Can telcos create more value by breaking up?
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Once primarily a regulators’ tool, structural separation is beginning to attract growing interest from operators facing financial and market pressures.

Gustav Grundin, Robin Nuttall, Lorraine Salazar, Halldor Sigurdsson, and Nemanja Vucevic

Sometimes, the whole is less than the sum of its parts. At least that is the belief underpinning structural separation—splitting an integrated telco operator into two freestanding businesses: one that operates the network (the NetCo) and one customer-facing entity (the ServCo). The idea is that the resulting units will perform better by clarifying management focus and improving capital allocation, given the fundamentally different nature of these two businesses. The hope, also, is that such a move will create a market structure that requires less regulatory intervention.

The concept of separation in the telecommunications industry has been around for over two decades, though for most of that time, it has been the government’s decision to mandate it, not the telco’s choice to pursue it. Yet integrated incumbents are beginning to embrace or at least consider separation voluntarily as a way to address deepening financial and market pressures as required infrastructure funding increases dramatically in the face of the investment-heavy evolution toward 5G and fiber to the home. So far, only a few telcos have fully taken the plunge. But with the telecom sector facing headwinds, structural separation is becoming a more frequently discussed topic of major industry stakeholders.

For management, boards, shareholders, and regulators pondering the prospect of separation, the central questions remain: Can breaking up a telco create more value in the long-term? Is doing so worth the risk? And how can telcos minimize that risk?

The Czech case for separation

Separation can take different forms, from accounting separation (the simplest and most basic) to functional separation (where the wholesale and retail businesses are set up as independent units) to legal separation (where new legal entities are established but overall ownership remains the same).

The most sweeping change is a full structural separation, which entails creating two distinct legal entities. Historically, most such splits have been the consequence of government action, as a way for regulators to address perceived deep-rooted market inefficiencies resulting from having one entity, often the former state-run monopoly, dominate the telco market. While a few incumbents have considered breakups on a voluntary basis, most have ultimately opted against this path given the massive complexities involved.
That is starting to change. In 2014, O2 in the Czech Republic showed that pursuing structural separation voluntarily could generate superior stakeholder returns while greatly improving the infrastructure of the country. Four years later, Denmark’s TDC Group was acquired by a Macquarie-led consortium of buyers at a 34 percent premium to the market price with a structural separation initiative as one of the core pillars of value creation justifying the takeover.1 Telecom Italia2 in 2018 started to evaluate the possibility of setting up a separate NetCo, and that same year Telstra3 came out with plans to establish a separate infrastructure business unit. Meanwhile, shareholders or board members of at least two other carriers, British Telecom4 and Telefonica,5 requested their companies consider the same.

A detailed examination of the O2 Czech Republic case offers a good illustration of the potential upside of separation. In 2014, PPF Group, a local private-equity fund, bought O2 Czech Republic from Telefónica Group. The new owner separated the network from the retail business and took the infrastructure unit, now named CETIN, private, while keeping the retail unit publicly listed under the O2 Czech Republic name. It didn’t take long for the move to pay off for the investors (Exhibit 1).

The deal not only benefitted the new owners; the country received a significant infrastructure upgrade as well. The creation of a pure network-infrastructure player lowered borrowing costs and improved capital access such that CETIN increased its network capital expenditures by 40 percent a year after separation. From there on, capital expenditures increased by 13 percent annually. This led to a jump in fiber coverage and broadband speeds at a level rarely seen in Europe (Exhibit 2).

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**Exhibit 1**

Separation in the Czech Republic created tremendous value for shareholders

<table>
<thead>
<tr>
<th>O2 market capitalization, CZK billion</th>
<th>O2 return on invested capital, % (including goodwill and intangibles)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Before separation</strong></td>
<td><strong>After separation</strong></td>
</tr>
<tr>
<td><strong>NetCo</strong></td>
<td><strong>Before separation</strong></td>
</tr>
<tr>
<td><strong>30.2</strong></td>
<td><strong>36.9</strong></td>
</tr>
<tr>
<td><strong>68.9</strong></td>
<td></td>
</tr>
<tr>
<td><strong>99.1</strong></td>
<td><strong>33.6</strong></td>
</tr>
<tr>
<td><strong>136.2</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Jan 2015</strong></td>
<td><strong>135.7</strong></td>
</tr>
<tr>
<td><strong>Jun 2015</strong></td>
<td><strong>32.0</strong></td>
</tr>
<tr>
<td><strong>16.9</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Jun 2016</strong></td>
<td><strong>+97%</strong></td>
</tr>
<tr>
<td><strong>Jun 2017</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Jun 2018</strong></td>
<td></td>
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<tr>
<td><strong>Jun 2019</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Jun 2012</strong></td>
<td></td>
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<tr>
<td><strong>Jun 2015</strong></td>
<td></td>
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<tr>
<td><strong>Jun 2016</strong></td>
<td></td>
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<tr>
<td><strong>Jun 2017</strong></td>
<td></td>
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<tr>
<td><strong>Jun 2018</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Jun 2019</strong></td>
<td></td>
</tr>
</tbody>
</table>

Source: CETIN; investor presentation; Bloomberg; expert interview

*NetCo privately held after separation, so no market valuation available

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1 “Denmark’s TDC to be split into three units—Macquarie-led consortium,” Reuters, February 28, 2018, reuters.com.
4 Christopher Williams, “BT faces fresh calls to spin off Openreach,” Telegraph, February 10, 2018, telegraph.co.uk.
5 *Telefónica considers fixed network sale,* Mobile World Live, July 5, 2018, mobileworldlive.com.
How separation can pay off

While the specifics of how PPF Group doubled its money with the O2 Czech Republic separation is a matter of debate, structural separation in general can fuel value creation in the following five ways:

1. **Regulatory relief.** Since separation invariably alters the existing market structure and typically increases retail competition, most cases result in some form of regulatory relief. There are even EU guidelines for regulations to this effect. Before separation, O2 estimated that retail price regulation impacted roughly 25 percent of its gross margin. The company also faced several predatory pricing cases. With the lifting of these restraints, O2 and CETIN gained greater pricing and contracting flexibility. Removing nationwide retail pricing controls was particularly important in a market where rates vary greatly, given the localized nature of competition.

2. **Greater addressable market.** A carrier-neutral NetCo can grow its wholesale business with other operators, since aggregating demand from multiple wholesale customers increases household conversion rates for fiber and, hence, return on investment for new builds. In the O2 case, the carrier-neutral CETIN, untethered from its former parent, grew beyond its original business by adding subscribers and traffic from the customer bases of other operators.

3. **Cheaper access to capital.** By operating independently, financing options for the NetCo improve considerably. Since it primarily invests in infrastructure, the NetCo can attract long-term investors who are interested in buying into a physical asset. Similarly, the ServCo’s investment profile is better suited to investors who are looking for higher risk-adjusted returns. As a result, the multiples for the two entities recalibrate in a way that increases their combined valuation.

4. **Sharpened management focus.** Investment horizons differ significantly for the separated entities; NetCos usually plan in ten-to-15-year time frames (for infrastructure investments that can last for 50 to 100 years) while ServCos work with one-to-three-year investment cycles (for commercial activities, such as marketing campaigns and promotions). By separating the NetCo and ServCo, decision makers can direct strategy and budget based squarely on the specific needs of each company, leading to greater strategic clarity and operating momentum. In the case of O2, the increased focus for management translated into higher

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**Exhibit 2**

Separation in the Czech Republic has led to a wave of fresh investment in the NetCo, which has resulted in faster broadband speeds

<table>
<thead>
<tr>
<th>Cetin capital expenditures, CZK billion</th>
<th>Cetin fixed access network performance by Mbps, % share of subscribers</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>2015A</td>
</tr>
<tr>
<td>2.5</td>
<td>2.5</td>
</tr>
<tr>
<td>3.6</td>
<td>3.6</td>
</tr>
<tr>
<td>4.1</td>
<td>4.1</td>
</tr>
<tr>
<td>3.6</td>
<td>3.6</td>
</tr>
</tbody>
</table>

Source: CETIN Company overview FY 2016; Investor Presentation Jan 2017; and 1H2019; CETIN Annual Reports; Bloomberg; Expert Interview

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6 In fact, the new European Communications Code (June 2018) states that regulators shall re-assess, amend or withdraw obligations if separation is voluntarily undertaken (art 76.2) See http://data.consilium.europa.eu/doc/document/ST-10692-2018-INIT/en/pdf.
customer satisfaction ratings for CETIN, and a faster buildout of O2’s O2 TV.

5. Better suited for a 5G world. Although analysts disagree on the exact numbers and magnitude, there is broad consensus that 5G will drive up the total cost of network ownership, given the massively increased densification of urban areas and the resulting heightened requirements on capillarity of fiber deployment. A strong, independent NetCo is better positioned to support the industry’s need for fiber rollout than an integrated carrier. As a neutral party, it is also a natural orchestrator for the increased network sharing that 5G is likely to prompt. A recent McKinsey 5G survey found that 93 percent of chief technology officers expect increased network sharing to occur with the onset of 5G.7

Why separation can backfire

While separation has the potential to generate significant value creation, it is also a high-stakes venture that can destroy value if managed poorly or pursued under the wrong preconditions. By giving up their network ownership ServCos could, for instance, face higher transaction costs in their day-to-day dealings with the NetCo and lose several important advantages, such as:

— preferential treatment in fixed deployment through price differentiation or operational integration
— ability to apply similar preferential treatment in mobile through bundling and cross-subsidization
— power to direct NetCo investments into areas that benefit the ServCo, driven by regional market-share differences
— full control of certain types of product development that require deep integration into the network (for example, certain IoT use cases)

The extent to which the loss of these advantages will impact the ServCo depends largely on the regulatory frameworks that will be adopted after the separation as well as on the details of the commercial contracts governing relations between the ServCo and the NetCo.

Separation is also costly and time-consuming. British Telecom estimated that a previous functional separation had cost them more than $1 billion,8 and historic cases indicate that the process can take anywhere from two to five years, consuming significant management attention, and potentially all but paralyzing leadership. IT systems separation alone can take as long as 18 months, during which time typical product development generally grinds to a halt.

When separation makes sense—or doesn’t

Carefully weighing the pros and cons of separation before making a choice is not simple. Individual markets and operators differ greatly with regard to the parameters that determine the potential upside and downside. Given the irreversible nature of the decision, management, boards and investors should carefully evaluate each of the drivers.9

These determinant factors include the scope of the current regulatory environment, which could be reduced as a result of separation and thereby unlock value; the amount of growth potential from increasing investments in infrastructure; and the extent to which the NetCo could play an active role in future network-sharing arrangements. They also include the ability of the ServCo to lock in some post-separation downside protection, such as a limited form of preferential coordination with the NetCo or a clear commercial opportunity on the retail side. Finally, there is the sheer complexity of the undertaking, the time required to complete it, and the sustained management focus required (Exhibit 3).

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8 “Strengthening Openreach’s strategic and operational independence,” Ofcom, July 2016, ofcom.org.uk.
9 For a broader overview of separation and spin-offs and key drivers of value creation, see Bill Huyett and Tim Koller, “Finding the courage to shrink,” August 2011, McKinsey.com.
Getting separation right

There is no doubt that executing structural separation is one of the most complex and arduous journeys a telco management team can undertake. Yet, done well, it can potentially deliver huge returns. Success stories to date provide a clear picture of the trickiest issues to address. These include:

— **Asset and activity delineation.** Deciding which assets belong to the ServCo and which should transfer to the NetCo is not a trivial exercise. When figuring out how to divide assets, executives need to consider both synergies and downstream implications. In addition to apportioning out core network functionalities and different customer interfaces, they need to address strategic questions such as how spectrum ownership will be assigned, choices that impact how the mobile network is designed and how wholesale capacity decisions are made.

— **Organization and process redesign.** The breakup will require the NetCo and ServCo to create new processes, retrofit other ones, and create efficient information-sharing mechanisms. These efforts are complicated by two factors. First, many processes (such as provisioning) crisscross the incumbent's network and customer-facing organizations. Disentangling them requires a comprehensive process redesign effort. Second, integrated players also depend on many informal and undocumented processes in their day-to-day work. Failing to manage the process-redesign effort effectively will almost certainly lead to disruptions in the network operations.

— **Commercial contract.** Creating a commercial contract that governs every
activity and service that the NetCo is currently providing to the ServCo is a monumental task. From a transparency and governance standpoint, it is also the most critical way to clarify any advantages the ServCo may forfeit after the split.

— **IT-systems separation.** Each telco has a unique IT setup, usually a patchwork quilt of operations support systems and business support systems, some of them homegrown, most of them integrated across functions that will end up on different sides of the separated entity. Inevitably, some systems will have to be duplicated, some retired, and some built anew.

Addressing these changes successfully hinges on two things—timing and teaming. First, management needs to pay attention to the proper sequencing of tasks. Not all issues can be addressed in parallel, since the resolution of some are prerequisites for tackling others. Secondly, different tasks require very different talent profiles and capabilities. Some tasks, for instance, require significant expertise and analysis. Others require a tolerance for slogging through straightforward but laborious work for weeks or months on end. Still others, like the separation of IT, require both. Shaping the right road map and establishing the right project teams will have a significant bearing on the quality of the outcome (Exhibit 4).¹⁰

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### Exhibit 4

**A structured approach is required in defining, negotiating, and documenting all principles toward structural separation**

**Phases of separation**

<table>
<thead>
<tr>
<th>TODAY</th>
<th>Up to 8 MONTHS (Organizational separation)</th>
<th>Up to 12 MONTHS (Legal separation, with group structure)</th>
<th>FUTURE (Legal separation, of entities)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Formalise target deal structure</td>
<td>Negotiate principal agreement</td>
<td>Write out contacts and terms of service agreements (TSAs)</td>
</tr>
</tbody>
</table>

**Objectives**

- 1. Define overarching direction and principles of separation
- 2. Write out contract principles
- 3. Mediate and "judge" between NetCo and ServCo
- 4. Develop TSAs and contracts
- 5. Mediate and "judge" between NetCo and ServCo (core team)

**Activities**

1. Develop "paramount principles" of separation
2. Define list of requirements for legal separation
3. Develop list of products/services required between NetCo and ServCo, and prioritize based on criticality
4. Define negotiation governance
5. Describe NetCo and ServCo business model and simulate P&L
6. Stress-test business models

1. Define financial split, to act as baseline for contracting terms
2. Develop business principles for each overarching product/service
3. Define responsibility matrix of NetCo and ServCo in each process step of product/service
4. Define high level business model for each contract/service
5. Develop TSAs for each overarching product/service, including:
   - Service catalogue
   - Pricing catalogue
   - Service level agreements
   - Transition governance
6. For relevant products/services, write up long-term contracts

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Structural separation offers the potential for significant value creation, but the risks and complexity of carving out deeply interconnected businesses are great as well. While the jury is still out on whether it will become a more widely adopted business model, success depends on a close understanding of the market and regulatory environment, a comprehensive change-management plan, and an investment case that recognizes that separation is a long-term play that requires considerable ramp-up time and downside protection for ServCo businesses.

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