Increasing focus on working capital in the telecoms industry

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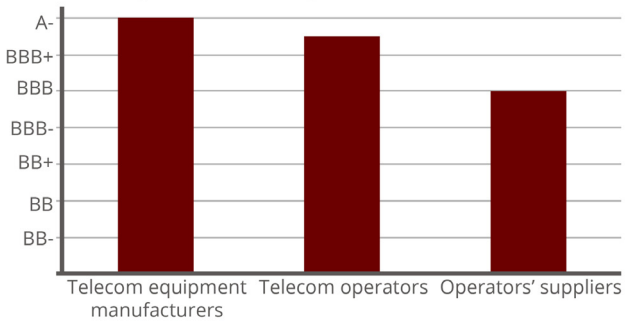
Communication companies display the lowest ratio of working capital to sales across sectors and have one of the highest capital expenditures ratio. Their working capital efficiency is used to support the funding of their capital expenditures and as the latter is increasing due to growing demand for network infrastructure, increasing data consumption and rapid technological innovation, we observe that initiatives aiming at working capital optimisation have been increasingly popular in the industry.

Rapid growth, continuous technological change and diversification strategies drive the need for investments from telecom equipment providers

Since 2007, the global telecom equipment market's revenue has increased at an average annual growth rate of 7.9% and this rapid growth is projected to be sustained by increased connectivity supported by the availability of affordable smartphones in emerging markets and a decline in communication tariffs, the continued deployment of LTE networks as well as the rollout of 5G networks expected from 2020.

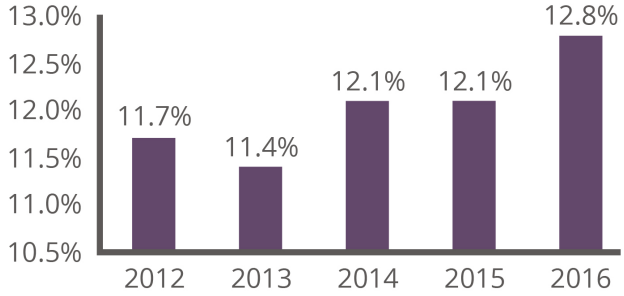
The industry that has traditionally been dominated by three players – Ericsson, Nokia and Huawei which accounted for 86% of the market in 2015 – is experiencing a commoditisation of telecom equipment and the emergence of Asian actors resulting in enhanced price competition among leaders and downward pressure on prices.

Average credit ratings (as of 25 June 2017)



Source: *Crédit Agricole calculations on a selection of top 10 operators and top 5 telecom equipment manufacturers by revenues*

Aggregate R&D ratio of telecom equipment vendors (% of sales, 2012-2016)



Source: *Xerfi, The Global Telecom Equipment Industry*

As developed markets have reached maturity in the rollout of LTE networks with 90% population coverage, providers have shifted toward the introduction of 5G technology, pursuing aggressive investments strategies to become market leaders and get the first mover advantage.

Moreover, the commoditisation of network equipment also induced equipment providers to pursue diversification strategies towards IT services activities (IoT, software focus activities, network security solutions, data analytics), often happening through the acquisition of specialised companies. For instance, Cisco acquired CliQr Technologies in April 2016, while Ericsson acquired NodePrime in April 2016. The creation of partnerships such as Cisco and Microsoft, Fujitsu and Microsoft, Nokia and Hewlett Packard has emerged as another route for diversification. This shift has broadened telecom equipment providers' competitive landscape as they have now to compete with well-established IT services companies like IBM, Hewlett Packard and Accenture as well as new entrants like Facebook which recently launched Voyager, a transponder and routing device for optical networks. The gradual move towards IT-services involves high investments from companies that are therefore growing concerned about optimising their cash flow generation to support growth opportunities while continuing to improve shareholder value.

Those significant changes in the telecom equipment industry require higher needs for liquidity for companies and they have increasingly been seeking out solutions helping them generate additional liquidity through working capital efficiency. For instance, solutions like supply chain finance have helped equipment providers extend payment terms to their suppliers, generating liquidity through payables creation. The on-boarding of suppliers in supply chain finance schemes is incentivised by stronger credit ratings of telecom equipment providers, allowing suppliers to benefit from lower cost of liquidity. Telecom equipment providers

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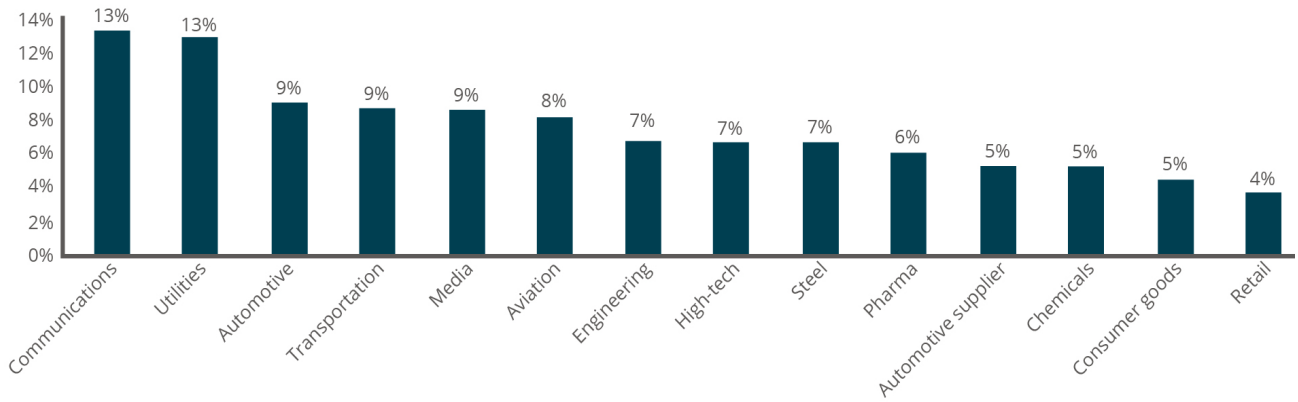
Capex-to-sales ratio



Source: *Reuters*

are also increasingly using receivables financing to optimise their working capital, through securitisation programmes, forfaiting schemes or customer financing initiatives. For instance, Cisco has an off-balance sheet financing programme consisting of revolving short-term financing, generally with payment terms ranging from 60 to 90 days. Huawei has a trade receivables financing with recourse programme, and ZTE has trade receivables factoring agreements with certain domestic banks.

Mobile operators' liquidity tied-up to equipment instalment plans

Mobile operators' increasing focus on working capital mainly stems from the balance sheet impact caused by sales of handsets to customers through financing plans. In developed countries, the near-saturation of smartphone markets lowered the number of first-smartphone acquisitions, turning down the volumes of smartphones sold. However, this decrease in volume of smartphones sold is not preventing the industry from displaying a growth in value as devices are getting more expensive. In fact, a study from Gfk Group estimates that the average price of unsubsidised handsets in 75 markets has increased by 7% from 2016 to 2017.

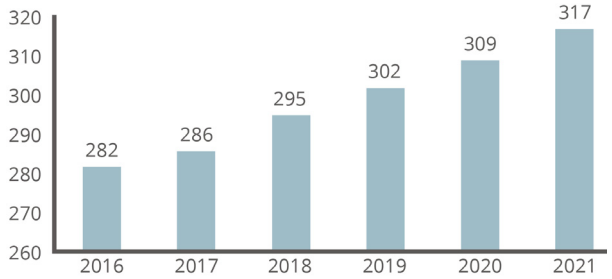
This surge in handset prices impacts mobile operators from a cash flow perspective as they are generally paying manufacturers within a 3-month delay, whereas their customers typically repay them over a 12 to 24-month period. Moreover, European countries also see their prepaid business decreasing against post-paid contracts. Consequently, operators are dealing with a significant portion of their liquidity tied-up to smartphones financing plans and pressure on their balance sheet as the value of their receivables and inventories is inflating.

To tackle this challenge, telecom operators increasingly resort to handset financing receivables securitisation programmes and other receivables financing solutions. For instance, Vodafone has an off-balance sheet handset receivables purchase programme, Deutsche Telekom has factoring programmes, improving working capital efficiency and cash flow generation. The securitisation process backed by customers' instalment payments is expected to become the third largest consumer finance market behind car loans and credit cards in the US. On the payables side, mobile operators' working capital efficiency is also improved thanks to supply chain finance initiatives as they generally benefit from stronger credit profiles than their suppliers. Among actors using payables financing, Liberty Global, British Telecom and Vodafone, have supply chain finance programmes.

IFRS 15 Revenue Recognition and IFRS 16 Leases standards impact

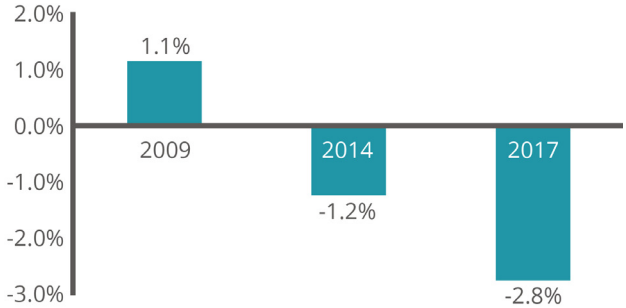
Telecom companies' 2018 financial statements are expected to be impacted by the IFRS 15 Revenue Recognition, which came to force from January 2018. The main principle

Global average selling price of smartphones 2016-2021 (in US$)



Source: *Statista*

Telecom operators NWC/sales evolution



Source: *Crédit Agricole calculations on a selection of 10 European operators*

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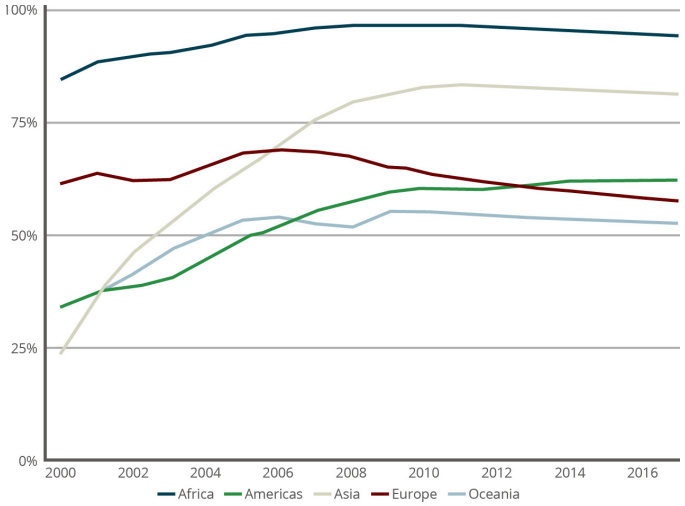
Prepaid as a % of connections (2000-2017)



Source: *Wireless Intelligence*

Smartphone sales Q4 2016 vs Q4 2017

	Units sold (millions)			Sales value (in US$bn)		
	4Q16	4Q17	Y/Y% change	4Q16	4Q17	Y/Y% change
Western Europe	38.3	37.0	-3%	16.1	18.8	17%
C & E Europe	23.6	25.2	7%	5.4	6.9	28%
North America	58.7	62.0	6%	27.4	28.5	4%
Latin America	33.1	35.0	6%	10.0	11.2	12%
Middle East & Africa	42.6	46.2	8%	10.6	10.9	3%
China	118.4	114.7	-3%	36.6	43.0	17%
Developed Asia	20.3	18.5	-9%	13.9	13.2	-5%
Emerging Asia	58.9	58.6	-1%	10.1	11.5	14%
Global	393.9	397.2	1%	130.1	144.0	11%

Source: *GfK POS measurement data*

of the new standard is to create a single revenue recognition model for all entities across every sector through a five-step approach. For telecom operators, the prior standard allowed to simply record revenue from what the customer paid, when the customer paid it. Consequently, the revenue recorded corresponded to cash flow received from the client. With IFRS 15, operators have to allocate a "relative fair value" between the handset and the service element. Therefore, the revenue recognition will correspond to the value and not the cash received by the client, with the total equipment revenue recognised at contract's inception and the service revenue recorded over the contract period. As a result, the difference between the cash flows and the revenue will be recorded on companies' balance sheet as a contract asset. Moreover, the implementation of IFRS 15 standards causes numerous challenges for operators: pricing, marketing, IT capabilities to switch revenue from service to handset and might trigger changes in business models.

Another upcoming accounting challenge is going to prompt telecom companies to focus even more on solutions boosting their liquidity from 2019: the telecom sector is likely to be one of the most impacted by the implementation of IFRS 16 Leases standards from January 2019 as some companies are leasing high-valued items like network equipment, cell towers, satellite transponders and fibre optic cables. The consolidation of operating leases on companies' balance sheet is expected to induce a 21% median increase in telecom's companies' debt and an 8% median increase in EBITDA. Debt ratios will therefore be impacted and will foster companies to seek for non-debt liquidity. Working capital efficiency is likely to be even more included in telecom companies' agenda to mitigate the impact of the new standards on their balance sheet.

What are the tools being used by the operators to manage these developments?

There are various niche financing solutions in the market from deconsolidation of stocks to deconsolidation of capex but in principle the most popular solutions are as follows:

Supply Chain Finance: Popular amongst the operators and equipment manufacturers as their strong credit rating help on those programmes.

Dynamic Discounting: Like supply chain finance, however in most of the cases financed by the buyer to improve margins.

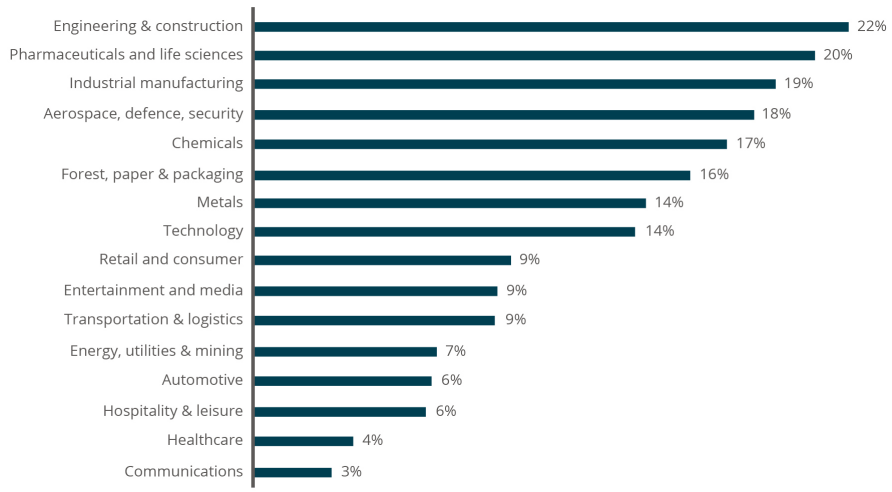
Securitisation: To tackle the handset financing by monetizing receivables as well as extending to CPEs and more traditionally to airtime bills.

Consumer Finance: Financing the handset sales with consumer finance businesses. Also leasing of handsets becoming more and more popular which is also provided by Consumer Finance arm.

Trade Finance: Bilateral Forfaiting arrangements for capex projects or other B2B transactions.

Credit Agricole CIB has a long dated track record in the TMT sector, including as a major working capital house, with award-winning securitisation and trade finance platforms and is also a very active player in supply chain finance transactions.

NWC/sales by sector



Source: *PWC 2015 annual global working capital survey*

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