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Analysis - Merger Prospects Grow in Prepaid

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by Keith Mallinson

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Leap and Metro's competitive positions are weak and unsustainable. Consolidation will ensue, but who will acquire?

The recession and looming mobile market saturation are taking their toll on unlimited voice and text pure-plays Leap Wireless International and MetroPCS Communications.

Their net subscriber additions are significantly down and well below recent Wall Street expectations. There's limited scope for recovery, with increasingly direct competition. Most troubling is net additions are almost entirely in network expansion areas, with few or no net additions in established areas. If overall net additions can only be achieved with new territories – where net additions are a certainty and to equal gross additions – network expansion is a path to ruin.

Unlimited has an intuitive appeal – particularly in tough economic times. Consumers – including those with poor credit ratings or limited budgets – can still obtain wireless service, use on average more than 1,500 minutes per month and control their expenditures. Wireless carriers carry limited credit risk by collecting payments in advance.



Keith Mallinson

BIGGER BUCKETS

The snag is prepaid unlimited is not a separate market from mainstream cellular. Distinctions are blurring as calling buckets get bigger and cheaper. Mainstream operators can easily attack by simply creating new price plans. Sprint Nextel has already done this with its Boost Mobile brand. In my October 2008 column, I warned against Leap's overzealous optimism with plans to add capacity during what has turned out to be the worst economic contraction since the Great Depression. Leap had just announced it would double Cricket's covered pops in the coming year.

So far, Verizon Wireless and AT&T have chosen not to compete with Metro and Leap head-on. T-Mobile is half-way there with prices that attract heavy users consuming on average around 1,100 minutes per month, versus a market average of around 850. The U.S. market leaders have maintained their higher-priced, postpaid offerings while tolerating low-end market share loss.

Unlimited is a tough business model because in contrast to per minute or bucket plans, price reductions cannot mitigate corresponding APRU reductions with increased usage. One way or the other – with the launch of new pricing plans or through acquisition – it is just a matter of time before the market leaders join in. This is inevitable as the United States approaches market saturation with penetration already exceeding 90 percent.

COST ADVANTAGE FOR LARGER PLAYERS

Size of network and subscriber base is crucial in wireless competition. Outside of rural areas, where competition tends to be benign, there are major consolidation forces. Financial performance tends to be weak where five or more wireless carriers compete. Exceptions are where one or two players

dominate.

Whereas nobody is making decent profits in the United Kingdom because market shares are fairly evenly spread among four of five network competitors, AT&T and Verizon in the United States and America Movil in Mexico enjoy significantly better financial performance than their smaller competitors.

Leap and Metro are rightly proud of their lean operations with low average costs in comparison to the large national operators. However, average costs do not determine competitors' pricing behavior. If AT&T and Verizon decide to attack, it will be on the basis of their low marginal costs for additional subscribers and minutes.

SO, WHO WOULD ACQUIRE?

Network technology is a most important factor in acquisitions. Cingular's integration of AT&T Wireless with GSM network technology in common was a great success. Four years on, Sprint with CDMA is still haunted by the iDEN network it acquired with Nextel. Telefonica set itself back years by converting CDMA networks to GSM in Latin America.

A merger between Metro and Leap is an obvious first step. With the same CDMA technology, complementary spectrum holdings and network footprints, such a combination could reduce costs and provide broader on-net coverage. This on-again, off-again merger will still not be sufficient to elevate EBITDA margins currently languishing in the twenties to percentages in the forties that investors crave.

Who else? In the short term, Sprint has more than enough on its plate. Sprint never ceases to amaze me with its willingness to add to its existing problems. However, I suspect neither the company nor private equity shops would have the means to put such an acquisition together. AT&T and T-Mobile USA are unlikely acquirers due to technology differences. This barrier will diminish by 2012, when LTE migration paths have been forged.

That leaves Verizon. The technology fits, the market positioning is highly complementary and the acquired spectrum would be a boon once mobile broadband really gets going. However, the antitrust challenges could be significant.

Mallinson is founder of WiseHarbor, solving commercial problems in wireless and mobile communications, www.wiseharbor.com.

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