitor is a pay TV operator, i-Cable and their subscriber base has been in structural decline over the last three or four years, peaking at about 330,000 in 2006 and falling to below 250,000 by 2010.

Now, perhaps we'll jump into Q&A.

Questions and Answers

Question 1: You talked about your pricing being at about US$26 (HK$199) a month but feeling like you have pricing power. Why don't you raise price?

Answer: There is pricing power in that when we cut price our competitors follows and when we raise price, our competitors follow. A year ago we had a very aggressive offer, US$13 (HK$99) for broadband services and our competitors followed on price but could not match our Fibre performance. That's why we dominated the market taking 93% of the net growth in the market in a four player marketplace. Then starting on September 1, 2010, we doubled the price to US$26 (HK$$199). We found that our churn still remains at less than 1.0% per month which evidences the addictive nature of our service. I think overall that telecom prices as a whole in Hong Kong should be very cheap because the cost to produce the service is very low because of our density. So, US$26 is a reasonable price for us to charge.

Question 2: So, you see that as kind of fair and where you'll stay for the time being? Is that a good way to think about it?

Answer: I think we can do that -- our margins will still go up as we price US$26 (HK$199) into our model, as it takes two years to roll through the 24 month contracts. Also, our margins improve over time, as our business evolves from acquisition mode done in Hong Kong to retention mode done from our Guangzhou call center operations.

Question 3: And you talked about your network architecture having a fundamental advantage in allowing you to deliver much faster speed at lower cost. Do you feel like you're going to be able to maintain that network advantage even as you grow your subscriber base?

Answer: Yes. Our network is incredibly scalable, not quite future proof but certainly very future friendly for the next couple of decades or so. Only 25% of our total capital expenditure, and we've put about US$450 million into the ground since our business inception, is electronics and the electronics mainly come from Cisco. In 5-7 years cycles or so we upgrade the electronics and then get a logarithmic increase in capacity. The Fibre, as you know, is passive and it's pretty much unlimited capacity for the foreseeable decade or so. When we launched the service in 2000 we offered 10Mbps as core service, then in 2005 upgraded to 100Mbps and now in the process of upgrading to 1Gbps, all without major investments in capital expenditure.

Question 4: So, what about expansion beyond Hong Kong then? Is your focus solely on Hong Kong at present or do you see yourself expanding into China?

Answer: We would look at other markets but our focus right now is on Hong Kong. As I mentioned, Hong Kong is a great market for us -- it's a big, big market relative to our scale today. Our goal is to become bigger than PCCW by 2016 for residential broadband in both subscriber number and ARPU.

Question 5: How are you thinking about leverage? I noticed you are net cash.

Answer: Yes. We all gone through business school, Finance 101 but the issue for us is that we're the new guys in town and we're taking on the incumbent. We're the David versus Goliath, so, going into the fight, we want to ensure we have a very strong foundation (balance sheet). I think that sends a very strong signal to our competitors, not to try and play games on the finance side, like going into a short-term price war, because we'll be here to see it through. Our balance sheet is that strong.

Question 6: Do you see that potentially changing going forward? If you want to make incremental investments, will you need debt? Or is there really no need to significantly ramp Capex going forward?

Answer: If there are new business opportunities like Free TV and other kinds of related opportunities, there's a possibility we could use some debt. As we have very strong free cash flow generation, our ability to service debt is also very high. In fact, we expect to double our free cash flow (after capex) as we are currently running at about 12% free cash flow margin with 32% EBITDA margin less 20% capex-to-sales. In FY2012 and beyond, we expect EBITDA margin to go up to about 35% and capex-to-sales to half to about 10%. So, our free cash flow should actually look very, very nice doubling to about 25% of revenue, in the coming years because we basically finished the network after about 12 years of investing. In short, we target to reach with our Fibre 2.0 mn out of total 2.35 million homes in Hong Kong, leaving out the low density areas. We joke that “we don’t do rich people” living in standalone mansions in Hong Kong, leaving them stuck with a legacy copper service, i.e. a reverse Digital Gap.

Question 7: Could you maybe expand a little bit more on the Free TV service?

Answer: Sure. Free TV is unique in Hong Kong in that the far majority of people have access to terrestrial free TV via a central coaxial system that is owned by the apartment complex. We will tap into the central coaxial system with our Fibre and then deliver Free TV. We're going transform the market from a four channel environment today, and disruptively introduce dozens of channels from around the World, similar to what you have in the States. Whereas Hong Kong is very advanced in most aspects like mobile phones, broadband access, it's way behind the times in terms of Free TV. We hope to bring Hong Kong forward to the 21st century.

Question 8: So, this would be effectively a video offering that you'd be providing alongside your broadband?

Answer: Yes. It's an advertising driven mobile, not subscription driven. There's no need for a set top box as we are sending unscrambled TV signals via the existing the central coaxial systems. With our Fibre approaching 2.0 mn homes pass by the end of the year and assuming 2 TV per home, we will have 4.0 million TVs coverage, which is 4x more than the two legacy pay-TV operators at about 1 mn each. Any

TV that is connected to the central coaxial system would have access to our Free TV, irrespective of the household being our customer or not, similar to tuning onto a new FM radio station.

Question 9: Why wouldn't you charge subscription?

Answer: Because we don't have a set top box, we can't and we don't want to. The beauty of Free TV is that it is Free, so take-up can be very accelerated. We don't want to be a me-too follower of the pay-TV operators, in fact we anticipate that we will destroy a lot of value in the pay-TV sector by converting traditional pay-TV viewership to Free-TV. As we don't have a million expensive set top boxs to maintain, so we can be profitable at much lower revenue points than legacy Pay-TV operators, i.e. another disruptive opportunity.

Question 10: What if the incumbent copies your Fibre deployment?

Answer: They are but it took us 11 years to get here today, so we expect it will take them a few years to catch us. Furthermore, it is more than the hardware, it is a combination of our improving brand, our superior bandwidth, and our Talent's mindset towards customer engagement. We mentioned account management. We're the only telecom carrier in a major city that I know of that is offering private account management for every one of our ½ million broadband customers, i.e. leave no customer beyond. I think if you've ever waited on a hotline you can appreciate the benefits of private account management, whereby each of our customers enjoys the attention of a dedicated account manager and access by direct telephone line.

Our approach is we're fundamentally different. We're disruptive. That's the way we approach things. We love it for you to go and burn bandwidth, as we have the fattest dumbest pipes in town. We love it for you to go watch big fat high definition videos and download and exchange content. We have the bandwidth and our competitors don't. We're love it for companies like Netflix, iTunes, Hulu etc and will embrace them to come to Hong Kong. Rather than net neutrality we will offer net affirmative action. I think I shared that with you when you were in Hong Kong, that we love it for Netflix to come to Hong Kong but they haven't because of copyright issues. If they wanted to come, we will embrace them and welcome them with open arms.

Question 10: How is PCCW responding competitively? Clearly you're taking a lot of share right at the moment, but are they and how are they adjusting their behavior either from a product improvement perspective or pricing?

Answer: They follow what we do but lagging. They're upgrading their network. We think it's only a matter of time before eventually they fully upgrade their network. But it's a kind of kicking and shoving approach. They're being pulled into it. We are leading the pack and they're following us. That's what you saw in the market share trend chart. You remember the chart, in terms of their subscriber base, it's basically flat over the last three years, whereas we've been taking a lot of market share. In fact, the far majority of our new customers come from the incumbent. It's not a case of new migrants coming to Hong Kong and using our service, it is a case of existing copper broadband users upgrading to our Fibre. That's the kind of transition we're seeing. We're saw dial-up to copper broadband and now copper broadband to Fibre.

Question 11: Your subscriber growth slow in the past six months

Answer: Yes, that is because we've doubled the price overnight on 1 September 2010 by putting a “1” in front of the “99”, i.e. from HK$99 to HK$199. In terms of pricing, we zig zag around as there are times when we focus on market share gain and then there are times when we focus on profitability. To mix it up a little bit and make it more interesting for the industry, we seldom stay constant. It takes different dynamics to seduce over customers. Some people are very price sensitive. Some people are very service sensitive. We want to capture different segments of the market.

Question 12: What's your current dividend policy or thoughts on returning cash to shareholders?

Answer: We pay out 60% to 90% of net profits in dividends. We're currently yielding about 4%. So, we offer both a growth and dividend yield at 4%, with a net cash of about US$50 million. As we own 53% of the company as a management team, our motives are aligned with minority shareholders with regards to dividends as a consistent income stream. Our founders have not sold a single stock in City Telecom since our NASDAQ listing in 1999, so paying dividends their way of transparently realizing value. In Hong Kong there is no dividend tax, so there is no tax incentive to use share buy-back instead of dividends.

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