

# Telefónica: becoming a tech company while preserving physical assets

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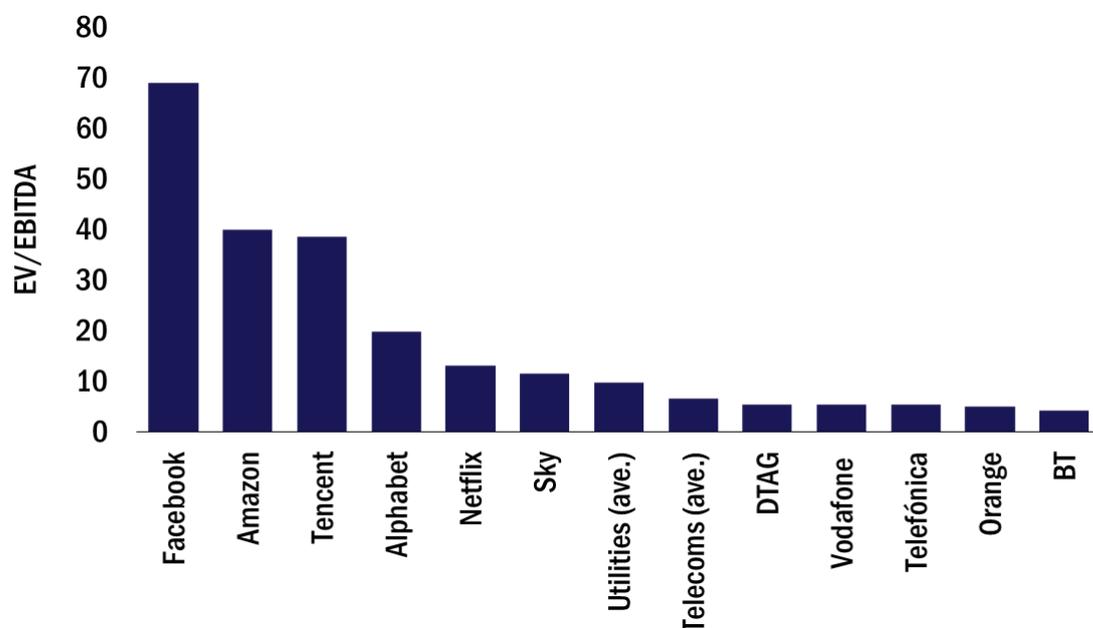
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The message from Telefónica’s 2018 Industry Analyst Day was clear: Telefónica wants to be seen as, and, more importantly, valued as, a tech company. This message came directly from José María Álvarez-Pallete, the Chairman of the Board, who was present at the event. Chairmen do not often attend industry analyst events, so his presence was an indication that, so far, Telefónica has not convinced investors that it can be both an asset-heavy operator and valued as a tech business.

## Telecoms stock is hugely out of favour

Operators, and in particular European operators, have extremely low EV/EBITDA multiples compared with other verticals, even compared with utilities. In one respect, this reflects the high margins that operators enjoy, but more critically, it reflects the lack of routes to any kind of sustained growth. Currently, Telefónica is performing at a similar level to its peers Deutsche Telekom, Orange and Vodafone: no better, but no worse.

Figure 1: EV/EBITDA multiples, last financial year end



Source: Analysys Mason and Damodaran, 2018

Investors value tech companies' ability to sustain growth in an era of flat spending. Telefónica wants the broader investment community, not just industry analysts, to believe in growth. As Álvarez-Pallete put it, "it is not easy in the current climate to believe in growth", but he does.

Markets, however, see no obvious catalyst for growth among operators, whether that catalyst is 5G, broader digital services, or even M&A. In Europe, the problem is more profound than regulation alone. Investors see free cashflow remaining constrained for many operators as pressure for more fibre increases; disruptive infrastructure-focused 'under-the-floor' players are as much of a nuisance as their 'over-the-top' counterparts. Investors view 'digital' efficiency gains as being often replicable and likely to be competed away, and contrast digital transformation, which is poorly understood, with the kind of 'brutal' transformation that they are more familiar with. They remain sceptical – and here they have the weight of historical evidence behind them – about the ability of operators to monetise adjacencies.

## Telefónica plans to transform into a tech business, but also defend the vertically integrated operator model

Telefónica is not the only operator to publicly redefine itself as a tech company, nor are operators the only kind of businesses that do so. (There is such a collective mania for such a transformation in all industries that surely history will not be kind to digital evangelists that redefine elevator companies as 'tech businesses that happen to sell elevators'.) One of the most vocal operators to redefine itself is Telstra, which announced on 22 June that it would downsize to a "smaller knowledge-based workforce" (that is, reduce the headcount by 25%) and that it would spin off an InfraCo, possibly into some REIT vehicle. Some might argue that this is 'brutal' transformation dressed up as digital transformation, but it is indicative of the kind of strategic thinking recently seen from Copenhagen to Rome to Melbourne: spin off physical assets, transform the workforce and reinvent as an asset-light tech business.

Telefónica is different. At no point during the analyst event was there a suggestion that Telefónica might transform itself into an asset-light business. Getting physical assets right is critically important. This was emphasised time and again. 'Traditional' capex (FTTH, RAN and so on) is still a huge chunk of investment, and the services over connectivity line of the Telefónica group P&L is only 13% of the total revenue.

Telefónica's first 'platform', network assets, stands it in very good stead. Telefónica is already far ahead of its peers in two key areas.

- Dense fibre deployment: it will face fewer cashflow pressures than late-movers such as BT and Deutsche Telekom, and the way is clearer for investment in other platforms.
- Virtualisation: the UNICA platform makes Telefónica a clear leader in Europe in this respect, and it should keep capex at steady, if not declining, levels.

5G was conspicuous by its absence in most of the presentations, and Telefónica continued the cautious tone set at Mobile World Congress 2018: 5G-readiness is more important than 5G now. It is as if Telefónica buys into the full-blown 5G Phase 2, post-Release 16, fully-virtualised, fibre-fuelled, sliceable B2B2X story, except that it does not appear entirely convinced that New Radio (NR) itself is a necessary feature. It looks as if Telefónica will do as much 5G NR as is required to remain competitive, but no more.

Whether heavy or light on 5G NR, Telefónica believes that the new network architecture will deliver growth that will be transformative, not just in the technological sense, but also in the financial sense. Digital transformation means more than efficiency; it means being able to tap into new sources of value, principally

enterprise-based, in a rapidly digitalising world beyond telecoms. The uncertainty is not whether there is value in digital services, but what share of that value operators will get.

At several key points during the event, Telefónica insisted that its key assets were hard-to-replicate or even unique. This could include anything from dense fibre and distributed Cloud infrastructure through to content, patents and intellectual property rights. It also pointed out that the scale of its subscriber base (larger than the number of unique users of Twitter) is a key asset that gives it a fighting chance against hyperscale competitors.

At Platforms 3 and 4 of Telefónica's four-platform model (that is, products and services, and cognitive intelligence), competition from other kinds of business gets stronger and it is more difficult to differentiate from hyperscale competitors. Hence Telefónica frequently stressed that both software and hardware was being developed in-house. This is important, because Telefónica does not want to become a vehicle for vendor solutions. Furthermore, most operators that are transforming themselves into digital ServiceCos and parking their network assets would struggle to thrive as independent entities, at least without the kind of pro-competition regulatory framework that most of today's leading operators have spent the last 20 years fighting against: a plea made forcefully by Álvarez-Pallete.

Telefónica's strategy is to transform into a technology company. While some investors and even operators see running a NetCo business as incompatible with running a digital ServiceCo business, Telefónica is undertaking a root-and-branch technology-led transformation of the vertically integrated operator business model. It points out the value of owning assets but also of providing digital interfaces to them.

The transformation is a long, arduous process. Telefónica is further ahead than most in laying the necessary (often non-digital) foundations, and this should progressively ease cashflow in each of its main markets, just as it has in Spain. While group financial metrics are generally moving in the right direction (excluding forex effects), there is still a very long way to go before transformation delivers the growth catalyst that Telefónica wants.