

## TYCO TELECOMMUNICATIONS

### Global Infrastructure – OPEX As A Competitive Advantage

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We sit here today at one of the most crucial crossroads of the telecom industry. Business fundamentals in the telecom sector have eroded significantly over the past 2 years, resulting in an environment that has had a significant impact on all segments of the industry. Perhaps, it's more appropriate to say that the business conditions have been "grounded" to the reality of underlying demand levels.

In either case, while weaker players are being filtered out, either by bankruptcy or consolidation, there is increased attention being paid to what will be the key success factors of the "Survivors" and what the ensuing business models will be. As such, the survivors are actively re-evaluating

corporate strategies and business models that will enable sustainable returns and long-term viability. Of particular focus is how global transport carriers are evolving the cost side of their businesses into competitive advantages. Put simply, this means developing the lowest possible Operating Expense (OPEX) structure as the cornerstone of a corporate strategy.

As a brief historical review, we observe that the late-1990s was a period marked by strong capital investment, ample funding from capital markets, and an atmosphere marked with exuberant expectations of growth and profitability. Consequently, many entrepreneurial networks, based on the "build and they will come" business model

philosophy, came into existence increasing competition to what we now know to be unsustainable levels. As these networks were deployed globally (funded by significant debt facilities from the capital markets), supply grew to exceed demand in most markets, setting the stage for the telecom bubble and the inevitable collapse of unit pricing.

Intense competition accelerated the collapse of unit pricing, driven by the fact that there just wasn't enough underlying demand. As a result, companies found themselves pursuing value added services and engaging in creative swap-type of deals to sustain their individual revenue growth rates. In hindsight, this only masked the underlying

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problem by establishing a perception that demand was continuing to grow at accelerated "internet-frenzy" rates, when in fact actual incremental demand stalled for some time.

Actual demand levels for bandwidth services are not as robust as originally forecasted, which, when coupled with the supply-demand imbalance and accelerated price erosion, has resulted in widespread deterioration of corporate revenues and profits. The highly leveraged business models based on robust demand forecasts simply imploded. The need to generate cash to service the massive debt facilities became the primary corporate focus, and a requisite for survival. We now understand

that the forces, which drove the widespread bankruptcies in the telecom sector, were started in motion as early as the late 1990's.

There's been a lot of discussion in the industry as of late regarding asset write-downs, and the perception of how companies establish more competitive positions by aggressively taking these write-downs. In reality, this is not a truly accurate representation of an asset write-down, so it is worthwhile to articulate the distinction between Capital Expenditures (CAPEX) and OPEX, and the respective impacts on a company's financial performance.

First, it's important to understand what is

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Picture: Tyco Telecommunications

TGN WorldWide Network

meant by the term “Asset Write Down”. When a company invests capital to construct a network, the CAPEX used to fund the construction shows up on the company’s balance sheet as a depreciable asset. Every fiscal period, over the useful life of the asset (typically 15 years), the company will take a depreciation charge in connection with this specific asset. For example Company X

spends \$1.5B to construct a Trans-Atlantic network. Based on a 15-year life, the company would take an annual depreciation charge of \$100M, a significant impact to a company’s bottom line performance. However, it is important to note that this \$100M does not have a direct impact on the company’s free cash flows.

When the revenue generating capability of

the network is negatively impacted to a point where the asset is unable to generate cumulative revenues over the accounting life of the asset that are greater than the cumulative costs of owning and operating the asset (as in the eroded market conditions we have experienced over the past 24 months), the asset is considered to be impaired and written

down to what is referred to as the recovery value.

When a company impairs an asset and writes-down the asset, they effectively reduce the remaining value of the depreciable asset. While this may sound quite significant, this is merely an accounting perspective that does not have anything to do with the real cash flows. In this environment, real cash flows

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WorldCom is an example of a current case in point to illustrate recent corporate activity on the importance of low OPEX structures. As is relatively common knowledge throughout the industry, WorldCom is under investigation for its corporate accounting practices in an amount totalling over \$9B. The essence of the alleged

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accounting practices is that WorldCom took annual OPEX charges (which need to be accounted for completely in the year incurred) and accounted for them as CAPEX (allows them to be depreciated over a 15 year accounting life).

From a GAAP and Net Income perspective, this type of accounting treatment would give WorldCom the appearance that they were more far profitable than they really were, and that they had the lowest operating cost structure in their peer group. The street (and WorldCom's competitor as well) was continually impressed with WorldCom's ability to maintain the lowest operating cost structure. We now recognize that WorldCom cost structure may have in fact been inaccurate and misleading. In this case, understatement of OPEX masked the cash

flow problems that WorldCom was experiencing and was a contributing factor the element of surprise that resulted in their filing for bankruptcy protection.

By examining the root cause of why previous companies and models have failed, we can outline the profile of a company that will survive the current telecom depression. The corporate profile of a survivor will adopt a business model that promotes financial stability, incorporates lowest possible operating cost structures, uses more effective sales methods and products, as well as a maintaining a manageable (and reasonable) debt to equity ratio. In order to realize this strategy, providers will need to establish effective operational tactics, which minimize OPEX and financial exposure while leveraging

core competencies and strategic relationships.

This focus on establishing the lowest possible OPEX structure is a fundamental element of Tyco Telecommunications' strategy for not only succeeding in the current telecom environment, but also influencing its outcome. The original concept of the Tyco Global Network (TGN) was based on a large-scale construction of dedicated infrastructure to serve the global market needs. As the development of TGN progressed, Tyco Telecommunication better understood the regional economics and real one-time and recurring costs related to each of the sub-networks. As such, the TGN footprint was optimized to focus on building those parts of the TGN where Tyco Telecommunications was capable of establishing and

maintaining the lowest OPEX cost structure.

With the TGN Trans-Pacific coming into service in December 2002, Phase 1 of the TGN is now complete. The resulting network architecture is a design where Tyco Telecommunications owns and operates infrastructure in the Atlantic, Pacific, and portions of Europe where the lowest possible cost structure could be attained. In order to service regions such as South America, Pan-Asia, portions of Europe and US Domestic, Tyco Telecommunications established strategic alliances with regional partners who were able to establish and sustain lowest cost positions in their respective markets. Partners who can not only provide network reach that is complementary to TGN's footprint, but also in some cases, provide value added services as well. This pragmatic approach

is critical for short-term success and longer-term viability.

While it is still too soon to predict the exact outcome of the telecom industry, those players that will "survive" the current telecom situation, are those companies that are refocusing their corporate business models and value propositions. Along those lines, several things appear to be certain. Strategic partnerships will play an important role in realizing short-term financial success and will help to rationalize the current supply-demand imbalance. Business models that promote flexibility and scalability to navigate through volatile market conditions will continue to emerge. And, finally, those companies that can establish the lowest relative OPEX structures are best positioned to achieve competitive leadership positions in their respective markets.



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