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Will the Anywhere Economy Slow Down?



The Bottom Line:	The telecom sector overall will weather the current financial crisis and impending recession. Yet the effect on individual players will depend on the role in the value chain, the core markets served and the geographies in question.
Key Concepts:	Consumer spending, enterprise transformation, capital expenditures, network expansion
Who Should Read:	CEO, CFO, VP of strategy, IT manager

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The Financial Crisis in Focus

The financial crisis in the United States and other world markets is only months old, yet it is already cascading out to other industries. The telecom industry and the Anywhere Economy it is creating face three immediate threats because of this crisis:

1. The collapse of the financial services and housing sectors has made credit more expensive and debt more difficult to acquire, which threatens the network expansions planned by telecom companies.
2. The financial services sector itself is a key source of revenue for enterprise equipment and telecom services, and the consolidation and collapse of the financial companies puts that revenue in jeopardy.
3. Loss of personal wealth, low consumer confidence and rising unemployment will cause both consumer and enterprise spending to slow overall.

Before this crisis, Yankee Group predicted that some countries would exceed one broadband line per person—a milestone we've dubbed the Anywhere tipping point—in 2009. Could these factors push back this milestone? And more seriously, could the turmoil in financial markets bring down today's \$590 billion Anywhere Economy?

Anywhere Momentum Slowed but Not Stopped

We believe the fundamental nature of the forces behind the Anywhere revolution will overpower the short-term obstacles created by the financial crisis. As highlighted in our September 2008 Report, *The Anywhere Tipping Point*, three seminal trends are under way. While these may be slowed to a degree by financial worries, their onset remains inevitable:

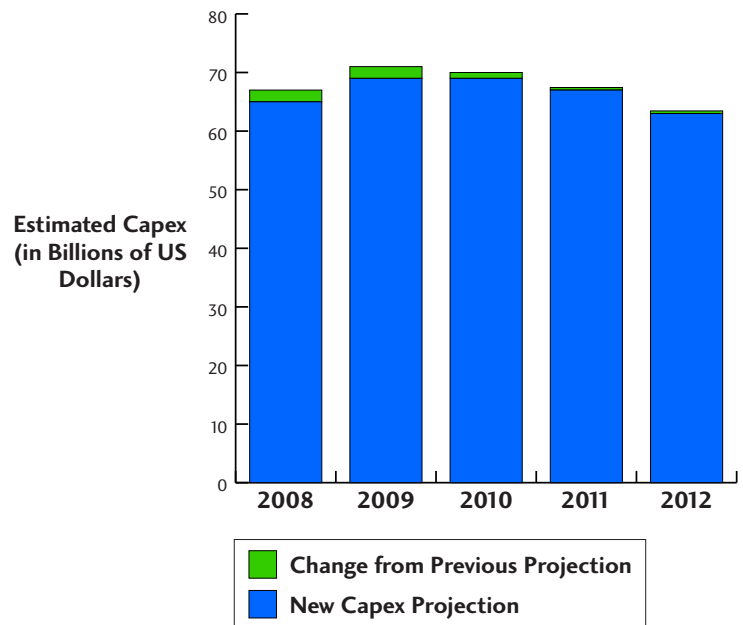
- **One common network:** While it is uneconomical to build a network that doesn't speak IP and connect to the rest of the communications world, incumbent network builders will lean toward leveraging their existing legacy infrastructure in the short term as they continue to move toward the strategic goal of an all-IP network.
- **Broadband demand:** Consumers and enterprises that use broadband connectivity as a utility will continue to drive usage and overall penetration.
- **Wireless ubiquity:** Mobile phones have made connecting to the network irresistible. According to several studies, people would rather leave their homes without their wallets than their mobile phones, making it likely they will cut back on many other services before they give up their Anywhere ones.

Yankee Group believes this demand for ubiquitous connectivity is irreversible, and that the financial crisis will only shape rather than stop the trend. In fact, financial turmoil may actually accelerate the development of alternative business models such as non-commit contracts, pay-as-you-go plans for a variety of services and loyalty programs that will attract and retain customers. As always, crisis breeds confusion, and out of confusion will emerge new winners and losers.

So in the context of this demand, how will current troublesome economic conditions affect the telecommunications ecosystem? We see the primary effects in four major areas:

- Operators will continue their Anywhere Network™ expansion plans.** The market crisis of early 2000 caused by the collapse of the internet bubble taught network builders to use their capital wisely. While most operators are in a better position to continue investing in their network expansion initiatives, we anticipate slight erosion in overall spending. As illustrated in Exhibit 1, Yankee Group had already projected a downturn in US capex in 2011 and 2012. As a result of the economic downturn, we are lowering our near-term forecasts as well. This trend is representative of other mature economies, where we will see operators curtail spending during the next 12 to 15 months as economic uncertainty persists, while continuing to adhere to long-term network buildout strategies.
- Discretionary spending will fall.** Every player in the Anywhere Economy from consumers to businesses to network operators will be closely watching their expenditures to avoid tapping credit markets. That means that while communications users will continue to spend on necessities, they'll cut discretionary spending in categories ranging from new mobile phone lines to handset upgrades to premium applications and services. While this won't dramatically affect core revenue for operators since most customers have long-term contracts, it will cap growth for the next 6 months to a year because of fewer upgrades and less new business.
- Big companies will gain the upper hand by introducing new products and services.** As investors and companies themselves become more risk averse and revenue falls back, only the best-capitalized and healthiest businesses will have the cash to invest in innovative products and services. This trend will favor the large operators and vendors because they will have more financial strength than small startups. But this will also mean that some of the riskier (and potential game-changing) ideas will be vetted out as investors look for pragmatic business models.
- Slower growth means that operators will squeeze network equipment vendors.** Yankee Group believes the downturn in capital expenditures, declines in discretionary revenue and tougher negotiating by large businesses will adversely impact many network equipment vendors, as highlighted in Exhibit 1. The two most capital-intensive markets that will experience further scrutiny are in the equipment for VDSL/FTTx for fixed networks and LTE and WiMAX for mobile broadband.

Exhibit 1.
The Change in US Capex



Source: Yankee Group, 2008

On the fixed side, cutbacks have already started in some Western countries, and HFC and FTTx upgrades are likely to slow down there. Countries high on the Anywhere Index such as France, Netherlands, Portugal, Japan, Korea and the United States will continue to invest with a stronger emphasis on rolling out efficiently rather than rapidly. In other countries where the FTTx investment hasn't started, it's most likely that incumbents will sweat their existing copper assets longer, either deploying VDSL as an intermediary step or making the most of the existing DSL solutions and trialing bonded pairs or similar work-arounds to increase bandwidth levels with minimal investment.

On the mobile side while investment in LTE has not really begun, there is a growing concern among the ecosystem of WiMAX vendors. Service providers will likely postpone significant investment decisions in next-generation mobile access technologies until technology uncertainties are ironed out, and they can better anticipate demand for new services. Investment is likely to be focused on better managing mobile broadband, increasing backhaul capacity and focusing on 3G technologies such as HSPA+, which have a clearer path to generating increased revenue for the operators.

The first and second vendors in each market will probably manage to keep established position while suffering some amount of margin squeeze, but it is the smaller players who will suffer as they struggle to attain scale. A certain amount of product line slashing is to be expected as well, especially among players generally considered to be too large for their own good such as Alcatel-Lucent.

Meanwhile, Chinese giants such as Huawei and ZTE are in the midst of transforming from no-frills solutions to full blown end-to-end infrastructure vendors. This metamorphosis might have to be put on hold as a reversion to low-cost strategies may be called for until the climate improves. Vendors who have significant enterprise product portfolios such as Cisco or Alcatel-Lucent will be better equipped to carry through, as the lack of investment won't be felt as much on end customers. Those with a strong presence in emerging markets will be better off as well, although not all emerging markets will fare alike. Successful strategies in emerging countries will require focusing on those that are heavy exporters of commodities. These economies always tend to hold up better in a slowdown than economies based on luxury goods and services.

Recommendations for Service Providers

- **If you have the means, a downturn is the time to invest in both the network and the business.** Today's investment is what will allow you to rebound when the economy overcomes its current troubles. While the temptation will be to sweat existing assets and focus on providing new services over legacy infrastructure, this is not prudent in all cases. Investment decisions should be dictated by the ability of existing infrastructure to handle consumer demand for broadband, as well as progress of key competitors in your particular region and future aspirations around the strategic direction of the business.
- **Beware the perils of price wars.** Remember that you always get what you pay for. The temptation to squeeze the vendors will be high, but a dollar of squeezed capex saved may come back to haunt you as two dollars (or more) of opex wasted down the line.
- **Be ready for the inevitable customer churn that comes with economic turmoil.** In a difficult economy, consumers and enterprises will be more willing to change their purchasing and usage behavior if there's clear financial or efficiency benefit. Network migrations that move customers to a new medium, service bundling, tiered services, managed services and other innovative models will all be critical in attracting these free agents.

Recommendations for Vendors

The picture for the vendors is the grimmest of all segments. The slowdown on investment will hit hard in many cases and require creativity and potentially difficult decisions to weather the turmoil.

- **Target the CFO.** In troubled times, the financial guys always hold more power, as decisions will increasingly be made based on a hard-and-fast cost/benefit analysis of dollars and cents. To appeal to this audience, focus on managed services and professional services that can reduce fixed costs and outsource services and operations. Moreover, focus on technologies that increase network intelligence and network efficiency, thereby reducing the carriers' opex burdens. Pie-in-the-sky pitches with untested revenue sources won't fly as the belts tighten.
- **Refocus on strong potential emerging markets.** Resources will be better allocated to emerging markets where the growth potential is still strong. In particular, emerging markets that export commodities (iron ore, steel, coal, concrete components) will be well positioned to weather the economic downturn. Moreover, major markets such as China are still in the midst of major infrastructure upgrades, and these will continue.
- **Reduce your average cost of sale.** Every percentage point per sale is critical, so hard decisions must be made around packaging, marketing, channel distribution, etc. Even seemingly innocuous things such as targeted event presence, immaterial channel distribution for commoditized products and tighter control of travel expenses can be very significant.
- **Focused R&D is paramount.** A targeted approach to development of new products and services will help vendors provide realistic returns on investments that their customers are looking for. Bring customer-driven initiatives to the front of the R&D queue.

Recommendations for Enterprises

- **Initiate your business transformation.** The changes in IT capabilities make work dematerialization a reality. The resistance is now in your own organization. Adopt cloud applications and home working/home sourcing to gain a few points of productivity that will help you carry over to the next boom.
- **Reduce your travel costs and embrace teleconferencing.** Install quality teleconferencing and desk conferencing and enforce its use. The ROI for such measure will be swift and impactful.
- **Tie budget to larger projects.** As spending tightens, the first thing to go will be small initiatives spearheaded by IT. But if a strategic investment (such as virtualization licenses) can be tied to a larger initiative (such as data center consolidation or green investment) then it has a better chance of remaining well-funded.