Exclusive Telco CEO & Private Equity Event

Presentation of the 6th annual exclusive Telco CEO & Private Equity Event hosted by Arthur D. Little in Vienna

On May 23rd, 2016, Arthur D. Little hosted its 6th annual exclusive Telco CEO & Private Equity Event with an impressive attendance of telecom CEOs, investors and leading banks.
This year's gathering focused on the industry's hottest topic, "Long term value creation – How to decompose and reconfigure a telecom operator?", and addresses some critical questions: In which fields to play? How to ensure innovation? How to produce efficiently? What assets to own and what to control?
The importance of these topics for operators, broadcasters, as well as hardware and content providers was highlighted by the over 60 top executives and shareholders of leading operators, internet players, software companies, media groups, equipment manufacturers, as well as regulators from 22 different countries attending the event.
The event began with a welcome by Karim Taga, Managing Partner, Arthur D. Little Austria, Global TIME Practice Leader. Subsequently, Richard Swinford (Partner Arthur D. Little UK), Nicolai Schaettgen (Managing Partner Match Maker Venture Austria), Jesus Portal (Partner Arthur D. Little Spain), and Bela Virag (Partner Arthur D. Little Austria) presented ADL's executive insights, in the presence of Ignacio Garcia Alves, CEO of Arthur D. Little. This was followed by a Q&A session, during which the participants engaged in a lively discussion about the implications of the findings and questions about future development.
Many guests stayed until after midnight and took advantage of the relaxed atmosphere to engage in high-profile networking and to share their experience with executive leaders.

Key insights shared:

- Given the continued pressure on core revenue while facing the necessity to maintain a stable CAPEX envelope, operators need to focus on profitable revenue growth and return on assets to maintain and grow cash flows
- Succeeding in new fields of play requires customer intimacy, focus, time, dedicated approaches, facing new competitors as well as new partners
- Innovation accelerates disruption of the industry; a new area of collaboration between start-ups and corporations has started and is gaining traction
- In order to co-create value, a culture of 'fail fast with persistence', clear focus and deep customer insight, appropriate vehicles, partnerships and enabling governance are all essential as is a coherent strategic commitment
- The legacy network's monolithic stacks are evolving into open and programmable clouds best suited to ensure the evolution of network functionality and service delivery
- Telecom operators must set-out a simple and clear vision for the end-state and a roadmap which aligns to the new realities, as customer demands are changing, significant cost saving options emerge and innovative forces both inside and outside must be leveraged.
- Reviewing a TelCo's assets is a catalyst for value creation: identifying core assets and reconfiguring asset portfolios enables operators to balance strategic intents, risk profiles and leverage cost-sharing potentials. Aligned with strategic vision and roadmap, reviewing the asset composition in light of 'control vs own' simplifies an organization and clearly creates value beyond financial engineering.

Field of play – identifying future value pools and the means required to access them

Telecom operators are under financial pressure for many years and only few of them are now beginning to curb the corner. Many need to focus on growing revenues and return on assets to maintain and grow cash flow and secure the necessary

CAPEX envelope to deliver next generation infrastructure while maintaining attractive levels of dividend distribution.

With margins in the core under pressure from competition, regulation and substitution, telecom operators seek new areas for revenues and margin. Given the size of their established customer bases (i.e. reach) and also their potential role to underpin the digital infrastructure and provide platforms or services in many rapidly growing new sector opportunities – be it financial services, or managed services in the era of digital transformation of all industries (e.g., Smart Cities, e-heath, connected vehicles, to name but a few) – they are presented with a plethora of new opportunities.

The initial challenge operators are facing is how to best select such opportunities: based on the anticipated size of the opportunity, the margin potential, the implementation complexity, degree of strategic risk involved or other criteria. We already observe some pioneering TelCo's making significant moves – in Digital advertising, in Smart platforms, in Data analytics, in finance/banking and Premium/OTT video. Most importantly, operators are placing different bets – and thus becoming less homogenous.

Once the field of play becomes clear, operators need to mature in managing these ventures (the 'sow and reap' approach). It is far from clear who to work with, and who to be wary of (i.e. the next cohort of competitors). Here again, we already see operators in Europe and in Asia employing novel approaches, and reaping the benefits – in excess of 20% of gross revenues in some cases. But to realize such successes, TelCo's will have to adapt their approaches and reinvent themselves to take on the relevant competitors in these fields – or find a way to work with them to achieve mutually beneficial successes, potentially stemming from value created in the core (e.g. multi-play), reduced churn, or margins generated from the new playing fields.

Open Innovation – from R&D/Product development centric organization to embracing 3rd party eco-systems

Today there is a better acceptance amongst operators that disruption stems outside of traditional competitive boundaries and proactive participation within multiple ecosystems is no longer a nice-to-have, but a necessity. The potential for open innovation is increasingly extending from pure growth-linked

objectives to internal innovation in processes, systems and tools resulting in efficiency as well.

Telecom operators have had to experience painful disruptions to their value pools and fields of play, particularly from startups that have built businesses on top of the platforms they provide. At the same time, new ventures present a potent partnership option. Operators are currently far from being the partners of choice for startups but are perceived as slow-moving, inefficient, decision-avoiding and ultimately non-value creating partners.

To co-create value within the ecosystem requires strategic commitment: customer intimacy, clear focus, appropriate vehicles and enabling governance are all essential.

The key step is to establish focus and avoid a me-too approach mimicking other operators or internet players. Grounding innovation activities within corporate objectives and maintaining focus areas help to achieve a clear proposition towards partners in the ecosystem. Prioritization and pruning of areas over an appropriate time horizon is essential directing and potentially redirecting resources.

Once innovation priorities are clear, a careful choice of innovation vehicles provides execution platforms. We observe willingness from operators to seek (and not source) collaboration via a value statement to the ecosystem. This is backed up by strengthened efforts in scouting the right partners. Involving your current organization within these vehicles is a deliberate choice, especially where R&D, technology teams are involved.

However, the core of ADL's executive insights focuses on how to make this work: no execution platform can succeed without the right governance and enabling transformation. There is an acute need to bring value to partnerships by dedicating attention, assets and resources with a lean and empowered team, rather than trying to force-fit it into established organizational paradigms and processes. Treating the entire innovation engine as an optional bolt-on to the existing businesses also does seldom prove successful.

In summary, succeeding in this new era of innovation requires deep customer insight, clarity of purpose and selected engagement models that co-opt the internal organization and processes. As observed with our clients, this journey is easier said than done and challenges will persist along the way. An enabling transformation that adapts the strategy and innovation approach backed by changes in mindset, operations and governance is required.

Future "production model" – transforming the network & IT factory

Through the use of Software Defined Networking (SDN) and Network Function Virtualization (NFV), network infrastructure is evolving from a closed monolithic stack to becoming an open cloud networking platform, enabling better responsiveness to changing customers' needs and a move towards architectures that allow carriers to innovate on par with web scale players.

The shift requires a transformation of current business and operating models.

We expect carrier business models to evolve as the ability to self-order, self-manage, and self-administer in real time with instant effect finally allowing operators to cater for the demands of B2B2x business models. Also, we expect operators to establish collaborative relationships with customers, partners and suppliers for new service development. But the most visible change will be in the carrier itself. Cloud networking will allow unmatched level of network automation that will reshape not just the network, but the entire carrier operating model, from sales, provisioning to customer servicing, as straight through order processing increases the attractiveness of e-channels over the traditional go to market approaches. The effect of the shift to virtualized boxes will not be limited to carriers, but will reverberate upstream to the entire supplier base that will see a shift from equipment to managed services sales. Given that the software based approach allows for many more alternatives, design risks shift to operators – something especially smaller operators will find difficult to cater for. So the question arises if they will buy network services from larger operators, instead of from suppliers?

A handful of carriers have already matured quite a bit in reinventing themselves and there appears to be more than one way to skin the proverbial cat. DT has made efficiency and centralization its top priority, where as AT&T and NTT are looking to meld the cloud and network into a new technology architecture. But they too have yet to answer the most difficult question: is it wiser to fix their legacy issues one-by-one, or could SDN and NFV be used for "greenfielding and migrating"?

Each telecom operator will come under increasing pressure from these new business models and must set-out a vision for what role will the carrier play in the age of the automated and programmable network. We see four priorities

1. **For operators to use their customers and/or end-users to reinvent touchpoints**
   Customers require self-order, self-manage, self-administer and instant network configuration changes, especially to support B2B. Co-developing and exposing their network's APIs will enableB2B2x business models.
2. **For operators to develop a longer term architecture now and assess what helps and what hinders progress towards it**
   The design of a long term architectural vision becomes possible and is needed. The roadmap must clearly lead up to this target picture and operators will need to balance short-term initiatives distracting form it and stubbornly retaining focus for the longer-term good.
3. **For operators – especially groups – to align operating models to the new realities**
   As networks turn into clouds, they lend themselves to being centralized. Groups finally have a real opportunity to demonstrate significant cost advantages over smaller players – if they manage efficiently across national boundaries. Smaller operators on the other hand will need to revisit how to source networks: as boxes or as managed services and from vendors or from other operators.
4. **For operators to create a culture of openness and innovation**
   Openness for innovation requires a fresh look in a software world. It is insufficient to have a pool of talented developers, even though even these may be hard to find. In a software world the source of innovation is much more dispersed and thus requires a new approach to managing innovation.

Winning the infrastructure game – reconfiguring your assets in light of "control vs. own"

Today's TelCo's consist of a multitude of assets, which, if composed properly, simplify the organization, optimize the balance sheet, accelerate investment into future technologies all while minimizing regulatory risks.

It is fair to say that datacenters, fiber roll outs, towers, RAN, micro-cells and legacy assets differ in longevity, risk / reward, operational orientation, risk profile and regulatory perspective. Thus, managing them requires differing paradigms. So far, operators have catered for this internally – giving away an opportunity for future value-creation: optimizing the asset base - in line with the strategic vision and roadmap

Regulated assets often enable more stable margins for fundamental services. For regulatory reasons, these cannot be integrated with the commercial activities as regulators demand true-cost representations. Mobile towers just like the RAN should be shared, too, but are not regulated to the same extent. The deployment of fiber is a long term and significant investments, quite opposite to new technologies assets like small cell which present a high risk, potentially high reward investment profile. Reconfiguring network assets enables a Telecom operator to re-balance its investment potential by matching risks to suit new market realities.

However, value creation does not merely stem from financial engineering. Spinning-off assets or sharing them goes well beyond unlocking of financial value, but improves agility by simplifying the organization. Carving out regulated assets, can give the rest of the company more flexibility in simplification, bundling and pricing or spinning off towers can raise cash and lighten the balance sheet. Partnerships with financial or strategic investors can provide a balance between investment requirements and risk sharing e.g. for fiber deployments or small cells – making sure operating models and risks are perfectly aligned.

Contemplating future investments and returns on assets requires reviewing the current asset composition to align with the future vision and roadmap. Re-considering asset portfolios in light of ‘control vs own’ is a catalyst for value creation. Leveraging strengths of new partners, simplifying investment in next generation assets, spinning-off network assets can be leverage to unleash the full value potential of the Telco’s infrastructure. Value creation comes from the simplification of the corporation, separating regulatory risks, and sharing non-differentiating assets which in turn leads to better services, improved customer experience and lower costs.

Focus areas during the Q&A discussion

The Q&A session following the presentation reflected the main theme of the evening: the readiness of operators to adopt new practices and embrace a change strategic direction.

Mindsets are evolving on asset ownership; towers are once again becoming a hot topic, and innovative partnerships, including with equity firms, have been shaped. Most reluctance on the part of operators stems from relates to their strategies for legacy fixed assets, but separations can offer a route out for those in a regulatory and competitive bind. Even where the regulator forces the separation of assets, which layers are kept by which company can for example be negotiated.

The concerns of operators investing into new play areas with new services were discussed, in particular the need for a realistic time horizon and the perils of selecting services not aligned with margin expectations. Also the need to back bets that should pay off, for example 5% of a TelCo’s yearly CAPEX invested in a Smart City initiative can secure a 15 year long term contract with a stable return. In addition, diversification initiatives can also create value measured by alternative KPIs (e.g. number of additional customer interactions, net promoter score (NPS), etc).

Finally, we debated what tangible (e.g. network) and intangible (e.g. customer base) assets TelCo’s can leverage, for example in the case of Smart Home services, how to become ‘smart client service providers’, and what they can bring to new partnerships to create value.

Arthur D. Little

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