The future of M&A in telecom

McKinsey & Company's analysis of past telecom mergers and acquisitions provides new insights into where the industry is likely headed.

By Jean-Christophe Lebraud and Peter Karlströmer

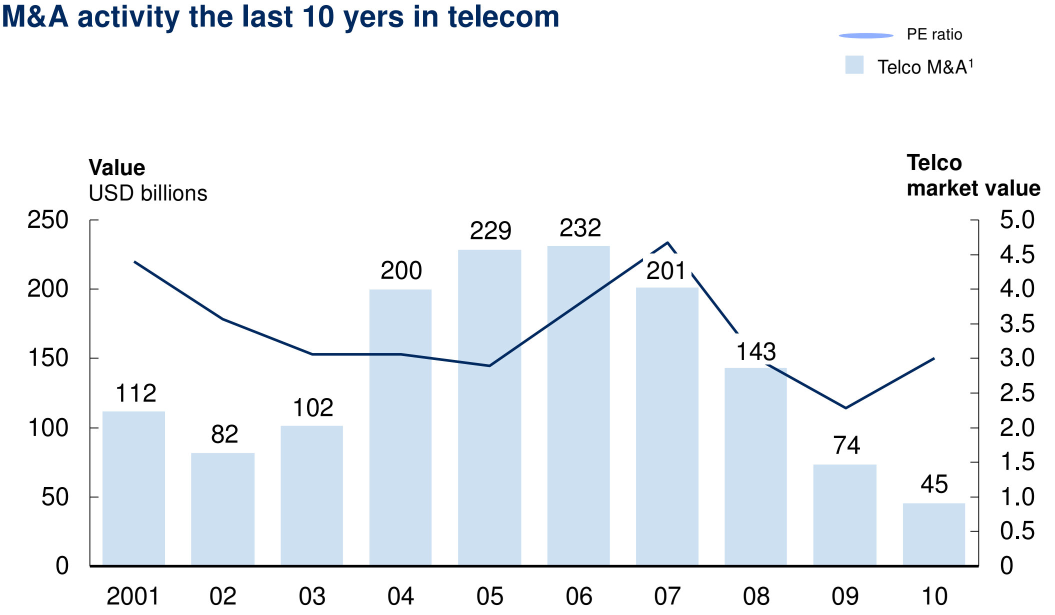
Mergers and acquisitions have been a mainstay of the telecom industry for many years. In the past decade, the telecom industry has spent an astounding USD 1.5 trillion on M&A activities, investments that have transformed the industry landscape into the competitive playing field we see today. However, the motivations behind the transactions have evolved over time, and we believe the industry is on the cusp of a new wave of M&A activity driven by some of the disruptions now taking place. To better understand this dynamic, McKinsey & Company has analyzed telecom deals over the past decade, and our findings uncover previously hidden insights about the deals themselves and the implications for the industry going forward. While these findings will likely make intuitive sense to telco professionals, many have nonetheless been surprised by the results.

LOOKING BACK TO SEE AHEAD

Telecom M&A activity over the past ten years reached a peak in the 2004-2007 period, triggered by a reduction in industry valuations (Exhibit 1)

EXHIBIT 1

M&A activity the last 10 yers in telecom



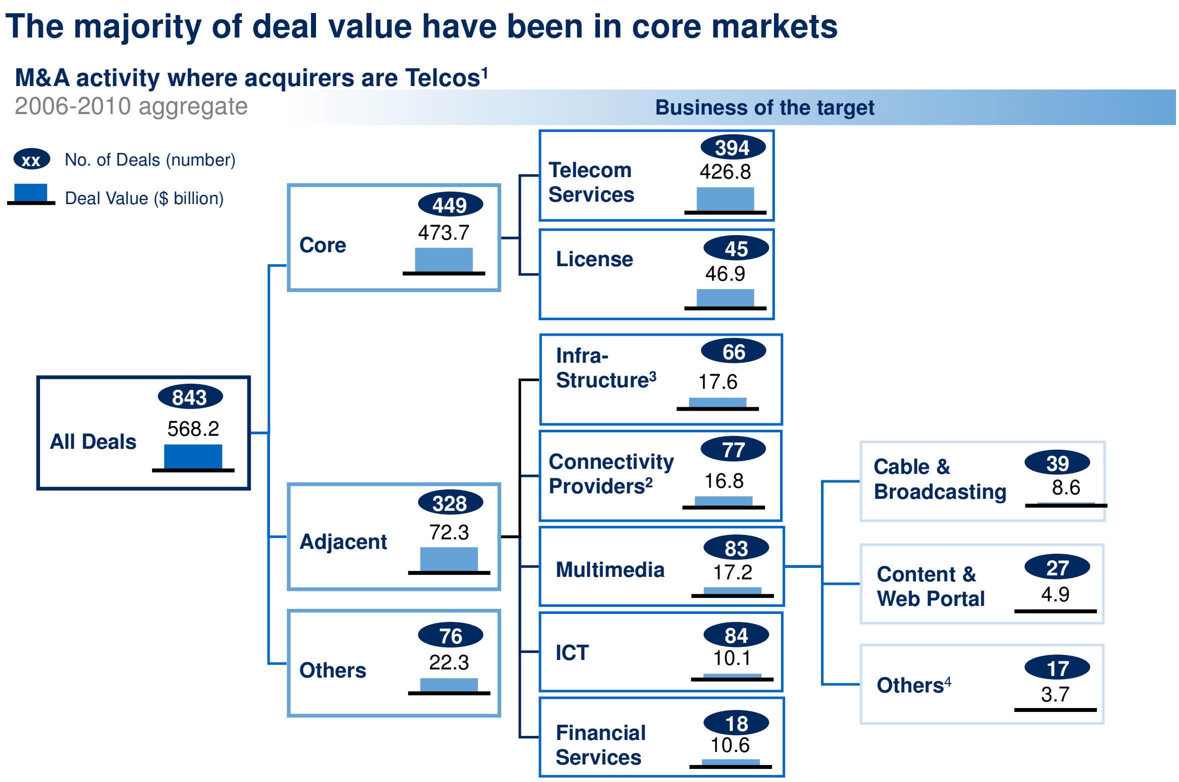
1 Based on completed deals where acquirers are telecom service players and which have disclosed deal values greater than USD 25 Mn; year as per announcement date

SOURCE: Dealogic

In value terms, the bulk of the deals from 2001 to 2006 took place in Europe and North American, with emerging markets generating less than a quarter of total activity in dollar terms. From 2007 to 2010, however, a profound shift occurred, with emerging market players pursuing deals much more aggressively. As a result, their share rose from the historical under-25 percent level to roughly half of all deals in value terms.

We also discovered that over 80 percent of aggregate deal value has focused on core telecom services and spectrum license market segments, with the remainder targeted toward adjacent markets such as infrastructure, connectivity providers, multimedia and financial services (Exhibit 2). As might be expected, core deals have overwhelmingly focused on telecom services, which comprised 90 percent of the total.

EXHIBIT 2



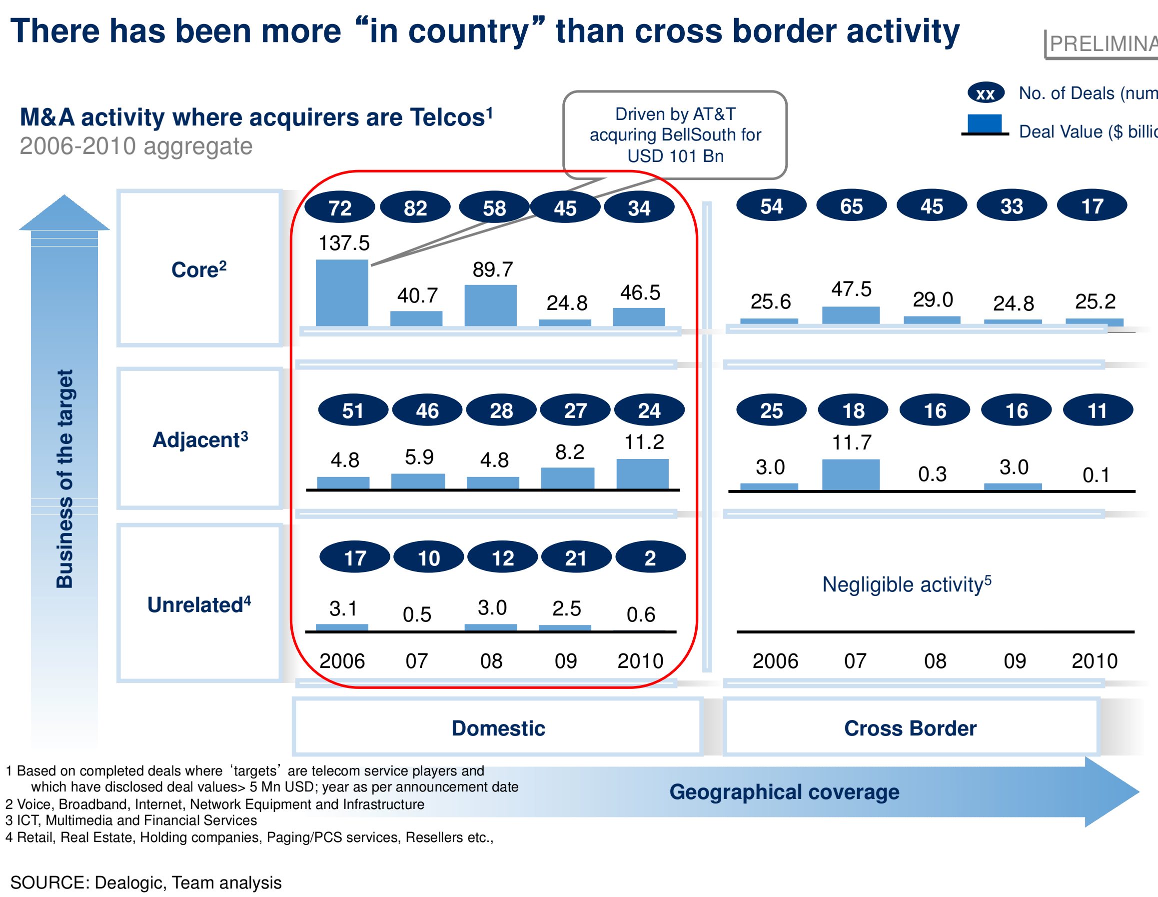
1 Based on completed deals where acquirers are telecom service players and which have disclosed deal values>USD 5 mn
2 Independent ISPs and broadband service providers 3 Network equipment & services 4 Advertising, Directory services, Entertainment etc.,

SOURCE: Dealogic, McKinsey Analysis

However, by analyzing how deals have evolved in the past 5 years in terms of number and type, we discovered significant changes in the nature of the transactions pursued in the industry.

First, while relatively stable in value, cross-border M&A deals in the core business area have steadily declined in number (Exhibit 3). Among several possible factors, slowing subscriber growth across the world might explain the reduced appetite for the kind of cross-border deal-making that allowed some of the larger European and Asian mobile operators to “buy into” emerging market growth early in the past decade.

EXHIBIT 3



Second, adjacent segment deals have steadily increased in value over the past 5 years, today accounting for roughly half of the number of deals made by operators (they do, however, on average remain smaller than core telecom deals). The blurring of formerly distinct value chains in the media, Internet, device and telecom sectors is likely compelling increasing numbers of telcos to explore growth outside of their core operations.

Finally, "in-country" deals continue to surpass cross-border M&As both in number and value. This preference highlights the value telecom players appear to place on their home markets, and perhaps indicates the increased comfort levels managers have concerning the capture of synergies in acquisitions that are close to home. The overall split between domestic and cross-border deals, which from 2006 to 2010 averaged 65/35, respectively, remained fairly stable during this period, even though fewer deals were struck during the latter years. Also, among regions, cross-border M&As have been dominant in Europe/the Middle East/Africa (EMEA) alone, while in the Americas and Asia/Pacific, these deals made up considerably smaller percentages of the total in terms of value.

FACTORS DRIVING THE FUTURE OF M&A

This rear-facing view can help leaders put telecom M&A trends into perspective and provide insights into what the future might hold regarding such deals. Based on these findings, we believe three fundamental drivers will determine the future of M&A in telecom:

1) The extent to which operators can gain scale benefits, and whether they can achieve these on a cross-border basis. A linked issue concerns whether large, locally focused operators—especially those in the US and China—will decide to go international.

Industry players are currently holding significant amounts of cash on the sidelines and ability to further increase debt financing (primarily those in the US and China), making the potential to engage in M&A deals substantial. Two groups of telecom players hold the largest pools of cash: Large international players and large local operators. On the other hand, historical analysis shows that improvements in capital productivity in the telecom sector diminish after revenues exceed approximately EUR 70 billion. With a number of key players already exceeding that threshold and others approaching it, the benefits of additional acquisitions will likely become less attractive for these companies, so it is not fully clear how the large operators will act during the next decade. We will likely see individual large operators taking fundamentally different stances on this.

2) The amount of in-country consolidation that regulators will allow. Recent industry actions suggest the in-country industry consolidation trend will accelerate, given the number of deals that have taken place in the past two years. Our research indicates that operators pursue in-country consolidation in order to improve their cost position through scale, achieve synergies and gain access to critical assets such as spectrum.

3) Operator decisions to expand aggressively in non-core areas. Our research shows that most telcos have already begun to move assertively into new areas in pursuit of profitable growth, and to resist the threat of players in adjacent value chains, such as Google, Apple and global IT service players. Some are adapting their core businesses to gain medium-term advantages; buying up retailers, business-to-business (B2B) service companies, and media players. Longer-term, they are moving into adjacent businesses, purchasing digital media, IT services and software players and the like, with an eye toward expanding into sectors that could, over time, become parts of their core business. In doing so, operators are building a broader portfolio of potential growth options. This implies a greater degree of risk as some of these options may not materialize, but the successful ones could ideally position operators in the long term IT, communications and media value chain.

Such moves bring their own challenges. Many of these sectors already feature a variety of global players and their inclusion will thus transform the competitive set that operators are used to battling— now a finite number of in-country peers—into what could become a wide-open free-for-all.

Furthermore, experience among operators that have acquired assets in adjacent spaces, whether B2B or B2C, highlights the difficulty of integrating players with starkly different business and operating models. The odds of the traditional telco business “stifling” acquired companies could be high if the integration and value creation plans have not been thought through well in advance.

Finally, expanding into new businesses will require leaders to change the traditional performance metrics used by telcos and their boards. In fact, while these adjacent companies perform less well on traditional telco metrics such as earnings before interest, taxes, depreciation and amortization (EBITDA) margins, they exhibit far higher returns on invested capital (ROIC) and growth, often making their total value creation capabilities greater than those of telcos.

The direction each of these factors takes will drive the telecom industry's future M&A intensity. A study of M&A deals in adjacent markets reveals that telcos currently acquire only small portions (often less than 1 percent) of the total deals available in financial services, IT services and media, and thus could be losing out to other players in positioning themselves to benefit from participating in these markets.

IMPLICATIONS FOR OPERATORS

While typically not a strategy in itself, M&A activity can help operators implement their corporate and country unit strategies more effectively. To align the M&A approach with their overall strategy over the next decade, leaders need to consider three courses of action.

First, they should develop answers to some fundamental strategic questions.

- **Is there still a case for cross-border telecom M&A?** The maturation of mobile markets in most geographies makes the traditional rationale of "buying" growth through cross-border M&A increasingly less compelling. That said, is there a rationale in benefiting from increased scale? And if so, when do scale benefits begin to diminish?

- **Can we improve our position domestically through M&A?** How extensively can we merge networks with competitors while retaining enough differentiation in the market? Can we possibly orchestrate full mergers in some countries? What steps must we take to reassure regulators regarding the long-term implications of any deal?

- **How far must we extend outside the core?** What are the future prospects and economics of our core business? How convincing is our "right to play" in adjacent markets given our assets and capabilities? Who big is our resulting need and opportunity to develop new businesses outside the core? How should we use M&A to succeed at scale in new areas?

Second, leaders should work to align their corporate strategy and M&A plans. We believe this will be more important than ever now, since many operators today are making significant shifts in their strategic direction and it will be important that their M&A goals are aligned to support the new overall strategic direction in a good way. This likely means that telco strategy and M&A functions need to have significant discussions and work closely together during the next several years.

Third, telecom players need to transform their M&A capabilities and ways of working to proactively pursue a wide breadth of opportunities that align with their strategic requirements. This could mean ensuring that the M&A team is set up correctly and has the right capabilities and capacity. Leaders should clarify their M&A approach, organization and the way they source deals globally, and work closely with investor relations to ensure they have the right story to tell the capital markets—especially if they aggressively pursue new adjacent areas that have different value creation profiles.

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The last two decades have been transformative for telecom players, moving the industry from primarily local to international and from fixed to mobile. These changes have in turn propelled the current multi-trillion dollar M&A flow, and we believe such deals will continue to play a significant role in shaping the industry going forward. Operators seeking to capture value from this activity need to think hard about any gaps in their strategy, capabilities and M&A set up, and understand the past for a glimpse of the future.

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