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iiNet Limited today reported a net profit of $7.1 million for the half year to December 2006 which included a profit on the sale of the New Zealand business, ihug, of $5.0 million. Net profit from continuing operations in Australia was $1.7 million. Group EBITDA of $14.8 million was 80 percent higher than in the half year to June 2006. What were the major highlights of Australian operations in the December 2006 half year?

MD Michael Malone
Improving the profitability of our core Australian internet service provider (ISP) business was our major financial achievement in the FY07 first half. Our underlying profitability improvement was primarily due to the increase in the number of customers on-net, that is the number of broadband customers that we've migrated on to our own network. The December 2006 half benefited from the increase in on-net customers to 100,000 at 30 June 2006 from 70,000 at December 2005, and by the end of the half we had over 124,000 on-net. Broadband on-net customers are substantially more profitable than off-net customers.

The primary driver of the decision to build our own broadband network in 2003 was to differentiate our product. We accelerated the build in late 2005 when the new management team at Telstra changed its attitude to wholesale customers and substantially increased the prices charged to iiNet for wholesale ADSL. Our ADSL2+ network covers 268 exchanges, with an additional 26 under construction, giving us the second largest ADSL2+ network, with over 125,000 customers on the network, and an addressable market of over 4 million households.

In the past, we preferred to work with Telstra where possible, only building when necessary. It is now a strategic imperative for us to reduce our exposure to Telstra by controlling our own cost base. We have extended this strategy in the past year with the roll out of high capacity “dark fibre” to 150 exchanges in Sydney, Melbourne and Brisbane. We also now switch our customers’ telephony calls through our own infrastructure which again reduces our cost structure.

On 21 December 2006, we received a positive decision from the ACCC reducing the price of Line Sharing Services (LSS), an essential input which we must purchase from Telstra for our broadband network. The December half year reflected the higher LSS charges prior to the ACCC decision and the real benefit of the new rate will flow through this half.

During the December half all unprofitable customer plans were re-priced, we improved subscriber invoicing methods, thereby improving collectibles, and reduced overheads. We amalgamated our call centres into a single virtual call centre, improving reporting and staff tools, which has reduced costs while dramatically improving responsiveness.

With higher gross margins and lower overheads, EBITDA for the December quarter was over 50 percent higher than for the September quarter.

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Group operations generated cash flow of $8.4 million which included a contribution from the New Zealand business in the September quarter. What is the trend in operating cash generation in the second half of FY07?

MD Michael Malone
Migrating big numbers of customers onto our own network made a major difference to our operational position; our customers get a better service and our margin improves considerably. In addition, the re-pricing of a number of products contributed to a positive operating cash flow of $8.4 million.

I believe this tells only half the story though. Included in the operating cash flow are LSS charges of $9.00 per subscriber per month compared with the recent ACCC determination of $3.20 and a number of non-recurring payments. Adjusting for these factors, on a normalised basis the operating cash flow for the half was $21.0 million.

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Capital expenditure was $9.3 million in the December 2006 half. What is your capex’ budget going forward and what level of free cash flow do you anticipate?

MD Michael Malone
Our broadband network is substantially complete in terms of our target number of DSLAM enabled exchanges. We expect to add about thirty exchanges this year and a similar number next year. Our future spend on network capacity will primarily be driven by the growth in our broadband subscriber base.

On our forecast subscriber growth, we are budgeting for capital expenditure of $15 million in FY07 and a similar level in FY08. The reported FY07 expenditure will actually be higher because it will include an additional $7 million carried over from FY06.

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Net debt fell to $19.9 million at 31 December 2006 from $50.5 million at 30 June 2006 reducing your net debt to equity ratio to 16 percent. What are your borrowing facilities and what is your balance sheet management strategy?

MD Michael Malone
Borrowings are $30 million lower after the sale of our New Zealand business and a small equity placement to PowerTel. We recently negotiated a new three year master facility with Westpac for $30 million of which $13 million remains undrawn. Interest rates on the new facility are lower, reflecting our improved credit quality. We have indicated that we are comfortable with gross debt of 1.0 to 1.5 times EBITDA.

We intend to maintain our balance sheet capacity to take advantage of any opportunities that may arise from sector consolidation within the next six to 18 months. There are some 600 ISPs which we believe will come under pressure next year as market growth continues to slow. Our broadband network gives us more control of our cost base which leaves us well placed to make opportunistic acquisitions.

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What are the trends in your key revenue metrics?

MD Michael Malone
Our major product lines now are traditional dial up, on-net broadband, off-net broadband, standard fixed line telephony and Voice over Internet Protocol (VoIP). Broadly speaking, dial up continues to decline, off-net broadband and fixed line telephony are stable, and on-net broadband and VoIP are growing. Given that on-net broadband and VoIP are our most profitable lines, we're quite happy with that.

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VoIP is a relatively new telephony product. What is the significance of VoIP to your business?

MD Michael Malone
With the focus on the new and exciting world of broadband, we often forget that telephony revenue still outstrips dedicated data revenue by an order of magnitude. The reality is that people still use telecommunications to talk to other people.

The promise of VoIP is simple: cheap phone calls. The technology for VoIP has been around for a long time and has been embraced by business, but the retail market is concerned about quality and complexity. Those perception barriers have fallen in the past year and VoIP is rapidly becoming a mainstream product.

We control the quality of service of VoIP calls on our network, then hand it to the destination network, so the call does not travel over the open Internet. The result is a telephone call that is indistinguishable from a traditional fixed line phone. We're positioning VoIP as an alternative to the standard telephony service, not just a "techy" toy. We expect it to become a compelling proposition that may even replace broadband as our lead-in product. VoIP has the potential to become an engine for the business in its own right.

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Growth in households accessing the internet has begun to slow and competition has intensified. How is increasing competition affecting your marketing budget?

MD Michael Malone
While the broadband market is still growing at a very healthy rate, overall net growth is slowing. We expect the market to reach saturation within the next two years. In that environment, the key differentiators are cost control, customer service and brand. I believe we are well positioned in cost control and customer service. In the current half year we'll spend between $5-$6 million on advertising, primarily focusing on Sydney and Perth, to build the iiNet brand as the fastest, most innovative, best value, broadband provider.

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iiNet is Australia's third largest ISP, but well behind Telstra, which has a market share of around 50 percent. What is your strategy to compete in the broadband market which is dominated by Telstra and Optus?

MD Michael Malone
Our key differentiators in recent years have been our focus on customer service and a broadband product that's far faster than the entry level product offered by the majors at the same price. We pride ourselves on the passionate commitment of our staff and the service levels delivered to customers. We've grown our customer base because of strong word of mouth referral, particularly in Western Australia. However, we really need to improve awareness of our brand on the east coast.

In terms of product, we need to demonstrate the "need for speed". While we've got a fast product, internet users moving to broadband have largely maintained their dial-up habits of web browsing, email and online banking for which a 256k entry level broadband is adequate. Over half of the Australian market is using 256k and thinks that is broadband.

We have a large footprint with the fastest ADSL2+ broadband to the home in place. We have also invested in dark fibre which gives us effectively unlimited capacity from the suburbs where our customers live back to our city hubs where the content is stored. As new applications increase the amount our customers are downloading, this dark fibre will become a more and more important asset.

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What is your strategy for bringing these new applications to your customers?

MD Michael Malone
We expect to partner with content providers, rather than trying to get into the content space ourselves. We expect to announce some exciting partnerships in the very near future, but it's early days. Last month, Bill Gates forecast that

the internet will revolutionise television within five years due to an explosion of online video content and the merging of PC's and TV sets. We plan to use our network speed to put us at the forefront of this emerging technology.

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Telecom New Zealand is making an agreed $357 million offer for one of your largest shareholder and Alliance partner, PowerTel. Does the prospective change of ownership of PowerTel have any implications for iiNet?

MD Michael Malone
We're happy with the consolidation of Telecom New Zealand and PowerTel in Australia. Telecom New Zealand also owns AAPT, which is our and PowerTel's largest wholesale customer. So the merger brings our largest wholesale customer together with our wholesale channel partner. It complements our decision a year ago to offer a wholesale product to leverage our assets across the retail customer base of other ISPs, as well as our own, to allow us to distribute the capital expenses over a larger base.

One of the big advantages is that capital requirements should become increasingly predictable. We're expecting to work with AAPT to obtain long term customer demand forecasts and with PowerTel to share the risk on the capital expenditure to meet that capacity.

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You paid a dividend of 1.0 cent per share this time last year from earnings in the half year to December 2005 and omitted a final FY06 dividend. What is your dividend policy and when can shareholders anticipate a resumption of dividends?

MD Michael Malone
We've paid dividends consistently for the past five years, with the sole exception of the June 2006 half. We have the capacity and franking credits to pay a fully franked dividend, so we are paying a fully franked interim dividend of 1.0 cent per share for the December 2006 half. We are happy with the early trading results for this half and anticipate paying a dividend for the full year.

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Thank you Michael.

For more information about iiNet Limited visit www.iinet.net.au or contact Michael Malone on 08 9214 2207.

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