ANALYSIS
from Central and Eastern Europe

June 2002

CENTRAL EUROPE TRUST CO. LTD

2002 – Year of Truth for Central European Fixed-line Alternative Telecommunications Operators

The year 2002 is going to bring many challenges to Central European alternative operators as they struggle to balance the need to capture opportunities in the opening markets of the Region with a reduced access to available financing. However, some companies seem to be better positioned than others to survive the difficult times and may emerge stronger as the turmoil ends.

RECENT MARKET DEVELOPMENTS

Liberalisation

The liberalisation of telecommunications markets of Central Europe is progressing - albeit not as smoothly as many originally hoped. The delays have been caused by a combination of lengthy interconnection negotiations, unclear cost-calculation methodologies, the relative inexperience of market regulators and a reluctance on the part of incumbents to co-operate with alternative operators even to the extent legally required.

Telecommunication market liberalisation is proving to be slower and more difficult than expected

Despite that, most of the alternative operators are forecast to grow this year, as they add income from the long-expected de-monopolisation of voice services to their data-focused business models - and take away market share from incumbent operators.

EXHIBIT 1: LIBERALISATION TIMESCALE

Country	Fixed voice liberalisation	Carrier pre-selection	Number portability
Czech Republic	2001	mid-2002	2003
Hungary	2002	2003	2003
Poland	2002	2001	2003
Slovakia	2003	2003	2005

Financing issues

Like their peers in other markets, alternative operators in Central Europe are experiencing difficulties securing the financing necessary

for expansion. This comes at the worst possible time for those operators who had scheduled aggressive roll-out plans that should have helped them improve their coverage and broaden their service offerings during this critical phase of market liberalisation.

In line with their western peers, CEE operators are finding it difficult to raise external financing

As a consequence, operators have had to drastically cut down their expansion plans; some have been forced to restructure their balance sheets, while the least fortunate have filed for bankruptcy.

EXHIBIT 2: VICTIMS OF THE DOWNTURN

Company	Country	Year	Issue
Elektrim	Poland	2001	Bond default
Netia	Poland	2002	Bond default
Kiwwi	CEE	2001	Bankruptcy
UPC	CEE	2001	Expansion scale-down

Ownership shake-up

The ownership structure of most of the alternative operators is likely to go through significant change over the next 6-12 months. Recent changes in the corporate strategies of many western operators, fuelled by an increased focus on survival, have made them reconsider their regional expansion policy and have often resulted in a decision to withdraw from the Region altogether. While cashing-out may not be easy at the moment, such shifts should eventually reshape the market landscape.

Many operators will get new owners over the next year as a result of changing investor preferences

In addition, the supply of cheap telecom assets is gaining the attention of deep-pocketed private equity funds which, attracted by distressed valuations, are beginning to team up with cash-stripped strategic players to acquire local operators. While such reshaping may eventually stabilise the Region's telecommunications sector, its immediate effect is mostly negative as "pre-consolidation anxiety" makes it more difficult for operators to focus on long-term strategies.

EXHIBIT 3: EXAMPLES OF COMPANIES WITH CHANGING OWNERSHIP

Company	Country	Issue
Aliatel	Czech Republic	Looking for new owner
CRa	Czech Republic	Looking for new owner
Euroweb	Hungary	Being folded into Pantel
GTS	CEE	Merger with KPNQwest
PanTel	Hungary	KPN's stake for sale

THREE KINDS OF OPERATOR

A closer look at the Central European fixed telecommunication market landscape reveals three distinct categories of operators fighting for position in the market: incumbent operators; asset-based operators; and other alternative operators.

EXHIBIT 4: CATEGORY CHARACTERISTICS

Category	Telecommunication Infrastructure	Services offered
Incumbents	Full-scale backbone and access networks	Universal voice, data and internet services
Asset-based	Full-scale backbone and limited access networks	Traditionally focused on data services; currently adding internet and voice services
Other	None or limited	Traditionally focused on internet services; currently adding voice services

I. Incumbent telecommunications operators

Most of the incumbent operators in the region - former monopoly PTTs - have been partially or fully privatised over the last 5 years and can thus rely, in general, on backing from their large foreign owners. The incumbent operators are still dominating national telecommunications with market shares typically exceeding 80%, despite the ongoing liberalisation and influx of new competitors.

Incumbent operators remain strong - despite the ongoing market liberalisation

Building on their traditionally strong presence in fixed-line and wireless voice businesses, incumbents are slowly but noticeably intensifying their efforts to regain their positions in lucrative segments of data and internet services, mostly due to the arrival of ADSL technology.

EXHIBIT 5: FOREIGN OWNERSHIP OF INCUMBENT TELECOMS

Incumbent	Country	Investor	Ownership stake
Czech Telecom	Czech Republic	KPN & Swisscom	34%
Croatia Telecom	Croatia	Deutsche Telekom	51%
Matav	Hungary	Deutsche Telekom	59%
TPSA	Poland	France Telecom	34%
Slovenske Telekomunikacie	Slovakia	Deutsche Telekom	51%

II. Asset-based telecommunications operators

Asset-based telecommunications operators began to appear in the second half of the 1990s with a strategy based on capitalising upon opportunities in the liberalising telecom markets of the Region.

What those operators had in common was access to assets useful for building telecommunications infrastructure such as the physical distribution networks of local power and gas utilities, TV & Radio broadcasting towers and country railway networks. These assets have enabled operators to bypass incumbents' existing infrastructure by building their own backbone networks or leasing dark fibres from the telecom arms of local utilities.

EXHIBIT 6: EXAMPLES OF ASSET-BASED TELECOMS COMPANIES IN CENTRAL EUROPE

Company	Country	Asset
Aliatel	Czech Republic	Electricity distribution network
Antenna Hungaria	Hungary	TV & Radio broadcasting network
CRa	Czech Republic	TV & Radio broadcasting network
Energis	Poland	Railway network infrastructure
PanTel	Hungary	Railway network infrastructure
Tel-Energo	Poland	Electricity distribution network

After securing backbone bandwidth, asset-based operators have looked to complement their networks by building metropolitan and local networks, sometimes using wireless infrastructure, to bridge the missing 'last mile' connection to their customers. As the networks became more comprehensive, asset-based operators tended to expand their product portfolios, with the aim of becoming full-scale data, internet and voice operators.

III. Other alternative telecommunication operators

This group of telecommunication operators consists of companies that did not have access to existing "network-friendly" physical infrastructure. Some operators (e.g. the now-bankrupt Kiwwi) entered the market with a delay but hoped to catch up with their more established competitors by ambitiously rolling-out a wide range of integrated internet, data and voice services. Other market players - ISPs - decided to add the potentially lucrative data and voice products to their existing internet access businesses.

Transition into full-scale telecom operators will be long and difficult for ISPs and newcomers

Assessing the progress achieved so far, the transition into full-scale telecom operators has proved difficult to accomplish. To be able to

offer a comprehensive package of telecommunications services, operators need to complement their infrastructures by either leasing parts of their networks from competitors, building their own backbone and access network or combining both strategies.

However, weak profitability in the underlying business model, a glut of capacity in existing backbone networks and difficulties in obtaining external financing have made this strategy difficult to follow. Most of these operators have remained without owned network infrastructure, providing them with limited manoeuvrability in near future.

Although some of the newcomers and ISPs will manage to transform themselves into fully-grown telecommunication operators, most of them will have to stick to their current niches, become part of a larger company or leave the business altogether.

EXHIBIT 7: EXAMPLES OF FALLEN TELECOMMUNICATION OPERATORS

Company	Country	Year	Issue
Kiwwi	CEE	2001	Bankruptcy
Callino	CEE	2001	Bankruptcy
Zephyr Telecommunications	CEE	2001	Closed down

ASSET-BASED TELECOMS: POISED FOR GROWTH

Comparison with other categories

The **incumbent operators** still suffer from monopolistic images, bureaucracy, overstaffing and slow market responsiveness. This hampers their effort to win customers in high-growth segments, such as tailor-made data services and VPNs. In addition, incumbents tend to be unfocused, have strongest presence in segments with modest growth prospects (e.g. residential fixed lines) and are burdened with legacy technology.

Incumbent and non-asset-based operators have their own problems

On the other end of the spectrum, **newcomers and ISPs**, despite their focus and flexibility, have found it more difficult than expected to attract sufficient numbers of customers; they have had to compete with both incumbents and their bigger and more established "asset-based" competitors. With further financing unlikely in the short term, catching up will be slow and difficult.

Positioned in the middle

This places asset-based operators as the potential winners. By contrast, the asset-based operators are better positioned to combine an upside growth potential with a sufficient level of downturn protection.

Asset-based operators combine growth potential with stability based on asset ownership

By blending the best of the two worlds, companies in this category can achieve above-market growth rates by selectively focusing on high-growth areas and luring away lucrative incumbents' customers, while they can also rely on two important stabilisers that other alternative operators do not have:

1. Fully operational and scalable **backbone networks**, often combined with metropolitan and, increasingly, local access networks. While ownership of physical infrastructure is becoming less important in the developed markets, where the value proposition and the ability to attract and retain customers are the crucial issues, the situation in Central Europe remains quite different. Operators throughout the region still face restricted access to local networks, ever-changing regulatory frameworks, lengthy interconnection negotiations and a limited supply of carriers' carrier services. All this makes the ownership of infrastructure an important, if not essential, ingredient for success for alternative telecom operators.

2. Significant **presence in the data services segment** (e.g. FR, ATM and IP) provides operators with a recognised "alternative" brand name as well as a steady cash inflow that makes them less dependant on external financing. They also boast skilled workforces, capable management, established sales channels and existing if modest client bases. All this represents a premium in the current hostile environment for telecom companies.

WHERE NEXT?

While the above represents a good starting point and gives asset-based operators an advantage over their "virtual" competitors, the managements of those companies now have to focus on two key issues if they are to become fully-grown telecom companies:

1. They must continue **broadening their product portfolio,** moving away from being purely data-oriented operators and adding internet access and voice services to their product range; this should help them leverage their existing assets, improve asset utilisation, increase profitability and ultimately make their revenue stream more stable and diversified.

2. Asset-based operators must also complement their networks both by **building their own local access networks** and continuing to lobby for swift **local loop unbundling**. This should also help them leverage their existing backbone capacities and massively expand their potential client base, as they unlock access routes to untapped SME and residential customers.

To conclude, although suffering from reduced sources of fresh financing, asset-based operators are likely to survive the current downturn as they possess cash-generating client bases, are often close to breaking even, and are usually too important to be simply closed down by their troubled foreign owners. Once the situation clears again, they are likely to be the companies benefiting most from accelerated demand.

Examples – "Asset-based operators"

Example I

Aliatel (Czech Republic):

Aliatel was founded in 1996 as a combined initiative of the local state-owned energy distributors. In 1998, telecom subsidiary of the German utility RWE acquired a minority stake in the company. Today, Aliatel offers a full suite of telecommunication services and aspires to become the strongest alternative operator in the country.

Aliatel operates a country-wide backbone network, which combines rented and proprietary optical fibres. Last mile access is by wireless, optical or rented connections. The existing investors have been seeking a strategic buyer for some time (Aliatel was in serious discussions with UK-based Energis in 2000) but have not yet been successful.

Example II

Tel-Energo & NOM (Poland):

Tel-Energo was established in January 1993 by Polish companies active in the generation, transmission and distribution of electrical energy. Tel-Energo's majority shareholder, with a 76% stake, is the national energy distributor PSE. The assets of Tel-Energo's shareholders proved useful for building its 11,000 km fibre optical network, which now covers most of the major cities and has international connectivity.

NOM is one of three Polish operators granted the right to provide domestic long-distance voice services. The company leases most of its infrastructure from Tel-Energo and provides a range of data and voice services to its customers. NOM is 15% owned by Tel-Energo, with the remaining stake owned by Polish utility and energy companies.

Example III

PanTel (Hungary):

PanTel was founded in 1998 as a joint-venture between the Hungarian national railway operator MAV and the Dutch operator KPN. The company, which has grown into one of the most important alternative operators in the Hungarian market, provides a full range of telecommunication services to business and residential users.

PanTel owns a 3,700 kilometre-long optical network and international connectivity. KPN, the company's major shareholder, is offloading its Central European ventures as part of an effort to reduce its debts and is therefore currently looking for buyers for its stake.

Belgrade
Kralja Milana 15
11000 Belgrade
Serbia & Montenegro
Tel: +381 11 334 4432

Bucharest
4 Gavril Musicescu Street
Sector 1
Bucharest, Romania
Tel: +40-1-231-6044

Budapest
1051 Budapest
Bajcsy-Zsilinsky út 12
Hungary
Tel: 36 1 235 4040

London
Marble Arch Tower
55 Bryanston Street
London W1H 7LZ
Tel: + 44 207 258 7100

Moscow
Office 9, 4th Floor
4 Mamonovsky Pereulok
Moscow 103001, RF
Tel: + 7 095 788 6867

Prague
Praha City Center
Klimentska 46
110 02 Prague 1
Czech Republic
Tel: +420 2 2171 9900

Warsaw
5, Ks. I. Skorupki Street
00-546 Warsaw
Tel: +46 22 583 6850

www.cet.co.uk