The challenge of late market entry

A long-term historic look at the financial performance of Three UK and the lessons for potential new entrants to the mobile market and regulators

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Introduction

Three recently announced its 2023 results and highlighted a loss at the EBIT (earnings before interest and tax) level as further evidence for the need for consolidation in the UK mobile market and the approval of its merger with Vodafone. Highlighting the losses of a single year fails to fully capture the structural challenges confronting the UK and other mobile markets around the world. In this paper, we take a long-term, historic perspective on Three's performance and highlight the challenges of new market entry and why consolidation rather than new market entry is key.

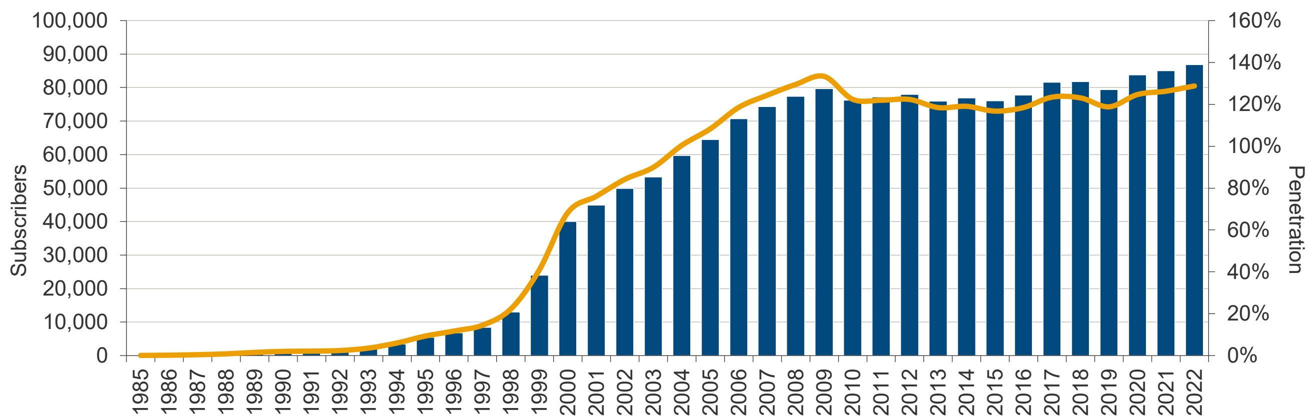
The launch of Three UK

Hutchison's Three UK acquired its "3G" spectrum licence in the infamous 3G spectrum auction at the tail end of the Dot Com bubble. In the auction, mobile operators had to rip up their business plans after the first few rounds as prices accelerated rapidly. Operators continued to bid on the belief that without "3G" spectrum, they would not survive, a belief fuelled by the euphoria surrounding the Dot Com bubble that had yet to burst. The result was aggressive bidding as operators effectively bid the Enterprise Value of their businesses in order to acquire the spectrum and ensure their survival. Three UK paid just over £4 billion for its spectrum and the right to enter the UK market as the fifth player.

Timing is everything

Mobile operators are subject to significant economies of scale due to the heavy fixed costs of running a mobile network so market share is critical to make the economics of the mobile business work. Winning customers is relatively easy when a market is growing rapidly, as it is easier to win a customer looking to sign-up for a mobile service for the first time compared to trying to steal an existing customer away from a competitor. The exhibit below shows the evolution of subscribers and penetration in the UK.

Exhibit 1: Total UK subscribers and penetration



Source: Operator accounts

Hutchison won its licence in April 2000 and its reference for the size of the market and the potential for growth when building its business plan would have been penetration and subscribers at the end of 1999. At the end of 1999, penetration stood at 41% representing 24 million customers and Three would have anticipated being able to capture a significant share of future growth.

Whilst Three acquired its licence in 2000, it did not officially launch until March 2003, although delays in obtaining 3G enabled handsets meant the business did not really achieve a full, effective commercial until 2004. Between 1999 and the end of 2003, penetration increased by 49%, representing just over 29 million new customers which were all acquired by competitors whilst Three remained on the sidelines. At the time of building its business plan and placing its bids, Three could not have imagined how the launch of prepaid in 1999 would lead to such a dramatic acceleration in penetration and growth which it could only watch whilst it built its network.

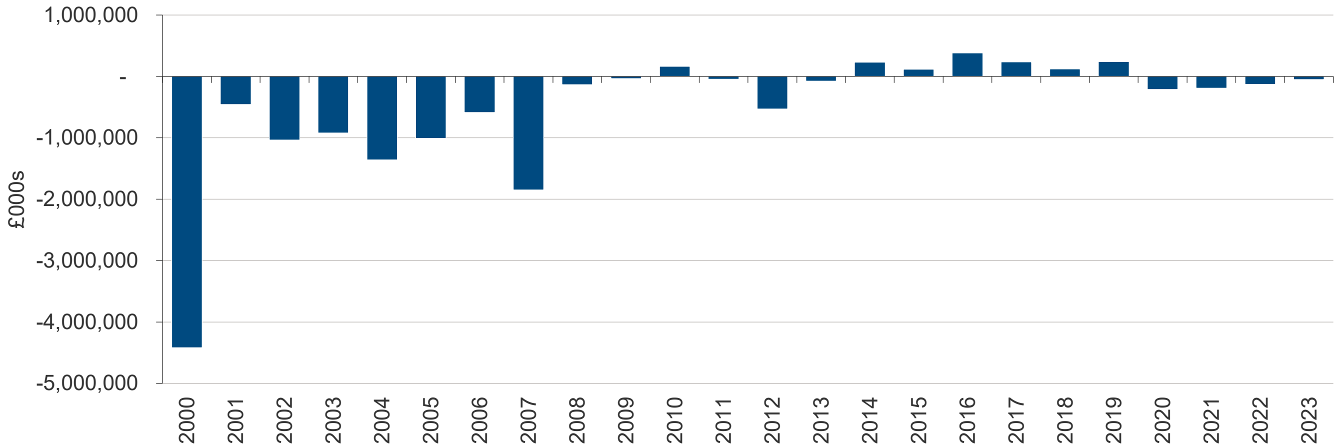
Although penetration continued to grow for the remainder of the decade, winning customers and market share became ever more challenging and it took more than a decade for Three to acquire 10 million customers representing just under 13% of the market.

In contrast, the third and fourth operators, T-Mobile and Orange launched in 1993 and 1994 respectively when penetration had only reached 6% by the time Orange launched. Timing is everything because by the time Three finally launched, T-Mobile and Orange had already acquired collectively almost 30 million customers. The challenge of capturing market share and subscribers as a relatively late 5th entrant had a dramatic impact on the financial performance of Three.

The cash trap

The famed author on strategy, Michael Porter, identified the “Cash Trap” as one of the key risks of late entry into an increasingly maturing market. Even though the UK mobile market was still in the growth phase when Three launched, it was in the decelerating growth stage. The exhibit below highlights Three’s annual operating free cash flow (EBITDA – Capital Expenditure) since launch. The company needed 11 years of trading before it became operating cash flow positive in 2010.

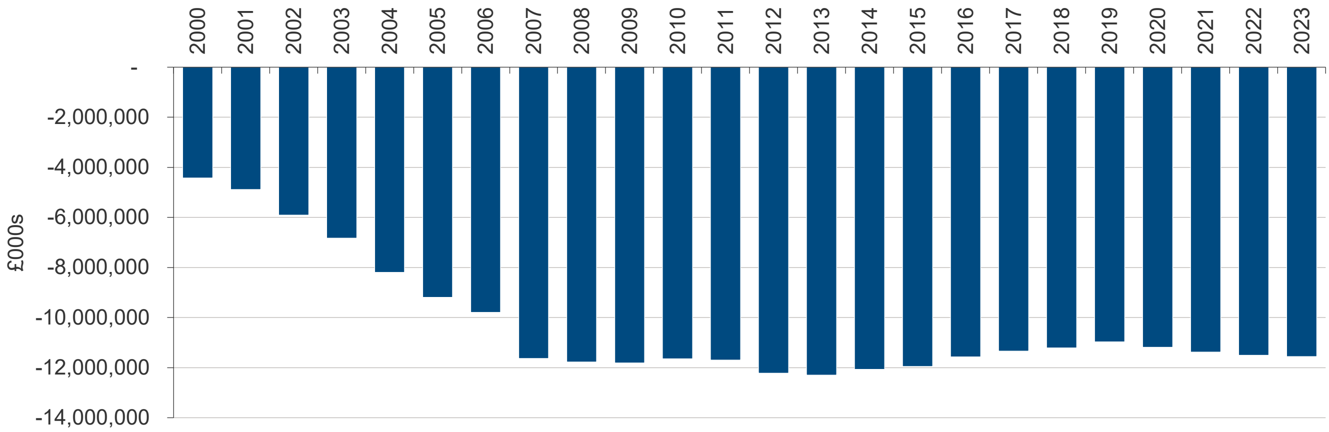
Exhibit 2: Three operating free cash flow



Source: Three company accounts

The full extent of the “Cash Trap” is best illustrated in a chart of cumulative operating free cash flow, shown below.

Exhibit 3: Cumulative operating free cash flow



Source: Three company accounts

The company's cumulative negative operating free cash flow position grew over the 11 years when it was not generating positive cash flows and bottomed out at around £12 billion. However, as the chart reveals, the company has not been able to recoup those initial losses. The market largely reached saturation and maturity in 2009 and with five players competing aggressively for the vestiges of growth, profitability was low whilst the need for continuing network investment remained high as data traffic growth accelerated. Today, the cumulative position is only slightly better than it was in 2009 with cumulative operating free cash flow losses of £11.5 billion.

The proposed merger between Vodafone and Three values the combined business at £15 billion. Three's stake is slated at 49% which translates to a value of £7.4 billion. That does not compare particularly well with the cumulative cash flow losses of £11.5 billion that were invested to arrive at where we are today. It is interesting to note that had Hutchison invested its first year of cash losses in a low-risk 10 year treasury bond, its initial outlay would be worth £9.3 billion today.

Lessons for potential investors

There are many markets where regulators are still seeking to promote new market entry and there are some investors who are still prepared to take up the challenge despite penetration growth being largely non-existent in most markets. A recent and expensive example is Mafab Communications US$ 273 million acquisition of 3.5 GHz spectrum in Nigeria in 2021.

Coleago has built a large number of spectrum acquisition business cases for new entrants and for at least the last 15 years, we have not been able to make the new entrant business case work, even with the most aggressive of assumptions. If Three struggled to create value, despite launching when the market was still in the growth phase, then it is difficult to see how todays' new entrants will generate value in markets which are now fully mature albeit potentially slightly less competitive. They face a very significant "cash trap," the challenge of building market share in a mature market where there is limited scope for differentiation. The Latin maxim, "caveat emptor" or "let the buyer beware" has never applied more strongly.

Lessons for regulators

Michael Porter explored the developments that take place during the different stages of the industry life cycle in his 1980 book, "Competitive Strategy." In the growth or maturity phase he highlighted that consolidation and potential exit were the most commonly adopted strategies or in some cases, the only viable option. It would appear, however, that some telecoms regulators are not disciples of Michael Porter and continue to promote new market entry into mature markets through devices such as spectrum set-asides for new entrants in spectrum auctions. Fortunately, this is becoming much less common, but there remains a belief within many regulators that more competition is always better than less. Today, this belief is usually evidenced by the resistance to inter-market consolidation such as the proposed merger between Vodafone and Three. In my recent paper, “The Longest Hangover,” I explored how “excessive” competition in the UK mobile market has pushed returns below the cost of capital which deters investment in innovation, new services or expanding coverage and capacity.

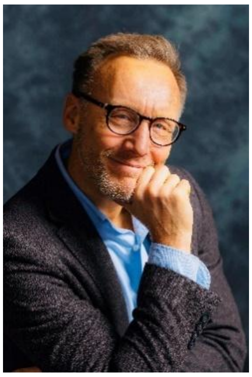
Regulators typically have a defined set of statutory goals which usually include promoting the interests of consumers on the one hand and creating an environment that encourages investment and innovation on the other. Unfortunately, to some extent, these objectives are in conflict with each other and regulators, it would appear, are struggling to find the right balance.

The key problem with promoting new market entry in a mature market is that whilst the investors in the new entrant are very likely to suffer, the need for the new entrant to capture market share often results in significant damage to the returns of existing operators. In an undifferentiated market, price is often the only mechanism with which to compete and a new entrant will often price at a discount in order to win customers. The downward pressure on prices, whilst good for consumers, rapidly pushes returns down below the cost of capital. The result is an environment where the industry does not have the incentive to invest and innovate which in the long run will ultimately be detrimental to consumers.

As I argue in the Longest Hangover, customers have benefited significantly from competitive mobile markets, largely at the expense of mobile industry shareholders. Regulators who continue to promote new market entry risk damaging incentives for investment and innovation. Regulators need the mobile industry to flourish so that it can continue to invest. In many markets, it is consolidation, rather than new entry, that is required to create an environment conducive to continued investment.

About Coleago Consulting Ltd

Graham Friend, M.A., M.Phil., (Cantab), ACA, is an economist, an award-winning author for The Economist and the Managing Director and Co-Founder of Coleago Consulting. Coleago is a specialist telecoms strategy consulting firm and advises regulators and operators on issues relating to spectrum, regulation and network strategy. If you would like to discuss any of the issues raised in this paper, then please contact Graham.



Email: graham.friend@coleago.com

Mobile: +41 798 551 354

