

Russian Wireline: On the Eve of a Major Reshuffle

Advanced Communications & Media

*Michael Alexeyev, Managing Partner
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The purpose of this presentation is to share what AC&M, an independent industry observer, thinks of where this market moves within the next 2-3 years.

- What's on the Agenda: critical market developments going forward
- Possible scenarios for Privatization: what is the likeliest outcome of Svyazinvest sale
- Liberalization of the LD market: implications for the incumbents and altnets
- New challenges
- Expansion outside Russia: is consolidation inevitable
- Longer term outlook

What is on the Agenda?

Russian wireline sector is approaching an important pivotal point – the entire telecom landscape in Russia may change pending on important regulatory changes and multi million transactions anticipated in 2005 and early 2006.

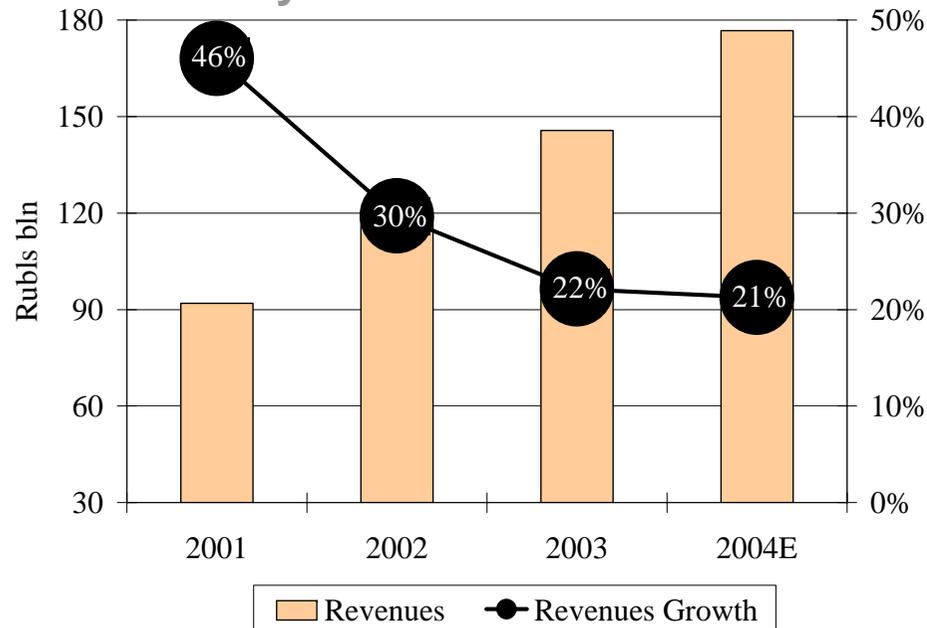
- **Privatization of Incumbent LTOs.** There are strong indications to the effect that up to 75% less one share of the powerful Svyazinvest holding should be auctioned already in 2005.
- **Liberalization of the Long-Distance Market.** The Ministry of Telecommunications already submitted a new Regulation on Interconnect for the approval by the Ministry of Justice. If ratified it will signify a de facto demonopolization of the long-distance market in the Russian PSTN environment
- **Trans-border acquisitions in CIS.** The move by Russian telcos to acquire assets in the former USSR implies incremental revenue but also additional risk exposure.
- **Public Offerings.** Comstar/MGTS, Corbina, TransTeleCom, Systema Mass Media, PeterStar?

Looks like what used to be a rather uneventful segment is going to get a new momentum over the next 1-2 years!

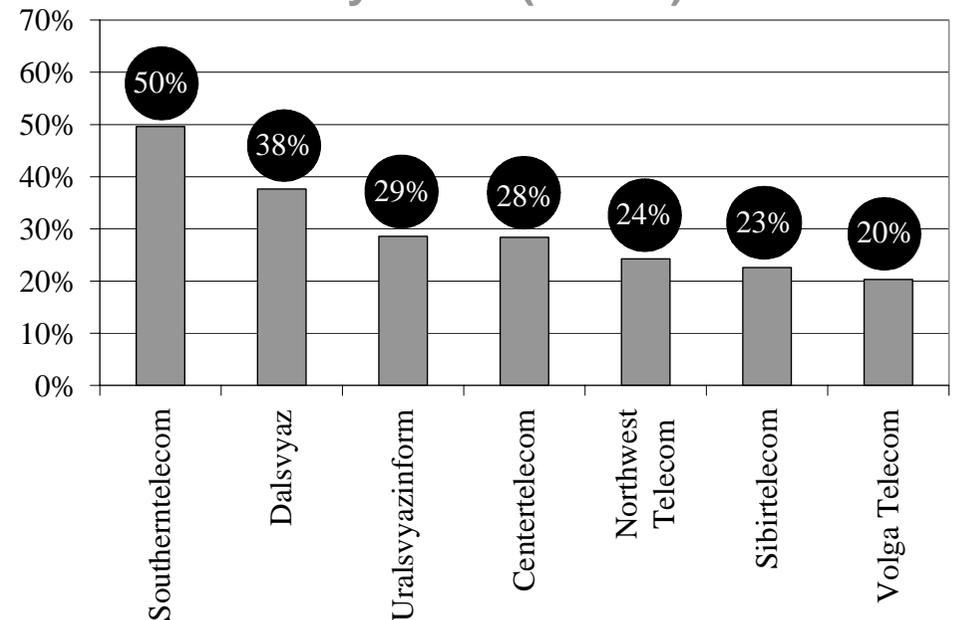
Problem at Hand

Revenue growth is rapidly slowing and operating margins are deteriorating. At the same time **debt to revenue** and **CAPEX to revenue** ratios are getting alarmingly high.

Combined Revenue by Svyazinvest LTOs



CAPEX to Revenue Ratio by LTOs (2004E)

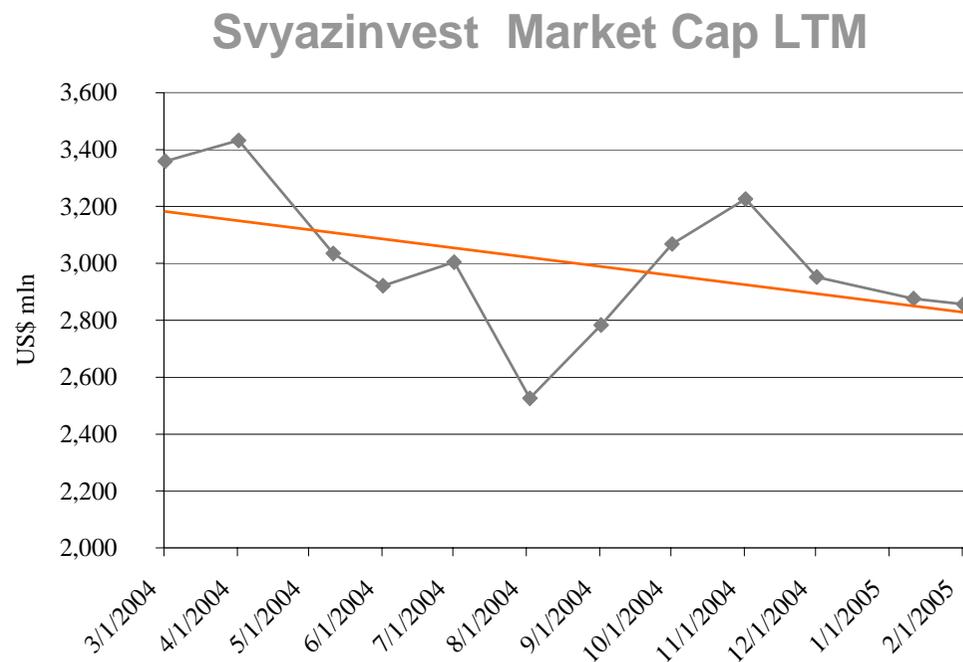


Svyazinvest market cap shrank from US\$ 3.5 bln in January 2004 to US\$ 2.9 bln in January 2005. Evidently, artificial pressure on the valuations of the incumbents intensifies in the run-up to privatization

Privatization: New Momentum for LTOs

Privatization of Svyazinvest should inevitably boost the performance by LTOs. Thus far the combined market cap of Svyazinvest daughters has been decreasing gradually despite positive trend in revenue and EBITDA.

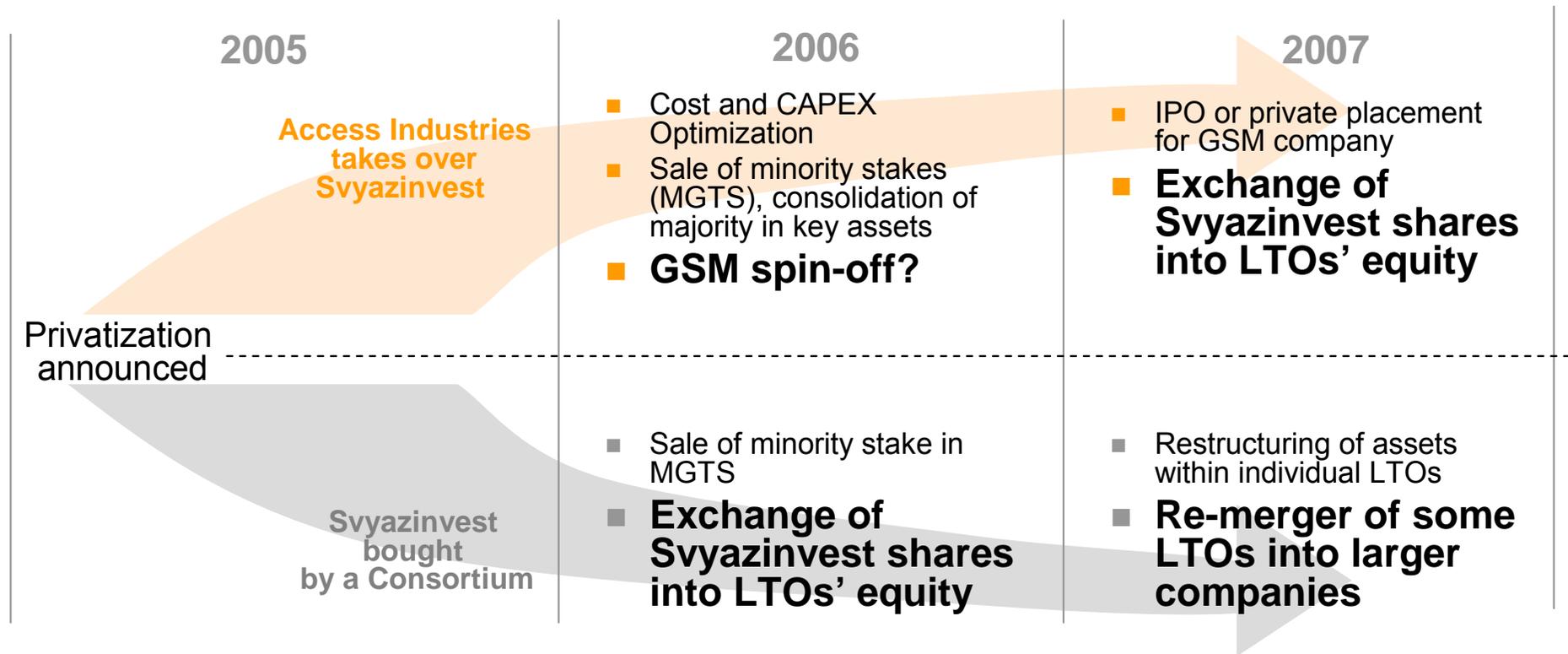
- **Private investors to focus on the efficiency** of LTOs and improve operating margins.
- **Svyazinvest to review CAPEX plans** with the view to curb excessive expenditures with questionable return on investment
- **Corporate governance standards** are likely to be improved dramatically when private investors take over



Having spent about US\$ 2-2.5 bln for 75% of the holding the private investors will definitely try to increase the market cap at the expense of the simple and easy to implement measures

Privatization: Possible Scenarios

The future of Svyazinvest depends to a large extent on whether the 75% less one share available ends up in the hands of a single strategic investor (most likely Access Industries) or a consortium (including Access, Systema and others)



Fundamentally there is hardly any alternative to the exchange of Svyazinvest stock into the equity of individual LTOs in the longer run

Liberalization of LD Market

Regulatory authorities are keen to open the market well before the deadline set up by World Trade Organization. Alternative LD operators may launch service already in 2005.

New Regulation on Interconnect opens the market for every operator who can meet the basic requirements on coverage and capacity:

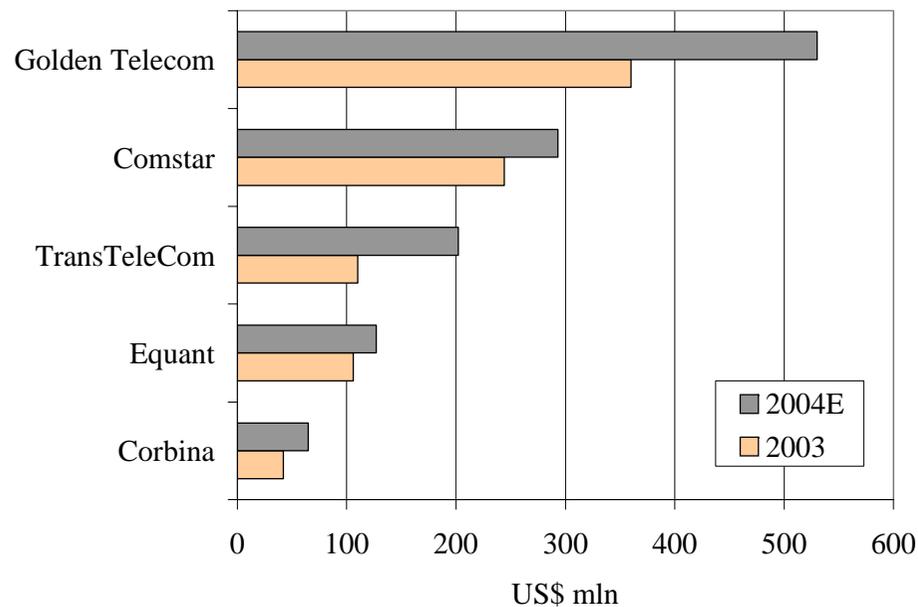
- **The draft Regulation on Interconnect does not require that the new LD carrier should have a proprietary backbone network.** Instead the new LD operators can lease capacity from Rostelecom or TransTeleCom.
- **New LD license holders will have to establish Points of Presence (PoPs) in 80 plus administrative units of the Federation.** However there is no specific requirement on PoP set up – it could be an elementary multiplexer rather than a sophisticated switching center. Regulation requires them to build 7 switching centers and 4 international gateways.
- **New operators should be able to transit at least 25% of LD market within each of seven macro regions.**

It was estimated that the fully blown LD network should not cost the new entries more than US\$ 35-50 mln (to be spread over 3-4 years).

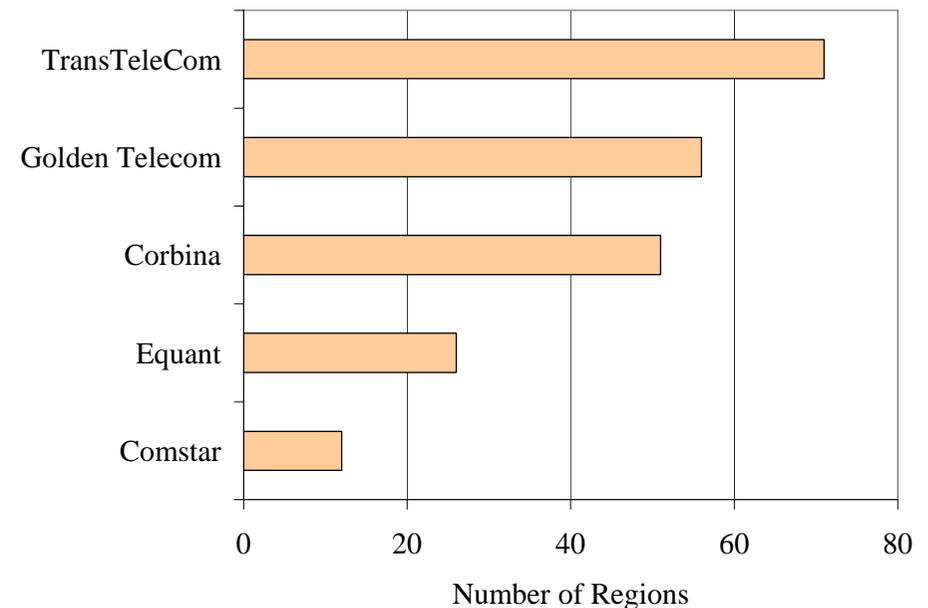
Liberalization of LD Market

There are several companies with multiple points of presence (PoP) across Russia who are very well positioned already to get the license and command large enough cash-flow to raise the adequate finance.

Service Revenue by Selected Altnets



PoP by Selected Altnets



The “entry fee” to the LD market appears to be very affordable. It is expected that at least 4 contenders will bid for the proper LD license. MTS, VimpelCom and MegaFon may also seek own LD licenses.

Liberalization of LD Market

Ironically, the liberalization of the market **should not dramatically affect Rostelecom revenue in the short and medium term**. Revenue lost to the competition in the switched voice services is likely to be compensated in the lease-line segment.

- Given the mix of the traffic, it is highly unlikely that the alternative networks should be able to cost effectively transit more than 20-30% of the traffic within the first few years of operation.
- The new entrants will have to lease at least two E1 bearers from either Rostelecom or TransTeleCom in each of 80 plus administrative units of the Russian Federation under the conditions of the DLD license.
- At the current Rostelecom/TransTeleCom prices, the annual lease of capacity for a single LD operator with 80 some PoPs should work out at US\$ 15 mln.
- Assuming that there will be 4-5 new license holders and Rostelecom splits the new market with TransTeleCom, there will be at least about US\$ 35-40 mln worth of incremental revenues. The additional revenue will be comparable to 20-25% of the total current proceeds from the DLD transit.

New Challenges

CLECs are out to compete for the premium residential market, SOHO clients and SMEs with a new range of wireline products and services

- Several HFC network operators (KomKor-TV, United Cable Networks) aggressively enter into the broadband IP access segment and plan to provide alternative local access telephony, subject to obtaining regulatory approvals.
- There is a rapid consolidation of CaTV assets – the largest network operator (National Cable Networks) already has access to some 1.7 mln households in St. Petersburg, Yekaterinburg and Nizhny Novgorod. For comparison NW Telecom has about 1.9 access lines in service in St.Petersburg, while NCN has 1.1 mln households connected.
- Alternative operators plan to by-pass incumbents' infrastructure altogether, using Wi-MAX and DVB-C technologies.

Alternative operators with “triple-play services” over HFC networks represent a material threat to incumbents. They penetrate the market under disguise of CaTV operators, but also move into broadband access and even telephony.

New Challenges

What is good for incumbents is not necessarily positive for alternative network.
However, the outlook for altnets is also rather positive

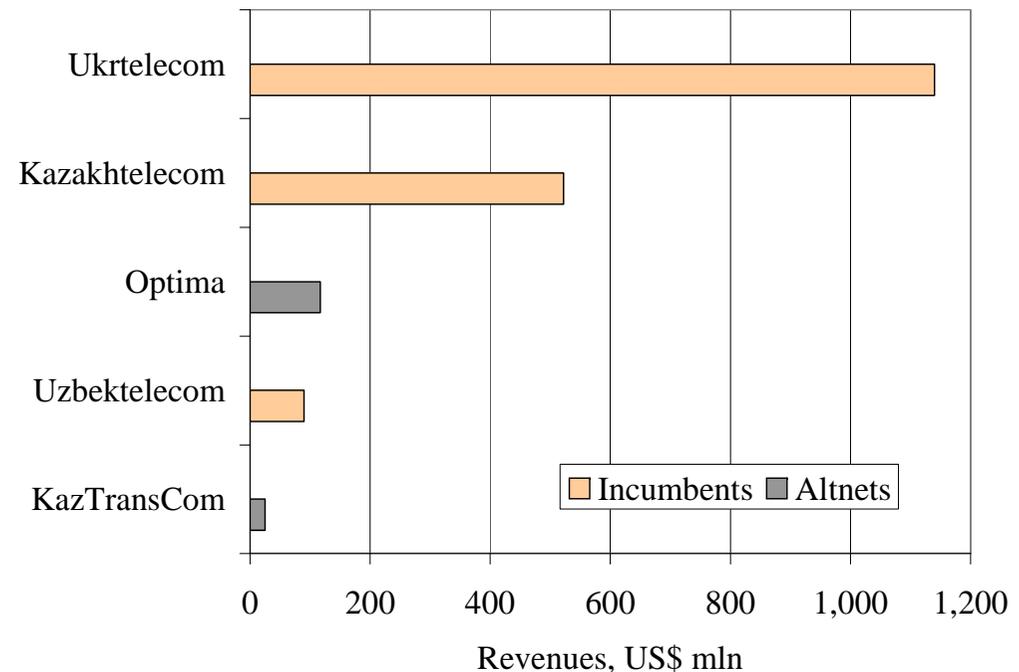
- The commitment by the regulatory authorities to crack down on re-file and eliminate the loop holes for the by-pass operators, who terminate millions of minutes worth of inbound ILD may dramatically reduce the volume of the transit revenue.
- The liberalization of the DLD market has both positive and negative implications. On one hand – altnet will be able to enter new market segments, on the other – they will see a considerable reduction of VoIP traffic as Russian regulatory authorities stop unorthodox interconnect arrangements.
- The Privatization and following break-up of Svyazinvest will open new opportunities for altnets: theoretically we may see some extraordinary mergers and acquisitions whereby alternative operators buy into incumbents.

Trans-border Acquisitions

There will inevitably be a consolidation of wireline assets within CIS. Russian telecom holdings will pursue opportunities outside their home market.

- **Ukrtelecom** may be for sale within the next 12 months
- **Optima-Telecom** of Ukraine is also a candidate for acquisitions by Russian CLECs
- **Kyrgyzstan** government indicated it may auction its stake in the incumbent PSNT operator

Selected Operators in CIS (2004)



Both incumbent operators and altnets may achieve very significant growth through acquisitions on the adjacent markets in CIS countries.

Summary

Critical developments	Implication for LTOs and Rostelecom		Comment
	Short Term	Longe Term	
Privatization of Svyazinevst	Positive for both Rostel and LTOs	Very Positive for LTOs	Is likely to lead to better margins and more efficient CAPEX
Liberalization of DLD	Ambivalent	Negative for Rostelecom	Will ultimately reduce Rostel's share in DLD transit
Diversification of CaTV nets into IP and LA	Negative	Very Negative	Having access to the households the CaTV will de facto break LTO's monopoly
M&A in CIS	Positive	Positive	Consolidation of incremental revenue and EBITDA. Alternative to organic growth

In the long term, the outlook for the Russian wireline market is rather positive: the transition to the more transparent and better managed business promises material upside for investors. However there is a lot of uncertainty over the timing for these positive changes.

Contact Information

Advanced Communications & Media Ltd.

11/2a Armyansky pereulok
Moscow 101960
Russia

Phone: +7 095 923-5480

E-mail: info@acm-consulting.com

Internet: www.acm-consulting.com