Rating Indian Telecom Companies

Sector Credit Factors for National Ratings

Special Report

This report is an addendum to the master report, "Corporate Rating Methodology", dated September 2012. The report describes the criteria applied by India Ratings in assigning corporate ratings. This addendum provides a high-level overview of how those criteria are most frequently observed in application to companies in this sector. Users are referred to the "Limitations" section of this report.

Sector Credit Profile

Highly Competitive: The Indian telecoms sector is among the most competitive in the world, with about a dozen operators competing in each of the 22 telecom circles[1] in the country and the average revenue per minute (ARPM) among the lowest – at about INR0.4 (USD0.01).

Capital Intensive: Indian telcos need to invest heavily in basic infrastructure to provide services for the large and geographically widespread population (1.2 billion), and to boost the currently insufficient spectrum of 5-10MHz. Telcos need to invest continuously in order to remain competitive – in light of changing technologies and to meet the growing traffic in voice and data. This generally results in stretched balance sheets, and prevents telcos from generating positive free cash flow (FCF) during the initial years of operation.

Regulatory Risk: Telcos globally are exposed to regulatory risks, while the intensity is much higher in India in the short term. The Indian sector suffers from an evolving regulatory framework and frequent policy changes, which has a negative effect on financial profiles and access to capital. Most Indian telcos suffer from a lack of regulatory clarity; however, some are more exposed than others, which the agency factors into individual ratings.

Long-Term Technological Trends: Indian telcos face a long-term risk emanating from deterioration in profitability and lower cash generation, due to the increasing popularity of data and adoption of smart-phones which would cannibalise traditional voice and text services. The risk is low, however, in the short- to medium-term, due to moderate penetration of voice and

Higher-Rated Entities: Entities rated in the 'IND AA' and 'IND AAA' categories have a strong market position; pan-Indian presence; offer diverse services; and own the best infrastructure in the sector. The ownership of a fibre- or copper-based infrastructure, along with a mobile franchise, is a key attribute for a higher-rated entity. Such telcos also have access to 3G and broadband wireless access (BWA, also called 4G) spectrum. Financial flexibility is strong, due to economies of scale, better operating margins and an ability to generate FCF.

Lower-Rated Entities: Entities rated in the 'IND A' category and below will typically exhibit less diversification in all aspects; higher operating costs; weaker liquidity; negative FCF generation and/or higher absolute debt levels; or a reliance on one product segment. These entities would typically lease all or most of the fixed and mobile infrastructure assets.

Specific Credit Factors: This report addresses India Ratings and Research Private Limited's (India Ratings) specific credit factors used when analysing Indian telecom companies on the national scale. For the purpose of this report, these entities primarily provide retail and enterprise telecom services including mobile, fixed-line, data, telecom infrastructure and equipment services.

The report then examines additional company-specific traits that may influence the rating – and therefore more finely categorise companies by rating level. Finally, the report explains how a company's financial profile (credit metrics) influences its creditworthiness and final rating.

Related Criteria

Corporate Rating Methodology (September 2012)

Analysts

Nitin Soni
+65 6796 7235

Sahil Aggarwal
+91 11 4356 7242
sahil.aggarwal@indiaratings.co.in

Rakesh Valecha
+91 22 4000 1740
rakesh.valecha@indiaratings.co.in

[1] The Department of Telecommunications (DOT) divides the country into 22 "circles", including four metropolitan cities and 18 states or union territories, based on state constitutional boundaries

Building Blocks - Indian Telecom Companies

	Sector Risk Profile	Company-Specific Traits					Financial Profile (historical where relevant and forecast, mid-points)				
		Competitive position	Diversity of service platforms	Infrastructure quality and ownership	Financial flexibility	Regulatory risk	FFO (INR)	FFO-adjusted net leverage (%)	FFO interest cover (%)	Op. EBITDAR margin (x)	Pre-div FCF/ Sales
IND AAA		• Top 2 in terms of revenue market share					50bn	1	10	30	
IND AA		• Top 3 in terms of revenue market share • Diversified service portfolio – retail and enterprise • Strong pan-India presence	• Operates multiple established platforms for providing service • Access to 3G & BWA spectrum	• Infrastructure of high quality – mostly 900MHz • Fiber based backhaul network • Mostly self-owned infrastructure	• Strong reliable access to funds • Well-spread Debt maturities • Solid Liquidity with large cash balances and free cashflow generation	• Regulatory risk is clearly benign or low	30bn	3	6	25	10
IND A		• Top 6 in terms of revenue market share • Service Portfolio may be heavily weighted to one service • Established presence in most of the circles	• May operate multiple platforms, but one may be developing with one established • Limited access to 3G & BWA spectrum	• Infrastructure quality is solid – mix of 900MHz and 1800MHz • Mix of fiber and copper • Mix of self-owned and leased infrastructure	• Strong reliable access to funds • Lumpy debt maturities • Limited liquidity due to weaker cash balances or free cashflow generation	• Regulatory risk is moderate • Financial impact is uncertain	10bn	4	4	15	5
IND BBB		• Small scale of operations, market challenger • Lack of service diversity • Presence in only few circles	• Operates one established platform • No 3G and BWA spectrum	• Infrastructure is less efficient – 1800MHz and higher • Copper based backhaul • Infrastructure mostly leased out	• Uncertain access to funds • Debt maturity schedule is a material concern • Minimal Cash balances or free cashflow generation	• High regulatory risk • Financial risk is certain, however quantum is uncertain	1bn	6	2	5	0
IND BB		• Little to no scale, market challenger, lack of service diversity, weak geographical footprint	• May be developing a single platform or may not own platform • No 3G and BWA spectrum	• Limited availability of 2G spectrum • Infrastructure mostly leased out	• Limited or lack of access to Funds • Tight Liquidity conditions • Minimal Cash balances • Negative free cashflow	• Regulatory environment is clearly unfavourable • Financial risk and quantum is certain	Negative	Negative	Negative	Negative	Negative

General
- Essential service
- Broadly constant demand
- Technology risk
- High barriers to entry

- Economies of scale
- Regulatory uncertainty
- Highly competitive
- High fixed cost requirements

- Weak balance sheets
- Strong growth prospects

Indicative factors observed or extrapolated for rated issuers. Ratio levels refer to the mid-point of a through-the-cycle range; actual observations are likely to vary from these. Certain sub-sectors may contain a small number of observations; where no observations currently exist, guidelines for a category are extrapolated based on India Ratings judgement. The factors give a high-level overview and are neither exhaustive in scope nor uniformly applicable. Additional factors will influence ratings, particularly where group relationships constrain or enhance a rating level.

Key Credit Factors

- Competitive position
- Diversity of service platforms
- Technology leadership/ infrastructure quality
- Financial flexibility
- Regulatory risks
- Financial profile

Company-Specific Traits

Competitive Position

India Ratings considers mobile revenue market share (RMS) as one of the most important operating factors in the analysis of an Indian telco, as the sector is predominantly a prepaid market with high churn rates. An operator among the top three benefits from a pan-India presence, pricing power, economies of scale, and ability to cross-sell its products and services. The economies of scale originate from a larger subscriber base, to which an operator can offer cheaper tariffs on calls originating and terminating on its network (“on-net” calls). India Ratings believes the Indian telecom sector can sustain only six operators, on a long-term basis, which can offer diversified services and own most of their mobile and fixed infrastructure.

Telcos offering enterprise[2] services and solutions – along with retail – face a lesser risk of revenue concentration. Most of the enterprise business contracts are of long duration and/or have high renewal rates, thus making it a more stable revenue stream.

India Ratings believes that a strong competitive position translates into greater profitability. A significant portion of operating costs is fixed in nature, and therefore higher revenues result in better profitability.

Figure 1

Competitive Position – Market Share

Rating category	Revenue market share
‘IND AAA’	Top two operators, pan-India presence
‘IND AA’	Top three operators, pan-India presence
‘IND A’	Top six operators
‘IND BBB’ and below	Emerging or niche operator, operations limited to a few telecom circles

Source: India Ratings

Diversity of Service Platforms

India Ratings believes that an ability to provide multiple services – including fixed-line, mobile, broadband and infrastructure services – leads to revenue diversification, which could be a considerable advantage in a situation of demand slow-down in one product segment. The access to 3G and 4G/BWA spectrum is important as it provides an early entry into India’s fast-growing data segment. Data penetration is in the low-single-digits, and the agency expects it to rise significantly by 2020. Moreover, most Indian subscribers will undergo their first internet experience on handheld devices, as the penetration rate of personal computers is relatively low.

Figure 2

Diversity of Service Platforms

Rating category	Observations
‘IND AA’ and above	Operates multiple platforms, and has access to 3G and 4G/BWA spectrum
‘IND A’	One established service platform; other services in the development stage; and with limited access to 3G and 4G/BWA spectrum
‘IND BBB’ and below	One established or developing service platform, and no access to 3G and 4G/BWA spectrum

Source: India Ratings

Quality and Ownership of Infrastructure

Indian telcos owning capex-efficient 2G spectrum in 900MHz have a distinct advantage in terms of creating a barrier to competitive entry, as it requires lower investment compared with 1800MHz or higher. India Ratings also notes that infrastructure ownership is important, as it not only helps in bringing down the operating costs but also contributes to additional revenue through leasing to smaller operators.

Related Criteria

Evaluating Corporate Governance (December 2011)
Corporate Rating Methodology (August 2011)
Parent and Subsidiary Rating Linkage (August 2011)

[2] The enterprise segment provides telecom services to businesses and institutions

Conversely, late entrants or smaller operators, which own spectrum in the 1800MHz or higher frequencies and do not own physical infrastructure (telecom towers), ride on leased networks which converts their business model to an operating expenditure (opex) one – compared with the traditional capex model – and hence results in lower profitability, which comes with the benefit of reduced capital investment. It also reduces the flexibility over their product and service offering, as they are dependent on third-party infrastructure to launch any new product and/or service.

Figure 3
Quality and Ownership of Infrastructure

Rating category	Observations
'IND AA' and above	Infrastructure of high quality – spectrum in 900Mhz, fibre-based backhaul network, and mostly self-owned infrastructure
'IND A'	Mix of 900MHz and 1800MHz, mix of fibre and copper backhaul, and a mix of self-owned and leased infrastructure
'IND BBB' and below	Mostly 1800MHz or above spectrum, and mostly leased Infrastructure and/or copper-based

Source: India Ratings

Financial Flexibility

Those telcos with strong access to capital markets and local banks, and with well-spread-out debt maturities, are well-positioned to meet continuous investment requirements and withstand any technological changes and/or acquisition of additional spectrum. India Ratings differentiates between Indian telcos' ratings based on financial flexibility – which is typically measured by an ability to generate positive FCF.

Figure 4
Financial Flexibility

Rating category	Observations
'IND AA' and above	Strong reliable access to funds; well-spread-out debt maturities; solid liquidity with large cash balances; and FCF generation
'IND A'	Strong reliable access to funds; lumpy debt maturities; limited liquidity with weaker cash balances or FCF generation
'IND BBB' and below	Uncertain access to funds; tight liquidity conditions; minimal cash balances; and negative FCF

Source: India Ratings

Regulatory Risks

India Ratings notes that although the regulatory uncertainty acts as a negative factor for most Indian telcos, the financial implications could be different for each of them. This risk could take many forms – for some telcos the regulatory environment is clearly unfavourable, as evident from the cancellation of licences; for others, the impact is uncertain and/or actual quantum is not clear. Therefore, India Ratings differentiates between the ratings of Indian telcos based on the certainty of the financial risk and quantum of financial impact due to the extent of a negative regulatory environment.

Figure 5
Regulatory Risks

Rating category	Observations
'IND AA' and above	Regulatory risk is clearly benign or low
'IND A'	Regulatory risk is moderate, and the financial impact is uncertain
'IND BBB'	High regulatory risk; financial impact is certain; however, quantum is uncertain
'IND BB'	Regulatory environment is clearly unfavourable, and the financial impact and quantum is uncertain

Source: India Ratings

Financial Profile

India Ratings' Master Criteria *Corporate Rating Methodology*, dated August 2011, lists the main ratios used in rating companies, and explains adjustments for features such as operating leases and pensions. The ratios listed below are viewed as key to analysing both the telecom companies' current and projected financial profiles.

India Ratings notes that financial metrics can alleviate only some of the pressure from the sector risk profile and company traits, and do not enable the company to completely detach itself -- even where, for example, financial leverage is very low. A company with a strong market position may still be burdened by high leverage which may exert pressure on ratings.

Funds Flow from Operations

India Ratings measures the size of an Indian telco by funds from operations (FFO); as unlike other corporates, a large revenue base does not always reflect profitability – due to long gestation periods and high costs for the initial network and marketing. The rating differentiation based on size underpins the strengths, including access to funds and better bargaining power with suppliers. FFO offers a measure of the ability to generate operational cash after interest and tax, pre-working capital, and before investments.

Figure 6
FFO Size

Rating category	FFO amount
'IND AAA'	INR50bn
'IND AA'	INR30bn
'IND A'	INR10bn
'IND BBB'	INR1bn
'IND BB' and below	Negative

Source: India Ratings

Leverage and Interest Coverage

India Ratings measures the balance sheet health of a telco through its FFO-adjusted net leverage – which measures the ability to repay net debt from cash flow generation. The ratio is critical for analysing a telco's credit metrics, given the capital-intensive nature of the industry. Low leverage reflects the ability to invest heavily in new technologies, acquire smaller telcos for inorganic growth, and to acquire infrastructure assets. India Ratings also looks at the FFO-based interest coverage ratio which measures the headroom of interest cover from its cash accruals. An interest cover of lower than 2.0x typically indicates tight liquidity conditions and a weak financial profile.

Figure 7
Leverage and Coverage Ratios

Rating category	FFO-adjusted net leverage (x)	FFO interest cover (x)
'IND AAA'	1.0	10.0
'IND AA'	3.0	6.0
'IND A'	4.0	4.0
'IND BBB'	6.0	2.0
'IND BB' and below	Not meaningful as FFO is negative	Not meaningful as FFO is negative

Source: India Ratings

Profitability

India Ratings measures a telco's profitability through operating EBITDAR margins. A high operating margin reflects economies of scale, pricing power and an ability to reduce costs. It also acts as a cushion against periods of tariff wars, and provides an ability to survive longer in the face of the intense competition.

Figure 8
Operating EBITDAR Margin

Rating category	Observation (%)
'IND AAA'	30
'IND AA'	25
'IND A'	15
'IND BBB'	5
'IND BB' and below	Negative

Source: India Ratings

FCF Generation

The generation of positive FCF is important for telcos given the capital-intensive nature of the sector. India Ratings measures FCF generation as based on FFO less working capital outflow and capex. An ability to generate cash clearly helps in either re-investing in infrastructure or repaying debt.

Figure 9
Pre-Dividend FCF/Sales

Rating category	Observation (%)
'IND AA' and above	10
'IND A'	5
'IND BBB'	0
'IND BB'	Negative

Source: India Ratings

Limitations

This Sector Credit Factor report describes indicative features observed for rated issuers in India. Ratio levels refer to the mid-point of a through-the-cycle range, and as a result actual observations are likely to vary from these. The weighting factors will vary substantially over time for any given issuer and between issuers based on relative significance agreed upon by the rating committee. The factors described give a high-level overview as a convenience for rating users, and are neither exhaustive in scope nor uniformly applicable. These may vary for a given rating category.

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