Sri Lanka : Telecommunication Sector

OVERVIEW

✓ With a CAGR in line growth of over 42.76%, the telecommunications sector has been a core driver of the Sri Lankan economy over the past five years. Much of the growth has come through the expansion in the mobile segment, which has increased at a CAGR of 53.68% for the same period. The granting of fixed CDMA licenses to the fixed line operators proved a catalyst to a significant jump in fixed line connections from 2005. The fixed line segment is dominated by Sri Lanka Telecom whilst the mobile sector is dominated by Dialog Telekom with a market share of 48% and 51% in their respective segments.

FIXED TELEPHONY

✓ The incumbent SLT is by far the largest fixed line operator in the island and owns licenses to provide fixed (both wired and wireless), mobile, broadband and media services in the country. The sluggish fixed line segment has revived, with a CAGR of 25.43% with the launch of fixed CDMA services from 2005. However, delay in offering CDMA licenses to SLT resulted in a decline in its market share as operators such as Lanka Bell and SunTel acquired majority of the subscribers.

✓ By 1Q2008, approximately, 70% of fixed lines were CDMA, which accounted for more than 90% of incremental connections. Currently, incremental connections are approximately 118,000 per month, and we expect momentum to improve with the clearing of most of rebel held areas in the North. Further, the only fixed wired line operator, SLT, has launched a special package offering wire line connections at cheaper rates which enable the users to enjoy a wide range of services including broadband. We expect this to boost penetration levels to reach a saturation of 20% by CY2011. Rates have progressively moved downwards with the effects of heavy competition.

MOBILE TELEPHONY

✓ The mobile telephony segment dominated by Dialog Telekom, witnessed a CAGR of 54.7% over the last 5 years which was mainly due to downward revision of tariffs by all operators and the falling cost of handsets. All four operators currently run on GSM networks while Dialog and Mobitel have moved onto 3G and 3.5G networks respectively. Mobile penetration in Sri Lanka at the end of 1Q2008 was approximately 44%. Incremental connections are approximately 280,000 connections per month and we expect this to increase with the entry of Bharti Airtel.

✓ Similar to the fixed segment, competition has seen operators slash rates, with market leader Dialog cutting rates by approximately 30% in FY06, 50% in FY07 and the latest being another 50% discount on call charges beyond 1 minute, applicable

Jeewanthi Malagala  
jeewanthi@jkstock.keells.com

John Keells Stock Brokers (Pvt) Ltd  
Company No. PV 89  
130, Glennie Street,  
Colombo 2,  
Sri Lanka.

Tel: 94112421101-9 (Gen.), 94112326003, 941124390478  
Fax: 94112326863, 94112342068

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from 3Q2008. Despite heavy reduction in call charges ahead of entry of Bharti Airtel, it is still believed that domestic call charges are relatively higher than those in the region.

✓ Mobitel, a fully owned subsidiary of SLT, has recently introduced a package to the state sector employees and pensioners offering call charges below the average. The company expects this to add at least 300,000 subscribers to its network which will further boost penetration levels.

✓ We expect penetration levels to reach 49% by CY08 and the curve is likely to flatten off by FY11 reaching penetration levels of approximately 60%.

✓ Although in the past minutes of usage have been extremely responsive to rate cuts, the series of latest price revisions have proved otherwise due to spiraling inflation in the country. Further, ARPU’s have dropped significantly with the proliferation of pre-paid subscribers. In addition, the recent taxes levied by the Government on mobile operators have been passed on to the users which have also led to a slow increase in minutes of use. Dialog, the leader in mobile telecommunication services in Sri Lanka, has seen a decline in Blended ARPU to Rs. 501 in 1Q2008 from Rs.590 in 2007.

✓ Most operators have invested heavily in building up the infrastructure to increase capacity and are currently under heavy cost pressure consequent to high energy costs and heavy network related depreciation. However, the possibility of a reduction in fuel costs may reduce the burden on cost significantly thereby minimizing the adverse impact on the sector earnings. Further, the Government has levied a tax per tower owned by operators amounting to a minimum of Rs. 25,000 per annum.

✓ Although both Dialog and Mobitel have undertaken aggressive 3G roll out, it is unlikely that these investments will generate a return in the short or medium term mainly due to the lack of interest in subscribers for such advanced facilities. Thus, operators focus on the provision of Value Added Services (VAS) which are likely to generate revenue until such time the investments in advanced technologies such as 3G begin to provide a return.

DATA SERVICES

✓ SLT holds majority of the market for data services and has 88,000 and 54,000 subscribers for Dial up and ADSL connections respectively. By 1Q2008, Internet and E-mail subscribers are estimated to be around 208,000 of which, the majority use dial up to access these services. The segment has experienced a CAGR of 24% over the last 5 years and with a penetration level as low as 0.97%.

✓ With such low levels of penetration, falling prices of PCs and its growing importance to economic development, there is a clear indication of room for growth for most of the operators in the industry. With the introduction on pre-paid internet cards,
it is likely that there will be a growth in the minute voice usage the next three years.

**Earnings**

- Over the last few years, the 2 giant providers of telecommunication services in Sri Lanka have invested both in infrastructure and technology to become leaders in the provision of fully fledged quadruple play services. Dialog has already begun provision of mobile, fixed, data and media services but is yet to see the contribution from data and media services to the group’s bottom line. On the other hand, SLT recently set up a company to provide IPTV although the service is yet to be commercially launched.

- Traditional voice penetration levels show room for further improvement, though entering the late growth phase, whilst the low data penetration provides significant opportunities. However, the industry as a whole is likely to see a reduction in their margins mainly due to lowered rates, increases in energy cost and higher finance costs with further turmoil possible when Bharathi Airtel enters the fray.

- Additionally, the focus on convergence and investments in related infrastructure is unlikely to generate a return at least in the medium term but would add to the operators’ cost in terms of higher depreciation. Earnings have dipped 6.1% in FY08 on the back of an 11% drop in Dialog earnings and subdued growth at SLT on account of a revenue write off on the rate rollback.

### Valuations

The industry witnessed a decline in the EPS growth mainly due to pressure on profitability as most operators began to expand their networks ahead of the anticipated increase in subscribers.

Currently, the sector P/E trades at approximately 14.2 times FY09E earnings, a 60% premium to the market. SLT stands to gain an increase in its market value given that the projected earnings or even a higher growth is achieved as contribution from its mobile arm and data services are expected to increase. Dialog on the other hand is likely to face tough conditions given its high level of dependency on mobile income which is likely to be under pressure over the next few years.

Despite almost all operators having undertaken extensive investments in terms network expansion for convergence, it is likely that the profitability of the sector will fall as these investments are less likely to generate returns in the short run, with its main segment, voice telephony, reaching the maturity period. In addition, the existence of fierce price competition among the operators will also cause reduction of their margins. However, we believe that the sector will revive given operative economic conditions for both subscribers and operators with a gradual decline in inflation by FY10E resulting in a 12.2% growth in earnings.