ALVAREZ & MARSAL PEPI MADRID

Spanish Telecom Industry View

The riders of lost value in the telecom industry

Introduction

For many, looking back at 2000 may sound like a trip to the Pleistocene. Others may think that this long-term vision will allow us to see the secular trends and eliminate cyclical forces.

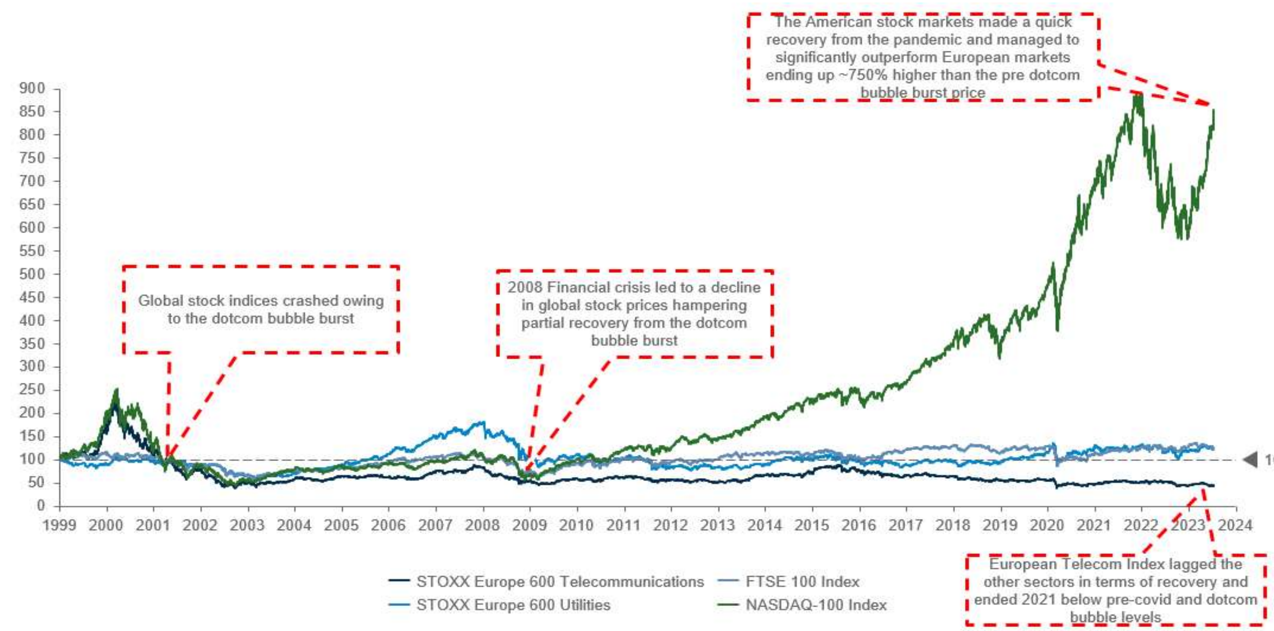
The fact is that in March 2000, Telefonica's shares peaked at € 27.5. Then the dotcom bubble burst, and 18 months later their shares had lost 70% of that value. All telco players suffered this collapse irrespective of geography.

Today, the industry is far from the glitz and glamour of the bubble times. In fact, telecom industry value (STOXX Europe 600 Telecoms Index) shows a cumulative decline of -81% vs. the peak in March 2000 (or -7% CAGR), while Nasdaq-100 has achieved a cumulative 346% increase (or +6% CAGR). Ultimately, there was value on the Internet, but it would not be the telcos to capture.

has shown a solid growth at c. 7%. A significant part of this underperformance may be explained by a European regulatory framework that has promoted fierce competition and fragmented infrastructure. Additionally, legacy technology and heavy organizations make it difficult for European incumbents to adapt to increasingly faster changes.

As a result, while in 2015 there were five European companies among the top 15 telcos by market cap (Vodafone, DT, BT, Telefónica and Orange), today only DT stays in this exclusive club, thanks to its successful entry into the US market in 2001.

This context has frightened away retail and corporate investors, is increasingly pressuring every industry Board, and has opened discussions about a deep transformation of the regulatory framework.

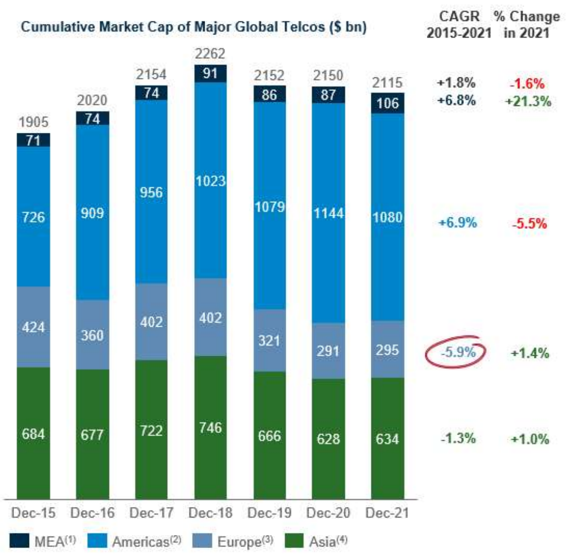


If we change our focus to more recent developments, we continue to observe the same pattern of decline. In fact, European industry has not even recovered the pre-COVID valuation.

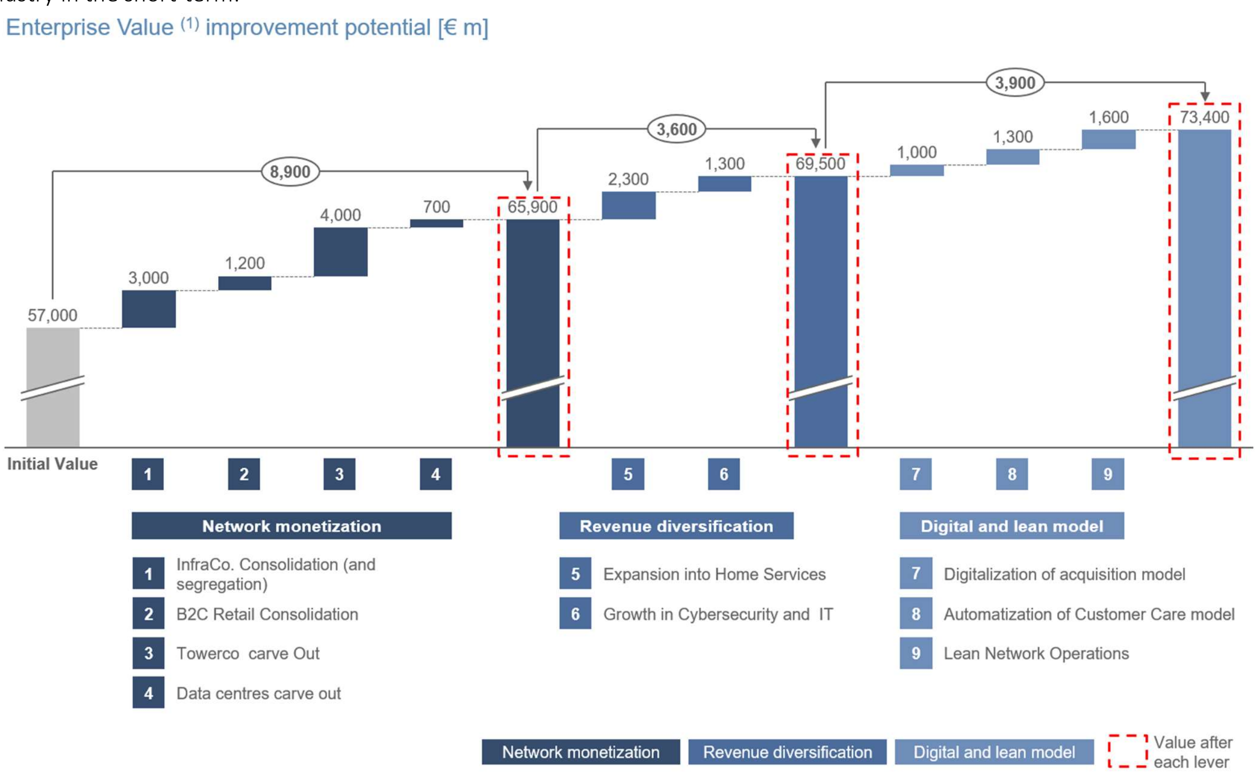
Nevertheless, more recent history does not paint the same picture everywhere. While the European telecom industry has declined by c. -6% pa. in the period 2015-2021, the US industry

Recently, major European players have started discussions with European Regulators about hyper scalers contributing their "fair share" to network investments. Perhaps Korea might be leading the pace if the private agreement between Netflix and SK Telecom is followed in other countries. Without a doubt, it could help to significantly increase the return on capital employed (ROCE) that is currently between 2-3 pp smaller than WACC for most players due to the increasing capex needs in fiber, 5G and IT transformation. Nonetheless, the result of this negotiation still seems too uncertain to be factored in the value creation plan yet.

So, considering the current European regulatory framework, the question is what should be done differently to return to value growth in Europe and how much value could be captured.



In this report, we have focused on the Spanish telecom market, a trendsetter in the European context. This market is characterized by three forces that will drive the European industry in the short-term:



Note: 1) Enterprise value is calculated using industry average EBITDA multiples

– **Fiber**, massively available, has killed other fixed technologies like HFC and DSL. With a household penetration rate of above 70% households, copper decommissioning is scheduled for 2024

– **Low-cost** attackers have successfully invaded the mass market, capturing as much as 35% market share in the competitive 4P segment (convergent bundles without TV)

– **Convergence** (fiber plus some mobile lines) has become standard, representing more than 80% of mobile portability. The average number is more than two mobile lines per bundle, leaving mobile-only segment as a niche market (e.g., youth and prepaid)

Despite this complex environment, we consider that the Spanish telecom industry has the potential to increase value by 30% through the application of three major levers that can likewise be applied in every European country:

– Infrastructure monetization
– Revenue diversification in non-core services
– Transforming into a lean and digital operator

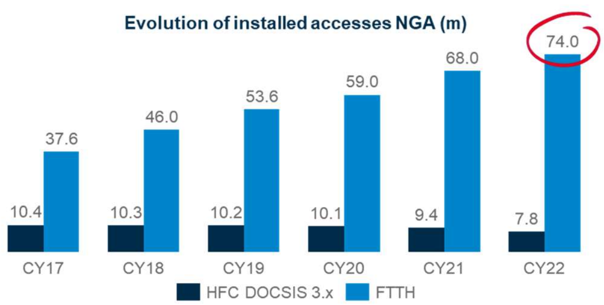
Infrastructure monetization

Towerco model has shown how telcos can capitalize assets hidden in their balance sheets. Spanish Cellnex, for example, operates more than 100 thousand sites across Europe and reports more than € 2500 m revenues with a 79% EBITDA margin. Financial markets have shown their interest in this model.

The tower carve-out process is not yet complete. In Spain alone, c. 45% of pylons are still owned by Orange and Vodafone (through their subsidiaries Totem and Vantage) for which the market expects a future carve-out. The assets they own in Spain could be valued above € 4 bn according to towerco industry ratios. Looking at the towerco industry from a European perspective, European consolidation is expected to increase scale synergies. Additionally, carving out active elements such as antennas may return additional value for telcos, but has not been considered in this analysis.

A natural next step would be carving out data centers and other IT related infrastructure. Telefonica has already started down this path, with the sellout of eleven data centers to Asterion in 2019, followed by four additional data centers sold to Nabiax in 2021. It is thought that € 700 m of value could still reside in the balance sheets of Spanish telcos according to the information reported.

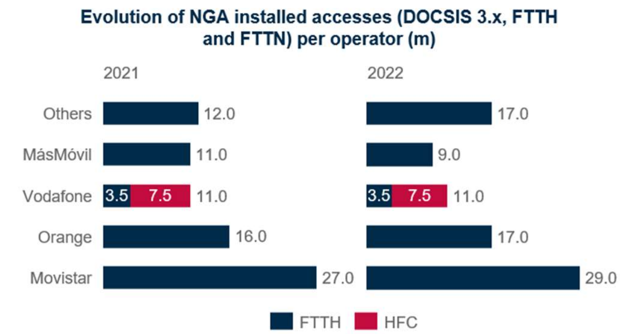
The most controversial subject is, without doubt, the potential spin-off of networks. Even given Telefónica's recent carve-out of 3.9 MHHP to Bluevia (valued at € 2,2b) to manage and develop fiber networks in rural areas, networks are still considered a core element by most players. The success of MVNOs in the last 5 years, however, has demonstrated that owning the network does not guarantee commercial advantage.



In fact, this focus on networks has resulted in infrastructure overpopulation. According to CNMC, there are 82 m high speed accesses (FTTH and HFC) available in Spain, representing an average of c. 3.5 high speed fixed connections per home. This network multiplicity is inefficient to deploy and to operate.

According to the O2-Cetin reference case in Czech Republic, an InfraCo-ServCo segregation resulting in a big, scalable, and efficient infrastructure platform could unleash potential value over €3 bn in Spain alone. This is taking into account the consolidation of small fiber providers who own more than 17 m connections (22% of total fiber deployed) and the potential integration of additional network carve-outs from big players (like Vodafone, MásMóvil or Digi) who would then become anchor clients for this InfraCo.

Recently, MásMóvil has moved in this direction through the segregation of 1.4 m homes, subsequently passed to Ucles Infraco in 2022 following the previous carve out of 1 m homes passed to Pentacom in 2019.



After the expected merger of Orange and MásMóvil, a second consolidation of the long-tail retail operators (like Digi, Finetwork, Avatel, etc.) could also follow. That potential integration could create € 1.2 bn additional value due to economies of scale in Marketing, Sales, Customer Care and SG&A activities. Vodafone could also join to try and consolidate a challenger to the Orange-MásMóvil merger, with additional synergies to be factored in.

Additionally, that integrated player would benefit from a stronger negotiation position to get better wholesale prices, especially favored in the case of an Infraco, as proposed above, which could challenge the current status quo of the wholesale market.

Therefore, the consolidation of the current fragmented market around two big platforms (InfraCo and ServCo) could well add up to more than € 4 bn value to the industry.

Moreover, an InfraCo-ServCo approach could significantly increase the efficiency of capital required for future development and, as such, help accelerate 5G deployment (future 6G) and meet the Digital Decade targets in rural areas.

In Northern European countries that are lagging behind in fiber deployment, co-investment vehicles between telcos and private investors are proliferating, such as the partnership between Proximus and Eurofiber in Belgium. Some municipalities have also shown their interest in co-investing.

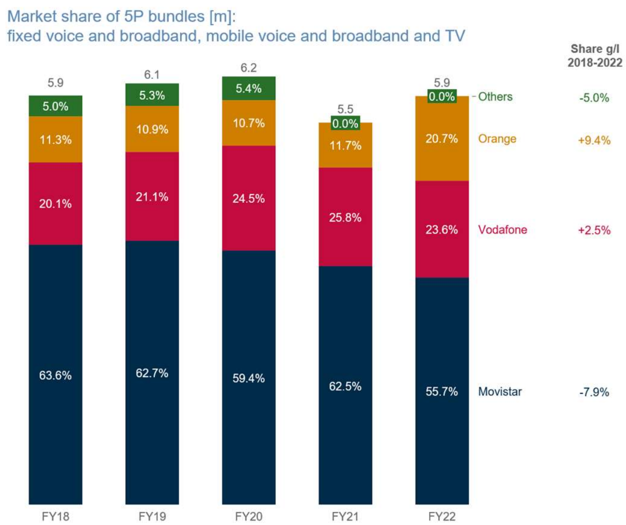
Last, but not least, telcos are accelerating the divestment of their legacy technologies. Of particular note, Telefónica has led the way by dismantling its centenary copper network, planned completion is mid-2024. Other European players are expected to follow suit, including old coax networks in Northern Europe.

Copper decommissioning is expected to provide significant savings in energy and maintenance; additionally, it will allow companies to attribute value to significant real estate assets hidden in the balance sheets. According to press releases, Telefónica may be considering the dismantling of around 5500 Central Offices in Spain. Decommissioning of other technologies like 3G should quickly follow to capture additional energy, maintenance, and even spectrum efficiencies.

Revenue diversification in non-core services

Prices (or more precisely, ARPU) have fallen between 5-8% p.a. over the last few years in Spain, and that decline is not expected to change given the success of low-cost offers in the market. In the last 3 years, Telefónica, Orange and Vodafone have cumulatively lost c. 3,3 m customers who ported their mobile lines to MVNOs in search of better prices.

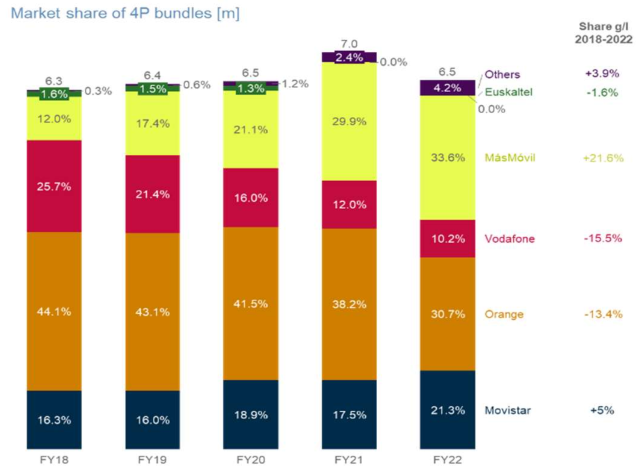
In this context, "premium" content has emerged as the last barrier to limit commoditization. Nonetheless, the demand for content bundles has stagnated at around 6 m homes in Spain and its growth stressed by the macro-economic situation. Movistar leads the segment with a 56% market share due to its unparalleled exclusive content.



The financial impact of this premium content in the telco's P&L is controversial. Vodafone challenged that paradigm when the company decided not to renew its rights for La Liga in 2018 due to its high cost. After some bumpy periods in between, their current market share in the segment is 3.5 pp higher than in 2018, after replacing La Liga soccer content by (supposedly) less expensive series content like Amazon Prime. On the other hand, it could be argued that Orange successfully leveraged Vodafone's decision to increase its market share in the segment by 9.4 pp.

In any case, the top 3 players are seeking shelter for their flagship brands in this content market, while they have progressively abandoned the hypercompetitive 4P market led by MVNOs.

Given that core telcom services face a less-than-certain future (5G impact on revenues is relatively moderate thus far), operators should think broadly about other home services to keep to growth targets. In the past, the combination of flat tariffs, single billing, single customer service and lower prices has been an unbeatable success model for bundles. Seemingly, consumers could be interested in bundling more services with their bills, but will they really want a one-stop-shop for all their home expenses? Moreover, do telcos have the required capabilities to deliver according to consumers' expectations?



In Poland, most players have entered the electricity market successfully and are reporting revenue growth. In Germany and Belgium some operators have started to explore the opportunity for charging electric vehicles (using telco's street infrastructures). In Spain, Telefónica has reached an agreement with Repsol (Solar 360) and MásMóvil reports more than 170 thousand electricity clients (in Lucera, EnergyGo and PepeEnergy). No doubt telcos have many assets that could be leveraged, such as their customer knowledge, marketing and product know-how, cross-selling channels, one billing platform and customer operations.

Similarly, other opportunities may be found in home security services whose development will require a mix of technology (IoT), customer knowledge, cross-selling, and home installation capabilities, that telcos also own. In Europe, Telefónica has taken the lead through its JV with Prosegur that has resulted in over 400 thousand alarms sold, according to information released by the companies.

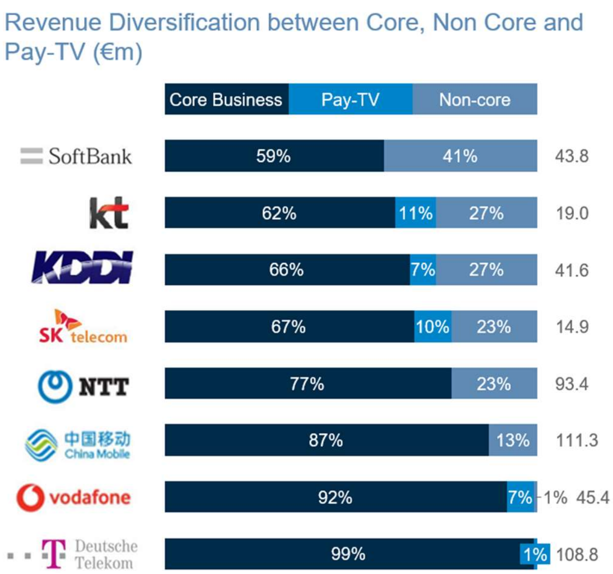
We estimate potential untapped value above € 2 bn by successfully addressing the opportunities around home marketplaces and adjacent services such as energy, home security, insurance, and others.

Nonetheless, the usual vertical approach (ie. "I sell what I produce"), will not work. Instead, alliances with leading companies, entrepreneurs, and third-party investors will be required to create a more open ecosystem. In this case, a segregated operating model (ServCo-InfraCo) could also help the business develop and grow faster by avoiding interference from the core business. To some extent, the ServCo objective should be how to monetize customer information and relationships, independently of networks and providers.

Cyber-security and IT services could contribute well above € 1 bn additional value to the industry. Similarly, partnerships with specialists emerge as a winning formula to get the best from each partner. For the time being, major players are more active in classical M&A activities, focused on acquiring technical capabilities and customer credentials, to be incorporated in their B2B offers. Some of these services could be adapted and extended to residential markets too.

Even though financial and insurance services have not been successful in Europe, the development of mobile payment and bank services in Africa promises a big diversification opportunity for players like Vodafone and Orange.

For a considerable time, European operators have looked at Asian operators like SoftBank, KT and KDDI who reach as much as 35%-40% of their revenues in non-core services. Major telcos should aim to reach around a 5% target in adjacent services to return to revenue growth given price pressure across the core business. Opportunities like the ones indicated above emerge as the most concrete alternatives to reach these objectives.



Transforming into lean and digital operations

Telcos have been developing powerful commercial battleships with an outstanding capability to upsell and cross-sell products (iPhones, Amazon's Alexa, or credit cards). Even though the "war machine" is an asset that will help operators extend their service portfolio to adjacent service lines it has, to some extent, also become a liability given the high weight of physical channels.

As such, telco front lines (including call centers and sales commissions) represent around 15-20% of total cost base and c. 30% of headcount. Despite being a recurrent hot topic on the agenda, digitalization of front-line activities has not yet happened. It is now more imperative than ever, as this could release additional value of over € 2,3 bn by reducing customer related costs in a context of continuous ARPU erosion. Additionally, younger customers show their preference for digital interactions.

Currently, approximately 70% of total sales are still performed in "physical" channels, either telemarketing or shops. Increasing the digital mix above 60% and implementing a disciplined focus on profitability (e.g,. value-based remuneration framework) could provide € 1 bn value growth. Of particular note, a full digital customer journey is required as, in practice, many of today's sales reported as digital end up being provided via telemarketing platform.

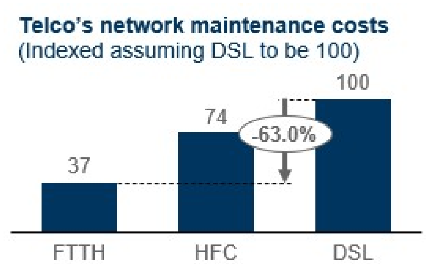
The digitalization of customer services promises an even brighter perspective given the huge potential of AI digital self-services. For example, most of today's customers' calls are related to billing and technical failures. In both cases, AI could be applied to attend and even to anticipate customers' calls.

In fact, just by increasing the penetration of chatbots above 50% of customer base and considering current resolution rates as reported by key players, the industry would be able to capture more than € 1,3bn in additional value.

The transformation of network maintenance is yet another unfinished area of improvement. Lean methodologies, initially developed for manufacturing, have been successfully adapted to network maintenance and operations, reporting efficiency improvement in the range of 20% in maintenance and repair.

The large-scale applications of these methodologies, progressive increase in scale of OEMs subcontractors, and associated efficiencies to new network technologies would provide additional value above € 1.6 bn.

As commented previously, the switching off and dismantling of legacy technology like fixed copper networks and 3G mobile networks will provide additional maintenance and energy savings in the range of 30% and 50% respectively. For example, the network maintenance cost of FTTH technology is estimated to be c. 65% lower than DSL and c. 50% lower than HFC.



Finally, technology evolution promises a revolution in network development and operation through the virtualization of functions (NFV, Network Function Virtualization). Working with traditional OSS/BSS components, NFV will increase efficiency and quality of service provision. Meanwhile, Open RAN (or open radio access network) will allow operating with hardware and software components from different vendors. Potential efficiencies associated with these technologies have not yet been factored into this analysis.

Final remarks and conclusions

In brief, the telecom industry, once the crown jewel for investors and financial markets, could yet attract their attention (and capital) once more.

We consider the Spanish market has potential to increase value by 30% through the application of a methodology similar to the one used by Private Equity industry: capitalize the value of the assets in their balance sheets, a thorough (almost obsessive) focus on efficiency and digitalization, and a careful application of M&A to grow and capture scale.

This formula lso involves embedding a culture of value creation at every level of the organization, as well as appropriate management of short and long-term decisions, especially those related to capital expenditure.

The aforementioned growth value would be captured by the collaboration of three different types of players: i) telco operators thinking out of the box, ii) investors participating in the segregation, consolidation, and development of future infrastructures; and iii) subcontractors and service providers supporting telco transformation into digital and lean operating models.

The outcome would result in a very different industry structure than today in terms of consolidation, infrastructure ownership, and boundaries with adjacent industries. Although not addressed directly in this analysis, Regulators should also participate in bringing this transformation to fruition.

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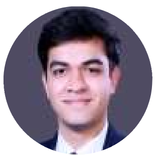

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