Investing in the European Telecoms Sector

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Introduction

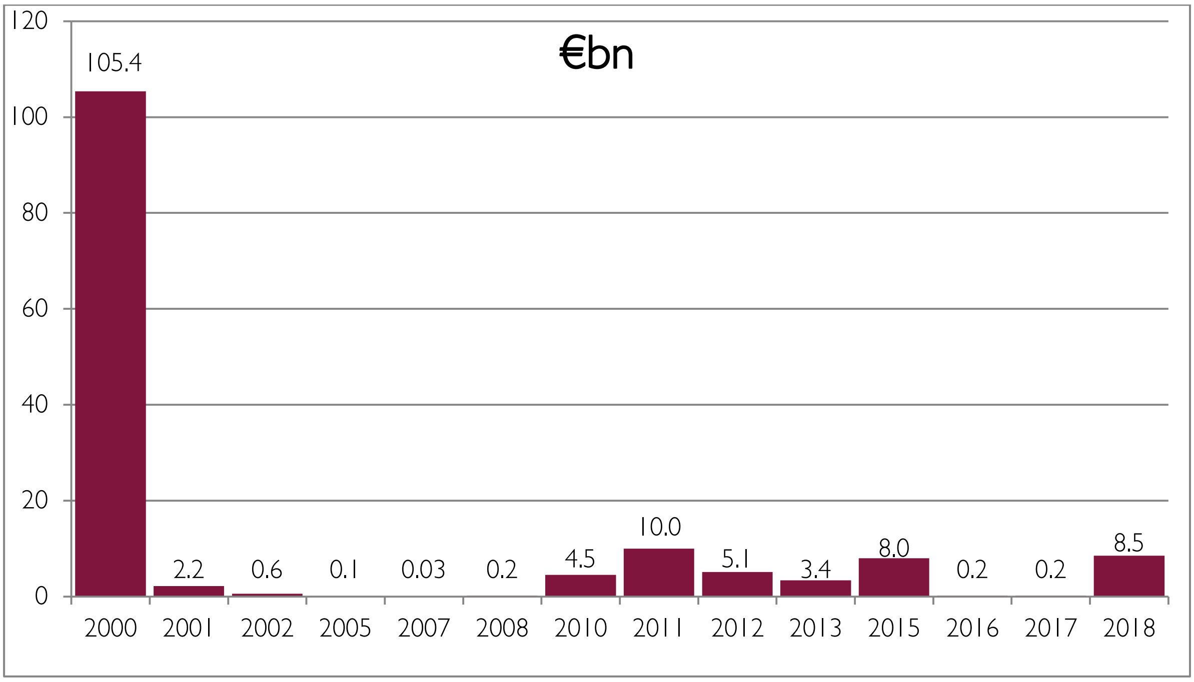
Telecoms are generally assumed to offer investors cash-flow stability and good dividends, which stand out as havens when markets are expensive or becoming more volatile. These shareholder priorities can, over the short term at least, oppose the ongoing need to invest in the future of the business. It is often assumed that this is limited to keeping up with technological progress and meeting consumer demand for more connectivity, but we have frequently observed that the regulatory outlook is a fundamental driver of the returns that can be made for the entire industry. In Europe, prior periods of intense investment have been followed by disappointing revenue and profitability as regulators at the national and EU levels have prioritised consumer protection over developing fast networks. Regulators have a further core requirement from the industry: that it delivers competitive networks, enabling European companies to compete globally. Understanding the alignment of interests and expectations is key.

As the perceived benefits of telecoms companies' shares stem directly from sustaining returns on capital that is already mostly deployed, and taking advantage of economies of scale, it is of vital importance that we understand whether the regulatory and consequent competitive backdrop supports these expectations. With the next stage of technological progress already rapidly approaching, we are focused on making sure our investments are aligned with the needs of the key stakeholders' and that they have strategies to ensure long-term dividend reliability. Significant resource has focused on discovering what role the move towards 5G mobile networks is likely to play in coming years, and integrating that into our understanding of how well (and how expensively) our potential investments are meeting these requirements.

What a Brief History of Telecoms Technology and Regulatory Cycles Has Taught Us

When given the opportunity, profitable telecoms companies will often either under- or over-invest, and fail to recognise the risk of new competitors and their own limitations in growing outside their core competencies. For example, in the era that ended with the dot-com market bubble, expectations for the future mobile internet were geared around the emerging 3G standards for networks. In 2000, companies spent in excess of €105bn - more than in all of the years subsequent to this.

Total Nominal Spending on Spectrum in Europe over the Last 18 Years



Source: National Regulatory Authorities and Bernstein Analysis

On top of a tendency for companies to make mistakes, regulatory intervention can appear to be an immovable, structural feature of telecoms markets. On our longer term horizon of five years and beyond, however, it can become cyclical. The tenure of the European Commissioner for Competition is five years, and the appointment can determine the viability of attempts to improve market fundamentals through consolidation. This produces different outcomes under similar circumstances depending on the approach of the Commissioner. Historically, different levels of consolidation, e.g. comparing four- and three-operator markets, have correlated with a significant difference in profitability. In some cases, by recovering similar network costs from a less fragmented pool of clients, the difference in profitability is about a third. The appointment of the next Commissioner will be made in the final quarter of 2019 and could trigger a change in the tendency to intervene. It would be dangerous to assume that major changes in profitability in the sector are assured, but we are very mindful of the opportunities the swing of the regulatory pendulum can present, and we know the market can get out of step with reality after long periods of disappointment.

Looking Forward

Since the prior periods of disappointing returns, there is a common consensus that former incumbents in regulated oligopolies can be terrible allocators of shareholders' resources. However, there is cause for hope; when a disappointing cycle of boom-and-bust has passed and regulators seek to drive investment back into the industry, we have seen periods where returns were allowed to grow. As regulators pushed for more investment in broadband networks through Fibre-to-the-Home, they were prepared to offer operators a path towards market-based pricing on new investments, i.e. an end to wholesale price caps based upon costs plus a meagre profit margin.

Companies that responded to this are positioned to bundle premium content. This reduces customer churn and means they face fewer risks from competition in the future. In our view, this is the position that markets such as Spain and France are now in, albeit both of these are seeing a reshuffling at the lower end of the market.

Conversely, in markets that lack extensive full-fibre networks, key incumbent providers face increasing risks to their core profitability on two fronts:

- A heightened risk of regulators forcing new investment, but on their terms rather than by promoting win-win outcomes
- New competition coming organically as technology and pricing allow well-resourced challengers to enter the market

Italy has been particularly hard-hit by the former factor despite already having very low levels of pricing, as the state has co-ordinated public investment in an open access fibre-based network that will challenge Telecom Italia's dominance. This has combined with the EU Competition commission preventing consolidation to a three-player market and encouraging Iliad to enter aggressively.

The second risk is a threat to the incumbent's future profitability in Germany. The sector leader Deutsche Telekom has not focused on upgrading its networks to full-fibre, and has relied upon an intermediate step also seen in the UK: Fibre-to-the-Cabinet. Early 5G trials are already being undertaken in various markets where the mobile network is being used to offer ultra-fast speeds without the cost of the line rental that an incumbent would normally be able to profit from. Underinvested incumbents could lose their reputation for superior home broadband speeds.

In Poland, the mobile telecoms and satellite TV operator Cyfrowy Polsat, has pioneered a similar high speed home broadband service using 4G standards. This has been achieved through having a good spectrum portfolio and the ability to capture stronger signals by putting antennas next to their satellite dishes, which are less susceptible to interference. It is our view that the technologies embedded in 5G will enable this sort of solution to be offered in other selected markets as well. Even a minor loss of market share from suburban or rural markets could cause threatened incumbents to panic because of their largely fixed-cost margin structure and richly priced customer bases. We are therefore avoiding taking the unnecessary risk of exposing ourselves to operators who have not upgraded networks and where there are competitors able to invest in new alternatives.

As a result, we think the market is pre-occupied with the dangers of overspending on 5G networks without an attractive revenue model from applications like autonomous vehicles or the internet-of-things. Meanwhile, the message from the European telecommunications industry is that the network transition is far more evolution than revolution, with spending to match demand, and no obvious reason for expenditure to be lavish. Therefore, there is greater focus on monitoring competitive threats to existing profit pools than threats to dividends from capital expenditure.

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About the Authors

James is responsible for covering the Telecommunications Sector and assisting in the management of the Emerging Markets Strategy.

James joined Edinburgh Partners from Martin Currie Investment Management in 2011. At Martin Currie he completed a graduate trainee role covering Global Financials, Industrials and UK stocks for income generating portfolios.

James graduated from the University of Edinburgh in 2008 with a first class Honours degree in Economics. James is a CFA charterholder.

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