INDUSTRY CONSOLIDATION
FUTURE TREND OR SURVIVAL STRATEGY

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Introduction

Some comments on technology, without looking at my papers - who said the following and when. “If you don't know where you are going, any route will get you there.” *The Quran*

Do we know where we are going? In many cases – no. The wide range of technological choices and uncertainties of deregulation have created the mindset of “if its profitable let's do it”.

The US Regional Bell Operating Companies are itching to go back into long distance, while imaginative software developers are selling products that let's one call virtually free, on the Internet. Others have established unlicensed Web broadcasters at very modest capital costs.

Why is it that many managers have lost sight of “shareholder value”, forgetting that the shareholders own the company. I believe, for a firm's shareholders, that a profitable alternative to the consolidation that has been occurring, is <u>simplification</u>. Decide to do one thing, specialize in it, do it well, and become the lowest cost supplier through efficiency and technology. If you don’t, you may be on the wrong side of history; three examples:

1. "No Future" - Lord Kelvin, discoverer of absolute zero, on radio (1908).
2. "Who wants that?" - Harry Warner, founder of Warner Bros. on talkies (1929).
3. "Commercially and financially impossible" - Lee de Forest, developer of the vacuum tube, on television (1934).

The Nature of Information Businesses Has Changed

Ten years ago, Information Businesses could easily be categorized. There were telephone companies, broadcasters, cable operators, TV and film producers, computer manufacturers, software developers, record creators, book, magazine and newspaper publishers, and consumer electronic manufacturers. Today, everybody has diversified into many businesses; leaving very few "pure plays".

This spread of interests is in the news nearly every day. In January, 1995 some of the more interesting items reported were:

1. MCI paid US $682.5 million for a nationwide broadcast satellite license. It is forming a 50-30 joint venture with News Corp to use the license to sell what it describes as a "unique package" of video, audio, information, and entertainment services to business and consumers in all 50 states and Puerto Rico; most of Canada will lie within the satellite's footprint.
2. Bell Canada is "looking at packaging services between the personal computer and the TV". An example is a sports production with broadcast, interactive and simulation components. They have applied to the CRTC to conduct technology tests in 1996, followed by marketing tests in 1997.
3. The Cable industry made a submission to the CRTC to supply two way local communications over cable TV networks by 1998.
4. The (UK) Cable Communications Association proclaimed that at September 30, 1995, cable passed 55,705,000 British homes. Of these, 1,216,375 (21.8%) used cable for local telephone services and 1,159,774 (20.8%) to obtain TV signals.
5. Sprint Canada targeted the spring of 1997 for the launch of its own local telephone services as a way of selling its long distance offerings.
6. AT&T announced a US $4.18 billion charge to cover 40,500 job reductions. It reported a 4.8% rise in long distance revenues on a 9% increase in traffic volume.
7. Sprint of the US, Deutsche Telekom AG and France Telecom completed the formation of a new "Global One" telecommunications alliance. It will compete with Concert, operated by MCI and BT (British Telecom) as well as with World Partners, a collection of international alliances led by AT&T.
8. Sony will ship "its first personal computer" in late 1996.
9. AT&T Paradyne announced its new Globe Span chip set. This uses a technology called Asymmetric Digital Subscriber Line that gives one way data speeds about 200 times faster than the high end modems currently in use. It is expected to be commercially available in parts of the US during 1996.

Mergers and Acquisitions Are Common

Industry consolidation always involves mergers and acquisitions. When considering entering a new area of business, a company can either build up a ne firm or buy an enterprise. The cost of creating a new and successful organization in a different segment of the Information Business will take time and likely have an immediate adverse impact on profits and earnings per share ("EPS"). On the other hand, acquiring an existing, successful firm can often improve profits and spread out the effect on EPS of the write-off of the premium over asset values, over a long period; goodwill can be amortized for up to 40 years.

In an acquisition, the buyer usually has to pay a premium over the quoted market price of the target's shares, or if still a private company, a premium over the relative value of comparable public entities. This is done in the belief that the combined enterprise will be worth more than the sum of the two separate parts. Unfortunately, this rarely happens; in many acquisitions, the premium is merely a transfer of future benefits from the purchaser's shareholders to the sellers. This is particularly true in transactions involving Information Businesses.

Such acquisitions, including many of the news items listed, above are examples of "Convergence". This term, which has been very much in evidence in recent years, refers to a business combination or strategic partnership between companies in Information Businesses.

According to Crosbie & Company Inc., in Canada during 1995, there were 62 announcements of mergers, acquisitions, or offers, totalling $11.3 billion concerning Canadian companies in the communications, broadcasting, motion picture, amusement, or recreational services field. This figure includes Seagram's (still a Canadian enterprise though run from New York) purchase of 80% of MCI (Universal Studios). Excluding that "Whopper", the $3.5 billion total was still significant.

1995 was also an active year for convergence mergers in the US. A number of well publicised transactions changed the face of several industry segments. Westinghouse bought CBS, becoming one of the largest operators of Radio and TV stations in the world; Disney obtained Capital Cities/ABC; TIME-Warner is close to buying Turner Broadcasting, and IBM absorbed Lotus. Few convergence mergers have had a long enough history to be able to draw reasonable conclusions about shareholders returns, but often, the record has been unsatisfactory.

Before 1995, the largest convergence transaction was the acquisition, by TIME, of the Warner organization. This resulted in Time Warner's stock declining from $48 (adjusted for a split) in 1989 (before the acquisition) to $16 in 1990, largely due to substantial losses from interest on it’s over $10 billion of debt. Since the mergers, Time Warner’s EPS have always been negative due to large interest payments and the amortisation of goodwill.

Another unsatisfactory example is AT&T's acquisition of NCR (National Cash Register) in 1991 for $7.4 billion in stock; since then, the acquisition has lost money virtually every year, for a total of nearly $3 billion. In September 1995, AT&T announced the intention to spin off, what by then had become AT&T Global Information Systems, as well as its long time owned network equipment business. This announcement added $11 billion to AT&T's market capitalization in a single day, more than enough to make up for the cost of purchasing NCR and the ensuing losses.

There have been merger frenzies in the past, similar to those of 1995, when diverse players entered the Information Business. Examples are CrisCraft, a boat manufacturer gobbling up television stations, and Gulf & Western, an auto parts company buying Paramount, a movie studio; none of them did very well until they decided which business they were really in. The major successes along those lines have been diversifications by tobacco companies, but that's another story, perhaps driven more by fear than by the profit motive.

The Current Situation

From this frenetic activity in the Information Business, two trends emerge:

The first is the need to spread the risk of creating information or entertainment content (mainly the cost of the "talent") over as many means of distribution as possible.

The second is the desire to offer “one stop shopping” to consumers. This is most noticeable for phone companies in the US, which dream of a return to "Ma Bell", which had seamless integration of local, wireless and long distance service for not only voice but also data, all on one bill.

As most companies are no longer only in a single segment of the Information Business, new categories are needed. Braxton Associates have developed what appear to be the most useful. They divide Information Businesses into four groups which cut across traditional industry lines:

1. Interface: software and on-line suppliers that allow users to make use of information more interesting with electronic devices;
2. Terminal: computer and electronics manufacturers that produce devices to send, process, and receive information;
3. Conduit: telecommunications, cellular, theatre, satellite and cable organizations that transmit content;
4. Content: publishers, creators and developers of information and entertainment products.

Each category is regarded differently by the stock markets. My firm, Corporate Valuation Services Limited, analyzed quarterly data from the Braxton database over the five years March 1990 and March 1995 for each category.

For instance, local telephone companies tend to be assessed on future dividend growth, while cable companies values depend on the number of subscribers, as well as on their cash flow, most of which has to be applied to repay debt.

Broadcasters sell at relatively high multiples of cash flow, because they are considered to have relatively low risks, while the values of film companies, which may have wildly fluctuating earnings, depend less on the number of hits they turn out ina year than on their libraries of past productions.

Cellular companies tend to be valued on the population in their service area and their degree of penetration, while long distance companies are judged solely on earnings and book value.

Shareholders Return Is Often Ignored

With deficit parameters diluting the values in different segments, mergers between companies in different categories can be prohibitive.

While they may seem utterly rational to both firms' management, investors may not agree that such measures add value; our theory is that what strategically seems a perfect fit, may not benefit the shareholders of the combined enterprise.

In particular, it is not true that "bigger is better", even though some transactions quickly become extremely seductive; who would not believe that adding a cable system could not be very advantageous to a telephone company? Or that it would be good for a broadcaster to merge with a film producer? How about a national cellular company buying into a long distance supplier?

Increasing Shareholder Return is becoming the principal reason for being in business; the shareholders own the company. A merger that creates a bigger company with less debt but lower EPS may not be in the shareholders interest.

What do shareholders want? In general, rising EPS, comprehensible risks and the minimum of surprises; in the US, when companies surprise investors by reporting EPS only slightly less than expected, their stock many times drops sharply.

To boost shareholder return, a company needs to have its stock steadily rise in price. This can be achieved by increasing the growth rate in earnings per share, or enhancing the multiple by managing to lower the risks.

Methods to improve growth in EPS include: accelerating revenue growth by premium priced new services; lowering costs by replacing people with equipment; enhancing return on equity by financing expansion with debt. Risks can be managed lower by understanding the market and often through combining operations with those of a competitor, in order to enlarge the service area.

The Alternative

Because of differences in the determinants of value, the merging of companies in different sectors will not necessarily increase shareholder value. Therefore, I believe that companies should look at alternative strategy: rather than convergence and trying to be all things to every customer, simply look at what you do best and decide to do it as well as you can, and specialize. Coincidentally, your investment towards lowering costs and offering premium products look to me toward the lowest cost supplier. Dave Nicol, famous for the “President’s Choice” private brand label, wrote the book on this; very profitably. In the grocery world he has lots of imitators. In telecommunications, cable and broadcasting sectors, very few.

