The Telecommunications Financial Meltdown

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Remedies for Telecom Recovery: One Year Later
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Lessons

• Incentive Structure
  • Governance
  • Transparency
• Regulation
  • Reduce uncertainty
  • Avoid cross-subsides
  • Target universal service
  • Investment NOT competition

Agenda

• Overview
• Irrational Exuberance
• Governance/Incentives
• Regulatory Institutions
• Lessons/Remedies

Overview

• Loss of Market Capitalization
  • Five Trillion dollars (US)
  • Nine-eight percent: IT/Telecom
  • $4.6 Trillion
• Buy/Lie/Sell High (D. Quinn Mills)
  • Barons of bankruptcy
  • Bankers of bankruptcy

Overview

• Loss of Market Capitalization
• Buy/Lie/Sell High
  • Barons of bankruptcy
  • Bankers of bankruptcy
Overview

- Loss of Market Capitalization
- Buy/Lie/Sell High
- Overhanging the Industry
  - Easy Financing
  - High Expectations
  - Irrational Exuberance

Precipitating Events - Irrational Exuberance

- Retirement Plans (401(k))
- Baby Boomers
- Media Coverage Increased
- Cultural Factors…
- Incentive Structure
- Internet/Telecom Boom

Precipitating Events: Incentive Structure

- Stockholders' Class Action Lawsuits Difficult
  - Private Securities Litigation Reform Act of 1995
  - False and misleading statements harder to prove

Precipitating Events: Incentive Structure

- Stockholders' Lawsuits
- Stock Options
  - Reporting of options
  - Tax treatment of options
  - Cap on tax deduction of executives' compensation

Standard & Poor's Indices

Telecom Act of 1996 -- Intent

- Competition Encouraged
- Interconnection Encouraged
- Cable Television Deregulated
- Universal Service Legislated
Regulation/Telecom Act 1996 -- Results

- Merger/Acquisition Frenzy
- Competition NOT Investment
- Prices Distorted
- Resale Approach
- Lack of Enforcement
- Monopoly Pricing of Spectrum
- Monopoly/Static Analysis

Precipitating Events: ITC Boom

- Telecom Act of 1996
- Technology Changes
  - Internet
  - Broadband
  - Digital Satellite
  - Wireless
    - Cellular
    - WiFi/Blackberry

Long Distance

- Overvalued IPOs
- Instant Millionaires
- Demand for Network
- Supplier Financing
- Over Capacity

Shifting Environment Destroys Value

- IXCs
  - Cellular into Long Distance
  - ILECs into Long Distance
  - Over capacity
  - WorldCom's accounting

Governance/Incentives-- Agent Problem

- Separation of Ownership & Control
- Board of Directors
  - Rolodex boards
  - "Collegiality trumps independence"

Governance/Incentives-- Agent Problem

- Separation of Ownership & Control
- Board of Directors
  - ...
- Interlocking Directorates
  - Compensation Committees
  - Audit Committees
Governance/Incentives Remedies

- Independent Boards
- Limits on Interlocking Directorates
  - Independent Compensation Committees
  - Independent Audit Committees

Governance/Incentives

- Principal/agent problem ...
- Bankers' Abuses
  - Valuations
  - Pushing growth
  - IPO Allocations
  - Undervaluing IPO's
  - Price manipulation

Governance/Incentives -- Bankers

Valuations

- "Eye balls"
- Capital expenditures
- Capacity
- Market potential
- ...

Governance/Incentives -- Bankers

Valuations

- Investment Decisions
  - Sunk cost decisions
  - Similar to office space
  - Not state-of-art techniques
- Real Options Methodology
  - May have avoided excess capacity in long-haul market

Governance/Incentives -- Bankers

Valuations

- Pushing growth
  - Over extended
  - Bigger fees
  - Out after IPO

Governance/Incentives -- Bankers

Valuations

- IPO Allocations
  - Friends & family
  - Reward to clients
Governance/Incentives -- Bankers

- Valuations
- Pushing growth
- IPO Allocations
- Undervaluing IPO’s
  - By thirty percent (30%)
  - Not to corporation
  - Friends & family/Rewards to clients

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