This methodology document stands superseded. Refer to ICRA's website www.icra.in to view the updated methodology document on this subject.

ICRA

ICRA Rating Feature

Rating Methodology for Telecom Tower Infrastructure Providers

Overview

This rating methodology describes ICRA’s approach to assess the credit quality of telecom tower infrastructure providers and supersedes ICRA's earlier methodology note on this subject, published in May 2016. While this revised version incorporates a few modifications, ICRA's overall approach to rating telecom tower infrastructure services providers remains materially similar.

Entities in telecom tower infrastructure industry include players that build and operate telecom towers, which are leased to the telecom service providers (telcos), usually on long-term contracts called master service agreements (MSA). This document covers the salient operational and financial drivers that ICRA considers while evaluating the performance of the telecom tower industry.

Industry Structure

Starting from the tower assets being captively owned by telcos a few years ago, the tower industry has emerged as a separate industry with telcos hiving off the tower assets to become asset light and derive benefits of asset sharing. Gradually, there has been the emergence of independent tower companies in the industry. Going forward, the tower industry is likely to become more independently owned as telcos are relinquishing their ownership of tower assets with the objective of raising funds to meet the requirements of their core operations. In addition, the value unlocking in the infrastructure assets can be done only through increased sharing, which will drive the optimum utilisation of assets.

Telecom tower players build towers, incurring the upfront capital expenditure (capex), and then lease the same to telcos, usually on long-term MSA. Typically, with the addition of more tenants on a tower, the tower company (towerco) benefits from operating leverage, boosting its profitability. Thus, the business potential of the tower industry remains linked to the growth of the telecom services industry as the demand for towers is a function of the network rollout plans of telcos.

Over the last two to three years, the telecom industry has been witnessing several challenges. Intensified competition in the industry has challenged the positions of erstwhile market leaders and forced the weaker telcos to exit, driving consolidation. This has resulted in significant tenancy losses for the towers industry. Despite losses, the Indian telecom tower industry is one of the largest in the world with around 5,00,000 towers and around 7,00,000 tenancies as on December 31, 2018.

Stress in the telecom services industry and the need to raise funds by the telcos have driven the consolidation in the towers industry as well. Some of the major transactions over last two years have been the merger of ATC Group’s entities with ATC Telecom Infrastructure Private Limited (ATC TIPL) and the acquisition of towers from Idea Cellular Limited and Vodafone India Limited by ATC TIPL. Further, the major transaction underway is the merger of Bharti Infratel Limited and Indus Towers Limited. Over the next one year, the industry is likely to comprise two large players owning 60% of the tenancies. Apart from these two, the other major tower owners would be BSNL Limited and an investment trust set up by Reliance Industrial Investments and Holdings Ltd (RIIHL), a wholly-owned subsidiary of Reliance Industries Limited. Other than these, there remain players with small, or localised tower portfolio.

Rating Methodology

This rating methodology aims to help entities, investors and other interested market participants understand ICRA's approach in analysing quantitative and qualitative risk characteristics that are likely to affect ratings of entities in the telecom tower infrastructure industry. This methodology does not include an exhaustive treatment of all factors that are reflected in ratings but enables the reader to understand the rating considerations that are usually the most important.

ICRA's risk analysis framework for the entities in the telecom tower infrastructure industry can be broadly divided into the following elements –

1. Industry risk drivers
- Demand drivers
- Competition
- Regulatory risks
- Operating risks

2. Business risk drivers

- Scale and market position
- Geographic diversification
- Customer mix and strength of MSAs
- Trend in operating parameters

3. Financial risk drivers

- Profitability
- Leverage and debt coverage indicators
- Liquidity and financial flexibility
- Capex plans
- Tenure mismatches, and risks relating to interest rates and refinancing
- Contingent liabilities and off-balance sheet exposures

4. Management Quality and Corporate Governance

5. Parentage

1. Industry Risk Assessment

Demand drivers
The growth in the tower industry is directly linked to the network rollout by the telcos. Over the last few years, stress and consolidation in the telecom sector has manifested into revenue loss and debtors' write-offs for the tower industry. Further, there has been uncertainty over the future rollouts by telcos over the medium term and its consequent impact on the tower industry. Nevertheless, the industry has weathered the headwinds. With the ongoing consolidation, coupled with strong balance sheet position, it stands on a firm footing to explore the future growth opportunities.

Going forward, the rising data demand points to the need for more active network expansion by the telecom industry and thus additional tenancies for the tower industry. However, the telcos might look at more innovative solutions and upgrades instead of outright new tenancies. The telecom industry's stressed financial position may also create pressure on the tower rentals.

While evaluating the credit profile of the tower industry, ICRA borrows from its assessment of the telecom services industry. The financial profile and capex plans of telcos indicate the potential for growth in the demand for telecom towers.

Competition

Typically, any towerco has a degree of immunity from competition for the already built towers, as a limited number of tenants makes it non-economical for other towercos to set-up new towers in the vicinity at various locations. Nevertheless, competition among the tower companies remains intense, especially for the incremental business growth, given that the number of telcos has reduced. Intense competition can lead to pressure on rentals and lower incremental growth for the tower companies. ICRA looks at various factors such as the towerco's scale of operations, its existing tenancy ratio and average rentals earned. Entities having high average tenancy ratio attracts more tenants, given the nature of the industry as increased sharing leads to reduction in rentals for telcos. Further, entities generating higher average revenues per tower reflects its position in the industry.

Regulatory risks

Though regulatory oversight of the operations of a tower company is not excessive, the industry faces significant permitting risks for setting up towers. Given the concerns on the potential harm caused by the radiations emitted from the equipment on a telecom tower, there are strict guidelines by the regulatory authorities for setting up a tower. This can be a time-consuming process and the risk of not getting permissions remains high, impacting the growth plans of a tower company. ICRA assesses the stand of the regulatory authorities on this matter and the past track record of the towerco in complying with the regulations.

Operating risks

The telecom tower industry is required to maintain stringent quality norms and uptime at tower sites. This remains challenging, given the level of electricity availability from grid and the dependence on other sources such as diesel generators, renewable energy and batteries. Further, it requires regular capex for the replacement of batteries and generators at tower sites.

In addition, over the time, the design of telecom towers has undergone a significant change from bulky towers to lean towers and even to mobile towers. Going forward, it may even require replacement of the existing towers with new low-cost ones. ICRA looks at the estimates of routine maintenance and replacement capex of the company and the need for future capex depending upon the changing requirements.

2. Business Risk Drivers

Scale and market position

Typically, each tower is an individual revenue and cost head. Hence, the profitability of a towerco is more dependent on the average tenancies than on the number of towers, making the industry profitability largely agnostic to scale. Nevertheless, a towerco's scale of operations, as reflected in its tower portfolio base and its presence across telecom circles determines its market position and ability to cope with competition. A towerco with a larger tower portfolio can be preferred by the telcos on account of the following factors:

- Large tower companies offer wider coverage, which helps the telcos avoid dealing with multiple tower companies and makes the network rollout easier; this reduces the administrative costs
- Telcos can benefit from volume discounts that come with entering into contracts for a larger number of towers
- Each incremental tenancy on a given tower lowers the rental for all the tenants while increasing the overall revenue and profitability for a tower company; the larger tower companies could have higher average tenancies, gaining greater cost amortisation and becoming more attractive for telcos

Geographic diversification

As mentioned earlier, the profitability of a towerco can be scale agnostic. However, an entity with large tower portfolio provides certain benefits to telcos, which in turn provides competitive advantage to the towerco. A key advantage provided by any large tower company is its presence across geographies, which makes it easier for telcos to deal with few towercos for their pan-India network coverage. Thus, a towerco with healthy geographic diversification is viewed favourably. Moreover, the presence in high-density circles increase the potential of higher tenancy and hence better profitability.

Customer mix and strengths of MSA

The customer mix of a towerco is an important rating driver. Since the telecom industry has been largely consolidated, the customer base of towercos has reduced. In such a case, the business dependence of a towerco on a given telco could be high, implying significant impact on its profitability and liquidity in the event of loss of business from the telco. Nevertheless, given that towers are critical to the smooth functioning of a telco, and it could be challenging to shift tower sites in a short period of time without disrupting service quality, the tower industry enjoys high customer stickiness. Overall, the credit profile of tower players draws from the strength of its tenants as these influence not only the future growth potential of the tower player, but also have a bearing on the timeliness of lease rental receipts.

ICRA looks at the key terms of MSAs entered into by a towerco with its major tenants to assess aspects including the lock-in period, renewal terms, escalation clause, impact of new tenant addition or vacancy on the rentals, various kinds of tenancies, and penalties payable on premature termination. All these are critical to assess the certainty of revenues, the likely impact in case of volatility in tenancies, recourse to a towerco in case of exits, etc. The average residual life of leases on the tower portfolio provides a measure of revenue visibility. Further, towercos having MSAs with strong compensation clauses in the event of termination are viewed positively as such measures indicate greater stickiness as well as adequate termination compensation.

Trend in operating parameters

The key operating parameters for tower companies are average tenancy ratio, average revenue per tenant per month (ARPT), and average revenue per tower per month (ARPTo). As the telecom tower industry is highly capital intensive, the tenancy ratio (average number of tenants per tower) has a strong bearing on the profitability and return potential, as it adds to the revenues at a relatively lower incremental cost. Since incremental tenancies result in lowering of rental for all the telcos at a predetermined rate, more tenancies are preferred by telcos too.

Apart from the tenancy ratio, the nature of tenancies impacts the revenues and profitability of a towerco. Incremental tenancies could be in the form a full tenant that takes up the space for antenna, electronic equipment and other active infrastructure; or it may be an add-on/loading tenancy, wherein an existing tenant takes up relatively lesser than full tenancy space to install equipment such as base transceiver station for new technology. This results in the addition of relatively lower revenue than a full tenancy. Thus, the impact of add-on/loading tenancies is better estimated through ARPT and ARPTo.

While how a towerco defines a tenancy (full vs add-on) may vary, which can alter the tenancy ratio and ARPT across towercos, each towerco would overall look to increase its ARPTo which becomes a key measure of the return potential. For instance, increasing tenancies may result in a decline in ARPT. However, it is expected to increase the ARPTo. Moreover, a weak demand scenario and or financial stress in the telecom service industry can lead to some downward renegotiation of rentals of tower companies. Trend in these metrics are important determinants of the credit profile of a tower entity.

3. Financial Risk Assessment

Since the prime objective of the rating exercise is to assess the adequacy of the entity’s debt-servicing capability, ICRA draws up projections on the likely financial position of the entity under various scenarios, taking into account the entity’s existing tenants mix, growth expectations, operating parameters, cost structure, working capital cycle, capex programme, debt repayment schedule, its funding requirements, and the funding options available to it. Besides, ICRA takes into account the commitments of the entity towards other Group entities, new ventures, and its investments in subsidiaries/SPVs. These cash flows are then used to determine the entity’s future debt-servicing capability under various scenarios.

The various financial metrics assessed by ICRA could be divided into four categories — profitability, leverage, coverage, and liquidity. This document provides a summary of why ICRA considers these ratios to be important. For a more detailed description, readers may refer to the note titled, Approach for Financial Ratio Analysis, published on ICRA’s website.

In case of Groups consisting of entities with strong financial and operational linkages, various parameters such as capital structure, debt coverage indicators, and future funding requirements are assessed at the consolidated/Group level.

Profitability

Profitability metrics are a measure of an entity's efficiency and return on investments. It is imperative for most businesses to invest regularly in physical assets and product development (such as energy saving solutions) to sustain or improve their competitive position. Entities that have superior profitability are able to do so through internally-generated resources with low dependence on external financing. Moreover, such entities are able to generate sufficient surplus for not only meeting debt servicing obligations but also to reward equity investors. This in turn improves their ability to attract fresh capital for future business requirements. Entities with higher profitability also have better resilience to economic downturns.

The entities in the telecom tower industry undertake upfront capex and expect to earn a steady rental income on the assets and hence have a long payback period. Given such capital-intensive nature, a telecom tower entity benefits substantially from its operating leverage. The increase in utilisation of tower assets through sharing brings more revenues to the entity at lower incremental costs and helps it register improvement in profitability. Consequently, the profitability of a tower company is directly linked to the growth in tenancies.

The largest cost head for a towerco is the power and fuel expenditure incurred on running towers. The industry largely works on a model of recovery of these costs from the telco, over and above the tower rental. The prevalent models are of reimbursement of actual power and fuel expenses, and of pre-determined fuel recovery irrespective of the actual expenditure incurred. ICRA looks at the tower entities' profitability, taking into consideration the net gain/loss on power and fuel reimbursements, while excluding the absolute values. Apart from this, employee expenses and administrative expenses are the major heads and indicators of the operating efficiency of the towerco. Receivable write-offs can depress the profitability of a towerco in case of stress in the telecom industry.

A towerco's ability to keep its costs under control and the increasing level of automation to track operational issues at towers can aid the profitability.

Leverage and debt coverage

Leverage ratios measure the indebtedness of an entity. Entities that pursue an aggressive financial policy, including heavy reliance on debt financing, are likely to be more vulnerable to downturns than entities that employ conservative financial leverage. A low financial leverage is viewed as a credit positive. Besides protecting the cash flows by imposing a lower debt service burden, especially during periods of stress, lower leverage also imparts greater financial flexibility to raise incremental external capital (debt or equity) for re-investment in business or to tide over temporary funding shortfalls. ICRA also notes that the extent to which an entity leverages its balance sheet is, in addition to business requirements, a function of the philosophy of the management towards growth and funding mix.

The capital intensity of the tower industry is high as the entire capex is done upfront, while the revenues are generated over a period of time. Thus, typical of other infrastructure sectors, a significant portion of the capex in the tower industry is debt funded. Entities with long tenure debt are viewed favourably. Typically, a towerco at a growing stage would have higher debt in its books. Once a tower portfolio stabilises, growth comes more from incremental tenancies rather than from additional tower rollout. This lowers the capex and allows for steady amortisation of debt.

Apart from the capital structure, ICRA pays attention to coverage indicators including interest coverage, debt service coverage, operating profit and net cash accruals relative to total debt, while evaluating the financial health of a tower entity. ICRA is particularly concerned with an entity's capability to honour its contractual obligations under stress conditions. For a stable tower portfolio with steady cashflow generation and predictable capex plan, the debt service coverage ratio (DSCR) over the life of the outstanding debt captures the level of comfort in debt repayment.

Liquidity and financial flexibility

Liquidity ratios measure the buffer, which an entity has in the form of cash or cash equivalents with respect to its obligations that can be utilised in case of any temporary cash flow mismatch. The existence of adequate buffers of liquid assets/bank lines to meet short-term obligations is viewed positively. In addition, ICRA notes that an entity with strong liquidity can mitigate the impact of any short-term exigencies or events that might adversely impact cash flows. The entity's liquidity and financial flexibility is assessed by its unutilised bank/credit limits, liquid investments, and the nature of its relationship with banks, financial institutions and other intermediaries, strategic importance of the entity to the Group to which it belongs, along with the financial strength of the Group entities.

In addition, ICRA looks at the working capital metrics of the tower entities, with receivable levels being the key. Receivables of a towerco can be on account of the tower rentals and other charges, especially the power costs. A routine payment cycle is expected and is usually followed in case of rentals. However, the power expenses can involve reconciliation and can be a source of disputes. A tower company with sound expense tracking and recording mechanism would have lower probability of claims getting stuck in disputes and hence would have better receivables management and more steady cash flow generation. Such companies are viewed favourably. ICRA also looks at the ageing profile of receivables, trends of debtor write-offs and bad debts, and also the management's approach towards preventing such recurrence.

Capex plans

ICRA looks at the capex philosophy of a towerco. It may follow the anticipatory rollout (i.e. tower rollout in anticipation of potential demand) approach or may choose to rollout based on at least one confirmed tenant. The latter lowers the risk for a tower company as it provides assured minimum rental from the outset and improves asset utilisation. Thus, built-to-demand tower erection is considered favourably compared to anticipatory development of towers. The capex plan of a tower company for the next few years and the funding plan thereof are considered among other variables to evaluate the future cash flows.

Tenure mismatches, and risks relating to interest rates and refinancing

Large dependence on short-term borrowings to fund long-term investments can expose an entity to significant re-financing risks, especially during periods of tight liquidity. Financial flexibility, and the existence of adequate buffers of liquid assets/bank lines to meet short-term obligations is viewed positively. Similarly, the extent to which an entity may be impacted by movements in interest rates is also evaluated.

Contingent liabilities/off-balance sheet exposures

ICRA evaluates the likelihood of devolvement of contingent liabilities/off-balance sheet exposures and the financial implications of the same.

4. Management Quality and Corporate Governance

All debt ratings necessarily incorporate an assessment of the quality of the rated entity's management. An entity with experienced management and independent directors on its board are considered positively. An entity should practice sound corporate governance policies to serve the interest of all stakeholders. The management risk analysis also factors in the historical track record of the entity or Group in timely servicing its obligations. Any delay or default history in the repayment of principal or interest payments reduce the comfort level for the rated entity's future debt servicing capability and willingness. Nevertheless, ICRA appropriately analyses the reason behind past defaults, which could also be due to adverse demand situations in the underlying industry.

In addition, the rated entity's likely cash outflows arising from the possible need to support other Group entities are of importance, in case the rated entity is among the stronger entities within the Group. Many tower companies have a track record of upstreaming cashflows through dividend, during periods of low capex. Usually, a detailed discussion is held with the management of the rated entity to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the rated entity's industry.

Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Policy of the promoter/management to risk taking and containment
- The entity's policies on leveraging, interest risks and currency risks
- The entity's plans on new projects, acquisitions, expansion, etc.

5. Parentage

Apart from standalone credit considerations, the likelihood of extraordinary support from the parent to an entity or the support that an entity is likely to extend to the other Group companies is factored while assessing the credit profile of the entity. This process involves an assessment of the ability and willingness of the parent to extend support to the entity (and vice versa), in addition to evaluating the entity's own fundamental credit strength.

Summing Up

ICRA's credit ratings are a symbolic representation of its current opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at, based on a detailed evaluation of the entity's business and financial risks, its competitive strengths, its likely cash flows over the life of the instrument being rated, and the adequacy of such cash flows vis-à-vis its debt servicing obligations. As the note has highlighted, for tower companies, special attention is paid to the scale of operation, positioning in the market, customer profile, geographical diversity, management strategies and an overall approach towards managing liquidity and growth.

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