

# Impact of Effective Regulation on Investment: an Investor's Perspective

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# Basic Focus of the Paper

- This paper aims to address two major considerations:
  1. the impact of the current economic crisis on the potential investments that may be considered by telecommunications operators and other interested parties; and
  2. the way in which effective regulation impacts these investors' consideration and assessment of potential telecommunications investments.

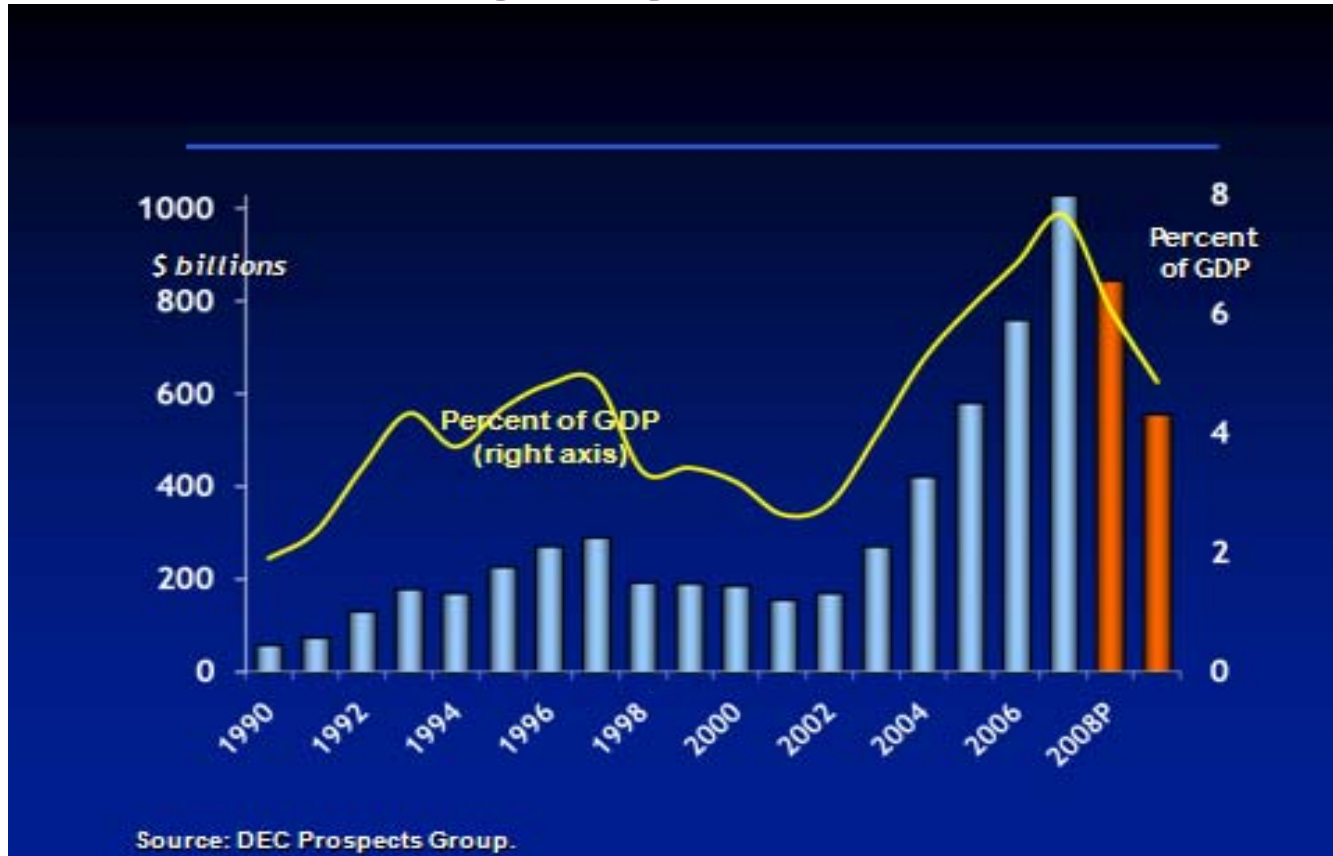
# What Started All this Investment?

- Since the late 1980's when telecommunications liberalization and privatization first started to take hold in a noticeable way outside of North America, investment in the ICT sector has attracted many interested parties around the globe.
- At the outset, the most active investors were other existing players in the ICT sector as incumbent telecom operators saw subscriber and revenue growth rates stagnating in their home markets and were also faced with the prospect of competition on their home turf. Consequently, such ICT operators sought to increase their market and revenue base by investing overseas and by capitalizing on the operating experience that they had already acquired.
- In general, global investment activity in the ICT sector started in Latin America (late 1980s to early 1990s), subsequently followed by many parts of Asia and then, subsequently, Europe, basically in line with liberalization developments around the globe. With a few exceptions, Africa and the Arab States were the last regions to adopt liberalization in the ICT sector and, thus, investment was delayed until the liberalization phases had commenced.

# Implications of Recent Events on Investment Activity

- The appearance of a global financial crisis at the end of the third quarter of 2008 has had a serious impact on both the overall appetite for international investment in the ICT sector and the manner in which such investments are evaluated and subsequently carried out.
- The World Bank recently stated on its web site that: “the effects of financial turmoil on developing countries increased in step, as risk aversion sent spreads soaring, equity markets tumbling, exchange rates falling and capital flows into decline. In this climate, growth prospects for both high-income and developing countries have deteriorated substantially, and a movement of global growth from 2.5 percent in 2008 to 0.9 percent in 2009 appears to be in the cards”.
- Many of the telecom operators that embraced growth through expansion after the dry spell that followed the bursting of the telecom bubble in 2001/2002, have found themselves yet again in the position of examining this expansion strategy in light of the new global downturn and general scarcity of funds.
- The overall result is that there appear to be two major reactions to the current investment challenges:
  1. those operators that have either completely retrenched from investing or that have severely scaled back their investment targets; or
  2. those who view the current crisis as an opportunity to invest in selected markets at a significantly reduced premium.

# Recent Evolution of Private Debt and Equity Flows

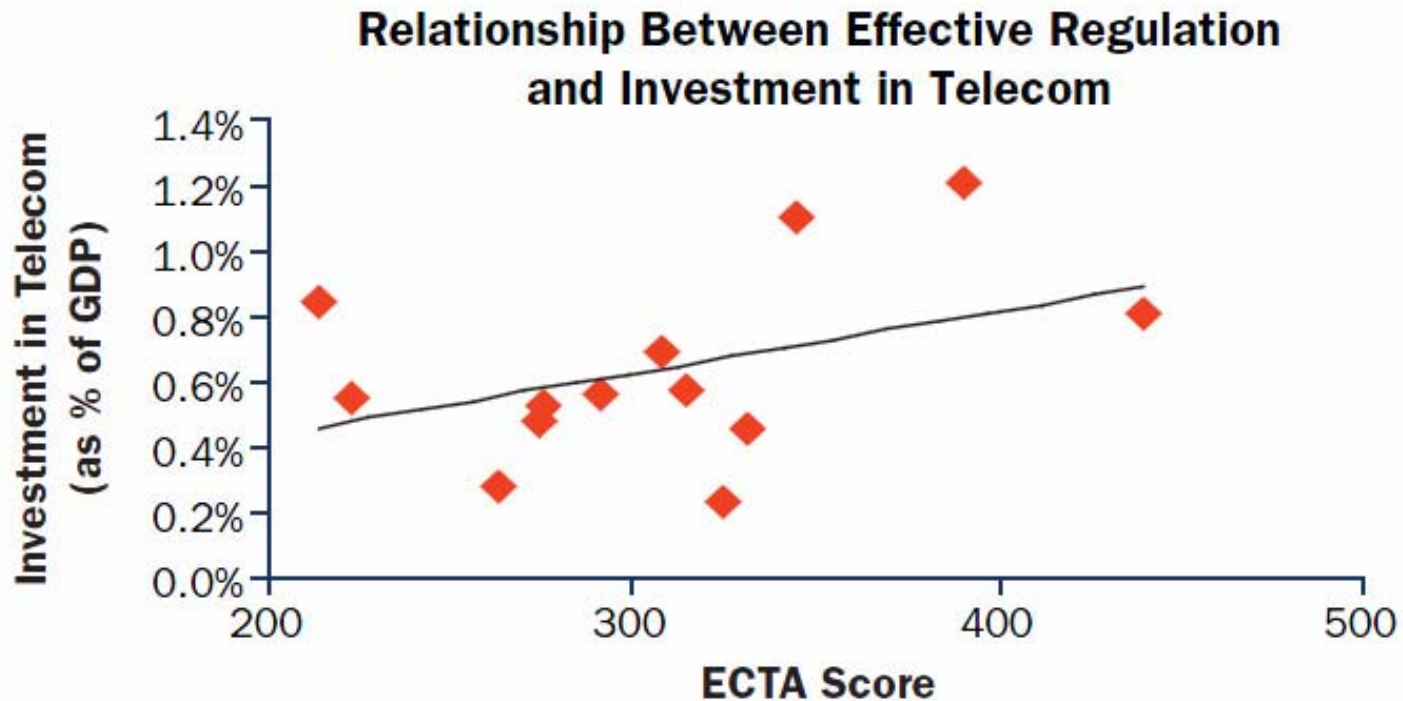


**This chart illustrates the global net private equity and debt flows for all sectors for the period 1990 – 1997 followed by the projections for 2008 and 2009, which show a sharp downturn in private capital flows.**

# Investment Criteria

- In the ICT sector, one of the critical aspects of due diligence is to analyze in detail the existing and future regulatory environment and to identify any elements of risk that may exist.
- In general terms, an investor in the ICT sector will be inclined to focus on the independence of the regulator from the government; the transparency of the regulatory process; the legal processes for regulation; and whether in general the framework achieves the correct balance between sustaining a fair competitive environment (and one that encourages and stimulates investment) and ensuring that there is not excessive competition/over-licensing.
- In principle, these investment criteria are paramount irrespective of the state of the financial markets and the availability of funds for investment. It is the **weighting** of the regulatory risk in this current environment that is more likely to change, based on the investor's appetite for risk in the face of scarce capital markets. The higher the perceived regulatory risk, the less likely is the appetite for investment. Logically, the opposite also holds true as has been identified by analyses conducted by the European Competitive Telecommunications Association (ECTA).

# The Impact of Effective Regulation on Telecom Investment



The economic analysis conducted in this study shows that effective regulation continues to have a strong and positive impact on the level of investment in telecommunications networks and services. The higher the overall effectiveness of the regulator, the greater the investment.

# Major Regulatory Risk Factors to be Considered- Part 1

The ranking/weighting of regulatory risk factors will vary by ICT investor

## 1. Overall transparency of the regulatory framework/regulator

- One of the most important considerations
- What is the level of independence and autonomy and the degree to which policymakers, ministries and legislative bodies are able to intervene in the day to day operation of the regulator.

## 2. Existing and planned ICT/telecommunications laws

- degree to which there is a clear hierarchy and framework
- distinction and relationship between policy and regulation
- procedures and mechanisms related to the appeal of regulatory authority decisions
- remedies and penalties
- overall market objectives

## 3. Licensing regime

- If licensing entity does not act in a transparent, timely and impartial manner, the business and operations of the operators/investors may suffer.



# Major Regulatory Risk Factors to be Considered- Part 2

## 4. Interconnection regime

- One of most crucial issues for operators
- Often the most contentious regulatory issue
- One which can significantly affect the perceived value of an investment

## 5. Competition safeguards framework

- Level of regulatory involvement in place to provide new entrants with a level playing field when competing against well-established incumbent operators
- Need for adequate safeguards in place to check/control anti-competitive behaviour

## 6. Tariff regulations and controls

- Effective and transparent tariffing regimes are required to facilitate the orderly and measured evolution to competition
- Modification of tariffing regime as markets become more competitive

# Major Regulatory Risk Factors to be Considered- Part 3

## 7. Regulatory fees and taxation

- An important and frequently detrimental factor
- Of particular concern in emerging markets is the number and level of fees and taxes imposed on operators

## 8. Universal service fund

- Often used in competitive markets to supplement market-based policies, and to address access gaps and market failures in remote and under-served locations.
- Growing question marks both from operators and regulators about the practicality and efficacy of using USFs to achieve universal access

# Investment Approaches

- No right or wrong answer when faced with the question of whether it makes more sense to invest in developing versus developed economies as this is very much dependent on the ICT operators/investor's strategy and rationale vis a vis investment in the sector.
- Some investors are seeking growth by investing in under-penetrated and underserved regions whereas others are seeking investments in developed economies with populations having significant acquisition power where revenues can be increased through the introduction of untested or newly developed revenue enhancing, feature-rich, usage-based services.
- However, in general terms, there has been an increasing investment focus on emerging markets. According to a report for the 2008 World Economic Forum, telecom industry growth in mature markets such as Japan, the US and Western Europe was expected to drop from the 6% average annual growth experienced between 1998 and 2005 to 1% from 2006 and 2011.
- Conversely, prior to the current economic crisis, emerging markets were predicted to grow at an average of six percent per year from 2006 to 2011 with higher growth of 19 percent in the broadband sector and eight percent in mobile.

Source: Rethinking Regulation in Emerging Telecommunications Markets – McKinsey and Co.; The Global Technology Report 2007-2008.

# Examples of Reasons for ICT Investment

Irrespective of investor profiles, investor objectives and investment criteria will continue to vary from investor to investor of the existence (or not) of financial crises; a telecom operator will likely consider the following:

- Growth through expansion rather than simply home market focus and growth
- Purely strategic to increase the operator's regional or global footprint thus capitalizing on scale
- Protective/pre-emptive measure to stave off competition in adjacent operating territories
- Additional revenue streams generated by management services and appreciation of brand equity
- Establish large customer base and create customer's profile in the hope of marketing new services

# Examples of Innovative Investment Deals in Times of Scarce Financing Sources

## The Zain Wana Deal – Morocco

In March 2009, Zain formed a 50/50 partnership with Al Ajial Investment Fund Holding (“Al Ajial”) for the purpose of investing MAD 2.850 B (USD 324 M) through a newly established joint venture “Zain Al Ajial”. In return, the partnership garnered a 31% ownership in Wana Corporate SA (“Wana”), the third mobile telecommunications operator in Morocco\*. This new investment by Zain and Al Ajial was structured so as to provide Wana with both the funding requirements and operational contributions needed to continue with its growth plan, including the launch of a new GSM licence in Morocco in the latter half of 2009. This significant minority investment structure was a bit of a departure for Zain in relation to its other investments over the last seven years in that it chose not to take a majority shareholding. Nonetheless, it allowed Zain to gain a significant foothold in Morocco with minimum investment, further extending its African footprint and allowing it to provide development, products (including the One Network and Zap) and services under a services framework agreement.

## The Lattelecom/TeliaSonera Share Swap Deal

In April 2009, after several years of grappling with the sale of Lattelecom, the national fixed line operator, the Latvian government approved a complex deal in the form of a share swap with TeliaSonera that was expected to net up to EUR 380M). Prior to this share swap agreement, the Latvian government owned 51 percent of both Lattelecom and LMT, a mobile telecoms operator, with TeliaSonera owning the remaining 49 percent in both operators. This approval to move forward was given after several failed attempts to arrive at other forms of divesting shares in Lattelecom. In accordance with the swap, the government will retain its 51 percent stake in Lattelecom, while TeliaSonera’s stake will first be purchased by the Latvian State Radio and Television Centre— and then sold to a strategic investor. In exchange for handing over its stake in Lattelecom, TeliaSonera will receive the both the state’s 28 percent in mobile operator LMT as well as Lattelecom’s 23 percent stake. There are still internal approvals required for the transaction to be concluded but the Latvian government stated that it hoped to conclude the transaction before the end of 2009.

# Lessons Learned

- **Markets are cyclical:** This reality is easily dismissed especially when the run-up in market asset values continue unabatedly for a long period before the market suddenly chooses a high-speed elevator rather than a gradual escalator ride to the bottom floor.
- **Focus on strategic capital raising plan:** Careful scrutiny of future cash requirements entails consideration of a multi-year plan, appreciation of prevailing market conditions and close attention to the impact of fund raising on implied valuations. Scepticism of market conditions may be an effective antidote to being caught by sudden closure or tepid market demand.
- **Ongoing focus on cost and efficiencies:** This is easier to fulfill by management than the previous “lesson” because it is known and controllable. It requires disciplined strategy and an ongoing commitment to extract costs where appropriate to improve financial flexibility in anticipation of choppy market conditions.
- **Doubtful market capitalizations:** Market prices should not be confused with implied valuations. Despite the systemic reduction in trading levels and the resultant deflation in valuation metrics, good operators will always enjoy access to capital, provided they are amenable to costs of capital reflecting the periods where capital supply is diminished.

# Best Practices to Secure Financing

- In order to ensure the best possible chance of success in securing access to capital and financing in the midst of these extremely challenging market conditions, adherence to demonstrated best practices should improve the likelihood of success. There are five key practices that should be considered when attempting to secure an investment:
  - Transparency of disclosures
  - Go-to-market readiness
  - Stay close to key advisors
  - Careful scrutiny of cash flow
  - Attempt cash saving transaction structures

# Conclusions

- For the most part, the availability or scarcity of capital is not likely to have a dramatic effect on the basic methodology of assessing regulatory risk; indeed, the risks remain the same.
- However, what it is more likely to be affected is the degree to which the regulatory risks are factored into the overall investment process in terms of prioritizing investments, overall valuation and discount factors to be applied.
- In fact, realizing that financial risk is generally the foremost priority in any potential investment assessment, it is likely that regulatory risk is not far behind in the list of critical considerations.





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