Wrestling the Subsidy Challenge

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In mature wireless markets around the globe, the subsidy model has driven operators' revenue growth by both attracting new subscribers and enticing them to upgrade their service plans. But today the subsidy model faces challenges.

Operators desperate for new customers have swallowed the increasing wholesale prices of iconic devices—and earnings have suffered.

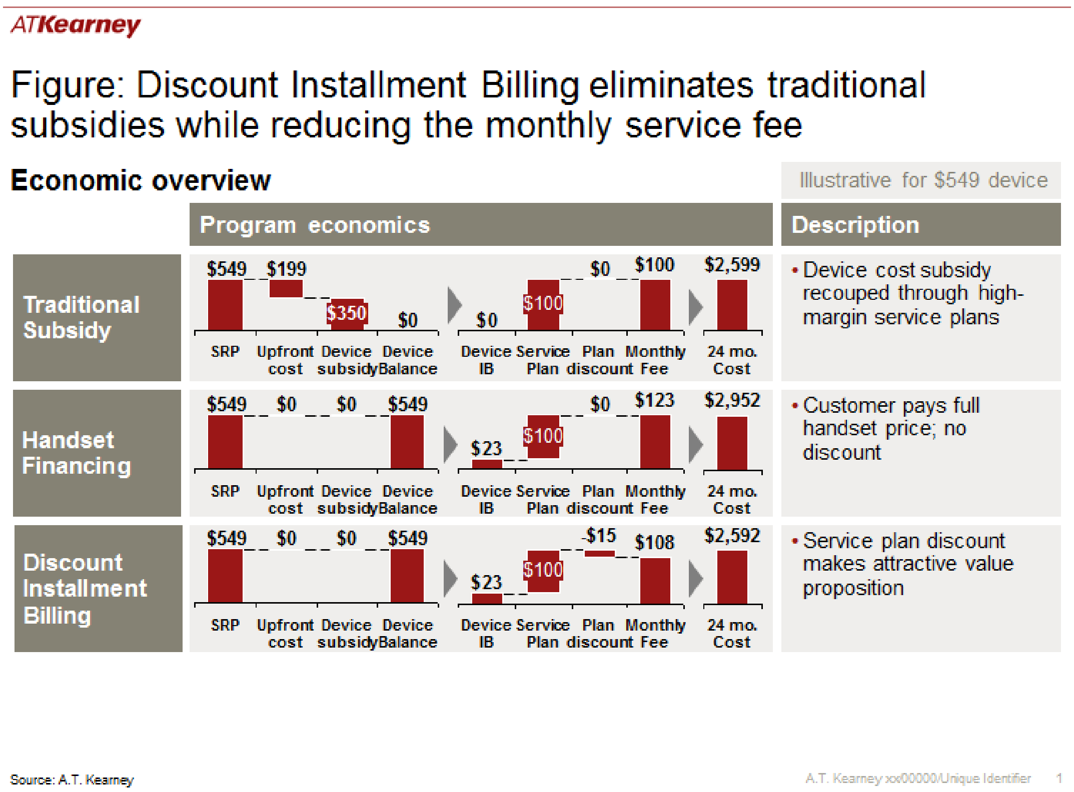
Some operators have experimented with an alternate go-to-market model, handset financing, but customers don't see it as a good deal. To successfully move away from subsidies, operators must offer an alternate source of value, which can come in the form of a service plan discount. This model, discount installment billing, can potentially threaten longer-term revenues, especially the widely-monitored metric of average revenue per user (ARPU)—but offers benefits including reduced subsidy budgets and an expanded customer base, which can ultimately drive absolute revenues higher than under the subsidy model.

The Problem: Subsidies Drag Down Earnings, and Financing Changes Aren't Enough

To find growth amid flattening revenues from existing subscribers, operators must seek new customers. Yet an iconic smartphone that may have once wholesaled for $400 now can cost the operator closer to $600—and the customer still expects to only pay the suggested retail price (e.g. $199). Consequently, operators' subsidy budget has to swallow the difference.

Handset financing offers promise to operators because it eliminates the subsidy. (*See Figure*) The new device cost is amortized across the 24-month length of the contract (in the example in the figure, at $23 per month), rather than occurring all at once in the first month. But under the financing model, the customer ends up paying more, as the middle of the figure shows. The lack of customer value explains why operators have found it so hard to move away from subsidies.

The Solution: Discount Installment Billing



In the bottom of the figure, customers forego the handset subsidy but get a $15 discount on monthly service. Discount installment billing makes handset financing an attractive customer value proposition. For equivalent or lower cost, the customer gains transparency and simplicity. There are no hidden fees and no device-specific plans. Customers understand, and pay for, the true cost of the device.

Meanwhile, for the operator, discount installment billing lowers subsidy budgets, resulting in earnings improvements. The disadvantage, however, is that it reduces the monthly service revenues per consumer. That discount on the monthly service plan will lower ARPU. Because ARPU is widely accepted as an indicator of company health, analysts may hesitate to accept even increased short-term earnings as a worthwhile tradeoff for decreased ARPU.

On the other hand, solving the subsidy problem is perhaps the paramount issue for most operators in mature markets. Discount installment billing offers the potential to solve this problem—as long as it's done correctly.

Key to Success: Full Commitment to the New Strategy

In our experience, for a discount installment billing strategy to work, the operator must wholeheartedly commit to it. The commitment may involve simplifying business models or changing internal structures, and it will almost certainly involve addressing growth and revenues. Timid or cosmetic changes will be insufficiently attractive to customers or insufficiently capable of counteracting shortfalls in service revenue.

Key differentiators in successful discount installment billing plans include:

•A well-executed early upgrade program to encourage trade-ins more frequently than every 24 months—resulting in happier customers, increased sales of smartphones, and more customer touch points to proactively manage churn.

•An effective secondhand device program to mitigate risks associated with increased inventory of traded-in smartphones.

•An expanded customer pool that no longer rejects customers who have less than sterling credit; instead they simply pay more up front.

•Expanded revenues from connected device sales, with multiple devices (perhaps including phablets and wearables) on a single account.

Where It Works Best

The move to discount installment billing will have bigger impacts for operators in certain situations:

1.Markets with high smartphone penetration, where freeing customers from unpopular contracts is more important than converting them to smartphone use.

2.Markets with potential non-traditional customers, including those with a poor credit rating.

3.Challenger operators chasing growth, because growth-oriented operators face particular subsidy challenges.

4.Where David can beat Goliath, because it’s riskier for large operators to trade known long-term ARPU for potential growth.

We expect that in the next two years, the majority of postpaid subscribers in mature markets worldwide will move to discount installment billing contracts. Early adopters will benefit from subscriber churn away from their slower-moving competitors. Then, as discount installment billing programs become an essential strategy for any operator, the keys to success will be in design and execution. The long-term winners will be the companies that offer customers a genuinely improved value proposition while mitigating the revenue risks.

A longer white paper on this topic can be found here [1].

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