MARKET RELEASE

3 November 2017

Managing Director's Review delivered at Spark New Zealand Limited's 2017 Annual Meeting, South Level 4 Lounge, Eden Park, Auckland on 3 November 2017

Good morning and thanks for the opportunity to speak this morning about the exciting future we see for Spark, as well as the future challenges we will have to navigate.

As you've heard from Mark, we have progressively reoriented the business towards a wireless future, making a strategic shift from a traditional telco with international interests to a New Zealand-focused digital services company.

We've replaced our dominant old-world brand with a portfolio of vibrant new brands. Our slow defensive culture is now customer-inspired, fast and focused on winning. We've replaced an outdated, complex network of IT systems with market-leading data network and service platforms.

As a result we've cemented market leadership in telco and taken leading positions in Platform IT services, analytics and video entertainment.

We are now looking to the next stage of our evolution.

At our strategy update in late June we set out where we aspire to be in 2020, and the three new focus areas we believe will get us there. These are:

- *Increased emphasis on wireless***:** customers have a strong preference for wireless connectivity. They want to be always connected, to have a seamless digital experience. Even in the home broadband space, it's becoming a wireless world. After all, home WiFi is simply a radio signal travelling from your device to a modem, which connects back into our network via a cable. Our wireless broadband product works the same way. The only difference is you connect to the network via the nearest cell site. We're focused on giving our customers the best, most seamless digital experience, and in many cases their experience will be better on our wireless broadband product, than on the aging copper network.
- *Get better at serving price-sensitive customers*: a larger than expected portion of the market is buying primarily on price, which is fueling price competition and consequent margin pressure. We are further developing our multi-brand strategy and using brands like Skinny to better serve this segment of the market, by widening its product portfolio and increasing its market voice.
- *Simplification, digitisation and automation*: our work to reduce unit costs to date has been good, but not enough for the future. Customers are demanding "more for less" and therefore profitability must be underpinned by further cost reductions. We need to become the lowest cost operator through radically simplified and digitised products, processes and services.

A significant factor in our move to focus investment on wireless is the unhealthy state – from our perspective as a retailer – of the consumer fixed broadband market.

A recent report on the New Zealand telecommunications market by industry analysts IDC pointed out that growth disguised the true picture of a market under incredible price pressure. It described the broadband market as a “glum place for telcos”, with rising input costs alongside ruthless retail competition driving down margins.

We agree with their analysis, and we are equally concerned about the current state of the market.

Five years ago, the highest end broadband deals would set you back almost $150. They offered data caps of 500GB a month (unlimited didn’t exist back then), only a very small number of people could get UFB fibre, and VDSL copper wasn’t that widely available. So most people could only get ADSL copper speeds, ranging from a few Mbps to (if they were lucky) 15 Mbps.

Now the best broadband deal in the market is arguably the Skinny fixed broadband unlimited plan for $68 a month – delivered on 100 Mbps fibre if it’s available in your area.

Taking this plan as an example: after we pay for Chorus or the local fibre company for line charges and deduct GST, we are left with only $16 out of the $68 to cover the costs associated with delivering a broadband service to the customer, including broadband management technology, national and international networking, customer service, sales and marketing, and billing and administration. All of that needs to be covered by $16, which frankly leaves us with no real profit margin.

You might think that Skinny is an extreme example – and it’s true we have a strategy that Skinny won’t be beaten on price. But this pricing reflects an extremely competitive retail market, and we only put this offer into the market to stem our market share losses to other retailers, many of whom offer a range of deals that include things like smart TVs, first three months free, bundled video streaming services or discounted Sky TV. If you factor in these freebies, the pricing isn’t too dissimilar to Skinny’s pricing. It’s a situation that drives margins seriously close to negative.

We don’t believe it’s sustainable for the wholesale access or line charge to be almost three times bigger than what we get paid to run the service over that line, so something is going to have to give.

Let me be clear, this is a great story for consumers. Customers are getting more bang for their broadband buck than ever before. But the IDC report questions whether these market conditions are sustainable, and we would echo that. There are more than 80 broadband providers in the market. I would suggest a lot of them are in a financial hole right now – and they are all hoping they can market their way out of this hole by attracting more customers and increasing their market share. But that strategy clearly can’t work for all of them, so I’d expect reality to hit for more and more players. We are now at the point where it is likely cheaper to acquire a customer base from another provider through an M&A deal than it is to try to attract those customers through marketing efforts. For that reason, we expect to see, and participate in, significant consolidation of the retail broadband industry over the next couple of years.

This market context is a driver for our investment in wireless broadband, and our repositioning towards mobile more generally. The reality is cellular mobile technology will continue to advance quickly and provide even better broadband services across wireless.
We are currently rolling out 4.5G and we are on the path to 5G. 4.5G is already enabling speeds into the 100's of Megabits per second. While we don't expect customers to achieve these sorts of speeds all the time during 'real world' usage, they are still a quantum leap from basic 4G and consistently better than what can be achieved with standard ADSL broadband on copper.

When 5G arrives, there will be another massive leap forward to theoretical speeds of up to 20 Gbps, and we will see a huge increase in capacity on the network. As 5G is rolled out, a higher volume of wireless broadband customers, using more data, becomes increasingly feasible.

There is plenty of work to do yet on 5G – the global standards haven't even been finalized yet – but the rapid evolution of mobile technologies reinforces that the opportunities for wireless broadband will continue to grow.

It is this confidence in the mobile technology roadmap that led us to launch a low-priced unlimited mobile plan. The performance of this plan is already exceeding our expectations.

In just a month and a half since launch, almost 20,000 New Zealanders have taken it up. Some market commentators had noted a risk to ARPUs, when in fact we're targeting and seeing the opposite effect. Before the launch of the plan, less than 5% of customers joining Spark were on plans costing $79 and above. Since launch that percentage has increased to almost 20%. Competitor reaction has been interesting, with both our competitors responding with higher capped mobile plans.

Parallels could be drawn to the US market, where both Verizon and AT&T responded to T-Mobile's launch of their Unlimited Plan in the same way. Both of those companies have since joined T-Mobile with an unlimited plan and abandoned the bigger capped plans, as they missed out on the ARPU growth of going unlimited.

Wireless broadband has four key advantages for medium-to-low data users:
- first – it is reliable: so is a great solution for customers who have previously had a poor copper connection;
- second - easy installation: its plug and play functionality means installation is very simple – there's no need for a technician to visit or for your driveway to be dug up;
- third - customer satisfaction: Which is the only test of a product that really matters, and for wireless broadband this is very high. Interestingly, our wireless broadband customers give a higher rating for speed than any other technology. That is not to suggest the actual speeds are higher, but that the speeds satisfy customers ***based on what they need from a broadband service*;**
- fourth - innovation and affordability: with the launch of our wireless broadband product we've been able to provide broadband at new price points such as Skinny's 40GB for $40 – easily the lowest priced broadband deal in the market. We've also been able to offer Spark Jump: a highly discounted broadband social service for low income families, focused on ensuring their children jump the digital divide and can continue their digital learning at home.

As you may have read in the news recently, the Commerce Commission has announced a study into New Zealand's mobile market.

NZ is a small market, with three mobile network providers and a dozen MVNOs (Mobile Virtual Network Operators) who buy access to a network off one of the network providers. But some observers believe the low market share held by MVNOs is a sign of lack of competition that needs to be remedied by the regulators. We would disagree.

The key question the Commerce Commission needs to ask in its review is whether the current market is working for New Zealand consumers. We say the answer to that question is a resounding yes, the market is serving consumers well.

New Zealand has three world-class networks delivering prices that are well below OECD averages – which is an outstanding achievement for a country with a tiny population spread across islands with terrain that makes efficient delivery of mobile services very challenging. The technology we're delivering gets better every year; the minutes, texts and data customers get increases every year; and our prices keep falling. The Commerce Commission has actually acknowledged this in their own reports. While the Commission did note that at the higher end, mobile broadband plans were still quite expensive compared with other markets, we think that recent moves such as the greatly reduced price point for unlimited mobile plans mean the market is moving very rapidly in the right direction.

Regulation of a market should only ever be contemplated if there is an identifiable market failure and we can see no evidence of one in our mobile markets.

This all comes down to the investment we and our industry counterparts have made, and continue to make, in our mobile networks. At Spark, for instance, we've spent just over $700m on our mobile network and associated spectrum assets over the past 5 years. We'd estimate that the other mobile network providers have spent at least as this much again on a combined basis.

And that's just direct network investment … if you factored in the indirect costs associated with IT platforms, core network connectivity, etc, the investment would be much, much higher. To give you a sense of scale, our total capex across Spark over the past five years – a period when we have no longer owned a fixed access network - was $2.3bn. If we are to keep investing in our networks to ensure NZ keeps up with the rest of the world when it comes to mobile services, there has to be a fair level of profitability for operators and there has to be an investment climate that gives us the confidence to keep making those investments.

We've therefore asked for a quick conclusion to the Commerce Commission's review process, and are urging the Commission to consider early on whether it can identify any genuine indicators of market failure that might justify further investigation.

We are working hard to establish strength in new markets in digital services, to defend against and/or partner with global digital competitors. Specifically, we've been building capability in:

- *Cloud services*: As Mark discussed, our significant investment in this business has seen us become a New Zealand leader in Platform IT. We are targeting to grow Platform IT revenue by 25% this year.
- *Cyber security*: We have invested heavily to protect our own networks over a number of years. We have now developed a high level of expertise in this area, to the point

where we are earning tens of millions of dollars of revenue each year from providing cyber security services to our customers, and are targeting 30% revenue growth this year.
- *Analytics*: Our big data analytics business Qrious saw significant revenue growth over the last financial year, underpinned by targeted business acquisition and a focus on product innovation.
- *Media*: we now have 300,000 signed up households on Lightbox, which means around a million NZers are watching Lightbox. We have a new, enhanced platform ready for launch early in 2018 and we're excited about expanding the range of video content we offer.
- *Internet of Things*: we are working to roll out nationwide low-power networks specifically for IoT. This will be enhanced by our big data analytics capability in Qrious. We are working with a number of customers on piloting IoT use cases, including our Connected Farms project.

The new paradigm for service is not human delivered - winning in new markets requires us to embrace an "all-digital" customer experience, with most of the need for service "designed out" of the core product.

We know from research that the only time human-enabled service matters is when a customer has a fault. In all other cases, Net Promoter Score (NPS) data shows us people who are digitally-enabled have a better experience with a self-service option. Gartner's recent customer behaviour survey indicated 87% of customers attempt to self-serve before picking up the phone. This is reflected in our customer behaviour – as per the pie chart on this slide.

We are investing in machine learning, digital assistants, self-service apps, automation etc.
We are already using artificial intelligence to improve the customer experience. Our customer-facing engineers have trained a first edition artificial intelligence robot, which we have called Tinkerbot. This bot proactively looks for customers experiencing poor broadband performance to diagnose and resolve their issue. This has resulted in a more than 40% reduction in call handling time and work effort, and high satisfaction levels amongst staff and customers.

Spark can lead the way on this and show other New Zealand businesses how to do it.

To succeed in new markets, we must find new ways of working to give us more flexibility and pace. We've been progressively adopting the "Agile" business model – one that has less hierarchy and allows teams to move faster – with terrific results in customer experience improvement and speed to market.

We are also exploring mid-career re-skilling to help our people adapt to this new world. This is an area that's troubling me as a business leader in New Zealand – we will potentially have people who are midway through their careers who don't have all the digital skills and knowledge needed to thrive in this new environment.

Most people would acknowledge technology is a force for good, but we need to put more work into ensuring it creates a better life for everyone.

We'll be using our experience and voice to participate in the leadership agenda required to enable all New Zealanders to adapt to the changing nature of work that is likely to result from digital innovation over the coming decades.

The future presents many challenges, but also some big opportunities.

Our ambition remains to be a company that can help all New Zealanders unleash their full potential through the power of our technology and digital services.

Thank you.

Please find attached the slides to be presented in support of the Managing Director's Review.

-ENDS-

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