

THE TELECOM BUBBLE HAS BURST, NOW WHAT?

The Global Asset Reallocation Game – How to Play, How to Win

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Overview

The past twelve months have witnessed one of the greatest collapses in modern economic history as more than \$1 trillion in value has evaporated from the telecommunications industry.¹ A wave of liquidations, reorganizations and bankruptcy filings has engulfed both small upstarts and the “financially unassailable” titans. However, the industry will not perish or become a mere footnote in MBA journals. Rather, telecommunications remains vital to the sustained growth of our economy. Consumers and businesses rely on basic voice and data services supported by the industry, and innovation has become an expectation rather than luxury.

This white paper briefly outlines the history and causes of the telecommunications collapse, then shifts to its two-fold focus: (i) what is next for the survivors, and (ii) how will those survivors leverage the substantial assets and infrastructure developed by companies in distress and demise. This paper supposes that a global reallocation of assets – bandwidth, fiber-optic networks, network electronics, operating licenses, and customer bases – is in the early stages of development and will only accelerate in the next 2 to 3 years. It concludes the telecommunications industry will resurrect as a new model for buying and selling complex assets of distressed companies emerges: Global Asset Reallocation. Finally, it proposes a model for how the reallocation game is played.

Background: Industry Collapse

Recently many fallen telecom executives have eagerly pointed to external factors, including economic decline, as the root cause of the bursting telecom bubble.² Certainly a macroeconomic slowdown, sliding stock market, and unsavory investment banking practices were contributing factors – perhaps even catalysts – to the slide; however, there is great oversight in this theory. Telecom companies across the board developed business models for expansion premised on one industry-adopted myth: Internet and broadband applications would fuel an unforeseeable demand for network capacity to support the increasing flow of data traffic. Telecom evangelists believed that data traffic would double every 100 days, and that it would continue to do so for the foreseeable future. While there were snapshots in time and even markets where growth actually exceeded this expectation, the reality is that demand was overstated.³

Further complicating the matter was the hyped buzz surrounding “killer applications.” A demand for exponential data growth rested on the assumption that e-mail, the first killer application, would be trailed by new killer broadband applications that would only accelerate Internet adoption and thus increase traffic on the network. As companies raced to create the next killer app, telecom network providers raced to create an infrastructure to support those apps. In the heyday, technical visionaries preached that legacy applications such as telephony and video conferencing would converge onto new data networks and become more feature rich, user friendly, accessible, and widely adopted. These evangelists of convergence promised that dozens of new applications would find

their way into our lives via a high-speed global network that connected us at home, at work, and even on the go through mobile technology.⁴ Meanwhile, venture capitalists invested billions of dollars in new technologies and applications that never passed the Alpha phase of development.⁵ Sadly, the telecom crusaders failed to take into account two impediments to hyper-growth: (i) adoption of new technology is generally slow except with early adopters who were echoing their Gospel, and (ii) the development and implementation cycle to achieve stable technology solutions is generally long.

Companies during this era of *irrational exuberance* sought to deliver broadband networking access to business and consumer subscribers everywhere. The pending communications revolution demanded greater capacity and transmission speeds to handle the merger of legacy and new applications in a bandwidth hungry world. This involved extensive technological development, replacement of legacy networking infrastructure, and a frenetic race of technological expansion to reach every corner of the globe. Ultimately telecom enterprises wanted to provide users with services and applications they demanded, regardless of location and time, reducing network bottlenecks along the way. Surely consumers and businesses would pay for this access. Somehow.

This brings us to the *Three Fatal Tenets of the Telecom Industry*:

Fatal Tenet #1: Build it and they will come

Historically voice and data networking companies had built their networks and managed their capital expenditures cautiously, carefully tracking historic growth trends and building out to meet reasonable growth estimates based on quarterly analysis. Racing to compete with the emerging data companies, telecom executives succumbed to a new mantra: build it and they will come. The consequence was a massive overbuild of networks at all levels – from undersea cable, satellite and wireless, to nationwide and metropolitan fiber-optics, and networks into high rise buildings and key suburban areas – for an over-anticipated revolution that is now in the trenches of a losing battle. This glut of network capacity depressed prices for telecom companies just as those companies were struggling to meet revenue expectations, debt covenants and repayment schedules.

Fatal Tenet #2: Expansion, Expansion, Expansion

Carriers, who once focused on regional or product specialization and market segmentation, were now delivering multiple, bundled services on a national or international scale. They underestimated the technical and business challenges required to expand quickly and simultaneously across diverse markets, which is illustrated by literally hundreds of failed partnerships, international joint ventures, new product and service launches, and market expansion plans.⁶ A lack of technical standards, poorly integrated back office and billing systems, and narrowly trained engineering and operations groups finally slowed down expansion for new products and services. Meanwhile many companies were learning that business in Bangkok was not conducted

as it was back in Ohio. In the end, overextension damaged large companies, led to the failure of overly ambitious new ventures, and demonstrated a fatal mistake: businesses had pushed their expansion efforts beyond the limits. There were simply too many competitors, too much capacity, and too many services, all in too many markets.

Fatal Tenet #3: Sure, you can walk on quicksand – if you try

In many respects the Telecom Act of 1996, which was imposed to set ground rules for competitors and incumbents on accessing and sharing the local network assets required to roll out many forms of broadband access, actually raised more questions than it answered. While the rules were being clarified, RBOCs and other ILECs with natural local network monopolies adroitly exploited the Act through extensive litigation and handsome Congressional contributions, and eventually found many ways to operationally and technically slow the progress of their potential competitors.⁷ Similar tri-pronged legal-political-business drama was unfolding in many overseas markets where regulatory environments were even less defined. Yet, companies eager to expand their networks knowingly ventured into this murky regulatory environment. For companies seeking to compete with the local players, it was equivalent to stepping in quicksand. For the industry-at-large, the optimistic number of broadband subscribers unraveled, slimming demand for more services, applications, and ultimately network capacity.

Unfortunately, the industry and technical visionaries were right about one thing: the adoption of new applications that would support demand for increased network capacity was dependent on broadband access reaching the highest number of subscribers possible. The mythology of exponential growth and an impending communications services and broadband revolution combined to create a collective industry mania fueled by exuberance and lack of judgment. Many flawed operational and financial decisions were made, an abundance of unsuccessful companies were launched, and Wall Street served as a co-dependent crutch for the industry's bad habits. Finally, with the push of unforeseen external circumstances, the telecom bubble burst and the industry fell to its knees.

The Players: Today's Industry Landscape

Telecommunications companies worldwide have felt the impact of the market and industry meltdown, and while the shakeout and industry consolidation are still in their early stages, some patterns are taking shape. On one side of the spectrum are the weak, typically new competitors and upstart carriers. On the other side are companies that have not only survived but are in an enviable position to leverage market opportunity. Somewhere in between are companies that have managed to survive, possibly protected by bankruptcy filings, and are restructuring their organizations and business plans.

The onset of the burst has put many new competitors and upstart carriers out of business. Often their business plans are built on dependencies: the resale of another company's

network, layering their network onto another operator, or plans to deploy radical new products or services that never fused. With minimal infrastructure or balance sheet assets to support them, when these companies run out of money they are not in a position to reemerge through bankruptcy protection. They have limited options and tend to liquidate quickly through Chapter 7 filings. The few assets they have are moved to auction, or to resellers of light networking equipment and assets. This category is replete with operators named by acronyms that describe the niche markets they were created to serve: ISPs, ASPs, DLECs, CLECs, BLECs, and ITSPs. A majority of these players have already exited the game, and many are on their last round of play.

A variety of telecommunications operators worldwide are now attempting to survive the current market environment. These “distressed carriers” are companies of all sizes and business models, from local and regional incumbents to national and international competitive carriers. Their balance sheets are laden with debts that were used to fuel rapid network and operational expansions. Plagued by debt, these companies face two difficult challenges. First they must devise a plan to restructure their business successfully, making crucial decisions about which assets and operations to sustain and shut down. Next they must decide whether to seek the protection of a bankruptcy filing, which offers tremendous flexibility in restructuring operations, but typically by removing equity holders. Despite the consequence, companies may face long-term competitive disadvantages if they don’t file for protection while their competitors file and emerge debt-free. A distressed company’s ability to quickly and effectively shed non-essential assets and operations is critical to its survival, regardless of bankruptcy protection.

Ironically, the carriers that appear to be in the most enviable position are the companies that were often ballyhooed as dinosaurs while the bubble was forming: they could or chose not to keep pace during the communications revolution. These carriers have cash flow positive balance sheets and profitable operations. They include operators worldwide, from PTTs and incumbent local network operators, to RBOCs and smaller regional or independent operators who over the past decade never wavered focus from delivering quality voice and data services to local or regional markets. Whether through prudent vision or a fortunate lack of vision, these operators now hold the prized tokens as the Global Asset Reallocation game begins. They have an unprecedented opportunity to acquire and integrate network infrastructure and technology developed by their industry peers, at a fraction of the original investment. These more cautious operators are mindful that overcapacity and overextension led to the demise of their competitors, yet they recognize that NOW is the time to strategically enhance their networks for future growth.

The global reallocation of infrastructure and technology assets will reach historic proportions in the next 12 to 24 months as hundreds of financially healthy operators acquire non-essential assets shed by hundreds of distressed operators. A Global Asset Reallocation market is taking shape, and it is the vision and savvy of buyers and sellers in this emerging market that will be the saving Grace for the telecommunications industry.

Rules of the Game: Selling and Buying Distressed Assets

Selling Distressed Assets

There are two conventional methods for telecom companies to fundamentally restructure their balance sheets and shed assets. The first, and historically most common, is to engage a traditional investment or merchant bank to assist in the sale of unwanted assets or operations. If this approach fails, or if the company fails altogether, the company engages a professional auctioneer or liquidator, who sells the assets to the highest bidder.

Typically, the investment banking engagement is based on selling some element of the business as a “going concern.” Banks require a substantial engagement retainer, and the seller pays a fee upon completion of the transaction. The bank’s M&A division studiously breaks out the operations of unwanted divisions and assets, assembles a book describing their value, provides detailed financial analysis of the balance sheets and holdings, and “shops” the operation. Expensive and often time-intensive, this method of sale is generally successful when the going concern complements the acquiring company. Unfortunately, companies of recent have shied away from this approach: few are interested in acquiring any going concern that carries associated expenses, personnel or liabilities. Going concerns are particularly difficult to negotiate when the concern is likely to be bankrupted if the bank cannot successfully market it and must resort to selling only the useful components of the concern. Accustomed to selling a business rather than the technology, most banks are ill equipped to sell intangible network assets such as undersea cable. Thus, many of these attempted sales stall out. Recent failed attempts include Viatel’s European network operations and 360 Networks.⁸

When investment banking efforts fail or the balance sheet cannot be restructured, bankruptcy and liquidation often remain the distressed company’s sole alternatives to shed its assets. Relying on bankruptcy or liquidation, the company wants to quickly and cost-effectively maximize its return on assets in order to return some funds to creditors or support the emergence of a downsized and reorganized entity. Attaining quick cash value for the remaining assets typically takes precedence over maximizing their value, and a professional liquidator or auctioneer is brought in to handle the sale. A quick review of the telecom assets for sale on web auction sites such as eBay reveals the high volume of assets currently being liquidated.⁹

Auctions can be effective for moving tangible assets or commodity items, such as office phone systems, furniture and computers. Unfortunately, they are highly ineffective for selling more complex, intangible assets, including transport network infrastructure (e.g., IRU capacity), network electronics (e.g., switching), and network-related real estate (e.g., data centers): compressed timeframes do not allow for proper due diligence, warehousing often dictates decommissioning and dis-integration of systems, detailed maintenance and support agreements cannot be reviewed or renegotiated, and infrastructure cannot be moved. Auctions achieve minimal value for complex assets: a company cannot purchase undersea cables with a Visa card for next day delivery by air – that just isn’t the nature of the sale. Typically, when assets are purchased via auction, the buyers are resellers who

profit by stripping out basic commodity items for resale. Since the value of an intangible asset is in the *integration* of network systems and infrastructure, tremendous value is instantly lost in the strip-down process.

The two contrasting methods for selling complex, intangible assets are distinct in their approach:

Investment Bank	Auction and Liquidation
High Value/High Return	Low Value/Low Return
Long Time Frame/Slow Response	Short Time Frame/Quick Response
High Expense	Low Expense

A vast supply of integrated systems and infrastructure in the global telecommunications industry must be reallocated in the coming years. A new model for selling these complex intangible assets must emerge.

Buying Distressed Assets

Challenges also face the companies with healthy cash positions seeking buying opportunities in the current market. These companies have a few options to fine-tune their searches for interesting buy targets, and there is no convenient way to quickly identify and evaluate details of specific assets and infrastructure available on the market.

Buying companies often rely on internal business and corporate development executives to develop a shortlist of targets and sift through the haphazard inbound flow of ideas from eager investment bankers. It is often a slow process that frequently leads to nowhere, outside of acquiring a going concern from an expensive investment bank. Similarly, these companies can identify bankruptcies and engage in negotiations with the estate or creditors committee. However, this bureaucratic approach is time consuming, wrought with politics and legal procedure, and lacks the technical information required to make a sound buying decision.

As we've discussed, companies can send corporate attendees to liquidations and auctions, but as we've seen, this approach is not particularly effective for companies looking to acquire strategic, whole network assets. During the liquidation sale, there is little if any time to evaluate the assets properly. Just as well, more likely than not the assets have already lost any strategic value they once held as an integrated and operating network.

Companies lucky enough to be on the buy side of the Global Asset Reallocation game are still searching for a marketplace that provides a global view of all marketable strategic assets that fall between the dysfunctional going concern and scrap-value liquidation sale.

Global Asset Reallocation: Methodology of a Leader

The traditional methods of buying and selling distressed telecommunications and networking assets do not provide a clean and efficient market for the massive global reallocation of telecom assets. A new marketplace is emerging where distressed companies can quickly and discreetly sell their non-essential assets at prices above scrap-value. Here, companies can acquire the strategic assets they want through a transparent process that preserves the maximum value of even the most complex assets.

This emerging electronic marketplace for telecom asset reallocation enables buyers and sellers to meet and quickly exchange information about strategic network assets that are available to change ownership. It focuses on physical assets – not business going concerns – so that buyers can select the assets they need to strategically complement, or supplement, their existing networks without acquiring unnecessary liabilities. This marketplace provides rapid access to the detailed technical and operational information required to evaluate a potential purchase, conveniently formatted and accessible 24 x 7. Knowledgeable sales agents are available to provide due diligence and answer questions.

This emerging marketplace unites highly qualified buyers and sellers of complex network assets worldwide on one platform, dramatically reducing the time and money spent marketing the sale and reducing industry reliance on investment banks and auctions for complex asset sales. By providing rapid results while preserving the maximum value of the assets, both buyers and sellers walk away feeling good about the transaction.

Telecom Asset Management LLC (“TAM”) was founded in June of 2002 to help buyers and sellers maximize the value of their assets during the reallocation transaction. TAM combines a sophisticated web tool called InfoCircuit™ with a global channel of experienced sales agents to create the sophisticated marketplace that unites buyers and sellers of strategic telecom assets.

An Electronic Marketplace for Global Asset Reallocation

The TAM online destination, (www.TelecomAssets.com), is built on an InfoCircuit™ platform that provides detailed Flash™ representations of transport network infrastructure, network electronics and network-related real estate assets currently on the market. By simply clicking on a worldwide map, users can quickly review assets available in the region or metropolitan area they identify. Using the prompts, they can drill down further to the exact co-location address and circuit ID number of specific assets. The web-based platform maintains a discreet environment for conducting private sales by providing an intranet with multiple layers of password-protected, secure access for easy administration and distribution of non-disclosure agreements, contracts, and service level agreements. Every user is required to register, so the database of qualified worldwide buyers and sellers grows every day. On the backend, TAM is aggregating data on both buyers and sellers in this exclusive database, and potential buyers are alerted when a new sale opens or assets they’ve requested become available.

Executive Sales Agent Channel

In addition to this powerful electronic marketplace and web platform, TAM has assembled a global network of industry experts – all former operational executives in the telecommunications business – in key markets to assist sellers in marketing their assets. These executive sales agents work one-on-one with the sell-side clients to market their assets on the InfoCircuit™ platform, gather the relevant technical and operational details that buyers will require during the due diligence process, and develop campaigns that maximize the value and return on their assets. These agents also work with prospective buyers to facilitate a timely and detailed flow of due diligence information and requests as well as assist with the preparation and submission of bids. TAM executive sales agents have executed deals with key carriers and network operators in their territories, and provide a professional direct sales effort to complement the TAM web tools and electronic marketplace. Just as a real estate broker knows his “farm,” TAM’s executive sales agents can provide advice and assistance with a level of technical and operational detail for their region well beyond the capacity of a banker or auctioneer.

TAM’s global network of locally experienced agents, combined with an innovative web-based application, provides the type of marketplace that will drive the global reallocation of telecom assets. Whether a company wants to shed its non-essential assets in a cost-effective discreet environment, or it is seeking undersea cable in Latin America to expand its network transport capacity, TAM maximizes the return on investment for both the buyers and sellers in the asset reallocation transaction.

Conclusion: Winners Resurrect

Business textbooks for generations to come will lament on the rise and fall of the telecommunications industry. What many are just now seeing is that the story becomes richer and more complex over the next 12 to 24 months as the industry comes back.

Once riddled by overly optimistic assumptions of growth, the industry has matured. Steady growth will return. New applications will emerge. Regulatory battles will be won and lost. Broadband will rollout on a wider scale, one day. And yes, more and more bandwidth will be consumed – eventually increasing demand for network capacity and higher transmission speeds. The fact is telecommunications remains a dynamic and fundamental component of our society.

The true telecommunications visionaries are only now emerging. They will remain focused on long-term goals, plan their businesses in an evolutionary (not revolutionary) fashion, and leverage opportunity in the emerging Global Asset Reallocation market. The winners and losers of this round in the game tell the greatest story – of resurrection.

In the months and years to come, buyers and sellers of assets who can move quickly and are guided by sound research and information will have the advantage. Telecom Asset Management, LLC, provides a global marketplace and methodology for astute carriers to leverage opportunity and emerge winners in the Global Asset Reallocation game.

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