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Take Two on U.S. Telecom Consolidation: T-Mobile Announces Intent to Purchase MetroPCS

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Consolidation rumors are common in many industries, and today, the telecom sector confirmed yet again that it is no exception. Speculation of another acquisition attempt was finally confirmed October 3, 2012, when Deutsche Telekom (DT) and MetroPCS announced that DT's U.S. operating company — T-Mobile USA — and the pure-play prepaid operator will merge, pending regulatory approval. The combination forms the "leading value-focused wireless carrier," according to the companies and hopes to accelerate T-Mobile's current "challenger strategy." As of 2Q12, T-Mobile's and MetroPCS' retail subscriber market shares were 9.0% and 3.1%, respectively.

Terms of the agreement include a $1.5 billion payment to MetroPCS shareholders, a 74% and 26% ownership stake split between Deutsche Telekom and MetroPCS, respectively, and the retention of the T-Mobile brand. Recently appointed T-Mobile USA CEO John Legere will remain CEO of the new company, and current MetroPCS CFO and Vice Chairman Braxton Carter will retain his CFO title and be transitioned to the new T-Mobile. The customer units for T-Mobile and MetroPCS will continue to run as separate units, led by T-Mobile COO Jim Alling and MetroPCS COO Thomas Keys, respectively. Executives at both companies stated that regulatory approval is expected sometime during 1H13.

At face value, the news looks to be an attempt by two struggling carriers to join forces and work aggressively to be the largest low-cost operator in the U.S. This union will most likely be largely focused on reaching the consumer and prepaid base. With regards to prepaid — still an important segment in the U.S. market — the combined entity will have over 14.5 million retail prepaid subscribers, which will directly challenge the second-place carrier in the prepaid segment — Sprint — with 15.4 million subs. However, where Sprint and T-Mobile have continued to exhibit quarter-over-quarter growth in the prepaid segment in recent years, MetroPCS has experienced some volatility in its subscriber base in 1H12. The question remains whether T-Mobile–MetroPCS can continue to capitalize on the prepaid market growth and take share from its closest rival — Sprint. (TracFone remains the leader in the prepaid space with over 21 million prepaid subscribers.)

When looking at a merger of two carriers, the network plays a significant role. In the now-defunct AT&T–T-Mobile merger, the carriers' networks were compatible. When we look back at the Sprint-Nextel marriage in 2005, we're reminded of the incompatibilities and the ensuing challenges it has presented Sprint over the past several years — so much so that Sprint is now in the final phases of decommissioning its iDEN network and working aggressively to migrate iDEN customers over to its new Direct Connect service on its CDMA network. The proposed merger of T-Mobile and MetroPCS also poses the challenge of bringing together customers on two separate networks. However, the U.S. mobile networks are currently undergoing a major transformation as LTE becomes the view to the future. And, with MetroPCS having been the first to market with LTE in September 2010, the LTE assets and spectrum it holds make it a very valuable partner to T-Mobile. In the interim, the new company will have to figure out messaging and strategy to help maintain (and grow?) its existing GSM- and CDMA-based customers. T-Mobile's longer-term plan is to refarm the MetroPCS spectrum and transition the latter's customers to a single network by 2H15.

The announcement also demonstrates T-Mobile's continued commitment to reinvigorating itself as a major market player. Continued momentum is needed since the carrier remains the only Tier 1 operator without an LTE network today. However, the merger bolsters its network transformation plans. This is in addition to the $4 billion network investment T-Mobile collected following the collapse of the AT&T merger, its spectrum swap with Verizon as part of VZ's SpectrumCo AWS purchase, and the sale of 7,200 cell towers for $2.4 billion in late September 2012. All of these actions point to an operator that is looking to make its next strategic step to remain relevant and competitive in the U.S. landscape.

In addition to our previously mentioned commentary, IDC provides its perspective on some of the opportunities and challenges a potential merger of T-Mobile and MetroPCS presents.

Opportunities

- **Migrating customers from prepaid to postpaid.** With regard to the consumer base, the merger provides an opportunity to move traditionally no-contract MetroPCS customers to postpaid plans. With 60% of MetroPCS customers changing devices every year, the new company has the opportunity to upsell prepaid customers into a broader device portfolio and postpaid plans. However, on the converse, with this type of churn on the device front, it also represents the potential of customers leaving for another mobile operator. Focusing on customer satisfaction will be critical (and a lesson can be learned from Sprint's experience following the Nextel merger), as losing customers during the transition will be detrimental in terms of maintaining and growing its subscriber base.
- **Network compatibility.** For T-Mobile, the acquisition will provide additional bandwidth in key markets, as MetroPCS has licenses covering 142 million POPs, including many of the largest cities in the U.S., where capacity is at a premium. Like T-Mobile, MetroPCS operates in the PCS (1.9GHz) and AWS (1.7GHz/2.1 GHz) spectrum bands. On average, MetroPCS holds 22MHz of PCS and/or AWS spectrum in major metropolitan areas. In addition, it also holds a 12MHz/700MHz license covering the greater Boston area.
- **LTE deployment.** MetroPCS currently provides service in markets covering approximately 100 million POPs, including in New York, Los Angeles, Philadelphia, Dallas/Fort Worth, Detroit, San Francisco, Boston, and Atlanta, as well as nearly all Florida metro areas. MetroPCS will also help T-Mobile accelerate its plans to deploy LTE. (As of 2Q12, 7% of MetroPCS' customers were on LTE.) T-Mobile — the last Tier 1 operator to announce an LTE deployment — currently plans to begin commercial LTE rollout next year. By contrast, MetroPCS had the distinction of being the first operator to have deployed LTE in the U.S. in September 2010 and completed deployment to 97% of its network by the end of 3Q12.
- **VoLTE Strategy.** The MetroPCS acquisition will also enable T-Mobile to leapfrog its main competitors in offering voice over LTE (VoLTE). MetroPCS introduced VoLTE in August 2012, the first U.S. operator to do so and well ahead of Verizon and AT&T, both of which appear poised to begin initial VoLTE launches in 2013. T-Mobile has been attempting to seed the market for VoLTE by launching voice over WiFi. Thus, both T-Mobile and MetroPCS are in lockstep in terms of their strategy for introducing IP-based voice services.

Challenges

- **Device portfolio.** In short, the merger of T-Mobile and MetroPCS doesn't solve the one problem the industry continues to talk about — no iPhone for T-Mobile or MetroPCS customers. More broadly, this news doesn't particularly enhance either of the operators' device portfolios. T-Mobile has a more advanced device lineup due to its longer tenure in the data market, but neither carrier brings an iconic device to the mix — or to their customer base. With smartphones now in the hands of more than 50% of all subscribers, a device portfolio that has breadth and depth is crucial. As a more formidable fourth-place carrier, perhaps it will have a better chance to bring exciting devices to market, but at present, there is no leading device that comes out of this union. As for iPhone, until LTE is broadly deployed across T-Mobile's network, it is unlikely to make an appearance in its device showcase.
- **Coverage issues.** In IDC's view, optimal capacity and coverage are best provided through a combination of low-band spectrum to provide a base of coverage along with higher bands to address capacity in the busiest parts of the network. Thus, while the acquisition of MetroPCS provides badly needed additional bandwidth to T-Mobile, the company will still

lack the low-bandwidth coverage that each of its major competitors have or will soon have via coverage at 700MHz (AT&T, Verizon) or 850MHz (Sprint).

- **MetroPCS' capacity constraints.** T-Mobile will need to work quickly to address emerging capacity constraints in MetroPCS' network. By virtue of its limited spectrum, MetroPCS deployed LTE in relatively small channels of 5MHz, 3MHz, or 1.4MHz. As a result, users have complained that data speeds are just barely better than the prior technology and considerably slower than LTE provided by competitors on larger channels. T-Mobile will need to work to integrate MetroPCS into its ongoing network modernization so that additional capacity can be provided in existing MetroPCS markets. Combining the two companies will enable LTE service to be expanded to a full 40MHz (20MHz uplink/20MHz downlink) in many of MetroPCS' markets.
- **Plan pricing.** One question that emerges is if (or how) T-Mobile will eventually restructure MetroPCS' rate plans. With 9.3 million customers accustomed to the carrier's $40, $50, $60, and $70 monthly plans (with taxes and fees included), any disruption in the model runs the risk of discouraging customers from transitioning to T-Mobile. This is in addition to some of MetroPCS' data plans, which remain unlimited, with no throttling. Carefully crafting new pricing plans and offering options to existing T-Mobile and existing MetroPCS customers will be paramount during the transition to a single operating company.

Bottom Line

At the end of the day, consolidation is a necessary evil in the U.S. market as a means to create efficiencies and the ability to scale more readily. Why will the FCC and DOJ look at this acquisition differently than the AT&T–T-Mobile deal of 2011? It's because T-Mobile and MetroPCS represent two underdogs who are struggling to compete in an uber-competitive market that is dominated by the likes of AT&T and Verizon. Will either of the "big two" lose sleep over this news? Probably not. AT&T and Verizon are focused on offering a comprehensive, premium experience to their customers. T-Mobile–MetroPCS will be a value play — an alternative for customers that AT&T and VZ probably don't want to deal with in the first place.

As for Sprint — this deal could put some pressure on the carrier in terms of net add and revenue growth it has enjoyed in recent quarters. The combined entity will closely trail Sprint in the number of prepaid subscribers each carrier owns. However, with any merger, there are growing pains — so while T-Mobile and MetroPCS are working out the details, Sprint should stay laser focused on its business and its message of simplicity and unlimited plans, which have continued to resonate with customers.

A union of T-Mobile and MetroPCS makes sense. Despite the complexity of having two incompatible "legacy" networks (GSM versus CDMA), there are synergies with the long-term path forward. In a market that is starved for spectrum — the new company has options, in a union that will facilitate a complementary convergence of spectrum assets. The deal also provides a potentially graceful long-term exit strategy for T-Mobile USA's parent Deutsche Telekom, which will retain the option of unloading its shares if it so chooses. However, the deal does present some upside. In a market that is struggling to find new customers, the prepaid space represents an area of growth (IDC expects a CAGR of 7.1% by 2017, compared with overall market growth of 2.7%). In a market where competition is fierce, a combined T-Mobile–MetroPCS stands a fighting chance to remain relevant.

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