Vodafone & Hutchison – merge or wither

Ben Ramsden, 14th May 2009

Executive Summary

We examine the current health of the Australian mobile sector and conclude that the local businesses of Vodafone and Hutchison are unsustainable over the long term. Their proposal to merge will be good for customers and shareholders alike.

Introduction

When our local ice-cream parlour closed down recently there was much disappointment within the local community. "We'll have to buy our ice-creams from McDonald's next door instead" many people said with a sigh. The parlour's ice-cream was nice, but not sufficiently compelling to enough people to compete against other local vendors. The business was unprofitable and could not survive. There are lessons in this unfortunate tale for the Australian telecoms market.

The Australian telecoms market

Telstra dominate...

...despite powerful and expert international competitors...

...but a compelling case for disabling them has not yet been made.

The $36bn Australian telecoms market grew by 5% CY07-08, slightly faster than the whole economy. Telstra dominate, accounting for 66% of revenue, 80% of EBITDA and 90% of NPAT in 2008. Telstra's major challengers, all of whom have powerful and expert international parents, have suffered from either poor strategy, execution or lack of scale to break this dominance, so far. There are arguments made for Telstra to be broken up or otherwise reigned in to support the rest of the industry to flourish. We believe that disabling a well performing player to give a leg-up to poorer performing rivals can only be justified where there is the potential for significantly greater economic benefit. That case may exist but has not yet been convincingly made.

2009 is a pivotal year for Australian telecoms...

This status quo is highly likely to change in 2009 due to several pivotal events:

1. Telecoms market regulatory review
2. National Broadband Network (NBN)
3. Telstra leadership regime change
4. Vodafone – Hutchison merger
5. Global economic crisis (GEC)

...the government has out-manoeuvred Telstra on NBN...

The government review of the telecoms regulation regime appears to be a whip to pull Telstra in line whilst the future structure of the industry is designed incorporating a NBN. This, along with Telstra's change of leadership, will foster a significant change in Telstra strategy.

...which itself lacks clarity...

The proposed NBN sounds great but currently lacks a clear delivery plan. Thus the regulatory and structural changes being made in preparation for it are far more significant in the short to medium term than its actual building.

...and the economic crisis.

The GEC is putting Australia into recession, significantly impacting foreign exchange rates and reducing the availability of funding.

= major and unprecedented uncertainty.

This paper will focus on the proposed Vodafone – Hutchison merger. It is important to recognise that this is being planned against a backdrop of major and unprecedented industry uncertainty.

The Mobile sector

Mobile is just under half the telecoms sector.

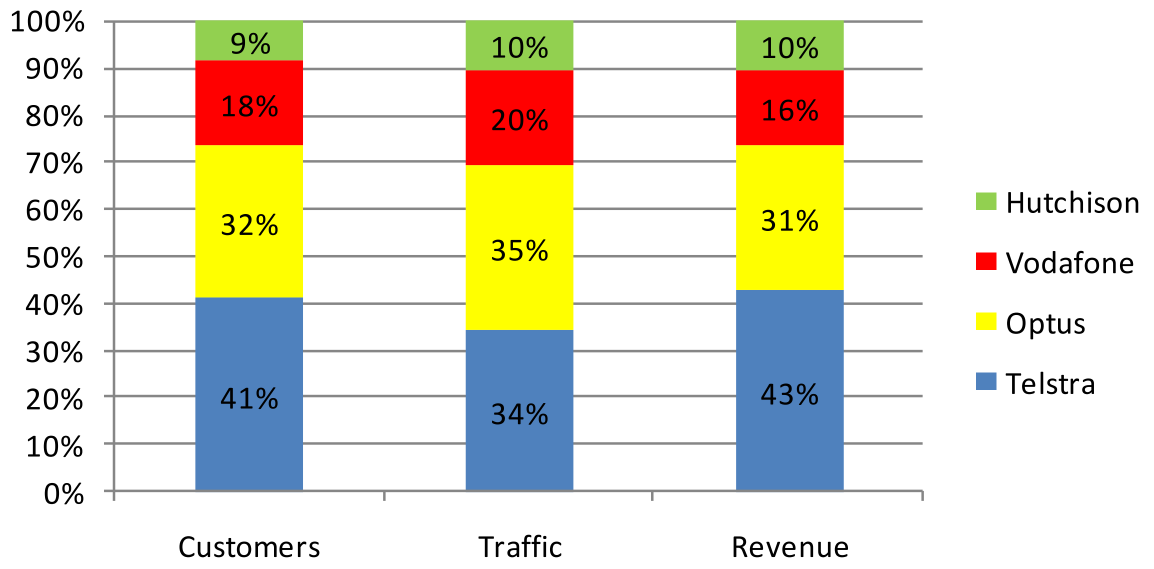
The mobile sector consists of 4 network operators and a number of Mobile Virtual Network Operators (MVNOs) who wholesale network capacity for retail under independent brands. It accounts for just under half the telecoms market and grew by 11% CY07-08.

Despite many years of sector growth, the smaller players, Vodafone and Hutchison, are not producing strong financial results. Optus' performance has disappointed although their Q4 results announced today indicate an improvement. Telstra is performing very well. Figure 1 shows the market shares of each of the 4 network operators.

There are many competing offers in the market, although customers wanting to buy on factors other than price have a limited choice.

We now consider the sector in more detail, with particular emphasis on issues relating to the proposed Vodafone – Hutchison merger.

Figure 1: Mobile market share 2008



Source: Company results and estimates. Traffic is outgoing mobile minutes. Calendar year 2008 except traffic which is Jul-Dec 08. Includes MVNOs as seen by the host operator.

Growth is ending...

Sector revenue has been growing strongly for many years as customers new to mobile are acquired and usage builds. As mobile penetration saturates and the national economy enters recession, growth will slow and may evaporate. Thus the fuel that has grown the market to where it is today will disappear.

...there are structural challenges...

Every player has a substantially different revenue share from every other and therefore lacks the scale to make a sustained, effective and profitable challenge on another. Thus the majority of operators have grown with the market, except for Hutchison who sacrificed profit to gain share.

The two smaller players (Vodafone and Hutchison) are sub-scale and must grow to achieve a long term sustainable position. This will encourage “grow at any cost” type behaviour. Let us explain.

...and poor financial performance.

Vodafone launched in Australia in 1993 and took many years to become profitable. It has reinvented itself several times in an attempt to improve its performance but have never achieved 20% revenue market share (an industry rule of thumb measure for minimum sustainable scale). It’s most recent results reported a profit of $107m on revenues of $2.44bn for the year ending 31-Mar-08. This is a poor result relative to global benchmarks.

Hutchison launched in 2003 looking to attract customers to exciting new 3G services. This was only partially successful so it augmented its offer with low priced voice tariffs, and recently cheap wireless broadband. It is yet to make a profit having accrued losses of $3bn since launch – that's equivalent to $1500 for every one of its current customers. Its most recent results reported a loss of $163m on revenues of $1.62bn for the year ending 31-Dec-08.

Hutchison's owners are effectively subsidising all Australian mobile customers.

Low pricing, supported by Hutchison's owners' deep pockets, has not only benefitted its own customers. Those of other operators have enjoyed lower pricing as their supplier struggles to compete *and* make a commercial return. In effect, Hutchison's charitable business approach is like a drug that the *entire* Australian mobile customer base is unaware that is it addicted to.

The era of full-service mobile only players is coming to an end

Vodafone and Hutchison are mobile only and thus have a limited telecoms product line. This specialism was arguably an advantage in periods of rapid growth, but in a sector with stagnating revenues the lack of breadth further exacerbates their lack of scale. For example, they are unable to sell service bundles which Optus is successfully using, and channel, sponsorship, advertising, network and corporate costs must be funded from mobile revenues alone. Longer term this presents a larger challenge.

The telecoms market is on the verge of a transformation that will eclipse mobile. In a few years time Australia's NBN will deliver ultra-fast broadband direct to the majority of premises in the country enabling a plethora of new services e.g. movies on demand, business or education tools, etc. In this world, wireless connectivity will be a crucial ingredient, but a relatively small part of the buying decision e.g. a bit like buying batteries today – often an afterthought and increasingly already included. Thus the era of full service mobile-only players is coming to an end.

High usage customers are costly to support

Telstra's challengers have targeted high usage customers with attractive pricing and are carrying a disproportionate amount of traffic as a result. The investment burden to support this will be considerable and is not sustainable without strong revenue growth.

Telstra successfully flaunt their superior network

Telstra have by far the most superior mobile network in terms of coverage and speed – reaching 99% of the population with enhanced 3G over a land area of 2m km^2. Although there are no handsets available to use the highest network speeds, Telstra's marketing has successfully differentiated them from other operators with fantastic results for Telstra. All other operators have plans to approach, but not equal, Telstra's network performance.

Real customers' choice is limited...

One player (Telstra) promotes network quality. The rest promote great pricing. No major player has a reputation for or promotes fantastic customer service. Customers therefore face a polarised choice between one supplier offering top quality high priced products with lack-lustre customer service, and several offering cheap products with similarly lack-lustre service

...with more competition in the urban areas.

The market is highly geographically concentrated with almost half the revenue from customers living in metropolitan Sydney and Melbourne. This has created a two-tier mobile market which is more competitive in the easy to access urban areas and less so beyond.

Attractive new services are offered too cheaply...

The sector offers attractive handsets and devices as a gateway to two main product sets: mobile voice & text, and mobile broadband. The latter set is a relatively new innovation enabled by 3G network build. Although it has generated a major revenue boost, the low retail pricing offered by Telstra's challengers to capture market share is believed to be mostly unprofitable. Thus a price correction for 3G services is required to put *challengers* in a sustainable position. It will be a difficult decision for them to make this because growth will suffer. This is not a problem for Telstra who have successfully built and promoted their huge "Next G" (3G) network.

The future options

So what are the opportunities for Vodafone and Hutchison in this tightening mobile market? Our candidates are:

1. **Build scale through consolidation**. This is their proposal
2. **Sharp niche focus** e.g. wholesale only, premium service for a narrow segment. Both parties have unsuccessfully tried to focus on other niches in the past and will be

understandably reluctant to try again.

3. **Significant gains from Telstra** in low-usage and outside-Metro segments. Once their network and channel has sufficient reach this will probably be attempted.
4. **Retail only**, possibly using wholesale capacity from a wireless enabled extension to NBN. Both parties already have some network sharing arrangements. Taking further is probably not possible until the NBN is well advanced.

Thus overall we believe that Vodafone and Hutchison have an unsustainable business model that will fail once economic growth stops. They have limited current options to solve and have chosen the one that can make a significant improvement with a moderate risk profile.

Vodafone Hutchison Merger

The merger delivers...

We strongly support the merger of Vodafone and Hutchison in Australia because it creates a sustainable economic future for them and therefore the opportunity for greater real customer choice.

...sustainable financial performance...

...and thus opportunity to invest...

Once Vodafone and Hutchison have completed a successful integration the combined entity will be large enough to be self-sustainable, and sufficiently profitable to invest in growth opportunities. Look out for Vodafone repositioning itself as a brand with broad appeal and launching into the low-use, rural and corporate segments. Longer term expect them to offer combined fixed/mobile services over the NBN.

...and encourage mature competition...

...including protection against excessive price increases.

The merger would fundamentally change the mobile sector from a 40/30/20/10 structure to 40/30/30 where mature competition based on stronger differentiation can flourish. Resurgence in MVNO activity is likely if players increase prices too much as they seek to recover margins depressed by excessive price based competition.

Without the merger other solutions will be sought...

If the merger does not go ahead the parties' parents will seek an alternative route to maximise their local assets' values in a saturated market and economic slump. Divestment will remain on the agenda – watch for parents match-making as the NBN market evolves. Thus it is unlikely that Vodafone and Hutchison will

...probably only a stay of execution...

continue long term as mobile-only independent entities.

...and “living dead” in the interim.

Pending long term structural change, each operator’s investment would be pared right back and the assets managed to maximise cash generation or minimise cash burn. This is similar to Telecom NZ’s strategy for AAPT which it has been trying to divest for some time now.

Australian Competition & Consumer Commission (ACCC) decision

It’s their call...

The proposed merger is currently awaiting ACCC approval which we believe should be granted.

..and it’s a tough one in the context of their duty.

The critical ACCC test is whether this merger is likely to result in “substantial lessening of competition” in a market. They will need to consider this very carefully because it may appear to do so *compared with today’s status quo*. The key issue is that today’s market is unsustainable and will unwind anyway if this merger does not go ahead. Thus a judgement needs to be made between two alternative futures, neither of which looks like today.

There is a cost for sustainability...

Together Vodafone and Hutchison account for 11% of the national telecoms market and 26% of the mobile sector by revenue. If the merger goes ahead it will remove one of the four independent mobile networks including the 3 brand. This is significant because they are a relatively innovative and dynamic competitor, albeit one sustained by an owner with very deep pockets. As discussed above, some prices will increase, although the potential for MVNO resurgence will act as a natural cap on price increases.

...but also a counterbalance

Significantly the removal of Hutchison will not affect the availability of wholesale capacity for MVNOs because they currently do not host any. We believe that operators’ desires to host MVNOs will limit any potential increase in sector wholesale pricing.

Every market is different.

The ACCC may look overseas and see countries with smaller populations yet more mobile operators than Australia. It is beyond the scope of this paper to consider whether four operators are too many for this sector to be sustainable *in all circumstances*. We believe that local geography, history, market structure and operator actions are all significant.

Conclusions

A controlled fix is best	We believe that currently both the market structure and pricing of some services are unsustainable and that this merger will deliver a controlled correction. Without it, slowing growth will lead to significant financial stress in some of the sector with an undesirable impact on customers.
If you can't beat 'em, join 'em!	This is a shotgun wedding, in a sector running out of gas, between two rivals who have exhausted every other avenue for achieving a sustainable future. These are not greedy "fat cat" capitalists looking to exploit the Australian market.
Rudd says "big is beautiful"... *...so long as he has control.* *This merger aligns*	It is the ACCC's job to look after consumers not shareholders, and they have a fine judgement call to make. As a state agency they should align with the government who are currently planning a restructure of the national telecoms market around the NBN. The government has clearly indicated that a nationalised monopoly is the best way of satisfying the future broadband needs of the nation. It also appears keen to reduce the dominance of Telstra. In this context it would seem myopic to prevent the merger of two minnows in the hope that this will provide better communications services for Australians and stronger competition to Telstra.

Note

The author is a customer and shareholder of Optus, Telstra and Vodafone. The opinions in this paper are solely those of the author. Nothing in this paper should be construed as advice and any contents should be independently verified before using for commercial purposes.

About the author

Ben Ramsden is an independent business growth consultant - specialising in business development and turnaround. He has 20 years experience in international utility and telecoms markets including with Vodafone and Telstra.

Contact:
Phone: +61 406 401 180
Email: Ben.Ramsden@iee.org