RATING METHODOLOGY - TELECOM SERVICES

July 2023

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in July 2021. While this revised version incorporates a few modifications, ICRA's overall approach towards rating mobile service providers remains materially similar. Also, a section has been added to provide a broad perspective on how environmental, social and governance (ESG) risks are incorporated by ICRA in its credit assessments.

Overview

The Indian mobile telecom service industry is the second largest in the world, with more than 1.14 billion subscribers as of March 2023. While the subscriber base has largely plateaued, the focus of the operators has been on increasing the penetration of data services, upgrading technology along with expanding the scope of digital services.

The industry landscape that was dotted with more than 14 players around a decade ago, has since witnessed significant consolidation and increase in intensity of competition, post the launch of services by Reliance Jio Infocomm Limited (RJIL) and is now left with three privately-owned telecom companies (telcos), namely Bharti Airtel Limited (BAL), Vodafone Idea Limited (VIL) and RJIL, along with the state-owned Bharat Sanchar Nigam Limited (BSNL) and Mahanagar Telephone Nigam Limited (MTNL).

The elevated competitive intensity manifested into one of the steepest price competitions, resulting in a sharp decline in the Average Revenue Per User (ARPU), which reached its nadir in FY2019. However, post the consolidation, the telecom operators implemented steep tariff hikes and aggressively focused on upgradation of subscribers to 4G from 2G, which, coupled with increase in usage of telecom services, resulted in a steady ARPU improvement.

The industry continues to grapple with high debt levels, which is primarily on account of the deferred spectrum liabilities which relates to the spectrum, which is purchased by the telcos from the Government of India to provide mobile services.

The sector is also focusing on digital transformation and non-telecom businesses viz., enterprise business, cloud services, digital services, and fixed broadband services. Further, in terms of the core business, technology upgrade to 5G could be the growth driver with anticipated increase in the data usage and digital services.

This rating methodology explains ICRA's approach to assessing the business and financial risk profiles of mobile service providers. It aims to help issuers, investors and other interested market participants understand ICRA's approach to analysing the quantitative and qualitative risks that are likely to affect rating outcomes in this sector. The list of rating drivers covered in this methodology is not exhaustive by itself but provides an overall perspective on the rating considerations that are usually considered the most important. For analytical convenience, the key factors are grouped under the following broad heads—Industry Risk Assessment, Business Risk Assessment, Financial Risk Assessment, Strength of Promoters, Event Risk, Management Quality & Corporate Governance Assessment.

Industry Risk Assessment

- Regulatory Risks
- Technology Risk

Business Risk Assessment

- Scale
- Competitive Position
- Technical Positioning and Spectrum Holding
- Business Diversification

Financial Risk Assessment

- Profitability Metrics
- Leverage and Coverage indicators
- Cash Flows and Liquidity Profile
- Capital Expenditure and Investment Plans
- Tenure Mismatches and Risks Relating to Interest Rates and Refinancing
- Foreign Currency Risk

Other Elements of Credit Risk Assessment

- Parentage/ Group Support
- Financial Flexibility
- Debt Servicing Track Record
- Contingent Liabilities and Off-balance Sheet Exposures
- Event Risk

Management Quality Assessment

Assessment of Environmental, Social and Governance (ESG) Risks

- Environmental (E) and Social (S) Risks
- Governance Practices

Industry Risk Assessment

Regulatory Risk

The telecom mobile service industry in India is regulated and the regulatory environment has a critical bearing on a mobile service player's rating since it affects a telco both operationally as well as financially. The regulatory environment influences, directly or indirectly, the intensity of competition, industry's pricing power, a telco's spectrum holding, possibility of spectrum addition, pricing of spectrum, opportunities for introduction of new services/technologies, and levies on the telcos. India's telecom sector is governed by the Ministry of Communications with specific roles performed by four main institutions:

- The Digital Communications Commission (DCC) (erstwhile Telecom Commission)
- The Department of Telecommunications (DoT)
- The Telecom Regulatory Authority of India (TRAI)
- The Telecom Dispute Settlement and Appellate Tribunal (TDSAT)

The DCC was set up by the Government of India in 1989 as the Telecom Commission to deal with various aspects of telecommunications and was later rechristened as DCC in 2018. This, along with the DoT, is responsible for the formulation of policies, licensing, spectrum management, and enforcement of wireless regulatory measures. TRAI on the other hand was established as an independent regulatory authority under the TRAI Act, 1997, and has a mix of mandatory and recommendatory powers. The mandatory functions relate to interconnections and standards for quality of services (QoS) while the recommendatory functions include amendments in the licensing framework. The TDSAT was set up under the TRAI Amendment Act, 2000, to adjudicate disputes with a view to protecting the interests of service providers and consumers of telecom services. The TDSAT's primary functions include arbitration of disputes between a licensor and licensee, between two or more service providers, and between a service provider and a group of consumers, besides adjudicating on appeals against any decision or order of the TRAI.

Over the past two decades, there has been a significant strengthening of the regulatory structure of the Indian telecom industry. Following the regulatory changes, the industry has moved from being one in which DoT acted as the sole service provider, regulator, policymaker and arbitrator (in case of disputes) to one in which the industry structure is highly competitive and there is greater delineation of roles and responsibilities. Further, the telcos have been allowed greater flexibility in fixing the tariffs.

There have been many regulatory developments in the past such as evolution of spectrum allocation process, approval of spectrum sharing and trading, reduction of interconnection usage charges, and changes in the limit of maximum spectrum that a telco can hold. With these, the regulatory risks have declined over the past few years with the emergence of a more stable and predictable regime.

A major issue which is sub-judice is the one-time spectrum charge. A telco holding spectrum beyond 6.2 MHz/circle between July 2008 and December 31, 2012 and beyond 4.4MHz/circle, between January 2013 till the expiry of the licence was required to pay a one-time market-linked price for the excess spectrum held. These also would translate into sizeable pay-outs for the telcos, including interest and penalties, which if needed to be paid would exert additional burden on the telcos.

Apart from these, availability of spectrum across bands as well as spectrum pricing and usage, along with auctioning of the same as per requirements of the industry remain important areas requiring constant involvement of the regulator.

Technology Risk

Telecom is a technology-intensive industry and changes and development of technology remain the most dynamic aspect of the industry. After operating primarily in voice services using the 2G technology, the Indian telecom industry witnessed frequent changes in terms of newer technologies during the last few years. These include upgradation to 3G followed by quick upgradation to 4G and now a transition phase to 5G. With the technology upgradation lined up, innovation in products and services will be a key differentiator and also a key monitorable.

Considering the intense competition prevalent within the telecom sector, a key differentiator remains the ability of an operator to offer a diversified portfolio of innovative products and services on superior technological platforms. A telco has to choose what products and services to offer and the technological platform for delivering these services. However, as telcos have to make considerable investments to be able to offer such services, ICRA's rating decision is influenced by the risk/return prospects of the technology platform chosen by the telco. Given the rapid technological developments, a telco faces the risk of competition from other players who have access to superior technology via global tie-ups and hence can offer high-quality services. Moreover, in the long term, keeping in view the rapidly evolving mobile telecom technology, there is a risk of obsolescence and asset replacement.

Another aspect of the technology risks faced by the industry is the device ecosystem available with the customers. While a telco may have spectrum in a particular frequency band to offer a particular service, the device ecosystem for that band and service combination may not be adequately developed. This can leave the telco's spectrum unutilised, thereby impacting its return on investments. Thus, technological advances pose a significant challenge on many fronts, including capability to support seamless transition without affecting the network quality, financial strength to support investment required to upgrade the network, and management capability to assess revenue potential from new services. Another possible risk, though not visible in foreseeable future, on technology front can be proliferation of satellite-based communication services which can pose a threat to the existing terrestrial network.

As technological upgrades require considerable financial investment, ICRA analyses a telco's financial ability to make periodic investments for technological upgrade and also analyses the risks associated with, and the prospective returns from, the combinations of various frequency bands of spectrum chosen by the telco.

Business Risk Assessment

The main factors that determine an issuer's business position are its scale and market position in terms of revenues and subscribers market share, ARPU movement, spectrum holding, attractiveness of its circles of operations, its operating strengths and economies of scale drawn from presence across circles, and business diversification.

Scale

Scale is an important rating consideration for the telecom sector, as it influences a telco's ability to tide through a period of adverse changes in the operating environment. Scale also gives an indication on the extensiveness of the company's customer base, penetration of its services, ability of the company to bundle products, and pricing power in the market. Larger scale also enhances the access to capital markets and thus provides financial flexibility. It can also enable a better leverage position with the tower companies, suppliers of the network equipment and the network management service providers, which can translate into superior network quality at competitive costs.

Given the highly capital-intensive nature of the industry and the extensive marketing costs involved in customer acquisition and retention, adequate pricing power of any player in the industry is critical. This in turn is driven by the prevailing competitive landscape as well as the scale and size of an individual telco.

Competitive Position

During the past few years, the industry structure has witnessed a transformation from a highly fragmented one to more of an oligopolistic one, with three private players and two state-owned telcos. This transition was accompanied with heightened competition, which brought along with it an aggressive pricing regime, translating into one of the steepest falls in APRU levels. This in turn impacted revenue growth and profitability metrics and had a critical bearing on the industry in terms of operational metrics and financial health. ICRA's rating decision at any point in time assesses the prevailing competitive intensity, the strengths of the various players and the strategies adopted by them to counter competition.

The competitive position of a telco is measured in terms of its revenue market share and its ability to generate revenue from its subscribers, measured in terms of ARPU. The relative position and strength of a service provider are integral to the sustainability of its operations along with its ability to counter competitive pressures. A larger market share also ensures greater network efficiency and utilisation, besides providing opportunities to cross-sell different products. Moreover, telcos who offer seamless coverage, better quality and lower congestion have a competitive advantage. ICRA has observed that the market share of a telco in a circle is directly proportional to the coverage quality. Thus, to determine the potential for subscriber growth and penetration of telcos, ICRA monitors the current coverage and network rollout plans, which include, among other factors, the current and planned number of cities covered and the number of cell sites in a circle, as well as certain quality of service (QoS) parameters which act as hygiene factors for provision of services by the telcos.

Moreover, relative positioning of the company also provides an insight on its ability to innovate and introduce new products and also implement price hikes/changes and increase ARPU levels. Thus, ICRA associates lower risk with players having a significant revenue market share.

Further, given the intense competition, market positioning also reflects the ability of the company to command premium ARPUs vis-à-vis the competition by way of technological upgradation, bundling of services, introduction of new products, and/or direct tariff hikes.

Apart from this, the quality of subscribers is also an important determinant of revenue generation and ARPU levels. A healthy addition to the subscriber base does not necessarily translate into revenue growth. Rather it depends on the quality of subscribers ascertained by the active subscriber base, the technology opted by the subscribers – 2G, 3G, 4G, etc. and the usage of the services by the subscribers. The subscriber mix of pre-paid versus post-paid is also a determinant of the ARPU level as post-paid subscribers on an average generate better ARPU and have higher stickiness compared to prepaid subscribers. While India remains predominantly a prepaid market, higher proportion of post-paid subscribers provide an edge to a telco to some extent. Moreover, higher proportion of prepaid subscribers results in higher subscriber churn since prepaid subscribers (especially economically marginal subscribers) are largely influenced by costs and remain targets of competitive pricing strategies.

Thus, while assessing market position, ICRA looks at the market share of the telco along with the trend in its ARPU levels.

Technical Positioning and Spectrum Holding

Another important parameter while analysing the operating profile of a telco is the spectrum holding across different spectrum frequency bands across circles. The adequacy of spectrum holding of a telco across different bands determines the number of subscribers it can service, the quantum of data it can handle, the services/technologies it can provide - voice, 2G, 3G, 4G/LTE, 5G, etc. and the associated growth potential. In addition, since spectrum in each band for each circle is allocated by the DoT for a fixed period (typically 20 years), the residual licence period of a spectrum is critical to assess the business continuity of a telco, especially in light of the fact that the renewal of this spectrum entails sizeable funding commitments, which can have a significant bearing on a telco’s financial profile. Telcos with sizeable spectrum across different bands for sufficient tenure are viewed favourably compared with telcos that may not have sufficient spectrum in critical bands or whose spectrum holding may be nearing expiry. Another factor examined to analyse the spectrum holding of a telco is the contiguity of spectrum in an individual band, although this is increasingly getting addressed in the auctions that have happened lately. Contiguous spectrum allows for better utilisation of spectrum and improved service quality.

Incrementally, the spectrum band is getting agnostic to the services that could be provided by the telcos and the technology on which these services are being provided. While lower band spectrum (sub 1 GHz) is more efficient and provides wider coverage, and a high band (2300 MHz, 2500 MHz, 3300 MHz, etc) is primarily used to create capacities.

Business Diversification

Business model diversification helps considerably to reduce the risk associated with competition, demand changes, litigation and other unforeseen issues. In the period starting H2 FY2017, which witnessed steep price-based competition and the mobile services segment was impacted severely, telcos with diversified operations were able to sustain the price shock and emerged stronger. While mobile services remain the mainstay of the telcos, other revenue streams like enterprise business, fixed line services, home broadband and tele-media services provide a degree of diversification to tide over pressures in one particular segment.

The telecom industry is in a transformation phase and the focus of the operators is on the digital services (which include content-based services – music, movies, etc, cloud-based services, personalised solutions for businesses such as embedded Communications Platform as a Service, etc) which provide another stream of revenue. These additional services not only act as a revenue source for the telcos, but also help in customer stickiness and retention.

While assessing this parameter, ICRA evaluates the proportion of revenues from non-mobile services.

Summary of the Salient Business Risk Factors

	Strongest	Weakest
Scale, Market Share and ARPU levels	The entity has large scale of operations, is the market leader with highest revenue and subscriber market share, with industry leading ARPU levels	The entity is a small player in the industry, and trails all the other players with low revenue and subscriber market share, with low ARPU levels
Technical positioning and spectrum holding	The entity has sizeable spectrum holding, with a significant proportion in the sub-GHz band, with a distant expiry profile, so as to enable it to provide an array of services	The entity has low quantity of spectrum, with a low quantum in sub-GHz band, with nearing expiries, which limits its ability to provide an array of services
Business diversification	The entity derives more than 20% of its revenues from non-mobile services like DTH, enterprise business, home broadband, etc	The extent of business diversification is low, and the entity generates more than 95% of its revenues from mobile services segment

Financial Risk Assessment

While assessing the financial risk profile of a mobile service provider, ICRA evaluates its profitability and cash flow generating ability, balance sheet strength and the sources of financial flexibility, all in relation to various committed and contingent obligations. ICRA analyses past financial performance trends as well as estimates future financial performance to assess the financial risk exposure of an entity. The financial metrics provide a useful reference not only to evaluate the performance trends of an entity over a given time horizon, but also enable a comparison with its peers. This document provides a summary of some critical ratios that ICRA considers important in its assessment. For a more detailed description, readers may refer to the note titled Approach for Financial Ratio Analysis published on ICRA's website. Some of the key metrics analysed are discussed below. To factor the uncertainty around how the various credit drivers could evolve in the future, ICRA also carries out sensitivity analysis to assess the impact of the key variables on the various financial metrics.

Profitability

A company's profitability levels and its ability to sustain/improve the same remain key factors while evaluating its credit quality. 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, product development, marketing, and human capital so as 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. Moreover, entities with higher profitability have better resilience to economic downturns and are more likely to generate adequate internal resources for re-investment and debt servicing.

Profitability can be influenced by multiple factors, including those that are company-specific, such as product/customer profile, diversification, etc, or those that are related to the industry, economy, or regulations. From a rating perspective, both the level as well as the stability in profitability metrics matter.

Since operating leverage is high for the telecom industry, sustained revenue growth is a strong positive and typically reflects increase in a telco's market share on the back of subscriber addition, improvement in ARPU or ability to command premium pricing. These factors along with improvement in cost structure results in improvement in profitability. The key components of a telco's operating cost structure are as follows:

- Network-related costs
- Customer acquisition costs
- Other regulatory pay-outs

Network-related Costs: For a telco, the key network related costs are cell site rentals (with implementation of AS-116 these are no longer classified in operating costs and are recognized as right-of-use asset / lease liability with corresponding depreciation and financial charges), transmission costs, power and fuel, and maintenance costs. Given the high capital intensity of the industry, sharing of infrastructure improves asset utilisation for the entire industry and helps lower funding requirements. Inadequate utilisation of network capacity can lead to significantly weak profitability. For the private telcos on average, these costs are around 25% of their revenues.

Customer Acquisition Costs: Customer acquisition costs include promotional tariffs, discounted traffic, margins given to distribution channels, and the means to lower subscriber entry costs such as subsidies on handsets and bundled packages. In a competitive environment, it becomes increasingly difficult to reduce customer acquisition costs. Therefore, ICRA analyses the strategies adopted by telcos to utilise their distribution channels effectively and the initiatives taken by operators to lower distribution costs.

Other Regulatory Payouts: Apart from the above operating expenses discussed, a telco has to make some mandatory regulatory pay-outs to the Government, such as licence fees and spectrum usage charges. Both are calculated as percentages of the Adjusted

Gross Revenue (AGR)[1]. Till 1999, telcos had to pay a fixed licence fee to the Government, but after the New Telecom Policy 1999, a revenue-sharing arrangement was put in place. The licence fee was set at 15% of the AGR initially. In 2003, the licence fee was revised to 6-10%, depending on the category of circle. In 2013, the fee was fixed at a uniform 8% of the AGR across circles. Out of this 8%, 5% goes towards funding of the Universal Service Obligation Fund (USOF)[2]. On the other hand, the telcos pay a Spectrum Usage Charge of 3-8% of their AGR depending on the quantum of spectrum held. However, during January 2014, the SUC for the spectrum acquired in and after February 2014 auctions was set at a flat 5%, which was reduced to 3% of the AGR for the spectrum acquired in and after the 2016 auctions. This was further reduced to zero for future auctions post September 2021. Any change in these regulatory pay-outs may have an impact on the profitability and the cash flows of telcos.

The ability to sustain/improve profitability is one of the key factors that ICRA looks at while differentiating between companies. The high capital intensity in the telecom industry mandates high operating efficiencies for telcos to be able to maintain stable profitability. Regulatory payments and ability to increase tariffs remain some key business challenges for telcos. Accordingly, a telco's ability to sustain adequate margins is a key factor to analyse.

The operating margins of the private telcos range between 40%-52%, while the RoCE remains low due to high capital requirements.

Leverage and Coverage indicators

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 adverse changes in the operating environment than entities who employ conservative financial leverage in their business. A low financial leverage is viewed as a credit positive for telcos. Besides protecting the cash flows of players by imposing a lower debt service burden, especially during periods of operating 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. While calculating overall indebtedness, ICRA includes lease liabilities and deferred payment liabilities as part of the debt.

ICRA assesses the financial policies followed by the company to determine the risk appetite of the management and the impact of the same on the financial performance of the company. ICRA also notes that the extent to which an entity leverages its balance sheet is, in addition to business requirements, also a function of the philosophy of the management towards growth and funding mix.

The extent of leveraging and, hence, financial flexibility, are reflected by leverage ratios like Total Outside Liabilities/Tangible Net Worth, Total Debt/OPBDIT and Net Cash Accruals (NCA)/Total Debt. Low leverage ratios reflect low reliance on debt funding, and better ability to raise funds from varied sources in times of need.

Apart from the capital structure, ICRA also pays attention to coverage indicators like Interest Coverage and Debt Service Coverage Ratio (DSCR) reflect the ability of the company to service its external borrowings after meeting its expenses. ICRA evaluates the coverage indicators of the company to determine how comfortably it can service its debt obligations through accruals from its business.

Cash Flows and Liquidity Profile

The rating exercise is primarily focused on assessing the future debt servicing capability of a company. Since it is cash that is required to service the debt obligations, it is imperative that a cash flow analysis is undertaken to evaluate the external funding requirements and likely financial position of the company, going forward. A cash flow statement represents the sources from which cash is generated, as well as its deployment. Analysed here are the trends in an entity's funds flow from operations,

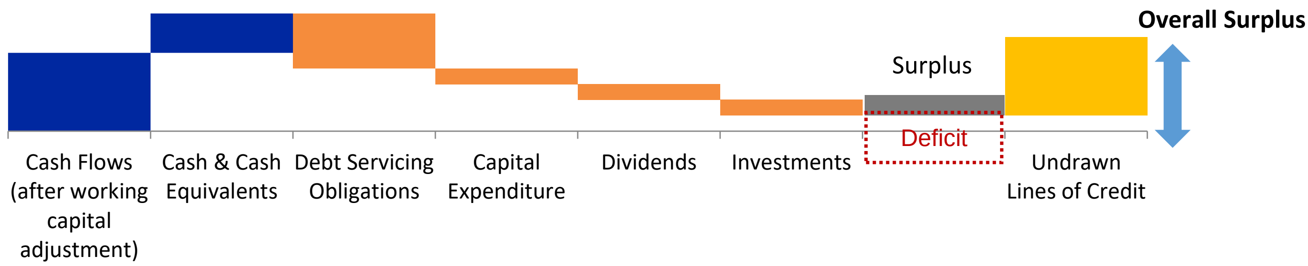
1 AGR is arrived at by reducing non-telecom revenues, receipts from USOF, non-operating income (dividend, interest, etc) from the Gross Revenue along with exclusion of access charges, roaming revenues and applicable GST. For latest definition, please refer to https://dot.gov.in/sites/default/files/AGR%20Amendment.pdf

2 USOF is a fund managed by an Administrator appointed by Central Government and this is an attached office of the DOT. This was established with a fundamental objective of providing services to remote and rural areas at affordable prices.

cash consumed to fund the working capital, the retained cash flows after paying out dividends or carrying out share buybacks, and the free cash flows after meeting debt repayment obligations and capital expenditure needs.

ICRA also evaluates the liquidity profile of the company to assess its ability to meet short-term fund requirements from various internal and external sources. The existence of adequate buffers of liquid assets and bank lines are viewed as a credit positive, and the same is evaluated alongside the drawing power available with the company to assess its ability to meet temporary shortfalls in funding requirements. 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 in the interim. While evaluating the liquidity profile of a company, ICRA takes into consideration the unencumbered cash balances and liquid investments available to the company, unutilised bank/credit limits available, and its internal cash generation capability. ICRA evaluates the free cash flows of the company and its variability to determine its ability to meet cash obligations like debt repayments and investments from its own internal cash flows. Higher the cushion available between the resources available (especially internal resources) and the obligations, better is the liquidity profile of an entity. ICRA also notes that the liquidity available with an entity may be for a temporary period and, hence, its overall policy towards maintaining adequate liquidity (given the trade-off between returns and liquidity) is accorded due importance in the analytical approach.

Liquidity snapshot over any defined period



Capital Expenditure and Investment Plans

The primary capex in the telecom industry is towards creating, maintaining and expanding the network infrastructure. Spectrum is the key raw material for the industry and is acquired through auctions for a period of 20 years. Spectrum acquisition involves sizeable cash outflow and generally has a deferred payment plan. The telecom industry is highly capital-intensive and there is a need for incurring consistent capex to stay ahead of competition and to provide adequate quality of services to the consumers. The capex intensity as measured by the ratio of annual capex to revenues remains high whenever there is a technology transition or there is a spectrum auction. On an ongoing basis (excluding spectrum acquisition related capex), the industry will be required to incur capex in a timely manner to keep pace with the technology changes. This was witnessed with the expanding of the network for 4G services and is likely to continue with the advent of 5G, which will prevent the capex intensity from dipping materially, being driven by the need for increasing fiberisation to take care of the rising data usage. The market position of the telecom operator, the quantum of the capex and the funding plans for the same are evaluated to understand the overall impact on the credit risk profile of the company.

Tenure Mismatches and Risks Relating to Interest Rates and Refinancing

Tenure mismatches, like funding of long-term investments through short-term borrowings, expose a company to refinancing risks. Such risks are especially significant in periods of tight liquidity. ICRA takes into consideration the adequacy of long-term funds in meeting the long-term funding requirements, measured by the current ratio, with a higher ratio signifying lower mismatch between tenure of assets and borrowings. While evaluating the adequacy of future cash flows, ICRA also takes into account the impact of movement in interest rates on the cash flows of the company, and the extent to which the debt servicing ability of the telco would be impacted by the same.

Foreign Currency Related Risk

The vulnerability of a mobile service provider to fluctuations in foreign currency rates is a function of its import content and foreign currency borrowings. Telcos have some volume of foreign debt, which coupled with sizeable imports of network equipment expose these towards foreign currency fluctuation risk, especially given that the revenue generation is largely in local currency. Foreign currency risk for a telco could thus arise from unhedged net liabilities [= foreign currency payables + foreign currency debt]. ICRA's analytical focus is on assessing a telco's hedging policy and the magnitude of such exposure relative to the profits.

Consolidated Financial Analysis

With telcos having different subsidiaries or joint ventures for providing various services, it is necessary to analyse their consolidated and group level financial indicators. Various parameters such as profitability, capital structure, debt coverage indicators and future funding requirements are assessed at a consolidated level, which provides a better picture of the company's financial risk profile.

Other Elements of Credit Risk Assessment

Parentage/ Group Support

The telecom industry is inherently capital intensive and requires regular capital expenditure commitments to support subscriber growth, allow for deeper network penetration to ensure adequate service quality, and introduce new products/services. Further, the shift in Government policy from administratively-priced to auction-based spectrum allocation has increased the industry's capital expenditure commitments. As a result, most industry participants have witnessed a significant increase in funding requirements, and the ability to raise funds through alternative sources has emerged as an important credit determinant. Apart from the financial strength of the telco being rated, an assessment of the financial strength of the parent/sponsor/parent group (referred to as promoter hereafter) has also become more important. The Indian telecom service industry is characterised by few players jointly owned by Indian and foreign promoters as well as well-established Indian promoters, along with state-owned telcos.

The telco's capacity to raise debt, in addition to its own financial soundness, is also dependent on the promoters' credit profile and on credit enhancements from sponsors in the form of guarantees. ICRA, therefore, assesses the ability and willingness of the promoters to support the telco by assessing their financial strength and evaluating the importance of the telco in the promoters' overall business plans.

If the promoters' credit profile is relatively stronger than the rated entity, ICRA assesses the ability and the likelihood of the promoter extending extraordinary support to the entity in the form of loans, equity, extended credit period and advances in times of credit or liquidity stress faced by the entity. If the promoter's credit profile is relatively weaker than the rated entity, the entity's rating may be lower than what its standalone credit profile assessment would have merited, given the possibility that the entity may at some point of time be bound to extend financial support to its weaker parent, possibly to the detriment of its own credit profile[3].

Financial Flexibility

An entity's financial flexibility (or the lack thereof) is reflected in its ability to access capital or money markets at short notice and enjoy the confidence of banks, financial institutions, and intermediaries. A strong financial flexibility allows an entity to raise fresh borrowings or refinance existing ones in quick time, whenever required. Financial flexibility could emanate from

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[3] *For more details on this, readers may refer to the document titled, "Impact of Parent or Group Support on an entity's Credit rating", available on ICRA's website*

factors such as an entity's large scale of operations with strong financials, large, unencumbered cash flows, unencumbered assets and the flexibility to borrow against such assets, or strong parentage or linkages with a strong promoter group.

In contrast, among the various measures of an entity's depleting financial flexibility, one relates to a high share of pledged promoter shareholding. A sign such as this may imply that the entity might be persuaded to distribute high dividends or support the promoter group through other means to the detriment of its own credit profile. If the promoters fail to repay their loans (availed by pledging of shares) or top up collateral when required, the lenders could sell the pledged shares. In some cases, this could trigger a change-of-control clause in the rated entity's bond indentures or loan documents and require it to redeem its debt ahead of schedule, creating a liquidity squeeze, besides affecting fresh capital raising ability.

Debt Servicing Track Record

The debt servicing track record of the company forms an important rating consideration. Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the company's future debt servicing capability and willingness. Nevertheless, the reason behind past defaults is also analysed, which could also be due to adverse industry scenario.

Contingent Liabilities and Off-balance Sheet Exposures

ICRA reviews the contingent liabilities and off-balance sheet exposures as disclosed by the entity in its Annual Report and evaluates the likelihood of their devolvement and the financial implications of the same. For telcos, a majority of such contingent liabilities are in the form of DoT demands for disputed computations, licensing disputes and one-time spectrum charges, among income tax and other tax-related demands.

Event Risk

ICRA recognises the possibility of events, such as unrelated diversification, mergers and acquisitions, business restructuring, asset sales and spin offs, capital restructuring; and litigations, which could have a material impact on the credit profile of a company. Incorporating the impact of such discrete events in the credit rating, from the beginning, is often difficult. Depending on whether and when such events occur, the rating opinion could be substantially different. To take rating decisions in such cases, ICRA applies its analytical judgment based on the rated entity's track record, the credibility of the management and the experience of having seen similar situations play out in other entities. However, given the nature of such events, it is possible that the rating may undergo a material change later, upon the occurrence of the event.

Management Quality

In addition to the business and financial risk analysis, all debt ratings incorporate an assessment of the quality of the entity's management and its financial policies. An experienced management are considered positive factors.

In addition, the likely cash flow impact on the rated entity, 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. 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 points assessed are:

- Experience of the promoter/ management in the industry
- Commitment of the promoter/ management to the concerned line of business
- Risk appetite of the promoter/ management and risk mitigation plans
- The rated entity's plans regarding new projects, acquisitions, and investment in non-core business segments
- The rated entity's policies on leveraging, interest risk and currency risks

Periodic interactions with the management also help to estimate the possibility of the management's tendency to deviate from its core philosophy in times of stress.

Assessment of Environmental, Social and Governance (ESG) Risks

Environmental (E) and Social (S) Risks

As this methodology highlights, while undertaking credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions while taking a forward-looking view on the risks and the mitigants. The relevant credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated entity/ transaction. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly. Further, it is not always feasible to fully or precisely disaggregate the sub-components of E&S risks in credit analysis since these considerations often tend to overlap.

That said, the materiality of the E&S risks and the time horizon over which they are expected to crystallise differs widely across sectors and entities. In some cases, while the E&S risks could be material, but their impact on the credit profile may be muted because of other fundamental strengths of the entity. In other cases, the adverse impact of the E&S risks is expected to play out in the distant future, and hence these considerations do not necessarily weigh on the rating today—with the expectation that when these risks manifest in the distant future, the rated entity by then would possibly adapt itself by realigning its business model.

While evaluating E&S risks, ICRA's objective is only to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile. As an example, ICRA only assesses whether an entity is exposed to physical climate risks, or carbon transition risks such as those arising from changes in regulations or other environmental and social risks; and seeks to understand the various mitigation and adaptation approaches that the entity is implementing to mollify these risks. Notwithstanding the above, as an example, it is possible that even if an entity A has a higher carbon footprint than entity B, it does not materially affect ICRA's credit opinion on entity A. This is because ICRA's credit opinion on an entity considers a wide gamut of credit-relevant factors, and the E&S factors are only one among those.

Given the service-oriented business, direct exposure of telecom service providers to environmental risks as well as those arising from regulations or policy changes is not material. However, since the tower sites, which hold a key to the network of the mobile service providers, consume electricity and in some instances run on diesel generators as well, the business remains exposed to environmental-related regulatory changes that may have cost implications.

Social considerations for mobile service providers include risks related to data breaches and cyber-attacks, which could affect the large volumes of customer data, apart from managing various facets of human capital, including skills, compensation, and training.

Governance Practices

A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the Board of Directors and the management. The constitution of an entity's Board and the Board's participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices by the way its financial statements are reported, level of disclosures, consistency in communication and openness in sharing information during the credit rating exercise. Besides, the corporate group structure (whether simple or complex), the rated entity's related party transactions and instances of supporting group entities at the expense of debt holders are assessed.

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the entity's business and financial risks, its competitive strengths, its likely cash flows over the near-to-medium-term and the adequacy of such cash flows vis-à-vis its debt servicing obligations and other funding requirements. ICRA's approach to rating telecom service providers also incorporates the evaluation of various business risk parameters such as the company's scale and market position, spectrum holding, the technology risks it faces, and the changes likely and under way in the regulatory environment. These factors apart, an evaluation is also made of the strategies that the telco's management has for managing challenges in the operating environment and of its overall approach to investment and growth.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating

		Strong			Comfortable			Adequate			Moderate			Weak		
Industry Risk	Industry Position															
Business Risk	Scale															
	Competitive Position															
	Technical Positioning & Spectrum Holding															
	Business Diversification															
Financial Risk	Profitability and Earnings Stability															
	Leverage															
	Coverage															
		Enhance					Support/ Neutral					Hinder				
Do these factors enhance or hinder the credit profile?	Diversification															
	Refinancing Dependence, Liquidity and Financial Flexibility															
	Currency Risk															
	Financial Policy															
	Management, Governance & Reporting															
		Very High				High				Moderate				Low		
Parent Support	Likelihood of Parent Support															
	Rating of Parent	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/C category	
	Final Rating	**AAA**	**AA+**	**AA**	**AA-**	**A+**	**A**	**A-**	**BBB+**	**BBB**	**BBB-**	**BB+**	**BB**	**BB-**	**B/ C category**	

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committees based on both quantitative and qualitative considerations.

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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