

# Winning the Telecom Famine

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*Applying Analytics to Create Value in Saturated Markets*



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# Introduction

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In today's challenging market environment, telecom management often implements spend-based segmentation and reactive pricing with a focus on short-term goals for subscriber acquisition. This approach, however, has been at the expense of significant market value, and a paradigm shift is now needed to escape the downward pricing spiral. Arthur D. Little has created a value management approach that is proven to preserve market value rather than destroy it.

When telecom markets decline, the pressure on top management increases. Well adopted pricing strategies, comprised of customer spend-based segmentation and reactive pricing, in many cases, lead to short-term achievement of targets at the expense of significant market value.

A paradigm shift from the traditional marketing approach to a value-driven approach based on forward-looking behavioral segmentation is required in order to retain and increase customer value. Arthur D. Little has created a value management approach towards product portfolio generation, pricing and market development, supporting leading telecom providers in winning the hunger games. The results of Arthur D. Little's work with operators are outstanding, resulting in an increase of total monthly gross add value by more than 20 percent.

This Report will focus on two objectives:

1. How to hunt for value in a saturated market
2. How to balance value hunting with investing the necessary resources

We start with a brief overview of the current telecom market environment, in order to put these objectives in context.

# Short-term Focus is Accelerating the Downward Spiral in Price Levels

Telecom markets today have become a zero-sum game when it comes to subscriber market share and gross adds; a gain for one operator is a loss for the others. European telecom market revenue has been declining over the last 3 years by 4 percent CAGR. One major driver for this development is a massive unit price decrease for telecom services (-10 percentage points for mobile voice and -80 percent for mobile data from 2010-2013).

This price decline is a structural problem. Over the last two decades, the cost of production in most telecom segments has been reduced due to new frequencies and technologies that enable lower unit cost. Today, however, operators are facing significant investments in new technologies, and decreasing prices have resulted in lower profits. A major trigger of falling prices is, in many cases, a poor balance of short-term and long-term pricing decisions. Short-term aggressive gross add initiatives have led to long-term market value destruction.

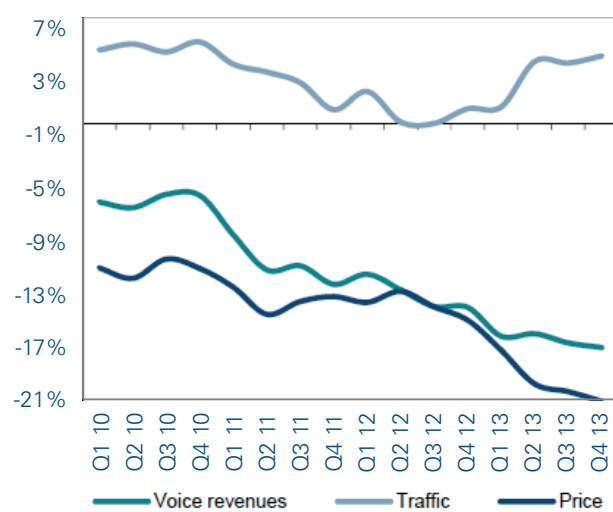
How difficult is it to escape this prisoner's dilemma? The telecom market has the intriguing dynamic that all players could benefit if they would optimize market value as a whole; it is not by default a zero sum game. There are still pockets of value to be identified and operators have the possibility to sell more, for more to increase market value.

Today, market players are eager to optimize for themselves with drastic consequences for the overall market. They have done so in recent years with more or less individual success. Now, with tightening profit margins (incumbent and 2nd entrant ROCEs<sup>1</sup> have fallen by 9 and 13 percent, respectively, between 2010-2014 in Europe) and some operators even falling below profitability thresholds, it is essential to escape this spiral.

## An increasing sense of urgency

There is no relief in sight and current market trends could lead to an accelerated downward spiral. Due to technological advances, CAPEX is increasing while prices continue to fall, eating away further at margins. Operators, therefore, need to reflect on volumes. Obviously, the industry is having difficulty in

Figure 1: European mobile service revenue drivers



Source: Arthur D. Little, Exane BNP Paribas estimates

fully monetizing technological advances, such as 4G and FTTH. Approximately 80 percent of companies taking part in the Arthur D. Little / Exane BNP Paribas 2014 telecom study do not expect superfast broadband to enable an increase in ARPU<sup>2</sup>. Most operators are struggling to transform data speed and volumes into sustainable price premiums.

Commoditization of connectivity and a lack of differentiation are pain points distressing the industry. At least 50 percent of the consumer's purchasing decision is driven by price<sup>3</sup> and the second strongest differentiator – the network – is diminishing due to roaming agreements and network sharing. Hence, the most common differentiation lever currently is price, accelerating value destruction.

1 Return On Capital Employed, indicating the value a business gains from its assets and liabilities

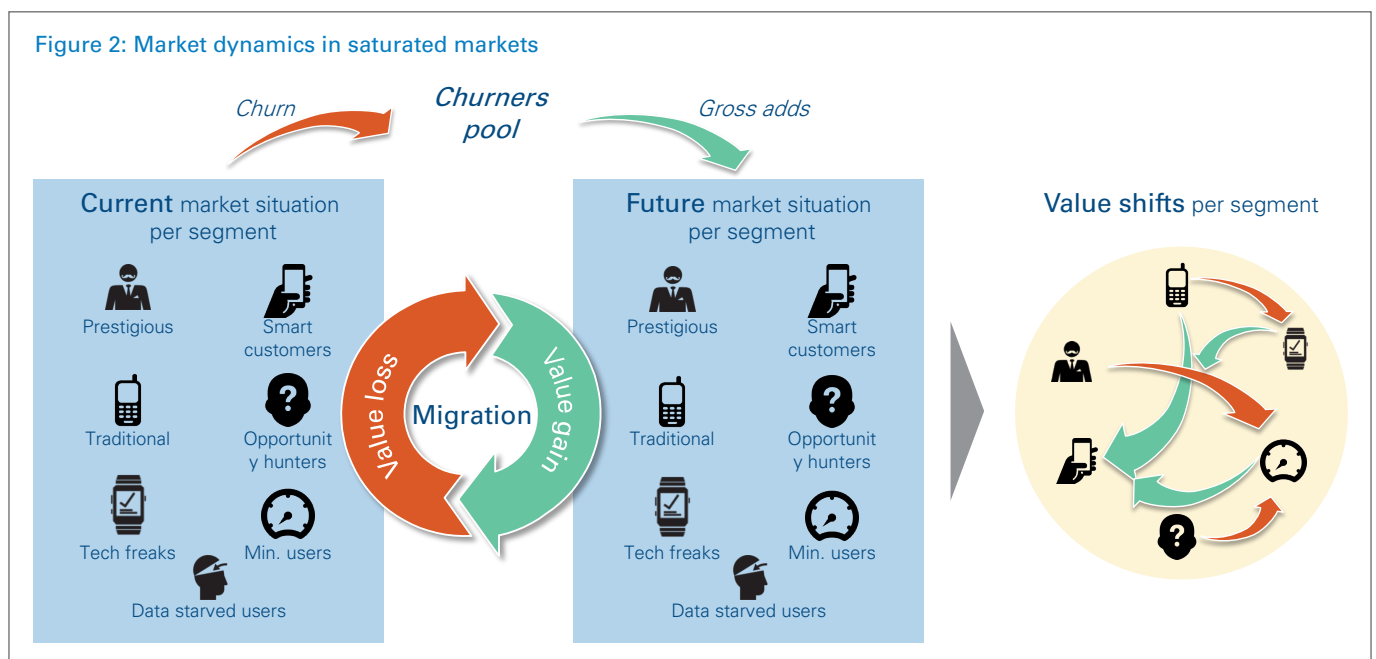
2 Arthur D. Little, Exane BNP Paribas, 2014

3 GfK Tele.Basics 2006-2011

### Top management’s dilemma

Declining markets, rising commoditization and increasing pressure to deliver prompt results do not make top management’s job easier. In order to achieve their gross add target in one segment, Chief Marketing Officers (CMO) often launch tariffs that result in migrations and cannibalization, overachieving their immediate target, and destroying significant market value, which explains the current massive decline in prices of -12 percent CAGR . While trying to do their job well in such detrimental conditions, the management board faces the following key questions:

- How can we achieve our ambitious short-term gross add targets without destroying long-term market value?
- How much risk should we take when making a pricing decision?
- Who should carry the responsibility of pricing decisions in the Marketing Department?
- Is the balance of the CMO’s gross add and retention focus still effective or are we wasting money and destroying market value?
- Are subscriber retention costs (SRC) principally more efficient than subscriber acquisition costs (SAC)?
- Should we try to attract and retain all customers or should we focus on any particular segments and avoid others?



# How to Escape the Downward Spiral?

Currently, the industry’s approach has been to segment the market based on customer spend into high-value, medium-value and low-value subscribers. This approach is clearly applicable since it helps to focus operations and investments on profitable segments. For retention activities, value-based segmentation still is effective.

In order to generate gross adds while increasing market value, and thus winning the hunger games in saturated telecom markets, reactive pricing is no longer sufficient. Rather, CMOs should focus on where pockets of value lie, identifying unmet needs that really matter to customers. Then operators need to create products that customers are willing to pay premiums for because they value their benefits accordingly. In short, sell much more, for more.

In order to do so, a shift to behavior-based market segmentation is essential. This innovative approach is based on observable usage patterns and specific behavior and creates customer segments, which can be further analyzed. The outcome of such granular customer analytics shall be incorporated in designing the value proposition and enable operators to boost gross adds by addressing the right customers with the right product at the right price (see figure 2).

This new segmentation enables operators to anticipate future value shifts among segments, and creates superior market understanding due to greater granularity. Arthur D. Little’s broad experience from advanced markets in Western Europe, as well as in Eastern Europe, Middle East and North Africa, enables us to identify segment-defining behaviors in a range of markets and geographies.

This new view on the market facilitates the introduction of an innovative methodology in order to assess, track and control market value: a forward-looking market value model. This dynamic model describes the whole market situation including market shares of all players, as well as gross adds and churn development per segment over a 12-24 month period. The model is future-oriented and simulates value shifts between segments on the basis of net adds for segments, migrations between segments and ARPU developments per segment. As such, the model identifies realistic market potential and helps steer the operator’s ambition and strategic focus (see figure 3).

A primary market assumption is that gross adds roughly equal churn; there are no real new customers in a saturated market. This means value creation is limited in each segment and the

Figure 3: Value-based vs. behavior-based segmentation

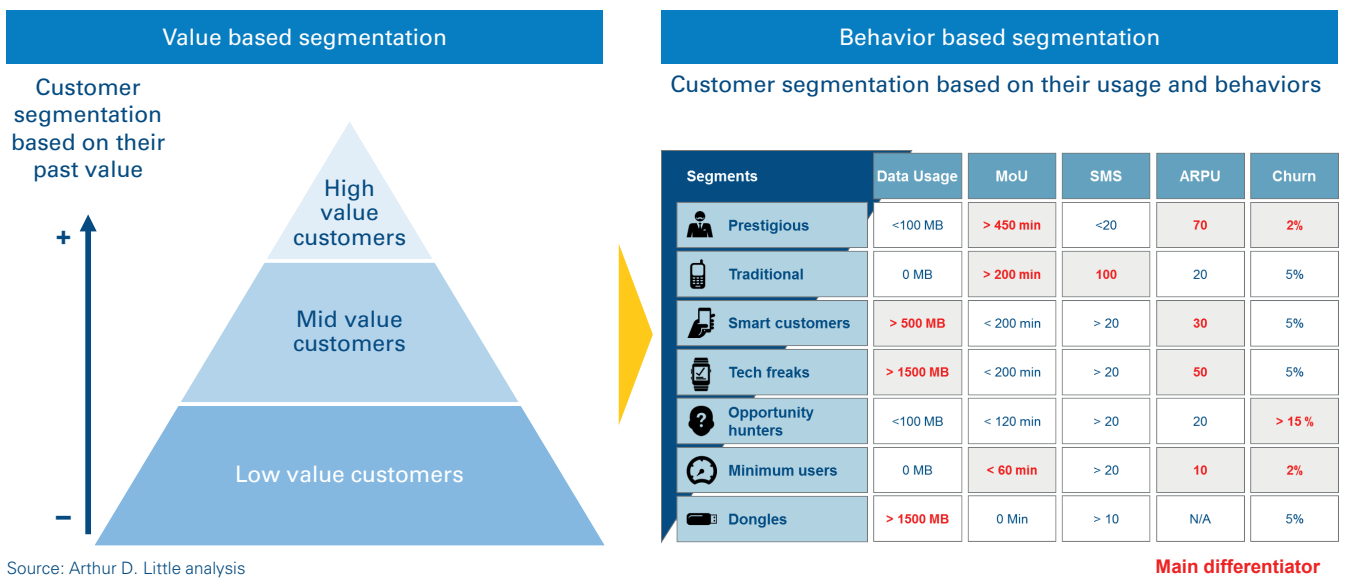
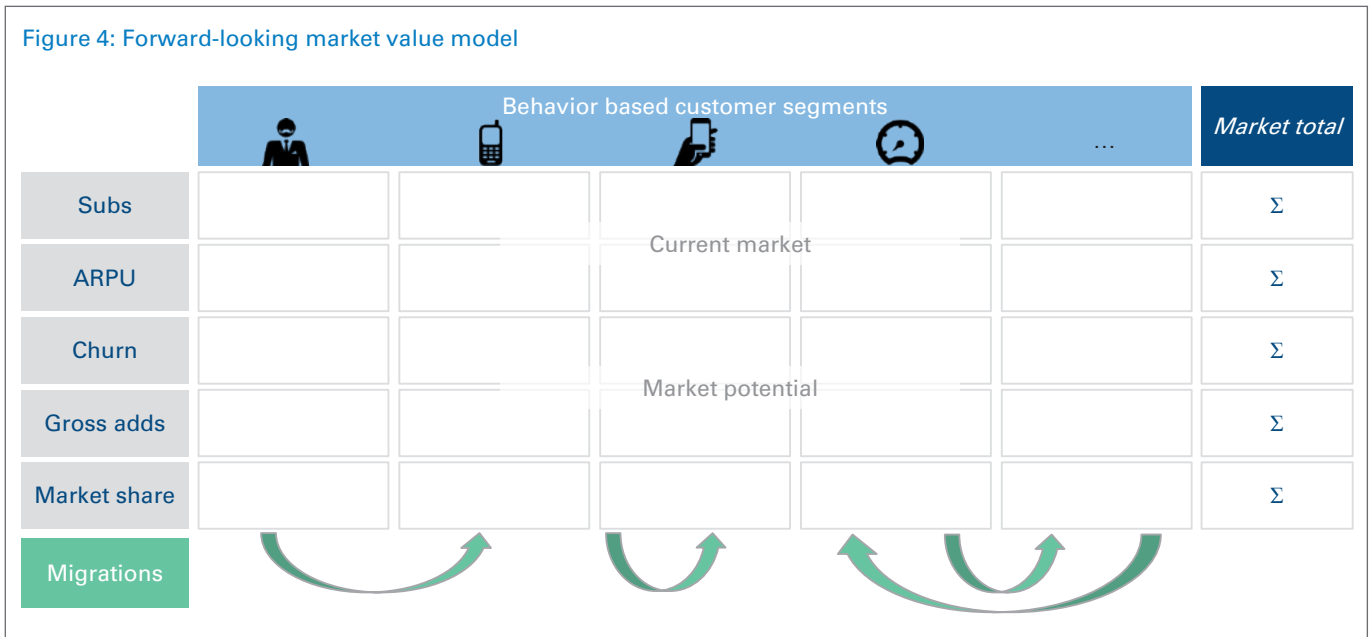


Figure 4: Forward-looking market value model



implication for the operator is to only invest as much as you can gain.

The benefits of this value management tool are as follows:

- A fully-integrated model that takes dynamic markets and interdependencies into account
- Highlights value shifts between segments and indicates where value will be
- Helps to prioritize focus segments for future activities
- Simple and easy to use for decision support – adoptable as controlling tool to track monthly performance
- Provides reliable and transparent market totals as a cross check with own ambitions

Figure 5: Identification of the market potential of individual segments

Market/Segment	Heavy conservative	Traditional rationalist	Young heavy users	Smart customers	Opportunity hunters	Minimum users	Datacards	Total
<b>1 Current market situation</b>								
<b>2 Market Potential</b>								
<b>3 Monthly ambition and current performance</b>								
<b>4 Yearly potential</b>								

# Detailed Analysis can Identify the Enablers of Value Creation

A detailed analysis of current spend effectiveness is required that complements the market value model and facilitates the development of a value proposition. The goal is to assess CAPEX and OPEX relative to the value created for relevant customer groups. There are several key questions to be addressed:

- What is the company doing to acquire and retain customers?
- What is the relative value generated by segment?
- Which resources can be used to invest in new products for more profitable customer segments?
- Where can we shift expenses from retention towards the generation of gross adds?

This spend effectiveness analysis first and foremost helps to identify segments that consume a lot of resources, but do not generate respective value. It also assesses whether the split of retention spend is justified vis-à-vis gross add spend. Hence, it enables the decision-makers to draw back from inefficient expenses in segments that are no longer the focus, and free

up resources for addressing gross adds in the focus segments more effectively.

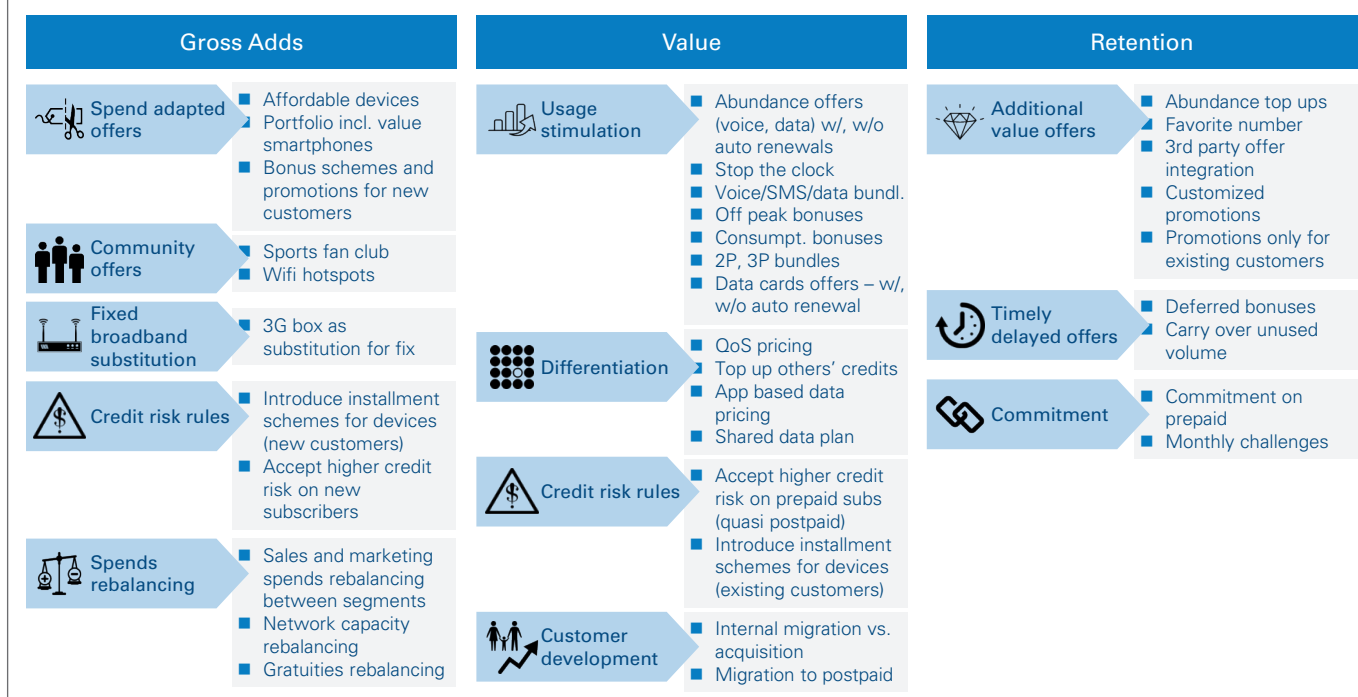
Some operators have successfully reduced retention spend to almost zero and invested in having the most attractive value proposition in the focus segments, for example, by using the lever of having the best handsets. So when it's time to sign a new contract, the customer automatically stays with the operator without any retention money spent.

After having reviewed market value shifts, customer needs and sources of additional necessary resources, the analytical foundation for value preserving pricing has been established.

## Value-driven pricing is determined based on segment analysis

The next step is to launch value driven tariffs. First, telecom operators need to evaluate the effect of the whole range of pricing levers.

Figure 6: Arthur D. Little's pricing approach





The Arthur D. Little pricing approach leverages 12 groups of pricing levers, addressing gross adds, value increase and retention. These need to be evaluated for each segment, based on gross add and revenue potential vs. profit margin. In saturated markets, non-traditional levers are often the most effective, as traditional levers have generally accelerated the downward spiral. Examples of non-traditional levers are the acceptance of higher credit risk and account for credit risk as SAC. Also migration rules can generate significant value for an operator (see figure 5).

After having identified the most effective pricing levers per focus segment, the pricing and tariff structure is developed. A successful tariff design is derived from an advanced analytics approach and encompasses the following elements:

1. Migration projections to calibrate cannibalization effects
2. "War-gaming" to quantify the migration effects of expected competitive responses – to manage value destruction by competitors
3. Margin and volume analyses to meet the prerequisite of profitability and network capacity

### What are the gains?

The advanced analytics value management approach is designed to help companies to achieve their strategic targets in saturated telecom and media markets. It provides realistic growth targets

and enables company performance to be controlled. The approach's transparency enables the company to take focused surgical actions in the case of deviations from the targets, rather than slashing market value indiscriminately. This approach also provides the CFO with a powerful controlling tool to monitor and steer monthly commercial performance. The specific model by market includes segment migrations and each of the tariffs. By marking the subscribers on a user level to the segments (e.g. for mobile MSISDN ), full transparency on gross adds and migration performance is provided and enables the company to respond quickly to market developments. Above all, telecom operators are empowered to evolve their pricing strategy from reactive pricing to a proactive shaping of market and competition.

Once this exercise is completed, the key is to add continuity by embedding value management in the organization. This may require specific skill sets, as well as changes in the organization and processes. The value-driven approach puts advanced analytics in the center of activities, empowering this number-focused field of marketing. It is crucial that the organizational structure supports the new paradigm and that the appropriate competencies are in place. Pricing decisions need to be supported by the appropriate rigorous mathematical analysis, complementing proposition managers' tasks. Implementation of the value management approach consequently requires a shift in the responsibility for pricing development from proposition managers to the analytics department. We are already seeing this shift in advanced FMCG companies.

Figure 7: Arthur D. Little's Value Management approach supports telecom operators to redesign efficiently their product portfolio by addressing 4 key questions

- 1** Where is the value in your own customer base ?
- 2** Where is the value in the market and where will it be in the future?
- 3** Where do you spend your money currently?
- 4** How to create value by focusing on future growth potential?



Source: Arthur D. Little analysis

# Winning the Telecom Famine

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Based on our experience, Arthur D. Little can provide the following answers to key strategic questions:

- The most effective lever to generate short-term gross add gains without jeopardizing long-term market value is to offer the customer what he really values, and give much more, for more (at higher cost) in the specific segments of future value
- Risk can be used as a gross add driver – making credit risk rules more flexible can be an effective lever to drive gross additions and value (e.g. smartphone installment schemes)
- SRCs are not principally more efficient than SACs – a combined focus of retention and acquisition is usually most effective, but needs to be assessed separately in each case and for each segment. In some cases, even a full focus on gross adds can work
- Churn is not always bad. Operators can use churn to grow value and control costs within your customer base by designing your portfolio in a way that attracts mainly higher value customers and avoids non-profitable subs
- Not all customers are “good” customers – Some customer segments should be avoided to free resources for more profitable customers
- Following the advanced analytics, value-management approach, pricing decisions should be supported by a strategic business intelligence and analytics function

In general, telecom operators in saturated markets should follow the credo “efficiency before beauty”; only the end result counts. The key is to rebalance spending according to value shifts. Furthermore, the best strategy to win the hunger games is to put the focus where value will be – and not where it is now. Key success factors are therefore:

- A proactive master plan beyond single tariffs to evolve the market by steering competition as well as customers accordingly
- Focus on value generating target segments, attract high value customers while also satisfying the mass market so as to not lose footprint
- Give much more, for more and be the most attractive provider in your focus segments

The key takeaway for management teams is that you can create value and outpace your competition in a saturated telecom market by applying analytics. Data analysis can become a significant competitive advantage and help you to escape the downward spiral. Take on thematic leadership and shape the market continuously, have a plan where the journey shall go beyond the next shareholder meeting. Arthur D. Little provides an innovative product portfolio design and pricing approach, enabling telecom operators to achieve short-term targets while not jeopardizing long-term ones.

Arthur D. Little has applied this innovative approach with operators in Europe and MENA region, and the results have been outstanding; this approach has resulted in an increase of total monthly gross add value by more than 20 percent. The market value model results in high transparency and the ability to steer the value in the market. The methodology becomes even more powerful if applied to the management of a group of companies creating transparency and alignment in the commercial environment and performance. Overall, the above-described approach empowers operators to increase company revenues while preserving market value.

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## Arthur D. Little

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