

# Learning The New Rules

A trading-range environment for capital-intensive businesses.

By Dan Ramsden ■ *Bentley Associates, L.P.*

The capital intensity of the telecommunications services and infrastructure sectors link these businesses to the capital markets to a perhaps greater extent than any other sector in the modern economy. Regardless of whether the product offered is a consumer handset or a strand of fiber, whether the handset is a telephone or a Palm Pilot, and whether the fiber leads to the desktop, the basement, or the curb, the telecommunications industry can never escape the capital expenditures that define it, and as a result, now

torical norm. Successfully funded business plans and new ventures are today qualified by their compliance with investor preferences. Strategies are created to be responsive to capital markets criteria. And capital markets, having lived through a decade of unprecedented but often illusive opportunity, only to see investment values forever disappear, have not only adopted the “show me” attitude of the skeptic, but a set of very specific criteria designed to protect against historical pitfalls, and the new attitude is more aptly described

the prior decade. The challenge is to learn—and play by—the new market’s set of rules. Simplistically, these can be explained using trading terminology:

If the 1990s bull market, in its relentlessness and appearance of unlimited potential, broke through technical resistance to describe a perpetually rising trend-line, and if this was followed by a bear market in which buying support was nearly non-existent, the current market is marked by volatility around a comparatively horizontal axis. In other words, whereas capital had during the past ten years migrated through respectively upward and downward patterns of strongly directional markets, we seem now to be in a trading range. Whereas the approach to valuation in the recently experienced bull and bear markets was largely one of estimating the value upside or downside potential, as a function of the overall capital environment, the current market is much more focused on business fundamentals, and the anticipation of directional value trends is no longer a primary decision factor.

In a trading range environment, and because in this case we are not discussing high volume churn economics but rather longer term capital deployment with a multi-year exit horizon, the investor’s objective is not to time peaks and troughs, but to benefit from the escalation of the trading range over the longer term. Alternatively, in the case of a creditor, the objective is to insure that a borrower’s business can withstand a decline in the same.

Whether your organization is seeking new equity capital or debt finance, the effect of this environment will largely be the same. The “bang for your buck” will not necessarily consist of holding

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more than ever follows the capital markets to success or failure.

The choice of words is key: the industry follows the capital. There was a time when capital followed innovation, and markets responded to opportunity, but the recent decade has to a large extent changed all that. Innovation and the capital that pursued it had been so rapid (and so massive) in the 1990s that before too long the role of leader and follower reversed, as new ventures and new business plans emerged more and more quickly to feed the hunger for investment capital. The consequence: competitive overcapacity, capital overexposure, economic imbalance, and market pullback.

Although the dust seems to have settled during the past six to twelve months from the ensuing wreckage, the relative roles of innovation and capital have not yet shifted back to their his-

as “show me the precise characteristics I want to see.” For telecommunications and its associated sectors, these characteristics usually have to do with barriers to competition in clearly defined markets; the ability to generate recurring and predictable revenues, preferably from multiple sources; the ability to control costs without hurting the service offering, and to access the lowest cost technologies on a demonstratively ongoing basis; and, more often than not, the willingness to accept conservative valuations by way of protecting investors’ downside.

Right or wrong, such is the current reality, and even the biggest and most successful companies in the telecommunications arena are governed by it. For organizations of all sizes, however, even the small ventures, future upside is no less significant than had been the case for quality and substantive businesses of



out for the additional 5% of equity dilution or the 50 basis point spread, and, while negotiating the best deal possible is always important, the diversity of capital sources is often insufficient these days to create a significant bidding dynamic. More likely, the prudent strategy consists of “locking the trade” and

focusing thereafter on increasing long term value with operating efficiency and sound business management. In short, there is no better way to optimize value than by executing the business plan: grow revenues and profitability, improve efficiency, and expand your markets. Use your new capital to escalate your fundamentals.

By the same token, if you are the seller of an enterprise, the good news is that buyers are active again, but you should be prepared for a more conservative valuation metric than you may have expected several years ago. If this reality does not suit shareholders' requirements, determine a strategy to move your company's trading range higher with improved profitability, and always seek to assess if your position is at least as adequate as that of the targeted buyer's to implement the plan. If it is not, you may want to revisit the strategy or otherwise reconsider the transaction. An often encountered obstacle to the

completion of corporate transactions in what has here been defined as a trading range environment, (and one that follows a major correction from what had been a long and significant bull market) is the broad differential between the seller's bullish recollections and the buyer's bearish fears. In other words, the divergence of bid and asking price... which will be the topic of next month's column. ■

#### About the Author

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