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Productivity Improvement through Higher Return on Capital by Axiata Group

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Abstract: *A company's return on investment can be measured by how much value it can return to the equity shareholders. Equity is part of the enlarged capital structure of a company where the other component is debt. This case study looks at how well Axiata Group perform in providing returns to its capital providers through the Return on Capital (ROC) ratio. The telecommunications sector has grown significantly over the last few decades fueled by growing demand for voice, SMS and more recently data services. Telecoms operators have invested in the network infrastructure to enable 2G, 3G, 4G and the forthcoming 5G technologies across their market. The high capital expenditure required to deploy a nationwide network has put a lot of pressure to their ROC particularly when the revenue generated is being compressed by hyper competition from market players as well as Over-The-Top (OTT) application providers. Axiata Group has embarked on a turnaround plan to halt the decline in ROC and pursue higher returns through its 'Triple Core Strategy'. The strategy focuses on value enhancement of existing services (example Voice, SMS & Data telecoms business) and value creation of new services (example Digital & Infrastructure business). It has also prioritized on efficiency gains and cost excellence to increase overall productivity. The outcome of the turnaround plan has been positive and Axiata Group is able to improve the ROC.*

INTRODUCTION

Telecom industry challenges

Among the challenges faced by many Telecom Operators (telcos) is declining return on investment in their business. The market landscape has become extremely competitive with the adoption of Over-The-Top (OTT) services such as Whatsapp and Skype which offer 'free' voice and data messaging services to the users. This is made worse when mobile telcos compete among themselves for market share through aggressive product pricing and OTT-like offerings such as free voice minutes and data plan bundles. All of this happen on the back of increasing user expectation for high quality network, which requires telcos to continue investing huge amount of capital in network coverage and quality. Axiata is not spared from the changing industry dynamics and to remain competitive, it has focused on generating strong return on investment as one of its goals for the group.

Return Ratio

Leading companies' performance are measured through various financial and operational key performance indicators (KPIs) and ratios. They are useful in understanding the financial position of companies as well as their market performance relative to other players in the industry. One such ratio is the Return of Capital (ROC). It can be expressed by two ratios namely 1) Return of Capital Employed (ROCE) and 2) Return of Invested Capital (ROIC). There is a slight difference between the two as highlighted in the equation below. However, as both are considered as 'Return Ratios', they are quite comparable and have been used interchangeably in this case study. 'Return Ratios' are used by management to gauge the efficiency of the company in generating profit from the available resources (in this case Capital). In the field of Operations Management study, this is similar to the measurement of productivity where returns is the Output while Capital is the Input. ROC can be expressed by the equations below:

$$\text{ROCE} = \frac{\text{NOPLANT}}{Average\ Capital\ Employed}$$

$$\text{ROIC} = \frac{\text{NOPLAT}}{Average\ \text{Invested Capital}}$$

where: NOPLAT = Net Operating Profit Less Adjusted Tax or Earnings Before Interest & Tax (EBIT) less Tax;

Average Capital Employed = Equity + Debt;
Average Invested Capital = Equity + Debt - Cash

Note: Depending on the analysis that is being performed, industry analyst could express ROCE/ROIC with slight variation on the numerator and denominator definition.

Many telcos including Axiata are using ROC as one of their KPIs. In fact, this is among the headline KPIs that the company publishes to the public on quarterly basis. In the last five years, Axiata's ROC is on a declining trend due to the competitive market dynamics and challenging business environment. Therefore, the management team has taken necessary steps to turnaround the company and improve its ROC.

COMPANY BACKGROUND

Axiata is one of the leading telecommunications groups in Asia with approximately 340 million customers in 11 countries in ASEAN and South Asia. The Group is listed on the Main Board of Bursa Malaysia Securities Berhad and ranks as the sixth largest company.

Axiata was originally part of Telekom Malaysia before it was demerged in 2008. Since its inception, the company has set its path towards becoming a telecommunication leader in the region. Over the years, the company has grown in terms of revenue and customer base through organic as well inorganic path via merger and acquisitions.

Axiata strength is in its main business of mobile telecommunication services. It is currently among the top 10 of global telcos in terms of customer base. Through its subsidiaries, Axiata connects people and communities via voice and data communications. It also provides a multitude of adjacent offerings ranging from media & content (for eg. Dialog satellite TV in Sri Lanka) to mobile payment service (for eg. Boost e-wallet in Malaysia). Axiata has also carved- out its network infrastructure or towers and spinned it off as an independent infrastructure & services company called Edotco.

PROBLEMS AND DISCUSSION

Declining Return on Capital (ROC)

In its journey to expand across the region, Axiata has deployed a significant amount of capital in the form of equity and debt. The capital intensive industry has posed a significant challenge to the company in its ability to increase ROC since 2013 in spite the double digit growth in total revenues. Whilst revenue and EBITDA have increased by 33% and 26% respectively, ROIC has decreased by 6 percentage points!

By disaggregating the ROC equation, it is clear that the Capital (equity + debt) portion has out-grown returns. In fact, in a recent four-year period, EBIT was trending downwards by -22% while Equity has increased by 26% and debt has risen by 43%. This is mainly due to high Capital Expenditure (CAPEX) invested in the period. CAPEX directly contributes to the increase in Depreciation cost, while sufficient Capital is needed to support the high CAPEX intensity of emerging market telcos such as Axiata.

Despite challenges ahead, light is at the end of the tunnel:

If one is too view this from the angle of productivity, the group has to halt the rapid decrease in productivity and implement a turnaround plan to resolve the issue. Axiata has executed a strategic plan to achieve just that.

Axiata has refined its core business operating model to pivot towards digital in the hope of creating a lean and agile organisation. The new direction is focused on creating further value from new opportunities while increasing efficiency in existing business.

Key transformation targets are identified and subsequently several execution strategies are defined for each core. The legacy service of mobile communication is the most important part of the group’s business and therefore will be the one that takes the highest priority with its transformation into a ‘Digital Telco’. Table 1 provides some of the example benefits of the execution strategy. The upside or positive impact are just some of the potential results that could help Axiata increase the returns and optimise the capital required.

Table 1: Example Digital Telco Core Execution Strategies & Key Benefits

Execution Strategy	Example benefit
Digitising the network and service platforms	Reduce operating cost in the long run (eg. simplified IT architecture) Increase time to market for new products & services (eg. from 3 months to 1 week to launch a data plan)
Convergence investment into future- proof fixed & fiber network)	Optimum capacity for exponential data traffic growth Avoiding diseconomies of scale of mobile network as it is not able to cater for future bandwidth demand at the same unit cost
Cost optimisation	Quick wins in cost savings and avoidance in key areas such as procurement, digitisation & optimisation in big cost items Structural change in operating model (eg. network sharing with other telcos)

A year after implementing the turnaround plan, the group has shown some improvements. The downward trend of ROIC/ROCE has stabilized.

Industry trend and benchmark: Telcos focus on efficiency

Axiata is not alone in the effort to increase productivity through improving ROC. Other telcos have faced similar challenges and some have even executed successful turnaround plans. External factors such as OTT threat as previously described has partly contributed to the lackluster performance of the overall industry. The average last five years Compounded Annual Growth Rate (CAGR) for Revenue, EBIT and ROC remain flattish.

Interestingly, some players such as Deutsche Telekom and Telenor have been able to beat the trend and perform better than the market. This study has briefly looked at the key success factors behind this.

Deutsche Telekom

Result: ROCE improvement by 1.8 percentage points in 7 years
Key success factors:

- Infrastructure transformation (legacy network migration to all-IP digital network)
- Cost transformation (reduce indirect cost)
- Portfolio Management (deliver on preferred business model & value generation, exit value decretive investments
- Risk Management (maintain low risk country portfolio)

Telenor

Result: ROCE improves by 3 percentage points in 5 years Key success factors:
Prioritization & Simplification (rigorous execution across activities related to capital
Cost reduction

Disciplined in capital allocation

CONCLUSION

As one of Asia's leading telecommunications groups, Axiata has investments in mobile network operations, network infrastructure, and digital internet companies. One of the recent focus areas of the company is on improving Return on Capital for the group. They have started a turnaround plan that has shown to halt the decline in ROC and improve productivity through financial and operational gains. This is important as it allows Axiata Group to continue investing in advanced technology to support Axiata core businesses namely Digital Telco, Infrastructure (Edotco) and Digital (Axiata Digital).

DISCUSSION QUESTIONS

1. What are the key issues that have affected the telecoms industry & Axiata Group's Return on Capital in the past few years?
2. Why does the growth in total revenue insufficient to improve their Return on Capital?
3. What are the strategies to turnaround the company and improve the Return on Capital?