



AFC/Tellabs Deal: Future Of The FTTP Market

By Jason Marcheck ■ *The Confluence Research Group*

Although rumored for months, the May 20th announcement that Tellabs had struck a deal to buy access networking equipment vendor AFC electrified the FTTP market. Carefully choreographed to follow, by one day, Verizon's proclamation that it is indeed going full steam ahead with its AFC-fueled FTTP deployment in Texas and eight other states, the joint Tellabs/AFC press conference painted a picture of a world-class sprinter jumping into the passenger seat of a Mustang that was already doing 60 mph.

The deal, a \$1.9 billion exchange of cash and stock, is supposed to help sell Tellabs products more effectively in North America, and AFC products more effectively abroad (with specific mention of the Tellabs 8800 and 8600, as well as the AFC AccessMax product line). And, while it was repeatedly stated by executives from both companies that this deal was not done solely for the health and well being of AFC's contract with Verizon, neither myself, nor the Wall Street analysts on the conference call were completely sold. The words 'Verizon' and 'FTTP' were two of the most uttered sounds during the conference's Q&A session. The key question in my mind was, "Why would a company as seemingly successful as AFC, with such bright prospects in its chosen market niche, sell itself to a company that, although essentially strong, has done its fair share of reeling over the past several quarters?"

Here's my take:

First, in AFC, we are looking at a company that clearly did not command the premium that those who

believed that its contract with Verizon was sailing smoothly would have expected. It is true that, on the basis of the May 19, 2004 prices of both AFC and Tellabs stocks, AFC shareholders received the equivalent of \$21.24 for each share of their stock that was selling for \$16.83 (which represents a 26% premium). However, even a cursory look at the numbers indicates that this was, at best, an even trade for AFC. The table below contains my rough cut at examining the deal.¹

	AFC	Tellabs	New Entity
Sales (annualized)	\$346	\$1,022	\$1,368
% Composition	25%	75%	
Cash & Investments	\$855	\$1,180	\$2,035
% Composition	42%	58%	
Free Cash Flow (annualized)	\$278	\$742	\$1,020
% Composition	27%	73%	

This table (above) indicates that the final transaction, which will result in AFC shareholders owning approximately 25% of the new company's stock, was based on the percentage of sales that each company brought to the deal. However, when looking at the cash and equivalents that AFC threw into this deal, there is strong reason to believe that AFC shareholders should have been paid more handsomely for their shares. So, in essence, Tellabs picked up a hunk 'o cash flow, and a company that is one of the leaders in the hottest areas of telecom right now at what many would consider a bargain. This begs the question, that if what AFC CEO John Schofield said

is true, and the company was not being shopped around, then why did it settle for what is, at best case, even money?

My feeling is that AFC was in a little more trouble than it could admit with regards to fulfilling the requirements of the Verizon FTTP contract (possibly in terms of both price point and scale of equipment to be delivered). It needed help from a seasoned Tier-1 counterpart that could help it maintain the momentum that it had generated as the result of the Verizon win. For

its part, Tellabs is in need of the proverbial home run. So, while I hesitate to subscribe to the notion that the deal will result in the 7 to 10% accretion in value that the AFC/Tellabs people cited in their conference call, the truth of the matter is that I do not think that there is any big conspiracy here.

At first blush, this looks like a fair deal between an aggressive company that bit off a little more than it could chew, and a larger company that recognized the opportunity to acquire good value at a reasonable price. With that in mind, there are snags that could cause pain for all parties involved, and result in the above mentioned increase in value not being realized.

Potential Pain Points of The Deal

First, for this deal to realize the 7 to 10% accretion that was cited in the conference call (by year-end 2005), management admitted to a strong reliance on a word that I instinctively treat as a red flag: Synergy. Very often, the word 'Synergy' is used in the context of describing M&A activity in much the same way that 'Karma' is used to describe the outcome of fates. Many people believe in both, I just don't happen to be one of them.

In the case of this deal, some of those on Wall Street estimate that for the new Tellabs/AFC entity to achieve the 7 to 10% accretion, it will have to show a blended growth rate in sales of 13%². That is a lot of growth for a \$1.3 billion company that, had it been together for the past five quarters, would have shown a CAGR of 4% during that period. So, in my mind, that means that Synergy will have to account for approximately a 9% increase sales growth. Iffy, if you ask me.

To cast further doubt on this estimate, there are several other factors that could likely rise up between now and December 2005 to hamper this effort. Those factors include:

- Multiple layers of integration – Before Tellabs can go about the task of rolling AFC into its fold, it must first, or at least simultaneously, contend with integrating AFC's Marconi acquisition into the mix.
- Continuing uncertainty regarding RBOCs and FTTP – Rolling out FTTP to a small Texas town is a nice gesture, but Verizon's true commitment to LARGE-SCALE last-mile fiber remains to be seen.
- Increased pressure from Alcatel – Expect Alcatel to seize this opportunity to become an active thorn in the side of the new Tellabs/AFC as it attempts to fulfill big FTTP contracts while contending with the above mentioned integration issues.

Of the three factors mentioned above, I expect the integration issue and Alcatel to have significant impact

on the ultimate success of this deal. First, complicated integrations are a Synergy killer. Second, Alcatel has been paying only a marginal amount of attention to FTTP. However, the French giant cannot be ignored. Like the RBOCs, once it makes its mind up to mobilize, those in its path will feel the effects. As such, my feeling is that Tellabs/AFC will do well just to have everything running smoothly at the end of next year, and will consider even money a victory.

Look at some of the Telecom chat boards and you will see the typical naysayers crawling out of the woodwork to bash this deal. Contrary to their skepticism, and Wall Street's initial tepid reaction, this deal is not doomed to failure. It is a challenging, yet doable deal, and personally, I hope it succeeds. I would like to see a good ol' American company challenge what is rapidly becoming the Hegemon that is Alcatel. If those at Tellabs and AFC can pull this merger together, I think it will be good for FTTP, and ultimately,

for the telecom market in general. ■

1 Sales and Free Cash Flow numbers are annualized based on the trailing 4 quarters (1Q04 through 2Q03). Cash and Investments are based on the Balance Sheets of each company as of 1Q03.

2 This number is an initial estimate quoted from investment bankers on the conference call that announced the deal. I-bankers do these shorthand calculations for a living, and the numbers were not refuted by anyone at Tellabs or AFC, so for a quick and dirty estimate, I'll buy it.

About the Author

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