FINANCIAL REVIEW

SE Due Diligence

HD **Who dares to lead will struggle to win**

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For the past 2½ years, Vodafone Australia has been a basket case as its market share and revenue collapse. Its customer base has shrunk from 7.5 million in 2010 to just over 5 million in 2013. By comparison, Telstra has grown to 15.3 million mobile subscribers, and SingTel-Optus has about 9.5 million accounts.

One option for its parent companies Vodafone Group and Hong Kong-based Hutchison Whampoa is to chip away and do nothing while hoping its reputation will gradually recover.

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But many in the market are of the opinion that over the next 18 months both companies will need to decide whether to go big by buying a local internet provider or go home by selling out their Australian joint venture, Vodafone Hutchison Australia (VHA).

In 2012, both parent companies decided to attempt a salvage of their Australian operation. Experienced turnaround strategist executive Bill Morrow was appointed chief executive, with a mandate to make sweeping changes as part of a three-year plan and $1.7 billion at his disposal. By November 2013 – halfway through the turnaround plan – Vodafone Hutchison Australia was officially on the mend, with profit margins improving and operating expenses going down.

The company had finished a cull of inactive mobile accounts and was meant to start regaining customers in the first half of 2014, which would act as a litmus test for the company's viability. But in December Morrow shocked many of his Vodafone Australia team when he announced he was quitting to become the CEO of NBN Co, leaving Vodafone Australia to an uncertain future.

The question for Vodafone Group and Hutchison Whampoa now is whether the setback of losing Morrow at a critical point makes cutting their losses and selling their assets a more attractive option.A lemon in a mature market

Vodafone Australia is also faced with having to diversify its product offering to include things like fixed-line internet services to remain relevant against Telstra and Optus – both of which are launching bundled offerings to attract customers and keep them loyal to their brands – or face a slow death as customers leach away.

Over the past decade, Hutchison Telecommunications Australia (HTA) and its successor VHA have bled cash like a ruptured artery, with cumulative underlying losses of over $4.25 billion. The company enjoyed a brief period of success in financial year 2010, with 7.5 million mobile subscribers and $155.3 million in net profit. However, it has since made an underlying loss for every other year – the worst being an $817.6 million hit in 2012. Though it technically made a $587 million profit in financial year 2009, this was skewed by the merger between HTA and Vodafone Australia.

"The net loss before gain on merger was $119.6 million," Hutchison Whampoa boss Canning Fok told shareholders in the company's 2009 annual report.

On the other side of the partnership, Vodafone Group CEO Vittorio Colao has also been very open about his preference for having total control of his **operations** around the world and is concentrating on growth markets such as Europe.

By comparison, Vodafone Australia has been a lemon in a mature market, with few prospects for substantial growth. Sources with an intimate understanding of Vodafone Australia say one of the main things keeping Vodafone Australia alive in its current form is the stubborn refusal of Hutchison Whampoa to sell an asset at a loss. But it is also understood Hutchison Whampoa is not particularly attached to the Australian operation and would walk away if a buyer offered an adequate bid, as would Vodafone Group. Over the next six months there will be two key points potential buyers will want to keep an eye on: who the new CEO is and whether Vodafone Australia can report a return to subscriber growth by June 2014.Executive talent difficult to lure

While both parent companies have a say in the CEO selection process, it is understood Vodafone gets the final say. The **company** has several high-quality executives with experience in helping damaged brands bounce back. However, it would be hard for either **company** to persuade high-quality talent to take the CEO role. Vodafone Australia is struggling to gain traction against its rivals and the **company**'s listed component, HTA, is a barely-traded shell that can't be given to would-be executives as an incentive.

One option touted within the industry is Vodafone's Africa, Middle East and Asia-Pacific region chief executive, Serpil Timuray. She was instrumental in turning around the **company**'s Turkish **operations** and making it into one of the country's strongest brands.

But picking another turnaround CEO would be problematic because Morrow's reformation of the **company** is incomplete. Forcing Vodafone Australia to go through another series of structural changes would cause significant problems and delay the **company**'s turnaround by 12 months as they learnt the ropes.

The most likely scenario is the selection of a CEO who will be tasked with completing Morrow's plan with minimal disruption.

This is because Vodafone Australia is not a total dud despite its plummeting revenue and customer numbers. Its earnings margins have been greatly improved by Morrow's cost cuttings and are as good as they were before Vodafone began experiencing its well-publicised network problems. Its earnings-to-revenue ratio was 20.8 per cent in the first half of 2010 but fell to 10.8 per cent in the first half of 2012 and has since recovered to 21.7 per cent in the first half of 2013.Asian telcos potential buyers

If the bounce-back in subscriber numbers occurs within the next six months, as Morrow has previously planned, then both parent companies can begin shopping around for potential buyers.

Japan's NTT Docomo has been mooted as a potential buyer of Vodafone Australia. It has significant cash reserves, has long been interested in ramping up its investments in the country and has a track record of partnering up in telecommunications joint ventures with Hutchison Whampoa from **Hong Kong** to Britain – albeit with mixed results.

Other Asian telecommunications companies like **China** Mobile could also consider buying into the Australian market while using their massive scale to offer cheaper products and services.

The other option on the table is the **purchase** of a local fixed-line internet service provider such as TPG Telecom or Perth-based iiNet. While it might seem mad at first, market sources indicate Vodafone Australia has reviewed the move twice – once under previous CEO Nigel Dews and once more under outgoing CEO Bill Morrow.

Vodafone Australia's initial plan in 2010 was to resell services made possible by the national broadband network (NBN), which was meant to connect all Australians to a ubiquitous wholesale telco network.

But significant delays to the rollout have meant that only a fraction of the population has access to the NBN, which in turn has made it impractical for Vodafone Australia to get on board. The **company** flagged an interest in buying Telecom New Zealand's service provider AAPT earlier this year but pulled out after reviewing the books.Sweeping consolidation a problem

Buying a local telco would finally allow it to offer **millions** of customers a complete package of communications services. The more products a user has with a single **company**, the less likely they are to leave – a fact that has driven Telstra to create and sell bundled pay TV, mobile phone and fixed-line internet services to **millions** of customers.

But the Australian telco sector has experienced sweeping consolidation, making the survivors both large and expensive. Where iiNet would have been worth about $500 **million** in 2012, its market capitalisation today is about $1 **billion**. TPG Telecom has also become a $4.365 **billion** giant with a share price which has more than doubled over the past 12 months.

Vodafone Group has the money required thanks to the September 2013 **sale** of its Verizon Wireless**stake** in the United States for $US130 **billion**. The **company** promised that 71 per cent of this would be returned to shareholders and created a £6 **billion** fund named Project Spring to pump money into **operations** around the world. But the major hurdle for any **purchase** and cash injection is the fact that it must be funded by both parties. Sources indicate Hutchison Whampoa is reluctant to make any more large contributions before Vodafone Australia proves it is a sustainable business.

The other option for Vodafone is to become one of Australia's biggest fixed-line internet resellers by working with Telstra and/or Optus. This would reduce the capital investment it needs to make and allow it to win customers in preparation for the NBN.

Such a move is certainly possible but it faces the challenge of Vodafone's damaged brand being unattractive to potential customers and thin reseller margins reducing its profitability. In any case, Vodafone Australia's every move will have a major impact on the local telecommunications market and on **millions** of customers. If the **company** invests in Australia and buys out a telco, Telstra and Optus will need to increase the attractiveness of their products by lowering prices and profitability.

But Vodafone Australia pulling up stumps could ironically be the worse outcome for the market leader. Telstra has largely escaped heavy-handed intervention by competition regulators thanks to the presence of three sizable players in the mobile network. By comparison, a duopoly in the mobile telco space will likely **lead** to a much higher regulatory burden for Telstra just as the **company** attempts to pump **billions** of dollars into pressing its advantage.

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