Payden & Rygel Global Ltd.

eye on the market

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DISAGGREGATION/ REAGGREGATION: Global Telecoms Come Full Circle

Governments, investors, and the private sector around the world are experimenting with how to best deliver ever-evolving communication technologies to consumers. The current dilemma of Europe's telecommunications industry demonstrates how mixing business models with politically mandated competition may not be the most effective choice.

Piling on the Debt

In recent years, Europe's newly privatised Ministries of Posts, Telegraphs and Telephones (then called PTTs, now Telecoms) imprudently pursued growth on the backs of their balance sheets; protecting their equity, piling on debt, and creating a huge drain on cash flows. They invested vast sums of money expanding overseas and bidding for licenses for spectrum to provide "third-generation" (3G) mobile phone service. Hamstrung by debt, Telecoms still require a hefty amount of investment capital to build out the 3G network infrastructure. The Telecoms assumed that the capital markets would provide the funds, but markets have reacted sceptically to bloated Telecom balance sheets. Nor has the industry fully convinced funders of consumers' unquenchable demand for 3G technology. All of this uncertainty translates into a lack of access to capital.

Demeter, Greek Goddess of Grain and Fertility adorns 62 Cornhill, London. Payden&Rygel Global Ltd. offices are located at 62 Cornhill near the old Corn Exchange.

In Europe's wireless space, governments believed that the competitive approach would bring cutting-edge telecom service to consumers quickly and cheaply. On the contrary, intense competition for licenses drove up license prices, virtually breaking the back of the newly privatised Telecoms. (Some observers criticize governments for over-issuing licenses. In Germany, for example, where the market could potentially absorb three players, six licensees now operate.) The bottom line is that 3G is not anticipated in Europe before 2004 at the soonest.

We All Make Phone Calls, So What's the Problem?

Why, in an industry that seems to be growing so fast, are companies struggling so much? The answer is simple — competition.

Twenty-five years ago, real competition in telecommunications was inconceivable. Government regulations and monopolistic markets created an industry run on inflated prices and inefficient business practices — and devoid of customer service. In the United States, where telecom giant AT&T's national long-distance network overpowered competitors, the industry lacked vitality and growth. In Europe and globally, cumbersome regulations gave consumers few telephone service options.

The age of monopoly was declared over in 1984 when AT&T was dismantled in the

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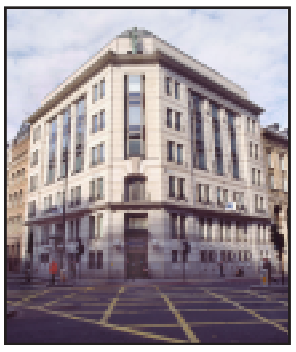
States and the Telecommunications Act deregulated long-distance phone service in the U.K. Most developed economies followed suit throughout the nineties.

The U.S. has undergone a post-deregulation change of philosophy in which regulators are moving toward a compromised model. Today's four regional bell operating companies (RBOCs) are the reaggregation of the former Baby Bells spun off from AT&T. American long distance companies, which were numerous after deregulation, now number only three major players, all of which are struggling to survive due to deregulation allowing RBOCs into the long distance market. The current trend in the U.S. is for once-disaggregated market segments (long distance, wireline, wireless, internet) to reaggregate.

A similar change of heart is evident among European regulators who have backed off their previous stance of complete competition to a middle ground allowing wireless operators share certain costs and facilities. The entire industry is settling around a oligopolistic model which, in our opinion, is a more sustainable model for asset-intensive, formerly regulated industries going forward.

Competition has created a heady environment for consumers who enjoy undreamt-of pricing, but from an investor's perspective, it has converted a playing field into a minefield. The stock market has seen a pummelling of Telecom shares, with the Dow Jones Total Market Telecom index falling 42% since the beginning of 2001. Previously high-flying companies have lost substantial value; other strong companies like AT&T have been dragged down "by contagion." Telecom bonds have severely under performed and in some cases led to defaults or bankruptcies; others are in the "Fallen Angel" category, i.e., investment grade issuers now downgraded to junk bond status.

What's an Investor to Do?



Telecom investment, which represents a large component of both stock and bond indices, has become a drag on index performance, an impossible-to-avoid '800-pound gorilla.' We do not see a catalyst on the horizon to spur improved performance for the rest of the year.

Prudent investors should remain extremely sensitive to risk tolerance and risk management. Pick bets carefully. Stick with companies that have strong balance sheets, customer-based business models, and management track records that indicate they can survive this difficult period. And don't forget to phone home ...

Key Terms

3G – "third-generation" mobile phones offering Internet browsing and video display

deregulation - the act or process of removing restrictions and regulations

monopoly - exclusive ownership through legal privilege, command of supply, or concerted action; a commodity controlled by one party

oligopoly - a market situation in which each of a few producers affects but does not control the market

spectrum - the range of electromagnetic radio frequencies used to transmit sound, data and television

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