

## ARCHIVED European telecoms: better together?

Rochelle Toplensky Oct 29 11:00 2

This is the transcript of the Live Blog session ending at 12:52 on 29 Oct 2014.

After a decade of intensifying regulatory and competitive pressure, the telecom industry have begun a fight back. While regulators have achieved lower tariffs for customers on mobile, telecom companies have suffered financially. Softening profitability in recent years has deterred these same companies from investing. EU President-elect Juncker wants more investment in telecom to better compete with US industry. Telecom companies want the regulators to loosen their grip. The result, much more consolidation.

Join Lex live on Wednesday 29 October midday (UK time) to discuss the pros and cons of the trend towards consolidation.

12:00pm [Alan Livsey](#)

Hello! Welcome to another Lex Live blog. Today the big call (ahem) is on European Telecoms. There has been much debate in the market about the declining levels of profitability at Euro telecom companies. Declining returns on capital have led to poor investment climates. After nearly a decade of increasing competitive pressure, encouraged by European Commission authorities keen to lower tariffs to consumers, investors sense that the mood has changed. Perhaps the EC would tolerate less competition and more consolidation-type deals if the whole process improved investment trends. Share prices in the sector have held up or even rallied without any clear evidence of strong earnings growth appearing.

So here are the issues:

**Is consolidation really coming?**

**Will it make any real difference?**

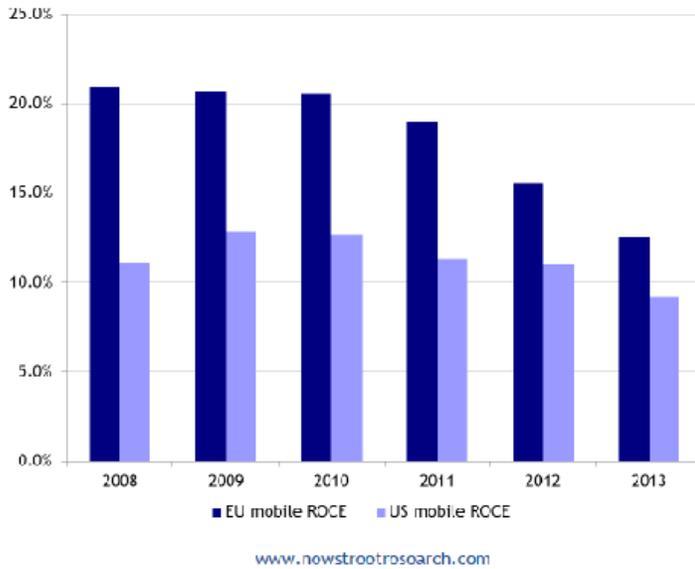
**The competition authorities in each country not just the EC must agree to it first**

Let's see what we come with it. Hope you like the discussion.

12:01pm [Alan Livsey](#)

So first off, let's consider the environment. In the EU returns on capital have been declining. Compare with the US here on this chart below:

- Fundamental reason why European telecoms has been a tough sector
  - High returns on capital, excess capacity with consumer-facing regulators

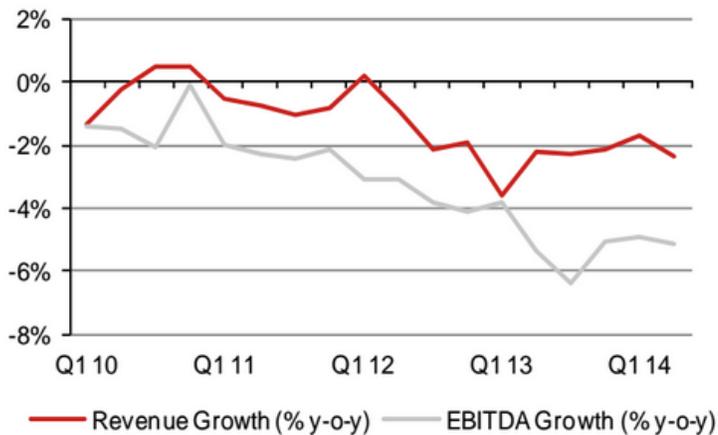


12:03pm **Oliver Ralph**

That decline is a result of what has been happening to organic growth in revenues and profits. It is not a nice story:

**Fig. 5: Sector organic revenue and EBITDA growth**

Organic growth y-o-y



Source: Company data, Nomura research

Source: Nomura

12:04pm **Alan Livsey**

So as you can see it's not been a great few years. To be fair the returns were well in excess of cost of capital, around 7.5%. Understandably, the previous Competition Commissioner, Neelie Kroes saw fit to push down tariffs where possible.

12:05pm **Oliver Ralph**

And here is what that regulatory pressure on tariffs has done to mobile service revenues – a sea of negative numbers.

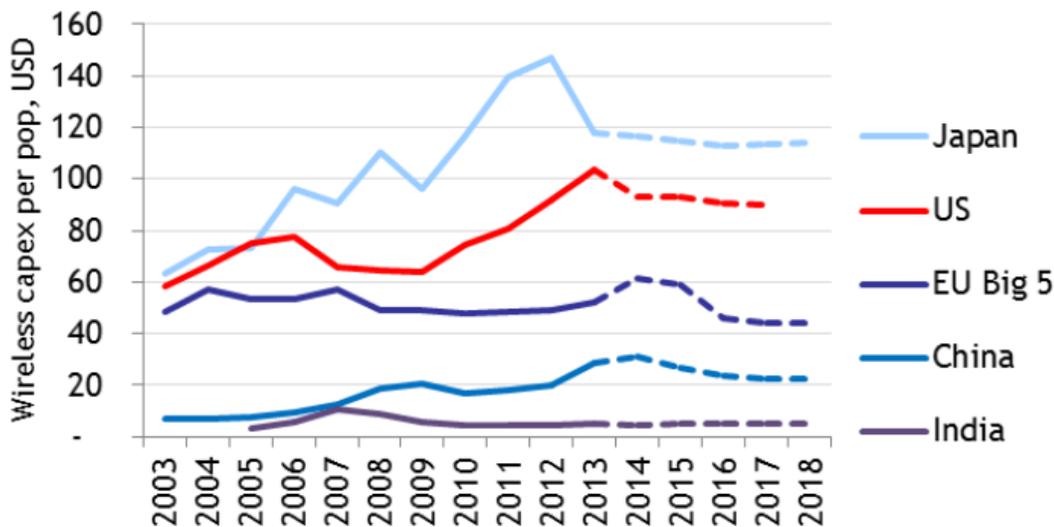
**Fig. 10: Service revenue growth by market (y-o-y)**

Market	Q2 12	Q3 12	Q4 12	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14	Q2 14
France	-7.1%	-8.8%	-9.6%	-13.2%	-14.6%	-10.7%	-9.7%	-8.2%	-7.0%
Germany	3.1%	1.6%	-0.3%	-3.2%	-4.1%	-5.3%	-4.9%	-3.3%	-1.8%
Italy	-6.3%	-12.5%	-13.0%	-16.1%	-16.9%	-13.5%	-14.4%	-14.4%	-14.5%
Spain	-11.7%	-12.5%	-9.3%	-9.5%	-9.3%	-15.8%	-16.8%	-15.0%	-14.3%
UK	-3.1%	-3.8%	-4.1%	-5.9%	-5.0%	-5.4%	-6.0%	-4.1%	-2.4%
Austria	-2.0%	-0.8%	-0.2%	-8.7%	-6.5%	-4.4%	-6.6%	-6.7%	-3.6%
Belgium	-1.5%	-1.4%	-2.1%	-9.9%	-11.1%	-14.5%	-15.8%	-8.6%	-6.3%
Greece	-5.3%	-10.3%	-2.7%	-10.7%	-14.0%	-12.4%	-8.8%	-9.8%	-6.0%
Netherlands	-4.4%	-5.6%	-4.1%	-5.0%	-6.5%	-6.5%	-8.5%	-9.8%	-8.3%
Portugal	-8.7%	-10.3%	-12.0%	-10.8%	-10.6%	-8.4%	-3.6%	-7.0%	-6.1%
Switzerland	0.2%	1.1%	-1.4%	-5.3%	-6.1%	-4.9%	-2.2%	0.0%	2.2%
Denmark	-14.0%	-14.4%	-18.6%	-11.0%	-7.7%	-4.9%	-3.3%	-4.3%	-5.0%
Finland	-3.8%	-4.4%	-4.6%	-10.6%	-7.2%	-6.0%	-4.1%	1.8%	-0.2%
Norway	1.8%	0.9%	3.5%	-1.9%	-5.6%	-3.4%	-5.8%	1.3%	4.6%
Sweden	-0.3%	-1.2%	-0.6%	-1.9%	-1.4%	0.5%	-0.8%	3.5%	2.1%
<b>Sector</b>	<b>-4.9%</b>	<b>-6.4%</b>	<b>-6.2%</b>	<b>-8.9%</b>	<b>-9.3%</b>	<b>-8.8%</b>	<b>-9.2%</b>	<b>-7.2%</b>	<b>-6.1%</b>

Source: Company data, Nomura estimates

12:07pm [Alan Livsey](#)

Thanks Oliver. So not only has profitability suffered but not surprisingly investment from these companies appears to have flat-lined, not helped by the global financial crisis, of course. Meanwhile investment in the US has gone ahead at pace. And don't think the EC hasn't noticed this trend in the chart below:

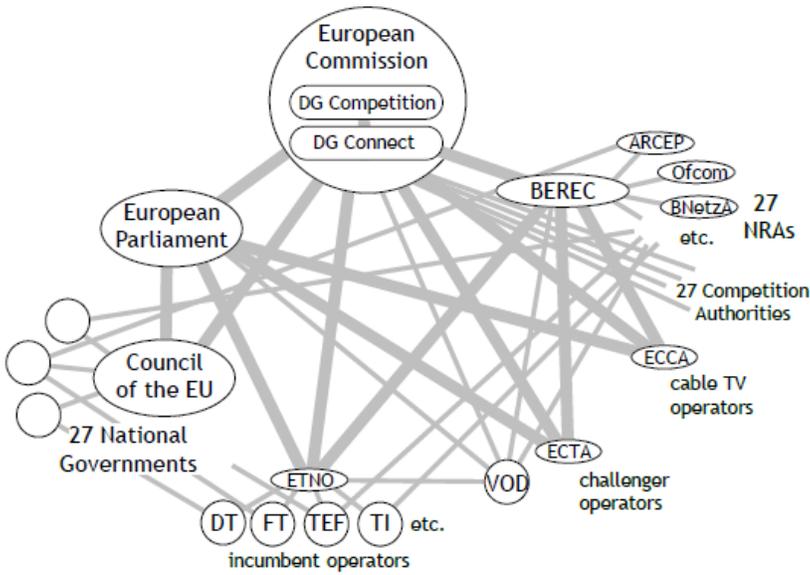


[www.newstreetresearch.com](http://www.newstreetresearch.com)

12:12pm [Alan Livsey](#)

The market believes that the EC has changed its tune; that it has concerns about the lack of investment affecting consumer take up of not just telecom service but more importantly the take up of broadband services as well. Well, it may believe in change but any move away from consumer-facing regulation will need to make its way through the thicket that is telecom oversight in Europe. We present to you the "other Web", see the chart below.

Chart 1: The main actors and linkages in EU telecoms regulation



Source: New Street Research

12:12pm **Oliver Ralph**

Nasty. Still, look on the bright side – there’s plenty of work for competition lawyers steering their clients through the mess.

12:15pm **Oliver Ralph**

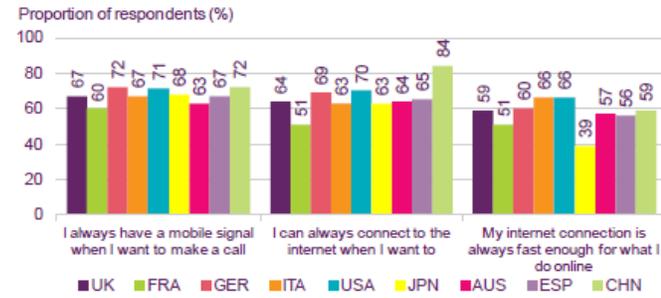
And those lawyers will have been busy. Telecoms consolidation has already started. Here’s Dealogic’s list of the top ten European telecoms deals over the past two years

2012 - 2014 YTD European Telecom targeted M&A: Deals above €500m sorted by Deal Value euro (m)						
Deal Value euro (m)	Deal Status	Target	Target General Industry Group	Target Nationality	Target Region	Acquiror
18,497	Completed	Virgin Media Inc	Telecom	United Kingdom	Europe	Liberty Global Inc
17,000	Pending	Societe Francaise du Radiotelephone SA - SFR (Bid No 2)	Telecom	France	Europe	Altice SA
10,545	Pending	Portugal Telecom SGPS SA (90%)	Telecom	Portugal	Europe	Oi SA, Telemar Participacoes SA
9,420	Pending	Sky Deutschland AG/ Sky Italia Srl	Telecom	Germany/ Italy	Europe	British Sky Broadcasting Group plc - BSkyB
8,711	Completed	Kabel Deutschland Holding AG (75.13%)	Telecom	Germany	Europe	Vodafone Group plc
8,550	Completed	E-Plus Mobilfunk GmbH & Co KG	Telecom	Germany	Europe	Telefonica SA
7,963	Pending	Ziggo NV (71.5%)	Telecom	Netherlands	Europe	Liberty Global plc
7,200	Completed	Grupo Corporativo Ono SA	Telecom	Spain	Europe	Vodafone Group plc
5,440	Completed	Nokia Oyj (Devices & Services business)	Telecom	Finland	Europe	Microsoft Corp
5,171	Pending	Telekom Austria AG (44.7124%)	Telecom	Austria	Europe	America Movil SAB de CV

12:16pm **Alan Livsey**

Next question: is the consumer unhappy? Ofcom has done some work comparing different telecom markets around the world to see how customers perceive their service. In the chart below, note the relative similarity of responses to the question. If customers hated their service in Europe it might show up in this graphic:

Figure 6.55 Smartphone connectivity



Source: Ofcom research, September 2013  
 Base: All respondents with a smartphone  
 Note: "I always have a mobile signal..." figures include all mobile phone users.

12:17pm Alan Livsey

It seems that Japanese consumers have high standards on broadband. But otherwise note the samey-ness. Maybe blame the survey.

12:18pm Oliver Ralph

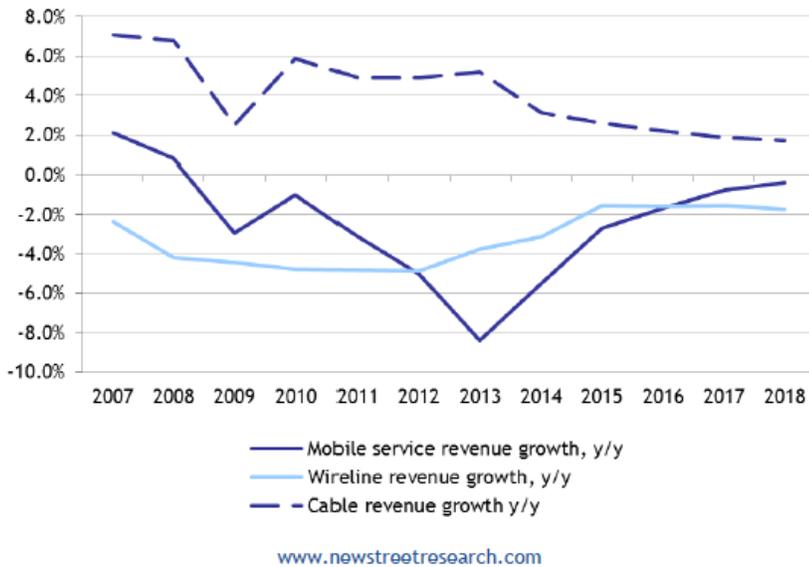
This is the one group, of course, who stand to lose out from consolidation. Fewer competitors means higher prices.

12:18pm Alan Livsey

Sorry make that Japanese consumer demand better internet connections on their smartphones, but you get the idea.

12:20pm Alan Livsey

Well, Oliver, yes there's some evidence of a turnaround at least on revenue growth. Or should I say revenue deterioration. Here's a chart of revenue rates of growth broken down by sub-sector:



12:21pm Alan Livsey

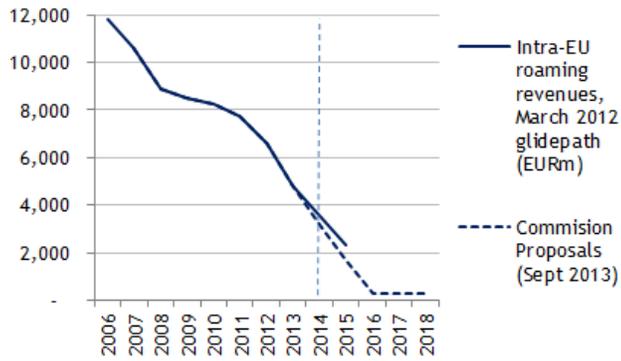
You can see the potential for some recovery on mobile, at least on New Street's estimates. Though that just means less declines, hardly inspiring.

12:21pm Oliver Ralph

Other than in cable, that's not a happy story.

12:24pm Alan Livsey

Anyway, the EC Competition authority has done its best to push down prices, especially in areas like mobile roaming charges. These have fallen a lot and could fall towards zero in the next few years. See the chart below:



12:26pm **Oliver Ralph**

Consumers perhaps ought to be happier than they are then. The big underlying question though is whether, without more consolidation, returns in telecoms are good enough to encourage the operators (and their shareholders) to invest in infrastructure.

12:28pm **Oliver Ralph**

As it is, telecoms has been a lousy place for shareholders to invest over the past decade. Here's the MSCI Europe (in purple) and the MSCI European telecoms index (in green)



Source: S&P Capital IQ

12:30pm **Alan Livsey**

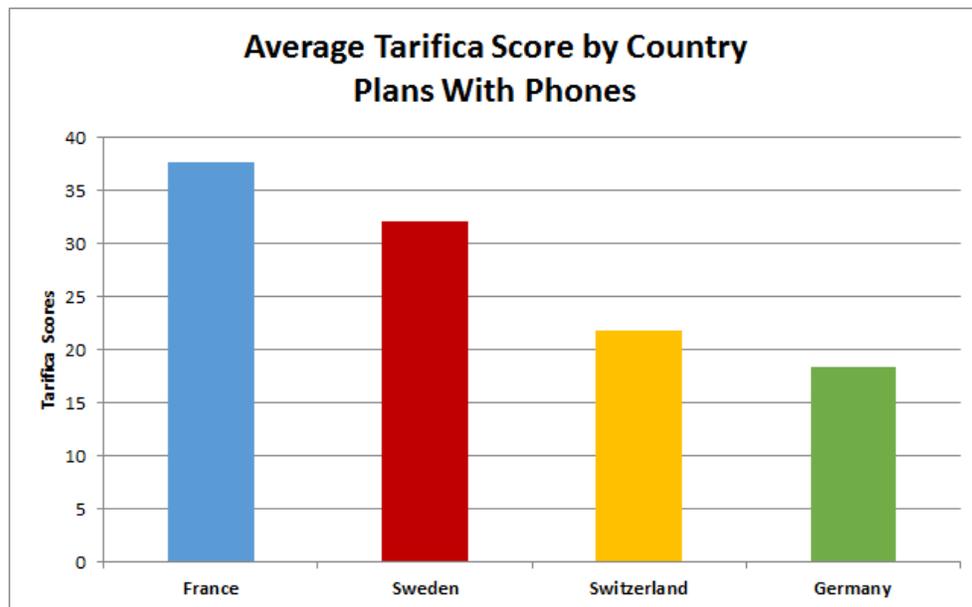
But the question needs to be asked: if roaming charges do fall to zero, what stops a UK customer using a French mobile contract from the UK. That is to say what stops the consolidation from going from, say, three in any country (considered the optimum number, these days), to three throughout Europe. A bit like what exists in the US. Would a surge in cross-border M&A improve the stock market returns of this sector. As Oliver has shown, a poor place to park one's money in recent years.

12:31pm **Oliver Ralph**

But would the regulators allow that? Would consumers be happy for the whole market to be controlled by three companies?

12:35pm **Alan Livsey**

One good reason, as we noted earlier, is the EC Competition Commission's consumer facing mandate. Not a bad thing, necessarily. Consider some data here from a group called Tarifica, who measure the all the benefits of mobile packages for consumers against their respective costs. They do this across country borders using a special algorithm which gives weight to the cost of data, voice and SMS components of any contract, anywhere. See how well France comes out in this small selection of European markets. Note that France has an intensely competitive market, while Switzerland's incumbent Swisscom has much more control over its pricing. Here's the chart:



12:36pm [Alan Livsey](#)

The higher the score the better it is for consumers.

12:37pm [Oliver Ralph](#)

Hardly surprising then that France is one of the main targets for consolidation. Numericable is in the process of buying mobile operator SFR. The bill for that deal is now on the way to shareholders via a €4.7bn rights issue launched this morning.

12:37pm [Alan Livsey](#)

Thus French consumers have done well, from their perspective (and Tarifica's!), than say in Switzerland or Germany where prices for packages are higher relative to the minutes and data allowances.

12:38pm [Oliver Ralph](#)

Alan, what's the next move expected in France?

12:40pm [Alan Livsey](#)

Yes, Oliver, but clearly these customers may have the most to lose, too. Interesting that German customers fare worse than those in Sweden. The latter telecom companies have some of the best returns on capital in all of Europe. And I can tell you, having been above the Arctic Circle there some years ago, the mobile reception is excellent everywhere.

12:42pm [Alan Livsey](#)

In France, the most likely area for consolidation now, we should see some move to acquire Bouygues Telecom. Martin Bouygues wants more (perhaps €8bn) than potential bidders such as Iliad and Orange are willing to pay (€5bn). The difference is due to Mr Bouygues desire to recover his investment costs. But of course the others don't care about that.

12:44pm [Oliver Ralph](#)

Bouygues, remember, missed out to Numericable in the battle for SFR.

12:52pm [Alan Livsey](#)

So to recap. While there are reasons to expect consolidation to occur in the European telecoms industry over coming year or two, and certainly we have already seen a number take place this year (eg, Orange and Jazztel), it's not clear that the EC will simply allow a wave of mergers to occur. They remain consumer-facing and frankly there's evidence that it has worked for some consumers very well. After speaking with a few European Telecom CEOs recently it's clear that they do believe it will occur, and make a difference. Investors seem to think so though as yet there is no evidence of an improvement in profitability. Until a truly massive cross-border deal tests the EC Competition Commission, such as BT buying Deutsche Telekom (crazy thought, yes), we may see the limit of its patience on the recent deal frenzy. And certainly the local regulators must be convinced as well.

Thank you for joining us today.

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