Bond Blog

PGIM FIXED INCOME

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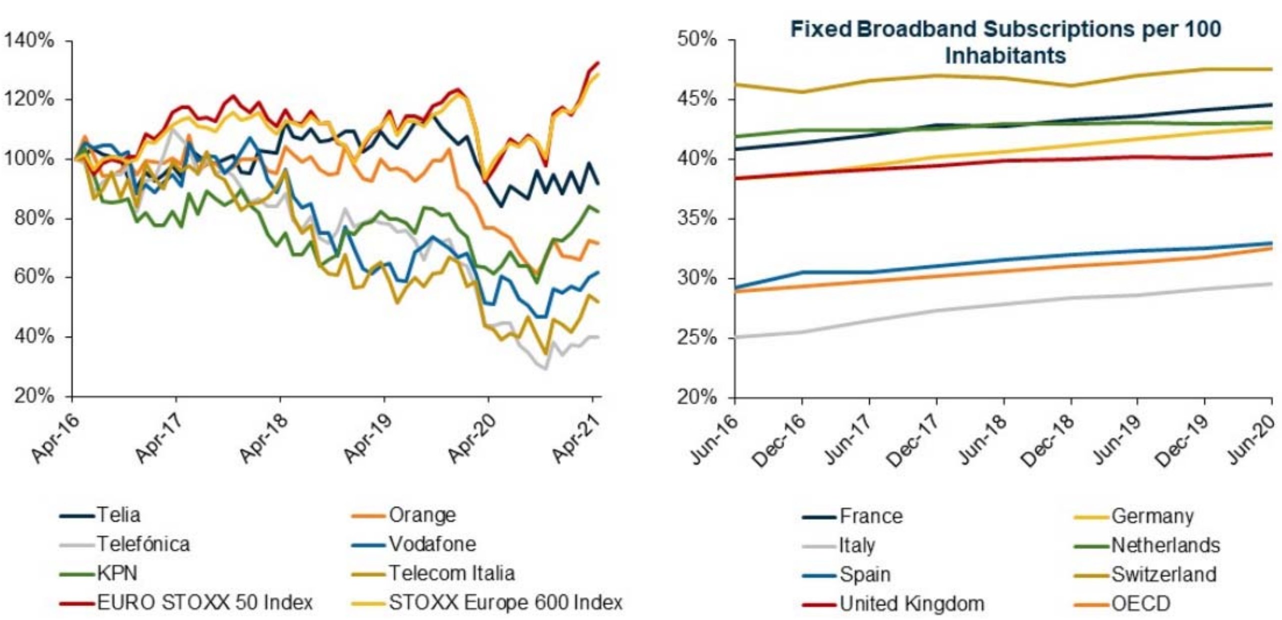
# EUROPEAN TELECOMS: FERTILE GROUND FOR CREDIT SELECTION

By Bruno Read-Cutting, Investment Analyst, European Leveraged Finance Credit Research Team

The telecom sector's infrastructure needs extend globally. In the U.S., the race for 5G capacity has saddled some of the world's most indebted non-financial companies with even more debt and raised questions about the potential return on these investments. The European telecom sector faces similar infrastructure needs as well as mounting shareholder pressure to improve lagging returns (Figure 1). While this has also resulted in significant debt issuance in the European markets, the sector's increasing segmentation has created opportunities to identify potential alpha-generating credits in less recognized, yet well researched, names and to diversify away from certain incumbents with stagnant or deteriorating credit profiles.

Much to the chagrin of equity investors, the European telecom sector's constant network investments have absorbed the lion's share of recent earnings, while strong competition has crippled the industry's ability to capitalize on its investments. Although this has led telecoms to explore alternative avenues to boost shareholder returns, it has also broadened the opportunity set for credit investments within the sector.

**FIGURE 1: INCUMBENT EUROPEAN TELECOM STOCKS HAVE UNDERPERFORMED…DESPITE STRUCTURAL CUSTOMER GROWTH**




Source: Figure 1 - Bloomberg, Share price and index data indexed to 100 as of April 2016, Figure 2 - OECD Broadband Portal.

Telecom profit growth comes from two primary channels: new customers and/or higher prices. There are limitations on the former, particularly in developed markets, such as Europe, and among incumbents with high market shares. With pricing serving as the main mechanism through which operators can attain returns on investments, shareholders remain hopeful the sector will be able to charge customers a premium for an improved service from each new technology. However, strong competition, encouraged by regulation, has made this a rarity.

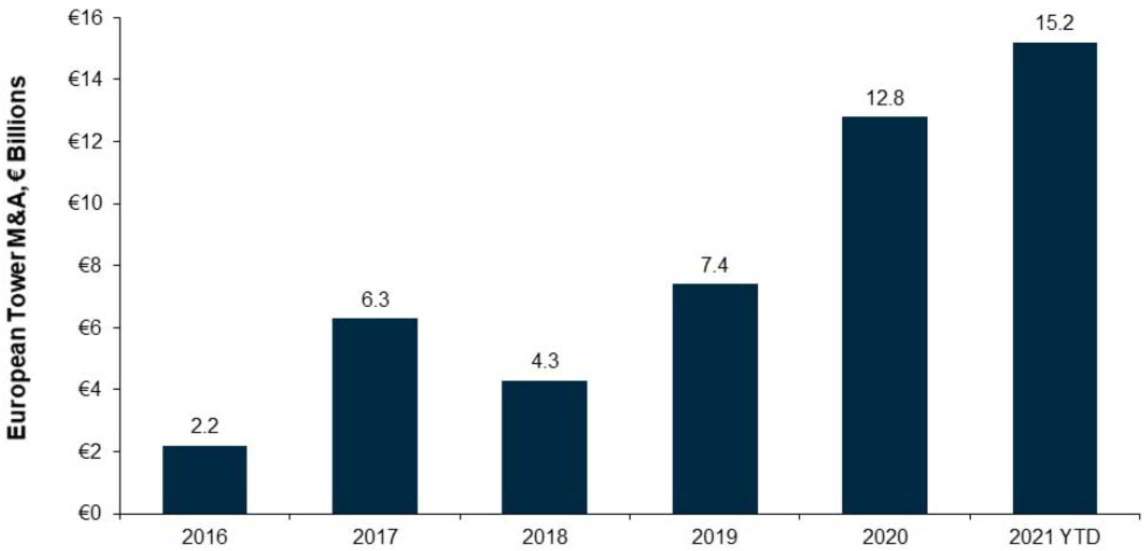
For example, numerous operators have already announced 5G tariffs for no additional fee over 4G services. Therefore, stagnant pricing has pushed operator returns below their cost of capital, contributing to their equity underperformance.

However, the sector's significant investments have locked an enormous amount of infrastructure value on the industry's balance sheets. Therefore, while network investments are still far from over, European telecoms have increasingly monetized their assets and customer bases in response to pressure on profitability and shareholder returns.

### Unloading Tower Stakes

Since 1G mobile networks were rolled out in the 1980s, the next generation has emerged an average of eight years later with each requiring increased density. For example, the 4G network is roughly 10x denser than the 3G network, and 5G networks are estimated to be 10x denser than 4G networks - i.e., a 100x increase over 3G. Therefore, the perpetual upgrading of equipment at existing cell towers has been matched by the need to continually build more sites. Operators have also needed to fork out eye-watering amounts of money on spectrum, which is an intangible asset required to operate mobile networks, as recently seen across the U.S. sector. As a result, European operators have been selling partial or complete stakes in their tower portfolios (Figure 2) as they yield attractive valuations and provide telecoms - such as Altice, which was one of the first to divest towers out of a need to deleverage - with a significant source of cash.

**FIGURE 2: TELECOMS ARE INCREASINGLY PARTING WITH THEIR TOWERS**




Source: Credit Suisse

Outsourcing tower portfolios also reduces telecoms' operational and capital expenditures, enhances network quality through improved maintenance and technical expertise, decreases time to market for network expansions, and improves the focus on core operations. Meanwhile, tower operators can capture significant growth vs. operator-owned towers as they can host several mobile operators on each tower, creating a beneficial situation where the network's capacity is enhanced as the overall costs for each operator decline. European tower operator Cellnex, where we maintain overweight positioning, has been the most acquisitive player with €36.5 billion in announced investments for the acquisition or construction of 121,000 towers since 2014.

### The Ongoing Need for Fibre

Fixed telecom networks lack the luxury of cellular towers. Fixed cables need to be physically connected to each location, and there are over 300 million premises in Europe compared with roughly 450,000 mobile towers. Higher reliance on home connectivity - accelerated by the COVID pandemic - has driven a surge in fibre-based broadband demand.

Yet, in order to ultimately meet long-term bandwidth requirements, Europe will need to upgrade most networks to fibre. But so far, only 40% of locations have been upgraded and at an average cost of €1,000 per home.

Given the significant fibre investments that lie ahead, fixed-network operators are increasingly partnering with infrastructure funds, which brings several benefits, including accelerated rollout plans, deeper levels of coverage, cost sharing, and removal of investments from balance sheets. The partnerships also allow operators to maintain their equity dividends and further monetize customer bases via guarantees on product adoption. Infrastructure funds find fibre networks attractive given their low maintenance costs, secular growth trends, stable cash flows and high-quality counterparties.

Several sector incumbents materially accelerated fibre build-out plans over the past year with the help of infrastructure players, thus providing a boon to consumers in these countries who will receive fast fibre connections sooner than otherwise expected. Some of these infrastructure providers are also relatively frequent issuers of private debt, which underscores the need for thorough credit analysis in less recognized names that are emerging in the sector.

Over the last decade, several mega-mergers have seen more mobile and fixed-line operators combine. Fixed-mobile convergence is a logical step that provides operators with additional capital to invest in their networks. The similarity of operations can generate significant cost savings and cross-selling opportunities, both of which have the potential to boost earnings considerably. For example, the £31 billion merger between O2 and Virgin Media in the UK, one of the largest M&A deals of 2020, estimates synergies of £540 million per year, an increase of roughly 15% on current joint earnings. These prospects have contributed to the recent, solid performance of the debt of Liberty Global's subsidiaries, such as Virgin Media, which have been adopting fixed-mobile convergence strategies.

Although proceedings in the sector over the last decade have been driven from an equity perspective, telecoms have almost solely relied on the credit markets to provide long-term capital. For example, around 50% of Cellnex's financing has come from the credit markets, while the aforementioned O2-Virgin merger has been partially financed with £5.7 billion of debt. Yet, the issuance has emerged from a range of credits - from private infrastructure entities to industry conglomerates - which emphasizes the need for accurate credit selection among companies with varying business models. The analysis process facilitates the ability to establish overweight allocations in certain, focused operators, such as Cellnex, while underweighting certain incumbents, such as Telecom Italia, where appropriate. As the demand for data is only set to increase, the credit markets will continue to fund the region's 5G and fibre expansion, in addition to any other technologies that might follow. Therefore, given these shifting market dynamics and a pipeline of significant debt issuance from a diverse range of companies, the European telecom sector will likely remain fertile ground for similar credit selection and alpha-generating opportunities going forward.

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