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India's telecom giant Vodafone Idea may run out of ideas with liquidity issues looming

by Vivane Raj

- **NUS-CRI 1-year PD illustrates a significant difference in credit health of Airtel and Vodafone Idea, two of the largest telecom providers in India**
- **A looming cash crunch and a substantial debt burden weigh heavily on Vodafone Idea, while Airtel fares relatively better with lower debt and growing market share**
- **NUS-CRI Forward PD indicates that both carriers' short-term credit risks will increase**

Once the largest player in the Indian telecommunications sector, Vodafone Idea has suffered significantly as rivals Bharti Airtel (Airtel) and Reliance Jio[1] have overtaken the top spots in the market. As a result of a price war with the introduction of Reliance Jio's near-zero contract rates in 2016, Airtel and Vodafone Idea were forced to sustain prolonged losses in order to match these low rates. Currently, Vodafone Idea is facing cash burn from a burden of unpaid government licensing fees. This is supported by the meteoric jump in the NUS-CRI 1-year Probability of Default (PD) (1-year PD) in 2019 and 2020 for the company. While there was a drop in the PD from its highest levels in Feb 2020 as seen from Figure 1, the NUS-CRI Forward 1-year Probability of Default (Forward PD[2]) indicates a deterioration in credit outlook for Vodafone Idea (see Figure 3). This is contrasted by Airtel, which managed to weather the storm relatively better. In sum, this brief analyses the credit quality of Vodafone Idea compared to Airtel and explore the factors which have caused this divergence in credit health.

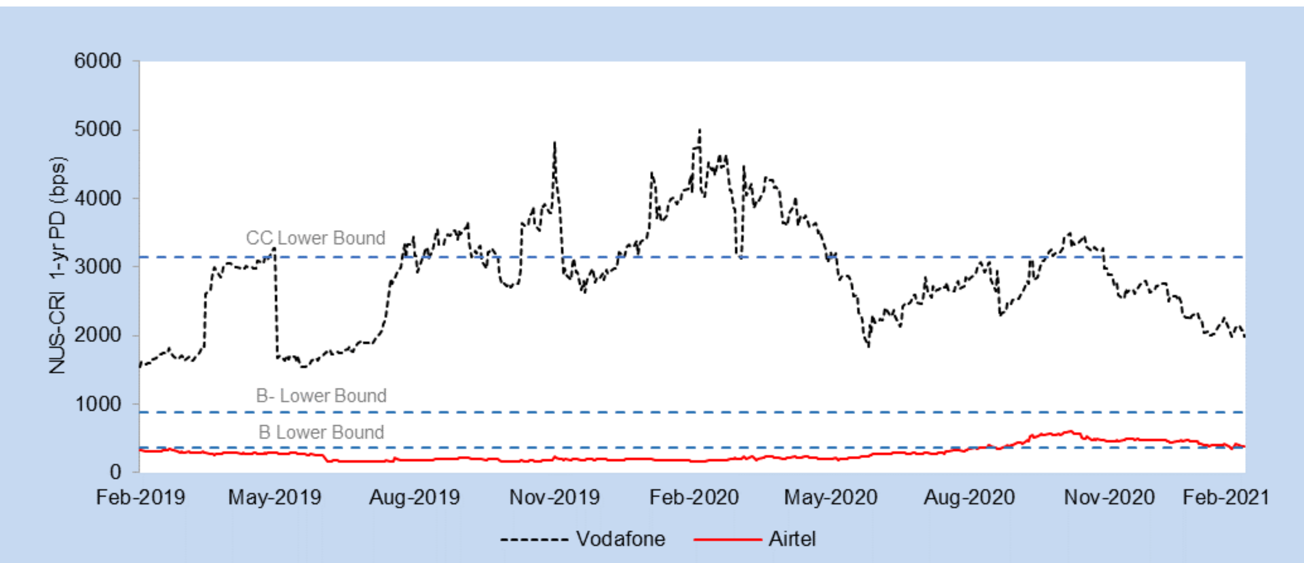

Figure 1: NUS-CRI 1 -Year PD of two of the biggest mobile carriers in India, Vodafone Idea and Bharti Airtel, with reference to PDiR2.0[3] bounds. *Source: NUS-CRI*

[1] Reliance Jio is part of the larger Reliance industries group, which also specialises in other areas such as petrochemical products. As such, it would not be directly comparable to analyse the group against two pure-play telecommunications companies.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.

[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-Year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

The Indian telecommunications industry was badly hit in 2019 after courts ruled that these companies were required to shell out a combined total of USD 13bn with regards to adjusted gross revenue (AGR) dues. These companies are essentially expected to pay increased licensing fees to the government. With this new ruling, revenues derived from non-telecommunication services would also be considered in the calculation of AGR, leading to ballooning deferred payments. Figure 1 shows a significant spread in the 1-year PD for two of the largest wireless carrier companies, Airtel and Vodafone Idea. While Airtel had a relatively high PD of 387bps in the middle of Feb 2021, it was far below its rival Vodafone Idea's, which had a PD of 1974bps in the same timeframe, after peaking at 5003bps in Feb 2020. The company narrowly avoided bankruptcy after the government provided minor reliefs for the company's AGR payments.

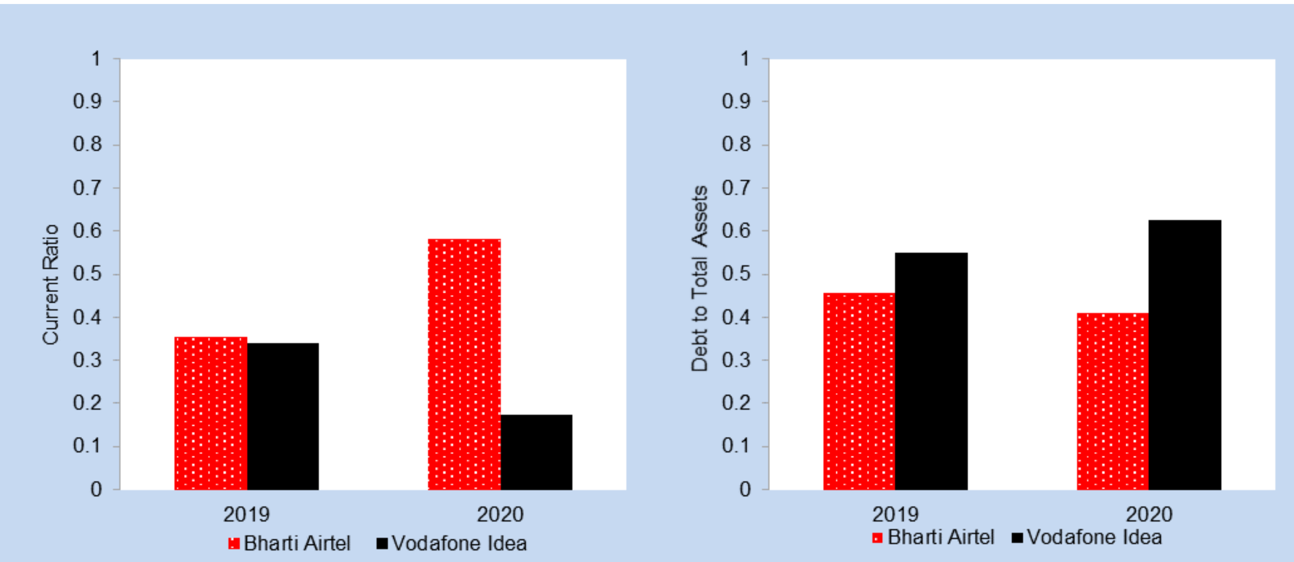

Figure 2a (LHS): Change in current ratio levels across 2019 and 2020 for Airtel and Vodafone Idea. Figure 2b (RHS): Change in Debt to Total Assets across 2019 and 2020 for Airtel and Vodafone Idea. *Source: Bloomberg.*

These payments may be difficult for Vodafone Idea to bear, especially given its limited liquidity buffers. The current ratio of Vodafone Idea halved from 0.34 in calendar year 2019 to 0.17 in 2020, as shown in Figure 2a. Vodafone Idea's cash burn is a result of the significant liabilities owed to the government. However, they have led to the drying up of liquidity in the company, further exacerbating its overall credit risk. At the same time, its inability to generate profits have led to the amplification of these issues. Vodafone Idea appears to be in dire straits, as it sustained a loss of USD 623mn this quarter. The carrier is bleeding customers, as they hop on to rivals such as Reliance Jio and Airtel. At the same time, its average revenue per customer is lower than its peers, significantly affecting its top line. This is juxtaposed by the relative improvement in current ratio of Airtel, as it increased from 0.35 in 2019 to 0.58 in 2020. Airtel appears to be faring relatively better, posting the first net profit in the last seven quarters, while improving its average revenue per user from INR 162 to INR 166.

In the same vein, Vodafone Idea has had an increase in leverage across the two years, as its Debt-to-Asset ratio rose from 54.8% to 62.5% in 2020, as per Figure 2b. While all carriers were affected by the requirements for spectrum payments, Airtel and Vodafone Idea were both the hardest hit, with the two companies obligated to pay 65% of the total amount due, and Vodafone Idea having to pay the largest amount out of any single carrier. These spectrum payments would carry an interest rate of 9%, further chipping away at the already-thin liquidity of Vodafone Idea. The mounting liabilities have further led to roadblocks for the company, as its resulting weak liquidity position would hamper its ability to bid for new licensing contracts with the government, as well as prevent them from investing in new towers. This puts Vodafone Idea in a difficult spot, preventing the company from effectively recovering and improving its credit strength by bolstering its cash flows. This is a stark contrast to the fall in Debt-to-Asset ratios for Airtel. Overall, the company experienced a marginal drop from 45.6% in 2019 to 41.9% in 2020 (Figure 2b). However, while leverage has cooled off, the absolute debt levels remain high, which has increased to INR 1.45tn in 2020 as compared to INR 1.26tn in 2019.

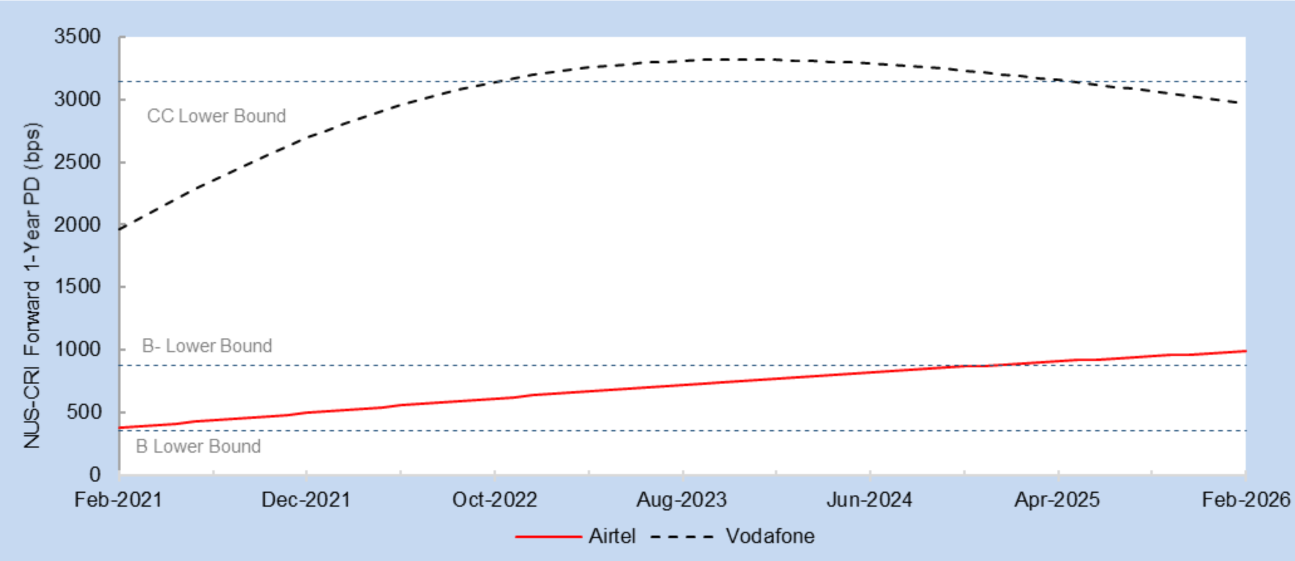

Figure 3: Corresponding NUS-CRI Forward 1-Year based on data feed at Feb 2021 with reference to PDiR2.0. *Source: NUS-CRI*

Looking ahead, both companies face a deteriorating credit outlook, albeit to different extents. The Forward PD for Vodafone Idea rises over the short-term to 2023, as seen from Figure 3, while the PD for Airtel follows a relatively linear growth over the same time. Further liquidity issues may arise due to the 10% lump sum payment due in Mar 2021 pertaining to its AGR payments. Vodafone Idea would be expected to cough up a further USD 801mn at current exchange rates. This balloon payment could further lead to a cash crunch, as the company's liquidity is already stretched thin as seen from Figure 2a. These payments may in the end pose a risk to the company's debtors. At the same time, the company is losing market share to Reliance Jio and Airtel, affecting its growth and cash flows. The company plans to ramp up its liquidity buffers through cost-cutting measures and asset disposals. However, these measures are only short-term band-aids, as the company's free cash flow remains weak with low revenue growth. As a result, the company hopes to de-lever through an equity capital injection, potentially giving a lifeline to the distressed carrier.

Airtel also has a deteriorating credit outlook going forward, albeit to a lesser extent, as can be seen from the significant divergence in Forward PDs per Figure 3. The company plans to increase its overall capex spending for spectrum licenses, bidding INR 30bn in Feb 2021. The company also spent cash to wholly acquire its direct-to-home business venture as well as significantly invest in infrastructure, such as Indus Towers, which is likely to provide only limited cost savings in the long run. These decisions ultimately will hamper Airtel's cash position going forward, and could affect its ability to service its debt when considering the increase in total debt to INR 1.45tn as mentioned previously. That being said, the company posted strong EBITDA growth, through customer base expansion, which could help in bolstering its cash flow position.

Overall, the shift in market dynamics between the three big players have led to compounding risks for Vodafone Idea. The industry faces a risk of consolidation into a duopoly, as Vodafone Idea struggles to compete with Reliance and Airtel, losing 5.7mn customers in Dec 2020 alone. The company has made efforts to turnaround and improved its EBITDA, albeit marginally. The company is hoping to outperform its peers by focusing on quality of services as well, currently holding the fastest internet speeds amongst the carriers. However, Airtel has been performing the best in terms of market share growth, as it absorbs most of the subscriber loss faced by Vodafone Idea. As the industry shifts towards 5G technology, Vodafone Idea may get left behind as the major players invest more in the necessary technology to facilitate the transition. As such, the company might have to play catch-up in order to maintain its major role in Indian telecommunications going forward.

Correction: The sentence: "These AGR payments are not considered debt, and thus failure to make these payments would not constitute a default under NUS-CRI definition" was erroneous and has been removed in this revised version.

Credit News

Bond selloff prompts stock investors to confront rising rates

Feb 21. While the increase in US Treasury yields reflects positive recovery expectations, it also indicates higher borrowing costs. The prospects of yields rising more than the general growth narrative can be disruptive for the equity capital market because investors use the 10-year Treasury yield as the discount rate for stock valuation. Bond prices fall as the pickup in inflation makes the interest payments of debt less attractive. Moreover, this increases the likelihood of the FED increasing rates to tamper down the general price level. (WSJ)

Covid-19 forces electronic shift in bond markets

Feb 19. COVID-19 has accelerated the shift to electronic platforms so that stuck-at-home retailers could continue participating in the bond markets. As of Dec 2020, 33% of trades were made using online platforms, with volumes in IG and Non-IG bonds increasing 3% and 7% YoY respectively. This shift was further catalyzed by the daily trading in ETFs, which traded in and out of bonds to keep an instrument tied to the underlying index. The shift to online trading platforms also allowed companies to raise much-needed liquidity, while simultaneously ensuring up-to-date price information and fast transfer of data to mitigate additional risk. Increased ease in trading also allowed companies to respond to trading demand, effectively leading to hundreds of billions of dollars. (FT)

Singapore makes pitch as Asia bond hub with Euroclear tie-up

Feb 18. Singapore is setting up a distribution link with Euroclear – one of the world's largest securities depositories, in doing so, SGX aims to promote its bond business. This is especially critical given the pressure on its core equity business from global competition. In 2020, Euroclear held over EUR 33tn in assets and settled over EUR 900tn in transactions. The alliance allows global investors to use assets in Euroclear to purchase Singaporean issuances. SGX is also gunning to be the first mover in Asia to list SPAC ventures. (FT)

Global companies raise massive cash through convertible bonds at start of 2021

Feb 17. Global companies are raising vast amounts of money through convertible bonds, which gives investors an option to change into equity shares later, due to soaring investor demand. Nearing the end of Feb 2021, companies have issued USD 19.7bn of convertible bonds, the highest in the last three years. US firms borrowed USD 8.6bn, while China borrowers USD 7.2bn in convertible bond debt. Due to their 'on risk nature, convertible bonds allow companies with low/no credit rating to raise funds without the hurdles associated with a bond offering. The rising trend of convertible bond issuance is set to continue in the near-term due to low rates, elevated volatility and issuance of conversion rights a significant premium to current share prices. (Reuters)

Riskiest borrowers make up biggest share of junk-bond deals since 2007

Feb 16. Year to date, 15% of the capital raised from the US junk bond market are from firms with CCC or below ratings. In 2020, the firms that are more well-endowed on financial terms started beefing up their balance sheets as emboldened by the low rates and loose lending conditions. Now as the dust settles, the relatively weaker firms are reaching the end of the queue for funding. Today, we see that the rally in CCC-rated US-domiciled debt has set the corresponding yields to a record low. (FT)

Europe's bruised bond markets signal there's more pain in store (Bloomberg)

Uber rids a leveraged loan repricing spree to slash debt costs (Bloomberg)

Ailing Macy's considers bond sale amid strong demand for high-yield debt (Bloomberg)

Regulatory Updates

FSC Korea to enhance recovery and resolution regimes of SIFIs

Feb 21. South Korea's Financial Services Commission (FSC) has revised their policy regarding the recovery and resolution regimes of Systemically important financial institutions (SIFIs). This improves their ability to respond to crises. The revised decree enforces a 3-month period for SIFIs to submit a resolution plan to the Financial Supervisory Services (FSS). The resolution plan should highlight key crisis management measures and include a measure for recapitalization and financing to address the possible bankruptcy. The new policy will also give the FSC the authority to ask SIFIs to settle certain issues that may hinder the resolution process. (Regulation Asia)

Bond buying remains BoE's stimulus weapon of choice

Feb 18. In 2020, the Bank of England (BoE) looked to its GBP 900bn corporate debt purchase programme to revitalize the economy. They found merit in Quantitative Easing as the tried and tested tool. Over the past year, the size of the programme has almost doubled to over GDP 1.24tn. Currently, rates are at a record low of 0.1%. They also gave a signal to banks that rates might be taken to below zero. This new guidance allows for transparent contingency planning for the central bank's monetary pursuits. (Reuters)

Bank Indonesia cuts rates and outlook as the recovery stalls (Bloomberg)

China rolls over CNY 200bn of medium-term loans, rate unchanged (Reuters)

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