tefficient

Industry analysis #2 2014 – public version

Based on figures up to December 2013

The art of balancing SAC and SRC

Premium version contains country-specific analyses of France, Germany, Poland, Austria, the Netherlands, UK, Denmark and Canada

This is the fourth[1] analysis on subscriber acquisition cost (SAC) and subscriber retention cost (SRC) from tefficient. The previous SAC & SRC analyses showed that an increase in SRC had a positive effect on contract churn without any negative effect on EBITDA – as long as not exceeding 100% of contract SAC. The recommendation for operators with SRC *lower* than contract SAC was therefore to increase SRC at the expense of contract SAC until the two meet. For operators with SRC *higher* than contract SAC the recommendation was to stop the SRC increase – since it's no longer effective – and instead accelerate work on fulfilling customer expectations.

This analysis shows that much has happened in 2013: Average unit SAC and SRC have both decreased significantly. How come – and what has it led to?

The analysis comes in two versions: This public version – and a premium version which adds country-specific SAC & SRC analyses on eight countries: France, Germany, Poland, Austria, the Netherlands, UK, Denmark and Canada. Instructions on how to get a copy of the premium version is found at the end of this document.

[1] Previous versions issued: February 2012 based on figures up to September 2011, August 2012 based on figures up to June 2012, March 2013 based on figures up to December 2012. Still available at www.tefficient.com/Analysis/.

Reporting of SAC and SRC

Subscriber acquisition & retention continues to be the **single largest cost item** for mobile operators in mature markets. Given this, it is still disappointing that only a minority of operators report their SAC and SRC figures.

To this analysis, we've been able to find **35 mature market operators** who report elements of both SAC and SRC:

- **3** [UK*, IT, SE, DK*, AT*, IE]
- **A1** [AT*]
- **BASE** [BE]
- **Bell** [CA*]
- **Bouygues Telecom** [FR*]
- **Cosmote** [GR, RO]
- **EE** [UK*]
- **E-plus** [DE*]
- **KPN** [NL*]
- **Orange** [FR*, PL*, ES]
- **PT** [PT]
- **Rogers** [CA*]
- **SFR** [FR*]
- **SK Telecom** [KR]
- **Swisscom** [CH]
- **TDC** [DK*]
- **Telecom** [AR]
- **Telekom** [DE*]
- **Telus** [CA*]
- **T-Mobile** [US, HU, PL*, CZ, NL*, HR, SK, AT*]

*) All operators in this country are compared in the premium country-specific analyses

There are also a few operators that report SAC, but not SRC. As the point of this analysis is to compare SAC and SRC, the SAC-only operators have been left out of this analysis.

Let's first categorise the 35 operators based on their reporting of SAC and SRC. The columns in Figure 1 show operators who report SAC, SRC or the sum of SAC & SRC[2] respectively.

The rows in Figure 1 show operators who report total cost and unit cost (per subscription) respectively.

[2] For operators reporting both total SAC and total SRC (A1, Telus, SFR), the sum of total SAC & SRC can obviously be calculated. Figure 1 doesn't display the logos of such operators in the "Sum of SAC+SRC" upper quadrant.

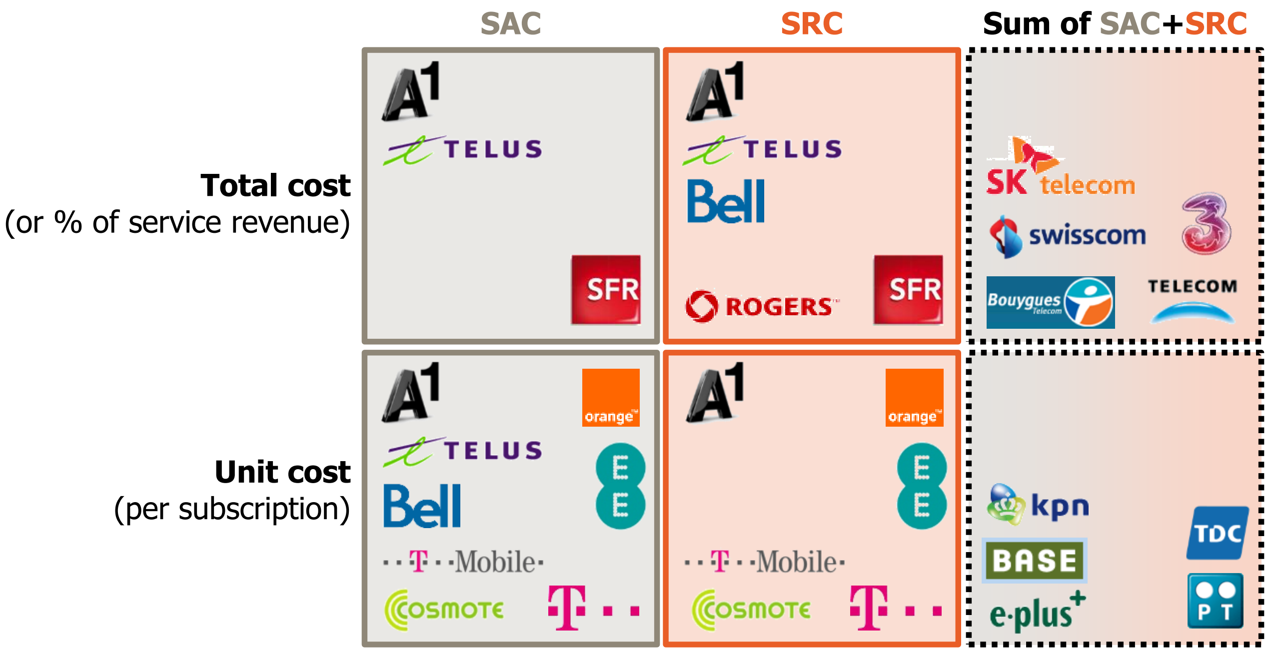


Figure 1. 35 operators[3] categorised based on their reporting of SAC & SRC

The fact that operators haven't found *one common way* of reporting SAC and SRC makes like-for-like comparison difficult. **A1** in Austria has the **best reporting** since they provide both *total* cost split on SAC and SRC – but also *unit* cost split between SAC and SRC.

The problem with e.g. Orange and T-Mobile's reporting is that it's impossible to know what the *total* SRC spend is as only *unit* SRC is reported – since the *number* of retained customers isn't reported.

It's still better than the right hand column, though. These operators do not separate between SAC and SRC – possibly due to a partial inability to differentiate customer retention from customer acquisition. Some operators don't have a clear retention philosophy and will routinely offer an existing customer who is up for renewal the same offer as a new customer would get. If this is how it's handled, retention and acquisition is essentially the same thing.

[3] Multi-country operators sharing the same brand are shown only once

Total SAC & SRC: Up to 26% of service revenue – but typically 16%

Let's start the analysis by comparing how much of operator service revenue that goes to SAC and SRC – covering the operators in the three highlighted quadrants to the right.

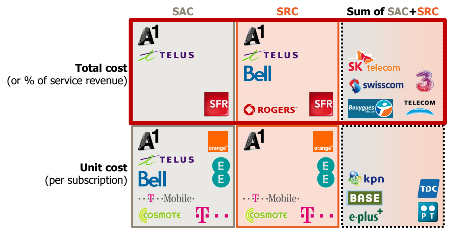


Figure 2 shows the development of **total SAC & SRC in relation to service revenue** for 14 reporting operators globally.

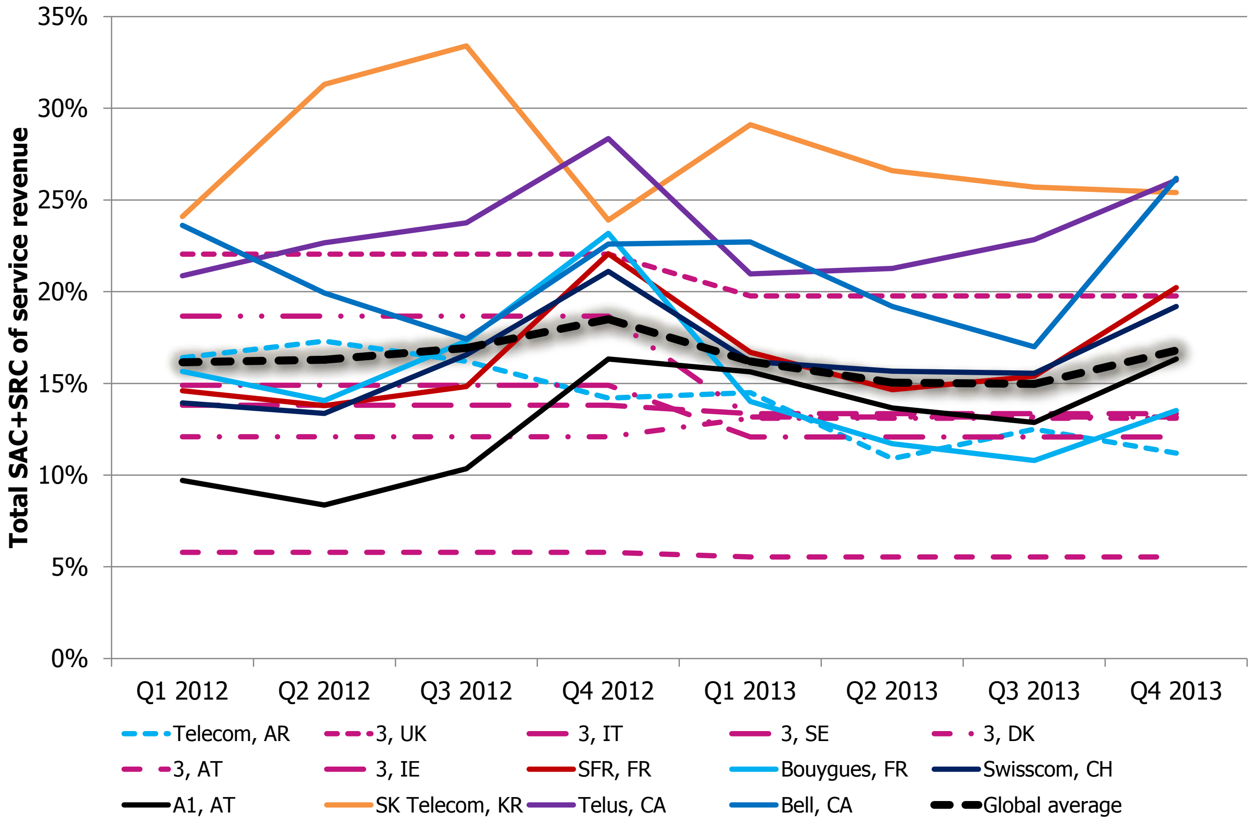
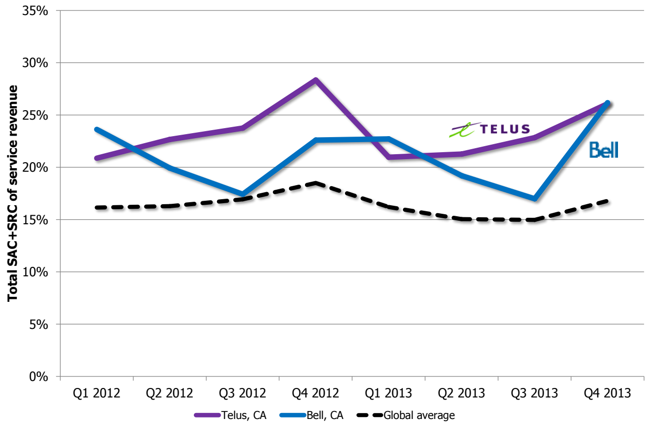
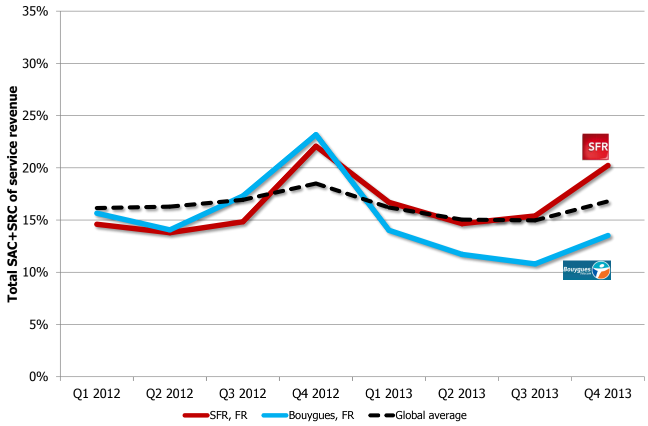


Figure 2. Total SAC & SRC in relation to service revenue for 14 reporting operators

The readability of Figure 2 is bad – we will soon break it down to improve. For now, please just identify the *Global average* line in Figure 2 as it will stay untouched in the following charts. It shows an **average SAC+SRC of about 16% in relation to service revenue** with seasonally higher levels during fourth quarters. The development is slightly positive; the share of revenue used on SAC & SRC has gone down in 2013 compared to 2012.

Figures 3 and 4 below break out Canadian and French operators respectively from Figure 2 – with the global average line intact.





Figures 3 and 4. Total SAC & SRC in relation to service revenue for Canadian[4] and French reporting operators

The **Canadian** operators averagely spend about 22% of service revenue on SAC & SRC which is well above the global average. The market is not very competitive but the business model is based on heavily subsidised handsets combined with super-long contracts (even though Canadians since December can cancel their three year contracts after two years without penalty). The premium country-specific analyses investigate Canada further.

The **French** operators are more in line with the global average. The introduction of the fourth mobile operator, Free, in January 2012 has actually helped the French incumbents to improve on this KPI since a much higher share of the market has been attracted by no-frills offers and -brands after Free's entry (the overall revenue has taken a hit, though). Figure 4 shows that **Bouygues** has been more successful than **SFR** in addressing its total SAC+SRC. The premium country-specific analyses investigate France further.

In Figure 5, the Canadian and French operators have been taken out to improve the readability.

[4] Bell does not report total SAC, just total SRC. But as they report unit SAC (COA) and churn, these have been used to calculate total SAC

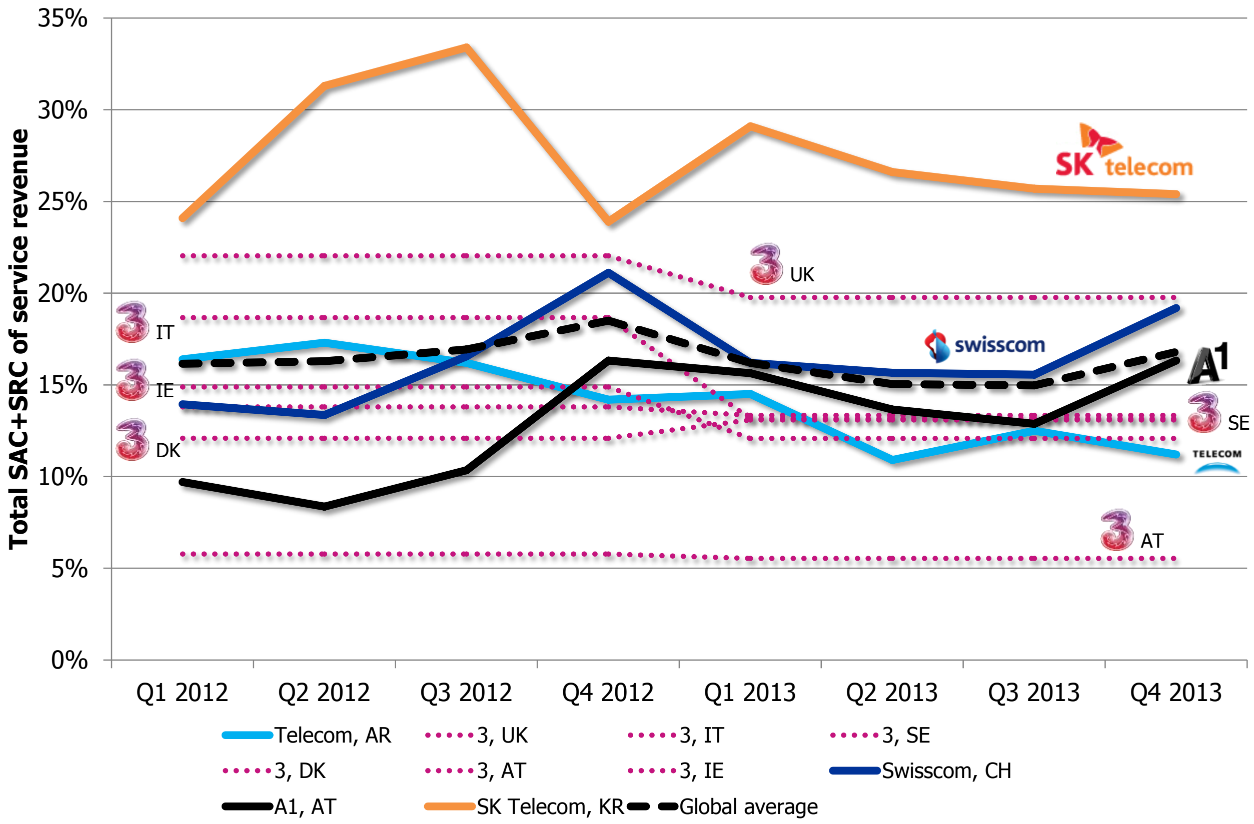


Figure 5. Total SAC & SRC in relation to service revenue for the remaining reporting operators

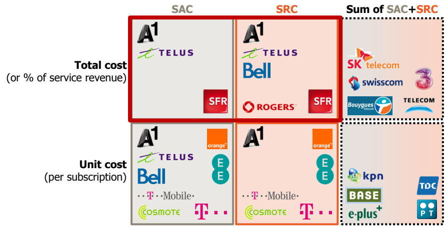
A1 from Austria [**black** line] took a cost leap upwards in Q4 2012 when it started to use much more on SAC & SRC, largely driven by SRC. The background is that in January 2013, '3' Austria eventually – after 11 months of waiting – got green light for its acquisition of Orange. With a much stronger number 3 operator in the country, A1 decided to defend its market leading position. '**3**', on their hand, reports that only about 6% of annual revenue[5] goes to SAC & SRC.

Telecom from Argentina has targeted to come out of their previous dependency on handset subsidisation and shows the opposite curve if compared to A1.

The top line in Figure 5 belongs to **SK Telecom** from Korea. In a very competitive market, SK has been above 25% throughout 2013. It could still be seen as an improvement compared to second and third quarters in 2012 when SK fought the LTE market share battle with local competitors KT and LG Uplus.

[5] '3' group has reported SAC/SRC for the first time for full year 2013 (with previous year). No half year figures have been reported, but will likely be reported 1H 2014 onwards.

Total SRC vs. total SAC – close to 100% or above



Of the operators reporting total cost, there are only four reporting both total SAC and total SRC – the two highlighted quadrants to the right.

This drawback will be compensated somewhat in the unit SRC vs. unit SAC analysis which follows.

But, before that, let's look at those we have total SAC and SRC data for: A1, SFR, Bell[6] and Telus.

Figure 6 compares total SRC with total SAC[7]. Operators with total SRC higher than total SAC are above the 100% line. **A1** stands out with total SRC spend more than 250% of total SAC spend. Also **SFR** and **Bell** have in certain quarters used much more on SRC than SAC. **Telus** has the lowest fluctuation but in total amounts still spend as much on SRC as on SAC.

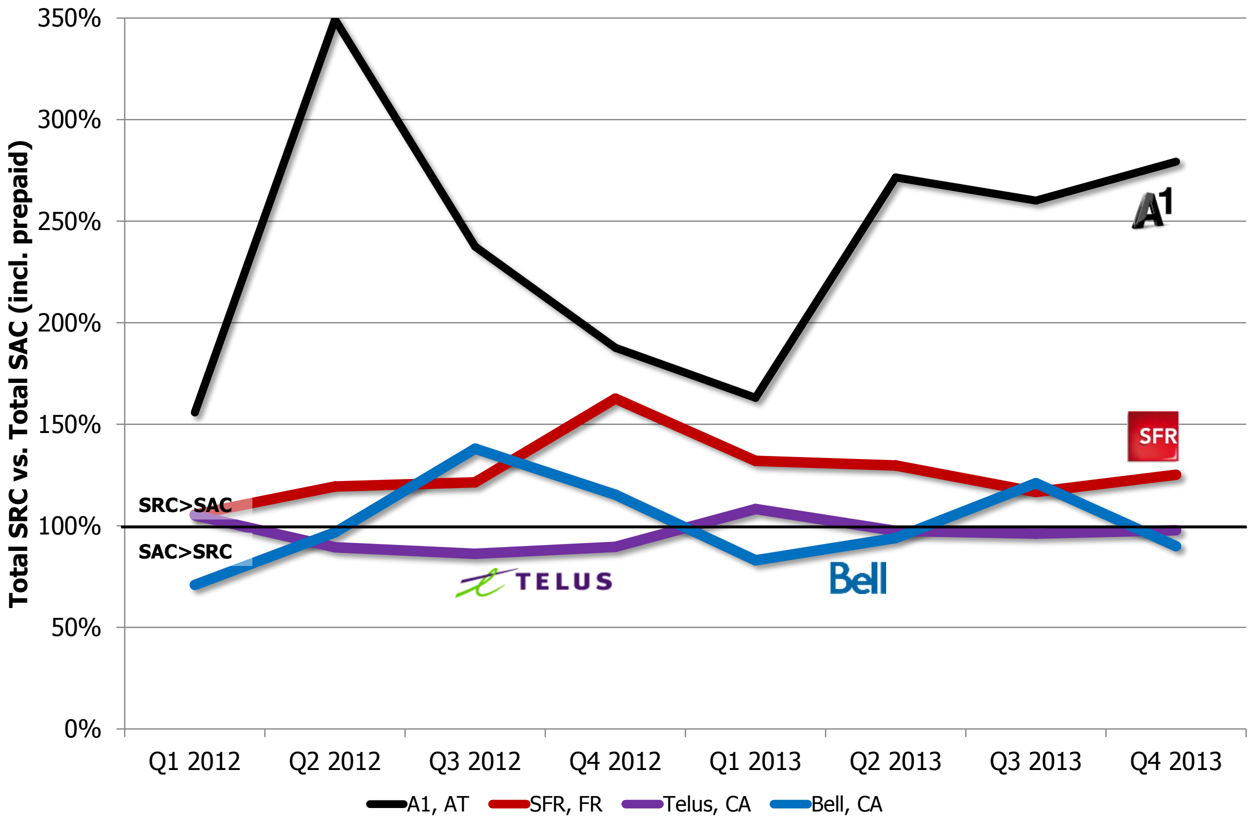
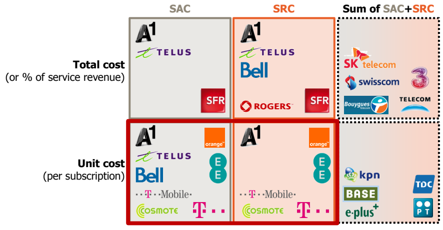


Figure 6. Total SRC vs. total SAC

[6] Bell does not report total SAC, just total SRC. But as they report unit SAC (COA, cost of acquisition) and churn, these have been used to calculate total SAC

[7] Note that prepaid SAC is included in total SAC which makes it different than the upcoming unit comparison. Prepaid total SAC in these markets is however marginal compared to contract total SAC.

Unit SRC vs. unit contract SAC – 83% and in decline



Let’s now compare unit SRC with unit contract SAC for the 16 operators reporting accordingly – highlighted to the right.

The logic in Figure 7 is the same as in Figure 6. Operators with unit SRC higher than unit contract SAC are above the 100% line.

For readability reasons, nine operators – which aren’t standing out – have been taken out of Figure 7. Three of them [T-Mobile PL, T-Mobile AT, Orange PL] are covered in the premium country-specific analyses. All 16 operators are included in the *Global average* line even if not shown in Figure 7.

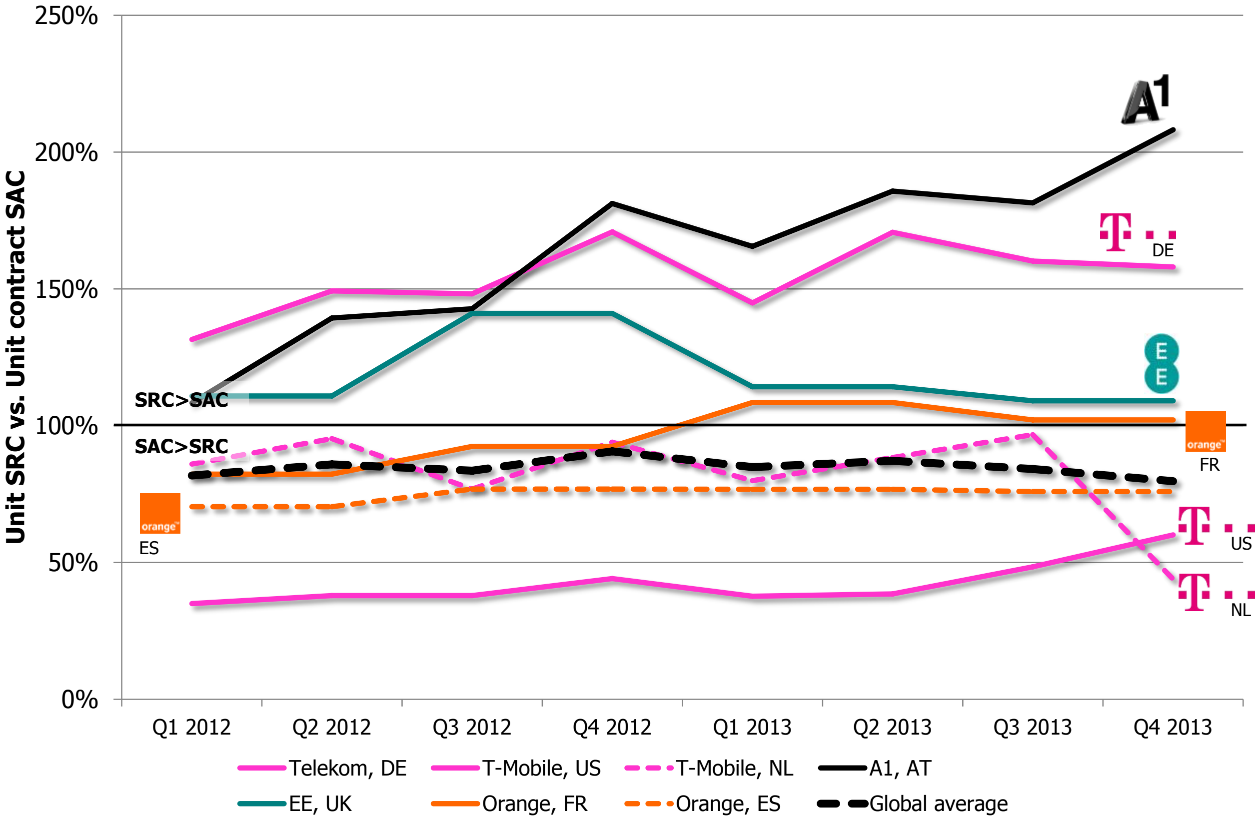


Figure 7. Unit SRC vs. unit contract SAC

A1 – who due to their almost complete reporting is the only operator who appears in both the total cost analysis and the unit cost analysis – stands out also here with a very high and increasing SRC in relation to contract SAC[8]. This suggests that A1 is focused on **defending** existing customer base. **Telekom** from Germany has a similar position and journey, though not quite as extreme.

[8] A1 doesn’t report contract SAC. In this analysis, A1’s reported blended SAC has been used instead. 31% of A1’s base is prepaid so the contract SAC might be underestimated with this assumption. If so, A1’s SRC to contract SAC ratio would consequently be overestimated.

Compare that to the curve of **T-Mobile USA** where the focus during 2012 and the beginning of 2013 clearly was on customer acquisition rather than retention. T-Mobile wanted to **grow** (but didn't). Through the transformative **un-carrier** strategy launched Q2 2013, T-Mobile has won a lot of new customers in spite of significantly lowered SAC. The relative increase in SRC (though in absolute terms flat) since then could be seen as an indication of the need to gradually start to defend a growing base.

It's worth highlighting **T-Mobile Netherlands** sudden drop in SRC Q4 2013. From spending about as much on SRC as contract SAC, SRC during fourth quarter all of a sudden was halved. Was this a general change in the Dutch market? The premium country-specific analyses investigate further.

In 2012, we criticised **EE**'s high SRC. During 2013, it's been reduced significantly and is today not much higher than EE's contract SAC. The premium country-specific analyses investigate if this has had an impact on churn and EBITDA margin.

Figure 8 shows the **average unit SRC and contract SAC** for the 16 operators in this section.

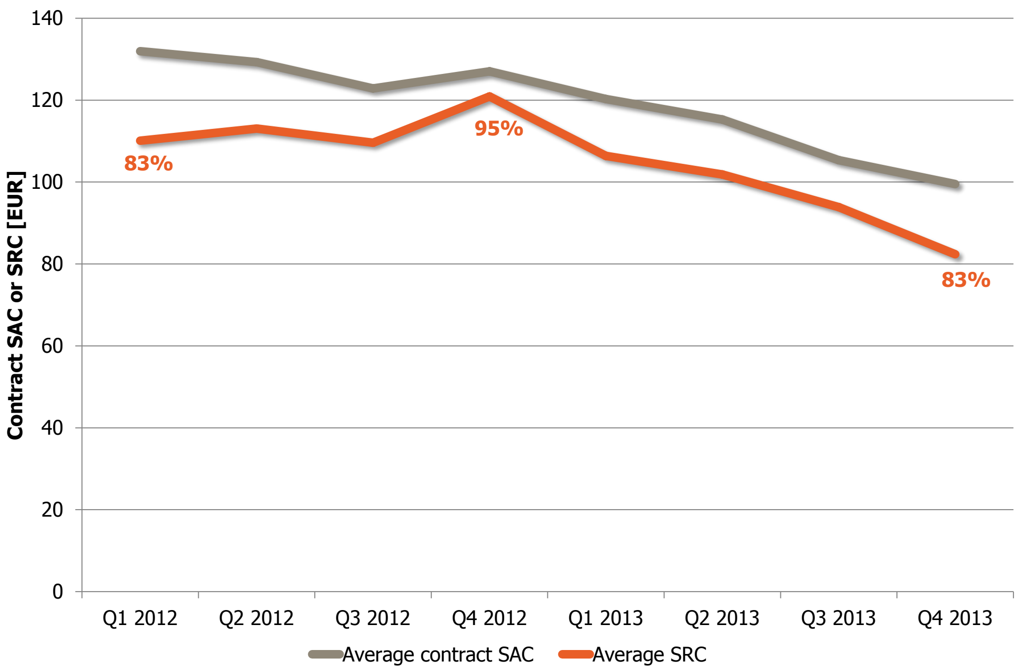


Figure 8. Development in average unit contract SAC and average unit SRC for 16 operators

The graph is both encouraging and surprising. Compared to previous years' analyses, the average SAC and SRC levels have decreased. This is of course very good – since we talk about the single largest cost item for a mature market mobile operator.

But the expectation was perhaps that the average **SRC** would indeed match the average **contract SAC**. For the 16 studied operators in this section, average SRC was **95%** of contract SAC during 4Q 2012 [about 120 EUR in absolute terms]. That percentage has however been decreasing since. SRC today only represents **83%**

of contract SAC [or about 80 EUR]. As seen in the two previous sections, the **SRC vs. SAC balance** is however very different between different operators.

Apart from tactical changes driven by the obvious cost pressure present at many operators, especially in South Europe, the **decrease in smartphone price level** has been a key driver behind the positive cost development during 2013 as shown in Figure 8.

But: The fact that the average operator uses **less on retention** – in absolute and relative terms – must have led to an increase in **contract churn**?

Nope. The contract churn has instead actually decreased since 2012 and – as an average – been stable at an annualised level of **14%** during the last three quarters – see Figure 9. Operators should be very happy with this development.

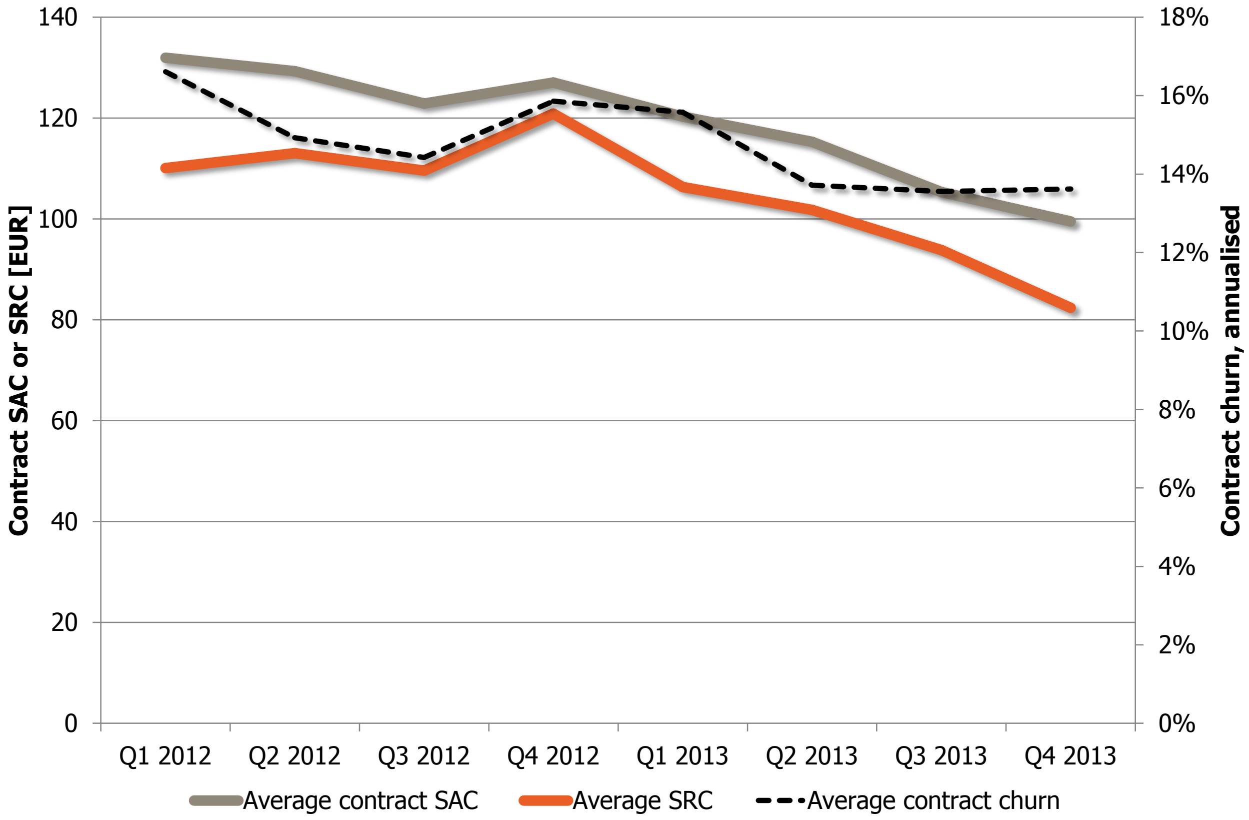


Figure 9. Development in average unit contract SAC and average unit SRC for 16 operators – compared with churn

The premium country-specific analyses investigate the relationship between SAC/SRC and churn for each country covered.

How to best balance unit SAC and SRC?

In order to defend margin, SAC & SRC needs to be controlled. But every operator is a victim of the market it is operating in. Without a uniquely different market proposition, it is difficult for one operator to single-handedly reduce unit SAC without losing market share – or to reduce unit SRC without increasing churn (thereby also losing market share).

But every operator can likely find their perfect balance between unit SAC and SRC: A balance that minimises total SAC & SRC spend. This balance is unique to every operator as the markets are different, the position within a market is different and the strategic targets are different. Moreover, it will change over time.

Figure 10 defines three operator archetypes: The acquisition driven operator, the balanced operator and the retention driven operator.

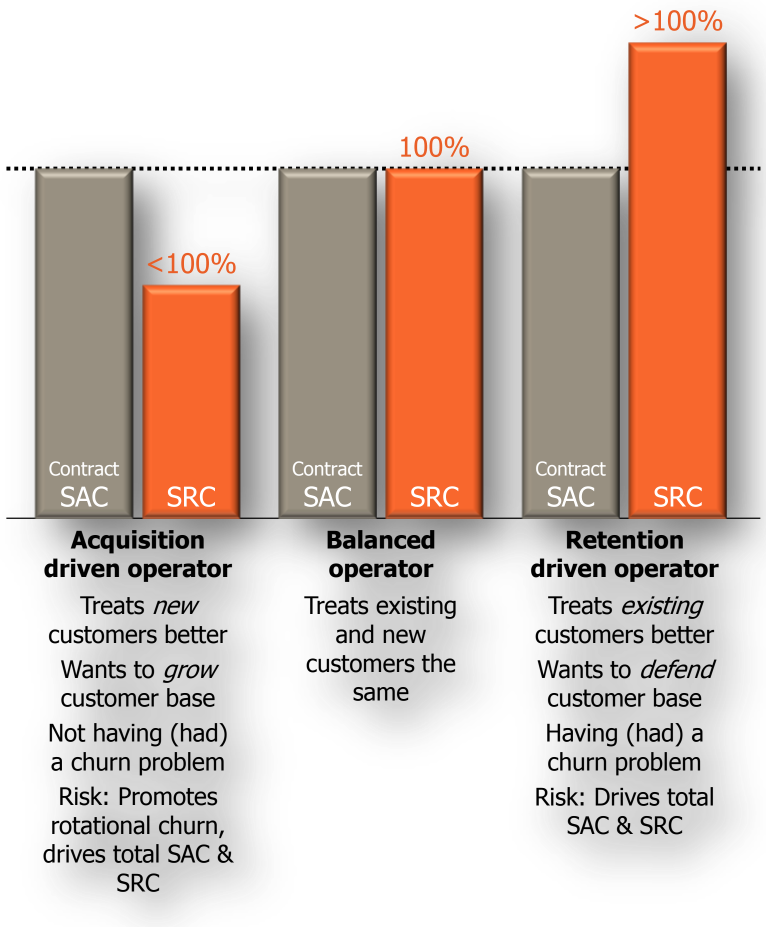


Figure 10. Operator archetypes when it comes to acquisition/retention balance

For the acquisition driven operator, unit contract SAC is higher than unit SRC. Typically, the priority of this operator is to grow and churn is not a prioritised problem. Most often, absolute SAC/SRC levels are low.

The retention driven operator has a unit SRC to unit contract SAC ratio higher than 100%. The primary priority of this operator is not to grow, but to defend existing customer base. Churn is – or has been – a problem and the operator has thus decided to treat existing customers better than new customers.

Is there then a perfect balance between unit SRC and unit contract SAC? As said, it depends on an operator's position and objectives, but in theory, **a value just above 100% should be optimal** since it doesn't incentivise customers to churn – and don't overspend on SRC.

The problem when incumbent operators, like **Telekom** or **A1** (see Figure 7), proportionally put so much more money into unit SRC is that competing challenger operators will have to put *even more* money into unit SAC in order to lure customers away from the incumbent. This then becomes a negative spiral where unit SAC & SRC continue to go up – and operator margins continue to go down.

Country-specific SAC & SRC analysis for eight countries

Country-specific analyses for France, Germany, Poland, Austria, the Netherlands, UK, Denmark and Canada are included in the **premium version** of this analysis.

The price per copy is **500 EUR** excluding VAT [outside of EU and in Sweden, Swedish VAT of 25% will be added].

In order to get a copy please send an email order to analysis@tefficient.com from your corporate email account containing the following details:

- Your company name
- The invoicing address of your company
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You will be emailed a pdf copy as soon as these details are correctly provided. The invoice should be paid within 30 days.

The premium analysis covers 38 pages in total.

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Conclusion

Reporting operators spend between **6% and 26% of service revenue** on subscriber acquisition and subscriber retention with an **average at about 16%**. Depending on market, position in the market and operator priority, operators are either acquisition driven or retention driven. Operators generally seem to become retention driven when unit SAC/SRC becomes high.

When it comes to the SRC and SAC balancing, unit SRC has averagely gone down from 95% of contract SAC 4Q 2012 to just **83%** of contract SAC 4Q 2013. Relatively speaking, operators are thereby – somewhat surprisingly – **more acquisition driven than retention driven** today than a year ago.

A few of the reporting operators have unit SRC to SAC ratios well above 100%. Even though ratios at around 100% can be recommended, it is worrying to see ratios climb above 150%. This might indicate that operators ran out of other churn control tools. It might also force smaller competitors to increase SAC even more.

On the positive side, both average **unit SRC and contract SAC have decreased significantly** in 2013. Even more positive is that the average contract **churn rate** has decreased – in spite of the absolute and relative reduction in unit SRC.

The country-specific premium analyses show that operators in certain markets have been able to reduce SAC/SRC significantly through changes to business scope or changes to business models. The launch of **no-frills subbrands** or the introduction of **quad-play** are good practices seen to reduce mobile SAC/SRC.