

ISPs: Download with caution

Analysts expect 2007 to be a big year in the Australian telecommunications industry. This is to be The Year of Broadband as the number of subscribers hits 4 million, the Federal and State governments step up with a \$5 billion infrastructure commitment and second and third-tier telecommunications providers take the fight to Telstra with threats to build their own high-speed network.



The internet is now a key part of the Australian business landscape. Almost every industry conducts some part of its business online – from dealing with suppliers or distributors to communicating with clients or collaborating with long-distance colleagues. The internet continues to revolutionise business in a country long-held captive by the tyranny of distance. But the toll collectors on the information superhighway are finding life tough. The landscape for Internet Service Providers ('ISPs') changed dramatically this year when Helen Coonan abandoned the \$880 million Broadband Connect Fund ('BCF' – a fund established to improve broadband services in regional Australia) at short notice, replacing it with the new \$160 million Australian Broadband Guarantee ('ABG' – a subsidy to provide affordable broadband to all households and businesses).

One result of this has been a dramatic consolidation in the number of fish in this big pond. And with the growing number of ISPs being dismantled, bought

out or closed down, now is the time for every lender or potential ISP buyer to be acutely aware of the warning signs indicating financial ill health.

Subsidy haircut

The removal of the BCF has hit wireless internet providers the hardest, as their \$3,300-per-customer subsidy was trimmed back to just \$1,100 – and that's only if they qualify: there is no guarantee former BCF recipients will receive funding under the ABG.

The impact on cashflow for the small players has fed into the well-established trend of consolidation at the small and medium end of the market. Australian Bureau of Statistics figures show that in the 18 months to September 2006, the number of small ISP/telco businesses fell 35 per cent as 169 closed their doors. The number of medium businesses in the market was down 31 per cent over the same period. We expect this trend to continue.

The biggest players in the market have benefited from these changes, snapping up the lion's share of those customers left seeking a replacement service provider and those new customers seeking the security of a large provider. The fact tier-one providers offer security that can't be offered by the minnows in the big pond should come as no surprise: the entire second-tier telecommunications sector turned over just \$8.7 billion last year, while Optus alone turned over \$7.2 billion and Telstra almost \$23 billion.

ISP/Telco Size	March '05 Quarter	September '06 Quarter	% Decrease
Very small	180	124	-31%
Small	312	199	-36%
Medium	162	112	-31%
Large	25	22	-12%
Very large	10	10	0%
Total	689	467	-32%

Source: ABS

For those that manage to survive the subsidy shock, the news doesn't necessarily get any better. Over the next 12 to 18 months, the small to medium ISP/telcos are going to face their most challenging period yet, with the impact of increasingly techno-savvy and demanding customers and tougher competition.

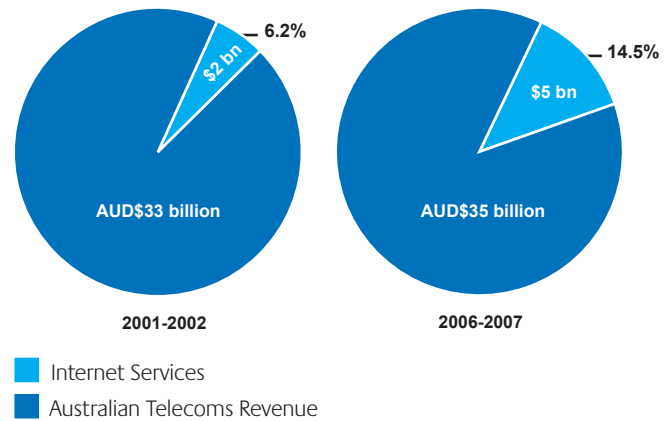
Customers empowered

Better understanding of the internet has empowered customers to walk if they don't get what they want. In the USA, figures put ISP customer churn rates at an average of 25% a year. But even worse than customer churn is the ability of unhappy customers to air their dissatisfaction over the internet – this bad news spreads like wildfire. The impact of negative feedback in customer chatrooms is that it very quickly creates a bushfire-like effect on a business's brand value.

The future of ISPs lies in giving customers what they want. Independent reports have shown that as customers become more aware of the potential and the value of broadband, they demand four key things of their ISP: faster connections (*always* faster connections!); competitive pricing; an effective SPAM filter; and useful support/technical service.

The other key to the future of ISPs lies in their ability to differentiate themselves. Big players like Telstra and Optus offer scale and perceptions of reliability, but the smaller players need something else to set

Growth in Internet Services as a Proportion of Australian Telecoms Revenue



Source: IBISWorld

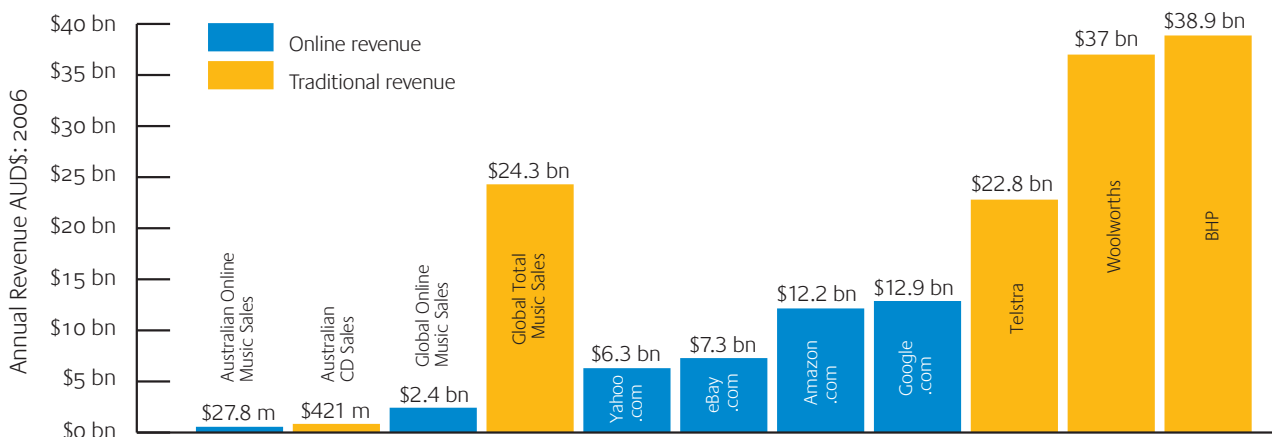
them apart: greater speed; cheaper rates; wireless connection; service quality; the latest technology and responsiveness to customer demands.

Finding value

All ISPs need to find an appropriate balance between the four major forces tearing at them: customers; suppliers; competition and their efficiency at capturing revenue. Where staff and resources are not appropriately allocated to these forces then one problem – such as customer churn – can impact all other forces, creating a domino effect.

The value of ISP/telco businesses is locked up in four core areas: the customer base, history and billing

Old world revenue versus new world revenue



How the revenues of the worlds biggest online businesses compare with Australia's biggest companies.

Source: IBISWorld and Ferrier Hodgson research

data; systems or software; brand and brand loyalty; and access to network connections and providers. These are the crown jewels that have to be clearly understood and closely monitored by every lender or potential buyer.

In a sale scenario, a potential purchaser may only be interested in one of the value drivers and may look to purchase only, say, the customer base. Another party may derive value in three or all of the components. It is common practice in the ISP community to separate the ownership of components into different corporate entities, which can make the sales process easier – or more difficult when purchasers want to pick and choose.

Customer Dynamics

As a result, many ISPs are formed and grow through the aggregation of customers from other ISPs through mergers or acquisitions. This means customer dynamics are forever changing – a swirling morass of new customers, churned customers and purchased customers who have come to the provider for diverse reasons: some through their own choice, some not.

The issue for buyers or lenders is that the actual rights to the customer relationship can be far more complicated than they first appear. Complexity arises when third-party resellers or agents have claims to ownership of customers.

For lenders, it is critical they fully understand their security and its location - specifically, which corporate entity the customers are domiciled in as well as the network infrastructure. Without the appropriate security over the core areas (the crown jewels), the lender has little or no control in the event of default.

Danger signs

Lenders or potential buyers also need to search or monitor the business for evidence of warning signs indicating it could be financially stressed. Typically, these include:

Did you know...

- The Telecommunications Industry Ombudsman is a free and independent alternative dispute resolution scheme for small business and residential consumers with unresolved complaints about telephone or internet services.
- The TIO has the authority to make legally binding decisions (up to the value of \$10,000) and recommendations (up to the value of \$50,000).
- The cost of dealing with these complaints is borne by the ISP. For example, if there is a complaint over a \$10 account by a user, and the query escalates beyond 'Level 2', there is an automatic, non-refundable charge to the ISP which can go as high as \$1,600.

As a result, most ISPs simply refund disputed accounts. This can be a significant cost for smaller ISPs – particularly if the claim is without merit. Having dedicated staff to process these complaints is also costly, but given the costs involved, ISPs cannot afford the expense of failing to monitor these complaints carefully.

- For companies considering purchasing an ISP, an understanding of the company's standing with the TIO can provide useful insight into its financial and operational health. If an ISP has failed to pay its TIO bill, it could be a sign the company is not travelling well.
- Statistics about complaint numbers are included in the TIO Annual Report (www.tio.com.au) and in the quarterly publication *TIO Talks*. Online forums such as Whirlpool often feature discussions about TIO statistics and can provide early warning about ISPs with problems.
- The level of TIO complaints provides a handy industry key performance indicator. Divide the number of Level 2 and 3 complaints by the number of Level 1, 2 and 3 complaints. The industry average dissatisfaction ratio is about 8%. An ISP that collapsed recently had a dissatisfaction ratio of about 40% – identifying that it had significant problems.

Dissatisfaction ratio

$$\frac{L2 + L3}{L1 + L2 + L3} = \text{about } 8\%$$

- Increasing or high rate of customer churn
- Significant levels of billing errors and overcharging
- A high level of customer complaints
- Complaints lodged with the Telecommunications Industry Ombudsman (TIO)
- Increasing number and balance of debtors
- Failure to pay customer refunds
- Continuing to charge churned customers
- Non-value added services, which cost ISPs money but add little value to customers (ie: premium news services, or gaming networks)

It is essential that lenders, potential lenders and potential buyers are alert to changes in any of these performance indicators and seek evidence these issues are under control.

Looking ahead

It's a jungle out there. The ISP/telco marketplace is both highly competitive and rapidly changing. It is tougher than ever for the small players – particularly those that built their business models around the generous Government subsidies like BCF. With those subsidies either gone or severely trimmed back, the trend of consolidation amongst the small and medium-sized players is likely to continue.

This will provide buying opportunities within the sector, but these need to be evaluated cautiously both by potential buyers and by the funders of potential buyers. The dynamics of the ISP/telco industry create unique security risks and lenders need to be aware of risks to their security cover. Everyone involved in this sector should be monitoring their exposure carefully and act swiftly should their ISP exhibit any of the warning signs identified in this article.



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