Overview

- **Ratings Outlook:** We believe ratings in the telecom and cable sector will remain steady in 2017. Our proportion of stable outlooks increased last year by 4% to 77%, led by Europe and North America, indicative of established positions and some utility-like attributes for the sector. However, directional outlooks have a negative bias, especially in Latin America (LatAm) and the Asia Pacific (APAC) region where our negative outlooks on several sovereigns cap some of the telecom ratings.

- **Forecasts:** Our global 2017 base-case forecast is for flat revenues. In the U.S., low-single-digit revenue declines for incumbent telco companies and mid-single-digit revenue growth for cable. In Canada, we expect modest overall revenue growth, with broadband growth offsetting voice and legacy data declines. We expect flat-to-low-single-digit top-line growth for Europe’s telcos and mid-single-digit growth for cable, with some margin improvement from cost-cutting and synergy realization from prior acquisitions (M&A). In LatAm, metrics are likely to remain stable although Mexico’s credit metrics are slightly weaker than last year due to currency depreciation. In APAC, although structural erosion of wireline voice continues, we expect rapidly increasing data consumption revenues to support modest revenue growth and stable profitability.

- **Assumptions:** Broadly, we assume revenue growth will be due to increasing data demand in wireless with higher volume plans, and in fixed broadband with shift to higher speed connections. In converged markets, this will be enhanced by cross-selling as operators increase their average revenue generating units (RGUs) per customer toward 3x.

- **Risks:** Offsets to these positive factors are intense competition, aggressive pricing, and expanded mobile data offers for little or no extra cost, as well as structural cord-cutting trends in fixed voice and video. These risks pressure the average revenue per customer (ARPU), notably in markets not benefiting from growing multiplay penetration, weakening EBITDA, and financial ratios. Any policy shift toward more aggressive shareholder returns or (debt funded) M&A could also pressure financial profiles and ratings.

- **Industry Trends:** We expect M&A interest in mature markets like the U.S. where operators are looking for scale economies to improve margins, and in APAC to find growth avenues in new geographic regions and products to increase in 2017. In the U.S., these aspirations could be enabled by relaxation of regulatory scrutiny under the new administration. This contrasts with other regions, particularly Europe where we think regulation will hamper new deals, and in LatAm where balance sheets are unlikely to support large outlays.
Ratings trends and outlook

Global Telecommunications

Chart 1 – Ratings distribution

The rating distribution is weighted in the "B" category, due in part to high leverage to support the capital-intensive nature of telcos and cable. The exceptions are telcos in Europe and APAC which also have clusters in the "BBB" category.

Chart 2 – Ratings distribution by region

The highest incidence of investment-grade ratings is at the "BBB+" level, supported by entrenched market positions, and relatively modest leverage.

Chart 3 – Ratings outlooks

Stable outlooks have increased to 77% from 73% a year ago, mostly on the conversion of positive outlooks, leaving the directional outlooks (positive or negative) with a negative bias.

Chart 4 – Ratings outlooks by region

Predominantly stable outlook across all regions, led by Europe where stable outlooks have increased from about 70% to over 80%

Chart 5 – Ratings outlook net bias

Our global telecom and cable outlook has had a predominantly negative bias since 2013, but has been improving over the last two years.

Chart 6 – Ratings net outlook bias by region

Our outlook bias has improved in Europe and North America, while a sharp negative move in LatAm’s and APAC’s outlook bias is primarily the result of negative sovereign outlooks, which cap many of our ratings, as well as higher leverage in LatAm.

Source S&P Global Ratings. Ratings data measured quarterly with last shown quarter ending December 31, 2016
North America

In North America, we expect broadly stable ratings despite mixed conditions. In the U.S., we have a modest negative outlook bias on aggressive wireless competition, and secular industry declines in the wireline segment. An acceleration of M&A, bolstered by a more open regulatory environment, could also pressure ratings, depending on financing plans. In Canada we expect steady cash flow growth, which combined with disciplined shareholder returns should yield stronger balance sheets, though in line with current ratings.

Europe

Europe is the only region with a positive outlook bias, and the highest portion of stable ratings at over 80%, supported by a continued soft recovery for telcos. However, there is fragility in the picture as balance sheets are stretched at many operators, and our ratings analyses incorporate the benefit of improving trends to provide more financial headroom and help ease leverage pressure. We have a stable outlook for cable ratings as well, where continued topline and EBITDA growth in the mid-single-digit range remain offset by aggressive shareholder returns and M&A appetite.

Latin America

Latin America has the highest negative bias at about 35%, though stable outlooks still predominate at about 65% in the region. We expect lower ARPs from increased competition in a weak macroeconomic climate, but stable ratings as lower investment spending maintains cash flow and preserves financial profiles. Negative outlooks mainly reflect somewhat high leverage due to currency depreciation in Mexico and the negative outlook on Brazil’s sovereign rating.

Asia Pacific

In Asia-Pacific, ratings trends remain stable, supported by steady growth in mobile data consumption and subscriber base. A modest negative outlook bias is mainly due to the negative outlook on the sovereign ratings on several emerging Asian countries and somewhat intensifying competition in the Australian market.
Source: S&P Global Ratings. Revenue growth shows local currency growth weighted by prior-year common-currency revenue-share. All other figures are converted into U.S. Dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate.
Key assumptions

Telecommunications

**Increased data consumption and bundling support modest growth...**

We expect low-single-digit growth on average, driven by continued cable broadband growth, expansion of telco fiber networks, and higher mobile data volumes. In converged markets, cross selling of bundled products will continue to increase ARPU. We also see bundling as having a moderating influence on competition by increasing customer stickiness, lowering churn rates, and blunting the impact of promotional activity.

**...But balanced by competition and long-term trends**

Positive drivers are balanced against entrenched sector challenges, including intense competition, lending fragility to our forecast. We also expect structural cord-cutting trends will continue to hurt telcos, led by ongoing erosion in fixed-voice and video subscriptions.

**Flat to lower capex can help cash flow, but only incrementally**

With the bulk of 4G network roll outs largely complete, we expect capex will curb in most markets, freeing up incremental cash flow. However, 4G capacity upgrades and catch-up fiber investments in markets like Europe will keep capex from falling back to pre-4G levels, and we expect capex intensity to remain above the historical average, limiting our previously expected growth in free cash flow.

North America

In the U.S., we assume intense competition and pricing pressure for telcos, because of maturing industry conditions and technology shifts, partially offset by growth in data revenue. In fixed, we expect structural cord-cutting on voice as well as erosion in digital subscriber line broadband (DSL BB) because of competition from cable, despite growth from lower margin internet protocol (IP) television and fiber BB services. We also assume weak spending by business customers coupled with a migration to IP-based services from legacy circuit-switched technologies. We expect flat to slightly lower capex as carriers have largely completed their 4G LTE deployments and fiber builds, although we believe further fixed network upgrades will be needed to compete with cable for broadband customers. Unlike telcos, cable’s strength is supported by BB subscriber gains and growth from commercial services, which is partially offset by modest video customer losses, despite some stabilization of cord-cutting by OTT video subscribers on improved video platforms. We expect stable capex spending as upgrading to data over cable service internet specification (DOCSIS) 3.1 begins since costs are relatively low and can be offset by lower customer premises equipment (CPE)-related capex. The potential benefits of lower taxes under the Trump administration is not likely to occur in 2017 but could translate into increased capital spending in 2018 and beyond.

Europe

In Europe, we assume stabilizing mobile prices on more moderate competition, monetization of higher mobile data traffic, scattered price increases in fixed, and increased penetration of multiplay products, supported by improved IPTV and high-speed BB offerings. We assume investment levels similar to 2016, which were down post-4G implementation, but mid-to-upper teens as a percentage of revenue due to increased fixed-line investment to compete with cable, and ongoing mobile capacity upgrades. Meanwhile, cable company growth will rely on BB customer additions and cross-selling of bundled products, but will continue to moderate as the performance advantage over telcos narrows. We also expect 2016’s elevated level of cable operator capex spending will be maintained in 2017 as several increase their network footprints with new builds.
Latin America

In Latin America, we think aggressive competition and/or a weak economic climate will lower ARPU in some countries, limit top lines, and hurt some companies’ profitability and financial metrics. However, we expect lower capex to compensate for weakened operating conditions and to support cash flow. In Mexico, we believe that EBITDA margins will decrease slightly as a result of a stronger competitive environment, higher subscriber acquisition costs in the wireless segment on account of postpaid subscriber growth, and increased content charges in the pay-TV segment due in part to currency depreciation. In Brazil and Chile, despite some pressures, companies’ cost-control measures should allow for stable to increasing profitability.

APAC

In APAC, we assume a boost in mobile-data revenues and moderate GDP growth should help to offset the saturation in developed wireless markets and structural erosion in wireline voice revenues. We estimate overall capex to remain somewhat high mainly because of ongoing investments for mobile spectrum and advanced networks such as 4G and fiber-based broadband. We believe these investments will constrain free cash flows to some extent, but should support business positions.
### Key risks and opportunities

#### Telecommunications

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<th>Competition</th>
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<td>1</td>
<td>Aggressive competition, both among telcos and between telcos and cable, remains the primary risk for the sector, limiting revenue and driving churn, while requiring large investments to keep pace with the network performance and content offerings of peer operators. Such investments can be an opportunity for differentiation, particularly in emerging cycles with new technologies or usage patterns, as opposed to late-stage cycles where we typically see a reversion to price competition.</td>
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<th>Technology shifts</th>
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<td>2</td>
<td>Long a feature for incumbents dealing with voice customers cutting the cord in favor of wireless, OTT providers introduced similar risks to mobile voice and short-message service (SMS), and now for video providers, notably cable, through a similar disruptive market shift. These technology advances have increased data demand, but commoditization and competition threaten to limit those gains. How telecom companies react to changing usage patterns in terms of pricing and their own content strategy present both a risk and an opportunity. Prudent investment that maximizes their competitive position and pricing that earns a return on their service offerings can mitigate the threat of disruptive technologies like OTT and preserve credit quality. This will be even more important with 5G on the horizon.</td>
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<th>Financial and M&amp;A policies</th>
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<td>3</td>
<td>With relatively flat telco conditions globally, financial policy and M&amp;A can have a decisive impact. With leverage already high in Europe, despite growth, decisions on shareholder returns will be a key credit driver. Meanwhile, ripe conditions for M&amp;A in the U.S. and weak operating conditions in LatAm will draw attention to valuations and acquisition funding in the former, and capex reductions in the latter, to maintain financial targets.</td>
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Despite our broadly stable outlook, we believe significant uncertainties weigh on the sector. Competition remains aggressive in all regions, weighing on ARPU despite gains in data consumption and bundling, and investment needs remain high in most markets. Secular shifts including fixed-voice cord-cutting and more recent video cord-cutting in favor web-based communication applications and OTT content providers remain a headwind for fixed players, nonconverged cable companies in particular. Data monetization has been positive for the mobile sector worldwide, but as with voice and SMS, maturing products can quickly become commodities with few differentiating features to support pricing. Data appears headed down a similar path with operators in many markets adding ever more gigabytes (Gb) into existing plans at minimal or even no incremental cost, thereby eroding the upside potential of migrating existing customers to larger buckets as consumption rises. In France for example, Free raised their 20 euro 4G data bucket to 50Gb from 20Gb for all existing customers. And despite optimistic forecasts, we question whether data demand can continue to grow at 50% or more per year continually. If data does become a commodity like voice and SMS, we believe the risk of a return to price competition increases. And while bundling allows operators to sell more products, we typically see price erosion per product, requiring continued growth of multiplay penetration to avoid a shrinking pie.

We also see balance sheet risk stemming from investor pressure to increase shareholder returns after several years of weak equity performance. In Europe, this could become acute with balance sheets at the weak end of the existing rating limit for several telcos, and with capex creeping up to constrain free operating cash flow. A rise in shareholder returns that outpaces a rise in cash flow could add more pressure to ratings.

Higher-than-expected mobile spectrum costs remain an ongoing risk for the sector. Competitive pressures, or governments looking to boost revenues, would be the likely drivers of these higher charges. For example, in APAC, while we see a low-to-moderate likelihood of materially higher spectrum charges, the impact would be felt most acutely among the smaller, second-tier players.
Industry developments

M&A

In the U.S., we expect M&A in the wireline sector to accelerate because we believe secular industry declines in fixed voice and aggressive broadband competition from cable incent wireline consolidation to preserve margins and, in some cases, stabilize the top line. The need for scale in cable to offset rising programming expense, changing consumer preferences for video consumption and technology convergence (i.e., increased demand for mobile video platforms) are factors we believe will spur more M&A in 2017 for telecom and cable providers, enabled by a Republican FCC that will likely be more open to consolidation. In late 2016, a number of transactions were announced including AT&T Inc.’s proposed acquisition of Time Warner Cable for $85 billion. We placed our ‘BBB+’ corporate credit rating on AT&T on CreditWatch with negative implications based on potential leverage risks. In Canada, the outcome of the competition bureau review of the pending BCE Inc. purchase of Manitoba Telecom Services Inc. will set the stage for future M&A in the industry, of which there fewer opportunities of size available.

In Europe, after several years of elevated M&A activity, regulatory authorities have highlighted their competition concerns: first by blocking consolidation in Denmark and the U.K., and then by only allowing the 3 Italia and Wind Telecomunicazioni SpA merger in Italy with steep concessions that will bring Iliad S.A., into the market. We think this will make additional large M&A consolidation unlikely, with the possible exception in France where attempts at consolidation were made in 2015 and 2016, and could resume in 2017 after the presidential election in May. In addition, we think a distinction will be drawn for M&A that creates stronger challengers, or accelerates convergence, opening the door to further cable consolidation and defensive fixed-mobile deals. However, we don’t see strong market incentives for incumbents in the key remaining countries (the U.K., Germany, and Italy) to aggressively push for large-scale convergence, given the product discounts that typically result. On the other hand, we expect disposals of noncore assets, as well as tower spin-offs, could continue with some operators looking to de-lever, and others looking to redeploy capital to higher return investments.

We don’t expect significant M&A activity in LatAm because players are focused on cost-cutting initiatives to mitigate profitability pressures.

In APAC, we expect a moderate uptick in M&A activities as major operators are making efforts to diversify their revenue streams and position themselves for the future. We believe some telecom operators are seeking for integration opportunities with media and content related companies given the accelerating telecom and media convergence trend. Also, we expect some players to try to expand into new geographic markets such as Europe or U.S. in order to find new growth drivers, as seen by Japan-based SoftBank Group Corp.’s recent US$31 billion acquisition of U.K.-based ARM Holdings.

Content

As operators continue to push multiplay products like quad-plays in Europe, some have already begun to look for additional products to bundle, such as banking or other financial products, like Orange S.A. is doing in France with their acquisition of Groupama Banque. Perhaps most notable has been an interest in vertical integration by operators into media content. This idea gained momentum with AT&T’s announced acquisition of Time Warner, which followed the acquisition of NBC Universal by Comcast in the U.S. and the buyout of CTVglobemedia and Astral Media Inc. by BCE in Canada. However, we think other markets will trail North America and APAC in this trend because of lower content cost inflation and lower ARPU contributions from video, as well as the stronger influence of free-to-air television and regulatory restrictions on exclusivity. We view the drivers at this stage as limited to diversification and a hedge on content costs. Any benefits from cost and management expertise synergies appear low, in our opinion, and we assume content from combined entities will generally be sold on a nonexclusive or arms-length basis lest the content business end up subsidizing the telecom business.
5G and the IoT

A much discussed but still nascent trend is investment in 5G, a standard that promises faster speeds and lower latency. One of 5G’s primary applications would be to support the development of the Internet of Things (IoT) into a wider application of connected devices for location tracking, monitoring, and controlling over telecom operator data networks. But while operators in developed APAC markets like South Korea and Japan, as well as in the U.S., are moving forward with testing, use cases for IoT services requiring 5G are still in their infancy with limited clarity on a profitable business model. We therefore don’t expect significant capital investments in 5G over the next one to two years, with the key catalysts being a critical mass of compelling use cases, and the finalization of technological standards, and we don’t expect large scale commercial 5G rollout until 2020.

Regulation

On the regulatory front, recent developments should impact all regions. In the U.S., we think that the Republican administration is likely to take a lighter approach, which could mean loosening or reversing policies in such areas as net neutrality, business data services, privacy, and set-top boxes. With respect to Title II, we believe cable providers will have greater freedom to monetize the increasing data consumption on their networks.

In Europe, the phase out of roaming fees will impact 2017 topline growth, though we view this as a one-time hit provided that the accompanying wholesale roaming caps are high enough to cover operator costs. We also believe further relief from market consolidation is unlikely under the current European Commission which has required structural remedies to address competition concerns. We expect a continued regulatory push for investment in rural 4G and next-generation access (NGA) fixed coverage, which remains poor in most European markets, but it remains to be seen how strongly and by what means regulators can spur investment that currently offers little return for operators.

In LatAm, regulation continues to impact telecom companies, specifically in Mexico and Colombia. For example, following the 2014 Telecom Reform in Mexico, consolidation has increased. In 2016, Axtel S.A.B. de C.V. and Alestra S. de R.L de C.V merged to boost their market and competitive positions. We also saw new participants entering the market, like AT&T, which acquired Mexican wireless providers Nextel Mexico and Iusacell to form AT&T Mexico in 2015, and subsequently announced its intention to further invest to extend its high-speed mobile internet service in Mexico. In Brazil, changes to the regulation of fixed-line concessions should eliminate requirements for investment in fixed-voice, facilitating monetization of this legacy asset to fund greater broadband investment, allowing companies to better meet current demand.

In AsiaPac, we view the regulatory environment as moderate in most markets. However, in our view, regulatory risks are somewhat elevated in countries such as Bangladesh, Pakistan, and Sri Lanka, which could manifest in higher taxes, tariffs, or other adverse regulatory actions. For these countries, telecom services are a key source of tax revenues and deterioration in their sovereign fiscal situation could lead to a higher tax burden on telecom operators.

Financial policy

U.S. telecom providers already have aggressive shareholder-oriented financial policies, which include large dividend payouts and share-repurchase activity. These distributions often consume a large portion of free cash flow. As balance sheets are already stretched, these issuers are funding acquisitions with large equity components in order to preserve credit metrics. However, using equity to fund these deals can constrain discretionary cash flow generation as dividend payouts increase. In cable, higher programming expense and increased demand for mobile video and OTT platforms could drive more consolidation in the industry. We believe that tax reform under the Trump administration is likely to improve free operating cash flow generation for telecom and cable operators although we don’t think this will occur until 2018 or so and we expect that that excess cash flow will ultimately be returned to shareholders rather than creditors.

In Europe, balance sheet leverage near our rating limits has kept shareholder remuneration in check at many telcos, especially as high capex has compressed free operating cash flow. However, we think
shareholders who have endured weak equity performance for the past year and a half will push for returns, and we have seen incremental dividend increases in the last reporting periods. A shift to more aggressive financial policy that exceeds improvements in underlying operations could pressure ratings. Hybrid issuance has also continued, though at a decreasing pace as several issuers near their limits for equity consideration. This has led some to look at noncore asset divestments, including tower asset spins to lower leverage and to redeploy capital in higher return investments. Policies at cable companies remain aggressive with high dividends and share repurchases, as well as M&A, keeping leverage at high levels despite growth and strong operating cash flow.

In LatAm, financial policies have been mixed reflecting ratings headroom. We expect companies with low leverage to continue distributing excess cash as dividends to their parents, while companies with high debt levels will remain focused on deleveraging to improve their balance sheets.

In APAC, we expect telecom operators to generally maintain a disciplined approach to shareholder returns and financial policy decisions despite ongoing capital investment in next-generation networks and mobile spectrum. M&A activity however looms as a potential threat to this fiscal discipline, particularly for telecom operators looking to diversify into new revenue streams or geographies.

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Related research

- Can The Spike In Hybrid Issuance By European Telecoms Continue? Dec. 05, 2016
- Asia-Pac Telecom: Growing Data Usage Spurs Convergence And Technology In Developed Markets, Nov. 22, 2016
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
Cash, debt and returns

Global Telecommunications

Chart 15 – Cash and equivalents / total assets

Chart 16 – Total debt / total assets

Chart 17 – Fixed versus variable rate exposure

Chart 18 – Long term debt term structure

Chart 19 – Cash flow and primary uses

Chart 20 – Return on capital employed

Source: S&P Global Market Intelligence, S&P Global Ratings calculations