



# Communications consolidation after an era of no restraints

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.....AT&T recently accepted an offer to be acquired by another company. So did MCI, which is what is left of MCI Worldcom. Both will become part of large local telephone companies, SBC and Verizon. Qwest also would like to buy MCI, but MCI had rejected its bid, as of this writing.

Mergers sometimes result from an acquirer's quest to fulfill a strategic vision for the future, and other times from the mopping-up of a bold vision gone awry. In this case, it is mostly the latter.

Wait a minute. Is that right? Most people think of AT&T and MCI as *boring* telephone companies, not as companies who had bold visions or, for that matter, bold visions that failed.

In reality the reasons for the failure are subtle, and the subtlety is worth understanding. Although we have not reached the end of all innovation in communications markets, these events do mark the end of innovative boldness by this market's largest firms.

More provocatively, there is a common view in industry circles that the AT&T and Worldcom sales will not affect innovative activity. I beg to differ.

## Landline

AT&T and MCI Worldcom heavily invested in all-landline markets. Landline markets involve several diverse markets: corporate data services, long-distance telephone service for consumers and business, and competitive local phone service—again aimed at homes and business. Landline businesses are distinct from

wireless ones, such as those supporting your cell phone.

To be sure, many of AT&T's businesses were straightforward, such as offering long-distance telephone services to consumers. The company also instituted several bold initiatives. AT&T launched Worldnet for business in 1995, which was early in the movement to Internet service providers. After that, AT&T bought IBM's ISP division and ran it for business customers; it also bought TelePort, a competitive data services firm. AT&T also built a thriving wireless business, then spun it off (though the division kept the brand name for marketing purposes). This spinoff left the parent heavily concentrated in only landline services. More recently, AT&T unveiled an ambitious voice-over-IP (VoIP) plan for business customers.

Worldcom also had its straightforward long-distance telephone business, but that was not all. It dared to grow enough to compete nationally with AT&T and Sprint in long-distance telephony. From 1993 onward, it started buying other companies. Worldcom openly talked about offering all services to all users, a radical marketing position. It eventually acquired MCI, MFS, and UUNet. UUNet had one of the best Internet backbones in the US. MFS was part of MCI, and was a thriving and competitive provider of local telephone and data services for business users in major cities.

In both cases, many of these actions were bold because AT&T and Worldcom went after them on a large scale. More concretely, both firms combined their

entrepreneurial actions with professional norms, bringing flocks of experienced engineers, accountants, lawyers, and consultants into the fray.

## Contrarians

AT&T and Worldcom were especially impressive to watch, because there had not been too many bold and innovative *large* firms in the landline business prior to the 1990s. Heck, there had not been many innovative *small* ones either. The mid to late 1990s were special. It was an era of the commercial contrarian.

Contrarians commercialize innovations with approaches not pursued by any other rival. That happens only if a firm conceives of a different product design than everyone else or has access to assets that let them develop a different distribution channel for supporting the product. Typically a commercial contrarian is an entrant into an established market.

Commercial contrarians are abundant in computing and electronics, but not in any other markets. In computing, contrarians are most often small, innovative entrants taking on a large incumbent, à la David versus Goliath, or Don Quixote versus the windmill. Occasionally this makes the news. Think of Netscape taking on Microsoft in the browser wars as one such example. More often this happens underneath everyone's radar screen.

When computing markets started to experience the entry of many commercial contrarians as far back as the 1960s, many

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observers forecast the same in communications. After all, the IC revolution upended communications equipment technology as much as it did computing and electronics.

Yet, the upheaval in communications did not happen nearly as quickly. Communications first experienced contrarians in the 1950s, but not in a flood-like manner. When MCI entered in the 1960s and started growing in the 1970s, it thought of itself as a trailblazer. Indeed, except for MCI and a few others, contrarians were still rare in the 1980s, even after the AT&T divestiture. So Worldcom's ambitions seemed unusual when former CEO Bernie Ebbers started growing the firm in 1993.

Ebber's timing was fortunate. Everything exploded in the mid to late 1990s. Three things caused this change: the Internet, the 1996 Telecommunications Act, and the growth of digital cell phone networks. Small ISPs dared to enter and offer service. Many other firms dared to enter as competitive telephone firms. Digital cell phone networks grew and promised to replace landline phones. To their credit, both AT&T and Worldcom got with the times (so did MCI and Sprint to some extent), becoming large contrarians in a few select places.

AT&T Worldnet's entry into the home ISP market in early 1996 had the flavor of a large contrarian taking on small incumbents. AT&T thought it could use Worldcom's professionalism and brand name to push aside most amateurish and small ISPs. They also gunned for CompuServe, Genie, Prodigy, and AOL, who, at the time, were all struggling to migrate to the Internet. AT&T's ambitions turned out to be too high, but it did comparatively well, especially at first.

Level 3's entry in the late 1990s was more of a large contrarian taking on large incumbents. Level 3 had three billion dollars of funding to build a state-of-the-art Internet backbone to compete against AT&T, Worldcom, and other incumbent backbone providers. In spite of such competition, Worldcom kept growing its backbone and publicly boasting about its proficiency.

Large incumbents also helped small

contrarians in mutually beneficial situations. For example, AT&T wireless made a deal with Research in Motion to carry the signals of the Blackberry on AT&T's network when Blackberry first launched. To its credit, AT&T took a risk. Only the truly faithful anticipated the success Blackberry eventually enjoyed (Today the Blackberry uses many different networks.)

The broader point is that AT&T and Worldcom made spirited attempts to become commercial contrarians. Both also held their own against others who were pushing contrarian agendas.

### Assigning blame

AT&T's and MCI Worldcom's failures arose from a subtle combination of events. At times their executives made calculated bets in uncertain market environments and were unlucky. Other times, their executives formulated unsuccessful strategies.

Some of the unlucky part was inevitable. The long-distance and local business markets became limited by fundamentals, such as flat demand growth. However, to be fair, much of this would have been difficult to anticipate. Although competitive local telephony is still viable for some business markets, recent court and FCC rulings about the 1996 Act—more than seven years after passage—have made home service unprofitable. In addition, prices for most data services plummeted after the dot-com crash. Worldcom's and AT&T's data business were the most efficient in the world, but it did not matter in the face of that crash.

Executives at both firms also made some inexplicable decisions. For example, even though it had never been in the cable business, AT&T decided to buy cable companies in 1998 and 1999. Company press releases talked about selling phone service and broadband over cable lines. This experiment ended dismally, and AT&T sold everything to Comcast at a much lower price. Buying high and selling low is a simple way to give away money, and AT&T did—tens of billions of dollars. Looking back, the short time between buy and sell also confirms how bad this idea was.

Worldcom's managers made spectacu-

lar mistakes. I cannot explain why, but Ebbers continued to provide upbeat and optimistic forecasts for Wall Street analysts and his own managers long after that made any sense. It is obvious, with the benefit of hindsight, that by the middle of 2000 Ebbers was articulating unreachable growth goals. This got in the way of what his managers should have been doing, which was trimming their organization's true costs to match the truly dropping revenue.

Even more spectacularly, Worldcom cheated on its books, publicly lying about \$11 billion worth of costs over several years. Whether or not you believe that the CFO, Scott Sullivan, acted alone or with Ebbers' complicity, the accounting fraud is indisputable. Discovery of the fraud led to a very messy bankruptcy. It took a while to stabilize operations afterwards.

After such events, why do Verizon, Qwest, or SBC want to buy AT&T or what's left of MCI Worldcom? In brief, some viable businesses remain if they were sold at a low enough price. To be sure, only the most self-confident or masochistic CEO would want the challenge, but there seem to be an abundance of such executives at Verizon, SBC, and Qwest. Who am I to second-guess them?

### More or less innovation?

These sales will lead to less bold innovation. Four factors push in the same direction.

First, without these mergers, both companies would have been innovative because neither has completely lost their entrepreneurial spirit. An example is the VoIP strategy AT&T recently initiated. I expect the same from MCI now that it has emerged from bankruptcy.

Second, local telephone companies tend to eschew the role of commercial contrarian. Although an uncontroversial characterization, the reasons for that behavior are a long topic for another day. Here is the key point: In effect, the assets at AT&T and MCI are moving from executives who sometimes innovate boldly to executives who never do.

Third, many market watchers interpret these mergers as white flags. Executives who were cautious during the 1990s feel

vindicated; they say so publicly. So the sales reinforce more cautious behavior everywhere.

Fourth, for landline markets, the boldest and most innovative firms will be small newcomers, such as Vonage or Skype. Look for such firms to push radical technologies and services, such as VoIP or video-phone service. The premerger AT&T and Worldcom had the same interests as these small firms, tilted toward easing access to local telephone networks for

new services. That tilting will cease after the mergers. Worse yet, small firms will not find many other large friends among the remaining landline carriers.

Overall this is not a good development for society. Even when boldness fails, others might pick up the idea, alter it, and sometimes prosper. That type of learning is extremely important for a market's progression.

If you look at it from that angle, these mergers leave a void. Although the bold

experimentation of AT&T, Worldcom, and MCI in the last decade ended terribly for their stockholders, their actions increased the diversity of approaches, benefiting everyone else.

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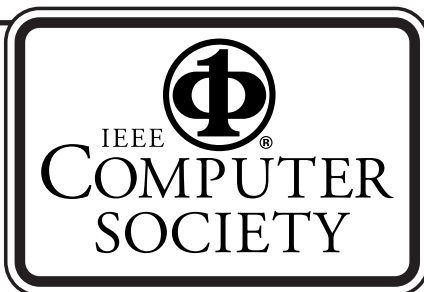
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