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EMEA Speculative-Grade Telecoms Companies Show Their Resilience In Recession

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The resilience of speculative-grade telecommunications companies across Europe, the Middle East, and Africa (EMEA) in the current recession may come as something of a surprise to those who witnessed their passage through the previous European market downturn. Between 2000 and 2001, such companies-–some of which had been heavy high-yield issuers-–came under particular pressure as a result of overestimated demand, intensifying domestic competition, and the significant use of debt to fund acquisitions and operational expansion. However, in the current recession, EMEA speculative-grade telecoms operators (that is, those with long-term ratings of 'BB+' and below) so far seem to have avoided the same fate, despite many of them carrying significant leverage. In fact, a number of them rated by Standard & Poor's Ratings Services--Virgin Media Holdings Inc. (B+/Stable/--) and Liberty Global Inc. (B+/Watch Neg/--), for instance--have been able to refinance successfully in the public debt markets. Telecoms and cable have been among the least affected industry sectors from an operating standpoint as telecoms services gain increasing importance for most consumers.

But risks remain. Although most companies are weathering the recession, we believe that speculative-grade telecoms companies continue to face risks related to high leverage and refinancing needs, more mature markets, and increasing competition. While these factors play a big part in determining our corporate credit (probability of default) ratings, they also influence our recovery ratings, which give investors our opinion on expected recovery prospects post default.

Subscription Services And Access Fees Sustain Operating Performance

In our view, the prefunded financial profiles and defensive characteristics of EMEA speculative-grade telecoms and cable operators businesses have enabled most to come through the financial crisis relatively unscathed, despite the often significant debt leverage.

Telecoms services have become essential for most consumers, and the fact that an increasing portion of companies' revenues are generated through the subscriptions to bundled services and/or access fees has helped to sustain their operating performance. Three characteristics highlight the relatively better resilience of the telecoms sector compared with other industrial sectors:

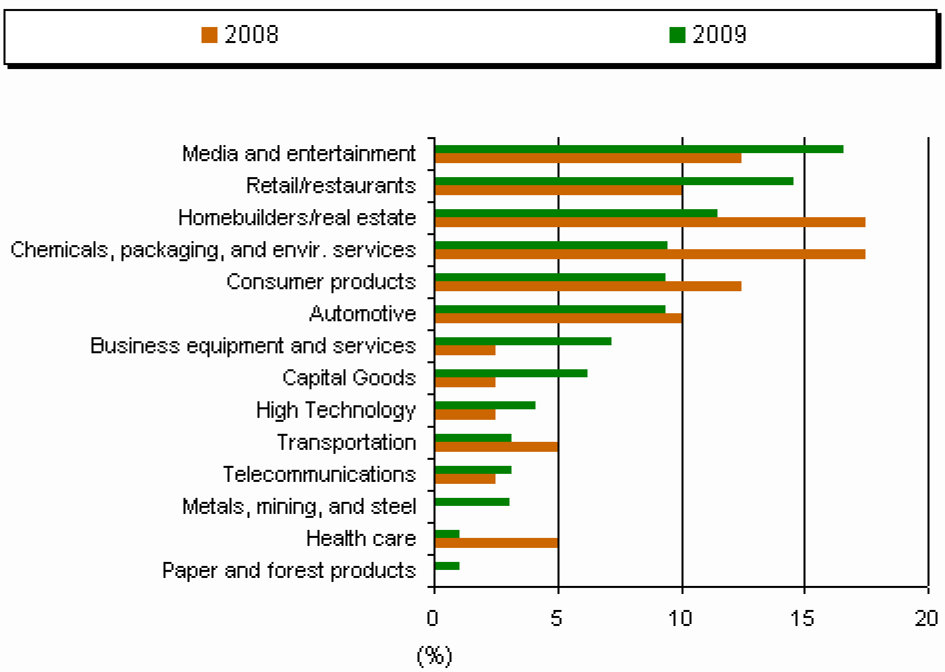
- In the 12 months to the end of December 2009, defaults among speculative-grade companies accelerated to a rate of 9.6% (12.8% when including our portfolio of private credit estimates) from 2.9% (5.1%) a year earlier, with total debt outstanding of more than €60 billion. In our recovery portfolio of more than 20 speculative-grade telecoms operators, by contrast, there was just one payment default: the Greek mobile services company WIND Hellas Telecommunications S.A. (CCC+/Stable/--). Default among telecoms companies represent about 3% of total defaults recorded in both 2008 and 2009 (see chart 1).
- Over the same period, the ratio of downgrades to upgrades proved more balanced in the EMEA speculative-grade telecoms sector compared with corporate issuers overall (see chart 2). Some 60% of corporate credit rating (CCR) actions in our speculative-grade telecoms recovery portfolio were downgrades (50% of these involving only one operator, WIND Hellas, which was downgraded three times in 2009), while the remaining 40% of CCR actions represented upward movements (in particular, two companies in our recovery portfolio, OJSC MegaFon

(BBB-/Stable/--) and Eutelsat Communications S.A. (BBB-/Stable/A-3), were upgraded into the investment-grade category). This is better than the overall trend, which in 2009 saw downgrades outpace upgrades (78% versus 22%) across all corporate issuers.

- Particularly strong investor demand and a supportive capital market, which allowed most telecoms operators to successfully manage their financing needs in 2009. In a period where the global financial markets have experienced one of the worst liquidity and credit dislocations since the Great Depression, speculative-grade telecoms companies such as Liberty Global, Virgin Media, or Wind Telecomunicazioni SpA (B+/Stable/--) have been among the first and particularly active issuers to successfully renegotiate bank financing and open up the high-yield bond market (after it was closed since mid-2007). In our opinion, the relatively resilient EBITDA generation of these operators gave investors more comfort about debt capacity.

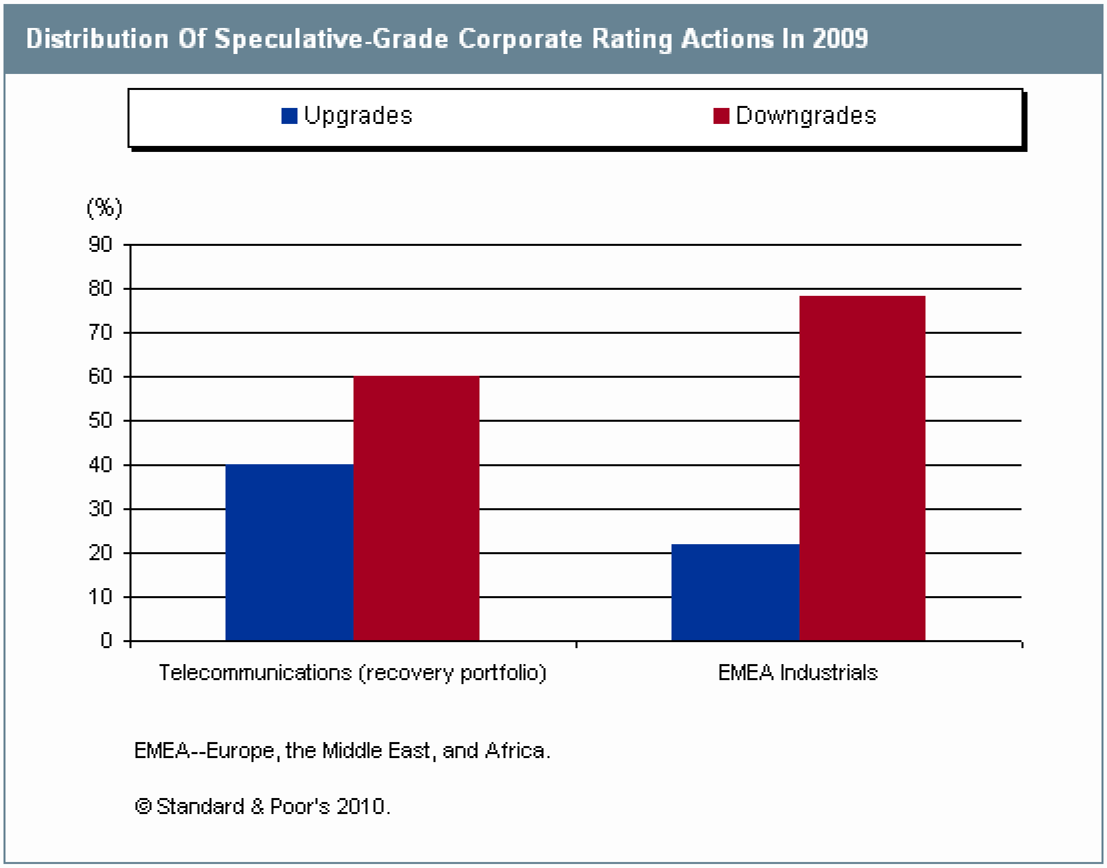
Chart 1

EMEA Default Distribution By Industry Sector* In 2008-2009



*There were no defaults recorded in aerospace and defense, oil and gas exploration and production, and utilities during the period. Note: Average no. of companies in 2009 dataset = 733. Source: Standard & Poor's public ratings and private credit estimates.

Chart 2



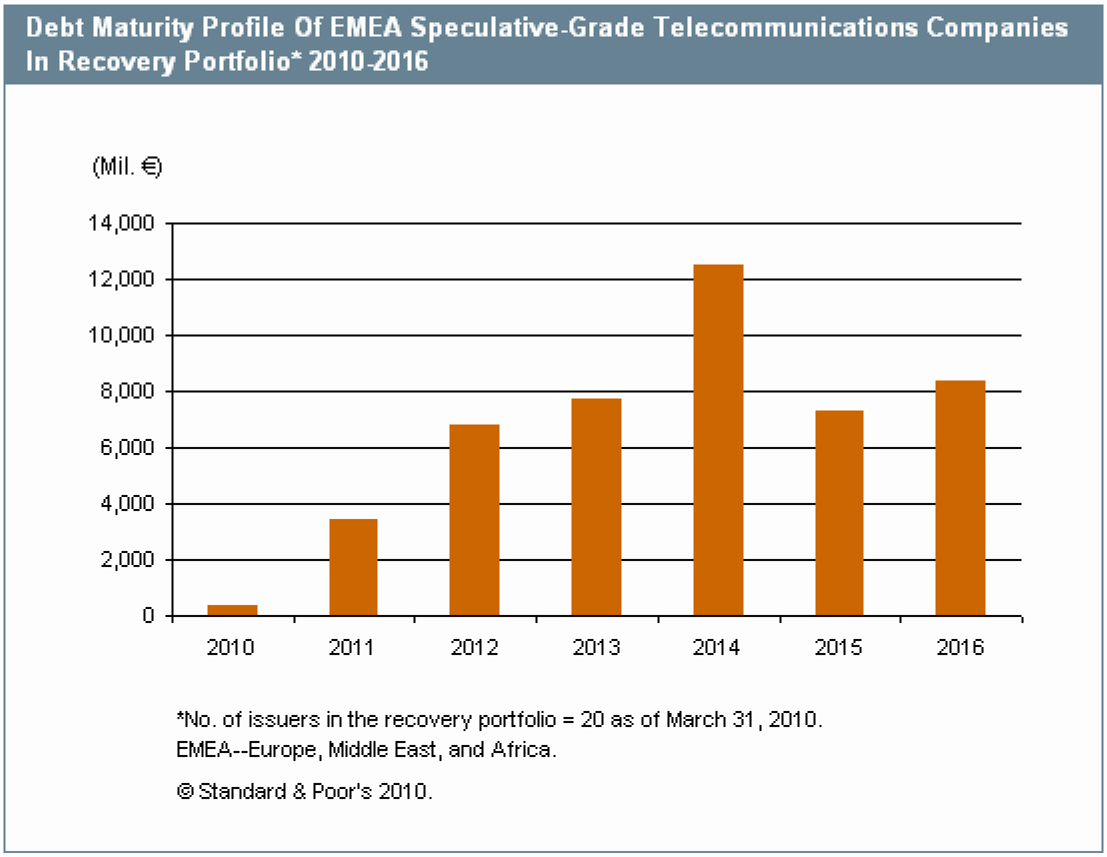
Risks Still Lie Ahead, With Refinancing Looming Large

Notwithstanding that most companies have been weathering the economic downturn so far, we believe that speculative-grade companies in the telecoms industry continue to face risks related to high leverage and refinancing needs, particularly when combined with operating underperformance in a scenario of sluggish economic prospects, more mature markets, and increasing competition.

Moreover, a material proportion of telecoms operators in our recovery portfolio are owned by private-equity sponsors that have, in the past, built up a track record of very aggressive financial strategies that pose a future risk. We think equity shareholders might exert pressure to either find new growth opportunities through acquisitions or the return of cash through dividends, share repurchases, or dividend recapitalizations (that is, when a company incurs new debt to finance a special dividend to shareholders). Furthermore, we believe that liquidity profiles and discretionary cash flow (DCF) generation could be significantly constrained as a result of such aggressive financial strategies. In addition, these companies might not, in our view, be able to reduce their high leverage and therefore potentially jeopardize their ability to refinance at times of weak operating performance.

Speculative-grade telecoms companies are generally highly leveraged. As of Sept. 30, 2009, we estimate that the average Standard & Poor's-adjusted debt-to-EBITDA ratio of telecoms operators in our recovery portfolio was 4.9x (5.4x excluding Russian companies). Their maturing debt, meanwhile, is set to reach a significant peak post 2012 (see chart 3).

Chart 3



As a result, refinancing is still one of the key risks facing these companies, particularly if forthcoming maturities are combined with an environment in which there are lower future growth prospects.

In terms of industry risk, in particular, the wireless telecoms industry is maturing. As a consequence, competition and pricing pressure appears to be increasing on all industry players, dampening growth rates and profitability across most markets. WIND Hellas, for example, faces unprecedented levels of competition and price pressure in a market severely impacted by the financial crisis.

Wireline telecoms companies also face significant ongoing challenges, with shrinking market shares (particularly their residential customer base) as a result of regulatory pressures, fixed-to-mobile substitution from wireless operators, and fierce competition from other alternative operators and cable companies. At the same time, pricing and top-line pressures, and increased capital expenditures to upgrade and enhance networks could constrain free cash flow generation.

Alternative network operators (altnets) face fierce price competition and margin pressures due to the potential increase in costs for customer acquisition and retention and restructuring expenses.

Although cable companies continue to see growth potential from broadband Internet and pay-TV services, the recession and intense competition are depressing broadband prices and subscriber growth rates. In addition, we think that cable TV subscriber churn could increase as a result of Internet protocol TV (IPTV) offerings from telecoms operators, along with ongoing competition from satellite TV operators and free-to-air digital terrestrial TV. In such a competitive market environment, free cash flow generation could remain constrained by high subscriber acquisition and retention costs or the acquisition of exclusive content rights.

The Evolution Of Recovery Ratings Through 2009

As part of our ongoing surveillance, we review our recovery assumptions as a result of credit or structural changes such as refinancing, covenant amendments, equity injections, debt restructurings/buybacks, and our assessment of a company's business risk profile. All these aspects potentially affect key recovery aspects in terms of operating stress, lenders' control, valuation, and waterfall at default, and are particularly important considerations in time of declining credit quality and high defaults.

In 2009 we took six rating actions affecting recovery ratings in our speculative-grade telecoms portfolio, reflecting changes in recovery prospects for particular debt instruments. In particular, we revised the recovery ratings on Virgin Media's junior-lien and unsecured debt instruments to '2' and '5' from '3' and '6', respectively, highlighting estimated recovery prospects in the 70%-90% and 10%-30% range. In the case of TDC A/S (BB-/Positive/B), meanwhile, the recovery rating on junior-lien instruments was revised to '4' from '5' and that on the company's unsecured euro medium-term notes was revised to '3' from '4', reflecting our expectations of 30%-50% and 50%-70% recovery at default, respectively, as a result of structural changes. Our action on Virgin Media followed the refinancing of a material proportion of first-lien debt with new unsecured bonds, rebalancing the mix of outstanding liabilities. (For more details, see article titled "Assessing The Recovery Effects Of Changes In The Capital Structure, Out Of Court Restructuring, And The Business Risk Profile Of EMEA Telecoms Operators," published April 26, 2010, on RatingsDirect.) TDC bought back a proportion of senior secured debt. These actions resulted in our assumption of a lower proportion of priority liabilities at our hypothetical default.

Other recovery rating actions came as a result of changes in our estimate of stressed enterprise values. This is either due to our reassessment of stress in operating performance on the path to default or to the main valuation variables such as multiples or long-term growth and profitability assumptions. The recovery ratings on Kabel Deutschland GmbH's (B+/Positive/--) unsecured debt instruments, for instance, were revised to '5' (highlighting modest recovery prospects in the 10%-30% range) from '6' following an upward revision of our stressed enterprise value at the hypothetical point of default, while the senior secured debt at Versatel AG (B+/Stable/--) was revised to '2' (indicating substantial recovery prospects in the 70%-90% range) from '1' as we reassessed our valuation slightly downward.

Uncertain Growth Prospects And High Leverage Could Push Recovery Ratings Further Into The Spotlight

Although speculative-grade telecoms companies have generally fared well in the current recession, in our view their highly leveraged capital structures suggests that refinancing will likely have to occur in the medium-term. Moreover, we believe the late cycle characteristics of the telecoms industry, illustrated by a lagging negative effect on revenues in the face of an uncertain macroeconomic recovery, could slow down growth in the short to medium term. Over the latter period, we are of the view that the sector also faces an increasing risk of market maturity--and in some countries, of ever-increasing competition and regulation--that could slow down growth rates even further.

High levels of indebtedness, if combined with operating underperformance, can make any refinancing particularly challenging. In such an environment, the credit quality of speculative-grade telecoms companies will in our view become increasingly important to potential lenders, particularly in regard to the companies' probability of default and ultimate recovery prospects for specific debt instruments.

Related Criteria And Research

- Assessing The Recovery Effects Of Changes In The Capital Structure, Out Of Court Restructuring, And The Business Risk Profile Of EMEA Telecoms Operators, April 26, 2010
- Performance Of EMEA Speculative-Grade Telco, Cable, And Satellite Companies Proves Resilient In A Tough Trading Climate, Feb. 3, 2010

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