May 9, 2005

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EX PARTE – VIA ELECTRONIC FILING

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

Re: WC Docket No. 05-65
WC Docket No. 05-75

Dear Ms.Dortch:

In their meeting of May 5, 2005, BT representatives made reference to an OVUM 2004 Report which is attached.

Pursuant to Sec. 1.1206(b)(2) of the Commission's rules, this letter is being filed electronically with the Office of the Secretary. If you have any questions, please contact the undersigned.

Respectfully submitted,

A. Sheba Chacko

Enclosure

MNC providers in Europe – 2004

By Jan Dawson

July 2004

Key messages

Things have improved since last year – in every department

Last year marked a low point for the MNC providers. There was very little to separate the main providers, who all used similar selling points to chase the same customers. Price erosion was terrible (partly due to this lack of differentiation) which led to knock-on effects on revenues and margins. However, in the last year, things have changed for the better. Players are learning to differentiate themselves more, to focus on smaller sets of target customers, and to work with partners to serve customers more effectively.

More differentiation needed – in security and application of SLAs

Despite improvements, differentiation appears to have moved to the margins. With every player offering IP/MPLS networks, multiple classes of service and high network availability rates, differentiators are now more subtle. The 'elevator pitch' will not work now, as providers have to work harder to convince customers of their merits. As network security becomes more important to enterprises, this provides a new arena for differentiation, as does the ability to guarantee service levels at the application layer, rather than the network layer.

This is still largely an unprofitable market – scale is necessary

Only very few players are profitable, despite the improvements of the last year. BT Global Services, Colt, T-Systems, Equant, Infonet and Global Crossing all recorded negative operating margins in the last financial year. There is a direct correlation between scale and profitability, with Infonet being simultaneously the least profitable and smallest of the network-owning operators (Vanco, as a virtual network operator, has been consistently profitable). This suggests that some consolidation will be necessary in order to drive scale efficiencies and provide profitability.

Vertical segmentation is crucial – but not all players are convinced

Vertical segmentation is a crucial strategy for targeting players in the enterprise market, but there is a dichotomy between believers and unbelievers among the major providers. Players such as Equant, BT Global Services, Colt and Global Crossing are among the believers and have adopted a focused segmentation strategy. Among the unbelievers are AT&T and Cable & Wireless. Segmentation is crucial in particular for selling services on the basis of business benefits, which vary from industry to industry – those players not adopting a segmentation strategy stand to lose out.

Clear strategies are needed to drive growth in revenues

Revenue growth has been elusive in the MNC market over the past couple of years, although MNC-related revenues seem to have risen slightly this year in Europe.

Heavy price erosion, difficult macro-economic conditions and the migration from frame relay and ATM to IP technologies have all exerted downward pressure on revenues. Growth is possible, but a clear strategy is needed. Simply relying on market growth to deliver revenue growth is unrealistic, as price erosion is likely to offset volume growth.

Analysis

Introduction

This is our second annual report on the major providers of services to multinational corporations. Our first report, published in July 2003, reached several stark conclusions about MNC providers:

- had little differentiation between them
- were chasing the same customers
- forced implicitly to compete on price
- faced massive price erosion, leading to flat or declining margins and worsening profitability.

As a result of these conclusions, we recommended several key steps for these players to take:

- identify your core, profitable customers – what do they have in common?
- jettison non-core, unprofitable customers
- understand your real differentiators – why do these core profitable customers buy from you?
- find more customers like them and sell to them on the basis of your true differentiators
- adopt a vertical segmentation approach to focus on core segments and core customers.

We have repeated last year's research and have spoken to all of the providers included in this report during May and June 2004, in order to determine what has changed, and whether players are adapting as they need to. We have also added questions about vertical segmentation strategies and about the overlap with the IT services and systems integration space. This last item will be covered separately in a forthcoming report.

Our focus in this report is on the European market, although to some extent the trends are in evidence in other regions as well.

Target customer base – more variety

Last year, we asked the major MNC providers what they considered their target customer base to be. Almost all expressed their target customer base in terms of the 'top [X] thousand' customers in the world, or in Europe. There were minor variations, with most speaking of multinationals, while BT Global Services spoke (as it still does) of multi-site organisations, and Vanco spoke (and still does) of multi-domestic organisations.

One of the negative side-effects of the lack of discrimination in the targets we saw last year was that each player had large numbers of unprofitable customers as they found it very difficult to know which customers were profitable and which were not. A key message of last year's report was, therefore, that providers had to work to understand which customers are profitable, and why. From our research, it is clear that many providers now have a much better understanding of which of their customers are profitable, with a number adopting a per-customer measure of profitability. Some are also beginning to incentivise their sales forces on margins, rather than simply on revenues.

Cable & Wireless told us that they had very deliberately weeded out their unprofitable customers and were now focusing on purely profitable customers, something which is reflected in the improved profitability of Cable & Wireless's European operations in the last financial year. AT&T, BT Global Services, Colt and MCI also told us that they had become more sophisticated in assigning profitability figures to large customers, and hence in improving overall profitability.

As a result, these companies are now better at knowing what sort of customers to target in future. Fortune 500 is still mentioned, but on the whole these providers have narrowed down their customer bases to a sub-set of the biggest companies in the world, as shown in *Figure 1*.

Figure 1 **Target customer bases of major providers**

Provider	**Target customer base**
AT&T	Large enterprise customers with a presence in several countries (usually at least 4), with no more than 40% in any single country except the US
BT Global Services	The top 10,000 multi-site organisations with European operations
Cable & Wireless	MNCs with requirements in several markets, European enterprises with multi-country needs, and Japanese companies requiring a presence in Europe
Colt	Colt targets enterprises in a wide range of sizes, but at the MNC level it seeks companies with operations in multiple countries, with an annual telecom spend of at least euro5 million
Equant	The top 5,000 MNCs in its target market, which means global MNCs and other large international institutions requiring multi-year, multi-service contracts. Target customers are usually among the largest 1,000 in the world, have complex requirements and are open to outsourcing their managed services
Global Crossing	Multinational or multi-regional enterprises, generally with annual revenues of between $250 million and $5 billion
Infonet	Multinational enterprises with operations in multiple continents, not just multiple countries. A large proportion of customers are 'Tier 2' although Infonet serves 33% of Forbes Global 500 companies
MCI	A range from the upper strata of mid-sized business customers to global MNCs. Target customers will require IP, data, voice and managed services in line with MCI's strengths
T-Systems	Approximately 1,500 large national and multinational enterprises, chosen on the basis of ICT spend and growth, complexity of requirements and openness to innovative ICT solutions
Vanco	'Multi-domestic' customers, with significant needs in several countries, usually with spend over £0.5 million per year

Source: interviews with providers

Although features do vary more between players, there are still certain features that are common to several players. Some providers are unwilling to serve single-country customers and insist on a presence in two or more countries, including AT&T, Cable & Wireless, Colt, Global Crossing and Infonet. However, other providers are happy to serve organisations with a presence in only a single country, including BT Global Services and MCI. The willingness to serve customers in-country also varies by geography – AT&T is willing to serve customers with operations in the US or Japan only, for example, while Cable & Wireless and BT Global Services are happy to serve UK-only companies.

Other providers recognise that, if a customer is to be profitable, they need to buy several services, not just voice or data services. Cable & Wireless, Equant, Infonet, MCI and Vanco all mention this as a characteristic of their target customers, but in reality it applies to all providers, since it is a feature of the basic economics of network infrastructure. The more the costs of the infrastructure can be shared among several services, the more economical each service becomes to provide, especially on a converged IP network, as a result, providers are increasingly seeking customers with multiple service requirements.

Vertical segmentation

Last year, we advised our clients in this market to adopt a vertical segmentation approach in order to improve profitability and carve out a niche rather than simply target the same customers as every other provider. This year, we asked providers whether they had adopted a vertical or other segmentation approach. *Figure 2* summarises the segmentation strategies of the major players.

Figure 2 **Segmentation strategies**

Provider	**Segmentation strategy**
AT&T	No deliberate vertical segmentation strategy, although AT&T is particularly strong in finance, manufacturing and distribution segments
BT Global Services	Within target customer base, split by vertical segment. Focus particularly on finance, government, industry, it solutions, property & services, retail, media & broadcast and pharmaceuticals
Cable & Wireless	No deliberate segmentation strategy, but technology, petrochemical and financial are among the sectors in which C&W is particularly strong
Colt	Colt segments by region (Europe, US and Japan) and by 'activity sector', including finance, media services, IT, retail, government and manufacturing
Equant	Equant has long employed a vertical strategy, and targets airlines, banks, energy/resources, shipping, leisure, automotive, pharmaceutical and government sectors
Global Crossing	Global Crossing segments first by customer size – 'Supers' are companies with annual revenues of over $5 billion, 'Majors' are companies with between $250 million and $5 billion in annual revenues. Within the Majors segment, which is the target segment, Global Crossing targets finance, healthcare, transportation & distribution and high tech sectors
Infonet	Infonet particularly targets the pharmaceutical, financial and manufacturing sectors
MCI	MCI considers itself strongest in the government sector (based on its US business) but also has significant business from other sectors, including automotive, retail, banking & finance, pharmaceuticals and travel
T-Systems	T-Systems segments its top customers by verticals, focusing on four key segments: financial services, public & healthcare, manufacturing and telecommunications
Vanco	Vanco has sales teams focused around certain vertical markets, including retail, oil & gas and logistics. Vanco tends to focus on sectors and companies with complex needs requiring managed services

Source: interviews with providers

There is now a dichotomy between those providers pursuing an active segmentation approach, and those for whom segmentation is a marginal exercise. In the former group are Global Crossing, Equant, BT Global Services and Colt. AT&T, Cable & Wireless and MCI are in the latter group. Others sit somewhere in the middle, not aggressively targeting particular vertical segments, but nonetheless seeing some success within certain sectors.

On looking more closely it is possible to see that 'segmentation' is not always what it appears to be. Some providers are packaging generic services, putting a very superficial service wrap around them and claiming to sell customised solutions targeted at particular verticals. This is unlikely to be convincing once the potential customer scratches the surface. However, several providers have adopted a full segmentation strategy, with sales and marketing teams focused on particular verticals, among them Global Crossing and BT Global Services, and are more likely to be successful with those target sectors as a result.

Those providers not adopting an active segmentation approach tend to see it as a cyclical phenomenon, which comes and goes in the enterprise market as providers swing from horizontal to vertical segmentation and then back again. They suggest that differences between verticals are slowly being eroded – for example, it is not only financial companies that require solid network security today. Furthermore, companies such as AT&T claim that focusing on verticals and trying to meet their needs too exactly can distract them from their focus on customer profitability, which is based on providing a generic set of services with large shared costs. There is a risk that over-customising solutions can lead to high incremental costs, minimising the benefits of sharing a single network.

Vertical sector research conducted by our IP-Enterprise@Ovum service suggests that there are still major differences among various vertical sectors. Although other verticals, too, are now worried about security, the financial sector is still more cautious about deploying new technologies than for example, the retail sector is. The degree of sophistication in buying network services also varies between sectors, with financial and manufacturing sectors being more sophisticated in their purchasing decisions than the retail sector.

This suggests that, at the very least, employing sector-focused sales and marketing teams is vital in winning business in today's market, even if the degree of customisation is relatively low. Another factor which should drive segmentation is the need to demonstrate 'business benefits' to purchasers of services. These benefits will vary greatly from industry to industry, and vertical segmentation is a key enabler both of understanding the business benefits for each sector and for designing solutions that provide such benefits.

Despite segmentation, still a great deal of common ground

In practice, certain sectors appear to be common to the majority of providers. These sectors are known to spend heavily on networking, to have multi-national requirements and to be open to managed services. *Figure 3* illustrates the sectors the major providers claim to serve well.

Figure 3 **Vertical segments targeted by major providers**

Provider	Finance	Pharmaceuticals	Retail	Government	Energy	High tech / IT	Manufacturing	Transport & logistics
AT&T	✓						✓	✓
BT Global Services	✓	✓	✓	✓		✓	✓	
Cable & Wireless	✓				✓	✓		
Colt	✓		✓	✓		✓	✓	
Equant	✓	✓		✓			✓	✓
Global Crossing	✓					✓		✓
Infonet	✓	✓					✓	
MCI	✓	✓	✓					
T-Systems	✓			✓		✓	✓	
Vanco	✓	✓	✓		✓		✓	✓

Source: interviews with providers

The finance sector is the most targeted sector of all, although manufacturing, high tech and transport & logistics also attract large numbers of players. We asked our interviewees for evidence of their strength in their target sectors. All providers offered examples of their current customers in their target segments, which is a good sign that these sectors represent more than just a wish list.

Figure 4 shows that no provider has cornered any particular vertical market – they may be stronger or weaker in serving different verticals, but there is no provider that is ahead of the rest in any chosen vertical segment. This is reflected in the answer to another question – 'which providers do you see as your main competitors?' Responses to this question are summarised in *Figure 4*.

Figure 4 **Major competitors**

Provider	**Major competitors**	**Single biggest competitor**
AT&T	MCI, BTGS, Equant and Vanco	Equant
BT Global Services	Equant, MCI, AT&T, Infonet, Colt, T-Systems and increasingly systems integrators	Equant
Cable & Wireless	BT Global Services, Equant and AT&T	Equant
Colt	MCI, Cable & Wireless, BTGS, Equant, AT&T, Infonet and T-Systems	–
Equant	AT&T, BTGS and Infonet	–
Global Crossing	Equant, Infonet, AT&T, MCI, BTGS and T-Systems	Equant
Infonet	Equant, AT&T, MCI and BTGS	Equant
MCI	Equant, AT&T, Infonet and national incumbents	–
T-Systems	AT&T, MCI, Equant, BTGS, Cable & Wireless and Colt.	–
Vanco	BTGS, AT&T and Equant	–

Source: interviews with providers

In addition to asking providers to list their major competitors, we asked them which single provider they consider the most threatening. Strikingly, all of those who responded to this question singled out Equant as their most formidable competitor. However, even those who did not name a single competitor did identify a fairly uniform set of players, every one of which were among the ten companies we interviewed for this report.

The players which came up most often were the four established global providers AT&T, MCI, Infonet, Equant, as well as BT Global Services, which was not included on most providers' lists when we asked the same question last year, suggesting that it has gained considerable ground. Other players were each only mentioned a handful of times, while Global Crossing is not yet high enough on the radar of the major providers in Europe to register at all.

Differentiators – some progress made

The key message from our report last year was that the major providers did not possess the differentiators that they claimed to. All the players had very similar lists of qualities they claimed set them apart from the competition including their networks, their customer service and their technology leadership.

Although, again, providers mention the same differentiators as each other, such as networks and customer service, several of the players now seem to have a clearer idea of what sets them apart from the competition.

Figure 5 summarises the responses of the major providers to the question, 'What do you see as your main differentiators?'

Figure 5 **Claimed differentiators of major providers**

Provider	**Main differentiators**
AT&T	Network reliability and security, especially when under attack, continued investment in its network, trust and brand
BT Global Services	Financial stability, high levels of customer service, wide product offerings, ability to offer network-centric ICT solutions based on MPLS network, application-level SLAs , security and reliability
Cable & Wireless	Combination of WAN, Internet and hosting services, network-based security
Colt	Customer responsiveness, financial performance, pervasive local access network
Equant	Global proprietary network, local presence, combined network and service expertise, customised service offerings and strong customer base
Global Crossing	Reliable, resilient network, open management model driving rapid decision making, customer service and backing of ST Telemedia
Infonet	Sales approach and distribution model, superior customer service/support and multiple service integration
MCI	Network assets, especially IP backbone, innovation in IP VPNs and converged solutions, customer service and ability to offer a one-stop solution
T-Systems	Completeness of ICT portfolio, ICT expertise, sector-specific expertise and substantial resources for large projects
Vanco	The Active Negotiating Position (ANP), which means Vanco re-bids all of its infrastructure contracts every year to reduce costs; service/cost flexibility, its people, ability to manage several complex relationships on behalf of the customer, 'asset-light model' providing flexibility and multi-domestic coverage

Source: interviews with providers

Networks as a differentiator

Providers believe that it is their network that sets them apart from competitors. However, many of them highlighted different aspects of their networks as the factor that makes them better. For example, AT&T claims that its network is superior, more resilient and better able to respond to attacks (this is difficult to demonstrate when things are running smoothly). In addition, AT&T points to its continued investment in its network as a differentiator (although its capex/sales ratio is actually no more than average among its peers).

There are other providers that also highlight the variations in their network as a source of differentiation:

- **BT Global Services** points to the fact that it is able to deliver a wide range of ICT services in a network-centric manner using its MPLS network. It is also able to offer application-level SLAs rather than simply network-based SLAs
- **Colt** suggests that its metropolitan area networks provide a differentiator, since it has more extensive local access presence than most of its competitors in major European cities, thus lowering access costs
- **Equant** points to its large proprietary network (which runs to 220 countries and territories) which enables it to control and manage that network directly
- **Global Crossing** claims that its network is highly reliable and resilient, and that because it was designed and built as an IP network originally, the migration to IP services is less disruptive than for some of its competitors
- **MCI** believes that its massive international IP backbone is a differentiator globally, but also that its extensive network presence in Europe allows it to offer deep in-country coverage.

All these providers have extensive and reliable IP networks. As a result of this, differentiation within networks becomes features such as local access presence, network security or the ability to offer application-level SLAs – providers are beginning to carve niches for themselves.

Customer service and support

All providers interviewed believe they offer a superior customer service. A number of players (including BT Global Services, Global Crossing, MCI and Vanco) provided internal figures, which suggested their customer satisfaction was improving or was better than their competitors. In one of the few pieces of externally verified evidence, Infonet was determined by independent market research company Telemark as having the best customer satisfaction of the major providers (with AT&T very close behind) in a study published in June 2004.

It is becoming increasingly clear that the two things that drive customer service are people and local presence. Equant and Vanco mentioned their people explicitly, while Colt, Equant, Infonet and MCI mentioned their local presence and support structures. Others, including BT Global Services, Global Crossing, Cable & Wireless and T-Systems, did not stress their local presence, which is a sign that they have yet to develop the extensive local presence of some of their competitors.

Breadth of portfolio

Several providers stressed that the breadth of their product and service portfolio was a significant asset, although in several different ways:

- **BT Global Services** provides the widest range of services of any of the providers, from WAN services through to IT services, with only T-Systems coming close to this
- **Cable & Wireless** claims that its ability to offer WAN, Internet and hosting services sets it apart from the competition, although a number of its competitors (including MCI) are capable of offering a similar combination of services
- **Equant** is developing a significant professional services business to enable it to offer a consultative approach to selling its network services, which is intended both to provide competitive advantage and to provide additional revenue streams
- **Infonet** stresses its ability to handle convergence between data, voice and video services as a differentiator. However, other operators are similarly well-placed to offer multiple services over converged IP networks, including MCI and AT&T.

Although these companies are undoubtedly able to trade on their ability to offer a wide range of services with some customers, not all customers want a 'one-stop-shop'. Our research has shown that enterprises with large internal IT departments tend to shop around and choose multiple providers, each chosen for its expertise in a particular area. All the providers we spoke to regularly partner with other players to bring in expertise they do not have in-house – breadth of portfolio does not necessarily provide a major differentiator.

Financial stability

Inevitably in a market which includes two companies recently emerged from Chapter 11-bankruptcy protection, providers are keen to stress their financial stability. BT Global Services, Colt and Global Crossing all highlighted their financial positions as differentiators. Of these, only BT is currently profitable, although none are in the dire straits several were in one or two years ago. Our customer surveys indicate that customers are still wary of post-Chapter 11 players, and that they are expected to provide more competitive pricing than the financially stable players – financial instability could be a liability in more ways than one.

Subtle differentiation makes the 'elevator pitch' impossible

There seems to have been an increase in the degree of differentiation between the major players in the MNC market within the past year. Players have a clearer idea than they did a year ago of what sets them apart from their competitors. However, much of this differentiation is at a more subtle level than it would previously have been.

There is a problem with this increased subtlety – it makes an 'elevator pitch' on a provider's differentiators almost impossible. Past differentiators such as an IP/MPLS network, four or five classes of service and global network 'presence' (whether proprietary or through interconnection) have now become 'table stakes' – necessary to be taken seriously but certainly not sufficient to differentiate one provider from another. The side effect of this is that providers are forced to use eye-catching differentiators such as price, to get their foot in the door, which means that although there are improvements, price is still one of the few features which really sets players apart.

Vanco: truly different

Despite the fact that most of the providers are still only subtly different, Vanco continues to be a truly different sort of provider. This is because its business model is fundamentally different from that of the other providers, as it operates as a virtual network operator. It does not own any significant network assets itself, but rather buys in network capacity as needed, to serve its clients. Every year, it re-bids all of its supplier contracts as part of its Active Negotiating Position, ensuring that it always gets the best price for the infrastructure it buys in. These savings are then passed on to its customers, providing a compelling differentiator in the form of annual cost savings.

Vanco does not employ an army of network engineers, it employs mostly very skilled customer service, sales and managerial staff, poaching many of its senior managers from competitors, and it claims to be able to differentiate on the basis of its superior people, as well as its competitive costs.

The downside to Vanco's business model is its inability to offer innovative services, because it will always be limited by the capabilities of the networks it uses. As MNCs increasingly demand complex managed solutions, Vanco will find it difficult to compete, especially in the area of network-centric security services.

However, so far Vanco is enjoying considerable success. Its compound annual growth rate is around 40%, and it is one of the few players in the MNC market to be consistently profitable. It is also worth noting that Vanco is still considerably smaller than the major providers in its market, generating under $200 million in revenues in the last financial year, although CEO Allen Timpany expects to catch up with Infonet (revenues $620 million) within the next few years.

The search for growth continues

Growth in revenues remains elusive for some of the players we profile in this report. There are several downward pressures on revenues, including competitive price erosion, market share loss, the impact of migration to lower-cost IP services, and the 'more for less' mentality among large enterprises. These downward pressures would leave MNC providers with a substantial hole in their revenues if they were unable to provide growth, and the trend in the past year suggests that at least some are succeeding.

Essentially, providers can adopt one (or more) of four strategies for driving revenue growth:

- win market share from competitors
- increase share of spend from existing customers
- expand into new geographic areas
- rely on market growth to provide revenue growth.

Providers are adopting some or all of these strategies in order to drive growth over the next couple of years, as shown in *Figure 6*.

Figure 6 **Growth strategies**

Provider	Growth strategy
AT&T	Capture a share of market growth as more MNCs outsource their networks to managed network providers, sell value-added services to existing customers
BT Global Services	Pursue opportunities outside of the UK, where the addressable market is greater. Focus on solutions and systems integration businesses particularly outsourcing, CRM, mobility and hosting in Europe; acceleration in the US; focus on mid-market in the UK; and using partnerships
Cable & Wireless	Providing additional services to existing customers, IP services, including IP voice
Colt	New product developments, technology advances in IP and MPLS, allowing Colt to serve MNCs with more complex needs, Ethernet & VoIP, extended network reach and moving into professional services
Equant	Professional services, adopting a consultative sales approach, advising customers and designing an optimum, integrated solution to meet their needs. Also, expanding market reach, moving into new geographic areas and using indirect channels, improving customer satisfaction to increase loyalty
Global Crossing	Targeting opportunities in wireless, converged IP products and managed services, migration from frame relay and ATM to IP/MPLS solutions, capturing market share
Infonet	Developing new, complementary revenue streams from voice, video, security and mobility
MCI	Converged IP solutions, improved access technologies enabling MCI to connect additional sites to VPNs, network management, hosting and security
T-Systems	Focus solutions, enhanced international 'big deal' performance, expanding wallet share, developing accounts
Vanco	Continued new business wins (Vanco has a CAGR of around 40% already), plus incremental wins of additional business from existing customers

Source: interviews with providers

Only the smaller players (in terms of MNC revenues) strongly emphasise winning market share, among them Vanco, Global Crossing and BT Global Services. This is borne out by financial analysis, which shows that, with few exceptions, revenue growth rates and size are inversely correlated. The more established MNC providers are focusing on selling additional services to their existing customers in order to increase their share of spending. This group includes MCI, AT&T, Equant and Infonet.

Only Equant and BT Global Services are actively seeking to grow by targeting new geographic areas.

Those providers seeking to drive revenue growth through new services are focusing on several key areas:

- **new access technologies** – several players are targeting new access technologies, such as DSL, Ethernet, WiFi and mobile as enablers of growth, especially with regard to smaller sites and remote access
- **new content and applications** – several other players are hoping to see an increase in spend flowing from new applications running over converged networks, such as voice and video
- **value-added services** – other players are hoping to see value-added services such as hosting, security and application-level service guarantees and provide incremental revenue streams
- **professional services and integration** – a handful of players are looking beyond managed network services and towards systems integration and professional services as a source of future growth.

No player seems willing to rely on market growth alone to drive revenue growth, even though the market is forecast to grow modestly in the next few years through a combination of growth in demand and increasing out-tasking of network management. Rather, successful players realise that they must drive growth in other ways if they are to offset the downward pressures of price erosion and competition.

Financial review

In our report last year, as well as reviewing the strategy of major players in the MNC market, we reviewed the financial performance of those same players. We found that the lack of differentiation between the players and the fact that they all appear to be chasing the same set of customers was causing dramatic price erosion. This in turn was causing revenue stagnation or decline, and declining profitability. We have returned to these same issues this year to see if the changes in strategy discussed above are having an impact on financial performance.

Price erosion

Price erosion is still a feature of the market, despite the increase in differentiation among the various players. Although a number of players, particularly MCI, claim to have seen price erosion slowing in the past year, it seems that it is still proceeding at a precipitous rate. Annual price erosion appears to be at 10–15%, with as much as 30% being knocked off the value of multi-year contracts when they come up for renewal, despite the improvements in differentiation.

The lack of differentiation is not the only cause of price erosion – two other factors are also at play:

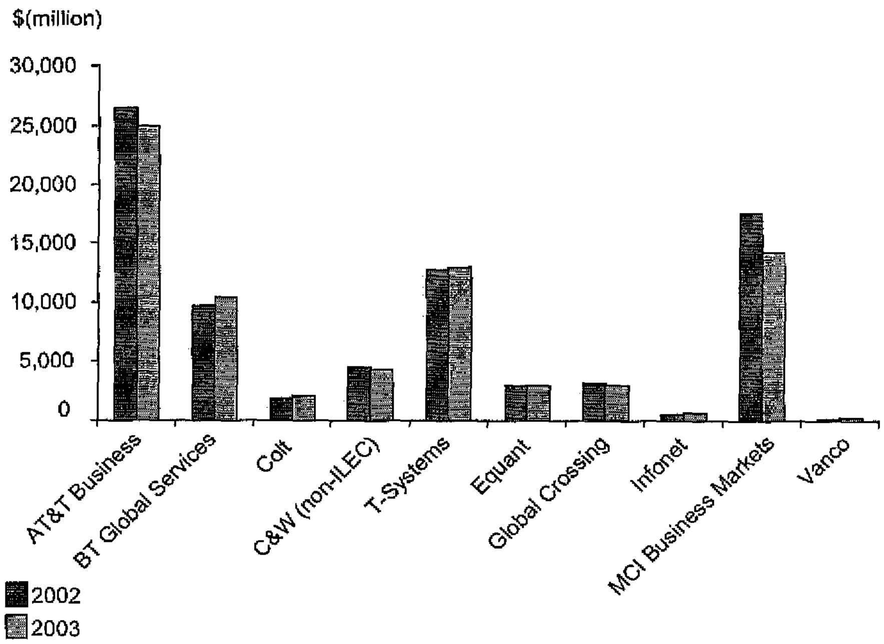
- **tough macro-economic conditions.** Since the US and European economies are still growing at a slow pace, many enterprises are keeping a tight rein on their IT and telecoms spending. Many CIOs still see networking as an area which should provide savings rather than an area in which to invest, although this is beginning to change
- **migration to IP technologies.** AT&T was the only provider to put a number on this cause of price erosion, stating that prices for IP/MPLS solutions tend to be sold at a 20% discount on frame relay and ATM services. Although most providers seek to use migration as an opportunity to sell new value-added services, there is still a considerable loss of revenues when migration takes place.

Revenue trends – largely positive, helped by currencies

> Note: because not all of the providers analysed in this report are 'pure' MNC providers, we have attempted to use the numbers which most closely reflect the MNC business of these providers. However, in some cases such a breakdown is not available and so the figures shown here do not fully reflect the MNC business of these providers.

Figure 7 shows the revenues for the relevant divisions of the companies analysed in this report for the last two reported financial years.

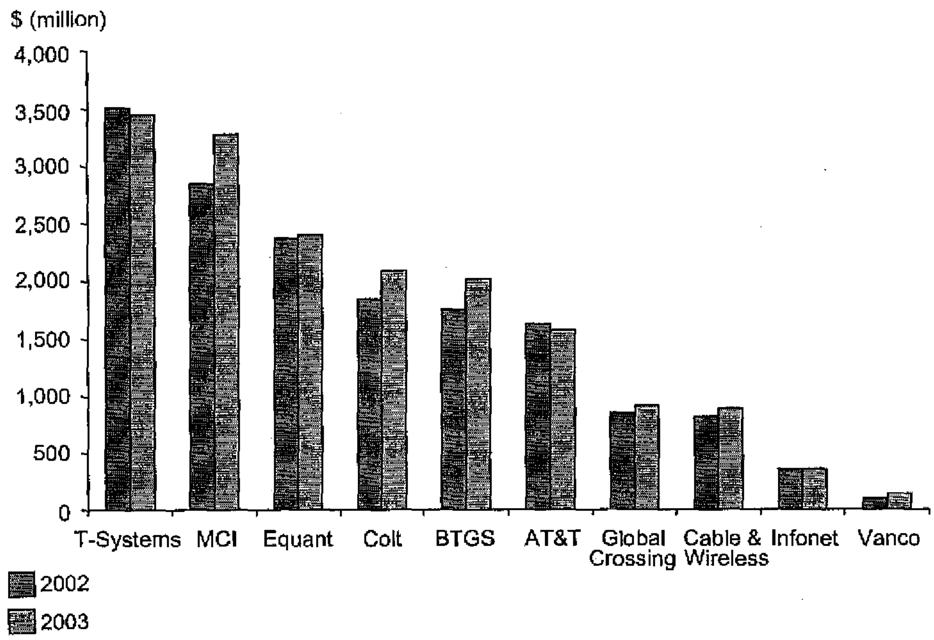
Figure 7 **Revenues for major providers' relevant divisions**



Source: providers, Ovum

Figure 8 shows the revenues these providers generate from the European region. We have excluded domestic revenues for Deutsche Telekom and BT, since this would distort the picture unreasonably by including revenues from national, rather than multinational, enterprises. Any comparison of this kind is necessarily imperfect, as a result, this figure should be seen as illustrative rather than authoritative.

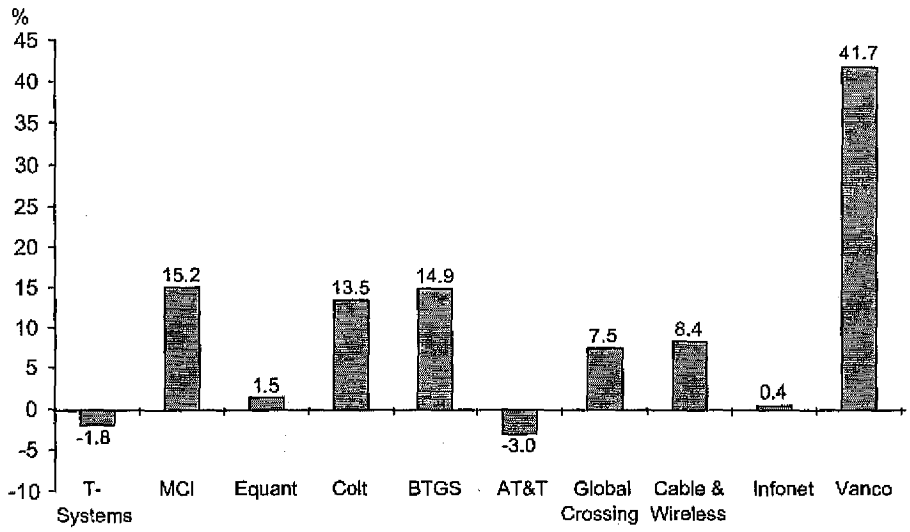
Figure 8 **Revenues from European region**



Source: providers, Ovum

T-Systems emerges as the largest MNC business in Europe, with MCI just behind it. Infonet is the smallest of the network owning providers, while Vanco is the smallest overall, though also the fastest growing, as shown in *Figure 9*.

Figure 9 **Growth rates, European revenues, 2002-2003**



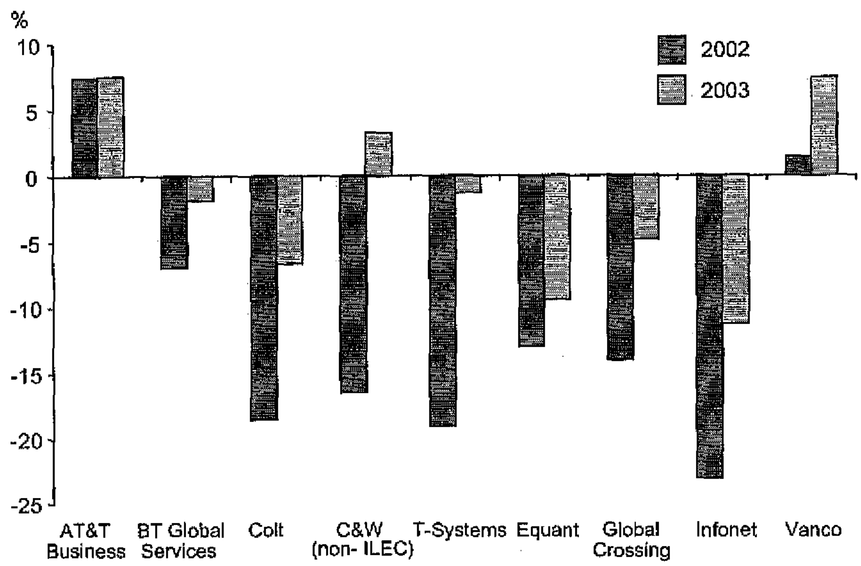
Source: providers, Ovum

Both AT&T and T-Systems saw a decline in their European businesses in 2003, while all the other providers saw increases. The US players, particularly MCI, saw a currency-related increase in 2003 which masks the more modest underlying revenue growth in local currencies. However, Colt, BT Global Services, Cable & Wireless and Vanco grew strongly during the course of the year.

Profitability

Figure 10 shows EBIT margins for the relevant divisions.

Figure 10 Operating profit margins for relevant divisions

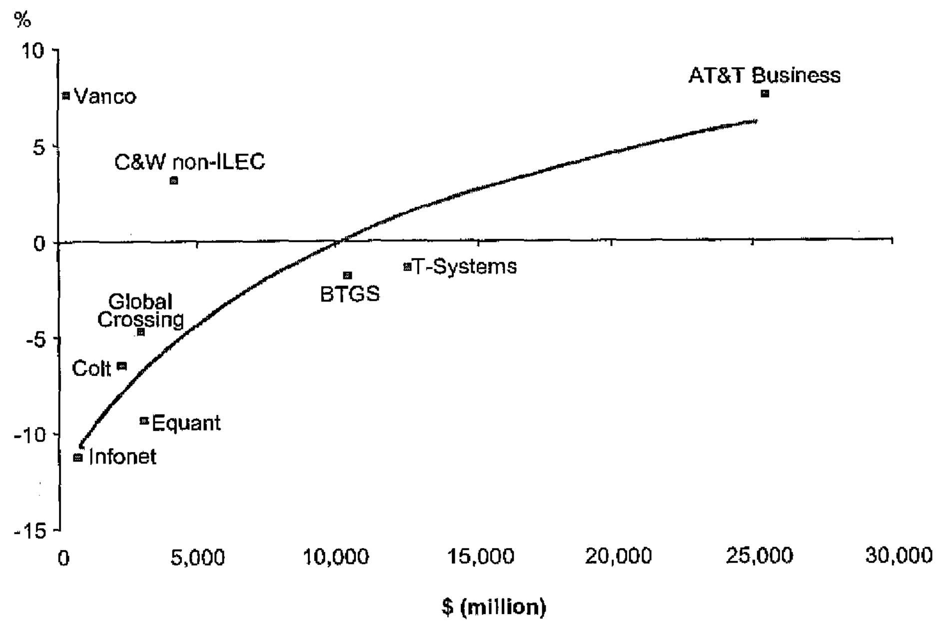


Source: providers, Ovum

Of the providers profiled here, only AT&T Business, Cable & Wireless's relevant divisions and Vanco are profitable at the operating level. None have an operating margin higher than 8%, which is considerably lower than the margins of most incumbent telecoms operators, for example. However, all the players profiled here made improvements in their operating margins in 2003, which was an achievement in the face of price erosion.

There is a very close correlation between scale and profitability, with only a couple of exceptions, as shown in *Figure 11.*

Figure 11 **Revenues and operating margins, 2003**



Source: providers, Ovum

With the exceptions of Vanco (which employs a fundamentally different business model) and Cable & Wireless, there is a clear correlation between scale and profitability, as indicated by the red line in *Figure 11*. (The figure for Cable & Wireless includes significant amounts of non-MNC business, as does the figure for AT&T consequently these are not directly comparable with the others). Infonet simultaneously has the lowest revenues and the lowest operating margin of any of the players, while AT&T Business has the highest revenues and the highest margins.

This should not be surprising – providing network services is a scale business. Constructing a global network entails certain fixed costs, which must be shared by the customers using the network. The greater the number of customers, therefore, the more profitable each one should be. It will therefore be interesting to see whether those companies currently furthest from operating profitability – Infonet, Equant, Colt and Global Crossing – can manage to achieve it without growing substantially.

Debt levels and the impact of Chapter 11

One of the scare stories told in an attempt to prevent MCI and Global Crossing from emerging from Chapter 11 bankruptcy protection was that they would come out with such healthy balance sheets as to allow them to disrupt the market considerably. However, although their debt levels are low, a brief look at the debt levels of the major players shows that MCI and Global Crossing are far from debt free. Neither Infonet nor Equant have any bank debt, although AT&T, BT and Deutsche Telekom all have higher levels of debt. However, neither MCI nor Global Crossing is in a position to sell services at a loss, since neither is consistently profitable at net income level.

Despite these facts, enterprise and wholesale customers appear to expect post-Chapter 11 providers to offer services at a lower price than their competitors. Therefore, even if MCI and Global Crossing do not deliberately adopt a price-discounting strategy, their customers may force them to. The risk then, is that other players will have to follow to remain price competitive and that the market will enter a downward spiral. The second half of 2004 will be a crucial period in determining whether this happens or not.

Appendix: financial performance

Some of the providers analysed in this report serve markets other than simply the MNC market, making direct financial comparisons are complicated. We have attempted, where possible, to use the financial figures which most closely reflect the MNC business for these providers. However, certain providers do not provide such a detailed breakdown of financial performance and so we have used the closest possible numbers.

Figure 12 shows the figures we have used in our comparisons.

Figure 12 **Figures used in financial comparisons**

Provider	**Figures used**
AT&T	AT&T Business
BT	BT Global Services
Cable & Wireless	National Telco businesses in UK, Europe
Colt	Colt
Equant	Equant
Global Crossing	Global Crossing
Infonet	Infonet
MCI	MCI Business Markets
Deutsche Telekom	T-Systems
Vanco	Vanco