Management Discussion & Analysis

Operational & Financial Review

Overview of 2008

Year ended 31 December 2008, compared to twelve months ended 31 December 2007, in accordance with International Financial Reporting Standards (IFRS)

2008 has been a tumultuous year globally – a year in which unprecedented macro economic pressures and volatile market dynamics have challenged national economies and the fabric of global commerce. During our long history as a company we have witnessed several periods of economic uncertainty and continued to demonstrate in 2008 that our business is resilient through periods of market volatility.

During 2008, the management of Telecom Egypt (TE) had three clear priorities. Firstly, to ensure continued prudence in our financial management for maximum flexibility, should global economic uncertainty turn out to be prolonged in nature.

Secondly, an unwavering commitment to safeguard profitability and the stable yield we offer to our investors, through a combination of solid top line performance and stringent cost controls.

Our third priority looked further ahead and was to ensure that the Egyptian telecommunications market has an orderly and sustainable future, underpinned by fair competition. A well functioning telecommunications sector is a critical component of any national economy and will continue to underpin the development of Egypt as a knowledge economy in the global market.

This led us during the year to implement a second round of tariff rebalancing and also to apply to the National Telecommunications Regulatory Authority (NTRA) for an amendment to the interconnection agreements which were written at the time of market liberalisation.

While it is clear that market dynamics in 2008 were extreme, and have yet to normalise, we nonetheless recorded a consolidated annual revenue figure which exceeded EGP 10 billion for the first time and an annual growth in net profit of 10 percent. We are immensely proud of this result and confident that TE has the right customer offering and one of the best teams to work through the challenges the coming period may present.

2008 also marked the ten year anniversary of the beginning of market liberalisation. The fixed-line voice segment has been open to competition since 1998. Moreover, the international access segment of the market was opened to competition in January 2006. While there has been much change in the landscape, we still own the only operational national network and have retained a large proportion of international gateway services.

As we explore other projects and capitalize on the strength of our investments, it is critical for us to optimize the opportunity our extensive infrastructure presents us with. Our position as the network of choice for other operators means that any pressure we have experienced on retail voice revenues during the period under review has been more than offset by a corresponding increase in wholesale revenues.

The strength of our wholesale offering is entirely based on the significant technical capacity and reach our network provides. It is this potential upon which we seek to continue to build.

Competition within the mobile market in Egypt continued to intensify during 2008. Over the course of the last five years this development has radically changed the breakdown of our revenues and means that our business today is much more diversified than ever before.

As our market evolves, it is, however, important for us continually to seek out new initiatives that allow us to leverage the combination of our unique geographic position and the capacity and quality of our infrastructure. One such opportunity is the TE North project.

Our objective with this project is to increase the service footprint of the existing TE Transit Corridor, the route of choice for all crossing submarine cable systems in this region, by building a private submarine cable system that links Egypt to Europe. This is designed to service the growing demand for IP traffic capacity from Asia into the West and at the same time lower the cost point of TE Data - our Internet arm.

The rationale is clear and we have made significant progress in delivering on this during the course of 2008. To date, we have announced sizeable commercial agreements in relation to TE North totalling USD 176 million which make the build out of this initiative extremely secure. Delivery of the TE North submarine cable is on track and expected in the fourth quarter of 2009.

Consolidated net profit for the full year period was EGP 2.7 billion and we are immensely pleased to be able to deliver a 10 per cent increase in consolidated net profit during such a challenging year. As a management team, we continue to behave with caution and with the interest of our shareholders at the forefront of our minds. Having reduced our debt position during the last two years and with significant cash reserves, we have no immediate refinancing requirements.

Based on this solid performance in 2008 the Board of Directors and shareholders have approved a dividend distribution of EGP 1.3 per share, the highest ever dividend payment in the history of TE.

With projects such as TE North on track and generating significant commercial interest, an increasing portion of growth business in the form of TE data and Vodafone Egypt, a more diversified revenue base than ever before, robust margins which continue to produce significant shareholder returns and a solid financial footing with which to weather the prevailing economic situation, we look to the future with confidence.

Operational review

At TE, our philosophy is to only grow revenues where our margins are not impacted. Profitability is central to our investment case, but in operational terms it is the quality and reliability of our connection that sets us apart. We have only been able to build and maintain such a large and loyal customer base because of this standard.

There is a common theme to both aspects. Productivity is a key driver to both profitability and service quality. Our productivity has increased with the number of fixed access lines in service per employee rising from 205 at the end of 2007 to 217 at year end 2008, when our employee count totalled 53,827.

Retail Services

We continue to enjoy a sizeable subscriber base and during 2008 we saw significant new interest in the quality and reliability of our service.

During the year we added over 474,000 subscribers net, an increase of 12.5 percent on the net subscriber additions we reached in 2007. A key driver to this growth was the promotional activities we launched in the final quarter. The resulting 4 percent growth in total subscribers means that our retail customer base now exceeds 11.7 million subscribers, delivering a monthly ARPU of EGP 51 over 2008 - a real achievement in the context of such uncertain times.

Fixed-line Voice Services

While our wholesale business has benefited from the increase in mobile traffic, our retail revenue base has seen some decline in usage as a result of mobile substitution. Egyptian mobile operators have dramatically cut call tariffs in the land grab for new subscribers. We have taken the necessary steps to address pricing inconsistencies during the course of 2008. From 1 July 2008 we implemented another round of tariff rebalancing, which has worked to mitigate some of the effects of mobile substitution visible earlier in the year.

Just as with the round of tariff changes implemented in July 2006, the aim of the second wave was to rebalance the revenues we receive from retail voice to a more competitive level. The end result is a corresponding rise in access revenues, comprising connection fees and subscription, which increased 6 percent year on year to EGP 1.9 billion and a stabilisation of retail voice revenues which reached EGP 3.0 billion.

The onus is now on us to ensure that our call packages are viewed as competitive and the unsurpassed quality of our service is fully recognised. We look forward to continuing to deliver on that customer promise.

Mobile Services

2008 saw particularly strong customer growth in the Egyptian mobile market, with prepaid services remaining the prevalent driver of market growth. Total Egyptian mobile customers expanded to almost 42 million by the end of 2008, equivalent to a penetration rate of 55 percent according to the NTRA. It is notable that the penetration rate within the Egyptian mobile market, and has more than doubled since 2006, following the award of the country's third mobile licence.

We can observe two dynamics at play in the Egyptian mobile market - the ongoing land-grab for subscribers through aggressive promotional tariffs and the launch of an increasingly wide range of advanced services.

Within this context, Vodafone Egypt (VE), our strategic and financial investment in the mobile sector, has importantly maintained its focus on profitability and revenue growth. Vodafone reports a financial year ending on 31 March, so the numbers we present in this report are from 1 April 2008 to 31 December 2008.

Under its new CEO, Richard Daly, VE continues to grow its share of revenues ahead of its competition with service revenue of EGP 8.9 billion for the nine month period to end December 2008 an increase of 15 percent year-on-year, while still growing the subscriber base to more than 17.6 million customers. We believe that the focus of the other operators will naturally shift towards revenue and profitability instead of number of subscriber additions and VE is well positioned in this respect.

Our investment in Vodafone Egypt has again made a substantial financial contribution to our 2008 results, delivering EGP 1.3 billion in investment income for the 12 month period. For VE as a whole net profit for the nine months to end of December 2008 was EGP 2.3 billion.

During this period, Vodafone Egypt recorded net additions of 3.5 million, a decline of 4.0 per cent on 2007 and its subscriber base generated a total of 22.9 million voice minutes in nine months in 2008.

Internet and Data Services

The Egyptian ISP market is fully liberalized and highly competitive, with over 200 ISPs offering a range of services, including dedicated, dial-up, pre-paid and premium services.

According to the NTRA internet usage at the end of 2008 stood at 10.5 percent per 100 inhabitants, all of whom are ultimately using TE's infrastructure to access the Worldwide Web.

Egypt's demographic profile remains highly conducive to continued demand for broadband access specifically, with more than 50 percent of Egyptians under the age of 25 and one third under the age of 15.

As a result, 2008 was another strong year for our broadband internet subsidiary, TE Data. For some time TE Data has been the market leader, but is not complacent in this position and continues to surpass its targets and fulfil its strategic objectives quarter-after-quarter.

TE Data's market share has grown considerably. In 2005, TE Data had just 30 percent of the market. As at year end 2008, just three years later, this has almost doubled to 59 percent market share, equivalent to 424,413 ADSL subscribers.

Wholesale

As Egypt's sole network provider, market liberalisation has, since its inception a decade ago, transformed the balance of our business and provided us with a revenue mix that is more diversified than ever before.

Our existing digital fixed-line network covers 95 percent of populated areas with more than 27,000 kilometres of cable, enabling us to cater for the growing demand from other operators to carry traffic over our network. Such reach is difficult to replicate economically, having been achieved over more than 150 years, and, therefore, affords us an enviable position at the heart of the Egyptian telecommunications market.

The increase in mobile traffic means that our wholesale revenue opportunity is growing strongly, driven by higher mobile penetration, usage and 40 percent growth in infrastructure leasing.

Wholesale revenues now represent one of Telecom Egypt's fastest growing revenue lines. Having grown from EGP 2.5 billion in 2005 to EGP 3.9 billion in 2008, total wholesale revenues have now overtaken the retail voice revenues we derive from our fixed line subscriber base.

Domestic

One of our priorities in 2008 was to address pricing inconsistencies in the market to ensure that we are able to compete with the mobile operators on price.

Our goal was to seek a reduction in the termination rates on the mobile operators' networks to allow TE to offer its customers a rate which is competitive to that offered by the mobile operators.

In 2008, following the detailed discussions between Telecom Egypt and the mobile operators throughout the year, the National Telecommunication Regulatory Authority (NTRA) announced an administrative decision in early September 2008 which included amongst other things, a reduction in the mobile termination rates to 11.3 piasters and 6.5 piasters per minute for fixed termination.

Ultimately, the intention on our side is that financial benefit of this decision will be delivered to Telecom Egypt's customers, allowing us to compete more equally with mobile operators to mitigate some of the effects of mobile substitution.

As at year end, the NTRA's decision was being challenged in the courts by two mobile operators and we are yet to see the final outcome of these challenges but have confidence that if the NTRA's ruling is upheld TE will be in a position to compete more evenly with mobile operators and to mitigate some of the effects of mobile substitution.

International

IInternational wholesale revenues comprised 73 percent of wholesale revenues in 2008 versus 75 percent in 2007, as domestic wholesale traffic increased proportionately during the year. This was primarily attributable to a combination of the growth in domestic mobile traffic and no real increase in international calls.

Financial Review

Year ended 31 December 2008, compared to twelve months ended 31 December 2007, in accordance with International Financial Reporting Standards (IFRS)

While 2008 was a very uncertain year, TE continued its path of careful financial planning and prudence, allowing us to end the year with record revenues of EGP 10 billion, a 3 percent increase in net profit and the highest dividend award in the company's history.

All of this has been achieved against a backdrop of volatility and distress in the domestic and international economies.

Furthermore, careful management of TE's significant free cash flow to fund our debt repayment programme, something that we have implemented since 2007, means we are in a very secure financial position.

We do not have any short term refinancing requirements and as we look out in 2009, we take confidence in our ability to fund debt maturity, to fulfil capex commitments and, in the absence of new acquisition opportunities maintain a healthy dividend payment from our free cash flow.

Revenues

Consolidated revenues increased by just more than one percent in 2008 to EGP 10.1 billion for the year ended 31 December 2008, from EGP 9.9 billion for the same period in 2007. Revenue growth was slightly below expectation for several reasons. We continue to experience some pressure on retail voice revenues as a result in the increase in mobile usage, but as the result recorded in the latter half of the year shows tariff rebalancing has gone some way to mitigate these effects. In addition, we took the prudent decision not to recognise any revenues in 2008 for the TE North project. Only when this project is complete in the final quarter of 2009 will we recognise revenues derived from this business.

The main driver for growth in the period under review was the revenues we derive from domestic and international wholesale, which accounted for 39 percent of our total revenues in 2008.

Revenues from retail services

As a result of the success of the second round of tariff rebalancing which came into effect on 1 July 2008 and the growth experienced in revenues from internet and data, total retail revenues for full year 2008 were EGP 6.2 billion, a marginal improvement on those generated in 2007.The positive effect of 2008 tariff rebalancing on access and voice revenues, in particular on local calls, mitigated the pressure we experienced during the first half of 2008 as a result of the intensification of competition from mobile operators.

In 2008, total voice revenue was the largest contributor to our revenues at EGP 3 billion for the full year 2008. This dynamic is expected to continue to shift moving forward, as the revenues we derive from our wholesale business continue to grow in importance as we cater for the capacity requirements of other operators.

Meanwhile, the success of our internet offering has also been instrumental in partially offsetting the pressure experienced on retail voice revenues during the period. Take-up of internet and data services, predominantly from TE's broadband subsidiary TE Data, pushed internet and data revenues up 26 percent year-on-year, to reach EGP 575 million in 2008, compared to EGP 456 million in 2007.

Revenues from wholesale services

The strength of our wholesale offering is anchored in the modernity of our technical capacity and reach our network provides. In 2008, we recorded total revenues of EGP 10.1 billion, EGP 3.9 billion of which was attributable to wholesale.

Over the last five years we have seen a compound annual growth rate of 19 percent in wholesale revenues. Wholesale revenues comprised 39 percent of our total revenues in 2008. Five years ago this figure stood at just 23 percent.

Total revenues from domestic wholesale services rose substantially on the previous year, ending 2008 at EGP 1.1 billion up 8 percent on those achieved in the twelve months ended 31 December 2007. This was driven mainly by revenue from leasing TE's extensive infrastructure to other telecoms providers, which recorded a 41 percent increase.

While the international access segment of the market was opened to competition in January 2006, we have retained a large proportion of international gateway services. Liberalization of the international gateway has not had a visible impact on the revenues we derive from the international wholesale segment. In 2008, international wholesale revenues accounted for 73 percent of our total wholesale revenues versus 75 percent of total wholesale revenues in 2007. As domestic third party usage increases, we can observe that this balance within wholesale is also shifting.

Operating expenses

At TE we have always maintained a strict control on our finances and have sought to reduce costs wherever possible in the interests of maintaining the healthiest margin. During the course of 2008, operating expenses were impacted by a one-off increase in employee costs relating to annual pay awards and bonuses awarded in the first half of the year.

The annual salary increase for 2008 was approximately 20 per cent – with 10 percent effective from January 2008 and another 10 percent effective from the first of May 2008. The reason for the subsequent salary increase in May was to ensure that in a more competitive market for telecommunications professionals, we continue to attract and retain talent especially in light of 30 percent increase in salaries made by the government and significant increases by other private sector companies.

In spite of these increased salary costs operating expenses decreased by 1.5 percent to EGP 6.0 billion for the twelve months ended 31 December 2008, as the decrease in interconnection costs experienced from September 2008 and lower depreciation and amortisation charges offset the impact.

Selling and distribution expenses

For the reasons stated above, an increase in salaries was the main contributor to a 26 percent increase in selling and distribution expenditure during 2008, to EGP 455 million from EGP 362 million for 2007.

General & administrative expenses

An increase in salaries, for the reasons stated above, and costs relating to TE's early retirement program were the main contributors to an increase in general and administrative expenses of 19 percent to EGP 1.4 billion for the twelve months ended 31 December 2008.

Earnings Before Interest Tax, Depreciation and Amortisation (EBITDA)

As ever, profitability is a key metric against which we judge management performance. We have worked hard to maintain healthy margins against the backdrop of a new and constantly evolving telecommunications landscaping Egypt, which has placed pressure on the margins of the mobile operators.

Our ability to maintain this profitability metric is a further evidence of our commitment to strict cost controls. To arrive at our EBITDA calculations there are three major cost items in addition to provision and impairment.

Firstly, interconnection costs which in 2008 represented 12.4 percent of total revenues declined from 13.7 per cent of revenues in 2007. Secondly, total personnel costs, including costs relating to our employees remuneration and other contributions, which represented 20.3 percent of total revenues with the one-off increases noted above are still within industry norms. Other operating expenditure is the final item and in 2008. This was higher at 5.0 percent in 2008 versus 3.3 percent in 2007.

As at December 2008, our lead margin before provisions was 51 percent, within management expectations. Our track record in terms of the stability of our lead margin is something of which we are immensely proud.

Financial income and expenses

As it continues to strengthen its position in the market, our investment in VE has again made a substantial financial contribution to our 2008 results, delivering EGP 1.3 billion in investment income for the 12 month period.

In 2008, the strengthening dollar and Egyptian Pound meant that TE registered a net foreign exchange gain of EGP 3.6 million, versus a loss of EGP 93.9 million in 2007.

As a direct result of our debt repayment program, interest expenses were down 39 percent from EGP 611.4 million in 2007 to EGP 370.7 million in 2008.

Income tax expense

Income tax expense before deferrals increased by 4 percent, to EGP 543.0 million for the twelve months ended 31 December 2008 from EGP 521.1 million for the same period in 2007.

Net profit

Telecom Egypt consolidated net profit increased 3 percent year-on-year to EGP 2.5 billion. The improvement in our net profit margin, standing at 24.3 percent at the end of December 2008, has been derived from increased investment income, primarily from VE; lower interest expense resulting from our debt repayment program; an increase in interest income as a result of our increased cash position; and the foreign currency gain recorded in 2008.

Investments in infrastructure

Our network is fully digitalized and has significant headroom capacity. We have, therefore, been able to implement a capital expenditure (capex) rationalisation program that has reduced expenditure, while maintaining quality and servicing the appetite for capacity from other operators.

In 2008, capex decreased year-on-year in line with our rationalisation program, reaching EGP 919 million.

Debt

At TE, we continue to generate significant free cash flow. Our cash position as at the end of 2008 was EGP 2.7 billion, reducing TE's net debt position to EGP 411 million. This represents a net debt to EBITDA ratio of less than 0.1.

Total debt stands at EGP 3.1 billion, approximately 2 billion of which, while payable before February 2010, can be comfortably financed from our operational cash flows.

Our aim is to keep sufficient borrowing headroom to maintain maximum funding flexibility in the context of volatile financial markets.

Dividend policy

We have consistently paid a dividend for the last three fiscal years. Our policy is to pay dividends, when permitted by law and subject to consideration of future capital expenditure and investment requirements, as well as our overall financial condition.

Shareholders elect to distribute all or part of the Distributable Profits at the Telecom Egypt Ordinary General Assembly.

Pursuant to Egyptian legal requirements, Telecom Egypt convened an Ordinary General Assembly on 31 March 2009 to review the audited financial statements for 2008 and to determine dividends, if any, to be distributed. All financial statements and resolutions were duly passed. A dividend distribution of EGP 1.3 per share was approved at our Ordinary General Assembly meeting on 31 March 2009, representing the highest ever dividend payment in the history of TE.