

Rating Methodology - Mobile Service Providers

[In supersession of “Rating Methodology - Mobile Service Providers” issued in [June 2017](#)]

Driven by various technology changes and key policy initiatives, the Indian telecom sector witnessed a complete transformation over the past decade. The Indian telecom industry has proved to be the fastest growing in the world and is currently the second largest globally in terms of subscriber base. India is only behind of China as far as total number of subscribers is considered. Further, the introduction of affordable data packs and lowering of tariffs has propelled India to the top position in terms of mobile data consumption, surpassing the combined mobile data consumption of the USA and China for the year 2017.

Although falling tariffs, as a result of intense competition among the service providers has benefitted the consumers, it has also severely impacted the balance sheets of the telecom service providers. Intense competition within the telecom sector, declining ARPUs (Average Revenue Per User) on account of price war among the telecom players, regulatory challenges, high level of unsustainable debt and increased losses have together caused significant negative business impact on the industry.

CARE Ratings assesses the credit worthiness of the Mobile Service Providers on the basis of an analysis of various quantitative financial and operational parameters as well as qualitative factor assessments. The qualitative factors include an analysis of the operating environment/industry and company specific parameters which include an analysis of its operating efficiency as well as its competitiveness as compared to other players in the industry.

While rating Mobile Service Providers, CARE Ratings makes a critical assessment of the following parameters:-

Operating Environment

CARE Ratings analyses the features of the industry to understand the risk factors affecting all the service providers within the industry and then focuses on the explicit factors affecting

Rating Methodology - Mobile Service Providers

the operator which helps in ascertaining the relative position of the operator in the given industry.

The key factors that CARE Ratings considers while evaluating the industry are as follows:

- **Structure of the industry**

An evaluation of the industry structure includes an analysis of the number of players present within the industry, its stability, entry barriers and level of competition. The key characteristics of the Indian telecom sector include high growth rates of data consumption, large subscriber base, declining Average Revenue Per User (ARPU) & Average Revenue Per Minute (ARPM) and high level of competition. The India Telecom Sector has now consolidated with 3 large players along with government owned entities remaining in the sector.

The sector, however continues to require large investments in network deployment and rollout of services and these projects typically have a long gestation period. CARE analyses the ability of the operators to invest in new technologies and complete their investments and capex plan in a timely manner, their capacity to absorb the significant customer acquisition cost as well as the financial flexibility to fund initial losses and any unanticipated delays.

- **Regulatory Framework**

Regulatory actions determine the area of service, type and nature of service, number of competitors, tariff plans and also the levies on the operators. Although regulatory uncertainties have been brought down substantially through an interactive mechanism, regulatory risk continues to be of paramount importance. Any new regulation can bring about a major change in the competitive environment resulting in major uncertainty with respect to the operations of a company. The presence of an independent regulator in the form of Telecom Regulatory Authority of India (TRAI) and the periodic introduction of a number of regulatory measures have ensured that the sector continues to remain on the growth path.

Company-specific/Business Parameters**• Market Position**

CARE Ratings considers market position to be an important operating factor in the analysis of telecom service providers. The relative position and strength of a service provider in the segment within which it operates is considered integral to the sustainability of its operations along with its ability to counter competitive pressures exerted by other service providers. The market position of a company is measured in terms of revenue, performance track record and incremental subscriber additions per month. Given the huge outlay required owing to the capital-intensive nature of the industry and the extensive marketing costs involved, having a widespread presence and large scale of operations is important as the scale and size determines an operator's ability to distribute fixed costs over a larger base. A larger market share also ensures greater network efficiency, better utilization of assets and scale advantages in marketing and distribution costs.

CARE analyses the relative position of an operator within the circles where it operates using trend analysis and peer group analysis of subscriber penetration levels and churn rates. CARE also analyses the potential for growth offered by the service areas within which the service provider operates and the strategic initiatives undertaken by the service provider to enhance its customer value proposition.

• Technology Risk

With the rapid technological developments in the telecom sector, the operators face the risk of technology obsolescence. As telecom is a technology dependent sector, operators have to continuously invest in technology upgradation and the companies who have access to superior technology can offer high-quality services at fairly reasonable prices. Thus, even though evolving technology offers new opportunities in terms of revenue diversification, it is important for operators to have the requisite financial flexibility to upgrade their network to match the technological advances. With the intense competition prevalent within the telecom sector, the key differentiator would be the ability of an operator to offer a diversified portfolio of innovative products and services which require superior technological platforms. As technological upgradations require considerable financial investment, CARE Ratings analyses an operator's financial ability to be able to make periodic

Rating Methodology - Mobile Service Providers

investments for technological upgrade and also analyses the risks associated with the prospective returns from the technological platforms chosen by the operator.

• Geographical Diversification/Consumer Mix

An operator with a diversified reach and strong presence in a large number of service areas would be at an advantage as compared to operators with presence in a limited number of service areas. Diversification not only ensures that the operator is not over dependent on a limited number of service areas and particular set of customers for its revenues but also allows operators considerable bargaining power with equipment and handset vendors/manufacturers. Telecom service providers nowadays provide various lucrative offers in partnerships with handset manufacturers and some handsets are particularly designed/manufactured only for the services offered by particular service providers. Further, consumer mix in terms of the number of prepaid and postpaid consumers is also a critical parameter considered in the assessment of an operators' performance as this gives an indication of the operators' usage levels and helps in the estimation of ARPU. Since prepaid ARPUs are lower as compared to postpaid due to lower levels of usage along with higher churn rates for prepaid, a higher proportion of postpaid subscribers in the total subscriber base of operator is considered to be an advantage. Thus, CARE Ratings assesses an operator's overall footprint in terms of the service areas covered combined with its ability to attract new subscribers and maintain its ARPU levels as these factors are an integral part of the overall credit quality analysis.

• Brand Image/Network Coverage & Quality

The Indian telecom sector is highly competitive with the service providers vying for a share of the market. In such a scenario, any reduction in tariffs by one operator is matched by its competitors to sustain their market share. The Mobile Number Portability policy protects consumers and ensures quality of service amid industry consolidation. Since tariffs are market driven, it is important for an operator to carve out a niche for itself through better network coverage and quality and through provision of innovative services which will provide an operator a differentiating edge over others and will enhance the operator's brand image. The ability of an operator to build its brand image amongst consumers is a critical parameter in determining the potential success or failure of the operator as this

Rating Methodology - Mobile Service Providers

determines its subscriber base and ultimately its ability to generate revenues. The customer acquisition cost i.e the cost incurred by an operator on sales and brand building is normally high for all operators and is an expense that is difficult to minimize due to the intense competitive pressure. CARE analyses the ability of an operator to absorb the high customer acquisition costs and also the consumer awareness the operator has managed to generate within its area of operation.

One of the important factors that contribute to an operator’s brand image is its network coverage and quality. An operator that offers seamless coverage, lower call drops and better voice quality is preferred by consumers and has a better market image and thus has a competitive edge. CARE Ratings assesses an operator’s network quality based on certain Quality of Service (QoS) parameters such as average call completion rate and number of call drops. CARE Ratings also relies on the Quality of Service and Customer Satisfaction Survey reports released by TRAI which gives an indication of where the various players stand in terms of QoS and consumer satisfaction.

Financial Profile

CARE’s analysis of the financial profile of an operator considers both historical and projected financial performance. Trends over a 3 to 5 year period are analysed and compared to the industry average. CARE’s financial analysis is focused on the stability and sustainability of earnings and cash flow, which underpins the ability of the operators to repay their debt obligations. CARE also analyses the future cash flows of the company under various adverse situations to analyse the financial flexibility of the company under various scenarios.

The telecom sector is capital intensive as networks constantly require upgrading to meet technological advancements. A proportion of the capital expenditure in telecom is considered non-discretionary and this level can rise or fall depending upon the technological shifts which occur from time to time which necessitates an increase in the capex to be incurred by the operator. The ability of telecom operators to generate sufficient internal cash flow to meet these capital requirements is considered to be a key factor that influences the credit quality of the operator.

CARE Ratings also assesses the financial performance of an operator in terms of its profitability at the EBITDA level. The EBITDA margins of the operators have been under

Rating Methodology - Mobile Service Providers

pressure owing to a number of factors and the pressure on the margins is likely to continue for some more time as a result of fall in tariffs, high acquisition costs and slower pace of returns on 3G/4G services.

• Leverage/Debt Profile

Leverage is a key factor in analyzing an operator’s long-term creditworthiness and solvency given the high capital intensity of the sector. CARE analyses various leverage ratios such as the debt to equity, overall gearing, debt to GCA and debt to EBITDA as part of its overall methodology.

CARE Ratings also pays special attention to the terms and conditions of the debt raised and the covenants associated with the various credit facilities. Companies in the telecom sector are required to make huge initial outlays during initial rollout and during modernization projects, which have a long gestation period. As a result, the ability of a telecom operator to arrange for long-term debt with suitable maturity assumes paramount importance in determining viability of its operations.

Promoter/Management Evaluation

Telecom Sector is a capex intensive sector and needs huge investments to fund any capex plans (modernization and replacement) arising out of demand with change in the technology used and business environment. The sector is highly leveraged and with the service providers making all efforts for customer acquisition and retention through various price competitive offers, the demand for huge investments to upgrade their infrastructure and to fund acquisition cost remains intact. Thus financial flexibility of promoters in terms of ability to infuse additional equity as and when required is a critical parameter while analyzing the risk profile of an operator. The financial flexibility of the promoters along with the way in which they propose to fund initial losses and the contingencies arising out of unanticipated delays or longer- than-anticipated gestation period is critically examined by CARE. The management of the company is assessed for its role in developing and implementing long-term strategies that provide the foundation for a sustainable long-term competitive advantage. CARE Ratings believes that the strength of the management team will play a crucial role in determining an operator’s medium to long-term competitiveness.

Rating Methodology - Mobile Service Providers

Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE Ratings assesses the credit quality of a telecom operator based on a number of qualitative and quantitative parameters which include the operator's positioning on technology, strategies to maintain and expand market reach, capability and plans to offer higher-margin services and to explore new revenue sources for better generation of returns from their investments.

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