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## Credit FAQ:

# European Telecoms Operators Jockey For Position As M&A Surges Forward

### **Primary Credit Analyst:**

Mark Habib, Paris (33) 1-4420-6736; mark.habib@standardandpoors.com

### **Secondary Contacts:**

Thierry Guermann, Stockholm (46) 8-440-5905; thierry.guermann@standardandpoors.com

Matthias J Raab, CFA, Frankfurt (49) 69-33-999-122; matthias.raab@standardandpoors.com

Xavier Buffon, Paris (33) 1-4420-6675; xavier.buffon@standardandpoors.com

Michela Bariletti, London (44) 20-7176-3804; michela.bariletti@standardandpoors.com

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Mergers and acquisitions (M&A) in European technology, media, and telecommunications (telecoms) have continued unabated in 2015, with total activity in the first quarter up about 33% from last year's record to nearly €60 billion. In this FAQ, Standard & Poor's Ratings Services examines the reasons behind the current surge in M&A across Europe's telecoms sector, identifies the major forces that are shaping competition in the telecoms marketplace, and outlines our view of the credit and broader business implications of M&A transactions for companies in the sector.

## Frequently Asked Questions

### What, in Standard & Poor's opinion, is driving the current wave of telecoms M&A throughout Europe?

We believe consolidation and convergence are the two key drivers behind the surge in European telecoms M&A, with regulation acting as a gatekeeper to transactions.

**Consolidation.** Fragmentation in Europe's mobile telecoms markets--which often feature four mobile network operators (MNOs) per country, plus two or three major leased operators (known as mobile virtual network operators; MVNOs)--has driven intense competition to win or hold on to market share. We consider that mobile consolidation can help moderate competition, stabilizing the negative pricing and revenue growth trends of the past two to three years. Consolidation can also improve profitability by increasing scale, which helps operators spread capital expenditure, spectrum costs, and fixed operating costs over a larger customer base.

While cable operators have generally fared much better than their mobile telecoms peers, they too can realize scale benefits through consolidation. Cable companies can amortize fixed selling, general, and administrative (SG&A) costs such as those for marketing and product platforms over a larger customer base. They can also leverage scale to negotiate more favorable content or procurement negotiations. In cases of geographically complementary assets, cable companies can use M&A to accelerate growth while avoiding the time and expense of investing in duplicate infrastructure.

**Convergence.** European telecoms and cable operators increasingly offer bundled products, delivering combinations of pay-TV, broadband, and fixed-line and mobile voice as a package. Bundling can help operators generate higher revenues by cross-selling services to increase the number of customers and average revenue per user (ARPU), and raise customer loyalty, reducing churn rates by up to 50%. To provide these expanded services, a fixed-line network operator can build a mobile network or lease one (via an MNVO), while a mobile network operator can build a fixed-line network or lease one (using local loop unbundling [LLU], or bitstream access).

Because of the time and expense involved in building a network, leasing arrangements can be time and cost effective, though offer lower margins. On the other hand, M&A affords operators the opportunity of offering converged products quicker and on a broader scale, while preserving the control and profitability of a network operator.

**Regulation.** Regulatory approval of M&A transactions will depend on the balance European and national regulators strike between ensuring enough profitability to encourage network investment and sufficient competition to protect consumers. Up until 2014, we believed that the European Commission was generally in favor of more competition, which dampened revenue prospects, margins, company valuations, and consequently M&A. However, since 2014, it has softened that stance. Judged in part by the Commission's May 2014 approval of Three Ireland acquiring O2 in Ireland and its September 2014 approval for Telefonica Deutschland to acquire E-Plus in Germany, we believe it is more aggressively asserting its jurisdictional authority over local regulators and increasing its focus on network investment.

That said, the receptiveness of regulators to M&A is likely to be tested in the U.K., where BT Group PLC (BT) agreed to purchase EE in February 2015 and Hutchinson Whampoa subsequently announced in March that its Three UK operations will acquire O2 UK. The BT-EE tie-up would make it about three times larger than its closest current peers in one of Europe's largest markets. Several BT competitors, including Sky PLC, TalkTalk Telecom Group PLC, and Vodafone Group PLC have called for Ofcom, the U.K. regulator, to scrutinize the effects of the proposed merger. Suggested concessions include the potential spin-off of BT's Openreach business, which provides local access network infrastructure across the U.K. to service providers, including BT's competitors. In May 2015, Ofcom proposed that BT open up its fiber network to competitor equipment, which would effectively give competitors greater access and control over BT's Openreach infrastructure.

With the planned Three-O2 combination, Ofcom will also have to consider a tie-up that would create the U.K.'s largest mobile telecoms operator and reduce the number of network operators in the country from four to three.

### **How does M&A affect Standard & Poor's view of credit quality among telecoms operators?**

To date, the credit effects of M&A in the European telecoms sector have generally been neutral. M&A can strengthen a company's business risk profile, although this benefit tends to be incremental in nature. Meanwhile, companies have largely kept within the limits of their financial profiles to avoid downgrades.

M&A can enhance a company's competitiveness, scale, scope, and diversity--all of which can improve margins. However, these improvements tend to be incremental and do not affect our ratings on these issuers, except in cases where the companies' business profiles were already at the high end of our assessment categories (BT, for example), or when the acquisition is transformative (as in Numericable's acquisition of SFR in 2014 or Liberty Global PLC's acquisition of Virgin Media in 2013). M&A transactions that illustrate more incremental credit effects include Vodafone's acquisition of Kabel Deutschland and ONO in 2014, and Liberty Global's more recent acquisitions of KabelBW, Ziggo, and Base.

Firms' financial profiles can potentially suffer from additional M&A leverage. But we evaluate on a case-by-case basis, considering valuations for the companies, headroom under the current rating, and the funding mix. Over the past two years of M&A in the telecoms sector, we've observed cable companies valued at about 10 times EBITDA and telecoms companies at about seven times. We see this gap narrowing, but believe it continues to reflect the relative stability of the cable TV business, and solid upside potential from the continued growth in bundling from triple-play (that is, fixed-line broadband, cable, and phone) and quad-play (triple-play plus mobile). Cable operators also typically have up to two more turns of debt to EBITDA (after Standard & Poor's adjustments), making it difficult for buyers to preserve credit ratings (particularly in light of shareholder return expectations). However, buyers have largely maintained their

ratings, which we ascribe to a starting point of relatively conservative balance sheets with sufficient rating headroom, and through balanced funding policies, including equity funding and hybrid debt issuance.

In the case of Telefonica S.A.'s acquisition of GVT in Brazil, Orange's acquisition of Jazztel in Spain, and BT's proposed tie-up with EE in the U.K., the financings have all featured a substantial use of new equity, and the first two have also employed hybrid issuance, highlighting their unwillingness to jeopardize existing ratings. Vodafone, on the other hand, had significant financial headroom in its 'A-' long-term corporate credit rating after a windfall gain from selling its stake in Verizon Wireless. However, Vodafone's all-cash funded acquisitions of KDG and ONO effectively burned through its rating cushion, resulting in a negative outlook, and eventually a downgrade in 2015 on further deterioration relative to our forecast. Similarly, Altice S.A. tested the limits of its financial profile when it bought PT Portugal last year, but then created enough headroom for its recent Suddenlink acquisition by aggressively cutting costs at SFR to improve EBITDA and give it more debt capacity. Liberty Global has relied on partial equity funding to mitigate the negative financial impact of its recent cable acquisitions, while Telenet Group Holding N.V. relied on balance-sheet headroom in its announced all-debt acquisition of Koninklijke KPN N.V.'s mobile operator Base. TDC A/S, on the other hand, used a hybrid issuance to finance its acquisition of Norwegian cable company Get to preserve its credit quality. We believe that working within a company's financial headroom, coupled with relatively conservative funding, can help to preserve ratings in future M&A transactions.

### **Why does convergence seem to take off in some markets, but not others like the U.K.?**

The U.K. market has lagged Europe in embracing fixed-line and mobile convergence, but we expect the BT-EE tie up will help jump-start the trend.

Talk-Talk and Virgin have been providing bundled services in the U.K. for a number of years, but their quad-play penetration has been relatively low at less than 20%, compared with more than 50% in markets like Spain. We believe this is partly due to their MVNO structure where lower mobile margins, particularly on data, provide less incentive to market bundles. In our opinion, the BT-EE transaction could accelerate U.K. convergence if BT actively markets quad-play services as a competitive differentiator against a background of increasing service delivery integration between fixed and mobile networks.

That said, we do not expect a sudden rise to Spanish or French levels of quad-play adoption because the underlying motivation to economize may not be as strong with the U.K.'s relatively healthy economy, and with fewer quad-play operators driving convergence than the French market for the time being. We believe similar factors have resulted in lower adoption rates in the Nordic markets. We also believe pay-TV is another factor affecting the U.K. market where content, particularly exclusive sports rights, may create enough "stickiness" to keep customers mixing and matching their fixed and mobile providers to meet their viewing preferences.

### **How important will content be for telecoms operators in the future? Will it become a competitive battleground?**

Competition for exclusive sports rights has recently made headlines for U.K. telecoms operators BT and Sky, but we do not see immediate implications for the rest of Europe.

BT's capture of Champions League football rights last year signaled a more aggressive stance to counter Sky's content-driven model and, in our opinion, helped drive material price inflation in the recent Premier League football

rights auction. However, we believe telecoms operators on the Continent will remain focused on their core business as service providers and take a more defensive or opportunistic approach to exclusive content, as in Liberty Global's All3Media joint venture and minority (6%) purchase of ITV last year.

In other words, we think telecoms companies will secure enough content to remain competitive, but refrain from making it a centerpiece of their services. Instead, we expect competitive differentiation will continue to be based on performance, driving investment toward infrastructure rather than content. Cost will also be a competitive tool, as will customer experience. Hence, many telecoms operators and cable providers are looking to invest in value-added services such as new set-top box hardware and software to enhance customer interactivity and usability.

In the U.K. market, Sky blurs the line between telecoms and media and has helped to make content more central to telecoms competition. Outside of the U.K. (and the U.S.), exclusive content typically does not command a similar level of viewership or subscription premium, particularly with robust competition from free-to-air TV. In fact, we believe many European telecoms operators take a more circumspect view of the U.K.'s recent 80% cost increase in Premier League rights, and we expect them to take a more measured approach in their home markets.

Previous efforts also raise questions as to the competitive benefits of trying to develop or buy exclusive content. For example, Orange sought to compete with Canal Plus in the late 2000s, but abandoned the project after it was unable to draw sufficient new customers to its cinema and sports offerings to make an economic return on the investment.

A key development to watch, however, will be Telefonica's acquisition of Canal Plus Spain, which it completed in April 2015. Although regulators stipulated that Telefonica offer its competitors wholesale access to one-half of its premium content, the company is actively pursuing original content where it will have exclusivity. Time will tell if it can use content to create a competitive advantage in a Spanish market where free-to-air TV still retains a significant share.

### **Does Standard & Poor's believe convergence will help alternative providers continue their rapid growth at the expense of incumbents?**

Not necessarily. Incumbent telecoms operators have faced several structural challenges to the competitiveness of their businesses over the past few years, but we think relief is on the way.

Incumbents have suffered from fixed-line cord-cutting driven by substitution with mobile voice, increased Internet Protocol telephony and TV, and cable broadband. At the same time, their mobile businesses have been hit by a commoditization of voice and text driven by intense competition among MNOs and MVNOs, and by negative regulatory changes. But over the next two to three years, we believe incumbents will increasingly realize gains relative to alternative providers after years of investment and cost-cutting. This should put them on a more even footing versus cable.

In addition, we believe incumbents in markets such as Germany, Spain, Switzerland, and the U.K. have the potential to monetize their fourth generation (4G) networks more effectively by providing fully convergent services across a more comprehensive fixed-line network than alternative providers, who tend to be smaller and more regional in scale, or who are mobile only with no fixed-line network. The greater converged scale should enable incumbents to realize capacity efficiencies by offloading mobile traffic to their wi-fi networks, and will become important because increased data use makes customers more likely to differentiate between operators and pay a premium based on network

coverage and quality.

While many fixed-line alternative operators have successfully adopted MVNO models, few have chosen to become network operators, with some notable exceptions like Numericable in France and most recently Telenet with its announced purchase of KPN's Base mobile operation in Belgium. BT is another, albeit different, example as a fixed-line incumbent making a return to mobile with EE. But we believe more fixed-line operators may decide to follow. If regulators do not intervene in wholesale data pricing as they have with voice and short message service (SMS), MVNO margins are likely to shrink relative to integrated telecoms operators as data increasingly drives mobile revenue. Vodafone's announcement in early June that it is in initial discussions with Liberty Global on potential asset combinations suggests more M&A to converge fixed and mobile companies may be in store.

## **Related Criteria And Research**

### **Related criteria:**

- Key Credit Factors For The Telecommunications And Cable Industry, June 22, 2014

### **Related research:**

- U.K. Telco Vodafone Downgraded To 'BBB+' On Tough Operating Conditions And Weakening Credit Metrics; Outlook Stable, May 28, 2015
- Telecoms Group Altice 'B+' Rating Affirmed On Expected Acquisition Of Suddenlink; Outlook Negative, May 21, 2015
- U.K.-Based Telecom Service Provide BT Group 'BBB/A-2' Ratings Affirmed On Announced Acquisition Of EE; Outlook Stable, Feb. 6, 2015
- Top 10 Global Investor Questions For 2015: Telecommunications And Cable Sector, Nov. 17, 2014
- EMEA Telecom Companies' Financial And Cost Discipline Should Offset High Investments, M&A, And Slack Growth, Nov. 5, 2014

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### **Additional Contact:**

Industrial Ratings Europe; [Corporate\\_Admin\\_London@standardandpoors.com](mailto:Corporate_Admin_London@standardandpoors.com)

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