Opportunities for Action in Technology and Communications

The Perfect Storm: The Shakeout in European Telecom

THE BOSTON CONSULTING GROUP
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After several years of heady growth and unchecked optimism about third-generation (3G) wireless services, European telecommunications companies are now immersed in a fight for their lives. Their old ways of doing business are being swept away. Only those telcos that understand the severity and dimensions of the change—and respond in time—will survive.

Like the fishing boat that was trapped in an unforgiving sea in the book *The Perfect Storm*, the telcos are caught in a freakish collision of disruptive forces and circumstances—some of their own making. Each of these forces is powerful on its own; together, they pack a punch of historic proportions.

On one front, the telcos are being buffeted about as a result of the huge bets they placed on 3G during the investment frenzy of 2000. European companies committed more than $100 billion for licenses and an even larger sum for network buildout—amounts that now seem preposterous. But the telcos are also reeling from waves of new competition in their bread-and-butter operations: local access and long distance. Meanwhile, new engines for growth—foreign investment and broadband, as well as wireless—are sputtering. In short, Europe’s telcos are facing monstrous debt just as their profitability and operating cash flows are sinking.

Although all this may seem bad enough, there is even more to the storm. To finance their debt, many telcos had counted on selling off some assets or spinning off parts of others in initial public offerings. But the cli-
mate for such moves continues to deteriorate as in-
dustry performance softens and near-term prospects
for 3G wireless grow progressively dim. Indeed, share
prices for most European telcos are less than half
what they were in March 2000.

Already, the fury of these forces is changing the face
of the industry. Giant telcos can no longer aspire to
be fully integrated players in as many businesses as
they want. To ride out this storm, companies must
become trim, agile, and tightly focused.

This means telcos will have to jettison far more of
their assets than they had envisioned, while making
sure to identify and retain the businesses they do best.
To stay afloat, telcos will also have to make short-term
tactical moves—cutting costs, bolstering profits, and
blocking competitors—while they craft long-term
strategies that play to their strengths.

Problems, Problems Everywhere

Early in 2000, when they were flush with cash and
high equity prices, many European telcos were antici-
pating a long period of growth and diversification.
Now, however, with the average telco’s debt burden
up by more than 300 percent since 1997, the indu-
try’s overarching issue is managing debt.

Were it not for declining profitability and weakening
cash flow in traditionally high-margin businesses such
as fixed-line access and long distance, the high debt
load would not be such a problem. However, at many
companies that invested in 3G licenses and wireless-
network improvements, debt service over the next few
years is likely to consume most of the earnings before
interest, taxes, depreciation, and amortization.
The profit picture for most European telcos is indeed bleak. Until recently, for example, the local-access business generated close to half of the total profit for major incumbents such as British Telecom and Deutsche Telekom. However, as regulators allow new players to enter this business, margins will shrink, much the way they already have in long distance.

Over the past few years, competition has caused long-distance prices in many countries to decline by an average of about 10 percent per year, and many incumbents have seen their share of the long-distance market fall from nearly 100 percent to less than 70 percent. A simulation by The Boston Consulting Group shows that between 2001 and 2004, pretax margins from local-access and long-distance businesses could decline by as much as ten percentage points.

Unfortunately, none of the areas in which operators have invested recently—foreign markets, broadband, or 3G wireless—can provide much help with debt repayment in the next two to three years. Most foreign telco investments, for example, are cash drains during the first few years. Data and broadband services, although potentially profitable, will not contribute large cash returns in the short term. And 3G services will certainly not provide the near-term returns that operators had hoped for. BCG expects that mobile operators will lose money on 3G services for many years as a result of delays in service rollouts, the unavailability of handsets, technical problems, and reduced projections for market penetration.

For all these reasons, the turbulence that is rocking European telcos is not likely to calm down anytime soon. Indeed, some of the biggest challenges are still ahead.
The Pressures for Restructuring

Some companies—such as BT and KPN—have already started to shed businesses and have announced plans to do more. This is just the beginning. Over the next two or three years, the European telecom industry will undergo a painful shakeup as most large integrated telcos struggle with rolled-over debts that come due and with new types of focused competitors.

Initially, some players that offer several services—for example, fixed-line, mobile, and data services—will sell off entire operations in order to reduce costs and raise cash. However, this round of restructuring will soon unleash a more dynamic wave of reorganization that will spread throughout the industry’s value chain.

Specialists, unlike integrated players, will take advantage of the economic differences among various business segments and business lines. In the local-access and wireless businesses, for example, competitors will operate in single segments—the network, value-added services, content, or sales and marketing. Improvements in technology will only sharpen the economic differences among businesses. As the industry deconstructs, specialized competitors will continue to find ways to cut costs and generate value, further endangering other players whose cost structures are too high or whose offerings are less clearly defined.

Short-Term Responses for Telcos

There is no “silver bullet” solution for surviving the unpredictable period ahead. Rather, telcos must flawlessly execute a large number of short- and medium-term actions while simultaneously preparing to
rebuild operating portfolios for long-term success. The short-term actions that telcos should emphasize include the following:

- Cutting operating costs and improving asset productivity in order to boost profits while continuing to roll out new technologies that can lower long-term costs

- Rebuilding strength in the balance sheet by using a combination of capital raising and dividend reduction

- Using tactical pricing and regulatory measures in order to prevent competitors from making inroads into current markets

- Stimulating demand by introducing new products and services, adding distribution channels, and establishing marketing alliances in order to reach new groups of customers and gain access to new services

**Longer-Term Opportunities for Telcos**

As important as such short-term tactics will be, they can achieve only so much. The players that come out of the storm with superior competitive positions for the long term will be those that take advantage of the opportunities the turbulence creates. Although there is no silver bullet, the clouds that have gathered for this storm do come with silver linings.

From the perspective of incumbent telecom operators, there may be three kinds of benefits: attractively priced assets and businesses will be available from companies in financial distress; a reduction in the
The number of real and potential competitors will alleviate pressure on pricing; and the context for negotiations with regulators may improve. The winners will likely be players that focus—at least for the next several years—on extracting value from these opportunities.

**Acquiring Assets and Businesses.** Europe’s telecom industry is entering a period of substantial corporate restructuring. The price expectations of sellers have fallen dramatically, to the point where even pure financial players are entering the market. Buyers that are attempting to build focused positions with real synergies should find it possible to create value through targeted acquisitions. The pace and level of merger-and-acquisition activity will not reach earlier peaks anytime soon, but the flow of deals is beginning to accelerate.

**Benefiting from Reduced Price Pressure.** Because capital markets have dried up, the threat of competition from new entrants and start-ups has receded. The “land grab” logic that drove wildly aggressive pricing for everything from Internet access to mobile phones no longer resonates. Financial markets now value profits rather than numbers of customers. As a result, there is less pressure to price aggressively. Remaining players need to review their pricing strategies, evaluating them by product and by customer segment. The goal is to ensure that these strategies reflect today’s competitive reality and that they capture fair market value for the services that are provided. Already we have seen some upward movement on pricing in markets that had appeared to be locked in downward trends.

**Negotiating Better Terms with Regulators.** The new market environment will create opportunities to negotiate concessions from regulatory bodies. The deci-
sion of German regulators to allow mobile service operators to share their networks is an indication of how regulatory climates may be changing. The benefits of a regulatory shift could be substantial. Regulators in many European countries have been relying on new entrants and market competition to achieve certain public-policy goals. In a less competitive environment, some regulators may be willing to make concessions to incumbents that agree to help advance public policy objectives.

Much of the near-term activity in the telecom industry will center on companies’ building specific lines of business. However, aggressive players will seek opportunities to strengthen their market positions in other ways. They will attempt to achieve this either by developing narrow expertise across larger geographic areas or by piecing together broader product offerings to attract specific sets of customers. We expect these players to appear in such areas as local-access service for businesses, bundled services aimed at consumers, and value-added applications designed for particular corporate and consumer groups.

Companies with healthy balance sheets will have a head start in acquiring new assets and assembling distinctive offerings. But all companies face the same essential challenges. They must build portfolios that are based on focused business models, and they must continuously seek out ways to sharpen their offerings and make them more valuable than those of competitors.

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The current debt crisis has pushed many European telcos to a historic turning point. Most incumbents now recognize that their problems are fundamental and deep rooted—and that radical solutions are
required. The eventual winners will be the players that do more than just ride out the storm. They will be the ones that harness the fierce winds to their own advantage.

Jean Baron-Mazloumian
Martin Naville

*Jean Baron-Mazloumian is a vice president in the Brussels office of The Boston Consulting Group. Martin Naville is a vice president in the firm’s Zürich office.*

You may contact the authors by e-mail at:
baron-mazloumian.jean@bcg.com
naville.martin@bcg.com

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