ACRA

Principles of Assessing Industry Factors in the Rating Analysis of Non-financial Corporations

Telecommunications

This document is part of the Methodology for Assigning Credit Ratings to Non-financial Corporations under the International Scale (hereinafter, the Methodology) and describes the specifics in conducting rating analyses of the operational and financial profiles of telecommunications industry corporations.

The document provides lists of indicators used, factor weights, assessment score boundaries for quantitative factors, and the principles of assessing qualitative factors for companies in the industry.

1 Industry Companies

The assessment approaches described in this document are applicable to companies whose core business is the provision of telecommunications and electronic services, broadband Internet access services, and the provision and maintenance of information and communication infrastructure.

2 Rating Factor Structure

Creditworthiness analyses of rated entities in the telecommunications industry are based on assessing eight indicator blocks, which are combined in two profiles and have their own weights totaling 100%. The weights presented in Table 1 are base weights, i.e., they may change depending on the assessment scores derived for indicator blocks (see Subsection 4.1.3 of the Methodology for a description of the floating weights concept).

Table 1. Scorecard for the telecommunications industry

Profile	Factors	Factors weighting	Sub-factors
Operational profile	Business profile	20%	Business model and infrastructure quality
			Regulatory environment
			Market position
	Financial policy and corporate governance	15%	Financial policy
			Corporate governance
Financial profile	Size	15%	Revenue (USD bln)
	Profitability	10%	Funds from operations (FFO) margin before fixed charges and taxes
			Qualitative profitability assessment
	Leverage	15%	Adjusted gross debt to FFO before fixed charges
			Qualitative leverage assessment
	Coverage	15%	FFO before fixed charges to fixed charges
	Liquidity	5%	Liquidity ratio
			Qualitative liquidity assessment
	Cash flow	5%	Free cash flow (FCF) margin
			Qualitative assessment of FCF stability

Source: ACRA

3 Operational Profile

The following describes the basic factors in the rating analysis of the operational profile, the degree of their influence when determining the credit rating of a non-financial corporation, and assessment specifics.

To assess operational profile qualitative indicators for rated entities in the industry, ACRA uses a set of characteristics specific to the industry that translate into a qualitative assessment category.

Operational profile indicator weights are shown in Table 6.

3.1. Business Profile

The business profile assessment is based on a qualitative analysis of the market structure of a company and its position in key markets. ACRA takes into account the size of the customer base, trends in distribution of revenue sources (by segment of telecommunications services), whether infrastructure is in line with the latest technological advances, and whether a company is able to quickly adapt technological innovations. In addition, the analysis involves assessing country risks and regulatory specifics. The business profile is assessed taking into account the following subfactors.

3.1.1. Business model and infrastructure quality

The financial sustainability of a rated entity is positively influenced by the absence of risk of technological obsolescence and the existence of a long-term strategy aimed at creating new products and implementing advanced technologies to meet the needs of consumers and global industry development trends.

The qualitative assessment category for the business model and infrastructure quality is determined according to Table 2.

Table 2. Qualitative assessment of the business model and infrastructure quality

Assessment category	Main features
I	Company has the latest generation infrastructure (low technological risk); all or nearly all the infrastructure is owned by the company
II	Part of the company’s infrastructure belongs to the latest generation (limited technological risk); large proportion of infrastructure is owned by the company
III	Some of infrastructure elements belong to the latest generation (moderate technological risk); infrastructure is partly owned and partly rented (approximately in equal proportions)
IV	Modernization of infrastructure is required for the company to provide services of the latest generation (high technological risk); significant proportion of infrastructure is rented by the company
V	Quality of infrastructure is very low, high risks threaten the smooth functioning of services, substantial investment in the development of infrastructure for services of the latest generation is required (very high technological risk); virtually all infrastructure is rented by the company

Source: ACRA

3.1.2. Regulatory environment

Regulatory environment largely determines the success of operations of companies in the industry. The assessment of regulation focuses on the following parameters: 1) appeal of the regulatory environment to investors; 2) regulatory barriers to the entry of new players (such as issuance of new licenses); 3) predictability; and 4) dependence of the total revenue of a company on the regulated part of this indicator.

The assessment score for this factor largely depends on current regulatory practices and the potential risk of them changing in the future. A well-established and predictable regulatory environment has a positive impact on the financial sustainability of a rated entity. The existence of legislative initiatives that have a negative impact on companies in the industry, on the contrary, has a negative impact.

The qualitative assessment category for regulatory environment is determined according to Table 3.

Table 3. Qualitative assessment of industry regulation

Assessment category	Main features
I	No regulatory risk, regulation is transparent and, historically, has been predictable (there have been no legislative changes that have worsened the position of companies for more than five years), regulation allows telecommunication companies to maintain a high profitability in the long term; issuance of new licenses is unlikely
II	Regulatory risk is minimal, regulation is transparent and predictable (during the last five years there have been no legislative changes that have worsened the position of companies), the rated entity operates in countries with high or adequate rankings* for the quality of public institutions, regulation allows companies to maintain adequate profitability in the medium term; issuance of new licenses is likely, but their number would be limited
III	Moderate regulatory risk, regulation is affected by non-economic factors (decisions may be politically motivated), there have been attested cases of unpredictable changes in regulation (during the last three years there have been cases where legislative changes worsened the position of companies), regulation allows companies to maintain medium profitability in the short term (or low profitability in the medium term); issuance of new licenses is likely
IV	High regulatory risk, regulation is non-transparent and subject to non-economic factors (many decisions depend on the political situation in the country, there are examples of introducing inconsistent and difficult-to-predict legislative changes), regulation does not allow companies to predict the level of profitability; new licenses are issued on an ongoing basis
V	Very high regulatory risk, regulation is absent or unpredictable or adverse changes for the industry are introduced to the legislation

* World Bank data
Source: ACRA

3.1.3. Market position

The market position is determined by a company’s share in the market or its individual segments, the ability to further expand market presence, and the level of diversification of operations (including the structure of revenues broken down by segment: wired or mobile communications, data transmission services, B2B or B2C services). Leading positions in the national market have a

positive impact on a rated entity's financial stability. By contrast, presence in a local market only and a weak competitive position adversely affect a company's creditworthiness.

The qualitative assessment category for the market position is determined according to Table 4.

Table 4. Qualitative assessment of the market position

Assessment category	Main features
I	National leader with broad geographic diversification of operations, able to provide the full range of telecommunications services and has a significant customer base; successful expansion into international markets; revenue is generated from several segments (mobile and fixed telephony, data transmission, etc.).
II	Key player in the national market, provides a wide range of telecommunication services and has a significant customer base; limited presence outside the national market; revenue is generated in several segments, with one leading segment
III	Significant player in a local market (or with a competitive position in local markets), able to provide a range of telecommunications services, has a limited customer base and operates in a market with increasing competition; revenue is mostly generated in one segment and the company is trying to expand into other market segments
IV	Local market player with a significantly limited customer base and exposed to considerable pressure from growing competition; revenue is generated in one segment and the company is not seeking to expand its range of services
V	Small local market player whose business largely depends on access to third-party infrastructure; present in one telecommunications segment and trying to expand into other segments

Source: ACRA

3.2. Financial Policy and Corporate Governance

To assess financial policy and corporate governance, ACRA uses a common set of characteristics that translate into a qualitative assessment category for all industries (for a general description of the concept of qualitative assessment of financial policy and corporate governance, see Section 5 of the Methodology).

The assessment of financial policy and corporate governance is carried out according to Table 6.

4 Financial Profile

The following describes the basic factors in the rating analysis of the financial profile, the degree of their influence when determining the credit rating of a non-financial corporation, and assessment specifics.

To assess qualitative indicators in the financial profile of rated entities in the telecommunications industry, ACRA uses a common set of characteristics that determine a qualitative assessment category for all economy sectors (for a general description of qualitative assessment of financial profile indicators, see Section 6 of the Methodology), and an individual set of qualitative characteristics according to Table 5.

Quantitative indicators in the financial profile are assessed in scores on the basis of being part of a particular range and qualitative indicators, on the basis of qualitative assessment categories according to Table 7.

4.1. Size

To assess the business scale of telecommunications companies, ACRA uses the size of their revenue, which is important for assessing the creditworthiness of rated entities. In addition, ACRA analyzes revenue dynamics: companies where this indicator exhibits high growth rates are assessed above those whose revenue stagnates or exhibits low growth rates.

4.2. Profitability

To assess profitability, ACRA uses the FFO margin before fixed charges and taxes. This allows for a correct comparative analysis of companies using their own infrastructure versus those who rent it.

In addition, ACRA assesses the profitability of the rated entity in comparison with the indicators of major competitors. ACRA also assesses how changes in a company's profitability over the past three to five years relate to the development trends of the industry: a company showing significantly higher profitability compared to its competitors is assessed higher than a company whose profitability is at the industry average or difficult to predict due to volatile performance.

Table 5. Qualitative profitability assessment

Assessment category	Main features
I	Very high profitability compared to competitors
II	Persistently high profitability (no significant fluctuations of the indicator over the last three years)
III	Profitability is at the industry average (no significant fluctuations over the last three years)
IV	Profitability is at the lower boundary of industry average values (low volatility of the indicator)
V	Persistently low levels of profitability or difficult-to-predict dynamics (highly volatile indicator)

Source: ACRA

The profitability of telecommunications companies has traditionally been high, so their quantitative assessment scores are higher than those of companies in most other industries.

4.3. Leverage

To assess leverage, ACRA uses the ratio of adjusted total debt[1] to FFO before fixed charges.

4.4. Coverage

To assess coverage, ACRA uses an indicator calculated as the ratio of FFO before fixed charges to fixed charges. This allows for a more correct comparative analysis of companies using their own infrastructure versus those that rent it.

4.5. Liquidity

To assess liquidity, ACRA uses the short-term liquidity ratio and qualitative characteristics.

4.6. Cash Flow

To assess cash flow, ACRA uses the FCF margin indicator, as well as the qualitative assessment of FCF stability.

[1] Given the currently established practice of assessing the cost of infrastructure rent for companies in the telecommunications industry, ACRA uses a multiplier of operating lease capitalization equal to 4x to adjust the size of debt.

If a telecommunications company owns its infrastructure, it needs to maintain a high level of capital expenditures and to fund them with cash flow (in order to avoid wear and tear of infrastructure, technological inferiority compared to peers, or deterioration of financial performance). Dividend payouts made by a company are analyzed separately. Amid high capital costs, high dividend payouts can exert significant pressure on FCF.

Table 6. Operational profile factors

Factors	Sub-factors	Sub-factors weighting	Sub-factors score				
			5	4	3	2	1
Business profile	Business model and infrastructure quality	50%	V	IV	III	II	I
	Regulatory environment	25%	V	IV	III	II	I
	Market position	25%	V	IV	III	II	I
Financial policy and corporate governance	Financial policy	50%	V	IV	III	II	I
	Corporate governance	50%	V	IV	III	II	I

Source: ACRA

Table 7. Financial profile factors

Factors	Sub-factors	Sub-factors weighting	Sub-factors score				
			5	4	3	2	1
Size	Revenue (USD bln)	100%	[0;1)	[1;5)	[5;10)	[10;50)	[50; ∞)
Profitability	FFO margin before fixed charges and taxes	50%	(−∞; 10%)	[10%; 25%)	[25%; 35%)	[35%; 45%)	[45%; ∞)
	Qualitative profitability assessment	50%	V	IV	III	II	I
Leverage	Adjusted gross debt to FFO before fixed charges	70%	(8; ∞)	(5; 8]	(3; 5]	(1; 3]	[0; 1]
	Qualitative leverage assessment	30%	V	IV	III	II	I
Coverage	FFO before fixed charges to fixed charges	100%	(−∞; 1)	[1; 3)	[3; 6)	[6; 10)	[10; ∞)
Liquidity	Liquidity ratio	50%	(−∞; 0.8)	[0.8; 1)	[1; 1.25)	[1.25; 1.5)	[1.5; ∞)
	Qualitative liquidity assessment	50%	V	IV	III	II	I
Cash flow	FCF margin	50%	(−∞; −10%)	[−10%; 0%)	[0%; 5%)	[5%; 10%)	[10%; ∞)
	Qualitative assessment of FCF stability	50%	V	IV	III	II	I

Source: ACRA

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