

Capex is king: A new playbook for telecoms execs

December 2014



pwc



As telecom growth slows, what are the new drivers of EBITDA multiples?

With old certainties fading, telecom execs are increasingly beset by ‘multiples envy’

Not so long ago, senior leadership teams at telecommunication operators (telecoms) knew what was expected of them and how to get it: strong growth in revenue and EBITDA delivered premium EBITDA multiples and superior investor returns.

But times are changing. Some executives are increasingly frustrated because, while they may be meeting Wall Street expectations, they aren't all getting the EBITDA multiples they expected. And worse yet, some of their competitors are. The old formula that brought years of success is not working anymore and their frustration grows as they watch while other operators somehow manage to find what eludes them. This ‘multiples envy’ forces them to ask: What are we doing wrong? What do they know that we don't? And who is missing the key – is it us or the analysts?

Understanding what drives multiples and how that formula changes as an industry evolves is fundamentally important to strategists. But this question is routinely ignored by the people who need the answers most. Too often, advisors brush past them and quickly move on to offering frameworks and advice. Worse still, telecom leaders rarely challenge this omission and fall back on the familiar measures of customer experience, network quality and accounting performance.

Concerned by this major deficit, we decided to conduct a wide-ranging study of the telecom industry's performance over the last decade to answer a deceptively simple question: as telco growth slows, what are the new drivers of EBITA multiples in telecom?

Lesson #1: Growth is gone and it's not coming back

During the gold rush years, telecom execs knew that rapid growth was the surest route to premium multiples. But after a long period of such accelerated expansion, global telecom growth has dropped to less than GDP growth. Some segments (e.g., fixed line) are already in absolute decline, and even global mobile revenue is expected to begin declining in 2018, according to some researchers. While some segments and regions will survive longer before hitting their peak, Western Europe provides a glimpse of how the industry is likely to eventually play out - a market struggling with year-on-year decline.

To be sure, growth options still exist, but the small scale of these opportunities means they are less a strategy within themselves and more a sliver of an overall portfolio. Consider this: in 2015, operators can expect to find mobile advertising opportunities amounting to only \$30bn, while the cloud will offer opportunities of \$35bn and M2M \$13bn. Even taken together, they are not enough to move the needle on a telecom industry worth \$2,000bn and beset by cannibalisation of voice and messaging revenue and pressure on termination rates¹.

¹ PwC analysis

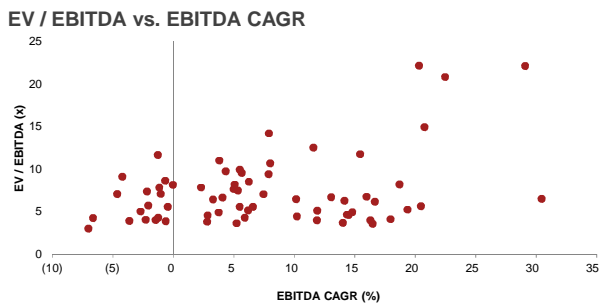
All of this begs the question: If revenue growth doesn't work anymore, then what does?

Lesson #2: Focusing on EBITDA and cash does not equate to focusing on value. Your investors know that already, so there is no premium multiple for directly pursuing those objectives.

Slowing revenue growth often triggers a renewed focus on EBITDA and cash. That's OK if you are comfortable with the very real risk that management teams might use the emphasis to run the business for cash and underinvest — hardly a long-term value play.

The good news is that investors (if not analysts) seem to be aware of that risk; we analysed the financial performance of 71 telecoms operators over the last decade and struggled to find a relationship between the annual rate of EBITDA growth and premium valuations as expressed by EBITDA multiples (see figure 1).

Figure 1: Fast EBITDA growth does not drive premium valuations



Each of these dots represents one of the 71 network operators in our study; the x-axis shows their annual rate of EBITDA growth over the last decade, while the y-axis looks for a correlation between that rate of growth and their EBITDA multiple (i.e. enterprise value divided by EBITDA).

We see the lack of correlation between EBITDA growth and premium valuations as an important finding. Leadership teams often assume that — because of analysts' focus on EBITDA — delivering on that agenda would be reciprocated through premium EBITDA multiples. Our data suggests this is not necessarily true; we struggled to find any sort of relationship.

To investigate further, we assessed other common metrics and how they correlate with EBITDA multiples; in the exhibits below we show the (lack of) relationship between EBITDA multiples and either EBITDA margin growth, growth in cashflow or capex/sales ratios at the 71 operators in our sample (see figures 2 – 3):

Figure 2: Faster growth in cashflow does not drive premium valuations

EV / EBITDA vs. EBITDA CAGR

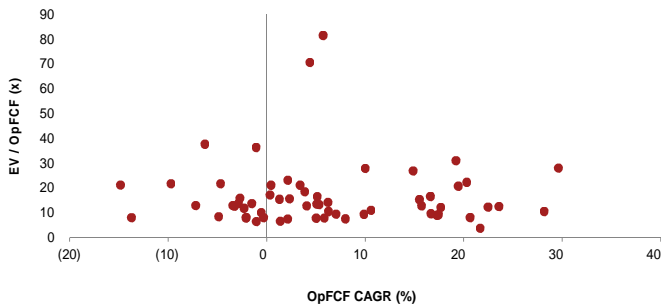
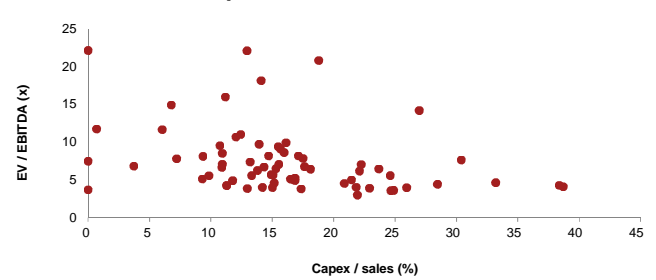


Figure 3: Often used, capex/sales, has no bearing on value

EV / EBITDA vs. Capex / sales



Source for Figures 1-4: Capital IQ, PwC analysis.

Again, each of the dots in the above charts represents one of the 71 network operators in our study; the y axis shows their EBITDA multiple (i.e. enterprise value divided by EBITDA), while the x axis shows EBITDA margin growth, growth in cashflow or capex/sales ratios in search of some sort of correlation.

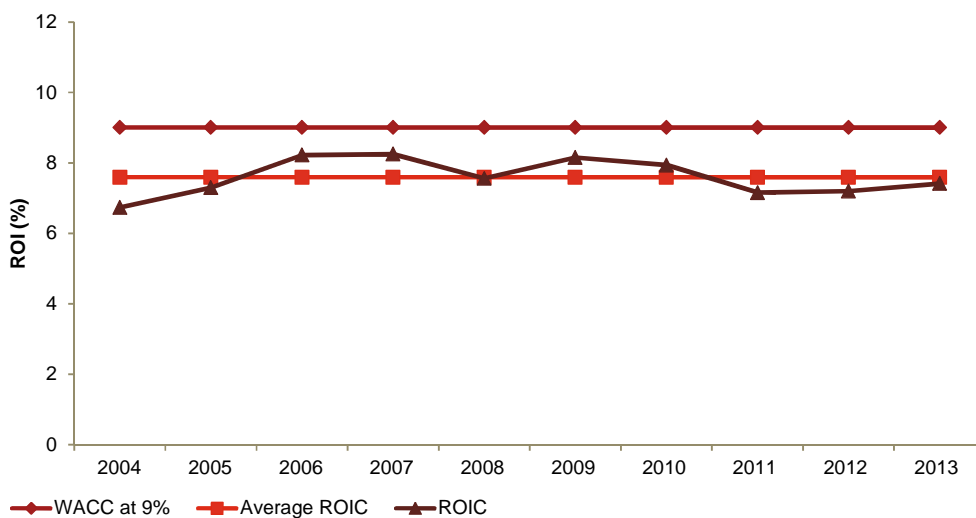
Senior leadership teams are paid to create value, not just control costs.

Lesson #3: The key to premium EBITDA multiples has been hiding in plain sight: delivering on the ROI that flows from economies of scale originally promised to investors. Welcome to capital value.

Our search to uncover the new levers of EBITDA multiples in the telecom industry reminded us of some basic truths: senior leadership teams are paid to create value, not just control costs. The predominant task of management is to take a considered view of the future, allocate capital towards strategies that maximise value for the providers of that capital, and manage the execution of those strategies through to the delivery of returns for those investors.

Hiding in plain sight was that most basic fact – in a capital-intensive industry like telecom, the key metric is return on capital, especially when that industry turns ex-growth. Revenue, EBITDA and cash are useful interim steps along the way, but the ultimate end-point is ROI. It's not a clever conclusion, but it's not the consensus conclusion either. Unfortunately, such basic principles have gotten buried in daily practices that shift focuses elsewhere. ROI is rarely more than a side note in most balanced scorecards and it shows: ROI performance in the telecom industry is not good (see figure 4).

Figure 4: Industry ROI



Note: WACC = Weighted Average Cost of Capital; ROIC = Return On Invested Capital.

Source: PwC analysis.

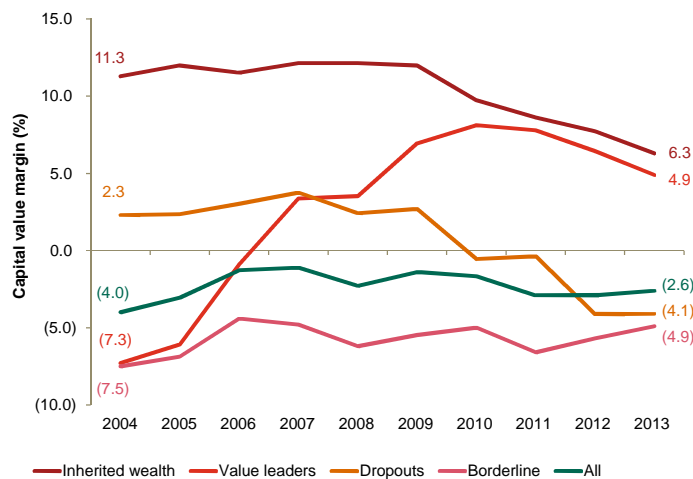
Real insights come from finding the outliers.

This global view provides helpful context, but the real insights come from finding the outliers. Here the data is surprising. In an industry beset by stagnant share prices and confusion about what really drives EBITDA multiples,

operators who consistently deliver a rate of return above the cost of capital consistently see premium EBITDA multiples, faster share price growth and superior investor returns (see figure 5).

Figure 5

Capital value margin by group



Cohort	Share price CAGR ⁵	Investor returns over cost ⁶	EV/EBBITDA (x)
Inherited Wealth ¹ telcos ¹	7.5%	1.2%	5.5x
Value leaders ⁴	9.6%	4.9%	7.0x
Dropouts ²	0.5%	(5.7)%	5.3x
Borderline ³ telcos ³	4.6%	(3.9)%	6.1x
All	4.9	(2.9)%	6.5%

Source: Captial IQ, PwC analysis.

Notes:

1. Operators with positive Capital Value for each of the last 10 years (from 2013)
2. Operators with 5 consecutive years (from 1999) of positive Capital Value followed by negative Capital Value for 2 years out of 2011, 2012, 2013
3. Operators with at least 1 year of negative capital Value in the last 10 years (rom 2013), without a consisitent upward trend
4. Operators which are not dropouts, which go from 5 years of negative Capital Value (from 1999) to sustained positive Capital Value up to 2013 (at least 3 years)
5. Taken from 2004-2013
6. Total shareholder returns – cost of equity (at 11%)

Paradigm shift in thinking

This is an important insight not just because it offers clarity, but also because it falls under management control. It sets out an agenda – already in place at progressive operators – that relegates EBITDA and cash in favour of capital returns, safe in the knowledge that investors reliably reward such behaviour with superior EBITDA multiples.

As simple as it may seem, this emerging best practice relies on a real paradigm shift in thinking. For too long, telecoms have been on auto-drive for much of their capex.

Departments assume if they had the money last year, they are going to get it again this year, under the premise of increasing traffic. But rarely do telecoms truly analyse that spending for its ROI or ask whether the investment should be made at all.

Delivering on the capex agenda is conceptually simple, but it is not easy to implement, and it puts pressure on execs to have better answers to tough questions

Executives are familiar with ‘product and pricing’ questions from analysts, but as the industry evolves, they should also expect some tough questions around the capex agenda such as:

- Which segments, products and price plans are driving ROI in each operational company (opco)? For example, what is the ROI for the unlimited package? Can management give an example of their commitment to ROI by cutting back on areas that underperform on the ROI agenda?
- Capital allocation to each opco can seem remarkably stable over time – how is the ROI spread expected to change over time and how does the capital allocation reflect that?
- The network is a ‘factory’ – what is the tonnage, the yield and the cost per GB/simultaneously attached user/etc. (as appropriate) for the main network elements?
- As a telecoms service mix changes, the impact on different network elements will also change – how is the asset mix changing? Are the new assets that are required reflected in the asset register so that they can be tracked?
- Are you reporting on product ROI each month? Do business unit leaders recognise how their customers and traffic drive asset additions? Can they manage ROI or is it just an allocation of network & IT costs?
- What weight does ROI have in the balanced scorecard of the senior leadership team?

Executives who can answer these questions will find themselves and their companies well on their way to implementing capex best practices. Their reward? An end to multiples envy by finding what has eluded them: higher EBITDA multiples and superior investor returns.

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