

Europe's telecoms mania

Why it happened and how it will be
resolved

By Hugo Dixon, Editor and chairman
Breakingviews

Financial pathology

- Telecoms mania 2000 an example of financial pathology to rival Asian crisis of 1997-1998
- Dotcom grabbed more headlines but much less significant financially
- Massive misallocation and destruction of capital

Causes

- US tech fever of late-1999 infected Europe
- Vodafone bid for Mannesmann (end 1999/start 2000) caused copycat M&A
- 3G auction round

Don't trust market signals

- Rising TMT valuations prompted investment binge
- Companies valued at multiple of many times capital invested (Tobin's q)
- So investment in high-speed internet connections (alternative networks)
- Incumbents felt they had to respond or lose market share
- And mobile mania (subscribers valued at many thousands of dollars each)

Doing a Vodafone

- Hostile bid for Mannesmann created a virtual pan-European footprint
- Already had US with AirTouch deal
- Idea was pan-European services, purchasing economies, branding
- Vodafone's rivals didn't want to be left out
- So copycat deals

Expansionary M&A

- France Telecom – Orange, NTL, Mobilcom, Equant
- KPN – E-Plus
- Deutsche Telekom – One2One (UK), Voicestream (US) Midsommer madness \$15k per sub
- BT – takes control of Viag Interkom in German; taunted by policy of minority stakes

3G auctions

- Companies could buy their way into the next generations
- Fevered times led to massive prices
- UK auction £22bn
- Spain's Telefonica Moviles had greenfield site policy in 10 separate countries

German 3G – moment of truth

- Frenzied auction
- Six winners each paying E8.4bn
- Worst of all worlds – too much competition, too much money
- Investors couldn't work out how money would be made
- Overcapacity drives down prices drives down ROCE drives down asset valuations

What is this technology anyway?

- Nobody had really asked what the new technology would do and whether customers were really prepared to pay
- WAP was a flop

Debt plays a role in every good financial crisis

- Borrowed to the hilt, often short-term
- Leverage magnifies shareholder upside in the boom and magnifies shareholder value destruction in the bust
- Think of a company with market value of E60bn and E40bn of debt. EV E100bn.
- EV declines 40% to E60bn. Market value of equity drops 66% to E20bn.
- European incumbents dropped 50%-90% from peak; the more indebted the bigger the collapse

Current crisis

- Companies writhing in agony as they seek to pay off debts
- Various options
 - Sell assets
 - Sell equity
 - Cut dividends
 - Cut capex
 - Consolidate

Some 'solutions' make problem worse

- Sell assets = pass the parcel. Nobody has spare cash. So attempt to sell assets just drives values down further. Fire sales.
- Small exceptions: Enel (fat utility from outside industry); or property sales
- Equity offerings depress share prices further
 - cf catastrophe of Orange IPO
 - Only rescue rights issues now.

Real solution – remove capital

- Less capex means more cash available for investors
- Lower investment also means less competition, less pressure on prices and higher prospective returns on capital
- Less cash spent today and more cashflow tomorrow would allow share prices to recover

Bankruptcy works magic

- Alternative carriers will go down this path
- Esprit already defaulted last year
- Others in the pipeline

Cut capex

- Delay investment in new networks
- Who needs 3G anyway? 2.5G good enough
- DSL? Come off it.
- Cable TV. Slower roll-outs.
- Capex for big boys shot up to over 20% of sales. Needs to come down to around 15%.

Consolidation by M&A

- Mirror image of last year's M&A which was all about expanding footprints
- Next phase will be about reducing competitors and cutting capital investment

Germany the best solution

- Consolidate 6 players into 4
- Not just network sharing (that's half pregnant) but full mergers
- Won't get back licence costs but could avoid follow-on investment
- Regulator still needs to be won over. Must allow consolidation.
- But 4 strong competitors better than 2 strong ones and 4 weak ones

Conclusion

- Pips are squeaking
- Managements face the axe – and rightly so in many cases
- Some action already taken but not enough
- Sunk costs cannot be recovered
- But wipe slate clean and equilibrium will be restored.