Telecommunications
EMEA
Special Report

European Telecoms - Mid-Year Review

Mature Markets Pose New Risks

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Related Research

- *Global Wireless Review (June 2009)*
- *European Telecoms - Liquidity Update (April 2009)*
- *Increasing Risk for Incumbent Telecom Fibre Investment (April 2009)*

Summary

Europe's telecommunications markets have performed slightly worse than Fitch Ratings expected at the start of 2009. This is due to the unprecedented combination of maturing markets and higher price competition, regulatory pressure and a weak economy.

Regulatory pressures (eg mobile interconnect) have been felt more sharply as headline revenue growth rates have stalled on maturing fundamentals. The sector's defensive qualities have generally held up, but operators in highly competitive and mature markets — such as the UK, Germany, Spain, Greece and Poland — have recorded the weakest results as aggressive price erosion, exacerbated regulatory pressure, and poor economic fundamentals have taken their toll.

The recession has brought into stark relief the fact that these markets have too many operators and that consolidation is needed, particularly in the mobile sector. Average revenue growth for these markets in the first half of 2009 recorded -3.2% yoy. Other markets like France, Benelux, Italy, while not immune to these trends, have proved more resilient due to their less competitive nature. Operators in these markets recorded average revenue growth of -1.8%.

Those operators with portfolios which include less mature emerging market operations have benefitted from stronger organic growth in these regions, and this has helped underpin group results even as some emerging markets (eg east & central European markets) experienced a strong drop-off in subscriber growth and pricing.

Liquidity has been provided by a resurgent bond market, with investors pre-funding much of the sector's 2010 debt maturities. This has relieved any short-term refinancing sector pressure. In 2009 to date, the major incumbent operators issued EUR35bn, equating to approximately 8% of total sector issuance.

Average sector leverage has been contained through a combination of cost controls, a less aggressive dividend policy, and in certain instances the scaling-back of discretionary capex. Fitch remains concerned, however, that in certain European markets where there is heavy cable TV infrastructure, eg the UK, Germany, Benelux, Scandinavia, Portugal and potentially Spain, incumbent operators are being challenged to upgrade legacy copper wire networks with fibre close to the home — in order to compete with cable TV's current network speed advantage. Much of this capex still has to be spent in Europe, as incumbents have held back fibre investment while awaiting clarity from regulators on return on investment calculations.

As many markets are now mature, and competitive pressures intensify, the need becomes more urgent to make this investment — while at the same time more difficult to justify from an overall return perspective, particularly in a weak economy.

The maturity of Europe's markets, and the need to successfully invest in fibre (and drive triple-play market share), together with the mobile data phenomenon and the possibility that any average revenue per user (ARPU) and margin uplift from mobile

data may end up being competed away, are seen as key threats to business models in the next two years.

- Broadband prices come under pressure

Expectations for the remainder of 2009 and into early 2010 are for similar trends to play out. As much of the sector softness is caused by competition and regulatory pressure, Fitch does not expect the economy in itself to play a significant part in ratings movement, unless perhaps to hasten some in-market event-driven consolidation.

Mid-Year Review: European Telecoms Sector

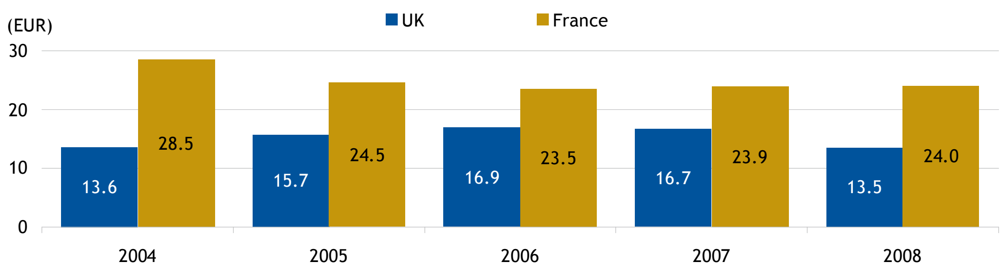
		(H1 unless stated) (%)[a]				
	Rating	Rev. growth	EBITDA growth	EBITDA margin (%)[a]	Adj. ND/ EBITDAR (x)[a]	FCF[a]
France Telecom	A-/Stable	-0.5	-2.6	34.7	2.1	EUR4,707
Telefonica	A-/Stable	1.4	3.0	39.7	2.25	EUR4,002
TeliaSonera	A-/Stable	-0.1	13.5	32.7	1.9	-EUR188
Vodafone (Q1)	A-/Negative	-2.4	n.a.	35.3[b]	2.9[b]	n.a.
Deutsche Telekom	BBB+/Stable	-1.5	-5.3	31.3	3.0	EUR1,656
TPSA	BBB+/Stable	-6.1	-19.5	37.8	0.9	PLN1,538
Royal KPN N.V.	BBB+/Stable	-1.0	2.3	37.6	2.5	-EUR327
Telenor	BBB+/Neg.	4.8	8.6	32.0	1.5	EUR1,258
SFR	BBB+/Stable	-0.8	12	31.7	2.2[b]	n.a.
Telecom Italia	BBB/Stable	-3.8	-0.2	41.20	3.4	EUR1,809
Portugal Telecom	BBB/Stable	-0.3	0.5	36.6	2.9	-EUR124
OTE	BBB/Stable	-6	-3	35.70	2.3	EUR118
BT (Q1)	BBB/Stable	-5	-14	25	2.4	-GBP243

Vodafone - Q1 numbers interim management statement only - no profitability or balance sheet disclosures
DT: Revenue and EBITDA growth - organic; Adj.net debt/EBITDA - LTM, w/o OTE; FCF - before dividends
[a] Excluding forex gains/losses
[b] Vodafone: Year ended 31 March 2009/SFR year-end 31 December 2008
Source: Fitch

- Mobile data is replacing traditional voice rather than adding significantly to the top line

The table above demonstrates the point that competitive and mature markets such as the UK and Germany, have affected the results of operators in those geographies. France Telecom, on the other hand, while being exposed to the UK market, still derives the majority of its cash flow from a less competitive French market — and has benefitted from this. TPSA's figures have been adversely affected by sharp regulatory pressure on mobile termination rates (MTRs) rather than any underlying weakness in its Polish domestic market. Operators with strong portfolios of emerging assets, such as Vodafone and Telefonica, have recorded above-average growth from these geographies, and Fitch expects this will continue, albeit at a slower pace.

Average Household Spend on Broadband Services



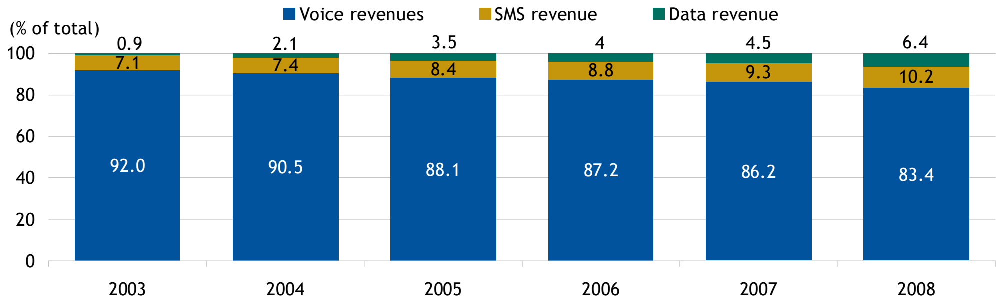
UK: Internet only excl. BT line rental fee
France: Triple-play services (fixed + internet + IPTV)
Source: Ofcom, ARCEP

The economy has undeniably had some affect. Some consumers have opted for lower-priced service bundles, and are keeping their mobile handsets for longer. Bankruptcies in the small- and medium-sized (SME) enterprise market in badly affected geographies (eg the UK, Spain) have also had headline revenue impacts for certain incumbents. However, the retail consumer has shown a determination to keep the broadband connection, and mobile phone data usage continues to grow — albeit at a slower pace and without significant ARPU pick-up. These trends have helped underpin revenue loss from the economic impact, as well as regulatory adjustments to items such as interconnect.

Fitch points to the maturity of Europe's telecoms markets as the cause for most concern. Incumbent operators have benefitted from strong broadband and mobile subscriber growth in the past five years, both of which have been highly cash flow accretive to operators. The economy has slowed this growth and highlighted the effects of a maturing market.

Without these growth drivers, most major European incumbent operators will be faced with flat revenue growth and continued declining margins. If markets remain as competitive, i.e. consolidation does not occur, Fitch is concerned that potential new revenue and margin growth services such as non-messaging mobile data may be competed away in the drive to offer "value" and retain existing customers.

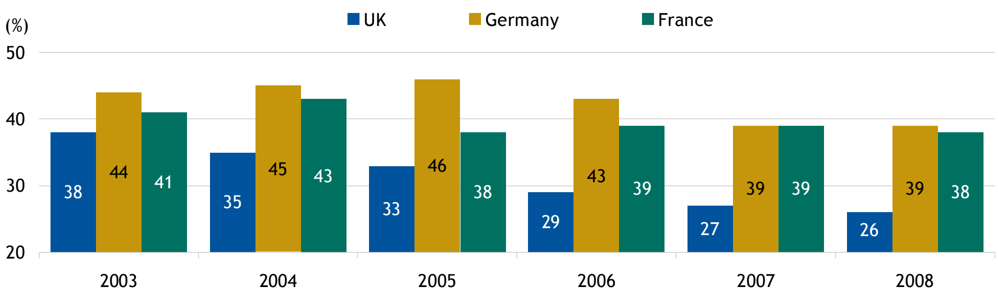
France - Mobile Retail Revenues by Service Category



Source: ARCEP

Due to stalling ARPU levels, operators are now challenged by the need to control costs at the same time as fighting hard to retain their existing customer bases. Rising subscriber retention and acquisition costs (SRC/SAC) as a percentage of service revenues demonstrate the underlying maturity of Europe's telecoms markets.

Average Mobile EBITDA Margins in Europe's Largest Markets



Source: Company reports