RBC Capital Markets

Research Industry Comment

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Integrated Telecom Services

Industry Update – Outlook Remains Positive

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Event

Highlights from two-day industry conference, *Canadian Telecom Summit*

Investment Opinion

- **Positive Fundamentals** – Underlying fundamental conditions for Canada's telecom sector remain favourable for equity investors. Operators are maintaining their focus on pricing discipline and productivity improvement. While the telephony operators will benefit, the cable and wireless operators have the most significant upside.
- **Regulatory Direction** – Reinforced our contention that while regulatory changes will continue in the direction of 'removing obstacles to competition' versus tilting the playing field and future changes will be *e-volutionary* rather than *re-volutionary*.
- **Regulatory Decision-making Process** – The CRTC is under increased pressure to accelerate its decision-making process. This may lead to increased use of interim decisions as well as greater reluctance to consider applications re-visiting previously decided issues. The application of regulations governing transactions with 'affiliate' (e.g., Bell Nexxia) is a key focus.
- **New 'Disruptive' Technologies -** Voice-over-IP (VOIP), cable telephony and wireless technology represent potential 'disruptive' technologies which are gaining momentum in the U.S. and Canada. Vonage plans to enter Canada by yearend, and Eastlink has secured up to 20% market share.
- **Valuation.** Canada's telecom companies trade at 16.9x and 15.2x 2003E and 2004E EPS (ex. TELUS) vs. 14.7x and 14.5x in the U.S. Using EV/EBITDA, the valuation multiples are comparable at 5.68x and 5.3x vs. 5.66x and 5.50x in the U.S. Given the superior regulatory clarity and growth prospects in Canada, we believe that the Canadian telcos represent attractive value at current levels vs. their U.S. peers.

Details

Over the past two days, we attended an industry conference on Canada's Telecom sector. The event featured senior representatives from each of Canada's major telephony companies as well as key public policy and regulatory officials. The following are highlights:

Highlights

POSITIVE FUNDAMENTALS

Underlying fundamental conditions for Canada's telecom sector remain favourable for equity investors. The Companies have refocused on their core businesses which should improve ROIC, while reducing the volatility inherent in higher-growth, non-core operations.

While the results for the traditional local voice business are being pressured by competition and the mandated price reductions under the price cap regime, demand remains positive for wireless and high-speed services. Operators are maintaining their focus on pricing discipline and productivity improvement (both operating and capital). As a result, the cash flows and debt leverage levels are improving for both the ILECs and CLECs alike. In addition, the CLECs have successfully restructured their balance sheets, providing them with increased financial flexibility.

While the telephony operators (both ILECs and CLECs) will benefit, the cable and wireless operators have the most significant upside in our view.

REGULATION

Local Competition – Not surprisingly, a key focus of the conference was on the state of competition, particularly in the local telephony market. As expected, the ILECs and CLECs went to pains to emphasize their respective well-established views. David Colville, CRTC Vice-Chairman reiterated the Commission's desire to see all markets open and sustainably competitive, but with a focus on facilities-based competition. The CRTC's focus is on: (1) removing obstacles to competition (e.g., access to rights of way, support structures etc.) – and Mr. Colville noted that a decision on in-building wire is expected 'shortly'; (2) ensuring compliance with existing rules; and importantly (3) the regulatory approach does not target market share or pick winners – instead the CRTC targets behaviour and practices that do not comply with the regulatory policies and practices.

Mr. Colville's comments were consistent with past meetings with the CRTC (please refer to our morning comment *Meeting with CRTC Chairman,* dated May 22, 2003). In our view, therefore regulatory change will be *e-volutionary* <u>not</u> *re-volutionary* with a focus on removing obstacles to competition as opposed to tilting the playing field in favour of one/a group of participants. One note – Mr. Colville specifically affirmed the Commission's opposition against requiring unbundled local switching.

Key Pending Issues

1. *ILEC Affiliate Rule* – The CRTC now requires that any regulated services offered by ILEC 'affiliates' such as Bell Nexxia should be appropriately tariffed even when included with non-regulated services. Accordingly, the Commission is reviewing in excess of 100 complex enterprise contracts currently in force. Until the necessary tariffing principles have been established, ILEC affiliates not only face increased uncertainty, but they are also prohibited from reselling the incumbent's tariffed services – which may delay their responsiveness to RFPs and/or reduce their price competitiveness, particularly when bidding for large enterprise contracts.

   A decision on tariffing principles is likely to be released initially (no timing specified), but significant work by the CRTC will be required before the many implementation issues can be resolved. In the meantime, there is a window of opportunity for non-ILEC operators to bid for enterprise contracts (e.g., AT&T Canada, TELUS in Eastern Canada and Bell Canada in western Canada). Ironically, the 'affiliate' rules may also result in an increase in pricing for enterprise customers as ILEC affiliates seek to ensure that pricing does not fall below the tariffed rates.

2. *AT&T's NextGen Application* – On April 15, AT&T Canada applied to the CRTC that the ILECs should be required to unbundle and file tariffs for NextGen services including Ethernet access service, ADSL/Gateway access service, and Wavelength access service. Given that these new services represent above-average growth potential, this is an important issue for the ILECs and CLECs alike. Furthermore, the outcome of the decision could have implications for capital investment in this area (we note that the FCC's Triennial Review decision [to be released imminently] is expected to address similar issue(s) with respect to broadband deployment.

3. *Call-Net Application* – On May 29, CallNet filed an application with the CRTC aimed at 'jump-starting' local competition through a request for: (i) 50% reduction in unbundled loop elements for a two-year period to be covered

by the deferral account; (ii) extend the no-contact period by the ILECs from three months to one year; (iii) reform and improve the customer cutover process; and (iv) increased consumer education of local telephony competition. While some of these items may have some sway with the Commission in the event that they help remove obstacles to competition, item (i) is a surprise particularly following the federal Cabinet's recent rejection of AT&T Canada's appeal of the Price Cap decision.

4. *Monopoly Bundling* – Rogers opposes the ability of the ILECs to bundle their regulated local telephony service with other non-regulated services (e.g., LD, wireless, DSL or video service). While Rogers' cable TV service is technically forborne from regulation, the ILECs raised similar opposition with Rogers ability to bundle its basic cable TV service with high-speed, wireless services etc.

5. *Phase II Review* – This review of the costs used in determining the rates for unbundled network elements has clearly taken a lower priority to the preceding issues. A Public Notice may be issued later this year, but such a review may take as much as two years to complete. While it is unclear how the cost levels will emerge (they may have increased in the event of lower assumed network 'fill' rates), the delay reduces the regulatory uncertainty in the near-term.

Regulatory Decision-making Process – A recurring theme from both the ILECs and CLECs was the need for the CRTC to accelerate its decision-making process. The application of regulations governing transactions with 'affiliates' (e.g., Bell Nexxia) and reduction in tariffs for unbundled elements are a key focus. The CRTC may respond through (1) increased use of interim decisions as well as; (2) greater reluctance to consider applications re-visiting previously decided issues. The risk with increased use of interim decision is the potential for material subsequent revisions in the final decision which would impact regulatory clarity.

OTHER

- *VOIP and Vonage* – Vonage's announcement to enter the Canadian market by yearend represents a new form of potential local competition. Vonage uses Voice-over-IP (VOIP) technology to provide telephony services for a flat rate. Users receive unlimited local and LD (North-America wide) calling plus a full suite of calling features for US$39.95 per month. A high-speed connection is required as is a small IP adapter (US$30 flat fee cost). While issues exist with respect to Quality of Service, 911 and power backup, these are likely to be addressed through future improvements.

- *Cable Telephony and Eastlink* – While cable telephony is relatively limited in Canada currently, the Atlantic-based cable operator Eastlink has secured up to 20% market share in certain telephony markets in Nova Scotia. While this indicates the future potential for cable telephony, the Commission is not prepared at this time to consider an application by ILEC Aliant to forebear from regulating the affected local telephony market areas due to concerns that ILEC's pricing response could threaten the sustainability of that local competition.

- *Wireless* – Wireless is increasingly being used as a technology to provide local telephony service in the U.S. We note that last week, BellSouth, SBC and their wireless subsidiary Cingular announced plans for *Minuteshare,* a service which will enable residential consumers to share a single bucket of minutes for calls made from either their SBC or BellSouth wireline and Cingular wireless phones. While similar plans are still emerging, there is potential for an independent wireless carrier such as Microcell to offer a similar proposition in Canada. Separately, there is little/no motivation to introduce wireless number portability in Canada.

- *Alberta SuperNet* – The SuperNet buildout (to 407 communities in Alberta) is regaining momentum following a lengthy dispute between two partners, Bell Nexxia and Axia. (1) Additional contracting support (SNC Lavalin) has been secured and (2) significant fibre has been secured from TELUS which will move the build forward with a completion goal of January 2005 (extended from July 2004).

- *AT&T Canada Rebranding on Target* – AT&T Canada appears on target to announce its rebranding by September 9. We understand that the new name has been selected, but will not be announced publicly until early September.

- *Primus Canada* – Primus Canada, a 100%-owned subsidiary of Primus Telecommunications [NASDAQ: PRTL] indicated that it has 900,000 residential and business customers in Canada. Quarterly EBITDA has been consistently positive and now exceeds $15MM/qtr. In Q1/03, EBITDA increased ~+20% to $18MM. The economics of the local telephony market do not appear attractive to Primus, but we suspect that it could enter the high-speed access market (possibly through a wholesale deal with a cable operator).

Valuation

Canada's telecom companies trade at 16.9x and 15.2x 2003E and 2004E EPS (ex. TELUS) vs. 14.7x and 14.5x in the U.S. Using EV/EBITDA, the valuation multiples are comparable at 5.68x and 5.3x vs. 5.66x and 5.50x in the U.S. Given the superior regulatory clarity and growth prospects in Canada, we believe that the Canadian telcos represent attractive value at current levels vs. their U.S. peers.

Exhibit – Telecom Valuation Comparison

	Share Price	EPS			EPS Growth Yr/Yr		EPS Growth CAGR	Price/Earnings			EV/EBITDA			Dividend		
	13-Jun-03	2002A	2003E	2004E	02/03E	04/03E	02-04E	2002A	2003E	2004E	2002A	2003E	2004E	2003E	Yield	Payout
Canada (C$)																
Aliant (Core Telco) *	$30.30	$1.65	$1.57	$1.72	-4.6%	9.1%	2.0%	18.4x	19.3x	17.7x	6.10x	5.99x	5.77x	$1.08	3.56%	68.6%
BCE Inc. (Core Telco) **	$30.70	$1.73	$1.97	$2.22	13.7%	12.7%	13.2%	17.8x	15.6x	13.8x	6.98x	5.85x	5.46x	$1.20	3.91%	61.0%
Manitoba Tel (Core) ***	$29.83	$1.77	$1.87	$2.10	5.9%	12.3%	9.0%	16.9x	16.0x	14.2x	5.55x	5.53x	5.25x	$0.88	2.95%	47.1%
TELUS	$23.02	$0.20	$0.83	$1.31	nmf	57.3%	nmf	nmf	27.7x	17.6x	6.49x	5.57x	4.90x	$0.60	2.61%	72.2%
TELUS - A	$21.14	$0.20	$0.83	$1.31	nmf	57.3%	nmf	nmf	25.4x	16.2x	6.23x	5.34x	4.69x	$0.60	2.84%	72.2%
Average					**5.0%**	**22.9%**	**8.1%**	**17.7x**	**19.1x**	**15.5x**	**6.22x**	**5.68x**	**5.29x**		**3.32%**	**62.2%**
Average (Ex. TELUS)					**5.0%**	**11.4%**	**8.1%**	**17.7x**	**16.9x**	**15.2x**	**6.21x**	**5.79x**	**5.49x**		**3.47%**	**58.9%**
U.S. RBOCs (US$)																
BellSouth	$27.06	$2.03	$1.95	$1.98	-4.2%	1.8%	-1.2%	13.3x	13.9x	13.6x	5.26x	5.34x	5.11x	$0.84	3.10%	43.1%
SBC	$26.02	$2.16	$1.66	$1.62	-23.1%	-2.1%	-13.2%	12.1x	15.7x	16.0x	5.06x	5.50x	5.38x	$1.13	4.34%	68.1%
Verizon	$39.79	$3.05	$2.75	$2.79	-9.7%	1.3%	-4.4%	13.1x	14.5x	14.3x	5.98x	6.14x	6.01x	$1.54	3.87%	56.0%
Average					**-12.3%**	**0.3%**	**-6.3%**	**12.8x**	**14.7x**	**14.6x**	**5.43x**	**5.66x**	**5.50x**		**3.77%**	**55.7%**

* Adjusted to reflect the market value of Stratos Global (TSX: SGB)
** Adjusted to exclude 100%-owned DTH satellite operation valued at C$1,500 per subscriber. BCE growth rates are normalized for the sale of Bell Directories
*** Adjusted to reflect the present value of the MTS put option re: Bell West ($458MM + est. Capital contributions in Feb., 2004). Discounted at 7%

Source: RBC Capital Markets Research Estimates

Aliant (TSE:AIT: Underperform, Average Risk) BCE Inc. (TSE:BCE: Outperform, Average Risk) Manitoba telecom (TSE:MBT: Sector Perform, Average Risk) TELUS (TSE:T.A:Outperform, Above Average Risk) BellSouth (NYSE:BLS: Sector Perform, Average Risk) SBC Communications (NYSE:SBC: Underperform, Average Risk) Verizon (NYSE:VZ:Outperform, Average Risk).

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SELL [U]	102	13.55	9	8.82

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