

Telecommunications Practice

# Telecom operators: Surviving and thriving through the next downturn

Telco operators are more vulnerable today than they were ten years ago. To thrive through the next economic downturn, they must act now—and with focus.

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**It has been a decade** since the last economic downturn—the longest gap between downturns in 50 years—and some companies are beginning to prepare for the next one. The most recent downturn made for extremely tough operating conditions for telecom operators. Customers sought to pay less and canceled contracts more easily in an environment of more intense competition. From 2007 to 2009, many European operators' average revenue per user (ARPU) dipped by more than 15 percent, and churn rates rose by the same amount for operators in both North America and Europe.<sup>1</sup>

To understand what operators can and should do to prepare for the next downturn, we studied what resilient operators in North America and Europe—those in the top quintile of the industry by total shareholder returns (TSR) and economic profit during the most recent recession—did differently (see

sidebar, “About the research”). These winners saw up to 48 percent greater revenue growth over the subsequent ten years than the rest of the telecom industry as well as stronger margin performance and greater economic profit by 17 percentage points.

Our research has revealed that, at each point in the cycle (pre-downturn, during the downturn, and post-downturn), a set of focused, high-impact actions, undertaken in the right sequence, has historically helped operators steer toward outperformance. The challenges many telecom operators face, including a difficult operating environment, supply-chain uncertainty, and heavy investment requirements in the coming years, have become more severe since the most recent recession. Telecom executive teams must plan now for the next downturn to build resilience and safeguard their company's outlook and growth. By combining high-impact actions

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<sup>1</sup> CPAnalytics; Capital IQ.

## Sidebar

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### About the research

**We analyzed the actions** of telecom operators before, during, and after the downturn of 2007–09 by first selecting the appropriate company set. This set comprises publicly listed telecom companies in North America<sup>1</sup> and Europe with revenue exceeding \$100 million in 2007, with a few exclusions—for example, companies with limited total shareholder

returns (TSR) data availability. Our analysis focuses on Europe and North America, but the insights can prove useful for operators across the globe.

We identified resilient companies as those with average TSR from 2007 to 2011 in the top quintile of the telecom industry. We compared these resilient

operators with the telecom companies in the other four quintiles, as well as with companies in other industries, across a variety of operational and financial metrics to assess the key attributes of resilience. Although we chose TSR as the key performance metric for our analysis, looking through the lens of economic profit yields similar results.

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<sup>1</sup> North America refers to Canada and the United States.

with approaches specific to their individual needs, operators can not only survive but thrive through the next recession.

### Operators today are in a worse position to withstand a downturn

Relative to companies in other industries, telecom operators were disproportionately affected by the most recent recession. Economic profit declined, margins deteriorated, and TSR suffered. This was especially true compared with adjacent sectors such as media and technology, which maintained more consistent profitability and higher returns on smaller asset bases.

Since then, the baseline scenario has worsened. Telecom performance has significantly lagged behind the market (large listed companies in Europe and North America), particularly in Europe (Exhibit 1). From 2007 to 2018, North American telecom

revenue grew 20 percent, 28 percentage points less than the North American market. In Europe, the picture has been even bleaker, with a 24 percent decline in revenue over the same period compared with market growth of 18 percent.

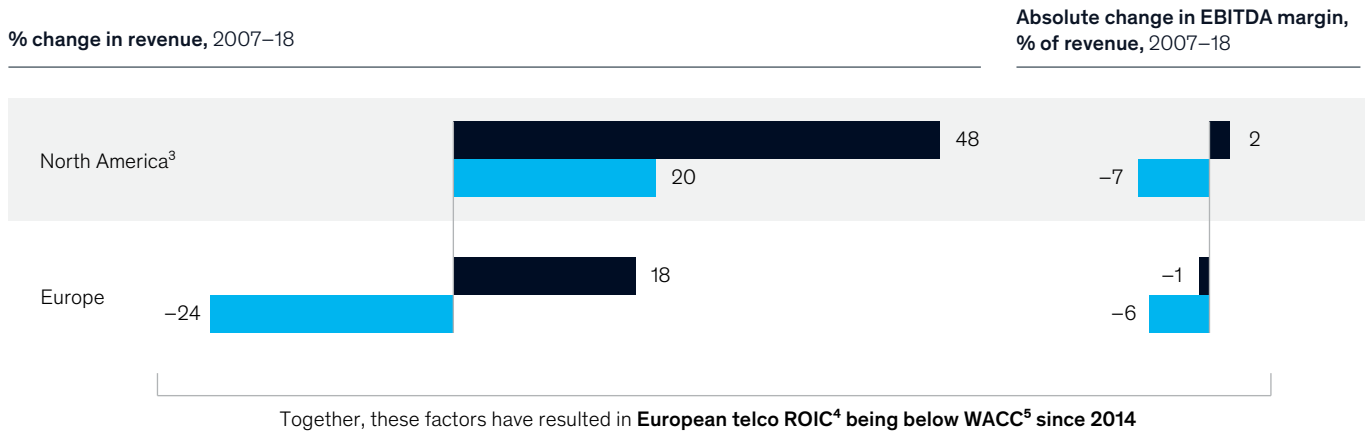
It's not just the top line that has suffered. While new operating models provided some scale efficiencies over the past decade, those savings weren't enough to compensate for declining revenue. The telecom industry in Europe and North America experienced six- and seven-percentage-point declines, respectively, in earnings before interest, taxes, depreciation, and amortization (EBITDA) margin from 2007 to 2018.

In addition, while many industries are deleveraging following the scars of 2007 to 2009, operators' use of leverage has been rising, driven by high capital-expenditure requirements and consolidation in parts of the industry. The margin decline combined

Exhibit 1

### Revenue and margin declines since the 2007–09 recession have left operators in a weaker position to weather a downturn today.

■ Market<sup>1</sup> ■ Telco operators<sup>2</sup>



Note: Includes North American and European listed companies with 2007 revenue >\$1 billion and telco operators with 2007 revenue >\$100 million. Excludes companies with extreme revenue growth (+300% or -100%) or with extreme EBITDA margins (+100%, -50%).

<sup>1</sup> Market calculated as a weighted average (according to average market cap 2007–18) of medians across sectors.

<sup>2</sup> Telco calculated as the median within sector.

<sup>3</sup> North America refers to Canada and United States.

<sup>4</sup> Return on invested capital.

<sup>5</sup> Weighted average cost of capital.

Source: CPAnalytics; Capital IQ; McKinsey analysis

with growing capital expenditure sets the stage for challenges and limits the cash available to pay mounting interest and capital repayments. Operators that have increased their leverage most quickly could face a liquidity challenge in the event of a downturn and the subsequent tightening of operation conditions (Exhibit 2).

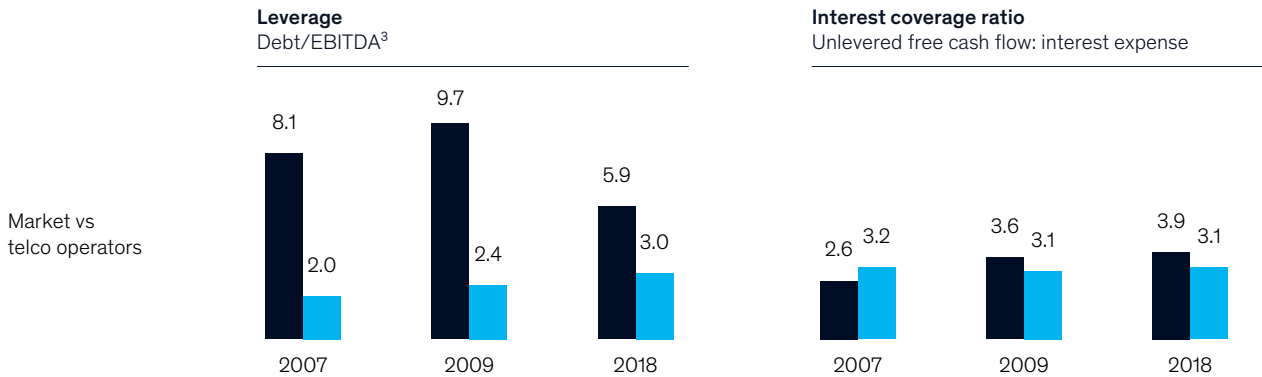
As consumer telco products become more commoditized and customers become more attached to their core services, it's unclear whether the next downturn will hit operators as hard as the most recent one. However, many of the factors that created the challenging conditions of 2007 remain

in place today. The increased capital-expenditure competition of the past decade will continue, with the investments required in fiber and 5G increasing over time and putting further pressure on leverage levels. Intensifying competition among operators, especially in Europe, will continue to limit their ability to adjust pricing to maintain margins for which returns on equity have already dropped on average below the cost of capital. Furthermore, competition from nontraditional operators, especially media and tech players for over-the-top (OTT) services such as video streaming and cloud storage, will continue to erode revenues. These challenges would only escalate in a downturn.

Exhibit 2

### Rising debt and falling profits have left operators exposed to liquidity risks, especially as operating conditions tighten during a downturn.

■ Market<sup>1</sup> ■ Telco operators<sup>2</sup>



Note: Includes North American and European listed companies with 2007 revenue >\$1 billion and telco operators with 2007 revenue >\$100 million.

<sup>1</sup> Market calculated as a weighted average (according to average market cap 2007–18) of medians across sectors.

<sup>2</sup> Telco calculated as the median within sector.

<sup>3</sup> Earnings before interest, taxes, depreciation, and amortization.

Source: CPAnalytics; Capital IQ; McKinsey analysis

## Lessons from the past

Fortunately, telecom operators can learn from the past. Key elements of the business model are the same today as they were before the most recent downturn, in which resilient operators (“resilients”) significantly outperformed the rest of the industry (“nonresilients”) as well as the market overall. Resilients increased revenues by 26 percentage points more than nonresilients during the downturn. This momentum continued during the recovery and beyond, with resilients increasing revenues by 38 percentage points more than nonresilients by 2018 (Exhibit 3).

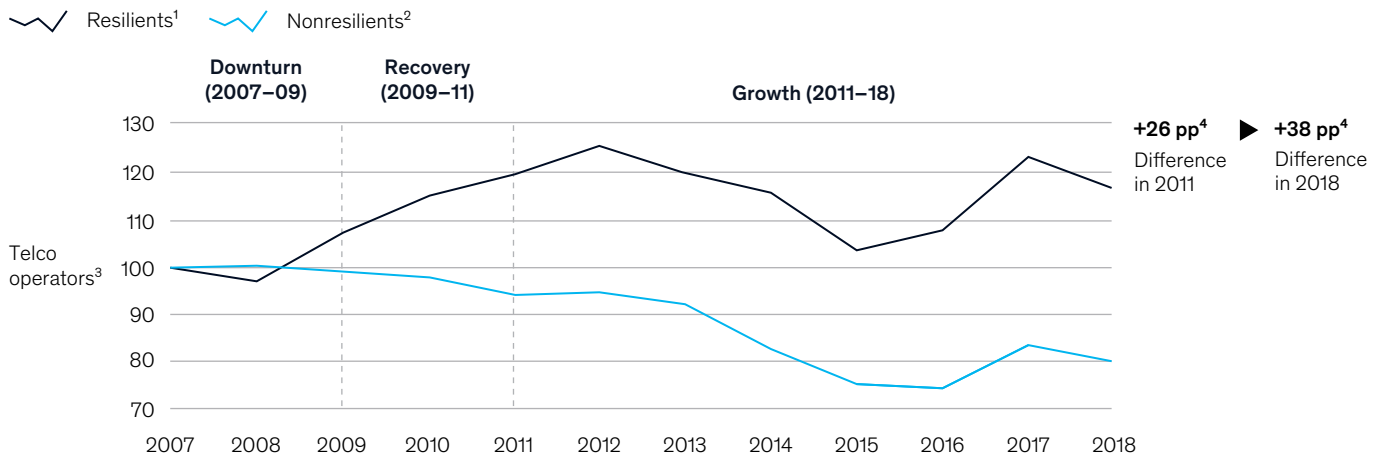
How did they do it? While they made bold moves, such as deleveraging the balance sheet sharply and cutting operating expenses for cost efficiency, a key determinant of their success was timing. In fact, resilients were making bold moves well before the downturn began. These moves, combined with others during and immediately after the downturn, allowed these operators to systematically outperform nonresilients.

Of course, nobody can predict the scale and severity of the next recession, but this article can serve as a guide for executives, outlining actions to take before, during, and after a downturn.

Exhibit 3

## Resilient operators outperformed nonresilient operators during the recovery and widened their lead in the years to follow.

Revenue growth, indexed to 100 (FY2007)



Note: Includes European and North American listed companies with 2007 revenue >\$1bn; telco operators with 2007 revenue >\$100m. Market calculated as a weighted average (according to average market cap 2007-18) of medians across sectors. Telco calculated as the median within sector. For nonfinancial corporations only. Excludes companies with extreme revenue growth (+300% or -100%) or with extreme EBITDA margins (+100%, -50%).

<sup>1</sup> Telco operators within the top 20 percent of the industry by total shareholder returns (TSR) during the most recent recession.

<sup>2</sup> Telco operators within the bottom 80 percent of the industry by TSR during the most recent recession.

<sup>3</sup> Telco calculated as the median within sector.

<sup>4</sup> Percentage point.

Source: CPAnalytics; Capital IQ; McKinsey analysis

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## Pre-downturn: Reinforce the core

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## During the downturn: Be nimble and protect key investments

3

## Post-downturn: Invest for growth

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1

### Pre-downturn: Reinforce the core

Preparing for the downturn may be the most important contributor to resilience. In the most recent downturn, resilient operators took a number of proactive actions that can prove instructive.

They started by optimizing the balance sheet and deleveraging, freeing up the cash they needed to continue investing in critical infrastructure during the recession, and ramping up investment and acquisitions into the recovery. Today, with leverage high, this will be more important than ever.

Telecom companies will be challenged to find a balance between deleveraging and continuing to invest in capital assets. Indeed, a high-quality mobile and fixed network is the core product of a telecom company. Resilient operators managed to keep up investments through the most recent downturn while nonresilient operators pulled back on such investments. Successful telco executive teams are generally willing to be aggressive, including by divesting noncore assets while seeking innovative solutions to sustaining network quality, such as network sharing and separation and big efficiency initiatives to reduce the total cost of ownership.

Finally, resilient operators heavily invested in their core revenue engines well before the recession, especially in areas with lead time. This could include building advanced analytics capabilities to better understand customers' willingness to upgrade hardware or services, so that the operator can personalize offers and solidify retention processes.<sup>2</sup> Such actions will provide a distinctive edge throughout the downturn.

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### During the downturn: Be nimble and protect key investments

Amid the downturn, resilient operators focused on efficiency and being nimble, reacting quickly to market opportunities and threats to their core business, reducing costs, and optimizing capital. Assuming the balance sheet is prepared in advance, this is the time to layer in short-term moves.

For example, a downturn provides a unique moment to begin the difficult process of cost rightsizing. Whether it be streamlining the organization or renegotiating with suppliers, such as hand-set providers, the urgency of the situation can be a highly effective impetus for change. Resilient operators

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<sup>2</sup> For more on analytics in marketing and sales, see Guido Frisiani, Jay Jubas, Tomás Lajous, and Philipp Nattermann, "A future for mobile operators: The keys to successful reinvention," February 2017, on McKinsey.com.

were able to reduce operating expenditures as a percent of sales by 1.2 percentage points more than nonresilients. One Spanish telco, for example, pursued operating and capital-expenditure cost-savings measures in 2008 and 2009. The telco reduced operating costs by 5 percent in the first three quarters of 2009 and was able to maintain profits on par with 2007 throughout the downturn despite significant revenue decline.

However, while rightsizing operating expenditures is important, reducing key network and IT investments during a downturn does not correlate with resilience, and safeguarding such expenditures should be a priority.

Beyond cost efficiency, the ability to make fast adjustments that affect sales and revenue is crucial during a downturn. Many markets, particularly in Europe, are so carefully balanced that big changes to price or aggressive marketing campaigns can be destructive. Resilient operators prepared the outline of campaigns in advance, which enabled them to be nimble in their decision making during the downturn. Some leading players used war-game scenarios to help set parameters for sales and pricing strategies so they could make the right decisions quickly at key moments.

### 3

#### **Post-downturn: Invest for growth**

Many of the benefits of resilience are harvested after the downturn. From 2007 to 2009, resilient operators grew revenue 9 percent more than nonresilient operators; by 2011, resilient operators had grown revenue 27 percent more than nonresilient operators compared with 2007. While the

actions in the six to 12 months after a downturn are partly dependent on the choices made before and during, resilient operators across the board focused on this growth and quick recovery. Specifically, resilient operators ramped up capital expenditures again after the recession much faster than nonresilient operators, to 16 percent of sales compared with just 13 percent among nonresilient operators. Of course, the ability to do so relies on having cash available to invest.

In deciding *where* to invest, resilient operators carefully analyzed how opportunities aligned with their strengths and their customers' needs. During recovery, multiples are still depressed, and competitors are likely still carefully scrutinizing spending decisions—but resilient operators had created room for investment via revenue growth and a healthier balance sheet. Thus, placing strategic bets on both organic and inorganic opportunities to create better customer service and network quality was a powerful tool for spurring growth and setting resilient operators up for the future. This activity is demonstrated in the higher rate of M&A among resilient operators during recovery: the average resilient operator performed 1.6 acquisitions in the year after the recession compared with 0.9 among nonresilient operators.

The recovery period is also the time for investments in long-term capabilities, and resilient operators have been able to not only grow healthier businesses but also implement next-generation operating models and capabilities. Resilient operators extended their lead beyond the end of the recession with large investments in technology, including artificial intelligence, advanced analytics capabilities, and automation across sales, customer service, and operations. Leading operators also pursued growth opportunities outside their core revenue engines;

**Resilient operators ramped up capital expenditures again after the recession much faster than nonresilient operators, to 16 percent of sales compared with just 13 percent among nonresilient operators.**

today, some are realizing a significant percentage of revenues from adjacencies such as digital and OTT services for consumers and cloud and cybersecurity services for businesses.

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As operator CEOs and executive teams begin to think about the next downturn, they should ask themselves several questions to gauge their preparedness and to guide their actions.

- **Is a potential downturn factored into my planning process?** A clear understanding of historical features of downturns and how they will affect key operating metrics is critical. Executives should consider how expected customer and supplier behavior will affect pricing, churn, and acquisition. And they must understand which actions will be harder to take in a crisis, such as those to reduce network spending, raise prices, or run successful marketing campaigns.
- **If a downturn hits today will I be one of the resilient on the other side?** Moving early makes all the difference. Resilient will have considered the key predictors of success going in, such as by reducing leverage (for example, through network sharing or divestments) or building a robust plan to reduce customer churn and propel acquisition. Now is the time to act.
- **Do I have a robust plan that keeps the revenue engine going while maintaining investments in the network in tough operating conditions?** The network is the ultimate asset for many operators in the longer term. A robust plan that

ensures key infrastructure investments can be maintained—for example, through creative partnership opportunities—is crucial for resilience.

- **Is the organization set up to be nimble and move quickly?** Speed will be a true differentiator for telecom players, many of which are already experiencing difficult conditions. Leaders should ensure the operating core can get campaigns and products to market faster than competitors; that governance is simple, allowing big decisions around investments and divestments to be made quickly; and that the company harnesses digital capabilities to shorten the timeframe of customer interactions. If operators lag in this area, they should set up market-development teams focused on speed.
- **Do I have the right leadership?** Thriving through a downturn will take the full strength and character of the organization, and big decisions will need to be made by the board and top executives. Operators should ask what each of their function's downturn plans are and ensure top talent is able to implement those plans. They should also think through leadership implications when setting objectives and incentives.

Operators that take immediate and sustained action will find themselves on the path to surviving and thriving through the next downturn. Those that prioritize specific actions in each phase of the downturn will likely find themselves outpacing their competitors on the other side.

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