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## Telecommunications service providers expect CAPEX to increase

Russian telecom market: 2022 outlook

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- **ACRA estimates show that in 2018, the Russian telecommunications market may grow by 3.7%, up to RUB 1.64 tln.** Afterwards, we expect the market to grow by 2.7% annually, with the growth rate slowing down by 2022. The key segment of the market is mobile communications, covering 50% of the market volume.
- **Sector's profitability will continue to restore.** Reintroduction of unlimited mobile data tariff plans should not affect ARPU (average revenue per user) and profitability of TSPs thanks to a cautious pricing policy. Strong competition may prevent companies from passing the growing data storage expenses down to users, which may restrict the profitability. According to our estimates, the FFO margin before net interest and taxes may reach 36% in 2018 and grow by 1–2 pps in the next four years.
- **Starting from 2019, ACRA expects that TSPs' CAPEX will surge.** According to ACRA estimates for the next five years, CAPEX (capital expenditures) for data storage infrastructure may reach RUB 250 bln, with a peak in 2019–2020. In 2021–2022, TSPs will start investing in 5G networks. As a result, the CAPEX to revenue ratio in the telecommunications sector may grow from the current value of 16% up to 24% by 2022.
- **Growing CAPEX may push sector's FCF down to negative values.** Large-scale investment projects will push down FCF (free cash flow) demonstrated by TSPs. In addition, FCF will be affected by annual dividends, the aggregate amount of which, according to our estimates, will not be lower than RUB 90 bln in 2018–2022. Therefore, we expect that the aggregate FCF in the telecommunications sector will enter the negative area in 2019–2022, which, in its turn, will further pull the absolute debt up. On the other hand, taking into account faster growth rate of FFO before net interest and taxes, we expect that the decline in the sector's leverage will be slow.

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Table 1. Operational and financial performance forecast for TSPs

Indicator	UoM	Actual			Est.	Forecast			
		2015	2016	2017	2018	2019	2020	2021	2022
<b>Operational indicators</b>									
Subscribers									
Mobile communications	mln subscribers	252.5	254.9	259.1	259.3	259.8	260.7	262.1	263.6
Fixed telephony	mln subscribers	33.2	30.3	27.9	25.8	23.9	22.2	20.8	19.6
Broadband Internet <sup>1</sup>	mln subscribers	31.8	32.4	34.9	35.4	36.0	36.6	37.2	37.7
TV <sup>2</sup>	mln subscribers	24.1	25.2	26.3	27.4	28.5	29.6	30.8	31.9
<b>ARPU</b>									
Mobile communications	RUB	299	291	299	311	323	331	338	345
Fixed telephony	RUB	382	370	363	337	319	313	311	314
Broadband Internet	RUB	462	468	460	462	467	472	474	477
TV	RUB	178	205	227	250	274	294	308	317
<b>Financial indicators</b>									
Revenue	RUB bln	1,492	1,522	1,579	1,636	1,687	1,732	1,776	1,820
FFO before net interest and taxes	RUB bln	542	515	555	590	610	626	645	665
FFO margin before net interest and taxes	%	36%	34%	35%	36%	36%	36%	36%	37%
Debt/FFO before net interest and taxes	x	2.20	2.19	2.15	2.12	2.10	2.07	2.03	2.01
CAPEX/revenue	%	21%	18%	16%	18%	22%	23%	23%	24%

Source: ACRA

<sup>1</sup> Landline broadband Internet services only.<sup>2</sup> Excluding satellite TV operators.

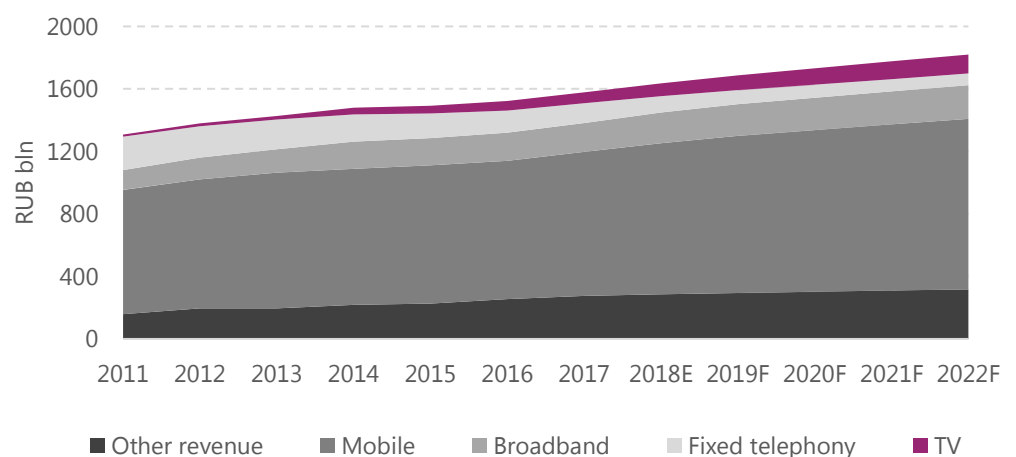
## Telecommunications market has been growing steadily, ...

According to ACRA estimates for 2017, the volume of the Russian telecommunications market amounted to RUB 1.58 tln. Over a half of the volume falls on the mobile telecommunications segment (58%, and this share has remained almost unchanged in the last seven years). The share of landline telephony has been steadily declining: from 2011 to 2017, the share has shrunk twice to 8%, while the shares of broadband Internet and pay TV services have grown from 10% to 12% and from 1% to 4%, respectively.

The only segment that has demonstrated a decline in its subscriber base is landline telephony. ACRA projects that, in the next five years, the number of subscribers in this segment will decline on average by 7% annually. The remaining segments of the telecommunications market have already reached the saturation point or are close to it. Therefore, we see no grounds for a significant increase in the number of subscribers. It is worth noting a certain change in the subscriber base structure in the mobile segment. According to ACRA estimates, at the end of 2017, the number of subscribers of Russian mobile operators amounted to 259 million, with about 14 million SIM cards in the M2M and IoT segment. We expect that in the next five years, the classic subscriber base will decline at an average annual rate of 0.3%, while the M2M and IoT segments, on the contrary, will grow by 10% per year on average. After 2020, the growth of the IoT subscriber base may accelerate, along with a gradual transition to 5G communication standards. In addition, with the growing average speed of mobile Internet access, we allow for the possibility of a certain flow of subscribers from fixed broadband segment to mobile segment.

ACRA expects that in 2018, the volume of the telecommunications market could grow by 3.7%, to RUB 1.64 tln. Amid a stable subscriber base, ARPU dynamics and the ability of providers to pass additional capital expenses onto subscribers will have a decisive influence on the market volume.

**Figure 1. Mobile communications as a key market segment**



M2M means Machine-to-Machine.

IoT means Internet of Things.

The forecast is made in compliance with [General Principles of Socioeconomic Indicators Forecasting](#).

Source: ACRA

...regaining profitability

In 2H2018, cellular companies started to reintroduce unlimited mobile data tariff plans. But this decision should not lead to such negative consequences as a drop in FFO margin before net interest and taxes to the minimum value (34%) observed during the intensification of competition several years ago. A more cautious pricing policy in respect of such tariffs will be able to support the ARPU growth in the segment.

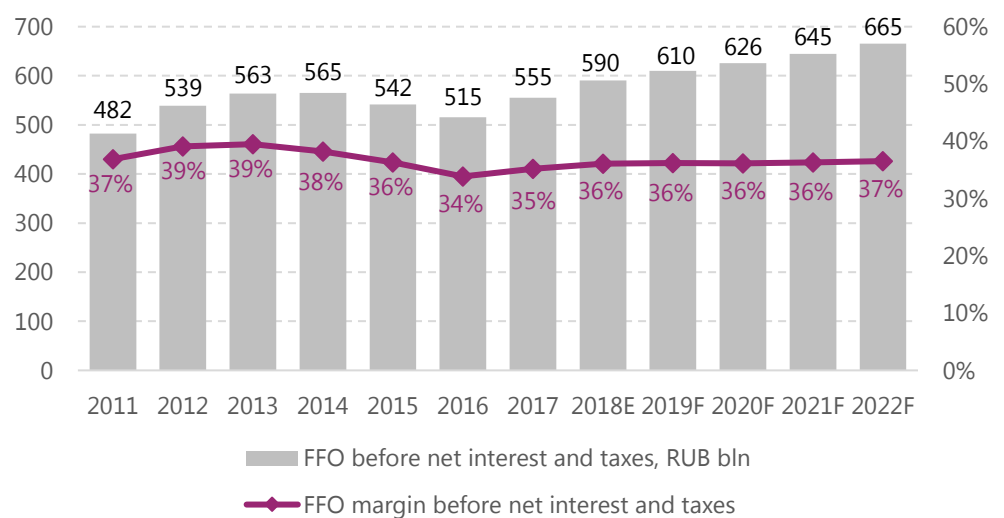
In the next two or three years, the entire market's ARPU will be affected by the need to cover expenses for building-up data storage infrastructure. However, in view of the strong competition, operators may encounter difficulties trying to pass such expenses onto consumers. In ACRA's opinion, the operators will be able to do so only in part of the increased operating costs for servicing new infrastructure. As a result, we expect that in this period, ARPU will grow by 3% in the mobile segment, 1% in broadband segment, and 7% in the pay TV segment, while in the fixed telephony segment, ARPU is expected to decline by 3% (all figures are annual averages).

ACRA projects that, thanks to the above-mentioned ARPU and subscriber base dynamics, the trend of restoring FFO margin before net interest and taxes will remain, but ACRA does not expect a significant increase in this indicator: in 2018, it will increase from 35 to 36%, and in the next four years, it may grow by another 1-2 pps.

*Network Neutrality is the principle that Internet service providers treat all data on the Internet equally, and not discriminate or charge differently by user, content, website, platform, application, type of attached equipment, or method of communication.*

In their run for higher margins, sector companies may try to eliminate network neutrality. However, currently, ACRA does not include this factor in its baseline scenario in view of high uncertainty in its implementation strategy.

Figure 2. Growing data storage infrastructure expenses may restrict margins



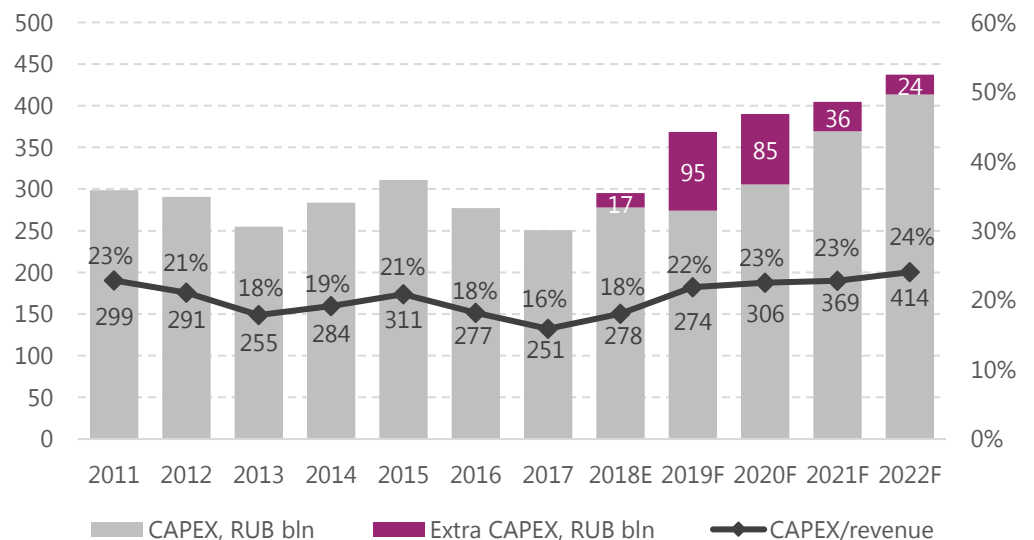
Source: ACRA

## Investments in data storage infrastructure and 5G networks will push CAPEX up

In the next five years, telecommunications operators will face two waves of heavy capital expenditures. The first one, which is actually already starting, is connected with changes in the Russian legislation that require the sector companies to store user data traffic. To comply with the new law, companies will have to build an appropriate infrastructure. The situation is complicated by the fact that the operators still have no clear understanding of the requirements for such infrastructure. Nevertheless, many companies have already taken first steps in this direction, and according to ACRA estimates, their extra capital expenditures will amount to RUB 15–20 bln by late 2018. CAPEX will peak in 2019–2020, and in the next five years, according to ACRA forecast, the aggregate capital expenditures of all Russian telecommunications companies for data storage infrastructure may reach RUB 250 bln (the amount may vary depending on the ruble exchange rate).

As CAPEX for data storage infrastructure declines, we expect a second wave of capital expenditures, which will be associated with investments in 5G networks. The progress on 5G projects will depend on the market demand. On the one hand, at present, we see no urgent need for new generation systems, either by retail consumers or by corporates. On the other hand, the state program for digital economy may accelerate 5G penetration. It should be noted that there is no consensus on the 5G network development model so far: one option is that each operator builds its own network, partially cooperating with other players; the other option is a single-operator infrastructure.

**Figure 3. Having invested in data storage infrastructure, companies will start to invest in 5G networks**



Source: ACRA

## Sector's leverage is stable

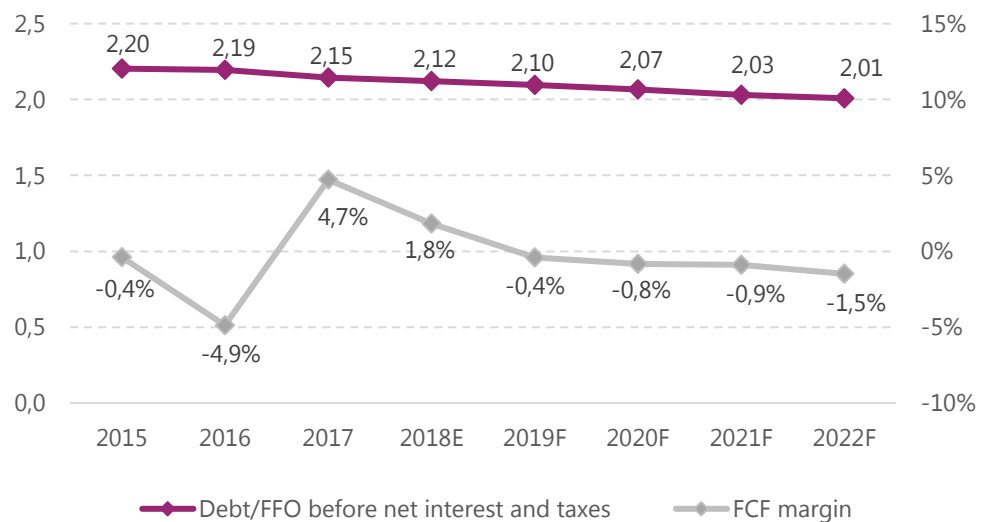
In 2015–2017, FCF demonstrated by telecom operators was under pressure from declining operating margins, and starting from 2018, the restraining effect has been caused by growing capital expenses. Historically, the telecommunications sector is one of the largest dividend generators in Russia, showing a noticeable outflow of funds. According to ACRA estimates, a certain decrease in dividend payments will be observed in the sector in 2018–2022, but the total annual dividends will not fall below RUB 90 bln.

ACRA expects that in 2019–2022, the above factors will push down the sector's FCF after dividend into the negative zone, while FCF margin will range from -0.5% to -1.5%.

To cover their negative FCF, telecommunications companies will likely have to borrow more. On the other hand, due to the higher growth rates of FFO before net interest and taxes, the sector's leverage may remain low or even decrease slightly. We are of the opinion that the ratio of debt to FFO before net interest and taxes may decline from the current level of 2.15x to 2.01x by 2022.

Our forecast includes an outflow of funds spent to repurchase shares by PJSC MegaFon and PJSC MTS. However, we note that in the future, such events as M&A, increased dividend payments, and share repurchase may increase the leverage, which, in turn, may adversely affect the solvency of certain companies in the sector.

**Figure 4. Irrespective of growing absolute debt, sector's leverage will tend to decline**



Source: ACRA

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