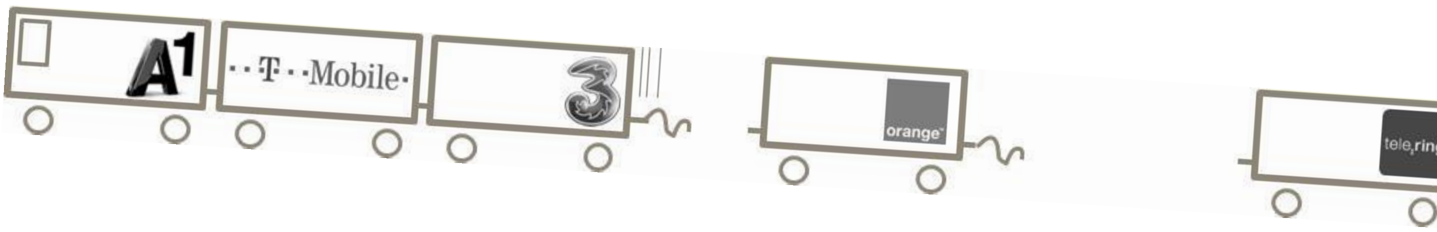
Public industry analysis #10 2013

Austria: The precedent for EU?

From four to three mobile operators

The quick fix of a broken market?



Austria, with a population of 8.5 million, used to have five mobile network operators, making it one of the most competitive mobile markets in Europe. Now there are three left.

When Hutchison-Whampoa, the owner of '3', made a bid on Orange, the European Union needed 11 months to approve it.

EU appears to have changed their thinking since. It's *roaming* that is under scrutiny now: If operators would agree to abolish roaming fees within EU, maybe EU could be more forgiving to national M&A?

Consequently, European operator executives are publicly advocating the need to cut the number of mobile operators to three per country. If Telefónica's bid for E-plus in Germany is approved by KPN's shareholders and by the EU, it will be the ultimate starting signal for Europe's march towards national consolidation: If it can be done in EU's largest country, why not elsewhere?

But since Austria serves as the the 4-to-3 precedent of Europe, let's check what the first six months with three mobile operators did to the business results.

Austrian market 2006-2012

Austria, with a population of 8.5 million, used to have five mobile network operators – A1 (Telekom Austria), T-Mobile, Orange (formerly One), '3' and tele.ring – making it one of the most competitive in Europe. The characteristics of the Austrian market continued also after T-Mobile's acquisition of tele.ring in 2006: **Low "me-too" bundle prices**, aggressive **handset subsidisation** and -sales focus, early **mobile data adoption** and high usage – but also, somewhat counter-intuitive, a **very high customer loyalty**. Operator margins continued to be on the low side and with shareholders being interested in leaving Austria, it was logical that the consolidation would continue: This time from four to three MNOs.

When Hutchison-Whampoa, the owner of '3', the smallest of the Austrian operators, in February 2012 made a bid on Orange[1] (number 3 on the market), the European Union needed 11 months to give its approval; much longer than what was the case for other mergers in EU previously – even though no incumbent was involved.

This gave A1 and T-Mobile plenty of time to prepare meeting the new up-scaled '3'.

In January, Orange was consolidated into '3'. All of Orange's business wasn't becoming part of '3', though. As part of the agreement, Hutchison-Whampoa sold Orange's low-cost brand *yesss!* to A1.

Expectation 2013-: Better business for the remaining operators

With yet a competitor out of the market, the industry might expect:

- Slower revenue erosion
- Improved EBITDA
- Improved churn
- Reduced subscriber acquisition cost (SAC) and subscriber retention cost (SRC)

Let's use the actual business results of the Austrian operators to test these four expectations against reality.

[1] Only minority held by Orange at this time – buyout investor Mid Europa Partners had 65% ownership

Slower revenue erosion?

Before looking at the revenues, we need to understand the market shares in Austria. Figure 1 shows the development per quarter during 2012 and 2013.

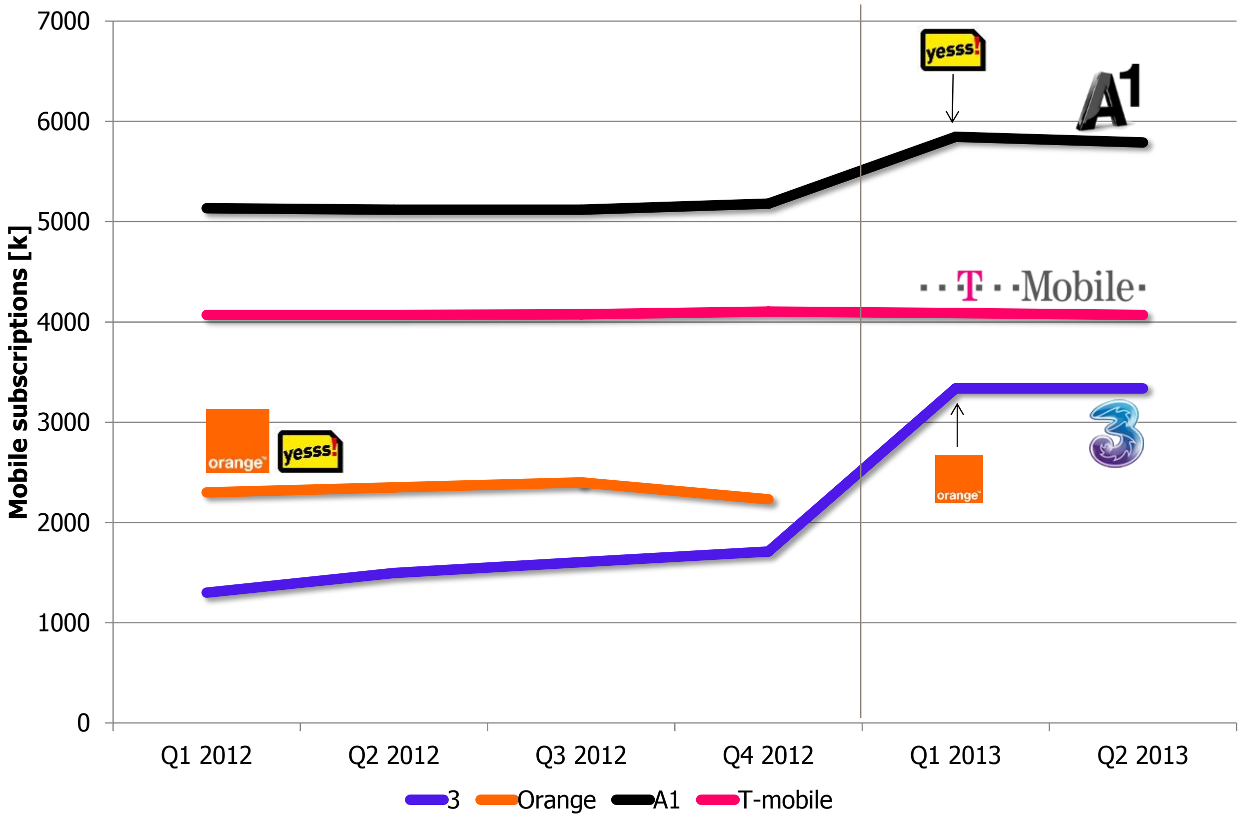


Figure 1. Development of mobile subscription bases

After the inclusion of the yesss! subscriber base in January, A1's market leadership improved further, reaching almost 6 million subscriptions[2]. T-Mobile has about 4 million subscriptions – a steady number since 2011. Orange did only occasionally report business results, but their subscription base was indicated by Orange group to be above 2.2 million by the end of 2012.

'3' reports only every 6 months, so the Q1 and Q2 subscription bases are shown as identical. In January, the subscription base effectively doubled when Orange (excl. yesss!) customers were included.

Figure 2 compares the revenue development of the Austrian mobile operators. 3's half-year results are evenly distributed into two quarters.

[2] A1 applied a stricter criterion on the subscription base in Q2 2013, but historical numbers have been adjusted

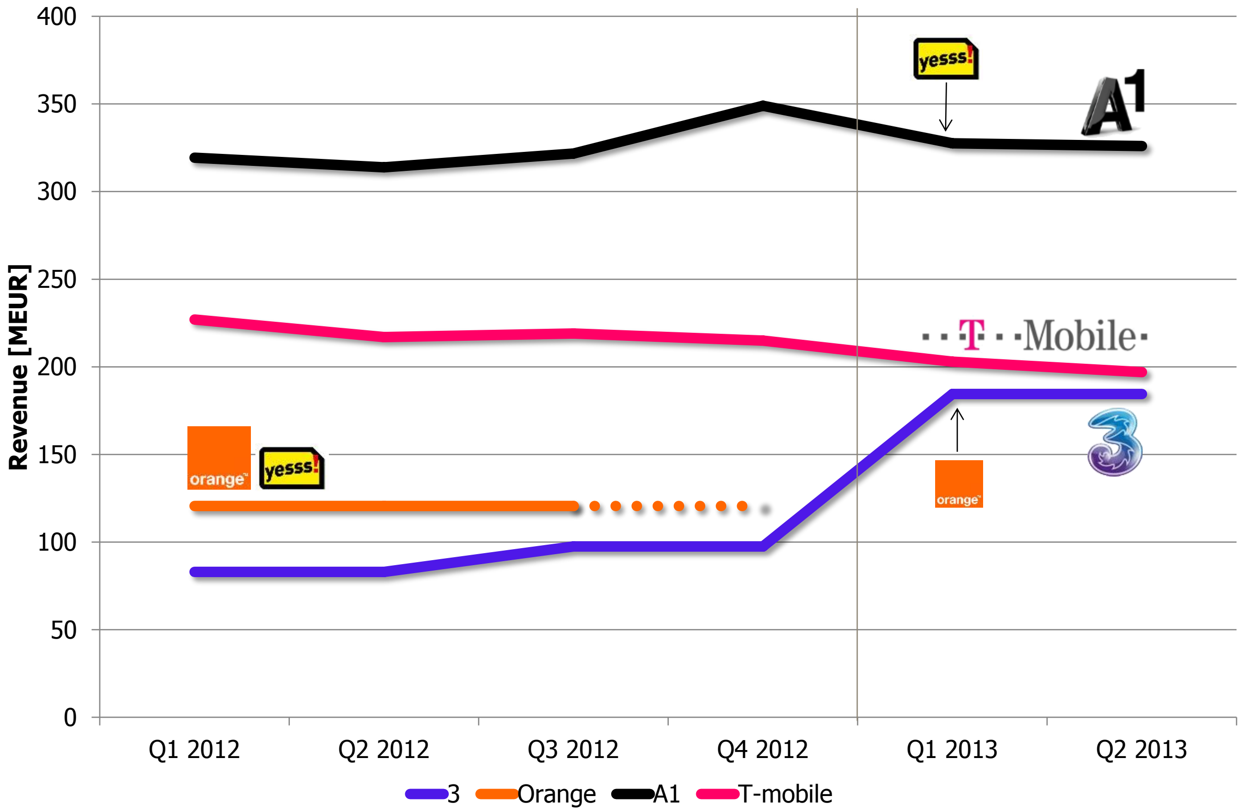


Figure 2. Development of total mobile revenues

The revenue erosion of T-Mobile has continued in 2013 after 3's acquisition of Orange. A1 seems to have fared a bit better[3], but we need to consider the strategic shift A1 did in Q2 2012, concentrating mainly on high value customers. This has led to that a more significant part of A1's revenues is equipment-driven now.

Take a look at Figure 3 that also shows the service revenue for A1, T-Mobile and '3' in addition to the total mobile revenue.

[3] Since A1 doesn't report mobile-only revenue, an assumption has been made that A1's mobile revenue equals what A1 calls "ARPU relevant revenues" and the total equipment revenue including A1's fixed business (mobile-only equipment sales not reported). The error is believed to be small since handsets should – like with other integrated operators – dominate A1's equipment sales.

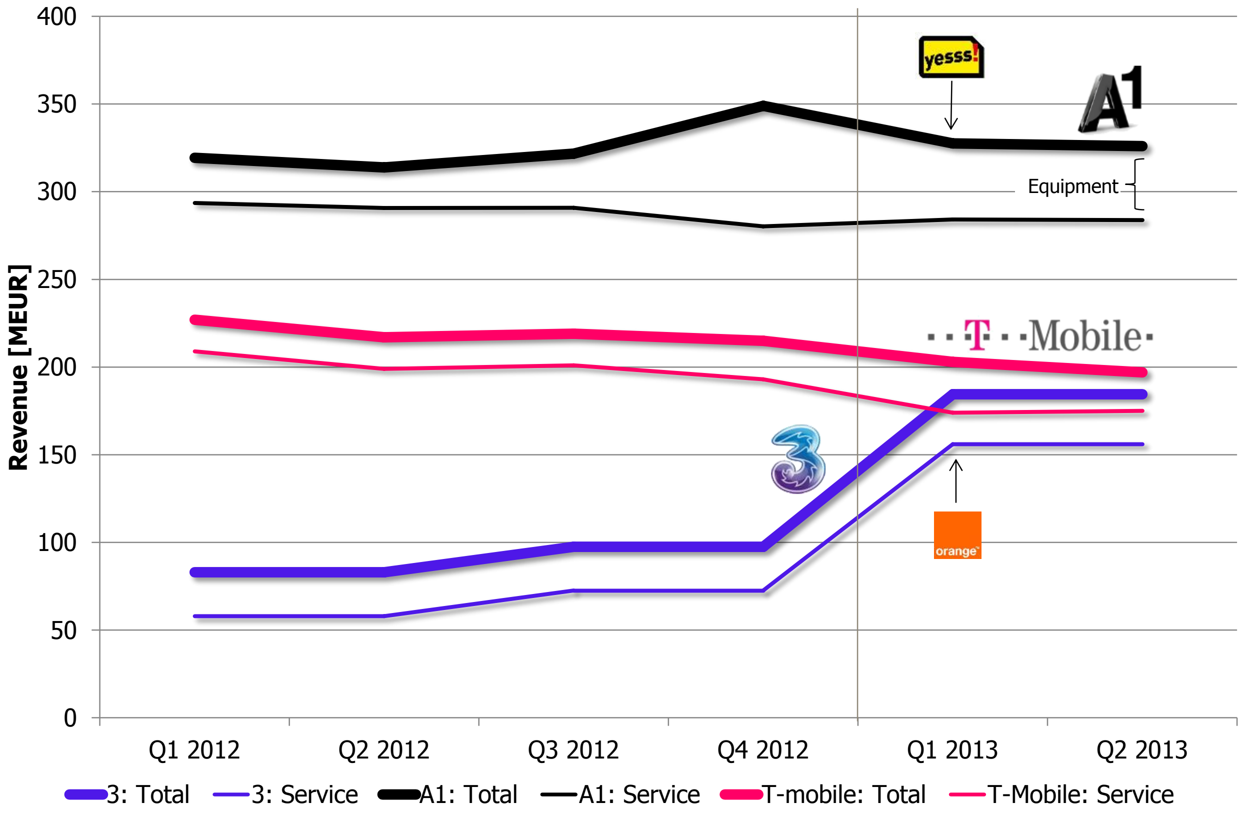


Figure 3. Development of total mobile and mobile service revenues for A1, T-Mobile and '3'

The equipment portion of A1's sales has increased significantly during the period. If looking only at A1's mobile service revenues, it's clear that revenue erosion continues also for A1 – have in mind that yesss! revenues have been added in Q1.

Has revenue erosion slowed down in 2013? No.

Improved EBITDA?

The old rule of thumb in the industry used to be that EBITDA margin equalled market share. With one player out of the market, the average market share increase – so the average EBITDA margin increases, right?

	Full year 2012		1H 2013	
Operator	**Market share**	**EBITDA margin**	**Market share**	**EBITDA margin**
A1	39%	25,1%[4]	44%	26,8%[4]
T-Mobile	31%	26,7%	31%	23,8%
Orange	17%	34,4%[5]	-	-
'3'	13%	13,9%	25%	24,4%
Weighted		***25,7%***		***25,3%***

Table 1. Comparison of market share (subscriptions) and reported EBITDA margin

Table 1 shows that '3' improved EBITDA significantly after having added the higher-margin Orange business. Also A1 improved slightly after adding yesss!

But the average EBITDA margin in Austria – weighted against the market shares – remained at the same, low, 25% level as before.

Figure 4 shows the EBITDA development in a graph.

[4] A1 doesn't report mobile-only EBITDA. The figures are instead for the integrated A1, including fixed. Since the fixed broadband market is quite competitive in Austria, there's little reason to believe that the fixed margin should be higher than the mobile margin.
[5] For 9 month period January-September 2012, not reported for the full year 2012

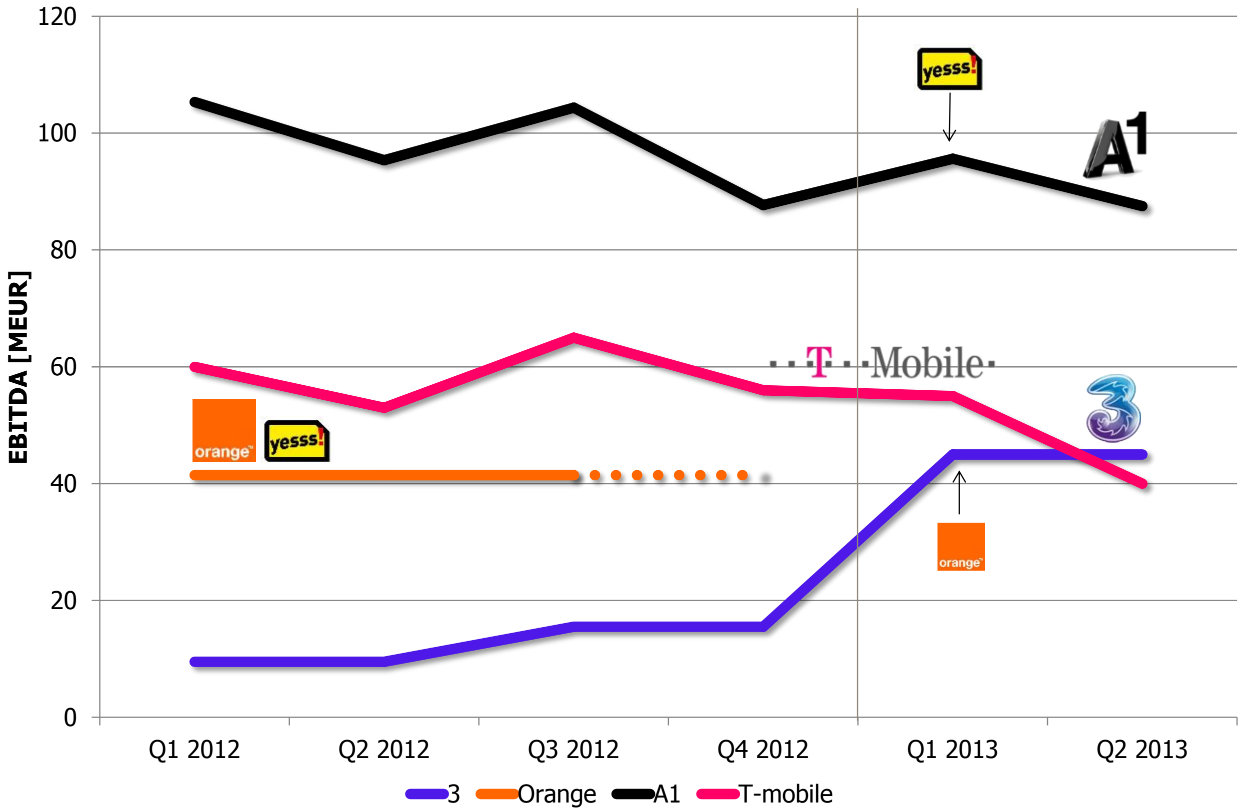


Figure 4. Development of mobile EBITDA[6]

Has EBITDA improved in 2013? No.

[6] A1 doesn't report mobile-only EBITDA. Figure 3 applies A1's reported integrated EBITDA margin (including fixed) to the mobile revenues in Figure 2.

Improved churn?

As said already, churn levels are traditionally very low in Austria – even if the number of operators has been high. Figure 5 shows the churn development in 2012 and 2013.

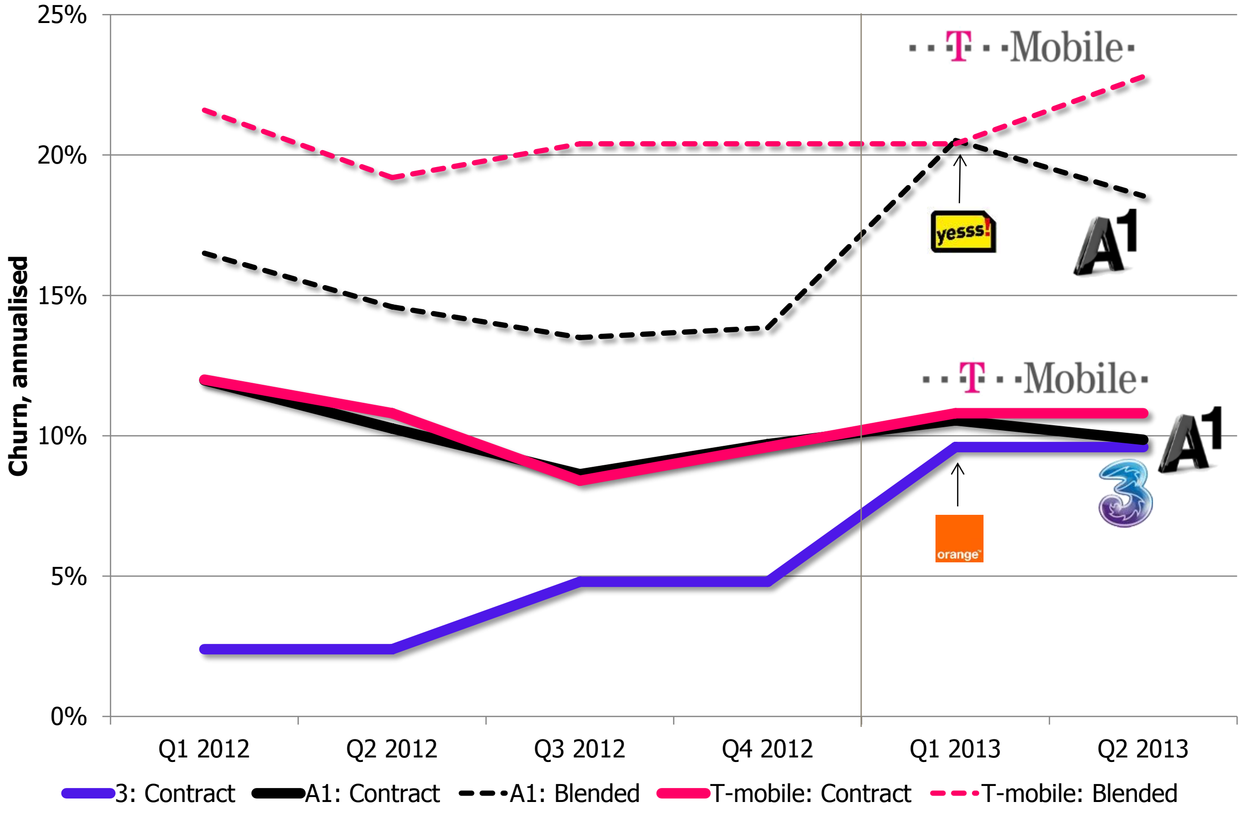


Figure 5. Development of mobile churn[7]

All three remaining operators are in 2013 having the same low contract churn of about 10% on annual basis. In contrast to other markets where '3' operates, '3' had the lowest contract churn in Austria. The addition of the Orange customers has significantly increased the churn rate for '3'.

A1's blended churn increased when yesss! was added, but is still lower than for T-Mobile.

Has churn improved in 2013? No.

[7] Orange didn't report churn. '3' doesn't report blended churn.

Reduced subscriber acquisition cost (SAC) and subscriber retention cost (SRC)?

Figure 6 compares the blended SAC and SRC as reported by A1 and T-Mobile[8].

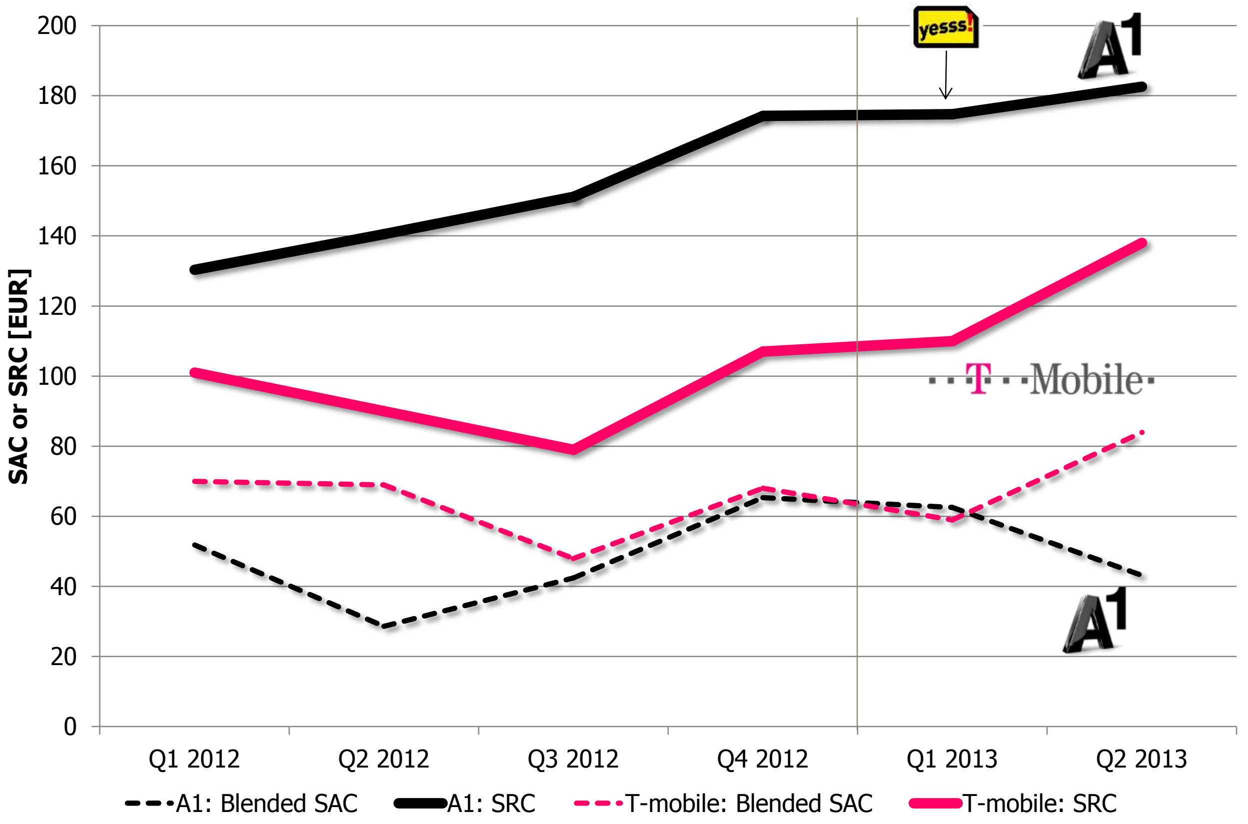


Figure 6. Development of SAC and SRC for A1 and T-Mobile

A1's subscriber retention cost (top line in Figure 6) has been increased throughout 2012 and 2013. According to Telekom Austria, this is because of A1's strategy shift to focus on high value customers. The absolute SRC level (183 EUR in Q2 2013), is very high also internationally[9]. What A1 appears to do less of in 2013 is acquisition: Blended SAC is on its way down since Q4 2012.

T-Mobile follows A1's SRC increase in 2013. Contrary to A1, T-Mobile increases blended SAC in Q2 2013.

In spite of the significant increase in SRC, neither A1 nor T-Mobile sees any reduction in contract churn rates (as seen in Figure 5). This means that also the relative the cost to defend the subscription base has increased in 2013 even though one competitor is out of the market.

Have SAC and SRC reduced in 2013? No.

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[8] '3' doesn't report SAC or SRC. Orange didn't report it.

[9] Compare A1's position: www.tefficient.com/.cm4all/iproc.php/tefficient%20public%20efficiency%20analysis%202%202013%20SAC%20SRC.pdf?cdp=a

Conclusion

Based on the 1H 2013 results of the Austrian operators, there is really nothing speaking for national consolidation as a quick fix to profitability issues in a market: Revenue decline continues, EBITDA doesn't improve, churn doesn't improve and SAC/SRC increases.

Is it too early to conclude? Maybe. But more likely the explanation is that it was the hungriest operator – '3' – that became bigger, becoming a more serious threat to market leaders A1 and T-Mobile. A threat that A1 and T-Mobile anticipated and took very seriously, indicated by their massive investments into customer retention.

With EU opening up to the idea of national operator consolidation, it's tempting for operator executives to not initiate necessary efficiency improvements but hope for a "quick M&A fix". The experience from Austria is, so far, that national consolidation doesn't fix a broken market, though.

Will the E-plus-O2 combination make it?