Article Title: ARCHIVE | Criteria | Corporates | Industrials: Assessing The Ratings For European Public Telecom Operators Data: Standard & Poor's increasingly is putting greater emphasis on its corporate ratings criteria when assessing creditworthiness of the European public telecom operators (PTOs). Direct or strong implicit government support and regulatory protection will decrease in importance as the national markets open up to competition. The companies' operational and financial profiles, therefore, will become increasingly important for assessing credit ratings. The main areas for assessing the business risk can be summarized into market characteristics, regulation, competitive position, and operating standards. Market Characteristics Future demand for telecom services depends on a host of factors, such as economic development, demographics, social trends, technological changes, and price sensitivity. Factors driving demand differ in the developing markets of Eastern Europe from the more mature markets in Western Europe. In Eastern Europe, the telecom markets grew rapidly in the past few years because of high pent-up demand, with long waiting lists for fixed telephones, while demand in Western Europe is driven mainly by the growth of mobile telephones and data traffic. A rapid growth in demand may offset a loss in income arising from reduced market share or price declines. To assess the risks of market share losses, Standard & Poor's analyzes customer and call mix of the incumbent PTO. For example, a PTO with a high proportion of business customers normally risks a larger revenue loss from competition than a PTO with a lower proportion. Also, an examination of the call mix is done to estimate the risks of market share loss. Competition is most intense in the international call segment, although competition also will increase in the national long-distance and local call segments when alternative infrastructure and cheap interconnection becomes available. Therefore, a PTO that is more dependent on international calls or exposed to competitive alternative infrastructure, may incur relatively larger revenue losses. The tariff balance between local, long-distance, and international calls also are examined. Low prices on long-distance and international calls will be crucial when the markets are fully opened up to competition and most PTOs, therefore, seek to rebalance their tariffs, raising their traditionally low-local calls and rental costs, and reducing their long-distance and international rates. Those companies that still have sizable adjustments to do, will be under considerable pressure to rebalance their tariffs before their markets are opened up to competition. Finally, the ratio of incoming to outgoing international minutes of use is analyzed since net settlement payments often constitute a significant cash flow stream for PTOs in the lesser developed economies. Regulation The regulatory framework varies among countries in Europe, and, when assessing business risk, it is critical to examine the regulatory environment in which the PTO operates. Especially in the Eastern European countries where the operators currently are making large investments to build out the fixed-lined networks, it is crucial to understand how the regulatory framework protects their cash flows. Uncertainty regarding future regulation can be the largest single factor determining credit quality. For Standard & Poor's, it is important to examine how the regulator chooses to balance between the interests of the PTO, its competitors, and customers. A regulator may provide support for alternative providers in order to stimulate competition and, thereby, lowering prices and increase overall market growth. For example, in Hungary, Poland, and the Czech Republic, regional licenses were awarded to open up local competition, while the PTOs' monopolies have been retained in the long-distance and international markets. Crucial for PTO operations will be the regulator's decisions concerning rebalancing rates, rules and prices for interconnection, universal service obligations, number portability, and carrier preselection. In most European countries, the regulatory framework has so far been relatively benign, and most of the PTOs have not had to deal with strict regulatory oversight. In an open European market, the need for strong and effective pan-European regulation will increase. Going forward, it is probable that the EU will get enhanced power to interfere in the control of the regulatory framework in each country. Standard & Poor's will study the regulatory environment and assess the actual impact of regulation on the PTOs' financial viability. Competitive Position In order to assess the strength of the rated PTO compared with its rivals, factors considered include: Number of competitors; Extent of alternative supplier infrastructure and the possibility to interconnect with the national PTO; Cost or price advantage of the alternative carriers; and Extent of product and service differentiation. Many competitors targeting the same group of customers can lead to falling prices and significant revenue losses, both for the incumbent operator and alternative providers. This revenue loss can be offset partially if competitors require interconnection with the PTO. Nonprice competitive factors, such as the quality of the services provided and product differentiation, can provide competitive advantages for competitors, and a high level of dissatisfied PTO customers may facilitate the competitors' possibilities of gaining large market shares. Going forward, the basic telephone market will gradually merge with media and computer businesses because of the increased need for data and multimedia transmission. This will give the PTOs the opportunity to expand in a fast-growing market, but, at the same time, will increase the business risk from increased competition and the costly investments that will be needed. Operating Standards In a competitive environment, the PTOs' ability to offer high-margin services and, at the same time, minimize costs, will become necessary. Therefore, Standard & Poor's will review the PTO's operating standards and marketing functions. Operating efficiency--measured in expense per line, operating margins, and number of customer connections per employee--is necessary to meet competition. It also is crucial to understand the technical sophistication and standard of the PTOs' telephone networks and their ability to offer high-quality telephone services and data and multimedia transmission. The technical standard of the networks, such as usage of optical fibers and level of digitization in the networks, and the number of mobile and ISDN (Integrated Services Digital Network) subscribers are also examined. Since many government-owned telephone companies have enjoyed monopolies, the need for efficiency has been low, and when these companies begin to compete with companies with more modern technology and slimmer organizations, they will need to operate more efficiently. In particular, the PTOs in Eastern Europe will have to continue to modernize their telephone networks and improve their operating efficiency in the next few years so they will be ready to face competition when their home markets open up. Possible measures to increase productivity are staff reductions and investments in infrastructure to increase the number of access lines and the quality of services. Standard & Poor's will, therefore, explore an operator's detailed strategic plans, especially its ability to sell timely and quality service that might enable it to weather the onslaught of competition. The success of implementing the strategic plans depends on overall management skills and flexibility. Apart from analyzing business risk factors, financial profiles also are obviously examined when assessing the PTOs' creditworthiness. The main change here will be that as the PTOs' business risks increase because of competition, some of the companies will have to justify their existing ratings by considerably improving their finances. Currently, some European PTOs in the 'AA' rating category have pretax net interest cover levels of about 5x, a level of coverage that is the average of 'BBB'-rated companies in more competitive industries. While this does not mean that the ratios of European PTOs will be compared across the board with different industries, it indicates that increasing competition could require considerably stronger ratios for the ratings of some companies to be maintained in the medium to long term. Rating Telecom Operators in Central and Eastern Europe Standard & Poor's currently rates seven telecom operators in Central and Eastern Europe. In general, Standard & Poor's uses the same basic criteria when analyzing telecom operators in any part of the world. The weight given to each analytical factor, however, can vary significantly depending on the region's specific characteristics. In the case of Central and Eastern Europe, for example, the analysis of the economic environment and its potential effect on the telecom industry becomes a crucial rating factor. In most cases, the operators in these countries are very dependent on robust demand growth to help finance their large, and rather inflexible, capital expenditure programs. Also, an economic slowdown in a country with relatively low per capita wealth levels could translate into a rapid increase in unpaid telephone bills. Another key rating factor for telecom operators in the region is the degree of protection provided by the regulatory environment. Regulators in these countries normally try to provide a stable environment to facilitate the investment in an industry that is strategically important to the development of the country. Standard & Poor's, therefore, places great emphasis on the study of the tariff system, regulatory barriers to competition, network development milestones, etc. In many cases, the operators in the region also need to improve substantially their operating efficiency, and Standard & Poor's evaluates the companies' restructuring plans, the government willingness to permit headcount reductions, and the country's labor market characteristics. Finally, the assessment of management quality and a careful evaluation of the technical expertise within the company are also very important factors when analyzing telecom companies in Central and Eastern Europe. Most companies are involved in very large network development programs and their track record is typically poor, or at best rather short. Having a strategic partner that can provide technical expertise and support is usually seen as a positive rating factor. From the financial profile point of view, it is important to measure the company's exposure to currency fluctuations. This relates not only to the liabilities that may be denominated in foreign currencies but also in that most of the equipment needed for network development has to be paid for in foreign currency. Standard & Poor's takes a rather conservative view on the company projections given the significant economic and operating uncertainties that could be faced in coming years. All other things being equal, an operator in Central or Eastern Europe would need stronger financial ratios to achieve the same rating than an operator in a more developed economy. com.spglobal.ratings.services.article.services.xsd.Object@468a6d21