Facing disconnection: **Hard choices** for Europe's telcos

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Two years ago, the fate of the Continent's telecom companies seemed to depend on their willingness to enter new markets aggressively and acquire expensive assets. Now, survival may depend on a selective retreat.

It once seemed that Europe's telecommunications operators could do no wrong: emboldened by a general belief that they would reap outrageous benefits from the rise of the Internet and from even newer technologies such as the Wireless Application Protocol (WAP), their shares were star performers. But the bright future that seemed so assured a year ago has disintegrated into uncertainty. After leading the bull market up to the year 2000, the telecom sector is now leading the downturn, and day-to-day trading remains volatile. Many players are struggling to survive.

Blame for the industry's change of fortune can be apportioned among various factors. Most incumbent operators, in their enthusiasm to capture a share of the telecom boom, amassed huge debts, largely from the scramble to stay ahead in the wireless arena. Over the past two years alone, companies spent $46 billion for third-generation (3G) mobile licenses in Germany and $36 billion for licenses in the United Kingdom. Meanwhile, new technologies such as WAP and UMTS (the Universal Mobile Telecommunications

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System) failed to take off. Finally, the gap between the best and the worst performers in the market widened across business lines, making it even more difficult for the laggards to attract capital to pursue their growth strategies. Without a truly significant breakthrough that would generate additional revenue—along the lines of prepaid telephone cards, which introduced mobile telephones to a new group of customers—it is difficult to see how some integrated incumbents will regain healthy growth rates or even survive.

The sector must therefore contemplate a fundamental restructuring. The present market structure in Western Europe—five large integrated incumbents and ten smaller integrated companies, most catering to national markets and generally holding majority stakes in several business areas—can't be sustained. Most companies will have to embark quickly on the unpalatable task of shedding their assets and stepping away from areas they thought were core businesses.

When they have done so, Europe will be left with two or three large integrated telecom companies holding majority stakes in data, wireless, and wireline services. Some of the remaining companies, generally incumbents in small countries, will have become more focused; others will have dropped everything except their wireline operations or succumbed to takeover. The timing is difficult to predict, but these changes are likely to unfold over the next five years (*see* sidebar, "The timing remains unclear").

The timing remains unclear

Even though the drivers of restructuring are clear, the speed of the overall industry transformation will depend on three main factors.

First, some European governments still hold either sizable stakes in telecom operators or influential golden shares, and sometimes both. Political considerations could thus override business ones in any transaction.

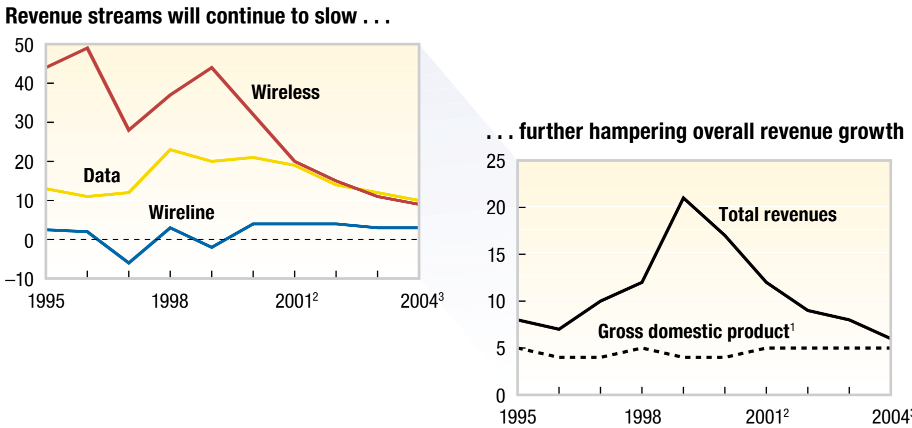
Second, the continued fall in the price of telecom shares and the volatility of stocks will make agreement on the value of assets and stocks difficult when mergers and acquisitions are priced. Some companies have been reluctant to sell assets they believe are undervalued by the market.

Finally, there is a tremendous stock overhang on the European market. By some estimates, shares valued at €90 billion to €100 billion remain to be issued from public and private offerings that have already been announced. Initial public offerings and other share offerings could be delayed for fear of saturating the market.

EXHIBIT 1

Slowdown ahead

Annual revenue growth for telcos operating in Western Europe,[1] 1995–2004, percent



[1] Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and United Kingdom.
[2] Estimated.
[3] Forecast.
Source: DRI-WEFA (Data Resources Incorporated–Wharton Economic Forecasting Associates); Gartner; International Telecommunication Union; McKinsey analysis

The need for less debt and greater scale

In the absence of a market breakthrough, overall revenue growth for the telecom sector is likely to fall by 2004 from the heady 20 percent realized in 1999 to levels approaching the growth rates of Europe's gross domestic products (Exhibit 1). Such anemic progress won't satisfy the expectations of the market and will make it harder for incumbents to service their debt.

The remedy for most companies lies in abandoning efforts to compete in all three main business areas: wireline, wireless, and data services. Wireline generates about 70 percent of total gross cash flows for most incumbents, so it will remain a major cash source for all of them. But providing both wireless and data services isn't an option for them all even though these are the two most promising avenues of growth, with revenues likely to have expanded by 9 and 10 percent a year, respectively, by 2004. Most companies will have to choose between the two, and some of them will have to be content with offering only wireline services because they lack the scale and buying power that are so important for success in the wireless and data markets.

During the exuberant years of the late 1990s, an incumbent's natural advantages, particularly its infrastructure, sufficed to secure a good share of a growing market. These assets remain vital but will no longer be enough to capture market growth, particularly as deregulation and new technologies open the infrastructure and the market to new contenders. Soon, factors that are influenced by scale, such as efficient marketing and the rapid development of new products and services, will become more relevant. When equipment makers and other suppliers develop a new product or feature, for example, they work together with larger operators, which thus have a head start in offering such novelties to the public and an opportunity to influence the way they are developed.

Moreover, to capture the growth potential of wireless or data services, a company needs deep pockets. It would cost tens of billions of euros—far more than the market capitalization of most small integrated operators—to buy even a 5 percent share of the European mobile-telephone market. To succeed in both areas simultaneously would require deeper pockets still. Yet most integrated incumbents have already made their big investments, particularly in 3G mobile licenses. By mid-2001, the total debt held by the eight largest European telecom operators already amounted to €240 billion ($213.7 billion), double the figure for 1999. Thus burdened, most incumbents will find a sustained integrated strategy out of reach.

Time for a decision

This state of affairs leaves many incumbents retaining their wireline businesses but having to decide whether they should sell—or at least relinquish control over—their wireless or data operations.

Wireless

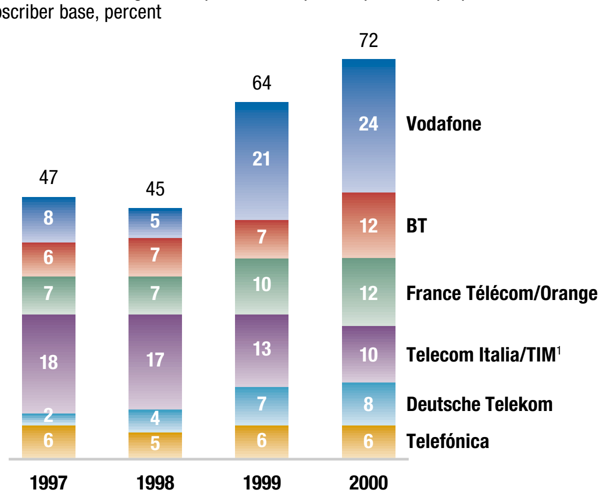
Europe's wireless industry is under intense pressure. Demand for the new technologies in which the sector has invested so heavily has fallen short of projections, and returns from that investment are unlikely to materialize for five to ten years. Substantial restructuring will certainly continue.

So far, the flurry of mergers and acquisitions has meant that the six leading wireless operators hold more than 70 percent of the subscriber base in Europe (Exhibit 2)—a clear sign of the value that operators attach to scale in this business. Vodafone, for example, has said that synergies from consolidation could represent up to 20 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA) within two to three years. Among the benefits of size and geographic coverage are preferred access to new technology, the development of a global brand that offers scale advantages in marketing, faster launches for new products and services, better offerings to corporations, and preferential roaming agreements (the pacts that allow customers to use their mobile telephones outside the base of their operators).

EXHIBIT 2

Six operators lead the market

Market share of 6 largest European mobile-phone operators, proportionate share of subscriber base, percent



[1]Telecom Italia Mobile.
Source: EMC World Cellular Database; McKinsey analysis

The pace and extent of the restructuring still to come will be affected by the emergence of mobile virtual-network operators (MVNOs),[1] which buy capacity from existing network owners. MVNOs such as Virgin Mobile, already present in some markets, will have an increasingly great impact as more countries change their regulations to give these asset-light operations access to networks. The development of wholesale markets, which enable infrastructure owners to sell excess capacity more easily, will also determine how quickly MVNOs expand throughout Europe. Since incumbents have to bear the heavy infrastructure costs that virtual networks avoid, those incumbents will need efficiencies of scale to compete.

How quickly applications for wireless data services catch the public's fancy is another question that will affect the timing of this restructuring. If our expectations are confounded, and public acceptance takes less than five years to develop, the contenders would have more room. Some of the pressure would thus be lifted from incumbents, which would share in the accelerated market growth. For most incumbents, though, we expect that growth will come too late to help them carry on as integrated operators.

Because of the need for scale, European wireless will eventually be dominated by three or four large operators—focused companies and incumbents that have successfully followed an integrated approach. At the national level, some domestic operators will remain competitive thanks to their existing infrastructure, but they will find their market share slowly eroded by larger rivals. We envisage that companies such as Orange and Vodafone, which already have a healthy presence in all of the biggest markets, will try to complete their pan-European coverage band as they search for ever greater scale. Others, such as Deutsche Telekom, Telecom Italia Mobile, and Telefónica

[1]MVNOs own the customer relationship of a wireless brand but not the infrastructure, which is leased. As a result, they can be more flexible in targeting valuable customer segments.

Móviles, which have operations in one or two large markets outside their home countries, could also bid for a wider Continental presence, though not all will succeed. Smaller companies that avoid being swallowed by the bigger fish could merge among themselves or forge alliances in an attempt to build regional competitors.

The unfolding of such a scenario could, however, be hindered by government antitrust watchdogs and by regulators pushing for increased competition and lower prices. Moreover, some mergers could make redundant the licenses for which each successful candidate paid billions of dollars. Writing off so large an investment would be a bitter pill to swallow.

Data

In Europe, revenue from data services—which make it possible to transfer digital information between different computers—has been growing by about 20 percent a year (compared with about 4 percent for voice services) as more companies wire together their branches and outlets and more consumers seek access to the Internet. At first, providers of these services focused on large corporations, such as banks, that rely on the massive real-time exchange of information, but the market is quickly diversifying.

National incumbents have strong local positions, since about 90 percent of revenues still come from domestic traffic. But these positions are coming under attack, first from operators of city rings and metropolitan area networks[2] and then from international data carriers, which are turning to domestic traffic as they attempt to find uses for their overcapacity. As these attackers try to expand their reach, they are moving quickly into the small- and midsize-business markets.

If incumbents do nothing, they will see attackers erode their share of domestic traffic. But to defend their current positions, they will have to make an expensive commitment to deliver more efficient services and to develop new capabilities. To harvest some of the growth potential, they could pursue asset-light data services for their domestic customers' foreign operations or target promising foreign niche markets—small and midsize businesses, for example. A further possibility is data hosting (services that manage and distribute content within a network).

The boldest option would be to enter the international arena with a large acquisition, perhaps of a global company hurt by falling market valuations. Such a strategy would depend heavily on scale to make an adequate return

[2]High-speed data carriers, connecting different locations within a city, that have targeted large corporate customers.

on, say, infrastructure investments and to attract the necessary expertise and other resources. We estimate that a company would have to be among the top three in each national market it entered if it is going to reach the appropriate scale.

> For a company that had the right internal skills, data services could prove **less risky** than wireless

For an incumbent with the right internal skills and expertise, focusing on data services could be less risky and less expensive than focusing on wireless operations. Although both data and wireless strategies can be approached one country at a time, the up-front costs for wireless tend to be much higher. Moreover, providers of data services can more easily focus on customers concentrated in small areas, such as urban centers.

Wireline

Owing to the competitive advantages of incumbency—a wide-ranging infrastructure, an unmatched customer base, and near universal brand recognition—wireline operators have been assured of reasonable and stable cash flows. Even attackers have posed less of a threat than expected. So barring unexpected regulatory moves, traditional wireline businesses will see little change in their basic structure during this period. Largely because legacy systems are grossly mismatched, the synergies from international mergers of wireline businesses would result in savings of a mere 4 to 6 percent of EBITDA. In reality, even such meager returns as these would be very difficult to capture.

Two factors could spark exceptions to this forecast. First, mergers between operators in neighboring countries could make it easier to extract value. Second, group-wide mergers of equals among integrated companies could result from tactical moves to block competitors or to buy coveted wireless or data service operations that were not available separately. But neither scenario is likely to create a strong rationale for wireline mergers, and deals will be scarce.

Meanwhile, the attackers continue to face competitive difficulty. Indeed, some of the larger incumbents may be tempted to take over struggling attackers, though we don't expect any significant shuffling of wireline assets. Instead, low-performing local attackers could continue to merge in an attempt to accumulate a significant customer base or to create a sustainable financial position. Also, incumbents that have achieved greater scale and operational efficiency are well positioned to exploit turnaround opportunities involving smaller companies.

In any event, wireline businesses cannot continue unaltered. Incumbents must still struggle with attackers for the small- and midsize-business markets, absorb continued price falls, address the substitution of wireline services by wireless ones, and deal with the possibility that consolidating attackers will succeed in renewing their vigor. To succeed, these incumbents will have to reduce their costs, enhance their capital-management skills, and profitably provide new infrastructure technologies, such as Digital Subscriber Line connections. In tackling these challenges, incumbents face a choice between following the traditional approach, which focuses on efficiency, or striving to reinvent their businesses as asset-light operations that concentrate on intangibles. Still, these issues are not likely to create a convincing argument for a fundamental restructuring of wireline operations.

A different landscape

The predicament of Europe's telecom incumbents means that all but a few must embark on restructuring of some kind—changes in the ownership of individual units rather than spectacular mergers at the group level. Many integrated incumbents that now resemble holding companies with numerous majority stakes will be left holding only minority ones, if anything, in some of these operations. Arguments that integration is necessary to offer customers bundled services and products, or that integrated operations create greater efficiencies, will ring hollow. While certain cost efficiencies are linked to integration, they can be achieved almost as readily by outsourcing—a credible option for putting together bundled offers, especially while regulators are demanding more transparency among businesses.

Moreover, companies hoping to succeed as integrated operators must give the corporate center a role that truly adds value. Like private equity firms, corporate centers should concentrate on promoting performance, allocating resources effectively, and managing critical assets, such as talent, brands, and finances, with an emphasis on transparency and accountability.

In the course of restructuring, an integrated incumbent serving a small national market might end up selling the wireless business to a larger incumbent with scale advantages in return for a minority stake in the larger company. Most big incumbents will have to make similar decisions as they sell assets to pay back debt and build sustainable financial positions. Eventually, long-term pressures to create value will probably outweigh control issues: financial markets place a penalty on the share price of integrated players that don't demonstrate a distinct ability to add value and will force those without a clear rationale for integration to break up. Our analysis has shown that the share prices of integrated companies are discounted by as much as 50 percent as compared with the total value of their assets.

Whether today's integrated telecom companies should abandon their emphasis on wireless or data services, or even both, will depend largely on their financial health and strategic aspirations. Companies that are heavily in debt, such as KPN and Sonera, will have the most difficulty continuing an integrated approach successfully; indeed, they could find even a focused strategy challenging. Companies with healthy finances, such as Telefónica, can be more flexible in seeking a growth strategy. Deutsche Telekom and France Télécom are among the remaining integrated companies that could play a relevant role in the restructuring ahead—but until they lighten their debt load, their development will be hindered.

Each incumbent operator enters this new landscape from a different position, and some clearly have more options than others. Debt position and expertise will be the essential factors in deciding whether to pursue an integrated or a focused strategy. For some companies, the direction could be obvious, especially if capital is scarce. But others will have to define their long-term aspirations clearly before making a decision. In the current environment, a single stumble could be enough to force a company out of the race.

By recognizing the changes and challenges ahead, the smartest companies can make decisions now, before the pace of change blurs the process. Boldness carries risks, but waiting and seeing could be even riskier. Q

This article draws on the Future of European Integrated Telcos, an initiative sponsored by McKinsey's European telecom practice. In addition to the authors, the contributors to this initiative were Chiara Aluffi Pentini, Rolando Balsinde, Paola Bonomo, Arnoud Boot, Francesco Buresti, Pietro Busnardo, Tomas Calleja, Gianluca Camplone, Luca D'Agnese, Dieter Düsedau, Michael Gassmann, Menno Groeneweg, Carlos Morales, Samuel Muñoz, Diana Olteanu, Angus Ridgway, Jürgen Schrader, Andreas Siemen, and Marc van Rooijen.

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