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WorldCom: Is There Life after Death?

Thursday, May 30, 2002
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The regulators and the Fed nearly killed WorldCom -- now they may have to try to save it.

WorldCom has rallied as much as 53% in the two weeks since it was ignominiously ejected from the S&P 500 Index on May 14. Low-priced securities of distressed companies are often subject to such large moves in percentage terms. But WorldCom's rally following its symbolic humiliation at the hands of **Standard and Poor's** gets my attention, and makes me wonder: has a bottom been reached for this beleaguered company? But perhaps the more important question is: *does WorldCom have a future?*

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The crux of WorldCom's future is the fact that it may be "too big to fail." As the largest single provider of Internet backbone data transport services, WorldCom's facilities are a strategic asset of the United States that cannot be permitted to go out of service. Seeing WorldCom restructured gracefully is surely an important priority of the **Federal Communications Commission** and the **Department of Defense** (yes, the Department of Defense -- is there anything more critical than communications in the war on terrorism in the homeland?). And considering WorldCom's heavy indebtedness and its status as a bellwether for the distressed telecom sector, the **Federal Reserve** will be watching closely, too.

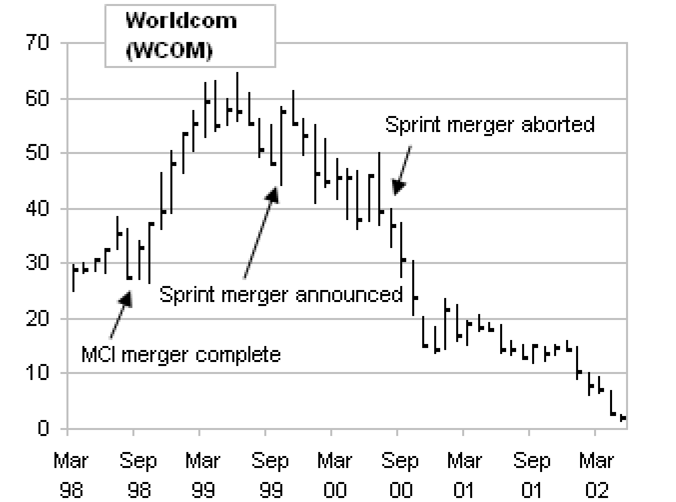
To find partners willing to take the risks necessary to keep WorldCom's facilities alive, regulators may have to bend some of their own rules about pricing and competition. And to keep lenders in the game, the Fed may have to keep interest rates low for longer than they might otherwise wish, effectively acting as a lender of last resort as they did when they brokered the shotgun restructuring of **Long Term Capital Management** in 1998.

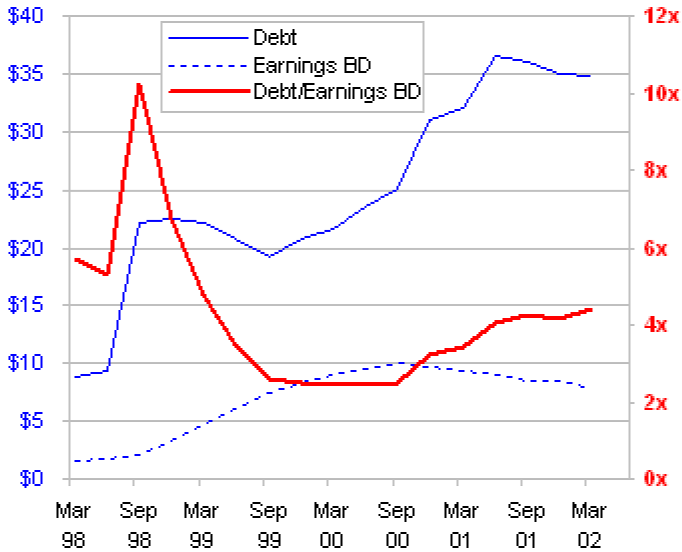
It's tragically ironic that WorldCom's best hope now is that it will be deemed "too big to fail" by regulators and the Fed. In large part the company's predicament is the result of the very same institutions having judged WorldCom to be "too big for its britches" two and a half years ago.

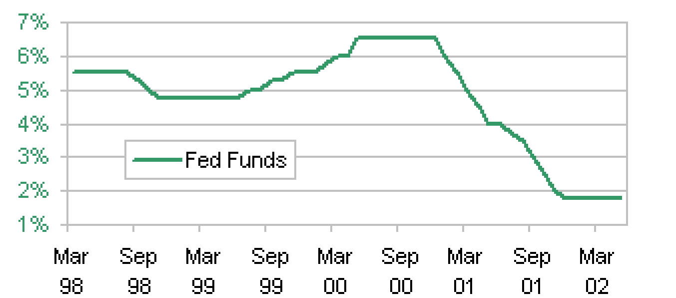
WorldCom's troubles began in October 1999 when the company announced that it would merge with **Sprint** -- having completed a merger with **MCI Communications** only a little more than a year earlier. The merged company would boast "...revenues of more than $50 billion, a market enterprise value of approximately $290 billion and significant operations in more than 65 countries."

The merger announcement was one of the catalysts for the NASDAQ's bull run to 5000 over the next six months. But after a brief rally, WorldCom's stock didn't participate. Soon it became clear that the FCC and the **Department of Justice's Antitrust Division** would oppose the merger. In June 2000 the DOJ filed a suit seeking an injunction against the merger -- and several weeks later WorldCom and Sprint called the merger off. Abandoning the merger was a severe blow for

WorldCom because its corporate strategy was based on revenue growth by acquisition --and margin growth by realizing economies of scale and consolidating excess competitive capacity.







At the same time WorldCom's financial structure was under attack by the Fed. In June 1999 the Fed began raising the Fed funds rate -- it would enact six hikes in less than a year, aimed at choking off what **chairman Alan Greenspan** saw as excessive stock speculation and excessive borrowing. With its cost of both equity and debt capital increased -- and further major acquisitions forbidden -- WorldCom found itself disarmed, and with no strategic future, able to make only uninteresting deals on bad terms.

Today the only deals WorldCom is making are the ones that help it stave off bankruptcy another couple months, such as [last week's receivables securitization] with **JP Morgan Chase** and **Citibank**. As it limps from deal to deal, income excluding depreciation and non-recurring items just keeps declining -- and all that debt just isn't going away.

Having nearly killed WorldCom, the regulators and the Fed now may have to try to save it. But can investors make any money on it if they do? If WorldCom's salvation comes in the form of a shotgun debt restructuring *a la* Long Term Capital Management, today's stockholders would be left with nothing. But if it comes in the form of a **Chrysler**-style bailout with government loan guarantees -- or if regulators permit a consolidation merger of the very type WorldCom tried to engineer voluntarily two years ago -- today's stockholders might manage to hang onto something.

Perhaps an interesting speculation. But a WorldCom that is only restructured *financially* may not be a very interesting long-term growth investment. Growth will only come if antitrust regulators permit the resumption of WorldCom's growth-by-acquisition and consolidation strategy. That's because the same technological imperatives that are making recovery so difficult for the semiconductor industry are operating even more harshly on the telecom sector -- and make rapid growth a *sine qua non* of economic survival.

For semiconductors, **Moore's Law** -- which predicts that the cost-effectiveness of integrated circuits will double every 18 months -- means that, in the absence of offsetting market growth, revenues will fall by half every 18 months, too (see "Semiconductors: Down By Law" May 22, 2002). Telecom has its own version of Moore's Law: **George Gilder** was the first to point out several years ago that the cost-effectiveness of communications bandwidth is growing even more rapidly than that of semiconductors, thanks to optical technologies such as dense wave division multiplexing (DWDM).

Gilder was right to envision an explosion of new uses and new users for a formerly scarce and expensive good made suddenly abundant and cheap. But he failed to foresee that the telecom industry could face insurmountable revenue growth challenges if end-user growth failed to more than offset collapsing prices.

For WorldCom, the path to that growth was consolidation and competitive dominance. So the Fed can keep rates low for a while longer, debt can be restructured somehow. But unless that path to consolidation is unblocked, a financially restructured WorldCom will have no other future than as an oxymoronic "competitive utility" -- unregulated enough to slowly starve to death along with the rest of its competitors, but too regulated to thrive. TM