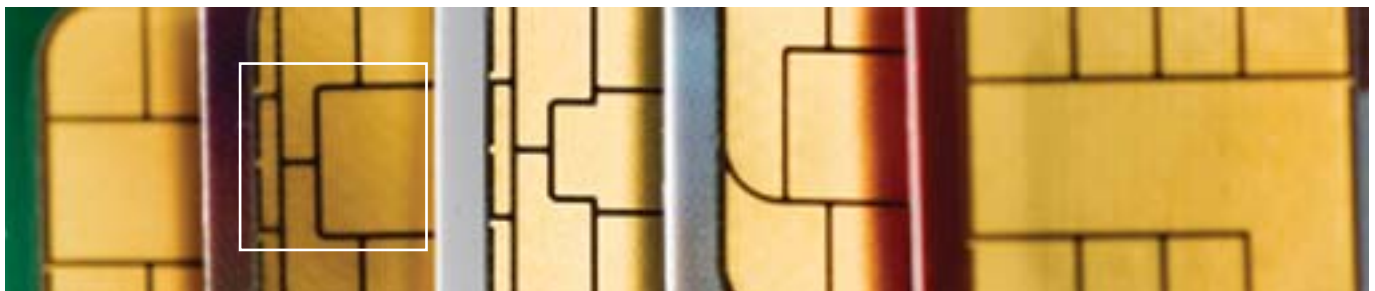


# Mergers & Acquisitions: Bust or Boom in CEE Telecoms?

*Driving Forces for Continued High M&A Activity*

*August '08*



2007 was a strong year for merger and acquisition activities in the Eastern European<sup>1</sup> telecommunication markets. Strategic and financial investors, in the course of the ten largest transactions alone, spent €3.9 billion to acquire telecommunication operators in the region. But will merger and acquisition activity in Eastern Europe endure in the light of the slow down in the world economy? Will remaining market growth, the limited numbers of operators which remain to be privatized and the dwindling number of pending license tenders in Eastern Europe be sufficient to sustain merger and acquisition activity? We believe so, as increasing pressure to consolidate is becoming an additional driver to maintain M&A activity at high levels.

Arthur D. Little has identified three trends for a continued high merger and acquisition activity:

- Some incumbents remain to be privatized which will lead to large ticket transactions.
- The tendering of new mobile licenses, e.g. of some further GSM and UMTS licenses and of many CDMA, WiMAX or TETRA licenses will lead to the establishment of new network operators, which can eventually become the target of transactions.
- The competitive intensity between operators in Eastern Europe, already almost at the level of saturated Western European markets, will continue to increase as market growth slows down. This will increase the pressure for market consolidation. We expect to see more and more cross-border and intranational mergers driven by a need to address cost synergy potentials.

*“2007 has been a strong year as strategic and financial investors have acquired stakes in ten telecommunication operators for €3.9 billion.”*

The ten largest transactions of Eastern European telecommunication operators were conducted for a total value of €3.9 billion<sup>2</sup>, split equally between strategic and financial investors (See Figure 1 overleaf).

Both strategic and especially financial investors should keep the Eastern European markets on their watch list. Eastern Europe may well be a “safe haven” for investors to fill their telecommunications deal pipeline in the current credit-crunch situation.

Telecommunications, Information, Media & Electronics (TIME)

<sup>1</sup> For the sake of simplicity we use the term “Eastern Europe” to cover all the countries in Central, Eastern and Southern Europe, including the European countries of the Community of Independent States (CIS).

<sup>2</sup> The acquisition price for GTS CE was not disclosed and is therefore not included in the sum of the value of the ten largest CEE telecommunication transactions in 2007.

Figure 1: The ten largest mergers and acquisitions in the Eastern European telecommunications industry in 2007

Target	Buyer	Seller	Acquisition Price (€m)	Stake Acquired
Bulgarian Telecommunication Company (BTC)	AIG Capital Partners	Viva Ventures/Novator	1,080	65%
MDC (Velcom) (Belarus)	mobilkom Austria	SB Telecom Ltd	730	70% (+ call option for 30% in 2010)
Telekom Srpske	Telekom Srbija	State	646	65%
Bite (Lithuania, Latvia)	Mid Europa Partners	TDC	450	100%
Invitel (Hungary)	Hungarian Telephone & Cable Corporation	Mid Europa Partners	470	100%
Volia Cable (Ukraine)	Providence Equity Partners	SigmaBleyzer	Undisclosed but above 200	Undisclosed
Serbia Broadband (SBB)	Mid Europa Partners	Southeast Europe Equity Fund	200	100%
Albtelecom (Albania)	Consortium of Calik Group & Türk Telekom	State	120	76%
SC Digital Cable Systems (Romania)	AIG Capital Partners	Private	45	40%
GTS CE (e.g. Czech Republic)	Columbia Capital Consortium	GML	Undisclosed	100%

Source: Arthur D. Little

Note: Cells in dark purple indicate financial investors, cells in light purple indicate strategic investors

*“Strategic investors have acquired stakes in four Eastern European operators for a total value of €2 billion in 2007 but have slowed down their activities.”*

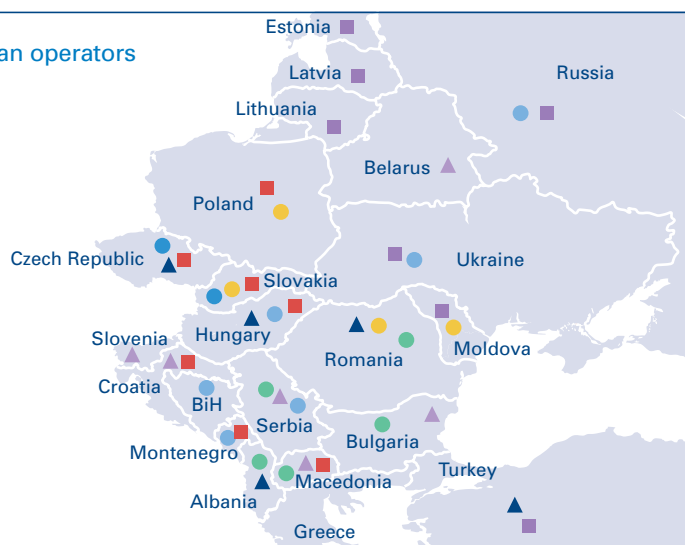
Leading Western European telecommunication operators as strategic investors have, by acquisitions and by winning license tenders, succeeded in building extensive empires of telecommunication operators in Eastern Europe (See figure 2).

This empire building has slowed down as **mobilkom Austria** was the only operator to continue to expand in 2007 by acquiring the Belarus operator **MDC**.

The investor landscape has shifted. It is now Eastern European operators who start to build their regional empires: **Telekom Srbija** has acquired 65% of the shares of **Telekom Srpske**, the incumbent in the Republika Srpska<sup>3</sup>, and a consortium of the Turkish companies Calik group and of Türk Telekom had acquired a controlling stake in **Albtelecom**. Further, **Hungary’s Telephone and Cable Corporation** has acquired the Hungarian alternative fixed line operator **Invitel**.

Figure 2: Empires, i.e presence of leading Western European operators in Eastern European countries

- Deutsche Telekom
- France Telecom/Orange
- Telefonica/O2
- ▲ Vodafone
- Telenor
- ▲ Telekom Austria/mobilkom Austria
- TeliaSonera
- OTE/Cosmofon



Source: Arthur D. Little

<sup>3</sup> Republika Srpska is a part of Bosnia and Herzegovina

*“Financial investors have acquired shares in six Eastern European operators for a total value of €1.9 billion in 2007 benefiting from lower competition from strategic investors.”*

Financial investors, especially private equity houses that specialize on Eastern Europe, continue to grasp opportunities to acquire Eastern European operators:

- **AIG Capital** bought 65% of the Bulgarian incumbent **BTC** for €1.1 billion, and immediately started a major transformation program. AIG Capital has also acquired 40% of **SC Digital Cable Systems** in Romania for €45 million.
- **Mid Europa Partners** acquired the Baltic mobile operator **Bite** for €450 million from **TDC** and also the leading Serbian cable and broadband provider **SBB** for €200 million.
- **Providence Equity Partners** bought an undisclosed stake in the Ukrainian cable company **Volia Cable** for an amount above €200 million from **SigmaBleyzer**.
- A consortium of private equity firms around **Columbia Capital** has acquired 100% of **GTS CE** for an undisclosed amount. GTS operates alternative fixed-line networks in the Czech Republic, Poland, Hungary, Romania and Slovakia.

Strategic investors dominated the merger and acquisition scene of Eastern European telecom transactions in recent years. The acquisition of **OTE** by **Deutsche Telekom** is a case in point. However, financial investors may now become more important, as strategic investors start to refocus on optimizing their existing operations and therefore stop acquiring new operators.

Therefore, financial investors may have the opportunity to realize attractive acquisitions while facing less competition during take-over negotiations from strategic investors, possibly leading to lower take-over prices.

*“The three drivers privatization, license tenders and consolidation will lead to a continued high level of merger and acquisition activity.”*

The slow-down in the world economy, the financial crisis and the flattening market growth rates in Eastern Europe might, one could argue, lead to a slow-down in merger and acquisition activity. Three trends will however continue to drive merger and acquisition activity in the telecommunications markets in the region:

1. **Privatization:** A few remaining “big ticket” privatizations of state owned incumbent operators are still pending.
2. **License Tenders:** The remaining license tenders of GSM and UMTS spectrum and the large number of CDMA or WiMAX tenders will lead to start-up operations which, in turn, will eventually become the object of transactions.
3. **Market Consolidation:** Slowing growth rates in the Eastern European telecommunication markets and increasing levels of competitive intensity will put pressure on operators to consolidate.

### 1. Privatization

Although most governments already sold their majority stake in the respective formerly state owned incumbent telecommunication operator, some privatization processes are still pending. Privatization processes are either driven by the motivation to liberalize the market in line with EU-regulation or simply by a desire of governments to cash-in. 2007 saw two already mentioned transactions triggered by privatization; the **Albtelecom** and **Telekom Srpske** sales.

We have identified seven operators that should be on the watch list of investors as they will be privatized in the next few years. Two failed privatizations are likely candidates for renewed attempts over the next two to three years as the respective countries need to adhere to EU regulation:

- The Latvian government was expected to sell 49% in **Lattelecom** but has stopped the sales process in mid 2007 as its price ambitions were not met.
- The Slovenian government is likely to start another attempt at privatizing **Telekom Slovenije**. The first attempt was also stopped because of diverging price expectations.

We expect five further privatization deals in non-EU countries which should equally remain on the watch list of investors:

- The government of the Federation of Bosnia and Herzegovina intends to sell 51% of **BH Telecom**.
- The government of the Ukraine intends to sell 67% of **Ukrtelekom** in a second attempt. This privatization has been under discussion for several years, so that the timing of this second attempt remains uncertain.
- Moldova is expected to eventually sell a stake in **Moldtelekom**.
- Belarus may eventually sell a stake in **Beltelecom**.
- The Serbian government intends to privatize a stake in **Telekom Srbija** via an initial public offering and has started the process.

Privatization processes are difficult to manage due to the contradictory objectives of the respective government and of the employees. While strategic investors are usually perceived to manage these different objectives better than financial investors, this may not be true for the remaining privatization processes.

Only financial investors may be ready to pay the price required by the respective government. They may be tougher in modernizing the often outdated legacy network infrastructure and in restructuring the operation, two important value creation levers justifying a high sales price in the first place.

## 2. License Tenders

The days of the big ticket GSM and UMTS license tenders are obviously over. Only a limited number of GSM and UMTS licenses remain. A new wave of tenders for CDMA, WiMAX and TETRA licenses is about to culminate, offering new investment opportunities. Those networks typically address markets that are not sufficiently covered yet and which therefore provide niches for growth.

Macedonia intends to tender a fourth GSM license and two UMTS licenses, Hungary intends to issue a fourth UMTS license. The remaining licenses are typically tendered with favorable conditions in order to attract the interest of investors to enter into fairly saturated markets<sup>4</sup>.

The CDMA standard provides the possibility to roll-out networks to offer cost-effective fixed wireless broadband and voice services. One of the latest examples is the CDMA license which Slovakia has granted to **France Telecom** for a one time fee of only €1.4 million. Another recent example is the tender of a CDMA 450 MHz license in Bulgaria or the announced CDMA tender in Romania. A range of further CDMA license tenders are expected in the next years as regulators strive to allocate the 450 MHz spectrum, freed from former use by analogue cellular networks.

CDMA licenses are typically acquired by strategic investors wishing to complement their existing networks.

WiMAX licenses will lead to another wave of tenders and of greenfield wireless network operators. They address the mobile broadband opportunity by providing low priced voice over IP services and wireless broadband access, mostly to suburban or rural populations. Bulgaria has for example issued five WiMAX licenses. Further WiMAX license tenders are expected to take place in the next 12 months in Lithuania, Romania, Poland, Macedonia, Russia and the Ukraine.

WiMAX licenses are typically acquired by alternative operators, often backed by financial investors, as the WiMAX operators compete with the service offerings of the established operators.

A very interesting example is the launch of "Virgin Connect" in 32 regions in Russia, including 20 cities, in May 2008. Virgin Connect is the first business of the **Virgin Group** in Russia and was launched through an agreement with the Swiss based telecommunications holding company **Trivon**. Trivon itself is backed by the private equity firms **Delta Partners** and **Eurasia Capital Management**.

In conclusion, the remaining license tenders continue to offer opportunities for investors to enter the Eastern European markets. The shareholders of the range of the new CDMA, WiMAX or TETRA operators are likely to eventually sell their shares to other strategic or financial investors, driving M&A activity.

<sup>4</sup>Low network coverage requirements, a permission to use national roaming, favorable interconnection terms or simply low frequency fees are exemplary favorable licence conditions. In 2007, the Polish regulator has for example awarded a fifth GSM license to private investors who now have to cover only 15% of the population with a GSM network.

Figure 3: Competitive Intensity in Eastern European telecommunication markets

Competitive Intensity	Country	Herfindahl-Hirschman -Index <sup>5</sup>	Number of Mobile Operators	Mobile Penetration Rate end 2007
High	Poland	3,252	6	109%
	Czech Republic	3,512	4	127%
	Hungary	3,625	3	104%
	Ukraine	3,635	11	117%
	Romania	3,636	5	106%
	Bosnia & Herzegovina	3,697	3	62%
	Montenegro	4,125	3	170%
Average in Eastern Europe		4,265	4.3	
Low to Medium	Slovakia	4,234	3	103%
	Croatia	4,240	3	109%
	Bulgaria	4,428	3	132%
	Serbia	4,452	3	105%
	Macedonia	4,893	3	89%
	Moldova	5,064	5	55%
	Slovenia	5,878	4	92%
Average of the nine largest Western European countries <sup>6</sup>		3,409		

Source: Arthur D. Little

### 3. Market Consolidation

The telecom industry in Central and Southern Eastern Europe has enjoyed strong growth for a long time. The growth rates have now slowed down as mobile penetration has reached high levels. A further indicator is that the level of competitive intensity, which can be measured with the Herfindahl-Hirschman-Index<sup>5</sup> (HHI), has almost reached Western European levels. The Eastern European markets show, at 4,265 points, a similar competitive intensity as Western European countries at 3,409 points on the index. Slowing market growth and increasing competitive intensity will increase the pressure on operators to consolidate.

Consolidation is driven by three objectives: The desire to tap remaining market growth addressed by another operator in another service area or in a different geography, the desire to take a competitor from the market or the desire to increase company value by realizing cost synergy potentials.

The extent to which cost synergies can be realized and their impact on company value is often overestimated but should not be fully neglected either. We categorize cost synergies into three clusters:

- Reduction of procurement costs for network infrastructure and for devices.
- Reduction of the salary expenses by optimizing processes, including product development processes.
- Reduction of marketing costs, usually by rebranding the acquired operator with the internationally recognized brand of the buyer and by consequently increasing the efficiency of advertising budgets.

Recently, two M&A processes were driven by the trend towards pan-European consolidation.

First, **Deutsche Telekom** has acquired **OTE**. The key reason for this acquisition was to complement Deutsche Telekom's strong footprint in Eastern Europe with the subsidiaries of OTE in South Eastern Europe. Deutsche Telekom also wants to realize cost synergy potentials.

Second, **France Telecom's** failed attempt to acquire **TeliaSonera** in mid 2008 was motivated primarily by France Telecom's ambition to expand the footprint in Eastern Europe. This failure signals that investors doubt that cross-border acquisitions add value. TeliaSonera has rejected the bid as too low while France Telecom's share price had dropped by over 15% after announcement of its bid for TeliaSonera. This failed attempt is a negative signal for the long awaited new wave of cross-border consolidation among the leading European telecommunication companies – but it does not change their fundamental logic. The next attempt at a large cross-border merger is just a matter of time.

<sup>5</sup>The Herfindahl-Hirschman-Index is a well established measure for the level of competitive intensity in any market. It is calculated by summing the squares of the market shares of all mobile operators in the respective country and ranges normally between 1,000 and 10,000 points.

<sup>6</sup>Arthur D. Little has assessed the competitive intensity in the nine country markets UK, Germany, Austria, Italy, The Netherlands, France, Spain, Belgium and Switzerland in the third quarter 2007.

### Conclusion

Arthur D. Little projects that merger and acquisition activity in Eastern Europe will continue to be intensive for the coming 18 months and beyond.

Three trends are fundamental for maintaining the merger and acquisition intensity at current levels: Privatization, license tenders and an increasing pressure to consolidate. The opportunities for merger and acquisition activity from privatization or from license tenders and greenfield operations become increasingly scarce and niche. While the two drivers license tenders and privatization processes lose in importance, the third driver, consolidation, will become an increasingly important trigger for Eastern European telecom transactions.

Strategic investors may play a less important role in future Eastern European telecommunication transactions as their empires are mostly built. The withdrawal of France Telecom's bid for TeliaSonera is a negative signal for the importance of strategic investors in the long awaited consolidation wave.

Private equity houses specializing in telecommunications investments therefore have the opportunity to jump into the temporary decline in buyer side interest from strategic investors. They may be able to realize acquisitions at favorable prices.

Clearly, timing of these acquisitions will be crucial and determine the return financial investors will be able to realize when re-selling the share.

### Contacts

#### **Karim Taga**

Director TIME Practice,  
Managing Director Arthur D. Little Austria  
taga.karim@adlittle.com



#### **Christian Niegel**

Senior Manager TIME Practice Germany  
niegel.christian@adlittle.com



#### **Oliver Lux**

Manager TIME Practice Switzerland  
lux.oliver@adlittle.com



#### **Evgeny Shibanov**

Business Analyst TIME Practice Austria  
shibanov.evgeny@adlittle.com



### About Arthur D. Little

Arthur D. Little has supported over 80 telecoms transactions in Western and Eastern Europe. Founded in 1886, Arthur D. Little is a global leader in management consultancy; linking strategy, innovation and technology with deep industry knowledge. We offer our clients sustainable solutions to their most complex business problems. Arthur D. Little has a collaborative client engagement style, exceptional people and a firm-wide commitment to quality and integrity. The firm has over 30 offices worldwide. With its partner Altran Technologies Arthur D. Little has access to a network of over 16,000 professionals. Arthur D. Little is proud to serve many of the Fortune 100 companies globally, in addition to many other leading firms and public sector organizations. For further information please visit [www.adl.com](http://www.adl.com)

Copyright © Arthur D. Little 2008. All rights reserved.