Arthur D Little

International Event

Exclusive Telco CEO & Private Equity Event

Presentation of the 9th annual exclusive Telco CEO & Private Equity Event hosted by Arthur D. Little in Vienna

On June 17th, 2019, Arthur D. Little hosted its 9th annual exclusive Telecom CEO & Private Equity Event in Vienna, Austria. The topic of this year's event was "Embracing the Future", focussing on the inorganic growth options that shape the telecoms industry. The event gave a preview of our study, covering a truly global view of the telecom industry, with over 100 C-level interviews conducted and more than 4.300 deals in the telecom sector analysed. The importance of this topic was highlighted by over 60 top executives and shareholders of leading operators, regulators, vendors, banks & private equity from 25+ countries attending the invitation-only event.
The event began with a welcome by Karim Taga, Global TIME Practice Leader and Managing Partner of Arthur D. Little Austria and an introduction into the various flavors of the telecom growth alternatives. Rajesh Duneja (Principal at Arthur D. Little and lead author of this year's study) followed with the presentation of ADL's key findings. The participants discussed the findings and major implications on telecom operators in a lively Q&A session. The informal discussion later continued on the rooftop terrace where participants debated and networked in a relaxed atmosphere until late in the evening, last guests leaving way after midnight.

Key insights shared

- In our global survey of board members and senior executives of telecom operators, over 60% of the respondents agreed that the telecom sector is facing disruption. In addition, more than 90% of the respondents agreed that inorganic options are a viable tool to survive in the challenging telecom market.
- Financial return parameters of telcos trail those in other industries. Consequently, the telcos command relatively low valuation multiples thus depriving them of easy access to capital. Telcos will have to find alternate sources to finance the growth of their core areas as well as entry into new areas.
- As the telecom value chain has been disaggregated, it is possible to mutualize assets. Infrastructure assets, especially towers and fibre assets, are increasingly being hived off into separate companies either through direct sales or by attracting further investment from Private Equity/Infrastructure Funds for network expansion. The new owners of hived off assets are able to extract additional value by mutualizing the assets.
- Telcos will have to simultaneously invest organically – in their core areas and in capability development for the future, and inorganically – in-market consolidation and to enter into new areas.
- Telcos will have to continually invest in core areas to compete with not only other telecom operators but also MVNOs, cable operators and alternative network operators (e.g. utilities offering fibre).
- The weak financial position of many of the telcos will lead to further market consolidation. With increasing convergence of services, mobile-only operators are keen to pursue inorganic options to enter fixed services. Similarly, B2B in-country market is consolidating through inorganic options.

- Inorganic growth can also be used as a viable entry strategy into new areas for B2C or ICT/B2B2x/Wholesale. Telcos will have to complement their skills with that of the acquired target to create new value propositions.

Challenging times with an uncertain future

Telcos cash flows are under pressure because of significant investment committed to 4G/FTTx and it has yielded limited returns for the shareholders. This has resulted in low valuations for telco stocks and telcos find it difficult to raise capital at competitive rates. Telcos need to find funds to invest in strengthening their core as well as in growing beyond their slow-growing core. We expect that increasing requirement for capital investments will continue to put pressure on margins. 5G services are not expected to bring immediate revenue growth in the consumer space as we see operators in many countries offering 5G services at similar or even lower prices than 4G plans. In addition, the industry faces significant threats from external sources and within the industry. All this will constrain telcos from allocating sufficient capex required for securing their future.

Reconfiguring assets to extract value and to finance future investments

Though organic growth options are limited, telcos still need to find capital to invest in their core and find new opportunities for growth. They would therefore need to leverage their assets that can now be mutualized either partly or fully. This trend has been made possible as the telcos value chain is being disaggregated. Mutualized assets are worth more if someone else also owns it and if it is non-differentiating for the operator. Accordingly, tower companies now have higher valuation than telcos by a factor of 2x to 3x on EV/EBITDA basis.

Similarly, in FTTH, even incumbents find it difficult to maximize their network utilization (on an average, only 25-30% of houses passed with FTTH/B in Europe are connected). Hence, a few operators have started to spin-off their fibre assets to monetize them.

Slicing of the 5G network offers another opportunity to various vertical industries. For example, public utilities or media companies, who usually have their own network, could form JVs with network operators to lease a slice of the 5G network capacity. This can help operators to defray their deployment cost.

Telcos can use the cash generated from the sales of assets to optimize their balance sheet assets and build the business of "tomorrow".

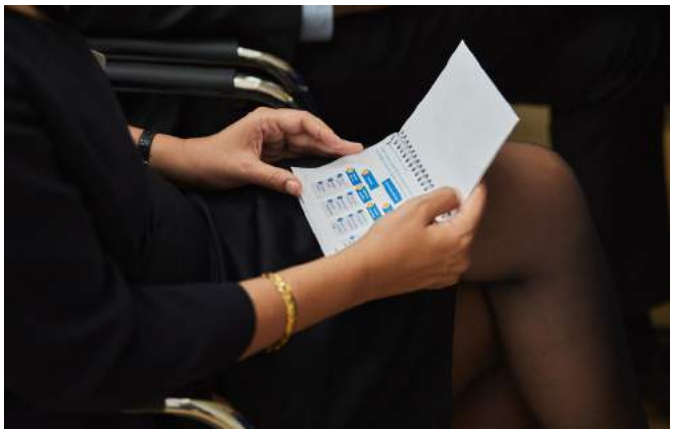
If telcos do not maximize returns from their assets, the shareholders will be presented with other options, such as Private Equity who can extract better value from unbundling the assets.

To secure future growth, telcos will have to invest in a balanced way between organic and inorganic options:

1. Innovate the core, driven by local competition
2. Build capabilities to prepare for the future, in particular for digital transformation
3. Secure reasons to be part of or drive the in-market consolidation to reach sustainable economics
4. Accelerate M&A in new businesses beyond core – i.e. in B2C as well as in ICT, B2B2X / WS to prepare for the future (to compensate for the stagnating / declining core business)

Exhaust organic growth options for both top and bottom line growth

Telcos will need to continue to innovate the core by investing in access network (both in ongoing 4G, upcoming 5G and fiber roll out), reinventing IT/NT and improving the brand. Telcos will increasingly have to adopt the architecture of internet companies. For example, X by Orange has begun offering B2B services on a platform completely built in the cloud. The service was launched within one year of being conceptualized.



To face the future, telcos will have to build capabilities in the area of digital transformation (with a focus on customer experience), commercial excellence and partnership management (for future asset management and getting into new businesses e.g., B2B2x). As stated in last year's report, digital transformation has become a must-do for telcos. Swisscom has leveraged and expanded its capabilities in telco billing to enter a new market (energy) by forming a peer-2-peer energy-reselling platform Tiko. Building on virtual grids and big data analytics, Swisscom successfully monetized smart home functionalities via utility partners.

In entering new areas, telcos would have to consider options to disrupt the market and not follow the existing business models. However, for disrupting the market, telcos need to develop certain capabilities on their own and complement by acquiring specialised industry-specific capabilities to offer new solutions. Orange in France decided to "surround the customer" by first offering fibre to home, followed by smart home solutions (Djingo, virtual assistant) and then internet-based bank. Many of the capabilities were developed by Orange in-house and complemented by acquiring Groupama Bank, an internet-based bank and not any traditional bank.

The telco delivery model is being decomposed and reconfigured as they face competition from a number of players along each layer of their value chain. In many situations, organic options are either not available or become difficult to execute because of the limited time available to capture the opportunities. In addition, given the rapid changes in the environment, telcos have limited time to respond to changes and opportunities.

Inorganic growth options as drivers of significant growth

To compensate for the stagnating revenues and building capabilities in the core, telcos need to consider inorganic area to spur growth.

Telcos are already exploring in-market consolidation by mergers between peers, fixed-mobile operators and across various B2B service providers.

Inorganic growth can also be used as a viable entry strategy into new areas for B2C or ICT/B2B2x/Wholesale. Telcos will have to complement their skills with that of the acquired company to create a new value proposition.

We believe that traditional expansions into new B2C services remain a valid possibility only in localized or regional contexts as seen by partnerships in Media, Smart Homes or Financial Services. Swisscom and Singtel have created JVs to make a "local" impact vis-à-vis established global players such as FB/Google as well as Netflix.

Telcos are very active in the B2B sector by making acquisitions in the ICT "traditional" areas, and also in emerging areas such as Campus Networking or Cyber Security. We highlight four guidelines for telcos planning to invest in new areas: (1) Find strength in a local market, protected by operational synergies or natural barriers; (2) Invest early in the market evolution that is being disrupted; (3) Invest to be a market leader; (4) Failure is acceptable and should be treated as an opportunity to learn and grow. Learning, experimenting and accepting failure is a preferable option to being on the side-lines.

Alignment between shareholders and board to build the new telecom operator

Never like before and board should align on reconfiguring the telco. We highlight the key questions shareholders and managers need to ask for the future of their telco:

- Where to invest for your core business and **how fast**?
- How to slice and monetize the assets? How to structure the deal in terms of control, type of assets assigned to a JV and rights to use the assets?
- What capabilities and what future product/market you should invest in to build your next generation telco beyond the core and what type of companies are to be acquired?
- In pursuing inorganic options beyond the core, how to align the interests of the shareholders and the management board? Should new business lines be managed by the existing telco or separately by a sister or parent company?

Insights and Q&A

A lively Q&A session after the presentation was focused on the impact of hiving off assets to third parties in terms of increased risk, complexity and ability to maintain good quality of service. While operators may aim to mitigate this risk through internal capabilities and partner management, ultimately, it must be properly assessed as the alternative to missing out on growth opportunities. In the end, it was discussed that the future of telcos should be viewed as a number of rational "make-or-buy" decisions, aimed at unlocking more shareholder value.

The discussion continued on to the value a telco can capture by taking over an asset which has a wider appeal. For example, content has universal appeal and if telcos leverage it for their customers then the value is restricted to the market share of the telco. Telcos have been following different approaches based on their business model. Some telcos see significant value in using the asset exclusively for their own customers whereas others create an independent JV and serve customers outside of their own customer base.

The last discussion was about expanding into new adjacencies where there is an inevitable need to consider acquisition of early disruptors and accept the associated risk. These risks should be part of the discussion with the Board. For example, Verizon has entered into drone business by acquiring multiple companies such as Skyward and PrecisionHawk, to have meaningful presence in various aspects of an emerging airborne based business.

Arthur D. Little

Arthur D. Little has been at the forefront of innovation since 1886. We are an acknowledged thought leader in linking strategy, innovation and transformation in technology-intensive and converging industries. We navigate our clients through changing business ecosystems to uncover new growth opportunities. We enable our clients to build innovation capabilities and transform their organizations.

Our consultants have strong practical industry experience combined with excellent knowledge of key trends and dynamics. Arthur D. Little is present in the most important business centers around the world. We are proud to serve most of the Fortune 1000 companies, in addition to other leading firms and public sector organizations.

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The PDF version of the presentation is available upon request.

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