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Boosting telecom profits in the MENA region

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Executive summary

A comprehensive product profitability and simplification exercise is critical for telecom companies responding to today's market environment. With their business model currently rendered unsustainable by increasing competition and rising network costs, companies first need to analyze in depth their range of service offerings. The resulting product rationalization can then enable the restructuring of market-facing and back-end operations and infrastructure, in turn laying the foundations for significantly improved profitability.

Escaping the "invest more, earn less" trap

Telecom operators in the Gulf Cooperation Council,[1] in common with telecom companies elsewhere in the Middle East and North Africa (MENA) region, are finding themselves caught in a trap. Inexorable telecom market dynamics are characterized by falling prices coupled with network traffic that is rising at unsustainable rates. Indeed, Cisco forecasts that global mobile data traffic will grow by close to tenfold between 2014 and 2019.[2] The result is that companies are saddled with reduced profitability while facing increased capital expenditure to keep pace with customers' needs. Telecom companies are therefore looking to achieve a rapid turnaround of their business model, as they seek to restructure their operations to ensure higher earnings before interest, taxes, depreciation, and amortization (EBITDA) to compensate for this rise in capital expenditure.

Previous efforts to increase profitability have often focused on rationalizing the principal subcategories of business costs. However, this has not proven to be a sustainable method of reversing profitability decline, as slashing costs without due attention to the company's key capabilities, strengths, and long-term goals leads to diminishing returns and can hamper its potential for growth.

Instead, we believe that operators should engage in a far-reaching, holistic revamp of the product portfolio, a streamlining of service offerings, and the elimination of loss-making products. This is then followed by a rationalization of market-facing and back-end operations. The process ensures that spending and investment are closely aligned with business requirements.

Such a comprehensive undertaking starts with a thorough review of product profitability. Strategy& uses a toolkit that allows companies to diagnose those product areas that reduce the profitability of their portfolio. The process does not, however, look only narrowly at product profitability. The toolkit's results are supplemented with investigations into how customers are likely to respond to product portfolio changes. Such segmental analysis, along with competitive analysis, is a key element in the extensive review of the product areas.

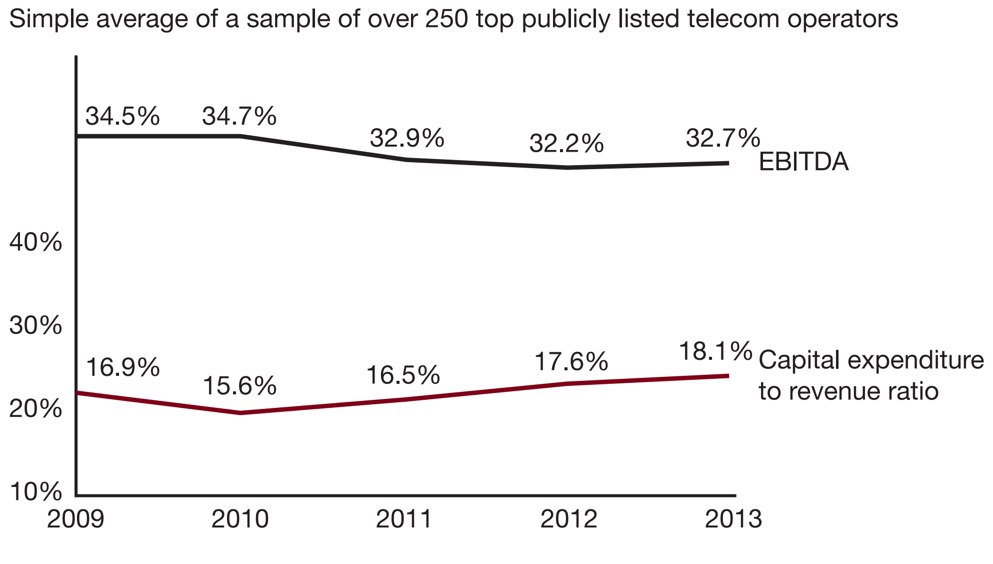
Unsustainable economics

Telecom companies are beset by increasing pressure on profitability, resulting from market saturation and rising capital expenditure. This has inevitably damaged total shareholder return (TSR). The average five-year TSR for a telecom company worldwide has fallen from 13 percent to just 1 percent over the past decade.

The EBITDA margin and the ratio of capital expenditure to revenue need to move in tandem to ensure the sustainability of the business model. Instead, the two are going in separate directions, a decoupling that has serious implications for the telecom industry (*see Exhibit 1*). Over the last 10 years, average EBITDA declined steadily while capital expenditure is rising. Industry trends, most related to increasing digitization and price wars, have eroded revenue and increased capital expenditure.

Exhibit 1

Capital expenditure is rising while profitability is falling



Source: Bloomberg; Strategy& analysis

Many operators have started to respond by closely managing capital expenditure while aiming to increase EBITDA by more than 25 percent within the next five-year period. This would take EBITDA back to historical highs, thus ensuring business sustainability, as such an increase would counterbalance the required rise in capital expenditure.

Companies cannot reach these targets with some of their most recent initiatives. Instead of aligning costs with growth, many have responded to increased competition with aggressive pricing strategies that have included subsidies, recurring promotions, and larger data allowances. These have had minimal impact on revenue growth, but have had an adverse effect on profitability.

For example, companies in the GCC region, where EBITDA margins are still comparatively high, are embroiled in price wars for voice and broadband services. In one large market, one operator is offering unlimited 3G broadband for under US$200 for 17 whole months, a price significantly below what is charged even in other emerging markets. The large number of such low-priced products, promoted by recurring marketing campaigns, has severe implications for the profitability of telecom companies and detracts from their business focus. It also reduces customer satisfaction because operators often cannot provide the data quality and speeds that customers expect.

Meanwhile, cost optimization and restructuring programs have largely ignored the cost implications of the existing product portfolio. These cost implications include expenditure on market-facing operations as well as back-end operations and infrastructure. Instead, they have mostly focused on overhead and shared services functions, with limited scope for further optimization.

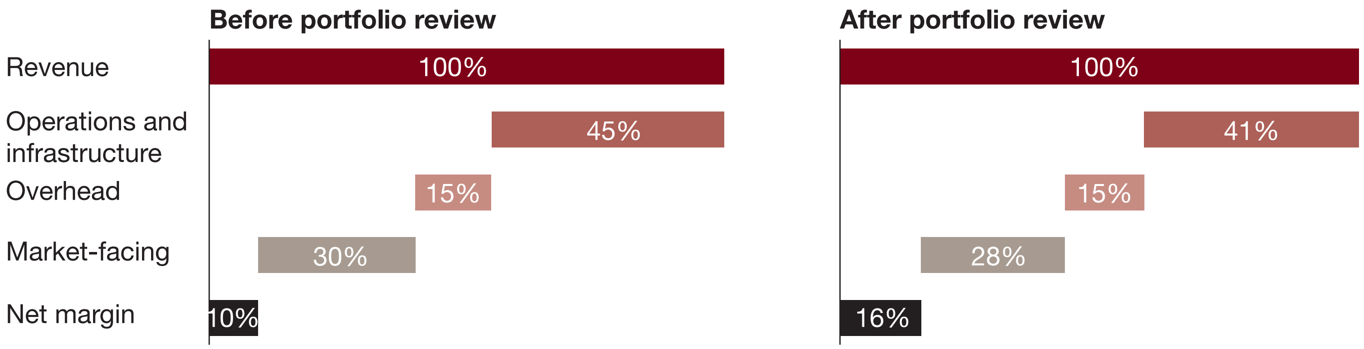
Using product analysis to set the stage for transformation

Companies need to look at these business challenges from a completely different angle if they are to achieve a sustainable transformation. Costs and growth need to be connected. To do so, they will need to proceed through two sequential stages of change.

The first stage starts by using the toolkit to review the existing product portfolio economics, both in terms of current individual product profitability levels and to project a view of the long-run incremental expenditure required. The latter directly feeds the business cases for new products and more broadly justifies feasibility studies for rollouts of new products. The second stage includes a thorough segmental and competitive analysis. This allows an operator to identify the remedial measures that derive from the product profitability review's evaluation of the customer and competitive implications. The conclusion of both stages unlocks the restructuring of the portfolio to increase its profitability (*see Exhibit 2*).

Exhibit 2

Reviewing the product portfolio reduces market-facing costs and operations and infrastructure costs, thereby increasing the net margin



Source: Strategy& analysis

The restructuring of the portfolio enables the rationalization of market-facing and back-end operations in the light of the products overhaul. This allows for informed and strategic investment. For example, one European telecom operator managed to achieve an EBITDA increase of more than €100 million ($108 million) within twelve months by eliminating 60 percent of products and terminating 80 percent of monthly promotions. This allowed the company to rationalize its operations extensively and to close technology platforms that the product streamlining rendered superfluous.

Portfolio analysis

The product portfolio analysis seeks to achieve a clear understanding of individual products and their growth potential. It highlights the products that account for the lion's share of profitability, and identifies what prevents comparatively poorly performing products from enjoying similar success.

During the first phase of this review, the toolkit uses inputs on relevant operational, revenue, and cost data. Direct and indirect costs are considered, based on available data complemented with the toolkit's benchmarks.

The toolkit also allows a company to gain a realistic view of the long-run incremental capital expenditure required per asset by identifying underlying trends. It does so by dividing asset items among the products, so that a suitable proportion of depreciation and amortization can be accurately allocated to each.

This analytical process allows the company to generate product profitability reports for the entire portfolio. A company can ascertain the contribution of individual products to profitability, assess current revenue and future trends, and build a forward-looking view of the evolution of the various cost elements.

With the forward-looking view, the toolkit can also focus in detail on the longer-term sustainability of individual products. For example, one Middle East telecom operator was interested in developing an Internet protocol television (IPTV)[3] offering. Because of the considerable investment beyond the up-front fixed costs required to make the service available, the toolkit product analysis determined that the offering would lose money until it attracted a very large subscriber base.

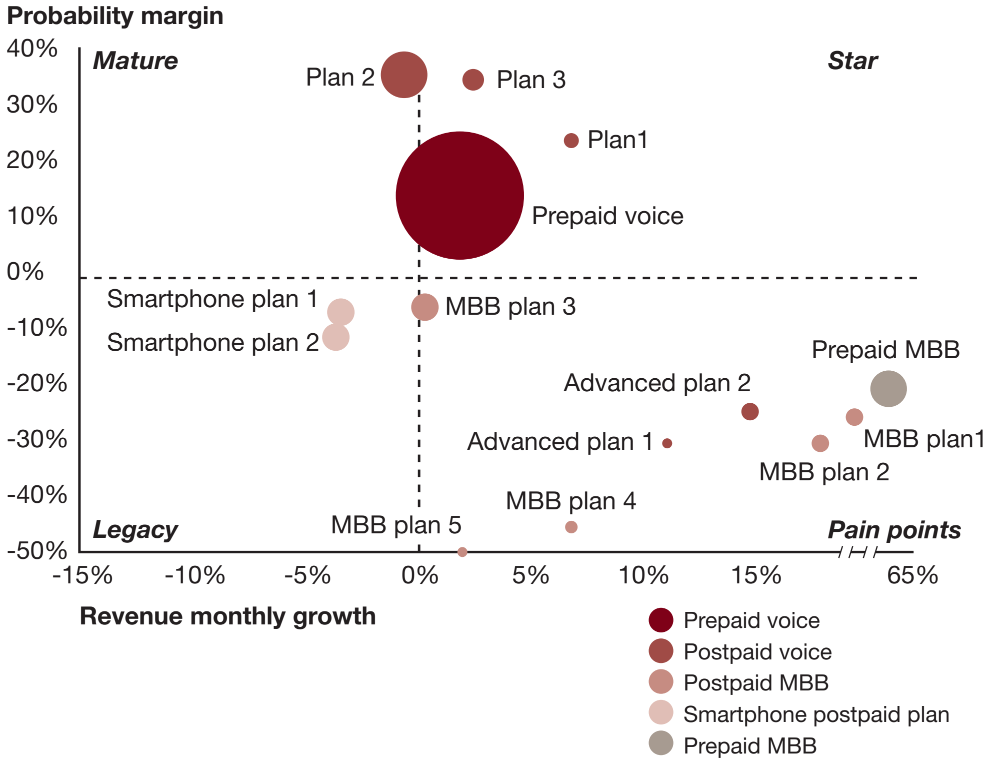
Indeed, the results of such in-depth analysis often turn out to be very different from what management expects. Products assumed to be stars end up looking like duds. Mobile broadband and the more expensive post-paid packages and add-ons are frequently unprofitable, their performance completely overshadowed by less-acclaimed products (*see Exhibit 3*).

Sometimes, companies find that products should not receive investment across an entire country. One Middle East telecom company investing in FTTH (fiber to the home) discovered that it was deploying infrastructure in regions that offered a low internal rate of return. Indeed, these investments resulted in just one-quarter of capacity being utilized, but nevertheless represented around 60 percent of total capital expenditure.

Exhibit 3

The product profitability toolkit identifies pain points in the portfolio, with sometimes surprising results

Profitability and growth analysis for mobile voice and broadband products



Note:
MBB = Mobile Broadband
Circle size = revenues
Source: Strategy&

The likely impact on the customer base

The portfolio analysis does not occur in a vacuum. It is complemented by a segmental and competitive analysis that takes place before any final decisions on the overhaul of the product portfolio are made. This can confirm the full range of potential revenue implications that might follow from altering the portfolio. It also significantly reduces the risk that a shake-up will result in the loss of valuable customers.

Companies can also clarify their thinking on the detail of various products, prices, and promotions through carrying out a behavioral segmentation of the customer base and the subsequent migration analysis. These investigate how the revamp will affect customers' behavior and the resulting revenue of each customer segment.

For example, the data usage of one customer segment may be growing faster than the associated revenue. This means that a tiered pricing model could be more effective in optimizing revenue from this segment. One mobile network operator in the Middle East managed to increase its average revenue per user by 20 percent in the mobile broadband category through a tiered pricing approach for its products.

Similarly, if the voice usage and associated revenue from another segment are falling, then flat-rate pricing and pre-bundled minutes could mitigate the reduction in revenue.

The competitiveness of the various products and services categories, and their features, within a company's portfolio should then be reviewed to identify potential target initiatives (*see Exhibit 4, page 12*). A more detailed analysis takes individual customer spending and type of usage into account. It creates a pricing heat map per product category that highlights current portfolio gaps (*see Exhibit 5, page 12*).

For example, if a company is looking to focus on lower-priced products, such findings would immediately allow it to identify areas where it is uncompetitive in the marketplace.

Exhibit 4

A detailed competitive analysis identifies gaps in an operator's portfolio and suggests new initiatives

Sample competitive analysis of mobile voice smart plans of three telecom operators

Products and service dimensions		Telco 1	Telco 2	Telco 3
Type of plans	Credit based	◔	◔	○
	Usage based	✓	✓	✓
	Sharing	✗	✗	✓
	Hybrid/prepaid	✗	✗	✓
	Zero/pay-as-you-go	✗	✗	✓
	Segmented/tailored	◔	◔	◔
Pricing	Monthly rental	◕	◔	●
	On-net effective rate	●	◔	◑
	Off-net effective rate	◑	◔	●
	Data bundled quota	◕	◕	◕
	Data fair user policy speed	◕	◕	◕

✓ Available option

✗ Not an available option

○ Low

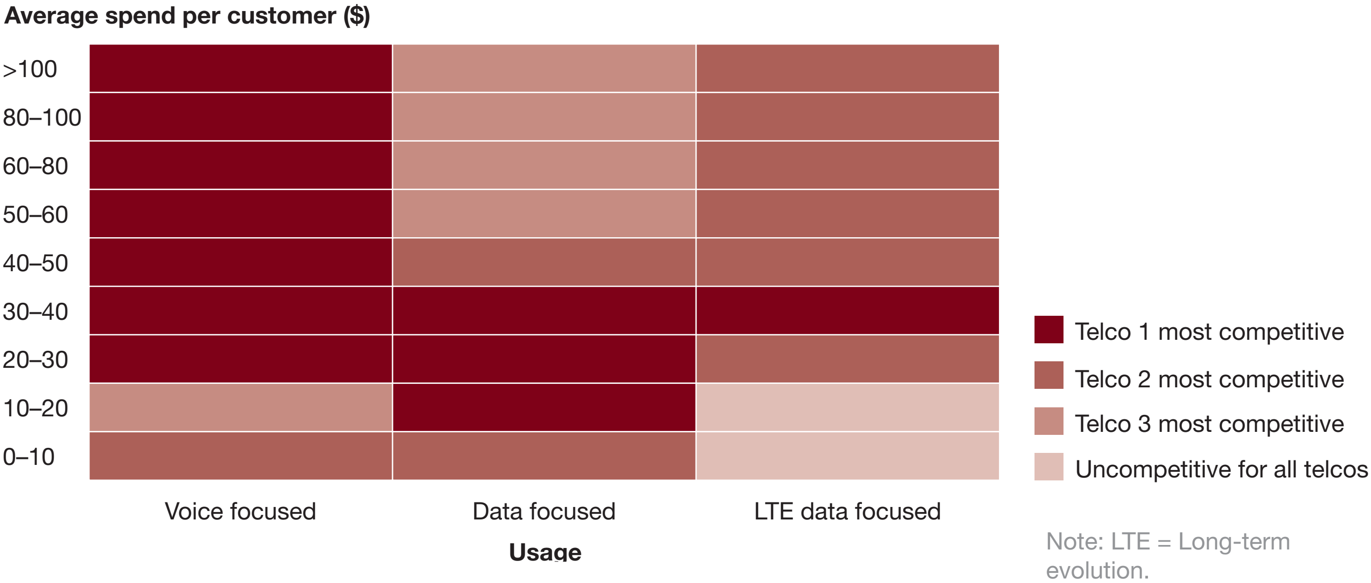
● High

░ Potential action area for Telco1

Source: Strategy&

Exhibit 5

A pricing heat map comparing consumer spending and data consumption per product category, postpaid products



Average spend per customer ($)	Voice focused	Data focused	LTE data focused
>100	█	▒	▓
80–100	█	▒	▓
60–80	█	▒	▓
50–60	█	▒	▓
40–50	█	▓	▓
30–40	█	█	█
20–30	█	█	▓
10–20	▒	█	░
0–10	▓	▓	░

Usage

█ Telco 1 most competitive

▓ Telco 2 most competitive

▒ Telco 3 most competitive

░ Uncompetitive for all telcos

Note: LTE = Long-term evolution.
Source: Strategy&

The benefits of simplification

A European telecom company was plagued by excessive complexity and inefficiency. The management had to contend with the implementation of challenging IT projects and highly convoluted service offerings. In one single market, the company was selling more than 200 different mobile tariffs containing more than 63,000 specific offer elements, and was running more than 150 monthly promotions. Several attempts to simplify the portfolio had failed.

Applying the product profitability exercise resulted in drastic simplification. The company eliminated 58 percent of the products and 82 percent of the promotions. The result was an increase in EBIDTA of 1.65 percent within one year.

Conclusion

Telecom companies are at a crossroads. They need to restructure their business model if they are to have any prospect of sustained growth in the face of intense pressure on profitability and rising capital expenditure. The instinct to cut costs first turns out not to be the correct approach. Instead, before anything else, they need to examine and restructure their product portfolios.

Once they have devoted more attention to profitable products, improved the less profitable ones, and eliminated those that make a loss, then they can take a truly informed look at their costs. They can rationalize market-facing and back-end operations and infrastructure projects in a manner that will allow them to establish clear priorities, optimize costs sustainably, and reorganize for the next wave of growth.

Endnotes

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

[2] Cisco, "Cisco Visual Networking Index: Global Mobile Data Traffic Forecast Update 2014–2019," February 3, 2015 (http://www.cisco.com/c/en/us/solutions/collateral/service-provider/visual-networking-index-vni/white_paper_c11-520862.html).

[3] IPTV involves delivering TV over broadband.

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