



ICRA's Approach to Rating Telecom Tower Infrastructure Companies

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From a credit perspective, the strength of a telecom tower infrastructure company lies in its ability to generate sustainable cash flows and to maximise returns on the capital invested, both of which in turn are exposed to the following risk factors:

1. Sponsor Risks
2. Ownership Structure
3. Operating Risks
 - a. Occupancy/Tenancy Level
 - b. Cost Competitiveness
4. Execution Risks
5. Market Risks
6. Contractual Risks
7. Counterparty Risks
8. Funding Risks
9. Financial Risks
10. Regulatory Risks

1. Sponsor Risks

Despite the non-recourse nature of tower infrastructure projects, the financial strength of the sponsor is an important key credit determinant, given that apart from contributing equity capital and subordinated debt, the sponsor is also directly or indirectly responsible for ensuring financial closure of tower infrastructure projects. Further, during the initial stage, projects can also involve recourse to the sponsor for debt servicing.

2. Ownership Structure

At present, there are broadly two kinds of operators in the domestic tower infrastructure industry:

- (a) Tower infrastructure subsidiaries, which are the spun-off tower divisions of the telecom-operator companies, and
- (b) Independent tower infrastructure companies (ITICs).

ICRA assigns lower risks to tower infrastructure subsidiaries of strong telecom operators, given the strong operational and management links between them. Moreover, tower infrastructure subsidiaries have an advantage in terms of assured occupancy from their parents, which in turn may serve to attract other tenants. Nevertheless, in certain cases, ITICs are in a better position to address the needs of telecom operators who have recently received licences and spectrum to launch operations in new circles because of their flexible roll-out plan offerings. Moreover, in some other instances, ITICs differentiate themselves by offering attractive payment terms (for instance, back-ended payment structure) to telecom operators, which enables the telecom operators to reduce their costs in their initial years of operation.

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3. Operating Risks

Operating risks pertain to the ability of a tower infrastructure company to establish a profitable and sustainable business model which is largely determined by the following key factors:

3.1 Occupancy/ Tenancy Level: The costs of operating a tower, particularly the ones borne by the tower company such as security and maintenance and ground rent, are largely fixed in nature. Thus each increment in tenancy is accompanied by a minimal increase in costs. This leads to a more than proportionate increase in profits for every increase in occupancy. Moreover, as per ICRA estimates, a tower infrastructure company earns reasonable returns only when its average occupancy level exceeds 1.7 times¹; thus its ability to retain and attract tenants is of paramount importance for its long term viability. This in-turn is significantly influenced by the following factors:

- **Contract or Anticipatory Approach:** Tower infrastructure companies normally set up tower sites going by the requirements of the telecom operators (contract approach), and the terms of the contract are specified beforehand in the Master Service Agreements (MSAs) signed by the two parties. However, some tower infrastructure companies follow the anticipatory approach, wherein they set up tower infrastructure at sites with reasonable demand potential and subsequently invite telecom operators to set up their network on these towers. In ICRA's view, the latter model involves higher business risks as the tower infrastructure company may not be able to achieve reasonable tenancy for its tower infrastructure and at profitable terms.
- **Emphasis on Client Servicing:** With competition intensifying in the domestic telecom tower infrastructure industry, client servicing is the key distinguishing factor that helps tower infrastructure companies increase and maintain the tenancy ratios of their tower portfolios.
- **Quality of Services:** Quality of services, as demonstrated by the up-time achieved by the tower infrastructure company, reflects its operating strengths and also determines its ability to compete with other tower infrastructure companies in getting future business. Thus companies with a track record of providing higher up-time are likely to attract more tenants for their towers.
- **Quality of Clients:** The presence of a reputed anchor tenant increases the tower infrastructure company's market visibility and perceived reliability factor.

3.2 Cost Competitiveness: Cost competitiveness plays a critical role in determining a tower infrastructure company's ability to withstand industry pressures. The cost competitiveness of a tower infrastructure company is reflected by its efficiency in optimising capital as well as operating costs.

3.2.1 Optimisation of Capital Costs: Broadly, the capital costs involved in setting up a telecom tower may be categorised under the following heads:

Table 1: Indicative Break-up of the Capital Cost of Establishing a Telecom Tower

Steel Tower	26%
Foundation Works, Civil Works	32%
Erection and Project Management Services	5%
Electrical Appliances/Equipment	36%
Approvals	1%
Total	100%

Source: ICRA's estimates

Going forward, with a large number of companies venturing into the tower infrastructure business, tower rentals are expected to come under pressure. Thus in order to stay competitive while simultaneously sustaining the overall returns on the capital employed, companies would be increasingly required to focus on reducing the overall capital costs. With steel and civil works constituting a significant portion of the total capital cost, companies can reduce their costs through initiatives such as (i) using advanced tower designing techniques to lower the overall steel usage, and (ii) rationalising civil costs.

¹ Please also refer to ICRA's note on "Telecom Infrastructure Industry in India"

3.2.2 Optimisation of operating costs: The operating expenses of tower infrastructure companies can be broadly classified under two heads: (i) non-reimbursable expenses such as site (land) rentals, security expenses, expenses on repairs and maintenance (of the tower), etc.; and (ii) reimbursable expenses such as electricity & fuel expenses, expenses on maintenance of air-conditioning and diesel generating sets, etc.

Non-reimbursable expenses: As rentals account for a significant portion of the non-reimbursable expenses of tower infrastructure companies, especially in urban areas, selection of appropriate sites at competitive rentals is important for their long-term viability. Moreover, as towers have a life of 15-20 years, entering into a long-term agreement with the land owners is also of critical importance for tower infrastructure companies as this not only reduces uncertainty over future rentals, but also decreases their relocation risks.

Reimbursable expenses: Reimbursable expenses, as the term implies, are usually passed on completely to the occupants of the tower; nevertheless, by controlling operating costs such as electricity and fuel expenses, tower infrastructure companies can enhance the viability of their occupants and in turn their own market positioning.

4. Execution Risks

As the tower installation process involves taking a large number of approvals and clearances from various authorities, tower infrastructure companies possessing the requisite skills and resources and having an established track record in the same are likely to face lower execution risks.

5. Market Risks

Given the presence of a large number of tower infrastructure players in India and their aggressive growth plans, ICRA assesses both the current and projected industry occupancy ratios. However a differentiation is made between tower infrastructure subsidiaries that are the spun-off tower divisions of telecom-operator companies; and ITICs as the former have an advantage in terms of assured occupancy from the parent entities.

6. Contractual Risks

In assessing contractual risks, ICRA takes up the underlying contracts or the MSAs between a tower infrastructure company and its clients to evaluate the adequacy of the coverage clauses and the extent of the company's exposure to market and counter-party credit risks. The contracts are also analysed to see if the terms are in accordance with the market trends. The other important factors assessed include among others the following (as in *Table 2*):

Table 2: Key Contractual Factors

Factor	Mitigating factor & its impact
Tenure of agreement	Longer the tenure of the contract, higher the predictability of revenues for the tower infrastructure company. Although tower infrastructure companies generally offer discounts on rentals in the case of longer-tenure contracts, such contracts lower the probability of tenants moving out of the towers, thus assuring a certain minimum level of occupancy.
Penalty clauses for premature exit from the agreement	Although it does not make economic sense for a tenant to shift out of a site once it has started using it (shifting electronic equipment to another site entails costs), an additional penalty clause in an MSA provides added assurance. Thus in case an MSA provides for a penalty payable by the operator for early exit, the risk of premature exit of the client declines significantly.
Re-negotiation of rentals	This risk is high, given the large number of tower infrastructure companies in the market and the incentive for tower infrastructure companies to charge lower rentals to ensure higher tenancy. However, the risk is partly mitigated if the MSAs are for longer tenure and the rentals and escalation clauses are specified clearly.
Coverage of space/ground rentals	In most cases, real-estate rentals are borne by the tower infrastructure companies. However, in case an MSA provides for sharing of such rentals beyond a certain level the same helps in insulating a tower infrastructure company's profitability against adverse movements in rentals.

7. Counterparty Risks

In assessing counterparty risks, an evaluation is done of the strength and reliability of the parties with which the tower infrastructure company has signed MSAs. This assumes considerable importance in ascertaining the credit strength of a company as a counterparty's failure to service the terms and conditions of the contract in a timely manner or their premature exit from the contract may severely impact the viability of the tower infrastructure company's business model.

8. Funding Risks

In assessing funding risks, the focus of analysis is on the tower infrastructure company's financial structure and its ability to tie up the requisite finances. The aspects analysed include, among others:

- *The capital structure of the company.* That is, whether the debt-equity ratio is in line with the underlying business risks and that of other companies of similar size and complexity.
- *The composition of debt.* Since the tower infrastructure business has a long gestation period, companies with longer debt tenure are better placed than companies with shorter debt tenure.
- *The nature of interest rate on the debt.* As a tower infrastructure company enters into definitive rental contracts with its occupants, a fixed interest rate debt ensures higher predictability of cash flows.
- *The pricing structure adopted for debt and the exposure of the debt to currency risks.* Such risks are particularly significant in case the company raises liabilities in a currency other than the one in which its revenues would be denominated.
- *The average cost of debt.* This is important, given that the cost of financing is a key determinant of a company's long-term viability.

9. Financial Risks

ICRA evaluates tower infrastructure company's past financial performance and draws up cash flow projections to assess the adequacy of their cash flows in relation to their debt repayment obligations. The process also involves a comparison of the service provider's key financial parameters and ratios with those of the others in the industry. The key parameters include capital cost per tower; average occupancy; and earning before interest, taxes, depreciation and amortisation (EBITDA) margin. The other key financial ratios that ICRA examines while rating a tower infrastructure company include:

- Earnings before Interest and Tax (EBIT)/Interest
- Total Debt/EBITDA
- Debt/Tangible Net Worth
- Retained Cash Flow (Net Cash Accruals)/Debt
- Free Cash Flows/Debt
- Debt Service Coverage Ratio
- Retained Cash Flow/Capital Expenditure

The ratio analysis is done taking into consideration the characteristics of the tower infrastructure industry. For instance, it is typical for a tower infrastructure company to have a high gearing as it invests heavily in setting up towers. Thus this gearing is viewed against the prospects of increase in cash accruals in future. While assessing the adequacy of future cash flows to meet debt servicing obligations, apart from the conventional debt servicing indicators, the issues looked at include peak funding requirements, means of funding the deficits, and status of funding tie-ups.

10. Regulatory Risks

The domestic telecom industry is a highly regulated one. The telecom infrastructure sector being a derivative of the telecom industry is sensitive to regulatory changes that have a bearing both on the telecom industry in general and on tower infrastructure companies in particular. Regulatory changes that have the potential to influence the intensity of competition in the industry are a key determinant of a tower infrastructure company's competitive positioning in the market.

In conclusion, ICRA's rating decision on a tower infrastructure company is influenced, in varying degrees, by several factors, the key among which are discussed in this note. ICRA remains open to incorporating changes in its rating methodology for rating telecom infrastructure companies either in response to or in anticipation of changes impacting the dynamics of the Indian telecom services. Such changes could be prompted by the evolving regulatory framework or change in competitive matrix among other factors.



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