Between a Rock and a Hard Place

2014 EMEA Telecom Executive Survey on Cost and Profitability Imperatives
At a Glance

**What Executives Said**
Even though nearly all respondents said they are undertaking cost reduction programs, more than two-thirds declared that their companies’ approaches to cost cutting have not significantly evolved from incremental toward more-transformative efforts in the past five years. And 43% of respondents said cost reduction projects have failed to reach completion due to other projects’ taking priority, which indicates that incremental cost reduction programs are unable to mobilize an organization’s attention in a sufficiently sustainable manner.

**The Fight for Survival**
A look at the 15 largest European operators’ profits and losses (P&Ls) reveals that although the industry’s average cost level represents approximately 67% of revenue, best-in-class organizations maintain that ratio at approximately 45%. Multiply that gap with the aggregated revenue base at play, and the result is close to a staggering cost opportunity of €100 billion.

**Three Steps to Transformative Change**
To survive, operators need to go beyond incremental cost cutting and pursue transformative change to meet the challenges of a competitive and radically changing industry landscape in which the demand for increased investment continues unabated. Companies can achieve that radical transformation by following three key steps.

- **Step 1.** Know your destination. Set cost goals based on a detailed and forward-looking understanding of costs.
- **Step 2.** Challenge the business model. Take a strategic, structural approach to cost reduction, because tactical, incremental improvements are not enough.
- **Step 3.** Stay the course. Build a highly visible, future-oriented corporate narrative to promote alignment and manage the transformation closely.

**ABOUT THE SURVEY**
Between September and December 2013, we interviewed 12 leading C-Suite executives of European telecoms operators and surveyed a further 55 executives about their views on profitability and cost reduction efforts.
So, what is preventing companies from successfully achieving such reductions? According to our recent survey of top executives at the largest European operators, all surveyed companies are undertaking cost reduction programs, but more than two-thirds of respondents said their companies’ approaches to those efforts have not changed notably during the past five years. And that partly explains why costs as a share of revenue have increased by 1.4 percentage points from 2007 to 2012.3

Clearly, a change is needed. To survive, operators need to go beyond incremental cost cutting and pursue transformative change to meet the challenges of a competitive and radically changing industry landscape in which the demand for increased investment continues unabated. Companies can achieve that radical transformation by following three key steps.

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The Fight for Survival

Our executive survey supports the markets’ severe view of European telcos: only a third of respondents said they expect healthy returns on invested capital (ROIC) from investments made for the provision of mobile and fixed data services (figure 1). If operators themselves don’t believe they can generate healthy returns, why should investors believe it?

Facing low returns and a complex mix of structural, strategic, and regulatory pressures, European telcos might well see a wave of mergers-and-acquisitions (M&A) activity sweep the Continent and eliminate the weakest members of the herd. Indeed, in the first three quarters of 2013, the technology, media, and telecommunications (TMT) sector saw a greater level of M&A activity than did any other sector globally, with 7 of the top 10 deals featuring TMT companies as targets.4

The European TMT sector accounted for more than a quarter of global TMT deals. Such deals as Verizon/Vodafone, Vodafone/KDG, América Móvil/KPN, and Telefónica/KPN Germany all point to a fundamental set of structural changes in the sector.

Because growth is not forthcoming, operators are understandably focusing their fight for survival on adjusting their cost bases to generate the cash required for the funding

Figure 1: What are your expectations for return on invested capital (ROIC) on investments made for the provision of data services (fixed and mobile)?

1 S&P Capital IQ data, 2010-2013
2 From November 20 to December 6, 2013, AlixPartners surveyed 55 senior telecommunications executives in France, Germany, Italy, Spain, and the United Kingdom about their views on profitability and cost reduction efforts. All referenced views of the respondents are drawn from these survey results.
3 S&P Capital IQ data, 2010-2013
4 TMT M&A Databook, International Financial Review (Thomson-Reuters), and AlixPartners analysis.
of infrastructure investment needs, which 56% of our respondents said they see as increasing. It’s an effort sorely needed: our analysis finds that the opportunity to take out cost is enormous. A look at the 15 largest European operators’ profits and losses (P&Ls) reveals that although the industry’s average cost level represents approximately 67% of revenue, best-in-class organizations maintain that ratio at approximately 45%. Multiply that gap with the aggregated revenue base at play, and the result is close to a staggering cost opportunity of €100 billion.

In other words, the industry’s entire capital expenditure requirement, estimated at approximately 18% of revenue for 2014, amounts to less than the cash that could be generated by achieving a best-in-class cost structure. However, operators’ cost reduction efforts are expected to fall dramatically short of the mark: the industry’s EBITDA margin is projected—at best—to stabilize in 2014 after a 1% decline in 2013, according to Moody’s Investors Service.

View from the Executive Suite

It goes without saying that reducing costs is a priority for almost all of the respondents to our survey, and 95% said their companies have approved or planned cost reduction projects for the next 12 to 18 months. The main thrusts cited for cost reduction are network upgrades, product reviews, and strategic reviews of countries (figure 2).

Even though nearly all respondents said they are undertaking cost reduction programs, more than two-thirds declared that their companies’ approaches to cost cutting have not significantly evolved from incremental toward more-transformative efforts in the past five years. And 43% of respondents said cost reduction projects have failed to reach completion due to other projects’ taking priority, which indicates that incremental cost reduction programs are unable to mobilize an organization’s attention in a sufficiently sustainable manner.

The results are, understandably, flat or declining EBITDA margins. Clearly, operators are failing to address the challenge vigorously. The will to do so, however, is there: 60% of respondents said they would like to move from incremental approaches to radical cost reduction, the need for which is felt in several major areas (figure 3).

To succeed where they have failed before, operators must change their approaches and pursue cost reduction programs through transformational changes.

Step 1: Know Your Destination

The problem with typical cost improvements is that they are based on a picture of where we are today; but today’s picture shows only where we come from, not where we should go. By the time incremental cost improvements have been implemented, average revenue per user usually has declined sufficiently to wipe out the advantages achieved.

Telecom operators therefore must set future-proof cost goals based on predictive cost analyses that indicate not only where...
they and competitors are today but also where the industry is expected to be three years from now. Getting to that level 12 to 18 months before the competition—and being able to repeat that performance consistently—are what set the leaders apart from the pack.

An integrated telco achieved just that by carrying out a comprehensive market, customer, and product profitability project. As the company expanded to new service offerings, costs remained stranded on the historical legacy business, diluting profitability. The company desperately needed to get a holistic view across multiple systems harboring complementary pieces of information. The approach chosen relied heavily on big data: the team identified true drivers of profitability by applying detailed allocation rules and specialized computing capabilities to extract in excess of 400 million transaction records from 18 information technology systems and reconcile them to the overall P&L. Armed with a detailed view of the cost of serving each of its customer and product segments, the company performed detailed diagnostics resulting in an EBITDA improvement of more than €20 million in the first six months. 5

Of course, cost allocation is a daunting task for most telecom operators—one that typically leaves executives resigned to living with a very incomplete picture of the company’s profitability across products and customer groups. “We are good at allocating costs to products and services but absolutely not able to allocate them well to customers,” noted one of our survey respondents. “Our business intelligence is based on products and services, and the customer is more than a collection of products and services.” Indeed, though direct costs (e.g., customer setup costs or bad debt) are easy to assign, many elements of the operational expenses are inadequately measured (e.g., data services) or a headache to allocate—chief among them, network and infrastructure costs. Subjectivity and approximations are often viewed as bigger dangers than is steering the company without a good understanding of costs. But there is a path out of this dilemma. Applying cutting-edge big data tools that integrate millions of records from the many systems that lie within billing and operating systems can largely eliminate the subjective aspect of cost allocation and allow a true picture of profitability to emerge. Armed with that knowledge, management can make informed decisions on rationalizing the product or customer base in the short term.

As the saying goes, what you don’t measure you don’t get, so making full cost and profitability figures available across the organization is essential. More important, the cost drivers have to be available in sufficient granularity to enable each function to manage its share of the equation. This granularity of information and functional ownership can be achieved by embedding in business as usual the data analytic results mentioned earlier to create visibility on customer and product profitability. That knowledge then has to be combined with an adapted incentive program that focuses the senior executive team and has shared P&L performance indicators at its core.

For operators that have persisted in achieving detailed cost allocations to customers and products, the benefits are clear: 77% of respondents to our survey who completed the allocation exercise said the effort met most or all of its objectives. In the words of one survey respondent: “It was an excellent effort because it provided us a lens through which to view our business that we didn’t have before. There were some surprises for management and for the organization, and we have been able to kick off an actual transformation program off the back of it.”

**Step 2: Challenge the Business Model**

Most telecom operators routinely focus on achieving incremental cost savings in selected functional silos such as reducing head count in support functions, optimizing procurement of handsets or network spare parts, and introducing Lean principles in customer service. And although those are important practices to sustain healthy operations, they typically provide only a 5 to 15% reduction in the few areas covered. And often, that barely amounts to taking out a couple of percentage points of their total cost base.

Accordingly, 70% of the respondents to our survey agreed that current cost reduction projects are not transformational enough. Indeed, the challenge telecom operators face today is of a different order of magnitude: reductions of more than 10 percentage points of the cost base are needed every year to stay in the game and keep up with the fast-paced evolution in customer needs (e.g., +66% compounded annual growth rate for mobile data traffic in 2012–17, according to Cisco). 6 As an example, some operators must deliver a 50 to 60% reduction in capital expenditure unit cost for 24 to 36 months while increasing the capacities of their broadband networks. That cannot be achieved only by adopting lower-cost technologies. As one respondent to our survey put it: “Every operator is figuring out how to cut costs. What’s important to understand is that in the beginning, you can do it with traditional tools like efficiency plans and employee reduction, but ultimately, you have to change your way of producing services. You have to change your business model.”

All of this calls for a strategic, structural approach to cost by, for example, adopting a new network architecture that is less complex and more standardized or even going for a network-

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5 AlixPartners experience.
sharing or outsourcing approach. The existing business model has to be challenged and modified coherently across functions to achieve the cost goals that both the customers and the competition relentlessly impose.

One of the pitfalls some organizations encounter at this stage is the inability of top executives—busy with delivering business as usual and each with an individual background and a personal power base in the organization—to envisage and agree on radical solutions. Instead, an impartial party, without political bias, might be most able to rapidly design a novel solution by freely thinking outside the box, by bridging across functional silos, by bringing new perspectives, and by relentlessly challenging the accepted state of affairs. Use of such an impartial party can lead to a faster implementation pace, can ultimately improve chances for success, and is an approach often taken by private-equity owners to transform their portfolio companies.

Finally, deep changes are most effective when they leverage a major evolution in the operator’s technology base—and they are often impossible without it. Thus, looking at technology step-change not bottom-up but top-down as an opportunity to redesign the business model and reduce cost should be a constant concern of every telecom CEO and C-level executive.

One example is the procurement alliance of two European telecom heavyweights with a multibillion-euro spend. Facing high investment plans in network infrastructure (fiber to the home, fourth-generation mobile technology) and increasing price pressure from a concentrating supplier base (five global suppliers in network and seven global suppliers in handsets), the two operators recognized that traditional sourcing levers offered only limited marginal opportunities and that a radical approach was required. A neutral clean team was established that received input on procurement data from both operators but shared back only the analysis output, which showed potential savings in the range of 5 to 10%. As a result, a procurement joint venture was agreed to and designed in detail, including its organization, governance, location, sourcing processes, interfaces, and processes such as marketing, technology, and information technology. The joint venture was up and running within one year, with high savings in excess of €1 billion, as demonstrated on the first joint requests for quotes.7

**Step 3: Stay the Course**

It’s no use denying it: cost reduction programs are not usually the most popular of corporate projects. As the survey results illustrate, cost programs in functional silos are often gradually superseded on the priority list by more-exciting projects and end up achieving only a fraction of their potential (figure 4). But there are ways to maintain focus momentum—and they are similar across industries.

First, to motivate the troops and create alignment, the narrative of the effort should focus on the future that cost reductions will result in, rather than on the past. For example, value creation for subscribers is a powerful rallying banner: “doubling bandwidth for the same price” is infinitely more compelling than extolling an abstract “x% cost reduction.”

Second, it is crucial to push the design granularity of the new solution down to a level that allows immediate transition to implementation. Execution momentum is crucial, and knowing exactly what to do next is a requirement for complex programs to succeed.

Third, a powerful and experienced project management office (PMO) team led by a senior executive with a successful change management record must be established. The PMO will maintain discipline, monitor the operational and financial progress of the various initiatives, facilitate cross-functional coordination, and hold team members accountable to measurable outcomes. One of the classic, common pitfalls is that the people assigned to the PMO are brilliant young line managers who lack experience with

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7 AlixPartners experience.

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**Others projects took priority**

<table>
<thead>
<tr>
<th>Factor</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Regulatory constraints</td>
<td>32%</td>
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<tr>
<td>Cost overruns with no additional funding</td>
<td>30%</td>
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<tr>
<td>Bad project planning</td>
<td>29%</td>
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<tr>
<td>Project complexity not fully understood</td>
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<tr>
<td>Overambitious objectives</td>
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<tr>
<td>Insufficient data or information technology capabilities</td>
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<tr>
<td>Have not abandoned/stopped any cost reduction projects</td>
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<tr>
<td>Lack of C-suite buy-in</td>
<td>16%</td>
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<tr>
<td>Lack of human capital</td>
<td>16%</td>
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<tr>
<td>Don’t know</td>
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Figure 4: If your company tried but abandoned any cost reduction projects, what factors were most significant in preventing the project(s) from reaching completion?
managing large change programs and who are given insufficient internal and external resources, resulting in program failure and a waste of corporate talent.

Finally, sponsorship by the CEO is essential. Frequent project reviews directly involving the CEO are required to ensure that alignment, momentum, and focus be maintained and that the organization stay the course.

The European subsidiary of a multibillion-euro global player in the telecommunications sector recently embarked on a 12-month transformational cost reduction program. Following five years of negative operating profit and facing the challenge of funding its growth, the company decided that radical action was required and that it had to first burn fat before building muscle. The first phase of the transformation focused on assessing the right approach and designing the plan for action. The plan called for a reorganization of the way the company did business: by simplifying the overall matrix structure; by going from more than 15 countries to 3 clusters, from more than 30 business units to 3 customer verticals, and from more than 25 to 11 direct CEO reports; and by putting costs in the hands of those who could control them in practice. The ambition: to reduce selling, general, and administrative costs by more than 30% and head count by more than 40% to fund specific outlined growth initiatives. Armed with a detailed plan, the CEO and management then transparently communicated the facts, goals, and approach to the whole company. Because the company’s top management had limited experience in managing large transformation programs, an experienced transformation office leader was assigned to support the newly appointed top leadership in executing the transformation. Throughout the effort, the CEO visibly led the charge, frequently keeping everybody informed of progress and successes achieved and answering questions about the program’s direction and ambition. Within six months, operating profit improved by more than €40 million, bringing the company out of the red and placing it on a growth trajectory.

**Urgent Need for Change**

European telecom companies face considerable financial, operational, competitive, and regulatory pressures at a time when infrastructure investment is increasing and M&A activity is both ramping up and bringing additional competitive threats from abroad. The need for operational efficiency is urgent—and large: our analysis finds cost reduction opportunities nearing €100 billion. However, the majority of respondents to our executive survey admit they have not significantly evolved their cost reduction approaches to meet that challenge. And as those industry executives agree, small, incremental changes will not be enough. Telecom operators that take a future-oriented, data supported, structural, and closely monitored approach to cost reduction will be best placed to achieve the transformational changes required to outperform peers in the current environment.

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1. AlixPartners experience.
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