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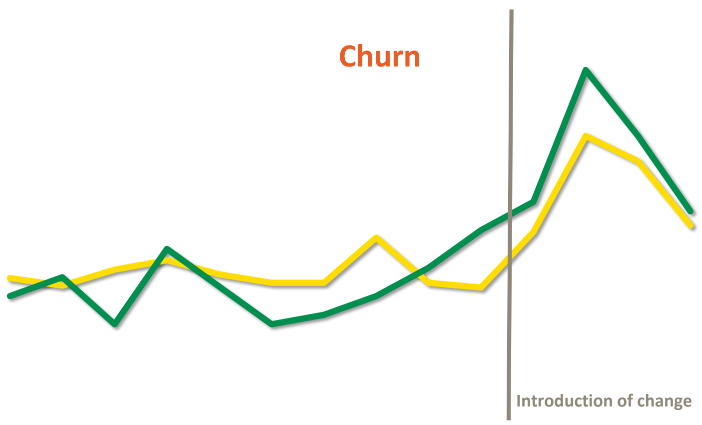
Public industry analysis #12 2013

If EU gets what it wants, this is coming your way as well

How six months contracts changed mobile in Belgium and Denmark



Denmark has had it for more than 10 years, Belgium got it a year ago and now EU proposes it for all of EU: Maximum effective binding period of 6 months for consumer mobile contracts.

What happens to a mobile market when such a change is introduced and why is this change actually so significant?

This analysis shows that when Belgian consumers no longer are locked into long contracts, it has a major impact. The question is also if the transition is over in Belgium: Danish figures suggest it might get worse.

Since the EU commission - as part of the 11 September 2013 "Connected Continent: Building a Telecoms Single Market" plan - is proposing that EU consumers should have a similar right to cancel contracts after six months, the question is obviously: Is this also your future?

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Mobile operators are widely depending on long contracts to recover SAC/SRC

In EU there is a limit on how long consumer mobile contract can be binding of 24 months and operators typically converge on offering 12, 18 and 24 months contracts unless selling SIM-only. Often consumers and businesses are treated differently and especially consumers have the attention of regulators and national watchdogs, resulting in initiatives, which enhances consumer protection. Such an initiative, to limit the maximum effective contract length for consumer mobile contracts, has recently been introduced in Belgium, where 6 months is now in practice the binding period on consumer contracts and this is applied to existing contracts too.

On 11 September 2013, Neelie Kroes announced the latest EU proposal "Connected Continent: Building a Telecoms Single Market", which a.o. includes the following points on consumer protection:

- ***Contract periods:*** *There can be no initial commitment exceeding 24 months, and a 12 month-only option must be provided.*
- ***Contract roll-over:*** *warning provided at least one month in advance, with an option to oppose tacit extension of the contract; in case where a contract rolls over the contract can be terminated without any costs with a 1 month notice.*
- ***Contract termination:*** *consumer to gain right to terminate any contract after 6 months without penalty with a one-month notice period; reimbursement due only for residual value of subsidised equipment/promotions, if any. Any restriction on the use of the terminal equipment on other networks must be lifted free of charge once any due compensation of subsidies and/or promotion is paid.*

The first and last points above is essentially, what was introduced in Belgium a year ago.

Mobile operators have since the beginning of the mobile industry educated mobile subscribers in mature markets to expect that mobile phones are free or at least sold significantly below the realistic price point. The operators have then relied on contracts of up to 24 months to recover the commercial cost, referred to as SAC and SRC (subscriber acquisition cost and subscriber retention cost). Figure 1 below shows the direct time to recover SAC measured as number of months average revenue per subscription (ARPU) to cover SAC[1]. The graph includes data for 26 mobile operators in mature markets, who reported SAC and mobile revenue details in 2012. Many of these operators are from EU countries.

[1] Time to recover SAC does not mean that all cost associated with a subscription is recovered in the calculated timeframe; it's merely a KPI to normalise SAC levels and make them comparable across operators. The real time before an average subscription becomes profitable is longer than the time to recover SAC.

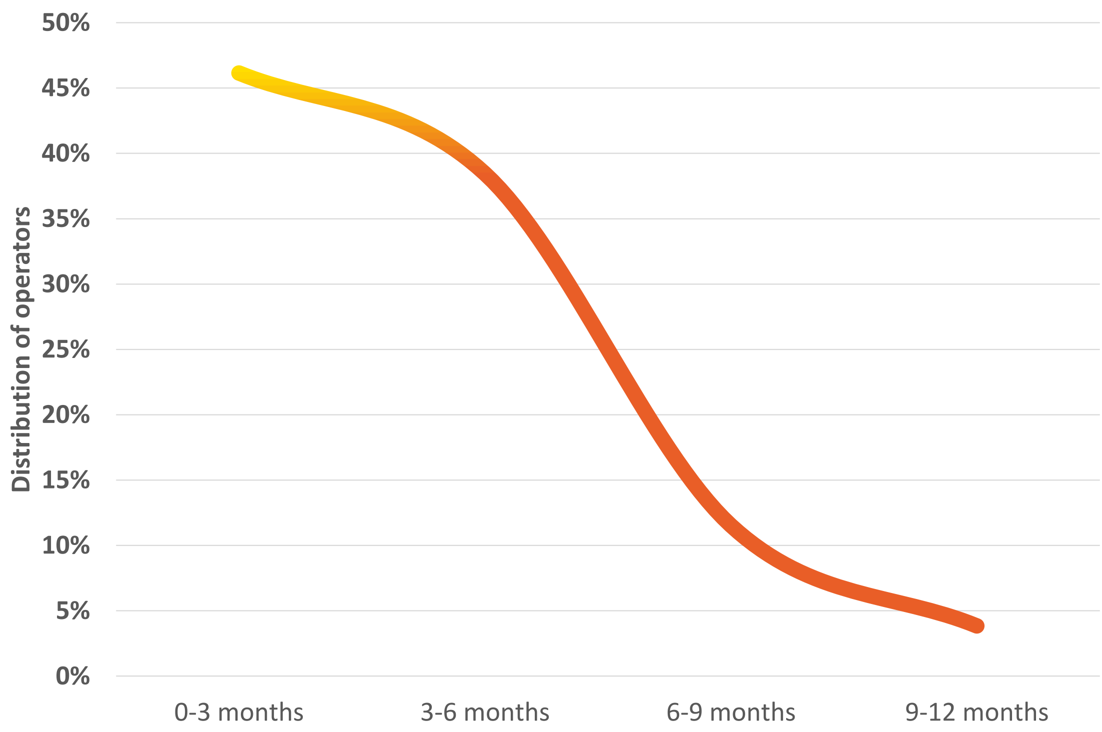


Figure 1. Time to recover SAC of mature market mobile operators

Given the graph in Figure 1, it is clear that for many operators it would be quite detrimental to be forced to limit the maximum contract length to 6 months, even if only for consumer contracts. An analysis of the expected longer-term effect of this change introduced in Belgium will inevitably include a look to the situation in Denmark, where the maximum contract length for consumer contracts has been 6 months for more than 10 years. A key difference between the conditions in Denmark and Belgium is that in Belgium the operators are allowed to ask for reimbursement of any residual subsidy value, which is not possible in Denmark – this aspect will be commented later in this analysis.

The change in Belgium

The change of the maximum contract length for consumer mobile contracts was introduced in August 2012 with some transitionary conditions until October 2012. The main lines of the change was that all existing contracts would automatically convert to the new conditions even if they were originally sold with a longer binding period.

This is how market leader Belgacom describes the change and its steps to go even further in the interest of consumer protection on its [Investor FAQ page]:

> **Consumer protection**
>
> The new law transposing the revised EU telecom framework strengthened the consumer protection rules and introduced new measures related to contract regulation imposing (i) a contract duration of 24 months maximum for consumers and an obligation to propose a 12-month maximum contract to all customers, (ii) possibility of early termination of fixed-term contracts after 6 months (without any penalty except potential reimbursement of the residual value of a free device) for consumers and small enterprises and (iii) specific conditions applicable to the replacement of an existing contract by a new fixed-term contract (in particular after distance selling). The new provisions are applicable on both new and existing contracts.
>
> Since July 2012, Belgacom decided to go a step further by offering the consumer the opportunity to discover the quality of its products and services with no strings attached. As such, all new fixed and mobile contracts, including promotional offers (but excluding joint offers), are non-binding as of July for the residential market. Some non-binding offers have also been designed for business customers having up to five numbers.

It is clear that Belgacom took a step further than what was dictated by the new law by offering all new contracts as non-binding.

What did the change in Belgium lead to?

One would expect that churn would increase, followed by some – maybe panicky – attempts either to stop the churn or to limit the effect of the churn, which would have some short-term effect on profitability. Did this happen? Yes, it did actually.

Contract churn

Mobistar does not report any churn numbers, but Figure 2 shows contract churn numbers per quarter for BASE and Belgacom's consumer segment[2], which quite clearly show that something happened around the time of the change.

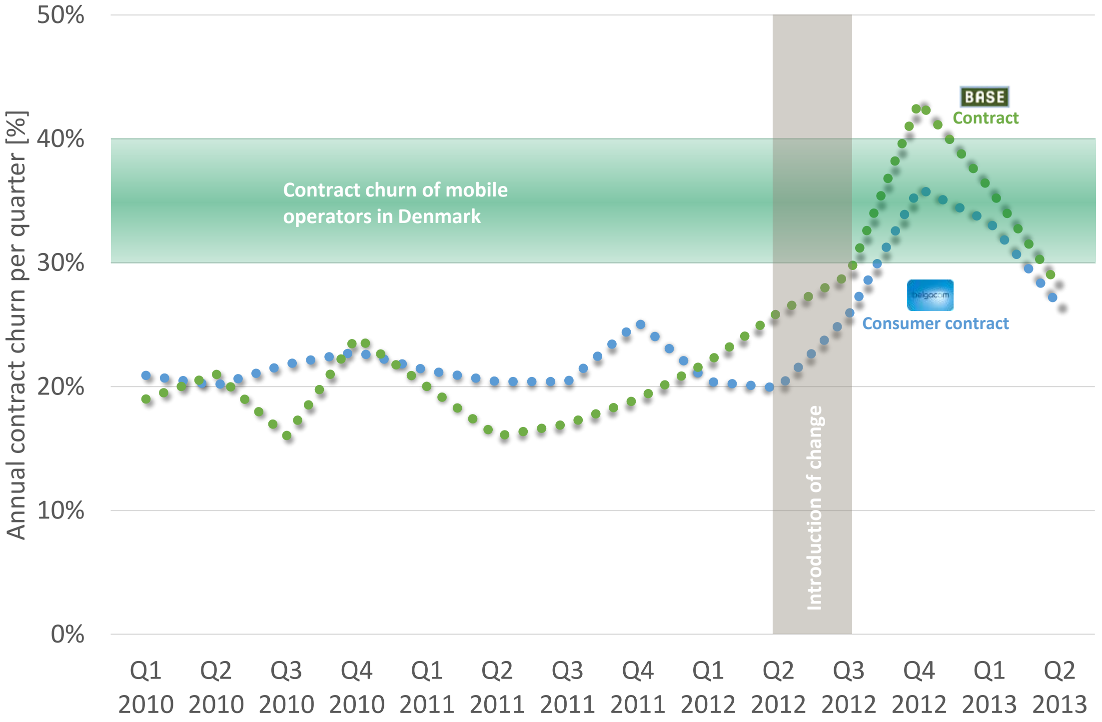


Figure 2. Contract churn development in Belgium around the change

From Figure 2 it's clear that a lot of subscribers at Belgacom and BASE chose to change their existing contract, which presumably had a relatively long binding period left. Coming from contract churn levels at around 20%, contract churn at 30%-40% may scare the Belgian operators, but such contract churn levels are consistent with those found in Denmark. The Belgian operators should expect contract churn to remain at the new higher levels and adjust their business model accordingly.

[2] Belgacom's mobile brand is called Proximus but both brands are used interchangeably by Belgacom e.g. on their websites and presumably the Proximus brand will be phased out at some point. In this analysis, the Belgacom name is used when referring to Belgacom's mobile service.

Contract vs non-contract subscribers

What about prepaid customers then? Maybe the new "relaxed" contract conditions could help persuade prepaid customers to take a contract? Figure 3 below shows the share of contract subscriptions of the total subscription base for the Belgian and Danish operators.

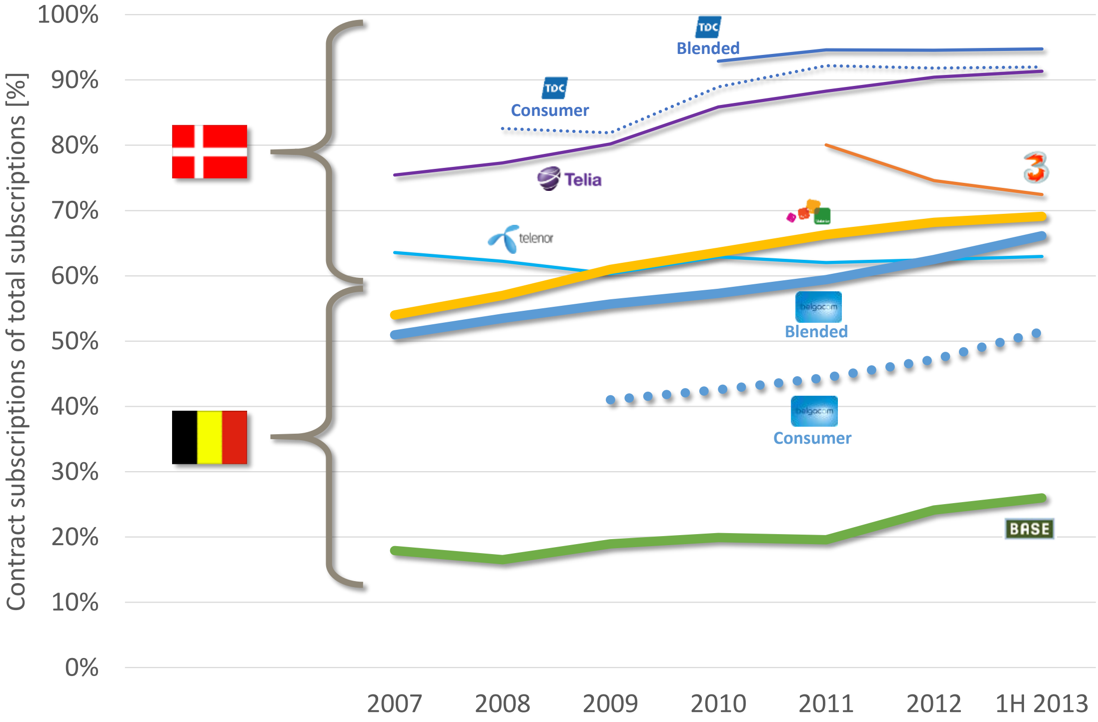


Figure 3. Development of share of contract subscriptions of the total subscription[3] base in Belgium and Denmark

Figure 3 shows that something happened with the subscription mix of the Belgian operators during 2012. The change is most noticeable for BASE, where the share of contract subscriptions started to increase from a stable level around 20%. Belgacom and Mobistar were already increasing their share of contract subscriptions and the change in 2012 does not seem to have significantly influenced their pace.

These numbers show that the Belgian operators are trying to acquire as many contract subscriptions as possible and the new law supports this development. When compared to the Danish operators, it's clear that a lot can still be achieved in Belgium in terms of converting prepaid customers to postpaid customers for increased loyalty and stronger relationships between operators and customers. The benchmark in Denmark is upwards of 90%.

[3] Subscription numbers exclude MVNO and M2M subscriptions where possible.

EBITDA margin

The ultimate measure of success is of course the EBITDA margin. Figure 4 below shows the EBITDA margin of Belgian operators per quarter.

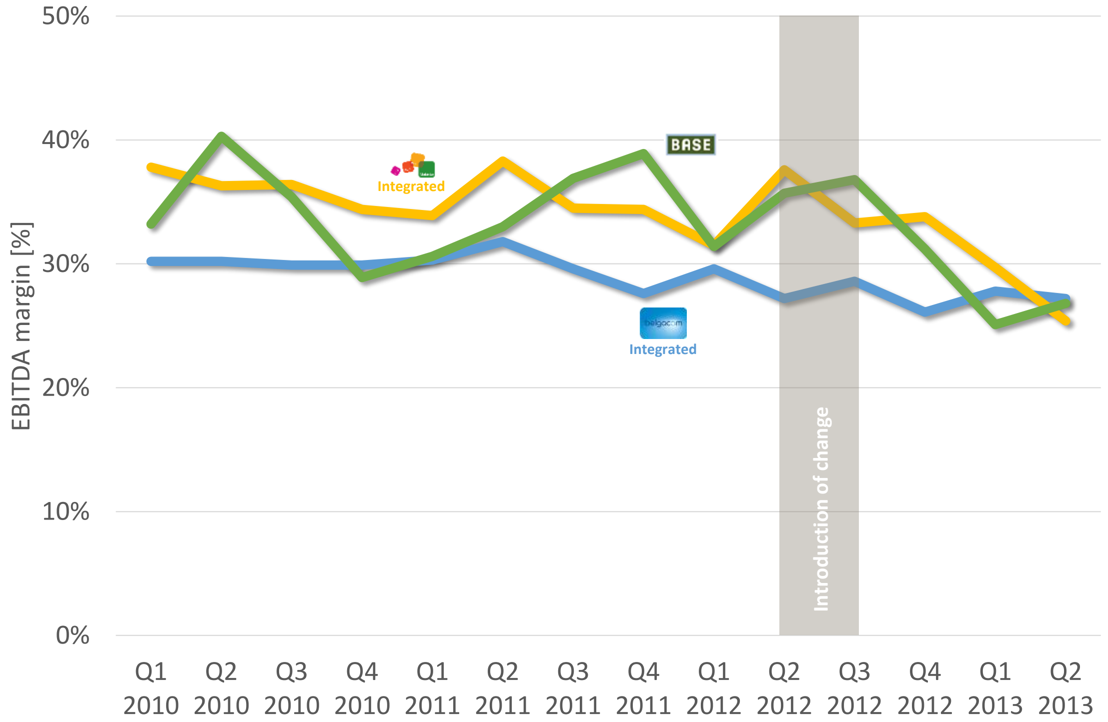


Figure 4. EBITDA margin per quarter for Belgian operators[4]

The Belgian operators have been used to EBITDA margins in the order of 30%-40% but these have now dropped to around 25% one year after the introduction of the new law. Mobistar and BASE have seen the steepest declines whereas Belgacom's decline is more gradual (see also footnote below).

Compared to Denmark[5], where only the incumbent TDC has a good business at around 45% EBITDA margin, the Belgian operators are very comparable within their market in terms of EBITDA margin. The 2nd and 3rd operator in Denmark, Telenor and Telia, have EBITDA margins between 10% and 20%.

[4] Note that Belgacom and Mobistar are represented here by their integrated group results as they do not report results of their mobile businesses in Belgium. For Mobistar the difference between integrated group results and mobile results is small due to the relatively small size of it's fixed and non-Belgian mobile businesses. BASE's results are mobile only.

[5] EBITDA margins for TDC and Telenor are for their integrated businesses in Denmark as they do not report mobile-only results. Telia reports mobile-only results and so does 3, but 3's accounting method makes their EBITDA margin incomparable.

Subsidisation of handsets

Subsidisation of handsets (or equivalent, e.g. dealer commissions) is typically the single biggest OPEX component for a mobile operator in a mature market where this sales tactic is used. Mobile operators in Denmark tried to survive with relatively large subsidies after the maximum contract length was cut to 6 months, but the market forces – predominantly led by price-challenging MVNOs – led to the abolishment of consumer subsidies a couple of years ago with associated lower service prices. However, in a market with price as the primary differentiation lever, there are bound to be elements of a price war from time to time and Denmark is no different, as mobile operators in Denmark have now started to introduce subsidisation into the instalment plan setup. At the time of writing this (mid-September 2013), all four MNOs in Denmark are offering the following consumer discounts[6] on a Samsung Galaxy S4:

Operator	Discount offered on Samsung Galaxy S4
TDC	1199 DKK (≈160€)
Telenor	2390 DKK (≈320€)
Telia	2400 DKK (≈320€)
3	1282 DKK (≈170€)

This development is probably a result of Telia and Telenor trying to capture lost subscribers and thereby hoping to recover lost margin in a longer perspective. It's probably not a result of a market not being able to survive without subsidies and/or long contracts, but when the operators' primary – if not only – effective differentiation weapon is price, then this development seems inevitable. If the operators had managed to build a differentiation strategy, which would be clearly communicated and accepted by the average consumer, then the operators might have been able to avoid price wars and instead use their individual strengths like quality, service and brand values when acquiring and retaining customers.

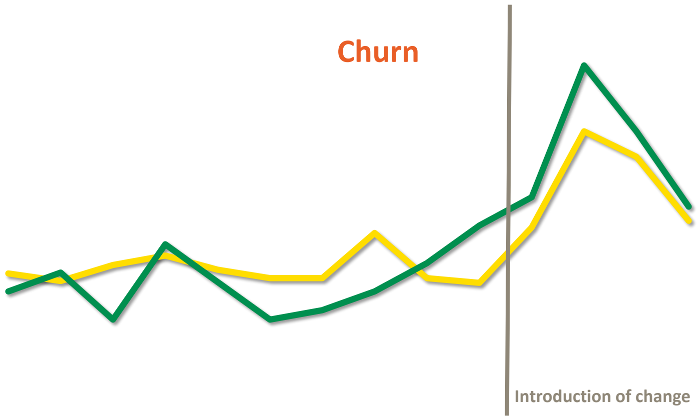
Subsidies in Belgium are also back in fashion – and then again, not really. Both Mobistar and Belgacom have mentioned "tactical" subsidies in their financial reports covering 2nd quarter 2013 but at the time of writing this (mid-September 2013), no subsidy seems to be applied when trying to order a handset and subscription online at neither Mobistar, Belgacom nor BASE.

Despite the provision in the new law in Belgium to allow operators to get reimbursed for residual subsidy in a handset, this option does not seem to be used in practice. It is likely that the operators have forfeited this option to avoid the potential badwill of asking for reimbursement upon contract termination and instead have decided to try to explore a new course to success under the new law, without having to pay customers to come on board.

[6] The discount is offered on the normal full price of a handset, i.e. the discount does not equal subsidy (the actual subsidy will be lower than the discount presented here).

Conclusion

The change to a maximum consumer contract length of 6 months had an immediate and noticeable effect on the Belgian market. Belgian mobile operators need to adjust to the new conditions and adapt their business models accordingly. The short-term effect of the change is skyrocketing churn numbers and decreasing profitability.



Denmark is a country of MVNOs and sub-brands just like Belgium. This abundance of choice for the consumer means that operators should try to build stronger relationships with customers e.g. through a contractual relationship – however short it may be – rather than a prepaid-type of relationship. The Belgian operators should continue to grow the share of contract subscriptions, as clearly there is still some way to go to reach the levels seen in Denmark.

For long, it seemed that consumer handset subsidisation had de facto disappeared in Denmark, but recent development shows that one or more operators felt that it would make sense to reintroduce subsidisation. Only time will tell if this was a good idea, but it might have been better long term to work on a consistent differentiation strategy rather than paying customers to join.

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