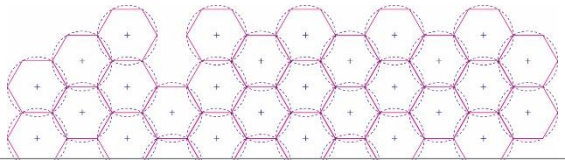
Structural solutions to telecom industry woes

Benoit Felten & Sam Wood



Throughout 2023, European network operators have been vocal in describing difficulties when it comes to their ability to invest in network infrastructure. A European Commission consultation on the matter could not reach a consensus on what the problem or solution were.

However, the starting point of their argumentation is hard to refute: European network operators suffer from low market valuation, especially compared with their counterparts in less competitive markets. It's worth exploring the reasons for that undervaluation and paths to improve this at industry level.

Shareholder Misalignment

There is no question that consumers as a whole use more broadband services than ever, whether in their homes (through fixed connections) or on their mobile devices. In order to accommodate this increase in demand, network operators (hereafter Electronic Communication Networks or ECNs) are investing significantly in network deployment and upgrades, primarily in fibre to the home (FTTH) and 5G. Economic theory would suggest that since supply followed existing demand, these investments should be viable and therefore valued by the communications networks shareholders.

However, traditional ECN shareholders seem to have limited appetite for the long-term investments that fibre and 5G require, as demonstrated repeatedly by market valuation slumps after such investments being announced (link to Proximus). Conversely, long-term investment funds like pension funds shy away from ECNs because they do not believe these companies can deliver the steady returns that fit their own business requirements.

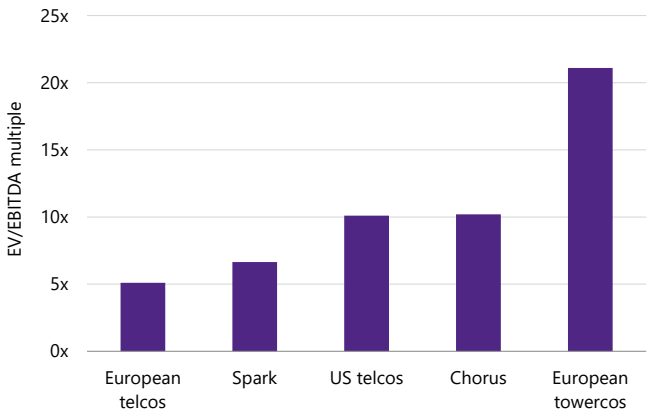
The dominant model for ECNs in the communications market today is vertical integration, whereby service providers also own the infrastructure used to enable the services they sell. There is mounting evidence that this model may not be optimal in terms of business and financial efficiency. Pure infrastructure players, be they FTTH wholesalers or towercos[1], are valued significantly higher by financial markets compared to vertically integrated players. Furthermore, pure service players, though uncommon, also seem to trade at higher multiples.

We have one leading example of voluntary structural separation resulting in increased valuation of the separated entities - Telecom NZ, in 2011. Post de-merger, after years of flat market valuation, both Chorus (infrastructure) and Spark (services) saw share prices rise. Between 2015 and 2023, the combined market capitalisation of Chorus and Spark grew by 150%, whereas that of European and US vertically integrated telcos[2] grew only by 15%.

The plan also delivered full FTTH coverage to 87% of New Zealand homes with 72% adoption.

While there are no European examples of structural separation yet, there are a number of examples of functional or legal separation (BT Openreach, TDC Net, CETIN) possibly on their way to full separation, and TIM is in final negotiations to sell off its infrastructure assets.

Figure 1: 2023 EV/EBITDA multiples of various players in the communications space



Source: Plum analysis, Morningstar Inc. European telcos: Deutsche Telekom, Vodafone, Orange, Telefonica, BT, Swisscom, Telenor, KPN, Telia, Proximus. US telcos: Verizon, AT&T and T-Mobile US. European towercos: Cellnex Telecom, Vantage Towers and INWIT.

[1] Tower companies (or towercos) are infrastructure companies that manage mobile towers for multiple mobile network operators.

[2] 'European telcos' include Deutsche Telekom, BT, Orange and Vodafone; 'US telcos' include Verizon, AT&T and T-Mobile US.

In mobile, examples of wholesale only operations are few but growing, with Malaysia, Mexico, the UK and New Zealand exemplifying various paths to separated mobile infrastructure.

The primary reason for lower valuation by financial markets of vertically integrated telcos compared to separated infrastructure and service players is that the business fundamentals and the time horizons of infrastructure are very different to those of services. Investors tend to want to finance either short-term, high-return and risky service businesses that don't invest too much CAPEX in infrastructure, or CAPEX intensive business models with long term but stable returns.

Vertically integrated operators are neither, and tend to be undervalued by the short-term investors that they have traditionally attempted to attract. A structural separation of these activities could deliver benefits to both the infrastructure side and the service side. For instance, Deloitte has estimated that after separation telco capitalisation can rise by up to 40%, compared to the original integrated company.[3] Arthur D Little also estimates that separating telcos into infraco and servco could yield an incremental 41% in enterprise value.[4]

Ways to envisage separation

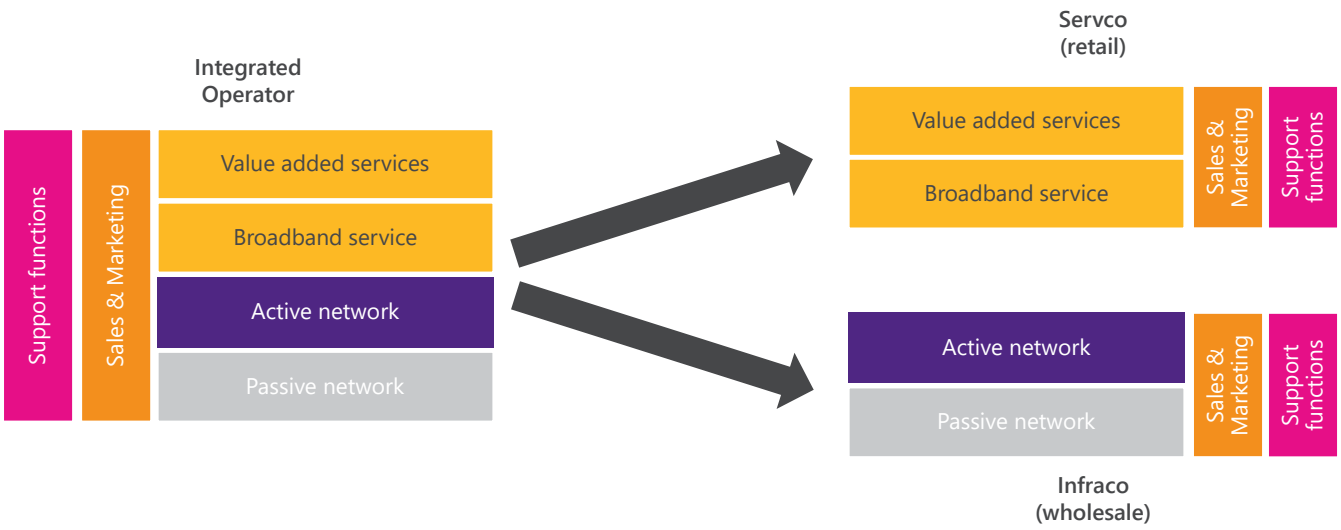
Separation was once considered as a regulatory remedy and, as a consequence, is unpopular amongst upper management of incumbent telecom operators. That is not what we are talking about here. We don't think that an enforced and reluctant process of separation necessarily leads to the positive outcomes the industry seeks.

We do however see that a voluntary and structured approach to separation has led to positive outcomes in New Zealand, that separate management of network and service entities seems to be delivering positive outcomes in the cases of CETIN and TDCNet, and that neutral host networks are emerging in many European countries, not to mention tower companies. This leads us to the conclusion that voluntary separation could deliver positive outcomes.

The question remains of how to operate this transition from vertical integration to separation. There are essentially two approaches that have been taken:

- **Demerging:** in this approach, existing shareholders of the vertically integrated entity receive shares in both the service and the network entity at the time of the demerger. They are then free to keep hold of their shares or sell them on the financial markets if they're not interested in one or the other. This is how Telecom NZ chose to separate in 2011. In this scenario, short-term shareholders will quickly sell-on their shares in the infrastructure player to long-term funds, leading to a radical shift in the nature of shareholders over a very short period of time.
- **Spinoff:** in this approach, the corporation sells the assets and associated teams of either service or infrastructure to an external party. This is the way that telecom tower deals are usually structured, but it is also the way that Telecom Italia (TIM) has decided to operate its separation.

Figure 2: Separation schematic assuming active network wholesaling



[3] Deloitte (2021). "Rise of the Netcos". https://www2.deloitte.com/content/dam/Deloitte/pt/Documents/technology-media-telecommunications/TEE/The-Rise-of-Netcos.pdf

[4] ADL (2020) Embracing the future - How can operators embrace telecom disruption? https://www.adlittle.com/sites/default/files/reports/adl_embracing_the_future-compresse.pdf

Benefits of separation

The better alignment of business models and time horizons delivered by a separated market ecosystem would deliver benefits across the board to industry and consumers.

The key benefits to the infrastructure side are:

- A **lower cost of capital** as infrastructure companies can borrow money at significantly lower rates due to their lower risk profile. For example, McKinsey noted that, due to lower borrowing costs and improved capital access, CETIN increased its network capital expenditures by 40 percent a year after separation.[5]
- The ability to **secure long term-funding,** as investment decisions on the infrastructure side don't need to compete with CAPEX requirements on the service side (product innovation, content rights, etc).
- An **expanded market opportunity and better asset utilisation** as infrastructure companies sell to all market players without discrimination.

The key benefits to the service side are:

- A greater **focus on innovation** as human and financial resources can be devoted solely to delivering better and more innovative services and leveraging unique customer relationships to compete with the global content and application providers.
- An **expanded market reach** as innovative products and service are no longer designed solely for own-network customers and can be rolled out to all customers nationally and internationally.
- Better **economies of scale** as service layer functions such as product design, marketing, sales, provisioning and customer support can more easily be centralised.

Analysts who have looked into this consider that a valuation upswing of European telcos of, on average 20%[6] - and perhaps as much as 40%[7] - could be unlocked by separating functions and ownership of infrastructure and services.

But there are also broader benefits in a separated ecosystem for digital Europe. Four key benefits can be outlined as follows:

- **extended reach for unsubsidised digital infrastructure:** as pure infrastructure players borrow at lower rates and expect lower returns, they will deploy infrastructure where vertically integrated players won't, and with no (or less) public subsidies;
- **emergence of pan-European service providers:** economies of scale in the service layer will make transnational operations more profitable and unlock appetite for pan-European consolidation. Today mergers across countries are mostly value destructive;
- **a more sustainable digital sector through more efficient use of infrastructure:** the predominance of wholesale infrastructure models will shift competitive dynamics to the retail layer of the market without impacting innovation which is now predominantly focused on higher network layers. This may lead to more efficient utilisation of assets. It would not only increase economic efficiency but also (and most crucially) environmental sustainability as the redundant multiplication of equipment and energy consumption by duplicated vertically integrated networks will no longer be necessary; and
- **reinforced sovereignty of network assets:** in a separated environment, rules enforcing sovereignty of ownership can focus on infrastructure. In a competitive service market, critical national infrastructure can more easily be served by more focused service providers who meet stringent requirements on security, quality, equipment brands, etc.

Regulatory implications

The current EU regulatory framework is tailored to work differently for different markets:

- the legacy fixed market is often characterised by a shared single nationwide access network with strong wholesale regulation and light retail regulation designed to avoid abuses of dominant positions and foster greater consumer choice. A similar regulatory approach have been adopted for Very High Capacity Networks (VHCN) in markets where the incumbent's position ended up being comparable (Netherlands, Switzerland, UK…);
- in VHCN markets where infrastructure competition is established, like Spain, there is limited to no regulation on wholesale or retail except in some cases regarding infrastructure sharing for home drops; and
- in mobile markets, there is limited to no regulation on either retail or wholesale markets, since both are usually considered to be effectively competitive.

A strong shift towards separation, especially by an incumbent with significant market power in either fixed or mobile, usually requires a strong rethink of the regulatory frameworks in a number of areas:

[5] McKinsey (Jan 2020). Can telcos create more value by breaking up?
[6] Credit Suisse (now UBS), European Telecoms, Breaking them up III, April 2021
[7] ADL (2020) Embracing the future - How can operators embrace telecom disruption?

- retail markets with increased service based competition typically only require regulation for consumer protection (pricing transparency, etc.) Arguably this could be handled by general consumer, rather than telecom specific regulation, even if it still comes under the latters' authority; and
- in some wholesale markets, separation would lead to infrastructure monopolies. The mechanics of wholesale price regulation in such markets would likely need to evolve into longer-term and more stable regimes which provide a higher degree of certainty[8], more reassuring for long term investors and better suited to infrastructure development and maintenance.

The Italian government, in the context of the imminent structural separation of Telecom Italia's fixed activities, has recently called for a rethink of the European regulatory framework along such lines[9].

Challenges

One argument that keeps recurring on these structural considerations is "why hasn't it happened yet". It's interesting to examine that question in the light of the broader industry trends:

- New Zealand and Australia have structurally separated, voluntarily in the case of New Zealand. The former is undoubtedly a success, the jury is still out on the latter.
- Italian separation of the fixed network is underway.
- Telcos all over the world have been divesting towers, their longer term asset. They mostly did this for cash, but there is some recognition that passive infrastructure (at least) is no longer a key success factor to business operations and being shared amongst competitors has led to lower costs of provision/operation.
- Rural broadband in Europe is increasingly deployed in a neutral host model with a single fibre network connecting homes and multiple service providers delivering services over that network.
- Rural mobile deployment is now following a shared infrastructure model in many markets.
- Mexico and Malaysia are examples of implementation of wholesale mobile networks designed to improve the coverage through more effective business models reliant on shared infrastructure.

However, corporate governance in the telecoms sector is not conducive to the kind of radical decisions that separation requires. Decision makers and boards are incentivised on metrics that require short term continuity, not disruption, and are therefore unlikely to lead their companies through such transformations.

The pressures to consider such approaches is only likely to increase however: In a high inflation environment, refinancing debt, which wasn't a key consideration in the last decade, is going to become a very significant challenge and may lead certain players to consider more radical options that can generate value for shareholders and tie the different layers of operations to the right time frames.

Conclusions

The fact that vertically integrated operators are frustrated with their levels of profit and valuation is understandable. It is however partly the result of investment choices in infrastructure that they made, knowing full well that infrastructure was a long-term investment that their own shareholders might not be too keen on.

The good news is that this can (relatively) easily be remedied. The structural solution is known, has been well identified by financial analysts for a while, has worked for a number of industry players and would likely be very welcome by the financial markets. All it takes now is for top management in these organisations to recognise these structural issues for what they are and have the courage to initiate a fundamental change that might lead to a challenging transition in the short term but will deliver strong benefits in the mid-term.

This is not a call for structural separation to be forced onto vertically integrated operators with significant market power, but we do urge policy makers to recognise the sub-optimal structure of the market for what it is: the root cause of a lot of the issues that electronic communication operators themselves raise as being existential threats to their future. In particular, we urge policy makers to design support for infrastructure buildout with the understanding that separated infrastructure is an inherently more efficient model that will deliver better results for the countries of Europe and cost less in public funding for the same (or better) outcomes.

[8] See evolutions in New Zealand: https://comcom.govt.nz/news-and-media/media-releases/2021/commission-establishes-maximum-revenues-and-quality-standards-for-chorus-under-new-fibre-regulatory-regime

[9] "A new vision for European and Italian telecommunications", Sen. Alessio Butti, Undersecretary for Innovation to the Presidency of the Council of Ministers, Dipartimento per la Trasformazione Digitale, October 2023

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About this Insight

This paper summarises Plum Consulting's reflections on the recent policy debate around the profitability of telecom operators in Europe and how it should be addressed. It draws on in-house research and conversations with many stakeholders in the industry (operators, investors, content providers, regulators and analysts.)

For more insight or discussions on this topic, reach out to Benoit Felten – benoit.felten@plumconsulting.eu or Grant Forsyth – grant.forsyth@plumconsulting.co.uk

For more information contact Plum at:

www.plumconsulting.co.uk