

# Outsourcing: what's next in international voice services

With international voice now a commodity business, carriers need seriously to consider whether they can justify maintaining it as an in-house service

To say that the telecommunications industry is undergoing a dramatic transformation would be an understatement. Diverse factors are forcing established carriers to evaluate long-held strategies. Technologies at the foundation of their networks are being challenged by the disruptive innovations of VoIP and 3G. Subscribers beginning with whatever came after the baby boomers all the way to grammar school students are demanding continuous connectivity and communicating in unforeseen ways. Over the course of just a few years service providers have experienced a tremendous increase in the urgency to innovate at all levels of the business, all while enduring the fundamental business pressures of increasing competition and declining margins.

One of the outcomes is a growing need for carriers to focus resources on their core business and maximise the efficiency of all other operations. This is particularly fitting in regards to how they conduct their international voice business.

## **HISTORICAL PERSPECTIVE ON INTERNATIONAL VOICE SERVICES**

Less than 15 years ago, international phone service was provided exclusively by incumbent carriers, the PTTs. As there was typically only one such carrier per country, they were able to set rates as they wished

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and use the extremely high margins to subsidise the expansion of their domestic networks. International traffic was exchanged in a clubby and profitable system of bilateral agreements with the monopoly carriers in other countries. The WTO agreement on telecommunications launched a global deregulation movement that introduced competition to telecommunications and by the turn of the century emerging carriers were picking up significant share of the international traffic in almost all of the developed countries of the world. Today, according to Telegeography, more than 50% of the world's international voice traffic

is originated by competitive (non-incumbent) carriers.

In addition to the emergence of alternative fixed-line carriers, the rapid growth of mobile service has added significantly to the competitive environment. Introduced in the mid 1990s, mobile phones overtook fixed line subscribers by 2002 and now account for more than two-thirds of total global phone lines. By 2005, more than 25% of international voice traffic was originating from mobile phones, and more than 40% of international traffic was terminating on mobile phones.

A slightly more recent development, the advent of voice over broadband, has introduced yet another new category of competitors for consumers' voice dollars. These include cable operators, with their powerful triple-play capabilities and "sticky" residential services – television and internet access – and independent consumer VoIP providers ranging from Skype to Yahoo and a myriad of smaller service providers.

## **INCREASING COMPETITION FOR SUBSCRIBERS**

The increasing competition for subscribers has forced carriers to continue to invest heavily in "customer-facing" assets and resources. Virtually every fixed-line operator has announced or is in the process of rolling out an IP migration strategy to reduce costs and support enhanced services. In the process, they should be evaluating – and no doubt many are – whether the current contribution of their international voice business warrants the infrastructure investment.

Mobile operators must continuously launch innovative new service offerings including multimedia messaging, IP video and content distribution just to maintain parity, while making progress on next-generation architectures such as 3G, Wifi, or Wimax that promise more subscribers and higher margins, at least until the next new thing emerges. In this context of rapid retail competition, technology upheaval, and service innovation, tried and true international voice service simply doesn't rate much attention. Despite its healthy growth rate, it has become highly commoditised.

The major social trends of increasing globalisation, immigration, and economic development continue to drive strong growth of international voice traffic. Yet, its contribution to the typical carrier's profitability is minimal – perhaps 5% EBITDA compared to roughly 40% EBITDA for retail services. The international voice business simply no longer fits

**CHART 1: TRAFFIC VOLUME CARRIED BY SELECTED MULTINATIONAL CARRIERS, 2005**

Source: Telegeography 2007 and pro forma 2006 traffic iBasis and KPN Global Carrier Services

most carriers' business model. While it is an essential service that must be provided to consumers, it doesn't enhance a retail carrier's competitive differentiation, it's not keeping pace with the profit contribution of other services, and it consumes valuable resources. It may even be a distraction for management, and a source of confusion for investors.

### TIME TO OUTSOURCE INTERNATIONAL VOICE

When American Express realised that credit card transaction processing was consuming valuable resources without making a significant contribution to its differentiation or EBITDA, it spun the function out and created First Data. American Express then signed a long-term contract with First Data to handle its transaction processing and ensured sustainable cost-efficiency. First Data was designed exclusively for that specialised function and did it very efficiently. The company built a successful business by aggregating the transaction processing of other credit card companies. American Express benefited from those scale advantages and focussed its resources on the front end of its business where it could achieve competitive differentiation by identifying customer segments and creating credit card products that appealed to a segment's specific needs. American Express' commitment to the outsourced model for its transaction processing requirements sent a strong signal to the rest of the industry that outsourcing the function was an acceptable practice. Transaction processing was integral, but it was not strategic.

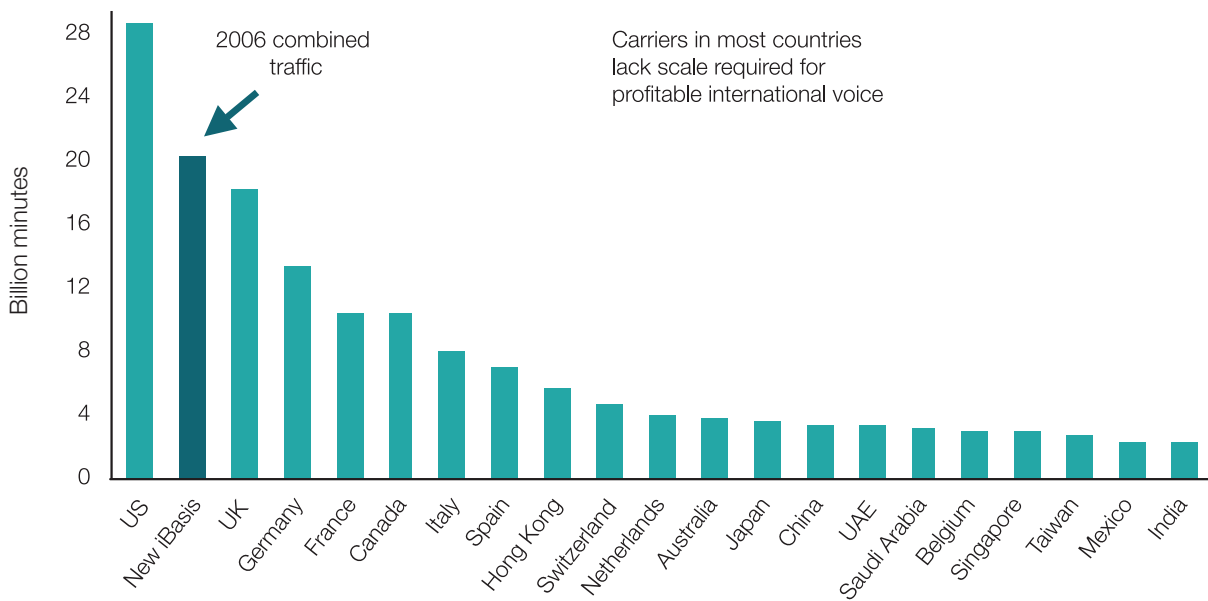
Similarly, 7-Eleven, the large American convenience store chain,

evaluated its business looking for ways to streamline and enhance profitability. Management asked two questions of each of its major operations: was it proprietary, and was it common enough in the industry that outside suppliers could achieve significant advantages of scale by providing it as a service to multiple companies. The process led 7-Eleven to outsource a variety of functions and strategically partner with other suppliers to maintain its focus on what it identified as its core – point-of-sale merchandising and product ordering. The strategy is largely credited with enabling the company to lead its highly

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competitive industry in a multitude of financial performance measures.

Telecom carriers are beginning to engage in the same thought process. To succeed in international voice requires tremendous efficiencies of scale. iBasis, with one of the lowest cost structures in the industry, didn't achieve EBITDA breakeven until it carried seven billion minutes of annual traffic. Today, according to Telegeography, there are fewer than a dozen carriers with that volume of international voice traffic. Moreover, if we consider outbound international traffic on an individual country basis, only six or seven countries have more than

**CHART 2: TOP 20 COUNTRIES – OUTBOUND INTERNATIONAL TRAFFIC**


Source: Telegeography 2007

seven billion minutes of outbound traffic annually. In other words, a carrier could have 100% of the outbound traffic from any but the top seven countries in the world and still not have enough scale to be profitable in international voice, conceptually. Of course, with 100% share you'd have more "pricing power" and the economics could change dramatically, but that opportunity went away more than a decade ago.

In summary, it is necessary in this commoditised business to have both a low cost-structure and very large scale of traffic. For most carriers, international voice traffic is not their core business. They will not have sufficient traffic to justify the investment required to migrate to the low-cost infrastructure of an all-IP network. Nor can they continue to justify the dedicated resources required to manage their least cost routing or the sourcing and management of a large number of international termination partners.

#### SPECIALIST WHOLESALE CARRIERS

Many will instead choose to use a wholesale carrier that specialises in outsourcing international voice services to enable them to focus more effectively on their core business. KPN effectively outsourced its international voice business by merging KPN Global Carrier Services into iBasis. Today, approximately 14% of iBasis revenue comes from insourcing international voice traffic from KPN and its retail brands in Europe. There is considerable demand in the market for a complete outsourced solution for international traffic, and, we expect it to grow as

a source of our revenue. iBasis is not the only player in international voice outsourcing. Belgacom ICS was formed from the international wholesale units of Belgacom and Swisscom, and Deutsche Telekom is providing outsourced international voice services for Slovak Telecom and Gamma Telecom.

Outsourcing promises to be a significant trend in the international voice business for some time to come. Today, iBasis carries 7% of all international voice traffic. With outsourcing becoming the preferred way to handle international traffic, we can envisage carrying 20% or even 25% of all international voice traffic in just a few years. As a carrier whose entire business is international voice – more than 20 billion minutes annually, whose operational structure and systems were designed explicitly to achieve the efficiency a commodity business requires, iBasis is well positioned for this next big wave in international voice. ■

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