United States Senate
Committee on Commerce, Science and Transportation

A Hearing on Wall Street's Perspectives on Telecommunications

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Chairman Stevens and other members of the Committee, my name is Luke T. Szymczak and I am a Vice President at JPMorgan Asset Management and I appreciate the opportunity to address the committee today, and share my perspective as an investor in telecommunications. My role is both as an analyst, whose responsibility is to have an all-encompassing view of an industry and the stocks in it, and also as an investor, who makes active decisions about which stocks to own in a portfolio, and which not to own. My specialty is telecom, and I am responsible for both the telecom services industry and communications equipment industry. As a result of over a decade of experience with the companies that supply the equipment that is used to construct the telecom networks, and the companies that operate the networks, I bring a very holistic perspective on the telecommunications industry.

Investors in telecom and technology stocks have had quite a wild ride over the last decade. Now that the excesses of the late 1990s have mostly been wrung from the system, one would hope that the outlook for the industry, from an investor's perspective, would be getting more attractive. Unfortunately, such clarity is not yet upon us. Investors are struggling with a number of issues. These include determining how the competitive landscape will evolve, attempting to forecast the rate of price and revenue declines, and making estimates of what returns carriers will realize as a result of the large investments that are currently being made in broadband access networks. Any one of these factors raises risks, but the combination complicates the analysis substantially, and the conclusions are sometimes far from conclusive.

The result is an investment analysis process that is dramatically more complex and uncertain than it was twenty years ago, or even ten years ago. The specific questions that investors face are not revolutionary. But we are in uncharted territory for telecom now that freer competition has been unleashed, and it is unclear just where this will lead over the next decade. Because so many other industries have seen brutal levels of competition following deregulation, investors are reaching conclusions that factor in a great degree of skepticism to reflect the high level of risk and uncertainty.

We certainly have seen some positive developments in recent years. Industry consolidation first in wireless, and subsequently in wireline, has begun the process of rationalizing the cost base from a regulated industry model into one of a competitive industry. This has contributed to the strengthening of balance sheets so that companies will have the resources and the financial cushion to contemplate large capital spending plans. Likewise, we have seen continued adoption of broadband access in the consumer market. And Incumbent Local Exchange Companies (ILECs) have made good progress in refining their marketing strategies and techniques, and also in demonstrating that they can at least moderate, and sometimes offset, the impact of the decline in access lines with the sale of additional services to the customers that remain. And, the ILECs in general have done a good job of improving their balance sheets, which should enable them to weather the storms ahead more sustainably.

There are many concerns. Nonetheless, there remains widespread concern that the major carriers' positions will overall worsen despite some of these positive indicators. Continued decline in access lines at the ILECs has a direct and immediate negative impact on their margins and profitability. Migration of wireline traffic to wireless continues as one of the key factors in the access line decline, but voice offerings from other competitors, both cable system operators and voice over Internet protocol (VoIP), seem to be playing an increased role.

Wireless growth continues to be healthy, but there is an increasing concern that with wireless penetration in the US now in the 70% range, wireless growth is likely to begin to slow in coming quarters. Even with consolidation in the industry over the last two years, concerns that we could see intensified wireless price competition as companies press harder to show subscriber growth seem reasonable. And the potential entrance of new competitors as a result of upcoming auctions remains a risk.

There is a very reasonable concern that the prevailing price of voice service could be reduced dramatically in the next few years. Today the average monthly revenue that an ILEC receives for an access line is in the $50 range, with a number of companies above this. Clearly, some VoIP services are currently at half this level, and some pure Internet services have a price near zero. It is hard to forecast the rate at which prices will decline. But the more exposure a company has to traditional voice service, the greater impact this price compression will have on its revenues, margins, and profitability.

There is a good degree of concern that we may soon see new entrants using new technologies with potentially more attractive economics than existing operators can achieve with their current networks. Likewise there is a high degree of skepticism that the substantial investment underway at the ILECs to build broadband networks to the home will deliver a satisfactory return on the incremental investment. It is true that sometimes investors can be too skeptical, and it seems that telecom investors have become extremely risk-adverse. However, in the case of broadband access network investments, the skepticism seems entirely rational given that there has yet to be a proven business model. Memories of the telecom meltdown that started in 2000 and resulted from the big spending programs of the late 1990s, which proved to be based on entirely misplaced hopes and business models, contribute to the skepticism. The big question is whether carriers' plans are more realistic and achievable this time around. It is a question for which one could make either a positive or negative argument, and the answer will come only with time, and thus the caution.

Obviously my summary list of negative factors in investors' views is far greater than my list of positives, and this helps to explain the relatively unenthusiastic view investors have for telecom services stocks. Clearly, this industry is tougher to analyze now than in the day when investment decisions were made on dividend yield, dividend coverage ratios, and return on assets.

In response, many investors have shifted out of US telecom stocks, into telecom in other regions, particularly emerging markets where growth is the dominant element of the story.

Even so, the US market has some positive attributes relative to alternatives. Most notably it is further along in the deregulatory path than some other mature markets, notably Europe. The regulatory environment here is likely to be more investor-friendly than it may prove to be in Europe. But it will take time for one to be able to prove this conclusion. On some measures, it appears that Europe is at least three years behind the US in wireline deregulation. For example, a decision on whether carriers will have to resell usage of newly-upgraded broadband access facilities to competitors has yet to be taken in Europe, whereas the policy in the US was set in the last Triennial Review. And in contrast to the US, where major carriers have made large commitments to upgrading access facilities, in Europe there remains uncertainty as to the attractiveness of upgrading access facilities.

There are opportunities ahead. Fortunately, telecom is a vibrant industry and all the change underway creates new opportunity. Look no further than the progress both wireless and the Internet have made in the last ten years. Although the forecast for the next ten years is uncertain, I am very confident that it will include potentially even more dramatic and hard-to-predict change. This will create significant opportunities for growth. Even so, it will be important for carriers to make wise choices about which opportunities to pursue, and which business models might yield the greatest success.

Ultimately, the carriers' success, or lack of success, will also have a significant impact on the communications equipment industry, which supplies the products to build the telecom infrastructure. It is no accident that the most successful competitor each in wireless infrastructure and wireless handsets is based in Sweden and Finland, respectively. The carriers in these two countries have always been the leaders in pushing the boundaries in the wireless business for over twenty-five years now. And this has created the ecosystem that keeps Ericsson and Nokia on the leading edge. Likewise, it is also clear that the US has the leading companies in the data networking industry. This is a result of the early adoption of local area networking (LAN) in this country in the 1980s, and also the brilliant growth of Internet adoption over the last decade and a half. This has given US companies, both large and small, a substantial lead over other competitors.

In my view, the success of US carriers in building great businesses around the networks of the future will be important in giving the equipment companies that sell to these US carriers the opportunities to develop and refine the technologies of the future. After these companies help the US carriers in deployment, they can then take these technologies and sell them to carriers around the globe. If the end result is a success, this should be good for both the stocks of US carriers, as well as the stocks of the equipment companies that supply them.