Rise of The Network Company:

Creating Value through Structural Separation of Network Infrastructure

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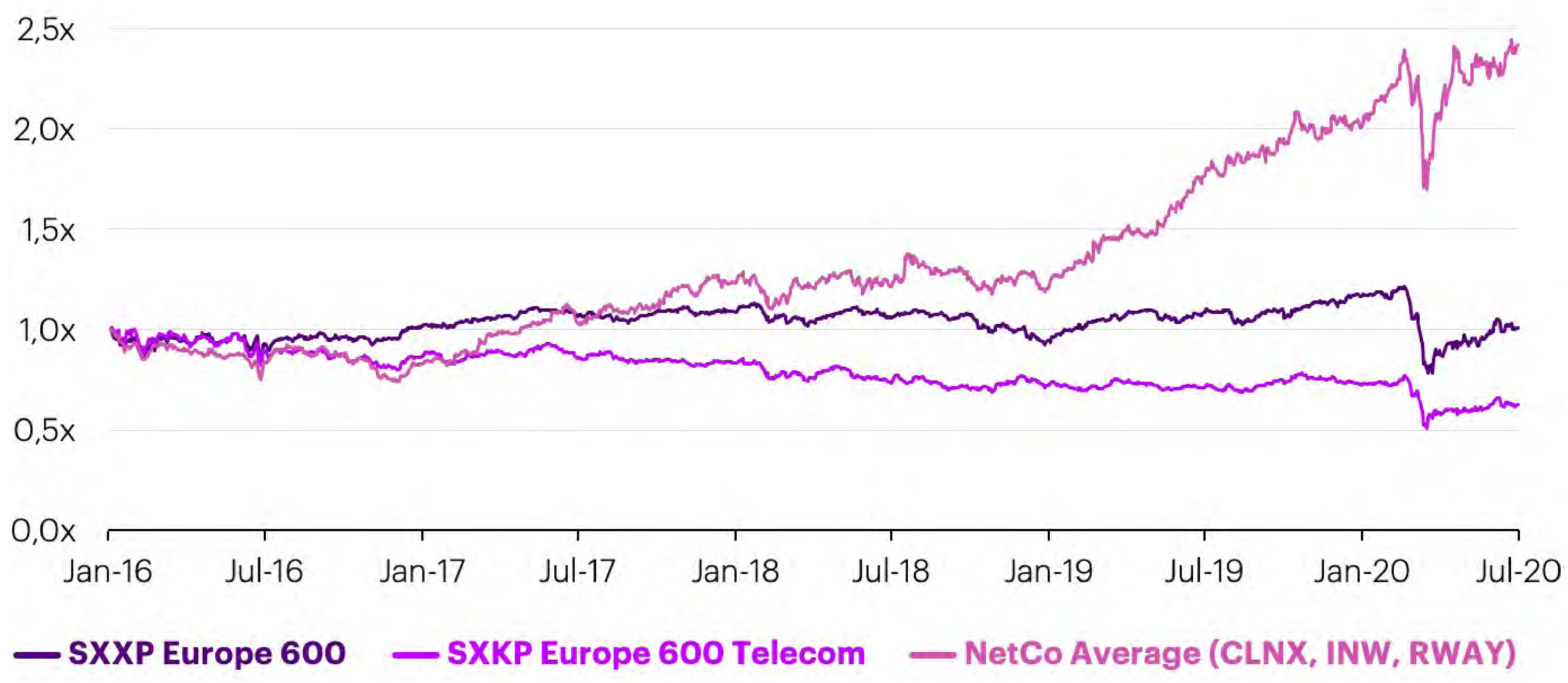
Not so long ago, suggesting to a fixed incumbent, cable company, or mobile operator in Europe that they should spin off their network access arm might have received responses ranging from skepticism to outrage. Why would they wish to shed a key source of competitive advantage? But fast forward a few years, and structural separation is an idea that Communications Service Providers (CSPs) are willing to consider. Some are already taking action.

So what has changed?

Over the past five years, CSPs have underperformed the wider European market by approximately 40 percent[1]. Increased capital intensity, highly-leveraged balance sheets and low asset returns from significant investments in network modernization have depressed shareholder returns, while low growth in consumer businesses has exacerbated CSPs' financial strain. Network companies, on the other hand, are achieving four times the shareholder returns that CSPs are generating – enabled by a streamlined risk profile, consistent demand, and stable asset returns[2].

Total shareholder returns – Telco vs Market vs NetCo (% rebased 100 = Jan 2016)



Source: S&P Global Capital IQ, S&P Global Market Intelligence, Accenture Analysis

[1, 2] S&P Global Capital IQ, S&P Global Market Intelligence, Accenture Analysis

The result is that the enterprise values of CSPs are now less than the sum of their individual parts. Finding new ways to unlock value is imperative. And while the financial drivers forcing CSPs to contemplate some form of structural separation are powerful, they are not the only reason. There are also strategic considerations that make separation a viable play. For example, the emergence of 5G and new network innovations call for a “connected industry orchestrator” that can serve as a platform and exchange for others to innovate new services such as edge compute or security. Today, that’s a role that integrated CSPs simply don’t have the management capacity or focus to bring about.

A conversation that would have been infrequent just a few years ago is now very much a live dialogue in the industry. Structural separation into a network company and customer-facing services business offers an opportunity to create value for the communications industry. It also creates a new asset class for institutional investors – one that can deliver consistent returns.

However, buying into the possibilities for network separation should not mask the fact that separation is a highly complex undertaking. It's a disruptive and difficult change to make. Doing so successfully requires focused and disciplined execution. Those that can make the pivot, however, can reap substantial benefits.

To maximize the chances of success, CSPs must consider three questions:

1

Why separate?

2

How to separate?

3

How to execute?

Why separate: Reasons to believe

The decision to structurally separate and its ramifications is a major undertaking. CEOs and CFOs must make sure that the evidence for their choice is compelling. The precise reasons to contemplate separation will vary from business to business. However, Accenture analysis suggests that there are several financial, operational and strategic drivers that all leaders need to consider.

Financial

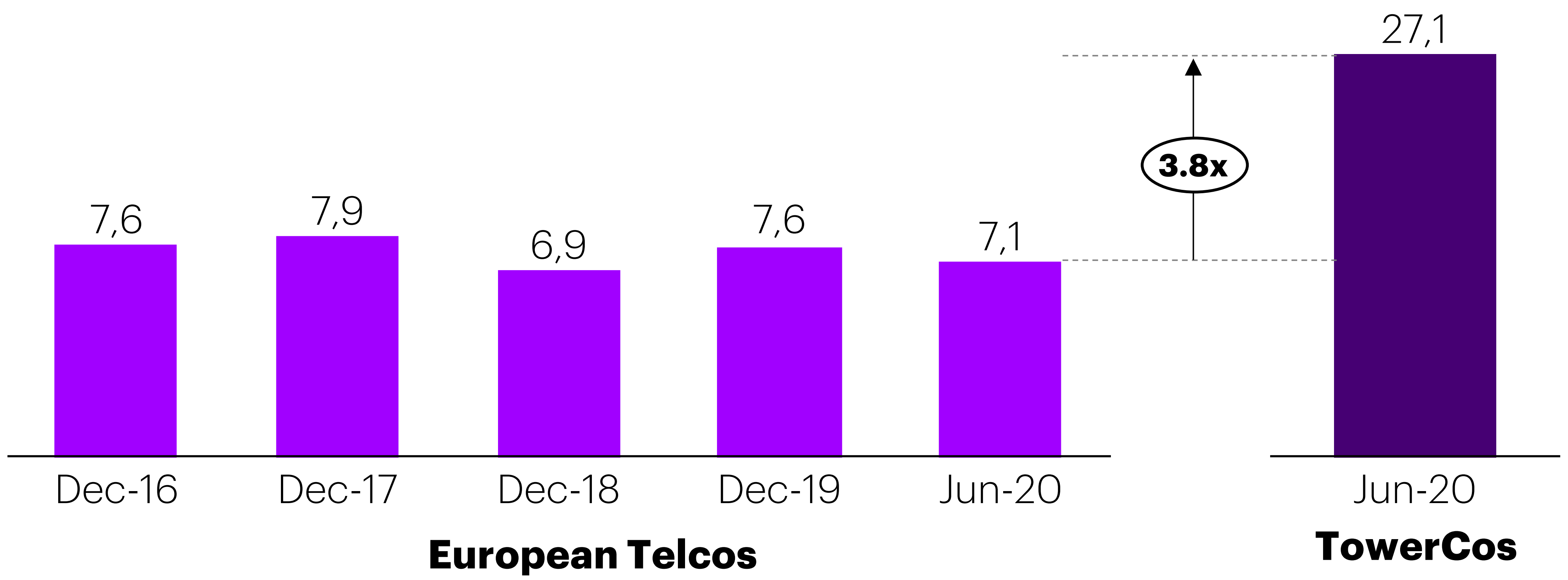
Over the past five years, European CSPs have seen margin pressures, high leverage, rising cost of capital and declining return on invested capital (ROIC).

Margin pressures: Pressure on margins has arisen from several converging forces. These include changes in customer behavior, regulatory directives on price, and the need to invest in fiber and 5G technologies. Finding new ways to fund both the core business and pivot to new growth has been a persistent challenge.

Rising cost of capital: The cost of capital for an integrated CSP is higher than for a network company. For example, analysts estimate one European CSP's cost of capital at 7.6 percent, while the network company that it spun out has a considerably lower rate estimated at 4.9 percent. That difference is critical at a time when CSPs are having to make significant investments in infrastructure. What’s more, the creation of a network company offers investors a new asset class at a time when there is a clear appetite for infrastructure investment opportunities.

Reducing leverage and increasing valuation: CSPs are also under pressure to improve their balance sheets due to high leverage from network investments. And as they contemplate separation of their networks, CSPs also need to bear in mind the significantly higher valuation multiples that pure-play infrastructure companies attract. Tower companies, for example, are commanding average multiples of over 27x earnings before interest, taxes, depreciation, and amortization (EBITDA) versus 7x for large European CSPs.[3]

Valuation multiples – Large European Telcos vs TowerCos (June 2020) (EV/EBITDA)



Source: S&P Global Capital IQ, Accenture Analysis

[3] Bloomberg Intelligence Report, January 2020, European Telecoms' Shifting Tower Strategy, S&P Global Capital IQ, S&P Global Market Intelligence, Accenture Analysis

Operational

In addition to the considerable financial benefits of separation, simplifying the traditional CSP business model can also generate strategic advantages, not least of which is the ability to focus on distinct core capabilities. Additional benefits of more focused management include better budgeting for multi-speed architectures, enhanced ability to identify and serve customer needs and greater agility.

A higher degree of focus also means that separate service and network companies are able to identify opportunities for efficiency, system and process improvements that can have a material impact on costs. For example, following the separation of O2 Czech Republic from its infrastructure unit (now called CETIN), O2 refocused efforts on reducing operating costs through the simplification of processes, products and internal and external communications, and to replacements and upgrades to key IT systems. This saw its EBITDA margin (between 2015 and 2019) grow from 27.1 to 32.6 percent.[4]

What's more, a dedicated services company can also focus its energies on enhancing its customer proposition, maximizing the performance of its sales, marketing and customer service.

[4] O2 Czech Republic Annual Reports, Accenture Analysis

Strategic

Combined with management's ability to focus solely on driving operational excellence and running a lean infrastructure business, the resulting capital efficiency can be repurposed to focus on new revenue streams. The monetization strategy pursued will vary according to the type of business (fixed versus mobile versus converged), customer focus (B2C retail versus B2B versus wholesale), and investment horizon (mid versus long term). But there are clear opportunities available for all.

Wholesale and wider-market access:
A true open access separation allows network companies to look beyond their former parent carrier and out into the wholesale market. This possibility is strongest for mobile and cable, where vertically integrated CSPs have previously discouraged wholesale or sharing.

For example, while Telecom Italia were INWIT's main customer following separation, INWIT also had long-term contracts with other national MNOs in Italy for the provision of hosting services, and with other radio service operators.[5] The revenues from these enabled the business to fund new growth opportunities.

Tower leasing: Leasing space on existing towers is another potential source of new revenue, as it is far less capital intensive for an operator to mount a small cell on a third-party's tower than build a tower of its own. This is an appealing proposition for CSPs looking to reduce incremental costs of a new solution and leverage needed assets without jeopardizing cashflow.

Future 5G opportunities: Future deployment choices taken with 5G also create many potential new sources of revenue. The precision of 5G networks will enable, for example, value-added services for private networks including security, tiered speed offerings, and specialist service networks such as super-low latency used in algorithmic trading.

[5] INWIT SpA Annual Report 2015

The integration of 5G into other networks could also enable new value-creating collaborations. CSPs and other infrastructure providers could jointly build a shared network platform, pooling capabilities to enable efficient running of the underlying network and create interesting 5G use cases on the back of this. Partnering with existing cloud providers to build a network platform for CSPs to co-create network services might be one example. This would see consolidation and outsourcing of network engineering, deployment, and operations for the 5G portion of the network.

Network optimization services, complemented by analytics to drive market-led price discovery, will also gain momentum to drive incremental return on investment (ROI). Shared services will be key to accelerating ROI and reducing cost and risk around 5G. This type of approach would dramatically change the economics of running core networks, while creating the opportunity for vertical industry plays or value-added networks (VANs) such as AgriNet, HealthNet, and UtilitiesNet that target customers with an end-to-end solution.[6]

All these 'reasons to believe' can support CSPs' decisions about whether to undertake structural separation. Once decided, the next step is to carefully evaluate separation options.

[6] Accenture Research

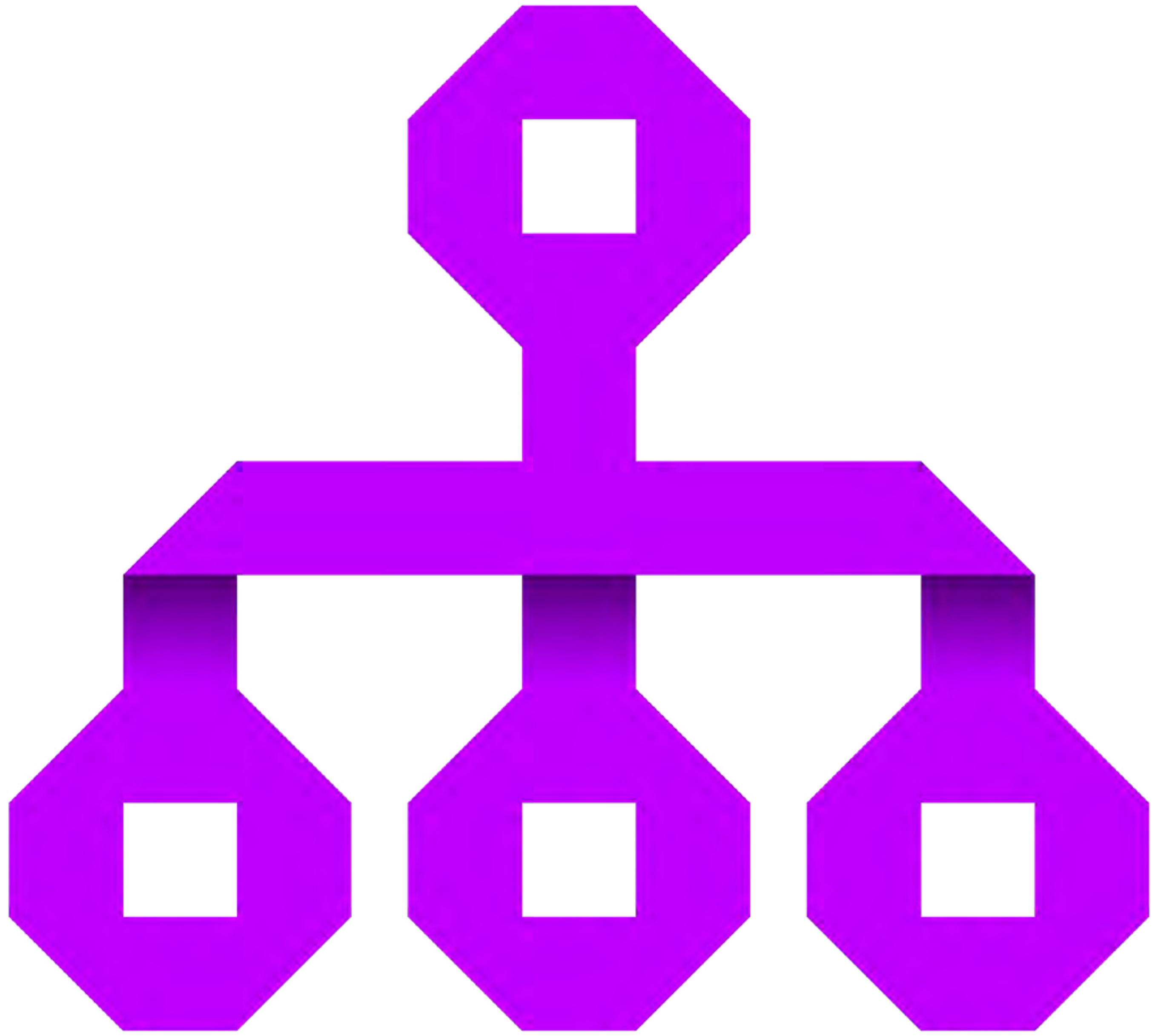
How: The options for separation

The decision to separate a network business, while complex, is just the start. Deciding precisely how to deliver separation requires the same detailed analysis. The priority is to determine the network company's remit. That choice presents several options, including:

Asset-holding companies, designed to bring in outside capital but retain as much control as possible (e.g. sale of towers)

Operational asset companies, involving asset transfers and some operational responsibilities, with the aim of both raising external capital and gaining the benefits of shared operations (e.g. tower sharing joint ventures (JVs) such as MBNL)

Independent network companies, in which assets, processes, ownership rights and therefore rewards are transferred. The network company is able to decide its capital envelope, dividend policy and fund-raising, working with the service company on an arms-length basis. They can operate as an independent network player such as CityFibre in the UK.



Ownership structure and design

CSPs also need to decide on the ownership structure and design of the new entity. Typically, we see three main routes, largely driven by the degree of control over assets and strategic roadmaps that services companies wish to retain:

1. **Legal separation**
   (new legal entity but same ownership)
2. **Joint venture**
   (new legal entity but shared ownership)
3. **Full divestment**
   (ownership sold to another independent entity).

Deciding which of these is the right path will depend on a careful examination of strategic fit and ease of execution.[7]

[7] Accenture Research

		STRATEGIC FIT					EASE OF EXECUTION		
CSP CONSIDERATIONS	**OVERALL DECISIONING**	**CONTROL**		**DRIVERS OF SHAREHOLDER RETURNS**			**COMPLEXITY**		
		Ownership Ownership of assets based on long-term strategy	**Management focus** Greater management attention for a more focused core business	**Access to capital** Access to external capital through expectation of returns	**Future revenue streams** Greater potential to monetize standalone assets	**Return on capital** Cost and capital efficiencies leading to improved ROIC	**Separation process** Indicative time and effort needed to progress from separation decision to Day One	**Technology** Level of complexity (e.g. modular, integrated, etc.)	**People** Complexity of people transfer
FULLY OWNED SEPARATE LEGAL ENTITY	**Preferred option** as the ownership remains with the CSP – increasingly attracting outside investment.	**High:** ServCo maintains control over NetCo, and thereby ensures ultimate control over agreements (e.g. asset leaseback costs).	**High:** Separation enables respective management focus in ServCo and NetCo on their discreet core capabilities.	**Medium:** Separation creates a low risk asset-holding business which is attractive to institutional investors seeking stable long-term returns. Lower risk investment opportunity leads to reduced cost of capital.	**High:** Improved operational efficiency and better access to capital unlocks the funds required to enable NetCo to focus on new growth opportunities.	**Medium:** Higher ROIC driven by high growth, cost efficiencies, and improved capital efficiency due to focus on monetization of assets	**Medium:** Reduced need to engage with third parties enables less lengthy separation period. Future ambition to wholesale may introduce new technology/ operational requirements to engage and manage new customers.	**Medium-high:** Limited redeployment of technology and systems as still owned by ServCo. Current technology roadmaps still aligned to overall objectives.	**Medium:** Limited re-organization effort as transfer of employees to a new entity can often be dealt with via contract novation within same group company.
JOINT VENTURE (JV) / ALLIANCE	**Becoming prominent** as CSPs combine their network infrastructures to de-leverage as well as unlock valuation.	**Medium:** Shared control; terms guided by joint decision making among JV partners.	**Medium:** Largely depends on the type of partner (e.g. institutional infrastructure investors can bring management expertise, while financial investors may focus purely on investment returns).	**High:** NetCo focus on infrastructure attracts long-term JV investors such as private equity, pension funds, and infrastructure funds. Predictable future cash flows reduce cost of capital.	**High:** As with legal separation, investments and results may vary depending upon the ambition of the JV partner.	**Medium/High:** As with Legal Separation; however, investments and results may vary depending upon the ambition of the JV partner	**High:** Need to account for additional time to secure a JV partner. Additional measures needed for data protection/migration and separation of IT infrastructure with depending on the involvement of JV partner (strategic versus financial).	**Medium-high:** Requires some effort to map capability gaps. Assessment of network compatibility required if JV partner is contributing network assets.	**Medium-high:** Limited re-organization effort, however, it is critical to map out key management and operational positions from both partners. Potential impact on number and types of roles depending on the type of JV.
FULLY DIVESTED	**Less adopted** due to loss of control, however seen in certain instances within Europe (e.g. during market exits).	**Low:** ServCo has no control of the divested entity and therefore loses operational control and flexibility. Contractual terms depend on going-in agreement; may change in future based on decision by new owners.	**Not applicable:** Largely depends on the buyer; greater focus if the buyer is an infrastructure provider (vs operator). No ServCo management control, therefore limited/ no impact on future strategy of NetCo.	**Not applicable:** Future financing strategies are dependent on the new owner – access to capital is easier if the owner is also a pure network infrastructure provider.	**Not applicable:** Capturing new revenue streams is dependent on the new owner – easier to capture if the owner is also a network infrastructure provider.	**High:** Deleverages ServCo's balance sheet and provides immediate cash inflow – typically at higher valuations vs. core assets	**High:** Lengthy, involving search of a buyer – timing of carve out/ divestment (i.e. parallel, sequential) extend timelines. Additional measures needed for separation of IT infrastructure. Requires full remapping of capabilities and identification of new systems per buyer needs and structure.	**High:** Significant efforts required to separate IT and network systems. Full capability mapping with the buyer required (i.e. back end versus front end).	**High:** Identification of relevant people to be transferred; decision on key management positions. Defining key roles and skills that need to be filled.

Execution: Minimize risk, maximize success

Depending on the approach and chosen structure, separation will involve addressing different degrees of complexity across functions. CSPs that have achieved significant benefits from network separation typically outperform on a wide range of factors including successful management of business continuity and potential risks.

Asset selection

Before starting the process of separation, it is critical to define which assets will be separated. That requires a careful analysis of both quantitative and qualitative factors to achieve the greatest value for both parties.

Transition versus build decision

CSPs need to decide whether to transition existing systems to the network company or start afresh. The former is likely to be cheaper and simpler, but legacy technology debt may weigh on future performance. Building from scratch will cost more and take longer. But a future-proof "greenfield" stack may support future revenue streams more effectively.

Overcoming complexity

Making an effective transition also depends on how well a CSPs is able to manage the separation of IT systems, processes, their workforce, and customers. That should mean setting up a modular service organization in both the services company and the network company to be able to appropriately govern services management (whether receiving or provisioning).

IT systems and processes

Different systems present varying degrees of complexity when it comes to separation. While operational systems are primarily within the core network infrastructure, integrated enterprise systems sit across the whole organisation, making them harder to disentangle. Many systems and processes are delivered by third parties and will require significant effort to document or redevelop. But that's also an opportunity to build a leaner and more efficient new structure within the new network company and introduce improvements via automation.

People and culture

The network company will require new financial and administrative roles. However, the extent to which these back-office functions need to be duplicated depends on the relationship with the services company. Many could be delivered as a service to the network company. But what must be created anew is the right culture and mindset among the new workforce – that's fundamental to success.

Customers

To ensure business continuity during separation, it is critical to monitor the impact on existing and potential customers during transition. While functions such as sales, marketing, and customer service typically stay in the customer-facing service business, other relevant areas of support such as trouble ticketing processes must be maintained to effectively minimize any disruption to customers.

Contract definitions

An activity not to be underestimated during separation is the inventory, negotiation, and clean-up of commercial contracts both between the service and network company and with external parties. For example, securing key commercial contracts with the service company from the outset gives clarity on secured revenues (MSAs) and future commitments to support operations (TSAs and SLAs), and minimizes the risks of separation.

Similarly, separation provide the opportunity to re-evaluate contracts with external parties (e.g. materials suppliers, ground or rooftop leases with landowners, etc.). Firms that can identify exactly what services are being separated (versus those retained) can maximize benefits from separation (e.g. by re-assessing procurement strategy and maximizing value from existing and new contracts).

Clean-ups

In addition, carve-outs typically leave service companies with technology and data migration issues that lead to unexpected costs. Identifying the specific clean-up activities (e.g. data migration, defining when TSAs will phase out, etc.) early maximizes the chances of a clean separation, eliminates stranded costs and avoids non-compliance with legal and regulatory guidelines.

The way ahead

CSPs face the dual challenge of reversing the decline in growth and return on invested capital as well as freeing-up capital to make investments in fiber and 5G. For fixed networks, the business case for providing a single FTTP network in a given area is clear, but the execution very complex. For mobile, potential value comes from increased market share enabled by wholesaling to gain volume that will be reflected in spectrum purchases and network build. With the recent acceleration in CSP hybrid cloud adoption, the network edge becomes a critical control point and as such this also becomes a critical factor to consider whilst evaluating the case for structural separation. In either case, network separation executed carefully can realize incremental value for CSPs looking to invest in long-term growth opportunities. Now is the time to act.

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