

Competition Hits Deutsche Telekom

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Like a dinosaur facing extinction at the end of the Cretaceous period, Deutsche Telekom (DT) is desperately trying to adapt to a new and rapidly changing environment. Once a government-owned monopoly, it must now compete in a world in which the European Union demands it open its network to competitors and new technology makes its core business less relevant by the day. What should it do?

History

From its 19th-century origins until 1989, DT was part of the German postal system (Bundespost), owned by the German federal government and granted a monopoly right to provide telecommunication services in Germany. As in many other countries with public phone systems, the quality of service was low (getting a new line could take weeks, or even months) and the price high (several times what was paid in the US for similar services). Some described DT as bureaucratic, inefficient, and sluggish, words that have been applied to other public utilities in the past. In 1989, the government formally separated it from the postal service as a first step toward privatization.

The new company faced an immediate urgent need for capital to upgrade the phone system of the former East Germany and finance the growing demands of new communication technologies (wireless, internet). The government decided in 1994 to convert DT to a corporation (Aktiengesellschaft) and raised cash by selling a minority interest to the public in November 1996.

During the 1990s, the company embarked on an aggressive program to improve its infrastructure, cut costs, improve service, expand its geographical reach, and develop new markets. Major physical investments were made in its domestic network on the theory that it would provide a lasting advantage against competitors. The number of employees was reduced from 230,000 at the end of 1994 to less than 170,000 at the end of the decade. Repair times and installation delays fell dramatically. Investments in Europe (particularly in Eastern Europe) and Asia gave it a strong international presence. The Global One alliance (later dissolved) with France Telecom and Sprint was aimed at the global corporate market. Wireless, internet access, and corporate network services were rolled out in the early 1990s.

Regulatory Environment

DT's privatization was accompanied by demands from European and German regulators that it offer a level playing field to potential competitors. The German Telecommunications Act of 1996 guaranteed access to its local network at reasonable

rates. German regulators were more friendly to entrants than their counterparts in (say) France (for example, they set lower access fees), but most analysts thought they left DT with major advantages as the incumbent service provider.

Pressure from the European Union (EU) was expected to weaken these advantages. In December 2000, the EU called for increased competition in “local loops” (the connection to retail customers) and termed “unbundled access” to local loops (a connection not tied to other services) a “short-term priority” (European Union communication, December 5, 2000). Some observers expected competitors to use this ruling to force DT to further open its network to competitors.

Facing the Future

In early 2002, DT had significant presence in domestic wireless, international fixed-line and wireless, internet access, and IT services (Exhibits 1 and 2). Nevertheless, two-thirds of its revenue was domestic and most of its earnings stemmed from the traditional domestic fixed-line operations that lay at the heart of the EU’s directive on unbundled access. Its challenges included:

- Intense competition in its core fixed-line business. DT’s domestic market share fell from 85% in 1995 to roughly 70% in 2002 and alternative technologies (principally wireless) have reduced the overall size of the market. Entrants have built their own networks, with the result that a third of German fiber is owned by competitors. DT has resisted further market share erosion only by pricing aggressively. The average price of long distance minutes, for example, fell by 20% between 2000 and 2001. (See DKW analyst report, May 27, 2002.)
- Intense competition in the growing wireless market. DT and Vodafone have roughly 40% each of the German market, but wireless voice prices are the lowest in Europe. New entrants could make further growth difficult unless the market expands substantially. Expansion into new services (3G, for example) would require massive investments of capital. Internationally, many analysts questioned the viability of VoiceStream, the US unit of T-Mobile, which had only a 7% market share.
- Massive debt. With debt of over (Euros) 60b, DT faces a potential cash-flow crisis. Its ratio of debt to 2002 estimated EBITDA was 4.4, well above those of most other European incumbents (British Telecom 2.4, Portugal Telecom 2.8, Telecom Italia 1.4, Telefonica 2.2, but France Telecom 5.5!) (Goldman Sachs analyst report, June 21, 2002).

Postscript

Chief executive Ron Sommer resigned in July 2002 after members of the German government expressed dissatisfaction with his leadership. With the government holding 43% of its stock and German citizens much of the rest, DT’s performance had become a political issue. In August, interim chief executive Helmut Sihler confirmed that DT was

discussing possible sales of its German cable and US wireless businesses in an effort to reduce debt.

Questions for Analysis

- (a) What are DT's strengths as a company? Weaknesses?
- (b) Where do you think DT's best opportunities lie for future profitability?
- (c) Bottom line: Is there anything DT can do to halt the erosion of its position?
- (d) Can you think of analogous situations in other countries or industries?

Additional Information Sources

- Company web site: <http://www.telekom.de>

Notes

This case was prepared by Mariagiovanna Baccara, David Backus, and Luis Cabral for the purpose of class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The authors thank Jim Coyle for helpful comments. © 2002 NYU Stern School of Business.

Exhibit 1
Major Lines of Business

Business	Description
T-Com	Local, long distance, cable, ISDN/DSL
T-Mobile	Wireless
T-Online	Internet service provider
T-Systems	Network services, web hosting, IT outsourcing

Source: Company reports.

Exhibit 2
Contributions of Major Lines of Business to Revenues and EBITDA, 2002Q1

Business	Revenues	Percent Change	EBITDA
T-Com	6,283	-0.9	2,467
T-Mobile	4,115	77.5	1,211
T-Online	387	8.7	17
T-Systems	1,874	-5.9	258
T-Other	111	40.5	(171)
Total	12,770	15.2	3,782

Source: Company presentation, Goldman Sachs report. Numbers are euros. Percent change refers to the change in revenues relative to the first quarter of 2001.