Strategic plans announced by Telefónica, Orange and Turkcell point to changing asset bases in 2020

December 2019

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In November and December 2019, Telefónica, Orange and Turkcell announced long-term plans and structural changes. None is revolutionary, but they nonetheless point to a trend that we have already identified in the telecoms space: a trend towards more M&A based on classes of assets.[1] This comment looks at how the plans announced by Telefónica, Orange and Turkcell relate to this trend.

Operators are adopting a more-discriminating approach to their assets

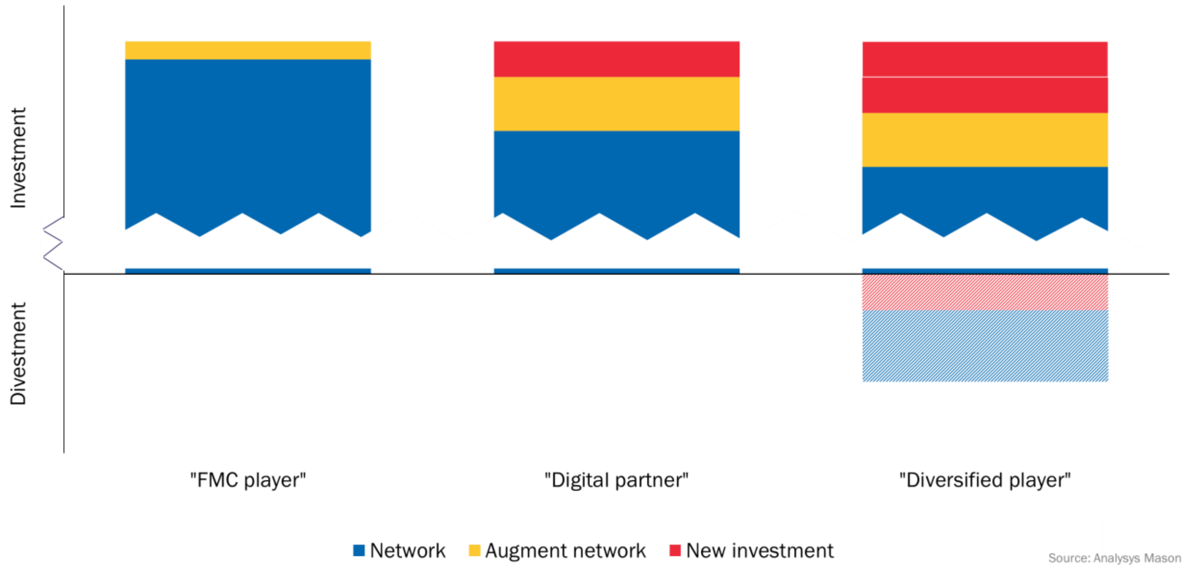
Most operators face stagnating revenue, low return on capital employed (ROCE) and share prices that their management believe undervalue their assets. In our recently published report *Operator investment patterns and business ambitions: four approaches for responding to revenue stagnation* we argued that operators will adopt a more-discriminating approach to their assets, focusing on:

- what they need to own (and how they can adapt their business models to suit the nature of the assets that they choose to own)
- what they should share
- what might deliver more value sold and leased back
- which assets they could acquire to create a better balance of safe cash-flow and riskier, higher revenue-growth.

This report argued that some operators will consider looser models than the familiar model grounded in physical network assets: not necessarily an asset-lite, cloudified model (hyperscalers without the scale), but certainly one that shifts the centre of the business and is open to more-dynamic M&A across all asset classes.

[1] For more information, please see Analysys Mason's *Operator investment patterns and business ambitions: four approaches for responding to revenue stagnation*.

Figure 1: Diversifying a telecoms operator's asset base



Source: Analysys Mason

Infrastructure may be worth more when released from the vertically integrated model

The first – and least surprising – step is to get out of challenging territories. Telefónica is already getting out of Central America, and now looks prepared to divest all of its businesses in South America other than that in Brazil, which will leave the company with OpCos in just four markets: Brazil, Germany, Spain and the UK. This is a change of strategy from only a few years ago when Germany and the UK were considered non-strategic. Orange MEA also looks like it will be set up for an initial public offer (IPO) or 'other opportunities'.

However, other business units will be formed as a result of vertical/structural separation of classes of asset. Both Orange and Telefónica are setting up subsidiaries that enable different classes of asset to be monetised independently – with co-investors or potentially even separately through divestment.

The creation of virtual subsidiary businesses has the following functions:

- to release value by decoupling management and making true 'standalones' in order to maximise utilisation of assets and to accelerate revenue growth
- to create more-flexible businesses that can give more prominence to potentially high-value assets to investors
- to create accounting transparency ahead of a possible sale or IPO.

Telefónica has created two virtual subsidiaries: Telefónica Infra and Telefónica Tech (this unit is discussed in more detail below). Telefónica Infra will incorporate Telxius, the tower and submarine cable business in which Telefónica has a 50.01% stake. Its assets will also include distributed antenna systems, data centres (including Edge) and greenfield FTTP projects (we assume mainly in Brazil).

Orange will create towercos for its 40 000+ sites in Europe, possibly consolidating them. It has created Orange Concessions for future FTTP co-investment in rural France. It is also looking to create 'FiberCos' in its other two large European markets, Spain (where it already has about 53% own-build FTTP coverage), and Poland (where it is targeting 30% coverage by 2021). It is unclear how much equity Orange would retain in future European FibreCos. These developments expand infrastructure spin-offs beyond the familiar case of towers.

There are several rationales for infrastructure partial divestments.

- Infrastructure is currently well-valued (possibly overvalued) so it is best to realise the value of the equity now while multiples remain high. Telecoms infrastructure businesses have, on average, EV/EBITDA multiples significantly larger than vertically integrated operators and there appears to be no shortage of potential investors.

- A dilution of incumbent-operator equity makes the network infrastructure more attractive for wholesale customers that compete against the incumbent downstream retail arm.

- Fibre infrastructure is necessary but expensive (and Europe does not have enough), and an operator cannot maintain OpFCF/dividend if it simultaneously builds lots of FTTP and buys 5G spectrum. Many operators, not least Telefónica, have significant debt already. It is better to own a 50.1% stake than have no FTTP.

None of this amounts to anything as radical as fixed structural separation. The co-investment opportunities are there mostly for greenfield projects. Orange says it will "optimise, develop and derive greater value from its infrastructure, whilst still retaining control". Most deals of this kind will be to sell non-operationally controlling stakes.

Turkcell also indicated various financial options in infrastructure areas. The options for its fixed unit Superonline include an IPO, a strategic pre-IPO co-investor, small local fibre acquisitions, more infrastructure sharing (it has a bilateral network-sharing agreement with cableco Turksat) and an asset-lite, sell-and-leaseback approach. Similarly, its Global Tower unit could get an IPO or it could go down the asset-lite route. For its data centres, the preferred option is to adopt the asset-lite model.

Tech units: nice to grow, nicer to sell?

For its Tech unit, Telefónica said that it would pull together B2B tech units with high-growth potential, initially cybersecurity, IoT/BigData and Cloud. Telefónica has an ambitious 30% top-line CAGR target.[2]

Telefónica said that the unit would be open to new acquisitions, although Telefónica's debt means that these will not be large. By the same logic, it is open to various forms of co-investment partnerships and divestment. Like infrastructure carve-outs, valuation multiples for some tech assets may be high, and therefore the value of the assets are best realised as a sale.

Turkcell's consumer digital services have performed extremely successfully and the company is now scaling up into an extraordinarily global range of markets where it has no telecoms presence. Its strategy is very much a standalone one for the unit, and it expects revenue to grow at a CAGR of 36%. Turkcell also made it clear that it is looking for co-investors in its techfin business unit Pay Cell.

Tech units could go the same way as infrastructure units. We may see many telco-spawned 'tech' businesses, with nuggets of valuable intellectual property but often largely resale, all competing in areas that are not

[2] For more information, see Analysys Masons' *Telefónica's aims for its new IoT, cloud and security unit look challenging*.

obviously tied to physical networks in a way that their parent companies businesses are. Overlapping towers are considered to be non-strategic. The same logic could be applied to overlapping cybersecurity and AI businesses.

European operators may be too late to make much impact

In outlining a set of possible IPO/M&A activities, Turkcell pointed to what it described as a global telecoms problem: the need for heavy investment coupled with slow revenue growth. This problem is not the same across the globe. European operators predict falls in capital intensity in the future as infrastructure demands start to wane. Operators in developed Asia–Pacific have already benefitted from a fall in capital intensity (a handful such as KT Corp have less than 10% capex/revenue), and it is they, not their European counterparts, that have the superior cashflow to develop major organic and inorganic digital/tech investment strategies.