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Creative Disruption

March 29, 2019 by Chris Hoare

It has been a long time since a single presentation has created as much of a stir among global telecom investors as Hiroshi Mikitani's, the founder and CEO of Rakuten, on the entry strategy of the Japanese e-commerce leader into the mobile industry at MWC this year. Following a deluge of client interest, we have carried out a deep dive into what Rakuten is doing (HERE). What we found out has the potential to be scary for the incumbent Japanese mobile operators, but may be rather less of a fright for the rest of the global industry.

We now think Rakuten is building capacity for 30m customers (~15% of the market), at much lower cost than the established Japanese MNOs. Economics are sufficiently good that the company can create value for itself with ARPUs around half the prevailing level. So what is Rakuten's secret sauce? The company would have investors believe that this is all about its embrace of virtualisation, but we do not see vRAN as the main driver of Rakuten's advantage. In our view Rakuten's prospective low costs are mainly attributable to its greenfield status, and in particular the fact that network capex and opex for a small cells network in Japan is very low. We estimate all-in Rakuten's opex per small cell at around $35/month (for backhaul and attachment fees). This means despite launching with 100,000 small cells [1], growing to 6-700k over time, Rakuten's overall network cost remains low. Prevalence of available dark fibre at a low fee limits the read across to most other global wireless markets we think. Building a pioneering virtualised network is certainly the right choice for Rakuten, giving it good future flexibility and optionality, but Rakuten's lean cost structures arise mostly from avoiding the plump layers of legacy costs at the three incumbents.

Clearly life is set to get tougher for these three incumbents. However, we think the near-term impact of Rakuten's launch (on market share and prices) is likely to be limited, and as a result we stay positive on the domestic incumbents (excluding SB KK). Why? Partly because the stocks have already fallen so far, but we are aware this is an excuse not a reason. Stocks that have fallen a long way can continue to fall. More importantly though, we suspect Rakuten may delay its commercial launch by a few months and will initially only go to market where it has a completed network. This coverage area is only c. 14m pops from day 1 (about 11% of pops). Thus the threat grows over time, but starts out slowly. The challenge for the incumbents therefore is to use the time they have to cut into their own costs and prepare to compete with the new entrant. In the near term they will benefit from declining handset sales, and having 'cheap' equity gives optionality. With strong balance sheets, we expect dividends will continue to rise which is the key driver of 2019 share price upside we think. Over the medium term revenues come under pressure, but with capex and opex cuts we think cash flows can be stable and dividends continue to rise. With share prices under pressure currently there is always the possibility of bigger share buybacks than investors expect. As a result, we remain constructive on both KDDI and DOCOMO (see HERE).

For the full weekly review and updated comp sheets, see HERE

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1. *yes, that's not a typo. Rakuten intends to start out in just three city areas with about the same number of small cells as the entire USA has today. We estimate that the Japanese incumbents have about a million small cells at present, and rising*