BT GROUP PLC THIRD QUARTER RESULTS HELD ON THURSDAY, 10 FEBRUARY 2005, BT CENTRE

FIRST SPEAKER:

BEN VERWAAYEN, CHIEF EXECUTIVE OFFICER

Good morning and I am sure you are as happy as I am to welcome Hanif Lalani to the stage as our new CFO. It is a bit odd seeing Ian sitting in the front row, but I have to tell you they are already four days into their new jobs so there is no reason to hold back on them.

Now we have talked about ICT many, many times, and Andy is talking more and more about networked IT services. That is probably an even better way to describe what we are doing there, but the most important factor is that we are winning in that area. As we do in Broadband and we are making very good progress on our converged mobile services.

You will see today that we are still in decline with our traditional business but the decline is slowing and you will see today that we are on track in our costs reductions.

Now you have seen this chart also many, many, many quarters and to be honest you have seen four quarters in a row that the green arrow went up. This time it went up 3.2% because the decline is held on 4% in traditional and our New Wave growth is 35% and if you put it in a three year perspective you can see that this has been our best quarter in three years, and that feels pretty good to be honest.

Let's look to our New Wave business and let's look to how our New Wave business is doing, if you look at it from a customer perspective. If you look to the pie chart, this is where we win and where we lose. Now you see Wholesale business growing here and that's a natural consequence of a lot of the new regulated products like WLR and CPS and LLU coming where you see a shift out of Retail into Wholesale. You see our major business growing 5% in a market described, I believe by everybody, as pretty tough. We are winning there which is a very, very good sign for the depths of what we have to offer. Then you have to look to our percentage of New Wave and you understand why, because the strengths for us is shifting more and more towards a full IP world where we have a differentiating position.

Putting New Wave in perspective, five quarters in a row growth over 30% and those trends are truly important. You see a trend that the top line is growing, and that growth, as I have said is the best in three years. You see 21% growth in ICT; you see a healthy 98% on Broadband and 104% on Mobility. Now let's dive into all of those three areas to get a better understanding.

First of all on ICT. This has been another very strong quarter for orders received. There are four interesting points here to make.

First of all I'm delighted to announce today the Barclays Bank win. It is a seven year IP services order that we got and it underlines the strengths that we have in the financial sector world-wide. This is a fantastic win for us and it is an important building block in our capabilities in the financial services.

You see two other wins in Europe, one in France and I think it underlines our capabilities to win in every European country. It is an ability to deliver not just a value proposition for people in country, but as you can see Thales is in forty-two countries. The NATO contract is in twenty-eight countries you will appreciate no doubt the security aspects around that. So it is a clear underlining demonstration of our capabilities.

Then maybe most importantly is the depth of our orders received. If you look to the number of major contracts you will see that it is not only in different sectors, it is not only in different regions, it is also with a whole variety of our product portfolio. We are not dependent on one product, not dependent on one offering, you can see a wide variety of offerings in the ICT business and that helps us to build the annuity for the future.

Of course we are delighted also to report progress on our acquisitions, Albacom is done and Infonet is as good as done, at the end of the month they have their EGM. I am delighted to see that we have made very, very quick progress and it was not an endless bureaucratic procedure that we had to go through and it went fairly quickly and that is very helpful for our capabilities in the ICT world.

Now Broadband. This is a phenomenal story. It truly is, a new connection every ten seconds is almost boring now. Well if you just step back and see what happened we have over 4.1 million at the end of December and that means that our target of 5 million is going well. You do the calculations yourself but I think it is going to pretty soon. Having said that, it is not just about volume of customers. It is also about coverage and we are today at 95.5%. We have enabled 3,989 exchanges and we are building right now to go from 99.5% to another 1.049 exchanges, then we have reached 99.6%. As I said earlier the coverage is almost as good as running water, and with this type of take up in the market we have a mass market now.
You have a fantastic leverage and the next stage is of course to translate an access product into platform products. The services, what can you do with it? Business use it more and more as a tool to work – agile working – you can see people changing from simply emailing and net surfing, downloading and to using it as a tool for applications. Therefore it is truly important that we have a third element next to the market creation of a mass market. Next is to go up in speed and you see that we have trials here to go up to 18MB and we will use that, and we will talk about it when we talk about 21CN, the same platform as we will use for other services in our network. So we have a clear capability not just on the number of customers, although that is very important, not just on the coverage but now also a portfolio of opportunities. We give to the market choices, how to position, whether you want to be an ISP investing in services or the network infrastructure you have a portfolio of opportunities. That will create a market in which other sectors of the economy can now be assured that it is worthwhile to invest. I think that is the important picture here.

From a retail perspective the story is slightly different. At Q3 almost 1.5 million broadband customers. Let's make no mistake about it, from an absolute number point of view this has been a record quarter. We have added 208,000 customers, but for market share it is 26% in quarter, and year to date 36% for BT Retail. Now you may have seen the announcement today that I think is changing the landscape and is exactly the answer in a change of environment. The changing environment is all about people using Broadband in a totally different way than when we started. It is not just high speed internet access anymore, the offer today is four times faster for not a penny more. That is a great offer and addresses, I would say, the fundamental of the market. This is not just about price, it is about value, and what it does here is make it clear to the market that there is an offer here for both consumers and business that allow them to get better use of Broadband without spending more.

Now on the business side, one of the key elements is to underline how crucial broadband is for their continuity of business, therefore we will have better guarantees about service levels.

Next Mobility. You could say the story is 112% increase in revenue and that is fantastic although that isn't the story, and 35,000 adds post-pay is very good if you take into consideration that we have spent less this quarter than last quarter on marketing. We have created the MVNO both for consumer and for business which is an important building to create a truly convergence story. I can tell you that Bluephone testing is going very well indeed, both on the quality of the calls and the coverage on the hand-over to GSM. So from a technical point of view we have taken crucial steps and I am delighted to say that those steps are going very well. We will have a soft launch in the time frame that we said and we have built from there a momentum in the market. Convergence is the name of the game now. If you travel to the GSM conference in the South of France you will hear a lot about convergence. That is a topic that was not on the agenda when we started this journey from this same room, over a year ago.

So let's now talk about our traditional business. It's in decline, but the decline is 4% and you can see is a trend in the right direction. It's a boring story, it is the same story as last quarter, and it is all about calls. So let's dive into calls.
The story there is exactly the same as last quarter. So look to the right-hand of the chart and you will see those elements that are more or less shifting from one part of BT to the other part of BT. It is re-balancing and it is no longer dial-up because people have Broadband.

On the other side of the chart, the left-hand is the decline in the market as such between 2% and 3% and the rest is market share. Now you see market share is a loss here for consumer of approximately 1.3% so this is the market share that we have and on business it is around 0.5%.

The story behind the story here is that it is also about how much of our business with consumers is contracted. Now you know that I have said now, for nine quarters in a row I believe, we have picked up 1.0% and I am happy to report the same thing today, our under contract percentage is now 61%. Every quarter has gone one percent up and that is very, very good for us.

At the same time just to give you a feel, some of our packages are really doing excellently. Option 3, which is all you can eat package increased in the quarter by 103% from 556,000 packages and that is an impressive number. So yes we are losing as we expected and we told you all many, many times about market share. But we are extremely controlled where we lose market share and in the high-end of the market we are doing exceptionally well.

Now 21CN. The crucial element of our way to go forward and I don't want to bore you with the technical slide because before you know it, we will be talking about core routers and multi-service, access nodes and other great stuff. What is important about this chart is the three messages.

The first message is on 7 January this year we had the first end to end IP voice call. Nothing in between, just IP all the way which is very important and the best thing is nobody noticed.

The second thing is that we are doing the testing on fibre not because we are going to plan fibre to the home, but to use and understand the fibre as a dynamic in a future consideration of networks which is an important element to see. If you can go to 18MB, as we have said in ADSL2+ then you get a better understanding how much life there is still in copper, a lot. There are different technologies opportunities with fibre that we need to understand.

ADSL2+ will use the same type of chassis, basically you don't have to mount another layer of capex over the existing 21CN if you go to the trouble to create new services.

21CN is about creating a network with the service diagnostic that allows you in real-time to change your services as you see fit. That of course has major implications to other parts of the market and it is absolutely crucial for us to communicate how we are going to design the network and what we are going to do with it. So Consult 21 is our answer to continuously inform them of what we are doing, and to make sure that we get their input when we design this network.

And that brings me as a nicely to the events of last week which was our answer to Ofcom. Now we have said a lot of things about last week so I would like to summarise here. The crucial message, I want to leave with you is that this is a unique opportunity. It is an opportunity for the market to move away from where we were; micro-managed on every single detail where at the end of the day nobody was winning anything. The only thing we were doing is adding red-tape and regulation to the tenth degree into a new framework. We recognise for our part where the bottlenecks are. Making sure that we ring fence that in a way that allows very strict regulation and more important, by I would say, transparency and confidence by establishing an independent equivalence board. Why not let one of the Ofcom Board Members be a member of that, so that they can be sure, that what we do in the equivalence part, and with the local loop is absolutely transparent. That would free us up from a lot of the red-tape that is more or less spilling over in other parts of the market where there is absolutely no need for that and you get a much better focus on where the value is.

At the same time we are offering to create a margin around local loop unbundling. If we can pull that in with some of the other consultations that are taking place right now. We are offering on Wholesale Line Rental a margin so the market could choose where to play. We give fair access to 21CN and we ask Ofcom to make a serious effort now on deregulating part of the business.

I think the package that we offered without being parochial, is a package that has all the elements in it to recreate the market, to reset the clock so to say and to create the best market place in the world here in the UK. We have enough players and if we give them the certainty that they need, the confidence of investors that they can choose a sound business plan and execute. They know what the market will bring them and that will be good for everybody. It will certainly be good for BT because with our 21CN and our innovation drive that you see across the business it is absolutely necessary for us to get that certainty. I think that you will see a lot of fine turning going on in the coming months, which means it will be back and forth on some of the issues. But the outline that we have given should be what I would expect it is answering many of the demands that are out there in the market.

Let’s go back to costs. Now you know that our whole formula is reduce the decline of traditional and take costs out because there is a margin issue that we have to address. We have said that we will have to do £400 million a year, year after year. How are we doing this year, well you can see we are spot on. We thought, why not give you a feel for what type of cost actions we have taken. It is not just the big ones like 21CN that we talk about it is a whole range of things. If you look to this chart you can see that what we have tried to do is to go into the absolute detail of the business and understand where we find cost opportunities. You will find them everywhere if you have this same innovative approach to process as we have for products. That is important because a lot of our cost is locked into process and if you unlock that you get a whole new focus on what a telco could look like. I will give you a number of examples, better use of accommodation, building use, a huge part of our costs, agile working gives a lot more productivity for our workers and a cost opportunity at the same time. Remote diagnostics where you used a computer over the line and you sometimes get a better result, but certainly you get a lower cost. Some of our issues we have outside the UK are issues that Andy has had to struggle with if you would look to the access cost in other markets. You will see that negotiating there is not something as easy as you find here in the UK, but we have found opportunities to bring our costs down and of course everybody’s evergreen is to bring the overheads down.

Now Earnings Per Share (EPS) that is what we focus on 9% in quarter and that is a good trend.

So what is Q3? I think we are delivering on our strategy, look to how we grow our business you can see that. Look to what we do in transforming the way we have a mix in the business and we have talked about our New Wave and we have talked about our ICT revenue, global revenue is up 10% and in Europe it is up 15%. So we have pretty strong numbers there. Then look to what customers buy from us, it is quite stunning. For those that follow this company for a while to see that we have now more Broadband lines than ISDN. If you see the MPLS network that Andy uses internationally to serve his customers, 32% growth in revenues. These are really very, very strong underlying numbers. It is of course absolutely vital that we have our cost programme on track and you have seen that. Lastly but not least it is also very important that we have built a long-term shareholder return and I think a 9% EPS helps us very much in doing that.

SECOND SPEAKER:

<u>HANIF LALANI - CHIEF FINANCIAL OFFICER</u>

Thank you very much Ben and good morning. Let me just say it is great to meet you all so soon and all at once.

Today I would like to get straight into my stride and take you through the Q3 performance, which I believe are a strong set of financial results.

As Ben highlighted earlier group turnover of £4.6 billion was 0.1% up on a headline basis and 3.2% higher taking into account the cuts in mobile termination rates.

Profit before tax of £545 million rose 4% with a reduction in EBITDA more than offset by reductions in depreciation and interest charges. This together with a lower effective tax rate delivered year on year growth of 9% in EPS.

The £387 million free cash flow includes the proceeds from the sale of Eutelsat and Starhub, which were previously held as investments in the balance sheet.

Net debt was reduced to £7.9 billion an improvement of £855 million over the prior year.

Now let's move on to some further detail on the performance of each line of business.

Firstly Retail the trends of recent quarters continue as customers migrate from traditional products to take advantage of New Wave solutions. An example of this was the decline in dial-up internet minutes as customers move increasingly to Broadband.

New Wave turnover grew by 38%. Most of the £280 million decline was in traditional business and resulted in total revenues of £3.1 billion excluding the cut in mobile termination rates. Turnover was 1% lower than the prior year.

Gross margin reflects the ongoing change and mix between traditional and New Wave and at 26.4% was 1.4% lower than Q3 last year. However it is on an improvement and it is an improvement on Q2 of 0.2%. The cost base associated with the traditional activities generated savings of £22 million and early leaver costs were £15 million lower year on year. Some SG&A savings were reinvested in New Wave businesses and the remainder helped to partially offset the gross margin decline. As a result operating profit declined by 15%. This is slightly worse than the recent trend but as we have explained previously Opex can vary on a quarterly basis. This quarter we increased expenditure on development on new entertainment services and on mobility.

Moving on to BT Wholesale. After deducting the impact of cuts in mobile termination rates, external turnover increased by 21% reflecting growth in both New Wave and traditional activities. The latter is due to growth in interconnect traffic and wholesale access and New Wave turnover increased by 80% predominately driven by

Broadband. At the same time lower volumes and the impact of regulatory pricing controls on traditional products reduced internal turnover by 3% to £1.3 billion.

For Wholesale total volumes were higher and resulted in an increase of around 20% in network activity levels, however this did not impair ongoing reductions in operating costs which were £14 million lower. All of this contributed to a £35 million or 4% rise in EBITDA. This together with a 2% in depreciation lifted operating profit by 9%.

Global services. Global services this quarter achieved another milestone with double digit turnover growth. The 10% top-line growth was driven by increases of 17% and 27% in solutions and consulting and systems integration respectively. Those rates of growth are directly related to strong order in-take in previous quarters. However the trends in recent quarters in global carrier reverse and revenue declined by 3%. This was as a result of cuts in mobile termination rates across Europe and as expected the final roll-up of AT&T revenues associated with the unwinding of Concert. An EBITDA of £148 million was 11% higher driven by a 38% improvement of global products. This combined with ongoing efficiency programmes resulted in global services recording its highest ever quarterly operating profit. At £9 million it was a £31 million improvement on the loss reported in Q3 last year.

Operating free cash this quarter is £2 million positive. In contrast to the outflows reported in the two previous quarters.

Moving on now to the group P&L. I shall take you through the year to date numbers to provide you with a better overall view of the trends.

Year to date gross margin fell by 1.4% as our traditional and New Wave businesses mix continues to evolve. Further reductions in SG&A pay have helped reduce total SG&A cost by £69 million. The net result was EBITDA pre-early leaver costs; exceptionals and goodwill declined 2.5% year to date at £4.3 billion.

Depreciation was £87 million than in the prior year as more shorter life assets became fully depreciated. Of course increased capital expenditure over the last few quarters will result in higher depreciation going forward once those assets are registered and are being utilised.

So year to date the operating profit pre-early leaver cost was £2.2 billion, £24 million lower than the same period last year.

Now let's take a closer look at operating costs.

Having realised around £300 million of cost savings in traditional areas year to date total operating costs are £44 million higher than last year. Overall cost of sales rose £200 million. That increase is due to the increase costs of servicing ICT contracts and ongoing expenditure on customer acquisition in both the Broadband and Mobility businesses. The rising cost of sales means that more of our people are focused on delivering work directly to our customers.

Payments to other telecommunication operators were £156 million lower reflecting the impact of mobile termination rate reductions. Higher volumes were also partially offset by improved management of international network costs.

Other operating SG&A costs up £45 million have risen in areas such as marketing and on New Wave R&D as we seek to bring truly innovative services to the market. At the same time SG&A pay has fallen by £114 million as our efficiency programmes continue to generate savings in none-customer facing activities across the business.

Now back to the third quarter and to the group capital expenditure. A 10% increase over the third quarter last year was driven primarily by two factors:-

Firstly spend to deliver some of our big ICT contracts, most notably £34 million relating to the NHS.

Secondly the continued roll-out of Broadband across the country has required additional capacity to be added to our backbone network. This explains the 8% rise within the intermediate network classification.

New network spend continues to grow up 7% on quarter 3 last year. This was driven mainly by new systems and 21CN trials. Our full year CAPEX guidance remains unchanged.

Now let me look at cash flow. As I am sure you are fully aware interest payments are highest in quarter 1 and in quarter 3. Net interest paid this quarter was £380 million. The adverse movement year on year is directly related to last year's restructuring of the interest rate and currency swap portfolio. The variance on the working capital tax at other line was due to a number of factors. You will recall that during Q3 last year we paid £362 million in annual deficiency and special pension contributions. This quarter as a result of making additional payments last March there was no requirement to make any deficiency pension contributions.

Also this quarter there was an element of catch up billing by and payment to suppliers. Additionally a number of customers delayed their payments until after their financial year-end closed. Thus working capital increased during the quarter but in subsequent weeks we had a significant increase in cash inflows in early January so were helped by the sales of investments including Eutelsat and Starhub our net debt closed as £7.9 billion this quarter end.

However with the completion of Albacom and assuming we complete Infonet our net debt at the end of March will be marginally higher.

In our Q2 results we outlined briefly our progress to produce IFRS complaint accounts. We highlighted the main differences that will arise as a result of four key accounting treatments and we gave a brief synopsis of each. To explain these changes in greater depth we have arranged a presentation for you in mid March we will then provide you with further details so keep your diaries free.

So in summary the trends in this quarter are very similar to those of recent quarters. Our strategy to grow New Wave business has allowed us to more than offset declines in traditional activities. With overall revenue growth now for four consecutive quarters. Despite the change in margin structure our continued focus on every cost line of the P&L has underpinned the development of New Wave businesses. The pace of transformation continues to accelerate as we evolve in the corporate market gaining credibility as an ICT service provider. Our very focused acquisitions supplement existing scales and reach whilst enabling us to extract and develop additional synergies.

The combination of all these actions and activities as well as good management of the bottom half of the P&L has helped us to grow EPS for each of the last eleven quarters. Our performance demonstrates clearly how we continue to invest in transforming our business and delivering solid financial results.