tefficient

Industry analysis #1 2015

Decoupled, non-binding, unsubsidised:

Increase loyalty. Increase revenue. Reduce SAC/SRC. Is the combo possible?

This analysis gathers and presents subscriber acquisition cost (SAC) and subscriber retention cost (SRC) for 34 mobile operators in 17 mature markets worldwide.

But since a mobile operator on average uses 15-20% of service revenue on SAC and SRC, we didn't stop there. Instead, we analysed the success of the operators who – in order to reduce SAC/SRC and improve margin – are challenging the mature market norm of binding contracts with coupled, subsidised, equipment.

Is it possible to increase customer loyalty and revenue while reducing SAC/SRC?

Sponsored by

TELE2

SAC/SRC – the single largest cost item for many mobile operators

Figure 1 shows the proportion of service revenue used on SAC (grey) and/or SRC (yellow) for 26 reporting operators in mature markets globally.

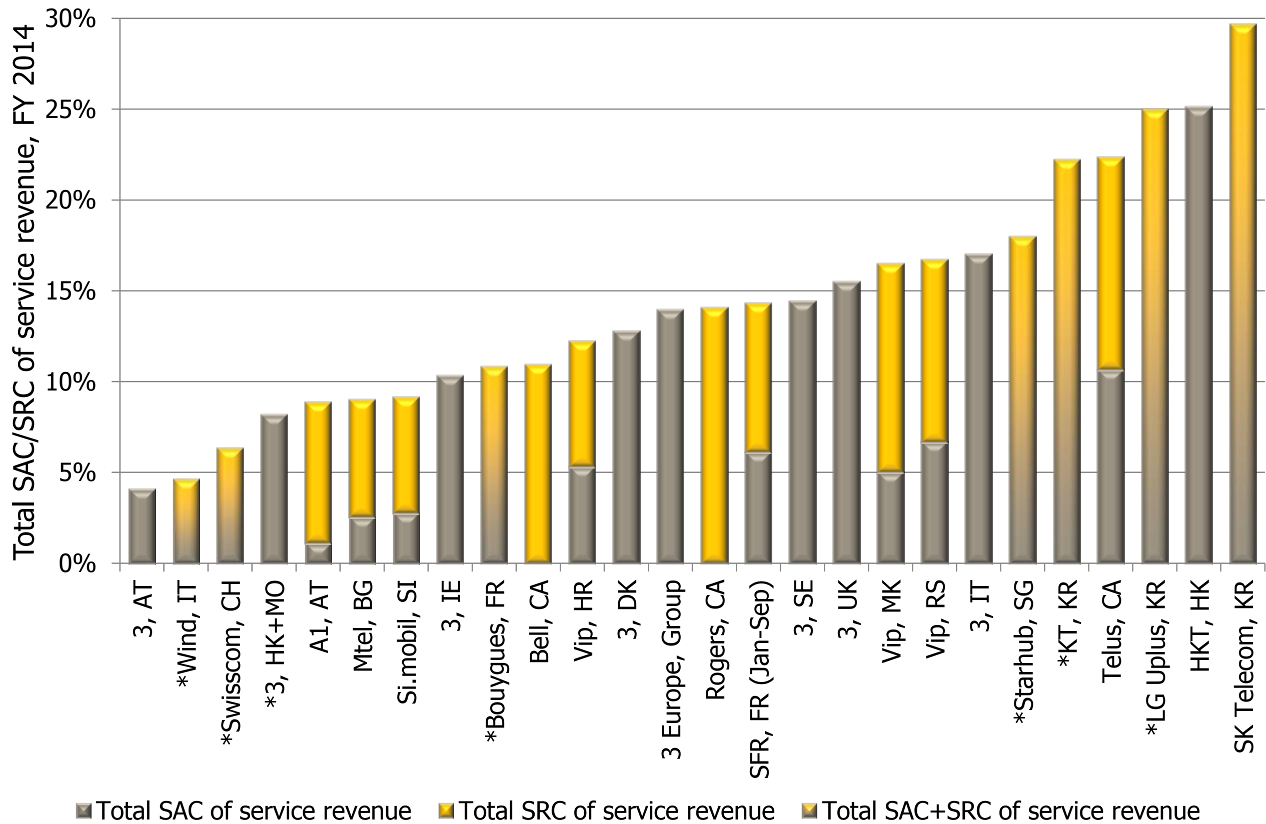


Figure 1. Proportion of service revenue used on SAC/SRC in 2014 **) Includes fixed*

Ideally, Figure 1 should have been more populated, but few operators are reporting the *total amounts* used on SAC and/or SRC. *Read more about how to read Figure 1 in the text box in the next page.*

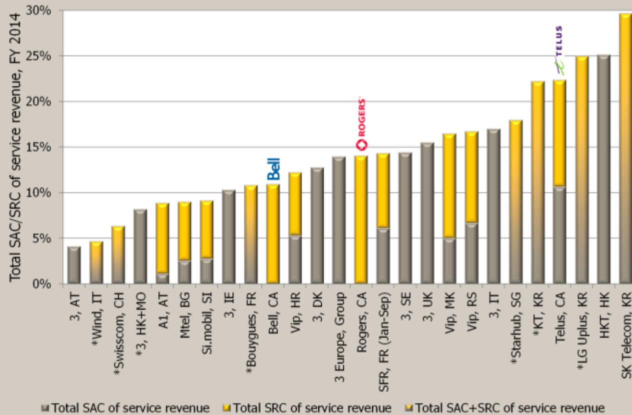
Based on this, we conclude that the average mobile operator in a mature market used **15-20% of service revenues on SAC/SRC** in 2014.

The market leading mobile operator in South Korea, **SK Telecom**, tops the chart having used close to **30%** of service revenues on SAC/SRC in 2014. The other two Korean competitors, **LG Uplus** and **KT**, are also very high – in spite of the fact that South Korean authorities introduced tougher legislation in 2014 to cap sales costs[1].

[1] See e.g. www.mobileworldlive.com/kcc-acts-calm-public-subsidy-bill-takes-effect

How to read Figure 1

Some of the 26 operators are only reporting SAC, some only SRC while some report the sum of SAC and SRC. This means that you shouldn't draw any quick conclusions based on the ranking in Figure 1 as either SAC or SRC might be missing.



Canada serves as such an example. In the small graph above, we've highlighted the three Canadian tier 1 operators. With 22% of mobile service revenue, **Telus** is one of the reporting operators globally who spend the most on SAC/SRC. The local competitors **Rogers** and **Bell** at first appear much better positioned, but their bars contain no grey, which means that SAC isn't included – since it's not reported. Rogers actually use more on SRC – 14% of mobile service revenue – than Telus (12%) and might well have higher SAC+SRC than Telus.

Some of the operators with only grey (SAC) bars in Figure 1 – i.e. all of 3's operations and HKT – might not look at retention as an activity separate from acqusition and thus categorise all costs related to customer acquisition and retention/re-acquisition as SAC. At least for **HKT**, who reports having used an amount corresponding to 25% of mobile service revenue on SAC, it feels unlikely that SRC is excluded.

For some other operators – e.g. Wind and Swisscom – SAC/SRC for **fixed** services is included in the reported SAC/SRC. In these cases, we have also included the fixed service revenue in the calculation. Since fixed SAC/SRC typically is significantly lower than mobile SAC/SRC, this tends to skew the proportion of mobile service revenue used on SAC/SRC in a downwards direction.

Also other Asian operators in similarly competitive smartphone-focused markets like **Hong Kong** and **Singapore** are high in Figure 1 – alongside **Canada**.

Many of the European operators in Figure 1 will be analysed in our country-specific deep-dive, which you find in this analysis – covering six European countries: **France**, the **UK**, **Austria**, the **Netherlands**, **Switzerland** and **Sweden**.

Un-carrier 1.0: Decoupled, non-binding, unsubsidised

But before going to Europe, let's start with the operator who – even though not having invented any of the elements – through its unparallelled business impact inspires other operators to navigate away from the subsidy model with binding service contracts and coupled, subsidised, handsets: **T-Mobile US**.

The parent of T-Mobile, Deutsche Telekom group, had certainly not been seen to follow any disruptive agenda before, but crisis is often the best motivation for change: By the end of 2011, **AT&T** had to realise that its acquisition of T-Mobile wouldn't be approved by the authorities and therefore had to pull out. The breakup fee – about 4 billion USD – helped to finance T-Mobile's new agenda.

In September 2012, T-Mobile recruited **John Legere** as CEO – an experienced manager, but without mobile background. It's fair to say that the industry didn't care much about his appointment. It took half a year until T-Mobile showed its first card when the **Simple Choice** plan was introduced at the end of March 2013.

T-Mobile would no longer sell binding contracts; no longer would handsets be coupled with the service plan; no longer would handsets be subsidised – customers could instead bring their own devices (BYOD) or buy them on instalment plans. *We summarise each operator's settings using the three handles pictured in the miniature on the right.*

At this point in time, the postpaid segment of the US mobile market was characterised by an almost 100% adherence to the subsidy model with long (24 months) binding contracts where handsets were coupled with the service plan and heavily subsidised so that the up-front payment of the handset was as low as possible. This model favoured the two biggest operators Verizon and AT&T at the expense of smaller players like T-Mobile.

Even though the Simple Choice plan was transformative, nobody realised that it would just be the first of many **un-carrier** initiatives from T-Mobile. And few, if any, could predict what they would do to the US market.

1 In Figure 2 below, the timing of the introduction of the Simple Choice plan is highlighted with this pink arrow. Up to this point in time, T-Mobile lost about half a million postpaid customers every quarter. Ever since, T-Mobile has **gained more than 600 thousand postpaid customers each quarter**. In Q1 2014 and Q1 2015, T-Mobile added more postpaid customers than AT&T and Verizon in spite of a significantly smaller total postpaid base.

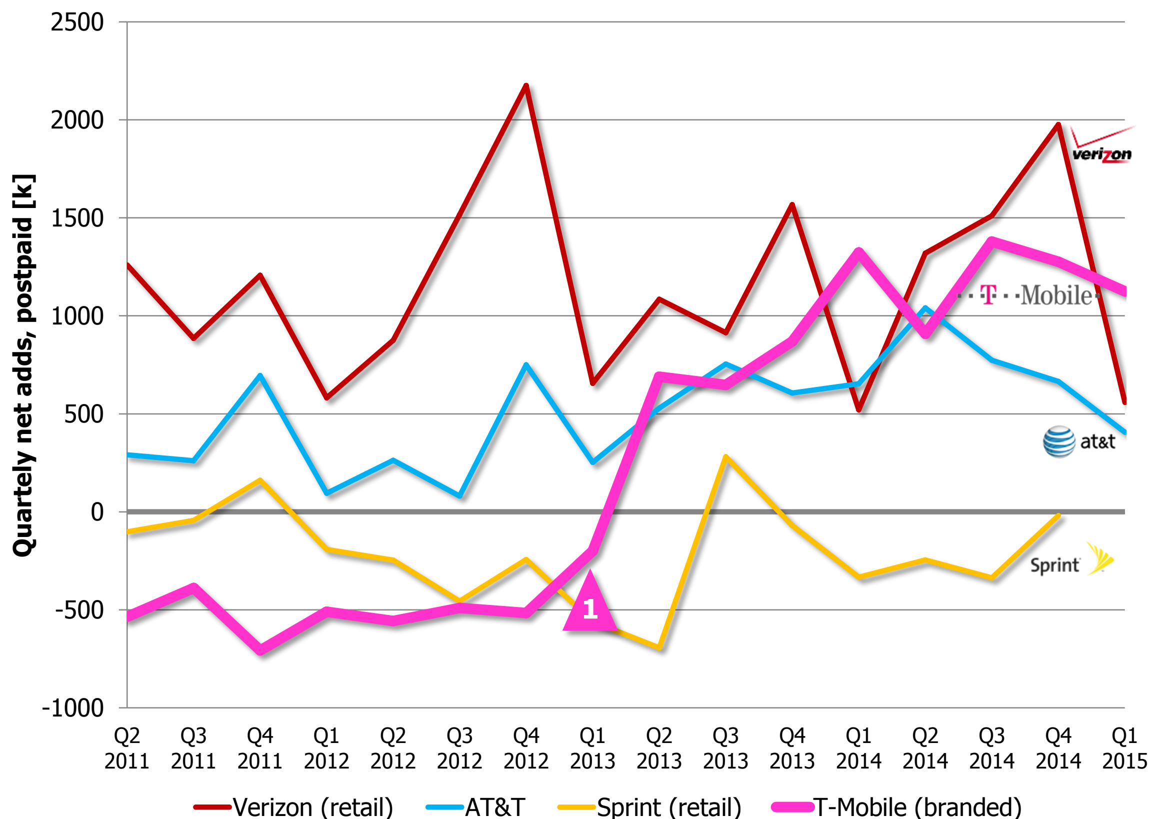


Figure 2. Postpaid net adds for the four largest mobile operators in the US

What's not visible in Figure 2 is that Verizon, AT&T and Sprint today keep up their postpaid net adds with tablets. The reporting of tablets doesn't have as long history, but Figure 3 shows the quarterly postpaid net adds if subtracting tablet subscriptions[2] and just showing phone subscriptions.

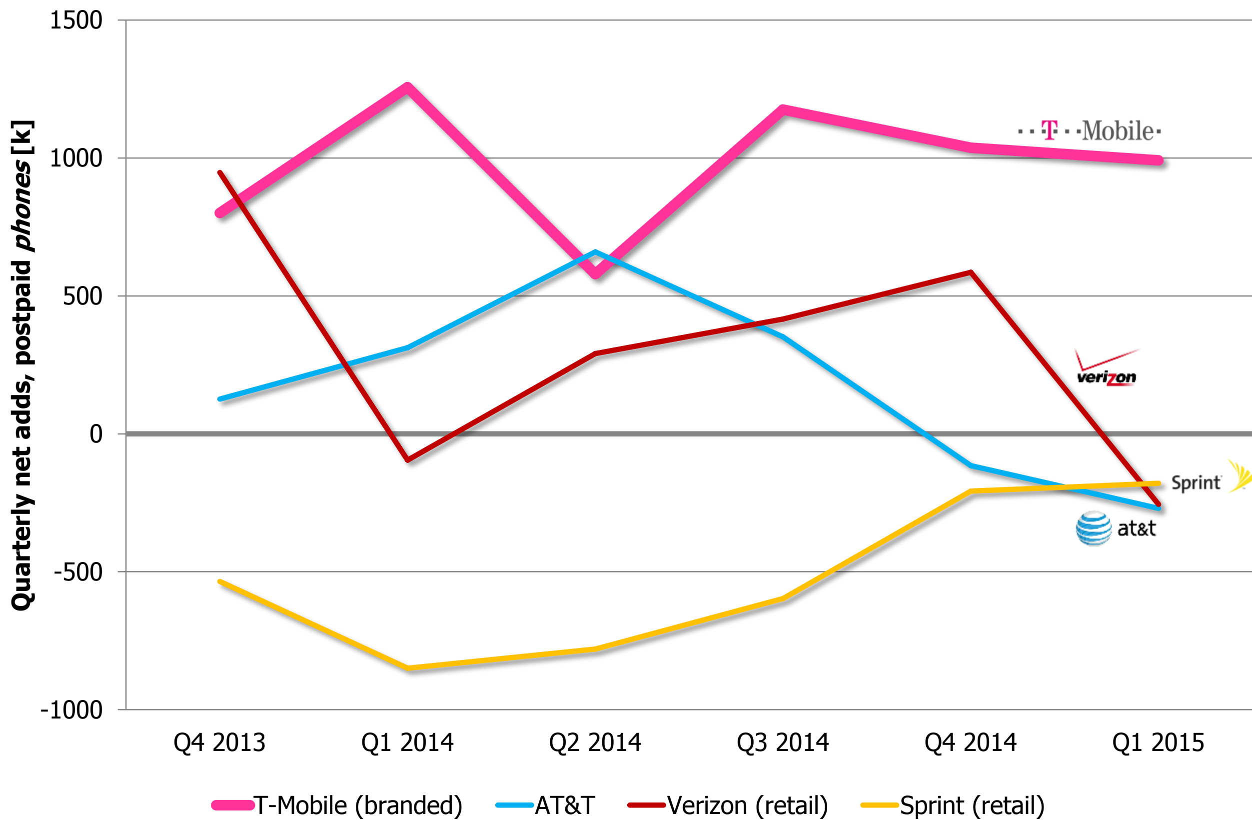


Figure 3. Postpaid phone net adds for the four largest mobile operators in the US

Figure 3 shows that when subtracting postpaid subscriptions for tablets, T-Mobile has added the highest number of postpaid customers in four of the last six quarters.

And – now it gets interesting – it appears as if the unit cost to add a customer has gone down for T-Mobile. Figure 4 shows the development of postpaid SAC – for as long as reported[3].

[2] For T-Mobile subtracting mobile broadband postpaid (said to principally consist of tablets)

[3] T-Mobile's parent Deutsche Telekom has regretfully stopped reporting it from Q1 2014.

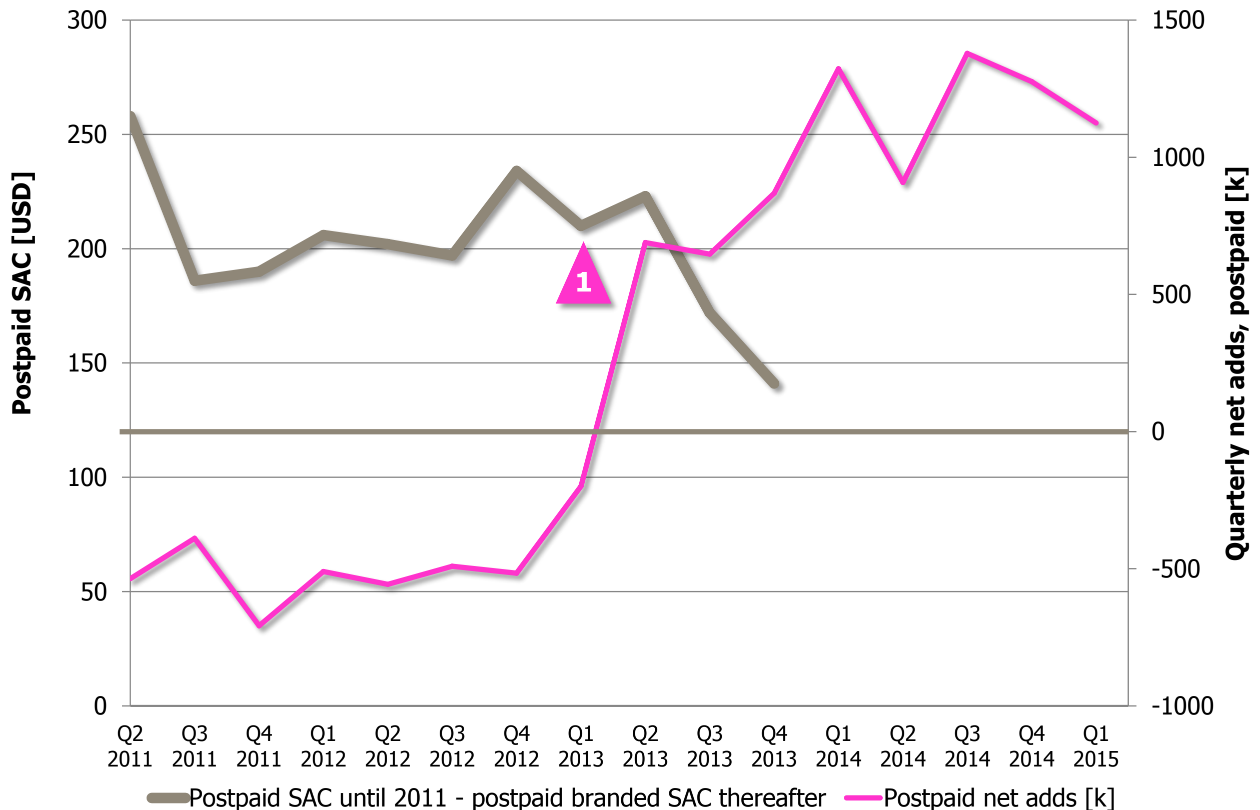


Figure 4. Development of T-Mobile's postpaid SAC – compared to postpaid net adds

We don't know if T-Mobile's reduction in postpaid SAC has continued – but we note that in the six month period Q2-Q3 2013, postpaid SAC came down **37%** from 223 to 141 USD. In the same time period, T-Mobile added more than 1,3 million postpaid customers. Less money spent per new customer, yet T-Mobile recruited new customers like never before.

But do they stay? Remember that in T-Mobile's model, postpaid customers are now on non-binding service contracts. All of them can churn next month if they like[4]. Counter-intuitively, the loyalty that T-Mobile's postpaid customers are showing is *higher* after the change to non-binding contracts, see Figure 5. A freedom to stay effect?

[4] If a customer is on an equipment instalment plan, it still needs to continue, but since there's no bundling, it continues separately from the (terminated) service contract.

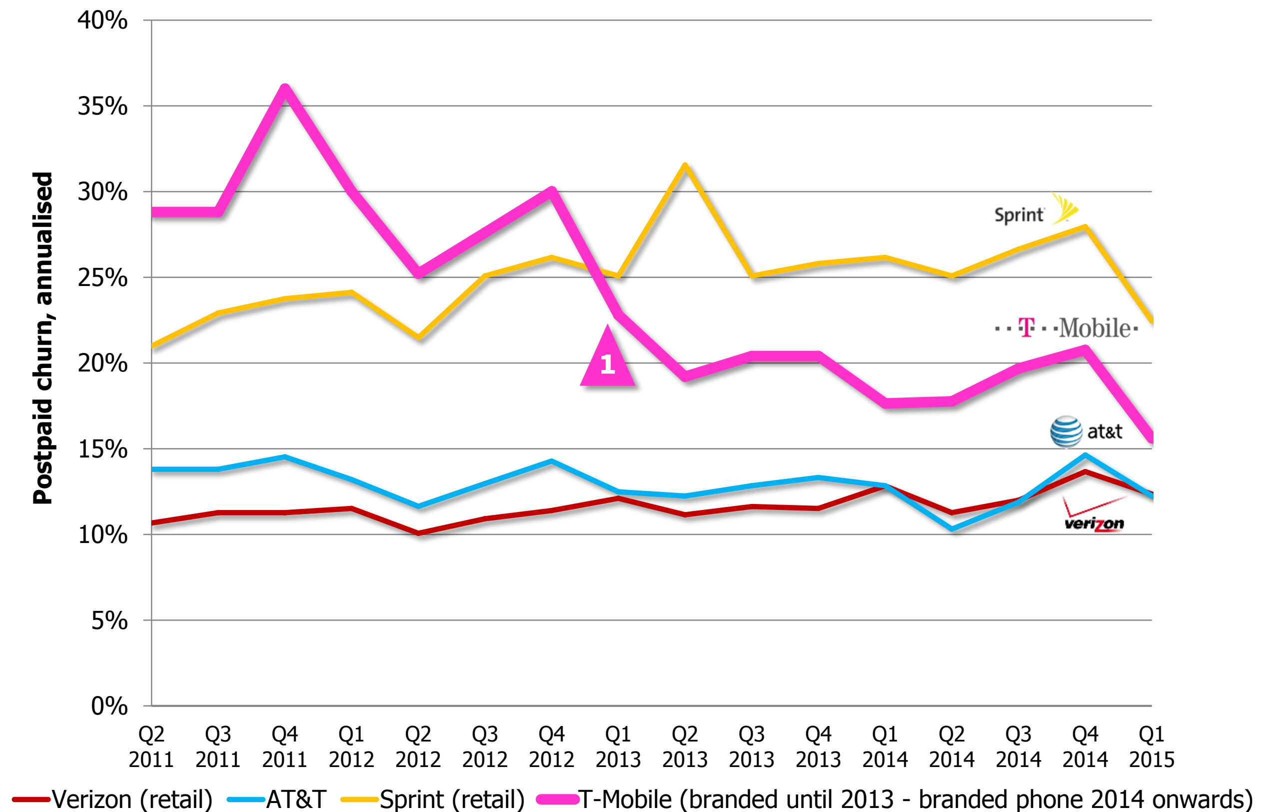


Figure 5. Postpaid churn for the four largest mobile operators in the US

T-Mobile's postpaid churn has come down from an annualised level of about 30% to a level of about 20% after the introduction of Simple Choice. But even though the churn trend is positive, T-Mobile still has some way to go before it is as low as Verizon and AT&T's. Note though that the difference has never been smaller than what it was in the past quarter (Q1 2015).

Handset subsidisation has been the primary tool for US operators to control churn; whenever operators needed to, subsidies were increased and customers then agreed to renew their contract for another 24 months – thereby keeping churn down at the targeted level. We like to call this *managed churn*; quarter after quarter operators report stable churn levels, moderating it with cash. AT&T and Verizon can be seen as examples of this. In the case of managed churn, the reported churn figure isn't really interesting – unless accompanied by a reported SRC figure. Regretfully none of the US operators currently report SRC.

With T-Mobile's new model – featuring non-binding contracts – SRC loses its meaning as there aren't any binding contacts to renew. Customers will stay as long as the like and as long as they are satisfied. With this in mind, T-Mobile's churn development in Figure 5 is not just nice to report for T-Mobile. It's **business critical** since it demonstrates an improvement in customer satisfaction – not an increase in cash going to subsidies.

tefficient

T-Mobile's journey from punching bag to market leader in phone net adds has inspired many European operators to consider implementing T-Mobile's decoupled, non-binding and unsubsidised proposition – or certain elements of it

Even though T-Mobile's financials haven't developed as favourably as the subscription base – it costs to grow even if T-Mobile's unit cost is lower – T-Mobile's journey from punching bag to market leader in phone net adds has inspired many European operators to consider implementing T-Mobile's decoupled, non-binding and unsubsidised proposition – or certain elements of it.

But, as said, not everything started with T-Mobile US. Europe has its own good practices – we start by going to France.

Free before mobile

Free comes with a background which is very different from traditional telcos. It is founded by a (then) young entrepreneur, Xavier Niel, who still holds the majority and still works in the company. Niel doesn't have the usual university background like his colleagues at French telcos; he entered communications through coding, developing services for the French Minitel terminal. Niel is a self-made man with a large private fortune. Some of that fortune he recently used to acquire Orange Switzerland for 2,3 BEUR (now rebranded to Salt).

Free has a history of **disruptive leadership**. When the company took its triple-play Freebox to the French market 12-13 years ago it was priced far below the market price at that time. For 29,99 EUR a month customers got fixed broadband, TV and telephony – all packed into one home gateway (the Freebox). It's interesting to note that Free has not changed that price point since, but gradually increased the value by e.g. including more TV channels and more international call destinations.

Other French operators copied the concept, the price and put "box" behind their product names (Livebox from Orange, La box from Numericable-SFR, Bbox from Bouygues).

Symptomatic for Free, the Freebox is designed in-house. It can have helped Free to make it a Wi-Fi homespot first and a femtocell later – both disruptive.

France: One disruptor and three copycats?

At the end of July 2014, Iliad, the company behind **Free** in France, surprisingly expressed an interest in buying T-Mobile US. Iliad's owner, Xavier Niel, had taken notice of how successful T-Mobile was in the US using approximately the same tools when disrupting the US market as Free had used when disrupting the French: **Decoupled, non-binding and unsubsidised** offers + value for money. Maybe he thought the cultures would fit.

Neither T-Mobile's management team in the US nor T-Mobile's parent, Deutsche Telekom, seemed particularly fond (to say the least) of the idea to sell to Iliad, though. Consequently, Iliad officially put an end to its attempt to acquire T-Mobile in December.

The actual market share development of Free should have impressed (see Figure 6): After launch in January 2012, Free reached **10 million customers within three years**, exceeding its long term market share target of 15%. In 2014, **66%** of the French net adds were on Free. The new long term target is a market share of 25%.

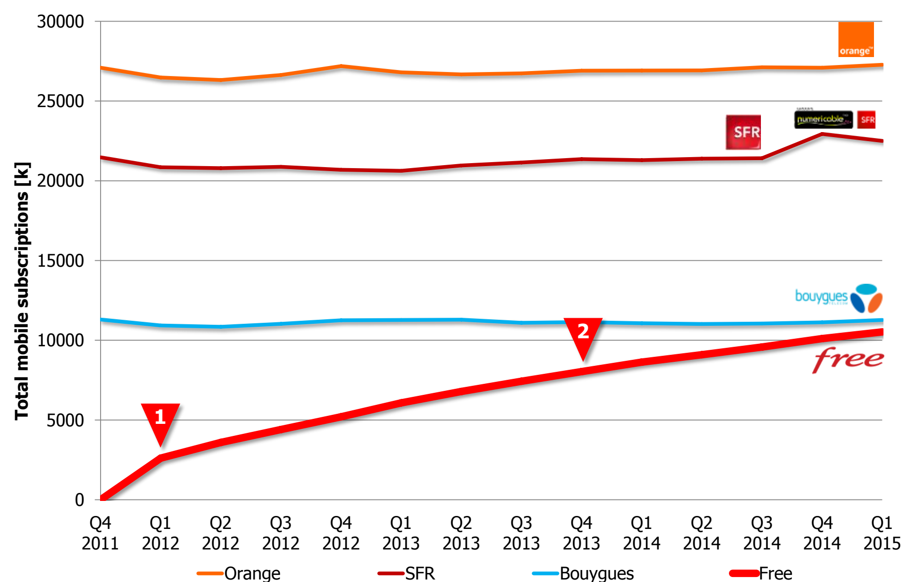


Figure 6. Development of total mobile subscription bases in France

To understand how this development was possible, it's important to remember than when Free launched mobile it had more than 5 million triple-play customers in France[5]; it was an established player. Exactly

[5] Has since grown to 5,9 million

as when Free disrupted the fixed market (see the "Free before mobile" box), Free's mobile price points **were far below the market price at that time** – even though the three incumbents Orange, SFR and Bouygues had taken measures to mitigate the impact of Free by e.g. introducing lower-priced sub-brands (Sosh from Orange, Red from SFR and B&YOU from Bouygues Telecom).

1

With a super-simple mobile offering with **just two plans** – one for 2 EUR per month and the other for 19,99 EUR[6] – Free rapidly took market share. In sharp contrast to how mobile has been sold by the main brands Orange, SFR and Bouygues, Free refrained from coupling handsets, binding customers and subsidising equipment (see miniature to the right). Free continued using its well-working **e-sales and telesales** channels rather than building a large chain of retail stores.

It took a few iterations, but 8-9 months after Free's launch, the three incumbents had eventually **dropped their prices in their sub-brands** to the exact level of Free. Step by step, Orange, SFR and Bouygues also started to change their orientation away from coupled, subsidised equipment and binding service contracts in their main brands. In Q3 2013, Bouygues e.g. launched 4G plans with non-binding options and with handset payment in instalments. SFR followed in the following quarter.

The French incumbents had no other option than to discontinue their historical approach. From 2011 to 2013 the following happened to mobile revenue:

- SFR lost 25%
- Bouygues lost 27%
- Orange fared better and only lost 14% (in part due to being the national roaming host of Free outside of Free's coverage area)

Even though the revenues of French incumbents decreased fast, profitability decreased faster.

Even though Free continued to take market share, certain trade-offs in Free's setup started to be visible when competition moved closer to Free's business model: Lack of physical retail and lack of equipment financing options.

Consequently, Free has lately begun to **expand the number of Free Centers** (which double as shops and service points) to 43 by year-end 2014 with a plan to add an additional 10 in 2015. It's still a small direct channel in a French perspective, though: Orange had 543 own stores in the end of 2014.

To compensate for its small store footprint, Free has rolled out about 1000 **SIM card dispensers**[7] around France in partnership with the Maison de la Presse and Mag Presse retail stores.

2

In December 2013, Free introduced a 24 month **phone rental** option and a couple of **instalment** options (4 or 24 months) providing customers with equipment financing. At the same time, Free stopped breaking out the mobile equipment revenue in its reporting, but Figure 7 shows that Free's total mobile revenues started to grow faster after these initiatives, suggesting that the equipment revenue indeed was helped by this latest model change of Free.

---

[6] Freebox customers get 2 EUR discount on the first (i.e. for free) and 4 EUR discount on the latter. Free has not touched the price points since their introduction but value has been increased by expanding on the international call destinations, SMS destinations, by increasing the data bucket and by including 4G.

[7] As you might expect (this is Free) developed in-house

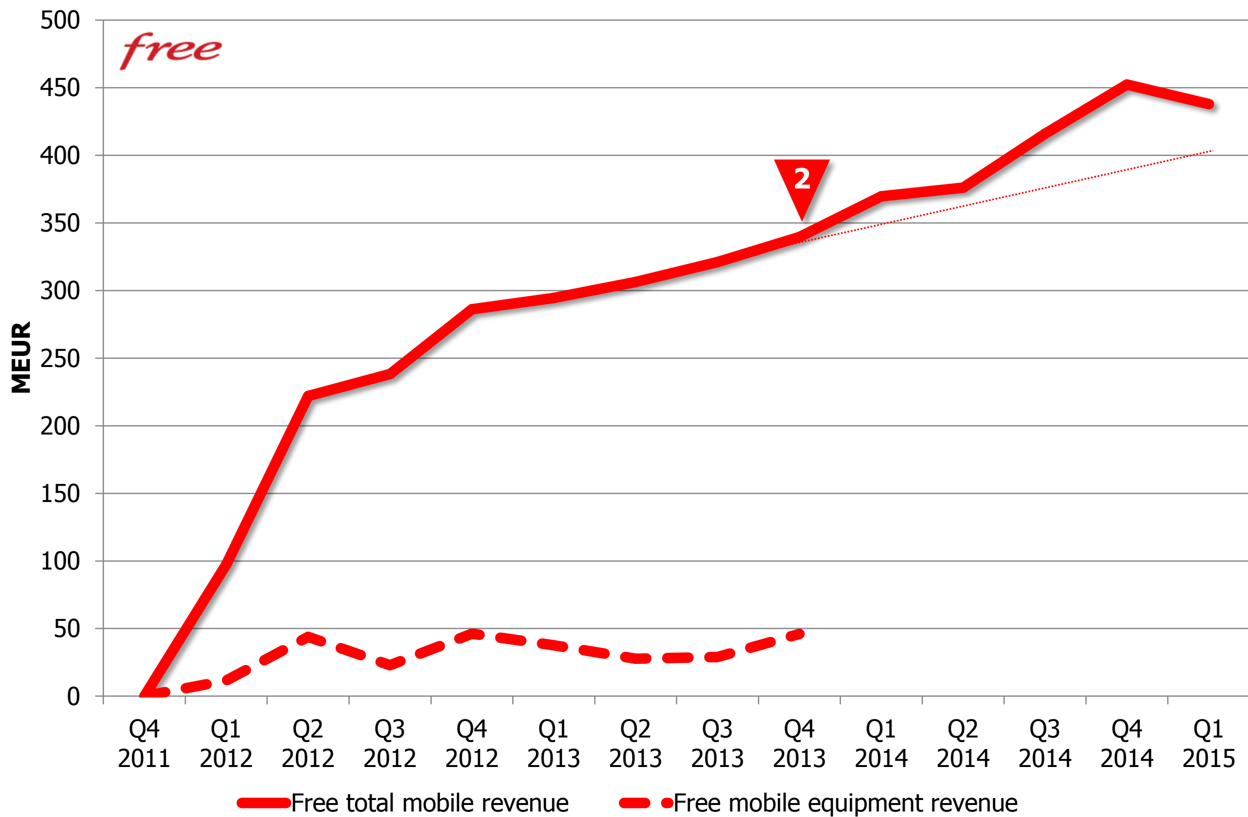


Figure 7. Development of Free's mobile revenue

Even though no longer reporting the mobile equipment revenue, Free comments that the change "drove a sharp increase in revenue from handsets" and points out that the phone rental option represents almost **50% of equipment revenue** in 2014.

Free also says the change has improved the subscriber mix within net adds, which means that more of their new customers now take the 19,99 EUR plan (as opposed to the 2 EUR plan).

The phone rental option represents almost 50% of equipment revenue in 2014

UK: Even a small model change can be differentiating

The mobile market in the UK has for years been the European market with the lowest average EBITDA margin. High equipment subsidies and high dealer commissions are the main explanations to it. Until 2013, UK operators – and their customers – seemed married to the coupled model with subsidised mobile equipment and binding service contracts.

This background makes it more interesting to follow the progress of **O2 Refresh** – an initiative to break with this model launched by O2 in April 2013.

Originally positioned as a "change phone as often as you like" solution, O2 Refresh **decoupled the phone contract from the service contract** – a novelty in the UK where operators until this point just charged a total monthly fee for both. With this simple change, customers could change to a new phone whenever – if paying off the remainder of the phone instalments.

Lately, O2 has chosen to rather put emphasis on the fact that O2 Refresh **cuts the bill by half** once the contract goes into its 25th month – a simple consequence of the decoupling between the phone and the service contract: After 24 months, the phone is paid off fully since all instalments have been paid.

With this, O2 positions O2 Refresh as a solution for customer loyalty and a **cost-efficient alternative to customer retention through high SRC**: It makes sense to remain loyal to O2. A customer who e.g. is 21 months into his/her contract might well actively decide to stay knowing that in a few months the monthly fee is cut by half. Invites from competitors to "come to us" are then turned down.

Noticeably, O2 Refresh **still binds customers** to a service contract – see miniature to the right – thereby representing a smaller change to the original model compared to e.g. T-Mobile US. This also means that O2 still can choose to subsidise the equipment price. In fact, equipment is cheaper for customers selecting larger service bundles.

Still, the change is significant enough to be differentiating – none of O2's operator competitors have followed (as indicated by the cat ad above).

Figure 8 shows the development of the postpaid subscription bases.

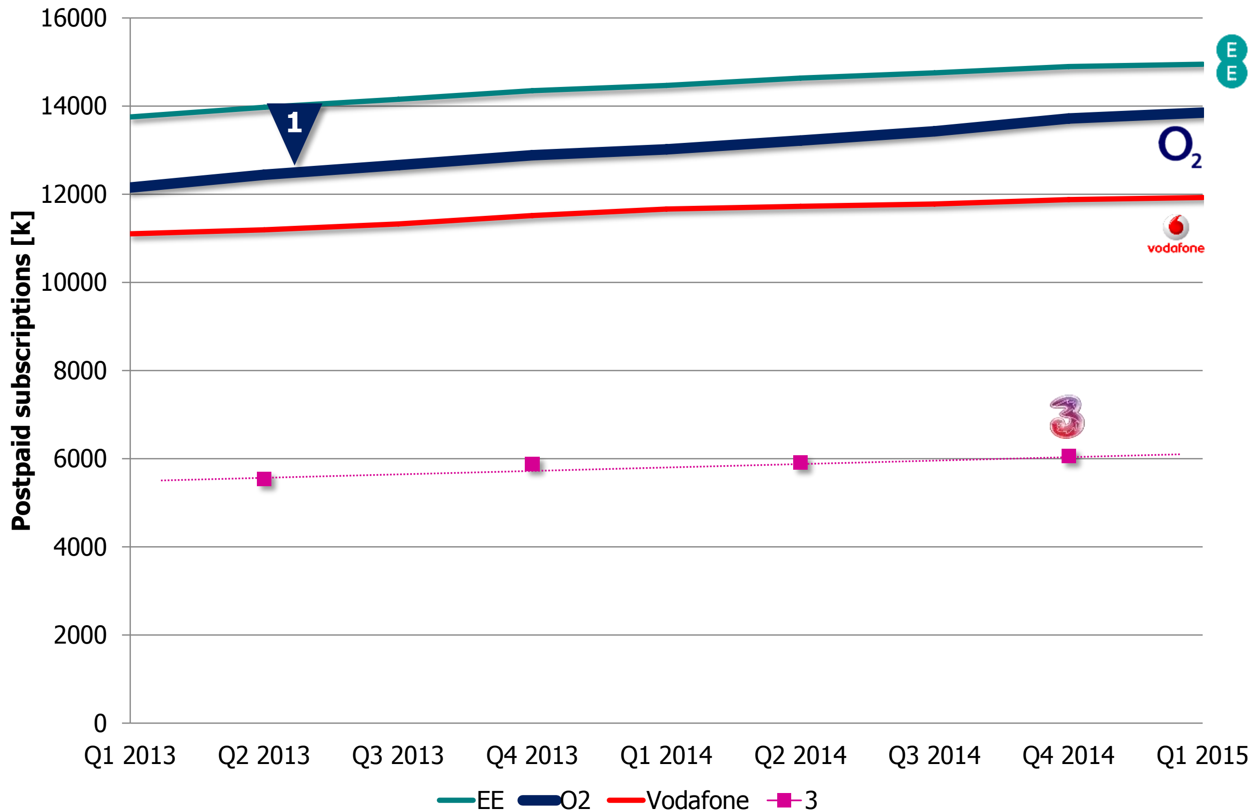


Figure 8. Development of postpaid mobile subscription bases in the UK[8]

1 The introduction of O2 Refresh is indicated by the arrow. It can't be said how much O2 Refresh has contributed to O2's growth, but in the period thereafter O2 has outpaced both EE's and Vodafone's growth.

O2's introduction of Refresh was phased, available to begin with only via O2's shops – and for certain phones and plans. The more general availability through other channels was added later. Even those customers who went for O2 Refresh at the first possible time (April 2013) have just now started to enjoy the "halved bill" – since the handset instalment contracts were 24 months long. O2 has recently reported that **1,5 million** of their postpaid customers (11% of base) will have reached this state over the coming 12 months. Much of the positive loyalty effect of O2 Refresh might therefore be ahead of O2.

Figure 9 compares the reported postpaid churn rates of the British operators.

[8] '3' reports every 6 months

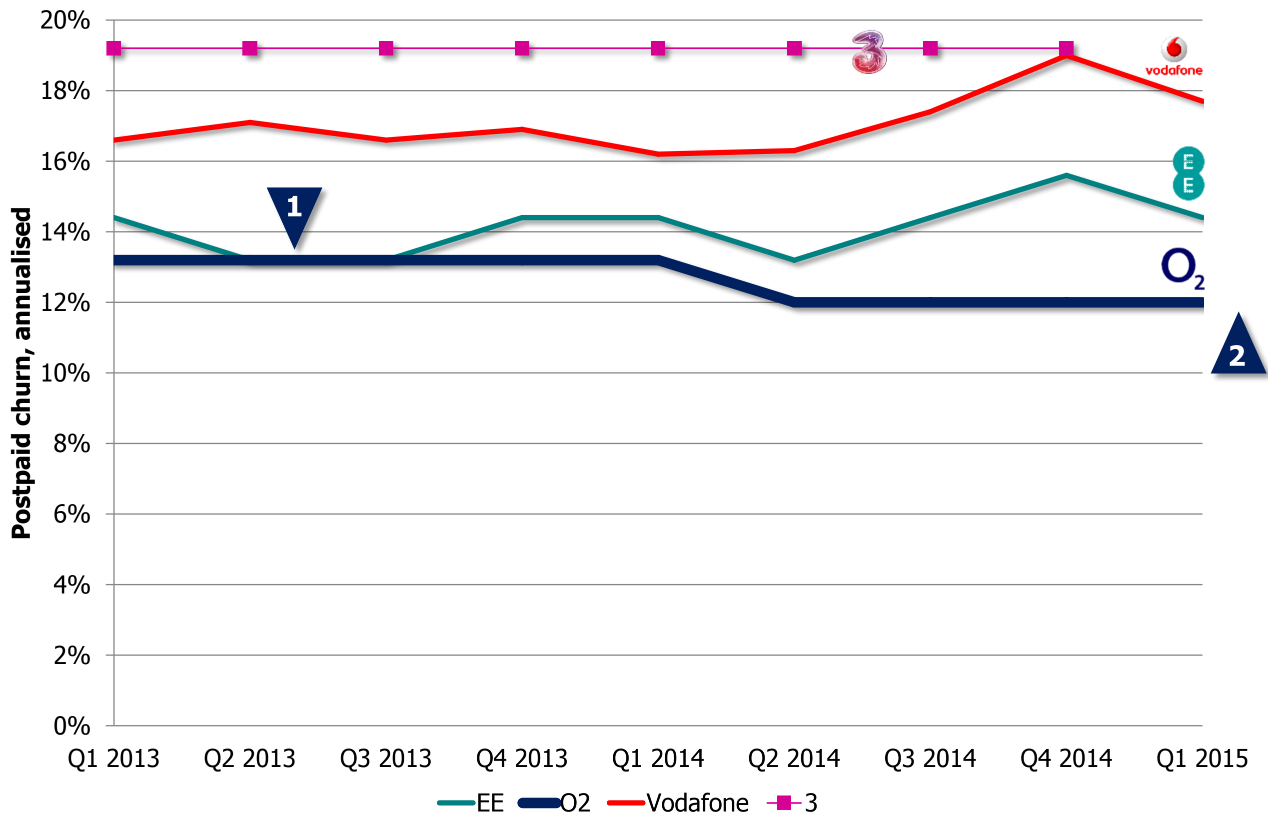


Figure 9. Development of postpaid mobile churn in the UK[9]

The 2nd arrow indicates when the first O2 Refresh customers started to experience a halving of their bills. It happened after the latest available reported information from O2. Yet O2 didn't experience any of the churn increase that Vodafone and EE saw in Q3 and Q4 2014. O2 Refresh might have contributed to this – in this period many customers on O2 Refresh were only months away from getting their bills halved. If so, O2 Refresh has **secured the loyalty** of a portion of the postpaid base – during what normally is a difficult and costly churn prevention period: The last months of a contract.

If so, O2 Refresh has secured the loyalty of a portion of the postpaid base – during what normally is a difficult and costly churn prevention period: The last months of a contract

To be able to draw definite conclusions on O2's churn development we would need to understand how their SRC developed as well. Regretfully, Telefónica group doesn't report SAC or SRC.

Without a doubt, O2 Refresh has had a major impact on O2's revenue composition – see Figure 10.

[9] '3' reports every 6 months – here assumed to be the same both quarters of a half year

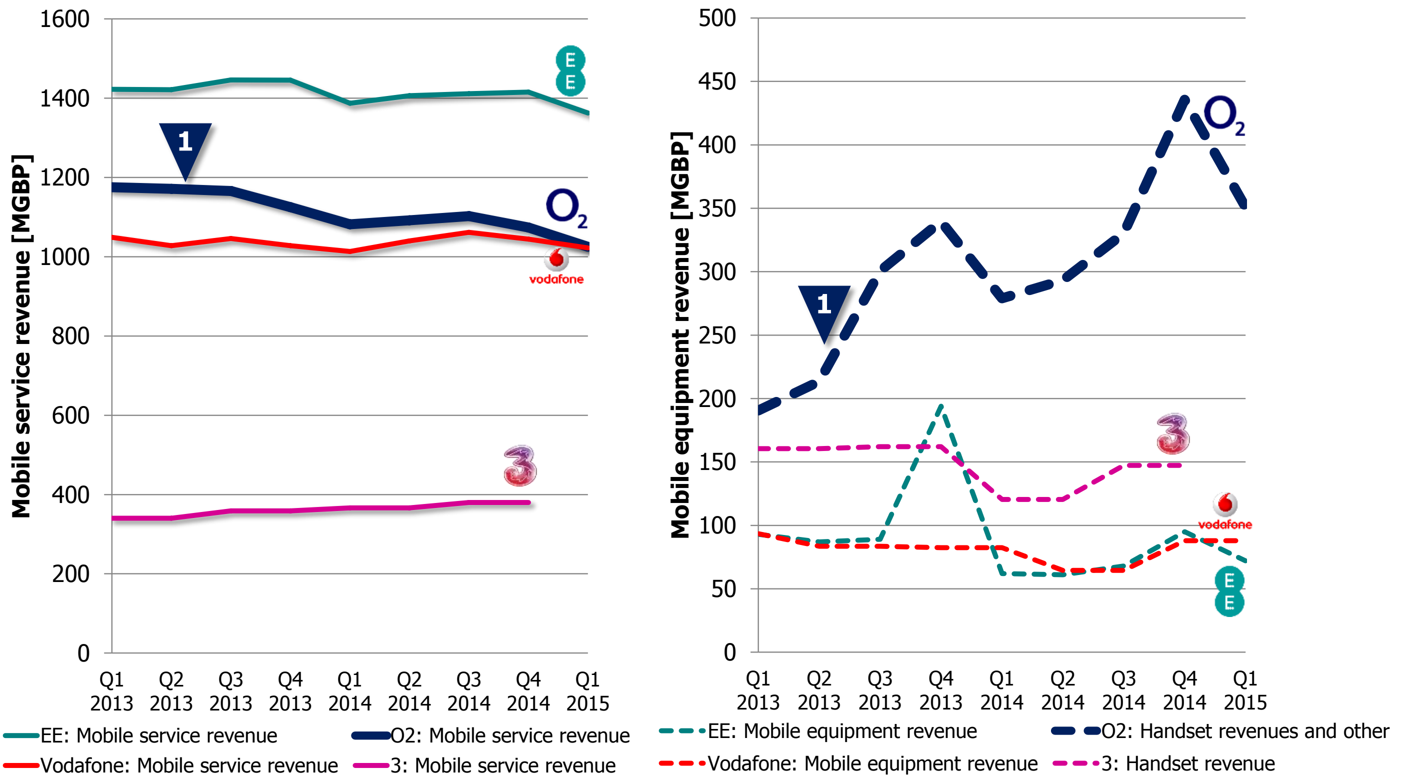


Figure 10. Development of mobile service revenue (left) and mobile equipment revenue (right) in the UK[10]

Looking at the left graph, O2's mobile service revenue has declined since the introduction of O2 Refresh. On the other hand, mobile equipment revenue has increased (right graph) – to represent **25%** of O2's total mobile revenue in Q1 2015. EE and Vodafone – both using the traditional subsidy model – have only 5% and 8% respectively of total mobile revenue in equipment[11].

So even though O2's capability to earn revenue on equipment has improved significantly does it help when service revenues decline? Let's in this table compare the total revenue development – services and equipment – within the time period of Figure 10.

[10] '3' reports every 6 months – here assumed to be the same both quarters of a half year. Vodafone reports total mobile revenue every 6 months but service revenue every quarter – equipment sales here assumed to be the same both quarters of a half year.

[11] '3' claims it has left the subsidy model behind and also reports figures that way. Yet '3' hasn't decoupled handset pricing from services pricing and customers thus continue to pay full fees also 25th months and onwards.

Operator	Total mobile revenue development Q1 2013 to Q1 2015
EE	-5%
O2	+1%
Vodafone	-3%
3	+5%[12]

O2 is warming the UK public to the idea that equipment is something you actually pay for (even on instalments) while O2 at the same time can show lower service prices and gradually move the comparison point from bundle pricing to service pricing

Even though O2's 1% growth in total mobile revenue isn't impressive for a two year period, it's better than the negative development of EE and Vodafone.

Little by little, O2 is warming the UK public to the idea that **equipment is something you actually pay for** (even on instalments) while O2 at the same time can show **lower service prices** and gradually move the comparison point from bundle pricing to service pricing.

Even though O2 is alone with a model like O2 Refresh in the UK, thereby granting O2 some differentiation, it could actually benefit O2 if some of their competitors would also embrace it, thus reinforcing the concept of paying for equipment.

[12] To Q4 2014 since Q1 2015 not reported

Austria: Consolidation gives relief, enables change

Austria was once a market with five mobile operators. In the last consolidation in January 2013, '3' acquired Orange, leaving Austria with only three mobile operators. The lower competitive pressure has given the Austrian operators an option to reduce sales costs and increase prices.

This is best seen in the development of total SAC and SRC for **A1**, the incumbent in Austria.

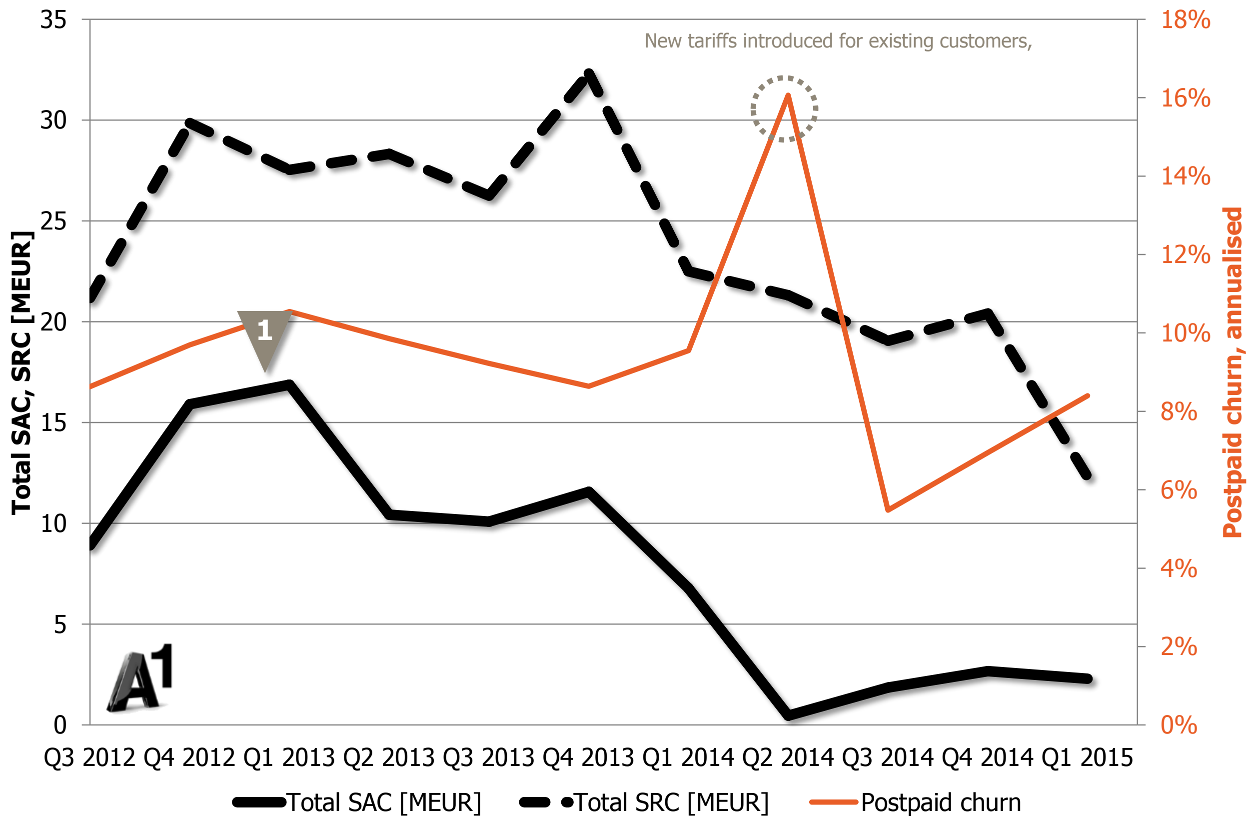


Figure 11. Development of total SAC and SRC for A1 – compared to postpaid churn

1 This arrow indicates the timing of 3's acquisition of Orange. At this point, A1 **started to reduce total SAC** significantly: Where A1 in Q1 2013 used 17 MEUR on customer acquisition it was two years later just 2 MEUR.

Also A1's **SRC was decreased**: During the same time period it went from 28 MEUR to 12 MEUR. With the exception of Q2 2014 (when A1 wanted to introduce new tariffs also to the existing customer base – thereby having to grant them the right to cancel the service) postpaid churn has not increased even though cash spent on customer retention decreased.

Also '**3**' has reduced its total SAC/SRC (from 9 to 6 MEUR per quarter) since their acquisition of Orange – whilst being able to reduce postpaid churn.

But the market consolidation also gave **T-Mobile** the courage to innovate a bit on its business model in Austria. In September 2014, the "**Wie-Ich-Will-Prinzip**" (What-I-Want-Principle) was launched decoupling equipment from services.

Contrary to what one might expect T-Mobile's model in Austria is *not* a carbon copy of the model so successfully used in the US – see miniature.

Key differences are that on the higher plans – Turbo and Extreme – T-Mobile Austria is giving the customer a "handy-bonus" – another word for **equipment subsidy**. And whereas T-Mobile doesn't bind SIM-only customers, customers who doesn't pay their mobile up-front are bound 24 months. And their service price goes up 3 EUR after those 24 months – when the handsets instalment ends.

In comparison to T-Mobile US, Wie-Ich-Will provides customers with some additional, although limited, flexibility but the model adjustments are designed so that T-Mobile Austria doesn't take any additional risk. Scrapping handset subsidisation has perhaps been regarded as too large a step.

Consequently, if you look for significant changes in T-Mobile Austria's numbers you won't find any. Not yet at least.

Figure 12 compares the reported postpaid unit SAC and SRC of T-Mobile with the postpaid churn rate and the non-service (=equipment) revenue.

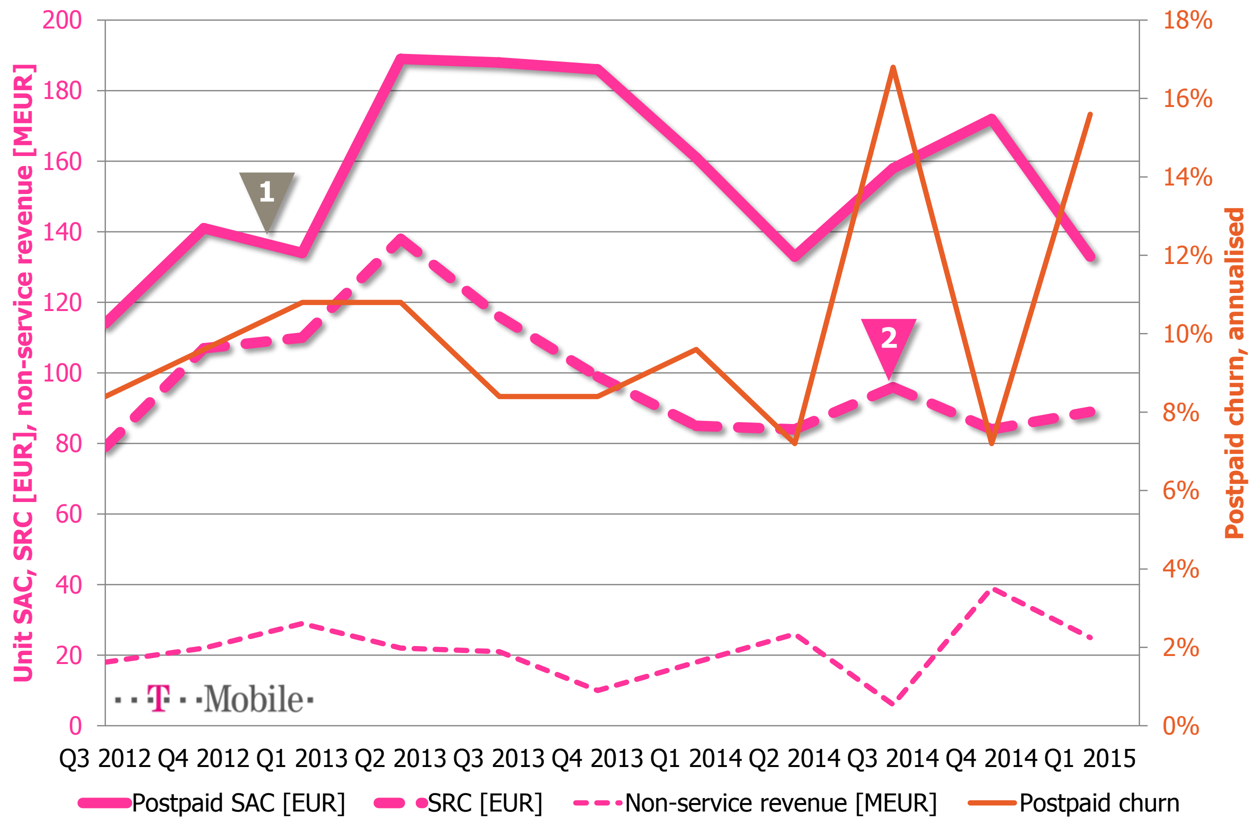


Figure 12. Development of unit postpaid SAC and SRC for T-Mobile – compared to postpaid churn & non-service revenue

2 The introduction of Wie-Ich-Will is indicated with the pink arrow. So far, it seems not to have had any major impact on T-Mobile's postpaid SAC or SRC. The high postpaid churn rates in Q3 2014 and Q1 2015 are not commented by T-Mobile, and should perhaps – similar to A1 – be seen as one-offs.

One change following the introduction of Wie-Ich-Will seems to be that T-Mobile now earns more of its revenue from non-service (i.e. equipment). Even more importantly, **total revenues are up**: 4% in Q4 2014 and 3% in Q1 2015 (year-on-year).

1 Also note that whereas A1 significantly lowered SAC and SRC after 3's acquisition of Orange, T-Mobile did the opposite, raising both. T-Mobile might have seen an opportunity to grab market share, which the next figure shows that T-Mobile indeed did – but solely from A1.

Whereas A1 significantly lowered SAC and SRC after 3's acquisition of Orange, T-Mobile did the opposite

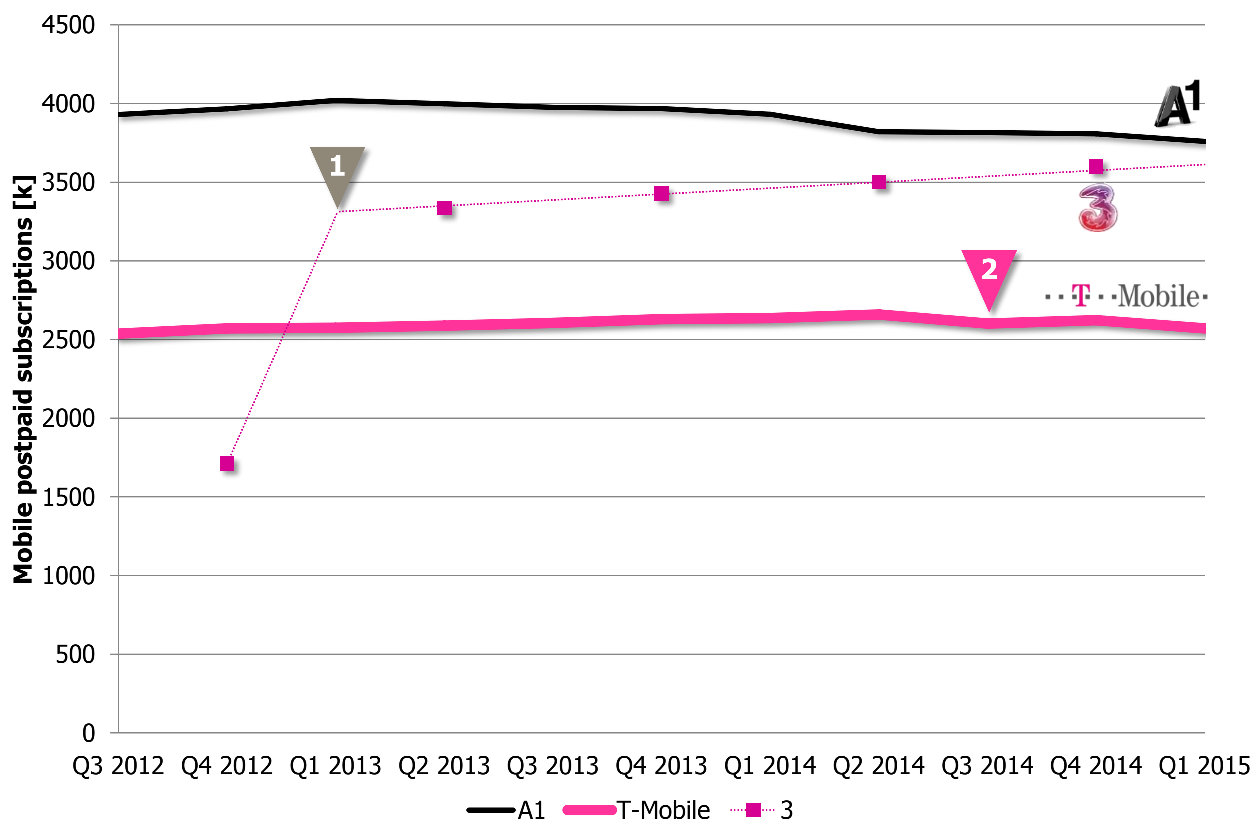


Figure 13. Development of the mobile postpaid bases in Austria[13]

Figure 13 shows that A1 has been on a negative trajectory since 3's acquisition of Orange (grey arrow) and that T-Mobile's growth appeared to have stalled at around the introduction of Wie-Ich-Will (pink arrow). 3 is gaining postpaid customers – but without growth in total revenue, see table below.

Operator	Mobile service revenue development Q1 2013 to Q1 2015	Total mobile revenue development Q1 2013 to Q1 2015
A1	-11%	not reported
T-Mobile	-1%	-3%
3	-3%	-7%[14]

In the studied time frame, T-Mobile defended its revenue better than Austrian competition.

[13] 3 reports every 6 months
[14] To Q4 2014 since Q1 2015 not reported

Netherlands: Change before change hits you?

Like Austria, also the Netherlands used to be a market with five mobile operators – now reduced to just three. The market is preparing for being expanded to four operators, though: Tele2, today an MVNO, is about to enter the market as a 4G-only operator.

To mitigate the impact of Tele2, the three current operators have intensified their efforts to recruit mobile customers while at the same time rolling out 4G networks. Figure 14 shows that **KPN** lately has been most successful in expanding postpaid base.

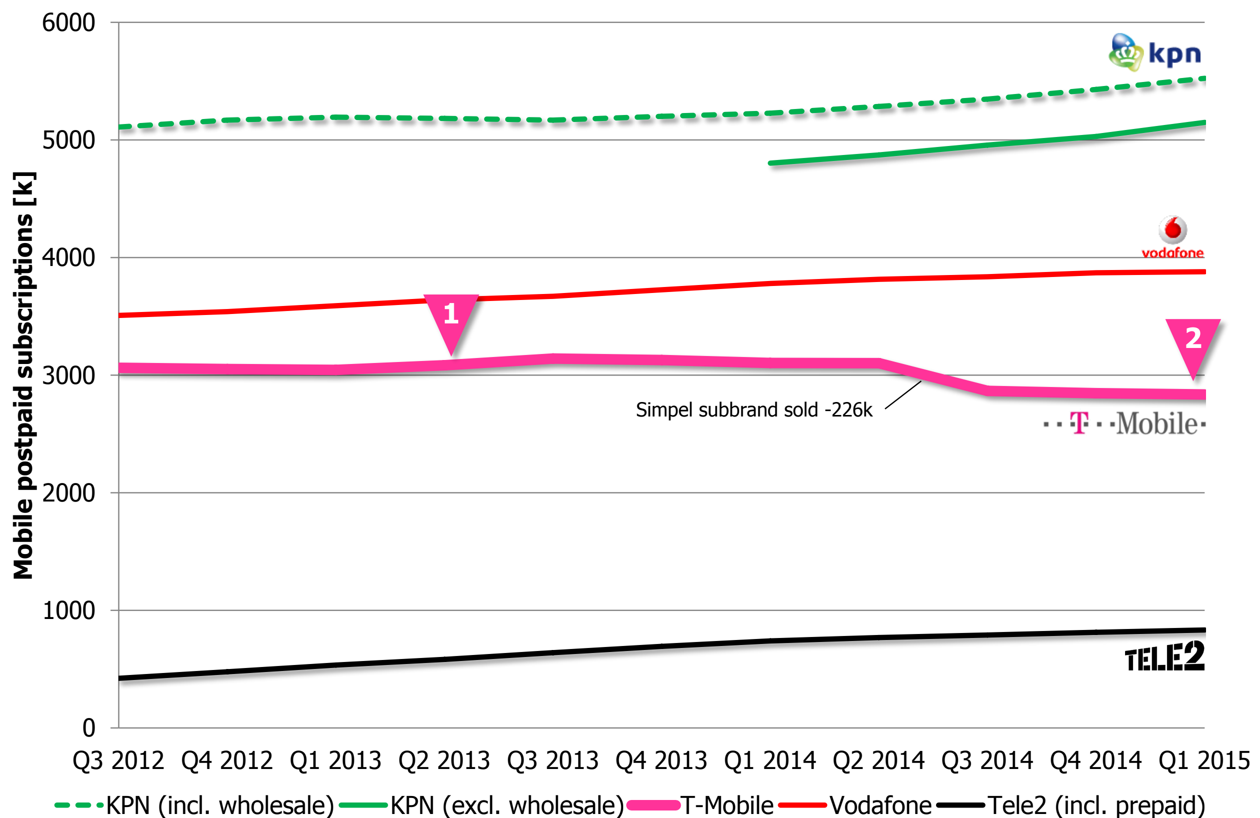


Figure 14. Development of the mobile postpaid bases in the Netherlands[15]

1 In May 2013, T-Mobile introduced "**Stel Samen**" (Put Together) giving customers a higher degree of flexibility when deciding on the service mix between voice and data[16]. It might be seen as a small step, but for T-Mobile this started their journey towards higher flexibility for the customers.

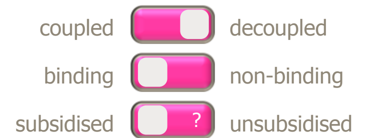
2 The next step wasn't taken until January 2015 when T-Mobile expanded the concept to "**Stel Samen & Stel Bij**" (Put Together and Adjust). Customers could now adjust their service

[15] KPN changed reporting standard in Q1 2015, now breaking out wholesale customers. This was done retroactively for 2014. Tele2's base (currently still MVNO) includes prepaid customers as Tele2 doesn't split the total.
[16] Apps like WhatsApp have already essentially substituted SMS in the Netherlands – the SMS usage is very low

composition every month – up and down. If buying a handset, customers could decide on how to pay for it – upfront, per month or a combination of both.

And after the chosen instalment period, payments end – in contrast to the subsidy model.

But in all this flexibility, T-Mobile Netherlands chose *not* to copy the cornerstone in T-Mobile US's offering: Non-binding contracts (see miniature). All of **T-Mobile Netherlands service contracts are binding – even for SIM-only**[17]. This is different also to T-Mobile Austria – who even if it binds customers who take handsets doesn't bind SIM-only customers.



It also appears as if T-Mobile Netherlands still subsidises equipment. Since equipment cost is the same regardless of service composition (again in contrast to T-Mobile Austria), this is not obvious, but the price points of equipment appear discounted in comparison to others.

In Figure 15 we can see how these changes have affected T-Mobile's postpaid unit SAC, SRC and churn.

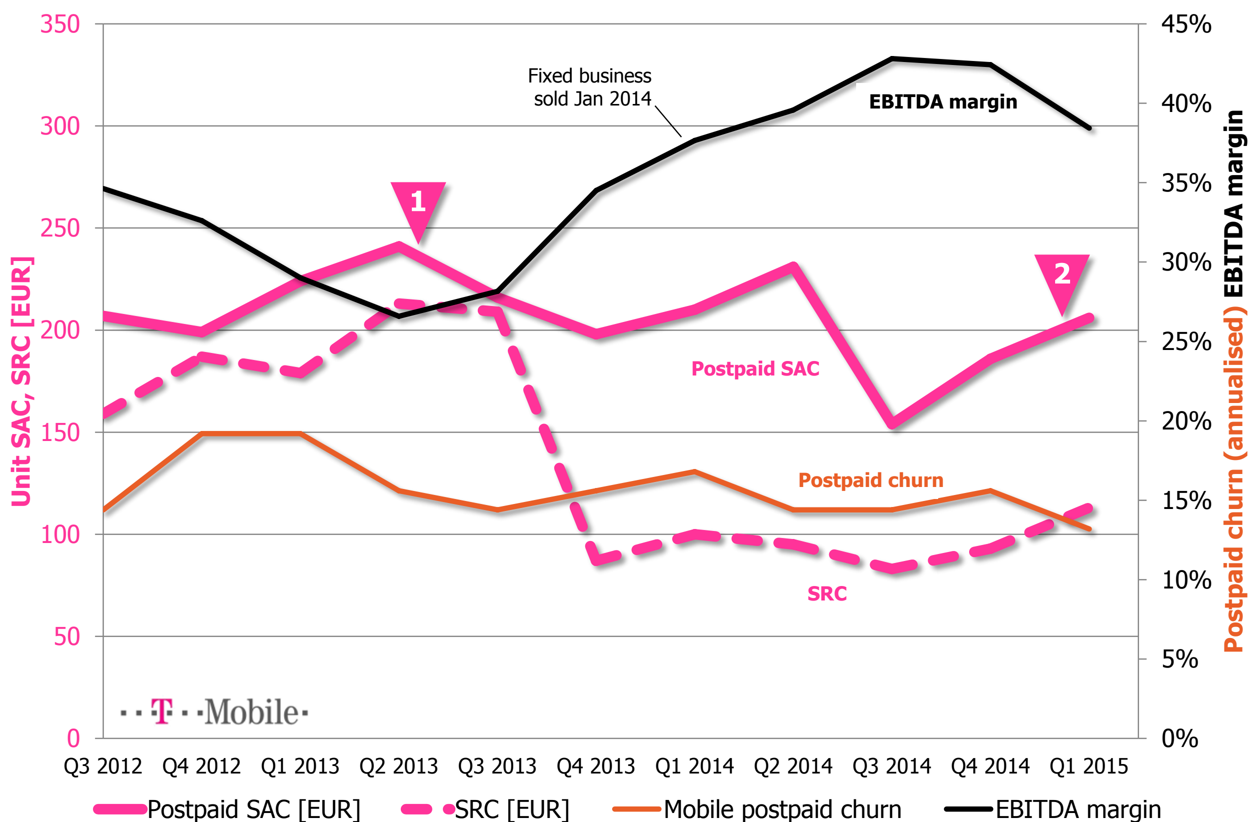


Figure 15. Development of Postpaid unit SAC, SRC, churn and EBITDA margin for T-Mobile Netherlands

[17] Non-binding SIM-only is available in T-Mobile's subbrand Ben. KPN and Vodafone also bind their SIM-only customers (KPN's subbrand Simyo being the only exception). Tele2 doesn't bind SIM-only customers.

1 Shortly after the introduction of "Stel Samen" T-Mobile reduced postpaid SAC but a more significant change was the **drastic reduction of SRC** from a level above 200 EUR to a level below 100 EUR. Interestingly this reduction didn't have any negative effect on postpaid churn which remained around 15% on annual basis.

But the effect on EBITDA margin was positive: T-Mobile's EBITDA margin went up **from 27% in Q2 2013 to 43% five quarters later**. In this period, T-Mobile disposed of its fixed business and this disposal also contributed positively to the EBITDA margin.

The question is if T-Mobile's reduction of postpaid unit SAC and SRC is sustainable. As shown in Figure 14, T-Mobile is losing postpaid market share to competitors – so even if churn is kept under control, T-Mobile have issues recruiting new customers. Figure 16 suggests why this is the case.

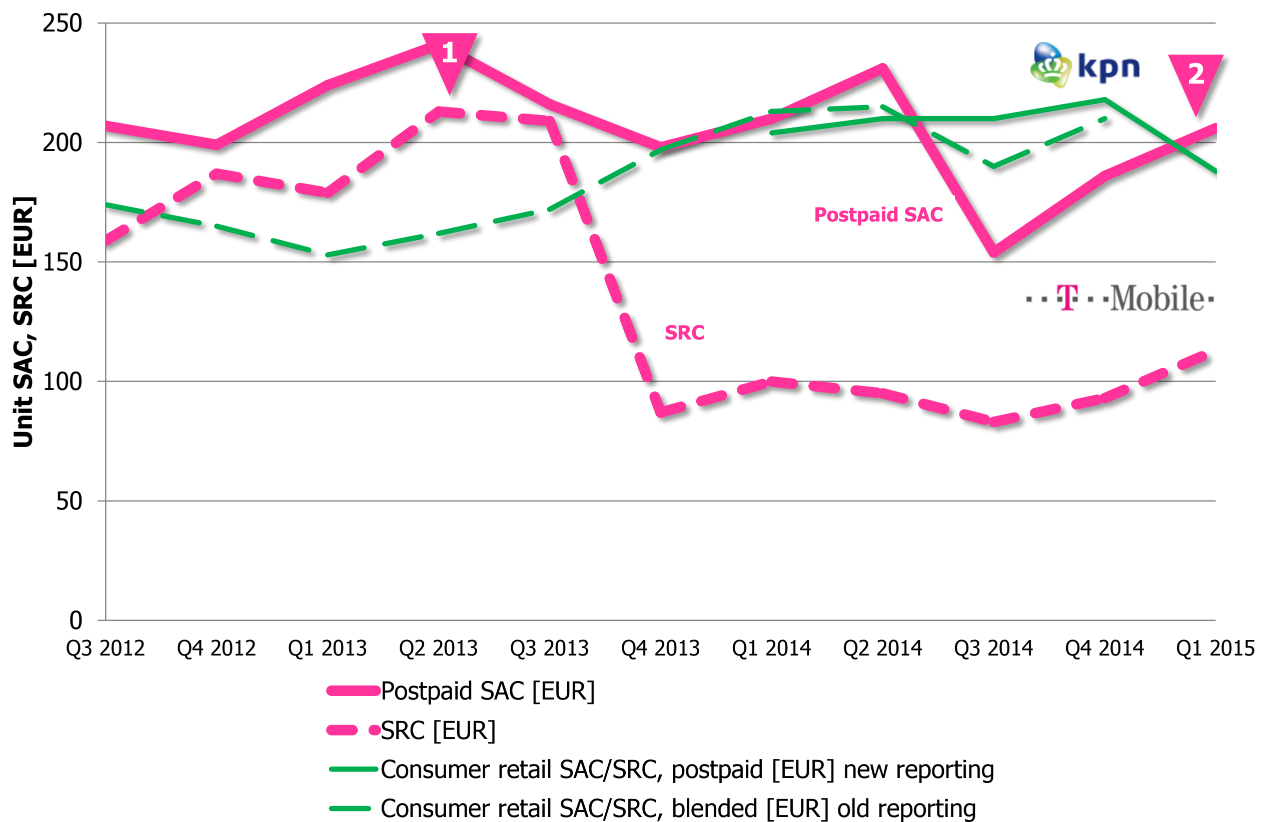


Figure 16. Comparing T-Mobiles postpaid SAC and SRC with KPN's SAC/SRC

Comparing T-Mobile's postpaid unit SAC and SRC with KPN's figures isn't straightforward since KPN reports *combined* unit SAC/SRC – for consumer and business customers separately. Since we don't know the volumes of retained customers in the T-Mobile case, we can't calculate T-Mobile's combined unit SAC/SRC. But Figure 16 suggests that it could be around 150 EUR since Q4 2013. If comparing with the plotted KPN

SAC/SRC figure for consumer[18] retail it has in the same period been around 200 EUR[19] – 33% higher than T-Mobile. Note also that when T-Mobile reduced SRC drastically, KPN *increased* its SAC/SRC.

The reason why KPN has taken postpaid market share (see Figure 14) from T-Mobile since early 2014 could therefore be a case of **market investment** from KPN's side – preparing for the entry of the fourth mobile operator.

As such, T-Mobile's change to higher (even if not full) flexibility for their customers might still have been a good one – the EBITDA margin expansion is impressive – but the large reductions in SAC/SRC that went with it might have been too aggressive given the market context. Maybe this is also what T-Mobile experienced: As shown in Figure 15, T-Mobile increased postpaid SAC and SRC in the latest two quarters.

T-Mobile's change to higher (even if not full) flexibility for their customers might still have been a good one – but the large reductions in SAC/SRC that went with it might have been too aggressive given the market context

[18] Believing the consumer segment is more representative for a comparison to T-Mobile

[19] KPN changed reporting standards in Q1 2015 which explains why there are two green lines in Figure 15

Switzerland: Can Sunrise rub salt into Swisscom's freedom?

Swisscom reports a **59% market share** in Swiss mobile. For a number of years, Sunrise and Orange (who rebranded to Salt in April 2015[20]) have, without visible success, been trying to challenge Swisscom's unparalleled market dominance.

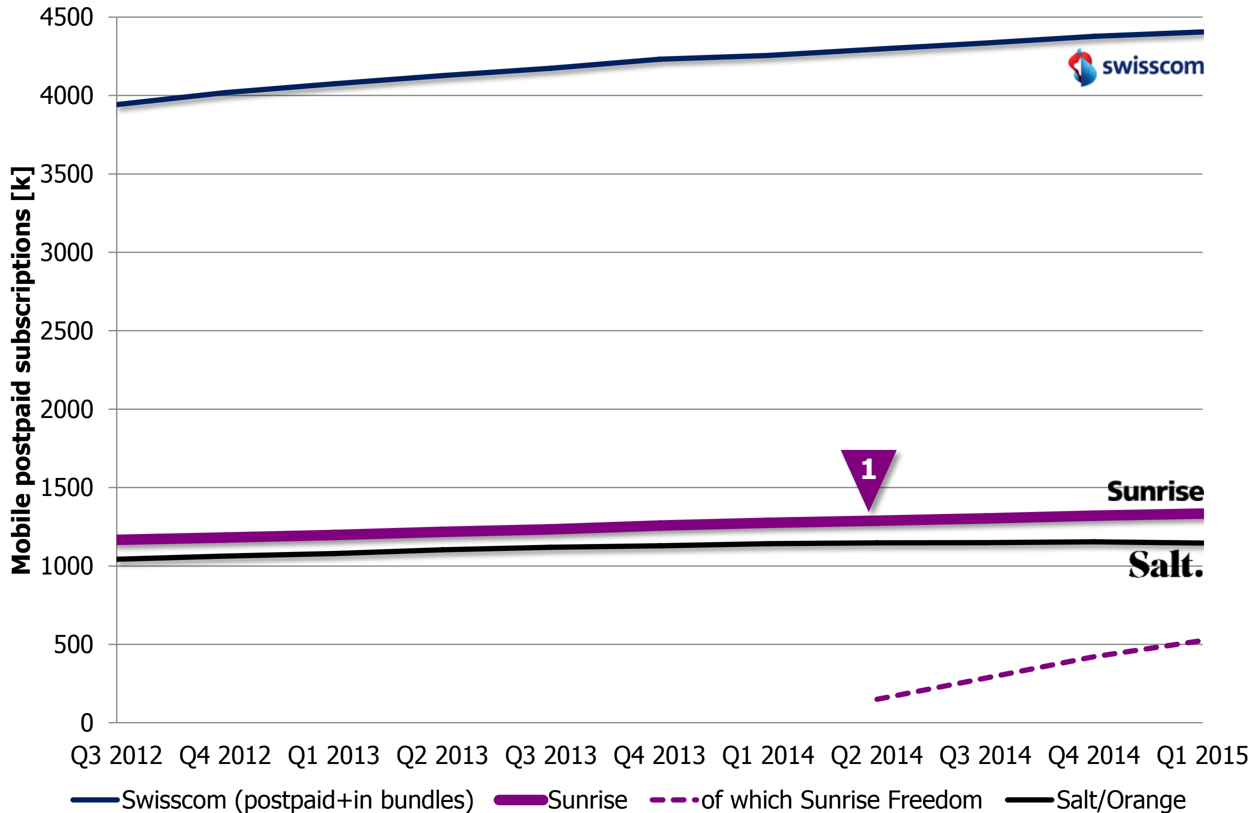


Figure 17. Development of the mobile postpaid bases in Switzerland

Possibly, Sunrise has found their method to become more competitive: With **Freedom**, Sunrise goes all-in on "decoupled, non-binding, unsubsidised" (see miniature). Sunrise Freedom was introduced in April 2014.

coupled — decoupled
binding — non-binding
subsidised — unsubsidised

As a newly IPOed company, Sunrise's investor communication puts a lot of emphasis on how successful Sunrise Freedom is as game changer. If we start noticing the dotted purple line in Figure 17, we note that Sunrise rapidly grows the share of postpaid base on Freedom: It was **39%** in March 2015 – less than one year after introduction. From Figure 17 it appears as if Freedom also has had a positive impact on Sunrise's postpaid intake – at least if compared to Salt. Swisscom's growth seems unaffected.

[20] Following the acquisition by NJJ Capital – privately owned by Xavier Niel, the main shareholder in Free in France

But it is when we look at Figure 18 it starts to become interesting.

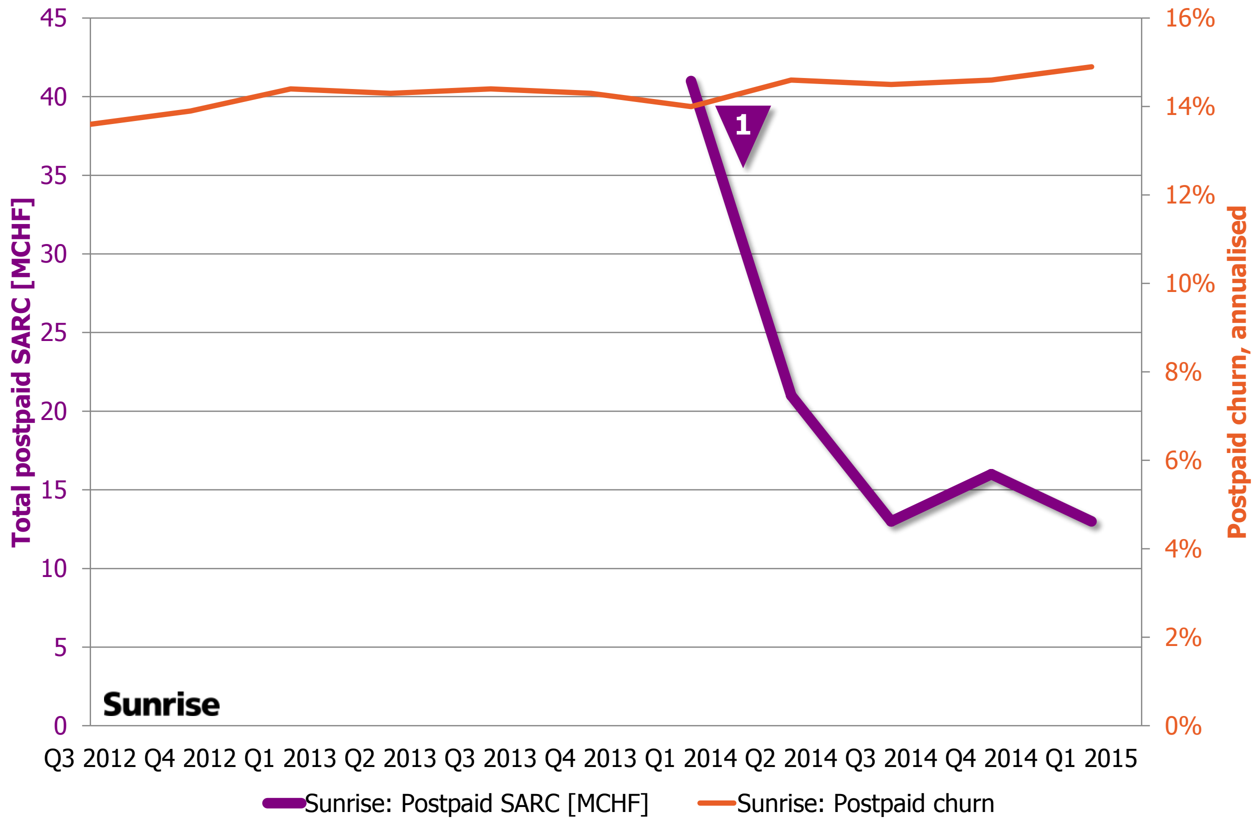


Figure 18. Development of total postpaid SARC and churn for Sunrise

Sunrise doesn't have a habit of reporting total subscriber acquisition and retention cost (SARC), but in Q1 2015 Sunrise provided figures going back to the start of 2014. The introduction of Freedom rapidly took down Sunrise's postpaid SARC **from a level above 40 MCHF to levels around 15 MCHF**. This is what could happen when handset subsidisation is abandoned.

Since Freedom allows customers to churn from the service contracts any month, it's interesting to note that the reported postpaid churn in Figure 18 only increased relatively little after the introduction of Freedom. The effect isn't as compelling as for T-Mobile US (where churn actually decreased; see Figure 5), but Sunrise's figures doesn't support the often-expressed fear that churn would increase substantially without binding contracts.

An explanation to the small churn increase of Sunrise can instead be found if we compare Sunrise's SARC with Swisscom's.

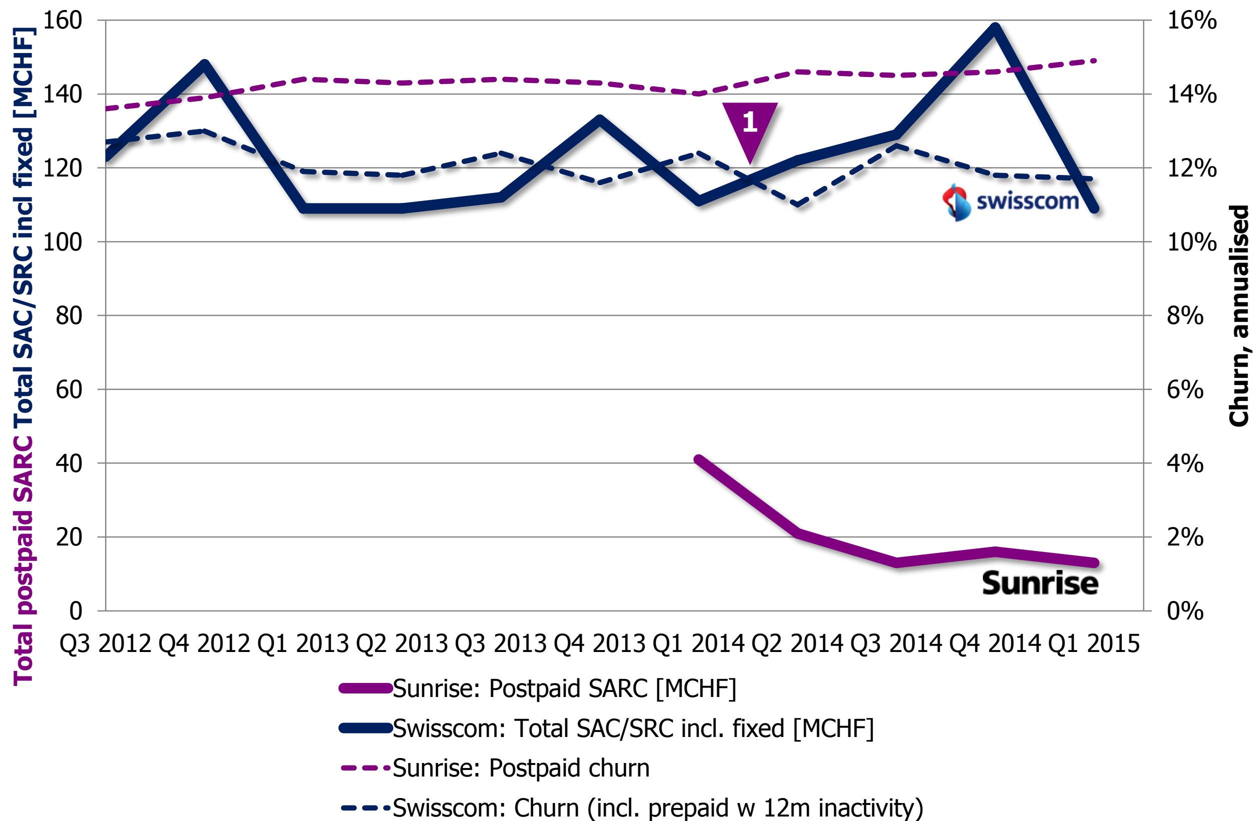


Figure 19. Comparing Sunrise's SARC and churn with Swisscom's

Figure 19 isn't apple-to-apple since Swisscom includes also fixed SAC/SRC into its reported total. Typically though, mobile totally dominates over fixed in terms of SAC/SRC. If we believe the trends, it's interesting to note that when Sunrise started its journey towards lower SARC with the introduction of Freedom, **Swisscom went the other way, increasing total expenditure on SAC/SRC**. In Q1 2015, though, Swisscom is back to a value similar to before Sunrise's model change.

When it comes to churn, Swisscom also includes prepaid, but with a very relaxed 12 month inactivity definition this shouldn't be disturbing the comparability too much. There's no visible effect on Swisscom's (very low) churn rate after the introduction of Sunrise Freedom.

The introduction of Freedom represents an inflection point for Sunrise's revenue

1 If we look at the next figure (20), we can see that the introduction of Freedom led to an immediate increase in mobile hardware revenue. Since service tariffs are no longer artificially inflated to compensate for subsidised equipment, Sunrise's mobile service revenues have been affected negatively, but surprisingly little. If comparing the total mobile revenue, the introduction of Freedom represents an inflection point for Sunrise's revenue: Before the introduction, total revenue was on a negative trajectory; after the introduction, it increased.

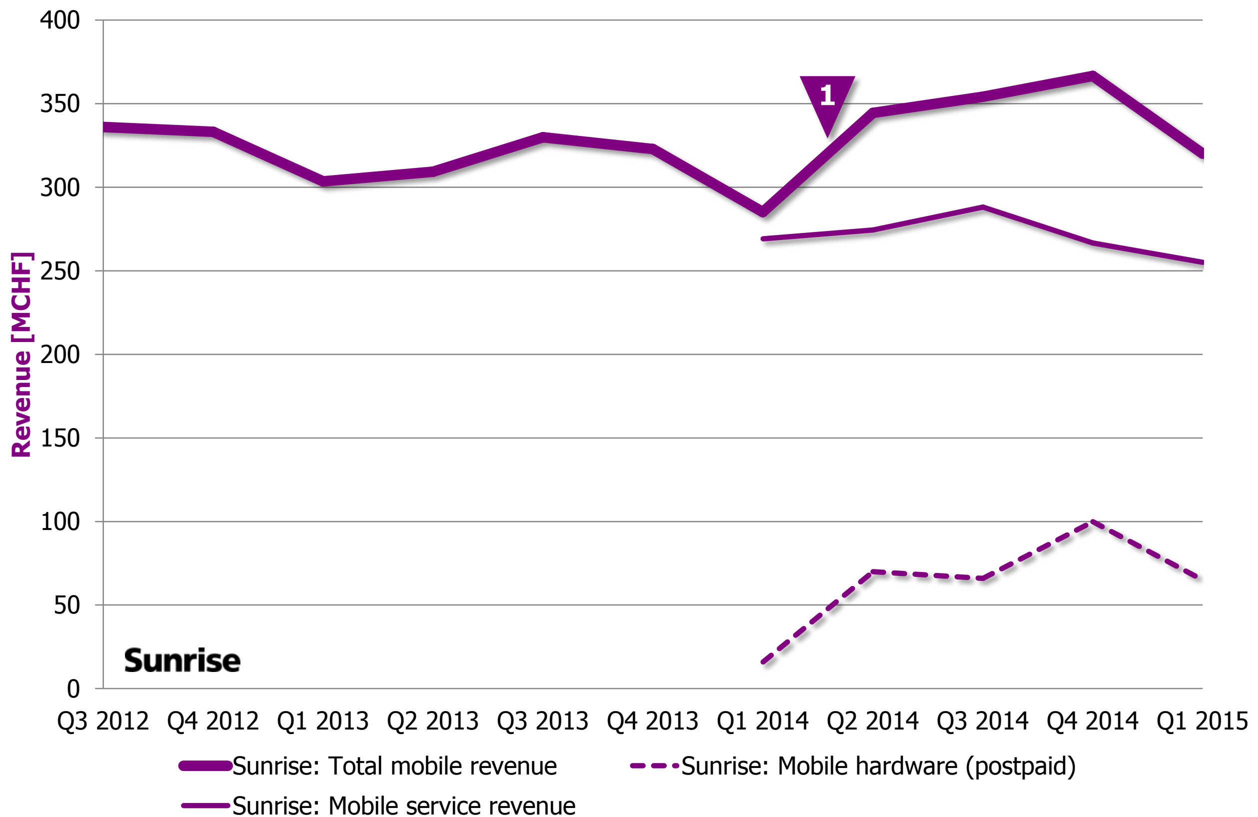


Figure 20. The revenue effect of Sunrise Freedom

In the subsidy model, a large share of the equipment-related revenue is recognised as part of the monthly service revenue during the contract binding period. Obviously, one of the positive revenue effects of going into the "decoupled, non-binding, unsubsidised" model is that equipment revenues can be recognised upfront. This explains some of the revenue improvements also in Sunrise's case. This fact shouldn't prevent anyone from taking this step, though: In all honesty, what's wrong with early revenue recognition? But to ensure the total revenue generation also in a longer-term perspective, it's great if an operator – when making this transition – can convince customers to **up their service plans** – even if just a tiny bit – using "much more value for just a little more" as stimulus rather than "same value for less".

Sweden: Tele2.0 ends status quo

In Sweden, equipment has come to stand for an increasing proportion of operator revenue. Let's take the figures from market leading **Telia** as an example, see Figure 21.

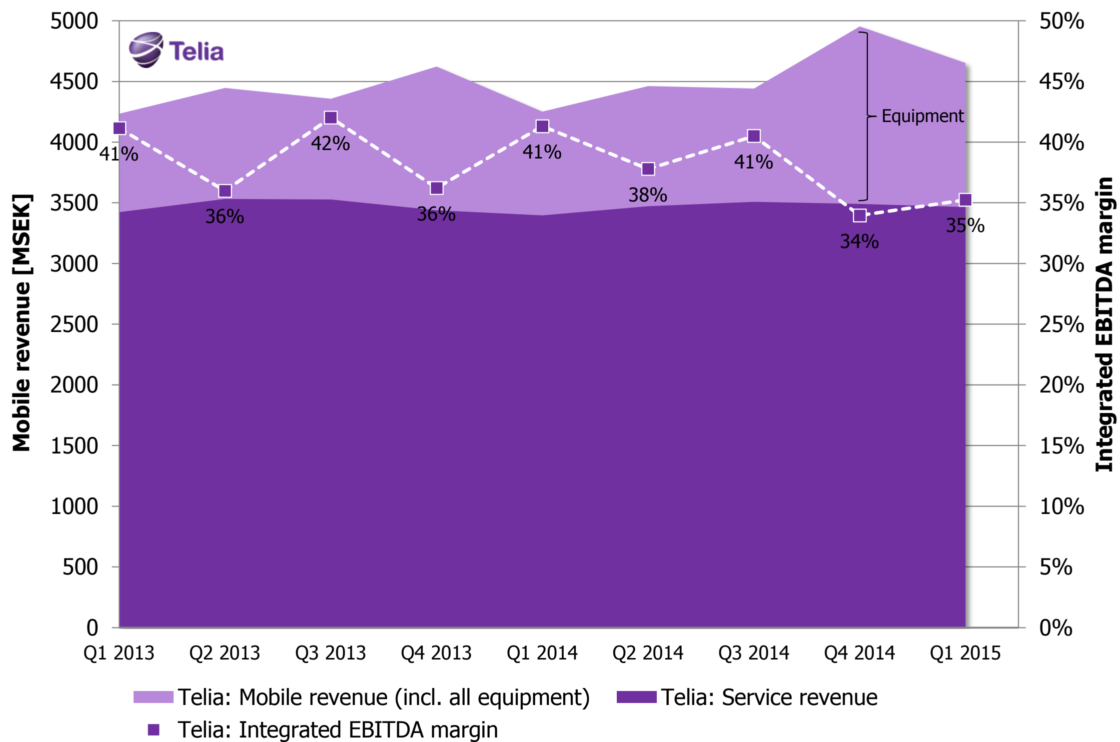


Figure 21. Development of mobile revenue[21], mobile service revenue and integrated EBITDA margin for Telia

Service revenue (dark purple) has been flat in this period – what makes the total mobile revenue grow is **equipment sales** (light purple). Please note what equipment sales do to Telia's integrated[22] margin: Whenever equipment sales increase (like Q2s and Q4s), integrated EBITDA margin goes down. The variation in mobile EBITDA margin would likely be even higher (if reported).

Why does the margin decrease when equipment is sold? Two main reasons:

1. Equipment can be **subsidised**, meaning that the recognised revenue is lower than the cost
2. Unsubsidised equipment is still often sold with a **low single digit margin** as percentage of revenue – if not, operators can't compete with electronic retailers

[21] Telia reports *total* equipment revenue only (possibly including fixed equipment) – all of this revenue is here assumed as mobile
[22] Telia doesn't report mobile EBITDA margin, just integrated. Fixed service revenues represented 47% of Telia's revenues Q1 2015.

One way or another, operators need to get out of the situation where revenue from what they produce profitably – services – isn't growing whereas revenue from what *others* produce and isn't profitable to sell – equipment – is growing. There's really no way around it other than having customers pay for their equipment.

> *Operators need to get out of the situation where revenue from what they produce profitably – services – isn't growing whereas revenue from what* others *produce and isn't profitable to sell – equipment – is growing*

But *how* do you get customers to pay for their equipment?
The short answer: Give something back. As shown in the T-Mobile US example, that something could be **freedom and flexibility** – combined with good value. Which brings us to Tele2.

After a year without disruptive initiatives from any of the operators in Sweden – bringing stable or slowly improving business results for all of Telia, Tele2, Telenor and 3 – Tele2 challenged the status quo in November 2014.

With a set of initiatives – grouped under the **Tele2.0** umbrella – Tele2 said it wanted to change "stupid" industry practices – starting with itself.

The key changes are adhering well to the topic of this analysis (see miniature):

- **Decoupled**: Service contracts decoupled from handsets
- **Non-binding**: All service contracts – for consumers and business customers – are month-to-month with the flexibility to up- and downgrade service mix (or quit) whenever
- **Unsubsidised**: Buy your equipment on an instalment plan – or bring your own

In addition, Tele2 introduced other changes like a free data on demand SIM for e.g. a tablet which the customer can top up with data when there is a need. In conjunction with this, Tele2 also removed the expiration date for all top-up data.

Tele2's results for the fourth quarter of 2014 came too soon after this change to provide any indication of the impact Tele2.0 had on the market. This is perhaps also why the Swedish competition didn't react immediately – they were still in doubt if Tele2 was onto something.

But two months later, **3** launched a new campaign seemingly pointing at Tele2. Under the slogan "A good deal always includes a mobile", 3 countered Tele2.0's weak spot: That customers no longer could get a subsidised mobile from Tele2.

3's pricing favours customers who take a mobile coupled with a binding 24 month service contract.

Shortly after, in February 2015, Tele2 introduced another change when significantly **expanding the data buckets** on the new Tele2.0 plans. Some looked at this as an indication that Tele2.0 had not been well received, but another possibility is that Tele2 planned this as a follow-up to Tele2.0.

Many of the original price points were upped slightly (likely to convince customers to up buckets to "much more value for just a little more"), while other price points were kept. To exemplify, 398 SEK which used to give a consumer customer up to 20 GB of data (and unlimited voice and messaging) became up to 50 GB.

Expanded data buckets resonate well with Swedes who have the second highest mobile data usage in the world.

As with T-Mobile US, **customer satisfaction** is now business critical for Tele2 – since customers on the new plans are free to leave any month they want.

If the competitive reactions were careful after Tele2.0, they were now much quicker: Within a few weeks, all of Tele2's competitors – **Telia**, **Telenor** and **3** – doubled most of their data buckets. With one distinction: Whereas Tele2's change is permanent[23], competition made the data doubling as time-limited campaigns[24].

1 When the **Q1 2015 results** of Tele2 were reported in April, it came in strong – especially if compared to the previous quarter. The fact that market leader TeliaSonera reported softer-than-usual Q1 results for Sweden the same day accentuated Tele2's improvement. Figure 22 below compares the EBITDA margin of the operators – where the black arrow highlights the introduction of Tele2.0.

[23] At least until further notice; when Tele2 doesn't bind customers conditions could (theoretically) be changed from next month onwards

[24] 3 has since ended that campaign, but came back to make some of the bucket expansions permanent in April. Telia and Telenor both prolonged their original campaigns, but Telia finally made the bucket expansions permanent in May.

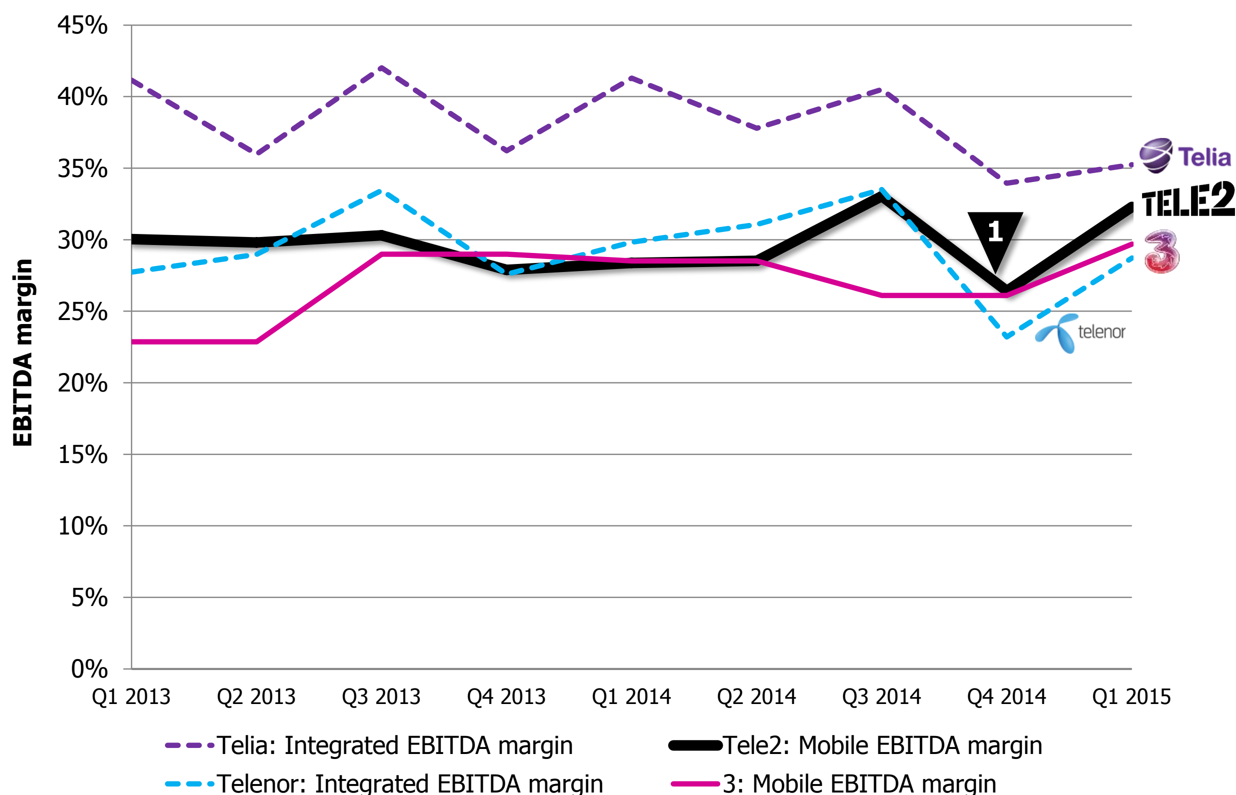


Figure 22. EBITDA margin development in Sweden – Telia and Telenor include fixed

Four months after Tele2.0 and just 6-7 weeks after the expansion of the data buckets, it's too early to draw conclusions. In the meantime, we observe that Figure 22 shows that Tele2 has never been this close to Telia on margin[25].

A difficulty when it comes to analysing the impact of Tele2.0 is that none of the Swedish operators report SAC/SRC and only two (Telia and 3) report churn (but not in a comparable way). Since Tele2.0 addresses postpaid only, it would also have been interesting to follow postpaid net adds – but regretfully Tele2 doesn't separate out postpaid when reporting customer base.

[25] Note that Telia doesn't report mobile EBITDA margin, just integrated. Fixed service revenues stand for 47% of Telia's revenues. When Telia still reported EBITDA separately for mobile and fixed, mobile margin was higher. We believe the *trend* is attributable to mobile (and explained by equipment sales) to a high extent, though.

Conclusion

Mobile operators in mature markets averagely use **15-20%** of service revenue on subscriber acquisition and subscriber retention costs. In spite of this, few of these operators grow.

It's time for operators to break away from the subsidy model. Consumers and businesses have embraced the digital way to buy and subscribe to content and cloud services. Netflix and Microsoft Office 365 are winning over cable TV bundles and PC software which requires installation. In this general trend, the concept of binding consumers or businesses on inflexible 24 months contracts isn't future-proof.

"The future is in flexibility and freedom – not control. Give customers the freedom to stay and they will reward you with their loyalty as long as they are satisfied."

T-Mobile has transformed the mobile market in the US with its "decoupled, non-binding, unsubsidised" approach. Also T-Mobile's competitors have followed: In Q1 2015, **70%** of AT&T's postpaid gross adds came on unsubsidised plans (Next or BYOD[26]). Verizon and Sprint reacted slower than AT&T, but still had take rates of 39% and 37% respectively for their unsubsidised Edge and lease plans.

We have analysed six European markets where one operator pioneered the "decoupled, non-binding, unsubsidised" model – or parts of it. The success of **Free** in France following a **full implementation** of this model is unparalleled in Europe. The first results of **Sunrise** in Switzerland are encouraging. The same goes for **Tele2** in Sweden. These results also come after a full "decoupled, non-binding, unsubsidised" implementation.

The outcome of the **partial implementations** done by **T-Mobile** Austria and **T-Mobile** Netherlands is more ambiguous. Whereas T-Mobile Austria hasn't abandoned equipment subsidy and still bind customers who take equipment from them, T-Mobile Netherlands are binding *all* customers – even those that are SIM-only. **O2**'s implementation of O2 Refresh in the UK – which is also partial since customers are still signing binding service contracts – has been contributing positively to O2's customer loyalty, but the results could also be seen in the light of that none of O2's competitors have yet followed.

It takes guts to break away from the subsidy model. We hope this analysis and the facts within it give more operators the courage to do it. And when you do, make sure to jump into the water at once, not just dipping the toe. There is a first-mover advantage.

The future is in flexibility and freedom – not control. Give customers the **freedom to stay** and they will reward you with their loyalty as long as they are satisfied.

Buying customer loyalty through high SAC/SRC has never been a good idea. At this point – with eroding service prices and escalating equipment prices – it's worse than ever.

[26] Bring your own device

International telco competitiveness specialist providing operators and suppliers with analysis, benchmarks and consulting. Expertise in quad-play, data monetisation, customer loyalty, acquisition vs. retention, Wi-Fi business models and higher margin equipment sales.

www.tefficient.com

This analysis is sponsored by:

Tele2 is one of Europe’s fastest growing telecom operators, always providing customers what they need for less. At last count, we had 13 million customers in 9 countries.

Tele2 is one of Europe's leading telecom operators. We offer mobile communication services, fixed broadband and telephony, data network services and content services.

Ever since Jan Stenbeck founded the company in 1993, Tele2 has been a tough challenger to former government monopolies and other established providers. Our success is largely the result of a strong challenger mindset – because that’s what we are: challengers. Every day, we confront complacent incumbents, outdated business models and narrow-minded ideas. We are all about embracing change, moving fast, taking initiatives, focusing on results, being straightforward – and celebrating our victories.

Our mission is to always offer our customers what they need for less, and ultimately our vision is to be the champions of customer value in everything we do.

www.tele2.com