Tough Times for India's Cellular Carriers

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It appears that the bottom has fallen out of the cellular market in India! At the end of December 1997, there were nearly 800,000 mobile phone users throughout the country (see Table 1), and the number of new connections was growing at an impressive 60,000 new subscribers every month—arguably one of the fastest growth rates experienced anywhere in the world. Cellular operators should have been exuberant!

Why, then, would a relatively successful cellphone operator—Hutchison-Max—sell its interests to a foreign partner? Why would Essar hand over management control to Swiss-PTT? Why would JT Mobile sell its Punjab operations to Essar so cheaply? And why is Koshika so desperate to find a buyer? HFCL has already reduced its stake in Fascel—one of the operators in lucrative Maharashtra—to the mandatory 10% and is planning to sell all its shares in the near future. HHS Communications pulled out of Tamil Nadu as soon as it got in. Also on the auction block are stakes in cellular companies from the BPL and B K Modi stable, Skycell Communications, and Hexacomm, say sources. Even the big guys like Reliance and Tata are struggling.

Why indeed! Things turned nightmarish almost from the beginning when cellular operators realized that their projections for subscriber growth (see Table 2) and airtime usage were simply unrealistic. In fact, the miscalculation of average airtime usage is the primary reason for their current financial difficulties. Additionally, operators expected revenues of $62.50 per month per subscriber! Failure to meet these expectations has resulted in insufficient revenues to cover huge government-assessed licensing fees.

To make matters even worse, the subscriber growth rate has been severely impacted by:

- A sluggish market followed by an industrial slowdown.
- U.S.-imposed sanctions after the nuclear tests.
- The income tax department's decision to tax subscribers.

The Cellular Operators Association of India (COAI) estimates the industry is losing $100 million *per month*.

Cellular operators in the *circles*, roughly analogous to a state, have petitioned the Department of Telecom (DoT) to:

- Extend their license period from 10 to 15 years. (Note: Some operators are asking to extend their license period to 20 years.)
- Place a two-year moratorium on payment of license fees.
- Limit cellular licenses to two per circle.

"If these measures are not taken, then several operators will fold over the next few months," says Mr. T. V. Ramachandran, COAI executive vice president. However, the highly-publicized Max deal has resulted in the DoT hardening its stance against any concessions.

The remainder of this article will examine the reasons why cellular subscriber growth and airtime usage in India have not met operator expectations, the government response, and what operators are doing to survive.

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Table 1
Cellular Subscribers

Operator	Circles	No. of Subscribers*
Bharti Cellular	Delhi, Himachal	125,229
BPL Mobile, BPL U S WEST	Mumbai, Tamil Nadu, Maharashtra, Kerala	122,801
Hutchison Max	Mumbai	122,772
Sterling	Delhi, Rajasthan, Haryana (Essar Cellphone), Uttar Pradesh (East)	113,743
Modi Telstra, Modicom Networks	Calcutta, Punjab, Karnataka	58,364
Escotel Cellular	Haryana, Kerala, Uttar Pradesh (West)	37,820
RPG Cellular, RPG Cellcom	Chennai, Madhya Pradesh	34,452
Birla AT&T	Gujarat, Maharashtra	28,652
Usha Martin Telecom	Calcutta	26,640
JT Mobile	Andhra Pradesh, Punjab, Karnataka	24,319
Skycell Communications	Chennai	23,044
Tata Cellular	Andhra Pradesh	18,500
Fascel	Gujarat	12,300
Koshika Telecom	Uttar Pradesh (West & East) Bihar, Orissa	10,134
Hexacom	Rajasthan, Northeast States	10,014
Reliance Cellular	Bihar, Himachal Pradesh Himachal Pradesh, Assam Northeast States, West Bengal	3,088
Srinivas Cellular	Tamil Nadu	License not Signed

* As of December 31, 1997

Source: Department of Telecom (DoT), Cellular Operators

Low Airtime Usage

The average airtime usage continues to fall short of expectations by a glaring margin. Initially, operators predicted an average monthly airtime usage of 300 minutes per subscriber. These predictions, coupled with exaggerated ideas of the size and buying power of the Indian middle classes, were responsible for the huge license fees levied by the Indian government. In reality, according to COAI data, 45% of subscribers use their cell phones for an average of two minutes per month, and 15% of subscribers do not use their cell phones *at all*. Even the so-called 40% high-end metropolitan users, on average, talk 120

Table 2
Indian Cellular Projections

Year	Subscribers
1998	1 million
2001	3 million
2005	7 million
2010	14 million

Source: DoT

to 130 minutes every month. In non-metropolitan areas, naturally, the average airtime usage is less than 100 minutes per month. Contrast this with the fact that full recovery of operating costs per line requires every cell phone holder to talk for a minimum of 206 minutes every month.[1]

At the low-end—roughly 15% of users—the operators' per-month subsidy amounts to US $21.10 per user. The cost of service is about $25 per line, plus a $4 service fee. Not surprisingly, banks and financial institutions are becoming increasingly reluctant to finance cellular projects, as they are convinced that most of them are not feasible.

The Government Response

Operators agreed to the huge license premiums because they thought the Telecom Regulatory Authority of India (TRAI) would extend them some leniency in the terms of payment. However, the government has been largely unresponsive to their requests for help.

They have asked the government to:

- Extend the license renewal fee from the current 10 years to 15 or 20 years, depending on the operator.
- Place a moratorium on license fee payments for two years.
- Increase the monthly service fee.
- Limit licenses to two per circle or metropolitan area.

Currently, operators claim they must pay the license fee before they can collect money from their clients, which is placing a tremendous strain on their resources. The finance ministry, however, has reservations about a moratorium on license fees—which total $450 million per year—because of the impact on the budget deficit. Even the demand for extending the license period, previously considered uncontroversial, has run into problems. The DoT's finance department feels that cellular operators should pay additional fees if the license period is extended.

Mr. Ramachandran points out, however, that the revenue loss to the national exchequer is misleading because operators are in no position to pay license fees. Only $225 million has actually been paid, out of a total license fee commitment of $450 million in the fiscal year 1997-1998. Even relatively strong operators such as Birla-AT&T and Tata-Bell Canada are behind on their payment schedule. Only Escotel—a joint venture between the Escorts Group and First Pacific of Hong Kong—and Reliance are on schedule.

Recession and Taxes

The phenomenal subscriber growth rate in 1997 prompted industry watchers to predict that the one million mark would be reached by March 1998 (India's fiscal year-end). However, an industrial slowdown coupled with tax notices led to a shortfall of 120,000 subscribers in the projected user-base as of March 1998. Subscriber growth dropped a whopping 60% in the first three months of the year, as can be seen in Figure 1. The number climbed marginally in March to 39,000, mostly as the result of year-end buying by companies and individuals.

On December 31, 1997, a former finance minister said that the income tax department would target cell phone subscribers as part of its efforts to increase the taxpayer base. Accordingly, it started sending tax notices to cellular phone subscribers in the first quarter of 1998. Many cellular operators are blaming this new income tax on the drop in new subscribers. According to insider sources,

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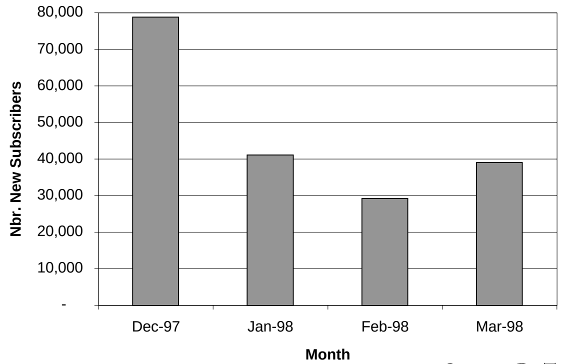
Figure 1
Subscriber Growth in 1Q98



Source: DoT

Table 3
Metro Areas & Subscribers

Metro	Operators	No. of Subscribers*
Delhi	Bharti Cellular	1,20,486
	Sterling Cellular	94,658
Mumbai	Hutchison Max	1,32,117
	BPL Mobile	1,10,911
Calcutta	Modi Telstra	29,386
	Usha Martin	22,180
Chennai	RPG Cellular	20,239
	Skycell	22,180

* As of March 31, 1998 (latest)

Source: DoT, COAI

operators believe that a "fear psychosis" has set in among potential subscribers.

Shifting Market Shares

Currently, there are four metro areas and 17 circles, and each has two cellular carriers. Against an average projection of 500,000 new subscribers per year, none of the operators in non-metropolitan circles could garner even half that number after just two years of operations. As of January 31, of the 34 existing operators, nine had yet to reach the 5,000-subscriber mark. So far, only 15 non-metro operators have crossed the 10,000 subscriber base mark.

Cellular companies in the circles have been increasing their share of the total cellular subscriber pie at the expense of operators in the metro areas.

As a result, cellular companies in the circles have been increasing their share of the total cellular subscriber pie at the expense of operators in the metro areas. Circle operators' market share increased from 30% in December 1997 to more than 37% by the end of March. Figure 2 shows how the circles' market share grew progressively through the second half of 1997.

In comparison, eight companies in the metros had over 545,000 subscribers at the end of 1997, while the circles accounted for 226,000—less than half the number of the metros. The number of subscribers in the metros had fallen to 551,750, while the number of subscribers in the circles had increased to 330,560 by March of this year—a growth rate of 46%.

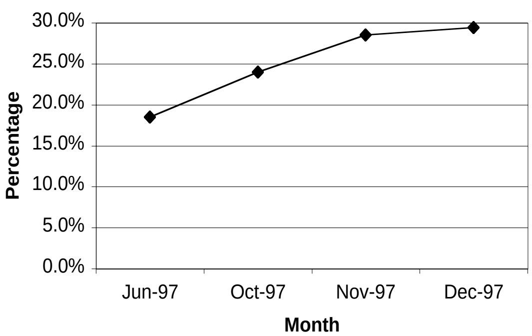
Industry Shake-Out

A domestic cellular industry shake-out has begun, with merger and acquisition (M&A) specialists predicting that there will likely be no more than six or seven operators remaining by the turn of the century. Their prediction is based on mounting negative cash flows—estimated by the COAI to be around $100 million per month—on the cellular companies' profit and loss statements, and no sign of increased airtime usage (almost a proxy for revenues) by subscribers. Losses in the first 18 to 20 months are surpassing operators' estimates for the first three to four years.

Says Coopers & Lybrand associate director Mr. Timmy Kandhari, "strong players—such as, maybe, Birla-AT&T, Bharti-BT, and others—will remain; weaker ones will shift out. We think that the M&A activity will start around October or November this year." The next installment of license fees is due then, and those companies, which have not reached financial closure, will certainly want to sell, he predicts.

Buy-out deals in the cellular industry that are nearing completion are indicative of the M&A activity in the next fiscal year. An industry analyst says, "There are two critical factors before the sell-outs begin. One, a buyer will wait for enough assets—in terms of equipment and subscribers—in the companies and, two, the seller has to be ready to sell at a price which will cover the liabilities of the company." Mr. Nanda K. Menon, assistant director at Jardine Fleming India Securities, feels that the liabilities of domestic cellular companies are so high that operators may be forced to sell their stakes at a discount (to the face value) or at par. "The days when promoters sold stakes at phenomenal premiums are over," echoes another analyst.

Figure 2
Circles' Market Share Growth



Source: DoT

Take the BT case, for instance. Demands for unrealistic premiums from Indian carriers in the telecom sector has forced British Telecom to drop its plans for expansion in the Indian cellular sector—at least for the time being. The company, which was actively pursuing options in other telecom circles, has now decided to back off for a while. The reason, says Mr. Arun Seth, country head of India and SAARC-BT, is that Indian promoters in the telecom sector are still hoping to get exorbitant premiums for their circles. "We would certainly like to improve our presence in the Indian telecom industry, but acquiring new circles at this point is out. Indian promoters are demanding unrealistic premiums. We have, therefore, decided to take a back seat in the acquisition game for a while," said Mr. Seth.

Revising Sales Projections

These problems have forced the major cellular handset vendors to start revising their sales projections. Vendors such as Ericsson and Motorola have slashed their market projections between 15% and 30% following sluggish growth in the first five months of the year. Other companies such as market leader Nokia, Alcatel, and Phillips are likely to follow suit.

Ericsson, for example, has reduced its projections for new cellular connections from 900,000–950,000 to 650,000–700,000 for 1998, says Mr. Rajeev Kapoor, director of Ericsson Mobile Phones. They had made some very optimistic projections based on last year's phenomenal growth; however, they were forced to revise those projections downward after seeing new cellular connections slow to 25,000 to 35,000 a month in the first four months of this year.

Motorola, on the other hand, made a relatively conservative projection of 550,000 for this year, which represents zero growth over the previous year. Similarly, other vendors are scaling down their projections.

One must also keep in mind that these 1998 estimates do not translate directly into new cell phone sales. Their estimates are just indicative of the number of cell phone activations expected, which includes prepaid SIM (Subscriber Identification Module) and prepaid cash cards, both of which sell in substantial numbers. In fact, sources expect that actual cell phone sales this year will be somewhere between 300,000 and 450,000. Last year, an estimated 350,000 cell phones were sold—through legal *and* smuggled channels—in the country. It should also be noted that vendors expect the numbers of cell phones supplied through the grey market to increase. Compared with last year's estimated ratio of 65:35 between the legal imported route and the grey market,

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this year, it is expected to be closer to 50:50. Vendors attribute this to a drop in subsidized cell phone sales and the slowdown in cellular growth.

Trying to Survive

With the government denying the two-year moratorium on license fee payments, the industry finds itself facing possible bankruptcy. For the first time since cellular service began in the four metros in 1995, subscribership has actually registered a negative growth. In April 1998, there were roughly 558,000 metro cellular subscribers. That base of subscribers has now dropped to 547,000. This sharp decline is primarily due to:

One operator dropped more than 3,000 subscribers in one month.

(1) Deactivations carried out by metro cellular operators.
(2) Reconciliation of actual subscriber counts in both metro and territorial circle operations.

Dropping subscribers for non-payment is becoming commonplace. One operator dropped more than 3,000 subscribers in one month. As a top executive of a metro operator put it, "These days, if a subscriber is even one day late in paying dues, we cut him off. Last year, we would have sent polite reminders and given him several weeks to remit the money." Bad debts—payment more than 180 days late—account for 15% of total revenues in Delhi, while in the circles, the figure is closer to 12%. As one telecom CEO put it, "Bad debt is nothing but a euphemism for fraud. It should be a criminal offense."

Beside canceling subscribers for non-payment, operators are also beginning to reconcile reported subscriber numbers with actual counts. "Numbers were padded by competing networks as a market strategy. Roaming subscribers were often included in the count of visited networks," points out an industry executive. "Now a lot of clean-up is happening, especially in the metro areas, in anticipation of the per subscriber license fee."

These drastic actions have been prompted by two factors:

- Effective September-October this year, metro operators will have to pay a license fee of $150 per subscriber, per annum. Cellular companies are, therefore, not interested in retaining chronic defaulters for whom they have shelled out a fixed license fee, regardless of whether they have recovered their dues.
- The Bureau of Industrial Costs and Prices (BICP) has detected a huge shortfall in the revenues of cellular operators in the states compared with projected demand in business plans. In its preliminary report, BICP noted that operators have been paying license fees since December 1995. Yet, actual income did not start accruing until the 1997-1998 timeframe, which has resulted in a negative cash flow from operations. Hence, the operators are unable to pay license fees from their operating incomes.

Desperately trying to survive, cellular operators are now concentrating on value-added services. Value, not volume, is the buzzword for 1998 in the cellular industry.

The MTNL Threat

In what could prove to be the fatal blow to India's nascent cellular industry, the Delhi High Court cleared Mahanagar Telephone Nigam Limited (MTNL)—the state-controlled telecom incumbent of India—to offer cellular services. In a move that impacts nearly 450,000 cellular subscribers in the Mumbai and Delhi metro areas, MTNL is now free to enter those markets as the third operator. With promises of cheaper cell phone services, MTNL becomes the first company in the world to offer both basic telephony and cellular services in the same area. This action by the Indian government will no doubt make foreign investors extremely wary of committing equity to joint cellular ventures in India.

Private operators fear MTNL's strength in wireline operations and worry that they'll be unable to compete with the telecom giant if the Delhi High Court order remains unchallenged. If this happens, India could once again see the return of monopoly telecom services—wireline *and* wireless.

[1] Data source: Cellular Operators Association of India.

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