Rating Criteria for Mobile Telephony Services

The mobile telephony services (MTS) market made a modest beginning in India in 1996. Since then, it has gathered momentum with high subscriber growth rates and a paradigm shift in terms of tariff and competition policies. Some of the major issues that have shaped the Indian mobile industry’s evolution include a shift from the initial licence-fee regime to a revenue-sharing one, the entry of more players, including the incumbent fixed line operator in each operational circle, and the decision to allow basic services operators to provide limited mobility services through wireless in local loop (WLL) technology.

CRISIL has actively participated in the fund mobilisation exercise for mobile telephony projects in the country. CRISIL undertook its first rating exercise for the domestic debt issue of a metro-circle MTS operator in October 1996. Since then, it has rated several metro and state circle operators. Concurrently, in order to address all rating-related issues and allow the proposed debt issuers to raise funds at acceptable costs, it has actively designed credit enhancement measures for specific domestic debt issues of MTS operators.

CRISIL assesses the credit quality of MTS companies on the basis of its widely applicable format of analysing business and financial risks. The ratings are forward-looking and specific attention is placed on the outlook for such services within the boundaries of regulatory considerations, promoter profiles and the geographical market for MTS.

CRISIL assesses the following key elements of MTS projects in its business risk evaluation:

- Regulatory risk
- Technology risk
- Project risk
- Market position

Business risk

In assessing the business risk of MTS operators, CRISIL first evaluates the risk factors that are common to the entire industry and then analyses the specific issues that define the operator’s market position. Given the fact that the mobile industry in India is still evolving, there are several risk factors. Some factors that are important from a credit perspective are:

Regulatory risk

CRISIL believes that, as with other private sector infrastructure projects in the country, the risk profile of MTS projects too has been strongly influenced by the regulatory environment governing the rights and obligations of mobile operators. Interconnect usage charges (IUC), frequency spectrum allocation between private, government and defence segments and connectivity between MTS networks and incumbent fixed line operators have been some of the key areas requiring regulatory guidance.
While the presence of an independent regulator and the gradual clearing up of the regulatory landscape augurs well for the industry, the stability and predictability of regulatory decisions remains an issue of concern from a risk perspective. Traditionally, regulation has lagged the pace of technological change in this sector, even in developed countries, and the same is likely to be the case in India. An example in this regard is the uncertainty associated with the controversial issue of limited mobility through WLL, where the delay in regulations has heightened the industry’s overall risk perception.

**Technology risk**

Mobile Telephony technology has been rapidly evolving in the last few years. The operators are at risk of competition arising from any technology with superior features or lower costs. The key challenge for an operator therefore would be the ability to upgrade its network to match the features being offered by competitors and at the same time remain cost competitive. Networks with cheaper and easier migration path towards higher versions like 3G could be at a slight advantage specially when value added services become significant. Another risk is the ability of the operator to adapt to the technology in order to ensure quality of services and smooth running of operations. Since the mobile base is rapidly expanding the new network needs to have the ability to integrate with legacy networks and scale itself up to service the increased subscriber base.

**Project risk**

Since the mobile subscriber base is rapidly expanding in India, the companies are required to continuously scale up their operations. As a result they are almost perpetually in project phase. For an expansion project, however, this project risk would be lower though such risk may also impinge on the original base network. The company’s project risk could be managed based on its ability to rollout networks through its license areas in a timely manner with adequate coverage, stabilise networks, synchronise marketing efforts with capacity and get interconnections from other major networks. Inability to achieve the above could lead to loss of potential customers, lower quality of services and higher costs. These factors would have direct bearing on the operators business and financial risk profile.

**Market position**

The competitive scenario plays a very important role in defining the characteristics of any industry. Thus, the entry of new operators in cellular circles along with the roll-out of WLL networks and their consequent impact on tariffs, net subscriber addition shares and the industry’s average revenue per user per month (ARPU) are factored in while assessing the business risk profile of MTS projects.

Since the industry-wide risks are common to all MTS operators, CRISIL analyses the operators’ market position based on the profile of their service areas, their performance track record, market share in their area of operation and their marketing strategies vis-à-vis their competitors. CRISIL considers net incremental subscriber additions per month (net adds) as an important indicator of a MTS operator’s market position. A MTS operator’s ability to maintain the momentum in subscriber additions and garner a higher share of the net adds reflects its overall competitive position in the market. The demographic and income profiles of the operational circles are also considered as they have a direct impact on the ARPU levels in a circle.

The targeted consumer mix, divided into prepaid and post-paid customers, is an indicator of the cellular operator’s likely usage levels and average airtime tariffs. These details, coupled with an estimate of intra-circle STD traffic, help to estimate the ARPU, which is one of the key variables in CRISIL’s risk assessment. Given the fact that prepaid ARPUs are lower than post-paid ones on account of the low usage, a higher share of post-paid customers in the overall subscriber mix is viewed favourably by CRISIL.

A company’s business risk profile would also be influenced by its ability to manage ARPU levels by having the right post-paid-prepaid mix as well as by its ability to charge slightly higher tariffs while maintaining its market share on the back of better coverage and service and superior churn management strategies. An operator’s overall footprint is also considered as larger operators benefit from lower operating costs per subscriber due to economies of scale. Also, a strong presence in at least one service area supports the market position by mitigating the impact of a delayed subscriber build-up in other circles.

CRISIL holds the view that a MTS operator’s ability to continuously attract new customers, manage its ARPU levels and organise its operations so as to derive economies of scale from a growing customer base would have a critical impact on the credit-quality analysis.
Financial risk

Existing financial profile
CRISIL analyses the MTS project’s capital structure, including the level of equity and debt financing. As with other large greenfield infrastructure projects, CRISIL believes that for most MTS projects too, the initial phase of relatively high business risk exposure can be significantly offset by a conservative capital structure.

CRISIL pays specific attention to debt-financing in MTS projects, examining the terms and conditions, tenures and related covenants for offshore and domestic credit facilities. It assesses the tenure of the debt-financing facility, specifically in reference to the moratorium on principal repayments. Project-financing facilities that offer a principal repayment moratorium in the initial years of operations are likely to ease the promoters’ cash flow burden.

The key financial parameters that CRISIL assesses include coverage at the operating margin level (earnings before depreciation, interest, tax and amortisation (EBIDTA)), standard cash coverage ratios, the project’s profitability at the EBIDTA level and its liquidity ratios.

Future financial position
The entire financial model prepared by the MTS operator, including all the details and assumptions pertaining to its operating revenues (average subscribers, churn rates, average air-time usage, average air-time revenues and the like) and operating expenditure, is considered for assessing the MTS project’s financials. CRISIL analyses the projected financials of the proposed MTS project with reference to the operator’s future plans, funding requirements for expansions and coverage and profitability ratios.

Cash flow adequacy and financial flexibility
Since CRISIL’s framework for assessing the credit quality of MTS projects is derived from its overall project finance ratings methodology, cash inflows and outflows are considered, irrespective of the related accounting treatment. This is specifically valid for licence fee outflows, wherein the MTS operator has the option of amortising the expense over the entire period of the licence agreement.

CRISIL places significant attention on the promoters’ financial strength and their ability to infuse funds into the operations, if the need arises. In several cases, debt-financing facilities are contingent on specified performance and capital structure requirements and may involve additional equity infusion by the project’s promoters. CRISIL specifically assesses the promoters’ ability to address all performance and capital structure covenants and maintain a steady drawdown from the specified debt facilities. CRISIL believes that the manner in which the promoters intend to fund initial losses and the contingencies available, in the event that the gestation period is longer than anticipated, would be of critical consideration. The funds requirements of other group companies as well as the importance of the cellular venture to the joint-venture partners is also assessed.

In certain cases, CRISIL also assesses the promoters’ overall flexibility to defer capex and delay the roll-out schedule while satisfying the mandatory coverage requirements specified in the licence agreement. CRISIL thus recognises the modular nature of telecommunications technology, whereby a MTS operator can delay a part of its capex in the event of resource constraints and limited business opportunities.