

Cable vs. Telco: The Battle Heats Up

S&P Ratings examines the competitive landscape as players from both camps scramble to sign up customers for voice, video, and broadband offerings

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October 10, 2007

The trends in U.S. wireline telecommunications of the past two years have continued over the past several months, with phone companies still losing residential-access lines while adding more digital-subscriber-line (DSL) customers. Meanwhile, competition between cable and phone companies for video customers has heated up. Overall growth remains good in the wireless sector, but not all carriers are benefiting equally. The cable industry seems to have peaked in terms of the number of video subscribers, though growth from advanced services is still solid.

Significant longer-term uncertainty pervades the telecom sector because the clear lines of demarcation between industry subsectors are all but gone. And the establishment of wireless as a substitute for a traditional wireline has redefined the balance between the two technologies.

Standard & Poor's Ratings Services believes that the key determinants of credit quality in both telecom and cable are a company's ability to differentiate its products and services and its financial policy. The first factor takes into account product substitution, intense competition, and mature major product lines.

Cable Is Likely to Grab More Telephony Share

Wireline companies have continued to lose access lines in the low- to high-single-digit percentage range. Some of these lines are being lost to wireless substitution because a good portion of younger consumers are shunning traditional phone service even as they form households. Cable providers are increasingly taking away a significant number of these access lines. Given that most major cable operators introduced their VoIP services only in the past couple of years, cable telephony is still in an early stage, and the potential market share remains unknown. According to the National Cable Industry Assn., there are already more than 12 million cable telephony customers—out of about 180 million phones in the U.S.—and the number is growing.

While the history of cable telephony is short, it's likely incumbent telephone providers will cede some minimal telephone penetration to cable companies. This low-hanging fruit consists of customers who just plain dislike their local telephone company as well as people who want to take advantage of cable telephony's attractive introductory prices. However, those introductory prices are often just that, and they may rise significantly after a year.

The combination of dissatisfied phone company customers and bargain shoppers means that most cable operators can likely attain telephony penetrations of 10% or more of their video

customers with a reasonable marketing effort. After that basic level is achieved, the cable company needs to make a more compelling case. In particular, this means explaining its telephone service to customers (addressing such issues as whether they can keep their old number and what happens to their phone service during a power outage), effectively bundling it with video and broadband services, and giving the consumer an economic incentive to change phone providers with an assurance that installation will be minimally inconvenient.

Success in cable telephony is certainly possible, judging from the experience of Cox Communications (S&P credit rating BBB-), the telephone pioneer among major cable operators. Cox had more than 2 million customers at yearend 2006. Similarly, metropolitan New York City operator Cablevision Systems (CVC) (BB) provides telephone service to about a third of its video customers, gaining these customers almost exclusively at the expense of Verizon Communications (VZ) (A).

Fighting Back with Video Services

Since the threat to wireline companies is real and growing, does that mean they face nothing but stormy seas for the next several years? Not necessarily so. While residential-line losses will continue for some time, especially as cable telephony is more ubiquitously deployed and marketed, the telephone companies do not lack defenses.

First, DSL service has mitigated a lot of the access-line losses. In the high-speed Internet realm, the cable companies' modem product initially outpaced phone company DSL by a margin of almost two to one. But we've seen a marked turnaround, with DSL and cable now garnering roughly equal shares of new customer additions on a national basis. And, depending on pricing, DSL can offset much of the cash-flow impact of access-line losses. There are, however, signs that growth of the broadband market for both telephone and cable providers may be peaking.

The second, and potentially most potent, defense against cable operators is the telephone companies' video product. Both AT&T (T) (A) and Verizon, which together serve about three-quarters of the country's switched access lines, have begun offering their own video services. Verizon's FiOS product in particular has earned a lot of publicity and, because it's completely fiber optic, offers the potential for virtually unlimited bandwidth for the residential customer. At midyear, Verizon reported it had just over 500,000 video FiOS customers. While that number appears impressive, FiOS is clearly in a nascent stage, given Verizon's base of more than 40 million telephone customers.

Verizon intends to roll out FiOS to 18 million homes by the end of 2010. While FiOS has required intensive capital spending, Verizon has a strong enough balance sheet to support the buildout at the current A rating. FiOS represents Verizon's most powerful tool for answering cable competition and winning back customers.

AT&T's U-verse video offering is less ambitious from a technical perspective and is considerably less expensive than FiOS, but it shares FiOS' goal of reclaiming customers lost to the cable companies. The recently launched U-verse service had only 51,000 video customers as of June 30. And while FiOS has the longer track record, we view both FiOS and U-verse as

early-stage undertakings. The jury will be out for some time, probably at least a year or two, before we have a more definitive verdict on the success of FiOS, U-verse, or any other similar video ventures.

Reducing Reliance on Wireline Service

Perhaps the best defense for a telephone company facing increasing competition for its legacy service is product diversity. Our decision in July to revise the outlook on both Verizon and AT&T to stable from negative took into considerable account the companies' declining reliance on their most vulnerable segment, residential wireline, as well as their strong free cash flows. The solid growth of Verizon's and AT&T's wireless segments, combined with their larger enterprise businesses (via their respective MCI and AT&T acquisitions) moderated the rating impact of their residential wireline segments.

Over the long term, if Verizon and AT&T can successfully deploy their video products and contain the associated operating and capital costs, they could realize a significant new revenue stream. Still, the obstacles to ratings higher than the current A for AT&T and Verizon are formidable. Given intense competition and uncertainty over the outcome of their facilities-based video strategies, it would take considerable time for each to demonstrate that they can win telephone customers back from cable; lure video customers away from cable, EchoStar Communications (DISH), and DirecTV Group (DTV); and maintain pricing in such a highly competitive environment.

Financial Policy Must Reflect Maturing Markets

Financial policy will play an increasingly important role in determining credit ratings. Currently, the ratings on Alltel (AT) (BB), Intelsat (B+), and Cablevision are on CreditWatch Negative because of pending leveraged buyouts.

Beyond the dramatic changes in credit quality that may result from LBOs and mergers is the broader issue of how companies use their cash flow as their businesses mature. Under these conditions, cable company ratings in particular will hinge more on financial policy. As cable markets mature, we expect cash flows to strengthen because the capital costs for system upgrades and consumer premise equipment related to the new services will drop. Allocation of at least a portion of this cash to debt reduction will lend stability to cable ratings at a time when cable providers will face the dual challenge of maturity and pricing pressure from FiOS, U-verse, and others. Conversely, policies that are overly friendly to shareholders could lead to financial parameters that might not support current ratings in a lower-growth environment.

The cable sector's traditional video product is nearing maximum penetration, yet the industry is still able to post low-double-digit revenue gains because of increasing sales of digital services, digital video recorders, high-speed Internet connections, and voice service. It remains to be seen whether cable can continue to thrive amid aggressive competition from satellite TV providers DirecTV and EchoStar, which have higher growth rates and are promoting price and additional high-definition programming, and from video offerings from the telephone companies. In a report card on the telecom industry published Oct. 6, 2005, Standard & Poor's predicted that

first-mover advantage would go to cable in the battle between telephone and cable but that phone companies could start to reassert their position with their video products in two to three years. That time has arrived.

To be sure, nontraditional cable-delivered services still have a considerable upside: digital TV, digital video recorders, cable telephony, and cable modems have yet to reach their peak penetrations. But for cable companies that are further along the advanced services curve, the ability to sustain annual double-digit revenue growth is less certain. While there is still revenue to be harvested from the introduction of high-definition TV and more video on demand, cable operators at some point will face moderating growth. With some cable operators already posting average revenue per user well above \$100, customers may be less willing to tolerate price increases when enticed by more competitive offers from telephone companies.

We see a similar situation in wireless in the next few years, when penetration will begin to peak in a tight pricing market dominated by four major national carriers. The timing for wireless maturation may be a little longer than for cable because the U.S. penetration rate, estimated at 80% by industry association CTIA, lags behind the 100%-plus penetration in some European and Asian markets. We note, however, that the financial policy for three of the four national carriers, AT&T Mobility, Verizon Wireless, and T-Mobile, is part and parcel of their parent entities' financial policies.

Some Likely Casualties

For most pure wireline players, including CenturyTel (CTL) (BBB), Citizens Communications (CZN) (BB+), Embarq (EQ) (BBB-), Qwest Communications International (Q) (BB), and Windstream (WIN) (BB+), the prospect of flat or declining revenues is not just a future possibility but a current reality. Given continuing wireless substitution and cable's inroads into the residential telephone business, growth prospects for their core businesses are minimal at best, as reflected in our mostly negative outlooks for the pure wireline companies. The pressure to satisfy equity investors lessens their ability to reduce debt to offset challenging business prospects.

Liquidity has always been a key rating factor, but in times of uncertain capital markets, it takes on even more importance. Overall, the telecom and cable sectors haven't demonstrated any particularly troubling liquidity issues due partly to recent opportunistic refinancing activities.

Many companies took advantage of favorable market conditions through the early part of this year to extend maturities and establish revolving credit facilities with good availability and limited covenant pressure. Issuers that completed such refinancings include Charter Communications (CHTR) (B-), Bresnan Communications, and Level 3 Communications (LVLT). In addition, financing related to M&A activities have bolstered liquidity at some companies with speculative-grade ratings, including PAETEC Holding (PAET) (B), NaVox (B-), Integra Telecom Holdings (B-), and Time Warner Telecom (TWTC) (B).

While it appears that telecom and cable companies will generally have access to cash, the cost of credit will be a concern. Standard & Poor's will monitor adequacy of liquidity at each company

and, especially for weaker credits, the impact of the potentially higher cost of maintaining sufficient liquidity under current market conditions.

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