Profitability and Growth of Telecommunications Sector - The Case of the Republic of Serbia

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Abstract
Distinctiveness of telecommunications sector reflects, among others, in the fact that it’s profitability or, generally speaking, financial strength, is not the object of interest only for company owners within this sector. This is a typically infrastructural sector whose development affects the efficiency and speed of other sectors’ development and national economy as a whole. Obviously, we deal with infrastructural sector with strategic character regarding development of national economy and society as well. Based on previously mentioned, it becomes clear that stability and growth of telecommunications sector is the matter of national interest.

Other important characteristics is that maintaining and improving the competition of telecommunications sector requires large investments. Thereby, sustainable growth is closely related to the possibility of providing high-quality financing sources. Such (sustainable) growth could be provided only by financially healthy and profitable companies often able to reinvest a great part of realized incomes and thus provide necessary external sources of financing. In that sense, profitability is not only the measure of current increase in owners’ wealth, but also the potential for future growth and success. In this paper, we deal specifically with the evaluation of sector profitability and the assessment of its investment capabilities.

Key words: profitability, competition, growth, capital expenditures, leverage, reinvestment, borrowing.
JEL Classification: M41; G30.

INTRODUCTION
Profitability is the key determinant of success. This equally refers to individual companies, branches, sectors, or national economy as a whole. Profitability provides realization of owners’ interest, and, accordingly, attractiveness to investors. Only profitable economy, providing necessary internal sources of financing, can provide sustainable growth. Besides, profitability is an inevitable determinant of liquidity and short-term financial safety. Hence logical interest for developing more quality measures for perceiving success (performances).
Telecommunications are usually defined as fast-growing, capital-intensive and potentially above-average profitable sector. Opening national markets, privatization of ex public telecommunications companies and management professionalization resulted in the appearance of the whole new range of products and services (whose life cycle is very short) with high success potential. On the other hand, fierce competition and very strong regulatory pressures in terms of cost amount created serious challenges for telecommunications companies regarding searching space for profitability growth in increasing the range between revenues and expenses, now turning its attention primarily towards more efficient cost management. In such circumstances, the interest for measuring profitability is even more evident. Finally, measuring profitability in conditions of serious economic crisis is a special challenge for analysts, when various economic sectors suffer differently the negative consequences of the crisis and when it is not simple to grasp to what extent the performances are the result of some other factors (effectiveness, efficiency, financial-structural problems, reached technical and technological level and so on).

While evaluating profitability of telecommunications sector in Serbia, we should not forget conditions surrounding it in the previous period, significantly different from those present in market-developed countries. Transition, incomplete privatization, change of ownership structure and insufficient level of quality in corporate management are just a few of the elements complicating business environment in Serbia. Creating incomes in such circumstances, even in telecommunications sector, is a serious challenge.

1. METHODOLOGICAL FRAMEWORK FOR THE ANALYSIS

Telecommunications sector is characterized as one of the most important infrastructural sectors with a huge influence on GDP growth, both directly by own performances, and indirectly by affecting the success of other sectors. In that sense, it is often stressed that it represents the driving force of national economy development, especially in developing countries. Having this in mind, it is relatively easy to say that evaluation of financial strength, investment capabilities and long-term profitability should represent an important information input for economic-policy regulators. Detecting problems that limit growth and future profitability could, by means of raising quality of strategic decisions, contribute to improvement of economic performances.

The object of our analysis are participants on the telecommunications market. This sector includes branches and companies dealing with cable, wireless, satellite and other telecommunication activities. In other words, these are companies providing services in fields of mobile and landline telephony, internet and distribution of media content. The importance of telecommunications sector comes from the fact that 452 companies with 16,916 employees did business within it in 2011.

Information base for the research of key-infrastructural-sector financial capabilities is made of summary financial statements for each sector, which are the result of collecting individual financial statements of companies within the sector. (Agency Serbian Business Registers, 2011) They represent the information base for further creation of other statements and numerous indicators. Having in mind the importance of infrastructural sectors and consequent need of analyzing their capabilities on one hand, and their heterogeneity on the other hand, financial analysis is imposed as a logical solution. Hence the direction of our research towards the evaluation of these sectors’ financial performances. To that end, we will use ratio analysis for the evaluation of sector’s profitability and growth, the analysis of financial leverage for the evaluation of financial risks and some elements of cash flow analysis for the evaluation of investment capabilities of the sector. By using these instruments, we will try to identify possible problems related to profitability level of the telecommunications sector in Serbia, attractiveness of this sector to potential investors, necessary intensity of investments, as well as the possibility of financing this sector’s activities from internal and external financing sources.
2. ANALYSIS OF INCOME-GENERATING ABILITY
Apart from the fact that profit represents the absolute measure of success, which has flaws due to ignoring the level of used equity, deeper analysis still has to start from the ability of companies, branches or sectors to generate incomes. Thereby, the analysis of income structure is especially important, since it can predict causes of sector’s (un)profitability. To that end, for the analysis of telecommunications sector success, it is important to understand the movement of operating income, net financial expenses (revenues), net income and earnings before interest, tax, depreciation and amortization (EBITDA), where the first three income concepts are balance positions, while the last derived income concept is the one not immediately visible from financial statements. The movement of these incomes for the chosen five-year period are displayed in Graph 1. Let us add that, at this point, we are putting aside net other gains and expenses, primarily due to a fact that they can have a transitory character.

The analysis of net income movement in the analysed period shows that telecommunications sector suffered the main strike of economic crisis in 2008, which was the only time when realized revenues were not enough to cover total expenses. Net incomes were also modest in the following two years, and more considerable growth did not appear before 2011 when income was higher by even 6.8 times compared to the previous year, which is a bit surprising if we have in mind that operating income increased by only 1.15 times the same year. However, before we deal with this issue more thoroughly, it seems appropriate to analyse income positions of telecommunications sector within total achievements of Serbian economy. (Malinić, D. Milićević, V., 2012a) In that sense, we offer comparative analysis of profit performances within the analysed sector and economy as a whole, along with the share of this sector in the number of companies and employees, total assets and operating revenues (Fig. 1).
Even from this brief analysis we see great disproportions between the share of telecommunications sector in the entire economy meaning the number of companies and employees, total assets and operating incomes on one hand, and the share in total operating and net incomes of the economy on the other hand. Unlike the modest share in the number of companies (on average about 0.48% for the analysed five-year period), number of employees (about 1.52%), total assets (about 3.81%) and operating revenues (about 2.43%), shares of operating incomes within the telecommunications sector in total operating incomes of the economy is above 10% in almost all analysed years (except in 2010). Regarding net incomes in 2007, about one fourth of total net incomes of the economy belongs to telecommunications, while the share in 2008 rises to 28.71%. Also, while economy in 2009 and 2010 reported great losses, telecommunications sector was in the profit zone. Indirectly, we can conclude that level of burden by financial expenses in telecommunications sector is lower compared to the economy. This seems to point us clearly to an above-average profitability in telecommunications. For now, sufficiency of such performances remains an open question.

In order to study more thoroughly the causes of made profit performances, we will go back to previously mentioned rapid income growth in 2011 compared to 2010. This net-income growth of 6.8 times is even more surprising due to a fact that nothing unusual happens in the most important, operating sub-balance. Namely, operating revenues in 2011 rise by 1.09 times compared to the previous year, while operating income rises 1.15 times. Faster growth of operating income compared to operating revenues is understandable, having in mind that growth of operating activities leads to degression of fixed costs, and accordingly to faster growth of operating income. However, these increases, marked as favourable, are still far from justifying the rise of net income by 6.8 times. We must search the reason for this in the part of income statement referring to financial activities. In that segment, we can notice two important things. Firstly, in 2011, financial revenues are higher than financial expenses for the first time in the last five years. Secondly, in 2011, financial expenses are more than halved, making only about 45.5% of financial expenses from the previous year. To be precise, they are lower by 12.8 billion dinars. Of course, this would be good news if we spoke about the fall of indebtedness within this sector. However, the situation is just the opposite. In fact, indebtedness is higher. The level of debt (long-term liabilities and short-term financial liabilities, i.e. interest-bearing liabilities) at the end of 2011 was higher by 11.5 billion dinars compared to the previous year, while debt to equity ratio increased from 1.77 to 2.22 in the same period. One question imposes itself-how come that financial expenses are falling dramatically?
The answer to the previous question must be sought in the analysis regarding movement of dinar exchange rate compared to euro, primarily due to a fact that loans are in stable currency, or, if not, in accordance with currency clause. In that sense, it is interesting to follow the movement of dinar exchange rate on one side, and rates of cost of debt for the average amount of debt, on the other side. Thereby, we generated cost of debt by comparing financial expenses to the average amount of long-term and short-term financial liabilities. This analysis is displayed in Graph 2.

Displayed results reveal very interesting things. Namely, when dinar exchange rate was stable, like in 2007 (in 2006 1€ equalled 79.00 dinars) and 2011 (when dinar was even higher by 0.86 paras (1 para= 0.01 dinar), cost of debt rate was in single digits. In the other analysed years, the value of euro rose steadily, which was always followed by higher cost of debt. The reasons for this should be sought in the fact that financial expenses are displayed cumulatively, and that they include foreign exchange losses and expenses based on currency clause effects, besides the expenses based on interest. Practically, it means that the fall of dinar value causes the increase of these expenses which brings to cost of debt growth. Without any deeper analysis, primarily due to the purpose of this paper and limited space, at this point we will state that cost of debt rates are very low in 2008, 2009 and 2010, and that they are hardly tolerable even for telecommunications sector. So, net income growth by 6.8 times seems impressive, but unfortunately, it is mostly not the consequence of operating activities’ or efficiency growth, but the dominant consequence of „playing“ with dinar exchange rate. Having in mind the present movement of dinar exchange rate, it is realistic to expect a new increase of financial expenses in 2012 as well as the consequent fall of performances. To this, we should add the possibility of deferring exchange differences, regulated by Rulebook on the Chart of Accounts which is directly opposed to international standards of financial reporting, whose mandatory application is regulated by the Law. The amendments of Regulation in question imply the possibility (not the obligation) that legal entities, in making financial statements, could decide not to report the effects of calculated exchange differences and currency clause within financial revenues or financial expenses, but to transfer them to accruals. Since such solutions deviate from International Standards of Financial Reporting, whose implementation is regulated by the Law, we cannot say that these statements are made in accordance with them. Using this alternative makes reported financial expenses at lower level than the real one, and makes balance sheets burdened by hidden losses.
Finally, EBITDA concept, also displayed in the graph, is often used for the evaluation of success in telecommunications companies. This is because telecommunications are expensive business, often requiring significant capital expenditures, and, accordingly, provision of necessary financing sources. Large infrastructural investments and their partial financing from internal sources could cause the appearance of small incomes or, from time to time, even losses in income statements. However, even in such circumstances, companies can do business successfully, service their liabilities regularly and compensate missing return in form of dividends with return in form of capital gains. In that sense, analysts often use EBITDA concept which indicates both profitability and cash flow from operations. The attractiveness of this profit concept is important especially in situations when there are considerable capital expenditures. Since amortization, being high in those situations, does not require immediate outflow, cash flow from operations is in fact higher than reported net income. Moreover, EBITDA becomes also free of interest and tax costs, thus providing the measure of earned income which, apart from being free of the effect of amortization of claimed fixed assets, is additionally freed of the effects regarding methods of financing. Displayed EBITDA values (in Graph 1) justify once again the evaluation of profit achievements from this perspective. Namely, EBITDA is considerably higher than net income in the whole analysed period, the least in 2011 - 3.1 times and the most in 2010 - 17.3 times. So, although net incomes are not impressive, which we will confirm later, EBITDA is high enough to provide successful functioning of telecommunications sector as a whole. Nevertheless, we should be careful in relying on EBITDA concept in the evaluation of performances. Generally, it indicates the ability of servicing operating liabilities and possibility of repaying debts, but it is not a flawless quantity; not only for the fact that financial expenses and tax costs represent real costs whose respecting can change considerably the image of company’s success, but also for the fact that EBITDA ignores the need to invest in working capital. Due to this fact, this concept represents a rough approximation of cash flow from operations. If rapid growth appears, it will definitely require higher investments in working capital, which is ignored by EBITDA (Stickney, C. Brown, P. Wahlen, J., 2007). In our case, there is no such problem since cash flows based on changes at positions of working capital are positive. However, we must warn you that financial revenues and net other gains and expenses stayed from calculating EBITDA, cumulatively making EBITDA higher than it would have been if we had included only operating revenues in our calculation.

3. ANALYSIS OF RETURN PERFORMANCES AND THE EFFECT OF FINANCIAL LEVERAGE

So far, the analysis has revealed two important things. Firstly, telecommunications sector, even in conditions of deep economic crisis (except in 2008) and considerable burden by financial expenses, manages to do business in profit zone. Secondly, having compared the incomes in telecommunications sector to the incomes of whole economy, we concluded that the sector has an above-average profitability. However, this is not enough to complete the profitability analysis. It remains to see whether reported incomes are sufficient for the existent investors and attractive to potential investors. To that end, it is necessary to relate realized incomes to the level of used equity or assets. For this purpose, we will use standard, globally accepted return measures: Return on Operating Assets (ROOA), which is necessary to perceive the profitability of so-called core business, Return on Assets (ROA), as a kind of measure showing capability of companies to service credit liabilities, and Return on Equity (ROE), as a measure of owner’s interest achievement. (Gibson, C., 2009) We displayed the movement of these returns in their decomposed versions (as a result of certain income margins and turnover ratios) in Table 1.
Even superficial analysis of calculated returns revitalizes considerably the image of telecommunications’ profitability in Serbia. To tell the truth, conclusion regarding an above-average profitability of this sector within Serbian economy still remains. From this review, we can see that all returns are much above the achievements of economy as a whole. So, ROOA is, on average, about three times higher than ROOA of Serbian economy in the whole analysed period, while ROA is slightly more than twice higher. Also, in 2007, ROE, being the measure of owners’ returns, was 5.5 times higher in telecommunications sector compared to the average of the economy, while in 2011, it was even 9.2 times higher. (Malinić, D. Milićević, V., 2012a)

Despite previous statements confirming an above-average profitability, at this point we have to stress that telecommunications sector as a whole (except partly 2011) was not profitable enough. Namely, ROOA and ROA, as returns used as success tests of so-called core business and measure of debt repayment capability, go between 8 and 11%. Such achievements are the result of considerably high income margins belonging to them, which are always (except in 2007) above 15% (see Table 1), and of very low turnover ratios (below 0.5 for total assets and below 0.6 for operating assets) which, in calculating returns, correct income margins downwards, on average by one half. The reasons for such low turnover ratios could be sought in the fact that the sector is capital-intensive (the share of fixed assets in operating assets is about 82% on average), but also in the fact that such assets do not manage to create sufficiently high revenues.

The key motive of insufficient profitability in the analysed sector lies in the fact that it (like the economy as a whole) bears high financial expenses very hard. Namely, financial expenses bring down the reached ROOA and ROA (except in the first and last analysed year), making ROE in 2008, 2009 and 2010 either negative or slightly over zero. It is well known that profitable companies often have ROE higher than ROA. It practically means that ROA is higher than cost of capital and that this excess runs to ROE, resulting in a logical situation when ROE is higher than ROA. It happened in 2007 and 2011. In the other three analysed years, which can be seen in Graph 3, ROE lags considerably behind ROA, which brings directly to the conclusion on insufficient profitability.
Previously described relations between ROE and ROA result from the effects of financial leverage which is directly related to level of indebtedness. Namely, the interest of borrowing exists when return is higher than cost of debt. It enables providing creditors from the achieved returns and increasing owners' return by the rest of them. Vice versa is also true. If return is lower than cost of debt, creditors will be satisfied again, but now in the way that their missing return will be provided from owners' return. So, additional borrowing could result either in positive or in negative effects of financial leverage (White, G. Sondhi, A. Fried, D., 2003). In all analysed years where ROA is higher than ROE (in the graph, these are 2008, 2009 and 2010), there is a negative effect of financial leverage. Vice versa is also true. In 2007 and 2011, ROA is higher than cost of capital, and, accordingly, ROE is higher than ROA, so the effect of financial leverage is positive.

In order to analyse deeper the movement of return performances, as well as the effect of financial leverage, we will explain more thoroughly the existent ROE and display it as a four-component return (Figure 1).

![Four-component disaggregation of ROE](image)

It is easy to see that two middle components of ROE represent ROA. It is the return depending on companies' operating capabilities (in this case sectors), since earnings before interest and tax (EBIT), is a profit concept free of financing effects. So, the level of middle ROE component is among others determined by operating capabilities, i.e. business risk. On the other hand, the first and fourth component of ROE are
directly related to indebtedness. In theory, if there were no debt in capital structure, the first and fourth component would equal one, meaning that there would not be financial risks and the effects of financial leverage. In such case, ROE would equal ROA. In case of indebtedness, which is more real, the first component is higher than one, since assets are higher than equity, just like the last component falls below one, since a part of income goes to creditors in the form of interest. So, the increase of indebtedness level will increase ROA as long as this rise is higher than negative effects of interest burden on the income. In other words, if the product between the indicators of indebtedness level and indicators of interest burden is over one, there will be positive effects of financial leverage, and if it is below one, there will be negative ones. Thereby, borrowing limit is equation of ROA with cost of capital, when ROA equals ROE. Again, it means that borrowing brings positive effects of financial leverage to the point when exceeding this limit brings negative effects of financial leverage.

During the analysed period, there is obviously a steady growth of indebtedness level in telecommunications sector, from 1.76 in 2007 to 2.99 in 2011. In that sense, conclusion is even more obvious if we mention that share of debt in liabilities was the acceptable 53.25 in 2007, while its share in 2011 is worrying, 68.95%. However, the whole image of indebtedness effects is perceived only if we include the indicator of interest burden in the analysis. We can see severe fluctuations in that segment, from negative quantities (in 2008), through modest achievements (in 2009 and 2010), to optimistic ones (in 2007 and 2011), where there is a positive effect of financial leverage. The real meaning of these quantities will be clearer if we mention, for example, that in 2010, from 100 dinars EBIT (belonging to owners and creditors), only 12 dinars are left in net income (belonging to owners only).

Decomposed ROE also reveals other causes of reported return performances of telecommunications sector. Apart from negative effect of financial leverage in three out of five analysed years and obviously raised financial risk, it is clear that the main obstacle to higher return performances are low turnover ratios, below 0.5. It means that average no. days of total assets turnover is more than 2 years (between 745 and 811 days). Thereby, capital intensity of telecommunications sector is comprehensible, but the fact is also that used assets do not manage to create sufficient incomes able to increase not only turnover, but also profit margin, and accordingly returns.

Perhaps it would be useful, in terms of previous considerations, to give a few warnings regarding years of highest ROE. Firstly, the fact is that returns are highest in periods of stable dinar exchange rate. It is important to consider this due to a fact that, in such situations, cost of capital burden profit the least, because there were no exchange differences. Having in mind the fluctuations of exchange rate in this year, according to this parameter, it is real to expect considerably lower returns in 2012. Secondly, the fact is also that ROE was highest in years when financial revenues were higher than financial expenses (in 2007 and 2010). Of course, this situation is favourable, but we should not forget that financial investments are not the basic activity of this sector. All this leads to cautiousness in the interpretation of favourable returns, especially in 2011.

Finally, we must point out the distinctiveness of the analysis regarding success of this sector based on cumulative financial statements and, in order to do so, slightly relativize our previous conclusions. Namely, cumulative performances themselves do not mean that financial and structural problems, as well as success, are equally distributed by branches and individual companies. It is evident that, within this sector, there are companies with better or worse financial structure, as well as those more profitable than the others. This is confirmed by the fact that, in balance sheet, there are even losses over equity in some companies, meaning that there are such companies which lost the entire equity due to unprofitability (losses). Such unprofitable companies reduced the profitability of the entire sector and hid the fact that some companies are much more successful than the others.
4. ANALYSIS OF INVESTMENT CAPABILITIES

We have already stressed that dealing with telecommunications is expensive business related to considerable investments. Investing in infrastructure by big companies or hiring infrastructure by small companies is very requiring financially. The situation is similar with new technologies and rapidly changing clients’ requirements which considerably shorten the life cycle of products and services, increasing in that way the needs for investments. Maintaining competition simply makes companies to follow new technical and technological achievements. Thereby, key limitation is the availability of financing sources. Since internally generated sources are generally not sufficient and dominant relying on borrowing is not possible due to growing risk, the capability of financing necessary capital expenditure is related to possibility of providing necessary sources in accordance with some target capital structure maintaining the acceptable relation between debt and equity. The lack of high-quality financing sources reduces investment capabilities, slows down growth and leads to reducing competition.

So, the evaluation of investment capabilities depends on level of required investments which should provide maintaining the existent capacities and necessary growth, possibilities of providing own financing sources and possibilities of further long-term borrowing. In that sense, the information on cash flows are very valuable, as those regarding cash flow from operations, pointing to capability of servicing current operating liabilities, payment of dividends and possibility of financing new investments, as those from investment activities, pointing to capability of sustaining operational capability of existent capacities and providing further investments in order to achieve the necessary growth, and from financing activities where we can perceive the level of financial effort and influence of operating and investment activities on financial structure. (Boer, G., 1999) Closely related to this is the problem of the evaluation regarding possibility of growth which would be financed only from internal sources or also from borrowed sources, provided that there is a financial balance. Having this in mind, we will rate investment capabilities based on movement of Free Cash Flow (FCF), being the relation between Cash Flow from Operations (CFO) and Capital Expenditure (CAPEX), as well as using internal and sustainable growth rates. Movements of these quantities in telecommunications sector in the analysed five-year period are displayed in Table 2.

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Free cash flow is one of profit concepts which is mostly defined as the remainder between cash flow from operations and capital expenditures necessary to maintain capacities at the existent level, or, alternatively, total capital expenditures. Since we cannot grasp from financial statements which part of capital expenditures refers to maintaining the existent capacities and which part serves growth, we are forced to accept the other definition, i.e. to consider total capital expenditures, which in this case includes investments in intangible assets, property, plants and equipment. (Wild, J. Subramanyam, K. Hasley, R., 2007) In that sense, positive free cash flow shows that a part of internally generated means remains disposable to pay out dividends, repurchase shares, repay debt or withdraw debt before its maturity. Vice versa, negative free cash flow indicates that a part of capital expenditures must be financed from external sources, own or borrowed ones.

Telecommunications sector obviously has negative FCFs in the first four years and positive FCF in the last analysed year. So, the fact is that investments were partly financed from external sources in the first four
years, dominantly from borrowed ones (long-term and short-term as well, especially in 2008 when short-term loans increased by 27.8 billion dinars), and let us say occasionally from own sources (issues equity). Only in 2011 did the positive FCF enable returning a part of loan and paying out returns to owners in the amount of 12.2 billion dinars. However, before drawing final conclusions, we should not lose sight of 2011 when there was a reduction of basic equity by even 21.3 billion dinars (withdrawal and coverage of losses) and that long-term loans were reduced by 24.1 billion dinars. All outflows are compensated by the increase of other long-term liabilities by 10.1 billion dinars and the additional short-term borrowing of 27 billion dinars.

We can get more precise information by calculating so-called CAPEX ratio, whose values are also displayed in Table 9. The obtained values show how much capital expenditures is, percentually speaking, covered by cash flow from operations. Since the values in the first four years are below 100%, it confirms again the previously drawn conclusion that a part of capital investments is financed from external sources, dominantly borrowed ones. In 2011, a very high CAPEX ratio could, at first sight, point to a positive conclusion that total capital expenditures is entirely financed from internally generated sources and that FCF should contribute to strengthening financial structure of the sector. However, we have seen that it is not the case. Of course, at this point we raise the question on how much capital expenditures should be financed from cash flow from operations. Although there are no strict, general relations posed here, we could say that capital expenditures should be financed from internal sources in the extent that provides maintaining target capital structure (relation between debt and equity). (Gill, A. Biger, N. Pai, C. Bhutany, S., 2009) The fact is that financial structure of the sector is deteriorating from the point of view of relation between debt and equity. At the beginning of the analysed period, the share of debt in equity and liabilities was 53.25%, while in 2011, the share increased to 68.95%. If we made an average of the relation between debt and equity in the analysed five-year period, we would come to the conclusion that debt share is at the level of about 61%, while the remainder from 100% is in the form of equity share. On the other hand, if we calculated CAPEX ratio for the entire five-year period, we would come to the conclusion that its value is 71.85%. So, taking the average capital structure as the target one (which does not have to be true, but it is the fact that it suits the current situation) on one hand, and the fact that, accordingly, about 39% of capital expenditures should be financed from internally generated sources (now 71.85% on average), we could conclude that the situation is very favourable in that sense. Still, we should also have in mind that long-term and short-term liabilities increased by 99.7 billion dinars in 2007 and that problem of their servicing is not negligible. This is confirmed by the fact that their servicing is done by substituting long-term loans with new, long-term liabilities and reaching for short-term borrowing (which happened in 2008 and 2011). In addition to that, the question remains whether the made capital expenditure is sufficient. Some parameters tell that it is not. A somewhat different approach to the evaluation of investment capabilities leads to the analysis of growth rates. In that sense, we should pay attention to internal growth rate and sustainable growth rate, whose values are displayed in the previous table. Internal growth rate, representing the relation between retained earnings and average assets of one company, points to growth, in this case of telecommunications sector, leaning just on internal financing sources. Results show that the internal growth rates are quite modest, including also 2011, when the reported income was highest. On the other hand, sustainable growth rate, representing the relation between retained earnings and equity, or in the extended version the product between retained earnings and return on equity, points to the possibility of growth, if, along with internal sources, we use external, borrowed sources, to a point that suits target capital structure. It is logical that sustainable growth rate is higher than internal growth rate, since financing sources are increasing, which is confirmed by the obtained profit. However, if we wanted to maintain the target capital structure or, perhaps, capital structure from the previous period, then the relation between sustainable and Internal growth rate would have to reflect the same indebtedness level. In other
words, if sustainable growth rate grows faster than the internal growth rate, it means that the company finances growth in a way that it increases indebtedness level, which is exactly the case in telecommunications sector. There should be raised cautiousness in such circumstances due to a threatening rise of financial and structural risks and risks based on potential negative effect of financial leverage. (Booth, L. Aivazian, V. Demirguc-Kunt, A. Maksimovic, V., 2001)

It is the fact that performed analysis points to a significant rise of profitability, positive effect of financial leverage (especially in 2011), serious rise of CAPEX ratio and the respective increase of sustainable growth rate. Although, at least at first sight, all this represents a good direction, we are still prone to a more cautious approach in the interpretation of these results. There are lots of reasons for that.

Firstly, in the interpretation of analysis results it is very important to pay attention to the problem of sustainability of reported incomes. That precise problem first refers to sustainability of operating incomes, especially because there are quite sharp fluctuations in the movement of these incomes through the analysed period. For example, in 2007, operating incomes decreased compared to the previous period, and in 2008, when the effects of crisis were most present, operating incomes increased by even 1.5 times, and then fell again in 2009. Only in the last two analysed years has the situation in this segment stabilized up to a point. Partially, these fluctuations could be the result of existing transitory (temporary) incomes, but the disposable information basis does not give us space for deeper analysis. A more serious problem is represented by reported income based on financial transactions. Namely, we have already pointed to the effect of fluctuations in dinar exchange rate compared to euro and to the effect of exchange differences when the value of dinar falls. At this moment, it is obvious that positive exchange differences from 2011 will be substituted by foreign exchange losses and that, accordingly, in 2012 there will be net financial expenses.

The other reason for cautiousness lies in sustainability of cash flows. Thereby, sustainable cash flows are primarily related to cash flow from operations, more precisely to cash flows with a repetitive character in that segment. It means that, in the evaluation of investment capabilities, analysts should not rely on transitory cash flows which have a temporary character and could be misleading in terms of conclusions. (Malinić, D., 2009) In that sense, we must pay attention particularly to the movement of liabilities towards suppliers and other operating liabilities where there are most significant liabilities based on earnings, along with liabilities based on interest and other financial expenses. Prolonging these liabilities increases CASH flow from operations and alleviates liquidity position. „Inflows“ based on prolonging liabilities to suppliers equal 5.6 billion dinars in 2011, and even 9.2 billion dinars for the inflows based on other liabilities in the same year. However, such position is not sustainable for a long-term since short-term creditors cannot tolerate this behaviour for long time. It is not possible to renew these sources, so they should not be considered a sustainable cash flow. It means that excluding transitory elements from incomes and cash flow from operations reduces considerably the reported positive cash flow from operations, and, accordingly, FCF in 2011. However, owing to dominantly high amortization, as a non-cash cost, cash flow from operations stay at a considerable level in 2011. Thereby, the problem is that FCF is mostly directed to repayment of high credit liabilities.

Thirdly, we should not forget that positive FCF and extremely high values of CAPEX ratio could be the consequence of insufficient capital expenditures. Speaking in favour of this is the fact that values of done capital expenditures in this sector in 2011 are the lowest compared to previously analysed years, and compared to 2007, they are lower by even 2.6 times. Speaking of serious stagnation in the field of capital expenditures, there is the fact that, except in 2007 which was extremely capitaly intense, capital expenditures were just above the amortization level in period from 2008 to 2010, while in 2011, amortization was higher by capital expenditures by almost 1.3 times. Having in mind that this is a capitaly intense sector, in such conditions we can hardly conclude that capital expenditures are sufficient.
Finally, in calculating growth rate (internal and sustainable) we started from the fact that the entire retained earnings is reinvested in profitable projects and that it is not used for covering accumulated losses. It is probably logical to a point where there is a valid assumption that retaining earnings is related only for the companies (belonging to this sector) with no losses in their total. We could also act otherwise and, with quite convincing arguments, reduce the retained earnings for the appearing expenses in the analysed years, which would result in negative rates in period from 2008 to 2009, and in rates lower than those reported here by about 1.6 times in the last year.

All the arguments stated so far have not damaged the view that profitability of telecommunications sector is above average. However, it does not mean that the reported income is sufficient. It is undoubtedly the sector with high growth potential, but we are sure that there is room for this growth to be higher.

CONCLUSION

Development of telecommunications sector represents one of the key determinants of national economy’s economic development. This is true for both developed and undeveloped countries. The importance of telecommunications in modern economy is primarily determined by the fact that this is an infrastructural sector which, probably more than any other, affects the development of other sectors, and hence, directly and indirectly, growth of GDP, economy and development of society as a whole. Due to information and communication support of economy, as well as raising the efficiency of other social segments by developing e-administration, e-health care, e-justice system, e-education etc., telecommunications are recognized as a strategically important sector for sustainable development. (European Commission, 2010) Incomprehension of this importance and possible failures in this field will have far-reaching consequences not only for this sector, but for national economy and society as a whole. In that sense, the evaluation of financial performances is important at least for two reasons. Firstly, the evaluation of the existent state is the basis for understanding financial stability of telecommunications sector, its profitability and growth potential. Many of displayed performance measures represent valuable early warning signals which could indicate stepping into crisis. Finally, in crisis conditions, when there is a fall of performances, the evaluation of current situation helps to discover causes and effects of financial staggering and to recognize courses of action with greater certainty. Secondly, making the intersection of any sector’s performances, including telecommunications as well, is also important because it sets the standard or the basis for comparing the effects of created strategy regarding development of telecommunications industry.

In Serbia, telecommunications sector is exposed to considerable long-term and short-term financial-structural risks. It is understandable up to a point, because, independent of this sector’s potential, it is still forced to share the fate of a quite devastated economy where it operates. The risks are related to the increase of losses and indebtedness level, considerable use of cash flow from operations for the purpose of repaying debts and so on. (Malinić, D. Milićević, V., 2012) We estimate that these financial-structural problems, although very serious, are not such that the sector like this one could not overcome them. However, ignoring such problems could potentially cause great damage not only to telecommunications industry, but to national economy as well.

In terms of profitability, the analysis confirmed that this sector is profitable above the average. It is supported by all comparisons with the achieved performances of Serbian economy. However, the same results show that there is no word of satisfactory profitability. Low turnover ratios indicate that used assets could not generate sufficient revenues able to provide higher return performances. Besides, this sector bears very hard the burden of financial expenses. This is partly the result of insufficient performances of so-called core business, and partly the result of unfavourable effects of foreign exchange losses. It is in periods when dinar was weaker that financial expenses were the highest (2008-2010), net incomes the lowest, and the effect of
financial leverage negative. It points to another conclusion - that stable business climate is absolutely necessary. Maintaining the competition of telecommunications sector implies significant capital investments. By default, it raises the problem of financing. Profitability and generating positive cash flow from operations are crucial here. This is because internally generated sources are the prerequisite of maintaining financial balance and providing sustainable growth. Profitability provides safety and increases the capacity to obtain necessary borrowed sources of financing. In that sense, it is good that the coverage of capital expenditures by cash flow from operations is mostly high (except in 2008), but we should not forget high credit indebtedness of the sector and high liabilities in terms of servicing debts. Eventually, we would like to point out the need for cautious interpretation of the obtained results. Here we mean particularly the need to reconsider sustainability of reported incomes and cash flows, since long-term performances determine only sustainable components of success. In addition to that, reported high values of CAPEX ratio are certainly and at least partially the consequence of insufficient capital expenditures. Also, the fact is that there are healthy segments of telecommunications sector which should be the foundation for further growth, as well as the other segments, i.e. companies burdened with losses which are sometimes higher than equity level. Such companies should be restructured wherever it is possible, and their balance sheets should be cleared of the existent dubiousness. It should not be allowed that bad companies draw other healthy parts of the sector into illiquidity and other financial-structural disorders.

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