2024 PREDICTIONS SERIES

Telecom Industry Retrenches in Response to Macroeconomic Pressures

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TBR

CSPs and Telecom-centric Vendors Will Have to Adjust to Headwinds in Their Industry and the Wider Economy

Macroeconomic and telecom industry-specific challenges that manifested in 2023 — for example, rising interest rates, inflation, lack of 5G ROI, technological complexity, and the end of key stimulus programs and various other economic support mechanisms instituted by governments during the COVID-19 pandemic — are expected to persist through 2024, prompting a response from communication service providers (CSPs) and their vendor partners.

The most impactful and pervasive issue confronting the telecom industry is the rising cost of capital, which has been increasing due to central bankers' shift from quantitative easing (QE) to quantitative tightening (QT) in an attempt to tamp down inflation. The result thus far is companies are now paying on average two to three (or more) times the interest rates they had grown accustomed to since the Great Recession, when central banks began holding interest rates at close to zero. This relatively abrupt change in monetary and fiscal policy has created a concerning situation for entities that are heavily levered with debt, which encompasses nearly all CSPs and many telecom vendors.

CSPs with the weakest financial positions began changing their behavior in 2023, primarily in response to the rising cost of capital, evidenced by fiber build targets being scaled back, assets being revalued and written down, and overall capex budgets being reduced. Some CSPs have also had to layer on more onerous covenants, such as pledging assets as collateral, to secure new debt issuances and partially offset the rise in interest rates.

TBR expects many CSPs with relatively stronger financial positions to also change their behavior in 2024. Changed behavior typically occurs after a reassessment of capital structure and capital allocation, which can lead to a variety of outcomes ranging from dividend cuts to capex reduction to M&A events. Said differently, CSP CFOs worldwide will be under an unusual amount of pressure to meet their objectives in 2024 and they are highly likely to place greater emphasis on cost optimization and cash flow management.

TBR maintains its belief that the telecom industry will look very different by the end of this decade as current events and entrenched challenges push the industry through an evolution.

Prediction: New Round of M&A and Bolder Combinations Are Likely to be Allowed by Regulators

Trend: M&A activity in the telecom industry heats up
Driver: Macroeconomic and industry-specific challenges
Result: Fewer, but larger and stronger, entities will remain

TBR expects M&A activity among CSPs and telecom vendors to heat up worldwide through 2024 as companies respond to market changes and combine to achieve greater scale. There is a growing list of telcos, cablecos and vendors that are entering acute financial hardship and will ultimately require a transformational financial event. That event could be recapitalization (with equity and/or debt), asset divestment (e.g., a business or regional unit, towers, data centers, spectrum), debt restructuring in bankruptcy (e.g., Chapter 11 reorganization), outright bankruptcy (Chapter 7 liquidation, which typically leads to asset fire sales or brokered combination arrangements), partial or full nationalization, or merger.

TBR notes that most financially challenged CSPs (which includes telcos and cablecos) as well as vendors that primarily supply CSPs are based in the U.S., Europe and select countries in Southeast Asia.

There is also a trend toward bolder M&A, with Vodafone (Nasdaq: VOD) and Three UK set to merge and TDS Telecom putting UScellular (NYSE: USM) up for sale. (TBR notes that UScellular is likely to be sold to a U.S.-based Tier 1 CSP.) Vodafone Idea is also in play as it requires a full recapitalization to continue running its business. Depending on what happens to Vodafone Idea, it is possible the India market could be reduced from three to two main private sector telcos.

Private equity firms (e.g., Brookfield, BlackRock, Blackstone, Elliott Management, KKR, TPG) will likely remain active in the telecom industry, providing capital infusions and driving changes among telecom operators, telecom vendors and shared infrastructure owners (e.g., towercos and data center real estate investment trusts).

Examples of this can be seen with AT&T (NYSE: T) and Telecom Italia. TBR also expects other types of entities in the telecom industry (e.g., towercos, outside and inside plant firms) to participate in M&A to attain greater scale. With debt financing more expensive now, TBR expects more deals will have partial or full equity components.

Bold M&A Combinations That Recently Closed or Are Pending and Likely to Be Approved

Operators	*Country*	*Status*
Rogers and Shaw	Canada	Closed
dtac-True	Thailand	Closed
Vodafone UK and Three UK	U.K.	Pending; likely to be allowed by regulators with some concessions

Note: List is not comprehensive.

Prediction: Cash Flow Management Becomes Priority due to Increase in Cost of Capital and Other Headwinds

Trend: Cost of capital (e.g., interest rates) is increasing
Driver: Central banks are engaging in QT to combat inflation
Result: CSP and telecom vendor spending will become significantly more conservative

Interest rates have increased across most of the largest economies in the world as central bankers attempt to tamp down inflation. This change in central bank policy from QE to QT has ended the period of artificially suppressed interest rates in the global economy and ushered in a period in which interest rates have returned to more historically normalized levels. This is an especially significant problem for CSPs because they tend to operate with high leverage.

During the period of QE, CSPs took on much higher levels of debt to fund dividends, cash-emphasized M&A deals, share repurchases, capex and spectrum. However, companies now face significantly higher interest rates when they need to tap the debt markets, either via issuing new debt or rolling over (i.e., refinancing) existing debt. This reality has put significant pressure on CFOs to reevaluate their capital structures and is likely to usher in behavioral changes to mitigate this headwind.

One key trend that began in 2023 and will broaden in 2024 is CSPs entering a cash flow management stage, whereby they reorient capital allocation toward debt servicing and paydown as well as general balance sheet improvements. This capital reorientation will prompt CSPs to undergo new restructuring programs; institute tighter opex controls; and/or keep flat, lower or eliminate shareholder payouts (via dividends and share repurchases). It will also likely lead to lower capex overall, a trend that began in 2023 from a global capex spend perspective (CSP capex peaked globally in 2022). CSPs are also looking to AI and price increases to boost cash flow.

Already, Lumen, AT&T, Ericsson, Nokia and other CSPs and telecom vendors have explicitly instituted cash flow management programs, and TBR expects entities in the telecom industry to either explicitly or implicitly implement or enhance the scope of cash flow management initiatives in their companies through 2024.

Telecom Companies That Prioritized Cash Flow Management

Operators: Altice, AT&T, BT, DISH, Lumen, Verizon, Virgin Media O2

Vendors: Adtran, Cisco, CommScope, Ericsson, Mavenir, Nokia

Note: List is not comprehensive.

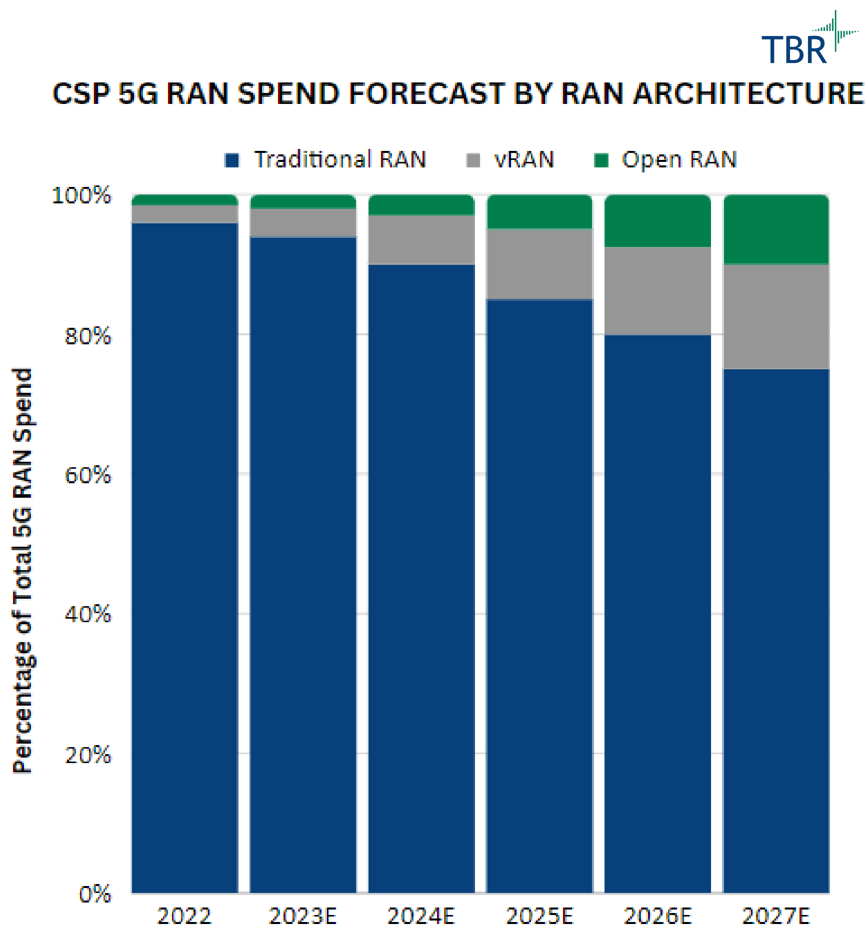
Prediction: Open RAN Will Not be Ready for Mainstream Adoption in 2024

Trend: Open RAN market is developing slowly
Driver: Technological complexity and relatively high cost compared to classic RAN
Result: Open RAN market is unlikely to scale for at least another year

Despite heavy (and sometimes excessive) marketing by vendors and hope among CSPs around open RAN, the reality is that the technology remains immature. Open RAN gear has been implemented successfully and is running live traffic in a few commercial networks (mostly in greenfield environments) in various parts of the world, but significant gaps still need to be closed in feature parity, performance parity and implementation cost parity with traditional RAN before open RAN can truly replace or augment traditional RAN. This inflection point remains at least another year away, and until this occurs, open RAN will likely remain a very small portion of the overall RAN market.

CSPs that have been clamoring for open RAN remain committed to the technology, but there is increasing acceptance that open RAN is not ready to be commercially deployed at scale (especially not in areas of the macro layer that are heavily trafficked) as a viable alternative to traditional, purpose-built RAN — and may not be viewed as ready at least through 2024. As such, open RAN will continue to have a limited impact on the RAN market in 2024.

In the meantime, CSPs will likely continue deploying open RAN-compliant kit (which is not true open RAN but has flexibility to become so as the technology evolves), with the expectation that CSPs can more easily leverage the benefits of true open RAN at a later date. This approach is already being employed by key operators such as Vodafone U.K. and KDDI (both using Samsung as the prime open RAN solution provider). Open RAN is also likely to be trialed and commercially deployed in nonmacro locations, such as small cells, leading up to improved technological maturity.



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