Article Title: ARCHIVE | Criteria | Corporates | Industrials: Rating European Start-up Telecom Operators Data: Standard & Poor's assigned ratings to 10 European start-up telecom companies in 1997 and 1998 (see table). Over the past few years, more than 200 companies have been created to operate in the European telecom market, and some already have reached considerable size. The impressive proliferation of newcomers in the European telecom market is being instigated primarily by the recent liberalization of most Western European markets, by the need to improve telecom infrastructure in Central and Eastern Europe, and by the rapid growth of cellular telephony services in all European countries. Rated European Start-Up Telecom Operators COMPANY MARKET CORPORATE CREDIT RATING Colt Telecom Pan-European—fixed line B/Stable Dolphin Telecom Pan-European—specialized cellular B-/Stable Esat Telecom Group Ireland—fixed line and cellular B+/Negative Esprit Telecom Pan-European—fixed line B-/Watch Pos Global Telesystems Pan-European—fixed line and cellular B/Watch Neg Netia Telekom Poland—fixed line B+/Stable Orange U.K.—cellular BB/Positive Polska Telefonia Cyfrowa Poland—cellular BB/Stable Turkcell Turkey—cellular B/Positive Vimpel-Communications Russia—cellular CC/Watch Neg Hermes Europe Railtel Pan-European—fixed line B/Watch Neg While these types of issuers are relatively new in Europe, Standard & Poor's has been rating similar companies around the world for many years. In general, Standard & Poor's applies the same criteria when rating a start-up telecom operator in any part of the world. Each market, however, has different characteristics that can cause very important variations in the final ratings. In Europe, for example, a history of lack of competition in most markets makes the analysis of the regulatory environment particularly important. When assigning telecom ratings, Standard & Poor's examines the companies' business and financial risk profiles. Business risk analysis can be divided broadly into four categories: market characteristics, regulation, competitive position, and operating standards (see "Key Elements of Analysis"). In addition, the operators' management teams and their strategic goals are assessed. In the case of start-up operators, the ownership structure can also be of importance since many of these companies have strong owners with experience in the telecom industry that can provide operational assistance and commercial expertise. The possibility of direct financial support from the owners rarely is factored into the ratings, however, since these companies are usually formed as nonrecourse projects, and the actual commitment of the owners in times of distress is very uncertain. The final rating will reflect a balance between the business and financial risks. However, the weight given to each of these two factors can differ very widely among countries. Companies operating in countries with underdeveloped regulatory frameworks or with significant macroeconomic uncertainties can face drastic changes to their financial profile as a result of sudden alterations in their operating environment. Therefore, an operator with strong financials in a country subject to a high degree of business risk may well have a lower rating than an operator with weaker financials in a country with better business risk. Most European start-up telecom operators can be classified as either alternative fixed-line carriers or as cellular operators. The business risk analysis is considerably different for these two groups. In general, the European cellular operators are considered to have a better business risk than the newcomers to the fixed-line telephony business. This is primarily because only a limited number of operators--typically two or three--are licensed to provide mobile telephony services in each country, which together with the very rapid growth of demand for these services is providing excellent business opportunities for these companies. In many cases, new European cellular companies have reached operating cash-flow break-even in less than a couple of years of operations. Some of the alternative fixed-line carriers also enjoy substantial opportunities for growth, but, typically, cash-flow break-even is only projected after four or five years of operations. The competitive environment also is quite different since cellular companies usually compete with companies that are also at an early stage of development, while fixed-line companies have to erode the market position of the well-established national telecom operators. Furthermore, especially in markets with lower telephony density that lack a developed nationwide fixed-line telecoms network, the capital expenditures needed to expand outside the larger city centers should be considerably lower for cellular, than for fixed-line, operators. Challenging Market For Alternative Fixed-Line Carriers The European market for fixed-line telephony currently is experiencing a period of transition, with the traditional monopoly providers--the public telecom operators (PTOs)--increasingly being challenged in their home markets by different international telecom alliances and new start-up operators. Rated alternative carriers in Europe are Hermes Europe Railtel B.V., Colt Telecom Group PLC, Global Telesystems Holdings Ltd., Esprit Telecom Group PLC, Esat Telecom Group PLC, and Netia Holdings B.V.. All these companies are rated in the 'B' category, reflecting the high start-up risks, with initial large investments and operating losses that these new operators experience. Going forward, the new carriers will face the challenge of establishing low-cost bases by expanding their own controlled networks and reaching favorable interconnection agreements, and, at the same time, growing their customer bases and traffic volumes. However, the carriers that manage to survive during their first critical years of operation and reach sufficient economies of scale to become profitable, likely will enjoy higher ratings over time as they become less vulnerable to adverse changes in their business environment. The general market characteristics for the alternative carriers in Europe are positive. Most PTOs still have close to 100% of the domestic fixed-line telephony markets, and a considerable number of subscribers will easily be tempted to change carriers as new companies enter the market with cheaper prices and, in some cases, better services. The new operators also will benefit from the rapid volume growth of the European telecom markets, resulting from competition-driven tariff declines, technological improvements, and the increased demand for Internet, multimedia, and other value-added services. New entrants typically compete very strongly on prices during the initial stages, cutting the PTO's prices by at least 15%. Price pressures, however, should abate gradually over time as the new companies capture market share and switch to technological superiority and good service quality as their distinctive competitive advantages. In many cases, the new entrants are building state-of-the-art networks that can offer more advanced and reliable services than the existing offering from the national PTOs. Also, not surprisingly, most newcomers are focusing primarily on the more profitable segments of the market (i.e. business clients or residential services in large cities). An important issue in the rating analysis is the assessment of the national PTO's competitive position and its expected ability to fend off new entrants. This is particularly important in the less-developed EU countries and in most of the Central and Eastern European countries, where the inability of the PTO to fulfill demand and to offer adequate service levels will provide very good opportunities to newcomers. A crucial factor in the analysis is regulation. Even if many alternative carriers are making heavy infrastructure investments and expanding their controlled networks, they still will be deon levels, churn will become increasingly onerous. Therefore, effective customer management through loyalty programs and high service quality will become a crucial success factor. Another important factor for the operators' profitability is interconnection, since a large share of revenues comes from origination of calls to, and termination of calls from, other operators' networks. As the regulators' involvement in the interconnection negotiations differs widely among different European countries, the terms and conditions for interconnection also vary between operators. Although the charges can be expected to fall gradually and converge between countries, a large variance between operators in the revenues and costs associated with interconnection also can be expected going forward. Key Elements Of Analysis For European Start-Up Telecom Companies Business Risk Analysis Market characteristics. This includes an analysis of various factors such as service territory, demographics, overall macroeconomic conditions, and the level of, and price for, telecom services in the country. This framework lays the foundation for the business risk analysis since these factors will drive future demand for telecom services. Regulation. Standard & Poor's usually meets with the national regulators before assigning a new rating since this is key to evaluating the likely evolution of the sector. Important issues in the analysis of a country's regulatory environment include: • Regulator's general attitude toward liberalization; • Timetable for specific liberalization measures; • Mechanism to establish interconnection rates; • Possible regulatory measures that affect tariff levels; and • Plans for licensing new operators. A number of other, more specific issues, such as procedures for frequency allocation or conditions for the use of existing infrastructure, are also addressed. It is not unusual that regulation is the predominant driver of a rating conclusion. Competitive position. An operator's competitive position is decided by various factors, such as technology used, price paid for the initial license, tariff structure, churn, marketing strategy, network coverage, and service quality. To a large extent, the operator's strategy regarding tariffs, marketing, and customer acquisition will depend on the number of competing operators and their market behavior. Standard & Poor's, therefore, also will examine the competitors' price and service levels as well as their overall marketing strategy. Operating standards. The quality and technology of the network will decide the type and quality of services that the operator is able to offer and also will affect its future operating costs. The roll-out cost and the quality of a network can differ considerably between operators, depending not only on network technology, but on their individual development strategy. For example, while a cellular operator may gain time and costs in the short term by setting up fewer base stations, this can prove costly to correct over the longer term, when higher usage may demand a more dense network. Financial Analysis In most cases, the financial analysis of a start-up telecom is based almost exclusively on projected, rather than on historical, figures. Therefore, the study of the assumptions supporting the company's projections is a very important part of the rating analysis. Alternative scenarios under different assumptions are also studied. An in-depth analysis of the company's real revenue potential is key, since in most cases these companies still have to prove their ability to sell their services. Projected operating cost levels are compared with those of similar companies in the industry and are also tested against expected levels of interconnection and leasing costs. Since Standard & Poor's focuses on an operator's ability to fulfill its debt obligations on a timely basis, the financial analysis is cash-flow oriented. The operator's capital structure also is examined to understand its financial flexibility and the vulnerability to changes in interest rates and currency fluctuations. Rating the Issue: Criteria For Notching of Junior Debt Standard & Poor's assigns two types of credit ratings: one to corporate issuers and the other to specific corporate debt issues. The first type is called the corporate credit rating (CCR) and is a current opinion of an issuer's overall capacity to pay its financial obligations on a timely basis, thus its fundamental creditworthiness. The CCR generally indicates the likelihood of default for all of the company's financial obligations without any priority of preference among obligations. Furthermore, Standard & Poor's assigns credit ratings to specific issues. Issue ratings also take into consideration the recovery prospects associated with the specific debt being rated. Accordingly, junior debt may be rated below the CCR while well-secured debt can be rated above the CCR. The practice of differentiating issues from the CCR is known as 'notching'. The ranking of a debt issue--relative to other obligations of the issuer--is the key determinant of recovery prospects. Notching down is indicated when a substantial portion of an issuer's liabilities would have priority over the rated issue, as, at least in theory, in bankruptcy, claims deemed to be adequately secured must be paid in full before distributions can be made to unsecured creditors. The differential for notching down junior debt is limited to one rating designation in the investment-grade categories. In the speculative categories, where the possibility of a default is greater, the differential is up to two rating designations. Debt is deemed to be junior if it is Subordinated. Even if it is called 'senior subordinated', subordinated debt is almost always notched to the fullest extent, since it is junior to all senior debt. One example of a rated European telecom operators with subordinated debt is Turkcell Iletisim Hizmetleri A.S. that has a CCR of 'B' and $300 million senior subordinated notes with a 'CCC+' rating. Unsecured - and significant secured debt exists. In cases where the CCR is within investment grade, if 40% or more of total debt is secured and 20% or more of total assets are encumbered, senior unsecured debt should normally be rated one notch lower than the CCR. In speculative grade, if 25% of total debt is secured and 15% of total assets are encumbered, senior unsecured debt should generally be rated one lower than the CCR. If these ratios exceed 50% and 30%, respectively, senior unsecured debt should be rated two notches lower than the CCR. For estimating asset values, book values are used as a starting point, although analytical adjustments are made where assets are considered significantly overvalued or undervalued. One example of a noninvestment-grade company with senior unsecured debt rated two notches lower than the CCR is Orange PLC that has a CCR of 'BB' and £500 million senior unsecured notes rated 'B+'. The lower rating on the notes reflects their effective subordination to the company's £1,750 million bank facility. The notching also takes into account anticipated developments in capital structure and asset composition. For example, the senior unsecured notes of ICO Global Communications (Holdings) Ltd., that has a CCR of 'B', were assigned a 'CCC+' rating as the company expects to put a large secured bank facility in place. Senior secured debt - and significant better secured debt exists. If the collateral that secures a particular issue is of more dubious value than other secured issues, that secured debt may be notched down from the CCR. The view on the collateral focuses on the varying potential of different types of assets to retain value over time--based on liquidity characteristics, special-purpose characteristics, and dependence on the health of the issuer's business. As an example, if a telecom

operator defaults because of lack of demand in its service territory, the market value of its network and operating license would likely be relatively small. The notching guidelines are the same as for senior unsecured debt. At a holding company whose operating subsidiaries have their own obligations that are senior to those of the holding company. The notching guidelines are the same as for senior unsecured debt. Application of the above guidelines is flexible, always taking into account unique aspects of a given issuer's asset composition. Important to note is that since the focus of specific issue ratings is relative to the various obligations of the issuer, no comparison between issues of different companies is warranted. For example, the fact that a senior issue of company A is not notched at all does not imply anything about its recovery prospects relative to the junior debt of company B--with the same CCR--which is notched down. com.spglobal.ratings.services.article.services.xsd.Object@241fb111
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