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Can EMEA Telecom And Cable Credit Quality Support More M&A?

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The telecom and cable industries were among the few active sectors in an otherwise subdued mergers and acquisitions (M&A) market in Europe in 2013. We expect this trend to continue over the coming months, because we see potential for further activity in 2014 after a strong start to the year. Capital markets continue to support refinancing and acquisitions in the sector, through bank and bond debt, equity, and hybrid capital. Buyers of all stripes exist in the industry, including strategic acquirers both from inside and outside Europe and from private equity. Gradually stabilizing credit quality and abundant capital provide a robust backdrop for more deals. Added to this, telecom operators facing continued top-line and margin declines may see disposals as a means of sustaining their credit metrics and ratings.

Fixed-line, wireless, and cable assets are all in demand. We consider that in-market (rather than cross-border) wireless consolidation appears the most likely to generate significant revenue and cost synergies. We nevertheless see fixed-mobile combinations as the most likely to gain support from all stakeholders, including regulators. However, the telecom sector has a track record of overpaying for acquisitions and hesitating to adjust shareholder remuneration downward to protect credit quality.

Overview

- We expect telecom and cable to stay among the most active sectors for M&A in EMEA over the coming year.
- We think Europe-based players are now more likely to be buyers of assets, and could find ways to limit the negative impact of acquisitions on credit quality.
- The sector nevertheless has a record of overpaying for acquisitions and being slow in adjusting shareholder policies.
- The need to invest in next-generation infrastructure could spur a phase of consolidation.
- The French telecom M&A market appears particularly interesting at the moment, owing to its market structure and dynamics.

The Credit Climate Is Stabilizing

We recently revised to "stable" from "stable to slightly negative" our ratings outlook for the telecom, cable, and satellite sector in Europe, the Middle East, And Africa (EMEA). Presently, 72% of ratings in the sector have stable outlooks (see chart 1), with a net balance--the difference between the percentage of positive and negative outlooks and CreditWatches--of minus 11 percentage points. Nearly a year ago, as of March 31, 2013, 70% of ratings were stable and the net balance was minus 19 percentage points.

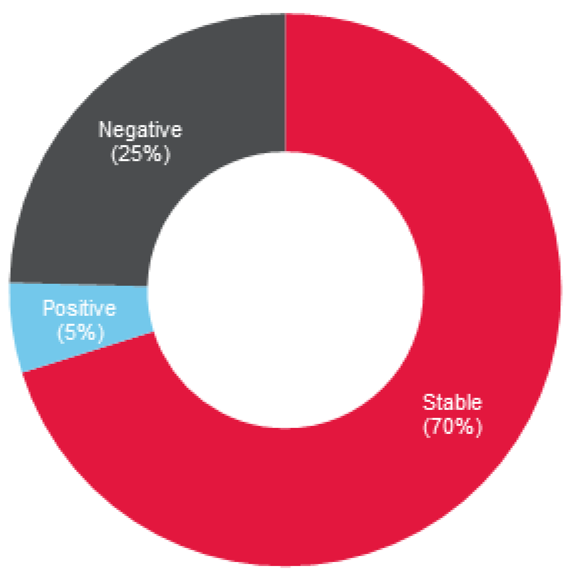
We still expect that industry revenues could decline again in 2014 as a result of competition and the tail effects of regulation. However, our less negative view of credit quality reflects various other factors: First, economic prospects and sovereign credit quality have stabilized across Europe's main economies. Second, companies have made late but significant adjustments to their shareholder policies in reaction to reduced cash generation capacity in the telecoms business over the next few years (see chart 2). Third, we see limited prospects for a further significantly negative impact from regulatory changes beyond expected cuts in EU-wide roaming charges.

Somewhat counterintuitively, our ratings outlook remains disproportionately negative for investment-grade telecom operators (those rated 'BBB-' or higher). This includes telecom incumbents that face very strong competition for mobile services or that have residual exposure to declining voice revenues and to higher priced offerings that consumers have shunned since the beginning of the crisis. So, while the less negative credit trends across the sector may support further M&A, we are mindful that the largest players--those more likely to lead consolidation--are often those whose credit quality has not fully stabilized at this point.

That said, not all large telecom companies are facing rating pressure at the moment. For example, we revised to stable from negative the outlook on Vodafone after its announced U.S. disposal, and we see the company as a potential consolidator in Europe. In addition, some companies have managed to structure deals that preserved their credit ratings via disposals and capital structure-strengthening measures. For example, we affirmed the rating on Telefonica when it announced the acquisition of e-Plus in Germany, even though we had a negative outlook on the Telefonica rating at the time.

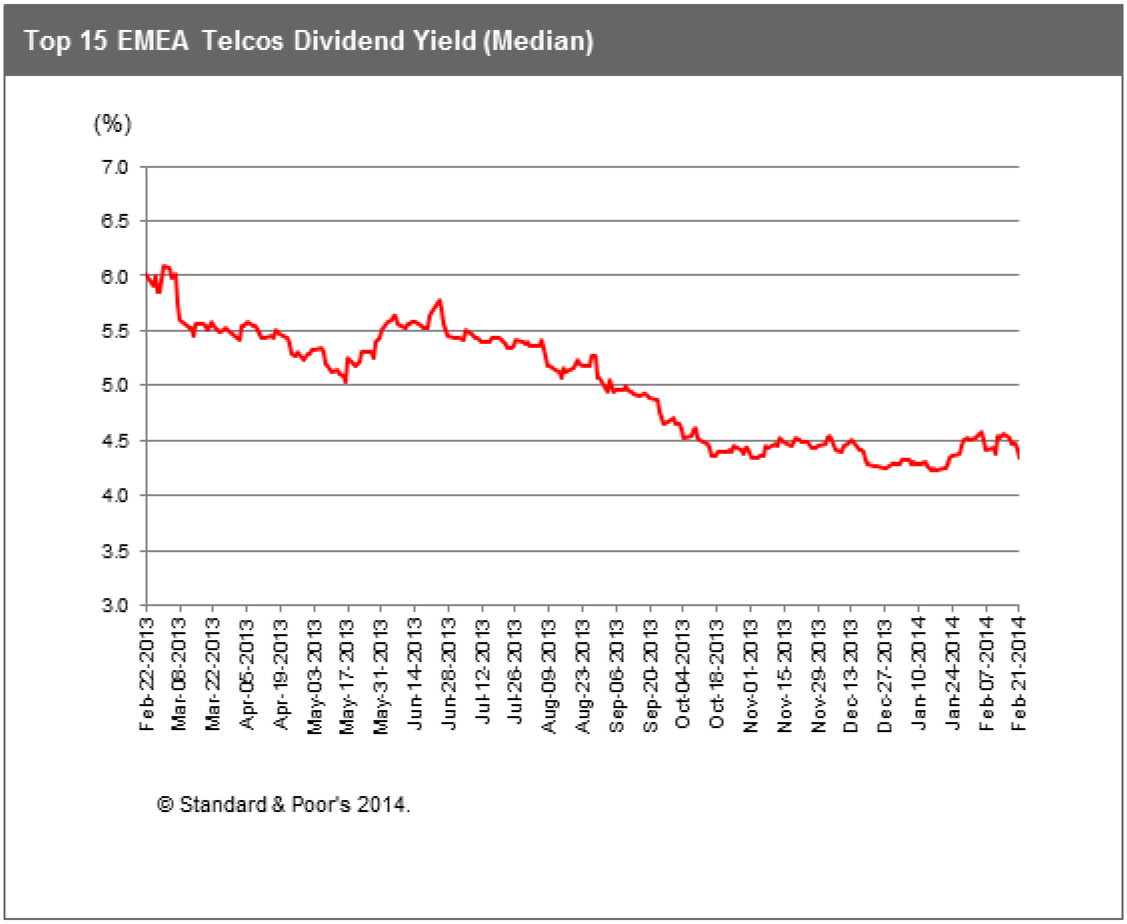
Chart 1

EMEA Telecoms, Cable, And Satellite Operators Outlook/CreditWatch Distribution*



*64 Companies As Of Feb. 17, 2014.

Chart 2



M&A Will Span Wireless, Cable, And Fixed Markets

We project various types of M&A activity across the sector this year. The most credit-supportive transactions are likely to be in-market (domestic) wireless consolidation, and in-market fixed-mobile combinations.

We expect to see wireless players looking for consolidation opportunities to better spread the costs of investing in fourth generation wireless infrastructure and to make better use of rare spectrum resources--frequency bands that regulators license to individual wireless network operators. A new era of investment awaits Europe's telecom landscape, and we see the ratio of capital expenditures to sales remaining at about 15% of revenues in the near term, in spite of the nonrecurrence of some spectrum acquisition costs. The round of spectrum auctions for the deployment of fourth-generation (4G) wireless technologies is now over for most large markets--apart from a few markets in Central Europe, such as Poland and the Czech Republic. This has resulted in generally larger-than-expected cash outlays. As we have previously highlighted, there is a growing lag in Europe in deploying 4G technologies compared with the U.S. and some markets in the Middle East or Asia.

In addition, while the auctions have generally confirmed the ability of "incumbent" 3G mobile carriers to provide 4G services, we believe that some imbalances exist, notably when some carriers are left out of the 800 megaherz (MHz) band that is most favored for wide 4G coverage and good indoor reception. The two ongoing merger plans in Germany and Ireland involve players that did not buy any 800MHz spectrum--the Telefonica bid to takeover of E-Plus in Germany and 3 Ireland's plan to acquire Telefónica's O2 Ireland. However, we see competition approval as a significant hurdle--indeed, competition authorities have raised concerns about both of these mergers. On the other hand, in the Netherlands, Tele 2's acquisition of 800MHz spectrum allows the Sweden-based group to start a green-field mobile operation in the Netherlands to compete with KPN, Vodafone, and Deutsche Telekom (DT)-—the latter having not acquired any 800MHz spectrum. Meanwhile, Tele 2 failed to secure any new spectrum in its existing Norwegian market, where a newcomer company called Telco Data acquired spectrum in the 800MHz, 900MHz, and 1,800MHz bands. At this point, we also expect that wireless consolidation plans are encouraged by the success of Everything Everywhere (EE) in delivering revenue growth and margin improvement, following early-stage difficulties after the formation of the U.K. joint venture between Orange and DT.

Outright acquisitions are not the only option to spread network costs, however, because network-sharing between carriers may help achieve cost synergies through improved asset efficiency. SFR and Bouygues Telecom in France recently announced network-sharing deals, while others are already in operation, such as between EE and Three in the U.K., and between TeliaSonera and Telenor in Denmark. However, we find such deals to be relatively complex to plan, agree, and execute, and believe they could prove difficult to manage from a legal, operational, or financial standpoint in the future if there were disagreements between the partners. Outsourced infrastructure providers, such as TDF in France or Arqiva in the U.K. provide alternative solutions.

Similarly, superfast broadband could make consolidation more compelling in fixed-line technologies. The generation of digital subscriber line (DSL)-based accesses, involving upgrades of telecom incumbents' decades-old copper networks and offering speeds of up to 20 megabits per second (Mbps) now needs to move to mostly fiber-based technologies of 30-100 Mbps to compete with the higher bandwidth offered by cable networks and the alternative offered by 4G wireless technologies—or customers may simply cut the cord. The largest carriers--including fixed-line incumbents--will have the scale to support the multiyear investments required to upgrade their networks. However, we believe that niche players, including "unbundlers" that rent the telecom incumbent's last-mile copper access, may find they would rather share deployment costs and combine with a competitor--that is, unless regulators step in to force the larger players to open their networks, which would be a potential deterrent to investment.

Unique to Europe has been the success of bundled fixed-mobile offerings (called "quadruple play", or "quadplay" for mobile and fixed phone, TV, and Internet), which are creating additional incentive for fixed-mobile combinations. So far, subscribers that take both fixed and mobile from the same carrier have demonstrated a lower propensity to churn than mobile-only, or even than fixed-only customers. Those benefits remain to be tested over a longer cycle, however, including a handset- or set-top-box renewal cycle. Still, we think it likely that wireless carriers will seek to strengthen their offerings with fixed triple-play services, as was recently achieved in Portugal via the Zon-Optimus merger, or as Vodafone is seeking to achieve by the acquisition of Kabel Deutschland in Germany. We also expect that fixed-line carriers with solid backbone networks will continue to attract carriers that need to expand their data transport capacity and enhance their enterprise offerings in their core markets. This was the reason behind Vodafone's acquisition of Cable & Wireless Worldwide or, more recently, DT's purchase of GTS in Central Europe.

Fixed-mobile combination is, however, only one reason for the attractiveness of cable assets. Other types of buyers have been courting cable assets for their solid revenue and cash flow growth potential, notably as the internationally diversified Liberty Global and Altice groups sought to expand their footprints.

Finally, we expect continued M&A transactions from private equity or single domestic investors for the cable, fixed, or wireless operations, as has been the case over the past two years. This is because of the limited synergies that established telecom groups can find in international acquisitions, and even in-market, as cable networks rarely overlap or compete in the same catchment area. As a result, for cable assets, we view the frontier between strategic and financial buyers as more blurred than for telecoms. What's more, if regulators derail consolidation plans, private equity may step in to buy assets from large telecom groups, as was the case for Orange Switzerland (Matterhorn Holding).

Impact Of M&A Transactions On Credit Quality Could Be Minimal--But Not Without Risk

Under our methodology, we would assess the ability of buyers to absorb acquisitions within their existing ratings primarily based on the potential business benefits (and execution risks) of any acquisition, the conservativeness of the deal funding, and the one-to-two year deleveraging prospects post-acquisition.

Given that there are many assets to be sold, and assuming appropriate adjustment of near-term shareholder expectations post deal, we envisage that consolidation could take place largely without damaging the overall credit quality of the sector.

We note, however, that the industry has a track record of overpaying for assets--as demonstrated by frequent and large asset writedowns. Added to this, steps to protect credit quality since the beginning of the industry downturn, including adjustment of shareholder remuneration, have generally come too late to protect the sector's credit quality completely. As a result, ratings on the largest 15 Western European telecom borrowers (see table 1) are now on average between one and two notches below where they were five years ago, reflecting a combination of weaker business risk profiles and lower deleveraging potential.

Table 1

Top 15 Rated EMEA Telcos	
Belgacom S.A.	A/Stable/A-1
BT Group plc	BBB/Stable/A-2
Deutsche Telekom AG	BBB+/Stable/A-2
Koninklijke KPN N.V.	BBB-/Stable/A-3
Orange	BBB+/Negative/A-2
Portugal Telecom SGPS S.A.	BB/WatchDev/B
Swisscom AG	A/Stable/--
TDC A/S	BBB/Positive/A-2
Telecom Italia SpA	BB+/Negative/B
Telefonica S.A.	BBB/Negative/A-2
Telekom Austria AG	BBB-/Stable/A-3
Telenor ASA	A-/Positive/A-2

Table 1

Top 15 Rated EMEA Telcos (cont.)	
TeliaSonera AB	A-/Stable/A-2
Vivendi S.A.	BBB/Negative/A-2
Vodafone Group PLC	A-/Stable/A-2

Ratings as of March 5, 2014.

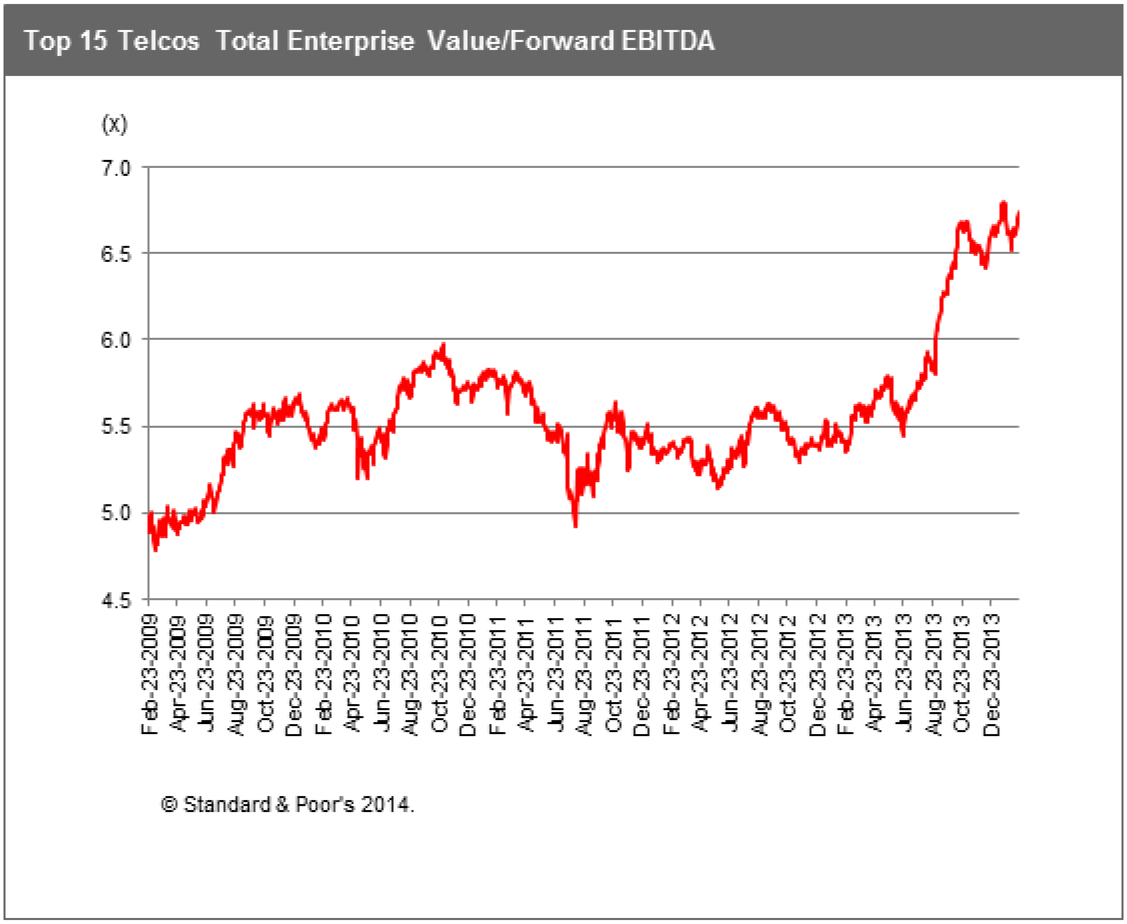
We consider that cross-border acquisitions present higher risks and potentially lower benefits than in-market combinations. On the one hand, entering a new market supports a company's footprint and enhances geographical diversification. On the other, we are somewhat skeptical as to the execution on those strategies and companies' ability to outweigh the financial, legal, operational, cultural, and managerial difficulties in operating in foreign, unknown environments. In addition, since the penetration rates for telecom services in many European markets are already very high, growth prospects are often very limited. We recognize, however, that there are many commonalities across EU markets, starting from a common regulatory framework--even if implementation is at the national level.

Geographical diversification benefits can nevertheless be significant. Vodafone and Telefonica have achieved the strongest diversification within and outside Europe, offsetting their strong presence in economically weak Southern Europe since the beginning of the financial crisis. For example, Telefonica's presence outside Spain helps the company maintain a rating one notch above the Spanish sovereign. As another example, Liberty Global's entry to the U.K. through the acquisition of Virgin Media, helped lift the rating to 'BB-' in 2013. The acquisition helped to achieve higher scale and diversity, which supported our decision to lift our assessment of the company's business risk profile to "strong" from "satisfactory".

European Players Will Likely Be Buyers Rather Than Targets Of Acquisitions

Over the past few years European telecom companies have been primarily sellers of assets or acquisition targets, in line with our expectations that they would focus on deleveraging and tackling their cost base in their economically weak domestic markets. However, we think this could now be changing, for a number of reasons. First, their valuations have picked up materially. For example, the EBITDA multiple of Western Europe's top 15 telecom companies (by debt amount) is now above 6.5x, compared with 5.5x a year ago and for the three years before that (see chart 3). This represents a significant change to the situation of the past few years.

Chart 3



Second, some of Europe's largest companies, such as Vodafone, DT, and Telefonica have rebuilt headroom for acquisitions by selling assets. Vodafone sold out of the U.S., and DT and Telefonica invited minority shareholders in their U.S. and German subsidiaries, respectively. Meanwhile, Telefonica sold its Ireland (still subject to regulatory approval) and Czech Republic units, and DT sold a majority stake of its online classified business Scout24. Vodafone and DT have been busy redeploying the proceeds to strengthen their business position in their existing footprint. Vodafone has pledged £6 billion network investments to Europe and acquired Kabel Deutschland. DT has acquired the infrastructure-based telecommunications service provider GTS and the minority stake of its subsidiary in the Czech Republic.

Third, we think concentration in the sector may be at a turning point. This is because of the industry's maturity in terms of revenues, and the need to invest massively in next-generation infrastructure. The two "test cases" currently before competition authorities in Ireland and Germany should provide guidance as to the potential for four-to-three consolidation in wireless by spelling out regulators' tolerance for concentration in two very different markets. Ireland is a small market with low average revenues per user (ARPU) and more recent spectrum auctions, while Germany's market is a large playground with an already developed 4G market and significant mobile virtual network operator (MVNO) power.

Finally, while a year ago we saw emerging players as likely buyers of EMEA telecom assets-—resulting in some important deals led by America Movil, Oi, and Etisalat--we think this is somewhat less likely at this point. Higher multiples and weaker emerging market currencies have made European targets more expensive. Furthermore, some deals are proving complex to execute. For example, America Movil withdrew an intended offer to acquire all of Koninklijke KPN in November 2013 after it emerged that KPN's board would not back an offer. That said, the acquisition plan by Brazilian integrated carrier Oi to acquire its shareholder Portugal Telecom is so far progressing as planned. The potential deal represents the "positive" side of our developing CreditWatch placement on Portugal Telecom. What's more, the stronger credit ratings of Gulf operators, which typically enjoy support from highly rated Gulf governments, in particular Ooredoo, Saudi Telecom, and Etisalat, give them potential acquisition firepower. Even if we downgrade the Etisalat rating by one notch after its acquisition of Vivendi's controlling stake in Maroc Telecom, it will still be, at 'A+', our highest telecom rating in EMEA, on par with Saudi Telecom.

A Larger Transatlantic Merger Is Not Unthinkable

Over time, we believe there will be greater interest in M&A between U.S. and European telcos. This is mainly because of the scale intensity of wireless and the slowly converging wireless technologies toward 4G LTE (long-term evolution) as opposed to the more fragmented 3G technologies. However, regulation and spectrum policies within the EU remain fragmented and dissimilar to the U.S. Currently, out of the large U.S. telecom and cable companies, we believe AT&T is the only one with a significant interest in the European market, but it does not appear that anything is imminent. AT&T has publicly stated that its plans for reaching agreement on a merger with Vodafone are on hold.

We have stated that if such a transaction were to occur, we do not believe it would enhance our overall view of AT&T's business risk profile, which we view as "strong," and there would be significant integration risks. Despite some potential benefits from geographical diversification and the potential for 4G mobile broadband growth in European markets, we believe there would be very limited scale benefits given AT&T's current size and purchasing power. European wireless fundamentals remain weak relative to the U.S. due to competitive pressures and a relatively less benign economic outlook. Moreover, we would expect that any large-scale European M&A transaction would be consummated with a significant amount of debt, which could push leverage well above our 3x threshold for AT&T's "intermediate" financial risk assessment, and result in a ratings downgrade.

The Funding Environment Is Supportive

Funding from capital markets to the sector is generally forthcoming, particularly through M&A. The debt markets have been very supportive of both telecom and cable refinancing efforts over the past few years, including for South European companies and for the most highly leveraged borrowers in the cable sector. Issuance size has not reached the peak achieved by U.S. telecom company Verizon Inc., which raised a record $49 billion in 2013 to part-fund the acquisition of Vodafone's stake in Verizon Wireless. Nevertheless, the recent past has provided landmark deals for the sector. Borrowers in the 'A' rating category, such as TeliaSonera, have tapped the bond markets for 30-year issuance. Ooredoo, the acquisitive incumbent from Qatar, recently issued its inaugural sukuk (Islamic bond). Unitymedia, a 'B+' rated issuer at the time, placed a 15-year bond, while Ziggo's €3.7 billion term-loan B was the largest since the financial crisis, according to LCD News.

The sector has also widely benefited from capital market appetite for hybrid issuance, with a string of issuances completed over the past few months. Out of these, we note that Telefonica's hybrid issues were specifically designed to mitigate the balance-sheet impact of its planned consolidation deal in Germany.

Finally, equity markets have also helped with the funding of large deals, such as the Virgin Media acquisition by Liberty Global, part of which was paid in shares. Equity markets have also been receptive of the initial public offerings of Numericable and its shareholder Altice, which stated their intentions to look out for acquisitions.

M&A In Related Sectors May Be More Muted

We believe that M&A in adjacent sectors such as towers, satellite, and telecom equipment will be less likely over the coming months. We do see growth in outsourced tower services in EMEA. We nevertheless think Western Europe may not be the easiest market for these services because carriers already have well deployed networks, which they tend to view as a competitive advantage. In the Middle East and, even more so, in Africa, we see potential for significant growth in outsourced tower deployments with multiple-tenant towers to achieve economies of scale.

The satellite sector has traditionally taken a cautious approach to M&A and has grown mostly organically, including via new satellite launches. However, a rare significant deal was agreed last year for Eutelsat to acquire Satmex.

The telecom equipment sector--which counts three European heavyweights Ericsson, Nokia (and its subsidiary Nokia Solutions and Networks, NSN) and Alcatel-Lucent--is subject to continued pricing pressure and commoditization, in spite of the rush by carriers to upgrade their networks. Meanwhile, our ratings on Nokia and NSN are still on CreditWatch pending a decision by Nokia on its future strategic direction and use of cash following the anticipated sale of its handset business to Microsoft. Post-merger integration in the sector has always proved difficult from a product and technology perspective, as shown by multiple years of low margins and cash losses by NSN and Alcatel-Lucent after their mergers in 2006-2007. We think this explains why players in the sector are less keen on M&A and prefer partnerships, such as the recently announced ones between NSN and Juniper on Internet protocol technologies, or between Alcatel-Lucent and Intel on cloud computing, or that between Ericsson and Ciena on optical technologies.

The French Telecom Market Is One To Watch

Irrespective of competition authorities' decisions on the German and Irish deals, we see France as a market to watch in 2014 given the potential for corporate activity in the telecom sector. We have negative outlooks on the ratings of Bouygues, Orange, and Vivendi.

France is almost unique in having only home-grown telecom players, and is a rare European market absent from the footprints of both Vodafone, which sold a 44% stake in SFR in 2011, and of Hutchinson-Whampoa. Of the four mobile network operators, three have little or no business outside France, while only Orange has a significant non-French footprint (mostly Poland, Spain, the U.K., Belgium, and a few smaller operations in the Middle East and Africa).

The French fixed-line telecom market has thrived on marketing and technological innovation over the past decade. A pioneer in Internet protocol TV (IPTV), fixed triple-play and quadruple-play offerings, the French market now faces the challenge of migrating its fixed broadband subscriber base from mostly asymmetric digital subscriber line (ADSL) to next generation access--very-high-bit-rate digital subscriber line (VDSL) or fiber to the home--in the face of low prices and high investment requirements. The successful IPO of Numericable should support investment in France's underdeveloped cable market, further exacerbating fixed broadband competition. We raised the rating on Numericable's main subsidiary YPSO Holding (now withdrawn) when it merged with its lower leveraged business-to-business sister company Altice B2B (Completel) and announced the parent company's IPO.

France's mobile market is even more shaken. It was long a market of three carriers providing high ARPU, heavily subsidized, mostly post-paid offerings--somewhat similar to the U.S. However, since Free's entrance in early 2012, France has witnessed an explosion of SIM-only offers and very rapid downward tariff repricing. Similar to the €30 euro per month that long made fixed-line triple-play offerings successful, Free has now rapidly conquered mobile market share with a €20-per-month voice-and-data wireless offer (€15 per month for its fixed customers). Significant uncertainties exist as to the market structure, because Free still relies significantly on roaming on Orange's network for its 3G offering--a deal that regulators want ended by 2018. It has also not acquired any of the 800MHz spectrum favored by carriers for 4G coverage and indoor reception. It is instead rolling out its 4G network on 2,600MHz spectrum, which is reputed to have a shorter reach (requiring more antennas) and weaker indoor penetration. However, SFR's 800MHz spectrum came with an obligation to give Free access in the less densely populated areas. Finally, SFR and Bouygues telecoms hope to reap €200 million annual synergies from their network-sharing deal from 2017.

With the rollout of Free's mobile network, France will also be one of the rare countries with three integrated carriers--those with extensive fixed and mobile reach. This creates a strong competitive landscape. While Bouygues Telecom offers fixed-line services as well, its network reach is far less extensive than the two alternative carriers SFR and Iliad, and its broadband market share is significantly smaller. Numericable offers mobile but only via a "virtual" MVNO agreement using SFR's network.

France is not, however, a 4G network pioneer market, despite the early use of "refarmed" 1,800MHz spectrum by Bouygues Telecom--4G started a year earlier in the U.K. and Germany, and almost two years earlier in Sweden. The 4G landscape is already looking full of risks, as a cut-throat pricing environment prevents network operators from applying any 4G pricing premium for the time being.

Vivendi has announced its intention to spin off and IPO SFR, its largest EBITDA contributor. Meanwhile, Numericable's main shareholder has expressed interest in a combination with SFR. Both Numericable and its 40% shareholder Altice were recently IPOed successfully.

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Related Criteria And Research

- Inside Credit: Telecoms Buck The Trend As Caution Prevails In European M&A, Oct. 30, 2013
- The Credit Cloud: For Now, Caution Is Holding Back European Mergers And Acquisitions, April 8, 2013
- Telecom Operator Orange Outlook To Negative On Competitive French Market, Higher Leverage; 'BBB+/A-2' Ratings Affirmed, Jan. 24, 2014
- Key Credit Factors For The Telecommunications And Cable Industry, Dec. 12, 2013
- Liberty Global PLC And Related Ratings Affirmed Following Announcement Of Bid To Purchase Ziggo N.V., Jan. 30, 2014

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