

Litigation won't cut it for Brazil telcos

THE BATTLE FOR competitive advantage in the Brazilian telecommunications industry has shifted to the courtroom. Since late April, Brazilian telcos have launched 11 major legal challenges against one another. Most of these lawsuits seek to block competitors from entering regional markets with long distance and cellular services. This was the case when BCP tried to prevent TIM from launching its GSM service in metropolitan Sao Paulo. Others, such as Embratel and Intelig, want to make interconnection rules fairer to competition.

For the most part, the legal maneuvers are short-term tactics that benefit no one but that probably don't hurt anyone either. At least 8 of these challenges have been defeated. But the lawsuits point to a more fundamental issue: how to resolve the unattractive returns to shareholders of many Brazilian operations? The challenge of growing profitably in Brazil remains, and operators must find innovative alternatives other than litigation to deal with it.

Some of the rules that are being contested today seemed reasonable at the time when the Brazilian real was at parity with the U.S. dollar. But today, the exchange rate situation is very different. The devaluated real makes it difficult to earn an adequate return on investments and to service dollar-denominated debt. Moreover, most operators overestimated the disposable-income ceiling of Brazil's 175 million inhabitants following privatization in 1997, resulting in lower-than-expected average revenue per user.

Take cellular telephony as an example. Conservative estimates suggest that the addressable market among middle- and higher-income users is fully penetrated in Sao Paulo and Rio de Janeiro, Brazil's two most important markets. Further market penetration will have to come from lower-income users. With average monthly prepaid ARPU of Real\$20 (around US\$5.50 at the current exchange rate) declining, it is fair to ask where earnings' growth will come from, especially with two more players, TIM and Oi, entering these markets.

Profitability for cellular operators will have to come from different sources. For instance, 20% of the users of a typical cellular incumbent operator represent around 50-60% of its contribution margin. Therefore, incumbents will have to get better at retaining their high-value customers and challengers will have to acquire more of them.

However, a profitable growth strategy designed around retaining and seeking high-value customers is not enough. After all, a significant share of a telco's revenues and margin does come from a very large number of low-ARPU customers. Many of these users belong to Brazil's less affluent segment, which represents more than 80% of the population. Their monthly household expenditures average Real\$200 (approximately US\$55). Unless they want to be niche players, operators must find profitable ways to

serve these customers. As it is not realistic to expect higher ARPUs from them, the focus must shift to cutting average cost per user (ACPU) in order to sustain margins.

The key components of ACPU are acquisition costs, network costs and service costs. Acquisition costs include handset subsidies, sales commissions and advertising. Network costs are mainly composed of transport and interconnection costs. And service costs are driven by billing and collections as well as customer service. Operators have some options for cutting ACPU, including: (1) reducing the unit cost of an item, for example, handset costs when purchases are pooled; (2) changing the mix of items in order to reduce the overall cost, in the case of customer service, by substituting live call handling by automated menus; (3) eliminating the cost item all together, as with interconnection costs when you incentivate customers to call others that also belong to your network, thus foregoing payment of interconnection charges to other operators.

One way to reduce ACPU is by consolidating and rationalizing operations, which brings the added benefit of using fixed assets more efficiently. This approach is being pursued by Telecom Americas as well as by the joint venture between Telefonica Celular and Portugal Telecom. For this strategy, flawless execution is the key to success. Operators will be faced with tough decisions that run counter to the habits and culture that were developed in a pre-consolidation environment of more than 20 operators. For instance, lowering marketing and advertising costs will involve rationalizing the offers that have proliferated over the last four years into a smaller set of common offers across the entire operation.

Finally, operators must explore every opportunity to share networks. Again, this runs counter to the culture of most telcos. But sharing a GSM network between two players can reduce capital expenditure significantly for each party and boost return on investment. Companies that can reduce the cost of network operations will see the benefits reflected in a lower ACPU. Once again, cellular operators must learn from the missteps of CLECs such as Impsat, MetroRed, Diveo and AT&T Latin America, all of which deployed overlapping networks to serve the same marketplace. The result: they won't obtain a return on those investments.

There is no silver bullet for improving the profitability of many Brazilian telcos. Legal challenges certainly won't do the trick. The telcos that succeed will pursue a strategy that keeps ACPU down ahead of competition while maintaining a value proposition that is attractive to high-end customers. ■

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