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Thinking like a 'ServCo': How telcos can drive B2C growth

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Even without legal or structural separation, telcos can accelerate the transformation of their B2C business units by adopting the mindset of a service company ("ServCo").

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The connectivity that telecom operators provide has launched hundreds of thousands of new applications and services, creating enormous value at the edge of the industry. Despite this, telcos have underperformed shareholders' expectations. Moreover, rising valuations for network and infrastructure assets have driven their returns more than B2C operations have done.

To reverse this historic underperformance, some telcos are separating their network operations (handled by a "NetCo") from their customer-facing operations (handled by a "ServCo") to expose the value of their network assets or attract external investment to fund network expansion. For those operators, the move is forcing a critical review of how to drive growth for and maximize the value of the resulting ServCos. But even those telcos that are unconvinced about the merits of legal or structural separation can capture substantial value by adopting the mindset of a delayered ServCo.

Few telco leaders have sufficiently embraced the scale of transformation necessary to win in the current hypercompetitive environment. Part of the issue may be that the network margins of an integrated telco provide a cushion that obscures the urgency of transformation. However, as the rollout of fiber to home networks reduces fixed-line differentiation and the move to online purchase journeys eliminates entry barriers for digital native providers, margins will erode, and competition will intensify.

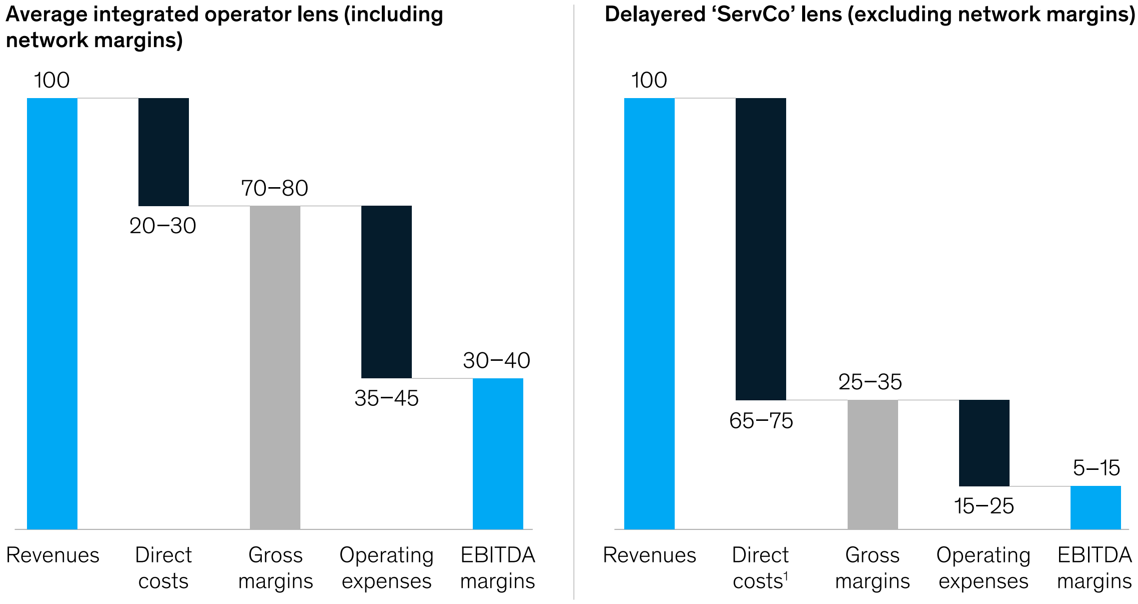
By adopting the mindset of a ServCo, B2C leaders of integrated telcos can accelerate transformation. An accurate reflection of a B2C business unit with lower margins (as well as lower capital expenditures) will promote a shift from the legacy practices that maximize short-term revenues (such as end-of-offer price hikes) to those generating longer-term customer value and satisfaction. At the same time, lower margins will make new revenue streams less margin dilutive—and therefore, more attractive. Finally, lower margins will mean that operators won’t be able to swallow the high sales and marketing costs traditionally invested in acquiring new customers, who often receive deep discounts. This will spur them to focus on existing customers and reduce the negative market price dynamics that this practice has driven.

Without the shield provided by network margins, B2C telco leaders face a dramatically different economic reality (Exhibit 1). Suddenly, margins drop to 5 to 15 percent, from 30 to 40 percent, casting cost cuts and revenue growth as stark imperatives. It becomes essential to maximize value from existing customers, drive loyalty, and increase engagement. Because of this, operators that adopt a ServCo mindset may be well positioned to reignite growth, restructure their cost bases, and reimagine their capabilities.

Exhibit 1

When the shield provided by network margins is removed, B2C telcos face a dramatically different economic reality.

B2C telco costs and margins, % of revenues



[1] Assumes network wholesale cost at ~50% of revenues, based on typical wholesale rates of FVNOs (fixed virtual network operators/MVNOs (mobile virtual network operators) and ARPU (average revenue per user) of integrated operators.

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The ServCo lens

To embark on the scale of transformation that a ServCo lens demands, B2C telcos will want to define a clear vision for how they will compete without the benefit of network differentiation. Then they can determine their approach to pursuing three key levers.

Each lever will require bold moves and fundamental shifts, but the rewards may be significant: there could be potential to quadruple valuations of telcos' B2C operations through margin improvements and multiple reratings. Depending on how many levers an operator chooses and how they execute these choices, it's possible to raise B2C margins (including a true accounting of network costs) to between 15 and 25 percent, up from 5 to 15 percent.

The three value-creating levers build on one another; although all telcos could benefit from engaging lever one, some will go on to engage level two, and others may pursue all three:

1. *Lever one: driving value from core connectivity.* A critical first step in a more expansive strategy is to optimize the existing connectivity business by driving growth in average revenue per user (ARPU) via customer value management and cost reductions. Telcos pursuing lever one without moving on to lever two will need to believe that the economics of selling connectivity alone can allow them to compete with players that also monetize customers across additional revenue streams. They will also need to believe in their ability to maintain a price premium over new digital entrants while achieving comparable cost efficiency.

2. *Lever two: growing new revenue streams beyond connectivity.* Building on the transformation of the core connectivity business, telcos can choose to grow new revenue streams by building new offerings in adjacent verticals, such as insurance and security. Alternatively, they can expand into new sectors by orchestrating an ecosystem of partners supported by a platform that allows customers to access a range of digital products and services—from home security to telehealthcare—seamlessly.

3. *Lever three: scaling the ecosystem across markets.* Telcos that are successful with levers one and two may consider scaling their B2C operations as platforms across geographies, wholesaling connectivity from local NetCos. Larger customer bases would allow these telcos to achieve further economies of scale, increase data monetization, and improve negotiation leverage with digital partners. Telcos embarking on this journey will need to believe three things: their platform can drive efficiencies while maintaining local relevance, the necessary local partnerships are within reach, and they can effectively compete with local operators.

The increased profitability of the core connectivity business (lever one) can also help fund investment in new revenue streams (lever two) as they are built. Meanwhile, repositioning telcos as digital platforms could drive a valuation multiple rerating. It could improve from the roughly four times enterprise multiple (the enterprise value divided by EBITDA) that the B2C operations of many integrated operators are valued at today to the roughly ten times multiple of many integrated operators with digital ecosystems.

Lever one: Driving value from core connectivity

To be successful, many telcos will likely need to drive ARPU growth from core connectivity while dramatically reducing costs. This is a precondition for levers two and three, and some telcos may determine that this approach is sufficient in and of itself.

Today's customers expect not only reliable connectivity and low costs but frictionless digital sales and service experiences and seamless interoperability between mobile and fixed-line services—across an increasing number of devices. While telecom operators have been pursuing digitization and cost transformation for years, the lower margins that come from adopting a ServCo lens can accelerate these changes.

An approach to personalized offers and pricing based on customer lifetime value (CLV) can raise ARPU by enabling continuous cross- and upselling and proactive churn management.[1] Capturing the data to underpin such personalized offers and surfacing them to drive conversion requires regular engagement with customers who often have little reason to interact with their connectivity provider other than when experiencing problems. Lever one requires new approaches to revenue, costs, customer experience, and customer interactions (Exhibit 2).

Exhibit 2

For telcos, thinking like a 'ServCo' requires new approaches that can overhaul KPI ambitions.

Approaches and KPIs of a typical integrated telco operator versus those of a 'ServCo'

From	To	KPI	Current result	Ambition
Focus on new customer acquisition	Focus on net revenue retention[1]	Net revenue retention	<50%	>100%
Infrequent customer interactions	Regular customer engagement	Visitor frequency	<1/month	>1/day
Short-term revenue obsession	Long-term customer experience obsession	Customer satisfaction score	<0	>55
High-cost indirect and retail channels	Zero-touch, digitally enabled, owned channels	Zero-touch journeys	~60%	>80%
High-cost legacy organizational structure and IT stack	Lean, digitally enabled, automated operating model	Operating expenses (excl network costs) as % of revenue[2]	~25%	<15%
Complex legacy product catalogue	Streamlined, simplified products	Number of legacy product codes	>1,000	<20
Siloed, waterfall operating model	Agile, test-and-learn mindset	Share working in agile model	<50%	≥80%

[1]Recurring revenue generated from existing customers over a set period, factoring in changes to average revenue per user and churn.
[2]IT, labor, media and marketing, and other indirect costs.

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As network differentiation dwindles, customer experience is becoming an increasingly important battleground. Simple tariffs (such as flat pricing), service models that automatically reimburse customers for network outages, gamified experiences, and loyalty programs can support longer-term customer relationships. These adaptations create the foundation for cross- selling connectivity offers and, should a telco choose to move on to lever two, for moving into adjacent services.

By accelerating the migration of transactional sales and customer care interactions to lower-cost digital channels, telcos can significantly reduce the scale and cost of large retail footprints. Simultaneously, they can invest in a smaller number of flagship stores to increase brand engagement. (In lever two, these can act as distribution channels for adjacent services.)

Examples already exist of integrated telecom operators that have succeeded in driving cost reduction and revenue growth through a CLV-based approach, beating out organizations that have moved more slowly (and might benefit from the accelerant that a ServCo lens provides). PT Telekomunikasi Selular (Telkomsel) transformed its core connectivity with new offers for underserved customers, seamless digital channels, a separate digital native brand, and a data analytics platform incorporating 9,000-plus data points per customer.[2]

The MyTelkomsel app now gives customers tailored offers, real-time views of data usage, and easy payment options. It has close to 30 million monthly active users, a tenfold increase over the previous app. Veronika, Telkomsel's chatbot, handles 97 percent of customer inquiries made through the app, as well as driving incremental revenues from phone credits and data packages.

To appeal to digital natives, Telkomsel launched by.U, a fully digital brand. In record time, its cross-functional team created and refined a platform that allows users to select a prepaid SIM card that arrives at their doorstep, activate their numbers remotely, manage top-ups and quotas, and make payments. To ensure that innovation continues after launch, by.U adopted an agile organizational structure. The brand reached its one-year customer acquisition goal in nine months. Within 15 months, it had nearly two million subscribers and a market-leading customer satisfaction score.

Lever two: Growing new revenue streams beyond connectivity

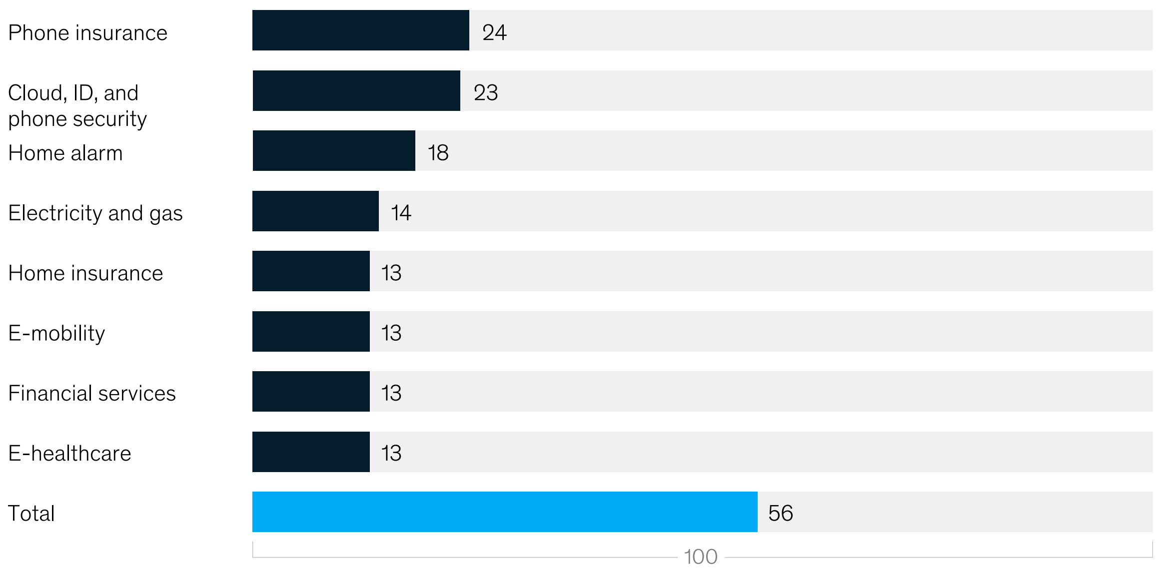
As the penetration of fixed–mobile convergence rises and the shift toward unlimited tariffs continues, opportunities for cross- and upsell within connectivity are dwindling. By moving beyond connectivity into adjacencies, telecom operators can reignite cross- and upsell opportunities and reduce their dependency on acquisition.

Telecom operators are already well positioned to venture into revenue streams beyond connectivity [3] : 56 percent of European customers say they would buy a service other than connectivity from their telco provider (Exhibit 3). Customers express the highest willingness to purchase phone insurance and products related to cybersecurity and home security, followed by products related to energy, healthcare, and financial services. Drivers of demand include discounts from bundling services, the convenience of a single point of contact, and loyalty benefits.

Exhibit 3

Customers are interested in buying services other than connectivity from their telco providers.

Customer interest in acquiring adjacent products from telco provider, % of respondents[1]



[1]Survey respondents were European telco customers in France, Germany, Italy, Spain, and UK; n = 3,362.
Source: McKinsey Telecom Adjacencies Consumer Survey, May 2020

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Telcos can draw on several privileged assets to grow adjacent revenue streams (see sidebar, “Telcos’ asset advantage”). These include rich insights on customers’ location history and creditworthiness, unparalleled access to customers’ homes, and the ability to authenticate customers.

With a careful eye toward market conditions, telcos might prioritize opportunities with growing revenue pools, unmet customer needs, clear customer pain points, limited competition, and a favorable regulatory outlook. They will also have to consider how best to expand their range of services and products, whether by building new propositions in-house or orchestrating a B2B2C ecosystem of partners.

Creating tailored adjacencies in-house

One approach to creating new revenue streams is to build new propositions in-house, potentially through acquisitions. Telcos that go this route need to possess two things. First, their existing assets, including customer relationships and data, need to provide them with a "right to win" in verticals beyond connectivity. Second, they need to have the capabilities for building compelling customer propositions that address untapped needs.

Norway's Telenor has unlocked growth by expanding into mobile phone insurance and security and privacy offerings. A prime example is its SAFE product, which provides protection against identity fraud and personal data theft. Since SAFE was released in 2020, it has attracted some 300,000 users who are willing to pay nearly $13 a month extra for the service. SAFE has met customers' desire for greater security protections and was directly integrated into the My Telenor app to facilitate the easiest access and payment. Telenor credits SAFE with reducing churn, increasing customer loyalty, and further driving top-line growth. Overall, adjacencies are responsible for two-thirds of Telenor Norway's ARPU increase between 2017 and 2020.

In Spain, Telefónica acquired 50 percent of the alarm business of leading home-security player Prosegur rather than trying to build a new proposition in-house, combining its own distribution channels and customer base with Prosegur's highly regarded product and brand. The resulting business, the country's first to offer 24/7 intervention services in response to a triggered alarm, was critical to Telefónica's success in growing its home-security customer base to 406,000 customers since launch, including roughly 60 percent year-on-year growth in the first half of 2022.

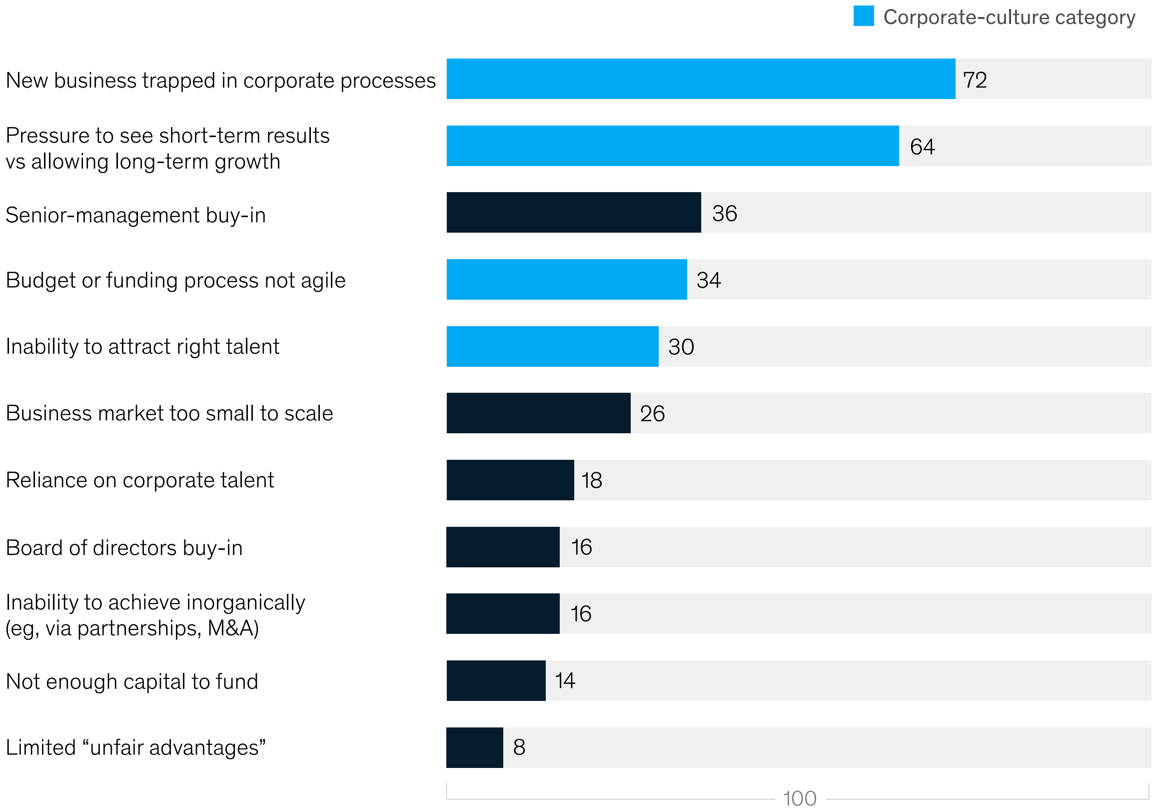
However, telecom operators have historically struggled to scale adjacency plays. Roughly 75 percent of these new businesses have yet to reach $100 million in revenues, and around half are achieving less than 10 percent profitability.[4] The main challenge here is cultural.

When it comes to building new businesses, surveys of telco chief experience officers highlight corporate culture as the primary obstacle (Exhibit 4). Cumbersome corporate processes, pressure for short-term results, and lack of buy-in from senior management can all stifle new initiatives. True cultural transformation is notoriously complex, and leaders may be reluctant to embark on this journey when viewing their businesses through a lens that includes network margins.

Exhibit 4

Telco operators cite corporate culture as the primary obstacle to succeeding in new business initiatives.

Key challenges faced by telcos in new businesses, % of respondents selecting category as a challenge



Source: McKinsey survey of 50 telco chief experience officers on new business builds, 2021

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Building a B2B2C partner ecosystem

European telecom operators that have sought to grow new revenue streams have often done so by developing new offerings in-house. By contrast, some operators in other markets and players in other sectors have successfully developed ecosystems that aggregate services from a range of partners. For example, in entertainment, many telcos are moving toward a B2B2C model that aggregates and recommends content from over-the-top media services.

As digital products and services proliferate, many consumers crave aggregation to support the discovery of new products and to simplify purchase and usage journeys. Seven in ten consumers say they value ecosystem offerings that simplify the purchase journey.[5] Consumers also need trusted ways to authenticate their identity digitally across services.

Telecom operators represent an attractive distribution channel for ecosystem partners. They have large customer bases that they can reach through owned channels, trusted brands, established digital and retail footprints, and the data to support a deep understanding of customers. Telcos can also provide incentive for ecosystem usage by upgrading or discounting connectivity and entertainment services, generating loyalty and engagement.

NTT DOCOMO has built a robust ecosystem offering digital content, healthcare expertise, financial services, and a B2C marketplace. The ecosystem was responsible for 23 percent of the operator's revenue in fiscal year 2021.[6] The telco has relentlessly pursued innovation in customer experience while building its ecosystem; in 2021, it had the highest number of AI-related patent submissions in Japan. It has inspired cross-product engagement through its d POINT CLUB rewards program, in which customers earn points by purchasing products and services from ecosystem players.

Strategic investments and partnerships have been critical as NTT DOCOMO has ventured into new verticals. It has built out healthcare and telemedicine solutions through partnerships with Genova Diagnostics, Medley, and OMRON Healthcare. It partnered with ORIX to launch a ridesharing service and with THEO to offer an AI-driven investment advisory. It integrates video services from several partners, including DAZN, Disney+, and Hikari TV.

A successful ecosystem across adjacencies can generate a “flywheel effect” with self-reinforcing cycles. When telcos better understand their customers, they boost engagement, which in turn attracts more partners and raises revenue. Improved financial performance allows telcos to capture economies of scale, resulting in lower-cost services and more users.

Lever three: Scaling the ecosystem across markets

The European telco landscape is highly fragmented, with 87 customer-facing entities catering to more than one million subscribers each. In the United States, by contrast, there are only 16. Many pan-European telecom operators run largely independently across markets, with separate websites, apps, tech stacks, back-end platforms, and billing engines. While NetCos are likely to remain inherently local businesses because they own and operate physical assets that can't easily be scaled into new markets, telcos' B2C operations have the potential to scale across geographies by partnering with local NetCos to offer connectivity.

Telcos that scale their B2C operations across borders can leverage investments and capture insights across a wider customer base, as well as improve negotiating leverage with digital services seeking distribution. Under this model, telcos' B2C platforms would operate like Amazon, running the front- and back-end systems for customers in different countries while maintaining the ability to localize the offering in the front end.

This shift is likely to begin with the integration of pan-European telecom operators' existing country-specific divisions. Down the road, this could drive consolidation of European B2C telecom, subject to regulatory approval—taking advantage of low valuations for B2C operations and potentially leaving single-market operators subscale in the medium term. If the European market were served by a total of 16 B2C telecom platforms, the same number as in the United States, and operators were able to reduce their B2C IT-related operating expenses and capital expenditures by half, this would save more than $5 billion a year.

While this is uncharted territory for telecom, the energy industry offers a glimpse into the promise of scaling beyond borders. Octopus Energy, a renewable-energy retailer, has scaled internationally by licensing the Kraken technology platform that it built for UK B2C operations to partners in nine countries. The Kraken platform hosts the entire customer service operation, manages disaggregated energy sources, communicates with industry bodies, and uses tools such as machine learning to offer dynamic tariffs. Revenues from these licensing arrangements grew by 584 percent in 2021.

Companies that have made the switch have saved more than $100 million in 2021. In 2022 alone, Origin Energy is expected to save as much as $80 million. Octopus Energy is now using Kraken to expand its offerings, integrating utilities such as water and broadband.

Key enablers and next steps

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Defining accountability and incentives

Regardless of which levers a telco exercises, it should carefully define the internal changes required to create end-to-end profit-and-loss accountability and establish incentives for improving B2C performance. This will include defining the internal transfer pricing for network access and determining which elements should be overseen by the B2C leader. In geographies with a competitive wholesale market, the internal transfer price can be informed by the market rate. Where such a market doesn't exist, the price can be set at a level that reflects the capital expenditure requirements (and cost of capital) for network investments, recognizing that the exact value may be less important than the visibility that the cost allocation provides.

Building the technology foundation

To help capture opportunities, B2C telcos can develop a technology architecture like that of e-commerce players. They can also strongly consider integrating third-party services via APIs, giving customers access to a range of services via single sign-on, maintaining a unified view of customer data, creating a single campaign orchestration engine, and centralizing billing and payments.

This approach may require decoupling customer and agent interfaces (such as websites and apps) from back-end platforms (such as billing engines and product catalogs) via APIs and replacing legacy components with off-the-shelf software-as-service tools (moving customization to front-end apps to reduce back-end complexity). This could enable true multichannel offerings, with elements such as a persistent basket, which saves items in customers' shopping carts. This can help increase conversion rates, lay the foundation for deep integration of third-party ecosystem offerings, and reduce IT run and maintenance costs.

The approach may also require decoupling network activation and management from customer management. This can allow B2C units to connect customers without operating the network and to support 5G use cases, such as network slicing, wholesaling the fixed-line network, and improving fault visibility across the fixed and mobile networks.

Reshaping the operating model and culture

Thinking like a ServCo requires a fundamental shift away from a traditional business model built around running a network toward a new model befitting a digital distribution business such as Amazon. This shift will require a combination of organic transformation, partnerships, and acquisitions as telcos rethink dimensions ranging from governance to data and analytics to financing.

As telcos' B2C units come to resemble digital sales and marketing organizations, they will need different capabilities, talent, and ways of working. Cross-functional, agile squads will help bring together commercial, marketing, digital, and data and analytics capabilities to transform connectivity and build revenue streams. This new structure will require different KPIs and performance incentives.

Telcos may need to form separate business units to incubate adjacent businesses and insulate them from short-term-profitability pressures. Partnership management will be a new priority as telcos seek out best-in-class partners, structure deals, and manage relationships. Telcos will also likely require new financial and reporting constructs to create transparency on the life cycle cost of new investments and to orient investment decisions around long-term plays.

Ultimately, telcos may be able to capture the most value by pursuing three levers: transforming core connectivity, creating a robust ecosystem, and developing a best-in-class platform that allows for scaling across borders. While this approach to international scaling is unexplored terrain, there are signs that it's also fertile terrain. Even for telcos not yet bold enough to experiment with this approach, it's time for a new way of thinking about the relationship among network, infrastructure, and customer-facing operations. When operators think like ServCos, the demands of the moment are thrown into sharp relief.

1. For more, see "Unlocking the value of personalization at scale for operators, McKinsey, February 24, 2022.
2. For more, see "How Telkomsel transformed to reach digital-first consumers," McKinsey, September 3, 2021.
3. For more, see "How telcos can succeed in launching new businesses beyond connectivity," McKinsey, February 25, 2022.
4. "How telcos can succeed in launching new businesses beyond connectivity," McKinsey, February 25, 2022.
5. Violet Chung, Miklós Dietz, Istvan Rab, and Zac Townsend, "Ecosystem 2.0: Climbing to the next level," *McKinsey Quarterly*, September 11, 2020.

6. This figure doesn't account for the revenue generated by NTT DOCOMO's enterprise/integrated ICT division, which was recently combined with its other operations.

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