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A new wave of M&A for Middle East telecom operators

Models for future growth

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Executive summary

The telecom industry in the Middle East and North Africa (MENA) region is on the verge of a new wave of M&A. Telecom companies are likely to pursue regional, or even global, targets within the growing information and communications technologies (ICT) sector.

These acquisitions will allow telecom companies to capture growth from adjacent industries, as well as to forge a new strategic identity. The arrival of cutting-edge talent, technologies, and research and development capabilities will facilitate the ultimate intention of many companies to become digital conglomerates.

Previous telecom M&A activity was principally intended to increase scale. It was usually handled by a dedicated unit that worked with the corporate leaders and the board, with minimal impact on existing operations. However, a move into ICT and other digital services affects the future value proposition and capabilities of business and functional units. These units therefore need to be closely involved as stakeholders in the finer details of telecom operators' new-style inorganic growth strategy.

Stakeholders must agree on the overall strategic intention of M&A activity, adopting a clear direction on the sectors to target, and deciding whether the necessary capabilities should be built from within or sourced from outside. Such clarity of purpose allows companies to assemble profiles of potential targets, anticipate synergies more accurately, and compose a coherent post-merger integration plan to create a comprehensive ecosystem in their new digital domains. Although the scarcity of potential targets in the region does make the acquisition process more challenging, companies must look harder, signal their intentions to the market, and even pursue global opportunities.

Companies must also develop an operating model that allows more flexibility in the way acquisitions are managed and then overseen. In assessing the success of this new breed of transactions, operators should embrace new performance management thresholds and indicators.

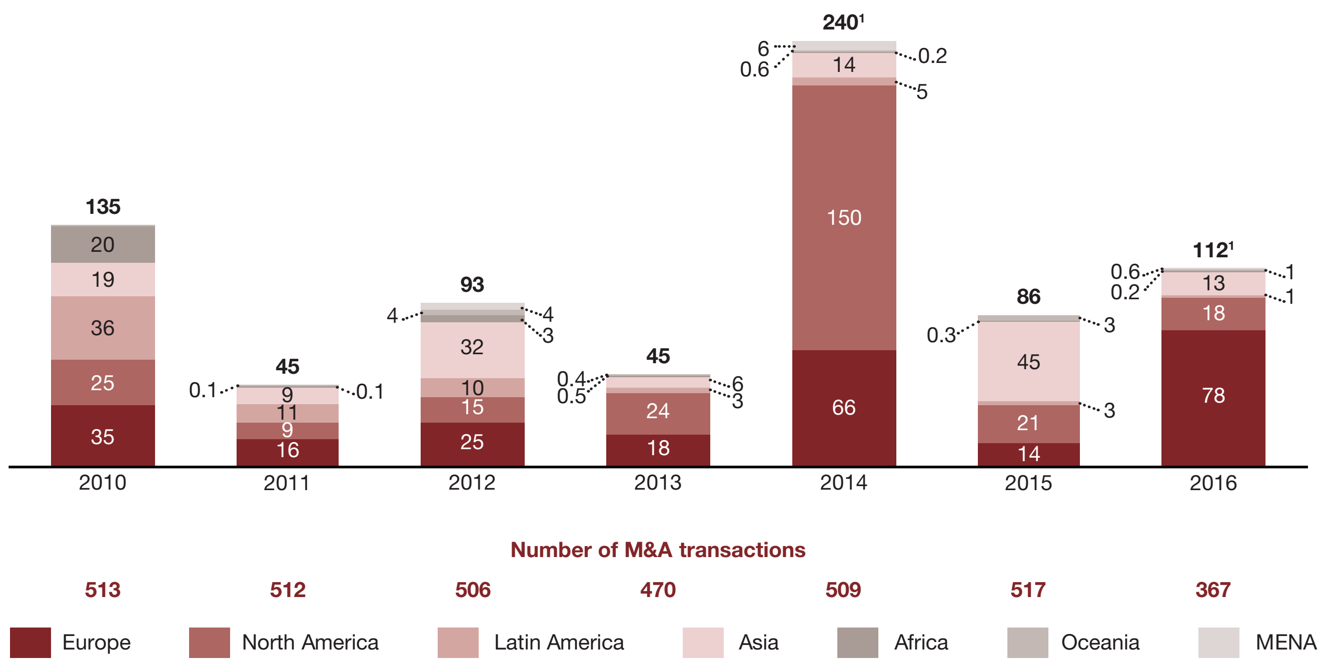
From scale to scope

M&A has been a constant item on MENA telecom executives' agendas. Increased activity is likely soon in the region if global patterns are anything to go by. Global telecom M&A activity has recovered after the global economic slowdown in 2008 and 2009, with an average of around 500 deals completed annually over the past seven years. M&A is thriving again because telecom operators have strong balance sheets and are constantly pursuing growth. By 2014, total global transactions were worth US$240 billion, the highest in 10 years. Much of this consisted of Verizon's $130 billion acquisition of Vodafone's 45 percent indirect interest in Verizon Wireless to gain full control over that company's operations. In 2015 and 2016, transactions amounted to $86 billion (517 deals) and $112 billion (367 deals), respectively. North America and Europe remain the most active regions, accounting for 68 percent of the value of all transactions since 2010. Asia accounted for 18 percent, while the MENA region represented just 1 percent, a mere 37 deals (*see Exhibit 1*). Operators in the U.S. and Europe contributed 49 percent of the total capitalization of acquired companies, versus 7 percent for MENA operators.

Global telecom M&A activity has recovered after the global economic slowdown in 2008 and 2009.

Exhibit 1
North America and Europe are the most active regions for M&A

(US$ billions)



[1] Totals do not sum due to rounding.

Note: Oceania includes Australia, Cook Islands, Fiji, French Polynesia, Guam, Micronesia, New Caledonia, New Zealand, Papua New Guinea, Samoa, Solomon Islands, Tonga, and Vanuatu.

Source: Thomson Reuters; Strategy& analysis

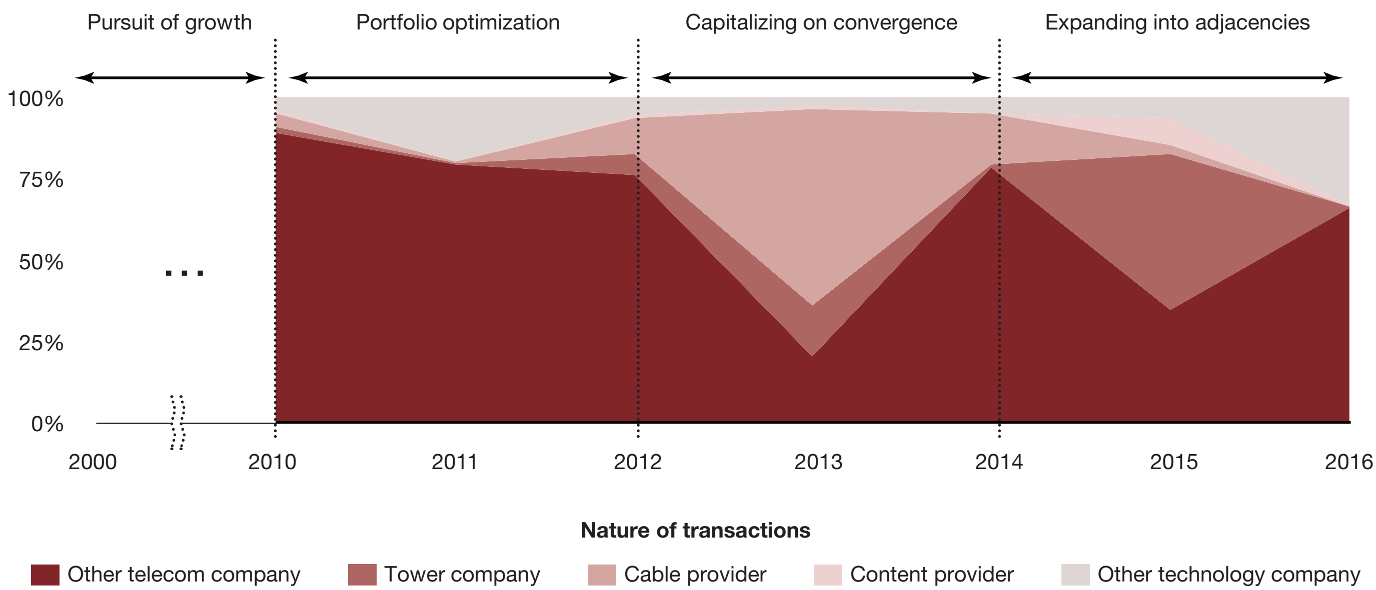
Within this M&A recovery, there have been four main themes that are to an extent being replicated in the Middle East — the pursuit of growth, portfolio optimization, capitalizing on convergence, and expansion into adjacencies. Globally, telecom operators have moved away gradually from the pursuit of scale to expanding into adjacencies through M&A (*see Exhibit 2, page 6*).

1. Pursuit of growth

Before the global financial crisis, cash-rich telecom operators expanded beyond their domestic borders, pursuing growth in new, undeveloped markets to counter slowing growth and the saturation of their home markets. These operators now derive a significant proportion of their revenue from international operations and a similarly high proportion of their value from group-level synergies.

Exhibit 2
Inorganic strategies are shifting from pure pursuit of scale to increased focus on scope

(Percentage of transaction type, 2010–2016)



Note: Other categories of telecom transactions are excluded from the chart.

Source: Thomson Reuters; Strategy& analysis

2. Portfolio optimization

Once scale was achieved and synergies captured, operators began to look inwards to optimize their portfolio with the aim of coherence.[1] Pressure from shareholders to divest non-performing assets after the 2008 crisis accelerated this trend. Attempts at portfolio optimization resulted in a change in M&A activity toward controlling stakes, in-market consolidation, and the divestment of non-coherent or non-performing assets. This greater control and coherence in the portfolio allowed operators to extract more synergies, focus on a homogenous set of capabilities across their different markets, and enhance their capital structure. Examples include TeliaSonera's consolidation of ownership stakes in Estonia, Lithuania, and Netherlands; Vodafone's exit from Japan, T-Mobile's sale of its towers in the U.S.; Etisalat's control takeover of Atlantique Telecom; and Zain's sale of its African assets. There were also smaller deals, such as Ooredoo's consolidation of its ownership in Asiacell and likewise for Saudi Telecom Company (STC) with VIVA in Kuwait.

3. Capitalizing on convergence

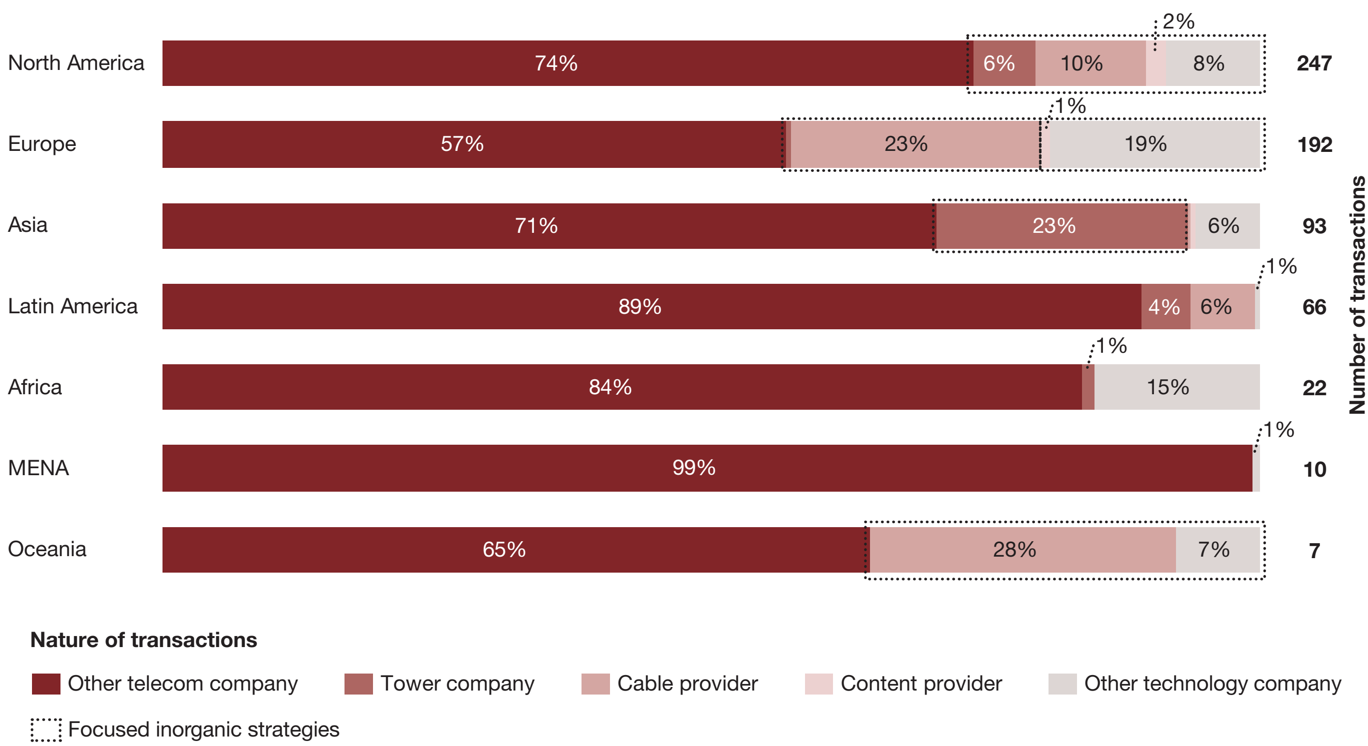
The telecom industry then focused on convergence. This involved operators looking beyond scale to unlock areas of value and to gain market share through multi-play offerings. Transactions with the aim of convergence mainly occurred in markets with a strong fixed infrastructure and legacy cable providers, such as the U.S. and Europe (*see Exhibit 3*).

With the growth in data consumption and the associated investment requirements, operators also aimed to capitalize on synergies from last-mile delivery and data offloading. Notable transactions within this convergence theme include the merger of Numericable and SFR in France, Vodafone's acquisition of Kabel Deutschland in Germany, and Verizon's acquisition of AOL in the United States.

Exhibit 3

Focused inorganic strategies occur mostly in mature markets such as Europe and North America

Cumulative telecom M&A by region and industry trend (US$ billions, 2010–2016)



Note: Other categories of telecom transactions are excluded from the chart.

Source: Thomson Reuters; Strategy& analysis

4. Expanding into adjacencies

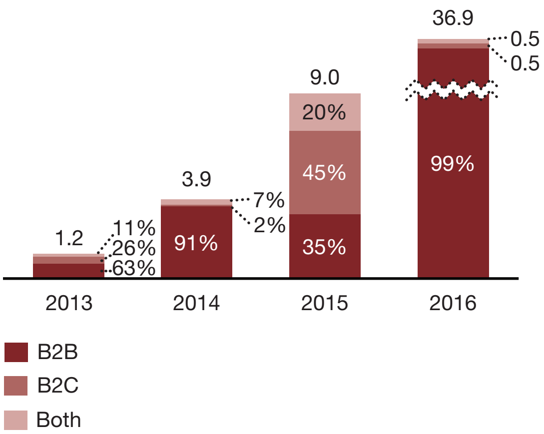
Most recently, telecom companies have pursued regional, or even global, targets within the growing ICT sector. This expansion into adjacencies increased sharply in 2015 and 2016, with a total of 213 deals valued at $14 billion (excluding Softbank's acquisition of ARM Holdings in 2016 for $32 billion) during these two years, versus 184 deals valued at $5.1 billion during 2013 and 2014.

Operators shifted emphasis again due to the growing intensity of conventional and unconventional competition and the difficulty of monetizing data consumption. Global operators focused on expanding their capabilities to position themselves as end-to-end ICT providers. Prominent examples include Verizon's acquisitions of Fleetmatics and Yahoo, Singtel's acquisition of Turn through its subsidiary Amobee, Orange's acquisition of Groupama Banque and a stake in Africa Internet Group, and Telstra's acquisition of iCareHealth.

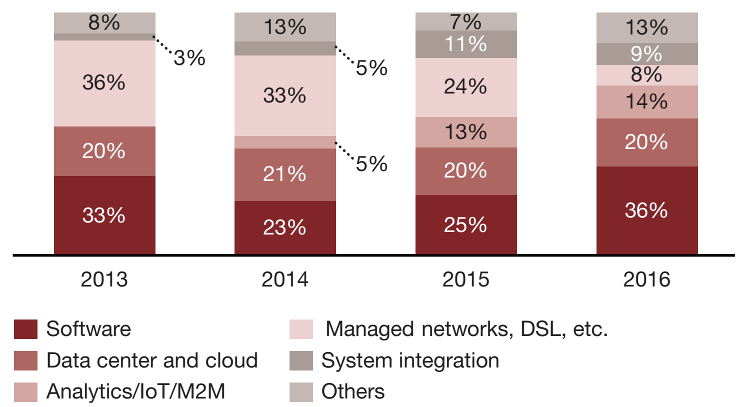
Interestingly, the majority of these acquisitions in 2016, 78 percent of the total value, were in the business-to-business (B2B) ICT space. Just 4 percent were in the business-to-consumer (B2C) space. A further 18 percent of transactions were both B2B and B2C. Telecom operators found a more compelling proposition in the B2B space, given the ease of bundling and accessing the extended capabilities without fully having to integrate the target into its operations. Such an approach proved to be more difficult for B2C propositions (*see Exhibit 4*).

Exhibit 4
Operators have been active in acquiring capabilities in adjacencies

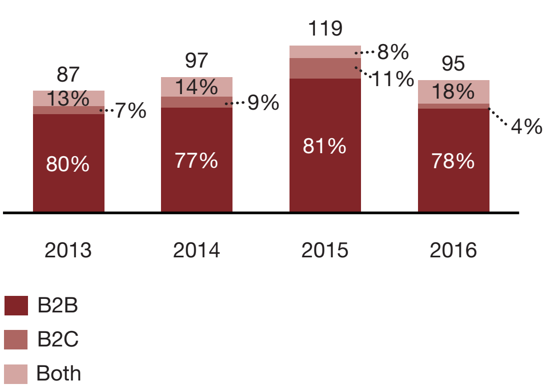
Total value and breakdown of technology deals by category (US$ billions, 2013–2016)



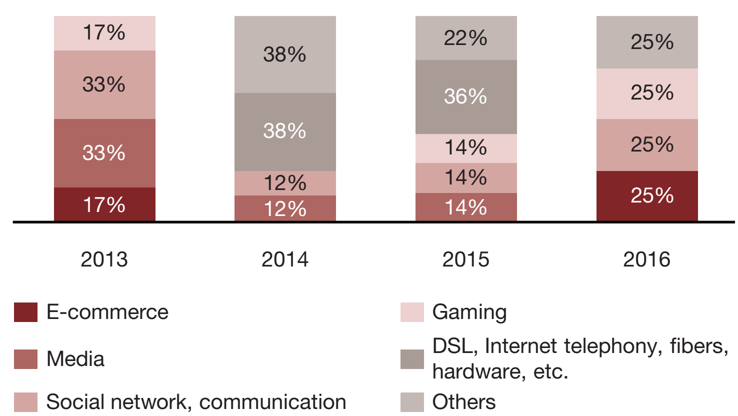
B2B deals in adjacencies by category (2013–2016)



Number and breakdown of technology deals by category (2013–2016)



B2C deals in adjacencies by category (2013–2016)



Source: Thomson Reuters; Strategy& analysis

Inorganic growth returns as the first priority

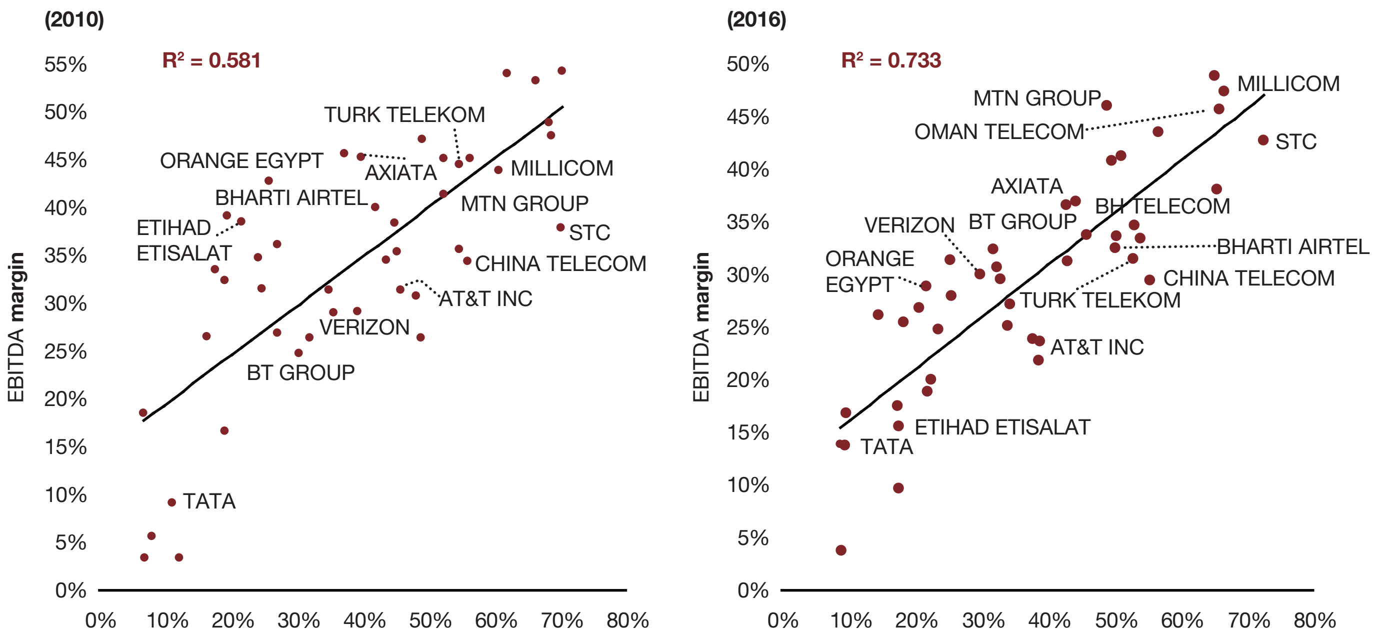
The two themes likely to dominate global M&A in the near future are consolidation and the emergence of digital conglomerates. The other themes will continue, however with less prominence.

Scale will remain important for the telecom industry and will continue to fuel consolidation activity through mega-deals within markets and across borders. The correlation between earnings before interest, tax, depreciation, and amortization (EBITDA) margins and revenue share has become much closer when measured across the global market. In 2010, this correlation stood at $r2=0.59$. In 2016 it reached 0.73 (*see Exhibit 5*). This has major repercussions for market concentration. It is likely that only the top three companies in any given market can retain their position, apart from those in huge markets such as India, China, and the United States. The result is likely to be in-market consolidation as shareholders of operators that find it difficult to reach a top three position look to leave the market.

At the same time, the top three players (specifically those occupying second and third position) may look to consolidate and improve their market position through acquisition. The formation of EE in the U.K. as a result of the merger of Orange and Deutsche Telekom is an example of this phenomenon, as was the merger of the operational subsidiaries of Millicom and Bharti Airtel in Ghana.

Exhibit 5
Scale remains critical for survival

Select telecom operators, EBITDA margin vs. Market share benchmark



Source: Bloomberg data; Strategy& analysis

The other aspect to consolidation is mega-deals or mergers of regional and global groups. As the industry stagnates, because it is maturing and markets are saturated, operators are likely to look internally at their cost models to create value. Improved sourcing is a primary means of value creation given the considerable capital expenditure requirements of enabling customers' data consumption. Sourcing also becomes a key factor in identifying appropriate targets. Hence, single-market players could become prime targets for acquisition, although sovereignty and national interest could hinder such deals.

Along with consolidation is the disruptive effect of digital technology. Digital is blurring traditional industry boundaries, which is leading to the emergence of digital conglomerates. Technology giants such as Alphabet (Google), Amazon, Apple, Facebook, and Microsoft routinely launch products and services across multiple industries. They pay little attention to barriers to entry and are equipped with the underlying digital foundations.

This relentless expansion has lessons for telecom operators. If they sit back and defend their turf, they will be fighting for control of a small slice of global consumer expenditure. The telecom industry's share of global consumer expenditure has been stable at around 3 percent for many years. However, if they follow the example of technology companies and advance into the digital arena, telecom operators could take some of the global consumer spending in other sectors, such as the 20 percent that goes on housing, 15 percent on food, 12 percent on transportation, and 10 percent on healthcare. Entering emerging digital domains and vertical markets will lead telecom operators to become digital conglomerates.

With respect to consolidation and expanding into digital adjacencies, operators need to focus on organizational change and capabilities building, rather than simply on capital spending. Operators can diversify their revenue with minimal capital expenditure given their strong balance sheets, access to customers, and provision of network connectivity, together with their understanding of digitizing operating models and technologies. However, moving into new sectors means that the operating model must evolve in tandem. For example, Orange's entry into the banking industry required it to become a digital conglomerate with exposure to telecom and banking rather than remaining a telecom operator that also provided mobile financial services. Orange's banking operations exploit synergies across industries, such as access to a broad customer base, but have a separate profit and loss account and management. To achieve this, Orange gradually developed capabilities focused on next-generation financial services (*see Exhibit 6*). The company began with simple telecom-enabled financial services, and then built up internal digital expertise. Finally, Orange was able to launch a fully fledged digital bank by acquiring Groupama Banque and digitizing it.

Exhibit 6

Orange used its "digital" capabilities to venture into banking

Orange's evolution into a digital conglomerate

Capability evolution path →

Developing mobile products and services	Building know-how on fully digitizing operating models	Launching a fully fledged digital bank
Orange took advantage of existing telecom assets to **develop and position itself as a digital player.** It **began** to **develop** cross-industry **mobile products** with a special focus **on financial services** (Orange Money, Orange Cash, Orange IoT Studios, Hiveworks, etc.).	After developing mobile/digital products, Orange turned to **digitizing Business Units' operating model and entire experience of a set of customers, launching** Orange Finanse in Poland, a **mobile bank**; and Sosh, a 100% **digital telecom company**	After successful experiences, Orange scaled up its financial services offering by buying Groupama Banque to **digitize the bank and create a full mobile bank.** Orange will rely on the bank's existing 530,000 clients[1] and its know-how to propel the **launch of Orange Bank in summer of 2017.**

Note: Hiveworks is the rebranded name created after management buy-out in 2015 of Orange Digital, Orange's stand-alone digital agency.

[1] As of November 2015.

Source: Orange website; Strategy& analysis

Another method is for operators entering digital adjacencies to take strategic positions in the venture capital ecosystem by establishing their own venture capital funds (*see Exhibit 7*). The aim is to support the development of interesting companies in adjacent industries so that telecom operators gain exposure to startups at an early stage and nurture their growth until they become suitable targets for acquisition. Startups also gain from this relationship. The venture capital companies provide them with access to market and user data, a large customer base for monetization, a strong distribution and marketing presence, and financing. This is particularly beneficial in emerging markets in which there are few venture capital companies.

In the MENA region, STC has created a $500 million fund called STC Ventures. Similarly, Zain Group has a dedicated team that invests in venture capital companies and has thus far completed four transactions.

Exhibit 7

Operators have been establishing their own venture capital funds focused on digital adjacencies

Most-active corporate venture capital firms

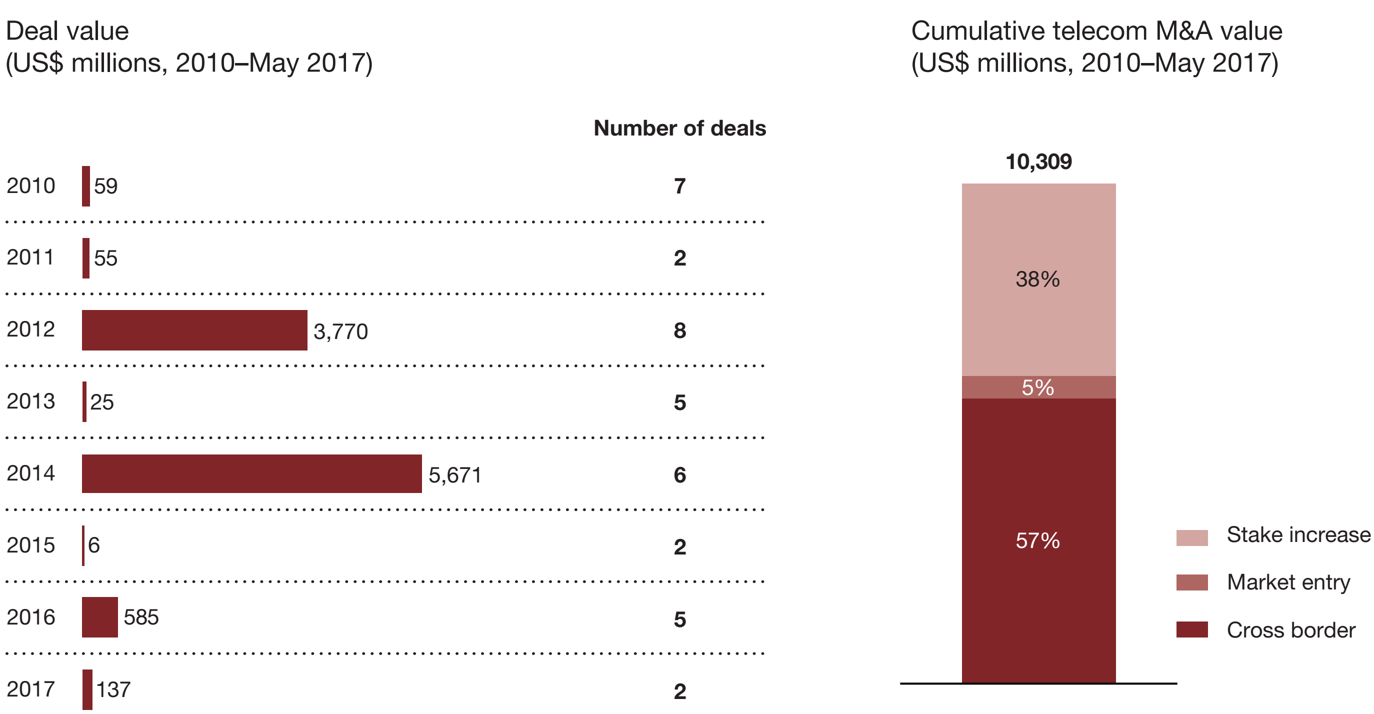
	Venture capital approach		Global rank in VC activity (First half 2016)	Number of investments
Comcast	Established corporate VC	Comcast ventures	**3**	- 226 investments in 154 companies
Qualcomm	Established corporate VC	Qualcomm ventures	**7**	- 286 investments in 200 companies
Verizon	Established corporate VC	Verizon ventures	**15**	- 83 investments in 60 companies
Telstra	Established corporate VC	Telstra ventures	**23**	- 48 investments in 42 companies - Over US$300 million invested in leading technology companies
Orange	Established corporate VC	Orange ventures	**27**	- 15 investments in 13 companies - More than US$58 million dedicated to investments in Africa
STC	Established corporate VC	STC ventures STV	**N/A**	- STC ventures placed 15 investments in 8 companies - STV established with US$500 million from STC
Ooredoo	Partnered to create VC	Rocket Internet/Asia Pacific Internet Group	**N/A**	- 9 investments in 7 companies
Zain	Invested in other VCs	Wamda Capital, Earlybird VC, MEVP, Colle Capital	**N/A**	- Wamda placed 30 investments in 24 companies and Earlybird placed148 investments in 90 companies

Source: CBI Insights; Crunchbase; Strategy& analysis

The coming wave of MENA M&A

As the MENA region accounted for a mere 1 percent of the cumulative global M&A deals between 2010 and 2016, there is clearly considerable room for growth in M&A activity. MENA deals are rare, and 98 percent of the value is from telecom-to-telecom scale transactions (*see Exhibit 8*). Telecom operators certainly have the cash and the appetite for acquisitions. Although MENA telecom groups have tended to follow the M&A pattern of developed market operators, albeit at a slower and delayed pace as they absorb the lessons learned elsewhere, an exact repetition is unlikely.

Exhibit 8
MENA telecom M&A remains rare and is focused on telecom scale transactions



Source: Thomson Reuters; Strategy& analysis

Despite the pursuit of scale and portfolio optimization, convergence is unlikely to become as significant in the MENA region. The triple and quadruple plays that worked to access the home segment in developed markets have been less effective in the region because of the dominance of free-to-air channels and ease of access for consumers, the considerable MENA presence of global over-the-top (OTT) players, and the lack of cable infrastructure. Moreover, mobile advertising brings in only one-fifth of the revenue per impression compared with the U.S., and there are no viable players in the region for acquisition. Although video is very important, MENA operators can address their video needs through partnerships with regional and global content producers and through acquisitions of smaller social media players and influencers.

Instead, the next wave of M&A in MENA will be fueled by the aspirations of regional telecom operators to offer ICT services, specifically those focusing on advanced B2B solutions and digital or adjacent consumer plays. This is likely to occur in one part of the MENA region, the countries of the Gulf Cooperation Council (GCC).[2] The B2B and B2C ICT industry in the GCC is expected to grow by 12 percent in the coming three years to reach $14.3 billion in 2020. IT consulting, system integration, and operations will constitute 44 percent of the market, and software/application development/customization will make up 17 percent. In terms of verticals, governmental entities, the telecom sector, and financial institutions are expected to account for the majority of expenditure on ICT. Much of this growth will result from national economic and digital transformation plans, with opportunities for public–private partnerships.

Capabilities for success

To take advantage of these opportunities, MENA telecom operators must urgently fill their capability gaps in advanced ICT and digital services. Inorganic growth, through M&A and joint ventures (JVs), is the most promising avenue. Such inorganic activity can also strengthen an operator's market positioning by ensuring alignment of the target with the operator's wider corporate strategy. By contrast, in-house development tends to be slow, has limited potential for scalability, and has been successful for only a few adjacencies that tend to be similar to the core telecom business. Similarly, the transactional partnership model has been used frequently in the MENA region with limited success. The results have been patchy demand for products that are below customer expectations, weak revenues, and no development of capabilities to improve the operators' position in the longer term.

Choosing inorganic growth alone will not suffice. Operators have to pay close attention to post-merger governance and integration models. Telecom operators should ensure that the typically nimble and innovative nature of target technology companies is preserved, and that it does not get diluted by the culture and problems of the acquirer.

The four key pillars of a successful inorganic growth agenda

MENA operators should base their inorganic growth agenda on four key pillars (*see Exhibit 9*). First, operators must define the strategic intention of their M&A activity in terms of target domains, ecosystem road map, and investment approach. Second, operators must then think through their deal sourcing strategy. Third, they must ensure the best operating model fit for each opportunity or domain. Fourth, telecom players must get their governance and performance management models right to maximize value creation and capabilities development.

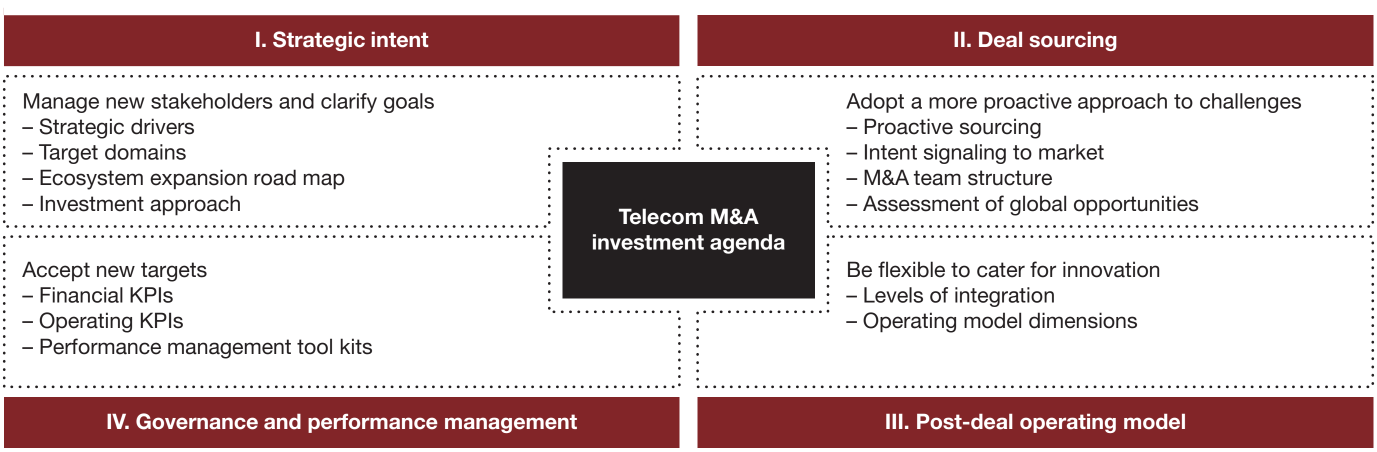
1. Strategic intent

Telecom operators should define their strategic intent properly by articulating the most important factors driving their investment strategy, their main target domains in terms of horizontal and vertical markets, how much they want to expand into the value chain of each play, and the most suitable investment approach.

Exhibit 9

A successful M&A investment agenda is built on four key pillars

Pillars of a successful M&A investment agenda



Note: KPI = key performance indicator

Source: Strategy&

Typical value propositions for B2B ICT are the Internet of Things (IoT, connected devices and sensors) and analytics, managed IT, system integration, and cybersecurity. For B2C, the primary focus has been on digital commerce, financial services, and content provision. To select their target domains, operators have to carry out segmentation and understand market needs, trends, and the competition. Operators must also assess and prioritize what is needed for success in the different segments and vertical markets. They should then evaluate their current capabilities and decide whether they are adequate, and which need to be developed, either internally or through partnerships, and which need to be acquired. Operators typically pursue the inorganic route for a combination of reasons: getting control of valuable intellectual property (IP), tapping into advanced or niche capabilities, gaining access to new technology and platforms, and increasing share of wallet.

Moreover, telecom operators will have to scale up their propositions into specific domains through building an ecosystem via a series of acquisitions. Singtel, for example, expanded across the digital marketing ecosystem by building on its acquisition of Amobee in 2012. Amobee is a digital marketing company that covers most of the value chain. This acquisition was followed by others: AdJitsu, Adconion, and Kontera in 2014 and 2015. Singtel also established new internal units, such as DataSpark in 2014.

As part of this process, key stakeholders across business and functional units must be closely involved in defining the overarching inorganic growth strategy. In general, the inorganic growth agenda has become increasingly intertwined with the overall corporate strategy and the aspirations of the different business and functional units, with a direct impact on their value proposition and capabilities as telecom operators expand into ICT and digital services.

The complexity of defining an inorganic growth strategy and the involvement of a multitude of stakeholders is in contrast to the trend in the recent past, in which scale expansion was mainly driven by a dedicated M&A unit that worked with corporate leaders and the board, with minimal impact on existing market operations.

2. Deal sourcing

Deal sourcing in the ICT and digital space has been difficult for MENA operators because of the scarcity of viable targets in the region and the lack of publicly available information. In response, operators should be more proactive. This involves looking more closely for companies with interesting technologies and propositions. It requires signaling a desire for deals to the market, whether directly through announcements, or indirectly through mandates to specialized financial institutions. This means establishing or reviving a dedicated M&A team that constantly scouts the market for deal opportunities, screens companies, performs due diligence, and as mentioned works with other stakeholders in the company. Finally, deal sourcing requires exploring global opportunities, such as by taking a majority stake in an international company and importing its capabilities to the MENA market. Alternatively, an international company can acquire a minority shareholding and set up a JV in the home market with the operator having a controlling stake.

3. Post-deal operating model

Operators need to establish a sound operating model for the interaction between their organization and that of the target company. The post-merger integration (PMI) strategy depends on the sought-after level of integration, which is itself based on a clear set of criteria, including strategic intention and synergies, cultural differences, the required agility, and the target's fit with core business functions. Operators need to be more flexible than they have been in the past when devising the PMI operating model, as the approach to value creation will differ greatly from one acquisition to the other.

Therefore, it is critical that the level of integration with the core business is appropriate, ranging from a full integration (such as when a target is acquired for technology or IP purposes) to a subsidiary that is managed at an arm's length.

Once the level of desired integration has been agreed, a clear operating model needs to be fleshed out and implemented. Typically, there are six levers to consider and align accordingly based on the strategic intent and legal and regulatory constraints (*see Exhibit 10*). In general, the greater the level of interaction and overlap between the target and the businesses of the telecom operator, the more emphasis there should be on service level agreements, alignment touch points, decision rights, and process alignment.

4. Governance and performance management

Following the completion of any M&A transaction, operators should ensure that they manage performance with care and diligence. In the past, MENA groups have shied away from properly measuring success, failure, and return on investment. Operators should be aware of, and ready to accept, new performance management thresholds and indicators when assessing the success of this new breed of technology transactions.

Given the nature of their business models, telecom and technology companies have different bottom-line margins. Whereas MENA telecom EBITDA margins have hovered at around 30 percent, technology company margins are usually closer to 10 percent. Moreover, whereas capital expenditure requirements for telecom companies have averaged 15 percent of total revenues, the respective figure at technology companies is 7 percent of total revenues.

Exhibit 10
A clear operating model between target and operator needs to be fleshed out and implemented along six main elements

Operating model elements

The greater the operational overlap, the more important the element (- to +)

	Key design elements			Design considerations
Supervisory governance	Board size and composition	Board roles and responsibilities	Committees composition and role	- Strategic intent - Shareholder composition - Legal or regulatory constraints
Executive appointment	Potential implications on Level 1 organizational structure	Management KPI requirements		- Strategic intent - Clauses in Articles of Association and Shareholders' Agreement - Strategy and business plan
Business plans and budgets alignment	Business plan and budget time lines	Planning approval process implications		- Group business planning and budgeting process and time lines - Involved stakeholders
Service level agreements	Definition of required service level agreements	Operational KPI requirements		- Scope of services - Operational interactions with group - Group internal and committed customer KPIs
Alignment touch points[1]	Alignment medium/ forum and description	Involved stakeholders	Alignment frequency	- Developed operational processes - Group and subsidiary touch points - Group committees and standing forums
Decision rights and processes alignment	Key touch point processes description	Group and subsidiary responsibilities	Selected decision rights	- Service level agreement and scope of subsidiary services - Set of capabilities - Existing processes

Note: KPI = key performance indicator

[1] Alignment touch points include meetings, reporting, etc.

Source: Strategy&

Operators must assess the operational performance of these new subsidiaries separately, using a new set of key performance indicators. Telecom companies typically evaluate their operations by looking at subscriber count, churn rate, the number of new subscribers (gross additions), average revenue per user (ARPU), and yield per usage type. However, as they start working with new business models and industries, operators should tailor their set of key performance indicators (KPIs) and start looking at metrics such as repeat rate, hours of usage, number of views, data center utilization rates, frequency of API access, the number of connected devices managed, the billability of the professional services team, R&D spend, and IP generation per year.

Conclusion

The next theme of telecom M&A is gaining momentum globally, with the aim of redefining industry boundaries through digital services. Cash-rich MENA operators must follow suit. Early movers can gain a significant competitive advantage. However, to succeed they must stop regarding deals as a stand-alone activity. Instead, they must understand that transactions in the digital domain are deeply intertwined with the corporate strategy of existing operations and require careful planning in terms of strategic intention, deal sourcing, type of operating model, and performance management.

Endnotes

[1] Amr Goussous, Nans Mathieu, Karim Sabbagh, and Chady Smayra "Managing telecom portfolios for sustainable growth," Strategy& 2012 (https://www.strategyand.pwc.com/reports/managing-telecom-portfolios-sustainable-growth).

[2] The GCC countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

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