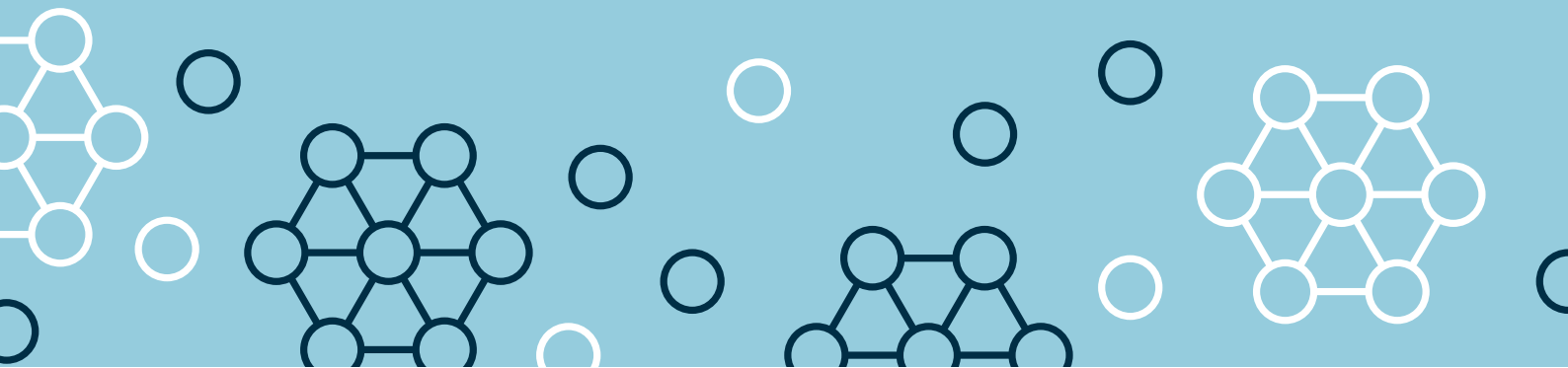**AlixPartners**
when it really matters

MARCH 2017

Beating OTTs at their own game: a golden digital opportunity that global telcos can't afford to miss

Telecommunications operators face a daunting challenge: customers have gotten used to the fabulous experiences that digital-native over-the-top companies (OTTs) provide. Now these customers are demanding equally exciting services from their phone companies. But it's hard for big, complex, and integrated telcos to swiftly and profitably meet ever-increasing expectations. Yet one opportunity beckons.

Telcos should embrace—not hide from—the digital disruption and other forces reshaping the landscape. They shouldn't let digital start-up "unicorns" run away with all of the digital business model ideas. In fact, global telcos are actually well-placed to create value in this game—if they recognize and seize the opportunity.

Today's consumers have fallen in love with digital-native, OTT applications, and services like Skype, WhatsApp, Netflix, and Uber (to name just a few). What's not to like? People can access those services anytime and anywhere by just tapping the apps on their smartphones or tablets. Those providers have acquired deep and detailed understandings of their customers, which enables them to deliver offerings tailored specifically to individual customers' needs and preferences—in real time. Plus, intuitive, self-service tools make it easy for customers to in turn interact with provider or form user communities. Transparency and simplicity rule.

It's not surprising that when it comes to their phone and data services, consumers are asking themselves, "Why doesn't my telco provide an equally great experience?" These heightened expectations put mounting pressure on telecommunications companies to step up their digital standards. After all, when consumers take stock of the quality of their telecom service, they're not comparing service across telco companies—they're comparing it with their experiences with digital-native OTT companies.

1

ServeCo

Trading and customer
relationship management

+

2

NetCo

Infrastructure
management
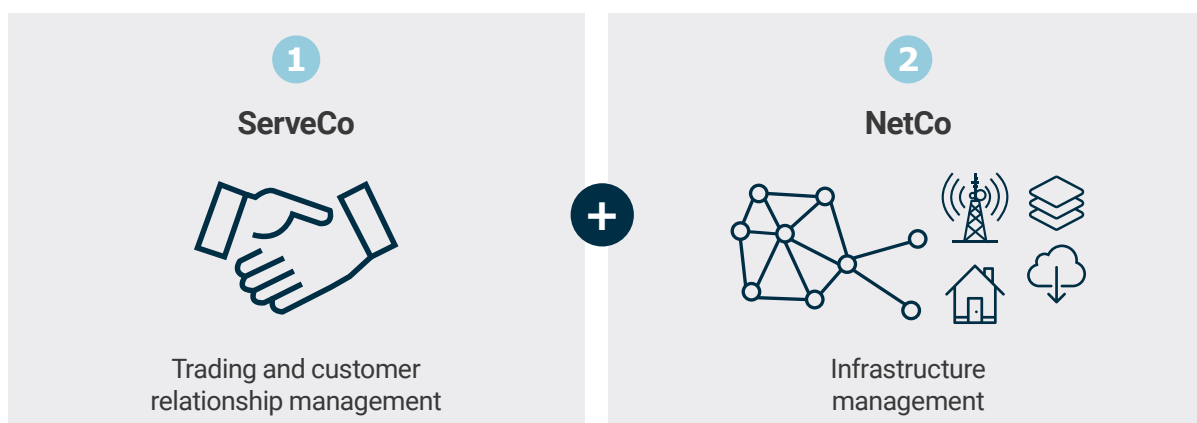
How can telcos survive (at least) and thrive (at best) in the face of this digital disruption? They will have to break open their existing business models and reconfigure the pieces to build radically new ones—and they should do it quickly. New rivals with little connection to the telecommunications industry are already encroaching on big telco's playing field. And guess what: they're here to stay. Telcos that remain complacent risk losing out to these savvier and nimbler upstarts. But those that take action now will stand the best chance of fueling fresh growth and creating high-value new businesses for themselves. But first, they'll have to deal with the challenges in their current business models.

A TALE OF TWO (CHALLENGED) BUSINESSES

Big, integrated telco operators don't compete in one business. They compete in two: on one hand there's trading and customer relationship management, which we'll call ServeCo, and on the other there's network infrastructure management, or NetCo. Each business has decidedly different dynamics and markedly different requirements from digital-savvy customers (figure 1).

Take ServeCo. In the company's interactions with this side of the business, consumers want to be instantly recognized and take fully digital journeys. This means that consumers want in digital form all of the interfaces they use to learn about, select, pay for, and use phone services. Those customers demand an easy way to make changes to their accounts, and they want to be able to do so themselves. For instance, a consumer might want an easy way to add a few gigabytes to his data plan. As with the digital-native OTT providers they use, consumers want real-time, cross-device usability, personalized interactions based on their history with the service and preferences, and

the option to join online communities. Service offerings and interfaces simply have to evolve rapidly if they're going to keep up with consumer trends.

Now let's look at NetCo. Customers want their telco network to be always on and always available. They demand 100% network coverage—that is, availability everywhere. They also expect top-quality performance, including sufficient data speeds. And they want networks to configure services instantly, which is still far from possible today but will be fully in place once software-defined networking takes hold. All of this requires huge infrastructure investments with lengthy rollout cycles.

Managing these two different sets of customer requirements across the two sides of the business isn't easy, and it doesn't always go well. Telcos usually offer little flexibility or they take too long to respond to customers' requests for changes in service. Interfaces can be frustrating. Service options and payment processes can be overly complex and confusing. Mistakes get made. The result? Disappointed and annoyed customers are rushing into OTT companies' welcoming arms to message, talk, and share data.

The situation puts telcos in a vulnerable position, especially given the even greater disruption to the industry that will come from other trends. For example:

• **Growth is becoming increasingly elusive and expensive.** Telcos are struggling to keep up and fund growth. On one side they face increasingly mature markets with vanishing traditional revenues—for instance, from voice and short message service—and on the other side a high investment ticket for data service growth—whether in media content, fixed-line fiber access, or 5G mobile networks.

- **Barriers are dissolving between markets, driving margins down.** Completing the Digital Single Market initiative for Europe is a top priority among European institutions. That development, along with the erosion of other barriers, will facilitate tariff alignment across markets and bring about the emergence of pan-European service models. As a result, lucrative business niches—such as roaming charges—will disappear and prices will get aligned to the lowest common denominator, driving margins down.
- **Technologies are maturing, challenging the telco business model.** Technology advances—in realms like cloud computing, the Internet of Things, virtualization, hybrid networks, software-defined networking, and the electronic subscriber identity module (e-SIM)—are breaking down barriers that had previously protected telco operators in local market dynamics. As the competition becomes more global, prices and margins will fall. At the same time, infrastructure funding needs will soar.
- **Transformation is difficult to accomplish.** Telcos face tough challenges in moving out of legacy systems and processes and in effectively streamlining their operations. To date, large operators have been good at making incremental improvements, but they generally have poor records of deeply restructuring their sprawling and overly complex businesses end to end in order to stay competitive.
- **Value creation through in-market consolidation is losing momentum.** The wave of value creation from in-market consolidation through M&A and network-sharing programs is ebbing. Major transactions have been completed, and recent failed deals indicate we may have reached the limits of how far consolidation can be pushed.

The upshot? Telcos must look to digitization as the next major driver of value creation. It's true that the digital transformation of existing telco operations is a must-do and will have a deep impact on efficiency. But one of the overlooked and more creative ways of harnessing digitization is to build new digital businesses: telcos can reap some of the value that OTT companies are harvesting today.

ARE TELCOS MISSING A GOLDEN DIGITAL OPPORTUNITY?

There's no doubt about it: the traditional telco business model is disintegrating. This moment presents huge challenges for large telcos, but it also presents new opportunities for those that can learn from OTT companies (figure 2).

To envision future models, let's take a quick look at the past. Consider telco operators' legacy business models. Many multinational telecom service providers were built up as a sum of local operations, which were typically added to the larger group through M&A deals. Each local operation was largely a vertically integrated business.

That legacy model gave way to today's model. Many of the multinational providers have now decoupled their applications and data and centralized their back-office operations, including procurement, data-center management, brand management, and product development. Those measures might sound efficient, but as we've seen, OTT players are still outinnovating traditional telcos in terms of high-quality, fully digital, and global user experiences.

FIGURE 2: The telco business model must evolve
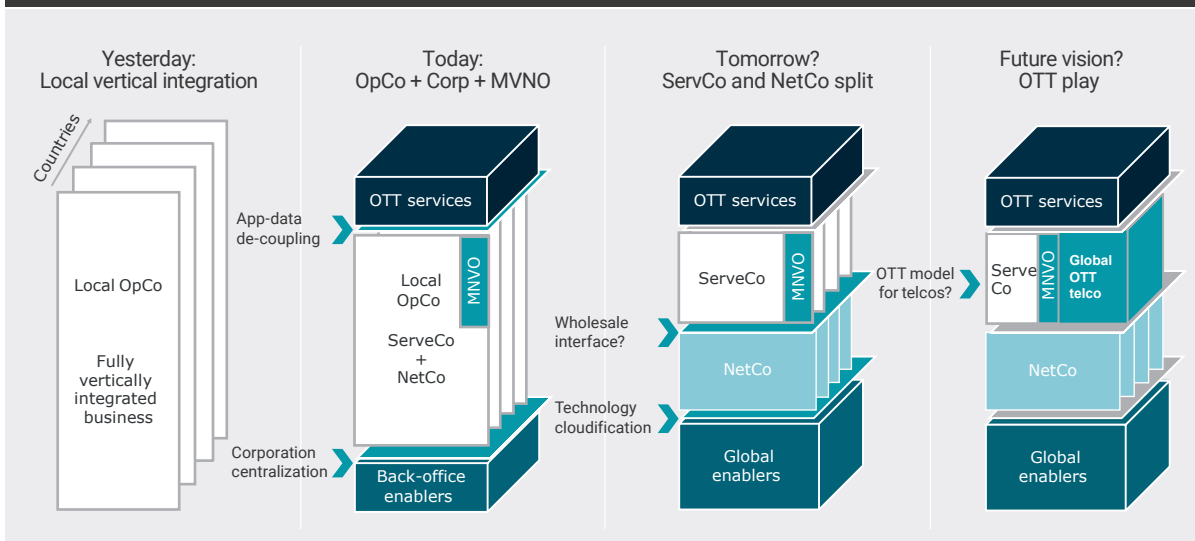
Source: AlixPartners

> By separating ServeCo and NetCo, telcos can take a leaf from OTT companies' book and build a new digital-native business that provides a global, fully digital telecom service.

Telcos should move to a model that widens the distance between their ServeCo and NetCo businesses. How can they do that? First, setting up a wholesale-like interface between their ServeCo and NetCo businesses—with arm's-length contractual agreements governing service quality—and second, taking advantage of cloudification would help. More and more businesses worldwide are demanding access to a wholesale interface: according to Gartner, by 2018 more than 20% of the top 1,000 global companies will be running their own mobile virtual network operators (MVNOs) to serve Internet of Things needs. Telcos that develop their wholesale interface capabilities could navigate a world defined by technology convergence, network sharing, network heterogeneity, network brokers based on e-SIM, and more-porous market borders drawn by regulatory changes. Thanks to new technologies, telcos will be able to globalize their back- and front-office solutions—typically through cloud computing. What's more, investors, who assess the two types of businesses differently, could value the businesses more highly when the businesses are separated.

By separating ServeCo and NetCo, telcos can take a leaf from OTT companies' book and build a new digital-native business that provides a global, fully digital telecom service. As wholesale interfaces become more common between telcos' ServeCo and NetCo businesses, that model will become easier to achieve. Through this interface, any telco or new start-up will be able to buy mobile and data network services in each country and build a digital-native networkless operator business that crosses geographies. The emergence of e-SIM will make the sourcing of mobile data bandwidth easier. And thanks to hybrid networks, they could combine mobile with Wi-Fi to move beyond the traditional MVNO model.

Big multinational telcos are best positioned to develop this business model today because they have networks in multiple countries. In theory, they could start moving toward the new vision now. They wouldn't have to negotiate multiple deals with different local wholesalers. Instead, they could serve as their own wholesalers. Those who make this move now could be the first to take their digital OTT telco business into the multinational space.

RIDING THE DRAGON OF DIGITAL DISRUPTION

There are many reasons telcos should grab the opportunity to develop a global digital virtual network operator (DVNO) business model.

- **The market is there.** Around big cities in Europe, for example, there is a huge digital-native customer segment, which will only grow larger in the future, thanks to ongoing urbanization as well as population aging.
- **The technology is there.** Most of the building blocks exist today, as we can see with all of the emerging players trying to own this niche. Further deregulation such as of media content in the European Union will increasingly lay the groundwork for transnational services. The emergence of e-SIM and associated network brokers in the near 5G future will provide essential leverage for the DVNO model.
- **The value creation opportunity is there.** A successful OTT-style DVNO can attract high-valuation multiples, thereby adding substantial shareholder value (figure 3). Moreover, that could compensate for some of the value lost through the decline of the telcos' traditional business.
- **Global telcos have unique assets.** Telcos have a head start, thanks to their networks, operations, relationships, and partnerships in a number of markets.

But executing on the opportunity can be challenging for traditional telcos for a number of reasons.

- **Disruption is difficult.** One of the biggest challenges is the defensive incumbent mind-set that most global telcos have developed over the years. That perspective can prevent them from both recognizing the opportunity and acting on it. Disruptive innovation can easily be seen as unrealistic or dangerous. To succeed, most telcos will have to incubate this new business separately—far from the core.
- **Talent is scarce.** Establishing teams with the skills to build a digital-native business can be tricky given the competition across industries to attract the best talent. Acquiring an existing start-up company in this field and augmenting it could serve as a convenient shortcut.
- **Time is of the essence.** First-mover advantage is critical. A telco that wants to enter this space should grow its global brand and snap up large numbers of digital-native customers across geographies before other big telcos can reach them.
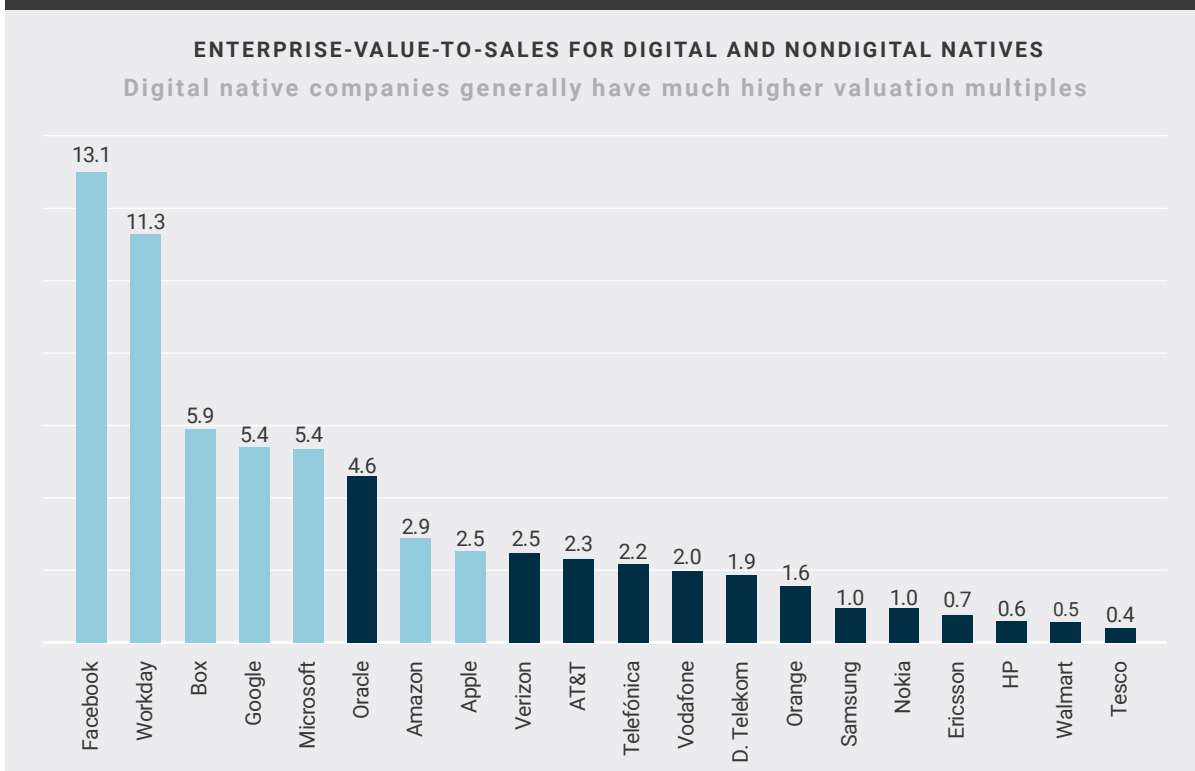
Wheels are already in motion, with start-up DVNO players like FreedomPop leading the charge (see box—**A case in point: FreedomPop**). Global telcos can join the race and use the unique assets already in their possession—their networks and their market presences—to proactively grab this opportunity to create their own version of a DVNO business first. Or they can risk being disrupted by more-progressive and more-agile players.

The lessons from other industries loom large: telcos that drag their feet or shy away from the opportunity because they fear cannibalization of their existing businesses could face the same fate that, for instance, certain complacent incumbents in the commercial airline industry are now experiencing. In that industry, traditional incumbents were blindsided by low-cost carriers that spotted and seized a market opportunity.

The message couldn't be clearer: telcos can't afford to ignore the disruptive dynamics that digital-native OTT companies have stirred up by offering customers unparalleled service experiences. To remain viable, telcos must face the forces reshaping their industry and overcome the challenges inherent in their current business models. Then they must embark on digital transformation efforts. At the very least, they'll have to step up their digital transformations to extract more value from their existing businesses. But the savviest among them will do much more: they'll draw on their unique, still valuable assets to seize a onetime-only opportunity to beat the OTTs at their own game. **A**

FIGURE 3: Valuation of digital-native companies versus traditional models

ENTERPRISE-VALUE-TO-SALES FOR DIGITAL AND NONDIGITAL NATIVES

Digital native companies generally have much higher valuation multiples

Company	Value
Facebook	13.1
Workday	11.3
Box	5.9
Google	5.4
Microsoft	5.4
Oracle	4.6
Amazon	2.9
Apple	2.5
Verizon	2.5
AT&T	2.3
Telefónica	2.2
Vodafone	2.0
D. Telekom	1.9
Orange	1.6
Samsung	1.0
Nokia	1.0
Ericsson	0.7
HP	0.6
Walmart	0.5
Tesco	0.4

■ **Digital natives:** platform models with same user experience globally, usually with network effects
■ **Nondigital natives:** companies in the 'Technology' sector that do not possess the above attributes
Sources: AlixPartners, Bloomberg (24 February 2017)

A case in point: FreedomPop

FreedomPop, a wireless Internet and mobile phone service provider based in Los Angeles, started out as a Wi-Fi hot-spot company and later began offering voice and data services. Through its freemium app-only offer, it provides standard free voice and data in addition to free roaming across multiple geographies, and customers can buy add-ons like unlimited calling, additional data, and faster connection speeds. The company provides all of those services over data because unlike MVNOs, FreedomPop does not buy minutes from network owners. Moreover, FreedomPop seeks out the cheapest networks it can find, providing services through hot spots as well as 3G and 4G mobile networks.

FreedomPop launched its service in the United States (with Sprint) as well as in the United Kingdom and Spain (with Three). In the year and a half following its inception, the service attracted more than a million users. The company plans to expand its offering to more than 30 additional countries—in western and eastern Europe and Scandinavia—with countries in Asia and Latin America also under consideration.

FreedomPop has captured the attention of some of the large traditional telecom players (Axiata and LetterOne—VimpelCom's parent—are shareholders) interested in hedging their bets on this model,[1] and it has attracted considerable interest from venture capital firms and tech giants such as Intel. To date, investors have channeled more than $100 million into FreedomPop.[2]

[1] Company website, AlixPartners analysis.
[2] Company website, AlixPartners analysis.

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