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THE FUTURE OF B2B TELCO

Shifting operating models to transform into tech

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As digitalization and software continue eating the world, the future of B2B telecommunications providers hinges on their capacity to shift to a tech orchestrator and platform model, seamlessly integrating connectivity, cloud, cybersecurity, data and applications. The transition is being driven by commoditization of voice and the advent of new communication architectures where cloud, networks, edge and computing are converging. Frontiers are blurring, with a range of actors being able to play this orchestrator role: hyperscalers such as AWS, Microsoft Azure or Google Cloud, IT services players, Telco operators... In embarking on this journey, B2B telcos need to navigate many strategic logjams: They must change their operating model, simplify the product portfolio, adapt their organizations to sell and deliver hybrid solutions (integrated and managed services). Additionally, they must adopt Tech players' best practices, take decisions regarding potential carveouts, automate operations, and renew and adapt their workforce.

B2B telcos have assets to address this challenge. Their natural strengths and capabilities, such as proximity to access networks, carrier-grade supervision, ability to manage enterprise data and identity, customer trust and security, are unique. However, to succeed in this complex journey, they need to be laser-focused on their strategy and articulate very clearly their value proposition to clients.

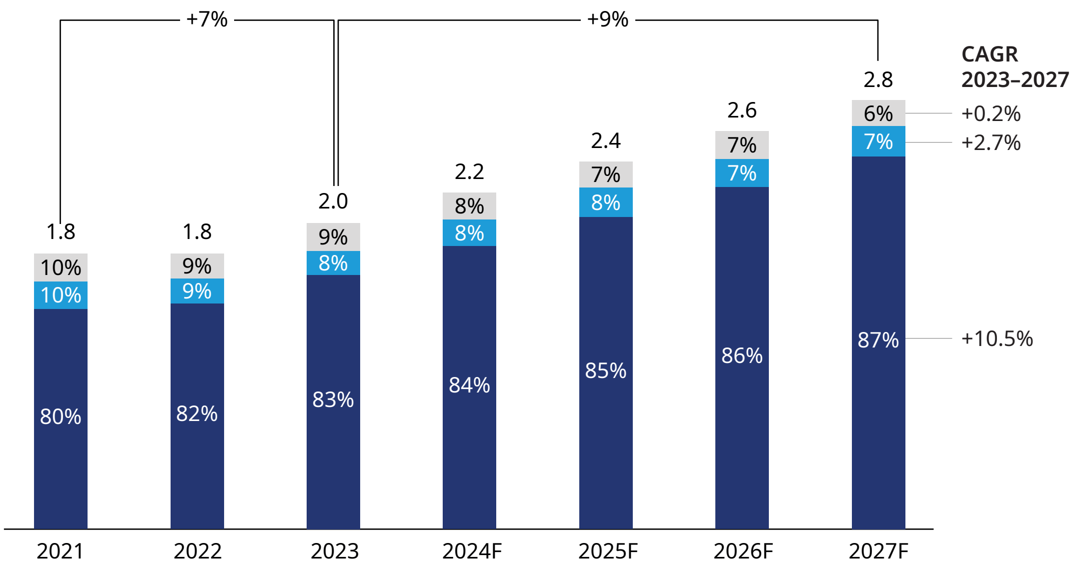
THE FUTURE OF B2B TELCO: THE CLOUD AND ENTERPRISE DIGITALIZATION ARE STILL IN THEIR INFANCY

The commoditization of traditional telecom connectivity is accelerating, as fixed voice revenue is declining between 8% to 15% annually depending on geography. This decline is not being offset by a rise in data and mobile connectivity revenues, which are growing a mere 1% to 3% growth per year. The challenge is that time-division multiplexing (TDM) and multiprotocol label switching transport profile (MPLS-TP), two networking technologies used for transmitting data across a network, still represent the bulk of revenues and earnings before interest, taxes, depreciation, and amortization (EBITDA) of B2B telcos, and both technologies are expanding at a sluggish rate.

On the other hand, the need for secured and enriched connectivity has never been so high and will continue to grow. We are only at the beginning of the migration to the cloud (private, public, and hybrid), which generates new connectivity architecture and needs, and are still in the infancy of Internet of Things (IoT) and digitalization of enterprises. Digital applications and Industry 2.0 will require smart integration of new types of networks (software defined networks), embedded security (in the cloud, at the edge, including identity management), orchestration of different cloud solutions, and structuring and exploiting data.

Exhibit 1: Global B2B market — Connectivity versus tech services

Total global amount in US$ trillion, percentage of total



1. Including Unified Communications, IT services (application services, BPS, consulting, hardware support, IaaS, infrastructure services), cybersecurity services; excluding hardware and software

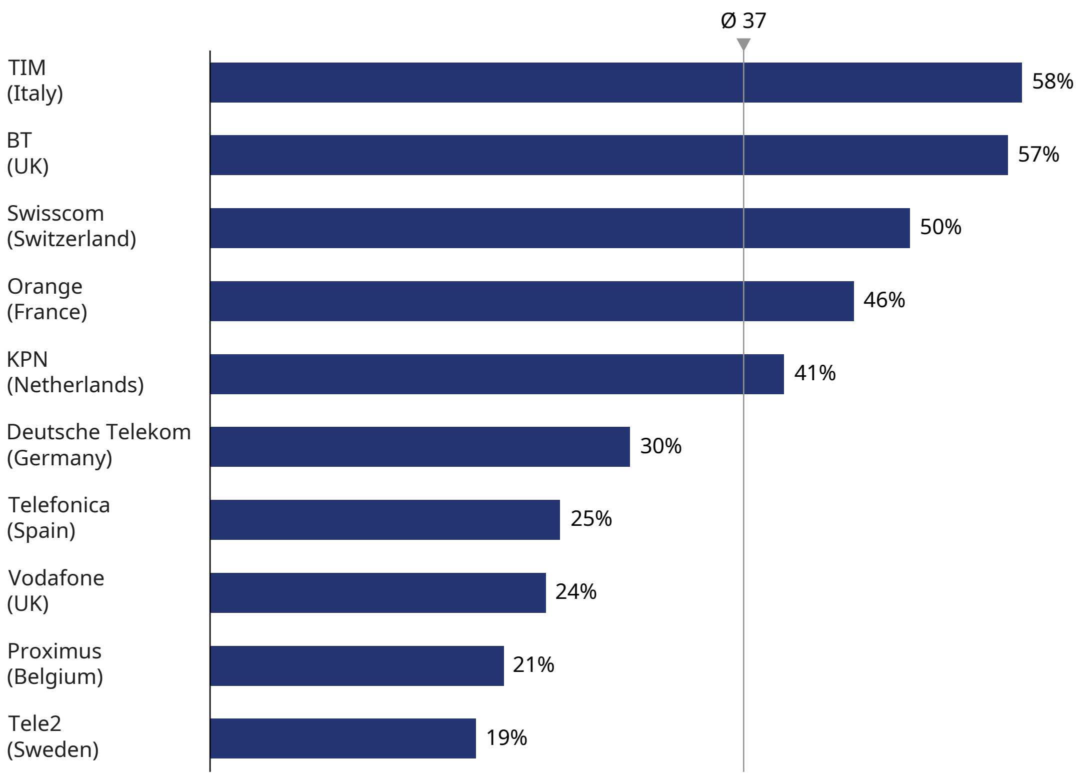
Source: Gartner and Oliver Wyman analysis

In this growing tech services market, value is migrating towards the capacity to integrate the different elements essential to the digitalization of the economy. The good news is that B2B telcos have already mastered some of the building blocks of this integration (cybersecurity, cloud orchestration, supervision, and connectivity integration), and these tech services markets are growing at around 10.5% per year. In 2021, tech services made up 80% of the B2B technology and connectivity services market, and over the past three years, tech services have increased its share of the addressable market by three percentage points, to 83%. Furthermore, we expect that by 2027, tech services will gain a further four percentage points in market share, to 87% (see Exhibit 1).

This attractive market opportunity led most telco B2B organizations to focus on and grow their tech service businesses over the past years. The mix of tech and connectivity services, however, differs greatly between operators which are at different steps of their B2B tech transformation journey, with some already above 50% (for example, BT and TIM) and some at or below 25% (for example, Telefonica and Vodafone).

Exhibit 2: Tech services share of B2B revenues (2023 or latest reported quarter)[1]

Percentage of tech services of total B2B revenues



Source: Based on public reporting, analyst models and Oliver Wyman Telco B2B market model

Along this journey, operators face not only the challenge to capture part of this growth, but also to manage the transition from a high margin, low growth business to a low margin, high growth business. The economics of telecom connectivity versus tech services differ radically: While connectivity generates high EBITDA, it requires significant capex. Cybersecurity and tech services, in contrast, carry lower margins albeit with lower capex. Consequently, when we compare the attractiveness of the telco sector with tech services, we find that telecom's return on capital employed (ROCE) — around 6% for European Telcos in 2022 — is substantially lower than ROCEs of 10% and beyond in the tech services sector.

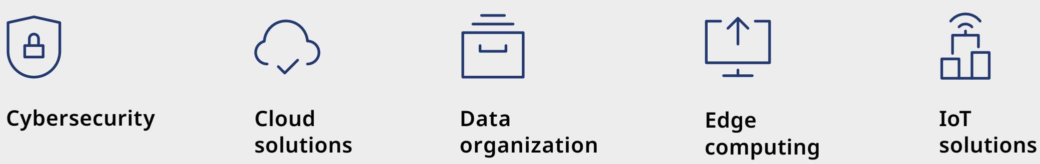
In synthesis, while the growing part of B2B is tech services, that has a lower EBITDA compared to the traditional connectivity business, it is an area where telcos can offset the slow-down of growth in connectivity and leverage their existing customer base and technological capabilities to capture market shares. While the margin profile is different, ROCE are similar or even better in services. In other words, telcos could get as good (and maybe better) return to shareholders if they leveraged their connectivity assets in enterprise to develop the services side (and use that to secure the return on their network assets, the core of their business).

WHERE TO PLAY?

With tech services spanning across a broad range of different domains and services, a strong prioritization is necessary regarding which products and services to be developed first. For B2B telcos this means they should build on their existing service capabilities (including managed network solutions a SD-WAN and CPaaS) and leverage their native strengths which include proximity to access networks, carrier- grade supervision, and the trust and ability to manage enterprise data, identity, and security. We have seen telcos embracing too large generalist IT activities (the "entropy syndrome"), driven by the aim of trying to cover all areas and spreading themselves thin by trying to become broad IT generalists (build, run, full outsourcing). This has led some to very low margin businesses, leaving telcos unable to transform their business.

We think the shift to an orchestrator positioning needs to be well thought out, considering B2B telcos' strengths and ability to add real value to enterprise digitalization in specifically selected non-connectivity domains.

Exhibit 3: Five tech areas at the centre of a new type of integration



Source: Oliver Wyman analysis

Cybersecurity

Cybersecurity needs to be a key area of growth for B2B telcos, playing to their competitive advantages. Their access networks allow them to get a jump on intrusions and breaches. Their supervisory know-how is second to none, letting them offer 24/7 carrier-grade supervision. That said, B2B telcos need to hink precisely about their positioning in the cybersecurity space. For example, pure tech services and cloud players may be better positioned on cloud and applications security. Telco operators have a significant market with a competitive differentiation that allows them to win business in network security, identity access management, endpoint security, zero trust and, as well, cyber managed services (SOC services, CaaS).

Looking at European markets, some operators already leapfrogged the competition: Orange Cyberdefense already generates €1 billion of revenues (or 12% of total Orange Business' €7.9 billion revenue in fiscal year 2022). Also, Telefonica Tech's integrated cyber and cloud unit contributed towards almost 90% of total revenues of €1.5 billion in 2022. Consequently, operators with beyond-connectivity ambitions need to accelerate to close the gap to competitors who increasingly operate also beyond their home markets. Also established players that benefit from a natural advantage in their home markets, will need to maintain the pace, as competitors are gaining on them. For example, Thales is aggressively ramping up its cybersecurity business and expects to see revenues of €2.4 billion in 2024, mainly through its recent acquisitions of Imperva and Tesserent.

Cloud solutions

Building cloud solutions holds great promise for the Telco industry especially on orchestration and managed services. Given their access to data centre infrastructure, telcos historically have provided private cloud services — and could continue to play a relevant role on cloud orchestration, especially for smaller businesses. The cloud is fully reshuffling the connectivity architecture — not participating to the cloud could be a challenge for B2B telcos. B2B telcos have the network engineers needed for designing the networks and cloud architecture of the future. Disengaging from cloud ultimately would mean losing relevance on new connectivity and identity management. B2B telcos of course are not here to replace hyperscalers: we see hyperscalers as partners and not competitors. Lastly, sovereign cloud, in the current market context, gets more and more traction — and as trusted critical infrastructure provider, B2B telcos are very well positioned to capture this opportunity.

Data organization

Telcos are well positioned to organize data securely, differentiate on sovereign cloud capabilities, and administer identity management. Telcos have entry to an abundance of data from access networks, mobile devices, infrastructure sensors, log files, and transactional records. Their reputation on managing critical infrastructure and data securely for consumers, businesses, and governments gives them a head-start versus generalist IT providers or hyperscalers to offer solutions around data sovereignty. Plus, the capabilities and standing of B2B telcos when it comes to data organization bodes well for cloud and cybersecurity services.

Identity management is a much too neglected field of play by B2B telcos, one where value will continue to migrate. But B2B telcos need to be agile, particularly as AWS and others appear poised to move into the sovereign cloud arena.

Edge computing

Edge computing — a decentralized computing framework where data is stored, processed, and analyzed closer to where it is generated to enable rapid, near real-time analysis and response — is a natural fit for B2B telcos, but for now is a long-term bet given its nascent use cases. Edge solutions enable enterprises to improve performance, reduce latency, and lower the amount of data transmitted over the network. This is particularly important for applications that require real-time processing, such as industrial automation, autonomous vehicles, and smart cities — usages that telcos as providers of local networks are well positioned to provide to consumers along with other services. However, the use cases — think autonomous driving and remote surgery — are still in their infancy, making the potential of edge computing a thing of the future for now. For a part, the infrastructure is already there, but edge data centers required very specific capabilities and latency. Not all telcos can claim they have the right edge locations today, and most need to work to expand and build such infrastructure to address most mature use cases and locations.

Internet of Things

Telcos have a clear advantage in Internet of Things (IoT) solutions, although the market has turned out to be less attractive than expected. Still, the convergence of IT systems with operational technology systems opens a range of new industrial IoT use cases. Those emerging use cases, including mobility and Industry 4.0, are driving enterprise demand for solutions to connect and manage an increasingly growing number of devices and sensors. While telcos have a strong position in this market based on their strength in local connectivity, the penetration of IoT solutions as well as related revenues has turned out to be much smaller than thought. That said, IoT is still in its infancy. With 5G and security maturing, with increased mobility needs, we estimate that IoT will finally take-off and scale-up, with B2B operators putting in place the right selective vertical approaches and ecosystems.

B2B telcos should be selective in their vertical bets

While connectivity services are a horizontal play, industry-specific solutions are increasingly becoming a must for B2B telcos to meet their clients' needs. Currently, B2B telco operators primarily customize standard products, with only limited products adapted to specific industries. In contrast, many IT and professional services companies have organized themselves along vertical industries. However, we see verticalization as being difficult for telcos given the large investment and complexity needed to build a strong value proposition per industry. Rather, B2B telcos should carefully pick their vertical bets (for example Telstra Health in the healthcare industry and Orange Industry 4.0 in manufacturing) while maintaining a horizontal portfolio with limited industry-specific customization.

VALUE MIGRATES TOWARDS TECH ORCHESTRATION AND PLATFORM PLAYS

The integration of networks, cloud, data, and security is crucial for the industrial applications of tomorrow. Telcos, IT services players, and hyperscalers all compete in this space, but there is room for partnerships.

Exhibit 4: Telcos, IT services, and hyperscalers in the industrial applications race

The capability to orchestrate solutions that incorporate connectivity and IT services will be crucial, as the industrial applications of tomorrow will require the seamless integration of virtualized networks, cloud, data, applications, and security. More importantly, this is not simply a matter of digital transformation; it is about connecting the digital to our physical world — our homes, cars, factories.

B2B telcos are not alone in eyeing this play. IT services players are also keen to build vertical applications, leveraging their integration know-how with edge and cybersecurity along with integrating connectivity and 5G. While large managed service providers (MSPs) are likely to grab a lion's share of the tech services bonanza, there are limits to their expansion into connectivity-related areas, given the strength and control of B2B telcos in key spheres (such as local level networks).

Next to IT services players, hyperscalers like Azure, Google Cloud, and AWS are also in the race. While most telcos and IT players active in applications and cloud services fear hyperscalers' increasing dominance beyond the public cloud, there is potential in considering them as partners rather than rivals —especially for B2B telcos that offer local connectivity which perfectly complements their highly scaled and often decentralized infrastructure, especially for hybrid cloud services, IoT, and private network solutions. Recent examples include Verizon's ThingSpace platform in partnership with AWS and Microsoft offering IoT solutions; AT&T's core network migration to Azure; and edge computing solutions enabled by AWS Wavelength in cooperation with multiple operators such as Verizon, SKT, KDDI, Bell, and Vodafone. These successful partnerships show how the connectivity and orchestration capabilities of telcos and the public cloud infrastructure and applications by hyperscalers can be integrated and can complement each other.

Source: Oliver Wyman analysis

This does not mean that enterprises will always buy fully integrated connectivity and IT solutions. The majority of these solutions will continue to be bought separately. Even if the share of RFPs integrating them is growing, we expect different forms of cross-sell and integration. Therefore, deciding on the degree of convergence of operating models between connectivity and tech services is not easy. Maximize convergence, or keep separated units or even proceed to carve-outs?

Christian Spielberg, Engagement Manager for the Communications, Media and Technology industry

RADICAL PORTFOLIO SIMPLIFICATION

Most B2B telcos struggle with complicated and bloated portfolios that are not sufficiently adapted to customer segments. Historically, the expansion by B2B telcos into IT combined with their client-centric culture has often resulted in taking on any client request — and consequently the acceptance of the growth of customized services as a necessary evil. Often, the integration of different partner products and the complexity to provide migration paths of existing legacy solutions used by enterprise clients adds to complexity.

A radical simplification of products and limitation of customizations is necessary as a condition for cost efficiency in delivery and service, for digitalization and funding of the new business. In addition, concentrating on strategic vendors typically improves profitability.

Exhibit 5: Inspiring examples of players that simplified their portfolio while improving their agility and business

Orange Business
Rationalization of seven to three business units along a drastic simplification of product portfolio by -50% within next 12 months

Telstra Enterprise
Slashing the existing B2B product portfolio by 50% within three years from 2019 to 2022 as part of its transformation strategy

BT Enterprise
Radical simplification and rationalization of Enterprise portfolio from more than 300 to less than 150 products (announced in November of 2023)

Telefonica Tech
Simplification and integration of product offering by merging cybersecurity and cloud and IoT and Big Data units into one joint segment

Source: Public announcement of operators and Oliver Wyman analysis

One of the most critical success factor for B2B telcos is to set-up place the strong analytical foundation enabling them to take clear decisions, based on transparency of revenues, costs, and margins. This can lead to ending activities with some clients, such as Nexans' decision to prune 40% of its clients and products, which realigned the business and doubled profitability.

GOING FROM TELCO-FIRST TO TECH-FIRST

The go-to-market model for tech services requires a different approach than the one for telco B2B connectivity services. The five dimensions are:

- **Seamless synchronization between sales and delivery:** Product simplification cannot come before there is coordination between sales and delivery; this includes full alignment on solution portfolio and delivery capacities between across the organization on what can be delivered.
- **Consultative selling under revised incentive and steering model:** Sales teams need to understand the client's existing IT infrastructure, business goals, and pain points to recommend the most suitable solutions. This contrasts with connectivity services, which are more standardized and may not require the same level of expertise. Sales incentive models need to reflect the pricing of managed services and incorporate elements to foster cross-selling.
- **Stronger margin visibility and economic discipline in sales:** The growing complexity of IT solutions raises pricing complexity and increases implementation risk. It is critical to support presales with tools and foster a mind-set of strong economic discipline to limit high-risk projects (including clear go/no-go processes for RFPs).
- **New pricing models:** Pricing for tech services can be highly variable and may include subscription models, usage-based pricing, or project-based fees. This diversity in pricing models requires a different approach to pricing and contract negotiations compared to pricing of telco connectivity services. Here, Telcos should also take inspiration from advanced tech players that have been successful in using AI and advanced analytics for personalization and dynamic pricing and discounting.
- **Reimagining strategic partnerships:** When entering the tech market, the business model for telco B2B faces an increasing reliance on technology providers, channel partners and integrators versus a connectivity business where telcos can monetize services through own assets. This requires telcos need to draw inspiration from major IT services players who have built their success on fewer partnerships with key vendors and hyperscalers, generating not only significant growth but also greater efficiency. Telcos' focus should be on "eye-level" partnerships, avoiding dependency or becoming a mere reselling channel. Additionally, telcos should reconsider their channel approach, using partners to expand the reach of their solutions, even if it means giving up the direct client relationship.

Segment-specific products and go-to-market: Enterprise versus SME

There is a sizeable market and growth both in the enterprise and the small and medium-sized enterprise (SME) segment. While the SME space often allows for simpler B2C-like products with higher margins in connectivity, most incumbents have difficulties in addressing the SME segment well in non-connectivity areas. Compared to enterprise products, SME solutions require a much higher focus on ease-of-use, a high level of automation and standardization (versus often highly customized enterprise solutions). Also, go-to-market model and sales approaches are typically high-touch and requires local sales teams. That being said, telcos cannot be successful with a “one-size-fits-all” approach in product and go-to-market addressing the full spectrum of business customers — but require a segment-specific portfolio and go-to-market model for small businesses versus large enterprises.

THE SKILLS CHALLENGE

Current B2B telco workforces are not well adapted to future challenges in key areas, such as sales and delivery. Selling and delivering tech services requires a completely new set of talents. The scarcity of skilled professionals and the fierce competition for critical proficiencies have placed immense pressure on chief human resources officers to revamp the workforce and redefine the employee value proposition in order to attract and retain key talents.

Exhibit 6: To lay the foundations of a future workforce, telco B2B operators face these challenges

Cultural and mindset shift

Required to “TechCo” thinking — this needs to come along a cultural change programme. Some Telcos also combine such with a re-branding

Courageous decisions in workforce strategy

Bold investments in reskilling and restructuring, from the bottom to the top of the organization (including considering external executives hires from the tech sector to drive the transformation towards Tech and IT), as well as a deemphasizing of legacy skill sets and roles which will be automated in the future

Strategic decisions on what’s core

Deciding on what should be partner provided or discontinued, to synchronize workforce capabilities and capabilities with portfolio strategy and value proposition

Source: Oliver Wyman analysis

In addition to a significant talent gap, telcos also have the burden of an aged, well-paid workforce — especially among European incumbents with significant share of civil servants — and soon-to-be-obsolete expertise. The shift in skill sets and capabilities is especially pronounced in sales roles, where selling of IT solutions and services requires very specific competences, greater focus on performance and increased ownership. Tackling those challenges requires a closer alignment of telco talent models with tech players than with the traditional telco world. We estimate that most of the B2B telco workforce is not adapted to move to tech. A lot of training, new hiring from tech work, and headcount downsizing, will be needed.

UNIFY GLOBAL PRODUCTS WITH LOCAL PRESALES AND DELIVERY

Tech services generate lower margins than traditional connectivity services, requiring a highly efficient cost structure to be competitive. However, most telco operators look back on a history of high margins as well as a high number of acquisitions with limited degree of integration.

Exhibit 7: Despite many waves of "lean" programs, telco current operating and organizational modes are often inefficient, driven by three factors

Organizational complexity and business units operating in isolation
A history of growth and expansion into new domains and markets led to high complexity in terms of the number of business units and the related governance — with business units often operating independently and on heterogeneous tooling and processes, with limited synergies

High selling, general and administrative expenses (SG&A) costs
Limited historical efforts in reducing overheads in SG&A functions. Additionally, organizational complexity often implies limited back-office synergies and multiple "ring-fenced" support teams across business units

Subscale business units and markets
Entrance into new segments and markets through acquisitions led to a long tail of subscale business units which add to organizational complexity but are often lack scale to differentiate from competitors and generate sufficient revenues and margins

Source: Oliver Wyman analysis

To tackle organizational inefficiencies that not only restrict operating margin but also slow down agility, product development cycles, and customer experience, operators need to:

- **Standardize group versus local level by function:** Create a unified global product function that develops homogenous, automated, scalable services on platform models for all markets; retain local delivery and sales and presales to deliver on customer focus, as IT/tech services require higher levels of consultative selling and integration than legacy connectivity.

- **Shift to a customer-centric organizational model:** Move from a technical-product-centric organization to a customer-centric one. Examples include Telefonica Tech where markets are leading, and domains are subordinated and Orange Business' recent shift, where zones are the primary profit and loss (P&L) owner.
- **Simplify P&L and business unit structures:** Reduce organizational complexity and consolidate small business units (including potential market exits in country long tail) to reduce overhead, governance complexity, and improve development and delivery of cross-domain solutions and services.
- **Accelerate near and offshore:** Most managed services are labour-intensive and, thus, require the adoption of a structurally different labour cost base to remain competitive with global integrators. Similarly, near- and off-shoring of labour-intensive managed services is critical.

THE TECHCO TRANSITION IS COMPLEX — STRATEGIC CARVEOUTS OF TECH UNITS CAN ACT AS ACCELERATOR

Necessary adjustments across portfolio, go-to-market, talent and operating model as elaborated across prior sections, B2B telcos are facing a significant and complex task ahead to be successful in the transition towards a TechCo. However, the success of early movers who doubled-down on non-connectivity — including France's Orange Business, Spain's Telefonica Tech, and Australia's Telstra Purple — point to the benefits of significant structural investments as well as organizational changes.

A trend which has accelerated has been the carveout of tech units — often fueled by shareholder pressure to optimize value. Indeed, a comparison of telco enterprise value-to-revenue multiples (which typically are two or three times) versus pure tech companies, (more than five times) points to the strategy's promise.

However, a carveout only unleashes value for the B2B telco when it is conducted on the basis of a strategic business rationale and enables the new unit to operate structurally differently — through management and investment autonomy, new channels, geographical expansion, and new partnership models. Given that tech units often represent a significant driver of future growth, carving out the highest growing unit raises concerns about the future of the remaining connectivity unit. The benefits of the carveout exceeding the risks depends on the operator and the market. Therefore, management and investors should carefully evaluate potential options (including scope and future go-to-market model).

We believe that a carve-out for sole financial purposes of multiple arbitrages or an uplift as part of a sum-of-the-parts-valuation does not justify the complexities and challenges it brings, as it easily can leave the "non-growing" part left behind and might only re-allocate value within the group

Emmanuel Amiot, Head of Communications, Media and Technology industry in Europe

ENDNOTES

1 Vodafone: Based on Q3 2024 results (Feb 2024), share of Digital services (IoT, Cloud, Security)

Tele 2: Based on FY2023 results based on “solutions” revenues based of business revenue for Sweden
Orange: Based on Q3/2023 presentation, first nine months of 2023 share of IT and Integration services of total enterprise revenues

BT: Based on Managed Services revenues of BT Business revenues FY 2023

Swisscom: FY 2023 forecast based on Q2 2023 “Solutions Hardware & Others” revenues out of total business revenues

TIM: Based on Q3 2023 financial results for first nine months of 2023 revenue share of non-connectivity services of total business revenues

Telefonica: Telefonica Tech Q3 2023 revenues out of total Q3 2023 business revenues as of Q3 2023 reporting at 19%, non-Telefonica Tech tech services approximated at ~5–6% resulting into assumption of ~25%

Deutsche Telekom: Based on 2023 forecast based on 2022 revenues for T-System out of total T-Systems and DT Germany business revenues — actual value for Germany might be smaller as non-disclosed share of T-System revenues international

KPN: Based on 2023 forecast (based on Q3 2023 reporting) for IT services, professional services and consulting revenues out of total business revenues

Proximus: Based on 2023 forecast (based on Q3 2023 reporting) for IT services out of total enterprise revenues

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