

# Pipeline

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## Telecom 2007 Year in Review: Looking Newer Every Day

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As 2007 was winding down, major players from different regions and previously distinct industries were taking aim at each other. Increasingly, competition is not two telcos squaring off; it's a telco wrestling with a cable MSO, or an application developer seeking concessions from a wireless carrier. New technologies, expanded capacity, and extended coverage seem to come online every day, making the industry seem new with virtually every passing day.

### The Changing Face of Competitive Players

Although 2007 was a bit quieter on the M&A front compared with recent years, there were still several moves that reflect the changing nature of the competitive landscape. As an industry, telecom benefited from rosier valuations and easier access to capital in the first half of 2007 than it had in recent years; how long these conditions last will dictate near-term activity.

The year began with *AT&T closing its acquisition of BellSouth*. To the chagrin of some competitive carriers, the deal gave AT&T control of the local incumbent facilities in four of the seven post-divestiture Baby Bell territories. Even more important to its long-term strategies and profitability, the move consolidated control of Cingular—formerly a joint venture between SBC and BellSouth—under the AT&T logo. Wireless continues to drive profitability across telecom, and with new services like 3G data, mobile video, and location-aware social networking and gaming on the horizon, AT&T will have control of its own destiny.

In a sign of the *growing importance of scale and network reach*, competitive carriers did their part to keep pace. PAETEC closed its merger with US LEC in February, then in September announced that it would acquire McLeodUSA, extending the company's footprint from coast-to-coast and adding dozens of new markets. In March, Integra Telecom announced its purchase of Eschelon, which upon its August close created a western-states super CLEC with combined revenues north of \$700 million. RCN acquired NEON, the northeastern fiber network operator, strengthening the combined company's fiber reach.

Telecom also saw its share of interest from *private equity investors* in 2007, further evidence that the financial world viewed telco assets as undervalued. In

June, a private consortium that included two U.S. equity firms agreed to buy Bell Canada for \$53 billion; the buyout is due to close in early 2008. Communications Infrastructure Investments (CII) made a series of network purchases throughout the year, including PPL Telcom, Memphis Networx, and Indiana Fiber Works, then organized the assets as Zayo Bandwidth, which bills itself as a fiber optic provider in 43 Tier 2 and Tier 3 markets. In October, an equity firm agreed to purchase Covad Communications and take the company private. Finally, business equipment vendor Avaya was purchased by two private equity groups in November for \$8 billion.

**What to expect in 2008:** AT&T and Verizon will start with the years-long integration of their recent mega-acquisitions largely complete, freeing them to compete on new services and with reinvigorated competitors. Recent CLEC consolidations have taken many carriers off the market,<sup>1</sup> but the pressure to get bigger to compete against the RBOCs and MSOs could result in a super-sized surprise or two in the year ahead. However, tighter credit means some deals in late 2007, so 2008 may be quieter, but certainly not quiet.

### Technological Evolution

A number of technology trends that had been gaining traction in recent years appeared solidly mainstream in 2007. Though not entirely new in their own right, together these technologies provide a vivid glimpse of the future of communications.



The market share for *voice over Internet protocol (VoIP)* had grown through 2006, but several developments in 2007 marked its arrival as a significant force in the industry. For one, early VoIP trailblazers like SunRocket and Vonage that provided standalone service (“bring your own broadband”) faced major patent infringement difficulties which undermined their business models. As those businesses failed or listed sharply, cable MSOs capitalized. Using retail VoIP to

<sup>1</sup> While 2007 saw the number of competitors decrease (in absolute terms), the network reach and overall strength of the consolidating competitive providers has increased.

round out their triple-play packages, the five largest MSOs surpassed 12 million telephony subscribers in 2007.

AT&T and Verizon countered by ramping up their *fiber to the node* and *fiber to the home* initiatives, respectively. AT&T went live with its U-Verse product in early 2007 and by the end of October had more than 120,000 TV subscribers; Verizon, which turned up FiOS TV in late 2005, had more than 700,000 TV subscribers by the end of the same reporting period. Although both initiatives are works in progress, their impact in 2007 was mostly positive. In a reversal of fortunes, Wall Street warmed to Verizon's fiber plans in 2007 and instead penalized MSOs like Comcast for slowing growth and lost video subscribers in the third quarter.

The year also saw *Metro Ethernet* continue to gain popularity. After building momentum for a decade, in 2007 a broad spectrum of providers—Ethernet pure plays, diversified CLECs, and incumbents—reports booming demand for Ethernet. The consensus view is that the market has reached a tipping point: although legacy TDM revenue will exceed carrier Ethernet for some time to come, new service orders are predominantly for Ethernet. Technologies that enable carriers to provision Ethernet via existing copper facilities to off-net small businesses have further broadened its appeal; likewise, circuit emulation techniques allow customers such as wireless carriers to leverage their significant equipment investments, while offering a ready migration path to metro Ethernet services when needed.

**What to expect in 2008:** The big telcos and cable MSOs go head-to-head on each other's home turf: telcos offering residential TV service, and MSOs stealing market share in residential voice and pushing into small business telephony. Metro Ethernet sales growth dwarfs incremental or static rates for legacy services, and represents the vanguard of the convergence hype that has been an industry staple for the past few years. More network operators cap legacy services, following the example of Cablevision's Optimum Lightpath, which in 2005 ceased sales of TDM services in favor of metro Ethernet.

### **Wireless Game-Changers**

The communications space is always a hotbed for innovation that changes how we interact with one another. In 2007, there was no shortage of new product introductions and nascent wireless technologies that have, or had, the potential to alter telecom's status quo.

Probably the most-hyped communications story in the public's consciousness this year was the rollout of *Apple's iPhone*. Between its January debut and general availability on June 29<sup>th</sup>, the "iPod cum telephone" stirred both wild-eyed kudos and pessimistic prognostications. By the end of Apple's fiscal fourth quarter in mid-October, the company reported sales of almost 1.4 million of the devices, which were ostensibly activated on the iPhone's exclusive network partner, AT&T. Despite questions about sales targets, slow network speed, and its suitability for business users, the iPhone made two lasting impacts on the telecom industry. First, it greatly raised users' expectations for wireless handsets. Some vendors and competing wireless carriers have voiced their hope that this will lead to a vibrant market for

high-end units—with unsubsidized high-prices to match. Second, Apple’s power position in its negotiations with carriers upends the established practice in the U.S. of wireless providers largely dictating terms to handset vendors. The iPhone set a new precedent for the marketplace, placing the emphasis on device capabilities and applications.

Another provocative gambit in Silicon Valley originated at *Google*. After more than a year of speculation, the company unveiled the Open Handset Alliance, a coalition of 34 handset vendors, wireless carriers, software developers, and component suppliers that are creating an open access device platform dubbed “Android.” In contrast to the closed, carrier-decides-all model which is the norm today, Google expects the platform will spur third-party software development and grant flexibility and customization options to consumers. In addition, Google made a number of high-profile pronouncements regarding the 2008 auction of coveted 700 MHz spectrum, and indicated that it would indeed bid.

The results for new wireless access business models were more mixed. High-profile municipal wireless networks in Chicago, Houston, and St. Louis flamed out before they had gotten off the ground, and others were similarly delayed or postponed, putting the viability of such “public access” projects in doubt. Sprint Nextel, which had touted plans for a nationwide WiMAX network, put its ambitions on hold while it searches for a new CEO and attempts to stabilize disappointing financial results as the year closes. Clearwire, which offers fixed WiMAX service in more than 30 metros nationwide, had a mildly successful IPO in March and reported that a majority of its markets are profitable. However, the company’s short-term prospects suffered when its erstwhile partner, Sprint, backed away from an agreement to build nationwide network jointly.

**What to expect in 2008:** A new breed of enhanced handsets combine with steady rollout of 3G data services to create a perfect storm of consumer interest in the mobile web. Development of third-party applications, especially on open source platforms or mobile web browsers, puts pressure on legacy wireless carriers to open their diverse networks. “Free wireless” offers begin to appear, but municipally-driven models continue to fade away.

### **Telecom Rookies – Emerging Stars?**

The most enduring development for the future of the communications industry is likely to be the growing role of players from outside the traditional telecom sector. In the previous section we discussed moves by Apple and Google to alter the communications landscape. But there are others.

Always poised to make a bigger splash, Microsoft has steadily inched into the communications space. Using its near-ubiquitous operating system, Office suite, and popular instant messaging app as a beachhead, Microsoft has worked to fold voice into its productivity platform. As the company shifts emphasis to collaboration tools, voice is key to its long-term strategy. Although not an overnight sensation, Office Communications Server 2007 gives businesses the ability to consolidate e-mail and instant messaging as well as voice, video, and presence on one server. By offering a compelling feature and savings combination, especially for small businesses without

an advanced PBX system already, Microsoft aims gradually to claim the market from traditional telecom vendors. With virtually unmatched clout, such a shift could drastically reorder the communications status quo.

More indirectly, Intel hopes to influence and profit from next-gen mobile wireless. The company is betting on WiMAX, and even in the wake of the dissolution of the Sprint-Clearwire partnership it reaffirmed plans to introduce a WiFi-WiMAX mobile chipset by mid-2008. As the largest PC chip supplier, Intel may have the greatest influence of any player in the pace and direction of 3G deployment.

**What to expect in 2008:** Application developers' role in the communications space continues to grow. New forms of communication, including but not limited to social networking and location-aware apps, become increasingly voice-enabled. Additional players, even farther afield than Apple and Microsoft, discover that their strategies are intertwined with communications, leading them to challenge or partner with established industry leaders.

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