



Looking into the Crystal Ball: Ten Predictions That Will Rock 2003

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The year 2003 will be a turnaround year for many ISPs, but there will be more blood in the water before this year is over. The scorched earth aftermath of the classic post bubble environment will be met with a tepid telecom turnaround sometime in 2003. This month's column will first set the stage with a prediction of the nation's health in 2003, and then make ten specific sector predictions that will rock Broadband Service Providers (BSPs).

On a macro basis – the world and US economy will continue to plod along, with the world economy slowing to 1% and the US economy slowing to 1-2%. While a double dip recession (defined as two back-to-back quarters of negative growth) is unlikely in 2003, the US economy will continue to sputter along, buffeted by the drunken binge of excessive consumer debt (with decreasing opportunities for consumers to refinance mortgages that cash them out and help fund the economy) and international tensions in such hotspots as Iraq, Iran, and North Korea. My guess is that we will go to war with Iraq and it will be over fast, although Saddam's parting gift will be horrendous civilian and infrastructure collateral damage, and the ensuing nation building process will be longer, bloodier, and more expensive than is today's consensus. Adding to this malaise will be some successes by various terrorist organizations, although the "good guys" will continue to become increasingly successful at thwarting their attempts to do Americans harm, both domestically and internationally.

The stock market will stabilize in 2003. True, it's likely that we'll instantly lose another 15% if there is another high profile domestic terrorist action, but it's more likely that we could see the markets zigzag their way to a 5% gain for the year. We'll also see a few more

scandals (though comparatively tame by 2002 standards) and a few more bankruptcies of well-known companies. The primary factor that will keep the markets under pressure is that PE ratios remain high – too high by historical standards – as the captains of industry have awakened from their drunken stupor of the bubble era to the hangover of the twenty-first century. If the market is too high by industry standards, why won't it continue correcting until the S&P500 reaches its more typical PE ratio of 15? The market cheerleaders (such as CNBC) are very effective at rallying disheartened investors and convincing them that this is really and truly the bottom and now it's a "stock picker's market" and time to invest money on all of those "good stocks" (whatever that really means). While the worst is behind us, these dosages of artificial enthusiasm will both help CNBC's ratings and will prevent the markets from hitting their real bottoms. And it's true that many of the large institutional investors are fidgety, having seen a 20%+ rebound from the market lows in October, and are looking to more effectively deploy their equity in 2003. The impact of the former will be to create a multi-year bottom where the markets will operate in a trading range, waiting for earnings to increase and bring the PE ratios back into line. In 2003, pricing power will remain very weak and companies will find it more effective to increase their earnings by reducing expenses – than by increasing prices. Consequently, investors will continue to wax nostalgically about the traditional earnings pop associated with most recoveries, that always seems "just around the corner." Inflation will remain tame and deflationary scares will continue to make headlines. Consequently the Fed will keep interest rates low, increasing them by no more than 150 to 200 basis points throughout all of 2003.

America's productivity increases will continue to be the envy of the rest of the world, and our trade deficit will help keep the global economy from imploding.

Ten Predictions for the Telecom Sector

Now for ten brave predictions that will form the basis of the 2003 landscape, and rock the world of many a company in the telecom sector:

1. A turnaround in the telecom industry? While the optimists will predict that the telecom industry will "turnaround" in 2003, it will really be a convictionless bottoming out that bumps along without the typical growth and resurgence that accompanies most bottoms. ISPs will need to keep their seatbelts fastened in 2003. And many of the companies emerging from bankruptcy will cause the survivors difficulty. Freed from their massive debts, some will feel empowered to party as it was 1998, as Covad signaled when it slashed its DSL rates, only weeks after it was reconstituted out of bankruptcy. And while Covad is a comparatively small company, the RBOCS are concerned about the impact of WorldCom shedding billions of dollars of debt and being freed from having to pursue from the economic realities of prudent competition.

2. The credit squeeze will continue and mitigate the benefits of a low prime rate. While the prime rate will increase moderately in 2003 (by 150 to 200 basis points), rates will remain relatively low but ISPs will find it nearly impossible to borrow. Financial institutions will continue being concerned about this sector and permit borrowing on the low end of multiples of cash flow.

3. Spam will get worse – much worse. It's easy to say that spam will get worse in 2003 – but I predict it will get much worse than most predict, perhaps doubling to be two-thirds of

¹ Visit http://www.barra.com/research/fund_charts.asp to see how the current PE ratio compares to the historical averages

the total number of emails circulated in America's piece of cyberspace by the end of 2003. Anti-spam software will help, but it won't be able to effectively stem the growing tidal waves of spam. The government will begin to act, but don't expect to see much relief in 2003. And the worst-case scenario will be that if spam is left unchecked, those without anti-spam protection will receive more spam than legitimate email within the next couple of years.

4. 2003 won't be quite as awful as 2002 for the cable industry. 2003 will be a sunnier year for the cable multiple system operators (MSOs). Stock prices will not test the 2002 lows, even though the clouds of reregulation will gather and later clear. While DBS will continue to erode the MSO's video market share, the sixty billion dollars in capital investments will facilitate the spawning of video on demand. However cable telephone growth will slow, as Comcast digests AT&T and focuses on rebuilding the video side of their busi-

ness. A few other companies, such as Insight Communications, will continue to deploy a cable telephony product. Several MSOs will begin generating free cash flow – although Warren Buffet will still treat their financials as being suspect. Through a combination of new services and rate increases, the cable industry will enjoy a double-digit revenue growth in 2003. Cable will continue to dominate the broadband marketplace, and not lose significant market share to DSL.

5. Continued pressure for the RBOCs. While remaining as the pillars of strength in the telecom industry, the Regional Bell Operating Companies (RBOCs) will continue to lose primary and additional phone lines to foes such as unbundled network elements, commonly known as UNE. Under funded pension plans will also adversely impact one company's stock prices. While DSL will continue to be the RBOCs' growth engine and the 2002 clean up of balance sheets will continue, operating income will remain under pressure, thus

keeping stock prices constrained. And the DSL option will remain elusive to millions of Americans since today's technology precludes the RBOCs from offering broadband ubiquitously to all of their voice customers. Technological enhancements are on the horizon, but won't be significantly deployed in 2003. Competition and demand will continue to preclude DSL from being priced to contribute to the average RBOC's profitability.

6. WiFi – a winner for the WLAN – but not ready for prime time as a residential broadband product. As a residential broadband delivery service, Wi-Fi will continue to be a technology seeking a market. While the economics of using Wi-Fi for a wireless LAN are overwhelming, companies that seek to serve up broadband to customers via a network of "hot spots" will struggle to build a viable business. Cable and DSL BSPs will more aggressively police their customers' sharing of bandwidth via hot spots, becoming concerned about spawning a parasite that siphons their

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revenues. By late 2003, residential Wi-Fi powered by Netizens re-purposing their bandwidth via hot spots will be dumped into the trashcan of failed economic models and will keep the failed models of "free DSL" and "free dial-up" company.

7. Customization becomes real. Companies like Yahoo have acknowledged the power of customization with their MyYahoo product. But later in 2003, Netizens will begin to enjoy true "freedom of choice" as very smart software adds relevance to their Net experience via personal portals. To some, the old style mega-portals will be left looking a bit like dinosaurs nervously contemplating the arrival of the ice age.

8. Broadband MMDS remains zzzzz. MMDS broadband will remain in suspended animation – hibernating until an economically feasible non-line of site technology can combine with indoor antennas and self-provisioning technology. Neither Sprint nor WorldCom has the financial flexibility to aggressively deploy MMDS broadband until these three illusive variables come into alignment.

9. AOL vs. MSN – and the winner is...?

AOL will begin to bleed customers towards the end of 2003 (although its Roadrunner broadband service will remain very healthy). And MSN will continue to narrow the customer gap between it and today's ruling 900-pound gorilla. AOL will continue to struggle to create synergy from the content side of its business – it won't materially affect their business in 2003. AOL's plan to facilitate the conversion of its dial-up customers to broadband is problematic because dial-up is a much more profitable business – and by the end of 2003, some progress will be made, but most will agree that it was not nearly enough. Microsoft will continue to gain market share and its relationships with Charter, Qwest, and Verizon, and will be joined by other companies.

10. It feels like 2002 all over again. BSP's best exit strategy will be a sale – the public market place will not turn friendly in 2003 and the IPO market will remain closed. Wall Street will continue to punish companies that tout EBIDA growth as a substitute to pursuing Business 101 fundamentals. Consolidation will continue. CLECs will continue to struggle. AT&T will try to reinvent itself. RBOCs will continue to feel the same about

UNE as cable MSOs feel about, well, mandated open access. Broadband will experience healthy growth and erode the base of dial-up users. Those companies that are quick, smart, and listen to their customers will continue to be successful. The technology hangover will continue through most of the year – making it difficult for all but the MSOs and LECs to raise serious money. And on December 31, 2003, many will be happy that the year is finally over...and will be hoping for a better 2004. ■

About the Author

Don Kent is CEO of eCablevision, a broadband consulting company. He has spent over 26 years working with early stage companies specializing in the delivery of broadband and digital content services. Please address questions or topics that you'd like to see discussed in subsequent columns to Dkent@eCablevision.com.

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