Iliad's Odyssey Into The Italian Telecoms Market May Bring Gloom, But Not Doom

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Like the Trojan army in Homer's epic tale, Italian telecoms operators have been preparing for a long-awaited attack. This time around, however, the war is about data allowances and wooing customers, rather than a bloody quarrel between an ancient king and a determined warrior during the siege of Troy. Will Paris-based Iliad S.A. turn out to be the Trojan horse for the Italian telecoms industry?

S&P Global Ratings believes Iliad will experience some success, but we do not expect it will crush its opponents. That said, the next few months are critical as operators watch for early signs of customer churn and adjust their offers to deflect the challenger. The degree to which Iliad's offer appeals to Italian customers, combined with the magnitude of operators' reactions, will determine if and how far the Italian market falls. Over the next few months, we will monitor pricing and customer moves to see if a change to our current forecast of a market revenue decline of 2%-3% is warranted.

Meanwhile, other market subplots have emerged, including shareholder activism at Telecom Italia SpA and a new ruling coalition government. While both have raised investor questions about credit impact, neither development has an immediate effect on our ratings and outlooks on Italian telecoms.

Key Takeaways

- France-based Iliad belatedly launched an aggressive mobile offer in late May 2018 in Italy.
- Our base case is that Iliad will reach its one million customer target within a year, but without severely disrupting the Italian telecoms market.
- We do not expect recent Italian political and market turbulence to directly affect the telecoms sector.

Iliad Will Likely Reach Its Customer Target Without Causing Material Market Damage

Iliad launched its Italian mobile offer in late May 2018, about six months later than anticipated. We view the offer as aggressive, but mainly in terms of the large data allowance rather than the price point. In our view, it reflects Iliad's need to win over customers with an attractive offer, without sending the market into a tailspin, and while attempting to address the costs of its roaming agreement with Wind Tre S.p.A. Iliad has a good chance of reaching its one million customer target in the short term, but we do not expect a severe disruption that triggers price wars and results in a rapid move to lower pricing, and our base case remains a modest 2%-3% overall market decline.

We expect Iliad's offer will appeal to value-conscious, data-hungry customers looking for a simple and easy-to-understand proposition. Iliad will also benefit from Italy's large prepay customer base, which has low switching barriers. At the same time, however, it faces the challenge of being an un-established entrant starting from scratch in an Italian market that is far less ripe for low-cost disruption than France was in 2012.

At €5.99 per month for 30GB on 4G, and unlimited talk and text, a strength of Iliad's offer is that it's easy to understand in a market where that is not always the case. Italian consumers typically receive at least three offers on most networks, and navigate frequent package changes, promotional periods, and minimum time commitments to avoid having to reimburse initial cost waivers. Depending on age and interests, the offers can multiply from there. The simplicity of Iliad's offer, provided it remains as consistent as its offer in France, is, in our view, a significant selling point, and may appeal to customers wary of incumbent Italian telecoms in the wake of the controversial switch to a 28-day billing cycle.

The offer combines a premium package with low-end pricing. The table of several competing market offers below highlights our view that while the pricing is competitive, the data allowance is the bigger selling point.

Table 1

Italy: A Comparison Of Mobile Provider Offerings

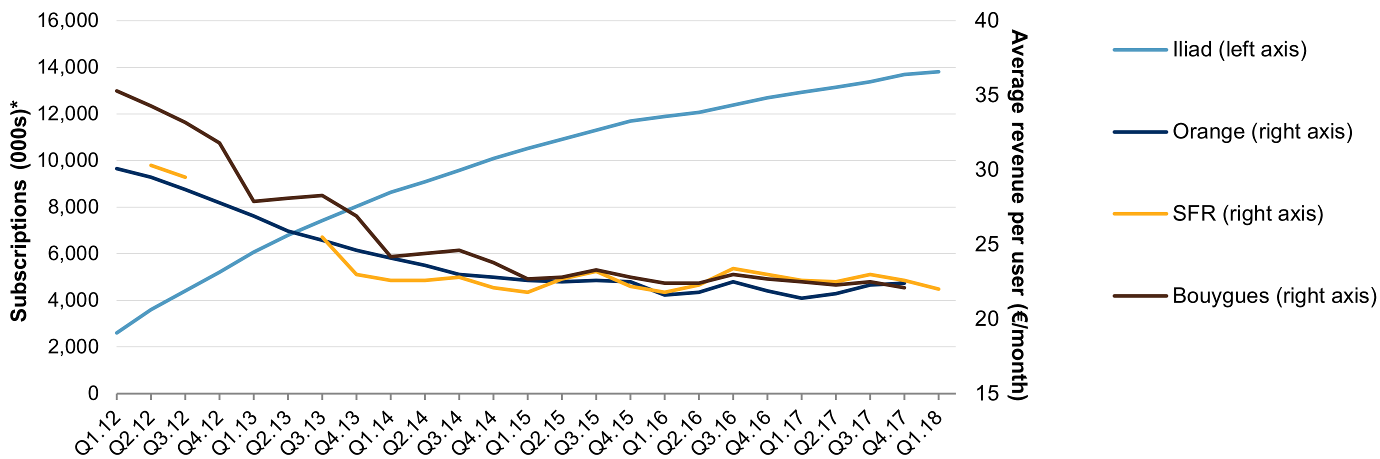
4G Mobile (€/month)	Iliad	Telecom Italia (TIM)	Telecom Italia (Kena)	Vodafone	Wind	Tre	Fastweb
Offer	First 1 million customers	TIM without limits Silver	Kena Special	Simple	All inclusive unlimited	All-in Prime	Mobile 700/8 Go
Cost per month	€5.99	€12	€5	€10	€12	€7	€6.95
Activation fee/SIM	€9.99 SIM	€25 SIM	€9	€10 SIM	€9 SIM	N/A	N/A
Period	1 month	1 month	1 month	1 month	1 month	24 months	1 month
Data	30 Go	5 Go	10 Go in 3G	5 Go	10 Go	10 Go	8 Go
Voice	Unlimited calls, SMS/MMS	Unlimited calls, SMS/MMS	1,000 minutes, 50 SMS	1,000 minutes, 1,000 SMS	Unlimited calls, 1,000 SMS	1,000 minutes, 1,000 SMS	700 minutes, 700 SMS

N/A--Not applicable. Source: Companies' commercial websites as of June 1, 2018.

With Italy still predominantly a prepaid market, at about 80% of customers, contract breakage fees do not present a significant barrier to switching. Fixed broadband also remains relatively weak, with average connection speeds of less than 10 megabits per second according to the European Commission's 2018 Digital Economy and Society Index report on connectivity. This places Italy in the bottom quartile for Europe, and below the other members of Europe's five-largest telecoms markets. Indeed, more than 22% of households in Italy rely on mobile rather than fixed for their broadband connectivity, a rate second only to Finland. In such an environment, data-hungry customers facing relatively low costs to switch may be willing to give Iliad a chance.

At the same time, we see several challenges Iliad must overcome. When it launched Free mobile in France in 2012, mobile average revenue per user (ARPU) levels averaged more than €30 per month. Iliad's €2 and €20 offers dramatically undercut the market. Combined with roaming on the country's strongest 3G network (Orange S.A.'s), Iliad enjoyed rapid growth, reaching over five million subscriptions in one year, and helping to drive a multi-year slide in French market ARPU in excess of 30%, or €10.

Iliad's Mobile Subscriptions And Competitors' Blended Average Revenue Per User



*Excluding machine-to-machine.

But in Italy, Iliad is entering a much more competitive and lower-priced market. Market ARPU is around €12 per month, little more than half of today's ARPU level in France. Even adjusting for multi-SIM customers, we believe average mobile spend per consumer is well below €20. And with low-cost offers already available from Kena, Wind Tre, and FastWeb at similar prices, it remains to be seen if those value-seeking customers will switch to Iliad's larger data allowance, or if savings of €5-€6 per month (compared to €10-€30 in France in 2012) is enough to persuade customers on more standard plans to switch.

Iliad's 30GB per month 4G data allowance is the most aggressive element in its offer, far beyond the current 3GB-5GB average consumption in Italy, even among smartphone users with 4G plans. While there may be pent-up demand, for many customers 30GB may be like having a Ferrari to circle the block. And super users who are seeking large monthly data limits may have concerns about the quality of roaming on the Wind Tre network. Wind Tre is the weakest of the three mobile networks in Italy, lagging Telecom Italia and Vodafone Group PLC (Vodafone) in terms of 3G and 4G speed, coverage, and latency according to OpenSignal testing. Until assured that it is really a Ferrari engine under the hood, super users may approach Iliad's offer with caution.

There are other challenges for Iliad. Key to its French growth story has been the conversion of its €2 customers to €20 plans as data needs grow. With no upscale plan currently on offer in Italy, Iliad lacks a similar customer migration opportunity and growth path. An upscale offer may be in the offing at some point, but with the entry package already 30GB, it might be years before average usage drives customers to seek larger data buckets. Iliad may also downscale the initial offer at some point as it comes with the caveat that it is available for the first one million customers. That said, perceived backtracking could compromise Iliad's marketing around simplicity, constancy, and giving money back to Italian customers.

There has also been recent speculation by Iliad's competitors about costs related to its roaming agreement with Wind Tre. While there are no details in the public domain on the terms, the speculation highlights the fine line Iliad must tread. It needs to gain customer scale for economic viability, but too much usage could raise roaming costs and pose risks to profitability.

Lastly, Iliad has no established brand recognition, distribution, or existing fixed product to cross-sell in Italy, whereas it did in France. A review of its website at the time of launch showed six stores and about 40 vending kiosk sites across the whole country. While we expect this to scale up quickly, it conveys the logistical challenge facing Iliad's lean Italian team to physically reach customers.

Cutthroat Price Competition Could Damage The Market

So far, we have not changed our broader expectations for the Italian market as a result of Iliad's offer, but if we begin to see a rapid deterioration in peers' profits and market share, we will reassess. In our opinion, the clearest sign of the market suffering beyond our expectations would be price cuts by competitors in response to a sharp rise in customer departures. Such an outcome would be the shortest route to our market forecast weakening. Barring that, we may have to wait until third-quarter data to first assess the impact on customer churn; second-quarter numbers may not give us enough to go on given Iliad's late-May launch.

Telecom Italia

For Telecom Italia, we expect a contained impact. Because Iliad's offer is likely to appeal to a similar customer base, we could see the reversal of some gains Telecom Italia has made since launching its low-cost Kena brand in March 2017. However, while Telecom Italia doesn't report separately on Kena, we believe it remains relatively small and any attrition should not materially change our forecast for Telecom Italia, which is in line with our overall expectation for a 2%-3% market decline in 2018.

We expect less competition for Telecom Italia's premium TIM brand customer base. Furthermore, with only about 25% exposure to the Italian mobile market (the bulk of the rest is to the fixed market and TIM Brazil), Telecom Italia can absorb significant mobile customer losses without breaching our forecast, all else remaining equal. Our outlook remains positive, with potential upside after the third quarter if results indicate market stability and support our current forecast.

Separately, we note that changes to Telecom Italia's board have raised numerous questions about strategy and revisions to its financial policy, which could affect its credit standing. We currently base our view on public statements by the board and management, both of which are committed to management's three-year plan. Management has publicly affirmed that fixed network assets are strategic and will remain under Telecom Italia's control.

While recent shareholder action by Elliot highlighted the potential for a structural network asset separation, we do not view this as a story unique to, or new for, Telecom Italia. We view structural network separation as an event risk. Should momentum build toward such an event, it could have material credit implications that we would assess on a transaction-specific basis. For now, however, we do not consider it a clear and present risk, and do not explicitly factor it into our ratings or outlook.

Wind Tre

Of the existing three mobile network operators, Wind Tre is the most exposed to Iliad's entry, despite it being the largest operator by number of mobile customers with about one-third of the market. This is due to Wind Tre's positioning in the low-to-mid range of the mobile market and the stronger networks of Vodafone and Telecom Italia.

That said, Iliad's customers will use Wind Tre's network under the national roaming agreement signed between the two players. Roaming revenues flowing to Wind Tre will therefore provide a significant hedge in the first years, which gives Wind Tre a window within which to execute the pending upgrade of its network and strategic repositioning toward the higher-end market segments.

The game is not just between Iliad and Wind Tre, however. We have emphasized that for Wind Tre the biggest uncertainties lie in how other operators would react. Following Telecom Italia's measures to preempt the expected disruption from Iliad's entry, the recent bout of price turbulence has been bad news for Wind Tre. Wind Tre's customer base has started to shrink earlier than foreseen. In such a market situation, the effective entry of Iliad may in fact be more positive than negative in the near term for Wind Tre, because losing customers to Iliad rather than to Telecom Italia and Vodafone means Wind Tre retains these customers on its network and receives related roaming revenues. Still, the major uncertainty at this stage is to what extent customer losses to Iliad will replace losses to the other two players, or come in addition, depending on the relative success of Telecom Italia and Vodafone's cheaper offers vis-à-vis that of Iliad.

Vodafone

We see Vodafone as somewhat less exposed to customer losses because of its premium brand and prices, which will dissuade customers leaving for competitive low-cost offers on a weaker network. We've already seen some early signs of this during the recent increase in competition at the lower end of the market, initiated by Telecom Italia's introduction of Kena. While Vodafone has experienced customer losses, the overall impact on mobile service revenues has been relatively moderate at 1%-2%, with customer losses mainly from the lower end, bringing blended ARPU up to about €15, mainly due to increased prepaid ARPU. The ARPU level at Vodafone is currently above Telecom Italia's blended ARPU of €13 and Wind Tre's ARPU at about €11, confirming our view that it preserves a premium brand in a highly competitive wireless market.

In addition, Vodafone's continued push on fixed-line offers should continue to cushion its losses in mobile service revenues as it keeps targeting its mobile customer base with converged offers.

However, we assume some impact on Vodafone's customer base, especially in the short term, as Iliad comes in with an extremely high data offer compared to Vodafone's main offers. Also, with a prepaid base of about 81% and annual churn of nearly 30%, Vodafone certainly remains exposed to some acceleration in customer losses, and it now faces reduced pricing upside for increased data bundles. We therefore assume a 2%-4% revenue decline during the next year, as well as about a 200 basis-point drop in the EBITDA margin as a result of losing profitable mobile customers while gaining lower-margin fixed subscribers.

The Sector Should Remain Insulated From Political And Market Headwinds

With the formation of a new coalition government, we have seen credit spreads widen in the Italian market. However, we do not expect that recent political and market turbulence will have a direct impact on the telecoms sector, which we see as generally insulated from macroeconomic cycles.

We would see a closer linkage if we considered Telecom Italia a government-related entity (GRE). But it has an independent board and the government has a low stake (we believe about 5%), so Telecom Italia is not a GRE. Unless the government was to substantially increase its holding, we do not anticipate changing our view.

A related issue is whether a hypothetical downgrade of the sovereign could limit the ratings on Italian operators. Given the current exposures and ratings, this is only a potential concern for Telecom Italia given that an upgrade (it currently has a positive outlook) could bring it to within one notch of the sovereign rating. If the sovereign rating were to fall two notches (to 'BB+'), we would need to assess whether Telecom Italia could be rated higher than Italy under our "Ratings Above the Sovereign" criteria. This would involve running a stress test to gauge Telecom Italia's ability to meet its obligations under a sovereign default scenario. If it passed this test, we could rate Telecom Italia above the sovereign, but this remains hypothetical as it assumes both an upgrade of Telecom Italia and a multi-notch downgrade of the sovereign. Worth noting is that we also run a transferability and convertibility test to assess whether the risk of foreign-exchange controls could cap our foreign currency ratings. For Italy, so long as it remains in the eurozone, we do not expect this to be a ratings factor.

If we see developments in the Italian telecoms market that diverge materially from the views outlined above, any ratings impact will be determined through a ratings committee.

Related Criteria And Research

Related Criteria

- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Key Credit Factors For The Telecommunications And Cable Industry, June 23, 2014
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015

Related Research

- Wind Tre S.p.A., Sept. 22, 2017
- Vodafone Group PLC, Sept. 12, 2017
- Telecom Italia SPA, Sept. 7, 2017