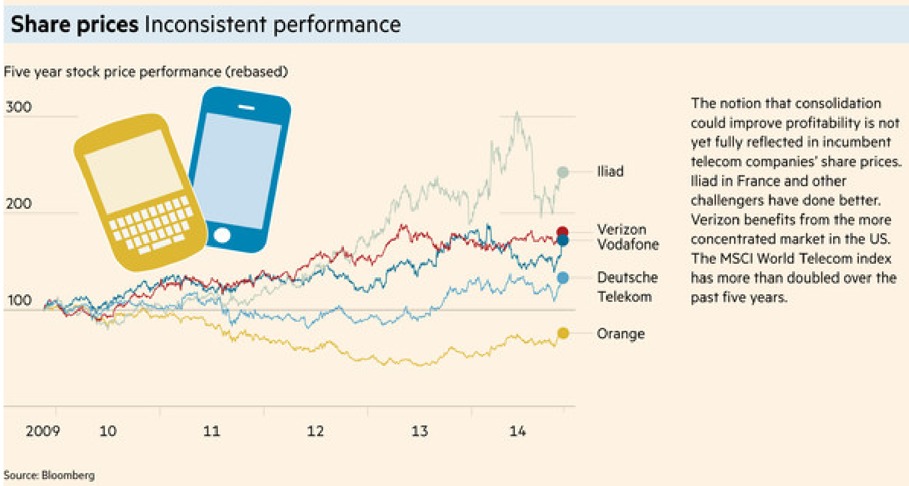
FINANCIAL TIMES

November 18, 2014 8:22 pm

Lex in-depth: European telecoms

Alan Livsey and Robert Armstrong

Competition and surfeit of providers mean Europe's telecoms groups must consolidate



The door is open. Europe's telecoms need only step through it. Jean-Claude Juncker, the president of the European Commission, wants a single market in digital communications to spark growth in employment and output. This cannot happen without increased investment from the telecoms industry. So the commission, with support from German Chancellor Angela Merkel, is looking favourably on consolidation of the sector. The idea is to increase the returns on, and therefore the incentive to invest in, infrastructure. This regulatory regime change could set off economically transformative events if the industry's leaders show imagination, initiative and flexibility.

The first domino fell this summer, when the third and fourth largest players in the German market, Telefónica's O2 and KPN's E-Plus, received approval for a merger. In an unusual move, the commission declared itself the proper authority to determine whether the merger was anti-competitive and pushed the deal through over the objections of the country's anti-monopoly authority.

The industry has endured vicious competition, particularly in mobile, for several years. Consumers have enjoyed low tariffs but mobile revenues in the markets have fallen by 18 per cent since 2008. Profits (at the level of earnings before interest, taxes, depreciation and amortisation) have been even worse, down 22 per cent. Return on capital employed in mobile has been cut almost in half in the same period, according to New Street Research.

Service quality also lags behind. The commission's digital agenda, set in 2010, targets high-speed broadband penetration of 100 per cent across the EU by 2020. France and Italy, to cite two prominent examples, have trailed other countries in the chase for the target.
As of January 2014, fewer than 3 per cent of Italians had broadband with speeds of 30 megabytes per

second – the EU average is nine times higher than that. It may not be coincidental shares in the incumbent carriers in those markets, Orange and Telecom Italia, have underperformed European stocks.

There is potential for consolidation. Seven of the largest European markets have more than three large players in mobile – the threshold beyond which competition tends to become irrational. France, Italy and the UK stand out as intensely competitive markets in which deals are likely to occur.

France: Bouygues + Iliad

France has four major telecom groups. In April, the Altice holding company bought mobile operator SFR from Vivendi for €17bn, in order to merge SFR's 22m mobile subscribers with the 1.7m fixed line subscribers at its cable subsidiary, Numericable. Despite this fixed-mobile merger, the market remains wickedly competitive, in mobile especially. French mobile operators offer consumers some of the cheapest packages available in big European markets, according to Tarifica, a consultancy. The flip side is that French mobile operators have some of the worst returns on capital employed – about 8 per cent – on the continent, according to New Street.

Four could shrink to three in the months ahead. The pieces on the chessboard are Orange, Bouygues Telecom, Iliad and SFR-Numericable. Bouygues bid for SFR in March. Now the aggressor is pursued; the poor profitability of Bouygues' telecom division makes it look like a juicy target for the others. Its ebitda margin is 15 per cent, roughly half that of Orange and Iliad. But it holds a big chunk of radio spectrum in the band most useful for 4G. Iliad has the balance sheet to make an offer and could use its own spectrum. It reportedly made an offer of €5bn last spring, but Bouygues is unlikely to sell its telecoms division for much less than €8bn, which would recoup the family group's infrastructure investment. The deal makes sense but the two sides seem to be far apart on the little matter of price.

Another possibility: SFR-Numericable buys Bouygues and then sells its infrastructure – towers and so forth – as well as a chunk of spectrum to Iliad. SFR-Numericable would then keep Bouygues' 11m mobile and 2m broadband customers tied to its network. The infrastructure-spectrum sale should help appease regulators by turning Iliad from a mobile virtual network operator or MVNO, dependant on others' infrastructure, into a proper carrier.

While it would be hasty to rule out any combination in this market, Orange is unlikely to be a consolidator. It purchased Jazztel, the Spanish fixed broadband company, for €3.4bn in September. Orange is already in a strong position with 44 and 71 per cent, respectively, of the mobile and fixed markets, by revenue. It can wait while the other parties come to terms, then benefit from consolidation without paying for it.

Italy: Wind + 3 Italia

In Italy, fixed and mobile revenues have fallen every year since 2009. According to Citi the latter have dropped 13 per cent year on year in the first half of 2014.

Not only is high speed broadband penetration low Telecom Italia (with a third of the mobile market) trails in 4G with just 2 per cent of its subscribers on the fastest wireless standard. Even in economically beleaguered France, Orange manages 7 per cent. Telecom Italia and Vodafone account for more than half of broadband subscribers.

If consolidation occurs, then, it will be between the two smaller players in this four player market: Wind and 3 Italia. Wind is highly leveraged at five times net debt to ebitda. The stronger balance sheet at 3 Italia (owned by Hutchison) would help here. Meanwhile, 3 Italia must covet Wind's spectrum. One hurdle could be the company's Russian owner Vimplecom, which may want non-rouble income. More than one-third of Vimplecom's operating cash flow comes from Wind.

Another possibility: Wind could reduce its leverage by selling its fixed line broadband business, Infostrada, to Vodafone Italia. Citi thinks Infostrada has more than a seventh of the broadband market in Italy. A sale could bring in up to €4bn on the basis of previous deal valuations in the sector, enough to wipe out nearly half of Wind's debt.

UK: BT + EE

The UK market is unlike that of its continental neighbours but is just as messy in its own way. Until recently the mobile companies had little or no fixed line exposure and vice versa. There are four mobile operators: Vodafone, O2 (owned by Spain's Telefónica), 3 (owned by Hutchison) and EE (owned jointly by Orange and T-Mobile). They compete, along with a Virgin-branded MVNO owned by Liberty Global. Mobile revenues in the UK have not grown on an annual basis since 2011.

In broadband, the market is also fractured with four big competitors: BT, BSkyB, Virgin and TalkTalk. BT and BSkyB control more than half the market and have captured most of the subscriber additions in the past few years.

BT may be the company that upsets this uneasy balance. It has decided to upgrade its MVNO service by using its customers' home routers as mini wireless masts, carrying mobile telephony signals through to the BT broadband network. Supplementing these with mobile hotspots in office buildings and shops, BT hopes to minimise its use of EE's network and its own investment, keeping costs and therefore customers' tariffs low. Vodafone, in turn, has announced plans to take the fight to BT by providing its wireless customers with broadband using the fibre network it acquired from Cable & Wireless Worldwide in 2012.

Adding another competitor to each sector could create chaos. Consolidation would provide relief. Orange and T-Mobile, itself owned by Deutsche Telekom, have voiced interest in selling EE. BT might be the right buyer. Based on its results so far this year, EE could be valued at £12bn, or about eight times ebitda.

Vodafone could also buy Liberty Global's Virgin business, giving it an optical fibre network with a fifth of the UK broadband market.

Price is no object

How should investors position themselves to take advantage of a changing European market? The obvious risk is buying a company on the assumption that it is a target, only to wake up one morning and find it is a buyer – and has paid a fat cash premium, whacking its own stock price in the process. The hope is that the companies involved do deals largely or entirely in shares, protecting their balance sheets while giving investors on both sides a chance to enjoy the fruits of consolidation. Share deals could have a regulatory benefit as well: if incumbent "national champions" are involved, regulators will not want to see them take on excessive leverage. It is up to the company boards to look past not only the usual points of conflict but to find deal structures that make sense.

Valuations should not be a barrier. Share prices and valuations of European telecom groups have moved up, reflecting hopes of further consolidation. The price to earnings multiple for the sector is at a decade high of 17 times, reflecting persistently weak earnings. But using the ratio of enterprise value to ebitda, valuations look about average, at six times. Enterprise value, which includes net debt, provides a better sense of potential acquisition prices. The sector overall does not look expensive.

Consolidation within European countries, by improving the returns on infrastructure investment, should bring Mr Juncker's dream of better 4G and broadband access closer to reality: a single European telecom market that ignores borders. Groups operating in Europe, such as Vodafone, are effectively holding companies that operate in different markets. A true pan-European telecoms market requires a regulatory rethink. Meanwhile, Europe's telecoms companies must do their part and consolidate.

RELATED TOPICS United Kingdom, Mergers & Acquisitions