

Equity Research Note (December 29, 2003)

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Communications Services

New Year's Resolution - Avoid the Bells

Investment Conclusion

No Way Out. While the Bells claim the majority of the remaining market cap in the U.S. telecom market, suggesting that they have won the local turf war, we believe their models are breaking down. Though their free cash flow generation appears to position them well to emerge from the malaise as beneficiaries of a more rational industry structure, we see multiple pressure points on RBOC models that bode poorly for long-term value, including the following: (1) mounting line losses; (2) revenue deflation; (3) worsening bad debt; (4) worsening credit ratings; (5) debt maturity problems; (6) weak enterprise strategies; (7) government mandated market share losses to non-facilities-based competitors; (8) cable MSO incursion; (9) wireless migration and substitution; (10) pricing pressure and cannibalization of product lines; (11) outdated networks; and (12) antitrust exposure.

We believe these overhangs are eroding RBOC fundamentals, supporting a long-term negative call on the group. We believe these trends are insurmountable, and that RBOC valuations are stretched. Our views may be more appropriate for SBC and BellSouth than Verizon, considering their weaker footprints, wireless franchises and enterprise initiatives and attractive tariffs inviting CLEC incursion. Verizon is doing a strong job improving customer service, offering innovative consumer bundles, and ramping up its enterprise strategy, but growth from wireless and next-gen initiatives will not be enough to offset negative trends in the company's wireline business in the future, in our view. For Qwest, though the company is not immune to these issues, we see intrinsic value above current levels based on normalized EBITDA (adjusted for \$800 million per year in contingent payments). Qwest has a quasi-rural footprint with limited intramodal and intermodal headwinds and should post superior absolute and relative growth aided by "classic Qwest" and planned out of region investment. Against this backdrop, we significant long-term risk to the "pure" Bells and recommend investors consider underweighting their stocks over the next year.

Access line losses are mounting, and are likely to accelerate in 2004. Over the long term, we believe wireless displacement of wireline phones, losses of lines to reinvigorated facilities-based CLECs, growth of cable broadband, and DSL cannibalization of second lines combined with the proliferation of integrated voice/data bundles riding on packet-switched access pipes will pressure RBOC models. Wireless number portability (WNP) should lead to increased displacement of wireline phones. Cable is turning on VoIP strategies, exacerbating CLEC and wireless pressures on the Bells. Further, advancements in wireless technology (WLL, Wi-Fi) provides another means of bypassing the Bells. We believe the Street may be too optimistic for improvements in RBOC wireline units in the near term. We predict line losses will accelerate in 2004 when secular pressures take a toll on wireline franchises ("a cliff effect"). Accordingly, we see risk to consensus.

The Bells are severely challenged relative to alternative and substitute products. The RBOCs suffer from the collapse of price umbrellas for legacy products, such as T1s. Further, frame relay faces pressure from IP VPN, while demand for second lines is waning due to growth in cable broadband, DSL and wireless. As more efficient technologies are introduced with lower price points, and as converged networks become mainstream allowing for more efficient use of existing infrastructure, there will be mounting pressure on RBOC revenues and profits which are tied to legacy networks and an artificially high price umbrella for existing service offerings.

New entrants and new technologies set the stage for price competition due to substitution and cannibalization. Cannibalization and substitution should accelerate in 2004 for the Bells. Pricing pressure should mount as "new entrants" ratchet up initiatives to compete head on with ILECs. Facilities-based CLECs, led by MCI and AT&T, promise to take bites out of the Bells' markets as CLECs leave the balance sheet restructuring phase of their sector behind. For cable VoIP, witness trial launches by cable MSOs, such as Cox, which uses MCI and Sprint, and by Cequel Communications, which may use Net2Phone. To date, CLECs have roughly 12% share of the local market, while cable MSOs have a small 1-2% share of the local telephony but two-thirds of the residential broadband market. Revenue deflation in the Bells' models is evident by looking at the growth in VGEs despite overall revenue declines. Substantial negative operating leverage of RBOC models, revenue losses due to substitution, and pricing pressure in legacy products should pressure RBOC outlooks, in our view, making current valuations difficult to justify.

Traffic continues to shift to wireless, while wireless displacement is increasing. Though the Bells are the dominant providers of wireless, they are not monopolists in wireless, so they inherently lose market share when traffic shifts to wireless. Wireless pricing dropped below wireline pricing in 2003 for the first time. Therefore, wireless displacement not only shifts traffic from wireline networks, but it also erodes revenues and profits for the Bells. It inherently leads to

revenue deflation on a per minute basis. As traffic migrates to wireless, it cannibalizes the wireline local market just as it did the long-distance market for the past several years. We believe the crossover in ARPM is a substantial negative for the Bells, as the ILECs still need to support copper infrastructure which requires little capex, while investing heavily to support rising traffic loads in their wireless businesses. The lower returns in wireless and lower implied revenue and cash flow of wireless usage puts structural pressure on the RBOC models and should lead to declines in profitability. We expect these trends to worsen, first due to the November 2003 mandate for wireless number portability (WNP), which should lead customers to increasingly rely on cell phones for connectivity, and due to the saturation of the wireless market with 145 million users.

The RBOCs have outdated networks. Extended depreciation schedules have allowed the ILECs to enjoy excess returns on their plant. They have been able to charge artificially high rates for voice services which will fall under pricing pressure as new entrants offer them with more value and for much less using converged networks. We believe the deregulation of the local market through the Telecom Act of 1996 and the introduction of packet-switched technologies, including VoIP, have eroded the value of the Bells' PSTN infrastructure. Further, deployment of Wi-Fi and wireless local loop (WLL) solutions undermines the value of ILEC copper. The Bells still need to support hub-and-spoke networks, just as line losses are accelerating and legacy products get cannibalized by packet-switched substitution. Duplicate networks mean higher costs and lower ROIC. RBOCs use of PSTN-based networks in the local loop exposes them to risk, not just because it is not competitive with more efficient networks, but because they may need to impair their networks in order to invest in packet-switched infrastructure. Further, the market is shifting from metered services to flat-rate utility models, which eliminates the RBOCs' arbitrage on their monopoly position and should drive pressure on their rate base. Over the long term, we predict an erosion of the RBOC tariffs and question the intrinsic value of ILEC models.

A holy grail for the Bells is growth in the enterprise segment. We believe the Bells' aspirations of moving upstream to serving the Global 5,000 are unattainable through organic growth because they lack the sales and marketing expertise, are inherently regional, and are focused on serving the low end of the market (i.e., consumers and SMEs). Further, the Bells lack the complete product set and Tier I data backbones required to service the high end of the market. We believe the RBOCs' best alternative to grow into the enterprise market is to bid for an IXC, likely AT&T and MCI, and create a "mega-carrier" with Tier I properties and a leading enterprise business. Barring such a move, we are skeptical of large inroads in the enterprise segment by the Bells, and we believe hopes for revenue acceleration from enterprise initiatives will disappoint Street views.

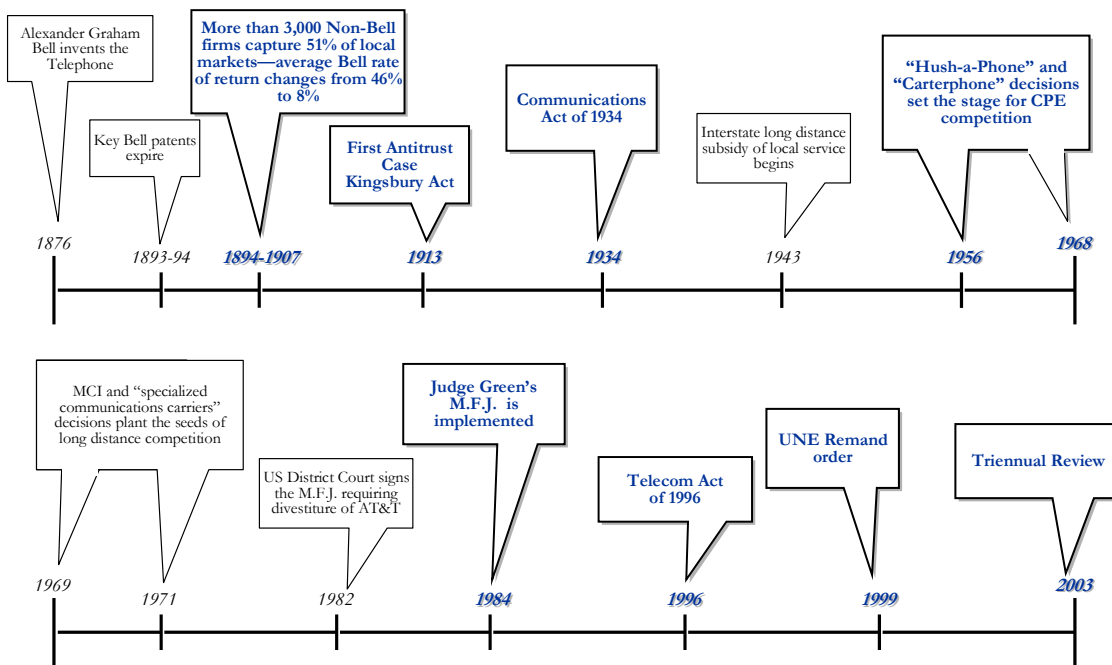
On February 20, 2003, the FCC delivered a blow to the Bells by keeping narrowband regulated. This meant the continued regulation of local dial tone and the upholding of a minimum three-year window for UNE-P which is a non-facilities-based local service delivery platform used by AT&T, MCI, Sprint and emerging telcos. As the state PUCs are generally pro competition (read – anti RBOC), we believe this decision was a substantial negative for the Bells. Already, UNE-P lines top 13 million, giving competitors a 12% share of the local market and allowing them to defend their consumer franchises with all-distance bundles. Prior to the Triennial Review, there already were major battles won by CLECs, such as the elimination of "glue charges" to combine UNE's into UNE-P and the Supreme Court upholding of TELRIC (forward pricing of UNE's rather than use of book costs of the Bells to determine pricing). With UNE impairment tests deferred to the pro competitor state PUCs, glue charges eliminated, and UNE pricing based on lower forward-looking incremental costs, UNE-P has become a viable platform to take share from the Bells in local dial-tone. Over time, we predict today's 13 million UNE-P lines could blossom to 30-40 million nationwide, or 30%-40% market share, similar share gains experienced by competitors like MCI and Sprint when they attacked AT&T's market in the 1970s-1990s.

Pension fund accounting and labor relations issues overhang outlooks. Given their substantial employee bases and large pension fund operations, which generally had assumed rates of return on plan assets of 8-10% or more during the collapse of the tech bubble over the past few years, the Bells have been continually lowering bottom line forecasts due to pension fund deficits and required lower rate of return assumptions to reflect poor market conditions. Generally speaking, these trends seem to have abated, though Verizon recently announced billions of dollars of charges for severance and pension funding overhang.

Steady declines in revenues have not impacted the Bells' capital structures materially so far, as the companies have been able to adjust cost structures and cut capital expenditures, which help them maintain healthy cash flow from and reduce debt. Despite the progress made during last 12 months, the Bell companies remain highly levered. As we believe revenues will continue to decline in the foreseeable future, the Bells could find it more challenging to eliminate costs and reduce capex, leading to pressure on margins and free cash flow, possibly resulting in dividend cuts and debt maturity troubles. Over the long term, as the RBOCs' core businesses come under pressure their credit ratings are likely to worsen, as already evidenced by recent cuts to the ratings of SBC by S&P and of Verizon by Fitch.

In our opinion, the logical extension of the Telecom Act of 1996 may be structural separation of the Bells into wholesale and retail arms, which could occur due to antitrust enforcement (Sherman Act/DoJ), much like AT&T was broken apart in 1984 following the 1968 Carter Phone decision and years of antitrust litigation. In October 2003, the U.S. Supreme Court began hearing *Trinko v. Bell Atlantic*, with the purpose of reviewing *Goldwasser* and whether the Sherman Act supercedes FCC policy and authority to [de]regulate the telecom market in the interests of furthering the goals of the Telecom Act of 1996. A number of other cases are brewing across the Bells, including *Covad v. Verizon*, *Covad v. BellSouth*, and various claims against SBC, among others. If the Supreme Court opens up the door for competitors as well as consumers and enterprises (i.e., rules in favor of *Trinko*), then carriers, consumers and enterprises may be able to sue the Bells for antitrust. At some point, we predict there will be a tidal wave of complaints filed against the ILECs, which represents billions of dollars of contingent liabilities for the Bells that are not properly factored into their assessments by the Street. Further, there have been calls for a reopening of government audits of the Bells' books in order to assess whether they have been overcharging their constituents and competitors for usage of their networks. Altogether, we call this overhang "Telecom Asbestos Litigation" and it could represent the single biggest negative secular call on the group considering the Bells' anti-competitive actions since 1996.

Historical Perspective



Source: ADVENTIS, Needham & Co.

NET/NET. We believe Bell valuations are extended. The Bells are reputable companies, but their stock prices leave little room for outperformance given the substantial risks facing incumbents from competition, technological change, regulatory overhang, government mandated arbitrage, and an inherently regional, monolithic culture that makes the quantum leap to serve the Global 5,000 difficult at best. We believe the RBOCs must offer investors a higher dividend yield than the current 4-5% in order to compensate for these risks. To this end, we believe share prices at or below 52-week ranges, representing yield approaching 5-6%, may be more appropriate, reflecting a proper spread to risk-free instruments and considering the limited upside to results over the long term. **Further, we continue to believe investors will get outperformance from competitive telcos, ranging from AT&T to more nimble players like Time Warner Telecom, which trade at inexpensive valuations relative to the Bells and seem well positioned for growth heading into a cyclical upturn in 2004 and likely headline consolidation between ILECs, IXCs and CLECs.** Competitive carriers outperformed incumbents substantially in 2003, and we believe this outperformance should become even more pronounced as ILEC models come under structural attack as per the aforementioned trends while competitive carriers move from balance sheet restructuring into a new phase of profitable growth characterized by EBITDA+, FCF+ and EPS+ inflection.

Other Public Companies Mentioned in this Report

AT&T Corp. (T \$19.76; Buy; disclosure – B)

BellSouth Corp. (BLS \$27.64; NR)

Covad Comm. Group, Inc. (COVD \$3.20; Strong Buy; B,E,G)

Cox Communications Inc. (COX \$34.08; NR)

MCI Group (MCWEQ \$0.04; NR)

Net2Phone Inc. (NTP \$6.68; Hold; B,E,G)

Qwest Comm. Int'l, Inc. (Q \$3.85; NR)

SBC Communications Inc. (SBC \$25.21; NR)

Sprint FON Group (FON \$15.85; NR)

Time Warner Telecom (TWTC \$10.1; Strong Buy; B,E,G)

Verizon Communications Inc. (VZ \$33.91; NR)

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