Rating Methodology - Mobile Service Providers

[Issued in February 2023]

Driven by various technology changes, evolving competitive landscape and key policy initiatives, the Indian telecom sector witnessed a complete transformation over the past decade. The Indian telecom industry continues to be the fastest growing in the world and is currently the second largest globally, after China, in terms of subscriber base which was around 1.17 billion (wireless + wireline) as of November 30, 2022.

Gradually, the sector started witnessing transition to non-telecom business such as enterprise business, cloud services and Wifi-Lan services which will find applications across various fields thereby improving the overall revenue and reducing the retail dependency of mobility service providers, which has been augmented by successful auction of 5G spectrum by Government of India.

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 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 mobile service providers sector include high growth rates of data consumption, a large, plateaued subscriber base, low Average Revenue Per User (ARPU) & Average Revenue Per Minute (ARPM) and high level of competition. The sector has 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 Ratings 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 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 tightly regulated.

Company-specific/Business Parameters

- **Market Position**

  CARE Ratings considers market position to be an important operating factor in the analysis of mobile 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 share, 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 Ratings analyses the relative position of an operator within the circles where it operates using trend analysis and peer group analysis of subscriber base, high-value subscribers, ARPUs and churn rates. CARE Ratings 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. With the successful completion of the 5G spectrum auction, the industry is geared up for the rollout of 5G services. The readiness of the operators in transitioning to 5G through setting-up of a sustainable infrastructure and the maintenance of the network coverage and Quality of Service (QoS) are the key parameters which will help the operators in sustaining their market share. As telecom is a technology-dependent sector, operators have to continuously invest in technology upgradation to stay relevant in the market. 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 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 the 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. Mobile service providers continue to provide various lucrative offers in partnerships with handset manufacturers. Furthermore, the customer mix in terms of the number of prepaid and postpaid customers is a critical parameter considered in the assessment of an operators' performance as this helps in the estimation of ARPU. Prepaid ARPUs are lower as compared to postpaid due to service differentiation and as a higher proportion of prepaid subscribers results in higher churn on account of price sensitivity, a significant share of postpaid subscribers is considered to be an advantage. Furthermore, the technology mix of the subscriber base is also a determinant of the ARPUs. The revenue generation thus depends on the quality of the subscribers ascertained by the technology used – 2G, 3G, 4G, etc. and the usage of the services by the subscribers. 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.

- **Brand Image/Network Coverage & Quality**
  The sector is highly competitive with the service providers vying for a share of the market through differentiation of service offerings. 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 operators having access to strong content base, either through their own development arms or through tie up with content providers is one of the important factors in determining their competitive strength. 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 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 Ratings analyses the ability of an operator to absorb the high customer acquisition costs and also the consumer awareness managed by the operator 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, high data speeds and better voice quality is preferred by consumers and has a better market image and thus has a competitive edge. 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 Ratings' analysis of the financial profile of an operator considers both historical and projected financial performance. Trends over a 3-5-year period are analysed and compared to the industry average. CARE Ratings' 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 Ratings 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 sector is capital intensive as networks constantly require upgrading to meet technological advancements. A proportion of the capital expenditure 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 the 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 are also dependant on tariff hikes. As the customer acquisition costs remain high along with longer gestation period of new technologies leading to lower returns on investments, diversification to new service areas and offerings remains crucial for providing higher revenue generation capabilities.

- 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 Ratings analyses various leverage ratios such as the debt to equity, overall gearing, TOL/TNW, debt to GCA and debt to EBITDA as part of its overall methodology. CARE Ratings also generally excludes intangible assets while calculating the networth, however, in case of mobile service providers, their spectrum holding, which is an intangible asset, is inherent to their ability to offer their services and hence it is not excluded while calculating the networth. The companies in the mobile service providers 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 an operator to arrange for long-term debt with suitable maturity assumes paramount importance in determining viability of its operations.

  For more details on Financial ratios please refer to the methodology on 'Financial Ratios-Non financial sector entities' which is available on www.careratings.com

Promoter/Management Evaluation

Mobile Service Providers 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 the 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 Ratings. 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.

Environmental Social and Governance (ESG) risk:

CARE Ratings assesses the environmental social and governance risks associated with the mobility service providers and the extent of their compliance in relation to the legal framework in India.

Environmental risk in telecom sector assesses the extent of initiatives taken by the entity in achieving carbon neutrality. With the implementation of 5G services leading to increased data consumption thereby resulting in higher energy consumption, which will lead to more carbon emission impacting the environment. Hence the mobility service providers must implement energy efficient next-gen equipment and green energy power solutions across its networks to achieve low power consumption and high performance.

Other initiative shall include achieving net-zero life cycle of equipment, which is achieved by standardization of designs, reusage/repurposing of existing network equipment and or usage of network components which are recyclable (creation of circular supply chain model) at the end of its useful life thereby minimizing the land pollution due to dumping of wastage of electronic components.

Social risk framework assessment shall include stronger push for better connectivity to rural and remote areas thereby improving access to remote learning or healthcare via telemetry will have greater impact in overall social development. Other measures shall be impact investing (social bonds, ESG bonds, blended finance models), means investing in social cause.

Governance risk in a corporate is determined by a host of factors, which includes and is not limited to the following, viz., financial reporting, corporate practices, adherence to code of conduct, board composition, whistle-blower policies, investor relations, etc. CARE Ratings tries to form a broad opinion from the available information regarding the governance standards of the entity being evaluated. CARE Ratings also assesses the composition of the Board of Directors of the company, the level of compliance with various policies, the quality of financial reporting and the adequacy in disclosure from the perspective of corporate governance.

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 mobile service provider based on a number of qualitative and quantitative parameters which include the operator's positioning on technology, strategies to maintain and expand market reach through prudent financial planning, capability and plans to offer higher-margin services and to explore new revenue sources for better generation of returns from their investments.

[For the previous version please refer to 'Rating Methodology - Mobile Service Providers' issued in November 2020]

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and detailed research. CARE Ratings Ltd, the parent company in the group, is one of the leading credit rating agencies in India. Established in 1993, it has a credible track record of rating companies across multiple sectors and has played a pivotal role in developing the corporate debt market in India. The wholly-owned subsidiaries of CARE Ratings are (I) CARE Advisory, Research & Training Ltd, which offers customised advisory services, credible business research and analytical services (II) CARE Risk Solutions Private Ltd, which provides risk management solutions.