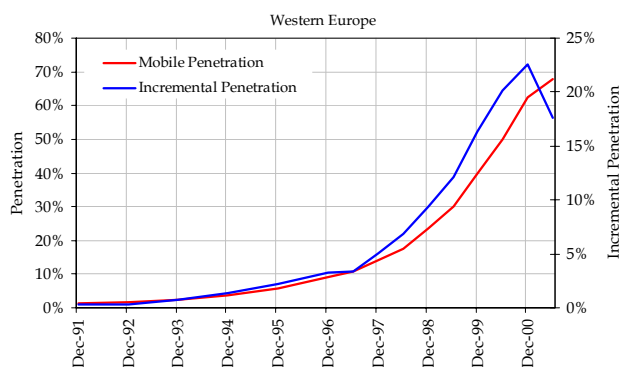


Fears About Debt Levels of Mobile Operators are Misplaced

Lenders and investors seem to be unduly pre-occupied with the debt levels of mobile telecoms operators. The historically high debt levels combined with negative reporting on the slowdown in the industry and delays in the launch of 3G services paint a picture of impending doom. Closer analysis shows that the conclusions that should be drawn are rather different.

What does a slowdown in growth really mean? Mobile penetration in Western Europe is approaching saturation, i.e. the penetration growth curve is close to the top of the product life cycle. 2000 saw the fastest penetration increase on record when over 20% of the population adopted mobile. 2001 saw a rapid slowdown in penetration growth. As the customer base stabilises gross additions will decline substantially. This is excellent news for EBITDA margins and hence cash flow in the short term.



Analysis of 50 mobile operators, mostly in Western Europe, showed that while EBITDA levels vary substantially, the cost of customer acquisition accounts on average for 26% of opex, and in some cases for over 30%. The decline in new additions combined with churn reducing measures means that customer acquisition costs are declining by as much as 50%. In addition over the last 15 months, operators in the UK, Germany, France, Portugal and Spain have successfully reduced customer acquisition costs for some or all customer segments. Some have moved to reduce prepay handset subsidies only. Others, such as Telefonica, have eliminated subsidies across the board. In March 2001 Telefonica stopped handset subsidies both for prepay and subscription customers. Overall customer acquisition costs fell by 33% in the six months to June compared to the same period one year earlier. Customer acquisition costs fell from 38% to just 18% of opex.

For example, a mobile operator with an EBITDA margin of 35%, and 25% of opex due to customer acquisition, a 50% decline in acquisition costs lifts the EBITDA margin to 43%. Operators that due to the absence of handset subsidies in their markets had a low cost of customer acquisition already have excellent EBITDA margins of 48% (TIM) and 47% (Sonera in Finland) respectively. In short, as market growth slows 2G mobile operations become hugely cash generating.

During 2000 mobile operators experienced an exceptional cash drain due to a combination of factors:

- Rapid penetration growth
- Investment in Internet portals
- Investment in GPRS
- The cost of 3G licences

Coleago has modelled several operators and found that the reversal from cash drain to cash generation in the second half of 2001 and 2002 compared to 2000 is dramatic. The trend is already apparent in the recent results reported by Deutsche Telekom and others. The Q3 EBITDA margin at T-Mobil, was 39.8% compared to 19.2% for the year 2000. Certainly bondholders have nothing to fear. Future funding needs are lower because much of the investment required for 3G can be paid for by cash generated from operations.

And what about the delay in 3G? Coleago has modelled the effect of a delay in 3G service launch and found that this results in a reduced funding requirement, particularly in the short term, while the 2G cash cow is being milked. The downside is that the firm value is slightly lower. However, much of the present value resides in the terminal value. Clearly what's going on in ten years is open to debate, but near term cash savings are a reality. This is why mobile operators are not concerned by the delay in 3G. Kim Frimer, Chief Executive at TDC Switzerland, announcing in November 2001 simultaneously with TDC that the launch of UMTS in Switzerland, originally planned in 2002, would be postponed until 2003 at the earliest was quoted as saying "I will not lose sleep if we don't launch until 2004." If new entrants also have to delay their 3G launch this is even better news for the incumbents.

There has been talk that much of the recent subscriber additions are not profitable. However, assuming a customer acquisition cost of €100 for a low-end prepaid customer, with an average monthly post VAT revenue of €10 and a 3 year life, the investment is well worth it. Other than the cost of acquisition, marginal costs are very low. Estimating marginal costs at €3 or less, the monthly profit on a €10 bill is €7. Adding inbound call revenue, the total contribution is around €9 per month. Over the three year life this marginal customer generates a revenue of €324. Given the initial outlay of €100 the IRR is 93% - that's a very good investment indeed.

The cost of converting existing customers to 3G customers is likely to be much lower than the cost of acquiring a new customer. With most products and services it is much cheaper to sell a new service to an existing customer than a new service to a new customer. Revenue from 3G services are likely to be substantial, i.e. €15-20 per customer per month for data transport alone (see research at www.coleago.com/download/index.htm). While in the medium term EBITDA % margins decline slightly due to the cost of 3G, the level of EBITDA will remain broadly constant. In the longer term, i.e. 5-7 years from now, EBITDA % margins will recover.

Of course this does not apply equally to all operators. Only operators with a reasonably high market share in a country achieve a high EBITDA margin. Some operators struggle to achieve sufficient market share to gain scale economies (e.g. in the Netherlands), others are hampered by onerous 3G roll-out conditions (e.g. Sweden), and in some countries new 3G operators are entering the market. There is also the threat of lower termination (interconnect) rates but this can be offset by higher call volumes. On balance most mobile operators are highly profitable at an operating level and represent a good bet for the future.