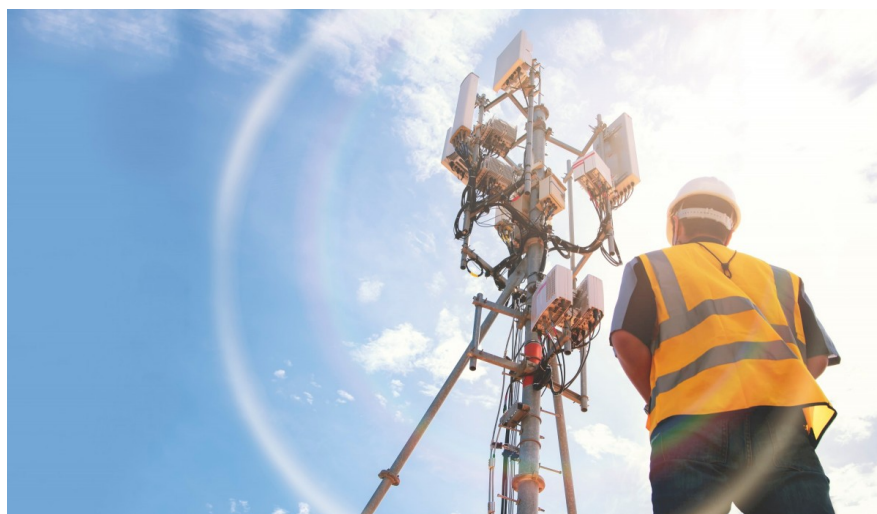


European telecom companies have been the underdog but prospects could be improving

After years of heavy pressure on revenues in the telecom sector, we make a call for near-term revenue stabilisation. From an operational perspective, the main themes for the telecom sector are the build-out of 5G and fibre networks. To improve the relative position of the sector regulators should review their measures to provide a more level playing field



Source: Shutterstock

War has a limited impact on the telecom sector

European- and US-based telecom operators are rather insulated from the conflict in Ukraine. Major operators have no sales in the region, the exception being VEON, which is largely exposed, since it is active in Russia and Ukraine. Telekom Austria had only 7.4% of its FY 2021 revenues coming from Belarus. For now, the impact of the war seems limited, with most companies maintaining their 2022 outlook.

Typically, demand for telecom services grows in line with GDP. If a severe recession would hit the global economy, telecom operators and handset vendors probably have to adjust revenue

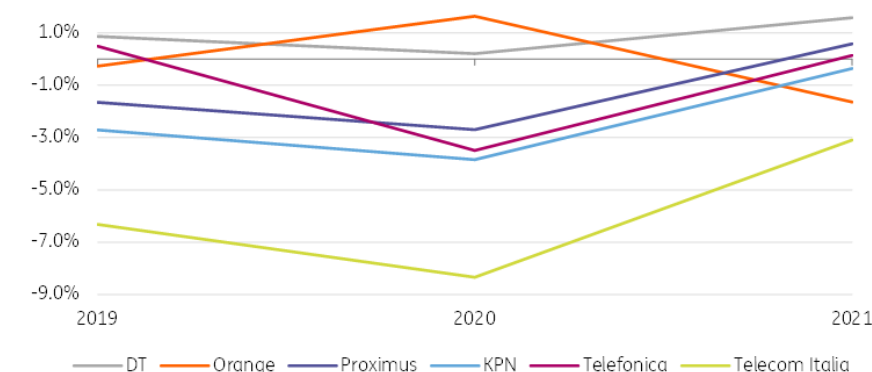
expectations in line with GDP expectations, on average. In Europe, however, service revenues have historically already been under pressure because of strong competition. We do not foresee a substantial impact on the financial solidity of companies resulting from this crisis.

The biggest risk for the sector comes from cyberwarfare

The biggest risk for the sector comes from cyberwarfare. State sponsored hackers could engage at some point in cyberwarfare, something the US government warns about. Hackers could try to impair (local) infrastructure, while telecom companies have to up their defenses. Interestingly, so far, we have seen limited impact from cyberwarfare that could possibly have been initiated as a part of the war in Ukraine.

However, we are starting to see revenue stabilisation in a couple of markets. For example, the market leaders in the Dutch, French, Belgian and German markets are close to revenue stabilisation. This is mainly driven by new broadband products, which are often offered with mobile services in a bundled product. Restructuring programmes continue to modernise the back-office of the operators and to phase out legacy technologies. Once programmes are over, this could be a tailwind for profitability. Despite good traction from bundled products and new high ARPU fibre products, many incumbents have segments that see price pressure, often in the business segments. This explains why we see positive trends in the sector, while revenues are not showing strong positive growth rates.

Domestic revenue trends European telecom operators



Source: Company, ING

Aiming for a level playing field

The European Commission aims for gigabit broadband for all households as well as for a fast 5G mobile connection in populated areas, which should be reached by 2030. It also aims to rein in some large technology companies. It has published proposals for the Digital Services Act (DSA) and the Digital Markets Act (DMA) which should reduce the dominance of the large technology platforms and create a level playing field with other sectors in Europe. The EU member states and European Parliament said they welcome the proposals. These are now subject to formal approval by the two co-legislators before they will be applicable. Hopefully, the competitive position of telecom companies will improve as well at some point in the future.

Competition has been promoted... and this has lowered prices for telecom services as well

Regulation has seriously impaired the profitability of telecom companies through tariff measures (for broadband wholesale access and roaming tariffs). Competition has been promoted, with four mobile operators in many European countries. This has lowered prices for telecom services as well. Governments have raised a lot of money through spectrum auctions and often incentivised new operators entering the market. Finally, product differentiation has been difficult because of net neutrality regulations. As a consequence, free cash flow has been under pressure from both weaker revenues, as well as heavy investments and dividends.

A case in point is Telecom Italia, which had a solid investment grade rating in 2005, but is now rated in high yield territory. The Italian market is characterised by heavy competition, while the company explains that its fixed network faces relatively high regulatory pressure from a multitude of measures. The company faces substantial pressure on revenues, as can be seen in the figure above. The interim result is that the company is investigating a break-up, having ramifications for the speed of the broadband roll-out in Italy. The downward pressure on credit ratings has been more widespread in the European telecom sector since most companies have already seen rating downgrades. This is illustrated in the table below.

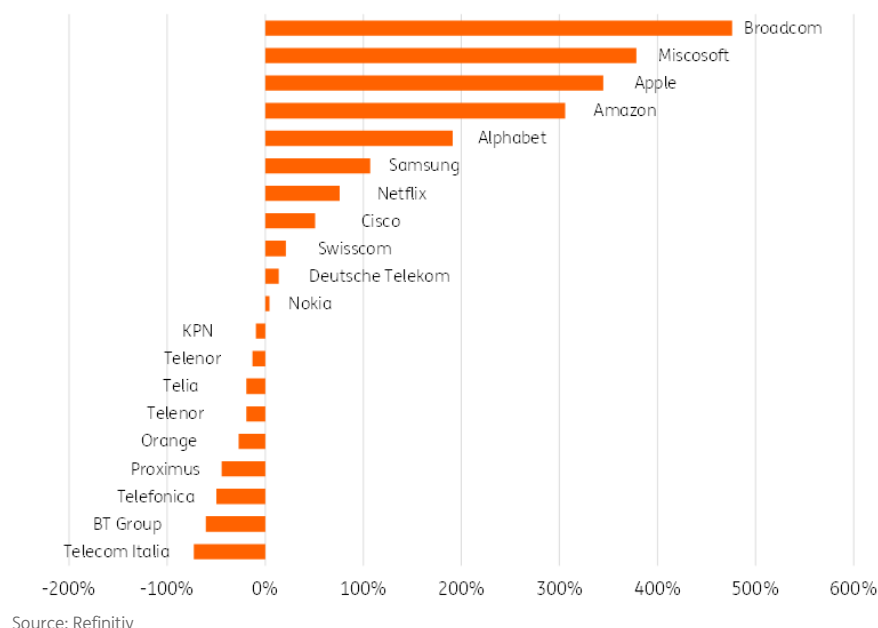
Downward rating pressure for European telecom operators

Company	31 Dec 2005	18 May 2022
Deutsche Telekom	A-	BBB
Vodafone	A+	BBB
KPN	A-	BBB
Telecom Italia	BBB+	BB-
Telefonica	A-	BBB-
Telenor	A-	A-
Telia	A-	BBB+
Orange	A-	BBB+
British Telecom	A-	BBB

Source: S&P

As a result, telecom companies have been at the wrong spot in the value chain, while companies that sell telecom equipment, media content or cloud storage have performed very well, as is shown in the figure below. While large technology companies have the means to invest in new (transatlantic) fibre networks, incumbents often can't fund all of their network investments from their cash flows. In our opinion regulators should pay attention to a call by the European Telecom Network Organisation (ETNO) in which they ask for a fair contribution for the network investment costs from companies that extensively use broadband networks.

Since 2015, unregulated firms did profit from internet with market cap. growth



Sector trends contribute to revenue stability

Nevertheless, broadband connectivity will likely improve across Europe and 5G is here to stay. The private sector is investing heavily, but there are also plans to invest €13bn in digital connectivity as part of the European Resilience and Recovery Plan. Typically, customer retention is relatively healthy for fibre products, especially when combined in a fixed-mobile converged offer. Net mobile networks and services could also contribute to the goal of revenue stability and eventually growing revenues. This year, 5G products and services will likely become widespread. However, it will be key for mobile operators to find good pricing policies for these new 5G services.

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