Splitting off IT divisions may not always bring operators the hoped-for benefits

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Several operators, such as Telefónica, SK Telecom and stc, have split off their IT divisions from their telecoms businesses over the past few years. Improving the valuation of the business and positioning the IT division to grow revenue from business customers more rapidly (often with a view to selling off a minority stake) are usually stated as the primary aims of this strategy. However, an assessment of the performance of these new IT divisions reveals that, in practice, it is far from clear that these aims are being met.

This is one of two articles looking at operators spinning out their IT divisions. In this article, we consider the impact of doing so on business valuation. In our other article, we consider operational impacts.

Several operators have separated out their IT divisions, and some have already sold minority stakes

Examples of operators that have split off their IT divisions include the following.

- Telefónica created Telefónica Tech at the end of 2019. This division comprises the operator's security, cloud, IoT and big data assets, and is focused primarily on the business market.
- TIM established Noovle in January 2021 as its cloud and data centre business. This move allowed the operator to concentrate assets and skills that were previously spread across multiple departments into a single company. There is speculation that TIM may sell a stake in Noovle.
- stc sold a 20% stake in its IT arm, solutions by stc, via an IPO in August 2021.
- SK Telecom spun off its IT and semiconductor businesses into a newly formed investment company, SK Square in November 2021. It plans to invest in areas such as media, security and e-commerce platforms, as well as digital healthcare and quantum cryptography. SK Square is now listed as a separate company following a stock split.
- Korea Telecom (KT) established KT Cloud, its cloud and data centre business, as a separate fully owned entity in February 2022. It is rumoured to be considering the sale of a minority stake in KT Cloud to a strategic partner.

Many of these new divisions have a significant focus on the business market, though most also provide wholesale and B2B2C services.

Operators may not have achieved their aim of improving the value of the business

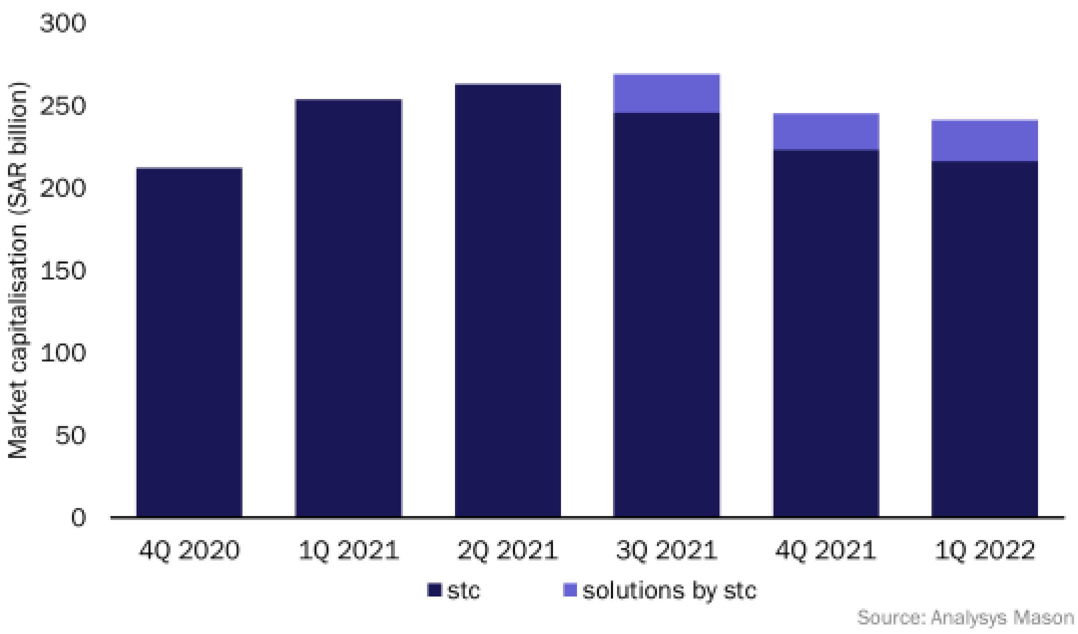
Operators' stated aims when separating out their IT divisions relate to two areas: business valuation and the ability to compete in the IT space. We consider here the first of these potential benefits.

Many operators consider their IT divisions to be undervalued. Telecoms businesses, and often the IT divisions within them, are subject to lower valuation multiples than many tech businesses. This problem is particularly acute when the IT business accounts for only a small share of overall revenue. For example, KT notes that its "Cloud/IDC business has been undervalued up until now hidden under KT's valuation, with its sales reaching only 1.8% of KT's consolidated sales."

Operators hope that by providing greater visibility for investors on their fast-growing IT businesses they will attract a higher valuation, thereby improving the value for shareholders and increasing prospects for further investment in the business. For many operators, there is also pressure to release capital from these IT units in order to reduce debt.

However, it is not at all clear that this increased valuation has been realised. For example, the combined market capitalisation of stc and solutions by stc at the end of 2021 was lower than that of stc before its solutions arm was listed (Figure 1). Furthermore, neither stc nor solutions by stc has notably outperformed its regional peers during 2022 in terms of share prices.

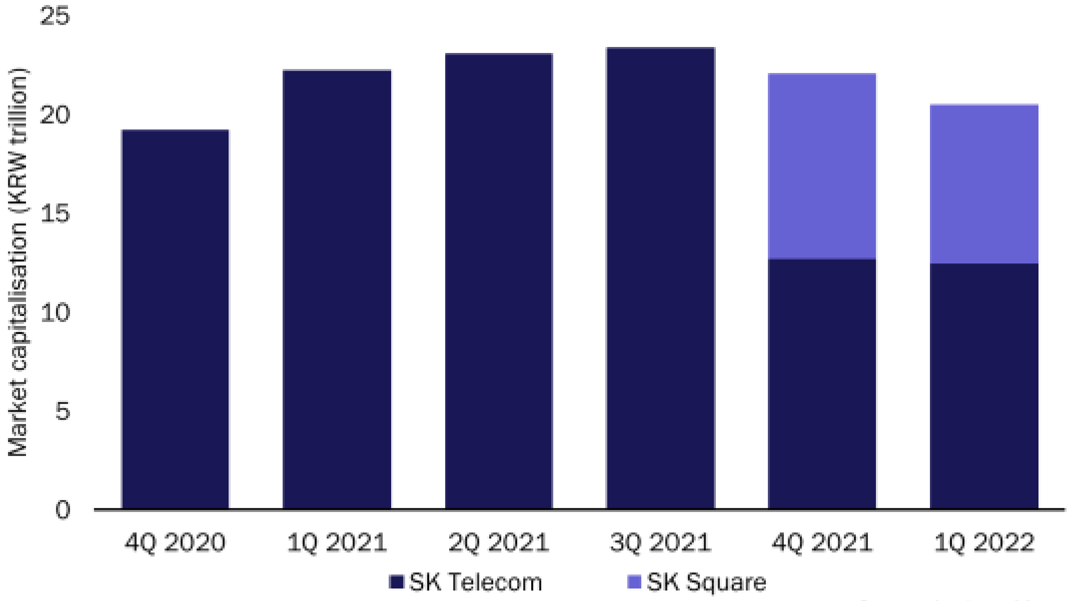
Figure 1: Market capitalisation of stc and solutions by stc, 4Q 2020–1Q 2022



The public sale of a 20% share in solutions by stc in August 2021 did release capital for the parent company, but the level of cash generated does not appear to have reflected an enhanced valuation of solutions by stc as an IT company. It probably did not help that direct sales to private businesses accounted for less than 15% of solutions by stc's revenue in 2020 (the rest came from sales to the government sector and from indirect sales to private businesses through stc).

Similarly, the combined market capitalisation of SK Telecom and SK Square was lower at the end of 2021 than before the spin-off (Figure 2). Growth in the share price of both companies has lagged behind that of KT and LG Uplus (the other major players in the South Korean telecoms market) in 2022.

Figure 2: Market capitalisation of SK Telecom and SK Square, 4Q 2020–1Q 2022



Source: Analysys Mason

SK Telecom plans to generate capital via a series of IPOs for individual companies within its portfolio, rather than through the sale of a share in its overall IT business (as stc has done). This may well prove to be a more effective strategy, both in terms of the valuation achieved and providing a longer-term cash stream.

It is far from clear that forming a separate IT arm is beneficial to operators in terms of valuation alone

Operators can raise much-needed cash by separating off and selling a stake in their IT arm. However, it is far from clear whether doing so provides a long-term advantage in terms of enhanced valuation. Many operators are considering separating and selling their IT businesses, but we would caution against assuming that it will deliver more than a short-term boost.

Read our article on the potential operational benefits (and drawbacks) of having a separate IT division here.