

ZOOMING, STREAMING - TELECOMS IN THE PLAGUED YEAR

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impact on the sector

2021

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THE YEAR SO FAR...

SHARE PRICES HAVE REMAINED RELATIVELY RESILIENT

The telecoms sector tends to be pro-cyclical, moving in line with the market, but the pattern has been a little different during the pandemic.

As seen in the figure below:

- Both the general and telecoms indices dropped in response to the COVID-19 crisis, but the fall in telecoms stocks was less sharp; and
- At the time of writing, while the general market index seems to have largely recovered, the telecoms index is not quite there yet.

EXEC SUMMARY

We have now lived a year of this impossibly drawn-out pandemic, a year in which terms such as “N95” and “PCR” have become woefully well understood.

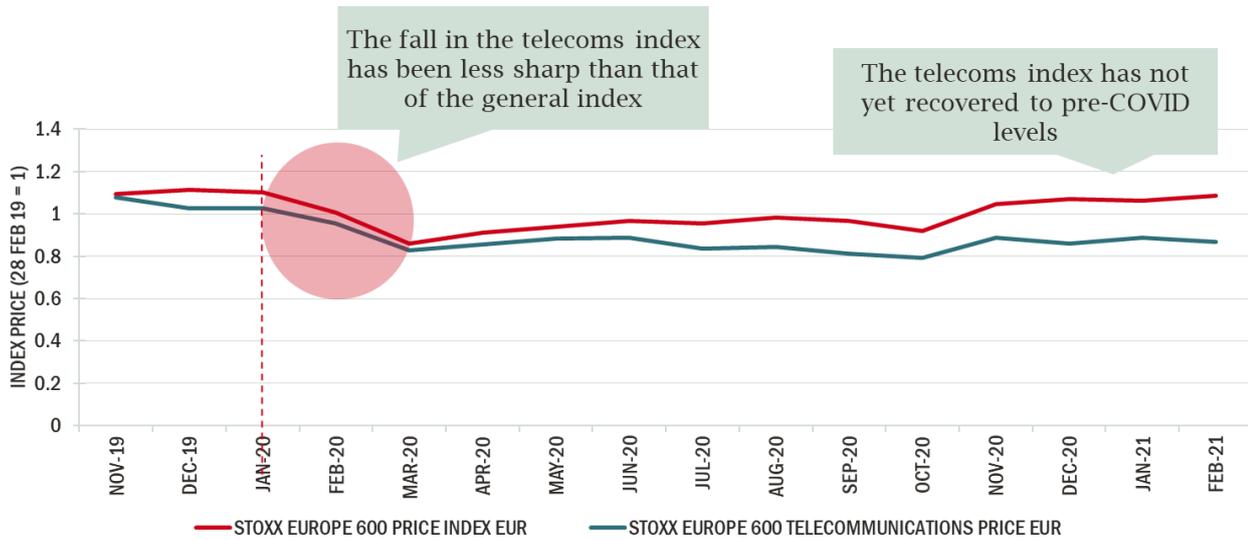
At the start of the crisis, there was significant uncertainty as to how different parts of the economy would respond. With regards to telecoms, we hypothesised that while the sector’s performance had historically been closely correlated with that of the wider economy, this time might be different.

In particular, we conjectured that in the short term:

- Social distancing and work-from-home requirements could increase dependence on telecoms services, making some operator revenues less sensitive to changes in GDP;
- Some revenue streams, though, would be under particular pressure, e.g. those from international roaming and enterprise/business revenues; and
- There might be less customer switching.

While it is still too early to judge the full impact of the pandemic, we comb some of the data available for operators in Europe to get a sense of trends in the last year.

FIGURE 1 IMPACT OF THE COVID-19 CRISIS ON STOCK PRICES TO DATE



Source: Bloomberg

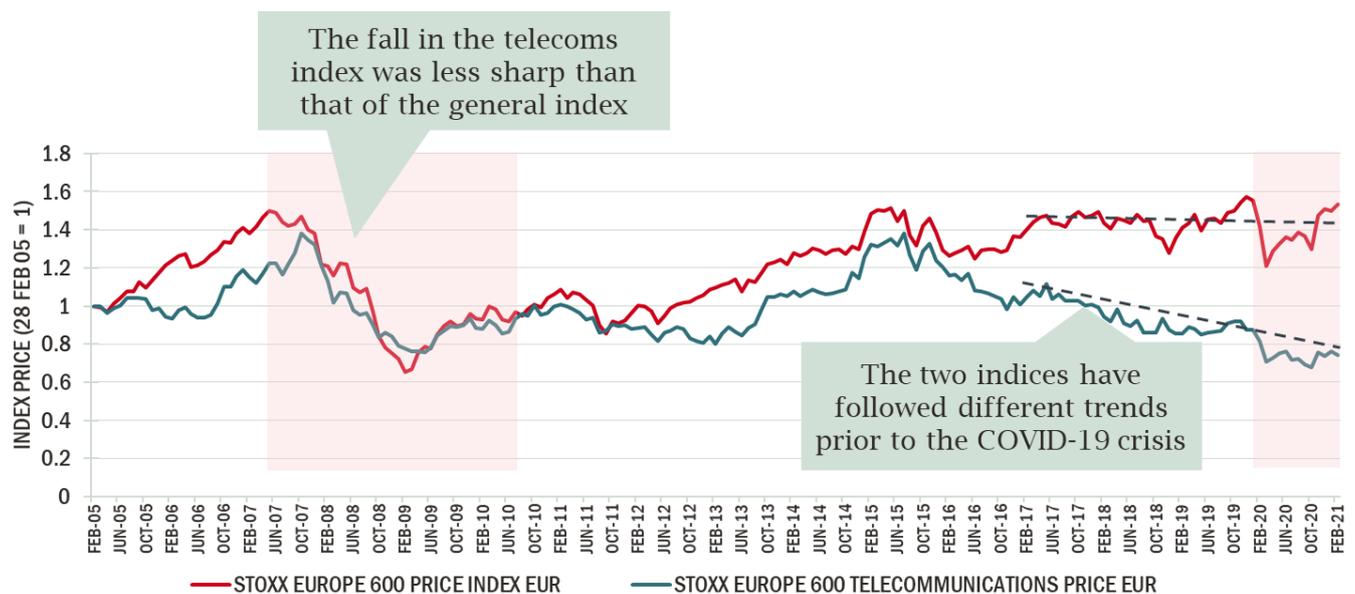
Note: The STOXX Europe 600 index covers 600 large, mid- and small- sized companies among 17 European countries, including the UK, France, Germany, and Spain. The STOXX Europe 600 Telecommunications index captures those companies for which telecommunications is the primary source of revenue

A comparison with the 2007-2009 global financial crisis (GFC) sheds light on both the relative severity of the pandemic for telecoms stocks and how things might develop.

As the chart below shows, during the GFC as well as in the COVID-19 crisis, the telecoms index did not fall as steeply as the overall market in the immediate aftermath of the crisis.

While telecoms stocks climbed back broadly in line with the market during the GFC, the recovery now seems to be slower. The divergence might be a reflection of differing trends pre-COVID: the broader market had generally been trending less downwards than the telecoms index.

FIGURE 2 IMPACT OF SEVERE ECONOMIC SHOCKS ON EUROPEAN TELECOMS STOCKS



Source: Bloomberg

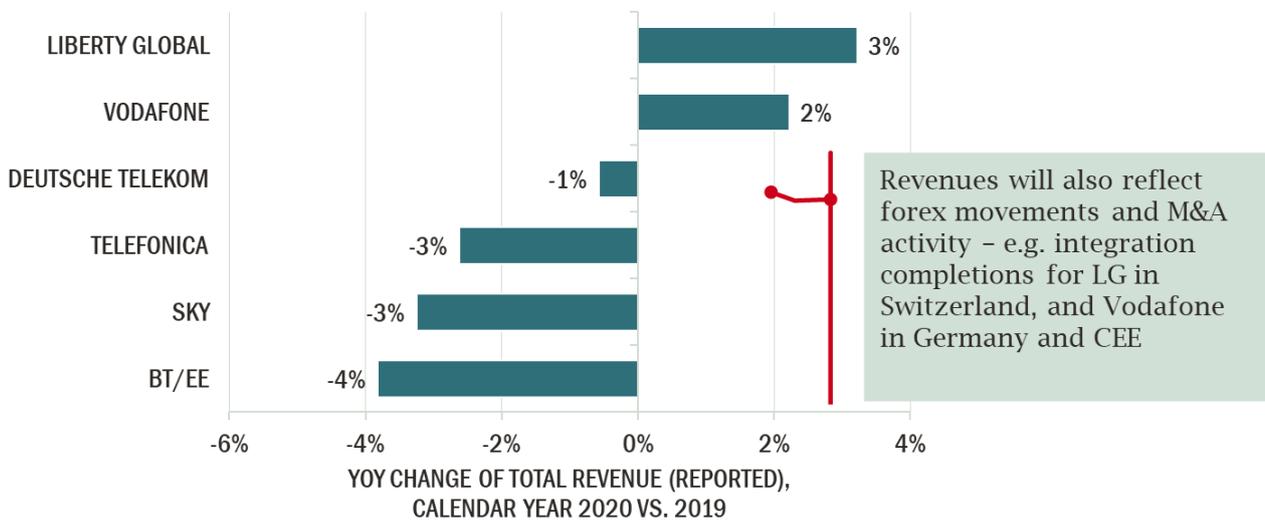
Note: The STOXX Europe 600 index covers 600 large, mid- and small- sized companies among 17 European countries, including the UK, France, Germany, and Spain. The STOXX Europe 600 Telecommunications index captures those companies for which telecommunications is the primary source of revenue

It is too soon to assess the full impact of the pandemic, but it does not seem to have strongly amplified the downward trend of telecoms stocks.

A MIXED PICTURE ON REVENUES, WITH THE EFFECT OF COVID-19 HARD TO ISOLATE

In looking at group-level revenue changes in 2020, we see a combination of small rises and declines on a year-on-year basis. The increases are owed to some degree to merger and acquisition activity in the preceding year.

FIGURE 3 CHANGE IN TOTAL REVENUE 2020 VS 2019 – EUROPEAN OPERATIONS



Source: Company financial reports

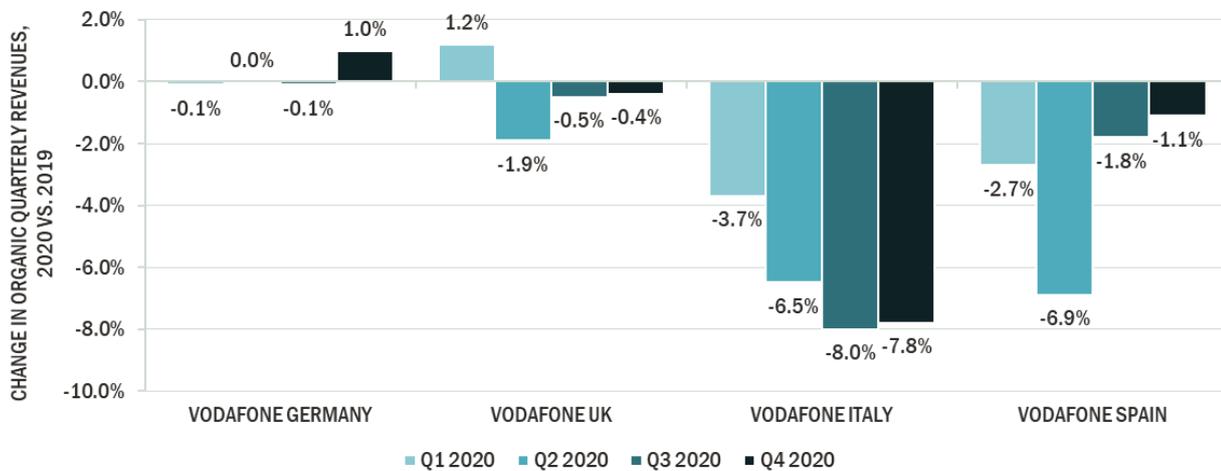
Note: Revenues calculated for calendar year 2020 based on total revenues reported. Revenues can therefore include consumer, business and wholesale segments depending on the entity's range of operations. Liberty Global values refer to its "Revenue as reported" category of total revenue. Vodafone values refer to its "Europe" revenues. Deutsche Telekom values refer to revenues from its "Germany" and "Other Europe" segments. Telefonica values refer to revenues from its Spain, Germany and UK segments. Sky values refer to its "Total Sky" revenues. BT/EE values refer to revenues from its "Customer", "Enterprise" and "Openreach" segments.

Some operators report changes in organic/rebased revenue to control for the effects of M&A and foreign exchange movements. This measure could therefore give a better sense of the impact of COVID-19 on total revenue.

Liberty Global reported a decline in rebased revenues of 1.5%. The effect on organic revenues has generally been negative for Vodafone and Telefonica, too, as shown below.

Interestingly, for both Vodafone and Telefonica the revenue impact of the pandemic in Germany does not appear to have been as severe as in other countries. This could be indicative of Germany having weathered the crisis better, at least initially: it has had fewer fatalities per million than other countries in the comparator set. Furthermore, the IMF estimates the decline in real GDP in 2020 to have been around 5% in Germany but closer to 10% in Italy, the UK and Spain.

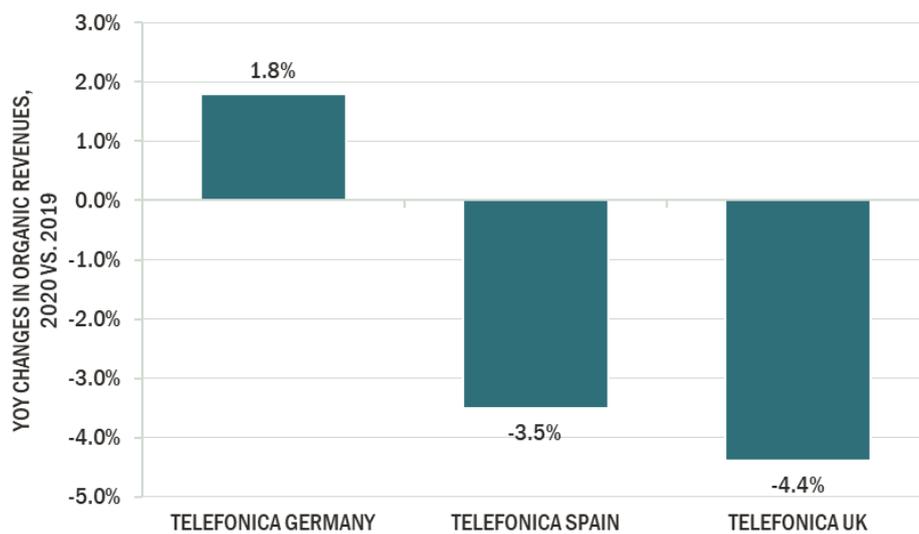
FIGURE 4 QUARTERLY CHANGE IN ORGANIC REVENUE FOR VODAFONE, 2020



Source: Vodafone financial reports

Note: Vodafone states that organic growth presents performance on a comparable basis in terms of merger and acquisition activity and movements in foreign exchange rates

FIGURE 5 Y-O-Y CHANGES IN ORGANIC REVENUE FOR TELEFONICA, 2020 VS 2019



Source: Telefonica financial results

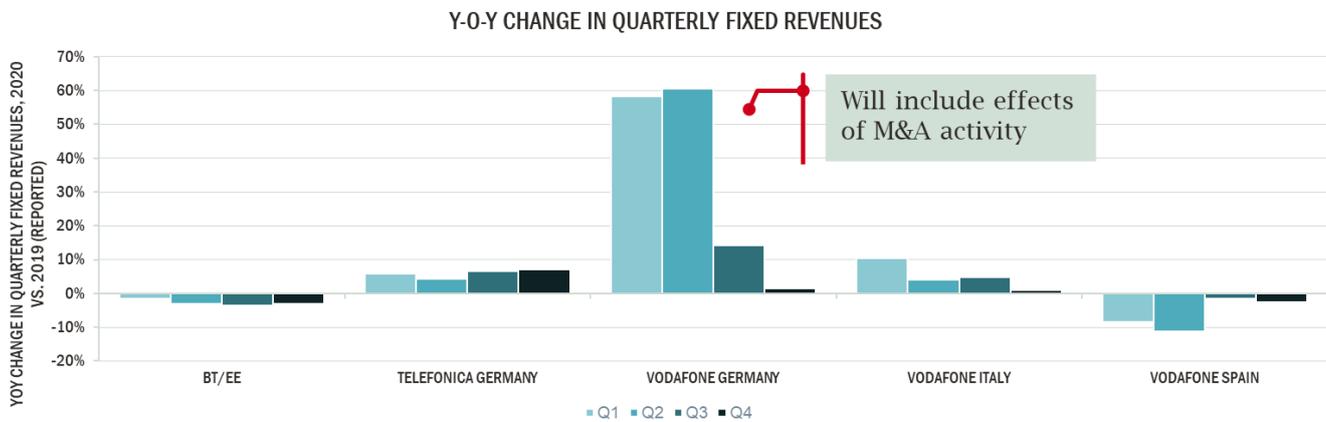
Note: "Organic" for Telefonica assumes constant exchange rates of 2019 (average in 2019). Considers constant perimeter of consolidation, does not include capital gains/losses from the sale of companies and assets sales (material), restructuring costs and other impacts (write-offs, material non-recurring impacts). In addition, excludes contribution to growth from T. Argentina and T. Venezuela and the results from Central America. CapEx excludes investments in spectrum.

FIXED AND MOBILE REVENUE CHANGES TELL THE STORY OF CUSTOMER USAGE

The changes in revenues for these European operators differ by segment. While we cannot isolate the effect of COVID-19, they appear to move in line with how one might expect customers to have altered their behaviour during the pandemic.

Fixed revenues seem generally to have been higher in 2020 than in 2019. As can be seen below, the year-on-year change for any quarter in 2020 was mostly positive on average. This would be consistent with a view that usage of fixed telecoms was higher during the pandemic, with people relying more on home broadband for both work and entertainment.

FIGURE 6 FIXED REVENUES – YEAR-ON-YEAR CHANGE, BY QUARTER



[Germany] **Growth in fixed-network business**, driven largely by **broadband revenue growth** of 5.7 % and a 2.3 % rise in revenue from variable call charges, offset declining revenues in mobile communications business. *(Emphasis added)*
 - Deutsche Telekom, “The 2020 financial year”



During 2020, we added 242,000 broadband subscribers, and the fourth quarter saw both Virgin Media and UPC Switzerland achieve their **best broadband adds** since 2017. *(Emphasis added)*
 - Liberty Global, Full Year 2020 Results, Press Release



[Germany] Fixed service revenue grew by 1.4%* (Q2: +0.6%*), **driven by customer base growth and ARPU accretive customer upgrades to higher-speed plans**, supported by **higher variable usage** during the pandemic lockdown. *(Emphasis added)*
 - Vodafone Group Plc, Q3 FY21 trading update

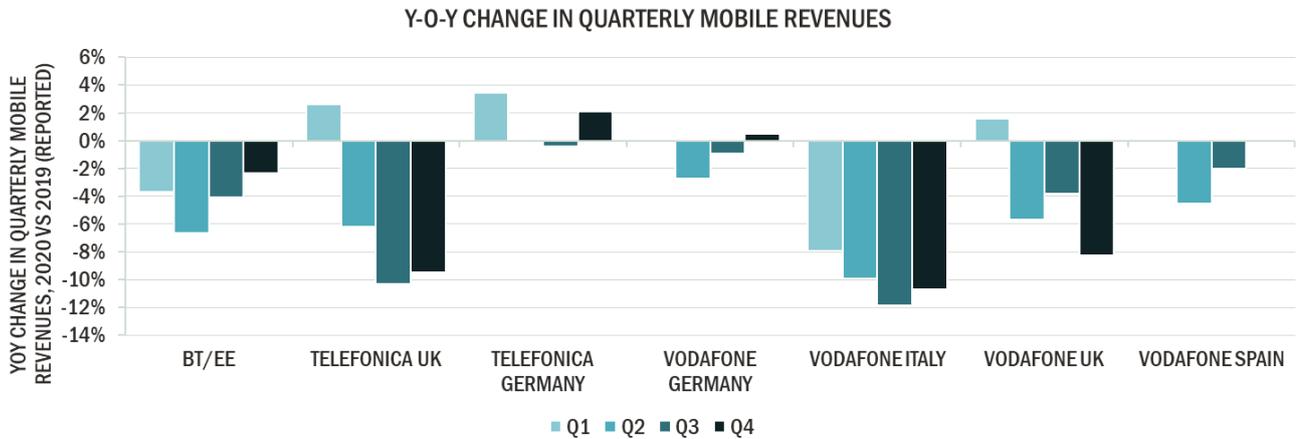
Source: Company financial reports

Note: The data above may not be on a like-for-like basis across companies - we have simply taken stated revenues. BT/EE refer to “Fixed” revenue for Consumer, “Fixed” revenue for Enterprise and Openreach “Total” revenue. Telefonica values refer to “Fixed Business” revenues. Vodafone values refer to “Fixed Service revenue.”

Some operators did see a decline in fixed revenues though. In the case of BT/EE, for example, this appears to have been due in part to declines in both legacy calls and lines, as well as enterprise and revenues. A fall in revenues from premium sports content also affected BT/EE, as well as Liberty Global, as consumers reduced their spending and pubs and clubs had to shut down. The scaling back of sports more generally because of COVID restrictions also had an impact.

Mobile revenues have been broadly lower in 2020 than in 2019 as a result of a fall in international roaming and delays to handset launches.

FIGURE 7 MOBILE REVENUES – YEAR-ON-YEAR CHANGE, BY QUARTER



[Customer] Mobile business declined by 1.1% **primarily due to lower revenues from mobile terminal equipment business**. In addition, negative trends in roaming and visitor revenues in consequence of the coronavirus pandemic had an impact. *(Emphasis added)*
 - Deutsche Telekom, “The 2020 financial year”



[UK] Revenues declined [...] driven by reduced roaming revenues and other COVID impacts [...] together with the release phasing of new handsets *(Emphasis added)*
 - Telefonica Results, January-September 2020

Source: Company financial reports

Note: The data above may not on a like-for-like basis across companies - we have simply taken stated revenues. BT/EE values refer to Consumer revenues for “Mobile” and “Equipment” (where equipment revenues will include both handsets as well as TV set-top boxes) and Enterprise revenues for “Mobile”. Telefonica values refer to “Mobile revenues”, which include Handset revenues. Vodafone values refer to “Mobile Service Revenue”

SOME SIGNS THAT CUSTOMERS WERE SHOPPING AROUND LESS

Among operators that report this measure, churn in any given quarter was generally lower in 2020 than in 2019.

FIGURE 8 YEAR-ON-YEAR CHANGES IN QUARTERLY CHURN

YEAR-ON-YEAR CHANGE		Q1	Q2	Q3	Q4
Telefonica UK	Total mobile	↓	↑	↓	↓
Telefonica Spain	Convergent customers	↓	↓	↓	↓
Telefonica Germany	Total mobile	↑	↑	↓	↓
Vodafone UK	Total mobile	↑	↑	↑	↑
Vodafone Spain	Total mobile	↓	↓	↑	↑
Vodafone Germany	Total mobile	↓	↓	↓	↓
Vodafone Italy	Total mobile	↑	↓	↓	↓
BT/EE	Post-paid mobile	↔	↓	↓	↓
BT/EE	Broadband	N/A	↓	↓	↔

Source: Company financial reports



We saw substantial churn reduction across all of our markets and achieved a record low at Virgin Media.

- Liberty Global, Full Year 2020 Results, Press Release



Telefónica Deutschland achieved solid financial results in a COVID-19 environment in Q3 20, with trading dynamics recovering to close to pre-pandemic levels and churn reaching historically low levels.

- Telefonica Results, January-September 2020

In Spain, the reduction in churn was probably influenced to some extent by a government-imposed temporary hold on number portability rules. For the other countries, it is difficult to control for general promotional or retention campaigns. However, it seems likely that the pandemic will have somewhat dampened the propensity to switch, because:

- Stores were closed during lockdown; and
- Mobile connectivity was less important because people were more confined to their homes.

While there is less information on broadband churn, it seems plausible that this too declined in 2020. Fixed connectivity has been critical during the pandemic, so customers may have wanted to avoid the risk of service interruption during a switch.

WHAT CAN WE EXPECT IN THE FUTURE?

The pandemic has not yet been contained, so it's premature to make a definitive assessment of the fall-out on the telecoms sector. As set out above, we have at least some insight into the impact on stock prices, revenues and churn. But we may need to wait a while longer to see if/how investment and the nature of retail competition are affected. We set out some initial thoughts below.

INVESTMENTS – SPEED UP OR SLOW DOWN?

There has been a strong push towards 5G and fibre roll-out in the last few years. The pace of deployment has been dictated by a combination of government targets, investment appetite and consumer demand.

The pandemic complicates matters:

- Investment appetite may be dampened by a fall in revenues/profit and the general economic downturn. Capital expenditure timelines could be pushed back;
- Consumer demand for faster, more resilient networks could have increased, given that some people may choose to continue working from home even after the pandemic is over.

It may be too soon to tell which of these factors will predominate. This is something to keep an eye on.

RETAIL COMPETITION – MOVING FAST OR SLOW INTO A NEW WORLD?

In recent years, speed and data allowances have become the most important elements in any fixed or mobile offering (remember SMS...?). At the same time, providers have tried to differentiate their services effectively. For instance, mobile operators:

- Design various combinations of speeds/data allowances to cater to different customer needs – so-called tiered offerings;
- Bundle their offers, either with fixed services, be it broadband alone or broadband with TV (referred to as “converged bundles”), or subscription services such as Spotify or Amazon Prime;
- Leverage different channels – some have a network of stores, others a leaner online-only operation.

Post-pandemic, customer needs may diverge further, with some demanding higher speeds and data allowances while others look to pare back spending. In such an environment, tiered offerings will remain an important price differentiation tool.

The inclusion of subscription services could become more attractive to customers in the wake of the crisis. Given that over-the-top (OTT) entertainment, streamed via the internet, has become more popular as people have had to stay home, the opportunity for a discount on such services may be welcomed.

The closure of retail stores because of lockdown serves as a good natural experiment to assess their importance as a channel for customers (mainly for mobile, as most fixed broadband sales take place online). It could be that we see some further rationalisations of store estates in the coming years.

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