Approval Sheet

WACC AND THE OPTIMAL CAPITAL STRUCTURE FOR PAKISTAN TELECOMMUNICATIONS CORPORATION LIMITED

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ABSTRACT

Broad Problem Area

The telecommunications industry is one of the most pronounced examples of excess volatility of stock market values over the last decade. During the second half of the 1990s, deregulation, privatization and the introduction of new technologies (Internet, DSL, UMTS, etc.) led to extraordinary growth expectations for telecommunications companies (Glaum & Friedrich, 2006).

Share prices increased sharply, clearly outperforming the stock market as a whole. In order to fulfill expectations, telecommunications companies embarked on strategies of aggressive investment in infrastructure and rapid internationalization. However, during the early 2000s, in an environment of weaker than predicted demand, overcapacity, increased competition, depressed prices and lower profitability (Fransman, 2002), share prices collapsed. Until early 2003, telecommunications stocks experienced a much more negative performance than the overall stock market.

In terms of growth in the telecom sector, Pakistan is second only to China. There is a huge potential market still to be tapped and, therefore, Pakistan should attract substantial investment in this field as well. With limited investment opportunities in the telecom sector in the developed countries, Pakistan is in the best position to leverage the market potential to attract investment. There is every reason to believe that all the tele-density targets prescribed by the Ministry of IT and Telecom will not only be achieved but may even be exceeded.

However, in spite of the growth witnessed in the worldwide telecom sector, analysts say the industry suffers from the same old problems: too many companies and too much competition. According to MarketWatch.com, without further consolidation, prices will stay under pressure and limit growth. What's more, consolidation alone will not solve the problem. Phone companies, which sit atop the telecom food chain, have mostly consolidated, but they face rising competition from new rivals such as cable providers. The result: tight reins on spending. That leaves hundreds of vendors struggling for a limited pool of revenue.

"There has not been an increase in [equipment] spending as a percentage of revenue," said Pat Comack, an independent telecom analyst at Zachary Investment Research. "Revenue growth is going to be minimal." Because of slow internal growth, the telecom industry is susceptible to broader market trends and volatile swings, and that's been the case so far this year. In a nutshell, the increased competition in the sector means slim pickings for investors.

A similar scenario of intense competition prevails currently in all Asian markets due to which investors face some business risks. Amidst the current market conditions, it remains to be seen if PTCL which has been sheltered from cutthroat competition for so long in its monopolistic environment will be able to earn adequate rates of return on its new ventures in this intensely competitive setting it now faces.

Given the above scenario, this paper strives to find out the optimal capital structure for PTCL; one that allows the corporation to get the most bang for its bucks.

In the same context, the paper will also analyze PTCL’s *WACC,* which happens to be a very important number, both to the stock market for stock valuation purposes and to the company's management for capital budgeting purposes.

This paper attempts to study the capital structures of a number of telecom service providers around the world and then to suggest an optimal capital structure for PTCL after its privatization, where the WACC would be at a minimum, thereby resulting in an increase in the stockholder value.

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