European telecoms: focus set on efficiency Deal-making off table, capex manageable in benign operating environment

Europe's telecommunications operators are headed for another year of modest corporate restructuring to enhance profitability as capital expenditure remains manageable, despite the 5G roll-out, in a still favourable fiscal and monetary context. The industry has demonstrated during the Covid-19 crisis that it was almost immune to the economic cycle, able to record resilient profit margins. Driving the restructuring this year will be two issues: the need to improve efficiency to offset upward pressure on costs and the opportunity in digitalisation to automate more processes – procurement, customer services.

The sector's credit outlook remains stable - excluding the unlikely event of largescale, debt-financed mergers and acquisitions.

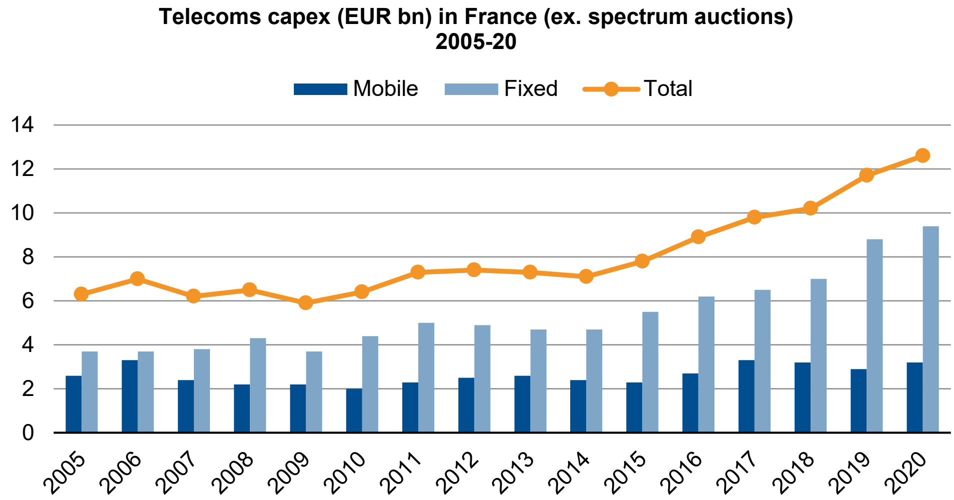
M&A will remain low down on CEOs' to-do lists largely because international deals are of little interest to European telcos given the lack of cross-border synergies to be extracted from such transactions. To put it simply, a minute of mobile traffic produced in Germany offers no advantages for a mobile network operator in Italy.

Anti-trust concerns remain impediment to national consolidation

Secondly, the European Commission remains hostile to national mobile consolidation on the grounds that the number of wireless operators in each country is already low – no more than three or four - to maintain sufficient competition. National telecom regulators have shown no more enthusiasm for more consolidation in domestic mobile markets.

The only national consolidation that looks possible is in merging a fixed operator with a mobile operator in the same country, as illustrated by recent the announcement of Orange Belgium's acquisition of cable operator Voo. However, after a decade of deal making, there are few remaining independent fixed-asset or cable operators in Europe.

Figure 1: Mobile capex remains stable despite 5G roll-out… much like 2G, 3G, 4G



Source:Arcep

Roll-out of 5G is not driving telecom capex higher

Investment in 5G will continue but the spending required is in little danger of stretching balance sheets. After all, 5G investment is merely replacing previous investments in 2G and 3G networks, which have dwindled to nothing, while 4G-related capex is in decline despite the persistently rapid growth of traffic across mobile networks.

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French mobile capex steady despite network upgrades

The experience of different European countries tells the same story, though data from France illustrates best how mobile capex has remained steady despite network upgrades and exponential growth in data usage. Mobile capital expenditure has been stable around EUR 2.6bn per year for the past 15 years in France even though mobile data traffic multiplied by around 60,000 times and the number of mobile operators in the country rose to three to four as Iliad SA entered the market in 2012.

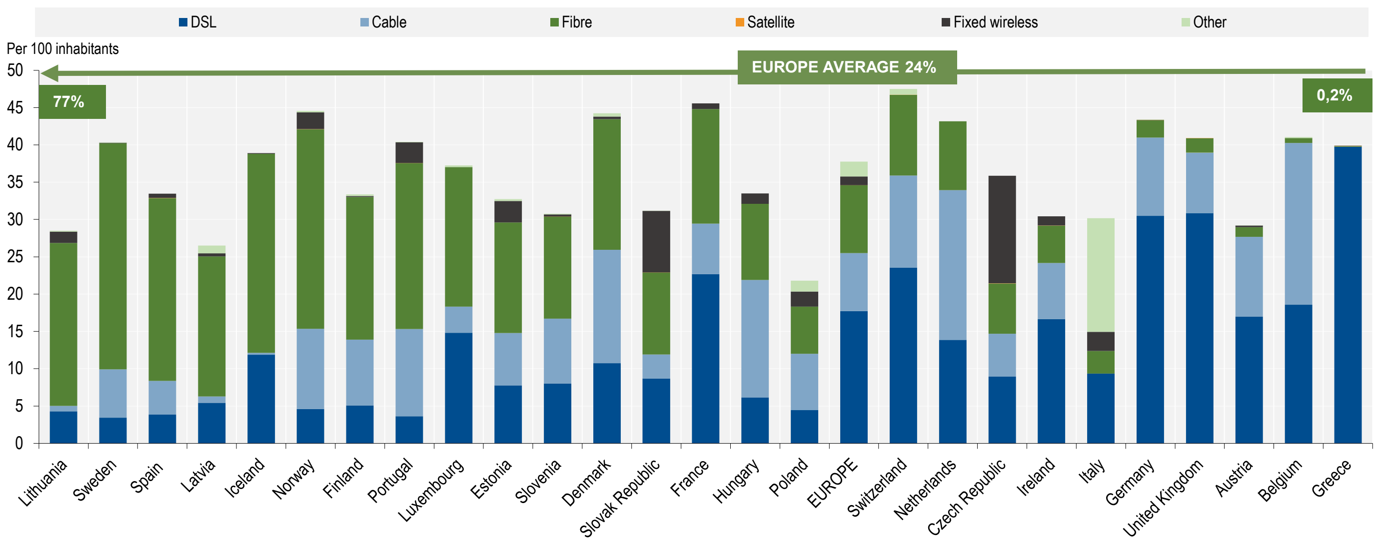
Auctions of 5G spectrum have led to modest final prices, with the few exceptions of countries with new entrants who bid up prices, while pandemic-related delays to auctions in some countries has had the effect of spreading out the costs over a longer period.

Move to fibre is still the main capex driver

Fibre roll-out varies hugely from country to country

As illustrated by the figures for the French market, it's the investment in the fixed network that is driving the increased capex across Europe. In France in past 15 year, 90% of the increase has been for fixed, that is to say moving the network form copper to fibre, and in particular to fully fledged fibre, i.e. FTTH. The speed of this transition varies significantly from one country to another in Europe, as illustrated in the latest OECD data (December 2020, **Figure 2**), with, on average, about a quarter of broadband lines already fibre. Among large European counties, Sweden, Spain, Norway and Portugal are the most advanced. Belgium, United Kingdom, Germany and Italy are among the laggards.

Figure 2: European OECD countries broadband penetration (%) ranked by proportion of subscribers with fibre (FFTH) connections (December 2020)



Source: OECD

Operators in the countries where they chose not to invest or to opt for fibre-lite technologies (like fibre-to-the-curb, or FTTC) are now under pressure from consumers and politician. These operators might have to increase significantly capex in fibre in the coming years in order to relieve this pressure.

Broadband pricing remains stable

We note also that the shift from copper to fibre will not increase revenues for telecom operators, as the price of the access is expected to remain largely stable. In Sweden, where fibre moved form 17% of all fixed broadband lines in 2005 to 77% in 2020, broadband revenues expanded exactly at the same pace as the number of broadband lines, implying that the development of fibre did not bring higher prices.

Financial investors more active; full takeovers unlikely

Infrastructure assets lure financial investors

Financial investors have become more active in some parts of the telecom industry, notably the infrastructure segment such as communications towers and fibre networks, as they provide stability and visibility on cash flows. We expect to see some more deal-making in this niche.

Altice Europe, Iliad – owners take listed companies private

Where financial investors are unlikely to venture is in terms of takeovers of fully fledged operators despite speculation surrounding Telecom Italia SpA. In fact, the trend has rather been for owners to take publicly listed companies private – Altice Europe, Iliad are good examples – after disappointing stock market performance over several years as earnings growth has not matched the expectations at IPO.

Low equity valuations and, more recently, rising interest rates are likely deterring financial investors from making big bets on the sector. The largest telecoms operators in Europe – BT PLC, Deutsche Telekom AG, France’s Orange SA, Spain’s Telefonica SA - are still considered as strategic national assets, ensuring that they are not natural targets for foreign investment funds.

New sources of growth hard to come by for mature sector

Sector faces tough search for new sources of growth

New sources of growth will remain elusive for the increasingly utilities-like European telecoms sector, confirmed by more evidence that diversification outside telecoms services has failed to significantly boost returns.

Venturing into media production/content purchasing for instance has not been a real success either in Europe, as illustrated by BT’s purchase of football rights or the creation of Orange Cinema Series (OCS) in France, or in the US, given the recent decision of AT&T to demerge WarnerMedia. IT services have also failed to transform operators’ fortunes: take KPN NV’s Getronics unit or Deutsche Telekom’s T-Systems business.

Investment in financial services, a strategy favoured by outgoing Orange CEO Stéphane Richard, has also failed to deliver expected returns, and there have been rumours of a possible disposal of the French operator’s banking business.

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