



WorldCom: On the Verge of Collapse?

Executive Summary

And the hits just keep on coming On the heels of the recent departure of controversial CEO Bernie Ebbers, WorldCom announced on June 25 that it had fraudulently allocated \$3.8 billion in expenses to capital accounts throughout 2001 and into the first part of 2002. This accounting scandal comes as the company has been aggressively trying to rebuild investor, customer, and employee confidence in the wake of the recent management change, ongoing SEC investigations, and softening telecommunications demand.

WorldCom needs to take full responsibility for its current condition. Blame should be assigned swiftly among the executives and board members as appropriate, and those responsible should be removed. This is truly a self-inflicted wound. Experienced telecom executives and governors with reputations for integrity must be installed to restore the confidence of customers and employees. The new WorldCom leadership must maintain a laser focus on operations—no deal-makers need apply.

Assuming the debt issues can be alleviated, the lawsuit judgments aren't crippling, and sufficient assets can be retained, the company and the business model are viable if they are properly managed. Clearly that's a lot of ifs; but unlike other struggling telecommunications companies, WorldCom has assets, customers, and a revenue stream, and will not go gentle into that good night.

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I. Introduction

In 1998, brash, little-known WorldCom with less than \$8 billion in revenue shocked the telecom industry by making a successful bid for number-two U.S. long-distance giant MCI, a \$19.7 billion company. A short five years later, WorldCom—a company built on 75 acquisitions and boasting \$35 billion in revenue—is crumbling under approximately \$30

billion in debt and charges of fraudulent accounting practices. WorldCom's architects are gone. Former CEO Bernie Ebbers resigned in April, and on June 25 WorldCom CFO and vaunted financial wizard Scott Sullivan was forced to resign. The company acknowledged that \$3.8 billion of expenses were capitalized inappropriately from the first quarter of 2001 through the first quarter of 2002, and the company's financials will be restated reflecting a net loss for 2001. This newest revelation shatters the fragile sense of optimism that the new management team was building with its employees, customers, and investors. Is this the final nail in the company's coffin? Or will the company survive, and what will survival look like?

II. The New WorldCom?

The company's immediate future appears to be in the hands of the creditors; and while conventional wisdom says the company will file for bankruptcy, we will leave that analysis—including the impact on investors—to our financial brethren. Regardless of what happens in the near term, there are essentially four possibilities for the company: continue to operate, file for bankruptcy, be acquired, or cease operations. Each of these options has significant implications for the industry as well as WorldCom's major stakeholders, customers, and employees.

Continue to Operate

Assuming the company can convince its creditors to restructure its debt, WorldCom could continue to operate without immediately filing for bankruptcy. Under this scenario, the company would still have enormous debt that would have to be paid down or serviced, creating significant pressure to produce positive cash flow or sell assets. The good news is WorldCom has assets to sell; the bad news is the price for these assets is at an all-time low.

The company is already considering the sale of some assets deemed non-strategic including its wireless resale business and some of its foreign assets, such as the Brazilian long-distance incumbent Embratel and Mexican competitive provider Avantel. In Latin America, WorldCom was never able to create and leverage the synergies between its Latin American properties that it promoted in the press and to the analyst community. Although aiming to rejuvenate Embratel in Brazil, operations remain status quo; Embratel continues to lose market share, especially to incumbent local operators that will profit from market liberalization and will attack the national and international long-distance segments. In fact, our model shows the combination of lower market share and price erosion will reduce Embratel's long-distance revenue (which represents 75% of its total current revenues) by 30% in 2003. In Mexico, Avantel was embroiled in regulatory battles with incumbent Telmex, and was not able to gain much market share in either the long-distance or corporate data markets. Although both Embratel and Avantel talked of entering the enterprise local markets, all plans have stalled over the last year.

The spin-off of MCI is another option for the company. Such an action was considered, but the company opted to maintain control of MCI (and its cash flow) in an effort to manage its financial structure. Unless WorldCom can raise enough cash, its operational viability is questionable. The company's consumer offering, "The Neighborhood," will be affected, as WorldCom will not have enough resources to continue to support the marketing and customer acquisition strategies behind this offering.

Whether these assets would raise enough cash to stabilize the company would depend on how the debt is restructured; but if they are insufficient other more strategic assets may also be included, essentially changing the nature of the company. For example, the sale of the pan-European network would convert WorldCom from a facilities-based global provider to a domestic carrier, eliminating a significant competitive advantage for serving multinational corporations (MNCs).

Under the microscope, however, WorldCom is a tarnished jewel in Europe. WorldCom's pan-European network is one of the least attractive in Europe's fiber-rich distressed asset pool. Metropolitan capacity aside, which is largely own build, WorldCom's meager long-distance fiber assets consist in large part of fiber leased from national utilities, such as highways, or joint builds conducted at high prices with hefty ongoing operations and maintenance charges. Also likely to be on the table is WorldCom's network construction arm, MKI, a moribund organization over which WorldCom has been dithering for almost two years. After all, who is building in today's market?

If the debt burden is not reduced, the pressure to produce cash from business operations will be intense. With demand depressed by economic conditions and an industry recovery nowhere in sight, significant positive cash flow may be elusive. This could force the sale of more assets, keeping the company in a state of continual turmoil.

Clearly, to generate significant cash flow, it is critical that WorldCom retain and grow its customer base and revenue stream as well as reduce costs. With WorldCom's reputation for tight expense control, the primary cost reductions will be personnel. In fact, there are already reports that an additional 17,000 employees will be released soon. Yet for the company to grow revenue it must retain critical technical, customer service, and sales personnel. We expect that without considerable incentives, key personnel will opt to leave the business under this plan; and without the assurance of key customer-facing personnel there will be significant defections, particularly among medium and large business customers. A "continue as is" scenario is clouded with uncertainty and could eventually lead to bankruptcy. Even if the creditors agree, this is a high-risk plan.

File for Bankruptcy

Filing for bankruptcy has some significant positives for the company's long-term viability, including the elimination of debt and creating a stable environment more quickly than a "continue as is" plan. In line with conventional wisdom, we see this as the most likely scenario. Bankruptcy will be painful, but the pain will be acute rather than chronic. The company will submit a restructure plan clearly articulating the road map for recovery. While the success of this plan will depend on the company's ability to execute effectively, customers and employees will have an opportunity to judge the viability of the plan and the company in relatively short order.

WorldCom, unlike many communications companies that have filed Chapter 11 bankruptcy, has a robust product set for all segments of the market and a significant broad base of revenue-generating customers. Assuming WorldCom can retain this customer base through the restructuring period (by no means a sure thing), the company can emerge from bankruptcy with a lighter debt load or even debt free and positioned to compete.

While bankruptcy may be cleaner than continuing as is, it will not be easy and there is no guarantee that a restructured WorldCom will succeed. Key to the company's success is once

again its ability to retain key personnel (technical, customer support, and sales) and profitable customers. Critical customers include enterprises (businesses with more than 500 employees), and to retain these customers WorldCom must convince them that it is and will be a going concern with the technical capability, customer service and support, network reach, product set, and capital required to address the complex problems of these large corporations. Capital is essential not only to provision and maintain subscribed services, but also to invest in new product development, service, and support innovations that are key to offering competitive products to this very savvy buying group, as well as operational and systems efficiencies that reduce costs and keep a company competitive. WorldCom has already made efforts to reassure the “logo” accounts, but these new issues are likely to undermine the company’s first attempts. Businesses in general and enterprises in particular rely heavily on communications to meet their business goals. WorldCom must come completely clean about its financial situation, quickly determine its course of action, and begin effectively executing the plan to reestablish its credibility with this constituency.

Be Acquired

Acquisition is a possibility but not a probability. An RBOC or a foreign-based carrier anxious to move into the U.S., European, or Latin American enterprise market may want to acquire the WorldCom enterprise salesforce, product set, and national and international network, but no one wants the debt or the potential liability that a successful shareholder’s suit could impose. Indeed, the salesforce is not as strong as in the recent past due to layoffs and defections, and customer service has suffered in this segment. Despite a dominant position in the European corporate networking market, the customer base is not as strong as it may initially seem. In recent years, WorldCom has been squandering a good reputation with European businesses that it won through MFS, the business-focused metropolitan carrier it bought in 1997. European businesses complain regularly of WorldCom’s cumbersome, incumbent-like behavior and off-hand customer management services. Although alternate choices are few, there is an exodus from WorldCom to other players with expanding European strategies, such as AT&T.

Exacerbating the poor customer service record is the fact that WorldCom has never succeeded in integrating the back-office systems of its various acquisitions, most notably MCI. For a company arrogating to itself the position of a next-generation carrier, it is really an old tech dinosaur.

Further complicating an acquisition is WorldCom’s admission that its accounting practices were fraudulent. It is likely that the shareholder class-action suits already announced will result in substantial financial judgments that would accrue to any acquirer. In addition, there are regulatory restrictions that would have to be addressed before either an RBOC or a foreign carrier could consummate this deal.

Rather than acquiring the company, it is more likely that competitors would pick and choose among the valuable assets including hiring away sales and technical personnel as well as pursuing vulnerable customers, rather than making a bid for the company in toto.

Cease Operations

WorldCom may have to cease operations, but not in the near term (6–12 months) unless there are further revelations or telecommunications demand contracts significantly. WorldCom,

along with AT&T, is one of the two primary suppliers to the top end of the U.S. enterprise market. Large corporations generally use multiple providers to meet their communications needs, and they typically have two- to three-year contracts with these providers. We expect current WorldCom enterprise or MNC customers to stay with WorldCom through the life of their contracts because they have existing relationships with alternative providers and are not solely reliant on WorldCom for communications services. Also, switching providers on the fly is difficult and, at times, painful. However, small and medium businesses (SMBs, companies with less than 500 employees) reliant on a single provider and without long-term contracts are likely to switch more quickly.

WorldCom's ability to attract new customers and new opportunities with existing customers will slow appreciably or evaporate entirely until the situation is more stable. Customers currently renegotiating contracts are likely to limit their exposure to WorldCom.

One of the critical consequences of a WorldCom failure is the future of its Internet backbone and the impact on consumers, businesses of all sizes, and other carriers if this asset is not operational. In the United States and around the world, the WorldCom UUNET Internet backbone is among the top Tier 1 Internet backbones. The overall Internet access market, both narrowband and broadband, will face severe consequences as a large number of ISPs utilize WorldCom's Internet backbone for data transport.

If WorldCom goes bankrupt, following on the heels of the KPNQwest failure (another major IP provider in Europe), the European Internet may also fall into crisis. WorldCom is a major driver of cross-border traffic flows in Europe and beyond, with a strong position in IP transit and associated IP wholesale services. Other IP transit players will need to scramble to pick up the WorldCom business, but serious hiccups may occur in service continuity during this process.

This is also a major issue in Latin America, where WorldCom and Teleglobe are two of the dominant IP transit providers for ISPs throughout the region. With Teleglobe selling off its Latin American "non-core" assets, and now the likelihood that WorldCom will do the same, there will be a major void in Internet connectivity. It is likely that Telefonica or Telecom Italia will seize the opportunity to more firmly entrench themselves in the region by taking over some of this business. However, transit buyers in Latin America, previously accustomed to purchasing backhaul and provisioning in a single sequestered facility such as WorldCom's POP in south Miami, will have second thoughts. Many will seek broader transit markets such as the NAP of the Americas. Purchasing from Tier 1 transit providers in a location where multiple service providers have established a POP will be perceived as lower risk and will become the norm in the region.

If the company is forced to shut down operations it will not only have serious ramifications for the telecom sector, but will also delay the economic recovery in the technology sector.

III. The Competition

WorldCom is the second-largest U.S. long-distance company, and one of two primary providers to the most powerful companies in the United States and around the world. It is a major provider to enterprises, U.S. and European SMBs, and U.S. consumers. It has local, national, and international assets as well as a robust service portfolio. However, the rapidly

deteriorating situation at WorldCom provides a clear opportunity for alert and savvy competitors.

Companies to watch include the IXC, RBOCs, and foreign-based carriers. The U.S. RBOCs will clearly pursue the consumer and SMB customers in states where they have Section 271 long-distance approval and can offer long distance as well as local and Internet access services. The RBOCs do not have the service portfolio or the network reach to fully serve the enterprise market. The cable companies with telephony capability will also attack the consumer and small business market. Inevitably, WorldCom's troubles present other IXCs such as AT&T Consumer, Sprint, and Excel as well as the RBOCs with the opportunity to step up and take share away from the company. Specifically, the RBOCs with their continuing entry into long distance are well positioned to grab a greater share of the consumer long-distance market as well as retain their local customers should The Neighborhood falter.

AT&T will certainly leverage its strength in the top end of the U.S. enterprise market (*Fortune 5000*), penetrating deeper into existing accounts and penetrating additional accounts in this segment as well as enterprises below the *Fortune 5000*. This could be a double-edged sword: if AT&T is too successful it may be vulnerable to charges of establishing a monopoly, especially in the top end of the enterprise market—a charge “I would love to defend,” said a senior AT&T official. Clearly, AT&T will also press its advantage in Europe and the rest of the world as well.

Understanding that most businesses want choice, Sprint also has a substantial opportunity to take share across the business market. Sprint must gear up its salesforce (there are plenty of qualified sales reps and managers available) and demonstrate and emphasize its own financial stability as well as its ability to execute to seize the moment and the momentum. Qwest could also take share, but the company has its own stability issues and is unlikely to actively pursue this opportunity as it sorts out its own strategic focus. Broadwing is also likely to benefit.

Foreign-based carriers such as Equant, Infonet, Cable & Wireless, T-Systems, and NTT America are positioned to attack the U.S.-based MNC market in particular, but these companies also have the capability to serve at least some of the U.S. domestic needs of large enterprises. Around the world other players will press the advantage. For example, in Latin America, Telefonica, Telmex and its subsidiaries, Impsat, domestic operators, and to some extent AT&T Latin America are likely to provide the greatest competition in the short term.

IV. Conclusions

While there are several possibilities for WorldCom, the most probable outcome is Chapter 11 bankruptcy, which will allow the company to try to reorganize and become a going concern. WorldCom needs to take full responsibility for its current condition. Blame should be assigned swiftly among the executives and board members as appropriate, and those responsible should be removed. This is truly a self-inflicted wound. Experienced telecom executives and governors with reputations for integrity must be installed to restore

confidence in customers and employees. The new WorldCom leadership must maintain a laser focus on operations—no deal-makers need apply.

The clear and present danger for WorldCom is not bankruptcy, but the threat that the ongoing investigations by the SEC and others including its own internal audits may uncover more wrongdoing. Customers, employees, and investors no doubt are waiting to see if another shoe is about to drop, but they won't wait long.

WorldCom must act swiftly to uncover the full extent of its financial issues and realistically assess whether it can reasonably overcome its current difficulties. Bankruptcy would protect the company's assets while this assessment is completed, but this must be done swiftly or there will be few customers or employees left when it is done. Assuming the debt issues can be alleviated, the lawsuit judgments aren't crippling, and sufficient assets can be retained, the company and the business model are viable if they are properly managed. Clearly that's a lot of ifs; but unlike other struggling telecommunications companies, WorldCom has assets, customers, and a revenue stream, and will not go gentle into that good night.