The Indian telecom industry's hyper competitive market structure has been awaiting some major policy and regulatory changes before it gives way to consolidation. With the government providing clarity on policies related to mergers and acquisitions (M&As), spectrum trading and sharing, and intra-circle roaming (ICR) over the past year-and-a-half, Reliance Communications (RCOM) and Sistema Shyam TeleServices Limited (SSTL) have become the first set of players to kick off the consolidation trend.

In November 2015, RCOM, the country's fourth-largest wireless operator, announced its decision to buy Russian conglomerate Sistema JSFC's Indian mobile telephony business in an all-stock deal valued at around $690 million. The merged entity will have 120 million subscribers with a strong standing in the Indian telecom landscape. According to data from the Telecom Regulatory Authority of India (TRAI), as of August 2015, RCOM's market share was only 11 per cent in terms of the total number of wireless subscribers in the industry. It was also the fifth-largest provider of broadband services after Bharti Airtel, Vodafone India, Bharat Sanchar Nigam Limited (BSNL) and Idea Cellular. While RCOM has consistently held this market share over the past few years, it has been unable to significantly expand its subscriber base and profits unlike other domestic operators such as Idea Cellular and Bharti Airtel. This is because it has not effectively tapped the growing 3G subscriber base, both in terms of subscriber additions as well as data revenues. Moreover, the stiff competition put up by Airtel and Vodafone in metros as well as Category A circles, and by Idea in the Category B and C circles has affected its 3G prospects.

RCOM's voice and non-voice business is driven by CDMA- and GSM-based wireless services across India. Its 3G services are available in 18 circles, including the Andhra Pradesh, Karnataka, Kerala, Tamil Nadu and Uttar Pradesh (East) circles, where it has ICR arrangements. In addition, it provides fixed line services, national and international long distance connectivity, broadband services and enterprise solutions. Its international operations are handled by its subsidiary, Global Cloud Xchange, which provides voice, data and internet networks and services, and also offers submarine cable infrastructure on lease. RCOM also owns 43,379 telecom towers that are used for both CDMA and GSM mobile networks, as well as over 120,000 km of intra- and inter-circle fibre networks across India.

Despite these diverse operations, RCOM's revenues have remained stagnant over the years, while its net profits have experienced a drop of 31.4 per cent, declining from Rs 10.4 billion in the year ended March 2014 to Rs 7.13 billion in the year ended March 2015. In the latest quarterly results, its net profits registered only a marginal increase, rising from Rs 1.53 billion during the quarter ended September 2014 to Rs 1.56 billion during the corresponding quarter in 2015. The operator's total revenues declined from Rs 54.03 billion to Rs 53.55 billion during the same period. The decline was largely on account of the non-realisation of the data segment's revenue potential due to low tariffs. In this regard, the merger with SSTL could have a positive impact on RCOM's financial performance as the former has been largely focused on improving margins through data revenues.

Two's company

While major telecom operators had been moving aggressively to ready their networks for the launch of 4G services over the past few months, RCOM had entered into discussions with Russian operator Sistema for a possible merger with its Indian subsidiary, SSTL. This alliance was strategic for RCOM while it also improved the prospects for the latter for launching 4G services.

RCOM is planning to launch 4G services in the 800 MHz-850 MHz band, which is currently being used for offering CDMA services. SSTL holds liberalised spectrum in this band in eight circles: Delhi, Kolkata, Gujarat, Karnataka, Tamil Nadu, Uttar Pradesh (West), Kerala and West Bengal. However, the lack of contiguous spectrum has meant that it has been unable to launch 4G services. It has also been adversely affected by the pressure of providing high speed services in the competitive data market.

The SSTL merger will allow RCOM to use the former's 800 MHz-850 MHz spectrum to provide better 4G services for competing with the companies such as Airtel and Reliance Jio Infocomm Limited (RJIL). Another added advantage will be the increased validity of the spectrum licence. SSTL's permits in its eight circles expire in 2033, while RCOM's end in 2021. The merger would allow for an extension in the licence validity period for 12 more years in the given circles. Meanwhile, SSTL will benefit from the upcoming launch and uptake of 4G services through its stake in RCOM.

After taking the above-mentioned factors into account, RCOM and Sistema signed definitive agreements in November 2015 for the demerger of the Russian operator's wireless business under SSTL into RCOM. The transaction will be carried out through a stock swap, with SSTL holding 10 per cent of RCOM's fully diluted capital. Following the acquisition, RCOM's promoter shareholding will come down to 54 per cent. SSTL, on its part, intends to pay off its existing debt prior to the completion of the transaction.

The merger is likely to be concluded by the quarter ended September 2016, subject to the approval of Indian regulatory and judicial authorities. Once complete, SSTL's minority shareholders will be given the option of exchanging their shares in SSTL with the pro rata RCOM shares held by the company.

RCOM's acquisition of SSTL's 800 MHz-850 MHz spectrum will allow it to take its total spectrum holding in the band to 148.75 MHz. The takeover will be in instalments of Rs 3.92 billion a year for the next 10 years. An appropriate payment mechanism has been agreed upon with respect to the disputed spectrum contiguity charges claimed by the Department of Telecommunications (DoT). According to RCOM, it will acquire approximately 9 million customers and about Rs 15 billion of annual revenues through the deal.

"The deal is beneficial for both operators. MTS currently is one of the smallest players in the market and is unable to operate on a larger scale. RCOM, on the other hand, has very high debt, which curtails its ability to acquire more spectrum. This acquisition gives RCOM access to spectrum that has a very long shelf life as it was acquired only in 2013," says Kunal Bajaj, CEO, Bombay Gas Telecom.

"However, it is difficult to say if getting access to spectrum will help RCOM improve its market position," he adds. "There are a number of other steps that the operator needs to take in terms of improving its branding, services, offerings and capex in order to improve its standing in the market. Going forward, some amount of consolidation is required in the industry because there is too much competition. However, not all mergers are going to be allowed from a regulatory perspective, given the spectrum caps."

According to a recent study by Fitch Ratings, large operators are seeking acquisitions as they require more spectrum to meet the growing demand for 3G and 4G services. Meanwhile, smaller loss-making operators are willing sellers due to the rising competition. This can be seen in the RCOM-SSTL merger as well, with SSTL investing equity in RCOM to earn profits from its wireless business, which it had otherwise been unable to achieve as an independent operator. "SSTL's entry into the equity capital of RCOM as a strategic investor will strengthen the competitive position of the combined company and provide subscribers a superior experience by fast-tracking the growth of LTE technology in India," says Mikhail Shamolin, president and chief executive officer (CEO), Sistema.

The merged entity will allow RCOM to have an aggregate of 120 million subscribers, after SSTL's heavy data users have been added. "The combination of our wireless businesses through the demerger of SSTL's wireless business into RCOM for stock consideration will generate significant capex and opex synergies for our mutual benefit," says Gurdeep Singh, president and CEO, RCOM Consumer Business. The additional spectrum will allow the company to serve its heavy data users and enable it to launch 4G services without further delay, along with the upcoming launches of Vodafone India, Idea Cellular and RJIL. However, the merger might not help RCOM reduce its debt, which stood at Rs 398.94 billion as of September 2015.

According to Fitch, the Indian telecom industry calls for consolidation and can only support five or six profit-making operators in the long term. Issues like inefficient spectrum usage by smaller operators and uncertain M&A rules have been preventing the industry from consolidation, but a correction of this situation can be expected following the completion of the RCOM-SSTL merger. For instance, smaller operators like Tata Teleservices Limited (TTSL), Videocon Telecom and Aircel could look to exit on account of recurring losses, the lack of spectrum in key circles, and the lack of resources required for investing in networks.

Performance over the past year

Strengthening its hold on the wireless business segment

According to its recent financial reports, RCOM's total wireless subscriber base stood at 111.6 million as of the quarter ended September 2015. Its 3G subscriber base and data traffic grew significantly over the past year, reaping gains from the data explosion in the Indian industry. There was a 25.2 per cent increase in the number of 3G customers, which rose from 29.7 million subscribers in September 2014 to 37.2 million subscribers in September 2015. Its total data traffic grew from 65.7 billion MB to 97.3 billion MB during the same period. This was largely on account of the greater proliferation of low-cost smartphones and the increased popularity of over-the-top players and their applications. In addition, RCOM's voice segment did not suffer significant losses, as was the experience of other domestic operators. Its voice ARPU declined only marginally from Rs 103 in September 2014 to Rs 100 in September 2015. This was a result of poor network quality, as indicated by TRAI's recent drive tests.

RCOM's main focus in the March 2015 spectrum auction was to strengthen its position in the 800 MHz-850 MHz band, and it was able to increase its holdings in this band to 5 MHz or more in 21 circles. At present, the company is utilising this spectrum to improve its RevB broadband service for premium customers. RevB provides speeds of up to 14.7 Mbps and improved indoor coverage.

Meanwhile, the company was unable to buy back spectrum in the 900 MHz band in some circles where its licences were due to expire. For instance, it acquired only 10 MHz of its total expiring spectrum of 39.8 MHz in the 900 MHz band. As a result, it lost spectrum in this band in the Bihar, Odisha, Assam, Northeast and West Bengal circles. It subsequently entered into discussions with BSNL, Vodafone and Idea Cellular to sign ICR agreements so that it could continue serving the Bihar, West Bengal and Assam circles. At present, RCOM has ICR agreements with TTSL and Aircel to offer 2G GSM services in these three circles.

With DoT's recent approval of the spectrum sharing and trading guidelines, RCOM's relationship with RJIL in the wireless segment is set to take definitive shape. As of September 2015, both companies were in advanced discussions for entering into a spectrum sharing and trading agreement in the 800 MHz-850 MHz band. This is likely to allow RCOM's customers to avail of RJIL's 4G networks on a minimal capex model. It is also expected to allow RJIL's subscribers to access RCOM's extensive 2G and 3G networks.

One of RCOM's other emerging ventures in the wireless segment is its partnership with Facebook for the latter's internet.org platform, which provides access to internet sites that are reduced, truncated and low on bandwidth consumption, and is focused on those that lack basic access to internet connectivity. RCOM claims that it has piloted this platform in seven circles over the past six months and reached out to nearly 1 million such users. However, internet.org has been unable to grow at a rapid pace in India as the net neutrality issue has not yet been settled.

Enterprise segment to drive revenues

RCOM has been focused on increasing its revenues from the enterprise segment. Over the past year, it has taken several initiatives and entered into partnerships to expand these offerings. In July 2015, it announced the deployment of its cloud delivery network's (Global Cloud Xchange) nodes in Delhi, Mumbai, Chennai, Bengaluru and Hyderabad. This platform is targeted at the banking and technology verticals as well as small and medium-sized enterprises due to its network transparency and cloud orchestration features. The full deployment of this offering is likely to be completed by end-2015.

RCOM also entered into a partnership with internet of things (IoT) platform provider Jasper in August 2015 in a move to enter India's nascent IoT industry. Under this partnership, RCOM's data centre facilities, combined with Jasper's control centre platform, will allow RCOM's enterprise users to launch, manage and monetise next-generation IoT businesses. In November 2015, the company announced its plans to invest $80 million in setting up two new data centres and expanding two existing ones over the next two to three years. The expansion is likely to be funded by RCOM's existing cash flow.

The company continues to be aggressive in tapping India's growing cloud computing market. It has also stated that it expects revenues from Global Cloud Xchange to contribute up to 25 per cent to the fixed line business in the next three years. RCOM has 11 data centres in India with a combined capacity of over 1 million square feet. Its customer base is around 3,200 Indian enterprises and 14,500 global enterprises.

Monetising its tower business

Over the past year, RCOM has been trying to sell its tower business, Reliance Infratel, as a way to lower its debt burden. The company is currently facing high interest payments on account of the expenditure undertaken in its wireless business in the form of spectrum payments and the setting up of network infrastructure. The high infrastructural opex is pushing the company to exit the tower business. According to reports, it is willing to settle on a deal at a slightly lower valuation as it needs the funds to reduce debt.

RCOM is in the final phase of its deal to exit Reliance Infratel, for which it has shortlisted four bidders: US-based Farallon Capital, Carlyle, Tillman Capital and American Tower Corporation. Two of these companies have proposed to buy out RCOM's entire stake in Reliance Infratel, while the others want to acquire 51 per cent stake in the business. Standard Chartered and SBI Capital Markets are managing this sale. RCOM holds a 96 per cent stake in Reliance Infratel, while the remaining is held by minority and institutional investors like George Soros' Quantum (M), NSR Partners, Galleon, HSBC Daisy Investment (Mauritius), Drawbridge Towers, and Investment Partners B (Mauritius).

The way forward

The main challenge that RCOM is set to face is the likely delay in the launch of 4G services as it may not be able to access SSTL's spectrum till regulatory approval is received. Moreover, the brand building of the merged entity and the payment for SSTL's spectrum is likely to affect RCOM's books. Meanwhile, RCOM is reportedly looking at a merger with Aircel, for which talks are at a preliminary stage. This move would be contingent on the ability of Aircel and RCOM to reduce their debt.

While RCOM remains aggressive on its inorganic growth strategy at present, it needs to reduce its debt in order to undertake further investments in next-generation networks. Exiting its tower business will help it focus on the wireless segment and improve its financial condition. Meanwhile, the actual impact of the additional subscribers and spectrum gained through the SSTL merger is likely to be felt only after the first quarter of 2016. It also remains to be seen how early RCOM can launch 4G services on the 800 MHz-850 MHz spectrum band and how they will be priced vis-à-vis those of other operators. Once the services are launched and the merger completed, RCOM will be in a much better position to compete with other operators. Its relationship with RJIL through spectrum sharing and trading arrangements will also be critical in the continued provisioning of quality 4G services to end-users. This will be its primary focus in the coming years.