

Exclusive Telco CEO & Private Equity Event

Presentation of the 8th annual exclusive Telco CEO & Private Equity Event hosted by Arthur D. Little in Vienna



On June 4, 2018, Arthur D. Little hosted its eighth annual exclusive Telecom CEO & Private Equity Event in Vienna, Austria. The topic of this year's event was "Harnessing digital", discussing the impact of digitalization on the telecoms industry. This year's study represents a truly global view of the telecom industry, with over 100 C-level interviews conducted and over 190 P&Ls of telecom operators around the world analyzed. The importance of these topics was highlighted by the over 70 top executives and shareholders of leading global operators, vendors, banks, private equity and venture capital funds from 25 countries attending the invitation-only event.

The event began with a welcome by Karim Taga, Global TIME Practice Leader and Managing Partner of Arthur D. Little Austria and an introduction into the various flavors of digitalization. Clemens Schwaiger (Associate Director at Arthur D. Little and lead author of this year's study) followed with the presentation of ADL's key results. The participants discussed the findings and major implications on telecom operators in a lively Q&A session. The discussion continued on the rooftop terrace where participants debated and networked in a relaxed atmosphere until late in the evening.

Key insights shared

- We expect an acceleration of telecom revenues of 3 percent CAGR globally in the next five years, driven by the North American market with a CAGR of 4.6 percent. However, we also expect capex investments to increase pressure on free cash flow.
- Telecom operators must leverage differentiation potential with an ecosystem approach, flexibility and scalability, delivery agility, cost efficiency, IT modernization and a single view of customer data to meet the increased demands through digitalization from both business and technological evolution.
- The broad adoption of digitalization could dramatically improve the financial performance of the telecom industry (+200bn FCF).
- To achieve digitalization, telcos need to make use of technology enablers, new interfaces and new ways of working – but their maturity differs.
- The majority of telecom operators see themselves as "becoming digitally smart" and, in general, over-estimate their competitors' positions.
- Reinventing as a digital company requires fundamental changes in four areas: customer focus, capital allocation, steering, organization and resources.

- Digitalization also opens up significant beyond-core potential for telecom operators, in particular in connected things, virtual and augmented reality, and virtualization.

Telecom operators have to act upon decreasing cash flows and weak stock performance

Total returns of telco stocks (in particular in Europe) are low, and top performance is essentially M&A driven. Strategic topics of capital markets day presentations of major telcos show high overlap, but also significant potential for digitalization within each. The world average capex spending in share of revenues is



going to increase by 7% annually over the next 5 years, driven by 5G and fiber expansion in developed markets and continued LTE investments in emerging markets, which will put additional pressure on free cash flow. Despite that telecom is the heart of the digital industry (i.e., the network), a number of industries are ahead of, or at least on par with, the telecom industry in digitalization, such as financial services and retail. Telecom operators have to act now to generate additional cash flow from digitalization. We define digitalization as the application of digital technologies, digital interfaces and new ways of working to change an existing business model and to provide revenue- and value-producing opportunities.



Digitalization is key to improve financial performance

Executives expect digitalization to result in significant savings in customer-care, sales, back-office and network processes. By 2022, 20 percent of the participants in this year's study expect full digitalization of customer care, and 19 percent anticipate full digitalization of their IT. Our analysis shows that broad adoption of digitalization could dramatically improve the financial performance of the telecom industry (+200bn FCF). An aggressive move into digitalization can improve EBIT margin by 10 percentage points within 10 years.

However, significant hurdles need to be overcome: Digitalization requires a cultural shift across all layers of the organization, as well executive trust in the potential behind a truly digital company. Often the "not-invented-here" syndrome and old-



school thinking hamper the cultural and mind-set shift. Telecom operators are also faced with the challenge of attracting skilled labor, as digitalization will require new skills. From a technical perspective, biased data, as well as the transformation of legacy systems, can manipulate the process of digitalization. Finally, telecom operators have to be aware that playing digital also means regulations such as the General Data Protection Regulation (GDPR) and net neutrality have to be incorporated into business operations.



How can operators leverage digitalization?

Arthur D. Little has developed a clear game plan for digitalization of telecom operators. We distinguish four different stages of digitalization:

1. Integrate digital ways: Digitizing existing analog processes and bringing the legacy system online, e.g., introducing e-sales, e-care, and simple process automation. The value at this stage is limited.
2. Become digital smart: Making customer-facing and internal processes smarter and automated through technology and new interfaces.
3. Reinvent as a digital company: Thinking and acting like large digital players, focusing on customers' experience and using agile leadership and organizational principles.
4. Beyond core expansion: Using enablers or new interfaces to venture into new revenue pools.

Fifty percent of study participants see themselves in the phase of "becoming digitally smart", but are not yet focusing on digital reinvention (13 percent) or expansion beyond their core businesses (3 percent). Digitally smart players adopt different approaches in their transformational journeys.

How to reinvent as a digital company?

Reinventing as a digital company requires fundamental changes in four areas.

1. Customer focus: True digital players focus on reducing friction for customers using their products/services and on controlling critical value chain steps. T-Mobile, for example, rewrote the rule of wireless through its “Un-carrier” strategy, unwilling to play by the status quo and unafraid to innovate.
2. Capital allocation: Clever storytelling allows digital players access to cheap capital and the ability to build structural competitive advantages. Telecom operators have significant OpFCF that could be allocated to drive large-scale infrastructure investments. Thus telcos should rethink their dividend and share-buy-back policies. Telcos also should speed up their capex steering processes, i.e. exiting failing investments faster.
3. Steering: Digital players exhibit fast and resolute decision-making and use KPIs to ensure alignment and relevance. A truly digital player makes extensive use of real-time information and provides access to available comprehensive information within the organization and to 3rd parties too.
4. Organization and resources: Digital players operate ambidextrous organizations and have a radically different mind-set and higher performance standards. Ambidextrous organizations blend productivity and creativity systems using a balanced steering and proactive transformation attitude. Cross-functional, collaborative culture is not impossible; concrete examples within the telco industry exist in examples such as Tele2. Reinventing as a digital player requires a radical mind-set change, with high software literacy, a new role for IT and the use of ecosystems.



Where and how to diversify beyond the core business?

Digitalization opens up significant beyond-core potential for telecom operators – in particular, in connected things, VR & AR, and virtualization. The real value, however, lies in the combination of digital enablers and the application for specific industry contexts – there is no one-size-fits-all. Telcos can leverage digital enablers to diversify based on existing capabilities and assets. A number of telecom operators have shown how these digital enablers and new interfaces can be used for diversification, such as Orange Bank, SoftBank Robotics, Swisscom tiko and Open Telekom Cloud.



Selecting the best entry model for diversification depends on expectations for time to market and organizational readiness. The organization’s innovation culture, size, experience with diversification, transformational programs, and level of interaction between the core and non-core business should be taken into account when assessing organizational readiness.

Shareholders often determine the expectation by the timeliness of the business impact. In the case of high pressure for immediate business impact, telecom operators can go for acquisition or “corp-ups.” We define corp-ups as commercial partnerships between corporates and start-ups, such as supplier relationships, re-seller agreements and new products, which can be implemented quickly. Long-term investments into diversification can, for example, be achieved through incubators or corporate venture capital.



Ten key success factors are evident from leading digital players

1. Create digital-native products and services and introduce new business models.
2. Radically simplify customer experience across all channels.
3. Massively reduce complexity in processes, operations and technology portfolios.
4. Leverage digital enablers across the value chain.
5. Leverage data analytics for decision-making.
6. Streamline processes to support the digital front-end.
7. Develop robust transformation governance.
8. Build on partners to source ideas and capabilities.
9. Proactively address cultural aspects.
10. Learn to participate in or even build ecosystems.

Focus areas during the Q&A discussion

The presentation sparked a lively Q&A session, as guests were eager to discuss the impact digitalization will have on the industry. Many of the points raised revolved around the value generation potential through digitalization and the options telecom operators have to capture a large share of this opportunity.

Many questions were asked about the most relevant use-cases for new revenue generation through digitalization. Topics covered most thoroughly were the opportunities for vertical expansion, how to digitalize the customer interface, as well as the role of telcos as ecosystem enablers, for instance using IoT platforms (smart city, smart campus, etc.). There was broad consensus among participants that digitalization is a sizeable opportunity for value creation for the telco industry.



The current and future allocation of operating free cash flow of operators was another key discussion topic. Although telcos typically generate substantial free cash flows, the study shows that only a small portion (i.e. less than 20% of total capex) is being invested in digitalization efforts by most operators. It was argued that, similar to OTT players, telcos should significantly increase their investments into R&D and growth areas, potentially at the expense of dividend payouts and share-buy backs.

In the concluding remarks, the discussion shed light on the reasons why the telecom industry is lagging behind other industries in digitalization. The debate highlighted the competition within national markets, the substantial barriers to entry into the telecom market and the mindset and skillset of existing resources as important inhibitors of digitalization.



Arthur D. Little

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Our consultants have strong practical industry experience combined with excellent knowledge of key trends and dynamics. Arthur D. Little is present in the most important business centers around the world. We are proud to serve most of the Fortune 1000 companies, in addition to other leading firms and public sector organizations.

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