



A HISTORICAL PERSPECTIVE ON THE TELECOMMUNICATION SERVICES INDUSTRY: LESSONS LEARNED

WHITE PAPER

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Miami
May, 2002

The telecommunication industry landscape has significantly changed over the past decade. In the 90's, as competitive strategies unfolded, we witnessed very dramatic and bold moves. Sadly enough, a number of these were short-lived, begging the question why. This paper explains why some strategies, once acclaimed by the markets, ended up failing all together.

A HISTORICAL PERSPECTIVE ON THE TELECOMMUNICATION SERVICES INDUSTRY: LESSONS LEARNED

As dramatic changes unfolded in the landscape of the industry over the last decade, we examine what telecommunication services companies did to keep up with the changes in the marketplace. Some fundamental questions regarding the future prospects for the sector remain. Yet we observe that bold moves made by some of the world's leading global telecommunication companies turned out to be duds, detrimental sometimes to their own existence, and definitely skewing the outlook for the industry.

In an attempt to learn from our observations, we review the market conditions leading up to some of these strategic decisions that shook up the industry landscape and provide an explanation as to why they failed.

HISTORICAL PERSPECTIVE

In the 1990's, as the telecommunications industry became more and more competitive, product and service differentiation became less noticeable and pricing wars broke out between carriers across all the market segments. Most innovations and new product creations were driven by the need to lower the cost of service so as to be able to decrease price, retain the customers and remain profitable. Yet revenue erosion remained an issue and with the emergence of VoIP and talks about "death of distance," companies needed to resort to other strategies to keep their revenues growing.

Telecommunications services companies, which traditionally already had structures that were very much vertically integrated, went out on acquisition binges and integrated entirely new lines of business into their corporate structures. The operative word(s) seems to have been "customer ownership." The motto might have been: "If it caters to the same client OR uses the same delivery medium AND can be bundled, buy it." Anything was good if it helped to acquire a new customer, or to sell more to an existing customer, or keep that customer from going away (locking in the customer).

While the markets may at first have applauded some of the bolder M&A moves to grow business at exponential rates, two fundamental questions remained:

A Historical Perspective... :Lessons Learned (Continued)

- ❖ Are customers really able to buy the right service at the right price and deriving incremental value from the services they buy under these models?
- ❖ Are the efficiencies and economies of scale promised under the auspices of the mergers real?

Why are these questions important? Because they are at the heart of how value is created for the shareholder: “Does the strategy support sustained growth of the company’s return on assets (ROA)?”

$$\text{ROA} = (\text{Revenue}-\text{Expense})/\text{Assets}$$

While it may be too early to tell for sure what the true potential for some strategies is, industry analysts and investors at large have taken a very bearish position towards the telecommunications services sector, which has been supported by recent examples of strategies that collapsed entirely.

Here are some examples.

LESSONS LEARNED

Strong vertical integration backfired for some. Certain companies significantly invested in global network deployment and sought to provide services to all market segments across the board. In addition to substantial infrastructure investments, the costs and timelines for building up all the business functions were not carefully assessed. Given the speed of technological obsolescence, the industry wide trend of margin shrinkage and the market’s expected return on investments and you have a formula for disaster. Less integration would have been less capital intensive and specific market focus might have produced better and faster results, hence improving expectations for ROA. Global Crossing and 360Networks clearly fit that profile.

Value-added services strategies are also being put under the microscope. Some service companies have entered the marketplace with high-end value-added services. Though the intrinsic value of the service may be there, the cost of educating the marketplace as an innovator may have been underestimated. More successful strategies may be to either enter a competitive but already educated market, or to enter the market with a low-end service and educate the customer base to up-sell later.

A Historical Perspective... :Lessons Learned (Continued)

XO Communications had a clear technological advantage and very competitive pricing, yet prospective customers failed to perceive the value of the services. Numerous services companies offering unified communications and VoIP services failed for the same reasons.

Bundling of services or horizontal service integration strategies have also proven to be risky. For some it has been the lack of expertise in a particular area that has cast a shadow over their prospects for success. For others, it is the consideration of significant investments in technological upgrades and in the integration of the lines of business to form logical and manageable business flows that has been scrutinized. In other instances, it turned out the customer wasn't all that interested in bundled services to begin with. In other sectors, bundling and service integration strategies are successful, mainly because they originated with customer demand, not necessarily because of the business opportunity or, sometimes, necessity. IBM moved out of the services business and AT&T spun off its wireless division and announced to sell its cable division in part because they realized the markets and the shareholders didn't perceive the value.

Strategies of opportunity often failed as well. Some corporations or organizations that happen to own their own private networks have entered the competitive telecommunications services arena to leverage their network assets. Sprint was very successful at this strategy. Swift and Equant struggle as they have drifted away from their core competency, which was banking and airline industry communications services respectively. Williams Communications, former subsidiary of a pipeline company, has recently filed for Chapter 11 bankruptcy protection. Enron acquired/built a company to both service its own needs as well as market communications competitively. That division is being auctioned off piece by piece since Enron filed for bankruptcy protection. Here is a classic example of the "Push" versus "Pull" phenomenon. When Sprint, 20 some years ago, started marketing its services, services were simple, choices were few and customers were both price sensitive and rather undemanding. These days, customers demand more of their service providers. Swift, Equant, Williams and Enron overlooked the cost of transforming their business (network infrastructure and business processes) to meet the needs of the broader market.

A Historical Perspective... :Lessons Learned (Continued)

Global joint ventures have consistently experienced problems. In the wake of deregulation and privatization, giant services companies were driven to take a stake in foreign markets. Instead of acquiring outright (sometimes restricted) or building large operations, some ventured in cautiously by forming joint ventures with equally large incumbent operators in the overseas markets. In an effort to service their MNC base and develop global service portfolios, they sought to share market experience and customer knowledge while also deriving economies of scale, operational and managerial efficiencies. Yet, most initiatives failed due in part because of the parent companies' lack of commitment to the offshore markets and the lack of alignment of goals and objectives. Concert, after folding twice, and Global One never demonstrated the ability to create economies, efficiencies or value for the shareholders.

Merger and acquisition strategies clutter the vision. In the mid- to late nineties, some companies took advantage of their strong market valuation and favorable IPO and Bond markets to rapidly grow their asset base and market share through mergers and acquisitions. As the prospects for the telecommunications sector seemed bountiful, less attention perhaps was paid to the effectiveness of organizational and strategic alignment of the businesses. Management realized that very large structures were harder to manage and that integration of the business lines, in order to create synergies and economies of scale, is an extremely complex, slow and costly process. WorldCom is facing drastic restructuring decisions as it crumbles under heavy debt and is considering selling off significant portions of its business under rather poor market conditions. An alternative strategy might have been: forming smart partnerships and alliances.

CONCLUSION

There isn't much left to say that hasn't already been said here, except for: *live and learn*. Some question marks about the industry's future are yet to be addressed, and there may in fact be some very valid assumptions behind the strategies discussed here. The point being, though, is whether today's industry leaders can live up to the challenges of the marketplace, or are they arrogant enough to ignore the lessons learned and feed tomorrow's headlines in the column of "*What went wrong?*".