

The ISP dilemma: Delivering our digital future

Compared to the glacial pace of the development of the conventional telephone, the evolution of mobile and smartphones has moved at warp speed.



Since the emergence of the first commercial – but somewhat unwieldy – portable handset in 1973, we have seen our phones become pocket-sized offices, with access to the internet, email, their own GPS, camera, sound system, global maps, barcode readers – you name it.

Evolving in tandem, we have seen cellular networks grow from the original 1G network launched in Japan in 1979, through the introduction of the digital 2G networks in 1991 and 10 years later to the emergence of 3G. It was 3G that provided us with our first true taste of internet access on the move, which drove the explosive growth in demand for smartphones, tablet devices and mobile connectivity.

But the 3G network may no longer be able to cope with consumer demand, and the 4G network – which operates at 100 times the speed of 3G – has been developed to meet our growing appetite for digital connectivity on the move.

The question of how to fund the cost of moving customers to the next generation digital network is just one of the challenges facing Internet Service Providers (ISPs) in an increasingly competitive environment where customer churn is high, sources of revenue are contracting and costs are soaring. For financiers associated with ISPs,

there has never been a more important time to be aware of the issues facing the sector and for staying in touch with the clients' cash flow and strategies to remain competitive.

The times, they are a-changin'

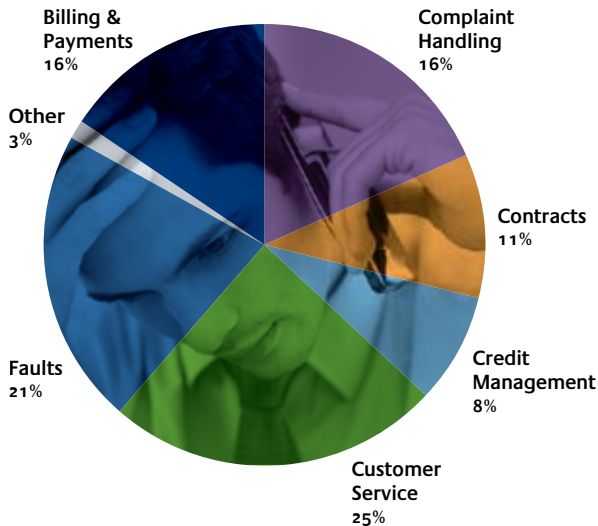
ISPs are currently facing a difficult confluence of new financial pressures. Some sources of income are disappearing and some new costs and probity requirements are throwing up fresh financial challenges.

Excess data charges are no longer a reliable source of revenue. Internet access over cellular networks can cost as little as 1c per megabyte on some pay-as-you-go plans and 200 to 300 times more than that (up to \$3 per megabyte) on others. Some ISPs have built these excess data charges into their business models as a constant source of income. Lenders need to be aware that these charges are fast evaporating as more and more ISPs recognise they are costing them customers. Increasingly, ISPs are replacing excess data charges with capped fees and shaped access speeds.

One of the growing areas of cost impacting many ISPs are the fines and expenses associated with the



New complaints – mobile phones Jan to March 2011



Source: TIO

Telecommunication Industry Ombudsman (TIO). The TIO is a free and independent alternative dispute resolution scheme for individuals and small businesses. The TIO has the authority to make binding decisions up to the value of \$30,000, and recommendations up to the value of \$85,000. It is an industry-funded scheme that charges members a complaint-handling fee for every complaint lodged by their own customers.

For the aggrieved, the scheme has become more accessible than ever, with simple-to-use online complaint lodgement in a few easy steps. Statistics published by the TIO show a significant increase in complaints involving billing disputes and connectivity issues associated with the provision of mobile internet services. This places additional pressure on ISPs: the TIO generated \$27.8m in complaint-handling fees during FY2010.

Customer dissatisfaction is rife: the TIO recorded a 98 per cent increase in complaints in the first three months of this year compared with the same period last year. For ISPs, an increase in complaints potentially leads to increased cashflow pressure through lost revenue and possible compensation claims, which – combined with a declining customer base – can result in a downward spiral of inferior service and high customer churn.

The TIO has established a useful benchmark, we call the survival quotient, which is used to measure the severity of complaints against an ISP. A simple formula:

$$\frac{L2 + L3}{L1 + L2 + L3}$$

(where L2 and L3 represent more serious level complaints and L1 represents less serious complaints) divides significant complaints by the total number of complaints, providing a quantifiable key performance indicator that can be used to benchmark the level of customer dissatisfaction between different ISPs.

The impact of the iiNet decision

Another issue of concern for the sector is the growing expectation that ISPs will play a larger role in monitoring the activities of their customers.

In February 2011, a highly anticipated Full Federal Court decision in the iiNet dispute provided ISPs with temporary relief on this issue. A group representing more than 30 movie and television studios alleged iiNet had effectively authorised copyright infringement by failing to take action against subscribers suspected of illegally downloading pirated material over iiNet's network.

While the case in the first instance and the subsequent appeal were found in favour of the ISP, iiNet was heavily criticised in the appeal for the way it handled notices of infringement. Fortunately for iiNet, the notices in this case suffered from shortcomings which played a part in the ruling. A High Court appeal is pending.

A key concern for ISPs is that they may be exposed to claims for copyright infringement committed by their subscribers. If found responsible, damages may be significant. Monitoring the activities of ISP customers and acting on infringement notices will amount to substantial new costs for the industry.

Connectivity and reliability is the key

Because of the level of competition in the ISP landscape, delivery and execution of customer service is more



Ramifications of the iiNet decision

- ISPs could be sued for copyright infringements by their subscribers
- ISPs may be required to monitor subscriber traffic
- ISPs could be required to implement compliance systems to combat copyright infringement
- It is uncertain if and how ISPs could be found liable for copyright infringement from streaming content

important than ever – indeed, this has become a basic requirement for survival. The iSelect Broadband Report, released at the end of May, found consumers are more likely to leave their current provider because of poor reliability and speed than cost. Only those providers who deliver consistently excellent service will survive.

This consumer expectation regarding the speed and reliability of their internet connection is hard to live up to. Recent data from AppsFire (a marketing platform for mobile applications) shows that smartphone users spend only 41 per cent of their time using traditional functions, such as telephony and messaging: the majority of their time is spent surfing the internet or other applications – this is where the future lies. Add to this the fact that, increasingly, consumers expect the same internet experience they get through their wired desktop to be available on their wireless device when they are on the move. Delivering this experience is not a straightforward task.

Connectivity issues generally arise from the inability of mobile internet service providers to cope with the level of demand for broadband services using conventional telephone technology. Existing cellular infrastructure is often not designed to handle high bandwidth and low latency internet access. For some providers, poor coverage and support has led to widespread exodus through customer churn.

Coupled with interference, congestion and excess service charges, it is not surprising to discover that the ISP sector faces widespread consumer dissatisfaction. This dissatisfaction is not cheap – not only do ISPs risk losing customers, but they are also potentially faced with those additional costs associated with the TIO.

The digital future

The answer to concerns about connectivity and speed lies in the capacity of our digital networks. There has been plenty of speculation about the next generation technology: the 4G network, which is expected to operate at up to 1000MB/s – about 100 times the speed of 3G. This is unlikely to be available in Australia for some time, so some carriers – including Telstra – are planning on launching a 3G hybrid called LTE or Long Term Evolution.

LTE is an upgrade of existing 3G infrastructure which is technically capable of running at 100MB/s – still ten times slower than ‘real 4G’, but ten times faster than what is on offer now. It should be more than capable of meeting our growing appetite for digital connectivity on the move. Telstra has already switched on its LTE mobile network, but is not expected to make it available to consumers until the end of the year.

The other major carriers will also need to consider the challenge of upgrading their existing 3G networks. The pure service providers – like TPG, iPrimus, AAPT, DoDo and Crazy Johns – purchase capacity and piggyback on the carriers’ networks, so they won’t be considering massive investments in cellular tower infrastructure or bandwidth.

An upgrade of current networks seems inevitable and while some mobile internet service providers have existing expansion capacity, others may need to approach their financiers in the not-too-distant future to seek funding for their move to the next generation network. Investors and financiers providing finances to this segment will face a number of questions, not all with a straightforward answer. What is the company worth? How much will it need for this move? Perhaps most challenging of all is deciding how to value a company which has as its key asset



a constantly changing and churning list of customers, unless the company is diversified and operating in a range of segments.

Many providers in this sector are resellers of wholesale services and operate on thin margins. The cashflow nature of the industry means finances in this sector are structured around cashflow-based lending rather than asset-based lending. Although the customer-base itself constitutes an asset that a lender can use as security, a customer-base is a rapidly changing thing that needs to be carefully assessed when it is bundled as part of any security pool.

Conclusion

There are a number of cashflow pressures at work in the ISP sector, all arising from the need to match change and provide cutting-edge service and support. Those unable to deliver this level of service may face survival questions in this increasingly cut-throat sector.

Over the next year, to remain relevant many ISPs are likely to be forced to make significant investments to move their business onto the next generation network.

In order to finance this critical move, they may turn to their investors and financiers for some or all of the investment. In this environment, lenders will need to be constantly aware of warning signs that identify the difference between success and failure.

It is important for lenders to be certain their ISP customers have high-quality, stable clients and that they provide robust levels of customer billing and support. Customer dissatisfaction and churn remain some of the most important issues facing the sector. Lenders need to understand these pressures and be aware of their impacts on cashflow – this knowledge will be a critical component in deciding whether or not to provide support.

Ferrier Hodgson has substantial experience in the ISP industry and is well placed to assist financiers with the complexities of ISP risk-assessments and to provide them with an overall financial health assessment or advice on cashflow lending.

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