The Vodafone–Three merger will help to address some of the weaknesses of the mobile-only model

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Vodafone and Three UK's owner CK Hutchison announced on 14 June 2023 that they had reached an agreement to combine their businesses in the UK. The merger will result in the creation of the UK's largest mobile network operator with 28 million mobile connections, 32.1% of the UK's total.

If approved, Vodafone will control a 51% stake in the merged company, Hutchison the remaining 49%. Vodafone will have the right to buy Hutchison's share 3 years after the completion of the transaction, as long as the enterprise value of the company has increased to GBP16.5 billion. The merger, which is expected to conclude before the end of 2024, will not require a cash exchange because the ownership distribution will be achieved by adjusting the debt ownership.

The merger will bring cost and capex benefits for Vodafone and Three in the mobile segment, but its benefits in terms of the fixed and fixed–mobile convergence (FMC) markets will be limited. The new entity will still lack the base of fixed customers to compete against the converged operators BT/EE and Virgin Media O2.

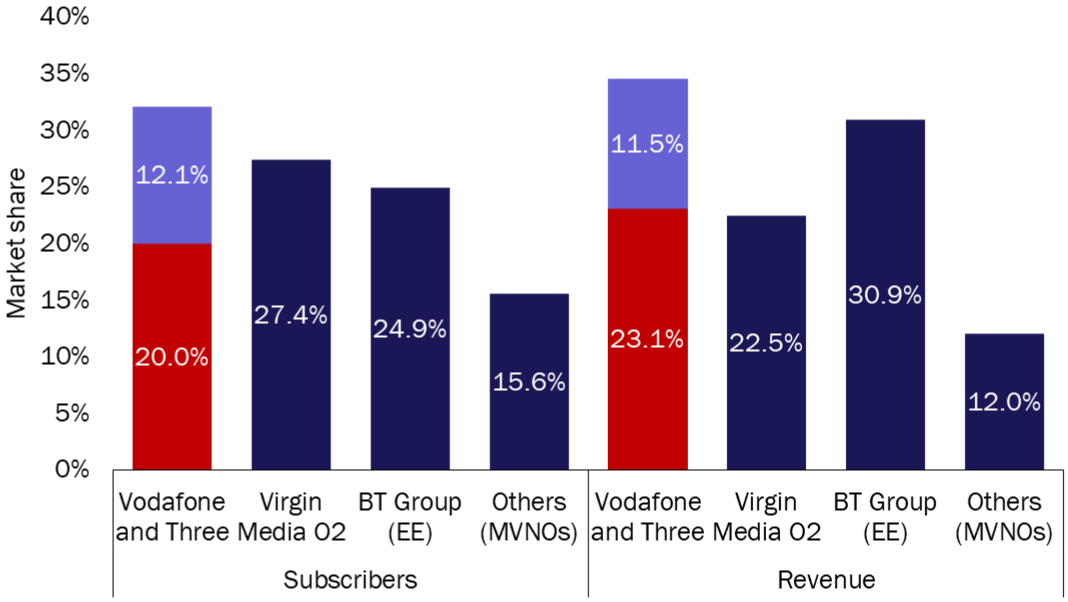
The combined entity will be the largest mobile operator, but will only be the fifth-largest fixed player

In their announcement, Vodafone and Three estimate that annual cost and capex synergies could go over GBP700 million by the fifth full year post-completion. These cost reductions are the main driver behind the merger. No mention has been made of the number of job cuts that will be made as part of the deal, but presumably reductions will be a major source of savings. Vodafone employs around 10 000 people in the UK, Three around 5000.

The combined entity will become the largest mobile operator in the UK, in terms of revenue and subscribers (Figure 1). Vodafone is currently the second-largest operator by revenue and third-largest by subscribers. Three is the fourth operator by both measures.

The combined entity will also have some clear benefits in terms of spectrum holdings (depending what, if anything, they have to divest as a condition of approval). Three has potentially valuable but underused midband 5G spectrum while Vodafone has far better holdings in the sub-GHz bands.

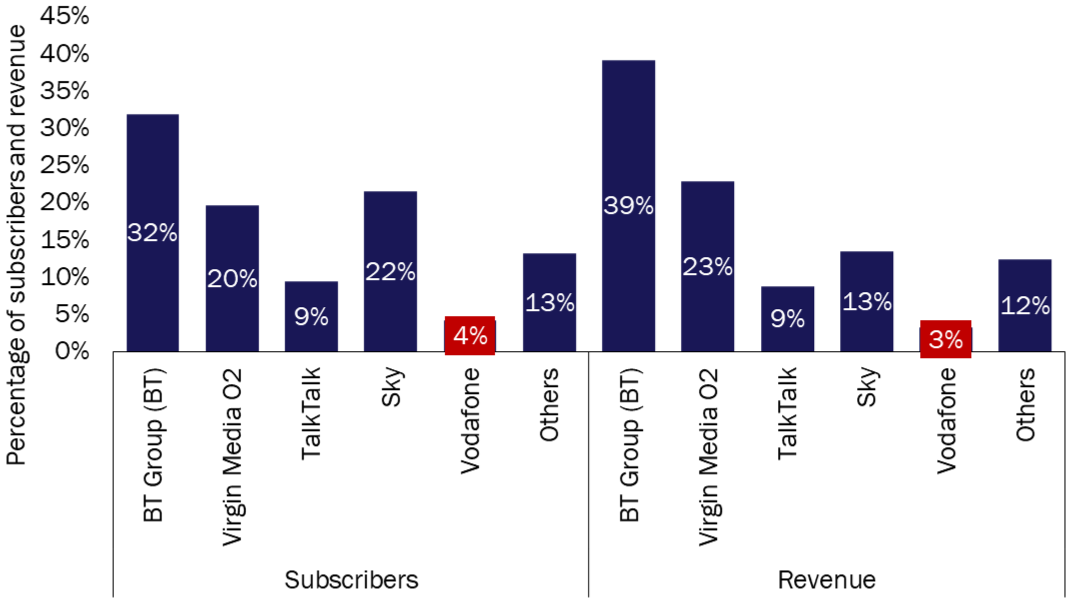
Figure 1: Mobile market share of revenue and subscribers, by operator, UK, 1Q 2023



Source: Analysys Mason

The merger will not help the operators' position in the fixed market though. Vodafone is the fifth-largest operator (by subscribers and revenue), while Three has almost no fixed customers (Figure 2).

Figure 2: Fixed broadband market share of revenue and subscribers, by operator, UK, 1Q 2023



Source: Analysys Mason

The logic of the deal is clear, but it will face several complications.

- **Regulatory approval.** The UK's Competition and Markets Authority (CMA) stopped a previous attempt by Three to combine with another mobile operator, when its proposed 2016 deal with O2 UK was blocked.

Vodafone–Three will need to argue how the market is different from 7 years ago and why the merger will not have a negative impact on the level of competition in the market. Vodafone and Three are arguing that a combined entity will be better positioned to invest in a 5G standalone (SA) network. They have committed to invest GBP11 billion over the next 10 years to roll out a nationwide 5G SA network, targeting population coverage of over 95% by 2030 and 99% by 2034.

- **Restructuring the mobile networks**. Vodafone has an active and passive network-sharing deal with O2, and Three has a passive infrastructure joint venture with EE. Both have been extricating themselves from aspects of those deals, but the proposed merger raises questions about the networks in the near term (for example, will Vodafone/Three continue to use O2's network in half of the UK?). The existing network deals would take several years to untangle even without a merger. This deal just adds to the complexity.

- **Competing against integrated operators**. Vodafone can provide fixed services through its own and wholesale networks (notably thanks to agreements with CityFibre and Openreach), but it lacks the base of fixed customers. The deal will give the combined entity more mobile customers to (potentially) cross sell fixed services, but this strategy has had only limited success for Vodafone so far. Both BT/EE and Virgin Media O2 have far larger fixed broadband bases (9.2 million for BT, 5.7 million for VMO2, compared to just 1.2 million for Vodafone). The integrated operators also have greater scale overall. BT's UK annual revenue is around GBP20 billion, Virgin Media O2's revenue is around GBP10 billion, compared to GBP8.4 billion for Vodafone and Three combined.

- **Market positioning.** Three is a market challenger that specialises in low-cost consumer deals while Vodafone has traditionally gone after a more premium/business audience. As long as the two brands are maintained, the positions are complementary but will need careful management and positioning to avoid internal competition. The situation is simpler in the business market, where Vodafone has a far larger share; despite repeated efforts, Three trails the other mobile operators in this market.

- **The success of fixed-wireless access (FWA).** Vodafone and Three are highlighting the potential for the new business to address the fixed market with a 5G fixed-wireless access offer, as T-Mobile USA and Verizon are doing in the USA. However, the opportunity in the UK may be far more limited. Broadband prices are already far lower in the UK than in the USA, and competition is greater. FWA is weaker than fibre on almost every measure (speed, capacity, cost, energy use) and 89% of premises will have access to at least one fixed alternative that offers 1Gbit/s by 2028. FWA will remain a niche product in the UK as in most countries.

Negotiations between Three and Vodafone began in May 2022. It has taken over a year to get to this point and it may well be more than a year before the deal gets the necessary approval. Even if the deal is approved, the combined entity will have several barriers to overcome if it is to compete effectively with the two larger, integrated operators.

For more information on the UK market, see Analysys Mason's *UK telecoms market report 2023*, *Fixed–mobile convergence in the UK: trends and forecasts 2023–2028* and *Operator business services: UK forecast 2023*.