The changing face of prepaid.

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Intro

The U.S. wireless industry has been dominated historically by traditional postpaid plans where the customer pays for voice and data services on a monthly billing cycle, and is bound by two-year contracts. Over the last 36 months, however, the wireless industry has seen significant changes specifically in the emergence of prepaid services.

Some major U.S. carriers are seeing a slowdown in net subscriber additions ("adds") of postpaid customers, while prepaid net additions are growing dramatically. Indeed, 4Q 2009 marked the first time that prepaid represented the majority of both the gross and net adds[1].

Are we witnessing a drastic revolution or slow evolution in the wireless market? We believe we are in the midst of a revolution where a portion of the U.S. wireless market is moving increasingly from traditional postpaid price plans to prepaid or no-contracts wireless.

Prepaid vs. Postpaid

With postpaid wireless phone service, the customer is charged for the usage in the prior month ('post' usage). Traditional postpaid plans do not have any limitations on the use of the service. Carriers typically require two items from postpaid customers:

1. A credit history. This permits the carrier to reasonably expect that the customer will pay the bill when it is due.
2. A contract. Most carriers require the customer to sign a long-term (typically two-year) contract committing to use of the service. Failure to complete the term would make the customer liable for an Early Termination Fee (ETF).

The prepaid model works differently. Prepaid customers are required to purchase credit units and associate these with their account as a balance. The balance is used to “pay” for the services. The customer’s maximum usage is limited to the amount of the balance. Once the balance is used or expires, the customer needs to purchase additional credit units before being able to resume the service. Prepaid does not require a credit history or contract.

Traditional prepaid is commonly referred to a Pay-as-You-Go (PYG) or Pay Go. A PYG customer pays for service on a per unit basis. For example, the most common PYG voice calls are charged for by the minute.

Prepaid is not a new concept in the wireless industry; U.S. consumers have historically lagged behind Western Europeans in adoption of prepaid, however. Recently the U.S. is catching up to Europe, as prepaid is steadily taking a larger share of the gross adds in the U.S.

Figure 1: Post and prepaid subscriber share in Western Europe and the U.S.

(Source: Deloitte Analysis[2]. 3Q 2009)

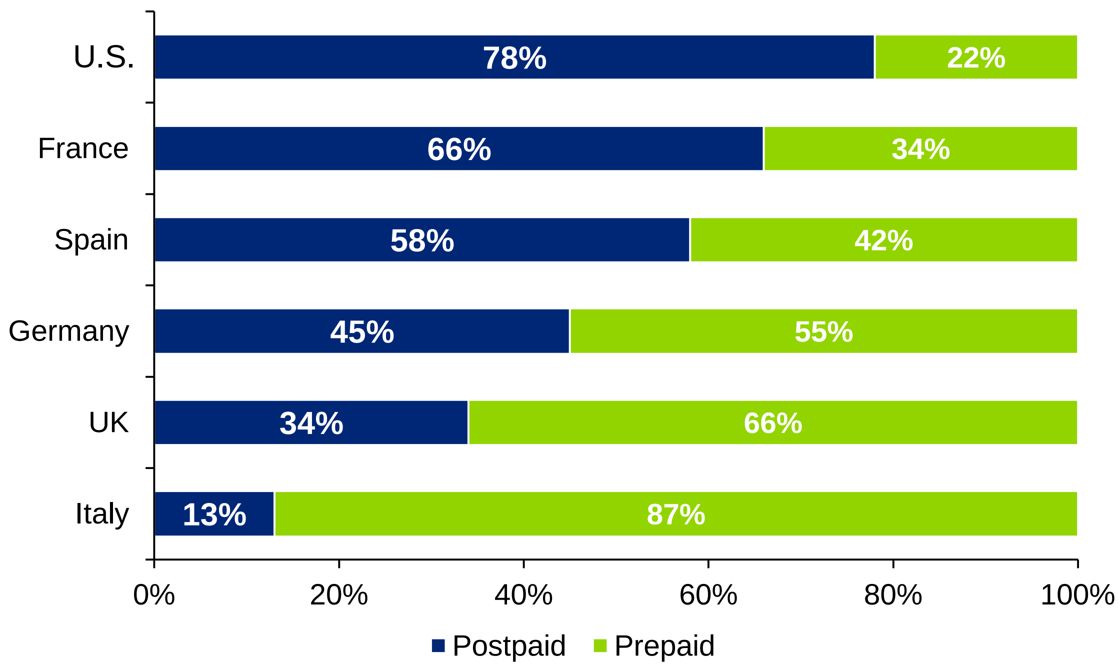
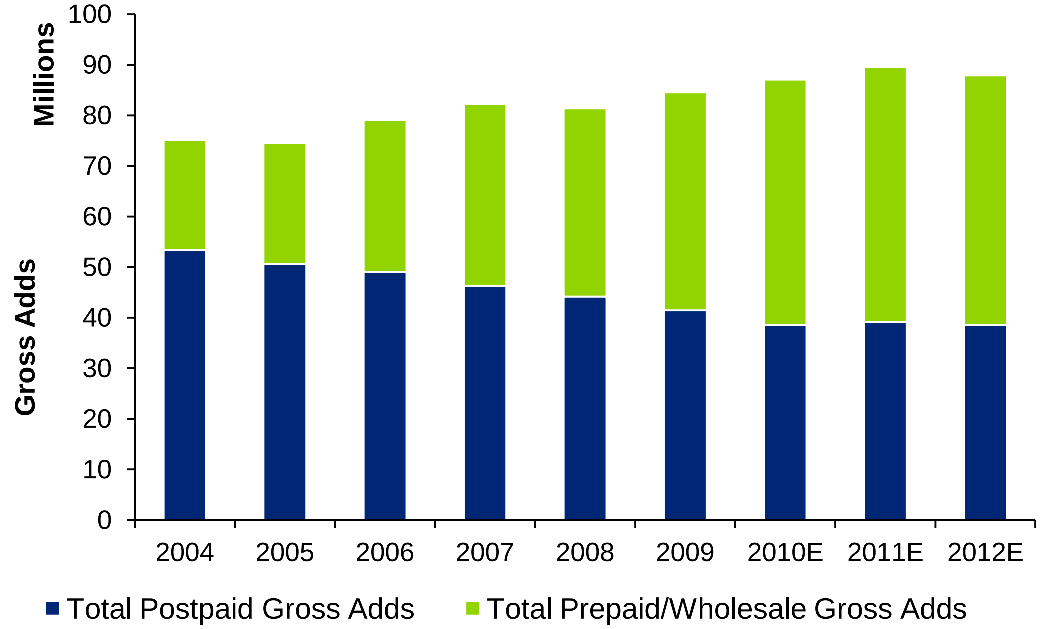


Figure 2: U.S. Gross Adds 2004–2012 (Source: Oppenheimer[1]; Deloitte Analysis[2])

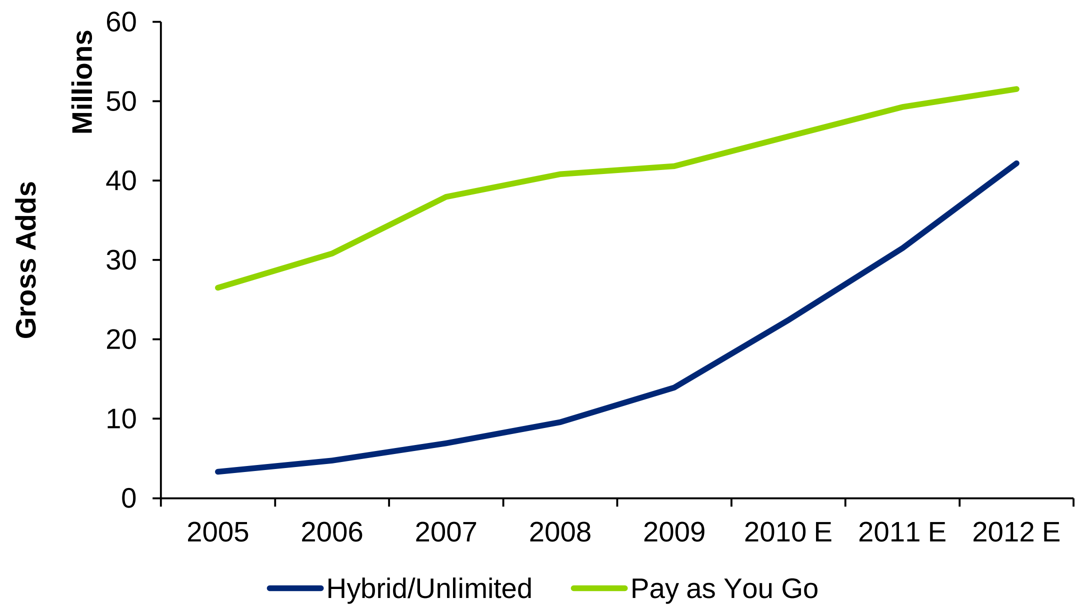


The rise of hybrid/unlimited — not all prepaid is created equal

Prepaid has come a long way from its historical status as a wireless option for customers who could not pass a credit check. In the U.S. today, prepaid growth is driven by the sales of another type of prepaid plan, the unlimited and hybrid prepaid plan.

Figure 3: Prepaid mix — hybrid/unlimited and Pay as You Go 2005–2012

(Source: Deloitte Analysis[1]; Oppenheimer[2]; Bernstein Research[3]).



Unlimited prepaid plans offer unlimited use of certain or all services (voice, SMS, MMS, and data). Hybrid prepaid plans offer usage allowances, commonly referred to as buckets, for certain types of services. Similar to postpaid, these plans require the customer to pay a Monthly Recurring Charge (MRC). The difference with postpaid is that the MRC is paid prior to the start of the service period and unlike postpaid plans, the unlimited and hybrid prepaid plans do not require the customer to go through a credit check or sign a contract. If the customer fails to pay the MRC, the service will stop automatically (i.e., the customer cannot use any service) and if not paid for within a certain period, the customer will lose his/her phone number.

Table 1: Comparison of select prepaid and postpaid service plans (Source: Deloitte Analysis[1])

	Prepaid	Postpaid
Average MRC for unlimited voice, data, and messaging	$40–$50	$70–$100
Handset (average price)		
Feature phone	$60	Free
Smart phones	$250–$450	$50–$200
Iconic/Exclusive handsets	N/A	$200–$300
Typical contract term	No contract	2 years

Why are customers choosing the hybrid and unlimited prepaid plans?

There are several reasons why these plans have very quickly narrowed the gap with postpaid. First, the same features and ancillary services are available with hybrid/unlimited and postpaid plans. In addition, the handset selection for hybrid/unlimited prepaid plans is becoming more sophisticated with the addition of smart phones further narrowing the difference between post- and prepaid. Since the plans are typically marketed by mobile virtual network operators (MVNOs), major retailers, or through direct carrier brands, they use the same carrier network as the postpaid service, and the coverage, call quality, and data speeds are identical.

What is in it for the carrier?

While MVNOs and the U.S. regional carriers have traditionally been the ones to launch prepaid services first, the Tier 1 U.S. carriers quickly recognized the opportunity for subscriber growth, better utilization of network capacity, additional revenue, and improved return on their investments that prepaid brings.

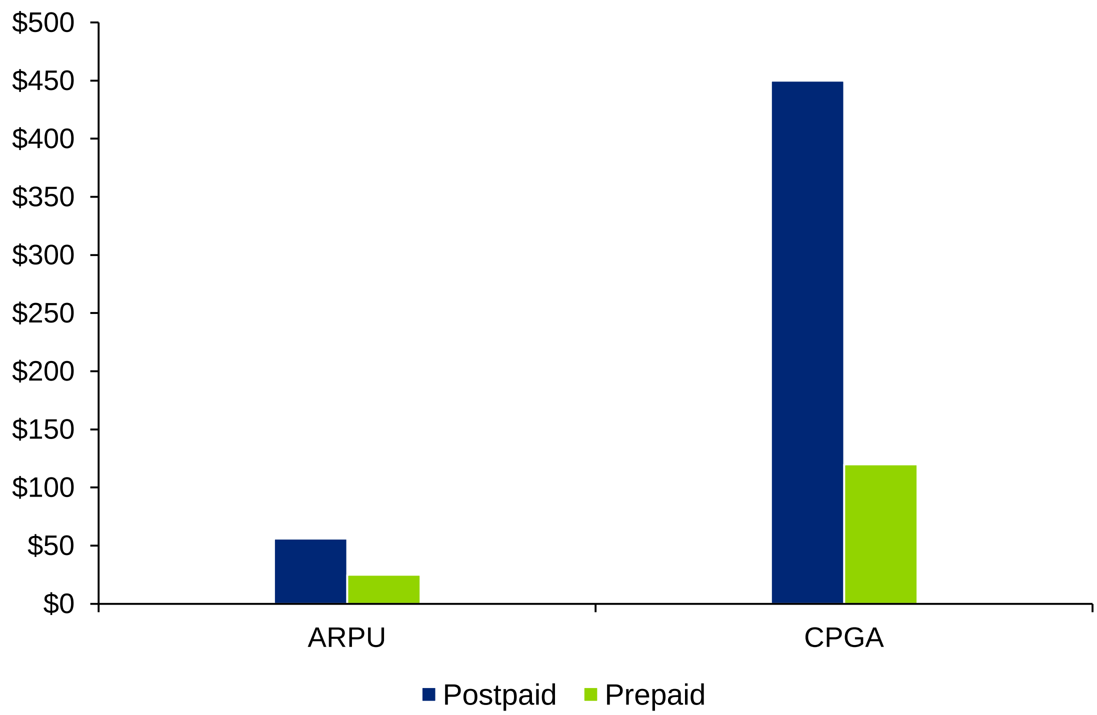
Subscriber growth: Prepaid plans allow carriers to target other market segments, either through wholesale/MVNO agreements or through their own prepaid brands. Offering prepaid plans also allows carriers to keep customers on their network as they move away from traditional postpaid plans. In a November 2010 study[4], one in five U.S. cell phone users with a contract-based service stated they are “very likely” (8 percent) or “somewhat likely” (12 percent) to switch in the next six months (i.e., outside of their ETF period) from a contract-based postpaid plan to a no-contract unlimited prepaid plan. This represents an estimated 24.6 million customers that are likely to switch to prepaid.

Better Utilization of Network Capacity: Prepaid allows the Tier 1 carriers to more fully utilize their voice network infrastructure as they experience excess capacity due to declining demand.

Improved cash flow and return on investment: For Tier 1 carriers, prepaid also offers a return on investment that is more attractive than postpaid. The cost per gross add

(CPGA) for a typical prepaid customer is three to four times lower than for a postpaid one ($120 prepaid versus $450 postpaid). Although the Average Revenue Per User (ARPU) for prepaid is lower than postpaid ($25 prepaid versus $56 postpaid), the lower CPGA means that the payback period for the carrier is much shorter, resulting in improved cash flow and less financial risk. For example, the payback period for a typical prepaid unlimited subscriber is six months, compared to 18 months for a similar postpaid subscriber[2].

Figure 3: ARPU and CPGA Comparison (Source: Deloitte Analysis[2])



Traditionally, prepaid churn is higher than postpaid (Q2 2010 1.5% versus 5.6%)[5] as there are no long-term contracts in place. This represents a risk for the carrier as it might lose the customer before it starts to make a profit. Including relevant churn metrics as part of the profitability metrics of prepaid plans is key. While trying to minimize overall churn, each carrier should plan for prepaid churn to ensure the prepaid customer base as a whole remains profitable.

Is this a prepaid revolution or evolution?

Is there nothing that can slow down this prepaid revolution? As with all movements, there are several factors that can influence the speed of the revolution or stop the momentum completely.

These include:

- Many prepaid carriers continue to struggle to implement viable financial (prepaid) business models as they try to lower the prepaid churn.
- Competitors can adjust pricing and contract-- term levers to postpaid plans, thereby diminishing the cost and flexibility advantages of prepaid providers.
- There continues to be a negative perception among traditional postpaid buyers concerning prepaid.
- Consumers’ continued focus on iconic handsets that are not always available with prepaid plans.

However, we continue to see declining smartphone prices and aggressive adoption of the prepaid handset portfolio to mimic the postpaid portfolio. These trends are likely to accelerate the evolution. We also see that consumers continue to focus on plans that offer the best financial value and flexibility. This is another strong indicator that the growth likely will not slow down.

At the beginning of this discussion, we asked the question; Are we witnessing a drastic revolution or slow evolution in the wireless market? Is this a fundamental change or a temporary “blip” in the market? For the reasons explored above, we believe we are witnessing a revolution that is quickly changing key aspects of the U.S. wireless market.

Acronyms:

ARPU: Average revenue per user (ARPU) is an indicator of the operating performance of a service provider. ARPU measures the average monthly revenue generated for each customer. Severely declining ARPU is typically a negative sign that may indicate a carrier is adding too many low-revenue generating customers to its subscriber base.

CPGA: Cost Per Gross Add is the total resources that are used to acquire (add) a new customer. Typically includes the costs for marketing, sales, handset subsidy, etc.

ETF: Early Termindation Fee is a fee that will be charged for early termination of the contract.

MMS: Multimedia Messaging Service is a standard way to send messages that include multimedia content to and from mobile phones.

PYG: PYG is a type of prepaid service where the customer pays per unit of usage (e.g., per minute of voice calls, per SMS, per MMS, per KB).

SMS: Short Message Service is the text communication service component of phone, Web, or mobile communication systems, using standardized communications protocols that allow the exchange of short text messages between fixed line or mobile phone devices

References:

[1] Oppenheimer, 3Q 2010 Wireless Recap and T-Mobile Meeting Thoughts, November 9, 2010.

[2] Deloitte Research: Deloitte conducted extensive research of the prepaid wireless in April–May 2010 as part of a presentation at the TeleManagement Forum in Nice, France on May 19 2010.

[3] Bernstein Research, Leap Wireless & MetroPCS: Low Cost Pre-Paid Wireless... a Survival Story; Initiating Coverage at Outperform, December 14, 2009.

[4] Infogroup/ORC, Net10 Prepaid Wireless Consumer Trends National Poll. November 3rd 2010

[5] Oppenheimer, Wireless Mid-Quarter Update, April 27 2010