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The Enron Network: The Emerging Telecom Industry Structure

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It has been widely predicted that the collapse of Enron and its politically explosive aftermath will not spur much in the way of regulatory changes, save those pertaining to accounting, executive compensation and corporate governance. These, of course, may well prove far-reaching. But in another way Enron's impact will reverberate far beyond specific regulatory changes. Enron will, by revaluing specific companies, radically transform industry structures in the telecommunications industry.[1]

The New "Divide" in Telecommunications

The Enron impact will be cumulative, on top of earlier shocks: the stock market bubble-burst, the recession and the collapse of numerous firms whose future was predicated upon permanent arbitrage of price differentials created by asymmetric regulation. What has been created is a new divide of "haves" and have-nots"—one far more consequential than the rapidly disappearing "digital divide" among consumers. This divide is a financial one, between companies with sound balance sheets and earnings, and those without them. The result will be to rewrite once again the stories of the fortunes of surviving telecom firms.

The telecom boom of the late 1990s was driven by soaring expectations of future growth and profitability. Investors bet "on the come" that exploding demand for new services—data and video, plus wireless voice—would generate profits. Stocks of firms with negative cash flow and distant break-even points projected were nonetheless bid to stratospheric heights.

The stock market bubble burst prompted investors to bail out of firms whose potential profitability was deferred. Patience went out the window. Firms with perfectly respectable business plans, who had never promised instant profits to their shareholders, found that investor standards had shifted beneath their feet. The resulting collapse in share values exceeded 90 percent for many formerly high-flying firms. And all this happened before Enron hit the fan.

Enron: Trust…But Verify

Ronald Reagan's maxim as to how to deal with the Soviet Union—"trust, but verify"—symbolizes the new investor attitude towards publicly-held companies. Companies with even a hint of financial shakiness will be vulnerable to steep devaluation. Worse, established firms are now under fire: WorldCom and Qwest are being investigated for questionable accounting practices that may have inflated reported earnings. And in WorldCom's case, the SEC is investigating the propriety of a $341 million loan made by the company to its CEO, Bernard Ebbers, for a $250 million margin call—and at 2.15 percent, less than half the then-prevailing prime lending rate of 4.75 percent. One estimate sets the largest known prior firm/CEO loan at $15 million.[2]

Further, the integrity of prominent securities analysts has been called into question, with stock recommendations seemingly tied to compensation paid their firms. And finally there is Global Crossing, whose insiders cashed in before the collapse while investors and employees were left holding the financial bag. In all, not a pretty picture.

The Coming Scrap Fire-Sale

Already, one small firm, IDT, has bought the assets of defunct-microwave carrier Winstar, at roughly one cent on the dollar relative to the highest assets value placed on the company at market peak. Several companies with fiber optic networks covering over one hundred cities are selling at bargain prices. Because these firms are not going to be able to show earnings growth quickly, sooner or later, someone will buy these assets for the proverbial price of a song. The result will be to transform industry structure—both as to market segment and particular firm positions.

The long distance industry is moribund. It is simply no longer viable as a stand-alone business, with margins shrinking ten-fold in the past five years. Only a combination with local firms, which are winning entry into long distance state-by-state, will impart value to long distance. The question is when regulators will realize that segmentation was a product of the Justice Department and not the market.

A graphic illustration of the long distance market's value loss is the case of WorldCom, which split into two tracking stocks in 2001: the MCI consumer business and the WorldCom business/Internet data-driven business. Both segments slipped badly in 2001. MCI Group's revenues fell 16 percent, while WorldCom Group's revenues fell 9.6 percent.[3] Consumer business revenue declines have been a regular feature for five years, but data decline is a new phenomenon. Merrill Lynch estimates that only 10 percent of the 39 million miles of optical fiber laid in the US is being used, and prices are declining 50 percent annually for fiber minutes.[4]

True, telecom shares all around have been in a funk, but most of the steepest falls have been companies with meager earnings. Pricing power continues to erode: The University of Illinois is renting multi-gigabit dark fiber for 20 years at the same price that Ameritech uses to sell three months of comparable bandwidth.[5] But despite the telecom tumble in 2001, Internet traffic volume quadrupled.[6]

This is where things get tricky. With a plethora of fibernets available for scrap value, why would anyone want to buy an established carrier at premium rates? Given the post-Enron desire for hard assets, goodwill alone cannot span the share price gap. Why buy AT&T and Sprint for tens of billions when you can buy a nationwide fibernet—with newer technology, in some cases—a decimal point or two cheaper? Plus you get a non-union workforce, further lowering the cost structure.

Logical purchasers start, of course, with the Bells. But there are other candidates, too, given the Crazy Eddie "insane" prices now prevailing in the long distance industry. No longer does it take a Bell (or a cable MSO—Multiple System Operator) to buy a nationwide fiber presence. Upstarts can get into the big leagues quickly and own physical assets. They can thus manage their end-to-end networks.

Conclusion: The Law of Unintended Consequences Strikes Again

Regulators seeking to micro-manage the transformation of telecom networks succeeded—in the short-term, at least—in creating a few hundred firms seeking to profit from regulatory arbitrage opportunities. By dividing up the market opportunity for new entrants into a few hundred micro-market slices, regulators hurt entrants with legitimate business plans to build new facilities.

Further, by insisting that local and long distance firms stay separate, regulators encouraged long distance firms to enter local markets, so as to replace declining revenues in core long distance businesses that were shrinking under the pressure of rapid price declines. The result was to make long distance firms weaker at the very time their financial cores were collapsing into a financial black hole.Worse for long distance company shareholders was that in those days local firms would have paid immense premiums to acquire the long distance carriers. Now, post-bubble, post-recession and post-Enron, long distance firm share values have long since surrendered their former gaudy premiums.

A new crop of regulators, chastened by the experience of their predecessors and as well by the crumbling market caps of former flagship contenders, will at long last allow the consolidation to take place that is a sine qua non of telecom sector recovery. What Washington regulatory advocates could not accomplish will have been effected by massive financial market scandals. The likes of Kenneth Lay and Jeffrey Skilling did not have vertical integration of the telecom market in mind when they fattened their wallets whilst shrinking those of their employees and their investors, but that will likely be one legacy of their abusive self-enrichment.

[ET CETERA]

VOD vs. pay-per-view. Many see video-on-demand (VOD) as the broadband "killer app" to drive multi-megabit bandwidth into the home. Consulting firm Jupiter Matrix predicts that today's 300,000 subscriber market for VOD movies will grow to 5.3 million in 2006, driving revenue from $16 million to $641.9 million.[7] By comparison, in 2001 pay-per-view revenues were $1.4 billion, up 60 percent from 2000.[8]

Ask not what your country can do for you. America's volunteer spirit is alive and well: In response to requests from the federal government for ways to fight terrorism on US soil, over 12,000 proposals have been submitted to the Office of Homeland Security.[9]

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[1] Enron's impact may affect many other industries, but such prospects are outside the scope of this newsletter, and outside the author's expertise as well.

[2] "Tracking the Trouble Caused by WorldCom's Bernie Ebbers," Washington Post, p. E1, Mar. 18, 2002. Ebbers asserts that the alternative to the loan, his selling his holdings, would have hurt WorldCom more than any loan, but at one percent of outstanding stock a sale would not likely have tanked the stock.

[3] Id.

[4] "Telecom's Troubles Spread From Upstarts to Sector's Leaders," Wall Street Journal, p. A1, Mar. 13, 2002.

[5] "Superbroadband Gives Researchers Easy Data Access," Chicago Tribune, Feb. 4, 2002. < http://chicagotribune.com/archives >

[6] "Boom Interruptus," Forbes, p. 39, Dec. 10, 2001. The estimate comes from Larry Robert, CEO of Caspian Networks and one of the founding fathers of the original Internet.

[7] "Ask and You Shall Receive," Wall Street Journal, p. R10, Mar. 5, 2002.

[8] "Steal This Movie," Forbes, p. 66, Feb. 18, 2002.

[9] "High-Tech Firms Vie to Fight Terrorism," Washington Post, p. A1, Mar. 31, 2002.

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