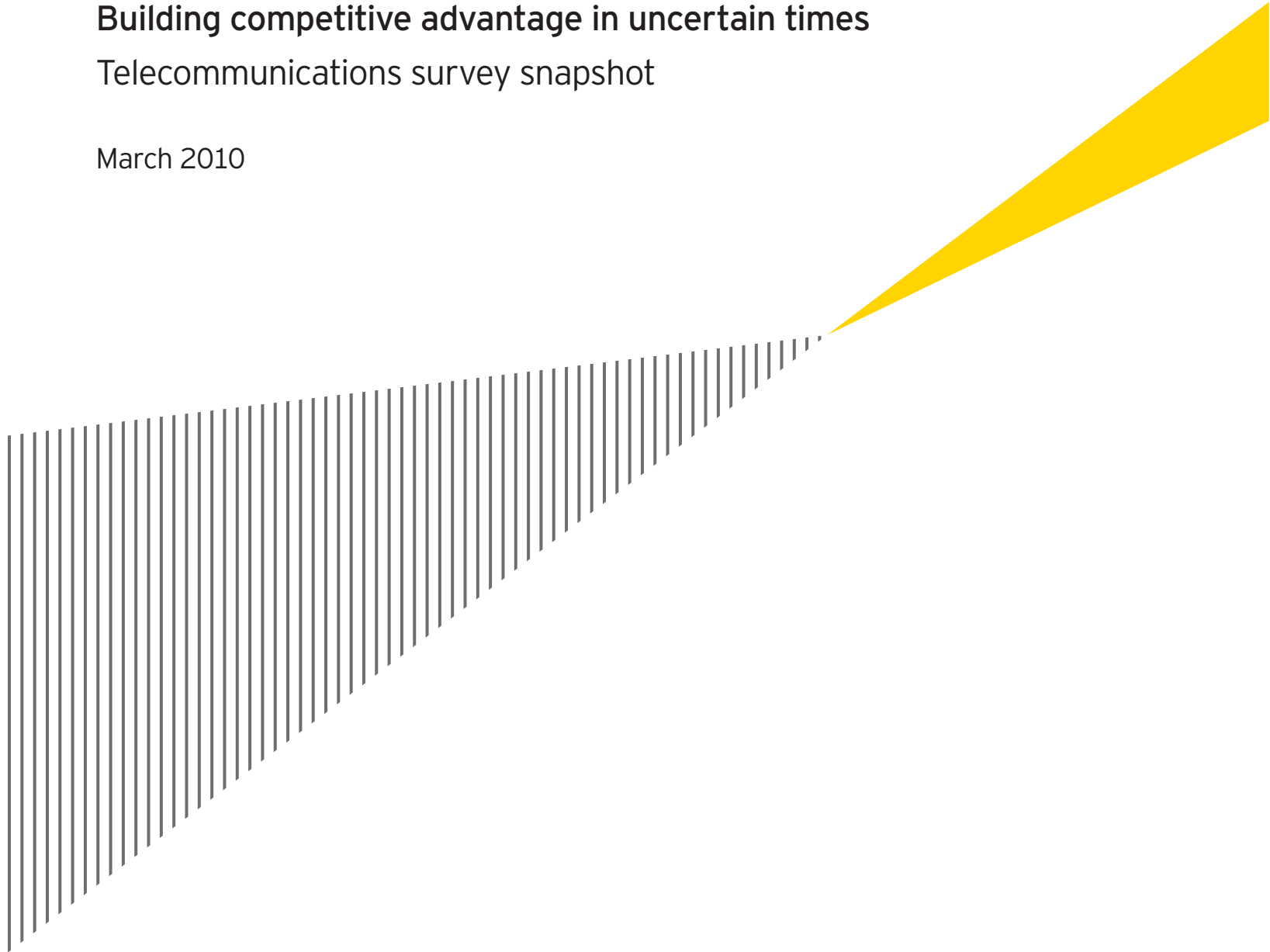


# Why capital matters

Building competitive advantage in uncertain times  
Telecommunications survey snapshot

March 2010





## Operators adopt a defensive approach to recovery

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As we enter 2010, telecoms operators across the world are cautious about the pace of recovery from the economic downturn, and are taking a highly defensive approach to the widespread consolidation that they believe will follow.

Industry leaders regard consolidation as being vital to reduce the current cut-throat competitive and pricing pressures. What is more, they assess the current environment as being favorable for acquisitions.

However, few telecoms respondents are intending to pursue deals themselves in the immediate future. Instead, they are happy to sit back and wait for other operators to drive the consolidation, enabling their own businesses to reap the benefits in the market without facing the risks of integration.

The result is a waiting game where the braver and better-funded players will press ahead with acquisitions - and may well position themselves as the industry's long-term winners.

### Taking the industry's pulse

This snapshot of opinion among senior leaders in the telecoms industry is drawn from Ernst & Young's global cross-industry survey of 478 C-suite and board-level executives, conducted by the Economist Intelligence Unit in October 2009. Of the global sample, 41 were telecoms operators.

To find out more about Ernst & Young's global survey, please contact [GlobalTelecommunicationsCenter@uk.ey.com](mailto:GlobalTelecommunicationsCenter@uk.ey.com)

# Widespread consolidation largely funded by bond issues

A comparison of telecoms respondents with those from our cross-sector findings reveals an industry low on economic confidence in the short term, but convinced that M&A powered by new sources of funding - notably bond finance will take off in a year or so's time.

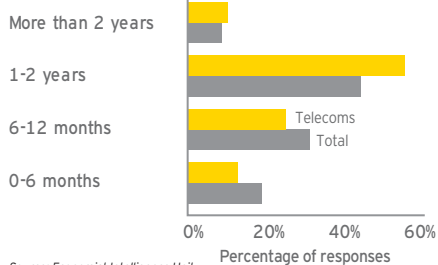
## Pessimism over the pace of economic recovery

Our research suggests that the economic downturn has combined with a pervasive change in the telecoms industry's technological, regulatory and competitive landscape to create deep uncertainty in the sector. On the positive side, telcos believe their own industry will recover faster from the current downturn than the economy as a whole (see Figure 1). More than one-third of telecoms respondents (36.6%) anticipate an upturn in their sector within 12 months, against only 15.4% expecting a general economic recovery in that timescale. However, more negatively, telecoms operators are more bearish than respondents in other sectors on the overall length of the financial crisis, expecting the downturn to last longer both in their own sector and the economy as a whole.

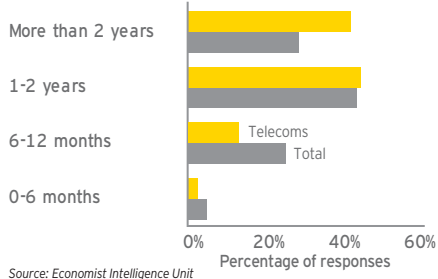
Figure 1: expectations of recovery (telecoms vs. all industries)

Q2: How long does your organization expect the financial crisis to persist in:

### a) your industry?



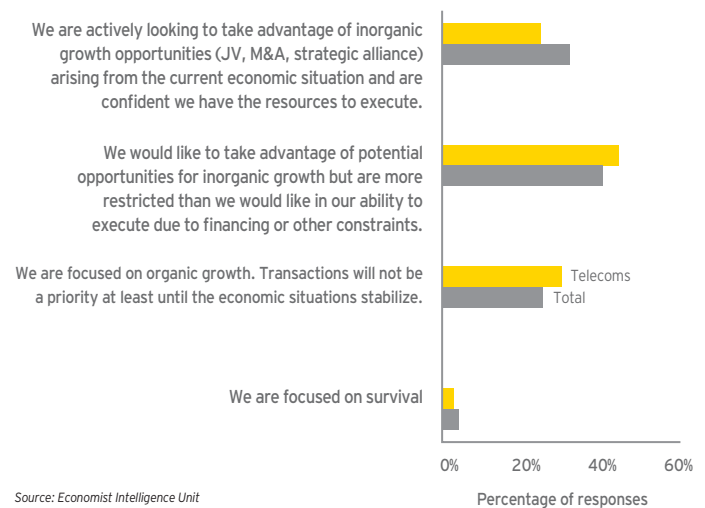
### b) in the broader economy?



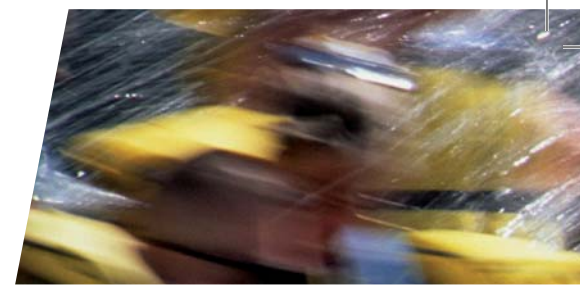
## Caution about financing and executing M&A

Telcos' current sense of uncertainty is also reflected in their assessment of their own M&A execution capabilities. As Figure 2 shows, operators are less confident than the market overall in their own ability to capitalise on inorganic growth opportunities in today's environment. While they believe the downturn will give rise to acquisition opportunities, they feel their liability to execute deals is currently constrained by financing and other restrictions.

Figure 2: attitudes to inorganic and organic growth (telecoms vs. all industries)



As a result, operators are more focused on organic growth, and less likely to transact in the immediate future than other sectors. While our findings indicate that they expect a growing number of deals to be done, they are initially looking to other operators to kick off the consolidation process.

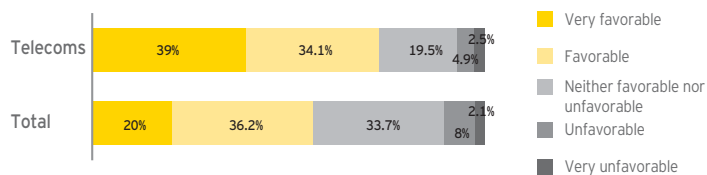


## Deals will come, but for now it's "wait and see"

Despite their concerns about financing and executing deals, operators strongly outscore the market as a whole in regarding the outlook for M&A as "very favorable" over the next six months. Some 39% of telcos take this view, against 20% of companies overall (see Figure 3). This clearly reflects their belief that consolidation in the industry is both inevitable and desirable. Indeed, when operators are asked to rank the effect of the crisis, an acceleration of consolidation in the telecoms industry scores highest.

**Figure 3: outlook for M&A activity in the next six months for your industry (telecoms vs. all industries)**

However, operators are not going to rush into doing deals, and are no more likely than other sectors to make acquisitions over the next year. For telcos, the main inhibitor on doing deals is regulation, which ranks as the number 1 in telecoms compared to number 7 across all industries. Operators are also more focused than other sectors on improving their ability to assess transaction risk and creating better valuation methods.



Source: Economist Intelligence Unit

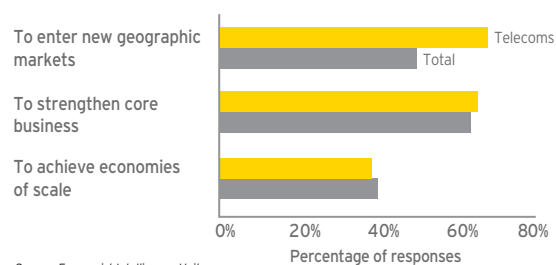
Despite these barriers, operators think the likelihood of acquisitions increases with time, and are actually more positive than companies in other industries about making acquisitions in one or two years time. But opinions over deal volumes are divided, with half of our telecoms respondents believing that restrictions on financing will continue to limit telecoms M&A activity, while over a quarter expect a return to pre-crisis levels.

## Focusing on footprint growth

As telecoms markets mature and penetration growth slows, in-market consolidation is providing operators with a way to gain market share, increase subscriber volumes and exploit some cost synergies. Our telecoms respondents regard consolidation as positive for all players in a market, including those not directly involved, who benefit from reduced competitive and pricing pressures and do not face integration risks.

**Figure 4: rationale for considering acquisitions (telecoms vs. all industries)**

**Q7: What is your current principal rationale for considering acquisitions? Select the top three.**



Source: Economist Intelligence Unit

When it comes to assessing opportunities for M&A, telcos are more focused than other businesses on expanding their footprint by entering new geographic markets. As Figure 4 shows, this was cited as a top-three reason for considering acquisitions by 68% of telecoms operators, against only 50% across all sectors. Strengthening the core business is also a major objective, cited by 66% of telco respondents.

Over the medium term, operators see the most attractive acquisition opportunities as being in their home/domestic markets, often with the aim of reducing competition which is again a more important objective in telecoms than in other sectors. In the meantime, network sharing is also being used as an alternative way to achieve cost synergies and other benefits (see information panel).

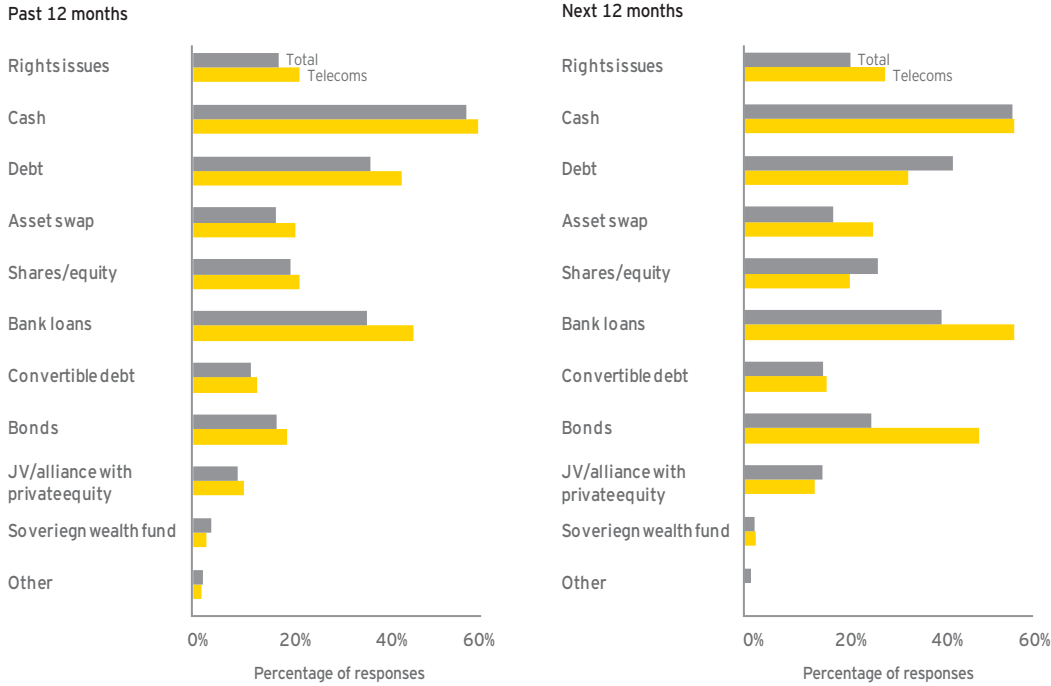


### The bond market beckons for operators

With operators preparing themselves for widespread consolidation in the medium term, deal financing is also changing as they revisit their strategies and strive to restructure for greater operational efficiency. As Figure 5 shows, bank loans, cash and debt have led the way for deal financing in the past 12 months. But, going forward, 49% of operators regard the bond market as a primary source of deal financing, compared to just 19.5% over the past year. This shift towards bonds in 2010 is much more pronounced in telecoms than in other sectors.

More generally, operators are looking to a wider array of funding sources over the coming year. Five funding options - debt, cash, bank loans, bonds and right issues - are favored by over one quarter of respondents for the coming year, compared to only three options over the past 12 months.

Figure 5: Main sources of deal financing in the past and next 12 months - telecoms vs. all industries (multiple responses possible)



Source: Economist Intelligence Unit



## Setting the scene for consolidation

As sources of deal financing are widened, so other areas of the capital agenda are being redefined. Strategic flexibility is of the utmost importance, with operators suggesting that increased consideration of “a wider range of strategic options” is one of the most important consequences of economic slowdown.

The scarcity of capital is just one of many constraints: levels of scrutiny, whether from board, shareholder or regulator, are rising. Indeed, regulation ranks as the top deal inhibitor in the sector, compared to 7th out of 11 categories across total survey responses. In this light, the end-game of consolidation may not be quite a foregone conclusion - regulators remain keen to associate service availability and affordability with choice in the marketplace.

Despite higher levels of scrutiny, operators are proving themselves pro-active - operational efficiency and cash flow liquidity score highly as areas of renewed focus while operators are more vocal than other sectors when it comes to restructuring different parts of the business, whether core or non-core.

In response to the downturn and pervasive industry change, operators have assumed a defensive stance. But once well-funded telcos take the plunge and start the long-awaited consolidation process, more will follow. In eighteen months' time, we believe widespread industry consolidation will be in full swing. Forward-looking telcos should start preparing themselves now to make the most of the upcoming opportunities

To hear more about this research, please contact your local Ernst & Young representative, or the Global Telecommunications Center ([GlobalTelecommunicationsCenter@uk.ey.com](mailto:GlobalTelecommunicationsCenter@uk.ey.com))



# Global Telecommunications Center contacts

**Robin Jowitt**

Global Telecommunications Transactions Advisory Services Leader  
tel: +44 20 7951 3057  
email: rjowitt@uk.ey.com

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**Vincent de La Bachelerie**

Global Telecommunications Leader  
tel: +33 1 4693 6205  
email: vincent.de.la.bachelerie@fr.ey.com

**Marc Chaya**

Global Telecommunications Markets Leader  
tel: +33 1 4693 8515  
email: marc.chaya@fr.ey.com

**Holger Forst**

Global Telecommunications Center - Cologne  
tel: +49 221 2779 20171  
email: holger.forst@de.ey.com

**Jonathan Dharmapalan**

Global Telecommunications Center - Beijing  
tel: +86 10 5815 2821  
email: jonathan.dharmapalan@cn.ey.com

**Prashant Singhai**

Global Telecommunications Center - Delhi  
tel: +91 124 464 4000  
email: prashant.singhai@in.ey.com

**Julia Lamberth**

Global Telecommunications Center - Johannesburg  
tel: +27 11 772 3385  
email: julia.lamberth@za.ey.com

**Serge Thiemele**

Global Telecommunications Center - Johannesburg  
tel: +225 2030 6050  
email: serge.thiemele@ci.ey.com

**Mike Stoltz**

Global Telecommunications Center - San Antonio  
tel: +1 210 242 7205  
email: michael.stoltz@ey.com

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