Updates to External Reporting

Spark nz

Investor and Analyst Briefing: December 2018

Summary

As outlined at Spark's FY18 results announcement the presentation of Spark's financial results will change from FY19 onwards as a result of:

- Adoption of the new accounting standards - NZ IFRS 15 *Revenue from contracts with customers* and NZ IFRS 16 *Leases*;
- Changes to the disclosure of Spark's long-term investments;
- Spark's shift to Agile and the associated cessation of Spark's previous business unit structure; and
- Other elective changes to the structure and detail of external disclosures

This presentation provides a view of impacts arising from these changes. A detailed financial workbook, containing restated financials for FY17 and FY18, has also been released alongside this presentation – it should be noted that:

- FY18 accounting standard adjustments have been audited by KPMG
- FY17 accounting standard adjustments reflect estimated impacts to aid comparability

FY19 guidance has also been translated to reflect impacts from these changes and is provided in more detail on slide 8 of this presentation.

While these updates have no impact on reported total cashflow it should be noted that:

1. EBITDA is now replaced by 'earnings before finance expense and income, net investment income, income tax, depreciation and amortisation' or **EBITDAI** – with the new 'net investment income' category including dividend income from Southern Cross (and any other investments) together with Spark's share of associates' and joint ventures' net profits and losses

2. These changes reduce the effectiveness of EBITDAI and NPAT as proxies for cashflow. Therefore, Spark is introducing a new cashflow metric that will supplement exiting metrics and be included as part of Spark's ongoing external financial reporting

3. Reported EBITDAI and EBITDAI margin increase due to adoption of new accounting standards

4. Reported net earnings after tax and earnings per share reduce due to adoption of new accounting standards

5. Spark is adopting the new NZX Listing Rules from 1 January 2019 which will apply to its reporting of FY19 interim results. As a result Spark will no longer produce a half-year interim report booklet, in the form it has previously, but will publish a market release, a supplementary results presentation, interim financial statements and a detailed financial schedule. Commentary on performance will be covered at a high level in the market release and in more detail as part of the results presentation that is already released alongside Spark's interim financial statements.

FY17 and FY18 restatements

Adoption of NZ IFRS 15

NZ IFRS 15 sets out the requirements for recognising revenue and costs from contracts with customers and is required to be adopted from FY19 onwards

	Impact on previously reported financials due to adoption of NZ IFRS 15	
	FY17 $m	FY18 $m
Operating revenues and other gains	(50)	(69)
Operating expenses	26	39
EBITDAI	**(24)**	**(30)**
Depreciation and amortisation	-	-
Net investment income	-	-
Finance income	14	18
Finance expense	-	
Net earnings before income tax	(10)	(12)
Tax expense	-	-
Net earnings after income tax	**(10)**	**(12)**
Earnings per share (cents)	(0.5)	(0.7)

Background

- Replaces NZ IAS 18 revenue and related interpretations and sets out the requirements for recognising revenue and costs from contracts with customers
- Requires entities to apportion revenue earned from contracts to individual promises, or performance obligations, on a relative stand-alone selling price basis
- Spark has elected to transition to NZ IFRS 15 using the full retrospective method

Impact on Spark's externally reported financials

1. For Spark's 'interest free' device offers a portion of associated operating revenue, reflecting the credit risk of the customer, moves to interest income outside of EBITDAI and is recognised over the term of the interest free period, rather than in the first month of the interest free arrangement. As the total value of devices on interest free arrangements increased during FY17 and FY18 there has been a net deferral of interest income following adoption of NZ IFRS 15; resulting in a reduction in reported NPAT.
2. Spark's Spotify and Netflix offers, along with certain cloud, security and service management revenue, move to being treated as agency arrangements with this resulting in associated costs for these offers being net off against associated operating revenue. This results in a net reduction in reported operating revenue, but no change in EBITDAI.
3. The deferral of commission costs is applied retrospectively and due to the timing and composition of Spark's prior treatment, this has resulted in a net decrease in earnings for FY17 and FY18 on adoption of NZ IFRS 15
4. Where Spark provides value added services such as Lightbox as part of a mobile or broadband plan, revenue must be allocated to each component of that offer. Spark has calculated the revised allocation of revenue to each these components, however to be consistent with how the business is managed and performance assessed, has elected to retain allocated revenue within the same product category in which revenues are currently reported. For example, revenue attributable to Lightbox as part of a bundled broadband offer will continue to be reported within broadband revenue.

FY17 and FY18 restatements

Adoption of NZ IFRS 15

Two examples[1] are provided below to illustrate impacts from adoption of the NZ IFRS 15 accounting standard

1 Shift from operating revenue to interest income for 'interest free' device sales; at a rate reflecting the credit risk of the customer

Example: Interest free device sold for $2,000 and repaid 'interest free' over a period of 24 months

	Before IFRS 15			After IFRS 15		
	Day 1	Next 24 Months	Total 24 Months	Day 1	Next 24 Months	Total 24 Months
Mobile device revenue	$2,000		$2,000	$1,700		$1,700
Mobile cost of sale	($2,000)		($2,000)	$2,000		$2,000
EBITDAI	-	-	-	**($300)**	-	**($300)**
Interest Income					$300	$300
Net profit before income tax	-	-	-	**($300)**	**$300**	-

2 Spotify and Netflix offers, along with certain cloud, security and service management revenue, move to being treated as agency arrangements

Example: $150 (excl. GST) pay-monthly mobile plan with Spotify subscription included as a value added service

	Before IFRS 15	After IFRS 15
Mobile plan revenue	$150	$125
Spotify 'revenue'	-	$25
Spotify cost	-	($20)
Net mobile service revenue	$150	$130
Mobile product costs	$20	-
EBITDAI	**$130**	**$130**
Monthly ARPU[2]	$150	$130

[1] Examples are provided for illustrative purposes only and do not reflect Spark's actual NZ IFRS 15 adjustments
[2] Mobile ARPU calculated as monthly net mobile service revenue divided by average monthly connections

FY17 and FY18 restatements

Adoption of NZ IFRS 16

NZ IFRS 16 sets out the requirements for recognition of most leases and is being early adopted by Spark from FY19 onwards

	Impact on previously reported financials due to adoption of NZ IFRS 16	
	FY17 $m	FY18 $m
Operating revenues and other gains	2	3
Operating expenses	70	66
EBITDAI	**72**	**69**
Depreciation and amortisation	(52)	(47)
Net investment income	-	-
Finance income	1	1
Finance expense	(33)	(31)
Net earnings before income tax	**(12)**	**(8)**
Tax expense	-	-
Net earnings after income tax	**(12)**	**(8)**
Earnings per share (cents)	(0.7)	(0.4)

	as at 30 June 2018 $m
Total assets	410
Total liabilities	(475)
Net assets	**(65)**
Retained earnings	(65)

Background

- Replaces NZ IAS 17 *Leases* and removes the distinction between operating and finance leases. Similar to the current finance lease model, this results in the recognition of "right of use" assets and related lease liability balances
- As a result, rental payments for leases previously recorded in relation to operating leases - including corporate property leases, mobile cell site leases and customer equipment leases - will move from being included in operating expenses, within EBITDAI, to depreciation and finance expenses outside of EBITDAI
- The impact on net earnings before income tax from an individual lease, over its term, is unchanged
- However the new standard results in a higher interest expense in early years, and lower interest expense in the later years of a lease when compared with the current straight-line expenses profile of operating leases; similar to a table mortgage.

Impact on Spark's externally reported financials

1. The fully retrospective application of NZ IFRS 16 restatements results in the combined depreciation and interest expense, for any lease in the early years of its cycle, being higher than the operating expenses previously recognised within Spark's externally reported financials. With Spark's long-term corporate property leases (which account for 80% of total adjustments under NZ IFRS 16) being in the early years of their lease period, both net earnings before tax and retained earnings subsequently decrease following application of NZ IFRS 16.
2. Change in the treatment of leases where Spark acts as the intermediate party (i.e. back-to-back leases)

FY17 and FY18 restatements

Change in disclosure of Spark's long-term investments

From FY19 onwards the disclosure of Spark's long-term investments will also change to align with NZ IFRS 15 and to apply appropriate focus on core operational performance

	Impact on previously reported financials due to change in disclosure of Spark's long-term investments	
	FY17 $m	FY18 $m
Operating revenues and other gains	(61)	(50)
Operating expenses	-	-
Share of associates' and JV net losses	4	3
EBITDAI	**(57)**	**(47)**
Depreciation and amortisation	-	-
Net investment income	57	47
Finance income	-	-
Finance expense	-	-
Net earnings before income tax	-	-
Tax expense	-	-
Net earnings after income tax	**-**	**-**
Earnings per share (cents)	-	-

Background

The disclosure of Spark's long-term investments has been changed to:

- Better align Spark's disclosure of operating revenue with "revenue from contracts with customers" as defined by NZ IFRS 15
- Apply more appropriate focus on the financial performance of the operational activities of the business, with returns from joint ventures and associates to be now reported separately

Impact on Spark's externally reported financials

Will not result in a change in reported net earnings however the following will move from being reported within EBITDA to now being recognised within a new 'investment income' category, reported outside of EBITDAI:

- Dividend income from Southern Cross; and
- Spark's share of associates' and joint ventures' net profits and losses

Existing FY19 guidance has already been issued inclusive of impacts from this disclosure change

FY17 and FY18 restatements

Combined impact

The resulting impact on reported FY17 and FY18 earnings is summarised below and provided in more detail in the accompanying detailed financial workbook

	Reported *excluding* impacts from new disclosures		Adoption of NZ IFRS 15 *Revenue from contracts with customers*		Adoption of NZ IFRS 16 *Leases*		Change in disclosure of Spark's long-term investments		**Restated** *including* impacts from new disclosures	
	FY17 $m	FY18 $m	FY17 $m	FY18 $m	FY17 $m	FY18 $m	FY17 $m	FY18 $m	FY17 $m	FY18 $m
Operating revenues and other gains	3,614	3,649	(50)	(69)	2	3	(61)	(50)	3,505	3,533
Operating expenses	(2,594)	(2,657)	26	39	70	66	-	-	(2,498)	(2,552)
Share of associates'	(4)	(3)	-	-	-	-	4	3	-	-
EBITDAI	**1,016**	**989**	**(24)**	**(30)**	**72**	**69**	**(57)**	**(47)**	**1,007**	**981**
Depreciation and amortisation	(430)	(434)	-	-	(52)	(47)	-	-	(482)	(481)
Net investment income	-	-	-	-	-	-	57	47	57	47
Finance income	16	16	14	18	1	1	-	-	31	35
Finance expense	(42)	(46)	-	-	(33)	(31)	-	-	(75)	(77)
Net earnings before income tax	560	525	(10)	(12)	(12)	(8)	-	-	538	505
Tax expense	(142)	(140)	-	-	-	-	-	-	(142)	(140)
Net earnings after income tax	**418**	**385**	**(10)**	**(12)**	**(12)**	**(8)**	**-**	**-**	**396**	**365**
EBITDAI Margin (%)	28.1	27.1							28.7	27.8
Earnings per share (cents)	22.8	21.0	(0.5)	(0.7)	(0.7)	(0.4)	-	-	21.6	19.9

FY19 guidance

FY19 guidance has been translated to ensure it can be appropriately compared to restated FY17 and FY18 actuals and interim and full year FY19 results

	Previous FY19 Guidance[1] Including adjustments for: New approach to disclosure of Spark's long-term investments	Impact from adoption of NZ IFRS 15	Impact from adoption of NZ IFRS 16	Translated FY19 Guidance[1] Including adjustments for: New approach to disclosure of Spark's long-term investments; and Adoption of NZ IFRS 15 and NZ IFRS 16 accounting standards
Total Revenues	**\$3,600m to \$3,670m** excludes projected \$10-\$20m Southern Cross Dividend	(\$75m)	\$5m	**\$3,530m to \$3,600m** excludes projected \$10-\$20m Southern Cross Dividend
EBITDAI	**\$1,025m to \$1,055m** excludes projected \$10-\$20m Southern Cross dividend and profits and losses from associates' and joint ventures'	(\$30m)	\$70m	**\$1,065m to \$1,095m** excludes projected \$10-\$20m Southern Cross dividend and profits and losses from associates' and joint ventures'
Capex [2]	**~\$410m**	-	-	**~\$410m**
Earnings per share	**23c to 24c**	(0.5c)	(0.5c)	**22c to 23c**
Dividend per share	**Total 25.0cps** at least 75% imputed[3]	-	-	**Total 25.0cps** at least 75% imputed[3]

[1] Guidance subject to no adverse change in operating outlook
[2] Includes purchase of property, plant and equipment and intangible assets, capacity purchases (including Southern Cross) but excludes leased customer equipment assets
[3] Likely to be made up of an ordinary dividend topped up by a special dividend to maintain a total dividend per share of 25.0c

Other reporting changes

Segment reporting

Spark has also made a number of other improvements to the structure and detail of its externally reported financials

Required changes to reflect Spark's shift to Agile and the associated cessation of Spark's previous business unit structure

Primary segment lens will move from business unit to product

In line with Spark's current reporting, product disclosures will be provided to a gross margin level, with both revenue and associated costs for each product separately noted

Consistent with current reporting practices a customer segment split of operating revenues will be provided for each product

Labour and other operating expenses will be reported at a consolidated Group level, without any product or customer segment split

Elective changes to provide greater performance insight and to improve the consistency of segmental reporting

Mobile device insurance revenue	To ensure consistency with reporting of similar products, mobile device insurance revenue has been moved from other revenue to mobile service revenue
Cloud, security and service management margin	To provide a more informed view of margins generated by cloud, security and service management an additional margin measure, identified as contribution margin, has been introduced. Contribution margin is defined as reported gross margin less labour and other costs that are directly attributable to the implementation and ongoing support of specific customer services.
Procurement and partners revenue	Procurement and partners revenue updated to consistently capture revenue generated by all customer segments and subsidiaries. The resulting minor increase in procurement and partners revenue is largely due to a reclassification of revenues previously reported in cloud, security and service management.
Managed internet revenue	To provide a clearer view of broadband and managed data performance, revenues associated with managed internet services have been moved from broadband revenue to managed data revenue
Voice connections	A breakdown of voice connections by technology type has been introduced; to be more consistent with current broadband disclosures and to provide greater insight into the profile of migration onto newer digital technologies
Voice over IP (VoIP) revenue	To ensure consistency with reporting of similar products, VoIP revenue has been moved from calling revenue to voice access revenue
Voice value added services revenue	To ensure consistency with reporting of similar non-bundled products, revenues associated with voice value added services (such as messaging and other smartphone services) have been moved from calling revenue to other voice revenue
Product costs	As part of moving to product as the primary segmental lens all "other intercarrier cost of sales" and some "other operating expenses" are now directly allocated to product costs for each relevant product-set
Depreciation expense	Depreciation expenses are now split into the following categories: • Depreciation of plant, property and equipment; • Depreciation of right-of-use assets; and • Depreciation of leased customer equipment

Other reporting changes

New cashflow measure

The adoption of new accounting standards and changes to the disclosure of Spark's long-term investments do not impact reported total cashflow. However they do reduce the effectiveness of EBITDAI and NPAT as proxies for cashflow.

Therefore, Spark is introducing a new cashflow measure, that will supplement existing metrics, to:

1. Better communicate the cashflow generated by Spark;
2. Provide a measure that is not impacted by changes in accounting standards; and
3. Facilitate a clearer reconciliation of any movement in net debt to underlying business performance

Spectrum purchases are excluded from this measure - to ensure that it provides a more stable and consistent measure of underlying cash generation.

To enable reconciliation of this measure to Spark's cashflow statement, a new category will be created within Spark's cashflow statement called "payments for purchase of spectrum"

The new measure is identified as "cash from operations minus payments for leases and capital expenditure (excl. spectrum)" and will be provided as part of ongoing external financial reporting

	Reported *excluding* impacts from new disclosures	
	FY17 $m	FY18 $m
Cash received from customers	3,425	3,508
Interest receipts	14	15
Dividend receipts	66	50
Payments to suppliers and employees	(2,609)	(2,595)
Income tax payments	(143)	(167)
Interest payments	(36)	(37)
Cash from operations	717	777
minus		
Payments for leases	(8)	(8)
Payments for purchase of property, plant, equipment & intangibles (excl. spectrum)[1]	(398)	(414)
Cash from operations minus payments for leases and capital expenditure (excl. spectrum)[2]	**311**	**355**

[1] No spectrum purchases were made in either FY17 or FY18
[2] Overall cash from operations minus payments for leases and capital expenditure (excl. spectrum) is not impacted by new disclosures

Disclaimer

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