BUNDLING WINS: THE CASE FOR CABLE + MOBILE INTEGRATION

MICHAEL HENRICH & MARTIN WEISS, JULY 2011

Does it make sense for European broadband cable and mobile telecommunications players to integrate? We think so: this is a powerful strategy for defying fully integrated incumbents going quadruple-play. It also allows the players involved to realize significant revenue and cost synergies, which may exceed the stand-alone operational free cash flow of the cable player. In order to succeed, mobile players should drive the integration process. They are the larger parties and many private-equity backed cable players will become available for mergers over the next years.

The pros and cons of cable and mobile players integrating have been intensely discussed over the past few years. So far, the skeptics have prevailed. They argue that mobile players operate in national markets while cable operators operate in regional markets, that there is a big cultural divide between both hard to bridge, and that integration would be long and painful, eating away at any potential benefits. And finally, the skeptics ask, if it is such a great idea, why isn’t it happening?

The skeptics are wrong: such integration is happening. In France, SFR took over Neuf Cegetel in 2008; and, in Croatia, Telekom Austria bought B.Net in June 2011 to merge the cable operator with its mobile operator VIPnet. In our opinion, more cable + mobile mergers will happen.
STRONG STRATEGIC RATIONALE: POSITIONING FOR THE 4-PLAY MARKET

There are strong strategic arguments for mobile and cable players merging.

- **Defying the incumbent**: incumbents increasingly go 4-play, which forces both cable and mobile operators to broaden the range of products they offer through strategic partnerships. For example, in France, after France Telecom combined its 4-play services under the Orange brand, SFR took over Neuf Cegetel, and Numericable signed an MVNO deal. Today, the French market is experiencing 4-play competition in full swing.

- **Adapting to saturated market economics**: broadband markets are reaching saturation across Europe, and market growth is slowing. Two variables are driving cable and mobile economics: churn rates and SACs (subscriber acquisition costs). Examples from Virgin Media and TDC show that subscribers to 4-play offers show less than halve the churn of customers using only triple play services (see graph 1). Another advantage of joining forces is to create a larger customer base for cross-selling, thereby reducing subscriber acquisition cost. Moreover, existing mobile players’ retail presence can also be used for selling cable services. Vodafone successfully demonstrated this in Germany when it began selling the Arcor DSL service in its high-street retail premises.

GRAPH 1

![Graph showing churn levels among subscribers to different product bundles](image-url)

Source: J.P. Morgan Cazenove 2011, Solon
Meeting 4G capital requirements: setting up 4G networks requires high levels of investment. The stability of the cable players and their ability to generate cash can support smaller mobile players to meet these capital requirements.

FINANCIAL IMPACT: DOUBLING THE STAND-ALONE CASH FLOW CONTRIBUTION OF CABLE ASSETS

European cable operators have a strong financial profile. They operate at a strong EBITDA margin of 40-50 percent with Capex requirements decreasing to well below 20 percent of revenues (average 2010 sector figures). That leaves operating free cash flow at about 55 percent of EBITDA (see graph 2 top). Recent trade sales (such as the takeover of cable operator KabelBW and Aster by Liberty) and IPOs (like Kabel Deutschland) clearly show the attractiveness of cable assets on a stand-alone basis.

GRAPH 2

Cash profile of the average European cable operator

$m\text{€}$, based on average figures 2010 and ~1m homes connected

- Revenue: 360
- Opex: 205
- EBITDA: 155
- Capex: 70
- OpFCF: 85

Avg. EBITDA margin: -43%

Avg. OpFCF / EBITDA: -55%

Development (CAGR 2008-2010)

+8% to +15%

+15% to +30%

+20% to +50%

OpFCF impact:

- ~5-20% of stand-alone cable revenues
- ~15-25% of stand-alone cable Opex
- ~10-30% of stand-alone cable Capex

Cash profile of merged cable operator including synergies

$m\text{€}$, based on average figures 2010 and ~1m homes connected

Revenue: 360
Opex: 205
EBITDA: 155
Capex: 70
OpFCF: 85

OpFCF impact:

- ~15-25% of stand-alone cable revenues
- ~10-30% of stand-alone cable Opex
- ~31-51

OpFCF impact:

- ~141-239

1.6x to 2.7x stand-alone cable OpFCF

OpFCF impact:

- ~66-144

OpFCF impact:

- ~18-72
Even so, cable operators could be even stronger if they merged with mobile players. The synergies that can be tapped into are:

- **Revenues**: 4-play offerings create a competitive edge and reduce churn rates; cross selling to the new combined customer base, and additional sales channels of the new partner.
- **Opex**: marketing budgets can be reduced with joint branding and multi-product promotions; and central departments can be streamlined.
- **Capex**: Savings due to combined backbone and mobile backhaul infrastructure.

Solon estimates show that, with fully realized synergies, the cash contribution of a cable operator merged into a mobile operator can more than double (see graph 2 bottom).

**OPERATIONS: INCENTIVES ARE KEY TO SUCCESSFUL CROSS-SELLING**

Attempts to cross-sell mobile voice services to cable players’ customer bases have shown remarkably varied success. Successful cable operators reach mobile voice penetration among their broadband subscribers of up to 40 percent (Aster) or even 82 percent (Virgin Media) while other companies show penetration rates of below one percent for mobile services (for example, UPC and Kabel Deutschland).

Virgin Media’s penetration rate demonstrates the strong potential of cross selling when the cable player’s offering is taken from 3- to 4-play. However, the evidence also highlights the importance of margin incentives for the selling operators. The outperforming companies all sell their mobile offers at estimated margins of over 50% vs. a 20-30 percent margin at the less successful operators. Cross-selling only works if it has a meaningful impact on the selling operator’s bottom-line. Obviously, this is much easier to achieve if mobile and cable players merge.

**INVESTMENT CONSIDERATIONS FOR A CABLE + MOBILE INTEGRATION**

If aiming for a cable and mobile integration, three points should be considered.

- **Cable consolidation**: mobile operators have a national footprint, and consideration needs to be given to how a regional cable player can be integrated into a national business model. A relatively high degree of cable consolidation is, therefore, a key element of a successful merger. This also means that there are extra benefits in consolidating cable for current cable investors as mobile operators pose a very good exit option.

- **Proof of concept in 3-play**: for the new player to successfully sell a 4-play offering, the cable operator should have demonstrated his ability of bundling and selling 3-
play products. It would be unwise to push 4-play in a market where consumers have not yet been developed into 3-play customers.

- **Mobile should be the driver**: the mobile part of the business will dominate the P&L of the combined entity. Consequently, the mobile player is the natural partner to drive the merger. Moreover, the integration solves mobile operators’ needs to defy the incumbent and generate the necessary cash flow for investing in 4G networks. And finally, many of the European cable players are backed by private equity and therefore will become more readily available while mobile players are mostly integrated into international corporations.

We expect to see further cases of cable + mobile integration in Western European as well as in CEE markets over the next five years. From an industry logic perspective, there is a clear business case.

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