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Top 10 Investor Questions For 2013: Global Telecommunications And Cable

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Top 10 Investor Questions For 2013: Global Telecommunications And Cable

The telecom and cable sectors have had several years of generally stable credit quality, and Standard & Poor's Ratings Services believes ratings will remain relatively stable in 2013. Some exceptions to this trend have been southern European incumbent telecoms, and wireline-only and regional wireless providers in the U.S., which have recently been under significant ratings pressure -- a trend we anticipate will continue. Beyond these pockets of weakness, we believe that many important developments may have credit implications for all players in the longer term. Massive shifts are taking place in every region, as industry players invest in new technologies while diversifying away from older services that are facing an unavoidable decline. With these larger trends in mind, the following are some questions we have received from investors globally about the telecom and cable sectors.

(Watch the related CreditMatters TV segment titled, "The Global Telecom And Cable Industry: Standard & Poor’s Addresses The Top Investor Questions," dated Dec. 5, 2012.)

How do your telecom and cable ratings reflect your economic view of various regions?

We view demand for most telecommunications and cable services to be fairly resilient against changes in the macroeconomic environment, reflecting how these services have become a near necessity for most households and individuals. We believe changes in technology and consumer preferences --and not economic factors -- largely propel demand shifts in these sectors (for example, the ongoing shift to wireless services from wireline in developed markets).

Still, no industry is immune to the weak economy, and severe economic stresses in a region can have a material impact on revenue and profitability, as has been the case recently for carriers serving markets in Spain, Portugal, Ireland, or Greece. In addition, we gauge growth prospects for carriers -- especially in terms of their ability to add ancillary services or raise prices -- by examining key economic drivers that center on disposable income, consumer sentiment, and new housing formation. Some regional observations include:

- Our anticipation for flat real GDP in the eurozone (European Monetary and Economic Union) in 2013 and limited growth in non-eurozone Europe curtails revenue growth potential for European players' domestic operations, leaving their emerging Latin American, Asian, and African subsidiaries as the main potential growth engine. Southern European players are typically facing the weakest domestic demand levels.
- Our economists assume that the U.S. recovery will remain weak, with annual real GDP growth improving only moderately to 2.3% in 2013. This scenario supports a low-growth scenario for most wireless and cable industry players, with a continued decline in wireline revenue.
- In Asia-Pacific our macroeconomic outlook is more upbeat, which should support demand for telecom services, particularly as consumers migrate to next-generation technologies. We anticipate that real GDP growth in Asia-Pacific excluding Japan will grow by about 6% in 2012 and 2013. In Japan, however, our growth outlook is more muted, with real GDP growth anticipated to remain weak at about 2% in 2012 and 1.6% in 2013.

Is 4G and 3G wireless investment translating into higher revenue and profitability for telecoms?

Although the 4G era is still in its infancy in many countries, we are seeing a few early trends emerge. Generally, our anticipation is that growth in mobile broadband will offset declining voice and text revenue but not spur margin expansion, on the whole, because of the high investments required, rising handset subsidies, and intense competition in many markets. Those players who underinvest in networks or spectrum will likely be at a significant disadvantage, in our view, and could rapidly lose market share. Some regional observations include:

In South Korea and Japan, we are seeing a greater-than-anticipated level of competition during the migration from 3G to 4G, which is limiting anticipated average revenue per user (ARPU) growth. We anticipate, however, that the returns from this investment will improve as these telecom players achieve critical mass in their level of LTE (Long Term Evolution) subscribers, noting that the costs of upgrading to 4G from 3G are materially lower than those to 3G from 2G. Furthermore, given the ongoing declines in per-unit data pricing, we anticipate that this investment will be essential to increasing data volumes to maintain overall revenue growth in the next few years.

- In the U.S. wireless market, we see the transition to 4G increasing the scale intensity and capital intensity of the wireless industry and potentially extending the already wide performance and profitability gap between the strongest players, AT&T and Verizon, and the rest of the industry. We believe this is a key reason why national competitors such as Sprint Nextel Corp. and T-Mobile USA have sought merger partners, but the Sprint transaction resulted more from future financing needs, and the T-Mobile deal is in pursuit of greater scale, in our view.
- In Europe, early investments in 4G broadband, coupled with fiber deployments, have supported domestic market shares for European players such as Portugal Telecom and Teliasonera, respectively, bucking earlier trends. However, the late allocation of 4G spectrum in many markets and Europe's fragmented telecom landscape are delaying, in our view, 4G rollout on the continent, particularly in Western Europe.
- In the emerging markets, countries are at different stages of evolution in the rollout of 3G services. Countries such as Pakistan have yet to formally launch 3G, whereas Thailand has only recently completed its 3G spectrum auction. At the same time, Indonesia, which launched 3G in 2006, has started to register faster growth recently because of the increasing availability of cheaper 3G-enabled handsets. In India, where telecom companies paid almost $15 billion for the 3G spectrum in mid-2010, telecoms are registering slower-than-anticipated uptake of 3G services, which still account for a small portion of carriers' revenue in emerging markets. Furthermore, 3G has yet to significantly benefit telecom company profitability because of strong competition and the high initial capital investment.

What is the near-term outlook for capital spending by telecom and cable companies?

We see sustained high capital spending across the board, given the need to upgrade fixed and mobile infrastructure and spectrum to support the growth in data traffic. However, the continued price erosion of telecom gear should partially offset any major spikes in capital spending budgets. Mobile broadband requires significant quality spectrum that is in short supply, which requires large investments. We anticipate that telecoms will continue to seek to outsource or share wireless network investments to reduce costs. We adjust commitments to tower companies and other external parties back onto telecoms' balance sheets.

U.S. carriers are facing a rise in capital spending as a result of 4G upgrades and fiber deployments. For example, AT&T announced in November 2012 it would invest about $14 billion during the next three years to build out its wireless and wireline businesses. We anticipate that AT&T's capital expenditures will remain about $3 billion higher than 2012 levels during this period. Sprint Nextel Corp., already in the midst of a multiyear overhaul of its wireless networks, would obtain additional resources to upgrade its network if its proposed merger with Japan's Softbank is completed in mid-2013 as anticipated.

For the largest Europe, Middle East, and Africa telecoms, we see capital expenditures remaining on average at 15% to 16% of revenue for 2013, including spectrum acquisitions. Individual companies may see spikes above that level when 4G spectrum goes on sale in markets such as the U.K., Poland, and the Netherlands. Emerging operations' capital expenditures are typically above that level, reflecting higher customer growth. European cable players are likely to spend a higher share of their revenue (20% to 25% typically) to support higher growth and given capitalization of customer-related costs.

In Asia-Pacific, we anticipate that capital investment for the larger developed market telecoms will average about 15% of revenue, including 4G investments. However, investment levels in individual markets are significantly more varied. In particular, we anticipate that the more developed Asian markets that are investing in both 4G upgrades and fiber-to-the-home fixed-line networks, such as South Korea and Japan, will invest capital of 16% to 20% or more of revenue in the next two years. In the emerging Asian markets, capital expenditures have decreased compared with two to three years ago, when companies were investing heavily in network rollouts. Nevertheless, capital expenditures are still high compared with those of many developed markets, as fixed-line service providers continue to invest heavily in fiber services and as wireless service providers increase network capacity to absorb the rapid growth in subscribers and data demand.

What effect will the proposed Sprint/Softbank and T-Mobile/MetroPCS mergers have on the U.S. wireless landscape?

Although these are significant transactions, we do not view them as game-changers for the U.S. industry as a whole. Therefore, we do not believe these transactions will have ratings implications beyond the companies directly involved. The Sprint-Softbank combination does not alter the number of players operating in the U.S. and is unlikely to provide meaningful synergies, because the two companies operate in different countries. Any competitive benefits of the transaction, such as cost savings on handsets and network equipment, would likely take time to emerge, and would likely result from Sprint's greater financial flexibility allowing consistently higher investment in the business.

We view the combination of MetroPCS and T-Mobile USA somewhat differently, in that it could result in an improved business risk assessment as a result of larger scale, including greater operating efficiency, better equipment pricing, and more spectrum to accommodate an LTE upgrade. We view MetroPCS' business risk as "weak," based on the potential for pricing volatility and high customer losses in the prepaid segment in which it operates.

Importantly, however, we also believe the combined MetroPCS-T-Mobile entity would remain competitively disadvantaged against the larger national players Verizon and AT&T, both of which have "strong" business risks based on their much larger scale and marketing resources, larger base of more profitable postpaid customers, higher average revenue per user, and lower customer churn.

Do the recently announced wireless mergers presage more telecom mergers and acquisitions across regions?

From a credit perspective, we continue to see limited benefits to cross-border acquisitions in the telecom sector, other than the geographical diversification of earnings and resulting reduction in exposure to any given countries. However, diversification benefits from Latin America (notably Brazil) are accruing to Telefonica, Vivendi, Portugal Telecom, and Telecom Italia.

By comparison, the large U.S. telecom carriers have limited cross-border geographic diversification. Although it is always possible that some could seek growth opportunities in developing markets, we generally do not believe cross-border combinations offer compelling synergies or other benefits on the business risk side that would offset the execution risk.

In-market consolidation in European mobile markets remains elusive, as regulators have supported the emergence of new players, blocked merger plans, or extracted significant concessions in exchange for merger agreements. Any easing of regulatory views on in-market consolidation could reduce the risks of further dilution of the business risk profile of rated European players. We continue to see potential for non-European players to buy stakes in the continent's telecoms. In what we see as a credit positive, European companies KPN and Telekom Austria, in which America Movil has taken a minority stake, have announced some of the industry's steepest shareholder payout cuts to protect their balance sheets. Many Middle Eastern telecoms have the willingness and balance sheet capacity to continue expanding through acquisitions outside of their home countries.

In Asia-Pacific, we have observed moderate mergers and acquisitions (M&A) activity during the past decade, as developed market telecoms invested in higher-growth emerging markets. But although we anticipate that some M&A will continue, the potential for cross-border M&A has decreased, in our view, because of the increasing maturity of these higher-growth markets, the high prices of available assets, and regulatory constraints to market consolidation. For example, in countries such as India and Indonesia, we see the potential for consolidation to help improve returns and reduce irrational market pricing behavior, but we anticipate that regulators will limit the extent of any market consolidation.

In light of the numerous dividend cuts by large telecoms in Europe, are dividends from the U.S. carriers sustainable?

We don't anticipate widespread dividend cuts by the U.S. telecom providers in the near term, but ongoing revenue declines in the wireline industry and rising capital expenditures in wireless could hurt free operating cash flow (FOCF), which may necessitate more conservative financial policies.

The two largest U.S. telecom operators, AT&T and Verizon, have good scale, diversified operations, and dominant positions in the wireless industry -- attributes that we believe will make for sufficiently strong FOCF to support current payouts. The pure U.S. wireline operators are in a less advantageous position, in our view, but we anticipate that they will maintain their aggressive shareholder-oriented financial policies in the near term. Still, secular industry declines, especially in the consumer segment, will likely pressure FOCF during the next several years and could force companies to reduce their dividends or sacrifice credit quality. Moreover, increased capital spending to support growth initiatives, such as fiber-to-the-tower builds, the deployment of fiber-based video services, and data center expansions, could also hurt FOCF. Consolidated Communications and Windstream, in particular, may find it challenging to maintain their dividends longer term, both having elevated FOCF payouts and having recently acquired lower-margin businesses.

We also believe that the expiration of accelerated bonus depreciation could result in higher cash taxes and lower FOCF although companies such as CenturyLink and Windstream, which have significant deferred tax assets from recent acquisitions, will be able to partially offset the effects of expiring accelerated bonus depreciation.

What could support the ratings of large European telecom incumbents?

We anticipate that macroeconomic and sovereign factors will remain significant risks to the ratings of European incumbents -- particularly in Southern Europe -- as these have significant exposure to the local economy, are large domestic taxpayers, and rely on the capital markets for their sizable refinancing needs, the cost and availability of which can be heavily influenced by government liquidity or funding requirements. These risks have led to significant rating pressures, which we anticipate could continue. However, if domestic macroeconomic trends and sovereign ratings stop deteriorating, these players may be able to stabilize their ratings through ongoing cost cutting, disposals of non-core operations, and continued adjustment of financial policy on profit and cash generation -- in particular on shareholder payouts.

What is the credit outlook for Eastern European, African, and Middle Eastern telecom companies?

Credit trends in these regions are somewhat better than in Western Europe, as economic headwinds are less strong and regulatory pressures are significantly lower. In Russia, the restructuring of the fixed-line market and granting of wireless 4G licenses to established players should allow good growth in local currency terms -- and may support wireless consolidation -- although governance weaknesses may continue to constrain our ratings there. Outside of Russia, we still anticipate that credit quality of Eastern European telecoms will remain volatile because of country, macroeconomic, and regulatory risks. Given the small populations of Gulf countries, any new mobile competitor creates meaningful disruption to established players' market shares and margins, as was recently the case in Saudi Arabia and Bahrain. Favorable demographics and growing penetration should make African markets the fastest-growing in the world, although how these factors translate into hard currency profits will depend on potentially volatile country risk factors.

Structural separation of monopoly fixed-line networks is being undertaken in several Asia-Pacific markets. What are the credit implications of this and do you anticipate that this trend will continue in other markets?

Structural separation -- a process whereby governments and/or regulators force incumbent telecoms to separate monopoly "last-mile" fixed-line networks into stand-alone regulated network companies -- is being undertaken in a number of markets in Asia-Pacific, including Singapore, Australia, and New Zealand. This is primarily to encourage competition in the retailing of fixed-line telecommunication services.

Importantly for creditors, any demerger of a monopoly fixed-line access network can materially hurt credit quality. Although these networks are typically used to carry structurally declining traditional telephony services, they still generate significant and relatively predictable network revenue and allow incumbent operators to better manage fixed-line retail competition. Accordingly, the loss of these networks can materially increase the business risk of these companies, and this, in turn, can more than offset the benefit of lower capital intensity. Structural separation should, however, help to improve the competitive position of other players in the market, by providing equivalent fixed-line network access to all market participants.

We anticipate that regulators in other markets globally will actively monitor the structural separation process in these Asia-Pacific markets. Regulatory interest will most likely come from markets with limited competition at the fixed-line network level, and existing regulations are failing to generate sufficient competition in the retailing of fixed-line services. For example, Italy is looking at structural network separation options to spur investments in next-generation infrastructures. This could spur competition in fast fixed-broadband services in one of the few large European markets without cable networks.

Handset receivables securitization is emerging as a new funding source for telecoms in markets such as South Korea. How does Standard & Poor's view this funding source and treat the source in its analysis?

The rapid growth in smartphone sales globally is creating a significant funding requirement for many telecoms. Telecoms often fund or subsidize the upfront smartphone cost and then recoup the cost over the contract life. In an attempt to alleviate this funding requirement, handset receivables securitization is emerging as a new potential funding source for telecom companies. To date, we have seen this funding source used in South Korea and Japan, and similar practices have emerged in Israel. We anticipate that this funding source will eventually become more prevalent, particularly for lower-rated telecoms that have a comparatively higher cost of funding.

In South Korea -- one of the most technologically advanced telecom markets globally -- all three of the major Korean telecoms are utilizing handset receivables securitization funding. These companies sell their handset receivables through the issuance of asset-backed securities from either special-purpose vehicles or affiliated financial institutions. From an analytical perspective, we apply our adjustments for trade receivables securitization, adding securitized handset receivables back to debt, because of the ongoing need for funding to support postpaid handset sales. However, we view this as an effective funding source that helps to provide funding diversity for these companies.

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