Steering through the global financial crisis will require communications and high-tech firms to address changing market demand, new competitive trends and industry consolidation.

Telecom: Facing the Global Crisis
Challenges and opportunities for the communications and high-tech industry

The communications sector has performed better than many other industries during the economic downturn. Between June 2008 and March 2009, stocks in telecommunications and information technology companies fell, but at a lower rate than the broader economy. This relative success could change at any time, however, as market demand and competitive trends are threatening profit margins. Companies that emerge from this recession stronger will be those that prepare for two major trends affecting the industry—consolidation and innovation.

As the economic crisis rages on, the telecommunications and high-tech industry has stayed afloat, thanks to several factors. One is the industry’s historical reliance on innovation for revenues, which has sparked success even as overall spending drops. A second is a reduction in prices, which, driven by regulation and competition, most companies were already doing before the downturn. Additionally, the industry has had the flexibility to delay investments and thus preserve cash.

European telecom operators are performing even better than their U.S. counterparts. They have weathered the storm either by taking advantage of their footprint in mature markets (France Telecom and Deutsche Telekom are good examples), building on differentiation (as Swisscom and KPN have done), or managing their debt.

Still, there are some major threats to the industry’s relative stability—namely, changes in market demand and new competitive trends.

Changes in market demand. Although the financial crisis has yet to make a big dent in market demand, there are some indicators that this is changing. Fixed-line revenues continue to decline, and while the drop in voice revenues has been countered by more broadband business, mobile has contracted. Price-related usage gains are falling, roaming revenues have collapsed and handset sales are down. Add in the woes of the broader economy, particularly in countries such as Spain, and revenues overall are under pressure.

Competitive trends. The convergence of fixed and mobile, and the need for continued revenue growth has spurred consolidation and blurred traditional industry boundaries. Indeed, smaller European companies with weak cash flow are under pressure as markets contract and credit tightens. In this macroeconomic environment, we believe that current stand-alone investment models are not sustainable, especially for non-leaders.
Successfully steering through the global crisis will require focusing on profit margins. Different companies will employ different strategies based on their specific situations, but there are some tactics that are common to all—for example, closing unprofitable businesses, exiting capital-intensive segments, focusing on sustainable niches, finding new areas of growth, reviewing pricing structures, and realigning costs amid declining revenues.

If the current economic crisis continues for any length of time, however, we could see a dramatic reshaping of the industry via increased consolidation and growth, and innovations in services and business models.

Consolidation and Growth
Recessions foster consolidation, which can help bolster endangered margins. Increased consolidation today would leave Europe’s telecommunications industry in better shape for the next wave of technology innovation. How much consolidation and further expansion occurs in Europe will depend on the level of external growth achieved in the next few months.

We see three possible trends: national consolidation, fixed-mobile integration and multinational expansion (see figure 1).

National consolidation. In both the mobile and fixed sectors, there is a strong correlation between EBITDA and market share.1 Smaller, local players that cannot generate solid cash flow will have to consider mergers to afford future technological innovations and ensure long-term survival.

Fixed-mobile integration. Market dynamics will push integration between fixed and mobile players. While investments and cost synergies have proven difficult to extract—and not as great as forecasts suggested a few years ago—customer needs are moving toward a convergence of services, particularly in the corporate segment where providers are offering seamless systems that combine fixed and mobile services with IT applications.

In the consumer segment, the boundaries between fixed and mobile markets are also falling, and most operators will have to converge to survive. Mobile firms are competing in the fixed market with substitutes and products such as fixed broadband. In response, fixed operators are launching mobile virtual network operator systems (MVNOs).

How will this play out down the road? We believe mobile leaders will acquire and consolidate sub-scale fixed alternative networks (altnets), taking advantage of their strong cash flow and brand recognition. Mobile and fixed altnets will merge to exploit the benefits of integration, provided they achieve sufficient scale (see figure 2).

Multinational expansion. Multinational groups will continue to pursue cross-border growth and consolidation. A multinational footprint reduces risk, adds to brand equity, product development and group functions, and is usually rewarded by investors. What will financially healthy multinational groups in Europe do next? We see three likely moves:

• Enhance their market position in the European telecom sector, sacrificing some financial power for added market power
• Expand cautiously into fast-growing emerging markets
• Expand to adjacent sectors, such as Internet and media, through partnering and select acquisitions.

Multinational groups may also spur local concentration by exiting national markets where they are not growing fast or profitably enough.

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1EBITDA is earnings before interest, taxes, depreciation and amortization.
In our view, these trends eventually will lead to a significant reduction in the number of European telecom groups—from 42 today to fewer than 30. There will be an accompanying increase in the market share of integrated, multinational companies, encompassing 75 percent of the mobile market and 65 percent of the fixed market.

Innovation in Services and Business Models
Creating more innovative services and business models will be crucial for network operators. In mobile, for example, operators still account for more than three-quarters of revenues in multimedia communications, but the battle is getting fiercer as online stars and equipment makers such as Google and Apple enter the picture. Indeed, these players are changing the rules of the game, trying to outrun mobile operators by creating better user experiences.

Apple’s iPhone is shifting from operator services to an open model, thanks to its innovative interface, and Nokia’s Ovi is doing much the same. They are stealing value and margins from mobile operators. To remain relevant, mobile operators will have to provide an integrated, compelling customer experience—from handsets to services.

We believe the best-case scenario for mobile operators is the market-shaper scenario shown in figure 3. Mobile operators not only control the distribution of bandwidth, they also occupy critical control points of the communications experience—software, handsets, applications and online services. In the worst case, which we call the “bit pipe” scenario, operators are merely conduits for outside companies, and the only way to raise revenues is to charge for use of bandwidth.

In fixed-line telecommunications, innovation essentially means upgrading to next-generation networks (NGN) to meet the demand for more bandwidth and ensure long-term differentiation.
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compared to mobile data services. NGNs already can address household requirements for data bandwidth—which are expected to pass 30 megabits per second by 2011—at a cost that mobile technology cannot match because of spectrum limitations.

However, the future of NGNs relies on a business model that can produce additional revenues to ensure higher returns by capturing more customer spending. This means asking the customer to pay a “fiber premium” for more bandwidth to keep entry barriers low and maximize adoption (see figure 4).

But the real breakthrough will happen when operators can cash in on the “bandwidth-hungry” content provided by others, since most of these new services will be provided by Internet and media companies.

Surviving the Downturn
Survival in these difficult times will require rationalizing struggling businesses while also focusing on growth segments to improve margins. Telecom operators can take advantage of their networks to tap into the content that others are providing now. To get there, though, it will take new revenue-sharing models in which Internet and media companies indirectly invest in new high-speed networks.

The industry has stayed relatively strong thus far through the economic downturn, but this is no time to sit back and declare victory. Dramatic changes are still ahead. Those that are prepared for these changes, will be in the best position to survive the downturn.

### FIGURE 4: Potential revenue models for network operators

<table>
<thead>
<tr>
<th>Customer</th>
<th>Internet and media</th>
<th>Hybrid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer pays a premium for more bandwidth</td>
<td>Service providers pay fee for guaranteed end-to-end service</td>
<td>Customer pays</td>
</tr>
<tr>
<td></td>
<td>Customer does not pay premium for fiber</td>
<td>Limited premium for more bandwidth to improve service</td>
</tr>
<tr>
<td></td>
<td></td>
<td>For additional services controlled by operators</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Internet and media providers pay a fee for guaranteed end-to-end user experience</td>
</tr>
</tbody>
</table>

ARPU* (€ per month)

Customer

<table>
<thead>
<tr>
<th>€5 to €8</th>
<th>€5 to €8</th>
<th>€7 to €12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service provider A</td>
<td>Service provider B</td>
<td>Service provider C</td>
</tr>
</tbody>
</table>

*ARPU stands for average revenue per user

**Source:** A.T. Kearney analysis.

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