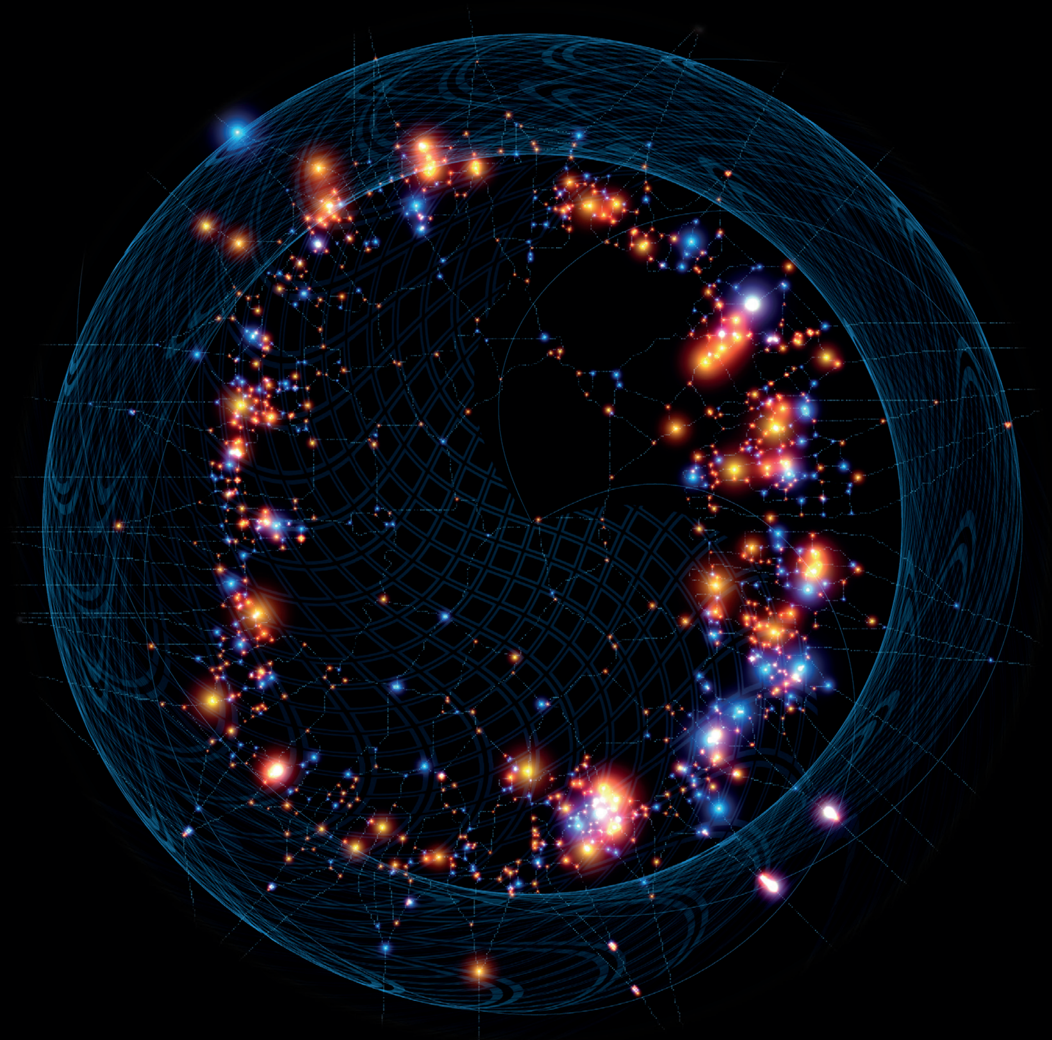
Deloitte.



Decision time for Europe’s telcos

June 2023

Decision time for Europe's telcos

As overcapacity makes connectivity a commodity and customers don't care anymore, telcos need to take action

Struggling to create value for shareholders, the European telecoms industry is at a fork in the road. Faced with a glut in capacity, there is a risk that the gradual decline in the industry's return on invested capital could soon go into free fall.

There are two ways to arrest this decline – maximize automation to achieve a step change in the efficiency of the core business and/or push much deeper into the (beyond-core) digital services market. In other words, telcos need to concentrate on running networks as efficiently as possible and/or develop compelling digital services that can compete with the best the Internet has to offer. Although both options are likely to require radical changes to operating models, they are the only ways that telcos can hope to maintain the backing of investors.

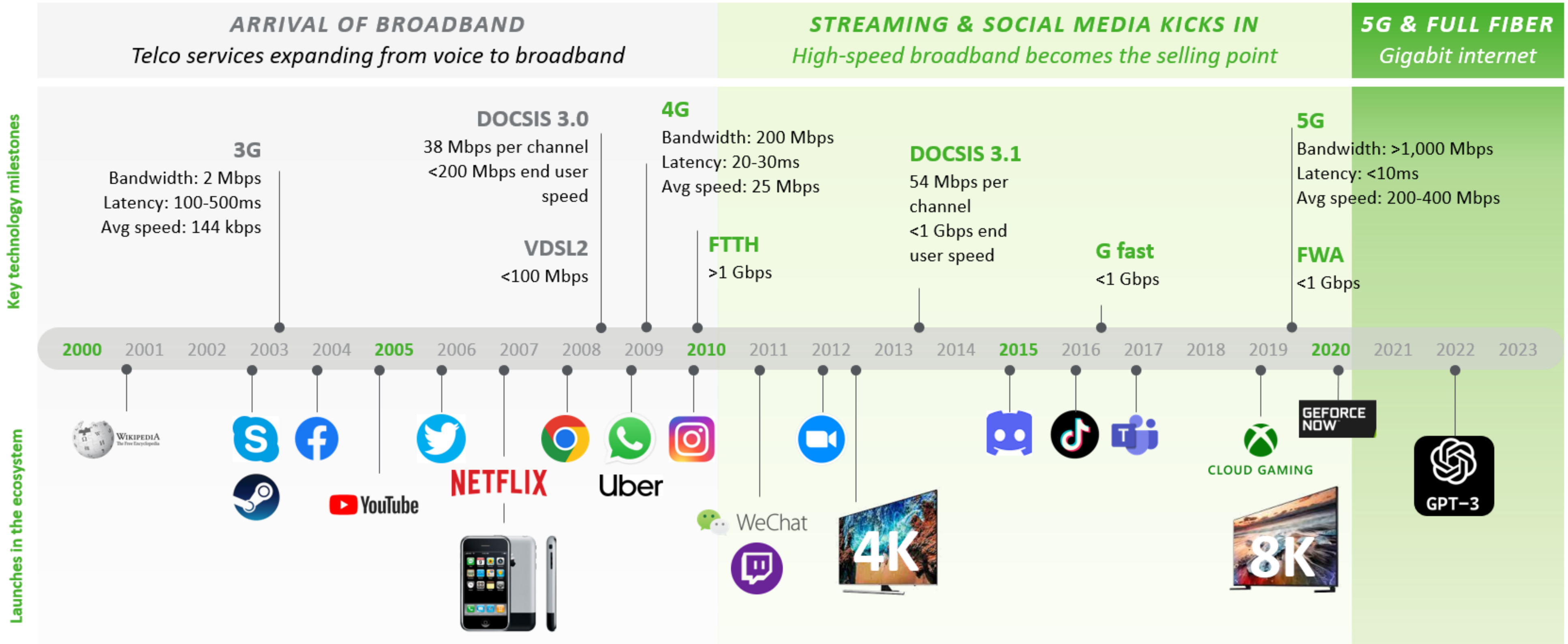
Today, many European telcos are 'stuck in the middle', aiming to be successful in both core connectivity and beyond core, whilst maintaining a costly integrated operating model.

Ironically, the root cause of the looming crisis is the telecoms industry's investment in highly efficient fiber and 5G networks. These technologies have brought about a step change in the capacity available to both consumers and businesses, creating a situation where most telecoms customers now have all the connectivity they are likely to need for the foreseeable future: the industry is creating its own overcapacity!

Telcos struggle to create shareholder value

Telcos initially drove digital development
Between 2000 and 2010, the telecoms sector prospered by deploying broadband, the foundations of today's digital economy. That decade saw the birth of Skype, YouTube, Uber and Instagram. In the following decade, the rollout of high-speed broadband propelled further growth, while enabling consumers to enjoy 4K television and films-on-demand (see graphic).

Over this period, many telcos successfully built a premium image and strong relationship with customers, thereby creating significant brand value.



Notes: Technology launch dates are indicative, launch dates may differ across markets
Source: Cisco, company websites, Deloitte analysis

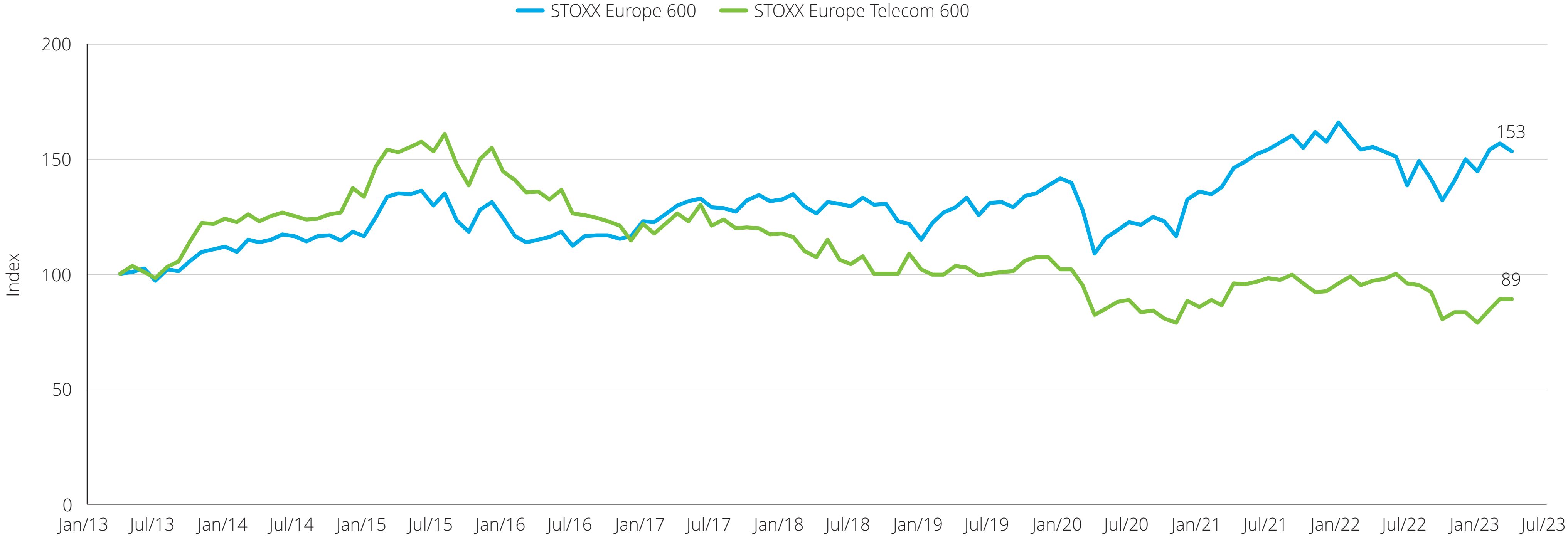
The glory days are gone

Unfortunately, telcos have since failed to translate their crucial role in connectivity to their shareholder returns. Telcos' shareholder return started lagging behind the broader financial markets in 2017.

Indeed, the gap between the performance of the STOXX Europe 600 and the STOXX Europe Telecom 600 indexes has widened significantly in this decade (see chart).

Stock performance of telcos vs the market

2013-2022, Europe, March 2013 = 100



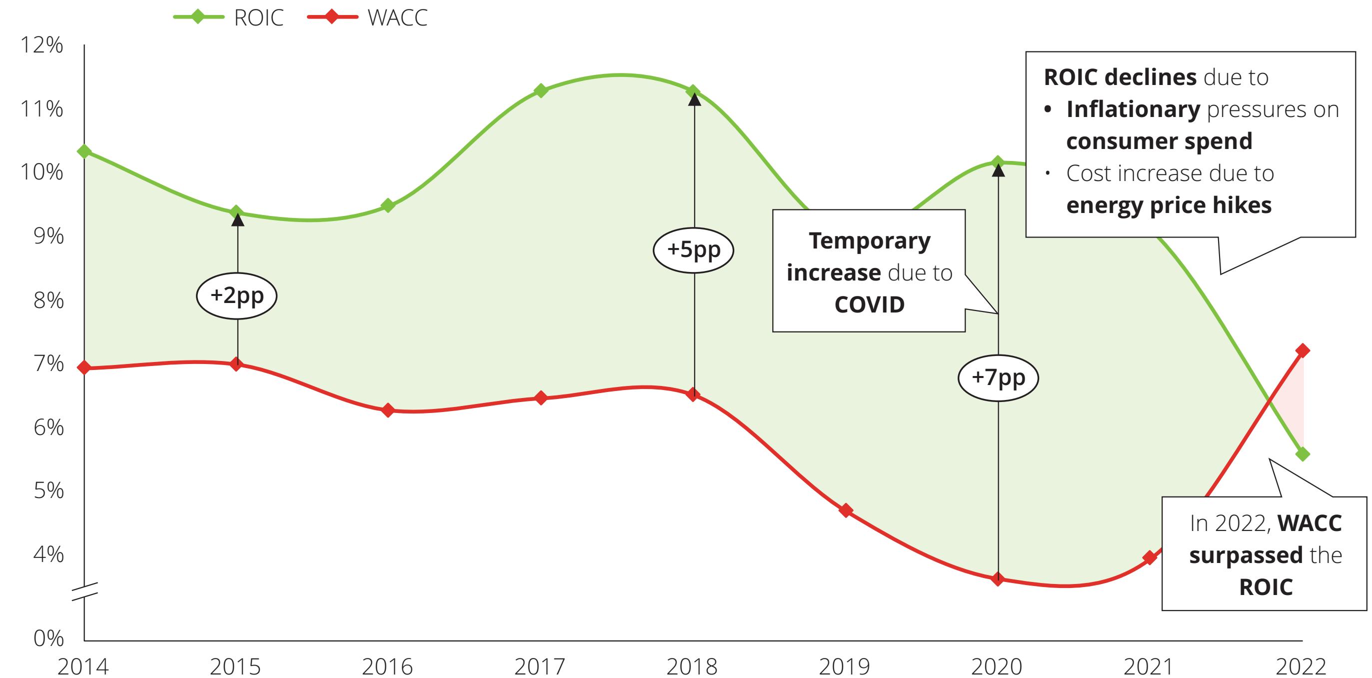
Source: Thomson Reuters, Deloitte analysis

The future doesn't look promising either

In today's structurally weak environment, telcos are even struggling to make a return on investment that will cover their weighted average cost of capital (WACC), which is rising with interest rates. In fact, figures from ETNO show that in 2022, telcos' WACC surpassed their return on capital invested (ROIC) – see chart. Considering ETNO's ARPU outlook for European telcos (<1% CAGR between 2022 and 2025), we expect the ROIC – WACC spread will remain thin.

Return on capital vs WACC for European telecom operators

2014-2022, Europe, % (annual)

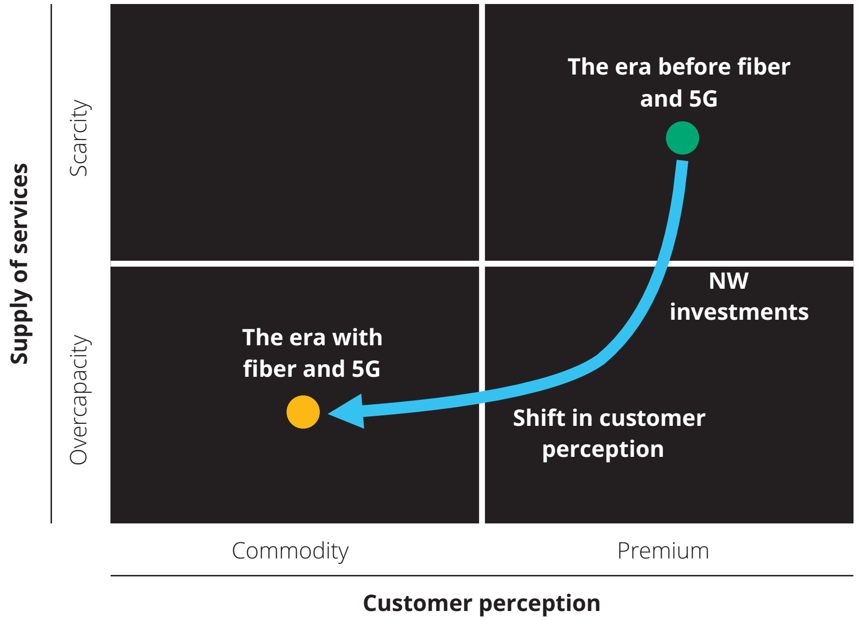


Source: ETNO The State of Digital Communications 2023, Stern NYU, Deloitte analysis

Changing industry dynamics will make the situation worse

The shift in telcos' strategic position
At the same time, customers' perceptions of telcos have changed. Whereas they were once seen as providing premium services, they are increasingly regarded as offering a commodity, akin to gas, electricity or water. As consumers engage with Internet services, such as Instagram and Netflix, they pay little heed to which telco they are using. In effect, telcos have lost their functional and emotional differentiators, forcing them to compete purely on price.

As depicted in the chart below, telcos' investments in 5G and fiber have actually worsened their strategic position. Whereas they once controlled access to a scarce product, connectivity is now abundant in developed markets, such as Western Europe. In this environment, there is a growing risk of a price war – one of the players may try to disrupt the market to gain market share and lift revenues



The era before fiber and 5G
when consumers highly valued connectivity and the capacity was balanced

Network investments leading to overcapacity
due to increased availability and technology leaps (FTTH, 4G, 5G)

Shift in customer perception
as connectivity is taken for granted and customers are not excited anymore about core telco services

The era with fiber and 5G
where operators' services & network quality are at par with each other, and the only differentiator is price

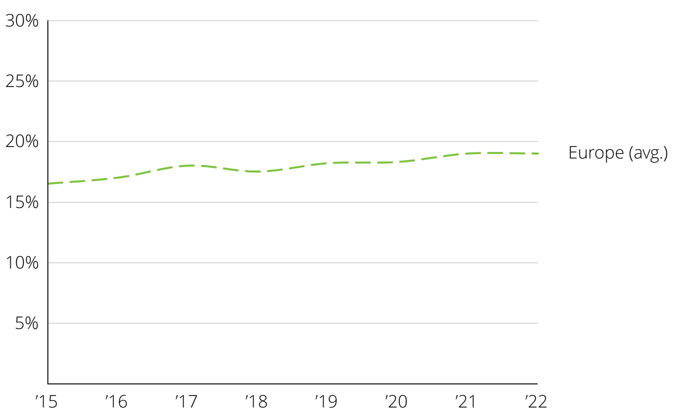
Network investments create overcapacity

Over the past decade, numerous OTT (over-the-top) apps have displaced telcos' core messaging, voice, and TV services, while generating massive amounts of data traffic. As a result, operators globally have seen global mobile data traffic grow from only a few exabytes per month in 2002 to over a hundred in 2022[1].

To accommodate this demand, telcos have invested heavily in their infrastructure: European telcos on average spend close to 20% of their revenues on capex. This figure has been rising steadily over past decade, as telcos have upgraded their traditional copper networks with fiber to the cabinet and are now investing in fiber-to-the-home/building and in 5G networks.

CAPEX as % of revenue

2015-2022, Netherlands & Europe, % of revenue



Source: ETNO State of Digital Communications

Fiber and 5G aren't going to come to the rescue

Thanks to the rollout of 5G and fiber-to-the-building networks, European telcos are able to provide both individuals and businesses with consistent connections of several hundred megabits per second. But consumers aren't that impressed. Very few, if any, everyday applications need anything like that kind of throughput, not even 8K video.

Even if four members of a household are using the building's broadband connection simultaneously, their combined usage is unlikely to result in traffic of more than 50 Mbps (see chart). Yet, the median download speed of fixed networks is already higher than 100Mbps in some markets and is rapidly growing to several hundred Mbps[2].

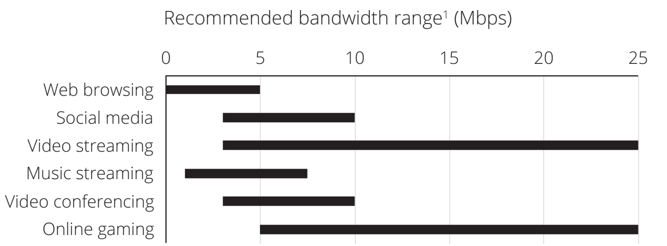
To add to the downward pressure on prices, in some markets, fixed broadband is now facing competition from 5G. Fixed wireless access networks can use 5G to provide households and businesses with fast broadband connections. In the US, in 2022, fixed wireless access accounted for about 80% of all net-adds in the US fixed broadband market.

Customers are becoming indifferent

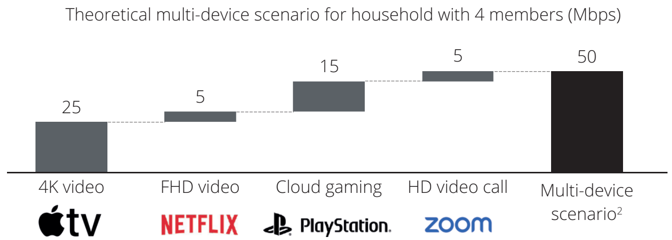
As the supply side changes significantly, from scarcity to overcapacity, on and between networks, the demand side is also changing significantly: where in the past decades, customers and businesses would look out for a new bundle/tier/upgrade/modem with excitement and talk about tariff plans at parties with pride, this is totally different today. When it all works as promised, connectivity services tend to generate neutral feelings (at best), while service interruptions result in dissatisfaction.

There is plenty of research that illustrates this sentiment change, both for mobile and fixed connectivity services. For example, in a recent Deloitte study in The Netherlands[3], 55% of customers said they can not tell the difference between 4G and 5G. Another Deloitte study, in the UK[4], showed that 75% of UK broadband customers are satisfied with existing broadband speeds. And a recent survey among German customer[5] showed that 82% see connection stability as the top requirement for their broadband service, with up-load and down-load speed following only on 4th and 5th place respectively.

Mobile



Fixed



Notes: 1. Download speed requirements may differ by platform and the quality of the content; 2. Selected applications are assumed to be run simultaneously
Source: Speedtest Global Index, company websites, specialist reporting, Cartesian, Deloitte analysis

1 *Source: Ericsson*
2 *Source: Ookla Speedtest global Index*
3 *Deloitte Digital Consumer Trends Survey 2022, NL edition*
4 *Deloitte Project Fiber Survey 2022, UK*
5 *Deloitte Broadband Consumer Survey 2023, Germany*

Stuck in the middle, telcos now need to make a strategic choice

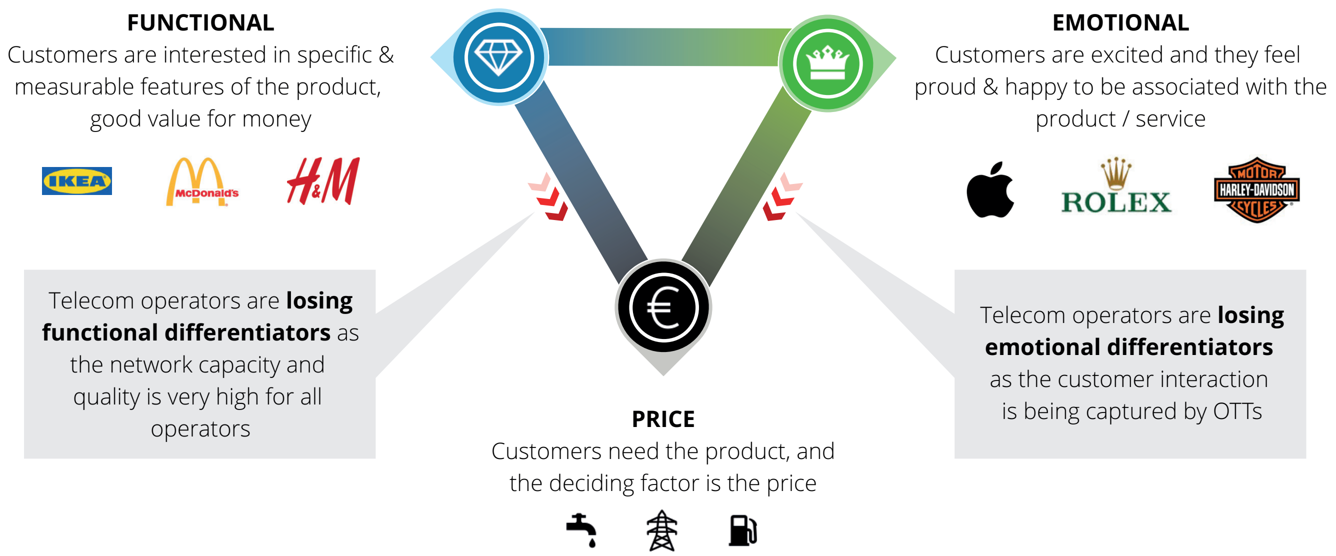
Is price becoming the dominant factor?
There are three basic ways a business can differentiate itself from the competition: by offering better functionality than competitor products, by building a more intimate emotional relationship with the customer and/or by offering the best value for money.

In the European telco landscape, in past decades, all three approaches have flourished:

- some telcos followed a 'best network' strategy, attracting both consumer and business customers based on best network coverage, speed and reliability. This is a strategy often adopted by incumbent telcos.
- others differentiated by expanding beyond core connectivity to offer premium content or gaming in the consumer sector and security or healthcare services in the business sector. This approach has worked well for many Asian operators, but not so much for European telcos.
- new market entrants / challengers often focus on providing the best value for money, aiming to grow market share by keeping prices low, or by offering moderate price levels, frequently punctuated by deep discounts

As a result of the overcapacity on and between networks, combined with customers' perception that connectivity is a commodity, telcos will increasingly struggle to succeed with the first two strategies, as depicted in the graphic beside.

Competitive differentiation of products/services in the eyes of customers



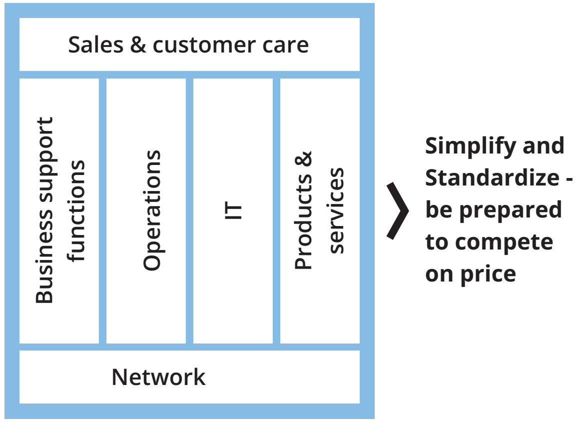
In markets where networks are of a similar high quality level and all have abundant capacity, functional differentiation becomes increasingly difficult, if not impossible. And most European telcos have failed to build significant revenue from new, emotionally-differentiating services, which are now dominated by OTTs. There are several reasons for this:

- telco executives and shareholders continue to expect (very) high margins. As new services typically provide lower returns than connectivity services, this dilutes average margins, thus reducing the appetite to approve new services.
- faced with significant challenges in the connectivity market (e.g. competitive pressure and planning constraints), management attention is drawn to these topics, reducing the time spent on building new revenue streams.
- operating networks and building new services are totally different businesses. It is very hard, if not impossible, to run both successfully in one integrated company with one type of people, a consistent culture and a single set of management systems.

How to get out of this situation?
We believe telcos need to do two things:

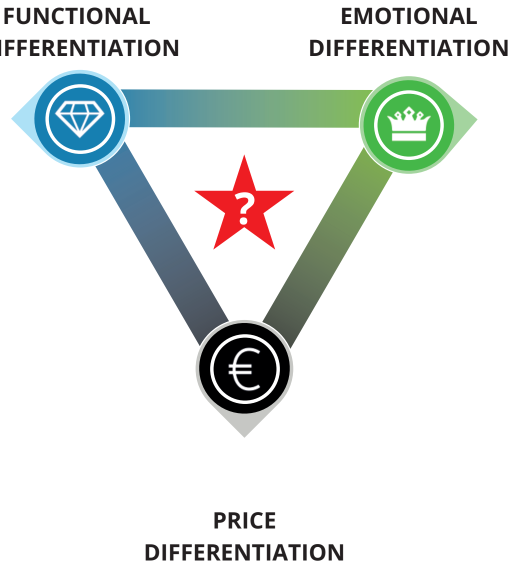
1. **Reduce costs significantly.** Emerging technologies, such as Open RAN, virtualisation, AI and cloud-native architectures, make significant cost reductions possible. It is likely that at least one of the operators in a market will exploit these opportunities. If this operator decides to then reduce prices to win market share (rather than enjoy higher margins), all the operators in the market will need to do the same. Reliance Jio's transformation of the Indian telco sector, starting with a for free period to win millions of customers, is a good example in this respect.

OPTION 1: STAY IN PURE CONNECTIVITY



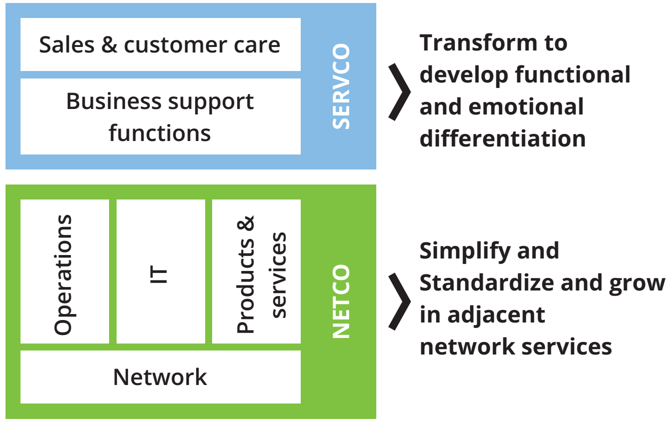
- **Radically simplify** and standardize products & services
- **Sell / discontinue beyond core activities,** continue near to core services (e.g. security, sovereignty)
- Provide **digital-native** customer experience with **self-service capabilities** to optimize customer support
- **Radically reduce** costs to be prepared for possibility of increased price competition

CURRENT STATE FOR MANY TELCOS



Many European telcos are **'stuck in the middle',** aiming to be **successful in both core connectivity and beyond core** whilst maintaining a **costly integrated operating model**

OPTION 2: ALSO GROW BEYOND CORE



- **Transform** product development, marketing, sales and marketing capabilities to an 'app-like' ServCo, focussed on innovation, partnerships and growth
- **Simplify and Standardize** the NetCo, focussed on performance, reliability and costs
- Consider **NetCo consolidation** or **network sharing** to reduce overcapacity and reduce costs

2. **Prepare the strategic decision how to sell connectivity services in the future.** Given the developments towards overcapacity and changing customer perception, it is key for an operator to investigate how connectivity in the future predominantly will be sold. Based on that, operators need to make a choice and adapt their operating model accordingly: Pure connectivity providers can remain an integrated company, based on simplified products, processes and organization. These operators should focus on a "digital first" customer journey with self-service capabilities, while radically simplifying their business to be able to compete on price, much like other utilities, such as gas, electricity and water. To grow beyond core services, operators should transform their operating model and potentially split into a NetCo and ServCo. To differentiate on functionality and emotional connection with its customers, the ServCo should focus on innovation, partnerships and growth, while the NetCo focuses on performance, reliability and costs.

To prepare is better than to be confronted

While there has been extensive research into how to successfully optimise a NetCo to create value[6], there seems to be no research how successful a ServCo could be. The uncertainty around the commercial viability of a (separated) ServCo may well be the reason why many telcos that venture into beyond core services, remain an integrated company.

In order to be prepared for that strategic discussion, in our next piece of research, we will focus on the question how connectivity will be sold in the future and how telcos can best organise their (integrated or separated) ServCo for that.

6 *TM Forum, 2022, 'Does TIM separation point to a wider trend?'; Morgan Stanley, 2019, European Telcos Build for Speed; Barclays, 2018, 'European Telecom Services – Make up of Break up'; Credit Suisse, 2021, 'European Telecoms – Breaking Them Up'; Deloitte, 2021, 'The Rise of the Netcos'; McKinsey, 2020, 'Can telcos create more value by breaking up?'; Accenture, 2020, 'Rise of the Network Company'; Arthur D. Little, 2020, 'Embracing the Future'*

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