

RAM

SECTORAL REPORT

Telecommunications sector



Telecommunication Service Providers: How will Revolutionaries Adapt?

Sri Lanka's telecommunications industry contributes significantly towards the country's development and plays an integral part in the lives of many. It is also a key component of the commercial world. Notably, the domestic telecommunications sector has been charting exponential growth, and continues to enjoy promising prospects.

The dynamic nature of the telecommunications sector allows little respite for industry operators. The government's liberalisation of this industry can be seen as the main driving force behind the rapid development of the country's telecommunication infrastructure and services.

This paper aims to explain the broad factors that RAM Ratings considers when evaluating the credit profiles of telecommunication operators ("telcos"). These include:

- Regulatory framework
- Operating environment and business risk
- Technological risk
- Financial risk

The telecommunications industry consists of a variety of sub-sectors such as data communications, telephony, the Internet and trunk cellular services, to name but a few. Nonetheless, the focus of this article will be limited to the telephony segment, with emphasis on the cellular sector.

Our analysis will be based on the experiences of Sri Lanka's 2 major cellular players, Dialog Telekom PLC ("Dialog Telekom") and Mobitel (Pvt) Ltd ("Mobitel"). Together, these 2 companies account for 80% of the local industry's revenue. The remaining 20% is shared between Hutchison Telecommunications Lanka (Pvt) Ltd ("Hutchison", a subsidiary of Hutchison Telecommunications International Limited) and Tigo (Pvt) Ltd ("Tigo", a subsidiary of Millicom International).

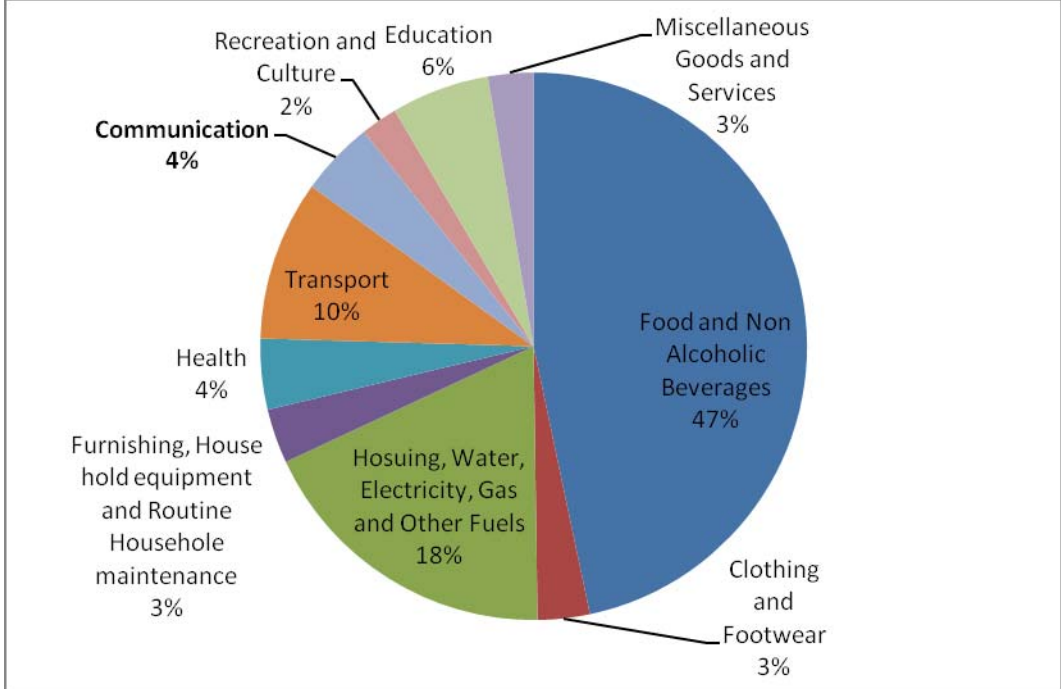
Meanwhile, the domestic fixed-line market is dominated by Sri Lanka Telecom (SLT) PLC, which provides both wired and fixed-wireless connections. The other 3 players in this segment (i.e. Suntel Ltd, Lankabell (Pvt) Ltd and Dialog Telekom PLC) only offer fixed-wireless services. RAM Ratings notes that traditional wired services in Sri Lanka have experienced a marked reduction in demand, due to the affordability and user-friendliness of cellular phones.

Moving forward, RAM Ratings expects the expansion of the cellular subscriber base to ease from historical levels, albeit still healthy, maintaining its trend of double-digit



growth. Despite the challenging economic climate in Sri Lanka that is weighted down by high inflation, we expect the telecommunications sector to enjoy fairly inelastic demand given the basic need for communication. Moreover, only 4% of the country's total household income is spent on telecommunications (refer to Figure 1). The potential for growth is clearly attractive enough for 2 more players to join the fray: Bharti Airtel Lanka (Pvt) Ltd (a subsidiary of Bharti Airtel Ltd or Bharti Airtel) and Reliance Mobile Lanka (Pvt) Ltd (a joint venture between Reliance Communications Ltd and Electroteks Global Networks (Pte) Ltd). With new players poised to enter the market, competition in all its dimensions, i.e. pricing, service quality, coverage and branding, is set to be elevated to an even higher level; this will eventually benefit consumers.

Figure 1: Weight distribution of new Colombo Consumers' Price Index



Source: Central Bank of Sri Lanka's annual report 2007

From the operators' perspective, the prevailing domestic economic environment will be a drag on their operations and profitability. Although the country's lofty inflation rates are envisaged to push up operating costs, this is unlikely to be matched by any meaningful increase in cellular revenues given the keen competition; this would ultimately resulting in tighter margins. In addition, such an economic landscape may also cause more post-paid subscribers to take longer to settle their bills or, in some cases, even default on their payments. Nevertheless, the risk of customers defaulting on payments is perceived to be low as there is a much larger proportion of prepaid subscribers than post-paid ones.

The intense competition has driven the industry towards technological innovation, and has propelled Sri Lanka to the forefront of many such developments in the

South Asian region, such as HSPA (High-Speed Packet Access, alternatively known as 3.5G) and 3G. The level of technological penetration is also rising, with traditional fixed-line services being replaced by cheaper and easier-to-access wireless technology. The introduction of new technology has been swift, as the major players view this as a key competitive advantage. Nonetheless, such rapid changes also entail the need to manage technological risk, which includes funding strategy, choosing the right technology that compliments the existing infrastructure so that costs are contained, and timing the rollout of new technology so that the balance sheet and cashflow are not unduly burdened. Management of such risk also encompasses the management's capability in forecasting customer demand and meeting this at the right time.

Regulatory Framework

The regulatory framework shapes the operating landscape and provides important insights into the level and pace of liberalisation, which is vital towards identifying the various operating risks faced by the players. To facilitate sustained development of the industry while protecting public interests, the Telecommunications Regulatory Commission ("TRC" or "the Commission") has been established. The Commission is governed by the Sri Lanka Telecommunications (amended) Act No. 27, 1996. The TRC is the official government body overseeing the regulatory framework of the Sri Lankan telecommunications sector. Operating licences have to be obtained from the TRC, which issues individual licences to each telecommunication service provider. We note that TRC has removed the earlier cap on foreign investment and ownership, in a bid to encourage foreign direct investment. As a result, 5 out of the 6 telephony operators in Sri Lanka are now held by foreign entities.

RAM Ratings believes that entry barriers arising from the regulatory infrastructure are fairly modest, given that a number of licences have already been issued (refer to Table 1). This is in line with the TRC's goal of providing the public with the best in terms of quality, choice and value for money. Every telco is required to apply for a licence from the regulator. However, approval is at the discretion of the Minister of Posts and Telecommunications, who will take the TRC's recommendations into consideration.

The initial expense associated with licence application is relatively minimal compared to the overall investment cost. We note that all tariff changes must be approved by the TRC before they can be implemented; the nod is generally given within a week. Nonetheless, the Commission exerts little or no control over minimum tariffs. Although this is beneficial to subscribers, the impact on smaller players must also be considered. Lacking the advantage of scale economies enjoyed by their large peers, these smaller telcos may have to resort to alternative ways of maintaining their profitability, such as focusing on niche markets.



Table 1: Licences granted by the TRC (as at 29 May 2008)

Type of licence	Number
Fixed telephony services	4
Cellular services	5
Data communication services	6
Internet-based data services	24
Public payphones	2
Paging services	4
Trunk cellular networks	1
Leased lines	1
External gateway operators	32

Source: TRC website

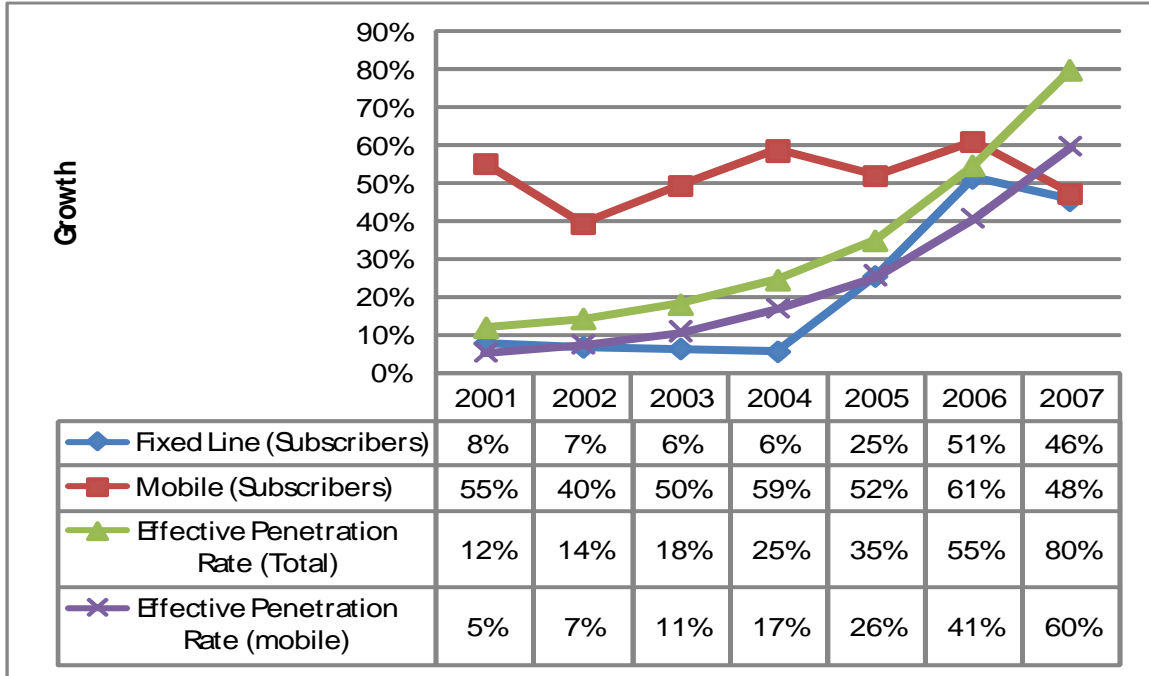
Operating Environment and Business Risk

The customer base of the telecommunications industry has been expanding impressively, with a compounded annual growth rate of 55% over the last 5 years (refer to Chart 1). In absolute terms, the subscriber base broadened from 1.4 million in 2003 to almost 8 million in 2007. This can be attributed to affordable handsets, telcos' larger network footprint and attractively priced service plans.

The Sri Lankan cellular sector consists of 4 players, which have fully deployed networks and have been in service for more than 4 years. In addition, another licence has been granted to an Indian operator, which is expected to commence business by end-2008. Of the existing players, Dialog Telekom (a subsidiary of TM International Berhad) commands just over half of the market (60% in terms of industry revenue) while second-largest Mobitel (a subsidiary of SLT) accounts for 18%; the rest of the market is split between Tigo (16%) and Hutchison (6%).

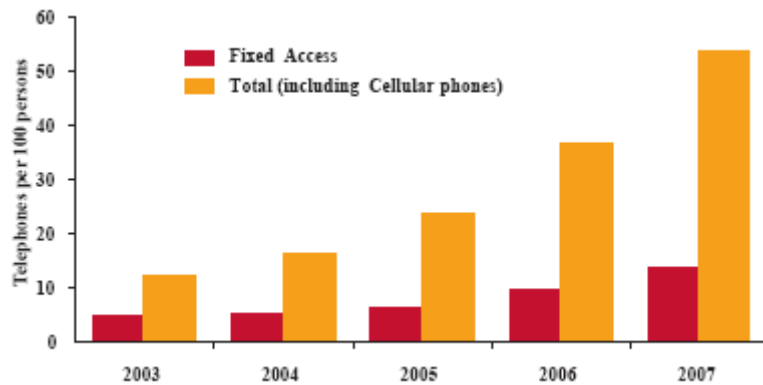
Although the TRC is meant to serve the needs of subscribers as well as telcos, the 2 largest operators exert a significant influence on the industry landscape, in terms of pricing, technological innovation and quality. These 2 telcos have always spearheaded the introduction of pioneering technology. RAM Ratings notes that the strength of a company's market position is crucial as it helps determine the consistency of demand and the telco's resilience against price changes - 2 key components of a strong credit profile.

Chart 1: Subscriber growth in Sri Lankan market¹



The effective cellular penetration rate in Sri Lanka increased from 41% in 2006 to 60% in 2007. Meanwhile, the nation's telephone density (number of telephones per 100 persons) rose from 37 in 2006 to 54 in 2007. This higher density is attributable to the network expansion of all the market players in the last few years.

Chart 2: Telephone density

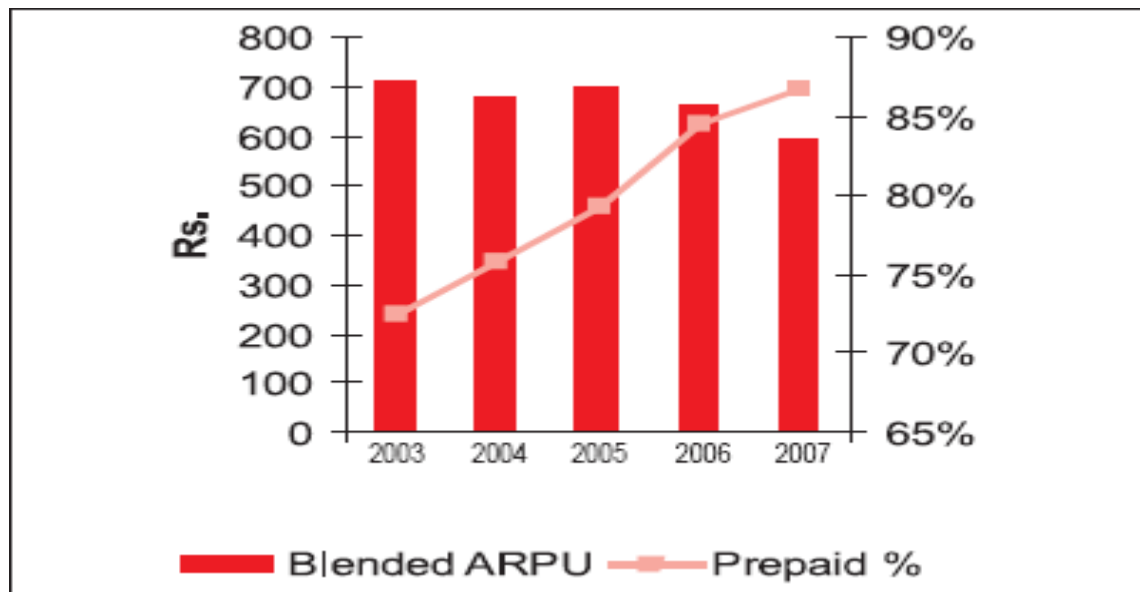


Source: Central Bank of Sri Lanka's 2007 annual report

¹ Effective penetration rate for subscribers within the 15-64 age group.

Over the last few years, local telcos' revenues have been driven by the prepaid segment. In fact, the revenue earned from this segment has out-grown that of the postpaid segment. On the other hand, the average revenue per user ("ARPU") of a prepaid sector is lower than that of the post-paid one. We note that overall ARPU has been tapering; this is expected to ease further as competition intensifies and a larger proportion of the revenue is taken up by prepaid customers. Although declining tariffs and ARPU will eventually lead to lower profitability per customer, the impact on bottom lines will depend on the scale economies of each telco.

Chart 3: Dialog's blended monthly ARPU



Source: Dialog Telekom's 2007 annual report

Although the ARPU of the prepaid segment is less than that of its postpaid counterpart, the former has lower credit risk since default risk is minimal. As the revenue generated from the prepaid segment takes up a much larger portion of the entire industry's revenue, its overall credit risk will be reduced.

RAM Ratings expects cellular subscriber growth rates to ease from historical levels but to stay healthy, maintaining its double-digit annual growth. This relative deceleration would, to some extent, discourage aspiring debutantes and enable the incumbents to consolidate their market positions and, consequently, their financial standing. Moreover, there is a capacity constraint in terms of the availability of mobile spectrum, which will enhance the credit profiles of the existing players. There is also, however, a downside for the incumbents since revenue potential through voice services will be reaching its limit; persuading current subscribers to embrace non-voice services will therefore be challenging.

Technological Risk

The telecommunications sector is constantly evolving, with rapid changes in technology and continually improving thresholds vis-à-vis technological performance. As such, technological obsolescence will always be a major threat in this industry, thus featuring prominently in RAM Ratings' assessment. A case in point is the present market leader, which in fact had been a late entrant albeit the first telco to roll out a digital cellular network. It had thus been able to displace the incumbents then. The ultimate consequence of technological obsolescence on the operators will depend on their degree of reliance on that particular technology for revenue generation. The less their reliance on a specific type of technology, the lower the level of technology risk and, hence, credit risk.

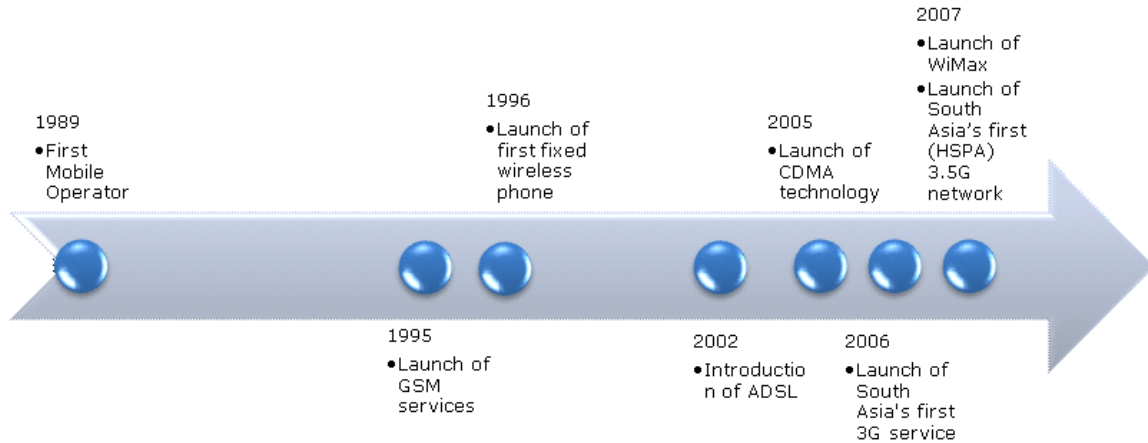
In the meantime, diversification is also seen as a means of mitigating technological risk. For example, the fixed-line revenue of SLT, the industry's only fixed-line telco, has been declining. Nonetheless, this impact has been offset by the stronger revenue generated by its other types of technology, such as CDMA and data/IP services. Shifting focus away from obsolete technology is an important survival strategy, and can enhance a telco's credit standing.

The domestic telecommunications industry has been quite dynamic in the last few years, enlivened by the launch of many new types of technology. In fact, Sri Lanka has been the first country in the South Asian region to unveil certain kinds of technology (refer to Figure 2). In this context, all the recent technological innovations have been introduced by the 2 market leaders, with the competition following close behind. Competition is fierce; technological gaps are swiftly bridged. A case in point is the launch of the first CDMA telephones in mid-2005. By the end of 2007, the other 3 players had already deployed full-fledged CDMA operations.

All said, however, the rapid introduction of cutting-edge technology alone cannot guarantee success in the market. Proper management of technological risk is recognised as a key success factor in this industry. Consideration is given to the operator's ability to determine the market's willingness to accept newer and more innovative products, thereby avoiding over-expansion. Issues such as the funding and timing of the rollout of new technology will have to be assessed, so that the cost of will not over-burden the telco's cashflow. Choosing the appropriate technology that can leverage on the existing one is also deemed vital towards managing technological risk.



Figure 2: Timeline highlighting the introduction of major technological innovations



Financial Risk

Apart from containing business risk, a low-risk financial profile is also vital for good credit ratings. A company's historical financials can be very useful in highlighting the company's credit status. Here, the stability and sustainability of its earnings will be crucial. However, historical records alone cannot be relied upon as ratings are prospective; future investments and their potential earnings will also have to be evaluated against past performance. For capital-intensive operations such as telecommunications, hefty capital investment must be assessed against the potential demand for related products; this includes comparing the response (for similar investments) in other countries, appraising whether other operators are also making equivalent investments, as well as the eventual price of the product in other markets.

RAM Ratings uses the margin on operating profit before depreciation, interest and tax ("OPBDIT") as the key indicator of a telco's profitability and efficiency. This provides an indication of the level and trend of the operator's recurring income. In Sri Lanka, the OPBDIT margins of the 2 major cellular players range between 30% and 40%, which is considered fairly healthy.

Table 2: Key industry² financials

KEY INDICATORS	31-Dec-07	31-Dec-06	31-Dec-05
Revenue	38,130.00	30,447.00	23,332.00
OPBDIT ³	13,030.00	12,819.00	7,437.00
Total assets	86,280.00	55,073.00	44,348.00
Total debts	11,504.00	15,099.00	19,689.00
Shareholders' funds and minority interests	56,373.00	28,901.00	17,755.00
KEY RATIOS	31-Dec-07	31-Dec-06	31-Dec-05
<u>Profitability (%)</u>			
Profit margin before depreciation, interest and tax	34.17	42.10	31.87
Profit margin before interest and tax	20.02	28.89	17.01
Pre-tax return on sales	16.55	23.93	13.00
After-tax return on equity	11.08	24.82	16.72
Return on capital employed	11.29	19.51	10.48
<u>Capitalisation (times)</u>			
Net gearing ratio	0.09	0.44	0.72
<u>Coverage (times)</u>			
Interest coverage ratio	9.62	9.87	8.36
Operating cashflow interest coverage ratio	14.53	10.71	11.23
OPBDIT debt coverage ratio	1.13	0.85	0.38
Operating cashflow debt coverage ratio	1.71	0.92	0.51

The domestic telecommunications industry has been registering tremendous growth over the last few years, peaking in 2006. This is reflected in the industry's improved profitability indicators. Nonetheless, hefty capital expenditure ("capex") and reductions in tariffs had crimped profitability in 2007, despite a broader subscriber base. Despite this, the industry's financial showing in 2007 is still better than pre-2006 achievements. Looking ahead, profitability is likely to ease further, as indicated by the larger players' latest quarterly results, i.e. for 1Q 2008.

The nature of the industry necessitates heavy investments. In the past 3 years, the 2 major players have almost doubled their assets. In this regard, their level of borrowings (both present and future) will be evaluated vis-à-vis the telco's sustainable cashflow, as a measure of its debt-servicing ability. The stability and sustainability of its cashflow depend primarily on the source of its income. The more certain this income, the higher the likelihood of a stable and sustainable cashflow and, consequently, the greater its tolerance for a substantial debt load.

² Combination of the 2 major players, i.e. Dialog Telekom and Mobitel.

³ Operating Profit Before Depreciation, Interest and Tax (OPBDIT)

In light of the more competitive environment, the major telcos have diversified into related areas, e.g. data/IP services, a range of fixed-line and cellular services and digital television. On the whole, they still rely heavily on their core telephony business, although revenue from alternative sources is now on the rise. As each sector will have its own risks, the overall credit profile of the company will depend on the size of its investment into other areas, as well as the general credit profile of the sector to be invested in.

Meanwhile, RAM Ratings also uses other financial ratios in the credit-rating process, such as:

- Gross and net gearing levels
- Interest coverage
- Free operating cashflow to debt cover

These allow the measurement of debt-servicing aptitude and the ability of the telco to meet its interest obligations. A reasonable measure of the effectiveness of investments can be arrived at by comparing the investments made by the company to the degree of cashflow variation over the following period. By making this comparison, we can make a reasonable judgement on the returns generated by the investments.

Challenges and Opportunities

The Sri Lankan telecommunications industry remains one of the most dynamic sectors in South Asia. Although there are mounting challenges in the form of limited customer base and stiff competition, growth is still envisaged to remain healthy in the near future. We note that telecommunication has become ubiquitous, and will continue as the main revenue earner for the current operators in the foreseeable future. With the boom in the business-process outsourcing (or BPO) model, broader bandwidth will be crucial towards sustaining this segment. Hence, data services can be seen as an area for potential growth within the telecommunications industry. As it is, the 2 major players have already diversified into this area.

The growth potential of the local market has been recognised by major international telcos, particularly those on the sub-continent, with 2 major Indian firms already poised to enter the Sri Lankan market. It will be interesting to observe the entry strategies employed by these 2 Indian firms, which are venturing into an already fiercely competitive and crowded market. A major player in the Indian telecommunications industry, Reliance India, which is entering the domestic market through a joint venture with a Sri Lanka-based firm, has proposed to provide subscribers with a single account that can access all services, e.g. cellular Internet, WiMax, and direct-to-home television. Nonetheless, this proposal has already encountered regulatory barriers as the TRC does not provide a common licence for all telecommunication services; it only grants individual licences for each type of

service. We note that the first Indian telco to obtain a licence, i.e. Bharti Airtel, has yet to commence operations. In the interim, cellular call charges have almost halved since its originally planned 2007 debut.

The fierce competition in the cellular segment is likely to intensify with the entry of new players. While the debutants are likely to leverage on new technologies, their business strategies are unclear at this juncture. Given that saturation point is likely to be reached over the medium term (penetration rate of 75%-80%), however, RAM Ratings believes that some form of consolidation is inevitable. Therefore, the industry is likely to witness some mergers or changes in ownership. Whatever the eventual outcome, the erstwhile instigators of change will need to adapt to survive in the future.



Published by RAM Ratings (Lanka) Ltd
Reproduction or transmission in any form is prohibited except by
permission from RAM Ratings.
© Copyright 2008 by RAM Ratings

RAM Ratings (Lanka) Ltd
No. 9, Arthur's Place
Colombo 4
Sri Lanka
Tel: +94 112 553089 Fax: +94 112 553090
E-mail: ram@ram.com.lk Website: www.ram.com.lk

RAM Ratings receives compensation for its rating services, normally paid by the issuers of such securities or the rated entity, and sometimes third parties participating in marketing the securities, insurers, guarantors, other obligors, underwriters, etc. The receipt of this compensation has no influence on RAM Ratings' credit opinions or other analytical processes. In all instances, RAM Ratings is committed to preserving the objectivity, integrity and independence of its ratings. Rating fees are communicated to clients prior to the issuance of rating opinions. While RAM Ratings reserves the right to disseminate the ratings, it receives no payment for doing so, except for subscriptions to its publications.