Wireless at a Crossroads
(First installment in a multipart series)

As record profits and low churn rates show signs of abating, wireless providers will need to adjust their strategies to accelerate innovation, cement customer relationships and improve operational efficiency to maintain revenue and profit growth.

Executive Summary
As they say, all good things must come to an end. After years of record profits and soaring subscriber numbers, the U.S. wireless market is now becoming saturated, with over 90% of adults in the U.S. owning a cell phone, according to Pew Research Center. The heady growth cannot continue without another swell of innovation spurring new sales, which does not appear immediately forthcoming. Pundits posit that machine-to-machine wireless (M2M) will be “the next big thing,” shifting the question to how to profit from the “Internet of things.” With a slowdown in the wave of game-changing technology, consumers are now value-conscious and much more inclined to use pre-paid service than they used to be.

The party is ending quickly. For much of its history, the U.S. wireless market has seen wave after wave of innovative “must-have” products (the feature phone, the smartphone and tablets). Revenue and subscriptions grew at a healthy clip. Now, the picture is emerging of a commoditizing market in which purchasing is driven increasingly by the need for replacements and upgrades. The new reality: Obtaining new subscribers now means taking them from competing providers.

In this environment, wireless providers must move quickly to revitalize their customer experience strategies, optimize their infrastructure and develop partnerships to revolutionize their product lines. One potential strategy is to take a lesson from leaders such as Amazon, Facebook and Google and leverage the data generated by subscribers and all digital consumers in every aspect of their lives — what we call ”Code Halos.” (For more on Code Halos, read our white paper, “Code Rules: A Playbook for Managing at the Crossroads.”) In other words, they must perform more like tech companies than telcos. As such, carriers no longer have the luxury of time – the time to adjust is now.

A Changing Landscape
The seemingly unshakable U.S. wireless communications market now finds itself at a crossroads. The market is quickly maturing, and the growing subscriber numbers, record profits and low churn rates will not continue forever.

Competitive forces are also growing from outside the traditional wireless sector. Internet technology companies are beginning to leverage their growing mobile experience, along with their
considerable ambition and resources, to enter the wireless marketplace. Two cases in point are Google and Facebook, which are targeting multiple elements of the wireless market, primarily to drive ad revenues. This is happening at the same time that wireless subscriber growth is declining (see Figure 1) and customers are becoming more price-sensitive.

The U.S. mobile market has entered a time of change that will affect the nature of competition in this space, as well as how companies win and the basis for growth going forward. As a result, providers are faced with the need to simultaneously initiate innovations in customer experience and product/service offerings while also improving efficiencies in their network and business operations.

A quick examination of recent history confirms the urgency. The industry has experienced previous periods where once dominant carriers were unable to adjust and quickly fell behind, disappeared or were absorbed by others. In the 2000s, several carriers, including Global Crossing, WorldCom, Nextel and the original AT&T Corp., suffered such fates. In the ’90s, fallen carriers included MCI, PacBell and NYNEX. The reasons were different, but the results were the same. And similar to the present, the fallout at those crossroads followed periods of strong business performance and market expansion.

Now, communications and tech giants such as Amazon, Google and Facebook are generating dramatically higher market capitalization than the wireless carriers that provide their essential infrastructure (see Figure 2, next page). This is due in part to their ability to track, understand and profit from their customers’ preferences and requirements as expressed via their digital footprints, or Code Halos. If wireless carriers could similarly create new product offerings based on Code Halo insights, they would be even better positioned to profit due to their powerful ecosystems, which consist of networks, billing and customer care infrastructures; marketing and sales forces; and retail channels.

The Good News Now

The U.S. wireless communications market has shown impressive strength compared with other developed markets, especially since the release of the Apple iPhone in 2007, which helped usher in the smartphone era. That performance was interrupted by a dip during the 2008-2009 recession, but record growth returned in 2010. Consider the following indicators of robust market health:

- **Sales growth.** Strong sales are attributable to the explosion in mobile data usage driven by the adoption of smartphones, tablets and other devices, as well as the accompanying new price plans. According to GSMA Wireless Intelligence, while European wireless revenues are contract-
Wireless Providers Not Reaping the Rewards
Tech and communication giants lead wireless providers in market capitalization.

![Graph showing market capitalization of wireless providers compared to other tech and communication giants.](image)

*Note: Valuations as of Sept. 24, 2013. Source: Company filings, NYSE, Capital IQ.*

Figure 2

...ing, U.S. revenues continue to expand, such that monthly average revenue per unit (ARPU) for U.S. carriers is now 80% higher than it is in Europe.²

• **Healthy profits.** While handset subsidies continue to be a drag on profit for U.S. carriers, individual profit records are also being set. For example, in the first quarter of 2013, Verizon reported the highest segment EBITDA margin (50.4%) on service revenues in the company’s history.³

• **Low churn.** U.S. customer defection rates are trending in historically low ranges of less than 1% to about 2% per month.⁴ The major U.S. wireless players showed declining or steady churn rates in the last few years. And adjusting for the shutdown of Nextel, industry churn has been low overall.

• **Pricing power.** Carriers have been able to increase prices in several ways, such as retiring unlimited data plans, which allowed them to charge for data usage, driving a windfall that helped justify and fund their investments in the 4G network. Case in point is T-Mobile’s disruptive move earlier this year to eliminate contract plans and subsidies for phones. Under these new plans, consumers pay full price for the smartphone through an upfront fee and monthly payment. The net result: These new plans took hold without carriers losing subscribers.

• **Robust M&A activity.** The acquisitions of Leap Wireless, Metro PCS and Clearwire have been announced or been completed. Even industry giants like Sprint and Verizon Wireless (the portion owned by Vodafone) have found buyers willing to spend billions on their acquisitions.

• **Capital investments in 4G and long-term evolution (LTE) network upgrades.** U.S. carriers are projected to spend $37.7 billion on the LTE rollout between 2012 and 2017, according to market strategy consultancy iGR.⁵ This aggressive build-out should translate to roughly one in five wireless connections in the U.S. being LTE by the end of 2013, according to GSMA Wireless Intelligence. That compares with roughly one in 50 in Europe for the same period.⁶

The Inflection Point

Despite the recent good news, change is afoot in the U.S. market, even in areas that until just recently exhibited positive signs. Consider the following:

• **Flattening subscriber growth** (particularly for post-paid subscriptions). While wireless revenue continues to grow, the pace of subscriber expansion has dramatically slowed, as the U.S. market nears saturation. In the second quarter of 2013, U.S. carriers added only 139,000 net new mobile connections, according to Chetan Sharma Consulting.⁷ The impact of the Nextel...
shutdown was clearly a factor, yet even in the first quarter, all subscribers increased less than 0.5%. According to the CTIA Wireless Association, the 327.4 million U.S. wireless subscriptions at the end of December 2012 corresponded to market penetration of 102.2%. And while growth of tablets and other new devices may be a positive force for subscription growth, factors such as consolidation of devices, bring-your-own-device (BYOD) programs and family share plans are likely to constrain subscriber growth even further.

- Increased focus on price/value. Value-based pre-paid wireless is now the fastest growing U.S. market segment, potentially reducing both ARPU and the consistency of revenue. (Watch for a future piece in this series for a more in-depth discussion of this trend and its implications for wireless providers.) Even Verizon isn’t immune to the more challenging environment. Its post-paid wireless-subscriber additions were down 40% year over year in the third quarter of 2013. Additional examples of how this trend is playing out include:
  
  In the first quarter of 2013, there were more net-new pre-paid mobile subscribers than traditional post-paid subscribers for the first time ever, according to Capital IQ.
  
  TracFone was the fastest growing mobile provider, based on the number of subscribers in the first quarter of 2013. The company had more net-new subscribers than all the post-paid carriers combined, according to Capital IQ.
  
  AT&T has invested in both the creation of its own Aio pre-paid wireless subsidiary and the purchase of pre-paid carrier Leap Wireless.
  
  T-Mobile acquired pre-paid provider Metro PCS.
  
  Emerging wireless price competition, even in the post-paid segment. After already creating a market stir with its $100-per-month unlimited voice and data plan, Sprint has further reduced the price of that plan to $80 per month. T-Mobile has also introduced an unlimited plan (along with other pricing changes), and in the second quarter of 2013, it led all U.S. carriers in growth of post-paid subscribers.
  
  - Outside pressures. As mentioned above, Google, Facebook and Apple are working to become both the “front door” to the mobile experience and the conduit for sales to and information about mobile device and network users. Cable operators are positioning their Wi-Fi networks as alternatives to mobile broadband, as are mobile broadband companies like Clearwire.

The Crossroads

The changes detailed above point to a market moving in the direction of a more mature, lower growth state, characterized by elements found in commodity marketplaces. This shift means the U.S. market will become increasingly like more competitive markets in terms of growth and other attributes, including:

- More aggressive and direct price competition.
- A need to grow the subscriber base by taking share and customers from other providers vs. attracting new users.
- Aggressive cost-reduction options, such as infrastructure sharing and outsourcing.
- Increased focus on the regulatory environment.

We believe carriers can effectively respond to these market changes by focusing on three areas that can impact performance, even amid slow growth and more intense competition: retaining and growing customers, developing innovative services and lowering costs in order to offer lower prices.

Customer Experience

Providing a strong customer experience is the key to retaining existing customers and proactively winning customers from other carriers. Consumers today measure their experience with their wireless provider (and other brands) not against that of other carriers, but against standards established by customer experience leaders such as Amazon and Apple. Several carriers are already investing in customer experience, with a renewed focus on customer metrics like NPS (net promoter score); however, as a group, carriers lag in providing a high-quality, personalized experience consistently across channels. Most also have not yet succeeded in translating directives to improve NPS or other metrics into actions on which teams can execute across the organization.
The work of defining an engaging customer experience can be long and all-encompassing, but there are a few key activities at the core. First on the agenda: segmenting customers using insights about actual customer behavior and customizing service to the needs and values of those segments rather than providing the same service for all. At the brand level, carriers also need to differentiate on meaningful attributes that distinguish them and counter the inability of many wireless customers to identify significant differences among carriers.

Aligning the company around a particular value set is a fundamental way of standing out in a share-driven market, where customers need a compelling reason to switch providers. The values or attributes that the provider chooses for differentiation need to be reflected in every aspect of the brand, including strategy, operations and customer experience, and they need to be supported by the provider’s business processes, systems and networks.

**New Product/Service Development**

Product and service innovations can help create “stickier” customer relationships and expand the revenue potential of a stagnant customer base. The goal is to create compelling new offerings for entertainment, productivity and commerce that entice customers to add incremental services to their mobile services contract. Subscribers are buying such offerings today in high volumes, just not from the carriers. Apple, LinkedIn, Paypal and over-the-top content providers like Netflix and Amazon are delivering these services and dramatically capturing revenues, profits, customer loyalty and — not surprisingly — market capitalization. Even advertisers are looking more to Facebook, Twitter and Google to target wireless subscribers on their phones than they are to carriers — notwithstanding carrier efforts in this area.

By tapping the subscriber’s digital footprint, or Code Halo, wireless providers could realize a vast array of new opportunities.

To get there, wireless carriers need to move from network- and equipment-defined innovation to market-driven innovation, creating an ecosystem in which different types of partners come together to serve customers. Traditionally, many breakthrough features were defined by the equipment manufacturer or through siloed, time-consuming and often sequential development processes. Today, in response to customer desires, many vendors — and even individuals — are creating advanced services that are independent of the equipment and run on top of the network, as part of a new ecosystem. To better drive these ecosystems, carriers need to rationalize and integrate their control and network infrastructures to be more flexible and responsive to the requirements of market-defined product development, rethinking their development integration points, organizational structures and business processes.

Critical to this effort will be establishing the specific way each carrier creates the value it will provide to make its ecosystem attractive. (The production, search, delivery model that we developed with MIT to help carriers address this issue will be the topic of a future paper). Ultimately, carriers will need to develop more effective teaming capabilities, giving trusted partners access to their network ecosystems, for example, by making application programming interfaces and software development kits available.

**Operational Efficiency**

Finding operational efficiencies will enable wireless carriers to reduce costs in a market with decreasing growth and increasing margin pressures. In a maturing market, cost reductions
Carriers can save money by consolidating or sharing functions, or even outsourcing capabilities like field operations to a shared service or a third-party provider.

As operators have been focused on M&A activity and aggressive network builds, many process and infrastructure technology areas also remain ripe for optimization. For example, many carriers still run multiple separate systems for operational support and business support across services and networks. Consolidating and rationalizing that infrastructure should yield significant savings, as well as greater flexibility.

Field operations and network infrastructure are other areas ripe for optimization. Carriers can save money by consolidating or sharing functions, or even outsourcing capabilities like field operations to a shared service or a third-party provider.

Looking Forward
Virtually all wireless carriers have made some effort to target one or all these areas. But arriving at the crossroads makes speed, focus and measurable impact — not business as usual — urgent priorities. Carriers also must understand their own source of value to the market.

For example, a company eyeing the wireless market should consider the cautionary tale of Facebook. Facebook debuted as a public company in May 2012, with a spectacular subscriber base of almost one billion and revenues of almost $4 billion. But analysts promptly called it to task for its lack of a mobile strategy and mobile revenues. By the second quarter of 2013, Facebook had taken fast and focused action and had grown its mobile revenues from a single-digit percentage to over 40% of its total ad revenues. And the share price and market cap of the company responded dramatically, with shares trading at $26.51 on July 24, 2013 and hitting a high of $54.22 on October 18, according to company information. We can’t know now if that will hold, but the episode illustrates the type of speed, clarity of objective and ability to create measurable impact that successful companies in this technology-driven space will need to demonstrate.

For U.S. wireless carriers, the inflection point has arrived. Changes are afoot, and the market is moving more quickly than the good news would imply. The question is, how will the wireless carriers in the U.S. respond to arriving at the crossroads?

Future installments of the “Wireless at a Crossroads” series will examine strategies for improving customer interaction, product innovation and operating cost, as well as the rise of the post-paid wireless market.

Acknowledgments
The author would like to thank industry expert Clarence Mitchell for his contributions to this white paper.

Footnotes


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