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KPN.AS - Q1 2013 Koninklijke KPN NV Earnings Conference Call

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OVERVIEW:

KPN.AS reported 1Q13 total revenue decline of 8.8% YonY.



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PRESENTATION

Operator

Good morning, ladies and gentlemen. Thank you for holding and welcome to the KPN conference call. During the presentation all participants are in listen-only mode and later we will conduct a question and answer session. I would like to hand over the conference to Mr. Hans Sohngen. Go ahead please, sir.

Hans Sohngen - Koninklijke KPN NV - Head of IR

Good morning, everyone. Welcome to KPN's First Quarter 2013 results conference call. Today, our CEO Eelco Blok and CFO Eric Hageman will take you through our first quarter results and address your questions during Q and A.

Let me briefly point out that disclaimers apply to this presentation and that any forward-looking statements made in this presentation do not differ from those already made in the press release published this morning. Because of the announced rights issue, we are constrained in what forward-looking statements we can give. And as a result we may not be able to answer all of your questions in detail. So please bear with us.

I would now like to hand over to Eelco Blok, CEO of KPN.

Eelco Blok - Koninklijke KPN NV - Chairman and CEO

Thank you, Hans. Good morning, ladies and gentlemen. Back in February we announced a EUR4b equity equivalent capital raise to strengthen our financial position and create the flexibility to drive forward with our operational strategy. In the meantime, we have taken a number of important steps in this process. In March, we successfully issued EUR2b of hybrid bonds in euro, sterling and US dollar tranches. We expect these hybrids to receive 50% equity recognition by the rating agencies. Two weeks ago at our AGM, our shareholders voted in favor of a EUR3b rights issue, which we expect to launch shortly.



Our Group financials in Q1 were according to our plans and showed a number of key developments. Revenues were impacted by the sale of Getronics International in May last year, and by increased competition across all mobile markets. EBITDA in Q1 reflected our commercial investments to grow in specific areas of our business, mainly in underpenetrated areas in Germany, but also our triple-play customer base in consumer residential.

CapEx was EUR75m higher this quarter, following an increase in customer-driven investments, such as handsets and TV activations and higher mobile network investments in the Netherlands to support the upgrade of our 2G mobile network combined with the rollout of 4G. And free cash flow of EUR85m Q1 reflects phasing within the year, which is a recurring trend throughout the last years. We are on track towards our operational and financial outlook, but have adjusted the dividend outlook, more on this later.

I will now look at some of the highlights of the first quarter, starting with the Netherlands. On February 4, six weeks after the spectrum auction was completed, we launched 4G services in the Amsterdam area. This made KPN the first mover on 4G in the Netherlands and we are making very good progress with the rollout as we have currently covered around 30% of the Dutch population.

The investments we made in our consumer residential segment are yielding results. The positive development of operational KPIs continued in Q1. We are showing increasing RGUs and increasing ARPUs. TV market share grew by 6 percent points to 24%, thereby surpassing UPC as the number two player in the Dutch TV market.

Furthermore, the introduction of KPN Compleet, KPN quad play proposition showed promising initial results. These good operational results are reflected in growing revenues in consumer residential.

On the cost side we made meaningful progress with the FTE reduction program in the Netherlands which we will complete by the end of this year.

In Germany our improved high speed data network enables us to increase our presence in underpenetrated areas and focus on postpaid and data growth.

In Q1 we have increased commercial investments such as customer acquisition costs and marketing to support the uptake of postpaid and data propositions. This is reflected in a record number of postpaid net adds in the first quarter, but also led to a lower EBITDA margin which was in line with our expectations and is expected to improve in the second half of the year. We are seeing intensifying competition in Belgium but BASE continued to show positive underlying service revenue growth.

Before reviewing the Q1 results in more detail, let's now look at the capital raising process. As I already indicated, we have taken a number of important steps in our EUR4b equity equivalent capital raise. First of all, we raised EUR2b in hybrid bonds in three different tranches in March resulting in EUR1b of equity equivalent capital. Secondly, on April 10 the general meeting of shareholders voted in favor of the rights issue, thereby granting KPN the authority to raise EUR3b of equity through a rights issue.

As indicated with the announcement back in February, KPN remains committed to an investment grade credit profile. The capital raised gives us the financial strength and flexibility we require to pursue our strategy. The proceeds will be used to continue to invest in KPN's operations and reduce KPN's net debt level. We target a net debt over EBITDA ratio between 2 and 2.5 times at the end of 2013.

With respect to timing of the rights issue, I can say the following. We expect to launch the rights issue shortly. As you may understand, I can't be more specific at this moment. We are pleased that America Movil has already indicated that they will subscribe pro rata to their shareholding, which is around 30%.

Let's move to the next slide, also following the Q1 results, we are confident that the Netherlands will stabilize towards 2014 and that commercial investments in Germany will lead to service revenue growth. As such, we are on track to realize the outlook which we announced on February 5.

With respect to the dividend outlook we have decided to pay no dividend for the financial years 2013 and '14. Our operational and financial outlook has not changed and we made this decision, because we expect to launch the rights issue shortly, and due to the fact that the rights issue will lead



to a higher number of shares outstanding. In line with our previous outlook we expect to start paying dividends again thereafter, subject to our operational performance and financial position.

Now I would like to hand over to Eric for the financial review. Eric.

Eric Hageman - Koninklijke KPN NV - CFO

Thank you, Eelco, and good morning everyone. Let's start by looking at the first step we took in the EUR4b equity equivalent capital raise. In March we successfully completed the issuance of EUR2b of hybrid bonds consisting of three tranches across different countries. EUR1.1b with a first call option in September 2018 and the coupon of 6.125%, \$600m with a first call option in March 2023 and a coupon of 7%, which after the swap to euros was 6.34%, and GBP400m with the first call option in March 2020, and a coupon of 6.875% post swap to euros of 6.78%.

Under IFRS the euro tranche is accounted for as equity and the sterling and US dollar tranches as liabilities. Coupon payments on the euro tranche are therefore not reported as interest paid, but as equity distributions and will not fall within the scope of our free cash flow definition.

As you can see on the top left of this page, gross debt and net debt in the first quarter increased by around EUR500m. To be more precise, bottom left you can see that in the first quarter net debt increased by EUR444m, driven by the payment of EUR1.3b for the Dutch spectrum licenses on January 9, partly offset by the EUR1b contribution of the hybrid bonds, of which 50% is treated as equity in KPN's gross and net debt definitions. The remaining EUR105m higher net debt can be explained by an increase of financial leases and some smaller other movements.

Now let's move to the next slide. Net debt over EBITDA at the end of the first quarter was 2.8 times. The slight increase was driven in part by the EUR444m higher net debt and in part by the EUR150m lower 12-month rolling EBITDA. The higher net debt mainly relates to the spectrum auction payment, a plus of 0.3 times which was partly offset by the positive impact of the hybrids at minus 0.2 times. As Eelco indicated earlier we target a net debt to EBITDA ratio between 2 and 2.5 times by the end of this year.

The first call dates of the three hybrids perfectly fit in our bond redemption profile with the Eurobond neatly positioned in the slot we had available in 2018. Following these transactions, we have smoothened our profile with around EUR1b to EUR1.5b of annual redemptions in the coming 10 years.

Please be informed that approximately EUR1.5b of the total EUR2b hybrid proceeds have already been used. We repaid drawings from a revolving credit facility which we needed to pay for the Dutch spectrum auction, and there was a EUR540m bond redemption on March 18.

The average coupon of our senior bonds is now 5.1%. Including the hybrid bonds this is slightly higher at 5.3%. The average maturity of our senior bonds is now 7.1 years.

Let's now move to the Q1 Group results. Total revenues for the first quarter were down 8.8%, impacted by the sale of Getronics International in May last year, impacting the results by 3.9% and regulation with 1.7%. Total revenues in our NetCo, Business, Germany and Consumer Mobile segments decreased year on year while consumer residential showed a EUR43m revenue increase in the first quarter.

Our operating expenses were down EUR143m or 6.9% in the first quarter, due to the sale of Getronics International in May last year, lower cost of materials due to the handset lease model, partly offset by higher commercial investments in Germany to support postpaid and data growth also in the underpenetrated regions.

Mainly as a result of lower EBITDA in Germany, our Group EBITDA, excluding restructuring cost, decreased by EUR139m or 12% year on year. Depreciation increased as a result of increased investments we have made in customer equipment, in our mobile and residential businesses. Let's now move to the Group cash flow.

In the first quarter of 2013 we generated EUR85m in free cash flow, EUR48m more than in the same quarter last year. First of all, let's look at the positive change in working capital year on year. This is explained by EUR27m positive change in working capital in the first quarter this year,

compared to a negative change in working capital of EUR270m in the same quarter last year. The sizeable difference between these two quarters is mainly related to prepayments made in 2012, but also due to a shift from payments made in the first quarter 2012 related to 2011 and other working capital improvements.

The negative effects on free cash flow year on year are related to EUR137m lower EBITDA, EUR75m higher CapEx due to increased customer driven and mobile network investment in the Netherlands, and EUR47m higher interest paid compared to Q1 last year, as we had to pay coupons in the first quarter this year related to two bonds; one issued in March and one issued in August last year.

It is important to know though that free cash flow of EUR85m in Q1 reflects the usual phasing within the year that we see in our business, whereby a large part of free cash flow is generated in the second half of the year.

Let me briefly update you on our pension funds. The average coverage ratio of KPN pension funds was 107% at the end of the first quarter. As the coverage ratio was higher than the 105% hurdle to beat, no recovery payment related to Q1 '13 will have to be made in the third quarter. A recovery payment of EUR19m will however need to be made in the second quarter related to the coverage ratio at the end of last year. The EUR19m top-up payment related to the coverage ratio of Q3 2012, which was due in Q1, was already prepaid in the fourth quarter last year.

I will now like to move to the financial reviews of the individual segments. Underlying revenues and other income in our Dutch division were down 6.1% year on year, corrected for the negative impact from M&A, incidentals and regulation. EBITDA, excluding restructuring cost, decreased by EUR20m or 2.5% year on year. The lower revenues and net negative impact from incidentals and regulation were partly offset by lower cost of materials due to handset leases at Consumer Mobile and cost savings as a result of the FTE reduction program.

EBITDA margin was 44.4% in Q1 2013 compared to 40.5% a year ago. The increase is mainly driven by the sale of Getronics International which was a low-margin generating business, the handset lease model in Consumer Mobile and the positive impact of our FTE related reduction program.

Let's now look at the Dutch segment in more detail. Revenue growth at Consumer Residential was a solid 9.4% year on year driven by continued customer growth in TV and fiber to the home, and supported by a positive contribution related to the acquisition of fiber service providers in the fourth quarter of 2012 and a EUR13m incidental.

EBITDA margin, excluding restructuring cost at Consumer Residential, was lower compared to last year, at 19%, due to increased distribution, marketing, content and service cost, mainly related to the growth of our fiber to the home and IP TV products. Furthermore, the lower fixed voice traffic led to a continuing decline of high margin traditional services.

Revenues at Consumer Mobile were down 8% year on year. Service revenues were down 4.9% although supported by EUR7m of incidentals. Regulation had a 1% negative top line impact in the first quarter. EBITDA margin, excluding restructuring costs, at Consumer Mobile was 36.6% in Q1, also supported by the handset lease model.

Revenues and other income at our Business segment were down EUR45m or 6% year on year due to lower traffic, continued price pressure and decline in traditional services, as well as reduced order intake of corporate customer projects, due to adverse macroeconomic conditions. Revenues this quarter were also impacted by lower hardware sales. The EBITDA margin was relatively stable at 25.8% as price pressure on higher subscriber acquisition and retention costs were offset by lower personnel costs as a result of the FTE reduction program.

Revenues at NetCo were down by 9.2% year on year, driven by the revenue decline at the Business and lower wholesale traffic revenues, related to lower volumes as well as pricing. EBITDA margin at NetCo was stable at 57.2%.

Let's skip one slide and move to the domestic OpEx breakdown. We have included a breakdown of operating expenses within the Netherlands. Please note that this overview excludes Getronics International. Overall, our operating expenses in the Netherlands declined by EUR72m in the first quarter or 6.9% year on year.



Let's look at some of the OpEx building blocks. Employee benefits decreased by EUR14m or 4.3% year on year due to lower personnel costs as a result of the FTE reduction program. Cost of materials were down EUR86m year on year due to handset lease model at Consumer Mobile, and lower hardware sales, mainly in our Business segment. Work contracted out increased by EUR36m as a result of higher cost of goods sold, such as TV, content cost at Consumer Residential and fiber-to-the-home access cost at NetCo and higher outsourcing costs.

The next slide shows you the good progress we made with our FTE reduction program in the Netherlands. Since the start of the 4,000 to 5,000 FTE reduction program we have realized around 3,000 exits and remain on track to finalize the full program by the end of this year. Around 1,100 FTE reductions were realized in the first quarter of this year alone, mainly within NetCo, Business and Consumer Residential.

Let's now move on to the financial review of Mobile International. Revenues and other income in Germany decreased by EUR34m or 4.3% compared to the same quarter last year, mainly due to a regulatory impact of almost the same amount. Underlying service revenues declined by 2.5% year on year. This was driven by competition in the ethnic prepaid segment, which remains fierce and the continued impact from customer optimization both in terms of customers optimizing their tariffs as well as their usage. The delta between revenues and service revenues is explained by hardware sales needed to support the uptake of data.

In the bottom left-hand graph you can see the individual elements that explain the EBITDA movement compared to the same quarter last year. First of all, correcting for EUR20m of regulation impact, you can derive the comparable EBITDA for the first quarter of 2012, which is EUR283m. The revenue decline I have already explained.

The EBITDA decline in the first quarter is largely related to EUR63m higher investments in growth compared to the same quarter last year. These investments will support growth in postpaid and data and are mainly related to customer acquisition costs such as dealer commissions to expand our addressable market and marketing costs to expand our presence in underpenetrated regions. Eplus also saw somewhat higher network costs in the first quarter, related to a larger scale network, which are required to improve and maintain the quality of our data network.

We are confident that these investments will lead to service revenue growth, albeit as it we said during the full-year results on February 5, at a lower margin. As a result, the EBITDA margin was 25% in the first quarter. The EBITDA margin in Germany is expected to improve in the second half of this year towards the medium-term margin range of 30% to 35% as the next phase of our Challenger strategy will lead to increased service revenue growth.

Revenues in Belgium declined by 4.2% year on year as increased competition in the mobile market impacted top line. Also regulation had a negative impact to the tune of EUR11m, having said that they still managed to continue to show positive underlying service revenue growth of 1.9% in the first quarter. The EBITDA margin in Belgium was 25.1%, negatively impacted by regulation, IT transformation costs related to temporary projects, and one-off costs related to the launch of Snow, our fixed-line product in Belgium which was introduced in the first quarter; more on this later.

I would now like to hand over to Eelco for the operating review of our first quarter results.

Eelco Blok - *Koninklijke KPN NV - Chairman and CEO*

Thank you, Eric. The positive developments we have seen in Consumer Residential in the last quarters continued in Q1. Revenue generating units and ARPU per customer continued to increase, driven by an increasing number of triple play packages and pricing discipline in the market.

Triple play is mainly driven by the continued strong growth of our IP TV product, which generated 116,000 net adds in Q1. As a result, our TV market share increased 6 percent points year on year to 24%.

Our leading TV product and regional marketing approach supported our broadband customer base with 15,000 net adds, thereby keeping our broadband market share stable at 41%. Fiber to the home continued to show good performance, with 31,000 net adds in Q1, leading to a fiber-to-the-home penetration of 30%.



Another positive development is the fact that for the second consecutive quarter we experienced a net line gain, now at 10,000. All in all, growing ARPU per customer, growing TV market share and a growing broadband customer base are now more than offsetting the decline in traditional voice, leading to growing revenues in this part of the business.

To expand the success of our Consumer Residential segment into our mobile business, we introduced KPN Compleet in January as a first step towards quad play for KPN's existing triple play and mobile customer base. We have seen a promising initial uptake with more than 30,000 activations for Q1 2013.

As you can see on this slide, we focus on providing additional value to our customers, not discounts. The additional value is provided through free TV channels, free unlimited calls within the family, and the doubling of total voice, SMS and data credits. Following positive customer feedback, we will upscale the commercial rollout of KPN Compleet in the coming periods.

Let's move to Consumer Mobile. In Consumer Mobile we have seen that service revenues and ARPU remain under pressure due to the competitive market and increasing share of SIM-only propositions versus propositions including handsets. However, we managed to maintain our total Dutch mobile service revenue market share at 45% in Q1.

Retail postpaid net adds were positive again in Q1 at 7,000, but as I said mainly driven by SIM-only propositions. The prepaid segment continued to be impacted by migration to postpaid and competition in the ethnic segment.

Let's have a look in detail at our successful 4G launch. On February 4, seven weeks after completion of the spectrum auction, we launched 4G services in the Greater Amsterdam area and have since then reached other large cities such as The Hague and Rotterdam. 4G coverage is currently at 30% of the Dutch population, this makes KPN the first mover on 4G, creating a head start versus competition.

Another positive development is that the number of 4G-ready handsets has increased from four available types at launch in February, to 12 4G-ready devices currently, making 4G accessible to our customers.

How are we offering 4G to our customers? We have integrated our 4G services in the existing high-value 3G propositions for both consumers and business customers. We are differentiating on speed and data quantity available to our customers. With respect to 4G we are focused on value and intend to up-sell our customers to higher data bundles in order for them to access 4G services.

4G is only available for customers that have a premium data bundle. In the consumer market, 4G is offered to customers with a 2.5 gig data bundle and we introduced a new 5 gig data bundle as well. For Business customers, 4G is available on all data bundles of at least 1 gig. We are encouraged by the positive feedback we have received from our customers and are working hard on creating a strong brand perception in the Dutch market.

Let's now look at the Business segment. Also in the Business segment wireless service revenues and ARPU remained under pressure, driven by price pressure as a result of the challenging macro environment. Traditional wire-line services continue to decline. Importantly however, we managed to maintain a stable market position. In the coming periods we continue to put a strong emphasis on data-centric fixed mobile propositions to further improve our positioning in the Business market.

We are encouraged by the continued good performance of our Challenger brands and the growth in new services, such as specific services for the health sector. In Q1 we agreed to sell infrastructure services and projects which generated revenues of more than EUR100m and had around 600 FTEs. This is a business that focuses on the installation and maintenance of cabling infrastructures for data and voice connectivity and on-premise data centers. The transaction was approved by the Dutch Competition Authority on April 15.

Let's continue with the operating review of Germany. The underlying service revenue decline in Q1 was 2.5%, this was due to a continued difficult prepaid environment as competition and lower usage of mainly SMS impacted total service revenues. Strong growth of postpaid net adds continued in the first quarter at 265,000 supported by our commercial strategy to drive the uptake of postpaid and data propositions.

As a result of the increased number of postpaid and data subscribers, data revenues increased strongly by more than 60% year on year. Both the postpaid and prepaid ARPU were lower year on year at EUR20 and EUR5 respectively. Postpaid ARPU was mainly impacted by regulation, while prepaid ARPU was also impacted by customer optimization and strong competition.

Let's look in some more detail at the progress of the execution of the German data centric Challenger strategy which we announced at our full-year results. As presented by Eric, we have significantly increased our growth-related investments in Q1 2013 compared to the first quarter last year. We have indicated that there will be a strong focus on postpaid and data.

First of all, this requires a high quality data network. We have again been able to significantly improve the network quality, both in terms of speed as well as capacity. Customers can currently experience speeds up to 21 megabit and we have already planned to increase the available speed to up to 42 megabit in the second half of the year as we roll out 3G dual carrier.

The network capacity has also increased compared to Q1 last year as the average throughput has more than doubled to 3.3 megabit, bringing this at least on par with competition. The improvements in network quality subsequently allow us to increase our presence in underpenetrated areas and offer postpaid and data propositions over a high quality data network.

As a result of the higher commercial investments in Q1, we have already seen a strong growth in postpaid net adds and data revenues. The total postpaid net adds have been high in the last four quarters and accelerated to 265,000, 160,000 higher compared to the same quarter last year.

As shown at the bottom of this slide, the growth investments are related to expanding our addressable markets. We do that by increasing customer acquisition and distribution investments, through third party channels, but also by expanding our own network of shops in underpenetrated regions. In Q1 we have opened 34 new shops in target regions, while we have closed a number of shops in more saturated regions. Marketing costs are increased to raise rent awareness.

We maintain a strong focus on improving our underlying cost structure in Germany which will improve our margin in the medium term. Progress is made toward structural cost reductions through partnerships. We have renegotiated the IT outsourcing contracts with ATOS. Furthermore, also in Germany we are disciplined on the FTE side. We are expanding commercially, but at the same time are reducing on FTEs.

Let's move to Belgium now. Although underlying service revenue growth remains positive, it slowed down to 1.9% year on year. This results from increased competition in the Belgian mobile market. The new telecom law which was introduced in October last year, essentially making every customer contract free and the competitive mobile market environment have impacted the number of postpaid net adds in Q1 which were negative at 8,000.

Prepaid net adds were lower year on year at 45,000. Postpaid ARPU was impacted by regulation and pricing pressure in the market. To restore our Challenger position in the Belgian market we introduced new mobile propositions for both consumers as well as B2B customers last week. Customers are not bound by a contract term anymore and these tariff plans offer flat fees including unlimited voice and SMS. For consumers, Spotify is available in the premium bundles and B2B customers have the opportunity to purchase internet anywhere.

Customer experience will be further improved by increasing the available speed. The recent introduction in April 2013 of 3G dual carrier results in speeds up to 42 megabit which are currently available to more than 60% of the Belgian population. In Q1 we have introduced our fixed line services, a simple and transparent proposition at a significant discount to competition. The triple-play product, Snow, is available for EUR39 which still allows a good return.

To conclude, we have taken two important steps in the EUR4b equity equivalent capital raise. We issued EUR2b of hybrid bonds and obtained approval by the AGM to issue EUR3b of equity through a rights issue. The final and most significant step will, of course, be the execution of the rights issue, which we expect to launch shortly.



Back in 2011 we implemented our new strategy. This strategy has resulted in stabilization of our domestic market positions. For the Netherlands we envisage a continued improvement of operational KPIs in 2013, evidenced by our Q1 results, with financial results expected to stabilize towards 2014.

Creating 4G leadership in the Netherlands is essential for our mobile business in both the Consumer and Business markets. Successful launch and speed of our 4G rollout are encouraging and we will continue our strong focus on customer value.

The continued positive operational performance in Consumer Residential have resulted in revenue growth. This indicates that the investments that we have made are starting to yield results. For Germany and Belgium, the strategic focus is on growth and we expect to do that by executing on the next phase of our Challenger strategy in both countries.

Our strong focus on postpaid has again resulted in record net adds in Germany. Commercial investments have been significantly increased to support further growth in postpaid net adds and data revenues, while the realized network quality improvements enable us to increase our presence in underpenetrated regions. We are confident that the investments will lead to service revenue growth again, albeit at lower margin, mainly visible in the first half of this year.

While we still have a lot of work to do, I believe that we are well on track with the execution of our strategy.

Thank you for your attention, and now we will take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). The first question is from Mr. Paul Sidney. Go ahead please, sir.

Paul Sidney - Credit Suisse - Analyst

Thank you very much, I have two questions please. Firstly at Eplus, given the increase in customer acquisition and marketing costs in Q1, I'm a bit surprised that the postpaid adds were not higher. I was just wondering if you could just give us a bit of an explanation of what happened in Q1 and how you see the postpaid add trend developing in future quarters.

And then just second question, given that you've got line growth in the Netherlands now, and have done for the past couple of quarters, is there a strong case for increasing prices, like for example what we've seen in the UK over the past few years? Thank you.

Eelco Blok - Koninklijke KPN NV - Chairman and CEO

Let me start with the second question on potential price increases in our fixed business. As we have also done in the previous years, we will increase prices again this year on our fixed businesses. Last year we have raised our prices during summer and that's what we expect to do this year also.

Then on Eplus the 265,000 increase of postpaid net adds is 160,000 higher than in the first quarter of 2011 and has increased over the quarters during 2012. And we expect to continue our investments and continue to have a high number of postpaid net adds growth also in the quarters to come.



Paul Sidney - *Credit Suisse - Analyst*

So just to briefly follow up, would you expect the year-on-year trend in postpaid net adds to be substantially higher, going forward, in terms of the year-on-year trend?

Eelco Blok - *Koninklijke KPN NV - Chairman and CEO*

The year-on-year trend will not continue to be as high as in the first quarter, because we started to increase our investments in the second quarter of last year, resulting in a growing number of net adds when you look at the quarters of last year. And that trend we will continue to see, not the trend up on the number of postpaid net adds, but the high number we have seen in the first quarter of this year.

Paul Sidney - *Credit Suisse - Analyst*

Okay. Thank you very much.

Operator

The next question is from Mr. Jonathan Dann, Barclays. Go ahead, please.

Jonathan Dann - *Barclays - Analyst*

Hi there. It's a question around the consumer mobile business. Could you -- have you done any analysis on the ARPU stripping out, say, I guess the handset leasing rental revenues so we can look at the, I guess, revenue, the ARPU at risk?

And I suppose a couple of different ways of attacking the same question. Do you -- what's your mix of smartphones in your consumer retail base? And, say, SIM-only as a percent of that postpaid retail base?

Eelco Blok - *Koninklijke KPN NV - Chairman and CEO*

Let me start with the question related to the ARPU. We see an increase of ARPU, committed ARPU, to 70% in the first quarter of this year. And we continue to expect a further raise of the committed ARPU on the one hand. But, on the other hand, given the increased price competition, we will see a continued pressure on ARPU.

The lease is in the -- is included in the ARPU. So the monthly lease fee is included in the ARPU we have on -- I don't know the number of the slide, but somewhere in the pack. The smartphone, the SIM-only percentage in our current base is around 40%.

Eric Hageman - *Koninklijke KPN NV - CFO*

Let the IR guys get back to you on the mix of the smartphones.

Jonathan Dann - *Barclays - Analyst*

Okay, thank you.



Operator

Next question is from Luis Prota Morgan Stanley. Go ahead, please.

Luis Prota - *Morgan Stanley - Analyst*

Yes, thank you. A couple of questions, please. First, regarding a potential network sharing in Germany, I understand that the 800 megahertz spectrum owned by Telefonica Deutschland might be an issue. But now that you will be getting EUR3b from the capital increase, have you considered to pay Telefonica half the cost of the 800 megahertz spectrum, so around EUR600m, and neutralize the negotiations that could drive a network-sharing deal in Germany any time soon?

And secondly, would you give us an update on the status of the 900 megahertz renewal in Germany, as well? Were there any changes? Or still an expected renewal of the annual payment? Thank you.

Eelco Blok - *Koninklijke KPN NV - Chairman and CEO*

Let me start with the question about a network-sharing deal in Germany. We are convinced that there is significant value to be created in the German market through either in-market consolidation or network-sharing partnership. And then we are talking about a full network-sharing partnership including 800 spectrum. And when balancing payments are needed to be able to create the value then, of course, we will take that into account when we discuss a potential network-sharing deal in Germany.

The synergies to be expected would mainly come from the network sharing and the IT. And, as you can imagine, we remain interested in such a deal in Germany when, of course, it creates value for our customers. That's where we are on network sharing.

On the 900 megahertz renewal BNetzA, the regulator in Germany, will finalize their thinking in the next couple of weeks. And they will present a preliminary decision. And then a consultation will start and probably will be finalized somewhere in the summer.

Luis Prota - *Morgan Stanley - Analyst*

Okay, thank you.

Operator

Next question is from Mr. Tim Boddy, Goldman Sachs. Go ahead, please.

Tim Boddy - *Goldman Sachs - Analyst*

Yes, thanks. Again staying in Germany, I just wanted to understand a bit better why the cost has come -- obviously the cost has grown strongly initially, but why we haven't seen a positive response in revenue or a particularly large up -- increase in postpaid net adds sequentially. Maybe it's possible just to add a bit more color in terms of, for example, how many shops you either have or plan to have in Germany and how that compares to your competitors. That would just be very helpful.

And equally, we've obviously seen large price reductions from several of your competitors in the last few weeks. Given that, are you still confident that you're going to see contract net-add acceleration?



The second question would just be on -- in the Netherlands and the extent to which you're planning to use quad-play to defend mobile. A lot of your competitors seem to be discounting on family bundles to try and put more mobile relationships against a fixed relationship. Is that something you've considered doing as a way of preemptively protecting your base from what 32 will do later in the year? Thank you.

Eelco Blok - *Koninklijke KPN NV - Chairman and CEO*

Let's start with the question about Germany. As we highlighted back in February, Eplus is executing the next phase of their strategy towards a data-centric challenger. We intend to grow our market share in the underpenetrated regions by leveraging the upgraded data network and a clear focus on postpaid. We will achieve this by increasing customer-acquisition costs, such as expanding distribution channels and targeted marketing on a region-by-region basis.

As such, in the first quarter of 2013 we have increased commercial investments such as marketing and acquisition costs. Also expand our footprint in underpenetrated regions.

For Germany Q1 showed the execution of the next phase of our Challenger strategy, which is expected to lead to service-revenue growth combined with lower EBITDA margin, especially in 2013 and improving thereafter. Meaning, especially the first half of 2013, margin will be lower due to higher commercial investments, amongst others, to focus on under-present -- underpenetrated regions, as Eric has explained during his part of the presentation. And the second half of 2013 we will improve on the back of these investments and strong Postpaid net adds over the last four quarters.

So the result of the accelerated growth of net adds postpaid will be leveraged in the second half of this year, leading to full-year 2013 EBITDA margin closer to the medium-term margin range of 30% to 35%, as we have announced at the beginning of the year, and a return to underlying-service revenue growth.

Unidentified Company Representative

Tariffs.

Eelco Blok - *Koninklijke KPN NV - Chairman and CEO*

Then the question on the tariffs in Germany compared to competition. As a challenger, we tend to price our offerings competitively. Our no-frills, postpaid brand Eurofone, for example, which we introduced in the second quarter of last year, is priced between EUR20 to EUR30. The latter offers unlimited voice, SMS, and one gig of data at a maximum speed of 7.2 megabits. If you compare to our average Postpaid ARPU of EUR20, that's pretty rational for us. And today we have no plans to make more aggressive prices. Because we believe that the current price level is not only competitive but also very attractive for the customers we target.

Having said that, let me reiterate that our next phase data-centric strategy is focused on commercial investments that support our postpaid and data focus. Also by targeting the underpenetrated regions where we have a low market share compared to our average share.

Then your last question about the mobile markets in the Netherlands. In January we introduced KPN Compleet, which earmarks the first step towards quad-play in the consumer market. With KPN Compleet KPN facilitates the total telecom demand of Dutch households. This quad-play product is not aimed at pricing discounts, but at services such as additional TV channels, free calls within the family, and a doubling of data, voice and SMS credit. And, as I already explained, the results of KNP Compleet are very promising, with already 30,000 customers signed up. And the most important aim of introducing KPN Compleet is to reduce churn in mobile.

Tim Boddy - *Goldman Sachs - Analyst*

Okay, thank you.

Operator

The next question is from Mr. Fred Boulan, Nomura. Go ahead, please, sir.

Fred Boulan - Nomura - Analyst

Hi, there. Two quick questions, please. Firstly, on mobile in Holland, if you could give a bit of color on the breakdown in additions between your different brands and if you've seen change in trends. You mentioned specifically Postpaid is driven by SIM only. So is this on the lower-tier brands or on the [KPN1]?

And I wanted to ask as well about the timing of the contribution of 4G. So should we expect revenues to improve with 4G in the coming quarters? Or is it a bit premature?

And secondly, to come back on Germany. Here you talked about the contribution of postpaid additions to top line. Can you clarify a little bit the timing you have in mind for this? Should we expect top line to start to improve from the second part of the year? And when specifically do you see growth? Is this possible this year or more realistic in 2014? Thank you very much.

Eelco Blok - Koninklijke KPN NV - Chairman and CEO

The trends in mobile in the Netherlands, just from a high level, Telfort is doing very well. KPN stabilizing high under pressure. So that are the main trends we see in the three main brands we offer in the Netherlands.

Timing on 4G. Of course, it will take some time to have a 4G customer base that really will have a visible impact on the service revenue. We have today several thousands of 4G customers. We are rolling out a network very rapidly. As I said in my part of the presentation, the 4G network is now available in the Amsterdam, The Hague, Rotterdam area expanding very rapidly -- mid of this year we will have a 50% population coverage. And then when the number of customers will accelerate then, of course, we will see in the future also a positive impact on service revenue.

And then the question on Germany.

Hans Sohngen - Koninklijke KPN NV - Head of IR

What was your question, Fred?

Fred Boulan - Nomura - Analyst

Yes, the question on Germany was more specifically on the timing for you. If we continue to see good postpaid additions when do you think we will see a (inaudible) of service revenue trends? And when you talk about growth, is this realistic at 1 point underlying ex-regulation this year? Or it's more something you -- it's more an ambition for 2014?

Eelco Blok - Koninklijke KPN NV - Chairman and CEO

No. We expect underlying service revenue growth already this year in there. And you should think of the second half.

Eric Hageman - Koninklijke KPN NV - CFO

But it is underlying growth.

Eelco Blok - *Koninklijke KPN NV - Chairman and CEO*

Underlying growth.

Fred Boulan - *Nomura - Analyst*

Okay. Thank you very much.

Operator

The next question is from Mr. Sasu Ristimaki, Merrill Lynch. Go ahead, please.

Sasu Ristimaki - *BofA Merrill Lynch - Analyst*

Hi, yes, thanks. I have two related questions on handset cost. Firstly, when you gave the domestic OpEx breakdown and indicated it was an EUR87m -- EUR86m improvement in costs and materials, how does this break down between the handset-lease model improvement and lower hardware sales?

And then the second part would be how significant are handset costs in Germany at the moment, i.e. are they a major contributor to the cost build up that you've had in Q1? Thanks.

Eelco Blok - *Koninklijke KPN NV - Chairman and CEO*

So maybe on the -- on Germany. So if you think about that three-pillar attack that we have, which is firstly on data, two on postpaid, three regionalization, then a part of that is, of course, related to the handset subsidies from two legs. On the one hand that is typical for a postpaid customer. That's where part of our growth is coming from. Secondly, it's also important for accelerated data revenue, because that is only possible with what we call the smart smartphones. So there is a part related to this. So that on the -- on Germany.

And for the Netherlands what was your specific question there?

Sasu Ristimaki - *BofA Merrill Lynch - Analyst*

The -- you said there was an EUR86m improvement in the cost for materials. And then I was wondering how does this break down between an improvement from the handset-lease model versus the slower hardware sales.

Eric Hageman - *Koninklijke KPN NV - CFO*

Perfect. About half of this saving that I mentioned as the absolute number is related to the cost of the handsets.

Sasu Ristimaki - *BofA Merrill Lynch - Analyst*

Okay. And if I -- a quick follow-up on Germany? If handsets are clearly a core part of your data-driven strategy, am I correct in assuming it will be difficult to pare down that handset expenditure, at least on a quick quarter-on-quarter basis this year?



Eric Hageman - *Koninklijke KPN NV - CFO*

I think if you -- again, as I said, a big part of the investments that we're doing, so the EUR63m that you saw in the EBITDA bridge, a big part of that is actually not related to a direct link between handsets and Postpaid. But, of course, for every postpaid contract that we have where there is indeed handset related, there is a direct link with the cost. So if we continue to grow our postpaid net adds, as Eelco indicated in one of the first questions, then obviously that --- you should see a linear increase there with that part of the cost.

But again, a big part of the cost is related to investing in the network. It's related to investing in opening those stories and closing some of the stores that we have done. It is the commissions that we put in the channel, whether direct or indirect. And it's related to in those areas where we have a lower than our average market share to increase our brand awareness.

In Q4 we talked about the city of Kassel where we had a two-year initiative. And this quarter, for example, we made huge strides in, for example, the city of [Dresden]. That's actually where the bulk of the investment goes, rather than subsidizing handsets.

Sasu Ristimaki - *BofA Merrill Lynch - Analyst*

Okay, great. Thank you very much for that.

Operator

The next question is from Mr. Dimitri Kallianotis, Citigroup. Go ahead, please.

Dimitri Kallianotis - *Citigroup - Analyst*

Good morning. I've got two questions, please. The first one is just to come back on your quad-play strategy. It seems you are saying, if I'm correct, that you don't want to do any discounts and we've seen in most European countries that to really push quad-play hard you need to put some discounts. So what exactly do you mean when you say you want to upscale the rollout of your quad-play? Could you really push the penetration much higher?

And my last question is on the triple-play offer that you've launched in Belgium. I wonder if you could give us any numbers in terms of net adds on this new offer. And also, based on that experience, if you feel you could do something similar in Germany? Maybe launching of the triple-play product based on the Deutsche Telecom network? Thank you.

Eelco Blok - *Koninklijke KPN NV - Chairman and CEO*

Let me start with KPN Compleet. We believe that the value adds we offer to our quad-play customers is of that more high value to our customers that we don't need to give them any discounts. And that's also the feedback we receive from the first customers and also from our sales people that the way we have presented our quad-play proposition is really doing well. We started with the KPN broadband customers that also have a KPN mobile subscription. And we will add the other brands to our KPN Compleet offering in the next quarters, making it possible to offer quad-play to a much-larger base than we have started with in the beginning of this year.

As I said, the introduction of our triple-play product in Belgium is very, very successful. But we have taken the decision not to disclose the numbers we have realized after the launch in the first quarter. From a price perspective, as I said, it's a very attractive offer in Belgium.

And then to Germany. Given the very low price levels of broadband and TV services in Germany it makes not really sense to start offering a similar triple-play package in Germany, given the small gap between the unbundled local loop prices and the retail prices of broadband and TV services in Germany.

Dimitri Kallianotis - Citigroup - Analyst

Thank you.

Operator

The next question is from Mr. Stuart Gordon, Berenberg. Go ahead, please, sir.

Stuart Gordon - Berenberg - Analyst

Yes, good morning. Two questions, please. First of all on the dividend and obviously you're going to be saving EUR40m there, which suggests you're a little bit nervous on the cash flow outlook, given that three months ago you said it was -- for many of your shareholders that that was kept. But also it gives you the option to stop paying interest on the hybrid loans that you've just taken out. Will you be categorically committing to pay that interest? Or does this move just give you greater flexibility with regard to your cash flows, going forward?

And the second question is on Consumer Residential, top-line trends are indeed looking better. But ex the incidental, it's a 16% margin this quarter. How should we be thinking about margin progression from here? Or should we be just thinking that current investments that are needed to stabilize the business are indicative of what is required, going forward? Thank you.

Eric Hageman - Koninklijke KPN NV - CFO

Shall I start with the first question? So if you look at the hybrid documentation that we have, there is the option to defer the coupon payments as long as we don't -- do not pay a dividend. However, not paying a dividend does not automatically mean that we will defer the coupons on the hybrid bonds. So we currently do not envisage any circumstances under which we would consider deferring an interest payment on the hybrids. Although we are aware that legal terms provide us the flexibility to do so. So the decision to cut the dividend was related to the expectation that the rights issue will be launched shortly.

And then with regards to cash, given the cash generation of our business and our very strong liquidity position, certainly also after the hybrid issuance, there is no reason to believe that a coupon deferral would be required. As we said also on the 5th, we reiterate it today, we intend to resume the dividend payments after 2014, obviously always subject to our operational performance and our financial position.

On residential?

Eelco Blok - Koninklijke KPN NV - Chairman and CEO

Yes, on the margin of residential, yes, you are right. Without the incidentals it's 16.8%. But we expect this margin to go up in the next quarters of this year because you need to take into account the FTE savings that will help to reduce the cost also. On other cost elements we have saving programs in place. And, as I said earlier, we will increase prices as we have done the last couple of years. That also will have a positive impact on the margin on the second half of this year.

Stuart Gordon - Berenberg - Analyst

And can I just go back to the first question? Can you give a reason why you chose to cut the dividend now and not in the past?



Eelco Blok - Koninklijke KPN NV - Chairman and CEO

Eric, will you take this question?

Eric Hageman - Koninklijke KPN NV - CFO

Sure. So we've adjusted the dividend outlook as we expect to launch the EUR3b rights issue shortly. We believe that a large rights issue should not at the same time be accompanied by paying a dividend to the same shareholders that were asking for an additional investment. So in order to reflect the impact of the rights issue and the increase in the shares outstanding that one can then expect, we are now cutting the dividend to zero.

Stuart Gordon - Berenberg - Analyst

Sorry to continue, but can you clarify what has changed then in the last three months? Because, I mean, you knew about the rights issue in February but you still gave a EUR0.03 dividend commitment at that time.

Eric Hageman - Koninklijke KPN NV - CFO

The main change is on April 10. So 10 days ago we had the shareholders' meeting in which the rights issue was approved.

Stuart Gordon - Berenberg - Analyst

Right, okay. So the dividend in February was only -- you didn't clarify that, but it was really only a dividend in the event that the rights issue wasn't approved?

Eric Hageman - Koninklijke KPN NV - CFO

What we said also during the AGM is that the dividend per share was EUR0.03. But obviously that was with the current shares outstanding. As we are announcing today that we will launch the rights issue shortly that obviously goes, as I just said, accompanied by a different number of shares. So the combination of those two, so the approval of the AGM on 10th plus the fact that today we're saying we will launch the rights issue shortly, makes us to also cut the dividend today to zero.

Stuart Gordon - Berenberg - Analyst

Okay, thank you.

Operator

The next question is from Mr. Akhil Dattani, JPMorgan. Go ahead, please.

Akhil Dattani - JPMorgan - Analyst

Yes, hi. Good morning. Just a couple of questions on your Dutch mobile business, please. Firstly, last week Tele2 on their results call suggested they'd be open to considering a roaming deal or a network-sharing deal in the Netherlands as part of their fourth license roll-out through the course of this year, potentially, if the economics of those were attractive enough. So I just wondered, against that backdrop, whether you'd at all be interested in such a collaboration and how you think about potential risks and rewards of doing something along those lines.



And then secondly, if we look at your consumer mobile margin performance this quarter it's clearly been very impressive at about 36%. I appreciate over the course of last year most of the margin expansion was being driven by the move to capitalizing handset costs. But I'd assumed that that was largely captured by the run rate at the end of last year. So I just wondered if you could help us understand what this incremental margin improvement reflects. What's driving that? And how sustainable we think that should be.

And then, very finally, sticking with Dutch mobile, we've seen Tele2 very slowly starting to achieve some improving net additions. They're talking about improving traction. And seem to suggest that trends will improve, going forward. So I just wondered if, within that backdrop, you're seeing any sort of impact at all. Obviously you've already mentioned some of the prepay losses and things that you're seeing in your trends. But I just wondered if you feel at this stage whether there's any need at all to respond to some of the pricing developments in that market. Thanks a lot.

Eelco Blok - Koninklijke KPN NV - Chairman and CEO

Okay. Let me start with the first question about roaming and network sharing with Tele2. Of course, we have a healthy view on wholesale and wholesale customers. But I can assure you that we will be very, very, very careful in roaming and/or network-sharing deal with Tele2. We don't want to end up in a situation as in Belgium or France where we give the new entrant the opportunity based on a very-aggressive priced wholesale deal with us. So that's our position to Tele2.

About the disruptiveness of Tele2 in the Netherlands, in our strategic plans we have taken into account a very aggressive entry by Tele2. As you probably are aware, back in February we provided a lower minimum, long term, total mobile market share in the Netherlands of at least 40% instead of the 45% to focus -- to be able to focus on the right balance between market positions and profitability.

And, last but not least, I would like to note that the Dutch mobile market is already highly competitive and well segmented, with high SoCs and a lot of MVNOs already operating in the Netherlands. And as Tele2 themselves announced they need to make investments to be able to start using their own frequencies on 800 and 2,600.

Then looking at the mobile margins, you have to take into account that in the margin of the first quarter is a EUR7m one-off and driven by the handset lease. There is also a positive impact on the margins that we have continued to see also in the second quarter of this year.

Akhil Dattani - JPMorgan - Analyst

Just to follow up on your response to the margin question, I guess if I look in your results file you disclose that ex the EUR7m one-off the margin is still 35.5%. So I guess still quite a nice improvement versus the last quarter or so. So can I just clarify, is that still being supported, even the underlying performance, by incremental capitalization of handset costs? Or is there something else that explains that further improvement?

Eelco Blok - Koninklijke KPN NV - Chairman and CEO

The step-up from the fourth quarter is not driven by additional impact of the handset lease.

Akhil Dattani - JPMorgan - Analyst

Okay. What should we attribute that to?

Eelco Blok - Koninklijke KPN NV - Chairman and CEO

Some cost savings in this part of our business.



Akhil Dattani - *JPMorgan - Analyst*

Fine. Okay, thank you.

Operator

Your next question is from Mr. Ulrich Rathe, Jefferies. Go ahead, please.

Ulrich Rathe - *Jefferies - Analyst*

Yes, thanks very much. Two questions on Germany. One short one on the Netherlands, please. The first one is, so I understand what you're doing, this execution of your strategy. I suppose one way to ask some of the earlier questions would be are you entirely satisfied with what you delivered as a result of the higher investments in the first quarter? How do you look at these numbers in terms of are they fully on track? Or do they fall a bit short of your expectations, as well?

Also I would like to ask in Germany what you think about subscriber quality. The big write-off in the fourth quarter of last year suggested that some of this accelerating intake is of lower quality. So I was wondering how you see the subscriber-intake quality developing at the moment.

And my last question is on the Netherlands. Very often when there is this threat of new market entry you do see the incumbent operators cutting prices in anticipation of the launch, wanting to signal a market-share defense. Is there any situation or scenario where you actually would be willing to or thinking about cutting price in advance of a proper launch by Tele2? Or is that all captured by the lower market share goals as you described earlier? Thank you.

Eelco Blok - *Koninklijke KPN NV - Chairman and CEO*

Looking at Germany both from a customer-growth perspective, quality of the growth and financial perspective, the Q1 results are according to plans. So our investment strategy in Germany is doing fine. We are satisfied. On track, on plan. So that's about Germany.

Then on the Netherlands, as I said, we have seen an increase of competition in the Netherlands. And we are responding by making changes to our propositions. That's what we have been doing starting in September 2011. And also during last year we have made some major changes to our propositions, both on the bundles but also on the actual price levels and promotions and subscriber acquisition costs. And that's what we continue to do looking -- going forward.

So this is on the Netherlands. And we have not a plan in place to make a big step. We are just watching very carefully what's happening in the market. We have adjusted our market share objective because we expect Tele2 to be very aggressive in the market. So we have the opportunity to balance growth and profitability in the right way.

Ulrich Rathe - *Jefferies - Analyst*

Sorry, could I just follow up on the subscriber quality? Are you happy with the subscriber quality given this huge write-off of Postpaid subscribers at the end of last year, which suggests that the subscriber intake in 2012 was subpar? Thank you.

Eelco Blok - *Koninklijke KPN NV - Chairman and CEO*

Yes, we are very happy with the quality of the Postpaid net adds. The Eurofone ARPU is somewhere between EUR20 and EUR25. And the contracted duration is between 12 and 24 months. So we are convinced that this quality growth will deliver underlying service revenue growth in the second half of this year. And another very sure thing when we look at the quality of the net adds is the much higher data usage in this new set of customers.



Ulrich Rathe - *Jefferies - Analyst*

Thank you very much.

Hans Sohngen - *Koninklijke KPN NV - Head of IR*

Okay. I would like to end this Q&A session with this last question. I would like to thank you for listening in. And please let all the other questions, let them know to the IR team. And I would -- I'm looking forward to speaking with you. Thank you.

Operator

Ladies and gentlemen, this concludes the KPN conference call. Thank you for attending. You may now disconnect your line. Have a nice day.

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