

the meridian

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Ringling up the profits

4



Handset pricing - the key to



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The mobile telecom industry is facing a huge paradox: While 80% of the world population is covered by mobile networks, only 25% of them have access to mobile services (source: GSMA). This raises two fundamental questions: Firstly, from a business standpoint, how can the mobile industry capture the remaining 75% of the market? And secondly, from an ethical standpoint, how can the mobile industry accept maintaining entry barriers to mobile services while societies are becoming increasingly digital? The issue faced by the mobile industry is not coverage... ultimately it is one of affordability.

Mobile networks have taken the lead over fixed line infrastructures in developing countries. They are quicker and cheaper to roll out than landlines and support more flexible billing features (prepay, micro-payment capabilities, cost control). The emergence of new wireless technologies such as Wimax is bound to reinforce the entry of developing countries into the digital society.

However, this stupendous growth is the just the tip of the iceberg. Even though 80% of the world population is covered by mobile networks, only 25% of them have access to the service [See Exhibit 2] with a very uneven geographical split [See Exhibit 1 & 3]:

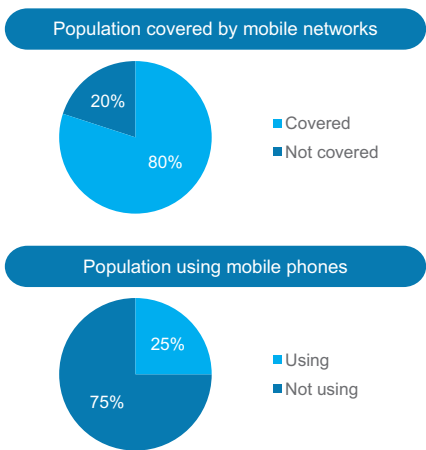
EXHIBIT 1:
UNEQUAL MARKET PENETRATION IN H2 2005

| | Subscribers | Penetration |
|-----------------------------|-------------|-------------|
| Worldwide | 2 billion | 31% |
| North America | 194 million | 60% |
| Europe | 518 million | 79% |
| Oceania | 22 million | 32% |
| Latin America and Caribbean | 150 million | 27% |
| Africa | 76 million | 9% |
| Asia | 692 million | 20% |

Source: Informa Telecom & Media Labs

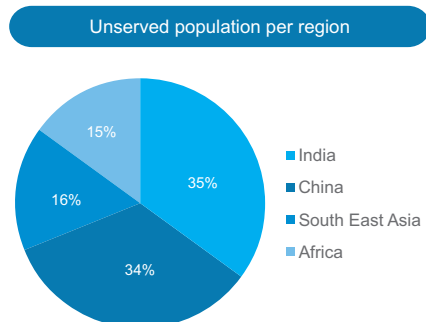
3 billion new subscribers ?

EXHIBIT 2:
THE TELECOM INDUSTRY'S GREATEST PARADOX:



Source: GSMA

EXHIBIT 3:
CHINA AND INDIA ARE THE MOST UNDERSERVED POPULATIONS



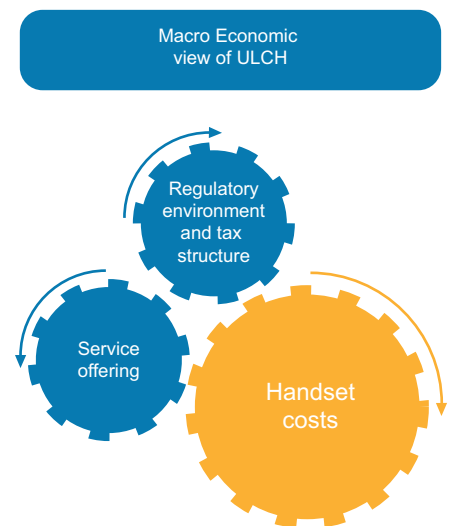
Source: Informa Telecom & Media Labs

There is very little room for additional subscriber growth in many developed countries. The mobile business model has matured towards a value-driven approach in Europe, North America, Japan and Korea through product innovation and renewed service pricing and selling. This trend has led leading handset manufacturers to develop increasingly costly devices (larger colour screens for mobile content, WiFi connectivity, etc). Yet overall industry growth rate has slowed down significantly in developed markets.

The industry is seeking opportunities in emerging markets with high growth potential. CSFB and GSMA forecasts suggest that the worldwide wireless population will reach 3+ billion subscribers by 2010. Over 67% of subscriber growth over the next few years will come from Latin America, Middle East, Africa, China and India, which is where the "next billion customers" are. Developing countries share the same issue: consumers cannot afford to buy today's handsets with an entry price tag of US\$50 to US\$100.

The Mobile industry's equilibrium relies on three key cost drivers: Regulatory flexibility and tax policies, availability of prices and services, and finally handset cost of ownership /affordability (See Exhibit 4).

EXHIBIT 4:
THE THREE KEY TELECOM INDUSTRY COST FACTORS



Source: Informa Telecom & Media Labs

The huge success of mobile telephony in developed countries - with the sharpest product takeup curve in history - was driven by ample access to market incentives. Western operators were able to subsidise handsets through vast investment clout, relatively high ARPU forecasts and customer lock-in contracts consistent with consumer habits. Indeed, profit comes first from subscribers and whether they can afford a handset which allows them access to the network and its services.

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In emerging markets, subscribers have lower income, lower expected ARPU, are very price-sensitive and less loyal, while acquisition costs remain high. Operators have no contractual ties to the vast majority of their consumer subscriber base and cannot afford to subsidise handsets.

As prices have not been adapted to consumer purchasing power, the issue has been bypassed by the users themselves. A secondary retail handset market appeared peddling used, then refurbished and now black market or cloned handsets (at around a third of the retail price). Handset manufacturers are left with unsupplied demand for cheap devices now served by an unofficial grey market accounting for up to 50% of the handsets supplied in Asian countries. Developing market operators, who by then had designed affordable services with very sophisticated prepaid plans and micro-credit payment capabilities, complained that the current handset offering was detrimental to their service as their customers were ill-equipped with poor quality devices (marketing issues aside, onboard SIM applications such as top-up implies strict handset compliance). (See Exhibit 5)

So GSMA have decided to address this “handset issue” in order to maximise access to the poorest populations and clean up the handset market. This initiative, called the Emerging Market Handsets (EMH) programme, defined the notion of Ultra Low Cost Handsets (ULCH). (See Exhibit 6) The goal is to combine efforts of GSMA, major handset manufactures and GSM operators (10 to begin with) in order to drive down the cost of handsets and supply this vast untapped market of at least 3.6 billion potential subscribers¹.

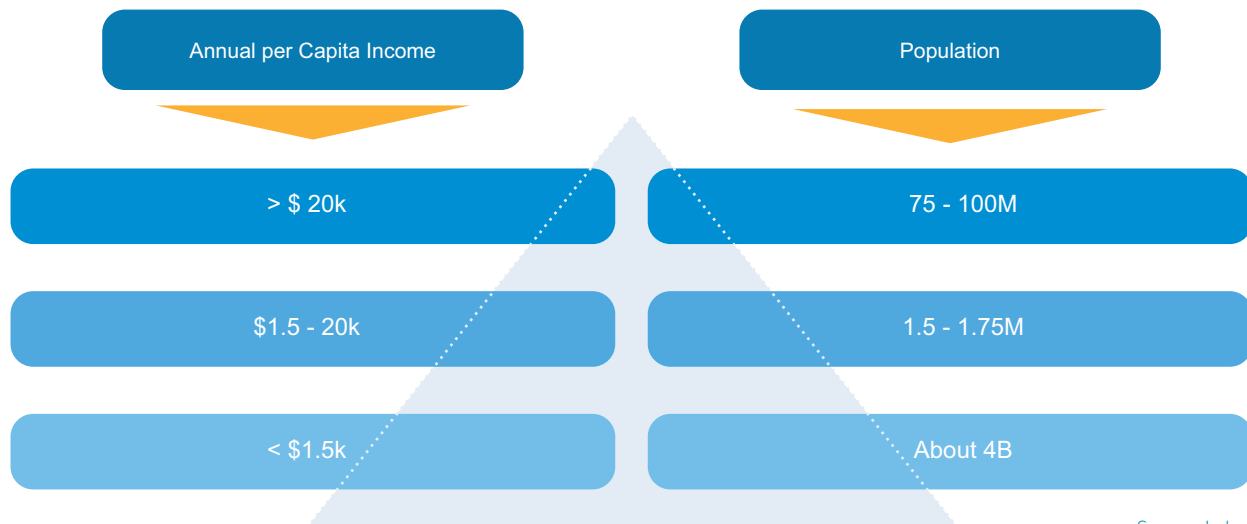
Who are the target users for these ULCHs? GSMA estimates that while the world’s first 1.5 billion users delivered as much as US\$30 per month in ARPU, the next 1.5 billion will deliver closer to US\$5 per month in ARPU in the coming years. Even with a 30% growth in revenue projections, this segment requires handset manufacturers and mobile operators to provide cheap phones and services for the low-end market.

Operators have committed to purchase 6 million handsets to be sold at US\$40, followed by 6 million to be sold at US\$30. These handsets have limited features (black and white screen, only SMS and voice capabilities) as defined by the standard specifications established by the ten founding operators. While Motorola won the first tender in February 2005 with the C115 and C117, new manufacturers such as Nokia, LG, Samsung, TCL, Pantech are now committed to producing ULCHs as well.

As for manufacturers, the challenge is clearly to reduce the bill of materials (handset assemblies, sub-assemblies and basic parts) aimed at cutting considerably the total cost of ownership of subscribers for the operators. The cost of the handset is an essential aspect in the acquisition of new users, but it might not be obvious for existing users. Indeed, in some cases, the business case is not as simple as it looks, especially if we consider that the total cost of ownership is made up of the price

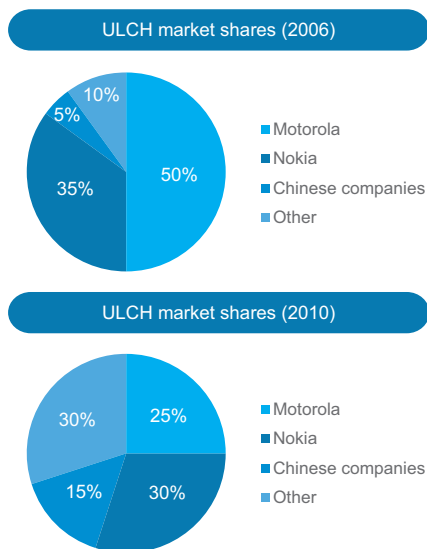
A vast untapped market of at least 3.6 billion potential subscribers

EXHIBIT 5:
POTENTIAL MARKET FOR ULCH



Source: Lehman Brothers

EXHIBIT 6:
MAIN ULCH VENDORS PRESENCE



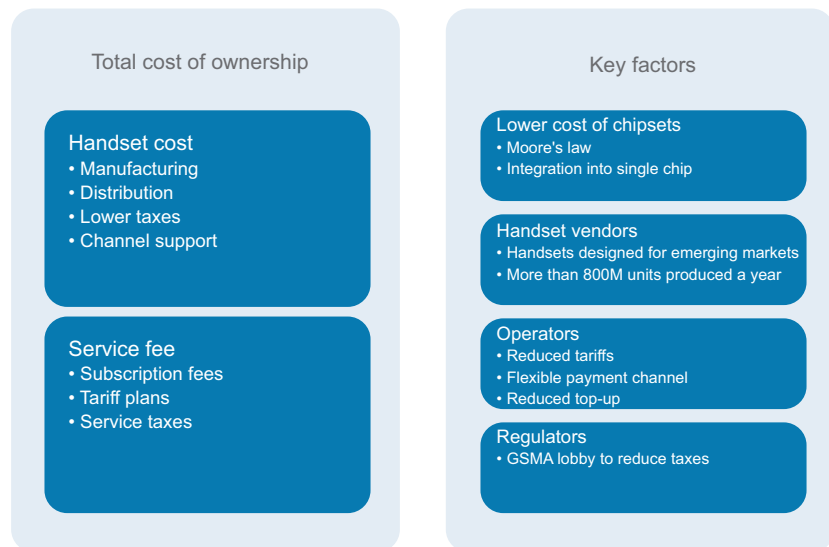
Source: Informa Telecom & Media Labs

of the handset plus the service fees. The handset price is not an issue in some cases as those users are already used to acquiring refurbished, used, smuggled and cloned units. As for service fees, the ARPU is not the correct indicator of total cost of ownership, since many low-end users are below average spenders. Moreover, micro-payment facilities allow topping-up for less than a dollar for an unpredictable period which varies according to when the calls are made, the top-up amount, the credit transferred by or to third parties, etc. The average revenue per minute per SIM is a more appropriate indicator (See Exhibit 7).

The ULCH is then more a process than a price point supported by a cheap product, considering the value chain impacted by various players (chip producers, OS developers, battery life development companies, etc.)

How can we quantify the ULCH market? The addressable market represents real opportunities for local and foreign investment because of its sheer size. The

EXHIBIT 7:
HOW ULCH CAN BE CHEAP ?



source: Lehman Brothers.

primary market concerns the EMH members' addressable consumer base (local and overseas operations of Orascom, Bharti, Turckcell, Telenor, Smart, AIS, Globe, Maxis and Singtel) where about 1.88 billion people are not serviced even though coverage exists. The overall market, as stated above, is estimated to be up to 3.6 billion consumers.

In terms of business returns, let us first look at the handset manufacturers. The overall profit margins of Motorola during the launch period of the ULCH in 2005, when 3 million ULCH devices were delivered, increased from 10% in Q1 2005 to 10.7% in Q3 2005. Market share over the same period soared from 16% to 19%. Obviously the high-end market dilutes the figures, but volumes are impressively huge when you consider that this low-end market would not be reachable without the EMH initiative.

The increase of market share is significant on the operator side too. Orascom in Algeria had 500 thousand subscribers in 2003 with a penetration of 1.6%. A 20%

drop in handset prices combined with revised tariff plans pushed the penetration rate in Q3 2005 up to 32%. Then the products and services developed by operators and third party system companies started becoming a key enabler for sustainable growth. Indeed, the amazing flexibility of prepaid systems, which enable users to make micro payments, person to person top-ups, free USSD call-back services, is independent from the handsets themselves. But cheap handsets can be considered as the trigger that removes the barrier to adoption of new services which are expected to drive traffic and revenue for the operators. According to Moore's law and the incredible efforts resulting from the EMH initiatives, we can expect that today's US\$30 handsets could even become suitable for offering 3G services in the near future.

The ULCH also has a future in developed countries. European operators are starting to express strong interest in ULCH. Indeed there is a market for low-usage market segments in which the drop in handset prices can justify a subscription and increased simple airtime. There is also a

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market for 2nd and 3rd handsets which are not subsidised by the operator.

Finally there is also room for high tech low cost handsets. Many operators fail to migrate users of traditional 2-2.75G networks to 3G services because of handset prices. On the other hand, operators cannot subsidise handsets indefinitely. Now that the industry has proved it can make considerable efforts to reach untapped markets, why not replicate the model to other smaller but financially interesting markets? What would the consequences of an agreement between the main European operators and Smartphone manufacturers be?

This idea is not so stupid. Indeed, the portfolio of mobile digital media (video,

music, games, etc.) is growing rapidly, and meanwhile most Smartphone buyers spend much less overall on service than the cost of the handset itself. Let's recall two of the fundamentals of the EMH program: ease of subscription to mobile services, and cheap handsets.

Of course, the growth of next generation services can be encouraged by the price decrease of the technology needed to use them. But this is not all. The operators' task of making mobility plans attractive is important too, bearing in mind that users consider first the handset price and then the tariff that goes with it.

Lehman Brothers did an interesting study on the impact of monthly spending according to the price of the handset in active ULCH markets. It appears that a US\$50 handset

is equivalent, on average, to 1.4 times the monthly spending of the individual. They then assume that reducing the handset price leads to 25% savings on their annual spending compared to the price they would have paid for a non ULCH and entry range handset. This annual saving goes up to 43% when the handset is a US\$30 one. So reducing the handset cost increases the affordability of mobile services for a constant budget (which tends to remain constant or to increase after ULCH introduction). This model is also interesting for western countries to reduce the amortisation period of next generation services. But the operators don't have to make the effort on their own. A strong partnership between operators, handset manufacturers and content enablers is essential.



We can see a clear paradigm shift within the telecom ecosystem. Social and business issues are being solved by taking the initiative to change the way the industry works. The EMH initiative opened up the opportunity for low-income populations to be connected and become mobile. The consequences are more far-reaching than simply the extra revenue the industry can generate. Just as energy for isolated populations supports their development, mobile communications has a positive impact on living standards. The initiative also demonstrated that industry players can cooperate to deliver to market expectations. There is much to learn from this example concerning for instance the take-off of next generation services.

This evolution in the industry demonstrates how the telecom industry can expand beyond anyone's wildest imagination. With a clear plan of cost reduction in handset manufacturing and distribution, the EMH has created a true potential for mobile service access and new subscriber growth for the coming years. Believing that selling US\$30 handsets is not a matter

of interest would be dangerous, because today's new low ARPU customers from emerging markets may become tomorrow's valuable customers. There are potentially 3.6 billion of them [See Exhibit 8]. ■

NOTES

(1) source: GSMA - BDA China estimate, 2005

Bio

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Adrien spent most of his career in software product management in USA and Europe. Adrien joined SLP Infoware in 2002 as product manager of customer-driven developments on SLP's flagship business application dedicated to predicting and managing customer churn for telecom operators. He also spent a lot of time at operators' sites conceptualizing new generation CRM software.

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Grégoire has an extensive international consulting experience in Telco & predictive marketing software industries. He joined SLP InfoWare in 2000 to head the take-off trainings of Predictive CRM projects. He then managed the creation of value models, implementation methodologies for continuous improvement & presales operations. He then joined Gemplus as Solution Marketing Manager in charge of combined applications for sim-cards and predictive CRM. Early 2004, They co-founded Squid Solutions, entirely focused on customer value management for telecom operators, providing services and software applications to deploy and industrialize predictive marketing processes."

EXHIBIT 8:

REPRESENTATION OF UN-SERVED POPULATIONS

30 largest un-served populations

Average penetration : 18 %

Subscribers : 793 million

Un-served population : 3.6 billion

Among the EMH scope

Average penetration : 15 %

Subscribers : 330 million

Un-served population : 1.88 billion

Source: BDA China

