



The Death of Triple Play – June 2002

European cable operators should halt the rollout of telephony services in order to concentrate on what they do best – television distribution and broadband Internet access. This strategy shift, from “triple play” to “dual play”, would radically improve cash flow, with television distribution as a cash cow, and create additional value for the new owners of the cable systems, as broadband Internet access provides the engine for future growth.

While the European cable sector clearly needs restructuring to reduce its excessive debt burden, the cable operators have a secure future for two reasons. First, the core business on which they are built, television distribution, is mature and generating cash. Secondly, the broadband Internet access market has very high barriers to entry, which reduces the probability of new entrants entering the market and thus avoids the potential for price wars that have destroyed profitability in so many other segments of the value chain.

Telephony

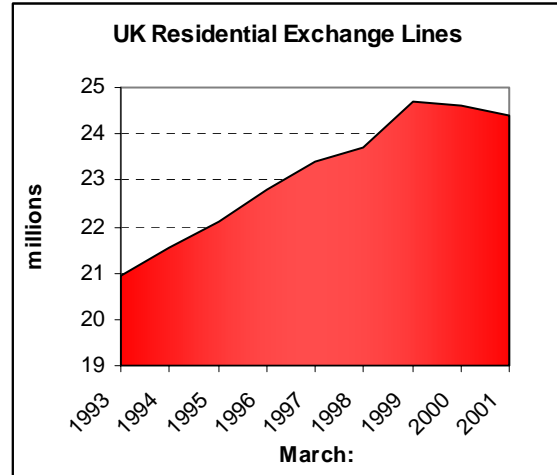
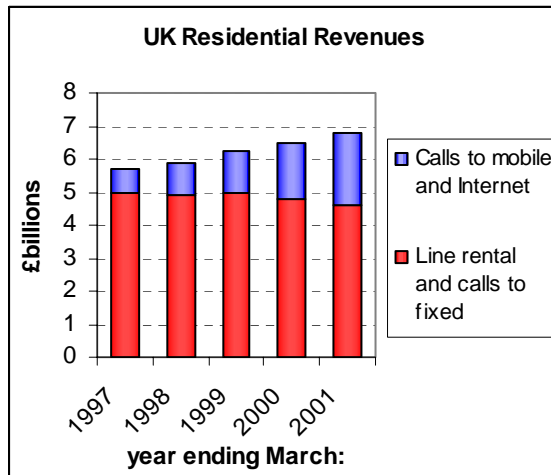
Our reasons for believing that telephony does not add value to cable businesses is three-fold:

1. Telephony has high fixed costs, resulting in substantial investments and operating losses in the early years of operation when penetration, and hence the number of subscribers, is low;
2. Even when cable operators have a sufficient number of subscribers to reap scale economies, residential telephony services are not sufficiently profitable to justify the incremental investment;
3. Fixed telephony revenues, and hence profits, from residential customers are stagnant and will begin to fall as traffic switches to broadband Internet access and mobile networks.

The greatest challenge in creating a profitable telephony business is generating sufficient scale to compete efficiently with the incumbent. In addition to the fixed costs for building the network, there are significant overheads associated with operating the billing, customer care and network management systems for fixed telephony. The roll out of telephony by AT&T Broadband in the US illustrates the problems of high fixed costs. By the end of 2001, two and a half years after launch, AT&T broadband had over a million telephony subscribers, a penetration of 15% in the areas where telephony had been launched, with an ARPU of US\$55 per month. However, despite this impressive performance, the business was not EBITDA positive. With CAPEX of US\$650 per subscriber, the business had a total cumulative cash outflow since launch of approximately US\$1.5 billion.

Telephony is also unattractive because most European incumbents have not yet fully rebalanced and as a result, make a loss on their Residential line rental. BT, for example, reports a negative margin of 6.5% on its Residential access business. Given the difficulties of differentiating basic voice services by any means other than price, cable operators have historically offered a discount to the incumbent on line rental. Even with the cable operators' lower cost base (once they have achieved sufficient economies of scale), their margins on line rental will be slight at best. Incumbents offset their low margins with much higher margins on calls, but for cable operators margins on calls will be lower as they are not only competing against the incumbents but also from indirect access operators. Overall cable operators are unlikely to make a reasonable return on the capital they invest on rolling out telephony.

Looking into the future, telephony may not be the cash cow that it currently appears to be. In the last five years there have been two drivers of revenue growth in the residential telephony market: rapid growth in high priced calls to mobile phones; and the use of the switched voice network for Internet access. Excluding growth in these two areas, revenues from UK residential subscribers – calls and line rental combined – peaked in 1998 and are now falling at the rate of two to three per cent per year. Revenue growth from calls to mobile is slowing as the mobile market becomes saturated and revenue growth from Internet access calls is slipping as migration to broadband leads to the number of dial up users declining. In addition, residential penetration of fixed telephony has begun to decline as a small percentage of households choose to rely solely on mobile telephones. The roll out of 3G networks, offering greater capacity and hence lower call costs, will accelerate this trend. Taken together we expect to see the revenues for residential telephony to continue to decline in the future with this decline accelerating as more voice traffic switches to mobile networks.



To summarise, continuing with telephony roll out requires huge additional investment and start up losses in order to enter a business with low profitability and declining revenues. Where investment and start up losses have already been sunk, such as is the case for the UK cable industry, the business may have some value both in terms of cash flow but also by increasing customer numbers for other services through churn reduction and better customer acquisition. However in Continental Europe, where telephony is in the early stages of development, it is time to cut the losses.

Broadband Internet Access

The Broadband Internet market is in a similar state of development to the mobile telephony market 10 years ago, with penetration limited to early adopters and prices still set at a premium. Broadband Internet access in cabled areas is basically a duopoly between the incumbent telco and the cable company. Experience in markets where both ADSL and cable modems are available suggest that cable operators are at least as successful as the telcos and that customers generally prefer the higher download speeds offered by cable operators. Thus cable operators are well positioned to follow the S-curve of penetration.

In comparison with telephony, the business case for Broadband Internet is far more attractive:

1. Fixed costs are smaller as IP equipment is far cheaper and more scaleable than circuit switched equipment and with a simple flat rate product, billing and customer care systems can be simplified;
2. Margins are healthy and CAPEX per incremental subscriber are reasonable, leading to a high return on capital employed;
3. The market for broadband access will continue to grow rapidly and with limited competition.

Thus the trough of the hockey stick is much shallower and the rewards much greater than for telephony.

Television Distribution

Pay television is a difficult market, with most platforms making losses. Cable operators should position themselves as the distributors and retailers of television content, playing to their strengths:

- Existing customer relationships;
- More convenient and lower cost distribution compared to DTH satellite;
- Greater bandwidth compared to Digital Terrestrial Television.

Rather than competing with existing pay TV platforms by entering into bidding wars for exclusive rights, cable operators should co-operate with existing platforms, offering another channel to market for their content, while the cable operators retain control over the marketing and packaging.

Experience has shown that there is little demand for digital television in itself. Where possible we believe that operators should attempt to develop their existing analogue business, for example by introducing an extended basic tier of pay TV on top of the existing "free to air" package. We believe that there are two conditions that could justify the launch of digital television:

- There is both a demand for additional pay TV services and a supply of content to fill the available bandwidth;

- Regulatory restrictions or technical restrictions such as lack of bandwidth prevent the launch of pay TV services over analogue.

We believe that the first of these conditions are only met in a few countries, generally the larger media markets where the potential audience is large enough to support a significant number of local pay channels. The second is dependent on both the quality of the network and the understanding of the regulator.

We believe that where DTV is launched it should be a limited broadcast only offering, with little or no interactivity and with no integrated return path. The largest element of cost for a digital television roll out is the buy-in cost of set top boxes. As customers place little value on the box, this cost generally has to be recouped through operating margins. Both interactive services and an integrated return path add greatly to the cost of a basic (approximately \$US100 box) with the inclusion of a cable modem adding around \$US80 and the processing power, memory and software for interactive services another \$US50. We do not believe that the incremental value delivered by interactive services in terms of increased revenues or penetration justifies the additional box investment. However in cases where research suggests that some customers value additional box functionality, a multiple box strategy with differing prices could be adopted, an example being Sky with higher priced boxes with Personal Video Recorder capability being offered at a price premium to the standard box.

Summary

Cable television networks remain valuable assets with genuine growth potential, particularly as the dominant Internet access method in their coverage areas. Refocused business plans after restructuring, stripping away deadwood such as telephony and interactive television, should allow networks to deliver on this potential.

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