HUNGARIAN TELEPHONE & CABLE CORP
Form 10-Q
November 15, 2004
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES

EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2004

Commission file number 1-11484

HUNGARIAN TELEPHONE AND CABLE CORP.

(Exact name of registrant as specified in its charter)

Delaware	**13-3652685**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1201 Third Avenue, Suite 3400 Seattle, WA 98101-3034

(Address of principal executive offices)

(206) 654-0204

(Registrant s telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety days. Yes x No ¨

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of Common Stock as of the latest possible date:

Common Stock, $.001 par value (Class)	12,680,417 Shares (Outstanding at November 12, 2004)

Table of Contents

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Table of Contents

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Item 1. Financial Statements

Consolidated Condensed Balance Sheets

(In thousands, except share data)

	September 30, 2004	December 31, 2003
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$ 29,175	21,191
Restricted cash		12
Accounts receivable, net	5,385	6,474
Current deferred tax asset	1,025	2,714
Other current assets	4,935	3,622
Total current assets	40,520	34,013
Property, plant and equipment, net	119,577	120,258
Goodwill	9,114	8,727
Other intangibles, less accumulated amortization	4,354	4,407
Deferred costs	2,326	3,598
Deferred tax asset	3,231	3,291
Other assets	1,904	2,262
Total assets	$ 181,026	176,556
Liabilities and Stockholders Equity		
Current liabilities:		
Current installments of long-term debt	$ 23,405	21,929
Excess cash amounts due under long-term debt agreement		3,820
Accounts payable	3,037	2,263
Accruals	3,749	2,803
Other current liabilities	2,216	2,280
Due to related parties	519	493
Total current liabilities	32,926	33,588
Long-term debt, excluding current installments	79,018	90,839
Deferred credits and other liabilities	4,501	5,770
Total liabilities	116,445	130,197
Commitments and Contingencies		
Stockholders equity:		
Cumulative Convertible Preferred stock, $.01 par value; $70.00 liquidation value. Authorized 200,000 shares; issued and outstanding 30,000 shares in 2004 and 2003	13	12

Common stock, $.001 par value. Authorized 25,000,000 shares; issued and outstanding 12,430,417 shares in 2004 and 12,230,670 in 2003		
Additional paid-in capital	146,417	145,616
Accumulated deficit	(104,207)	(119,548)
Accumulated other comprehensive income	22,358	20,279
Total stockholders equity	64,581	46,359
Total liabilities and stockholders equity	$ 181,026	176,556

See accompanying notes to consolidated condensed financial statements.

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Consolidated Condensed Statements of Operations and Comprehensive Income

For the Three and Nine Month Periods Ended September 30, 2004 and 2003

(In thousands, except share and per share data)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2003**	**2004**	**2003**
Telephone service revenues, net	$ 14,355	$ 14,246	$ 44,506	$ 44,238
Operating expenses:				
Operating and maintenance expenses	6,121	5,090	17,514	15,770
Depreciation and amortization	3,087	2,752	9,057	8,373
Total operating expenses	9,208	7,842	26,571	24,143
Income from operations	5,147	6,404	17,935	20,095
Other income (expenses):				
Foreign exchange gains (losses), net	2,507	4,568	4,481	(5,065)
Interest expense	(2,163)	(2,178)	(6,914)	(6,846)
Interest income	571	295	1,821	773
Other, net	(93)	(171)	42	(360)
Net income before income taxes	5,969	8,918	17,365	8,597
Income tax (expense)	(669)	(507)	(1,945)	(493)
Net income	$ 5,300	$ 8,411	$ 15,420	$ 8,104
Cumulative convertible preferred stock dividends	(27)	(27)	(79)	(79)
Net income attributable to common stockholders	5,273	8,384	15,341	8,025
Comprehensive income adjustments	2,247	2,110	2,079	1,342
Total comprehensive income	$ 7,520	$ 10,494	$ 17,420	$ 9,367
Earnings per common share:				
Basic	$ 0.42	$ 0.69	$ 1.24	$ 0.66
Diluted	$ 0.41	$ 0.65	$ 1.20	$ 0.63
Weighted average number of common shares outstanding:				

Basic	12,429,504	12,195,680	12,359,301	12,167,957
Diluted	12,956,570	12,938,269	12,900,342	12,877,024

See accompanying notes to consolidated condensed financial statements.

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Consolidated Condensed Statements of Stockholders Equity

(In thousands, except share and per share data)

(unaudited)

	Shares	Common Stock	Preferred Stock	Additional Paid-in Capital	Accumulated deficit	Accumulated Other Comprehensive Income	Total Stockholders Equity
Balances at December 31, 2003	12,230,670	$ 12		145,616	(119,548)	20,279	$ 46,359
Proceeds from exercise of options	172,247			689			689
Common stock granted to Employee/Directors	27,500	1		112			113
Cumulative convertible preferred stock dividends					(79)		(79)
Net income					15,420		15,420
Foreign currency translation adjustment						2,079	2,079
Balances at September 30, 2004	12,430,417	$ 13		146,417	(104,207)	22,358	$ 64,581

See accompanying notes to consolidated condensed financial statements.

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Consolidated Condensed Statements of Cash Flows

For the Nine Month Periods Ended September 30, 2004 and 2003

(In thousands)

(unaudited)

	2004	2003
Net cash provided by operating activities	$ 24,787	22,593
Cash flows from investing activities:		
Construction of telecommunication networks	(4,059)	(2,542)
Decrease in construction deposits		307
Grant funding received for capital expenditures	223	
Proceeds from sale of assets	37	17
Net cash used in investing activities	(3,799)	(2,218)
Cash flows from financing activities:		
Repayments of long-term debt	(14,381)	(12,540)
Preferred dividends paid	(52)	
Proceeds from exercise of options	689	664
Net cash used in financing activities	(13,744)	(11,876)
Effect of foreign exchange rate changes on cash	740	624
Net increase in cash and cash equivalents	7,984	9,123
Cash and cash equivalents at beginning of period	21,191	13,922
Cash and cash equivalents at end of period	$ 29,175	23,045

See accompanying notes to consolidated condensed financial statements.

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Notes to Consolidated Condensed Financial Statements

(unaudited)

(1) Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying unaudited consolidated condensed financial statements of Hungarian Telephone and Cable Corp. (HTCC or the Registrant) and its consolidated subsidiary, Hungarotel Tavkozlesi Rt., (Hungarotel), together the Company include all adjustments, consisting mainly of normal recurring accruals, necessary for a fair statement. Results for interim periods are not necessarily indicative of the results for a full year. All material intercompany balances and transactions have been eliminated.

The accompanying unaudited consolidated condensed financial statements are prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP). In preparing financial statements in conformity with U.S. GAAP, management is required to make estimates and assumptions. These estimates and assumptions affect reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as revenues and expenses during the reporting period. Actual results could differ from those estimates.

The unaudited consolidated condensed financial statements should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2003, including the notes thereto, set forth in the Company s annual report on Form 10-K filed with the United States Securities and Exchange Commission (SEC).

(b) Earnings Per Share

Earnings per share (EPS) is computed by dividing income attributable to common stockholders by the weighted average number of common shares outstanding for the period. The computation of diluted EPS is similar to the computation of basic EPS, except that the weighted average shares outstanding are increased to include additional shares from the assumed exercise of stock options and warrants, and the conversion of the convertible preferred stock, where dilutive. The number of additional shares is calculated by assuming that outstanding stock options were exercised, or preferred securities were converted and the proceeds were used to acquire shares of common stock at the average market price during the reporting period.

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

The following is a reconciliation from basic earnings per share to diluted earnings per share for the three and nine month periods ended September 30, 2004 and 2003:

	3 months ended		9 months ended	
	2004	2003	2004	2003
	($ in thousands, except share data)			
Net income attributable to common stockholders (A)	$ 5,273	$ 8,384	$ 15,341	$ 8,025
plus: preferred stock dividends	27	27	79	79
Net income (B)	$ 5,300	$ 8,411	$ 15,420	$ 8,104
Determination of shares:				
Weighted average common shares outstanding basic (C)	12,429,504	12,195,680	12,359,301	12,167,957
Assumed conversion of dilutive stock options and cumulative convertible preferred stock	527,066	742,589	541,041	709,067
Weighted average common shares outstanding diluted (D)	12,956,570	12,938,269	12,900,342	12,877,024
Net income per common share:				
Basic (A/C)	$ 0.42	$ 0.69	$ 1.24	$ 0.66
Diluted (B/D)	$ 0.41	$ 0.65	$ 1.20	$ 0.63

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Notes to Consolidated Condensed Financial Statements

(unaudited)

For the three and nine month periods ended September 30, 2004, 2,550,000 and 2,530,000 stock options and warrants, respectively, were excluded from the computation of diluted earnings per share since such options and warrants have an exercise price in excess of the average market value of the Company s common stock during the respective periods. For the three and nine month periods ended September 30, 2003, stock options and warrants of 2,530,000 and 2,550,000 respectively were excluded from the computation of diluted net loss per common share because the effect of their inclusion would be anti-dilutive.

(c) Foreign Currency Translation

The Company uses the Hungarian forint as the functional currency for its Hungarian subsidiary. Accordingly, foreign currency assets and liabilities are translated using the exchange rates in effect at the balance sheet date. Results of operations are generally translated using the average exchange rates for the period. The translation of the subsidiary s forint denominated financial statements into U.S. dollars, as of September 30, 2004, has been affected by the strengthening of the Hungarian forint against the U.S. dollar from 207.92 as of December 31, 2003 to 200.52 as of September 30, 2004, an approximate 4% increase in value.

(d) Stock Based Compensation

The Company applies Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and related interpretations in accounting for stock based compensation awards granted under its Long-Term Incentive Plan.

The Company adopted the pro forma disclosure requirements of Statement No. 123, Accounting for Stock-Based Compensation and related pronouncements. The fair values of these stock options were estimated at the date of grant using a Black-Scholes option-pricing model. The Black-Scholes option valuation method was developed for estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility.

Had compensation cost for the Company s stock option plans been determined based on fair value consistent with the methodology of Statement No. 123, the Company s net income and earnings per share for each period would have been adjusted to the pro forma amounts indicated in the following table. For purposes of pro forma disclosures, the estimated fair value of the options is amortized over the options vesting period.

As a result of a modification to the options of a former employee, the Company recognized compensation expense of $21,000 in 2003 but no corresponding expense in 2004. The Company recognized a $42,000 expense in 2004 as a result of certain stock grants from its 2004 Long-Term Incentive Plan.

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

	Three Months Ended September 30		Nine Months Ended September 30	
	2004	2003	2004	2003
Net Income				
As reported	5,273	8,384	15,341	8,025
Plus: stock-based compensation expense included in reported earnings	28		42	(21)
Less: stock-based compensation expense determined under fair-value method	(237)	(255)	(408)	(631)
Net Income				
Pro forma	5,064	8,129	14,975	7,373
Earnings per share - Basic:				
As reported	$ 0.42	$ 0.69	$ 1.24	$ 0.66
Pro forma	$ 0.41	$ 0.67	$ 1.21	$ 0.61
Earnings per share - Diluted				
As reported	$ 0.41	$ 0.65	$ 1.20	$ 0.63
Pro forma	$ 0.39	$ 0.63	$ 1.16	$ 0.57

In May 2004 the Company s stockholders approved the Company s proposed 2004 Long-Term Incentive Plan (2004 Plan). Upon adoption of the 2004 Plan, the Company agreed not to issue any more options from either the Company s 2002 Incentive Stock Option Plan (2002 Plan) or the Company s Non-Employee Director Stock Option Plan (Director Plan). The remaining shares of the Company s common stock which were reserved for issuance pursuant to options to be granted under the 2002 Plan and the Director Plan were rolled over to the 2004 Plan.

Effective October 2004, the Company amended the 2002 Plan and the Director Plan to allow the remaining options outstanding under such plans to be governed by terms similar to those contained in the 2004 Plan with respect to the exercise of options, tax withholding and the period in which option holders no longer associated with the Company could exercise their options. Holders of options under the 2002 Plan and the Director Plan may now exercise their outstanding options and pay the exercise price, in whole or in part, pursuant to a net share settlement to which the option holder elects to have shares of stock withheld upon exercise to pay the option exercise price. Option holders may also have a portion of such shares issuable upon exercise withheld for the payment of taxes attributable to the option exercise. As a result of such amendments, effective October 1, 2004, the Company accounts for all of its outstanding options under the variable method of accounting. The variable method of accounting requires the Company to accrue an expense or a forfeiture as the market price of the Company s common stock changes.

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

(2) Cash and Cash Equivalents

(a) Cash

At September 30, 2004, cash of $2,466,000 was comprised of the following: $447,000 on deposit in the United States, and $2,019,000 on deposit with banks in Hungary consisting of $41,000 denominated in U.S. dollars, the equivalent of $16,000 denominated in euro and the equivalent of $1,962,000 denominated in Hungarian forints.

Cash equivalents amounted to approximately $26,709,000 at September 30, 2004 and consisted of Hungarian government securities, denominated in Hungarian forints, purchased under agreements to resell upon maturity within three months.

(3) Related Parties

The amount due to related parties totalling $519,000 at September 30, 2004, represents cumulative preferred stock dividends in arrears and is due to TDC A/S (TDC), which held 42.2% of the Company s outstanding common stock (60% of the Company s preferred shares) and Ashmore Investment Management and its Affiliates (Ashmore), which held 22.1% of the Company s outstanding common stock (40% of the Company s preferred shares) as of September 30, 2004.

10

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Notes to Consolidated Condensed Financial Statements

(unaudited)

(4) Segment Disclosures

The Company operates in a single industry segment, telecommunications services. The Company has constructed a modern telecommunications infrastructure in order to provide a full range of the Company s products and services in its five concession areas in Hungary. While the Company s chief operating decision maker monitors the revenue streams of the various products and services, operations are managed and financial performance is evaluated based on the delivery of multiple services to customers over an integrated network. Substantially all of the Company s assets are located in Hungary and all of its operating revenues are generated in Hungary.

Products and Services

The Company groups its products and services into the following categories:

Telephone Services local dial tone and switched products and services that provide incoming and outgoing calls over the public switched network. This category includes reciprocal compensation revenues and expenses (i.e. interconnect).

Network Services point-to-point dedicated services that provide a private transmission channel for the Company s customers exclusive use between two or more locations, both in local and long distance applications.

Other Service and Product Revenues PBX hardware sales and service revenues, as well as miscellaneous other telephone service revenues.

The revenues generated by these products and services for the periods ended September 30 were as follows:

	3 months ended		9 months ended	
	2004	**2003**	**2004**	**2003**

	($ in thousands)			
Telephone services	$ 12,183	$ 12,574	$ 38,316	$ 39,218
Network services	1,690	1,278	4,876	3,819
Other service and product revenues	482	394	1,314	1,201
	$ 14,355	$ 14,246	$ 44,506	$ 44,238

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Notes to Consolidated Condensed Financial Statements

(unaudited)

Major Customers

For the periods ended September 30, 2004 and 2003, none of the Company s customers accounted for more than 10% of the Company s total revenues.

(5) Goodwill, Intangible and Other Long-Lived Assets

Goodwill and intangible assets that have indefinite useful lives are tested at least annually for impairment. The Company completed its annual impairment test as of January 1, 2004. Based upon the results, the Company concluded that there is no impairment to the carrying value of goodwill reported in its financial statements.

Intangible assets that have finite useful lives are amortized over their estimated useful lives. Intangible assets, which consist of concession rights, are amortized over the twenty-five year concession period using the straight-line method.

(6) Commitments and Contingencies

Annual Concession Fees

Under the historical regulatory structure in which the Company received its operating licenses it paid a one-time concession fee and was required to pay annual concession fees based on net telephone service revenues that varied between 0.1% and 2.3% depending on the concession area. In 2001, the Hungarian government made changes to the Communications Act, whereby the concession system was replaced with a notification system. Under the notification system, other telecommunications providers can enter the Company s markets by paying a nominal fee. The Company believes that this change violated the terms upon which it received its concessions which would have required competitors entering the Company s markets to pay fees similar to the Company. Therefore, the Company has accrued but withheld the payment of concession fees in the amount of HUF 157 million (approximately $0.8 million at September 30, 2004 exchange rates) for 2001 and believes that it does not owe any more concession fees for 2002 and future periods. The Company is currently in discussions with the Ministry regarding the mutual termination or amendment of its concession agreements.

The Company and its subsidiary are involved in various other claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters and the issue described above will not have a material effect on the Company s consolidated financial position, results of operations or liquidity.

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

(7) Proposed PanTel Acquisition

On September 27, 2004, the Company entered into certain agreements with KFKI Investment Ltd. and its affiliates (KFKI) (the KFKI Agreements). The KFKI Agreements, along with agreements that the Company had previously entered into with Royal KPN NV (KPN), dated May 4, 2004 (the KPN Agreement), and MAV Rt. (MAV), dated July 14, 2004 (the MAV Agreement , and together with the KPN Agreement and the KFKI Agreements, the PanTel Agreements), provide through a series of transactions for the purchase by the Company of substantially all of the assets, and assumption by the Company of substantially all of the liabilities, including all the outstanding debt, of PanTel Rt. (PanTel) for an aggregate cash purchase price of 26.9 million euros (approximately $33.2 million as of September 30, 2004) and 250,000 shares of the Company s common stock. The PanTel Agreements provide for the Company to continue to operate the business under the PanTel brand name.

The transactions contemplated by the KPN Agreement involve a complex process with three critical stages concluding with the purchase by the Company of KPN s 75.1% interest in the PanTel business. The conditions to the completion of the first stage included, among others, the purchase by the Company of MAV s and KFKI s equity stakes in PanTel, 10.1% and 14.8%, respectively, approvals from each of the Company s and PanTel s bank creditors and the Hungarian Competition Authority to the transactions contemplated by the PanTel Agreements and the assurance to the continued use by the Company of PanTel s critical rights-of-way.

The second stage provides for PanTel to transfer substantially all of its assets and liabilities to an existing subsidiary in order to effectuate the final structure of the overall acquisition. On completion of the third stage the Company will take full ownership and control of 100% of the subsidiaries of PanTel, thereby purchasing the existing business of PanTel.

The conditions of the third stage must be fulfilled or waived by June 30, 2005 and, if not fulfilled or waived by such date, then the Company and KPN shall have certain rights to alter or terminate the transactions contemplated by the KPN Agreement.

PanTel is Hungary s leading alternative telecommunications provider that has a fiber optical backbone telecommunications network covering all of Hungary. PanTel principally provides voice and data services to business customers throughout Hungary in competition with Magyar Tavkozlesi Rt., the formerly State controlled monopoly, and other newer entrants into these markets.

(8) Subsequent Event

On November 10, 2004, the final conditions of the first stage of the PanTel acquisition were fulfilled as the Company purchased MAV s and KFKI s equity stakes in PanTel, 10.1% and 14.8%, respectively, for an aggregate cash purchase price of 9.9 million euros (approximately $12.6 million as of September 30, 2004) and 250,000 unregistered shares of the Company s common stock. The Company funded the 9.9 million euro cash purchase price paid to KFKI and MAV from its working capital. The Company did not, however,

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

assume control of the management of PanTel as contemplated by the KPN Agreement. The Company expects to complete the third stage which provides for the Company to take full ownership and management control of PanTel around the end of the year.

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Introduction

Hungarian Telephone and Cable Corp. (HTCC or the Registrant and, together with its consolidated subsidiary, the Company) is engaged primarily in the provision of telecommunications services through its operating subsidiary, Hungarotel Tavkozlesi Rt. (Hungarotel). The Company earns substantially its entire telecommunications revenue from measured service fees, monthly line rental fees, connection fees, public pay telephone services and ancillary services (including charges for additional services purchased at the customer s discretion).

Since commencing the provision of telecommunications services in 1995, the Company s network construction and expansion program has added approximately 130,000 net access lines through September 30, 2004 to the approximately 61,000 access lines acquired directly from Magyar Tavkozlesi Rt. (Matav), the formerly State controlled monopoly telephone company. During the late 1990s, the development and installation of the network in each of the Company s Operating Areas required significant capital expenditures.

The primary risks facing the Company are the ability to retain existing customers and attract new customers in a highly competitive market that is constantly in flux due to a challenging regulatory environment, new competitive fixed line telephony entrants, mobile telephony penetration and macroeconomic factors. These risks will be addressed by the success of the Company s operating and marketing strategies, as well as market acceptance of telecommunications services both within and outside the Company s Operating Areas. The Company is further seeking to solidify and expand its presence in the Hungarian telecommunications market through strategic merger, acquisition or alliance opportunities. For example, the recently announced proposed acquisition of PanTel will provide the Company with significant market opportunities in the business communications market. The Company is also continuing to explore wireless service solutions so that it can be a full service provider in Hungary thereby providing traditional fixed line, data and wireless telephony for residential and business customers.

The Company s results and financial position, reported in U.S. dollars, continue to be significantly affected by movements in the Hungarian forint/U.S. dollar exchange rate.

Critical Accounting Policies

The Company s discussion and analysis of its financial condition and results of operations are based upon its consolidated condensed financial statements which have been prepared in accordance with generally accepted accounting principles in the United States (US GAAP). This requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. US GAAP provides the framework from which to make these estimates, assumptions and disclosures. The Company chooses accounting policies within US GAAP that management believes are appropriate to accurately and fairly report the Company s operating results and financial position in a consistent manner. Management regularly assesses these policies in light of current and forecasted economic and regulatory conditions. The accounting policies the

15

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Company believes to be critical to understanding the results of operations and the effect of the more significant judgements and estimates used in the preparation of the consolidated condensed financial statements are the same as those described in its Annual Report on Form 10-K for the year ended December 31, 2003.

Comparison of Three Months Ended September 30, 2004 and Three Months Ended September 30, 2003

The Company s Hungarian subsidiary s functional currency is the Hungarian forint. The average Hungarian forint/U.S. dollar exchange rate for the three months ended September 30, 2004 was 203.63, as compared to an average Hungarian forint/U.S. dollar exchange rate for the three months ended September 30, 2003 of 230.91. When comparing the three months ended September 30, 2004 to the three months ended September 30, 2003, it should be noted that all U.S. dollar reported amounts have been affected by this 13% appreciation in the Hungarian subsidiary s functional currency.

Net Revenues

(dollars in millions)	**Quarter ended September 30,**		
	2004	**2003**	**% change**
Measured service revenues	7.6	7.7	(1)
Subscription revenues	5.9	5.7	4
Interconnect charges:			
Incoming	0.5	0.9	(44)
Outgoing	(2.1)	(2.3)	9
Net	(1.6)	(1.4)	(14)
Net measured service and subscription revenues	**11.9**	**12.0**	**(1)**
Connection fees	0.4	0.6	(33)
Other operating revenues, net	2.1	1.6	31
Telephone Service Revenues, Net	**14.4**	**14.2**	**1**

The Company recorded a 1% increase in net telephone service revenues for the three months ended September 30, 2004 as compared to the three months ended September 30, 2003.

Measured service revenues decreased in functional currency terms by approximately 13% as a result of:

- 3% decrease in average access lines in service from approximately 196,600 for the three months ended September 30, 2003 to approximately 191,400 during the three months ended September 30, 2004. Approximately 2.5% of the 3.0% decrease occurred in the residential customer group as a result of further mobile penetration and economic conditions that resulted in some customers not being able to afford telephony services in general or customers who choose to continue with their mobile service and drop their fixed line service when deciding to reduce their communication costs. The remaining 0.5% of the 3% decrease is attributed to business customers due primarily to increased competition from fixed line operators through carrier pre-selection as well as mobile providers;

- An overall decrease in call minutes by 5.4% that is partially correlated to the decrease in the number of lines serviced over the same period in the prior year. Internet usage was

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

the only service to increase in terms of minutes of use over the same period in the prior year. Calls from the Company s customers to mobile subscribers decreased by 12% over the prior year, representing the greatest decrease out of all of the Company s call services. The decrease is attributed to increased competition from mobile providers who offer mobile to mobile calls at rates that are lower than fixed line to mobile rates.

As of June 2004 the Company began offering discounts off of its listed call tariffs to some of its significant business customers;

Off-peak call minutes decreased at an overall rate of 0.5% compared to that of peak call minutes that decreased by 8.1% compared to the prior year. This trend would indicate that some business customers switched to the Company s competitors through carrier pre-selection as the bulk of call minutes during peak hours are used by business customers.

The Company is focusing on retaining its existing business customer base by offering discounts to its listed call tariffs in exchange for fixed term contracts. To a lesser extent the Company will also be promoting higher margin products such as ADSL connections to customers within the network. Penetration for higher cost products like ADSL connections is expected to be limited due to the economic conditions in the Company s operating areas. The Company also plans to enter competitors markets to provide lower cost fixed line services. Due to economic conditions and pricing issues, both within and outside the Company s Operating Areas, the Company did not opt to raise call tariffs on most of its calling services, although it was allowed to do so by the Hungarian regulatory authority. Accordingly, the same call tariffs were in use during the quarters ended September 30, 2004 and September 30, 2003 apart from the business customer discounts described above.

Subscription revenues decreased in functional currency terms by approximately 8% as a result of (i) a 3% decrease in average access lines in service between the two periods; (ii) customer transfers from higher monthly fee subscriptions to lower monthly fee subscriptions; and (iii) no Universal Service revenues recorded for the quarter ended September 30, 2004 compared to $0.3 million for the quarter ended September 30, 2003.

No Universal Service revenues were accrued for the three months ended September 30, 2004. Previously, the Hungarian government set up a Universal Services fund to provide (i) country-wide access to fixed line telecommunications services at reasonable prices, (ii) public pay telephones, (iii) operator assisted services, and (iv) free emergency services. The funds to be received by the Company from the Universal Services Fund were based upon the number of customers, which meet certain requirements defined in government regulations. The Company believes its prior contract, which expired June 30, 2004, continues to apply to the revenues that have been accrued up to June 30, 2004. The Company is currently in the final stages of negotiating a new Universal Service Provider agreement with the Ministry. Under this new agreement, as a result of the strict conditions stipulated to receive funds for being a Universal Services Provider, the Company does not expect to receive any money in the future for being a Universal Services Provider.

Net measured service and subscription revenues have been reduced by net interconnect charges which totalled $1.6 million and $1.4 million during the three month periods ended September 30, 2004 and 2003, respectively. The Company is paid a per minute interconnection fee for completing long distance wireline and mobile calls over the Company s network to the Company s customers (incoming). The Company pays interconnection fees to other national

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

wireline and mobile operators to terminate calls from the Company s customers (outgoing). As a percentage of measured service and subscription revenues, net interconnect charges have increased from 10% for the three months ended September 30, 2003 to 12% for the three months ended September 30, 2004. This increase results from unbalanced movements in the incoming and outgoing interconnect prices in the Hungarian telecommunications market due to governmental efforts to bring interconnection fees in line with European Union levels. New interconnect prices were made effective from June 15, 2004. Fixed line operators interconnect prices have been reduced significantly, 38% in Hungarotel s case, whereas the mobile operators interconnect prices have remained consistent. The majority of Hungarotel s interconnect expenses relate to mobile network terminated calls. As a result, interconnect expenses continue to be charged at rates comparable to the same period in the prior year while interconnect revenues were reduced by 38%. The Company along with other fixed line operators in Hungary have taken the rate reduction decision to court, arguing that the newly arbitrated interconnect fees to be charged by the fixed line operators is less than the actual cost of terminating those calls. It is unknown at this time when a court ruling will be handed down.

In 1997 and 1998 during the construction of the Company s networks, the Company connected a substantial number of its current customer base. The Company has been amortizing to revenue the connection fees received back in 1997 and 1998 over the last 7 years while at the same time amortizing as an expense over 7 years the initial cash outlay for connecting those customers. The amortization period for revenues and expenses for those customers is coming to an end resulting in a 33% reduction in connection revenues. The revenue attributable to the addition of new customers, added to the Company s network after 1998, is significantly lower than that attributable to customers from 1998 and earlier.

Other operating revenues, which include revenues generated from the provision of direct lines, ADSL access, operator services, internet services and other miscellaneous telephone service revenues, increased to $2.1 million for the three months ended September 30, 2004, as compared to $1.6 million for the three months ended September 30, 2003. In functional currency terms, other operating revenues increased approximately 10% for the quarter ended September 30, 2004, as compared to the quarter ended September 30, 2003. This increase is primarily due to increased leased line, ADSL access and internet revenues between the two periods.

Operating and Maintenance Expenses

	Quarter ended September 30,	
(dollars in millions)	**2004**	**2003**
Operating and maintenance expenses	$ 6.1	$ 5.1

Operating and maintenance expenses increased 20% for the three months ended September 30, 2004 as compared to the three months ended September 30, 2003. In functional currency terms, operating and maintenance expenses of Hungarotel decreased approximately 6% for the three months ended September 30, 2004, as compared to the three months ended September 30, 2003. The 6% decrease is due to the decreasing number of new connection fee charges amortized during the three months ended September 30, 2004 in relation to the number of connection fee charges that have been fully amortized. See discussion of amortization of connection fees above. In U.S. dollar terms, however, such decrease in costs in functional currency terms has been offset by the 13% appreciation of the Hungarian forint combined with a significant increase in the Company s U.S. dollar denominated operating expenses between the periods of 112%. The significant increase is due primarily to additional one time compensation charges in the quarter ended September 30, 2004.

Table of Contents

Part I. Financial Information

HUNGARIAN TELEPHONE AND CABLE CORP. AND SUBSIDIARY

Depreciation and Amortization

(dollars in millions)	Quarter ended September 30, 2004	2003
Depreciation and amortization	$ 3.1	$ 2.8

Depreciation and amortization charges increased $0.3 million, or 11%. Depreciation and amortization charges remained consistent in functional currency terms between the two periods.

Income from Operations

(dollars in millions)	Quarter ended September 30, 2004