An Approach to Rating Mobile Service Providers*

ICRA Indonesia's rating methodology for mobile service providers focuses on evaluating the regulatory trends impacting the sector, the company's business position or profile, its management strategy, and the risks associated with fresh investments. ICRA Indonesia evaluates the financial risk profile of company by analyzing the sponsors' strength and commitment to the business, besides the company's capital structure, profitability, free cash flows, and coverage indicators. Additionally, ICRA Indonesia assesses the credit risks arising out of expansions, restructuring, and strategic alliances to determine their likely impact on the company's debt repayment ability.

Regulatory Risks

The telecommunications industry in Indonesia is highly regulated and in ICRA Indonesia's view, the regulatory environment has a critical bearing on a mobile service company's rating since it determines the intensity of competition for incumbents and delineates the opportunities for new entrants.

Indonesia's telecommunications sector is regulated by the Ministry of Communication and Information through an independent regulatory body named Indonesian Telecommunication Regulatory Authority or Badan Regulasi Telekomunikasi Indonesia (BRTI) that was established in 2003. The establishment of this independent board is expected to protect public's interest (telecom users) and to support as well as to keep healthiness, efficient competition along the telecommunication business that can be attractive to investors.

Indonesian telecommunication has changed from a duopoly competitive environment to a full competitive industry since 1999 when the government issued Law No. 36 Year 1999 on telecommunication. Nowadays, as a regulator, BRTI has an authority to review the implementation of operational performance standard on network and telecommunication services, the competitive rivalry amongst network and services operators, and obedience on telecommunication devices usage in line with applicable standards.

Telecommunications Law classifies providers of telecommunications into three categories: (i) providers of telecommunications networks; (ii) providers of telecommunications services; and (iii) special telecommunications providers. A License is required for each category of telecommunications services. In addition, the government also issued some new regulations on telecommunication such as those pertaining to technology development applied on this industry.

Issuers' Business Position

The main factors that determine an issuer's business position are attractiveness of its service areas, its operating strengths, economies of scale drawn from presence across service areas, and its cost structure.

Market Potential of the Service Area of Issuer

According to the licensing agreement, all mobile service providers have been assigned specific network such as Global System for Mobile Communication (GSM) or Code Division Multiple Access (CDMA) providing telecommunication services on their service areas. The operating and financial viability of a mobile service provider depends on factors like addition to subscriber base, average revenue per user, and potential for growth, all of which are driven by the economic prospects of the service areas. ICRA Indonesia, therefore, analyses relevant factors such as penetration rate along its service areas. ICRA Indonesia considers the addressable market measured by the total number of population as well as expected penetration of mobile services and their growth rate.

Existing Subscriber Base and Composition

For rating an incumbent mobile service provider, ICRA Indonesia looks at the attractiveness of its existing subscriber base as reflected by:

- Size
- Net month-on-month additions, and
- Prepaid/post-paid mix.

The existing subscriber size and net month-on-month additions determine the market share of the operator on both a static and dynamic basis. The mix of postpaid-prepaid customers and the trends in the same are important since postpaid subscribers on an average generate higher average revenue per user (ARPU) and demonstrate higher loyalty towards the service provider as compared with prepaid subscribers. Also, with the decline in activation and up-front charges, an unfavorable postpaid-prepaid mix of subscribers increases subscriber churn since prepaid subscribers (especially marginal subscribers) are heavily influenced by costs and can be easily poached by competitive predatory pricing strategies. However, some of the retention barriers for postpaid subscribers could also get lowered once number portability is introduced and activation charges decline because of competitive pressures.

Intensity of Competition

The implementation of Law No. 36 Year 1999 on telecommunication signaled the end of duopoly regime for cellular operators in Indonesia. Following the implementation of this law, several telecommunication companies commenced their cellular services in Indonesia using GSM or CDMA networks. Apart from two old players namely Telkomsel and Indosat, there are other players using GSM technology such as XL Axiata, Hutchison 3, and Axis Telekom Indonesia (later acquired by XL Axiata). Meanwhile, along the CDMA networks players include Telkom, Indosat, Bakrie Telecom and SmartFren Telecom. The bigger number of operators has raised the intensity of competition, leading to operators significantly lowering rentals and tariffs to maintain/increase market share.

Initially, these measures affected the incumbent operators' revenues and profitability, but over a period of time, these operators found themselves largely compensated by the significant growth in domestic mobile subscriber base and increase in minutes of usage. However, going forward, further reductions in tariff may not get adequately compensated by an increase in minutes of usage or subscriber growth. In the case of new entrants, garnering market share in the growing mobile market is important for their viability in the long run. Thus, understanding the strengths of various players and the strategies adopted by them to counter competition is important to estimate their future market shares and profitability. Therefore, to arrive at a rating decision, ICRA Indonesia evaluates the competitiveness of the players by assessing their network coverage and quality, brand development efforts, customer service standards, sales and distribution network, cost structure and financial strength.

Network Coverage and Quality

As mobile subscribers want to be able to use their phones everywhere, the operator who offers seamless coverage, better voice quality and lower congestion has a competitive advantage. Coverage is even more relevant for players in an archipelago like Indonesia. ICRA Indonesia has observed that mobile service providers who have lower coverage relative to competition in a particular service area usually have a lower market share in that service area. Thus, to determine the potential for subscriber growth and penetration of mobile operators, ICRA Indonesia evaluates their current coverage and network rollout plans, which, among others, include the current and planned number of cities/highways covered and number of interconnection points in a service area. Furthermore, ICRA Indonesia assesses the adequacy of the spectrum available to the operator to service its current and expected growth in subscriber base over the long term and its capability to support higher capital expenditure if the current spectrum allocation is inadequate.

Brand Image

ICRA Indonesia has observed that in a competitive environment, any reduction in tariffs can be matched by competitors. Thus plain vanilla price planks have given way to building up brand image among subscribers. In choosing an operator, customers usually go by their own brand evaluation and also rely on word of mouth publicity. With increasing price competition, product comparisons are becoming more difficult and branding and quality of service becoming more important. Thus ICRA Indonesia believes that players with a common brand across various service areas would enjoy higher consumer awareness, and this in turn would reduce advertising costs.

Customer Care and Retention

Mobile operators spend substantial resources to add customers and thus customer retention is critical for them. The loss of subscribers is measured by “churn”, which is the ratio of subscribers leaving the network to the present subscriber base. Churn can either be voluntary (subscribers opting for a better package offered by a competitor, citing low service quality to move over to another service provider, deciding to discontinue with mobile services altogether, etc.) or involuntary (subscribers disconnected by the operator because of credit problem, for instance). High voluntary churn can have a large impact on an operator’s profitability, since the higher the number of subscriber an operator loses, more it has to add to sustain growth in its total subscriber base. Thus, ICRA Indonesia evaluates the customer care and retention strategies of operators while arriving at a rating opinion. The evaluation involves an assessment of the entire chain, beginning with initial customer contact, through problem solving and ongoing support, to monitoring the reasons for exit.

Providing another dimension to the assessment of customer care and retention is the pyramidal structure of mobile revenues, wherein a small proportion of subscribers accounts for a significant portion of revenues. Usually, new entrants devote considerable resources in luring away these “high-use” subscribers from incumbents. Therefore, while assessing an operator’s customer care and retention strategies, ICRA Indonesia also evaluates an incumbent’s systems that seek to identify such customers and retain them.

Sales and Distribution

ICRA Indonesia believes that in the mobile service business, an operator’s sales and distribution network is of considerable importance since this network allows the operator to respond effectively to changing market and consumer needs, and attract new customers as well. Thus, ICRA Indonesia evaluates the current and proposed distribution strategies of mobile service providers while arriving at a rating decision. The evaluation involves an assessment of the direct and indirect distribution channels of the operator, and the operating, technical and financial support that the operator extends to the channel partners.

Operating Costs

The operating costs of a mobile service provider have three principal components:

- Network related costs
- Customer acquisition costs
- Collection and administrative costs

Network Related Costs: For a mobile operator, the main cell site/network related costs are cell site rentals, transmission costs, and maintenance costs. ICRA Indonesia evaluates the operator’s strategy to lower these costs, for instance, by entering into long-term contracts for site rentals, or sharing cell sites with other operators. Transmission costs are dependent on both the choice of the connecting media (fibre optics or microwave links) and on whether such media are owned by the company or are rented.

Customer Acquisition Costs: Customer acquisition costs include sales and distribution expenses and means for lowering subscribers’ entry costs such as subsidies on handsets and bundled packages. In a competitive environment, it is becoming increasingly difficult to reduce customer acquisition costs. Therefore, ICRA Indonesia analyses the strategies adopted by mobile service operators to utilise their distribution channels effectively. ICRA Indonesia also assesses the initiatives taken by operators to lower distribution costs by adopting new channels for mass marketing such as providing online web registration facilities, and forging alliances with companies having established customer links (credit card issuers, retail chain outlets and consumer durable financing companies).

Collection and Administrative Costs: ICRA Indonesia evaluates the mobile service operator’s bad debt levels, collection expenses, and other customer and company related costs under this parameter. The bad debt levels depend on the credit systems in place and the proportion of postpaid customers in the subscriber mix. Although, like most other operating costs, these costs are largely influenced by market dynamics, operators can control them to an extent by superior management. Therefore, ICRA Indonesia analyses the operator’s credit system in detail, covering the entire range of operations including verification of new customers, assigning of credit levels, monitoring of usage pattern, and assessing of billing and collection mechanisms. ICRA Indonesia measures credit norms in terms of monthly collection efficiencies, the collection cycle (the number of days in which an operator collects 95% billing for a particular month), the ageing profile of receivables, and collection costs as percentage of postpaid revenue. Good credit evaluation systems mitigate the chances of fraud and bad debts. Overall, a good indicator of an operator's cost competitiveness is its collection and administration expenses per subscriber.

Economies of Scale

One of the main operating costs for mobile service operators is interconnect costs. Interconnect costs refer to the costs of interconnecting with other networks in the same telecom service area (e.g. a landline to a mobile network) and linking operators in different telecom service area. The interconnect arrangements and rates charged for carrying traffic through interconnecting networks can have an impact on the costs, profits and business strategies of operators.

Mobile service companies having operations in a larger number of service areas can have better bargaining power with other operators and long distance carriers, which in turn can provide them with a competitive edge against players operating in one or two service areas. In addition, large operators can negotiate better terms with vendors for capital equipment as well as consumer equipment, repairs and maintenance, and can distribute their marketing and operating costs over a larger base of subscribers. Moreover, players with a common brand across service areas enjoy higher consumer awareness and benefits of lower advertising costs. Thus, ICRA Indonesia associates lower risk with players having operations in a larger number of service areas.

Management Quality and Strategy

A rating decision is significantly influenced by a mobile operator's management strategy for future growth and profitability, and its ability to execute such strategies. This is particularly important in an industry that is characterised by rapid changes. ICRA Indonesia, while evaluating a mobile service provider's management quality and strategy, specifically examines the following aspects:

- **Strategy to maintain market position:** This is important while rating an incumbent mobile service provider since the competitive scenario is changing continually and significantly.
- **Strategy to build up new areas of expertise and new sources of revenues:** With voice becoming increasingly commoditised and therefore vulnerable to price risks, ICRA Indonesia evaluates mobile operators' strategy for introduction of new higher-margin data and video services.
- **Acquisitions and venturing into related or unrelated businesses:** ICRA Indonesia evaluates the mobile operator's risk appetite for acquisitions and for related or unrelated diversification. This can become a rating concern if the acquisition or diversification has a long gestation period or is funded mainly through debt, which can affect the operator's capital structure and profitability.

Besides the specific issues discussed, ICRA Indonesia seeks to gain an understanding of the mobile service provider's risk philosophy, particularly in the context of adopting new technologies, and its financial policies.

Foreign Promoters

ICRA Indonesia evaluates the operational and financial strengths of the foreign promoter of a cellular service provider while arriving at a rating decision. The foreign promoter's experience in working in multiple-operator market, and expertise in setting and operating networks based on new technologies can be an additional advantage.

Approach to Technology

Currently, mobile service providers are faced with a number of competing technologies. The key differentiators in future would be innovative products and services that rely on a superior technology platform. The operator has to choose what products and services to offer and the technological platform to deliver these services. However, as mobile service providers have to make considerable financial investments to be able to offer such products and services, ICRA Indonesia's rating decision is influenced by the risk/return prospects of the technology platform chosen by the operator. Moreover, in the long term keeping in view the rapidly evolving mobile technology, there is a risk of obsolescence and asset replacement. Therefore, ICRA Indonesia factors the same in cash flow modeling by assuming periodic up-grade of the network to account for technological obsolescence.
Thus, technological advances pose a significant challenge on many fronts including capability to support seamless transition without disturbing network quality and existing subscriber services,

financial strength to support investment required to upgrade the network, and management capability to assess revenue potential from new services.

Sponsors' Strength and Financial Flexibility

The mobile service industry in Indonesia has been witnessing a healthy compounded annual growth rate (CAGR) of around 17.1% during 2008-2013 in terms of number of subscribers. As a result, most operators have large funding requirements, and the ability to raise funds through alternative sources is an important credit determinant. Apart from the financial strength of the operator being rated, an assessment of the financial strength of the sponsors also becomes important.

ICRA Indonesia therefore assesses the ability and willingness of the sponsors to inject additional funds in the mobile venture by looking at their financial strength and the importance of the mobile service venture in the sponsors' overall business plans. In case the mobile venture has foreign promoters, ICRA Indonesia examines the regulatory requirements that the foreign promoter must comply with to inject additional funds into the Indonesian company. The mobile venture's capacity to raise debt, besides its financial soundness, is also determined by sponsors' relationship with the lending institutions and credit enhancements from sponsors in the form of guarantees and comfort letters.

ICRA Indonesia would also evaluate the financial flexibility available to service providers in case the gestation period is longer than initially expected. An important source of financial flexibility could be moderate gearing or the option to issue equity to other strategic investors.

New Project Risks

Some operators have acquired newer service areas, while the newer entrants are in the process of setting up their mobile networks. From a rating perspective, ICRA Indonesia would look more favourably at mobile service providers who have a good track record in setting up cellular networks in an efficient and timely manner. ICRA Indonesia would also evaluate the status of all approvals and clearances as required under the cellular licensing agreement.

Further, ICRA Indonesia would assess the status of funding tie-ups of the mobile operator to meet the proposed capital expenditure. This would involve evaluation of the promoters' ability to meet the equity requirements and the status of loan agreements with suppliers and financial institutions.

Financial Evaluation

ICRA Indonesia evaluates mobile service providers' past financial performance and draws up cash flow projections to assess the adequacy of their cash flows in relation to their debt repayment obligations. The process also involves a comparison of the service provider's key financial parameters and ratios with those of the others in the industry. The key parameters include capital cost per subscriber, average revenue per user (ARPU), operating cost per subscriber, operating profit before depreciation, interest, taxes, and amortization (OPBDITA) margin, and collection efficiency. The other key financial ratios that ICRA Indonesia examines while rating a mobile service provider include:

- Total Debt/OPBDITA
- Retained Cash Flow (Net Cash Accruals)/Debt
- Retained Cash Flow/Capital Expenditure
- Free Cash Flows/Debt
- OPBDITA/Interest
- EBIT/Interest
- Debt/Tangible Net Worth
- Debt Service Coverage Ratio

The ratio analysis is done taking into consideration the characteristics of the mobile service industry. For instance, it is typical for a mobile service operator to have a high gearing as it invests heavily in setting up networks in new service areas, or upgrades its network. Thus this gearing is viewed against the prospects of increase in internal cash accruals in future. If the prospects are positive, there are chances that the gearing would decline to better levels in future.

While assessing the adequacy of future cash flow to meet debt servicing obligations, apart from conventional debt servicing indicators, the issues looked at include peak funding requirements, means of funding the deficits, and status of funding tie-ups.

Conclusion

Over the last few years, the mobile telecom sector has witnessed a spate of mergers and acquisitions (M&As) because of the capital intensive nature of the industry, which requires players to have deep pockets and the advantages of economies of scale. The M&As have resulted in the emergence of a few strong players, with operations covering a number of service areas. Going forward, ICRA Indonesia expects another round of consolidation with more smaller players likely getting acquired by stronger operators.

The mobile service industry in Indonesia has witnessed strong growths during the last few years. In ICRA Indonesia's view, growth is likely to continue, albeit at a slower rate, on the back of declining handset prices, falling tariffs (because of competitive pressures), and increasing prepaid penetration. In addition, the prospects of mobile operators have improved with the significant decrease in equipment costs improving their inherent viability. However, with competitive pressures likely to remain intense, the subscriber retention and acquisition costs of operators may increase even as the existing tariffs and rentals may decline further. In addition, technological advances cannot be ruled out in the medium to long term, which in turn can significantly increase the investment requirements of mobile service operators.

In conclusion, ICRA Indonesia's rating decision on a mobile service provider is influenced by various factors, which have varying degrees of importance. ICRA Indonesia remains open to incorporating changes in its rating methodology either in response to or in anticipation of changes impacting the dynamics of the mobile service sector. Such changes could be prompted by the evolving regulatory framework, technological advancement, media convergence, and declining costs, amongst other factors.

* Adopted and modified from ICRA Limited's Rating Methodology for Mobile Service Providers.