Telecommunications in Asia-Pacific: Opportunities After the Storm <u>v4.0</u>

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As Asia-Pacific economies most distressed by the capital crises of 1997-98 stabilize and begin their recovery, enormous opportunities in the region's huge telecommunications sector are emerging for investors, governments, the telcos, recent market entrants, and ultimately for the Asia-Pacific people themselves.

Clearly, however, turbulent market dynamics and rapid technological change will make the risks associated with these opportunities substantial. Despite the region's stabilization, investors must recognize how to assess investment opportunities and to what extent the various economic downturns may increase the payback period on their investments.

Big table stakes. Prior to the economic crises, the business plans of the major players in the region forecasted requirements of more than $150 billion for realization through 2002. This figure encompassed all the infrastructure needed to address the growing need to provide fixed and mobile voice and data services to more than half the world's population. Even after the crises have passed, infrastructure requirements are sure to be greater than $100 billion.

But this does not foreshadow the coming shakeout and expected acquisition of unprofitable niche players who are caught in liquidity traps caused by over-optimistic business plans, post-crisis capital rationing, reduced growth rates, churn and fraud, and unseasoned management, among the key factors. These firms are attractive targets largely for the location and reach of their networks, and in many cases, they have been made even more enticing to Western capital by the currency devaluations of their respective countries.

Economic tsunami? The coming investment wave offers enormous implications for the region's economic development – and for the future of regulated and deregulated telecommunication markets. Our data show a positive correlation between the number of telecom players and teledensity, or number of phone lines per capita.

Historically we have found that a 1% increase in a country's teledensity correlates with a 3% increase in GDP. This is why we expect that, overall, the inevitable investment in the region's infrastructure will be a boon to its vast population.

The CEO perspective. To add to our view of future scenarios, Ernst & Young surveyed 20 of the region's top telecommunications chief executives and senior management in late 1998. Because all are key influencers of telecom's future, we asked them to look out to 2002 and envision what the telecom landscape may look like in such areas such as technology, customers, competition, resources, and regulation.

For all of Asia-Pacific's cultural and economic diversity, the chief executives seemed to agree on a range of broad issues relating to telecommunications. Among their key themes:

<u>The Internet</u>. This phenomenon is driving the convergence of voice and data more quickly than first imagined, with the speed of technological change challenging the adaptability, resources, and fundamental underpinnings of incumbent telcos.

<u>Capital Rationing</u>. Capital is scarce but needed for the coming – and expensive – transformation of legacy, fixed wire, circuit-switched networks to fixed and wireless Internet-Protocol (IP)

networks. While incumbent telcos command almost all profits in the region's telecom sector, recent entrants are mostly unprofitable. As a result, many in the latter camp will find it difficult to raise the necessary investments needed to stay on the cutting edge of technology.

Customer-Driven Markets. Customers and competition will be the driving market forces. PTTs will have to learn how to be much more responsive much more quickly.

Understanding the trends. These themes portend some fundamental trends we have observed about today's Asia-Pacific telecommunications marketplace that will define the winners and losers of tomorrow.

Cash advantage. Over the past five years, the financial performance of the region's telcos has divided them into two camps: the "haves" and the "have-nots." The former – typically the long-established incumbents like Australia's Telstra, Singapore Telecom, and Japan's NTT – have enjoyed most of the region's profits during that period, while almost every new entrant (the "have-nots") has lost money.

In fact, the worst performers in the latter category have been the wireless companies. According to a recent global Goldman Sachs study, wireless communications ranked last in 45 industries rated by economic value-add and return on capital. That's not so surprising when the churn and fraud rate for wireless companies typically exceeds 25%, while in some Asian nations it reaches nearly 50%.

The circumstances for recent entrants are made worse by capital rationing and, in many Asia-Pacific nations, by currency devaluations. Worst-hit was Indonesia's currency, which lost 70% of its international value during '97-'98, while other hard-hit countries lost an average of about 35%.

With hard currency difficult to obtain and many borrowing avenues now closed, recent entrants will be hard-pressed to match the customer-driven price competition of the larger, cash-rich incumbents. What's more, as the market demand for Internet access regains its momentum, capital requirements for new infrastructure will become acute.

Acquisitions. Such a situation has not gone unnoticed by outsiders such as British Telecom that has invested in a number of second-tier telcos such as New Zealand's Clear Communications and Malaysia's Binariang. Its apparent strategy is to develop a regional network of hubs to provide seamless service to multinational companies.

NTT is another example, having entered a joint venture with BT in fixed and mobile networks in Singapore. Meanwhile Cable and Wireless has also been active on a number of fronts including its establishment of Singapore's top mobile system and its majority interest in the second-largest carrier in Australia, C&W Optus. Both NTT and BT, in fact, recently announced their intent to acquire stakes in Japan's International Digital Communications (IDC).

Interestingly, U.S. RBOCs and other telecommunication players, with a few exceptions, are largely absent from the expansionist tendencies shown by the European telcos. This seems due to their preoccupation with the intensified competition in the U.S. market.

Another technique, championed so well by Worldcom in its market ascent, is to use rising stock values as currency for deals. We expect that the stratospheric valuations of Internet companies and telcos in all financial markets could lead to acquisitions of smaller service providers. That's especially a possibility for Internet service providers in nations with devalued currencies who are finding it ever more difficult to acquire dollar-denominated access to the U.S. Internet backbone.

Constrained access. The economic downturn has contributed to a slowing of the Internet's adoption rate by businesses and consumers in those nations most depressed.

Though many CEOs agree – and research data confirms – that business-to-business Internet use will be a key driver of its adoption, any subscriber slow-down for reasons of cost, lack of access, or some combination of the two will put Asia-Pacific economies further behind the U.S. and Europe where the take-up is occurring at a much faster rate.

Worse still, most executives believe, would be government intervention that would complicate the situation. Said one, “The telecommunications sector is where the government can do a lot of damage if it does not think things through. In telecommunications, the governmental restrictions are awesome and the impact is huge.”

Still, another countered, governments should be concerned: “The majority of the population will not be able to access the Internet or even a telephone if the market is liberalized, as the new entrants will focus on the big cities and ignore the rural population.”

To be sure, remote connectivity is a political hot potato. When teledensity is just 5% in some parts of Asia, it’s hard to sell the population on value-added services when POTS will do. In developed countries, of course, a universal service obligation is one option but it is difficult to administer in the developing world. The introduction of satellite and wireless solutions will help, but with over 50% of the region’s population never having used a telephone, much work needs to be done. Consequently the resolution of remote connectivity will continue to be hotly debated.

Overall implications. In our view, how companies emerge from today’s uncertainties will depend on the country. On the one hand, a government intent on commercializing its telecommunications market does not always open it up for competition. Instead, its relationship with an incumbent may bias it toward maintaining high prices and restricting new entrants.

On the other hand, it could open its market to unbridled competition. Frenzied license auctions that led some nation’s wireless operators to grossly overpay for their spectrum rights has made high rates of churn and fraud all the more unbearable.

We fear the latent impact of the regional economic crisis could be that governments slow down on deregulation and opening markets when exactly the opposite is needed. Another scenario could be that, having fostered new entrants in the past, governments might restrict additional market entrants, so the former could improve their returns. Unfortunately, this would deny consumers and businesses access to value-added services and lower costs.

Strategic options. Clearly telecommunications companies are facing strategic choices: Either they become a focused local supplier, or they become part of a regional or global alliance – or part of a larger whole. And, if they join an alliance or larger entity, is it for expansion purposes or to defend existing markets?

The choices are especially difficult because the stakes are so great, but the even larger risk is that of not doing anything. That is, by 2002, the region’s relatively cheap acquisitions may well be history.

Given the region’s increasingly diverse economic landscape, investors need a common framework for evaluating the market’s opportunities. Factors such as urban/rural population ratios and geographic topography can affect teledensity as well as cellular and Internet penetration rates, all of which can vary widely from one locale to another.

Other considerations include the competitive and regulatory environments. What is the competitive landscape? And, given the competition’s financial viability, what could be its end-game in the market?

Looking to the future. As we mentioned, the business plans of Asia-Pacific telcos will require substantial capital between now and 2002 – with most projected to come from private capital. But given the region's capital shortage, this seems optimistic.

Given, too, the regulatory and market risks associated with realizing these business plans, the capital shortage means that private capital can and should seek quality investments, whether targeting incumbent telcos or new entrants.

We suggest that investors focus on some fundamentals such as the quality of customer access, the quality of existing customers rather than the number of new customer signups, the track record of management, technological flexibility, and a reasonable risk profile. By all means, investors should not be captivated by new infrastructure investment because this will require a much longer payoff period. Nonetheless, we have observed many examples of the "build-it-and-they-will-come" philosophy.

Most CEOs in our survey agree that Asia-Pacific has seen the worst of its economic woes, but it will be several years before consistent growth returns to those countries hit hardest by collapse of their financial institutions, currency devaluations, and capital flight.

Still, with fixed and wireless telecommunications increasingly becoming the underpinnings if not accelerators of GDP, the region's opportunities for all of its stakeholders – investors, telcos, consumers, and businesses – should more than justify the risks.

We remain surprised at the relatively low-level of acquisition and investment by both the major regional players and the U.S. telcos – especially when potentially profitable market positions can be acquired at what amounts to fire-sale prices.

[About 1,850 words]

<u>Sidebar #1</u>
The following comments came from interviews Ernst & Young conducted in the Asia-Pacific region in surveying CEOs of telecom companies and key influencers in the telecom sector. They are part of a worldwide survey of more than 90 companies that we consider to be most influential in telecom's future.

About the Internet...

> *"The Internet is our biggest threat…unless we get into this segment we will be displaced."*
> *"With the materialization of the Internet as a viable alternative to carry voice and data, the network owners will need to write off their networks."*

About capital rationing…

> *"I wouldn't be surprised if [traditional PTT] incumbents are driving 500% of the industry profit while recent entrants are losing 400% of it."*
> *"The number of phone lines installed in 1998 decreased compared with previous years [mainly] because our telecom sector's development is based on foreign investment."*

About customers and competition...

> *"Customers have thus far tolerated poor service and they are no longer willing to do so."*
> *"People want to have the option of getting everything they want from one location."*
> *"The top strategic issue will be to keep the loyalty of customer."*
> *"If you don't cannibalize your customer base, someone else will."*

About government regulation...

> *"Instead of constraining the industry, governments need to facilitate the entry of this new (information) age."*

"It is impossible to be a world-class player unless you face world-class competition."
"Regulators are more interventionistic and deterministic – they do not focus on the needs of the customer as much as they should."