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Weathering Economic Turbulence *A Telecom Perspective*

The economic storm will not spare telecommunications operators. But core communications-service revenue should prove resilient and operators may be able to take advantage of the turmoil by making anti-cyclical investments. In brief, the worldwide financial crisis will have the most significant impact on four areas of the telecom business: M&A, operating costs and capital spending, core service revenue, and additional services for enterprises.

WEATHERING ECONOMIC TURBULENCE: A TELECOM PERSPECTIVE

Telecommunications operators, like companies in every industry, are bracing for the possibility of slower growth, especially if the global financial crisis causes a worldwide recession. But as providers of an essential service, telecommunications operators are likely to be shielded from the worst effects of the downturn. Some operators—those with the financial and market strength to invest while others are retrenching—may even be able to strengthen their positions during this turbulent period.

There are four dynamics most likely to unfold during this challenging time.

The credit crisis will slow M&A, but only in the near term. We have come a long way from 2005, when Telefónica rounded up \$32 billion in financing for its O2 deal in 48 hours. The easy money is gone, and very few boards of telecom companies would be interested in selling anyway, given the level at which their companies' shares are trading. But the current malaise in capital will not last forever, and when it ends, operators with strong balance sheets and cash positions may find themselves with some good opportunities. For one thing, an economic downturn—growth in the EU is expected to be a mere 0.2 percent in 2009, compared with almost 3 percent in 2007, the European Commission said in early November 2008—will prompt consolidation as industry players seek greater efficiency. In addition, the credit crisis has forced many private equity firms to the sidelines. That suggests a shift in value-creation tactics away from financial restructuring and toward the operational improvements that favor telecom companies. In particular, we would expect to see stronger operators accelerating consolidation by acquiring marginal players in distress, along with an

increase in cross-border M&A, as well-established companies in the U.S. and Europe look to expand into developing markets. In addition, some companies in developing markets like the Middle East, Africa, and Asia may be in a position to become more opportunistic on the M&A front because of their strong cash flows and relatively low debt levels.

Operators will accelerate their attempts to optimize costs and will reduce their capital spending.

In any economic downturn, it is prudent to do a rigorous evaluation of expenditures. Indeed, before the crisis hit, many operators were already taking steps to streamline their business models; those initiatives are now likely to be accelerated. We would also expect operators to consider outsourcing more processes as a way to control operating expenses.

On the capital spending side, operators that want to conserve cash are pulling back on their infrastructure investments in developed markets and rethinking the pace at which they will roll out next-generation technologies. They are also giving more serious consideration to network-sharing models.

Does it make sense to cut capital spending? To some extent it does, but rationality in making these decisions is key. Certainly, some strategic investments directly affect a company's ability to meet demand and remain competitive into the future. The development of mobile broadband infrastructure is one, next-generation networks are another, fiber rollouts (including fiber-to-the-home, with which Verizon has had success in the U.S.) are a third. Anti-cyclical investing could be a huge advantage for those who have the ability to do it.

We learned this in 2001, when the companies that stuck with their 3G investments amid a wider telecom crisis emerged with unassailable positions in an important area of mobility. The timing may be right to continue with long-term strategic investments, since further negative effects on stock-market value might be marginal.

Core communications-service revenue will prove resilient.

Recent history provides clear evidence that telecom-service revenue is unlikely to be permanently hurt by an economic contraction. Especially in their core markets, well-run operators often emerge stronger from economic downturns, having survived circumstances that caused weaker competitors to fail.

The resilience of communications revenue is a function, in part, of the relative youth of the industry. But it is also a function of telecom's position as an essential service in mature economies. When times are tough, replacement cycles for handsets lengthen, purchases of high-end phones (like the iPhone) typically slow, and nonessential services like new media and digital content may be used less. But people still turn to their existing devices to talk on the phone, watch television, and use the Internet.

The scenario is somewhat different in developing nations, where communications services are more nascent and still in a growth mode. Operators in these countries could see a drop in subscriptions or reductions in average revenue per user. Turkcell, Turkey's leading mobile-phone operator, experienced the latter in 2001, when a recession caused individual consumers to cut back on mobile-phone minutes. The company continued to add

subscribers, however, and emerged from the crisis stronger. Similarly, Telefónica de Argentina survived the 2001 local financial crisis—in which a deep recession produced an unemployment rate of 23 percent—partly by cutting its operating expenses by 9 percent.

In short, it is difficult to imagine any telecom operator escaping the impact of the global crisis. The near term will probably be easiest for geographically diversified players that have a presence in developing markets where the crisis has not been as severe as it has been elsewhere.

Enterprise customers' desire to find cheaper ways of doing business may lead them to make greater use of certain telecom services. There is nothing positive about customers going out of business—and that has already started to happen as the impact of the credit crisis has spread. But the increasing cost-consciousness of enterprise customers—including their desire to cut back on travel expenses—may spark demand for communications services that support videoconferencing, telecommuting, and teleconferencing. As customers look to get a better handle on their SG&A costs, there may also be increased demand for VoIP, managed services, and automation.

In this brief discussion, we have highlighted some of the challenges that the current crisis will create for telecom operators. It will crimp M&A and put pressure on costs, force some vulnerable telecommunications companies out of business, curtail growth in developed as well as developing markets, and prompt consumers to be more disciplined about how they use even core communications services. But the turmoil will also create opportunities for operators that have the financial strength to maintain their long-term investments and the foresight to plot a strategy for a post-crisis world. Those who can navigate the turbulence may indeed find an upside.

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