

# Pivoting the international carrier business

*Evolution of wholesale business and innovation in international telecoms*



The international carrier industry has not brought much satisfaction over the past years. Traditional international carrier products are suffering low growth or are in structural decline, while service and asset innovators emerging in the adjacencies are making a mark in value creation. Telecom groups could have captured those trends through their international wholesale departments or subsidiaries, but their potential as trend hunters has been hindered by fragmentation or missing purpose. Telcos should rethink their international wholesale strategy, regroup, and overcome their internal resistance to change. As the business evolves and is disrupted by new entrants, we emphasize the need to revive international operations consolidation and reboot their mission.

## International telecom wholesale remains unknown to many

The international wholesale/carrier business is a niche segment that remains unknown to many, even within the telecom community. We have found that only a small group of professionals has real knowledge of telecom subsectors, such as international termination, submarine cables, IP international interconnection, Internet exchanges, international roaming, international messaging, and emerging products in the international connectivity domain.

The legacy part of this business is overly mature, and the magnitude of revenues associated with the subsectors is small compared to traditional “national” products. The former can be estimated as a fraction of the total telecom business (in terms of dollars, it is tens of billions versus trillions).

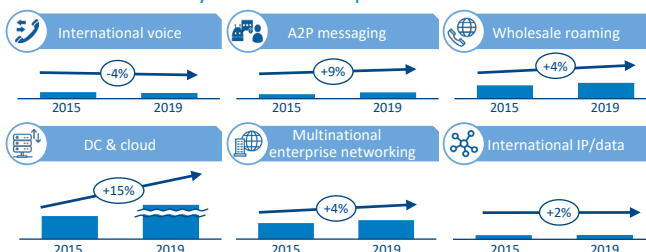
## The wholesale business is overly mature

The legacy telecom wholesale business consists primarily of four product lines – international voice, roaming, messaging, and capacity (IP transit and managed connectivity) – with voice being the major product line by gross value. However, the business mix has been changing due to the high maturity of voice, which is dropping, along with a shift to application-based communications.

Wholesale voice revenues have been declining at the rate of around 4% year-on-year between 2015-2019, due to the

onslaught of over-the-top (OTT) communication (see figure below). International voice traffic in 2019 was 7% lower than in 2018, while OTT communication volumes grew during the same period to three times those of legacy voice. The trend post-COVID is expected to be largely similar. Further, the margins for the voice transit business are rock-bottom at 2%-3% for many key destinations. In response, many international carriers adopted a volume growth approach by acquiring or integrating their operations with other carriers to increase the scale of the business. However, a few followed a different approach: purposely permitting low-margin route volumes and gross revenues to fall while they focused their efforts only on higher-margin routes.

Revenue evolution by main wholesale products



Source: Arthur D. Little analysis

The roaming business is similarly mature and is being impacted by regulations. In recent years (pre-COVID), the tariff regulations imposed in markets such as the EU had a temporary positive effect, as it changed customer behavior and resulted in additional traffic. However, the traffic growth is barely expected to compensate for the tariff decline in future years.

On the other hand, the messaging business has compensated for the decline in person-to-person (P2P) messaging with significantly growing volumes of application-to-person (A2P) messaging. While the P2P messaging market has been declining by 9% every year driven by OTT substitution, the A2P market is growing by 8% every year due to new use cases (e.g., marketing, customer engagement, and authentication).

Finally, the capacity business has become the key driver of telecom wholesale business in recent times. International capacity needs have been growing multi-fold, with increasing penetration of 4G (now 5G) and fiber services and adoption of cloud-based services. Though international capacity prices have been declining yearly around 25%-35% (depending on the route), the demand for capacity is compensating for the price decline.

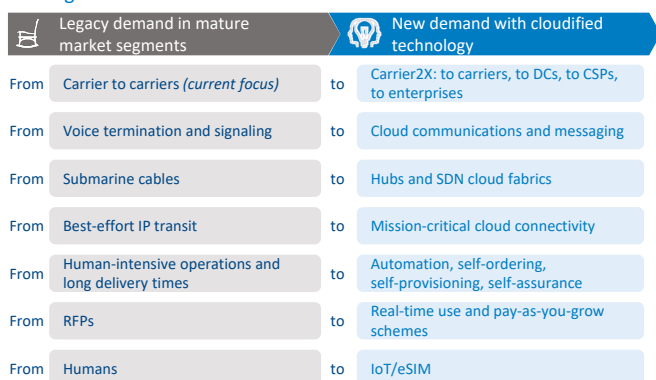
## International telecoms have evolved much beyond traditional international telecom wholesale

In the last five years, the international telecom landscape has changed profoundly, to the point that we need to expand the notion of wholesale to one of global solutions. The word “wholesale” is sort of outdated and limited now, with its use pointing to something narrow and declining today.

From one side, investors’ interests have shifted toward either heavy infrastructure-based models (e.g., towercos, fibercos, data centers, and submarine cable hubs) or digital cloud-based platforms (e.g., cloud communications [CPaaS], edge content delivery networks, cloud exchanges and cloud fabrics, and software-defined networks) that can directly address multinational enterprises from cross-border positions.

From the other side, a tectonic paradigm shift has shaken up the international telecom and wholesale market from strategy, product, and operational perspectives. New products have shown a high innovation potential, being based on transparent, automated, real-time platforms developed at a global scale (see figure below).

### Paradigm shifts in the international carrier sector



Source: Arthur D. Little analysis

The new product categories that have emerged from the traditional international wholesale market are pioneered by nontraditional telecom players that command the value creation. The corresponding value generated in revenue terms has already largely exceeded that of the legacy wholesale market, which remains largely not transparent.

The innovators benefit from positive investor sentiment resulting from the new global platforms. These platforms have reconstructed core international carrier products (e.g., international voice, messaging, and roaming), putting digital technology and software at the center of their proposition. As a result, they scale far better than traditional international carrier models. For those companies that entered the stock market, market capitalization has reached nearly US \$200 billion.<sup>1</sup> Half of this value comes from companies established since 2008, which is remarkable, as these business segments were created around Internet backbones first established by Tier 1 international carriers 20-25 years ago.

## International carriers suffer from fragmentation and missing purpose

Over time, telecom wholesale has evolved from a trading business among a few players into a heavy asset-based business or high innovation game, but traditional international carriers’ strategy remains (*with only a few exceptions*) somehow anchored in past approaches and products:

- Strategy is focused primarily on serving internal needs and only opportunistically on generating third-party profits. Big bets and M&A initiatives are rarely started by traditional international carriers.
- Product portfolio largely remains centered around the set of four mature products (i.e., voice, messaging, roaming, and capacity), while the world moves toward cloud-based platforms.

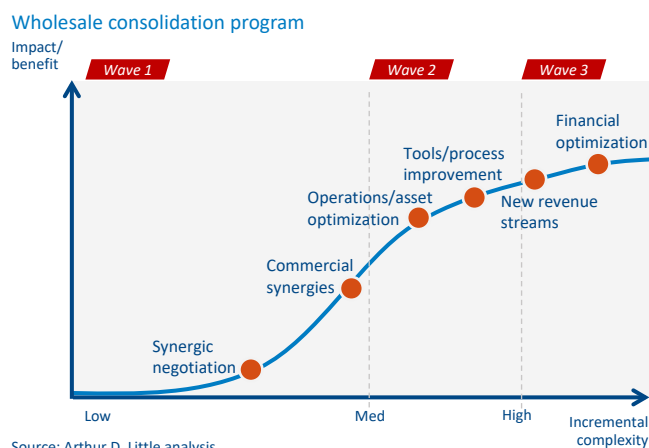
These international carriers – departments, divisions, or standalone operations – could have captured trends earlier and could have had the capability to make inroads into the new topics if their company or telecom group had better managed fragmentation of operations, given a purposeful mission toward innovation, and trusted the sector to bring remarkable insights on new opportunities. Instead, the market has been left open to disruption by new players or consolidators.

<sup>1</sup> According to Google Finance on 4 June 2021, nine companies made up this market capitalization: Akamai, Cloudflare, Equinix, Fastly, Limelight, Megaport, Sinch, Twilio, and Vonage.

## If innovation is too ambitious, wholesale consolidation offers short-term cost benefits

With consolidation, telcos can pool their resources and invest better in infrastructure and/or platforms. The consolidated entity can then offer services to its captive operating companies (opcos) at prices below or on par with the market, maintaining the value within the consolidated entity or among the opcos. Further, the value of these assets increases with the geographical extent of the network. By building a large, interconnected international network, the telco can offer reach to many more locations and promise higher-quality services. Thus, it can better fulfill the connectivity needs of enterprises and smaller carriers served by its B2B business and enable third-party business at the same time.

The consolidation of international wholesale business is not new to telecom operators; it has been discussed since the early 2000s. The trading nature of voice and roaming, which characterized the wholesale business then, made consolidation an obvious solution – higher volumes led to improved negotiation power and beneficial pricing for the consolidated entity (see figure below).



Today, wholesale consolidation still has two primary objectives: increasing scale and pursuing efficiency. Telcos with a small footprint consolidate their business with other telcos and inflate their size to get a seat at the wholesale negotiation table, which is dominated by large telcos and incumbents. This consolidation helps smaller telcos protect their interests and eventually serve third parties that are not aligned to any of the big groups. In the long term, such businesses become standalone, and profit generation becomes a more prominent motive.

From our experience with various telecom groups, we have observed that such consolidation can unlock value up to some percentage points of the combined EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) of the participating entities.

## Resistances galore, no matter the objective

Though wholesale consolidation is understood to bring clear value, it faces a lot of internal resistance (as with many M&As). Even when consolidation occurs, the consolidated entity has narrow scope and limited investment power. In consolidations that involve two or more independent telcos, a key point of contention is the governance of the consolidated entity, which entails the following aspects:

1. **Shareholding structure.** The shareholding of each participating telco in the consolidated entity determines the value the telco derives individually.
2. **Staff appointments.** The telco in the consolidated entity that has the right to appoint the CEO and senior executives has better direct control, though the consolidated entity's staff are supposed to work independently.
3. **Asset monetization and write-offs.** When the new entity has the option to unify platforms and resources or build its own assets, it may choose to write off the parent's assets, which impacts the parent's balance sheet.
4. **Value sharing and sharing model.** When one of the parents has large operations compared to those of the other entities, it may move most of the value to its opcos, where it potentially has 100% ownership, rather than retaining the value at the consolidated entity.

In consolidations within a group, the challenges are similar. There is an evident power struggle between large opcos trying to protect their own business while the group tries to do the best for all opcos. The opco managements may also be concerned about losing flexibility on retail offerings or their wholesale staff being rendered redundant. Last but not the least, the group will have to convince opcos of the potential for creating value and must implement a value-share mechanism that is agreeable to all entities involved.

In addition to the above, in both types of consolidation, the stakeholders need to manage the challenge of gaining the trust of telecom regulators, tax authorities, and minority shareholders.

Such resistance has delayed many wholesale consolidation initiatives in the past, despite the evident and recognized value creation opportunity. The zeal to set up the ideal partnership or consolidated entity impacts the ability to begin the process. In a few cases, partnerships that were established for many years have been broken or reformed due to the challenges outlined above.

## What should telcos do?

Telcos should keep a close watch on innovation in the international telecom segments. They should create and train teams capable to monitor these trends and act when necessary.

Consolidation in the international wholesale market offers such an opportunity. Consolidation is unavoidable, as it offers both significant cost savings and opportunities for growth, although the window of opportunity for cost-efficiency is almost closed due to the hypermaturity of underlying products. Telcos and telco groups must focus their attention on innovative mega infrastructure or internetworking solutions. Many shareholders should recognize that their small operations are unfit for the future challenge. To remain relevant and protect value, telcos should consider these key points as they revive their wholesale/international carrier business:

- 1. Be ready to engage in consolidation.** Groups should begin or revive international telecom initiatives among their opcos, irrespective of past failures. Small stand-alone telcos should look for potential suitors for a consolidation or centralized orchestration, based on strategic fit and potential synergies. If there are ambitions for a significant role in the international business, then the telco should aim to be a shareholder rather than a customer. Groups and stand-alone entities should also be open to further consolidation opportunities, as the market landscape is expected to change continuously.
- 2. Build a strategy based on investments and innovation.** Though cost savings by consolidation can justify cost of consolidation itself, it does not offer a long-term purpose for the wholesale entity. The entity will lose its meaning once synergies are achieved and will continue to have declining profits due to hypermaturity of products. Thus, we strongly suggest the wholesale entity be based on a plan of investments in large capacity and innovation in new products. The entity should develop a plan to be sustainable based on third-party revenue in the medium to long term.
- 3. Set up transformation governance.** Most telecom international initiatives start well, identifying consolidation paths and developing a strategy, but falter in implementation. Strategy does not get beyond the boardroom due to disagreements on governance. We strongly suggest telcos to work on governance principles from the start, securing commitment up front with the right support from a third-party facilitator.

In a large telecom's portfolio, value creation and realization are the only way to remove any doubt related to new investments or consolidation. The setup must be conducive to attracting capital and talent into the industry for investments in new assets and developing new products. For telecom groups, that translates to tough questions, which will be the focus of a follow-up Viewpoint.

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## Arthur D. Little

Arthur D. Little has been at the forefront of innovation since 1886. We are an acknowledged thought leader in linking strategy, innovation and transformation in technology-intensive and converging industries. We navigate our clients through changing business ecosystems to uncover new growth opportunities. We enable our clients to build innovation capabilities and transform their organizations.

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