What does Rakuten's launch delay mean for Japanese mobile?

By Chris Hoare | August 25, 2019

Perhaps the worst kept secret in global telcos in recent months has been that Rakuten was planning to delay commercial launch. Now that the Japanese challenger has opened up to the problems it is facing building out its network we addressed the likely implications for the incumbents. The note we published (HERE) also set out our overall thinking on the market, explaining how we & why we think the analogy with how new entrants trashed cash flows in other markets is a poor one.

On the face of it our position seems hard to justify: we are both constructive on Rakuten and on the incumbents Rakuten is set on disrupting. This reflects our view that Rakuten will gain customers (and therefore create value for itself), but that the incumbents will be able to off-set this pressure through their own actions.

For Rakuten the logic behind our case is simple: the company is investing c. $5bn to enter a market with an EV of c. $250bn. As long as the technology works (which it does) and the company can hit modest subscriber targets, it ought to be able to at least recoup its investment. Yet trading 40% below its level prior to the announcement of mobile entry, the share price is still discounting that the venture will destroy substantial value. Since we think this is unlikely we are positive on the stock.

The situation for the incumbents is less simple, as here we see two conflicting trends: on the one hand revenues are set to come under pressure, as a result of Rakuten's entry. Offsetting this though we see a number of levers available to the incumbents to maintain cash flow and returns. Ultimately therefore the likely share price outcome depends on the extent to which revenue pressure can be offset through these levers.

Bears believe that revenue pressure will be intense, and quickly overwhelm the ability of the incumbents to offset. But we think this ignores the fact that the Japanese telco market is a good one to defend. Churn is low (well below 1% per month). Price sensitivity is low (HERE). Network quality is high and consumers rate network quality as important (HERE). There is no sharing so as Rakuten is experiencing (HERE) the challenge for a new entrant is more severe than elsewhere. Regulatory support for the new entrant is questionable which explains why the roaming deal is relatively unattractive. Furthermore, Rakuten is likely to target only customers within its own coverage area which is c. 11% of Japanese pops initially. All these things suggest to us that Rakuten's impact on incumbent revenues will be relatively modest, reducing growth by 2-3% per year we think.

Just as importantly though we note a number of levers that the incumbents have to offset this pressure:

1. Capex cuts (HERE)
2. Opex cuts
3. Reduced handset subsidies (HERE)
4. Share buybacks
5. M&A (HERE)
7. Payout ratio increases

As a result, we are confident that cash flow will not get squeezed in the medium term and that the companies can continue to grow shareholder remuneration. Returns are high, which suggests the Japanese should trade on a widening premium to the rest of the world. On this basis, we remain constructive.

Furthermore, if one considers the incumbents ability to weather a storm you also understand why we are less concerned about Softbank vs the other incumbents. SB has some discrete advantages, such as lower exposure to Rakuten's customer base (HERE) and fewer MVNO customers, but ultimately weathering the storm is going to be as much about flexibility as anything else. SB we think has a greater ability to flex its business model, as we are already seeing for instance in the YJ acquisition. As a result, we are constructive on all the Japanese mobile operators, but see Softbank as a particularly poor short. KDDI remains our top pick.

Full 12-month historical recommendation changes are available on request

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