Telefónica: To Europe Through the Big Door

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Telefónica’s decision to put forth an offer for the acquisition of the mobile telephony company, O2, is a giant step forward in the internationalization of the Spanish operator. The purchase not only brings a further 24.6 million users to Telefónica’s client portfolio, but also much growth potential in Europe’s two major markets: the United Kingdom and Germany. Furthermore, the move contributes to the reorganization of Telefónica’s assets, distributing a larger part to mobile communication along its business lines and reducing the importance of Latin America and Spain as geo-strategic areas.

In the wake of the operation, the mobile telecommunication area will generate 48% of Telefónica’s profits before interest, taxes, depreciation and amortization (EBITDA), compared to the 38% it currently contributes. This will undoubtedly affect the company’s profit and loss statement, considering that mobile telephony is the telecommunications sector with the highest growth and the best margins. This is a coherent strategy in line with Telefónica’s aim to become “the telecommunications operator with the best combination of growth and return in the industry”.

With the purchase of O2, Telefónica also reduces its long criticized exposure to the Latin American market - this will fall from 34% to 28% of its EBITDA -, and opts for a greater presence in Europe, which will rise from the current 7% (not including Spain) to 21%. However, Spain continues to be very important to Telefónica as 51% of the gross operative result comes from the local market.

This operation is a sign of continuity in César Alierta’s strategic line during his years of management as president of Telefónica. Without completely abandoning its own areas of the means of communication and the Internet, the company has been redirecting its activity towards telecommunications, placing emphasis on mobile telephony. Among other operations, Telefónica has decided to sell its shares in several radio and television businesses, its portal, Lycos, and more recently, its 35% flotation of Endemol, the producer of “Big Brother”. At the same time, the company has bought ten of BellSouth’s mobile telephony subsidiaries in Latin America, the Czech company, Cesky Telecom and even a 5% share in China Netcom.

### Highlights

1. O2 reckons with 24.6 million clients, takings of some 9,800 million euros and an EBITDA of 2,600 million.

2. For Telefónica, the purchase of O2 means diversifying the risk of its international expansion, until now focused on Latin America, and increasing the importance of the mobile phone business from 38% to 48%.

3. In terms of number of clients, the purchase of O2 positions Telefónica as fourth European Operator (50.4 million clients), after Vodafone (with 97.5 million), Orange (with 66.7) and T-Mobile (with 61.6).

4. The Spanish operator had already made several failed attempts to penetrate the heart of Europe: the alliance with BT and Worldcom, the attempt to fuse with KPN, or the purchase of UMTS licenses in Germany, Italy, Austria and Switzerland.
It is important to highlight two elements which will be crucial for the success of the operation: first of all, maintaining O2’s management team, the company’s success-maker over the past few years; and secondly, the joint capacity of Telefónica - fundamentally with its mobile subsidiary - and the company of the British flag, for integration and synergy creation.

O2’s management team has created the basis for company’s success and can contribute a great deal of knowledge for the future development of Telefónica in other more developed markets. Until now, Telefónica had centered a large part of its international activity on emerging markets with a high growth potential. O2’s experience in much more established markets, such as the United Kingdom and Germany, could be very useful to Telefónica for transferring certain practices to the Spanish market and also as a knowledge platform for the group’s future expansion.

The importance of maintaining the British operator’s management team - and of not sowing doubts about its management once the acquisition has been consolidated -, explains both the president of Telefónica’s statements underlining the quality of O2’s management team, and the fact that its decision center will continue to be based in the UK. But the fact that O2 is to report directly to Telefónica’s head office rather than being merged into Telefónica Móviles is even more revealing, and is something that has surprised some analysts.

As far as the capacity for integration and synergy creation, Telefónica has already demonstrated its competence in this area by handling these processes on other occasions. It did so in the 90s, a time of great expansion in Latin America, and also in more recent operations such as the aforementioned acquisition of BellSouth or Cesky Telecom. Scale economies are essential in the telecommunications industry, and with this acquisition, Telefónica not only becomes the world’s fourth mobile operator in terms of number of clients, but also multiplies its potential European clients by 3.8.

Finally, the operation also represents one more step towards the creation of a European telecommunications market, as did France Télécom’s recent purchase of Amena. This is a process which injures some national identities, but which from a strictly business viewpoint is indisputably necessary.