

Gauging Mobile Performance

Performance trends and success strategies for winning in the mobile industry



Historical earnings may have been healthy, but price wars, declining revenues and a sharp drop in profit margins and share prices all point to a struggling mobile industry. Remaining competitive requires actively pursuing cost-cutting initiatives through strategic cost management. An A.T. Kearney analysis finds that mobile operators especially in Europe and North America have become more efficient and have kept absolute costs almost flat. But to achieve real performance improvements, they will have to go further.

The mobile industry remains attractive in terms of earnings, but operators are beginning to see a changing and more competitive environment. With more competing mobile networks per country, the emergence of virtual network operators, regulatory interventions on pricing, and continuing pressure to subsidize handsets in most markets (even the iconic iPhone), companies are feeling the pinch of declining revenues and margins. Most operators in developed markets are searching for ways to reduce their operational costs and capital expenditures to protect margins. Operators in emerging markets are employing more radical business models such as full network and IT outsourcing to make sure that they stay lean rather than add too much cost as they expand their operations.

With this in mind, A.T. Kearney has identified the most powerful cost and performance trends in the mobile industry. Using Global Cost Benchmarking (GCB)—an activity-based cost benchmarking tool to ascertain operational efficiency—on numerous client engagements since 2002, we analyzed current and historical costs, revenues and operational data. We also performed one-on-one interviews with mobile executives at

our annual GCB Conference, where executives from more than 70 operators around the world share their thoughts and insights on the industry.¹

This paper discusses the analyses, first identifying patterns in the evolution of costs in the mobile industry and then highlighting key performance factors that mobile operators can use to improve their profitability and shareholder value.

Five Major Cost Trends

Evaluating cost data since 2002, we identified the following major cost trends in the mobile industry.

Absolute costs are almost flat as operators become more efficient. The relative cost position for operators on a per customer basis dropped an average of 6 percent per year from 2002 to 2005 for indirect costs (*see figure 1 on page 2*). This effect was mainly driven by a continually growing customer base, combined with an increasing focus on cost transparency that is slowing the rise in absolute costs. In 2006, the effect intensified: Absolute costs were kept almost flat (2 percent increase) even as the market saw an increase in customers, and indirect costs per customer dropped by an impressive 13 percent compared

¹ For more information about the GCB study, please see *Mobile Operators: Tired of Margin Pressures?* at www.atkearney.com.

to 2005. We expect to see this trend accelerate in the future with more mobile operators targeting absolute costs.

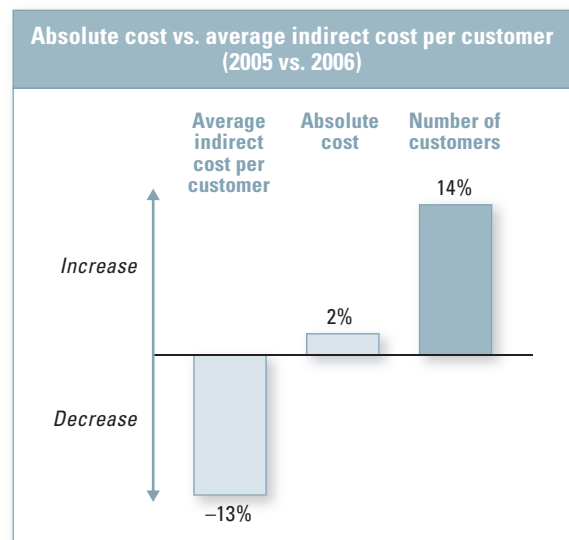
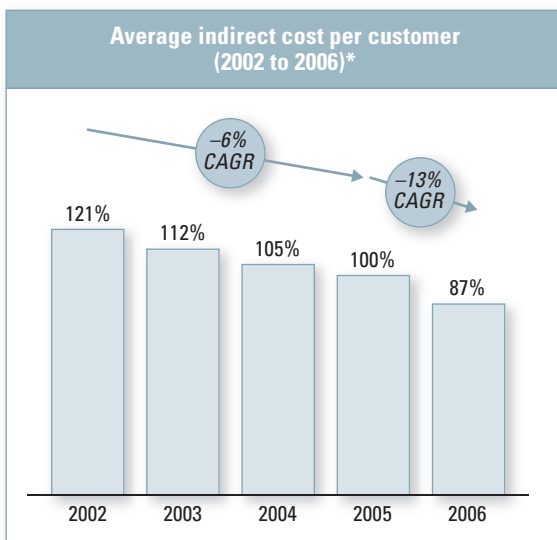
Customer-facing activities are still costly, but improving. Sales, marketing and managing customer relationships require significant expenditures. This is especially true in maturing markets where it costs more to acquire new customers. We expect operators to refocus their marketing and sales spend, pushing for effectiveness and efficiency. They are bringing sales in-house and moving more toward online sales or telesales. Operators that focused on improving their customer management techniques in the past have become considerably more efficient since making improvements to back-office functions and eliminating free services for low-value customers.

Technology costs are declining. Although the mobile industry as a whole is having some

success with cost reduction initiatives, network divisions are the only area that have been able to reduce absolute costs (by 2 percent) in our sample. Network expenditures have a high component of fixed costs, and therefore the area is benefiting from continued growth in subscribers and use. The total decrease on a per customer basis is 18 percent, with even larger declines in cost per minute or per megabyte.

IT costs are also going down, but at a slower rate. IT is a challenging area as costs are heavily influenced by market activities and cannot be evaluated in isolation. Consider the cost of pursuing and retaining customers (customer-facing activities) and the consequences of that pursuit in more applications and rising infrastructure costs for middleware (connectivity software) to enable the vast array of systems to work together. This helps explain why costs are not going down as quickly.

Figure 1
Mobile operators are keeping absolute costs almost flat



*Cost per customer for 2005 = 100%.
CAGR = compound annual growth rate

Source: A.T. Kearney

Group and support functions remain costly.

Support and overhead functions such as human resources, finance and legal show the highest absolute cost increase on the local level—an almost 6 percent rise since 2005.

Multinational operator groups have experienced rising costs in central or shared functions that are recharged to their country operations, which indicates a trend toward more centralized shared services. However, as functions become more centralized, there is a tendency to duplicate activities at the local level. Additionally, the residual nature of support prevents these costs from being scaled back to the same degree that activities are outsourced to a shared services function. We found a slight positive correlation between a higher group share of total costs and costs exceeding the benchmark, indicating that so far centralization has worsened cost performance. But it may be a transitory effect as multinational groups complete the migration to a more integrated cross-border business model.

Large mobile groups have yet to realize full-scale synergies, but shared services have resulted in some savings in capital and operational expenditures for IT functions.

Double margin pressure expected for emerging and growing markets. At first glance, the average revenue per user (ARPU) numbers in emerging and high-growth markets seem low and unattractive. However, these operators frequently generate above-average margins on earnings. If customer income and labor cost differences are taken into account, ARPU numbers are relatively high. For example, current differences in cost per customer between Western and Eastern European markets are primarily driven by above-average subscriber growth rates, with operators in emerging markets growing 16 percent more than their counterparts. In addition, the less intense competition in these markets can allow operators

to charge higher prices for their mobile services.

This increased revenue can result in overcompensating for perceived process inefficiencies. Because margins are still high, costs are in most cases not a major issue to be tackled. However, operators in these markets must focus on costs or risk margin pressure from two areas in the future. Cost structures will converge to the higher levels of mature markets, and customers will begin to demand the same high levels of service and product portfolios that customers in mature markets enjoy.

What Is a Successful Cost-Cutting Strategy?

Across the board, our panel members say they plan to cut costs and improve efficiency, realizing that balancing the cost base is key to achieving overall market success. When reviewing the data, we found operators overall increased efficiency by 34 percent from 2002 to 2006. The obvious next question was: What cost strategies were the most successful?

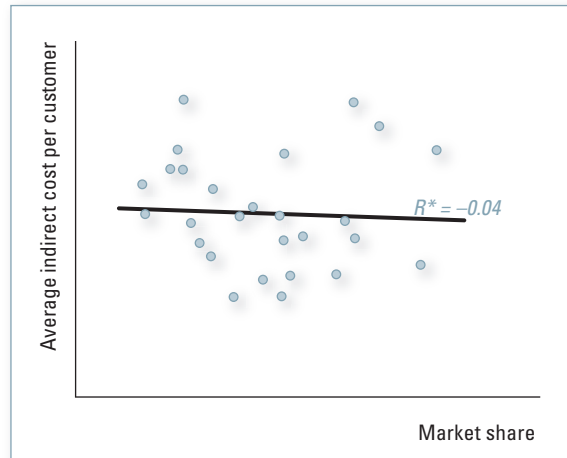
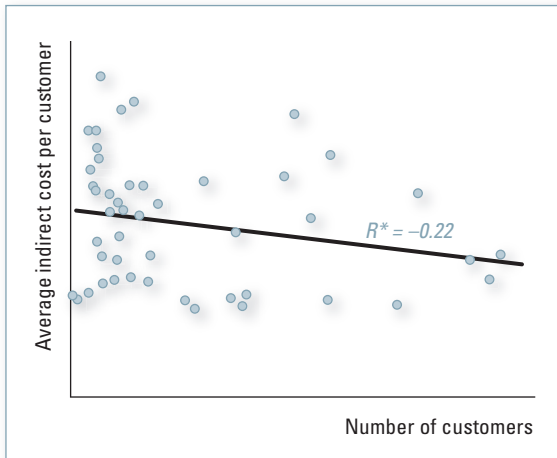
We decided to test five hypotheses, both in terms of generally held beliefs in the mobile industry and whether or not our data supported these beliefs. The following offers a brief discussion of each.

Do large operators have a significant advantage? For smaller operators (those with less than 2 million customers), size is often presented as a root cause for cost inefficiencies. Conversely, arguments for large operators often focus on their size and the inherent benefits, such as the ability to “scale” fixed costs in networks and IT, a stronger bargaining position with suppliers and internal sharing of best practices. When asked their opinion, 75 percent of our panel believe that operator size is one of the deciding factors for overall cost performance.

These assumptions do not align with the data, however. Although a slight size advantage can be observed for larger operators, the impact is

Figure 2

Operator size has only a slight impact on cost



* R measures the statistical correlation between two variables; values range from 1 (100% positive correlation) to -1 (100% negative correlation).

Source: A.T. Kearney

not significant (see figure 2). This applies to both absolute size (total number of customers) and the relative size as measured by market share.

These findings fly in the face of commonly held beliefs. For years, as high fixed costs associated with the mobile industry dominated competitive strategies, the belief was that while larger operators with more market share spread their high fixed costs across their larger customer base, smaller operators used low prices as a means of increasing market share. Now operators are working against that paradigm, turning fixed costs into variable costs, and size advantage often seems to be offset by inefficiencies—increased cost of communications, duplicated efforts and inertia, among others—within the larger organizations.

The aggressiveness of small operators is furthered by their approach to cost management. With lower costs and the flexibility to set prices, they can now rival their bigger competitors and

target specific customer segments. However, very small operators do suffer a size disadvantage as evidenced in the GCB panel.

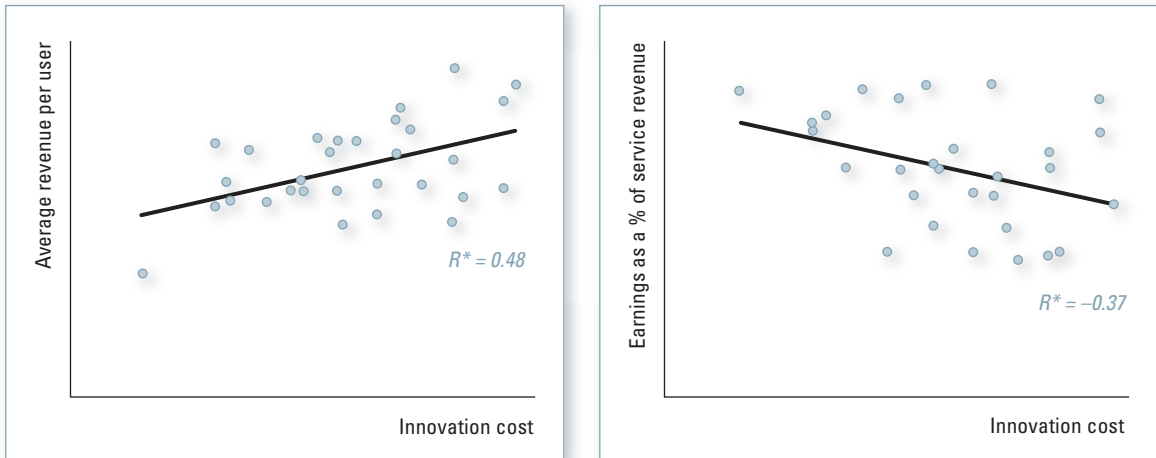
Paying a premium for being premium—is it worth it? Being perceived as a premium brand is still the ultimate goal for many operators. The common belief is that investments in an innovative product portfolio and a premium customer experience will eventually lead to increased profitability, which will compensate for these investments.

We found this to be only partially true. Premium operators achieve above average ARPU numbers, but this does not convert into increased profitability. Measuring the premium operator by its innovation-related activities (value-added services, sales, marketing and customer management), we found that investing in these activities is clearly correlated with ARPU ($R=0.48$).² While many customers value an enhanced product portfolio and better service and are willing to pay a premium for

² R , or correlation coefficient, measures the statistical correlation between two variables; values range from 1 (100% positive correlation) to -1 (100% negative correlation).

Figure 3

A premium positioning does not necessarily translate into higher earnings



*R measures the statistical correlation between two variables; values range from 1 (100% positive correlation) to -1 (100% negative correlation).

Source: A.T. Kearney

these, an operator's investments are not fully recovered by the higher ARPU (see figure 3).

Indeed, large portions of these premium portfolios are sunk costs. Premium offerings such as portals, handsets and free-of-charge call center hotlines should be reassessed and at a minimum targeted at select segments, not the entire customer base.

On the other hand, premium operators with solid profits often take a low-cost approach to nondifferentiating activities—focusing on cost efficiency, not leadership, in strategic areas. These operators invest in customer experience while also cutting costs in nondifferentiating activities. An example is a low-cost approach to back-office functions such as finance or facility management, combined with a premium customer experience in shops and marketing.

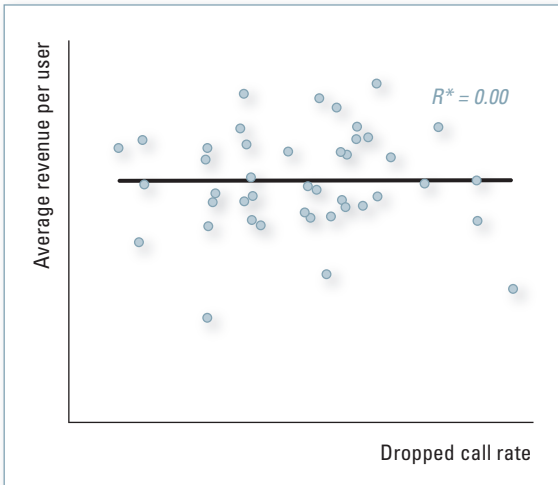
If an overall premium positioning in sales activities and market approach does not necessarily translate into higher earnings, what

about a premium approach to the customer experience? We took a closer look at two possible touch points: network quality and customer relationships.

Improving network quality. Investments in superior network quality are a hot topic with operators around the globe. Such investments are often justified by claiming that, in today's saturated mobile markets, premium prices are only achievable with exceptional network quality. The belief is that below-average quality will be penalized by potential and existing customers.

Yet, according to our data, today's mobile networks—especially in Western markets—are already delivering relatively homogenous quality as defined by dropped calls and congestion rates. The additional network quality offered by some operators is not valued by customers, at least not enough to generate higher ARPU (see figure 4 on page 6). Instead, customers seem willing to accept lower network quality for lower prices. This does

Figure 4
Improving network quality does not always generate higher revenue



*R measures the statistical correlation between two variables; values range from 1 (100% positive correlation) to -1 (100% negative correlation).

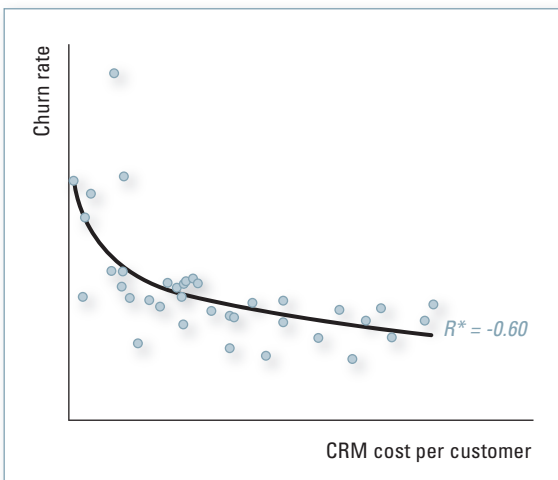
Source: A.T. Kearney

not mean that network quality can be lowered without affecting the number of new customers acquired or customer churn rates. It means that most customers only marginally perceive the added value of such improvements. Mobile broadband may allow operators to differentiate in terms of download speed, but the increasing use of flat-rate pricing will make it difficult to increase earnings from a premium offer.

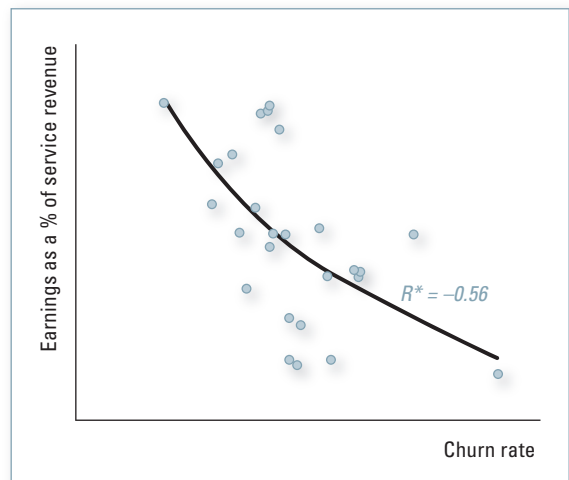
Managing customer relationships. As markets mature, the battle for more customers can get expensive and operators often shift investments from sales to customer relationship management (CRM). Subscribers cared for by attentive staff tend to stay longer, thus leading to a lower churn rate. With a stable customer base, less money can be spent on pursuing new customers and advertising.

We observed a correlation of CRM cost per customer to the churn rate of $R = -0.6$, suggesting that CRM may well be a powerful tool to increase profitability (see figure 5). However, saturation is

Figure 5
CRM is a powerful tool to increase profitability



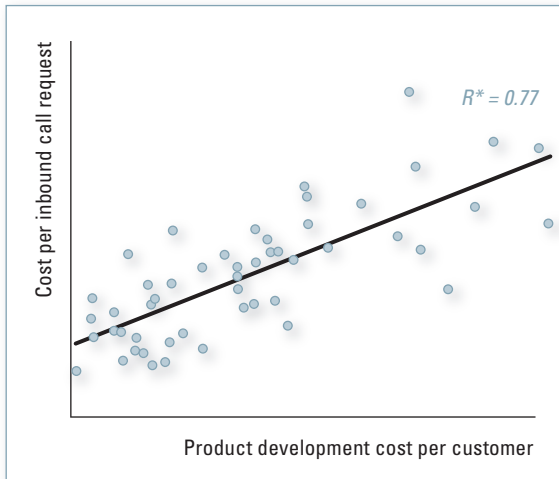
*R measures the statistical correlation between two variables; values range from 1 (100% positive correlation) to -1 (100% negative correlation).



Source: A.T. Kearney

Figure 6

The impact of product complexity on cost (call center example)



*R measures the statistical correlation between two variables; values range from 1 (100% positive correlation) to -1 (100% negative correlation).

Source: A.T. Kearney

quickly attained—at around 35 percent of the maximum investment in CRM, the curve flattens dramatically. It appears that only a small amount of CRM activity is necessary to exceed customer expectations. Once that level has been reached, the common (re)purchase drivers—tariffs and handsets—kick in.

Are overly complex products to blame for cost gaps? Ask anyone dealing with customers on the frontlines what drives costs in the value chain and the answer is likely to be the same: product complexity. More product variants require more and better-targeted customer communication. The sales and marketing group will argue that more service is necessary to target new customers and thus revenue streams.

The complexity of products and services is often blamed for increasing costs on both the front and back end of the organization. This effect is reflected in the GCB data: Complexity does in fact

increase costs along the value chain. To evaluate this, we compared the product development cost per customer as a measure for product complexity with the cost per inbound call request at a call center. The impact is clearly visible in figure 6, which shows a correlation of 0.77.

Thus, it becomes imperative not only to gauge customer needs and what they truly value but also to improve operational efficiency. For the latter, we suggest an integrated approach along the entire value chain—reviewing the product portfolio to streamline product variants, reengineer product development processes and initiate other measures to get a grip on product complexity and costs.

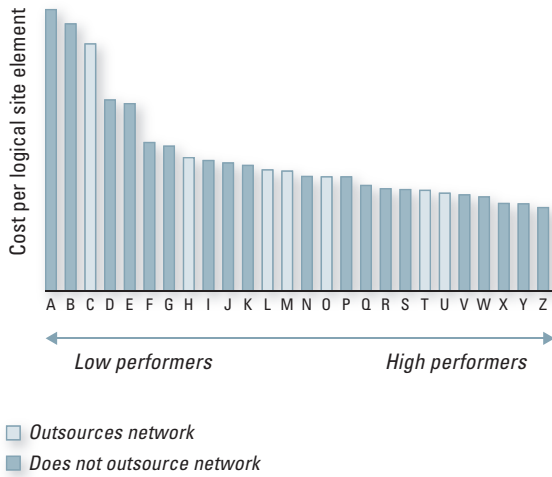
Is outsourcing a cost management panacea? The degree to which operators now use outsourcing as a means of reconfiguring their value chains is unprecedented. Operators are outsourcing their radio access networks and their core and transmission networks to third-party providers. The goal for new operators is to turn a fixed cost into a variable cost and thereby improve cost performance. (For older operators, the goal is often to improve scale.) Also, the outsourcer can offer economies of scale and advanced processes and efficiencies, which are supposed to lead to significant cost advantages. Nokia Siemens Networks, Ericsson and Alcatel-Lucent have all entered this market as a response to operator pull but also to offset declining spend for their traditional network hardware businesses.

However, our data suggests this approach is at best unproven. We analyzed the operational efficiency of operators that had outsourced their radio access network or their call center operations only to find that they are performing as well, or as poorly, as their competitors (see figure 7 on page 8). The data indicates that capturing cost advantages depends heavily on contractual conditions. Outsourcing, in addition, is only attractive if the outsourcing partner has process expertise and is large

Figure 7

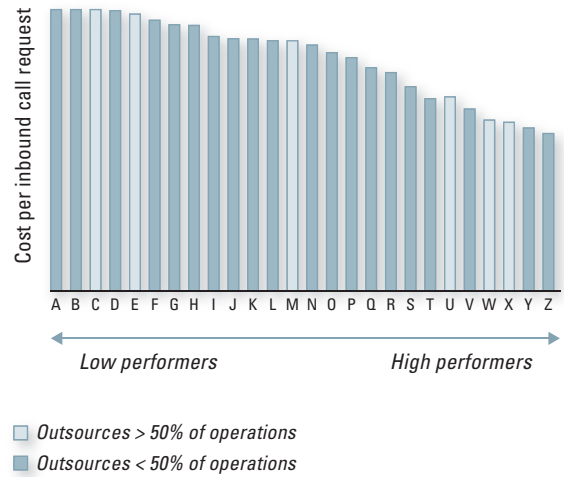
Outsourcing has little impact on a company's cost performance

Cost performance for radio access networks



Note: actual sample size = 52 companies.

Cost performance for call center operations



Note: actual sample size = 48 companies.

Source: A.T. Kearney

enough to benefit from its size—benefits the operator cannot achieve alone. Even when considering areas other than networks, we did not find cost advantages for outsourcing. In conclusion, outsourcing can be done well or it can be done poorly: It is not a cost management panacea. This aligns with A.T. Kearney's experience in outsourcing and offshoring across multiple sectors.³

Refuting Commonly Held Beliefs

Based on our experience and results from the Global Cost Benchmarking study, we can confirm several commonly held beliefs in the mobile industry while refuting others. We have learned, for example, that even small operators can produce superior

performance, and being a premium operator is only profitable as long as the operator has a clear understanding of what really attracts and retains customers. Cutting costs in IT and customer management requires first reducing complexity in marketing and product development. The key to outsourcing begins with writing the contract and ends with the implementation, and there is no justifiable need for excessive support and overhead.

Clearly, managers today have to possess good information about their own businesses and best practices as well as from other sectors if they are to meet their tremendous cost challenges, detect improvement opportunities and enable and monitor change.

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³ For more information, please see *Execution Is Everything: The Keys to Offshore Success* at www.atkearney.com.

