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Global Telecommunications Financial Performance Tracker

Full Year results 2005

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Following the successful publication of our first half-year study earlier this year, it gives me pleasure to introduce the first full year results of KPMG's Global Telecoms Financial Performance Tracker. As with its predecessor, the Tracker records and analyses the financial performance of the top 20 companies in each of the three major telecoms regions of the world – Europe, the Middle East & Africa (EMA), the Americas and Asia Pacific (ASPAC). Our member firm Partners have then developed perspectives on the key trends in each region's telecom industry based on these performance indicators, and offer indications as to how these may play out in the quarters to come.

To this end, this edition of the Tracker provides a view on the two industry trends that are providing the underpinning framework for telecommunications service provision in the so-called 'next generation'. As competition for customers continues unabated across the globe – and particularly in the world's more saturated, mature markets, the desire to build size and scale into operations has never been stronger. Consolidation was a defining pattern in telecoms service markets in 2005 as carriers look to increase revenue volume in increasingly lower margin traditional connectivity businesses. The North American market was particularly impacted by a wave of 'mega mergers' in 2005.

Telcos and celcos are not simply digging deeper into their traditional backyards, however. New technologies and business models are allowing them to dig into neighboring competitive spaces. 2005 saw carriers across the globe leverage these convergence trends to bring bundled voice, data, and broadcasting services to the market, and to continue to blur the lines between fixed and mobile services.

Successful strategies for telecoms carriers are of course those that deliver truly improved financial performance, and not simply increase market share or launch headline-grabbing converged multimedia services for their own sake. In this regard, the year to come will likely bring the industry a clearer picture of whether these attempts to consolidate and converge service offerings are paying off in improved returns on investment in both infrastructure and operations.

I hope that the on-going monitoring and analysis of the industry by KPMG's Communications practice through this report will serve to keep you informed and on top of the ever evolving and ever expanding telecoms sector.

Yours sincerely

Sean Collins
Global Chair, KPMG’s Communications practice

Americas region full year results 2005

What the numbers indicate

- A relatively healthy year for sales growth was due to the continued expansion of 'basic' mobile connectivity subscribers, and increasingly the value-added services that mobile-centric customers want. Fixed line services are serving as a drag on growth overall.
- Operational cost reductions, and increased scale of operations, are having the desired impact on profitability.
- Return on Capital Employed (ROCE) is still low when compared with other industries, but 2005 results show some indication that consolidation strategies may soon begin to have the desired impact on operations.
- Cash flow from operations remains steady but 2005 saw a slight dip, as price-based competition to maintain or improve market share takes its toll.
- Debt levels have leveled out in 2005 as consolidation and market expansion strategies have run their course.

Challenges for the future

- Maintaining market share and retaining newly acquired 'bundled' customers will be the first priority, in an attempt to improve margins and profitability over the longer term.
- Defining 'Multi-play' services around distinct new and existing customer segments will be the main tool towards differentiation, largely centered around voice, broadband and cable TV packages.
- Existing facilities based service providers in both the mobile and fixed space to improve their 'supply chains' with multimedia content and applications providers, to ensure that customers can access new services on demand.
- Customer relationship management will be a critical tool for maintaining market presence to determine ultimate price points and billing relationships.

Metric	All companies			Excluding mobile		
	2003	2004	2005	2003	2004	2005
Sales growth (%)	10.5	4.8	7.4	9.5	0.3	-0.7
Pre-tax profit (US$ billion)	31.6	20.0	40.0	25.3	12.5	29.9
Profit margin (%)	9.4	5.6	9.1	8.9	4.3	8.3
Return on capital employed (%)	9.3	5.5	8.8	9.4	4.9	9.2
Cash flow from operations (US$ billion)	91.6	82.9	77.4	77.3	66.5	52.0
Total debts (US$ billion)	345.7	399.8	400.3	301.5	332.5	331.4
Gearing (%)	44	42	32	48	49	37

Source: KPMG International – August 2006. The results used in the half year tracker calculated ROCE using PAT rather that EBIT, therefore accounting for a much lower ROCE. Pre-tax profits, cash flow from operations and total debts are in US dollars. Gearing percentage calculated using debt/debt+equity.

Regional trends

Throughout the Americas, continued intense competition served as the catalyst for M&A activity to combat price erosion with larger scale of operations. In North America, consolidation surged ahead as carriers sought to build back up the comprehensive service operations of decades back, unifying long-distance, local telephony and in most cases mobile offerings as well. In Latin and South America, acquisitions carried forward a general trend of creating portfolios of similar businesses across the region. As elsewhere, price competition is one of the key issues for both the fixed and mobile sectors. Increased market presence is starting to pay off for successful acquiring parties, not only because of the expanded scales of their businesses, but in their ability to improve both capex and opex performance by getting better deals from their suppliers.

Like the rest of the world, North American carriers are seeing another front open up in the battle for customers – the market for converged telephony and broadcasting services. In fact, no other region has seen as pronounced a fight between telcos and broadcasters – in this case the cable television incumbents. The immediate concern for combatants on either side of the field is locking in subscribers in these hyper-competitive, increasingly saturated markets. This added to the continuing investments needed to successfully deliver more comprehensive, multimedia service packages will likely weigh down profit growths, but triple- and even quadruple-play efforts are showing some early positive counter-balancing effects.

Driving all these competitive efforts is the desire to create an enduring relationship with subscribers that can act as a competitive buffer to the disruptive new, IP-based telephony services that are leveraging the region's increasing broadband penetration. Internet-centric players still have substantial power and are driving out margin in the last stands of long distance voice services, which in turn is increasing regulatory attention on the role that these new, non-facilities carriers are playing in the telecoms ecosphere. Control over the 'last mile' to customers – be it over a fiber connection to the home or the enterprise, or a wireless link – will be the defining competency in the battle to come.

EMA region full year results 2005

What the numbers indicate

- While overall sales growth improved substantially in 2005 over 2004, the slow-down in mobile growth reveals the extent to which Europe's mobile markets are saturated – fixed line operations, thanks to broadband, are the new growth driver.
- Both overall profitability and profit margins continued to climb last year, although effective levels of competition are increasing.
- Return on Capital Employed (ROCE) also improved, and while low compared to other industries, is at a much more favorable level than counterparts in similarly mature American markets.
- Cash flow also healthier in Europe, and again is largely due to the rapid expansion of data services and broadband businesses.
- Debt levels overall were steadily reduced in 2005, aided in particular from the efforts of mobile carriers in paying down their 3G-driven debt.

Challenges for the future

- While scale has been achieved for many of the region's top carriers, the business of managing disperse operations across several markets continues to provide operational challenges.
- Creating seamless mobility experiences – particularly on non-voice, multimedia services – is paramount for European carriers if they are to make their 3G investments pay off.
- Scale and expanded market presence brings with it increased transparency on international and wholesale services, and price levels are thus under threat in the year to come.
- Perhaps more so than other regions, carriers need to be mindful of the attempts of regulators to introduce 'equivalence' regulation which stands to place facilities-based incumbents at a distinct disadvantage.

Metric	All companies			Excluding mobile		
	2003	2004	2005	2003	2004	2005
Sales growth (%)	3.5	1.9	6.4	0.8	-0.4	8.3
Pre-tax profit (US$ billion)	-7.4	34.5	45.0	18.6	39.7	48.7
Profit margin (%)	-4.8	3.8	7.0	6.1	8.8	11.6
Return on capital employed (%)	5.3	7.9	9.3	4.0	5.8	8.0
Cash flow from operations (US$ billion)	114.5	124.5	128.7	79.0	92.0	88.4
Total debts (US$ billion)	346.5	357.6	329.7	256.8	317.5	244.5
Gearing (%)	38	38	39	53	55	47

Source: KPMG International – August 2006. The results used in the half year tracker calculated ROCE using PAT rather that EBIT, therefore accounting for a much lower ROCE. Pre-tax profits, cash flow from operations and total debts are in US dollars. Gearing percentage calculated using debt/debt+equity.

Regional trends

While Europe is host to the largest concentration of mature, slow-growing telecoms economies, the region has still not seen the levels of price competition that has characterized North America. Even in the region's robust mobile sector, most European markets are usually only served by two cellular providers. Slightly less intense competition is the legacy of the fact that, naturally, Europe's markets are individually small, and have been serviced by incumbents well-guarded by their national borders. This has helped them maintain reasonable cash flow levels and return on cash even through the recent downturn.

In 2005, however, the story changed significantly, in two important ways. Firstly, consolidation fever accelerated in Europe as well – many incumbents expanded or consolidated investment portfolios that brought scale, and increased effective levels of competition for companies across the region. European consolidation had several strategic objectives, many in line with the scale-seeking attempts of their American counterparts. In fact, many European carriers have actually hunted for scale in the less mature Latin and South American theatre. Like the U.S. market as well, Europe's carriers have been investing in deepening their service portfolios to include both fixed and mobile services, in many cases bringing back cellular operations previously spun out of fixed line incumbents. Finally, consolidation also was seen in new service businesses, as traditional carriers look to fold professional services and integration businesses, as well as Internet companies into their operations.

The second important change has come in the return of organic growth in fixed services as broadband growth soars in the region. Uniquely in 2005, EMA saw a 'flip' in growth trends away from mobile, penetration of which has reached true saturation (again, in distinct contrast to the Americas, where there was still strong organic mobile growth). The health of the fixed broadband market served as a welcome source of growth, not in the least because Europe's mobile competitors are still struggling to push 3G services into realizing their potential. Opportunity has been created therefore for carriers in both fixed and mobile spaces around converged, next generation service offerings, but the future also brings risk, particularly as broadband penetration brings with it the threat of new Internet-based service competition.

Asia Pacific region full year results 2005

What the numbers indicate

- Sales growth, still largely mobile-driven, improved slightly in 2005, reflecting both organic growth in developing markets and growth in value-added services in mature Asian markets.
- Profit levels remained stable, but profit margins dipped slightly, reflective of the levels of price competition that are evident throughout Asia.
- Return on Capital Employed (ROCE) remains the highest of all the regions, thanks to the scale of operations in Asia, but also dipped slightly in 2005 as competitive pressure increased and capital investments continue.
- Reasonably healthy cash flow improved in 2005, and in fact more growth in cash flow was seen in the fixed sector as broadband-based triple-play strategies begin to show results.
- Asian operators reduced their debt levels slightly last year, and in general mobile carriers are in better shape than in the other regions.

Challenges for the future

- Price erosion continues to be the biggest threat for carriers in growth markets and mature markets alike. The cost of acquiring customers is mounting, and customer expectations on all services – mobile, broadband and even value-added services like IPTV – will continue to impact average revenue per subscriber.
- High growth market leaders in Asia's largest economies must invest more in CRM applications and strategies, as the basis of competition swiftly shifts from new customer acquisition to existing customer retention.
- While successful 3G strategies were effectively 'born' in Asia, the challenge still remains to bring substantially higher-value non-voice services to Asia's less mature markets, still largely defined by pre-3G, SMS-driven value-added content.

Metric	All companies			Excluding mobile		
	2003	2004	2005	2003	2004	2005
Sales growth (%)	7.6	4.1	5.1	7.0	3.7	3.8
Pre-tax profit (US$ billion)	39.9	48.8	47.1	22.3	28.5	27.4
Profit margin (%)	10.9	13.2	12.8	9.1	11.6	11.3
Return on capital employed (%)	13.4	15.1	14.2	10.6	12.2	11.6
Cash flow from operations (US$ billion)	82.7	82.2	92.8	55.0	56.6	59.4
Total debts (US$ billion)	253.6	243.4	231.8	210.2	199.3	185.7
Gearing (%)	37	32	28	43	38	34

Source: KPMG International – August 2006. The results used in the half year tracker calculated ROCE using PAT rather that EBIT, therefore accounting for a much lower ROCE. Pre-tax profits, cash flow from operations and total debts are in US dollars. Gearing percentage calculated using debt/debt+equity.

Regional trends

Asian telecom markets typify the world's two defining telecoms growth trends, and their carrier's strategic responses to them. The growing scale of service operations in Asia is massive. More than fifteen million new mobile subscribers were added to Asian networks every month in 2005, half of them in two markets, India and China, alone. Asian carriers are now amongst the world's largest operators of mobile services, and the successful growth stories have a tremendous impact in the world's least developed markets, as mobile connectivity has in effect become basic connectivity. Mobile competitive pressure on fixed line services has also long served as the catalyst for fixed line carriers to defend themselves with rapid broadband roll-outs in the mature markets of North Asia – Korea, Japan, Hong Kong and Taiwan.

This in turn has made the region notable for its massive advances in developing convergence services. Mobile carriers in mature markets have been at the world's forefront of pushing the 3G envelope. Korea and Japan alone were home to nearly two thirds of the world's 3G subscribers in 2005, and growth of mobile data services has helped keep revenues and profits buoyant in the sector. However, broadband-rich fixed incumbents have not stood still, and have been using DSL installed bases to offer a host of converged service offerings, particularly IPTV.

Uniquely for the world's telecoms markets, Asian carriers have been more closely aligned with the national infrastructure initiatives and general pro-technology policy pushes of governments, and this has been another key to their success. Government pressure can have positive benefits for the telecoms economy: it is governments that are leading the charge to roll out Fiber-to-the-home or curb strategies throughout the region. Japan is the most salient example, where incumbents still pour trillions of yen into last-mile fiber projects and millions of Japanese now enjoy 100Mbps broadband access for less than US$50 per month. But carriers are beginning to see the threat of loss of control in continued investment in high-capacity fiber access, and this is causing tension between governments and carriers in markets such as Australia and New Zealand. This tension between the previously mutually compatible interests of the state and its telecoms carriers will need to be resolved soon if players in the region are to continue to maintain their world-beating lead in next generation services.

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