Analysis - Tide Turns in Telecom Consolidation

By Keith Mallinson Friday, June 15, 2007

AT&T's merger with BellSouth was a high water mark for telecom consolidation. The tide is now on the ebb with the announced $27.5 billion private equity purchase of Alltel by TPG Capital and Goldman Sachs. Private equity sets strong management incentives and creates a unique financial performance benchmark with this pure-play wireless operator. Large and diversified, publicly held carriers AT&T, Verizon Communications and Sprint Nextel will be under increasing pressure to deliver comparable financial returns to a highly leveraged Alltel. If they falter, they also will become targets for buyouts and breakups based on the private equity market's appetite for cheap debt, highly leveraged investments and drive to separate high-performing from low-performing assets.

While most large North American carriers have been seeking to combine wireless with wireline ownership, Alltel has done just the opposite. It has bulked up in wireless voice and broadband EV-DO to 12 million subscribers by separating wireless from wireline. In 2002, it bought the wireless assets from fixed and mobile operator CenturyTel. It acquired Western Wireless in 2005 and Midwest Wireless in 2006. It spun off its own legacy wireline operations in 2006.


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Nobody knows for sure whether diversified carriers offering double, triple or quadruple plays and combining telephony, Internet, TV and wireless will deliver superior competitive performance than standalone wireline, cable or wireless companies. If Alltel was being acquired by Verizon Wireless or AT&T, we might never find out. There are precious few wireless pure-plays remaining that are in a position to prove the alternative business model's full potential. Leap and Metro PCS are much smaller than Alltel and have succeeded through pursuing what is currently still a niche strategy with their low-price no-frills services. T-Mobile USA is independent of a wireline partner, but is strategically compromised by the German parent's commercial and political constraints with its troubled wireline business in the home market.

Alltel – a focused market participant with significant market shares in its licensed territories – will surely give the diversified carriers a run for their money, where they compete directly and as an example nationwide. Alltel's executives will be highly focused and well-rewarded for financial performance with a debt burden likely to rise from 1.3 times annual operating cash flow today to a multiple of perhaps seven or more. The example Alltel sets also will keep the executives at the diversified carriers on their mettle – to the benefit of all telecom consumers and shareholders alike.

WHO'S NEXT?

Another buyout deal for a major carrier will most likely soon ensue. Bell Canada Enterprises, a diversified carrier with all four quadruple play elements, is on the block after four years of share price stagnation. One hurdle is to sidestep foreign ownership restrictions. It remains to be seen whether local private equity owners have the stomach to restructure its sprawling operations.

Sprint Nextel is also an obvious candidate, although it is unlikely to be so willing a patient for the leveraged buyout treatment as Alltel. Similar to Alltel, Sprint Nextel wisely spun-off its wireline access business, under the name Embarq, in May 2006. What remains, is a poorly performing mix of several different networks and businesses facing significant challenges. Sprint Nextel presents thorny dilemmas for the private equity buyers. Reining in expenditure is a tried-and-tested formula for success in many buyouts, but it is precisely this kind of throttling back on iDEN capital investment in anticipation of migrating subscribers to CDMA that has caused the recent problems with customer retention. Making matters worse, it is also committed to a variety of risky new ventures including conversion of its push-to-talk customer base to CDMA2000-based Q-Chat, its Pivot quad-play joint venture in conjunction with cable operators and its WiMAX foray.

Private equity is often confused with venture capital, but there should be no mistaking these highly leveraged debt deals. They are based on squeezing incremental performance out of proven, cash-generating businesses that can service massive debt loads. Leveraged buyouts are for investing in established businesses, not startups. Private equity deals with heavy debt burdens do not support unproven initiatives. For Sprint Nextel, a buyout will most likely result in cutting back, running from or spinning out some of its more speculative schemes.

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