SPRING 2001 VOLUME 7:1

PDV *OBSERVATIONS*

Bad Connection: Hanging Up on the Telecommunications Sector

Other than the dot-com companies, perhaps no other industry epitomized or helped inflate the tech/momentum bubble more than the telecommunications sector (”telecom sector”). So, it comes as no surprise that some of the most severe market carnage has been reserved for this industry since the bubble burst. From the March 2000 NASDAQ peak, the telecom sector has seen its collective market value drop from $640 billion to $220 billion (down roughly two-thirds).

Formerly “must-own” companies in this sector whose stock prices have been decimated include some of the most popular and highly visible of yesteryear, including **Cisco, Nortel, Lucent, Corning, JDS Uniphase, Applied Micro Circuits, Ciena, Sycamore, Juniper, PMC-Sierra** as well as smaller companies like **Covad, Northpoint, PSI Net, Winstar Communications, Teligent** and **XO Communications.**

Unfortunately, the crushing drop in their stock prices attracted legions of market participants to “buy the dips” all the way down, fueling more wealth destruction. With a bellwether company like Cisco down over 80% in market value, you may be tempted to begin building positions in Cisco and the other telecom companies. However, we would advise caution. We do not believe the sector has bottomed, nor are we attracted *yet* to the valuations in the sector. To understand why, let’s first retrace how the industry ended up in this mess.

The Internet Takes Off

The bubble started with the Net’s explosive popularity a few years back. As more mainstream consumers began using the Net, a huge market developed for new telecom services, such as DSL and broadband services. Investors correctly decided that any company able to get a sizable share in this new exploding market would become very valuable. What some did not anticipate, at the time, was how excessive competition and overcapacity would sabotage this market opportunity.

The passage of the Telecommunications Act of 1996, in hindsight, doomed industry participants by allowing new companies to compete for business in the exploding new market against the old-line telecom companies like AT&T and the Baby Bells. This increased competition, and the overcapacity created by the easy credit described below, ultimately proved to be the industry’s undoing.

At the time, there was tremendous excitement about what these new companies might be able to achieve, given the old-line telecom companies were generally perceived as having outdated networks that were adequate for voice transmission, but wholly inadequate for the

Inside this Issue:

delivery of the new generation of telecom services.

The New Telecoms Were Invited to a Huge Junk Bond Party

As increasing numbers of new telecom companies sprang up to take advantage of the market for new telecom services, they were confronted with the need for an incredible amount of capital to build out the infrastructure to support the delivery of these services. With the promise of returns years away, these new telecoms seemingly faced an insurmountable problem getting the necessary financing.

Luckily for these new telecoms, the junk bond market came to their rescue. Yield-chasing institutional buyers of junk bonds were only too glad to lend these new unproven companies $billions, as the junk bond market was at the time suffering from a dearth of product; many companies outside the telecom area were actually using the cash flow generated by the strong economy to retire debt. Undoubtedly, these junk bond investors were mesmerized by the seemingly unlimited potential of the new telecom services market.

Spend, Spend, Spend

Armed with ample credit, the new telecoms began spending freely to build out the needed infrastructure to deliver the new telecom services. Unfortunately, many of these new telecoms had unsustainable business plans, wholly dependent on their ability to continue accessing the capital markets at good rates at any time. For a while, it seemed they did have unlimited access. The market's then collective infatuation with the Net's potential, and the public's undeniably huge demand for the new telecom services, made the market receptive to any telecom company out of money and returning to the capital markets for more.

Brokers, which stood to earn huge fees from all this activity, happily greased the process. Everyone was happy for a while, as the brokers earned fat underwriting fees, the telecoms got their financing and equity holders saw their holdings go straight up.

The Music Stopped

Like all investment bubbles, this one eventually had to come to an end too. And it did, peaking around March 2000. The dot-coms and telecoms have been two of the hardest hit sectors since then. Over just a few short months, the capital markets shut tight to companies that were not profitable. As most of these new telecoms were still many years away from being profitable, they were suddenly unable to raise more money to run their businesses and complete the build-out of their infrastructure.

With all the debt they had accumulated over the past few years, the interest payments burned through what little cash they had left, bankrupting many of these companies. Many others are on their deathbed. With the crushing debt loads they are carrying and lack of meaningful cash flow, it is absolutely certain that there will be many more casualties before a turnaround for the industry can begin.

So Much for the "Must-Own" Glamour Stocks; It's Still NOT Time to Buy

Some of the best performing stocks during the telecom bubble were those of the telecom equipment suppliers that enable the build-out of the infrastructure needed to deliver the new telecom services. These include former investment favorites like Cisco, Juniper, Lucent, Nortel, Corning, and JDS Uniphase. Novice and professional investors alike, giddy with the seemingly unlimited rosy prospects of these companies, piled onto the stocks, pretty much driving them straight up.

Cisco, for example, became one of the most owned stocks in portfolios managed by professionals, as they "invested" in herd-like fashion, fearful of being criticized for not showing such a "must-own" stock in their portfolios. These investors continued feverishly to overload their accounts with Cisco, despite its obvious overvaluation in the latter stages of the tech bubble. But that was during the days of the "new era," when valuation didn't matter, or so it seemed.

Is it time to buy the telecom equipment suppliers whose stock prices have fallen 80% – 95%? While you would expect a value-oriented, bargain-loving firm like PDV Financial to swoop up the stock of these companies at such reduced prices, we have no desire right now to invest in these stocks. Why? There are a number of reasons.

The Financing Time-Bomb

As the capital markets shut out the new telecom companies last year, they had no choice but to slow purchases of telecom equipment. This was most unfortunate timing for the telecom equipment suppliers, as the Wall Street masses had pushed the companies' stock prices into the stratosphere in anticipation of years of rapid and uninterrupted growth. To maintain investor confidence and mollify Wall Street analysts, they had to find some way to prop up customer demand. The telecom equipment makers decided to become "bankers of the last resort" for their struggling customers, by shipping products to them on credit and booking the revenues immediately. These were only "real" revenues to the extent that the debt is repaid fully and on time.

Whether this comes back to haunt the telecom equipment makers depends on how adequately reserved they are for bad debts. The dirty little secret that they don't want anyone to know is that their reserving seems grossly inadequate. In essence, they have been overstating their true revenues over the past few years. The more demand slowed, the more sales they made on credit. With the avalanche of new telecom companies going bankrupt, unreserved bad debt losses are rising. Expect to see a lot more "one-time" bad debt write-offs that will likely be recurring (how's that for an oxymoron) to evidence just how under-reserved and over-stated their revenues have been.

Customers Turned Competitors

The former customers of the telecom equipment makers have become the latest thorn in their side, by unloading used and near-new equipment onto the market at a fraction of what it would cost to buy equipment directly from the telecom equipment makers themselves. The telecom equipment suppliers say they are not worried, but that's like whistling past the graveyard. Common sense suggests that the telecom equipment suppliers will see their sales hurt because of this. With so much resale products in the secondary market, it will take quite some time before these competing products are cleared off.

Demand Will Continue to Plummet

There are no signs of capital markets opening up to help further finance the new telecom companies. Private venture financing has also dried up, as even the ultra risk-takers are in no mood to lend more money to companies that have for the most part demonstrated their inability to earn a decent return on the money already invested. These companies are in no position to buy any more equipment from the telecom equipment suppliers, as they fight for survival and use whatever little cash they have left to service their debt.

Interest Rate Reductions Won't Help Much

We agree with the general consensus that the Fed will continue lowering interest rates for the foreseeable future. However, despite sizable interest rate reductions so far, the junk bond markets have not revived for the telecom market.

Even if lower interest rates eventually revived the junk bond market so that the new telecom companies could get additional capital, we don't think this will re-ignite capital telecom spending any time soon. It is highly likely that any money raised will be used first to pay down their crushing debt loads to prolong their survival, rather than for more equipment purchases.

Cyclical Growth Companies in Disguise

Now that the tide is out, we find that these telecom equipment suppliers are not "new era" hyper-growth companies after all; they are in fact cyclical growth companies that contract from time to time. They tend to bob up and down with the economy, though each new cycle should be higher than the last. As such, these companies deserve earnings multiples that are considerably lower than those accorded to them amidst the bubble.

For the Survivors, Contraction and Then Slower Growth

We expect the survivors in this industry to experience a prolonged period of contraction before growing again at much slower rates. We think the market will be surprised by how much these supposed hyper-growth companies will in fact contract.

We also believe their earnings over the past few years were aberrationally high, and that the level of their ***normalized*** earnings are in fact much lower. Growth from the lower base will also be slower. Our belief is based on several factors.

First, demand will continue to drop as more new telecom companies get into financial trouble. Growing bad debts will mean that the telecom equipment makers will no longer have the ability to prop up demand through easy credit. Unreserved bad debts will also reduce earnings.

Second, their earnings will no longer benefit from investment portfolio gains that were lumped together with operating earnings during the tech bubble, gains that originated from their investment in other tech companies during the boom. In fact, such gains are turning into massive realized losses, which the companies are now trying hard to separate from their operating earnings. But their net earnings are being hit by these losses.

Third, the precipitous drop in their stock prices has made their stock options worthless. To retain employees, they will have to begin resorting to cash compensation which, unlike stock option issuance, has to be passed through the income statement, reducing their earnings accordingly.

Fourth, with more fiscally disciplined capital markets going forward, future spending on equipment will need to be justified on a cost/benefit analysis. In many cases, equipment will not be purchased because the distant pay-off will not justify the huge upfront costs. In the meantime, the huge over-capacity in the industry still needs to be worked off.

If we are correct that earnings for the telecom equipment suppliers will contract first before growing again at much slower rates, then the stocks' current p/e ratios are actually much higher than they appear, as the "e" portion of the equation will drop much further. The stocks of these telecom equipment suppliers are therefore still overvalued in our opinion and should be avoided, despite the 80% to 95% drop in their prices.