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**Portugal Telecom's Strategic Partnership with Oi**  
**The Value Creation Potential**

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## **Abstract**

### **Portugal Telecom's Strategic Partnership with Oi: The Value Creation Potential**

Portugal Telecom (PT) has been in the Brazilian Telecom Market for over a decade. After the end of the Joint-Venture with Telefónica, PT and Oi, a resident telecom player, decided to combine strengths in order to create value for both companies. The success of this partnership depends on the Brazilian operator's performance, and which competitive advantages will be possible to achieve. Portugal Telecom will receive the return under the form of dividends, firm value increase, scale and geographic projection. The key point of the partnership is the management of the integration process as it will determine whether the expertise is transferred between companies.

The project aims to analyze the motivations of the strategic partnership, the Brazilian Telecom Market, and the integration process, leading to withdrawal of final conclusions.

## **Portugal Telecom**

Portugal Telecom (PT) is a Portuguese multinational corporation dedicated to global telecommunication markets. The company offers services in terms of fixed and mobile communications, as well as multimedia, incorporating data and corporate solutions. By the end of 2011 the company's operational revenues were 6.147 billion Euros, reflecting an increase of 64.3% from 2010. PT's services are presently offered in Portugal, Brazil and developing markets such as Cape Verde, Mozambique, Timor, Angola, Kenya, China, S. Tomé and Príncipe and Namibia. Portugal Telecom seeks to foster innovation and high-quality products, having achieved success in the multimedia area in Portugal for instance with the implementation of a Signature TV service (MEO) and broadband optical fiber. The company's route during the latest years was marked by the development of business opportunities in areas of rapid growth such as mobile voice, broadband internet access and multimedia. The Portuguese multinational is determined to maintain leadership within the domestic market in all business segments. Improving productivity and service quality through innovation is also crucial to the company, while rationalizing operational costs. Lastly, Portugal Telecom's stocks are among the most traded in Euronext Lisbon, being present in the New York Stock Exchange, where increasing the shareholders' value is part of the company's mission.

As for its international projection, demand for improved synergies and sustained international revenues, the Portuguese company has established in Brazil a strategic partnership with the operator Oi.

## **Group Internationalization to Brazil**

On what concerns the Portuguese companies' internationalization, the 90's decade was marked by two relevant changes. Firstly, the world's globalization of capital reflected

the migration of capitals through the markets. Companies in all types of industries were then able to invest in foreign countries, due to privatizations and government deregulations concerning barriers to market entry. Also, the enlargement of the European Union led to the creation of government oriented guidelines in order to promote national companies' internationalizations.<sup>1</sup> At the time, Portugal Telecom was a state-owned firm, and Portugal felt the need to develop a more competitive economy, delivering conditions for Portuguese organizations to internationalize.<sup>2</sup> The conditions included a three-year financial support (35\$Million) and the reorganization of the state's financial internationalization instruments regarding credit, exportation and investment insurance coverage policy.

Portugal Telecom's internationalization process started in 1998. The largest Brazilian privatization was taking place, and Portugal Telecom bought considerable participations in Telesp Fixed and Cellular, and CRT.<sup>3</sup> Thus, the door was open to invest in the Brazilian market. Moreover, Brazil was seen as particularly interesting to the Portuguese group due to the language proximity which could be helpful when transferring knowledge between Portuguese and Brazilian companies. The Portuguese firm's campaign in Brazil is marked by the Joint-Venture with Telefónica (Spanish Telecommunications Multinational Operator). In April 2003 Portugal Telecom and Telefónica create a new cellular operator named Vivo, each with a 50% share. Rapidly this joint-venture became the largest cellular operator in South America and the 4<sup>th</sup> biggest at a worldwide level. This partnership was a symbol of the Brazilian market and terminated in July 2010, when Portugal Telecom sold its participation to Telefónica for 7.5 Billion Euros.

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<sup>1</sup> The Treaty of Amsterdam, 1997.

<sup>2</sup> Portugal Telecom Internationalization Perspective, Manoel Justiniano Melo da Fonseca and Joaquim Ramos Silva, August 2011.

<sup>3</sup> Telebrás Privatization (1998) – "[www.compoliticas.org/redes/pdf/redes3/25.pdf](http://www.compoliticas.org/redes/pdf/redes3/25.pdf)"

Nevertheless, one cannot ignore how Brazil was changing during the 90's, namely by the end of the decade when the capital globalization's effect was more visible. Several reforms (*Plano Real* - pack of measures created by the Brazilian Government) were taking action in Brazil with the goal of opening the overall Brazilian market to direct foreign investment. Economic deregulation reflected therefore the consequences from terminating tax barriers and restrictions to foreign investment. Likewise, the privatization of many public companies, such as Telesp, was seen as an opportunity for investors, as these new private companies would need capital to grow and remain competitive.

In terms of the Brazilian economy, the government enforced the need for promoting better conditions for the poorest sectors of society. Hence, the demand increased as the medium and medium-high classes had more purchasing power and new personal needs to satisfy. As well, the consolidation of Mercosul helped developing conditions to foreign investment concerning the exchange of capital and investment in Mercosul collaborators. Lastly, the Brazilian liberalization of commerce led to a significant growth of the families' consumption.<sup>4</sup> From 1999 to 2002 it increased 1.7%, from 2003 to 2006, 3.2%, and from 2007 to 2008, 6.7%.

The Brazilian growth during the last decade was critical to Portugal Telecom's success. The improvement in the performance in the Brazilian Telecom Market is a consequence of not only the large investments made but also of the Brazilian economic growth.

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<sup>4</sup> IPEADATA: [www.ipeadata.gov.br](http://www.ipeadata.gov.br).

## **Brazilian Telecommunications Market**

The increase in the Brazilian Gross Domestic Product (GDP) during the latest years accounts for the middle class enrichment which has been leading to the development of new social needs, therefore increasing the penetration of telecommunication services.<sup>5</sup> Brazil has a history of modest living conditions affecting the vast majority of its population from the highest economic classes to the lowest. Investments in fixed infrastructures and network have led to the growth of the telecommunications market where companies try to withdraw the full potential of these new tendencies namely in terms of cellular usage, internet and broadband, and signature television services.

In the post-privatization period, between 1999 and 2008, private companies invested heavily in the development of telecommunications in Brazil. Even though R\$ 148 Billion represents a large investment, it wasn't enough to spread the telecommunication services throughout the entire population. In fact, investments were made having in mind business profitability and had an impact only on the areas with higher population density, leaving several Brazilian regions with no telecom services.<sup>6</sup> During the upcoming years, until 2013, global investments are expected to reach R\$ 67 Billion (approximately 30 Billion Euros), focusing mainly on cellular 3G expansion and broadband services.<sup>7</sup>

It is crucial to understand how the market has evolved in recent years. In 2004, the telecommunications market reached a R\$ 79.851 Million operational revenue for major

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<sup>5</sup> Brazilian GDP and Population Evolution: [www.teleco.com.br](http://www.teleco.com.br).

<sup>6</sup> Rodrigo Abdalla de Sousa, Sectorial Studies Director (IPEA) – Boletim Setorial 2011

<sup>7</sup> Boletim Setorial 2011.

players and during the next 4 years, until 2008, the market has faced a R\$ 122.244 Million revenue jump, which represents a 53% growth.<sup>8</sup>

Critical to understand the market is the notion of convergence. The Brazilian telecommunications market, as well as more developed telecom markets such as Portugal, has been suffering a substantial change in the type of service segmentation. In the old type of segmentation companies were single service providers, not combining offers and, for instance, when it came to data services, the service provided was internet. Nevertheless, in accordance to the development of technology, companies that used to act in close segments, with intrinsic differences at a product level, can now provide all the services they couldn't before, due to IP platforms. This situation is the consequence of convergence in the telecommunications market.<sup>9</sup> The market is divided into four major segments: fixed voice, mobile voice, broadband data transmission and Signature-TV.

The Fixed Voice sector represents the fixed wire line that allows individuals to communicate by telephone. This segment is centered in three companies; Oi, Telesp and Embratel. At the end of 2011 the segment leader was Oi, with a 44.7% market share. The entire fixed segment represents a total of approximately 42 million signatures all over the Brazilian territory, which carries a growth of 1.2% from 2009 to 2010.

Regarding Cellular Communication, data reveals a larger growth, reflecting the investments made in this segment. In 2003, there were 46.4 Million signatures in Brazil. Eight years later the number increased to 242.2 Million signatures. The growth represents a significant 20% increase in Brazilian cellular signatures, per year. Cellular Voice itself as developed a lot during the last decade, for which we can consider a high

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<sup>8</sup> Telecommunications Statistics: [www.teleco.com.br](http://www.teleco.com.br).

<sup>9</sup> Technological Convergence: [www.idec.org.br/telecom](http://www.idec.org.br/telecom).

penetration segment. The Brazilian Institute of Consumer Defence has compared monthly payments in fixed voice and cellular voice, coming to the conclusion that cellular voice allows customers, most of the time, to save almost 50% on a monthly basis. Additionally, customers usually don't choose a postpaid plan, but a pre-paid card. This type of service covers approximately 80% of all cell phones. Being so, the Brazilian population does not use the cell phone with the same freedom as in other countries, like Portugal. In fact, having a pre-paid card will lead to customers making the best use of the amount paid, trying to rationalize the calls, limiting cell phone usage. The segment is centered within four companies; Vivo, Tim, Claro and Oi. These companies represent more than 95% of market share.

The Internet and Signature TV represent a convergence service that is offered to the Brazilian population on a monthly payment basis. Generally, the package offers the customer additional channels, besides the open channels, and an internet data service with a limited traffic speed. However, convergence of the services has been leading firms to add fixed voice and broadband to the package. As a matter of segmentation, we will separate the services and consider Internet/Signature TV a segment alone. This sector follows the Brazilian growth pattern as well. In 2011 there were 12.7 Million signatures for television services, whereas there were 9.8 million in 2010, leading to a growth of almost 30%. Net and Embratel are the segment leaders with a 55% market share.

The broadband submarket is considered the high-speed data transmission service. The internet service in Brazil has been provided in two possible ways; ADSL by fixed wire line or Cable Modem by cable TV. The broadband line offered via satellite or optical fiber is not quite present in Brazil, yet. Moreover, the Brazilian data transmission service is marked by low connection speed. Among the users, 63% have an internet

speed of less than 300kbps and 78% have under 1Mbps. Adding to this situation, there are records of companies not providing the promised speed, which is related to the lack of competition in this segment, providing on the one hand less attractive prices and, on the other hand, reduced service quality.<sup>10</sup> However, the latest investments have generated a growth of 15% from 2010 to 2011. The segment leader is Oi with a 29.9% market share at the end of 2011.

### **Oi positioning in the Telecommunications Market**

Oi is the main Brazilian telecommunications' operator with its participation in all the market segments and overall national reach. Through the concessions of Telemar (TMAR) and Brasil Telecom (since 2009) Oi offers its services at a wide and national level.<sup>11</sup> The Brazilian operator provides converged service packages under the telecommunications segments for households, companies, governmental entities and other telecommunication enterprises. By 2011, the number of Oi customers increased to 70 Million, a 4% growth from the previous year. At a net income level, the operator has faced a shy 0.3% growth from 2010 to 2011. This fact is mainly due to the large investment in broadband and 3G coverage, representing a 61% increase in Capital Expenditure. Moreover, the Operational Margin (EBIDTA) has suffered a 14.9% decrease from the higher costs related with the first steps of the strategic plan, following the investments stated.

Oi believes its national projection, covering the entire country, will create the necessary resource to compete with foreign multinationals present in the market. The Brazilian telecommunications market offers a geographic barrier to most companies, that cannot easily compete in every state or region. Players are highly dependent on concessions to

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<sup>10</sup> Telecommunications Segments: [www.idec.org.br/telecom](http://www.idec.org.br/telecom).

<sup>11</sup> Oi Website: [www.oi.com.br](http://www.oi.com.br).

perform. Regarding the convergence in the telecommunication services, Oi was the pioneer and still is the only integrated operator in Brazil, thus leveraging an important distinction and having the potential to cover all the market segments with combined offers. At the end of 2010, 64 million accounts were Oi's clients. In the Fixed Voice (Oi Fixo) there were 20 million, whereas 39.3 million were the Cellular Voice (Oi Móvel) participation in the market. Adding to these, 4.3 million Customers in broadband (Oi Velox) and lastly 275 thousand in Signature TV (Oi TV). The operator is the segment leader in Fixed Voice, as well as in Broadband.<sup>12</sup>

Oi has developed its strategy towards the need to increase competitiveness by developing broadband and the 3G segment. Combining the company's market knowledge with PT's experience will allow Oi to deliver more benefit to their customers. Improving financial performance, reducing net debt, is also critical to Oi. To achieve such goals, the operator tries to dive deep into convergence, elaborating differentiated solutions and keeping a special focus on each segment of the market. In the broadband area, expanding the clients' base and promoting the evolution of these services will be critical to the development of the segment. Within the following 2-3 years, several investments will be made to overcome infrastructure difficulties at a 3G coverage level.<sup>13</sup> Therefore, operational efficiency will also be critical to foster faster returns on these investments. For individuals, Oi will bet on converged mobility for personal usage, fostering the postpaid services, maximizing the customer utility and communication freedom, via cell phone, wire line or internet. Regarding households, Oi will work together with Portugal Telecom to compel the evolution of broadband

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<sup>12</sup> Market Share Statistics: [www.teleco.com.br](http://www.teleco.com.br).

<sup>13</sup> Information acquired at a meeting with Portugal Telecom's Investment Department combined with Boletim Setorial 2011.

combined with the Signature TV service, in a converged service package, looking at the example of MEO's Service.

### **The Strategic Partnership with Oi**

Portugal Telecom sold its Vivo's participation to Telefónica on the July 28<sup>th</sup> for the amount of 7.5 Billion Euros. Nevertheless, with the end of the prior joint-venture, Portugal Telecom still wanted to be present in the Brazilian Telecommunications Market. At the end of July 2010, PT secures 22.38% of the Brazilian operator Oi, for the amount of R\$ 8.4 Billion (approximately 3.7 Billion Euros), almost half of the amount obtained from the participation in Vivo. Likewise, Oi will in the following years buy at least 10% of Portugal Telecom's stocks.<sup>14</sup>

Regarding the partnership, understanding the characteristics of the Brazilian telecommunications market and potential for development in terms of wire line, cellular voice, broadband and Signature TV sectors was crucial. Namely in broadband and fixed Telecommunications, PT analyzed the potential of growth in Brazil, when comparing it to other markets coming to the conclusion that the penetration in the Brazilian market is extremely low. Besides, the fixed and broadband sectors represent segments where Oi is the leader leader.<sup>15</sup>

In a generic way, Portugal Telecom defined several major milestones to be achieved. The very first was to reach one-hundred million clients, considering the number of Oi clients. Secondly, PT wanted to maintain leadership within all markets where they operated. Also, having two-thirds of international income was a major goal for PT. Finally, comparatively to its European Peers (such as Telefónica), Portugal Telecom wanted, as a fourth objective, to remain competitive in a top quartile operational and

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<sup>14</sup> Portugal Telecom: [www.telecom.pt](http://www.telecom.pt).

<sup>15</sup> Telecommunications Service Penetration Comparison: [www.anatel.gov.br](http://www.anatel.gov.br).

financial performance basis, through the increase of the operational results margin and strong cash flow generating potential of Oi.

### **The Motivation**

Portugal Telecom has been present in Brazil for over a decade, allowing the company to possess expertise regarding the Brazilian Telecom. Such know-how comes from the Joint-Venture with Telefónica for approximately one decade with Vivo. At the same time, the Portuguese firm believes that the Brazilian market's know-how can be highly complemented with the knowledge provided by the Portuguese Telecommunications market.<sup>16</sup> An example of such possible combination is that Portugal Telecom understands what did or did not work in Portugal, regarding the reasons for success. Besides, considering the “delay” between the Brazilian and the Portuguese telecommunications market, PT is expected to help Oi deal with challenges the first has previously faced. Therefore, Portugal Telecom truly believes Oi will be able to grow faster with PT's knowledge.<sup>17</sup> In fact, extensive national experience has allowed the Portuguese telecommunications leader to develop several operational capacities such as the convergence between fixed and cellular services, for instance when it comes to mobile broadband.

Given these facts, Portugal Telecom has grown in all the telecommunications' segments. One cannot overlook the latest success, MEO. Since 2008, PT has drastically changed the way individuals see television, under a new type of Signature TV package. ME is nowadays the market leader with 35.5% of market share, converging Television, Internet, Broadband and Telephone in a single package.<sup>18</sup> Besides, Portugal Telecom

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<sup>16</sup> Information acquired at a meeting with Portugal Telecom's Investment Department.

<sup>17</sup> Information acquired at a meeting with Portugal Telecom's Investment Department.

<sup>18</sup> Portugal Telecom Financial Results Report, March 30<sup>th</sup> 2012.

was also a pioneer in the development, installation and maintenance of optical fiber in Portugal. Being recognized by key telecom players worldwide as a company which promotes best-in-class technological and innovation skills, the Portuguese company will through the strategic partnership with Oi, make an effort to transfer its successes to Brazil, namely MEO and the optical fiber.<sup>19</sup>

Operational synergies are expected to arise from the combination of Portugal Telecom's know-how with Oi's Financial Strength.<sup>20</sup> The Portuguese firm mentions how important Oi's strong cash flow generation capacity is. Besides, when analyzing the pro-forma 2009's financial highlights, one can perceive the strategic partnership with Oi leading to similar scale operational levels (compared with the Telefónica's Joint-Venture) but providing a stronger balance sheet, which reflects the decrease from 5.528 to 2.184 million Euros in PT's net debt. Also, with the investment on Oi, the Brazilian operator would be able to apply its capital to broadband infrastructures and wire line with more confidence. These investments are expected to take place in more distant years, delaying the return for Portugal Telecom when it comes to the payment of dividends.

With the establishment of the partnership with Oi, Portugal Telecom became the largest shareholder in the Brazilian operator. At the same pace, Oi agreed to have a minimum of 10% of PT's shares (currently at 7%), which also makes the Brazilian company the largest shareholder in Portugal Telecom's group. Moreover, several benefits are available to Portugal Telecom, like being directly represented in Oi's board of directors, having the right to appoint one director. A second benefit refers to the veto power concerning the decisions of the other major shareholders, Andrade Gutierrez and La Fonte, Carlos Jereissati's. Andrade Gutierrez is a firm that operates in the construction

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<sup>19</sup> Portugal Telecom: [www.telecom.pt](http://www.telecom.pt).

<sup>20</sup> Portugal Telecom Financial Results Report, March 30<sup>th</sup> 2012.

market and Carlos Jereissati is a well-known business man controlling La Fonte, a distribution group. These are Oi's three major stockholders, and Portugal Telecom is, in fact, the only telecom player with participation in Oi, being directly more influent in Oi's strategic decisions due to its expertise in the telecommunications market and also considering the comparable larger participation followed by the veto power over the other two shareholders.

The Brazilian operator Oi seeks to find the best tools to compete with multinational players inside Brazil. Embratel is controlled by the Mexican organization América Móvil and Vivo by the Spanish multinational Telefónica. The strategic partnership with Portugal Telecom is an initial step for Oi to improve competitiveness and find the necessary know-how to dispute the market. Given this, Portugal Telecom resources are planned to be used mostly inside Brazil to improve their performance and to compete. However, as stated by Zeinal Bava (Chief Executive Officer of Portugal Telecom since 2008), the association established between the Portuguese and Brazilian companies will potentially lead to invest in external opportunities. While under a Joint-Venture with Telefónica, PT couldn't afford to invest in other Latin American markets, such as Argentina or Venezuela. These markets are highly influenced by Telefónica's presence. With the exchange from Telefónica's Joint-Venture to the partnership with Oi, a new sight of opportunities arises, potentially leading to new acquisitions. Thus, Portugal Telecom expects this strategic partnership to bring a new geographic projection, allowing the firm to forecast a presence in other markets such as Argentina, Venezuela and also improving its performance in Africa. At the moment, the Brazilian incoming revenues represent 52.6% of a total of 57.7% of international operational income for PT.

## **The Integration Process**

The last decades of strategic mergers, acquisitions and partnerships have shown investors that establishing a partnership with a contract, where all the synergies and expected returns are extremely visible, does not necessarily mean the agreement will be successful.

To Portugal Telecom and Oi, the partnership is based on know-how transfer, in technical and non-technical abilities, combined with mutual investments, on the one hand, to increase the value of both firms, and on the other hand, to promote network improvements on the Brazilian market, allowing Oi to invest with more confidence in infrastructures, namely at distribution chain and wire line network levels.

Given the reports of past international cases of failures in partnerships, measures are being taken to prevent similar situations and, therefore, increasing the likelihood of success for this cooperation. Hence, the main goals do target the transfer of Portugal Telecom's expertise to Oi, and mutual team learning experience.

On what concerns the integration, PT and Oi have agreed on several procedures to promote the transfer of knowledge between companies. Such procedures will be translated into four major measures.<sup>21</sup>

Firstly, Portugal Telecom has created, at the beginning of the agreement, a committee for innovation, technology and product and network development, in sum, enclosing operational activities, to work directly within Oi. This committee was created with Oi employees, and is supervised by Portugal Telecom's CEO. This fact is representative of the priority PT gives to the transfer of know-how. While Zeinal Bava has control of this committee, the corporation is more confident that the accurate know-how is being

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<sup>21</sup> Information acquired at a meeting with Portugal Telecom's Investment Department.

transferred, as well as that the monitoring of the activities inside the Brazilian operator is taking place. Portugal Telecom's CEO usually travels to Brazil every 3 weeks, keeping up to date with the changes inside Oi.

The second measure put in place by the partnership is related to the exchange of Portugal Telecom's Human Capital to Oi. Several directors "left" the Portuguese company and were employed under Oi firm to represent the Brazilian telecom player. Such action had the purpose of clearly showing they are focused on creating success for Oi, and not for Portugal Telecom. If they were under Portugal Telecom's contracts, Brazilian employers could think they were, after all, always thinking about the Portuguese multinational and its success, forecasting their return to Portugal, perhaps considering a career improvement. According to this fact, there were 3 directors moving to Brazil; the customer care director, which had created a customer care revolution inside PT, at a national level, in terms of call-centers and customer care support with technical and non-technical questions; the network development director, who implemented the fiber network in Portugal; and the network maintenance director, a critical person to PT's national market. These arrangements were a critical measure to ensure the transfer of know-how, not only due to the directors' experience, but also because their committees at the Brazilian firm will handle customers directly, and this link between firm and customer is critical to the success of every company.

On a third level, Oi is present on Portugal Telecom in its board of directors. When both organizations established that PT would buy 22.38% of Oi and Oi would buy a minimum of 10% of Portugal Telecom (so far 7% have been bought), there was a need to place Brazilian directors in PT's administration. Being so, Portugal Telecom's board of directors has now 2 non-executive directors from Oi.

Finally, the fourth measure was to allow the transfer of know-how by mutual learning experiences for Portuguese and Brazilian teams. On a weekly basis, Oi's teams come to Portugal Telecom's center (and vice-versa) to share experiences and learn about how each company's processes work, and what methodologies they use. This measure is, once more, a critical step to ensure the Brazilian company is learning from the Portuguese one, as PT's know-how will essentially be used to help Oi grow. These teams base themselves on several operational areas: equipments, customer care and product development, but also strategy and marketing areas, such as pricing and segmentation. Usually, meetings of 30 minutes to 1 hour take place every week between different teams.

Thus, Portugal Telecom is aware of the need to control and ensure the know-how exchange, promoting synergies in terms of learning opportunities and experience which are, in fact, a must for this partnership to work and achieve success.

### **Further Perspectives**

The consolidation of PT's partnership with Oi will work towards the value creation in both companies. Hence, if Oi's competitive advantage is achieved in Brazil, there are other South American opportunities to be explored, as well as in Africa. The sustainability of such link will highly depend on the initial years. Capital will be invested and the dividend returns will be delayed. Portugal Telecom's transfer of know-how, while influencing Oi's major decisions, is a critical and necessary step.

## **Discussion Questions**

### **How do you evaluate the rivalry within the Brazilian Telecom Market?**

The contextualization of the Brazilian telecommunications market represents a crucial analysis to understand how the partnership between Portugal Telecom and Oi will create value for Portugal Telecom, being an industry “a group of firms producing products that are close substitutes for each other” (Porter, 1998) . Given this fact, the attractiveness of the Brazilian telecom market will be analyzed under Michael E. Porter's Model of the Five Forces (Porter, Michael E., 1985). Michael Porter's Five Forces Model is a framework used to analyze the attractiveness and intensity of a given market, under the study of five forces that directly affect industry competition. The author refers to these forces as conditions that are related to the companies' performance and industry environment, reflecting not only the way the organization serves the clients' needs, but also the overall profit the company has. Being so, the five forces considered are: the threat of new competition or potential entrants, the creation of substitute products or services, the bargaining power of customers, as well as suppliers, consequentially affecting the internal rivalry inside the industry. In most cases, if one of the forces is very intense it will negatively impact the profitability of the industry and the operators. An attractive industry is, therefore, the positive and smooth combination of these five forces.

Regarding the threat of new players, the Brazilian Telecom market has to be analyzed under the light of an open market prior to privatization. Plano Real is an example of a package of measures put together by the government to open the overall Brazilian market to foreign capital. Likewise, we must understand the improvement of living conditions as a consequence of the economic development in Brazil, considering the growth of the Gross Domestic Product. Such improvement in living conditions is

directly related to the increase of economic purchasing power, namely in the middle class, creating new tendencies and opportunities, at a social level, for telecom operators. Nevertheless, the telecommunications sector requires a considerable amount of capital investment with fixed costs not easily refundable. Being a communication service, it is necessary to have base infrastructures to perform the activity. Regarding the national projection, players do need concessions to operate in each region of Brazil, elaborating a geographic barrier to new competitors. Other barrier cases are related to the need of technical and operational expertise in the telecom market, the cost disadvantage comparatively to competitors for not having scale economies or learning economies, as well as the customer loyalty other operators have and new players do not. All these conditions and barriers represent a weak fraction of possible entrants, even though the overall market profits are increasing, there are considerable barriers to the entry, and incumbent companies possess an advantage in comparison to any new player.

Considering the threat of substitutes, substitute products will herein be considered to have similar performance characteristics, similar occasions for use and the same geographic market (David Besanko, 2009). An example of a substitute product can nowadays be an electronic mail, replacing a telephone call. In this case there is tendency for replacement as e-mails are “free” and much more convenient to use. Nevertheless due to convergence, operators are providing combined service packages where each individual can choose whatever tool he wants to use, but the revenue will always roam to the same operator.<sup>22</sup> Given these facts, there is likelihood to use substitute services, although convergence allows companies to control this market characteristic within their offerings.

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<sup>22</sup> Free in the sense that the internet connection service encompasses many usages besides sending e-mails. Also, the client doesn't pay for each email he sends, so for the purpose sending an email will be herein considered free.

In terms of the buyers' bargaining power, the first characteristic observed is that buyers are not used to a great extent of quality service. Also, the amounts paid for the telecom services have never offered the communication freedom we Portuguese, as an example, are used to. Following this fact, we can perceive the Brazilian consumer as price sensitive, even though the sensitivity should be decreasing with the increase of economic purchasing power. However, at a personal usage level, telecommunications operators sell to millions of individual clients, and the significance of each customer is very low, as they do not buy in large quantities. Moreover, the dependency level of telecom services has to be considered. Nowadays customers are extremely used to the possession of a cell phone or the use of the internet, and the penetration rates should drastically increase in terms of broadband and 3G. Regarding the power of suppliers, or manufacturers in this case, there are two aspects to understand. The first considers the dependency of suppliers on these big multinationals. A telecom operator will probably have a huge participation on the total volume attained by a manufacturer. On the other hand, the suppliers' market should be intense in terms of competition, as there are few major operators in the telecom segment providing services to the entire country.

The Brazilian Telecommunications Market is fierce. There are only four major players though highly competitive. Three of them are controlled or influenced by multinational companies with the expertise and know-how in telecom required to outperform competitors.

It is the case of a market driven by tough sustainability in terms of competitive advantage as innovation is a daily need and the resources are scarce. However, not a single force seems to negatively impact the industry rivalry for incumbent players. This situation can be linked mainly to the existence of powerful market barriers to entrants, as well as to the dependence for telecom services, in terms of customers and suppliers.

Hence, although it is highly competitive, the telecom market is still extremely attractive for the existing players.

### **How will Portugal Telecom create Value?**

Portugal Telecom's partnership with Oi is expected to generate positive value creation for both companies. In fact, Portugal Telecom's intrinsic investment return will depend highly on Oi's success, according to the motivations of this strategic agreement. Thus, in order to fully understand Portugal Telecom's Value Creation, one must firstly study how Oi will be able to create a competitive advantage in the Brazilian Market.

Let us firstly have an insight about the competitive advantage's concept. A firm reaches a competitive advantage whenever it outperforms its competitors in a certain market (Cool, Almeida Costa and Dierickx, 2002). In order to outperform competitors, one player must successfully create and deliver more economic value than its rivals (David Besanko, 2009). Economic value is understood under the notions of consumer surplus and producer surplus. The first implicates all the additional benefit a consumer will gain after paying a certain price for a service. The second represents the way a company creates profit. In fact, producer surplus is the margin between the price sold and the cost incurred to provide a service. In order to achieve a competitive advantage, a firm must offer a larger value than its competitors, which will directly mean the organization is delivering higher benefits or lower prices, given the player's capacity to achieve differentiation or cost leadership (David Besanko, 2009). Differentiation is related to products or services with perceived higher benefits than its opponents, while cost leadership reflects the provision of the same benefits as the competitors, only at a lower cost. Besides, the achievement of a competitive advantage on a given market might be related with firms' unique resources (Barney, 2007) or even a privileged market

position (Shapiro, 1989). Resources might be especially valuable, non-tradable and hard to emulate by competitors, such as specific capabilities and competences, privileged information knowledge or even brand reputation. Such, can provide the firm with capacity to provide more benefits and/or keep a controlled and safe cost structure. In the case of a privileged market position, the competitive advantage is based on the fact that competitors do not have the incentive to replicate a firm's resources given that would be unprofitable. This type of situation is clearly visible namely when the cost to develop or upgrade a technology to face a direct competitor's action would surpass the actual losses from not keeping the pace, for instance because the firm doesn't have the necessary know-how to do it fast and with few capital. Given these facts, Oi's market positioning will be analyzed knowing that "a firm's profitability depends jointly on the economics of its market and its success in creating more value than its competitors" (David Besanko, 2009).

Oi has been looked at as the major telecom player in Brazil due to its broad scope and presence in all the market segments, such as Fixed Voice, Cellular Voice, Broadband and Signature TV. Besides, the Brazilian operator possesses the largest share in Fixed Voice and Broadband service provision. Even though there is a quite large variance in terms of populated regions, the market still offers a natural barrier regarding the concessions needed to operate. The telecom player Oi is the only company able to provide services to the entire country, covering its three regions. Adding to this fact, considering the new segmentation tendencies of the telecommunications market, PT's partner was the pioneer and still is the only operator which delivers converged services. Convergence allows, as understood, the combined offer of multiple telecom services.

Nevertheless, the Brazilian telecommunications market has led firms to invest in more profitable and populated regions, leading to great disparity when comes to the

development of infrastructures all around the country. Being so, providing better quality broadband and 3G services will require further investments from Oi and other players if they want to remain competitive. In order to gather the needed capital, the Brazilian operator has agreed on a partnership with Portugal Telecom, so it can safely invest and get telecom expertise from the Portuguese market leader. It is crucial to understand that prior to the Portuguese operator's investment, neither of Oi's shareholders had expertise in Telecommunications. Therefore, PT is entitled to nominate one member to Oi's board, as well as to have veto power over the other two major shareholders, Andrade Gutierrez and La Fonte. Under these measures, Portugal Telecom and Oi will work together to develop 3G services and Broadband, implementing optical fiber and Signature TV service like MEO. Moreover, Portugal Telecom has been conveying to Oi the need to better segment the market in terms of specific client needs, the urgency of promoting and maintaining the relation with clients, leading to post-paid services developing more freedom when it comes to customers' communication. Success and improving both companies' value will greatly depend on the achievement of these goals.

In order to reach the proposed goals, know-how transfer among companies will be crucial and consequently foster improved quality in service delivering, better maintenance and the operational cost control due to PT's expertise, supporting Oi to avoid possible mistakes. All these effects are significant to achieve competitive advantage, regarding the increased perceived benefits by customers and the consequential expansion of consumer surplus.

If success in the partnership is achieved, Portugal Telecom will have, together with Oi, more capital to invest in other opportunities such as Argentina, Venezuela and developing African Markets. Besides, the shareholders' value will also increase as they

will be able to withdraw improved returns from their investment. However, the return for Portugal Telecom should be delayed, and for now is perceived as unvarying by the firm, due to the large investments to be made in Brazilian infrastructures. The development of Broadband and 3G services reflects the critical path for the partnership. Also, it is relevant to change communication habits when it comes to pre-paid services, requiring investments in marketing and communication advertisement. All these investments to be made will delay the return for Portugal Telecom, which will eventually come after 2 or 3 years.

### **How has the integration process been managed?**

The transfer of expertise between Portugal Telecom and Oi will be critical to the good development of the strategic partnership. “More than ever, in today’s climate where cash is king and credit is tight, alliances are a smarter, swifter, more reactive and economical way to pursue strategic opportunities and gain competitive advantages” even though partnerships are usually “difficult to plan, execute and maintain over time”.<sup>23</sup> In fact, partnerships, acquisitions or mergers tend to have similar problems when dealing with the integration process and its sustainability over time. In order to analyze the presented transfer of know-how, one will “need to understand the interconnectedness of (...) stages and how weaknesses in prosecuting one stage can feed into the subsequent stages and erode the chances of overall success” (Sudarsanam, 2003). Many failures in partnerships are also due to the lack of understanding of how different firms are, and how their values will conflict among collaborators. The companies’ culture and processes are the main cause for a miscoordination between firms. But not only the cultural values are relevant; the transfer of expertise, as well as the communication within organizations also tends to be forgotten, and employees simply

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<sup>23</sup> INSEAD Website: [www.insead.edu](http://www.insead.edu).

do not understand the “code” and end up rejecting the strategic choice of their managers.

Regarding the planning for the integration process, two fundamental criteria should be taken into consideration: the need for strategic interdependence and the need for organizational autonomy (Haspeslagh, Jemison, 1991). The strategic interdependence need is related to the central task of any partnership, “the value that is enabled when the two organizations are combined”. Value can be created under an operational dimension (Resource Sharing), moving people, knowledge or sharing information (Functional Skills Transfer), improved insight, coordination or control (General Management Skill Transfer) or leveraging cash resources (Combination Benefits). Organizational Autonomy reflects the need to understand which areas must remain autonomous and how much autonomy each company should be given, when considering a partnership (Haspeslagh, Jemison, 1991).

As for Portugal Telecom and Oi's case, the integration process will allow the creation of value mainly at a Functional Skills Transfer level, even though the other dimensions of value creation are also relevant. Under this view, we will further analyze the mechanisms that have been used to leverage the conditions for success. Portugal Telecom developed an operational committee to work inside the Brazilian Operator. The creation of this committee reflects, in the first place, a need to fit into Oi's culture, as Brazilian companies usually work with committees and not with departments. Besides, this operational committee is directly supervised by Zeinal Bava, the Chief Executive Officer of Portugal Telecom. With it, the company wants to make sure the correct know-how is being passed along, as well as getting the accurate information about Oi's procedures. Zeinal Bava's committee travels to Brazil every three weeks, keeping up to date with the Brazilian telecom operator. This committee is an effort of

Functional Skills Transfer, and it's formed by specialized PT employees trying to help Oi's staff in operational areas. On the other hand, is it also relevant in terms of General Management Skill Transfer, as Zeinal Bava has enhanced insights concerning the Brazilian operator and can monitor how the know-how is being transferred between partners.

Portugal Telecom and Oi also agreed on moving some Human Capital from PT to Oi. That was the case of three of PT's directors: customer care director, network development director and network maintenance director. In fact, the directors were employed under Oi contracts. They do not belong to Portugal Telecom anymore, and their goal is to create success for Oi. Regarding such decision, Portugal Telecom is clearly assuming its dedication to the Brazilian Telecommunications Market and Oi. Besides, rather than still working for PT, these directors are now enclosed in Oi's staff, reflecting their dedication to the Brazilian firm. Such mechanism will promote the proximity between both firms, allowing Function Skill Transfer, as Portugal Telecom is willing to let go of some critical directors to the national market.

The third mechanism is directly related to the boards of directors from both telecom companies. Portugal Telecom has bought 22.38% from Oi, and the former will buy a minimum of 10% from PT (presently at 7%). Portugal Telecom has the right to nominate one non-executive director to the Brazilian company's board, as well as the right to have vetoing power over the decisions and suggestions from the other two major shareholders. With Oi's participation in Portugal Telecom, Oi will be PT's largest stockholder, while the Portuguese organization is already Oi's largest stockholder. Likewise, the Brazilian operator has the right to appoint two non-executive directors to the Portuguese board. This tool is based on General Management Skill Transfer, as both firms try to withdraw some autonomy from their partners, while monitoring the board's

decisions. Crucial to understand the strategic partnership is the position of Portugal Telecom inside Oi, being the only stockholder with expertise in Telecommunications and given the vetoing power over the other stockholders, a clear influencer in the Brazilian firm's strategic choices. Fourthly, The Mutual Learning Experience Teams are small groups of technicians travelling between Portugal and Brazil to learn about each partner's procedures, methods and mechanisms. These teams focus their meetings on operational and management topics, on a weekly basis. Functional Skill Transfer is the goal of these meetings, where detailed content is explicitly taught.

Portugal Telecom and Oi aim to have the best conditions to achieve success in the integration process. The dedication shown is intensive and the know-how transfer seems to be a clear goal for both companies, allowed by the proximity of the language. Portugal Telecom understands adaptation to the Brazilian operator is needed, as the road to follow is a mutual learning experience. Nevertheless, the Portuguese player will never be able to control Oi's decisions. In fact, both firms have autonomy to choose their way, and in order for the integration process to be successful, perhaps a more structured plan would be helpful, considering several stages to be complete, possible problems occurring and the weaknesses of each stage that could destroy all the effort that was put so far. The integration process is the tool through which firms will or will not be successful in this partnership. On the paper, all the goals are explicit, the synergies, the opportunities, the terms, but a totally different situation, is in place to make people familiar with, and to coordinate cultural values and organizations' methodologies in order to work together.

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**Appendices**

**Exhibit 1**

	<b>Fixed</b>	<b>Cellular</b>	<b>Broadband</b>	<b>Television</b>
<b>Telefonica/Vivo</b>	Telesp	Vivo	Telesp	TVA
<b>Oi</b>	Oi	Oi	Oi	Oi
<b>Claro/Embratel/Net</b>	Embratel	Claro	Net/Embratel	Net/Embratel
<b>Tim</b>		Tim		
<b>Vivendi</b>	GVT		GVT	
<b>Nextel</b>		Nextel		

Fig. 1: The Brazilian Telecommunications Market segments and the brand positioning of major players - Adapted from the original version.

(Source: Teleco.br).

**Exhibit 2**

	Revenue R\$ Millions		Market Share			
	Raw	Liquid	Fixed	Cellular	Broadband	TV signature
<b>Telefonica/Vivo</b>	12.319	8.262	26,00%	<b>29,50%</b>	22,30%	5,80%
<b>Oi</b>	10.925	6.940	<b>44,70%</b>	18,90%	<b>29,90%</b>	2,80%
<b>Claro/Embratel/Net</b>	10.836	7.451	18,70%	25,30%	26,00%	<b>55,00%</b>
<b>Tim</b>	6.382	4.371	1,40%	26,00%	-	-
<b>Vivendi</b>	1.462	894	6,10%	-	9,00%	-
<b>Nextel</b>	2.356	1.683	-	-	-	-
<b>Others</b>	2.271	1.518	3,10%	0,30%	12,70%	36,40%
<b>Total Brazil</b>	<b>100,00%</b>	<b>100,00%</b>	<b>100,00%</b>	<b>100,00%</b>	<b>100,00%</b>	<b>100,00%</b>

Fig. 2: The distribution of market shares and respective revenues for major players in the third period of 2011 - Adapted from the original version.

(Source: Teleco.br).

**Exhibit 3**



Fig. 3: Brazilian map divided into the three major regions where Oi is present. (Source: ri.oi.com.br).

**Exhibit 4 and 5**

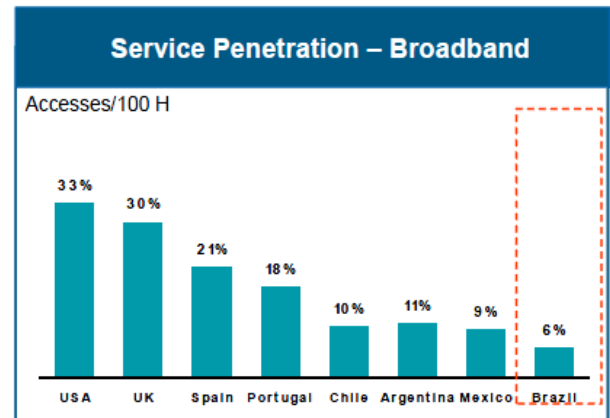
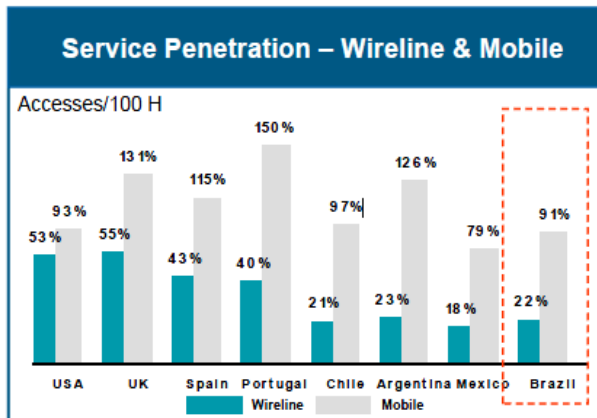


Fig. 4: Service Penetration Comparison – Wireline & Mobile.

Fig. 5: Service Penetration Comparison – Broadband (Source: Anatel, Telecom.br)

**Exhibit 6**

per 100 individuals	2003	2004	2005	2006	2007	2008	2009	2010	2011
Fixed Voice	21,8	21,7	21,6	20,8	20,9	21,6	21,6	21,7	N.D.
Cellular Voice	25,8	36	46,8	53,6	64,2	79,2	90,5	104,7	123,9
TV Signature	2	2,1	2,3	2,5	2,8	3,3	3,9	5	6,5
Broadband	0,7	1,3	2,1	3,1	4,1	5,3	5,9	7,1	N.D.

Fig. 6: Evolution of segment consumption in terms supports' density – Adapted from the original version.

(Source: Teleco.br)

**Exhibit 7**

<b>Millions</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
Fixed Voice	39,2	39,6	39,8	38,8	39,4	41,3	41,5	42	N.D.
Cellular Voice	46,4	65,6	86,2	99,9	121	150,6	174	202,9	242,2
TV Signature	3,6	3,9	4,2	4,6	5,3	6,3	7,5	9,8	12,7
Broadband	1,2	2,3	3,9	5,7	7,7	10	11,4	13,8	N.D.
Internet Consumers	-	-	-	32,5	39	62,3	66,3	N.D.	N.D.

Fig. 7: Connections/Signatures evolution per year – Adapted from the original version.

(Source: Teleco.br)

**Exhibit 8**

<b>Brazil</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
Population	178.741	181.106	183.383	185.564	187.642	189.613	191.481	190.756
GDP in R\$Millions	1.700	1.941	2.147	2.369	2.661	3.032	3.185	3.675
Annual Growth	1,10%	5,70%	3,20%	4,00%	6,10%	5,20%	-0,60%	7,50%
GDP per Capita	9.511	10.720	11.709	12.769	14.183	15.990	16.634	19.016
Annual Growth	-0,20%	4,30%	1,90%	2,70%	4,90%	4,00%	-1,20%	-

Fig. 8: Evolution of Brazil's GDP and Population (in thousands) - Adapted from the original version.

(Source: Teleco.br, IBGE and CENSUS 2010)