Broadband Leapfrog: Israel Is About to Vault into a Wired and Wireless Future

Brian J. Friedman, CFA
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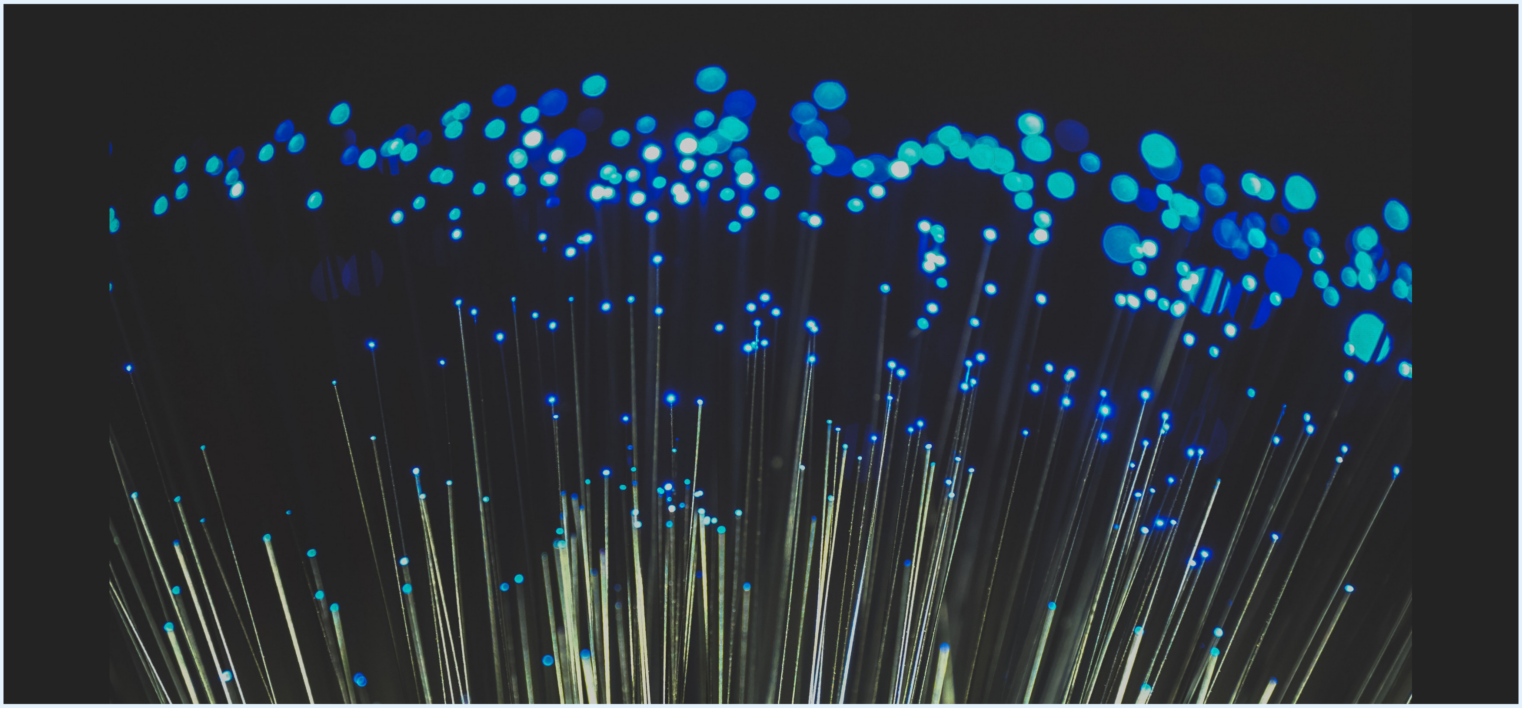

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Slow residential internet speeds are a surprising inadequacy for the technologically sophisticated Startup Nation. Consumer broadband infrastructure in Israel lags the United States and other developed countries while straining to support the COVID homebody economy. Fortunately, after years spent waiting for an almost-finished infrastructure upgrade to be completed, Israelis are about to enjoy a sudden leap into a broadband future. Access to wired and wireless networks is likely to improve, with wider implications for Israel's ongoing economic transformation.

Israel is poised to vault over longstanding obstacles to high-speed connectivity that are relics of the country's legacy of socialized industry, sector monopolies, tycoons and cronyism, and outdated regulations. What is enabling the sudden leap over these obstacles is political and economic change, fueled by the pandemic, by laws encouraging de-monopolization and increased competition, and by a policy shift away from debt reduction toward infrastructure spending. This spending – in energy, water, housing, and transportation, as well as broadband – means to support Israel's rapidly growing population and to link Israel's more affordable exurban residential communities with its urban job centers.

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Waiting to Get HOT Wired

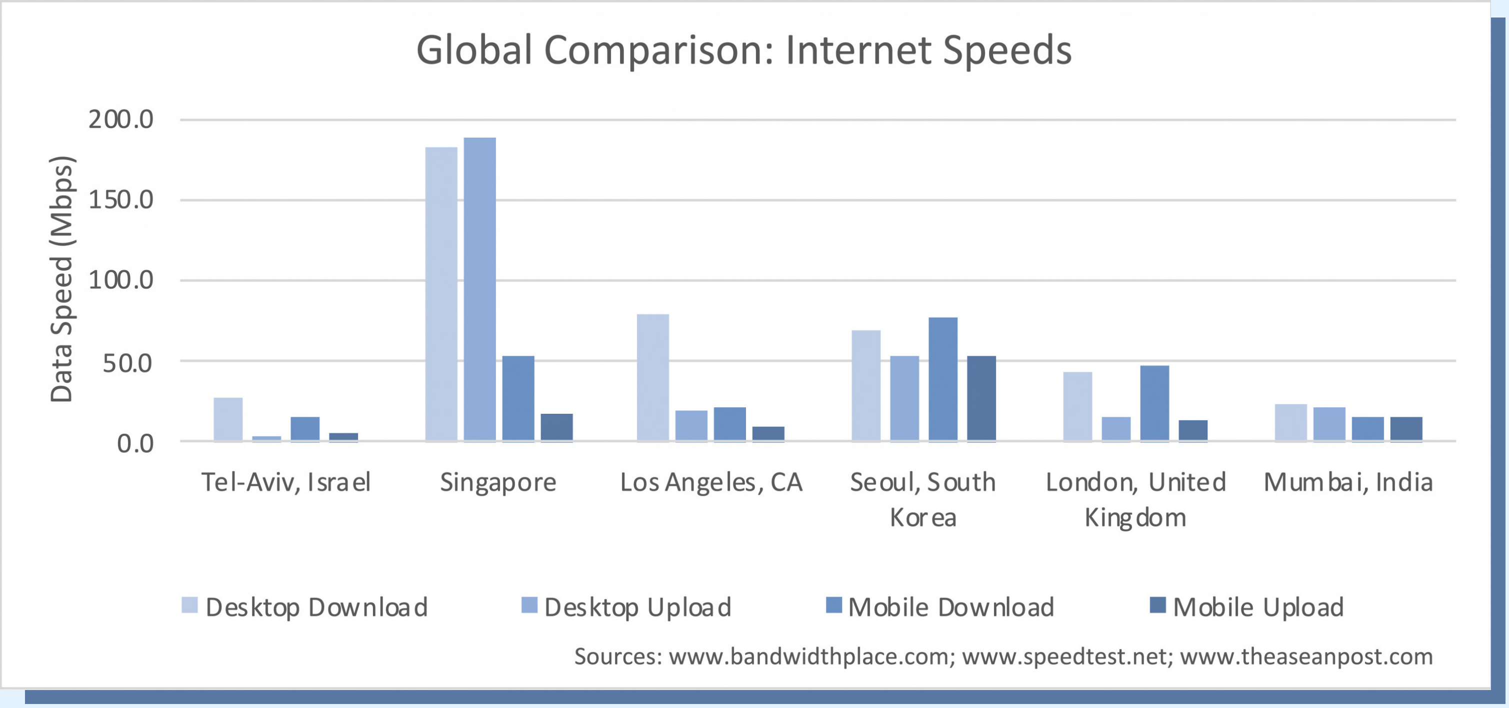
As with most other domestic industries, telecommunications infrastructure bottlenecks are a legacy of Israel's socialist past. Until the 1980s, the Ministry of Communications supplied telecommunications services. Israelis often waited months or even years to receive a telephone line. In 1984, Israel consolidated its telecommunications activities into a government-owned corporation called Bezeq.

Today, most Israeli households are connected to fixed broadband services through legacy copper wire digital subscriber lines (DSL) built by Bezeq. Some newer buildings link to the Internet through coaxial cable TV systems familiar to American cable broadband subscribers. Coaxial infrastructure also comes from a single source company, called HOT.

Bezeq DSL holds a 70% share of the Israeli wireline infrastructure market, with HOT supplying most of the remainder. A very small percentage is supplied by a floundering fiber optic venture called Israel Broadband, Ltd. (IBC). The Israel Electric Corporation established IBC in 2013, but it has taken until the enactment of regulatory reforms in the first quarter of 2021 for IBC to truly come alive. The reforms allowed HOT to acquire a controlling interest in IBC, with a legal commitment to connect 1.7 million households to fiber optic broadband within five years. Besides having HOT as managing partner, IBC is now a better funded joint venture among the Israel Electric Corp., Cellcom, and the private equity Israel Infrastructure Fund, backed by the Harel Insurance Group.

Bezeq also was a monopoly provider of cellular communications services, through its subsidiary Pelephone, until 1994, when Cellcom entered the market. Another private sector competitor, Partner Communications, launched in 1999. It was not until 2012 that Minister of Communications Moshe Kahlon licensed two more cellular competitors. With five players in the market, prices for mobile communications services plummeted and service quality improved.

But while the mobile telephony market became more dynamic, wireline infrastructure lagged. To this day, according to Bandwidthplace.com, fixed residential broadband data download speeds in Tel-Aviv average just 25 Mbps and upload speeds are a meager 3 Mbps – highly problematic for graphics intensive applications such as architectural renderings or video games. By comparison, average speeds in the United States are 3 to 4 times faster. Global consumer broadband leaders such as Singapore or South Korea average speeds 6 to 7 times faster than the typical Israeli residential connection.



The Telecommunications Tycoons

Bezeq remained a government telecommunications monopoly until 2005, when the Israeli government sold a 30% controlling stake to an investment group led by Haim Saban. The government liquidated its remaining shares on the Tel-Aviv Stock Exchange piecemeal between 2005 and 2014. In 2010 the Saban group sold its controlling stake to Shaul Elovitch's Eurocom Group.
Following his acquisition, Elovitch leveraged Bezeq to take over Israel's leading news web site Walla! in 2012, and – in a transaction with significant conflicts of interest – sold his separately-owned Yes satellite television company to Bezeq in 2015. These fateful sales hindered the upgrade of Israel's fixed broadband network for years by stretching Bezeq's balance sheet, just as competition in mobile communications intensified and profits nosedived. Perhaps even more importantly, Elovitch soon became embroiled in Prime Minister Netanyahu's corruption scandals with the revelation that he likely bartered favorable press coverage by Walla! for Netanyahu in exchange for government approval of the Yes merger with Bezeq.

Frustratingly, the broadband upgrade remained one step from completion for years. Bezeq had already installed a nearly nationwide Fiber-to-the-Curb (FTTC) network more than a decade ago, but the company refused to build the final Fiber-to-the-Home (FTTH) connection to customer residences if regulators disallowed adequate returns on its investment. With Elovitch in charge of an indebted Bezeq, however, regulators in the Ministry of Communications faced political pressure to avoid the appearance of a bailout by the government.

Forcing the Pipelines Open

The stagnation became more and more untenable as demand for bandwidth hungry applications skyrocketed, with consumers increasingly using mobile networks for data services. As the boundaries blurred between mobile and wireline data, Israeli regulators searched for ways to promote competition while stimulating the large investments necessary to upgrade mobile networks to 5G services and wireline networks to much higher bandwidth. Despite the substantial consumer benefits of Kahlon's mobile telecommunications reforms in the early years, low prices for services and more limited cash flows for providers now inhibit next-generation 5G investments.

The COVID economy revealed the inadequacies of Israel's telecommunications infrastructure and motivated the government to finally take action. Fortunately, an embattled Elovitch had been forced to resign in 2018 when his holding company, Eurocom Group, filed for bankruptcy. A year later, global private equity firm Searchlight Capital bought his controlling stake. With Elovitch out of the picture, the Ministry of Communications turned its attention to the economic realities of the telecommunications industry.

Getting Public Buy-In

While price caps have kept broadband prices low for Israeli consumers, the government is now recognizing that infrastructure upgrades require an increase in pricing, and that Bezeq, HOT, and IBC need to earn respectable returns on their fiber optic investments. The government will likely allow consolidation of the wireless sector as well. These changes may also be politically unpopular and hard to sell to a resistant public. Still, despite initial price increases, 5G should ultimately prove competitive with ultra-fast wireline networks for many applications. Fewer players in these formerly separated telecommunications silos will likely become stronger competitors with each other as the boundaries between high-speed wireline and wireless networks blur in the coming years.

Other important issues in the telecommunications industry are yet to be resolved. For example, Bezeq has lobbied for many years to end "structural separation," the requirement that infrastructure and data services come from separate providers to prevent monopolization. These regulations had forced Bezeq to sell its network services wholesale, at prices fixed by the government, to customer-facing independent internet service providers. With Bezeq now allowed to charge higher prices for wholesale services, structural separation now looks like an inefficient model. Instead, the government is trying to generate greater competition between two wireline players – Bezeq and HOT – and most likely a smaller roster of upgraded wireless companies.

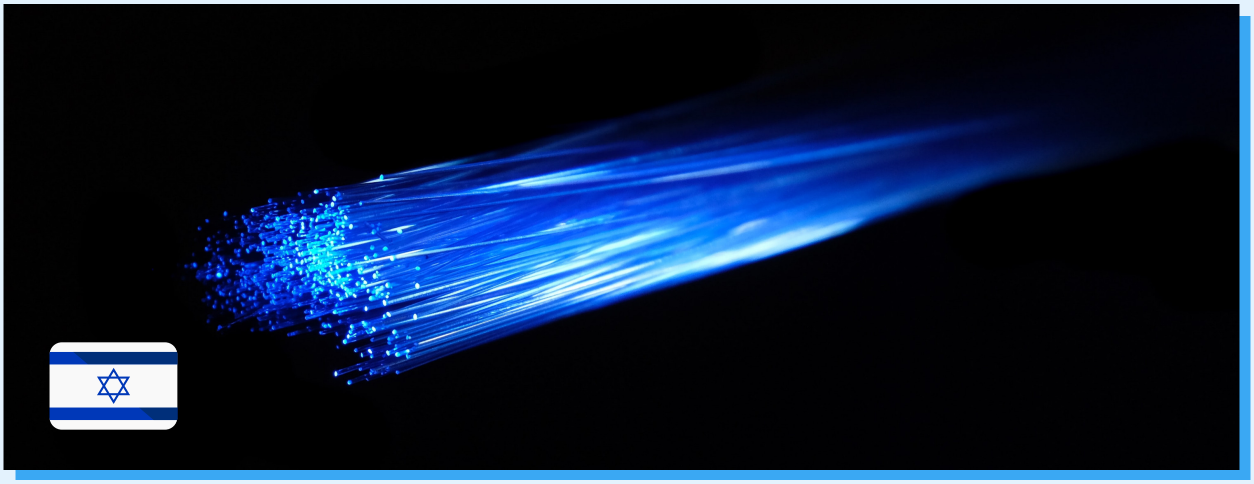
Making Connections

Telecommunications in Israel reached a crossroads during the COVID pandemic. Wireline and wireless networks require significant investments to upgrade their technologies, but the regulatory structure is well past its sell-by date. The receding power of Israel's politically connected tycoons – in this case, Shaul Elovitch – is helping to break down barriers to difficult regulatory decisions. With its new incentive structure in place, Bezeq claims it will connect one million Israelis to its FTTH network by the end of 2021.

If Bezeq and HOT adhere to their regulatory commitments, most urban residents will be connected to a FTTH wireline network. Since a universal service obligation was one of the regulatory constraints removed to get the infrastructure upgrade cycle moving, residents of more peripheral areas will likely fall behind due to the much higher cost of constructing high speed networks in areas of low population density.

Still, despite fears that consolidation will raise prices and slow the network rollout, it appears that a new model of competition is evolving. Rather than just competition between like-type infrastructure, future competition will likely be more intense across wireline and wireless infrastructures.

As a result, Israel should not be a bandwidth laggard for much longer. The government has finally recognized that regulatory inhibitions that might have worked for slower wireline and wireless data speeds are now as outdated as the DSL networks themselves. Reforms enacted this past quarter should allow Israel to leapfrog over longstanding hurdles on the path toward joining the league of global bandwidth leaders, and toward a more connected, competitive, post-COVID economy.



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For more information contact:
Amy Kaufman Director, Investor Relations
303.861.3798 | akaufman@israelinvestmentadvisors.com
www.israelinvestmentadvisors.com

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