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Telecom Investment
Opportunities in the
MENA Region
*Multiple Options
Remain Despite Global
Economic Slump*



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EXECUTIVE SUMMARY

Optimism reigned supreme—despite the broader market gloom—as more than 200 senior telecom executives, investors, investment bankers, and advisors gathered in Doha, Qatar, in mid-March for the TMT Finance & Investment Middle East 2009 conference. Booz & Company was a conference partner at the third annual telecom, media, and technology (TMT) event organized by international telecom consultancy BroadGroup.

Three key factors are fueling that optimism. First, consumer spending on telecom services has exhibited strong resilience despite the economic crisis, as customers have shown they are reluctant to curb spending on communications services. Second, telecom operators are recognizing the potential of convergence between telecom and other industries, such as financial services, media, healthcare, and education. Third, the current economic crisis has created opportunities for strong players to acquire distressed operators at attractive prices. Such opportunities continue to beckon to the Middle East and North Africa (MENA) telecom operators that have established their success in cross-border expansion in recent years.

MENA telecom operators, thanks to their strong balance sheets, have sufficient financial leverage to continue to participate in these growth opportunities: expanding traditional businesses, capitalizing on convergence between telecom and other industries, and acquiring weaker operators. The challenge remains in securing the necessary financing to make the most of these opportunities—especially during this economic crisis, which has constrained capital access globally.

KEY HIGHLIGHTS

- Telecom is not immune to the global economic slowdown, but it has proven to be more resilient than many other industries.
- Growth opportunities abound not only in traditional, core telecom services, but also in new enterprises such as mobile media and banking, as well as through opportunistic acquisitions.
- MENA telecom operators, because of the relative strength of their balance sheets, are in a good position to capitalize on growth opportunities or acquire distressed or cash-strapped operators.
- Although capital costs have increased and availability of capital is limited, many MENA operators have the financial wherewithal to fund growth.

THE GLOBAL CRISIS AND TELECOM

The economic downturn has wreaked havoc globally: Capital markets worldwide have been hit hard and credit has tightened significantly; global mergers and acquisitions (M&A) activity dipped sharply, declining 43 percent in 2008 after increasing by 22 percent annually over the three previous years. The MENA region has not been immune to the slump. Economic growth, although still positive, has slowed in many MENA countries, and Gulf Cooperation Council (GCC)¹ equity markets have been significantly affected.

Healing will take time and a global rally in the credit markets won't materialize until the end of 2009,

according to Darren Rickards, head of corporate banking for Central Europe, Russia, the Middle East, and Africa at Bank of America/Merrill Lynch, speaking at the TMT conference in Doha.

Telecom stocks, too, have stumbled. In 2008, Verizon's share price declined by 17 percent; China Mobile Ltd.'s by 38 percent; and Vodafone Group's by 41 percent. In addition, as available capital has become scarce, M&A investments have slowed in many industries, including telecom—

even in the MENA region. Telecom investment was almost cut in half in 2008, falling to US\$10.4 billion from \$20.6 billion in 2007. Several regional transactions were shelved or canceled.

However, the underlying fundamentals of the MENA telecommunications industry have held up, even during the challenging environment of 2008. The number of telecom subscribers in the MENA region increased by 4.5 percent to 227 million, while MENA telecom

operators' revenues increased by 11.5 percent to \$40.6 billion.

This strength echoes the telecom industry's historical resilience, as compared with other industries. Consumers view telecom as an essential service, and it constitutes a relatively small percentage of their disposable income. In some markets that are not yet saturated, telecom is exhibiting strong growth, driven by the expansion of network coverage. For all of these reasons, investment in telecom is warranted.

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INVESTMENT OPPORTUNITIES FOR MENA OPERATORS

There is no shortage of appealing investment opportunities for MENA telecom operators—in both core, traditional investment arenas and a new breed of businesses.

Core Telecom Investment Opportunities

Many MENA telecom operators, such as Zain, Etisalat, Qtel, Batelco, Saudi Telecom, and Orascom, have relied on cross-border M&A to fuel growth. Typically, the recent reduction in the availability of funding globally would curb companies' moves into new markets and industry-wide M&A. However, because the economic crisis also has had a negative impact on the valuations of many telecom providers and has hindered the ability of many operators to secure necessary funding, even strong operators may now consider shedding nonstrategic assets. As a result, there have been opportunities for well-financed companies to exploit, particularly with cash-strapped or distressed operators that are ripe for buyouts. This dynamic, coupled with the scarcity of greenfield opportunities, indicates that bigger consolidation deals are imminent.

Some MENA operators continue to aggressively pursue M&A transactions. During the first quarter of 2009 alone there were significant telecom transactions in Iran, Bahrain, India, and Morocco. Jeremy Sell, acting chief strategy officer of Qtel, indicated in Doha that this trend will continue. "It is not difficult to go out and buy things in the downturn," he said, adding that Qtel would likely tap into the debt market as opposed to raising capital by selling equity.

Simultaneously, MENA operators are now looking inward to generate value from their investments. Operators are becoming more conscious of the bottom line and are endeavoring to maximize the value of their assets. Incumbents, for example, are now seeking to release capital from their infrastructure. Batelco Group CEO Peter Kaliaropoulos confirmed his company's strategy regarding infrastructure sharing: "There is value to release in all of our assets. We must catch up and shift to infrastructure sharing in most, if not all, of our markets." Moreover, operators are seeking to create value and capitalize on the synergy potential of their cross-border investments. Ali Alahmed,

Etisalat's executive vice president of planning and strategy, stated, "We need to consolidate our investments and extract synergies from them."

Regulators play a key role in creating an environment that is conducive to investment: Regulatory policies remain a catalyst for telecom investments, whether for cross-border M&A or investments in existing operations. William Fagan, regulatory authority executive director for ictQatar, an independent regulator, emphasized the importance of the regulators' role: "It is not enough to focus on the consumer. An investment-friendly environment must be created."

A New Breed of Telecom Investment Opportunities

New business opportunities are emerging for telecom operators—in

such industries as mobile banking, education, and healthcare. These are nascent businesses with enormous room for growth.

The convergence of media and telecom, in particular, remains a hot-button issue. At Doha, several telecom operators spoke of the threat—real and perceived—from social networking and mobile content applications providers such as Google, YouTube, and Yahoo.

The MENA region's online landscape is dominated by leading U.S. companies. Google, Facebook, Microsoft, Yahoo, and YouTube have a virtual lock on the market; they featured regularly among the three most visited Web sites in each of 13 MENA nations in early 2009. Many leading online content providers don't yet have Arabic content

online, creating both a void and an opportunity for telecom providers.

Telecom operators are concerned that these applications providers will relegate telecom companies to little more than pipelines—commodity services that do not provide real value. As a result, operators increasingly are shifting their focus further down the telecom service value chain, past networks and pipelines and into content and social networking. Telecom operators recognize that they need to regain ownership of the interface with their customer. At the TMT Finance & Investment Middle East conference, Dr. Fahad H. Mushayt, head of Saudi Telecom's strategic investments unit, spoke of his company's commitment to expanding its scope of operations by recognizing the convergence of telecom and media. In the MENA region, media is forecast

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to grow at an annual pace of 25 percent through 2014. However, its scale is relatively small: Digital media will represent only about 3 percent of total telecom revenue in 2009. Nevertheless, there are indications that action in several areas of the converged telecom-media space will drive investment:

1. *Regional traditional media companies.* These businesses will likely seek access to digital traffic to distribute their content. Access

to telecom networks in regional markets may enable them to best serve the region.

2. *Regional telecom operators.* The incumbent telecom providers are likely to develop mobile ad delivery capabilities beyond SMS/MMS channels and gain greater control over content.

3. *Regional digital media companies.* These growing companies are likely to integrate innovative applications and

premium content into existing telecom services—probably through partnerships with telecom operators.

4. *Global media companies.* Traditional media, advertising, and digital media companies are likely to seek access to the MENA region's relatively strong economic base by expanding investments and their presence into the region.

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THE OUTLOOK FOR FINANCING TELECOM INVESTMENT

The slowdown in telecom M&A reflects the woes of the cross-border growth market. Capital has become increasingly expensive and access to financing has become more difficult. As a result, most company valuations have been negatively affected and shareholders are adopting more prudent and risk-averse strategies.

Nevertheless, many MENA operators still have sufficient capacity on their balance sheets to raise the necessary funding to continue investing. MENA operators, on average, have only one-third of the debt-to-cash-flow ratio of their European counterparts.

The prevailing sentiment at the conference was that equity markets are unlikely to be the source of much financing in the short term, and operators should favor debt markets. Aggressive cross-border mergers and acquisitions in pursuit of scale, though a successful strategy for MENA operators in the past,

will likely be less appealing to lenders and shareholders than targeted transactions with tangible synergies.

Bankers at the conference stressed that club loans—smaller, syndicated loans—are still available and an optimal source of financing for the telecom sector for the next several months. Despite the tighter credit markets, it's not all doom and gloom, said Mehmet Abbasoglu, executive director and head of MENA TMT at J.P. Morgan. "Find the right opportunities and financing will come," he said.

In addition, global equity-based stock transactions (or "paper deals") actually increased in 2008, rising 27 percent. This might provide an ideal solution for stronger operators looking to acquire companies in distress, as well as fragile operators that have struggled to secure financing and are seeking funds, but whose shareholders do not want to exit the industry.

CONCLUSION: WHAT COMES NEXT

The global economic crisis has spared few industries—but the telecom industry, particularly in the MENA region, has exhibited relative resilience. Nevertheless, the downturn has spurred telecom operators to rethink their investment strategy.

New opportunities have emerged from the downturn. Weaker industry participants are seeking exit strategies and even some stronger ones are looking to shed nonessential assets and release value from their existing investments. That is creating an opportunity for industry participants to strike opportunistic mergers or acquisitions.

Moreover, new growth opportunities are emerging at the crossroads where telecom meets other industries, such as financial services, health,

education, and media. These are nascent opportunities and operators are seeking to capitalize on this convergence.

Some MENA telecom operators are well positioned to leverage their balance sheets and reinforce their leadership positions. They can, for example, boost capital expenditures to enhance their coverage before the competition does so. They also can secure better terms and discounts from vendors by offering to pay in cash. Operators can acquire struggling or cash-strapped operators at attractive prices.

Access to capital may be more difficult to secure nowadays; nevertheless, it remains available. Lenders recognize both the industry's relative resilience during downturns and its strong prospects.

Endnotes

¹ The GCC includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

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