

UNDERSTANDING THE CLEC CRISIS



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As telecom investors bite their nails and watch stock prices continue their downward spiral; they are beginning to ask themselves how this could have happened. After all, the Telecommunications Act of 1996 promised a brave new world for the industry, one where the local marketplace would finally be open to competition and both consumers and wise investors would come out on top. At the beginning it looked as though that was going to happen very quickly. Trusting in the new environment and believing they had the support of the regulatory agencies, companies sprang up overnight. Likewise, investors jumped into the fray funding one startup after another. According to VenturXpert figures for the year 2000, \$3.104 billion was invested in the communications industry by private equity investors.¹

were lowered by the ever-increasing debt load carried by service providers, their primary customers. At the end of 2000, equipment maker Lucent had \$7 billion in outstanding vendor financing.²

Meanwhile, new companies continue to fail at record rates. In a November 24th article, The Wall Street Journal reported that during the first six months of 2000 the 41 publicly traded CLECs had a negative cash flow of \$19 billion, leaving them with a collective \$34 million in cash and cash equivalents as of June 30, 2000.³ In addition, with Verizon's acquisition of One Point Communications, we may be observing the beginning of an acquisition trend by the ILECs.

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But does this mean that the competitive local exchange industry is on its deathbed? Not all industry experts think so. Just ask New Paradigm Resources Group, Inc., the nation's leading competitive telecom analyst organization. They feel that "The current market shakedown is painful and few enjoy this Darwinian process but ultimately it will

be good for the industry, leading to stronger companies, more innovation and improved services."⁴ Lehman Brothers echoed the sentiment in their November 2, 2000 industry update, stating that "those companies positioned to weather the storm should enjoy healthier fundamental positions and arguably higher valuations when the clouds clear".⁵ The Strategis Group, a Washington DC based market research and consulting firm, predicts that CLECs will capture more than 17 % of the U.S. local phone service market by the year 2004.⁶ It is certain though, that the survival of the CLEC industry is

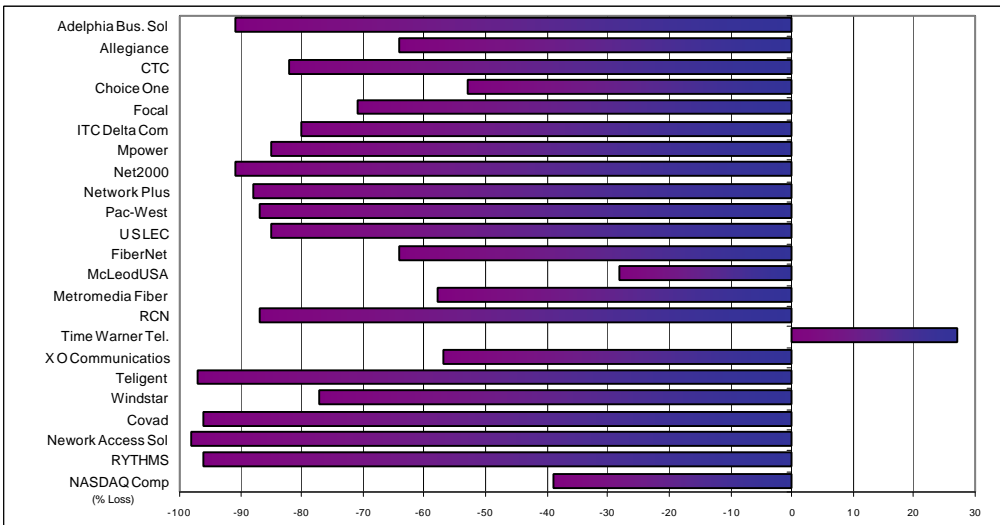


FIGURE 1 The above chart, based on a comparison by CIDB World Markets, shows the average percentage stock losses for CLECs in the year 2000.

One look at the Nasdaq exposes the painful reality- the brave new world of telecom has yet to materialize. Hitting record lows at the end of the year 2000, the technology-laden index was driven down by decreasing values in telecommunications stocks. This is due in large part to the depressed stock values of telecommunications service and equipment providers. The valuations of equipment providers

¹ VenturXpert
² The Standard, December 2000
³ Wall Street Journal, November 2000
⁴ New Paradigm Resources Group
⁵ Lehman Brothers Industry Update

Five short years ago the Telecommunications Act of 1996 was passed, opening the telecommunications industry to competition. No one really knew if the RBOCs would cooperate or, failing that, if the regulatory agencies would force their compliance. Yet investors channeled cash in record amounts into business models that failed consider the possibility that the environment would become unfavorable. Unknowns such as competition, technology, and legal and regulatory problems accompanied with the RBOCs reaction, led to a minefield of difficulty for newcomers. Today, companies that are able to utilize their knowledge are entering the market, yet investors remain hesitant to invest no matter how sound the business model or how proven the experience. This holds true despite the \$30 billion of unmet customer demands from the local telephone service industry that still remain.

Investor Risk Tolerance : Investing in Uncertainty	
1996-2000	2001
Certainty: ⚡ Customer desire to leave RBOC ⚡ Pentiful financing	Certainty: ⚡ Customer desire to leave RBOC ⚡ Competition ⚡ Technology ⚡ Regulatory environment ⚡ Legal environment ⚡ RBOC reaction
Uncertainty: ⚡ Competition ⚡ Technology ⚡ Regulatory environment ⚡ Legal environment ⚡ RBOC reaction	Uncertainty: ⚡ Scarce Financing

directly tied to whether or not CLECs are able to free themselves from dependence upon the incumbent RBOCs.

Success is Rooted in Failure

The key to success as we move forward in this new market is to determine why companies failed. A brief examination of fundamental business principals shows that the answer is simple. First and foremost, CLECs operated under the reasonable assumption that the

RBOCs would police the ILEC CLEC relationships better. As we now know, these assumptions proved false. This unfortunate miscalculation, coupled with poor strategy, poor planning and ineffective execution proved the demise of many CLECs.

Further investigation reveals that the downfall of many startup CLECs, no matter how well financed, was simply that they failed to balance key business factors successfully. A strong business model addresses and balances six crucial factors: competition/market selection, operational capability, customer acquisition, content integration, capital utilization and total product offering. Closer examination of each of these critical areas will provide insight into why so many companies have not been successful in the telecommunications realm.

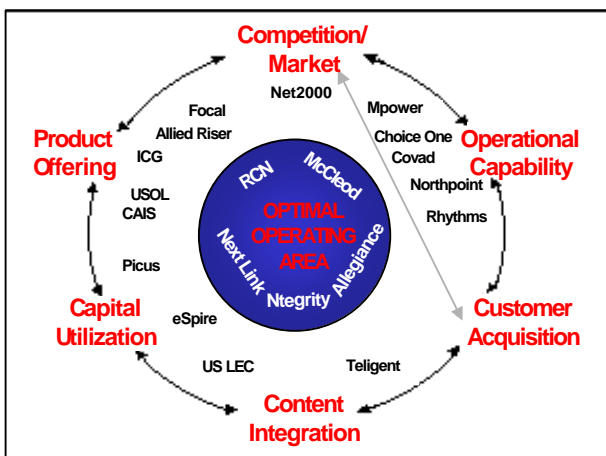


FIGURE 2 The above chart illustrates the six key factors necessary to a successful business plan.

Market Selection

Several companies failed to realize how market selection would affect their ability to execute. Effective market selection must consider the accessibility and defensibility of the customer base, as well as the operational requirements that need to be met in order to serve that customer base.

When competing against an established company that holds a majority of the market, it is wise to select a customer segment that is both accessible and defensible. Customers should be easy to reach and even easier to defend against being snatched away by the competition. For the most part, early CLECs did not concern themselves sufficiently with this aspect of market selection. As Scott Cleland, chief executive of The Precursor Group, an independent research firm, puts it, "They all ran after the same customers, the same buildings and the same investors."⁷ According to the 1992 U.S. Census, of the 5.5 million businesses in the United States, just 668 firms are considered very large businesses (in excess of 10,000 employees).⁸ However, despite the relatively small scope of this market many startup CLECs chose large business customers as their target market, assuming that they would be able to generate significant revenue with the least amount of sales activity. After all, business customers typically generate larger volumes than residential customers and have extensive and complex telecommunications needs.

Unfortunately, companies underestimated three very important things: the complexities involved in servicing these accounts, the intensity of competition from other CLECs, and the ferocity with which the RBOCs would protect this market. Elliot Hamilton, Senior Vice President of the Strategis Group, was quoted as saying "the glut of new companies all competed for the same basket of businesses, which had them cannibalizing themselves more often than taking customers away" from the Baby Bells.⁹ This portion of the market remained one that the Regional Bells felt they could not afford to lose. The decision to attack it proved a grave and, in some instances, fatal mistake. The increased number of competitors drove price-based competition. When competing on price, there are few winners. Margins decrease, making it incredibly difficult to be profitable.

⁷ CNET, December

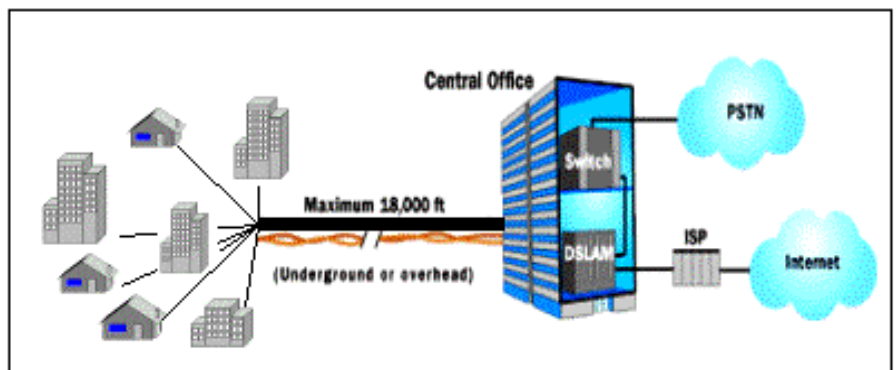
⁸ US Census 1992

⁹ CNET, December

¹⁰ Maryland Tariff

Operational Difficulties

CLECs attempting to execute the operational phase of their business plans trusted that their dependence upon the RBOCs would minimally affect their ability to serve customers. Unfortunately, these same CLECs discovered that collocation was extremely expensive, access to customers was impaired, and methods of recourse were limited. After all, the direct result



of doing a poor job of delivering service to CLECs benefits the RBOC. If the incumbent company has processes in place that are slow or

FIGURE 3

The above chart, based on a comparison by CIDB World Markets, shows the average stock losses for CLECs in

outdated and result in service delays to CLEC customers, there is really no incentive for improvement. Either customers will choose not to convert or they will return quickly, fearing that the startup is unable to provide adequate service.

Ultimately, companies failed to build brand equity since customers blamed their new telephone company for any problems they experienced. This only served to build the strength of the RBOC brands.

The first fatal operational error was to lease collocation space from the ILEC. According to Maryland tariffs on collocation, a CLEC requiring small collocation spaces of only 100 square feet paid in excess of \$60,000 to prepare

collocation space in an RBOC central office.¹⁰ Monthly lease, telecom fees and service order charges could total \$5,000 a month. Using as an example the recently defunct Digital Broadband, a company that serves 1,000 customers would collocate in approximately 350 central offices. This means paying \$21,000,000 to prepare their spaces and \$1,750,000 a month for telecom fees and space rental. In most cases, these expenditures began prior to bringing any customers onto the network. Not only is collocation with the incumbent phenomenally expensive, but it also leaves the company dependent upon the RBOC to convert customers efficiently to their network. Concerns with the RBOC's responsibility for making the actual physical cross connect to a competitor's network should be evident.

The second problem came about when CLECs needed to access the local loop, the arteries of the telecommunications network, which are controlled by the RBOC. The RBOC controls not only the ability to access the local loop but also charges a hefty fee for that access. In addition, the only way to connect to the local loop was to be connected by an RBOC technician. The difficulties associated with this have already been discussed. New Networks Institute, an ISP industry watchdog group, reports in a recent survey that 71% of ISPs provisioning DSL service have experienced lost orders through the incumbent.¹¹ According to the Washington Post, Chairman of the House Commerce Committee, W.J. Tauzin feels that "the Bell's competitors are fundamentally unsound" due to their reliance on incumbent networks. He was quoted as saying "That's a business plan doomed to failure".¹² Although it is not impossible to circumvent the use of the RBOC loops, it is extremely difficult and requires a great deal of creativity.

"As we approach the fourth anniversary of the U.S. Telecom Act, the regulatory scene remains unsettled and dynamic."
-Melinda Mullet, Arthur Andersen

CLECs irresponsibly viewed the RBOCs' idle overtures toward deregulation as an indication that competition was readily embraced, and were stunned when this proved untrue. Interviews with former Bell executives revealed that when negotiating

agreements the competitors did not have the leverage needed to be able to build in penalties for poor response time and poor service. When service issues first began to occur, the CLECs, failing to comprehend the RBOCs' lack of incentive for improving service, attempted to work problems out with the incumbents. When this method failed, startup companies discovered that they had tremendously underestimated the influence the incumbent providers held over the legal and regulatory environment in the telecommunications industry. When an RBOC did not adequately fulfill its obligation, there was no true method of recourse. Complaints about failed processes were repeatedly met with deaf ears by responsible regulatory agencies and the legislatures. The key reason was the Telecommunications Act of 1996 was unclear when it came to providing penalties for companies that did not honor both the letter and the spirit of the act. Melinda Mullet, director of regulatory analysis with Arthur Andersen was recently quoted in CLEC Planet as saying "As we approach the fourth anniversary of the U.S. Telecom Act, the regulatory scene remains unsettled and dynamic."¹³ In other words, the Telecom Act set the stage for a game that can be played by more than just the dominant player, but failed to clearly specify the rules of play.

Customer Acquisition

Failing to see the acquisition of customers as one of the key challenges of the business proved detrimental for many companies. Companies overestimated their ability to acquire the needed volume of customers at a reasonable cost. Failure to aggressively staff their organizations with skilled marketing and sales professionals raised acquisition costs resulting in sales budgets and sales targets that were never met. What was required was the creation of a marketing and sales model that allowed the company to rapidly acquire customers at a low per customer cost. Success in the telecom industry is dependent not only upon creating new and innovative sales and marketing plans but also on having skilled professionals to execute them.

¹⁰ Maryland Tariff

¹¹ CLEC Planet

Content Integration

Most CLECs approached the competitive telecommunications industry purely from an access perspective. These companies assumed that customers would find offers of discounts or speed engaging enough to woo them away from the incumbents. The failure of competitive carriers to assess the value of content or applications relegated them to using pricing strategies for the sale of commodity products. Companies with a content offering were able to attract customers on the basis of differentiation rather than price competition. Few have pursued a content-integration strategy. The benefits of recognizing and leveraging the synergy between access and content far outweigh any additional investment involved.

Capital Utilization

The capital outlay that is required to make even the most conservative of business plans a reality is considerable. Successful capital utilization focuses solely on the return on assets. Many companies not only lost sight of this basic measure of business efficiency and risk mitigation but also overlooked the fact that the level of corporate debt is a prime indicator of risk level.

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-- Lehman Brothers

This is evidenced by the fact that capital spending in the telecommunications industry has grown 26% since 1996, while total revenue has grown just 10.5%.¹⁴

When companies began financing their plans, they were met with a great deal of cooperation on the part of equipment providers. Favorable financing strategies were created which allowed a company to purchase expensive, fully equipped switching equipment. Frequently companies purchased equipment that exceeded their needs. One reason is that Wall Street was valuing companies that were acquisition ready. In order to be considered acquisition ready, network components needed to be able to integrate easily into the network structure of an incumbent or other carrier. This

prevented companies from purchasing off-brand or less expensive switches, preferring the highly expensive and inflexible Lucent or Nortel switches used by the RBOCs. In addition, overly ambitious estimates of customer growth helped sway companies to purchase oversized switches. Purchasing expensive switches without customers or with very few customers is an enormous risk to take and requires taking on debt prior to having any income.

Collocation with the local RBOC means paying excessive collocation charges, and being dependent upon the incumbent to switch customers to their network.

As the market has grown, so have the number of opportunities for alternative collocation space. Internet service providers and long distance carriers provide collocation space at a discount. Companies that collocate at an alternate site pay competitive prices and reduce the role that the incumbent telephone company plays in the provisioning of service. The benefits are far greater than monetary savings. The company can control the transfer of service to a great extent without relying on RBOC technicians.

Product Offering

New companies faced a real challenge in trying to understand what services their customers wanted and what they expected to pay for these services, often failing to offer the right product at the right price. The product set offered by the company should be defined by the target market and confirmed and determined through solid market research. Offering the right service at the wrong price due to poor capital utilization or inefficient customer acquisition can be just as detrimental as offering the wrong services. Not offering a sufficient variety of services is another pitfall. DSL provider CAIS chose to offer Internet service only to MDU customers. Research indicates that the take rate for DSL alone in this group is approximately 25%, while the take rate for voice services is approximately 97%. Choosing to offer voice and data services in a bundle would have created a larger customer base and made more efficient use of their network structure. Unfortunately, a lack of solid

market understanding meant that companies invested tremendous amounts of money to offer services that may not have appealed to their target market.

The Conclusion

During the boom, companies were able to hide poor performance with seemingly limitless rounds of funding. However, due to the current state of the economy, that is no longer possible.

Will the market turn around tomorrow? Probably not. But when it does, the companies that, despite adversity, learn from their mistakes, will not only be survivors but winners.