

## STRATEGIC GROWTH CHOICES AND COMPETITIVE PRIORITIES FOR FIXED LINE TELECOM INCUMBENTS

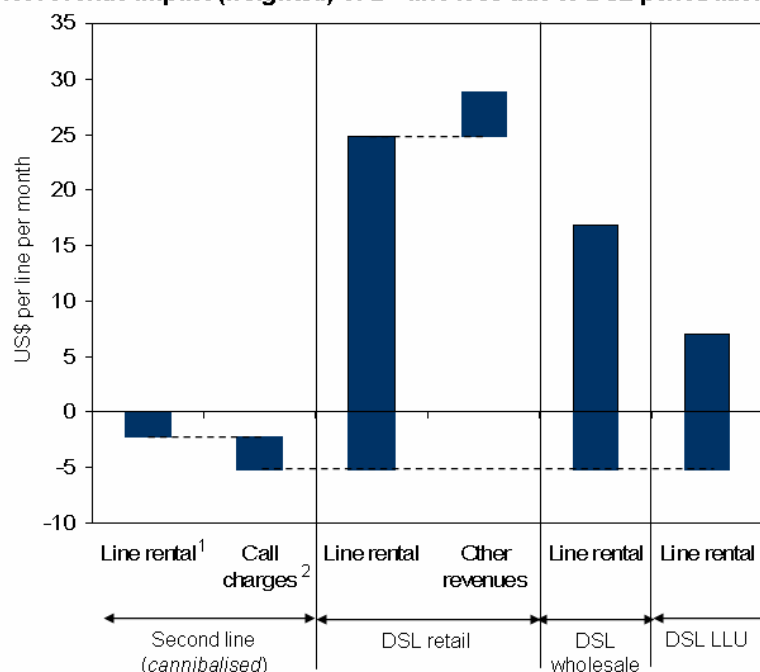
Fixed line telecom incumbents are pursuing growth through broadband and mobile services to offset decay in their core fixed-line voice business. However, the early-stage challenges—coupled with the incursion of multiple new competitors—in these growth businesses led many incumbents to follow diffused (and sometimes misguided) strategies. However, an in-depth evaluation of these trends suggests the need to focus on cable broadband / voice as the most serious long-term competitive threat while de-emphasising economics and legacy impact issues in strategy development. These are discussed below in detail.

### 1. Myth-1: Broadband cannibalises fixed-line revenues

Fixed line incumbents are belatedly—but aggressively—rolling out DSL services in most key. Their initial inertia was attributed to broadband’s potential cannibalisation of (second) lines, particularly in the US. An earlier study by Index Partners, however, found the arguments flawed.

As the diagram below suggests, DSL has a positive net impact on incumbents’ revenue, given that broadband revenues exceed second line revenues under all business models (retail/ wholesale/ LLU). It is important to note fixed-line incumbents *do not own* the broadband franchise (unlike the second-line franchise) and hence a gradual DSL rollout offers a head-start to cable broadband players without necessarily delaying the loss of access lines (particularly given that second lines subscribers are the most likely “early adopters” of broadband services).

**Net revenue impact (weighted) of 2<sup>nd</sup> line loss due to DSL penetration**



Note: Weighted estimates used for second line revenues: 1) US\$ 12.6 x 17.5% and 2) US\$ 16.9 x 17.5%, where 17.5% indicates the average number of DSL connections that lead to the termination of a second line contract

Source: Index Partners

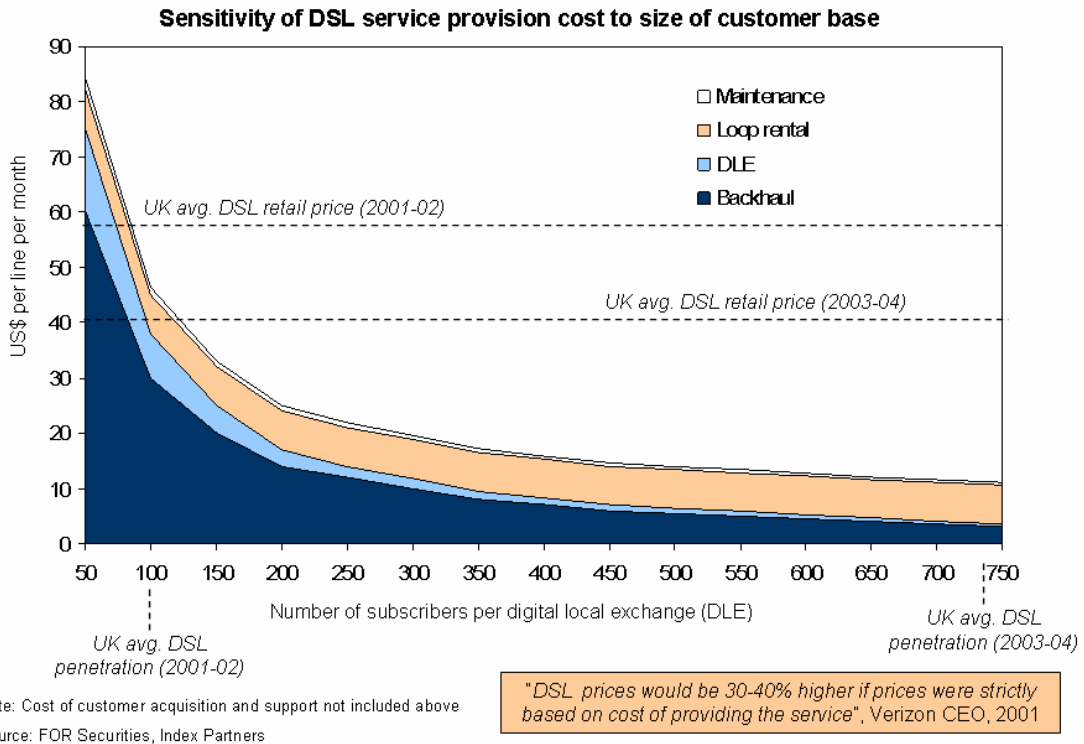
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**Broadband presents a profitable growth opportunity for incumbents**

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## 2. Myth-2: Broadband is not a profitable proposition

Several fixed-line incumbents delayed DSL rollout given their lack of "immediate" profitability (the extra-caution reflected the prevailing dismal financial state (high-debt) of most incumbents). However, an earlier study by Index explicitly revealed DSL's long-term profitability with penetration growth, even in a scenario of competition-induced decay in tariffs. This is driven primarily by scale benefits of DSL service provision as well as hardware cost decay over time (DSLAM and modem prices fell ~50% during the last 2 years). The profit margins are likely to remain sustainable given the trend towards "segmented" or "tiered" pricing (which improves alignment between revenues and costs) as well as emergence of potential new streams (e.g. advertising/ billing/ e-commerce commissions, etc.) in the long-term. This is illustrated in the diagram below.



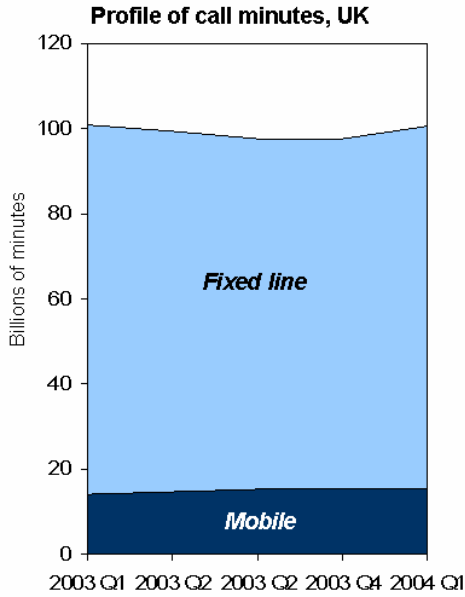
## 3. Myth-3: Mobile cannibalises fixed-line revenues

Mobile's cannibalisation of fixed-line revenues has been limited and is likely to taper off in the medium term. Mobile services are cannibalising fixed-line *usage* rather than *access* lines (for example, the percentage of mobile-only population has remained stable at ~8% during last 2 years). The MoU (minutes of usage) impact of mobile on fixed-line services remains limited (see diagram above); in most cases mobile is believed to generate incremental traffic. However, the financial impact of any marginal increase in cannibalisation (driven by reducing mobile tariffs) will be minimal as fixed-line operators rebalance their revenue model by migrating to a fixed structure (summarised in diagram below).

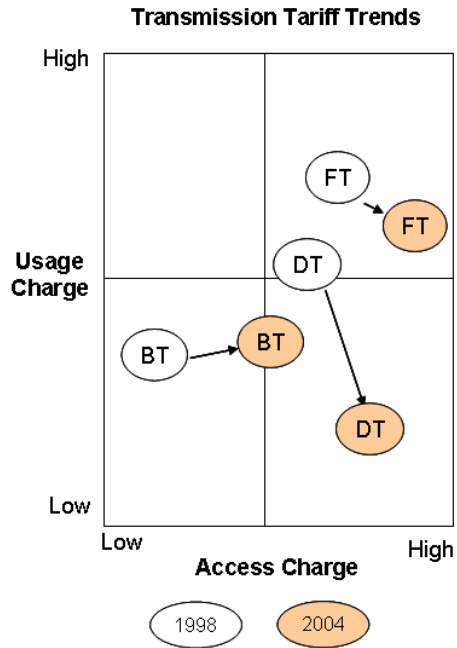
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**Mobile cannibalisation of fixed-line revenues is not significant**

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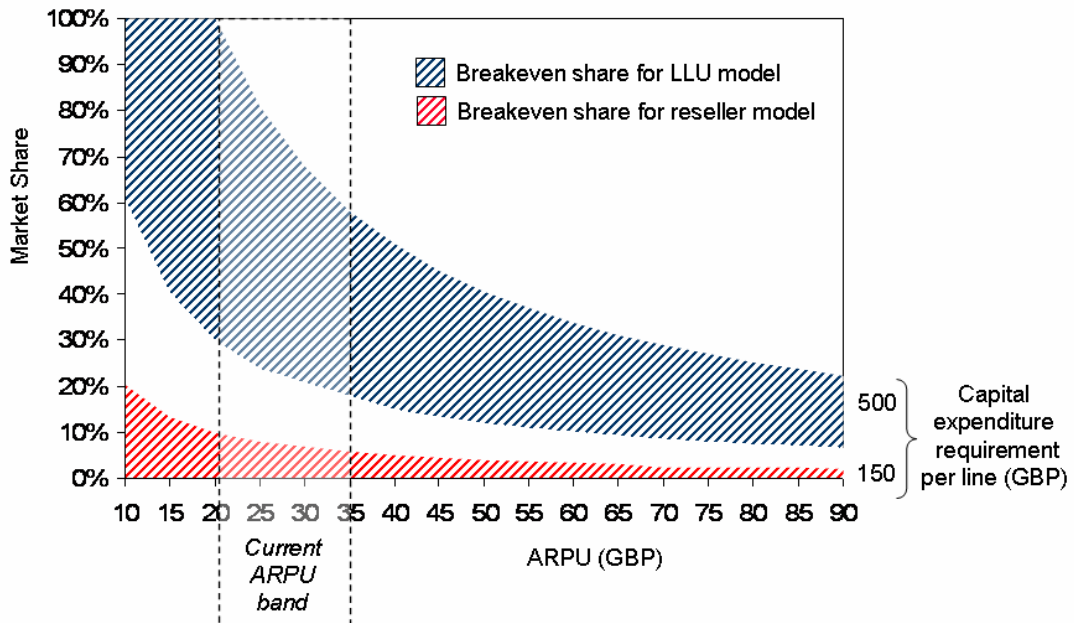
Source: Ofcom, Index Partners



## 4. Myth-4: Opening network to competition destroys value

Opening network to competition (wholesale and LLU models) offers significant strategic benefits to incumbents as it *creates incremental revenue streams* and *eases regulatory (pricing) pressure*. Furthermore, a proliferation of DSL in broadband market (stimulated by opening of network) could potentially encourage online content leaders (e.g. Yahoo, MSN, etc.) to forge partnerships rather than enter access business themselves (thereby limiting competition and opening up additional revenue opportunities). Preliminary evidence of such "virtual integration" is emerging on both sides of the Atlantic with the announced partnerships between Yahoo / MSN and SBC / Verizon / BT. In contrast, partnerships between established online content players and cable broadband providers are less likely given the traditional content stronghold of cable firms ("*SBC and Verizon have outsourced their portal [to Yahoo]... that is a mistake*", CEO of Comcast, the largest cable company in the US).

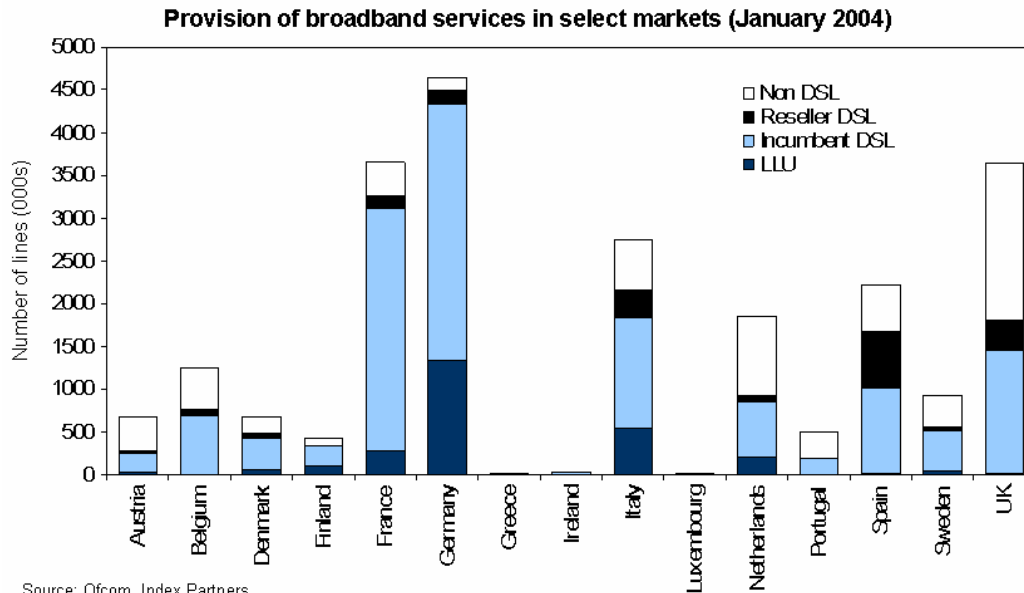
### Economics of DSL LLU & reseller models: Breakeven market-shares for ARPU & capex scenarios



Source: FOR Securities, Index Partners

The corresponding risk of any significant growth in competition remains limited given the economics of both LLU and wholesale models (summarised in the diagram above). Few LLU challengers are likely to be able to garner a “viable” market share (as suggested in the diagram above) given the business’s *lack of competitive differentiation* (with incumbents’ DSL offers) and the *need for significant funds* (for both capex commitments as well as the need to convince customers of long-term staying power). The wholesale (or DSL reseller) model – while relatively more viable – suffers from lack of compelling product/ service differentiation.

Market data (as summarised below) seems to validate the above conclusion given the relative dominance of incumbents in most broadband markets.



While the growth of competition is likely to ease regulatory pressure (primarily pricing) at the retail end, the “limited” viability of LLU suggests that wholesale prices will continue to be closely regulated to encourage competitive activity as well as network investments.

## 5. The reality: Cable broadband is the nemesis

Cable firms pose the most serious long-term threat to fixed-line incumbents, notably to their core voice business. Cable broadband penetration into homes is likely to be an anchor for attracting voice business into the cable network with “bundle pricing”. This implies immediate **loss** of *access and interconnection revenues* and potential **increase** in *interconnection costs* with an increasing share of calls terminating in non-incumbent networks. This “Trojan Horse” strategy threatens to neutralise the value of two most fundamental assets of incumbent fixed-line operators, namely, customer relationship and the physical network.

UK is, however, an exception with BT marginally exposed to this threat given already strong position of UK cable firms in voice telephony (~35% telephony penetration of households in their footprint area). However, an additional ~8% of BT households in UK cable areas remain vulnerable given their use of cable broadband. The threat is more serious in the US, where cable is aggressively looking to grow its current low share of the voice business (projected to grow from 5% in 2005 to 22% in 2010) by rolling out VoIP over broadband lines.

**"Cable broadband is the trojan horse"**

## 6. Implications for industry participants

Incumbents therefore should prioritise and focus their strategic response to contain the cable threat (rather than react to all emerging “challenges” at the same time). This implies an incumbent strategy to maximise DSL’s share of the broadband market, *irrespective of the specific business model* (incumbent / reseller / LLU). The direct benefits of such a strategy are containment of cable threat to core business, a relaxed regulatory/ pricing regime as well as sustained (though reduced) revenue streams from resellers and LLU participants. The indirect benefit of such a strategy is reduced hardware prices (scale benefits) that in turn will likely drive penetration in “marginal” user segments. Furthermore, a DSL stronghold in the broadband market will allow the incumbents to “manage” the rollout of VoIP – which is likely to be the next “disruptive” force in the core voice business. In Europe, the trend remains positive for incumbents as DSL is increasing its share of broadband connections driven primarily by incumbent penetration (incumbents hold ~80% of the DSL market while resellers and LLU participants have ~15% and ~5% of the market respectively). In the US, DSL has ~40% share of broadband access lines of which the incumbents control ~75%.

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**"Broadband & mobile are growth opportunities and not threats...  
... while cable is a serious threat to incumbents' core revenue streams"**

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The evolving competitive dynamics and consequent strategic shifts in the broadband market raise significant and important questions for investor and business participants in this market, e.g.:

- What will be the size and profitability of the broadband access and content markets?
- Which revenue models (e.g. fixed “buffet” pricing, tiered pricing, etc.) are likely to win? What are the risks associated with each?
- What are the relative values of different competitive threats on each key business segment?
- How does the likely pricing and demand scenario impact the profitability and cash flow position of a specific business?

Answering these questions require rigorous, independent, timely and insightful analyses of relevant issues within the telecom, media and technology industries. Index Partners leverages its knowledge and experience across these converging sectors to help investors and companies assess specific business / investment opportunities.

Notes:

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