REVIEW OF GLOBAL TELESYSTEMS (GTS) [1]

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Part A: GTS Profile
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PROFILE OF GLOBAL TELESYSTEMS (GTS)

1/Origins and Development

George Soros' Involvement

The history of GTS can be traced back to 1983 when it was formed under the name San Francisco/Moscow Teleport, a not-for-profit venture funded by a charitable trust operated by George Soros. Its original remit was to improve communications between Russian and U.S universities.[2]

Soros, a 68 year old Hungarian born financier and philanthropist operates the Quantum Investment Fund which is said to have contributed to a personal fortune of over $5 billion.[3] His philanthropy which takes the form of various charitable institutions, including the Open Society Foundation, was estimated to be in the region of $362 million in 1996. According to a Soros Foundation spokeswomen:

> "the main aim of George Soros's philanthropy is education, supporting an independent media and creating an environment for open, critical thought"[4]

Given the concern which Soros expresses for openness in society it seems appropriate that the main legacy of his Russian experience should be a telecom and communications company such as GTS.

The company was incorporated as a for-profit corporation in 1986, while its name changed to Global Telesystems Group, Inc (GTS) in February 1995. By this stage it was a conventional commercial operation, far removed from its charitable origins.

[1] This paper has benefited from funding provided by the Targeted Socio-Economic Research (TSER) Programme of the European Commission (DGXII) under the Fourth Framework Programme, European Commission (Contract no.:SOE1-CT98-1114; Project no: 053).
[2] Business Week (3/5/99)
[3] The European (17/7/97)
[4] Quoted in Ibid.

The Russian operations of Soros have not been without their problems with reports in 1997 that he had to re-structure the operations of GTS when it was discovered that certain employees had been diverting funds into Swiss bank accounts.[5]

Soros' interest in telecoms in the ex-Soviet Union also led him to take part in a consortium which in 1997 bought a 25 percent share in Svyazinvest the national telecoms holding company privatised by the Russian Government. Also involved in the deal was Morgan Stanley Asset Management which has a significant interest in GTS. Following the economic crisis in Russia in 1998 there were many who felt that Soros timed his intervention badly, with the $1.9 billion consortium stake (of which he had contributed $980 million) valued at little more than $1 billion by the middle of 1998.[6] The publication, the European, implied that the deal was murky in nature and was not in the best interests of the telecoms industry in Russia. Examining the members of the Soros consortium it stated that, "the only glaring absence from the group is anyone who knows anything about telecoms".[7]

In assessing the involvement of Soros with Svyazinvest it is not entirely apparent if there is a tie in with his connection to GTS. In one of its annual submissions to the SEC GTS mentioned Svyazinvest as a potential "risk factor" stating that:

> "The Russian government has reorganized the Russian telecommunications industry so that one entity, Svyazinvest, now owns a majority interest in most of our principal venture partners and other telecommunications service providers in Russia. This reorganization could have a material adverse effect on our operations and the price of our common stock because:
>
> - Svyazinvest is likely to become a stronger competitor; and
> - Our business relationships with our principal venture partners, which make up a major component of our business strategy in Russia, may be hurt"[8]

Perhaps the most that can be said is that if Svyazinvest does destabilise the position of GTS within the region then the presence and influence of Soros is likely to mitigate this.

As GTS' "celebrity investor" it is no surprise that Soros has brought the company into contact with other notable world figures. In 1996 he was involved in a joint venture deal with Prince Albert of Monaco, which involved the Principality's establishment of an independent country code -a move aimed at competing with the existing monopoly operators. The new company was to be known as GTS Monaco Access SAM and was to provide international phone services to cellular phone companies, cable-television companies and other telephone newcomers.[9]

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[5] Ibid.
[6] European (31/7/97, 20/7/98)
[7] European (31/7/97)
[8] GTS. SEC Form 10K, 1998 , p57
[9] Wall Street Journal (26/3/96)

Alan Slifka and Gerald Thames

Another key player in the founding of GTS was Alan Slifka whose Abraham Fund is geared towards international reconciliation (in particular between Jews and Arabs). In a review of this individual, Forbes stated that, "sometimes, Slifka's do-good activities yield investment opportunities" [10] and so it proved with GTS.

In the 1998 GTS Annual Report, on a page entitled “a thank you”, credit for the foundation and development of the company is given to Slifka, Vice Chairman throughout the 1990s and Gerald Thames who acted as President and CEO from 1994 until 1999 and who is now Executive Vice Chairman.. No mention is made of Soros - an indication perhaps that his contribution was financial rather than managerial.

In this same Annual Report the company’s history is divided into two phases, each of which, it suggests, were personified by the two key individuals mentioned. Slifka had the “financial acumen” to see the profit potential in the non profit making organization which he spearheaded. The changing direction of the company was assisted by the arrival of Thames, with his strong telecommunications background (he previously held the position of president and CEO of British Telecom, North America). Through his influence the company started looking West and took the initiative in the Hermes Europe Railtel (HER) project in the mid 1990s (see separate profile of HER in part B) . At the same time the company began to respond to the liberalisation of telecom services in Russia and the CIS, developing itself into a leading alternative telecoms company, serving government and business customers in cities such as Moscow, Kiev and St Petersburg.

Given the positive influence of Soros and Slifka in the formation of the company, it is interesting to note that GTS was compelled to mention the two individuals within its 1998 SEC submission under “risk factors” due to the size of their combined share holdings.

Recent Developments

In the late 1990s the company made rapid progress and was regarded as one of the most significant players in the European broadband market. Its growing pan-European network was apportioned a high value on Wall Street and its share price made steady progress (see Share History, below). Its successful development was acknowledged in October 1999 when the company received the World Communications Award (WCA) for “Best Wholesale Carrier”. In December 1999 it was named “Best New Carrier” by the members of the European Competitive Telecommunications Association (ECTA).[11]

Throughout 2000, however, the company has had to contend with a change of market sentiment as the belief has spread that a future bandwidth glut will affect its earnings. In September 2000 GTS’ CEO, H. Brian Thompson, resigned as the company faced

[10] Forbes (7/9/98)
[11] GTS Press Release (2/12/1999)

increasing difficulties with its stock price falling by 90 percent in less than a year. The company was reported to be seeking ways of raising finance with forecasts estimating that it would run out of cash by June 2001. A take-over was also widely predicted with companies such as BT, Deutsche Telekom, Telefonica and France Telecom seen as the most likely candidates.[12]

2/Investors

Historically GTS has raised finance through public and private offerings of equity and debt securities. Through the issuance of its common stock it received net proceeds of $370.1 million, $89.8 million and $141.7 million in 1998, 1997 and 1996 respectively. In addition, as of the end of 1998 the GTS Group has debt securities totalling $1.6 billion [13] A significant proportion of these securities fall into the high-yielding, "junk bond" category. In late 1999 it raised a further Euros 500 million through the issuance of a further high yield bond.[14]

George Soros, one of GTS' co-founders, was one of the main early investors and continues to hold a big minority stake. As of 1997 this stake was estimated at 26 percent. The importance of Soros was reflected in 1998 by the inclusion on the Board of Directors of Frank Sica who is Managing Director of Soros Fund Management LLC and head of Soros Fund Management's Private Equity operations. At the end of 1998 Soros held approximately 4.7 million shares in the company.[15]

Alan Slifka was co-founder of GTS and by September 1998 it was estimated that his stake was worth $151 million.[16]

Oscar Castro, who runs a fund called Montgomery Global Communications was described as having a "big position" in the equity of GTS.[17] At the start of 1999 GTS was this fund's largest single stock holding.[18]

The top 5 institutional investors in GTS as at 31/3/99 were:

- The Equitable Companies (9.8 million shares)
- Putman Investment Management (4.7 million shares)
- Fidelity Management and Research (4.6 million shares)
- AIM Management Group (3 million shares)
- Massachusetts Financial Services (2.9 million shares)[19]

[12] FT (12/10/2000)
[13] Annual Report, 1998, p20
[14] FT (20/11/99)
[15] CBS.marketwatch, 7/6/99
[16] Forbes (7/9/99)
[17] Barron's (31/8/98)
[18] Upside (March 1999)
[19] Yahoo Finance Web site (21/6/99)

3/Aquisitions, Mergers and Joint Ventures

Acquisitions and Mergers

In 1995 Hermes Europe Railtel (HER) was established as joint venture between GTS and 11 European railways acting under the corporate entity, HITRail B.V. The objective was to establish a high speed transmission network across national borders in Western Europe. The network began to operate in late 1996. Since the inception of HER the position of GTS within it became increasingly dominant and today it is a subsidiary of the company. By the end of 1998 GTS had a 86 percent stake in HER.[20] In 1999 it bought out its final railway partner, taking complete control of the operation (HER is discussed more fully in part B of this report).

In the course of 1998 GTS invested nearly $20 million in the purchase of leading ISPs in Central Europe. These include ATOM and Internet Technologies in Poland, Datanet in Hungary and Netforce in the Czech Republic. These purchases improved GTS' ability to offer IP services such as e-commerce and web hosting.[21]

In June 1998 GTS, through its subsidiary, HER, bought 75 percent of Ebone A/S one of Europe's largest internet backbone providers.[22]

In August 1998 GTS and AmTec agreed to a merger of their Chinese operations.

In October 1998 GTS purchased NetSource Europe ASA for $155 million in cash and stock. This pan-European operator, based in Norway, caters primarily for small and medium sized business. [23]

In December 1998 GTS was thought to have missed out on buying the telecoms unit of Eastern Group which went to NTL, the UK cable company for £91 million. The unit has a fibre optic cable network covering the south and east of England, together with 121 radio masts across East Anglia serving mobile phone networks.[24]

Also in December 1998 GTS took control of Esprit in a $757 million deal. Approximately 65 percent of the holders of Esprit voting stock accepted the deal, indicating that the strongly independent company did not give up easily.[25] Boardroom conflict at Esprit around this time may have contributed to the deal going ahead (see Esprit profile in part C of this report). The deal which was officially a merger under a "pooling of interests" arrangement was the largest of its type by a US company making a UK take-over. The arrangement had significant tax advantages over a direct take-over.[26]

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[20] FT (9/12/98)
[21] Annual Report, 1998 p7
[22] FT (9/12/98)
[23] New York Times (10/10/98), FT (9/12/98)
[24] FT (23/12/98)
[25] FT (12/12/98)
[26] FT (9/12/98)

In January 1999 GTS denied that the company was in merger talks with COLT although it was admitted that talks had taken place the previous year.[27]

In April 1999 GTS bought a 52 percent controlling interest in Omnicom (France) for around $210 million from the company's founders and managers . Omnicom provides telecom services to 11,500 small and midsize business in France.[28]

In August 1999 GTS took control of Belgian telecommunications services company, InTouch, in exchange for cash and stock. The company serves the residential and SME market in Belgium.[29]

In February 2000 GTS acquired Netcom Internet Ltd of the UK in an all paper deal valued at $91.5 million. The company is an ISP focusing on the business-to-business market.[30]

In July 2000 GTS bought the Internet division of CS-COMPEX, a company based in the Czech Republic.[31]

Joint Ventures

In Russian and the CIS GTS works with a number of joint venture partners. These include: Sovintel, which is jointly owned with Rostelecom, which operates in Moscow providing local, national and international services: Sovam Teleport which is the founder of "Russia-on-line": Telecommunications of Moscow (TCM) which provides voice-based services including conference call and voice-fax storage services and TeleRoss, a backbone service operating between 14 Russian cities.[32]

GTS co-operates with BT in Central and Eastern Europe (Hungary and Czech Republic) through its provision of sales and support for the Concert operation.[33]

Through its subsidiary HER, GTS has operating agreements with numerous other telecom companies. It has negotiated a facilities deal with COLT to carry its traffic across Europe.[34] HER has a partnership agreement with Cable and Wireless in the UK through which it is assisting the UK operator to develop its European network.[35] The computer services group ICL announced it would be leasing capacity from HER as part of its move into the data communications market.[36] Chello Broadband, an ISP, has an agreement with HER to lease services on its network.[37] It also counts amongst its customers many of the incumbent carriers such as BT and Deutsche Telekom.

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[27] (FT 14/1/99).
[28] New York Times (15/4/99)
[29] GTS Press Release (18/8/99)
[30] GTS Press Release (4/2/2000)
[31] GTS Press Release (18/7/2000)
[32] GTS Annual Report 1998 p14
[33] BT web site, June 1999
[34] FT (13/2/98)
[35] FT (9/12/98)
[36] FT (28/10/98)
[37] Business Wire (2/11/98)

In January 1999 GTS announced that it was working on a 50:50 joint venture with FLAG Telecom in the construction of a transatlantic cable known as Flag Atlantic - 1. The project is due for completion in the first half of 2001.

Flotations

In October 1999 GTS floated off part of Golden Telecom, one of its major Russian interests. The IPO on NASDAQ raised $140 million for GTS which retained a 65 percent stake in the company.[38]

4/Network

As a new arrival on the scene GTS has been able to approach its network development without the shackles of aged equipment and infrastructure. According to the company it has, "…the most extensive, advanced and sophisticated fiber optic network in Europe".[39]

In mid 1999 it was estimated to have 12,000 km of high capacity fibre-optic cables representing the most extensive network in Europe.[40] The company's own figures indicate that as of April 1999 it had a network of 13,200 km, with a presence in more than 50 cities predicted for the end of 2000. By 2000 its network had grown to 17,000 km.[41]

In 1999 Bear, Stearns and Co indicated that GTS was developing a 25,000km pan-European fibre network, a 12,000km transatlantic network (with FLAG) and CLEC fibre networks in 12 of the top cities in Europe. By the end of year 2000 they suggested that GTS would have the most extensive network of all the new entrants in Europe.[42]

A crucial factor with GTS' network is its modernity, based upon high capacity 'self healing' SDH technology, the system of choice for the growing data transmission market. Much of the network is equipped with Wave Division Multiplexing which increases capacity by many times and offers substantial price savings.[43]

The bulk of GTS' network capacity is provided through the HER infrastructure. More recently, the network being constructed by Esprit has also come into GTS' possession. For a fuller discussion of these two networks see the HER and Esprit sections of this report.

[38] FT (1/10/99)
[39] GTS Web site
[40] Business Week (3/5/99)
[41] GTS Web site
[42] dowjones.com (13/5/99)
[43] FT (9/12/99)

5/Addressable Market

Market Size

According to the 1998 GTS Annual Report the company's services are addressed at a European market worth $130 billion, with the carrier segment accounting for $30 billion of that total.

In 1999 the value the global communications market was put at £438 billion per year. Of this, Europe accounted for 31 percent, the U.S. for 27 percent and Japan for 12 percent.[44] The long-distance market in Europe has been estimated at $200 billion a year compared with $160 billion for the U.S..[45]

Credit Suisse First Boston suggested that the European telecoms market was growing at around 11 percent a year (comprising of volume growth of 17 to 18 percent and price deflation of 6 to 7 percent). It calculated that the market would grow from $194 billion in 1999 to $413 billion by 2005.[46] Virtually all of this growth was projected to come from data and mobile traffic with voice traffic growing just enough to offset predicted price declines.

This growth of data in Europe is a reflection of an identical trend at the global scale. Credit Suisse First Boston estimate that by 2005, 85 percent of all telecom traffic will consist of data.[47] Applications outsourcing is part of this growing data market. Durlacher Research (London) predict that in Europe it will grow from $14 million in 1999 to $1.5 billion by the end of 2004.[48]

According to Commerzbank the telecoms sector in Europe is growing at 8 percent a year. It predicts that the value of the top 6 territories: the UK, Germany, France , Italy, Spain and the Netherlands will grow from $129 billion in 1997 to $246 billion in 2005. Much of this growth will come from mobile services (from 19 percent in 1997 to 34 percent in 2005) and from the internet. [49]

With the growth of the Internet in Europe there will be an increasing need for bandwidth. Estimates from Dataquest indicate that the number of European PCs going on line will rise from 13 million at the start of 1997 to 69 million by the end of 2002.[50] Estimates from telecoms consultancy, Ovum, indicate that total pan-European bandwidth demand will exceed 9 Tbit/s in 2005 (up from 339 Gbit/s in 2000). The market for managed bandwidth is forecast to grow from $2.5 billion in 2000 to 10.7 billion in 2005.[51]

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[44] Observer (17/10/99
[45] Business Communications Review (July 1999)
[46] Credit Suisse First Boston , Viatel Research Note (21/9/99)
[47] Credit Suisse First Boston, op cit
[48] quoted in Tele.com, 25/10/99
[49] FT (18/3/99)
[50] FT (18/3/99)
[51] FT (15/3/2000)

Target Customers

GTS is focused upon the corporate market using its advanced network to attract high value voice and data business from European businesses. As of 1999 it was estimated that GTS had 35,000 business clients in 20 countries.[52] It also claimed to have 180 wholesale customers, including most of the major European carriers and ISPs.[53]

In GTS' own assessment it states that, "ultimately the company's customer base will embrace every segment of the business market, from small and mid-sized businesses to ISPs and telecommunications companies".[54] GTS' strength within the business sector was enhanced by the merger with Esprit which was incorporated within the GTS Business Services division.

6/Share History

GTS held its Initial Public Offering (IPO) via Merrill Lynch in early 1998, with a distribution of 12.8 million shares priced at $20.[55]. Given the Russian locations of the bulk of the company's operations, Barron's indicated that "most individual investors probably do not want to buy into the risk".[56] A year and a half later with the shares around $90 there are undoubtedly many who wish they had taken that risk. Individual investors, though, are not the only ones wiser with hindsight. A number of investment banks were also "squeamish" about the IPO prospects due to the market conditions at the time.[57]

With its level of exposure in Russia GTS was always going to be vulnerable to any economic downturn in that part of the world. When the crisis arrived in mid 1998 the shares of GTS fell from around $55 to around $25, before gradually climbing back up to new highs.

While both GTS and Esprit were listed on Nasdaq and Easdaq prior to their merger in early 1999, there was subsequently some talk of a London listing. Such a listing would put the company close to the FTSE 100 and may also improve its valuation. As the FT pointed out companies such as COLT enjoyed a much higher rating than the enlarged GTS even though its earnings were much lower.[58]

In May 1999 GTS announced that it would indeed be seeking a new listing in Europe - but on the Frankfurt rather than London exchange. In the US the company opted for a new listing on the New York Stock Exchange which it believed provided a better level of trading liquidity and market intelligence than on Nasdaq. [59]

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[52] Business Week (3/5/99)
[53] GTS Web site
[54] 1998 GTS Annual Report (p10)
[55] Annual Report, 1998 p36
[56] Barron's (2/2/98)
[57] Investment Dealer's Digest (21/7/97)
[58] FT (9/12/98)
[59] GTS Web site

In June 1999 GTS announced a 2 for 1 stock split, in the form of a stock dividend, increasing the company's authorised common shares from 135 million to 270 million. With the shares hitting over $90 in June 1999 the move would make the stock more marketable. The official line expressed by GTS' Chairman and CEO, Brian Thompson was that "the stock split highlights our strong belief in the company's long term potential for creating shareholder value".[60]

Soon after opting for its listing on the New York Stock Exchange the company experienced a severe reverse in its fortunes. During 2000 its share price suffered a prolonged decline standing at $2.81 by October 2000.[61] By this stage its problems had little to do with its Russian exposure. Rather the markets feared that the company's earnings would suffer from an anticipated glut in the supply of bandwidth.

7/Company Data

In May 1999 GTS employed 4,000 workers in Europe with a small number (100) in the US.[62]

Table 1 shows the rapid rise in the company's revenues between 1994 and 1999. No less dramatic, however, was the increase in the company's losses during the same period (Table 2). As already mentioned, during 2000 there were concerns that the company was on the verge of running out of cash.

Table 1 - **GTS: Revenues**
Revenues ($ millions)
1994 8.3
1995 30.5
1996 62.5
1997 121.5
1998 372.4
1999 852.2
Source 1999 Annual Report

[60] CBS.marketwatch (22/6/99)
[61] Interactive Investor Web site
[62] Business Week (3/5/99)

Table 2 - **GTS: Net Profits (Losses)**	
	Profit (loss) ($millions)
1994	(18.0)
1995	(44.2)
1996	(76.2)
1997	(134.8)
1998	(255.8)
1999	(616.7)
Source 1999 Annual Report	

8/Strategy

At its inception GTS was primarily focused upon the ex-Soviet Union and was described within the financial press as a "U.S company that considers Russia its home market".[63] Part of its strategy in these early days was to use Russian nationals in its top management positions which allowed it to quickly develop strong contacts within the Russian communications industry.

In its 1998 Annual Report GTS makes clear in its “Management’s Discussion” that from its inception until 1998 its goals were:

> 1/ providing telecom services in emerging markets, particularly Russia and 2/establishing and developing the HER network in order to capitalise upon the liberalisation of the European telecoms market.

On January 1, 1998, telecommunication services within the European Union were deregulated and GTS set out to reinvent itself. This was made plain in the 1998 Annual Report which referred to 1998 as “a watershed year” during which “we changed our strategy”.[64]

In addition to deregulation the economic crisis in the emerging markets of the ex-Soviet Union further encouraged the company to focus upon new territory. By the end of the year GTS had announced its merger with Esprit telecom, with the purchase of Ebone and Netsource underlining its new strategic positioning as an integrated telecommunications services company. In October 1998 the change in the corporation’s outlook was reflected by a realignment of its operations into five lines of business: GTS Carrier Services, GTS Business Services, GTS Access Services, GTS Business Services - CIS and GTS Mobile Services - CIS. In March 1999 it added a sixth line of business: GTS Wholesale services.

In more detail the company’s future strategy is stated as:

[63] Global Finance (July 1996)
[64] 1998 Annual Report, p2, p18

- to continue the development of the HER network and by supplementing it via the FLAG transatlantic cable agreement
- extend the market penetration of the HER network and enhance it through the provision of GTS controlled local access
- capitalise upon the growth in data/IP traffic by expanding GTS' IP-based capabilities and products
- Increase the customer base within the "high usage" category and route traffic over GTS' own network [65]

In May 1999 the company announced a further re-structuring involving the formation of two sales and services operations - one focused on the retail market, the other on the carrier market. In addition a new unit called, GTS Business Products was to be established, responsible for corporate market analysis and strategic product development.[66]

In a recent SEC submission the company also gave an indication of how it planed to use the depth of the GTS Group to enhance its offer to its business customers:

> "We intend to integrate the marketing and service offerings of our Business Services with the network infrastructure of our Carrier Services, Wholesale Services and Access Services lines of business. Our Business Services line of business plans to utilize Hermes Railtel's network to transport city-to-city traffic within Europe and to utilize the least cost routing infrastructure of Wholesale Services to terminate international traffic outside of Europe. We intend to offer direct local access to our Business Services customers in those cities where Access Services establishes operations. In addition, both Business Services and Access Services plan to work closely together to identify key customers and to develop joint service offerings".[67]

The shift that took place in the company during 1998 is shown by the fact that in that year only 10 percent of the company's asset base and less than 25 percent of its revenues were generated in Russia and the CIS. Further investments in this region, its original target market, have been "temporarily suspended".[68]

Business Week also identified 1998 as the year GTS changed its strategy, moving from a simple telecoms wholesaler (carriers' carrier) into a, "full service continental phone company".[69] This change of strategic direction led to the purchase of Ebone, Netsource, Esprit Telecom and Omnicom. By mid 1999 the same publication was suggesting that GTS was becoming a "fearsome presence" in Europe.[70]

Using its extensive, state of the art network, GTS is aiming to attract the big business users of telephony and data services. It is also tapping into the growth of the Internet

[65] Ibid.
[66] GTS Web site
[67] SEC 10-k document (1998, p6)
[68] Annual Report 1998 p3
[69] Business Week (3/5/99)
[70] Ibid.

and the increase in data traffic which will follow between the US and Europe. This is the rationale behind its involvement in the Flag - Atlantic 1 joint venture.

Commenting upon the merger with Esprit the FT agreed that the new entity would be a "formidable force" in European Telecoms.[71] Apart from taking out a direct rival GTS was aiming to increase its network in the West of Europe and, just as importantly, to secure new business contracts. As David Cleevly, Managing Director of Analysys, put it, "this is all about securing traffic to fill the networks".[72]

By creating such an extensive network GTS has put itself in a position to break away from restrictive and costly agreements with domestic operators thereby controlling its own pricing and quality strategy. Commenting upon what was needed for a European telecom operator to be viable in the modern operating environment the FT indicated that, "the merger between GTS and Esprit satisfies all the criteria...".[73] That GTS was in full agreement with these sentiments was revealed by its reproduction of the FT's comments in its 1998 Annual Report.[74]

At a wider level, the merger with Esprit, together with the involvement of GTS with other digital technology providers, was seen as part of the general convergence between telecom firms and computer networking companies (and in turn software providers).[75] The spate of mergers between telecoms and high tech outfits (e.g. Nortel and Bay networks and Alcatel and Xylan) in the late 1990s indicated, in the words of the FT, that "the days of the telecoms-only company are numbered".[76] In an earlier article, the FT made a similar point , using the idea of a convergence between telecoms hardware and software. According to this model:

> "the transmission infrastructure is the hardware element of the data wave. Billing systems and customer care systems are the software component"[77]

The merger between GTS, with its extensive network, and Esprit, with its customer focus and software knowledge, was in keeping with the logic of this industrial convergence.

The joint venture with FLAG represents a continuation of GTS' strategy of operating its own autonomous network and of freeing itself from the prohibitive interconnection fees of the traditional telecom companies. As the Vice-President of FLAG put it, "new operators in Europe understand that if they cannot get access to international markets on a low cost basis they cannot compete".[78]

In defining the merged companies goal as that of becoming Europe's pre-eminent provider of carriers' carrier and business communications services, David Oertle,

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[71] FT (9/12/98)
[72] Quoted in FT (9/12/99)
[73] FT (9/12/98)
[74] 1998 Annual Report, p15
[75] FT (24/3/99)
[76] Ibid
[77] FT (10/6/98)
[78] FT (18/3/99)

Esprit Chief Executive, indicated that the two companies had saved three years of development by combining their operations. Reviewing these goals for the combined group, Gerald Thames of GTS, demonstrated rather more caution than his Esprit counterpart, indicating that, "our goal by 2003 is to be one of the top 2 or 3 pan European carriers".[79]

The strategy of GTS is endorsed by Bear, Stearn and Co which states:

> "we believe that there are few - if any- companies as well positioned as GTS to take significant market share away from the incumbent PTT's in Europe and to capitalise on the burgeoning demand for broadband data, Internet, and international services" [80]

In a rapidly consolidating industry GTS is likely to be involved in more deals as the newly liberalised markets of Europe take shape. This was made clear in the 1998 Annual Report which stated that, "we expect to make significant acquisitions in the future".[81] With its HER network GTS will come into contact with numerous other players with the European market. Future deals could perhaps emerge from collaboration and personal contacts established through these links. In this respect it is interesting to note that Esprit was itself one of HER's customers.[82]

At present, though, GTS is recognised essentially as an *independent* operator, something which sets it apart from many of its competitors which are embroiled in multiple alliances and consortia. Within its 1998 SEC submission GTS identified this as an advantage when it came to its wholesale operations, stating that:

> "Because our Western European activities are not affiliated with any of the major consortia or large Western European telecommunications companies, our Wholesale Services line of business may be considered an attractive service provider for Western European carriers who may otherwise be reluctant to obtain services from the larger operators of international gateways that are often their competitors in the retail market."[83]

9/Competitors

The "peer group companies" of GTS which come from the category of "small long distance telecommunications companies" are listed as Able Telecom, CTC Communications, MGC Communications, Startec Global Communications and Viatel.[84]

Business Week listed GTS' main rivals as Viatel (with its 5,500km network linking 20 European cities) and MCI WorldCom (which is constructing its own Euro-

[79] Quoted in FT (14/1/99)
[80] Quoted on Dowjones.com (13/5/99)
[81] Annual Report (1998, p19)
[82] FT (10/6/98)
[83] SEC 10-k Document (1998, p26)
[84] Multex.com (15/6/99)

network).[85] The purchase of Omnicom also brings GTS into direct competition with France Telecom.

The FT agreed that GTS' chief rival was MCI WorldCom which also owns and manages its own facilities. Another key player, it suggests is Qwest which is targeting the European internet market through a tie up with KPN the Dutch national operator - an alliance which strongly mirrors the GTS/Esprit merger.[86] By focusing on the business sector GTS is also attempting to tap the same market as COLT.

In its 1998 SEC submission GTS explicitly identified the competitors within the business sector:

> "Competitors in this segment include MCI/WorldCom, COLT, Viatel and RSL, which compete in multiple countries, and country-specific competitors such as Energis (UK), Arcor (Germany), Telfort (The Netherlands), Retevision (Spain), Infostrada (Italy) and Cegetel (France). These providers are generally more entrepreneurial than the public telecommunications operators and other dominant providers and sometimes bring experience from more mature markets. Like us, these providers often target small, medium and large-sized business customers or other market niches". [87]

One of GTS' main competitors had been Esprit with the FT describing them as "the fiercest of rivals".[88] This rivalry looked set to heighten when, only a month before the merger, Esprit announced the creation of a new division, Esprit Telecom Networks, which would have directly competed for GTS' carriers' carrier business.

10/Additional Threats

Over capacity

With the rapid application of new digital technologies the shortfall in data transmission capacity across Europe and between Europe and the U.S is being quickly addressed. With the proliferation of new entrants laying their own network the prospect of over supply has become a reality. This was recognised by the FT which stated that:

> "if the growth in data fails to match the growth in capacity, further consolidation will leave a few large groups fighting over distinctly thin pickings" [89]

In early 1999 GTS pointed out that it had sunk enough fibre cabling across Europe to carry 20 times the total current traffic across the continent. The FT picks up on the inherent danger within this emphasis upon capacity, pointing out that at present GTS

[85] Business Week (3/5/99)
[86] FT (9/12/98)
[87] SEC 10-k Document (1998, p35)
[88] FT (9/12/98)
[89] FT (9/12/98)

is only one of a dozen operations constructing state of the art pan-European networks. The consultancy, Analysys, puts the number of telecom firms across Europe which intend to create their own facilities at around 140.[90] Such a proliferation, suggests the FT, "will see the death or withdrawal of some of the weaker operators, particularly among the later entrants".[91]

In September 2000 this prediction proved correct with UK-based Iaxis going into receivership with debts of $200 million.[92] The company was widely seen as the first victim of the capacity glut in bandwidth and the resultant fall in prices. With the dramatic fall in GTS' share price during 2000 it was finding it difficult to convince the markets that it would not also fall prey to the changing economics of the industry.

GTS is perhaps relying upon its 'first to market' advantage to ensure that it does not become one of these "shake-out" casualties. In any case, key individuals within the group have denied that over-capacity is a problem, with David Oertle stating that he does "not see a glut of transmission capacity for years".[93] That GTS is quite aware of the network construction which is underway is made clear in its 1998 SEC submission within which it stated that:

> "Various telecommunications companies, including MCI WorldCom, Inc., Viatel, Inc., KPN-Qwest, Deutsche Telekom AG, France Telecom S.A., Global Crossing Ltd., and British Telecommunications plc, have announced plans to construct, have begun to construct or are operating fiber optic networks across various European countries. Some of these networks include, or their promoters have expressed their intentions to include, transatlantic connectivity".[94]

Technological Change

Related to the problem of over capacity is the speed of technological change within the telecoms industry. Until now new wave companies such as GTS have used the technological advances of the past few years to undercut the incumbent carriers burdened as they are with antiquated networks. As time passes, however, innovators such as GTS might see themselves being overtaken by technical advances (e.g. by satellite-based systems). This danger has been recognised by the FT which in a discussion of COLT indicated that:

> "what is becoming rapidly apparent... is that even sophisticated new operators are being caught out by the speed of technological progress" [95]

[90] FT 17/3/98)
[91] FT (18/3/99)
[92] FT (10/9/2000)
[93] Quoted in FT (10/6/98)
[94] SEC 10-k Document (1998, p35)

[95] FT (18/3/99)

Powerful Incumbent Competitors

Another danger in the newly liberalised European market is that the former monopoly operators will do their best to hamper the new arrivals by "only just" applying the new directives. The autonomy which GTS is developing via its own network will mitigate part of this danger - but not all of it. In the case of the UK, for example, 85 percent of customers still access the telephone network via BT.[96] This gives the company considerable scope for limiting the impact of new competitors. In the case of Carrier Pre-Selection (CPS), for example, BT has been influential in obtaining a delay in its implementation. The proposal which was mandated by the European Union in 1997 has the potential to open up the residential market. As Iain Osborne, Director of Regulatory Affairs, at Esprit Telecom put it, "BT never wanted this", and as a result made a protest to OFTEL claiming that time would be needed for its network to be improved sufficiently to accommodate the changes.[97]

The former monopolies could also club together to protect their "old boys' network". In 1998 BT announced an alliance with its erstwhile rival, AT&T. According to the FT a few years ago such a joint approach, "would have been as likely as Coco-Cola and Pepsi Cola co-operating to market a global drink".[98]

To begin with, suggests the FT, the incumbents looked to forge alliances with the new telecom companies, thereby increasing their competitiveness against their old rivals. Now, it suggests, they are seeing these "Young Turks" as a major threat and ganging up against them to produce their own "seamless" networks. After all, companies such as GTS and WorldCom have shown that it can be done quickly and fairly cheaply. In the case of GTS, the BT/AT&T link could pose a particular danger as one of the alliances targets is the carriers' carrier market, a key revenue earner for GTS.

The FT also points out that BT and its allies are busy constructing an extensive European data network which, "will dwarf networks being constructed by rivals such as WorldCom and Esprit".[99] When reviewing the outlook for the European telecoms industry the story of the hare and the tortoise springs to mind. Something similar is implied by the FT which states that: "slow to start but difficult to stop once they get going, the giants are waking up".[100]

The rapid rise of GTS has also made it a potential take-over target. After the victory of Olivetti over Deutsche Telekom in the battle for Telecom Italia, there was speculation that the German company might look towards, among others, GTS and HER as a possible consolation prize.[101]

In this respect the contact which HER has with the industry's giants could make it a conspicuous target. Earlier it was suggested that the HER network could help GTS

[96] FT (9/6/99)
[97] Quoted in FT (9/6/99)
[98] Quoted in FT (28/7/98)
[99] FT (21/7/98)
[100] FT (17/3/98)
[101] FT (26/5/99)

establish links with potential take-over targets. Clearly, though, this contact with second parties could prove a two edged sword.

Following GTS' take-over of Esprit (and AT&T's purchase of IBM's global data communications network announced the same day), the Wall Street Journal stated that this showed that it was perhaps easier to buy networks than to build them. Expanding upon the idea, it went on to argue that, "the 2 deals show a trend towards buying pre-existing networks from second-tier carriers, rather than building new ones from scratch".[102] In the future GTS might be on the opposite end of such a deal. Given that its market capitalisation has declined drastically over the last year, such a development is looking increasingly likely.

Russian Exposure

Mention must also be made of the potential dangers which continue to affect GTS through its high level of involvement in the ex-Soviet Union. These "risk factors" ranging from corruption to uncertainties surrounding individual currencies were dealt with in some detail by the company within its 1998 SEC submissions.[103] The effect of Russia's problems upon GTS has not escaped the attention of the Business Press. The headline in the Washington Business Journal in 1998 stating, "Wrong number? Russian investment proves costly to GTS" sums up the type of negative coverage which GTS has experienced through its connection with the region.[104]

[102] Wall Street Journal, Europe (10/12/98)
[103] See, for example, SEC 10-k Document (1998, p57)
[104] Washington Business Journal (11/9/98)

PROFILE OF HERMES EUROPE RAILTEL (HER)

1/Origins and Development

As stated in the GTS section, much of the credit for GTS' involvement in the HER project is given to Gerald Thames. The rationale behind the network was to use the existing railway infrastructure across Europe to construct a cross-border fibre optic network. Part of the capacity would be used for the individual railways own communication needs, while the additional capacity could be exploited commercially. The idea had already been applied by MCI in the US, Mercury in the UK and by Japan Telecom in its home market.[105] More recently the same strategy has been adopted by Qwest in constructing its network within the US.

The idea of a pan-European network using the railways' rights of way had been talked about since 1989.[106] With the need for European Governments to provide for "alternative" telecoms infrastructures from the beginning of 1996, prior to the opening up of the whole market in 1998, the time was now ripe for the initiative to take off.

Today, HER forms part of GTS Carrier Services which is headed by Jan Loeber who has been managing director of HER since its inception.

2/Investors

The $500 million HER project was announced in 1995 as a joint venture between HitRail (a consortium of 11 European railways) and GTS. At the beginning GTS held 33 percent of the equity of the new company (with a provision for this to rise to 50 percent) and as managing partner in the venture was responsible for the raising of the necessary capital. This it did through a combination of vendor finance (with Alcatel being awarded the main contract) and recourse to the debt markets. In fact one of HER's subsequent fund raising exercises in December 1998 via a high-yield issuance, represented the first such deal struck in a local currency within the fledgling European high-yield market.[107] In the early days it was also anticipated that the company would be partially floated at a later date.[108]

In more recent articles relating to HER, the number of railway companies which are still actively involved in the project was put at two, i.e. the Belgium and Swedish national operators.[109] In mid 1999 it was announced that GTS had bought out the last of the original railway partners (NMBS/SNCB). The Belgian Railway's 6.8 percent share of HER was converted into GTS shares.[110]

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[105] Economist (28/1/95)
[106] European (3/8/95)
[107] Euromoney (May 1999)
[108] European (20/1/95)
[109] Handelsblatt (22/8/98), Wall Street Journal (2/12/98)
[110] GTS Press release (7/7/99)

3/Mergers, Acquisitions and Joint Ventures

Acquisitions

In June 1998, HER acquired a majority interest in Ebone A/S, one of the leading Internet backbone providers in Europe. Ebone focuses on connecting Internet Service Providers in Europe to the global Internet. As of mid-1999, the Ebone and HER networks connected 24 cities in 14 countries and together served more than 100 ISP customers.[111] In the context of the HER network this purchase can be seen as an attempt to use its extensive capacity to carry traffic generated from within it own group of companies and not just that of third party companies.

Further information on joint ventures can be found within the main GTS profile.

4/Network

Originally the network was designed to connect 12 cities in five countries, opening to its first customers in the summer of 1996. This was to rise to 19 cities in eight countries by the end of that year and 55 cities in Western and Central Europe by the end of 1999.

As of May 1999, the HER operational network actually connected 21 cities in 10 European countries - stretching more than 10,000 route kilometres. According to the company web site the full network will consist of 25,000 kilometres of high capacity fibre designed to interconnect points of presence in over 50 cities in 20 countries. HER is building its network on the most accessible and cost-efficient infrastructure base in each of the regions served. Most of the fibre-optic cable has been deployed using rights-of-way and existing assets of railways, motorways, pipeline companies, waterways and power companies. In October 1997 HER finalised the construction of two undersea cables connecting the United Kingdom to the Netherlands and to Belgium.

The latest transmission technologies, including Dense Wavelength Division Multiplexing (DWDM) and Synchronous Digital Hierarchy (SDH), optical multiplexing equipment and fibre optic cables, are equipping the HER network to provide its carrier customers with a level of trans-border services not available today in Europe through traditional half-circuit, leased line arrangements.

The network consists of SDH links operating at the 2.5 Gbps (STM-16) level. Multiple STM-16 links are currently being introduced using DWDM technology. The network is designed to provide its customers with a wide variety of bandwidth requirements ranging from VC12/E1 capacity (equivalent to 2.048 Mbps) to multiple VC-4/E4 capacity (equivalent to 140 Mbps). Critical elements of the HER network, including network maintenance and control systems, are designed to ensure a high

[111] HER Web site

quality of service. Current key resilience features include:

- Meshed fibre topology allowing multiple paths to each node
- Two points of presence per primary city in each country
- Built-in hardware and power redundancy
- Redundant management systems and facilities

Employing these techniques results in overall network design availability of 99.99 percent or better on all major routes.[112]

The HER network is controlled by a single network management centre and supported by advanced operational support systems. The HER Network Operations Centre (NOC) is located near Brussels, with a back up centre in Amsterdam.[113]

5/Addressable Market

According to the 1998 GTS' Annual Report the European carrier market accounts for $30 billion annually.

The main customers for the network were originally envisaged to be the existing incumbent operators who could use the cross border facility to lower costs. Initially HER presented itself, in the words of its Managing Director, Jan Loeber, purely as a "wholesaler of telecoms capacity".[114] By 1998 HER's customers included key industry players such as BT and Deutsche Telekom.[115] As of 1998 HER counted a total of 40 out of Europe's 60 largest telecoms operators as its customers, including Global One, WorldCom and Carrier 1.[116]

In GTS' 1999 SEC submission the target customers for the HER network are set out in some detail. These are broken down into seven segments, consisting of:

- Existing Public Telecommunications Operators.
- Global Consortia of Telecommunications Operators.
- International Carriers.
- Other Carriers.
- Internet Backbone Networks
- Resellers.
- Other Service Providers.[117]

As GTS has developed, the role of the HER network has also expanded. Today it also serves GTS' own customer base, incorporating Esprit's business customers. .

[112] Ibid.
[113] Ibid.
[114] Quoted in (European 3/8/95)
[115] FT (21/12/98)
[116] Handelsblatt (22/8/98)
[117] SEC form 10-k, 1999 (p 15-16)

6/Share History

Not Applicable

7/Company Data

As of 1999 Hermes Europe Railtel employed over 300 staff representing 23 nationalities recruited throughout Europe.[118]

In 1998 GTS Carrier Services (incorporating HER), in its first year as a separate division, accounted for $85.3 million dollars (or 23 percent) of GTS' total revenues.[119]

8/Strategy

The original ambition of HER was to be a wholesale infrastructure provider. As The European noted, "Hermes does not intend to compete with the huge telecom operators it wants as customers".[120] This "non competitive" approach meant that the project would not, "be squashed by nervous, protectionist-minded telecoms giants" and also made it a politically acceptable proposal throughout Europe.[121] Commenting on the project the day after it was announced in 1995 the FT stated that:

> "Because it will be complimentary to, rather than competing with, existing telecom operators it does not expect regulatory problems. Yesterday, the indications were that both Brussels and existing networks welcomed the initiative"[122]

The delicacy of the original proposition to construct the network led to the launch of an investigation by the European Commission which subsequently requested comments from interested parties.[123] As this stage GTS would have been tempted to paint as benign a picture as possible of the new network's future use.

In reviewing the "ambitious plan" to build a telecoms network across Europe's rail infrastructure, Gerard Caccappollo, the Corporate Director of HER, admitted that "the original scheme did not work out".[124] It is unlikely, however, that GTS regretted a project which put it in a key position for the provision of pan-European telecom services. As for the incumbent national operators, it is perhaps they who feel that things did not work out quite as they had planned. The valuable asset which the HER network has become is undoubtedly one which they would rather was not in the hands of an emerging telecoms force such as GTS. For its part, GTS has gradually

[118] HER Web site
[119] GTS Annual Report, 1998, p19
[120] European (20/1/95)
[121] European (20/1/95)
[122] FT (16/1/95)
[123] Network News (28/2/96)
[124] Quoted in FT (10/6/99)

increased its stake within HER which is now classified as a subsidiary company.

In assessing the increasing dominance of GTS within HER, it is likely that its position as a single, focused corporation allowed it to develop a clearer ongoing strategy than the HitRail consortium which was made up of disparate national rail organizations, each of which would have had its own particular agenda. Indeed, in the case of some of the participants, such as British Rail, it is likely that issues such as its own denationalisation left it little time for marginal projects such as a telecoms network. Moreover, once the individual rail operators had secured a link up throughout their network, thus improving their own internal communication systems, then there would have been a natural tendency to drop out of the consortium. This perhaps explains why of 11 involved parties, only two were still involved in the consortium in 1999 (with both of these being bought out by the end of the year). The idea that the national railways lost interest in the project is given credence by the contents of the press release announcing GTS' purchase of an additional 10 percent of HER's equity. It states:

> "HITRail indicated that it decided to divest its interest in HER because the investment in HER was no longer consistent with HITRail's strategic direction. HITRail also stated that the terms of the sale were consistent with the returns it had intended for the investment in HER."[125]

In summary, it could be argued that the original strategy for HER was simply to get the project off the ground without incurring the wrath of the existing industry giants. Once the project was secure then GTS was able to strengthen its own position within the consortium and to re-define the role of the network itself. To be successful in the European telecoms market any new entrant would need to develop its own, independent infrastructure. This GTS has done, somewhat stealthily through its early involvement, and ultimate dominance, of the HER project.

Now that the HER operation exists as an integral part of a increasingly significant player within the European telecoms market, GTS seems to be at pains to emphasise its non-aligned status. On the company web site under the heading "neutrality" it states that:

> "HER has dedicated its infrastructure and services to serve the needs of global and local telecommunication operators and service providers in Europe. HER does not suffer from conflicts of interests with its customers"

Looking at the development of the HER network, GTS states within its 1999 SEC submission that:

> "We intend to reinforce and extend the market penetration of Hermes Railtel's network by enhancing the scope, capacity, reliability and efficiency of our infrastructure, and by providing our own local access. As a result of these enhancements, we believe that we are well-positioned to generate additional revenues from existing carrier

[125] GTS press release (19/3/98)

> customers and attract new customers as demand for seamless transatlantic city-to-city services increases. Targeted new customers include the U.S. regional Bell operating companies, as well as U.S. and European Internet service providers"[126]

9/Competition

See the main GTS profile, above.

10/Other Threats

As a provider of wholesale services HER would be particularly affected by the development of over-capacity within Europe. This subject is discussed with the "other threats" section of the GTS profile. Likewise, technical change could also leave HER with an out-dated network. This fact is explicitly recognised by GTS within its 1999 SEC submission where it states that, "the technology of our Hermes Railtel network could become obsolete." [127]

As the operator a pan-European network, HER is also reliant upon licensing and authorising agreements with individual nation states. In the case of the European Union some uniformity is provided due to the members states' obligation to apply E.U. Directives affecting telecom liberalisation. Other countries could prove more unpredictable - a factor which could affect the expansion of the network. This danger is recognised by GTS which states that:

> "The loss of, or failure to obtain, these licenses, authorizations or registrations or a substantial limitation upon the terms of these licenses, authorizations or registrations could have a material adverse effect on Hermes Railtel"[128]

Despite HER's attempts to emphasise its neutrality, its position within GTS could alienate potential or existing customers. Such a danger is also recognised by GTS which states that:

> "Many of the services we plan to offer in our Access Services and Business Services lines of business could compete with the services offered by customers or potential customers of our Hermes Railtel network. This development could negatively impact Hermes Railtel's ability to attract and retain customers..."[129]

[126] SEC Form 10-k, 1999, p8

[127] SEC Form 10-k, 1999, p6
[128] SEC Form 10-k, 1999, p40
[129] SEC Form 10-k, 1999, p48

PROFILE OF ESPRIT TELECOM, (GTS)

1/Origins and Development

Esprit Telecom was founded in 1992 by Walter Anderson and Michael Potter in response to the liberalisation of the European telecommunications market.[130]

Anderson who had an interest in 26 percent of the company's shares in 1998 agreed to act as a "special adviser" in the merger of GTS and Esprit. Given that the vote to merge was not particularly clear cut (around 65 percent in favour) his support would have been crucial. Perhaps his own disagreements with the board of Esprit (see below) encouraged him to view the merger favourably.

One of the other founders of the company was Michael Potter who although "mild mannered" by nature became renowned for his "trenchant attacks" upon the behaviour of incumbent operators who he accused of intransigence in the face of the process of liberalisation.[131] His mild nature seemed to be reflected in his business philosophy, in particular in relation to his view of workforce relations. Interviewed in 1998, he stated that:

> "Esprit is more like a Silicon Valley company than a militaristic incumbent - we motivate and inspire employees giving them share options to help success"[132]

In part, Potter seemed to be alluding to the company's "stock incentive scheme" which allocated stock to executives and employees according to contract and/or performance. In 1995 1.2 million such shares were issued, with 640,00 and 70,000 in 1996 and 1997 respectively.[133] The scheme was abandoned during 1997, an indication perhaps, that by then the company was being taken in a new direction.

Following the take-over by GTS Potter quickly announced that he would be leaving the company in order to form an investment group, Paradigm Ventures, which would focus upon high-technology projects within Europe.[134] Announcing his departure in January 1999, he summed up his experience at the company by stating that:

> "Esprit Telecom has been able to participate in and help shape one of the greatest commercial revolutions of this century - the end of the old system of national telecommunications monopolies in Europe. In the process, we have helped introduce superior services, cost savings, and the powerful concept of choice to Europe's 375 million people. I am proud to have played a part in that revolution during my 8 years with Esprit Telecom"[135]

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[130] Esprit Annual Report 1997, p1
[131] FT (17/3/98)
[132] Quoted in FT (17/3/98)
[133] Esprit Annual Report 1998, p24
[134] FT (2/2/99)
[135] Esprit Press Release (25/1/99)

Potter was a founding member of the Global Telecommunications Society and a founding member and currently Vice Chairman of the European Competitive Telecommunications Association (ECTA).

Soon after its creation Esprit started to target the business market, quickly earning a reputation as an "aggressive operator".[136] Some of this aggression was revealed in 1995 when it publicly criticised the Dutch Government's plans to establish a second telecoms operator arguing that it was had not gone far enough in facilitating a "real" alternative provider.[137]

In 1998 Esprit was again at the fore of the liberalisation battle. Objecting to the alliance announced between BT and AT&T, it petitioned the EU competition authorities arguing that the deal could lead to a "tremendous re-concentration of market power that would deny consumers and service providers in Europe access to a greater variety of services at lower prices".[138]

David Oertle was brought in as the new CEO in May of 1997 - having previously worked with AT&T, Sprint and Telstra. Mr Oertle seemed to quickly fit in with the pugnacious company philosophy stating in a press interview that, "we see ourselves as an attacker", his ambition being to make Esprit the "MCI of Europe".[139] After the take-over by GTS he also announced his departure, relinquishing his new role of "Senior Advisor" with the new group in May 1999.

During 1998 some of the company's aggression seemed to be turned inwards, in the form of an acrimonious dispute between Walter Anderson and key Board members (among them Oertle). According to the FT the Boardroom dispute had been simmering for 2 years, with certain Board members feeling that Mr Anderson, "often failed to understand the limits of his authority as non-executive chairman".[140]

In October 1998, Anderson was replaced as Chairman and at an egm in November the investors Apax and Warburg Pincus called for his removal as a Director of the company.[141] This resolution was upheld and on 23 November 1998, Anderson was voted out. A few weeks later on 8 December 1998 the Board announced that agreement had been reached with GTS for a recommended offer.[142] The "merger" was valued at $757 million.[143] Once the merger was completed Esprit was incorporated within GTS' Business Services division.

2/Investors

[136] Telecommunications (June, 1995)
[137] Ibid.
[138] Quoted in FT (1/8/98)
[139] Quoted in FT (10/9/97)
[140] FT (15/10/98)
[141] FT (20/10/98)
[142] Annual Report 1998, p5
[143] FT (12/12/98)

The European Venture Capital Journal listed Apax Partners as the source of Esprit's original capital.[144] According to Esprit sources Apax Partners first invested in Esprit Telecom in February 1994.[145]

The FT, in a discussion of Harbour Vest Partners, noted that Esprit was one of its previous investments.[146] From the table below it can be seen that they disposed of their share holding during the 1998 fiscal year.

In 1998 The FT estimated that Walt Anderson and the venture capital vehicle Gold and Appel, for whom he is attorney at law, held some 26 percent of Esprit stock.[147]

The following table shows the directors' interest in Esprit's ordinary shares at 30 September 1998.

Table 1 – **Directors' Interests**		
Number of ordinary shares	As at 30 September 1997	As at 30 September 1998
Walter Anderson		
(Gold and Appel)	20,073,600	32,968,520
John McMonigall		
(Apax Funds)	32,294,100	33,557,600
Dominic Shorthouse		
(Warburg Pincus)	15,442,150	15,442,150
William Johnston		
(Hancock/	10,131,400	---
Harbour Vest Partners)		
Michael Potter		
(Abacus)	3,985,000	3,985,000
Jonathan Hudson	1,051,850	827,053
Source: Annual Report 1997, p22, 1998, p20		

The Press Release announcing Esprit's IPO stated that, "the original investors in Esprit Telecom include Apax Partners, HVP Partners L.L.C., and E.M. Warburg Pincus & Co. Inc."[148] Of these three venture capital groups it was Warburg Pincus which was last to arrive in 1996. Speaking of their investment at the time, new Board member Dominic Shorthouse, of Warburg Pincus, stated that:

> "When we saw Esprit Telecom's rapid growth and innovative approach to telecommunications services, we were reminded of other

[144] European Venture Capital Journal (1/3/99)
[145] Esprit Press Release (8/11/95)
[146] FT (19/5/99)
[147] FT (15/10/98)
[148] Esprit Press Release (27/2/97)

> investments that we have made in the telecommunications industry that have produced very substantial companies. Warburg believes that Esprit Telecom represents one of the best telecommunications investment opportunities in Europe today"[149]

Like GTS Esprit has turned to the bond markets bond markets to raise finance. In December 1997, the Company raised £181 million gross proceeds from a dual-currency ($230 million; DM 125 million) sale of 10-year Senior Notes at 11.500 percent, and in June 1998 successfully raised an aggregate £140 million ($150 million at 10.875 percent and DM 150 million at 11.000 percent) of Senior Notes due 2008. These offerings raised finance to support the continued expansion of the Esprit Telecom business across Europe, including the development of its pan-European broadband SDH ring network, the expansion of its sales organization and switching operations, the development of new billing and other systems, and selective acquisitions.[150]

3/Mergers, Acquisitions and Joint Ventures

In October 1992 Esprit acquired Mid Atlantic Telecom UK.[151] In July 1993 it bought Mitel Telecom's Atlantic Call Division in the UK.[152] In June 1997 Telecom Europa Ltd, a UK service provider was bought, "as part of the company's strategy to expand beyond the large and medium sectors".[153]

In July 1997 Esprit purchased Swift Global BV, a service provider based in Holland. Like Telecom Europa, this business had built a successful indirect access based business, providing international voice telecommunications services to SME's. Together, the two acquisitions added nearly 900 new business customers.[154]

In November 1997, the Company acquired Dutch Service provider IMS Interaktieve Media Services BV, which added approximately 1,700 customers.[155]

In May 1998, Esprit Telecom acquired business of Plusnet Gesellschaft für Netzwerk Services mbH ("the Plusnet Business"), one of Germany's leading telecommunication services companies, from Thyssen Telecom AG, a subsidiary of Thyssen AG.[156] Standard and Poor's, the credit rating agency, responded to the announcement of the takeover of Plusnet by placing Esprit on "credit watch with negative implications" due to the increased leverage involved. [157]

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[149] Esprit Press Release (27/8/96)
[150] Esprit Annual Report 1998
[151] FT 910/9/97)
[152] Ibid.
[153] Esprit Annual Report 1997 p5
[154] Esprit Annual Report 1997 p5
[155] Annual Report 1998, p1
[156] Annual Report 1998, p1
[157] FT (12/5/98)

Joint Ventures

In April 1996 BTG, the Dutch Association of the biggest telephone users selected Esprit as its preferred carrier.[158] In April 1997 Esprit Telecom Benelux signed an indirect access agreement with P.T.T. of the Netherlands.[159]

In its 1997 Annual Report Esprit indicated that it had joined forces with Fibernet, the data-networking specialist, in order to improve its UK network.[160] In the "recent developments" section of the same report, Esprit announced that it had entered into a interconnect agreement with Deutsche Telekom, enabling the company to offer indirect access based services within the German market from the 1998 fiscal year.

In the accounts section of the 1997 Annual Report mention is made of a 20 percent stake in a "start up" company called Long Distance International Ltd (LDI). In the following year's Annual Report it is stated that this investment was sold during the year resulting in a gain of £200,000.

With effect form 1 February 1998, the Group acquired the trade, assets and liability to the curator-in-bankruptcy of Budget Phone Card BV, a customer in liquidation.[161]

4/Network

Esprit Telecom developed one of Europe's most advanced digital telecommunications networks stretching across eight European countries. The full network was designed to cover 9,000 route kilometres, connecting 30 cities.[162]

Esprit's Network Management Centre (NMC) allows it to monitor the performance of the entire network from a single source, 24 hours a day and 365 days a year. This ensures easy fault diagnosis and rapid repair. Prior to establishing the Network Management Centre, Esprit Telecom used a distributed management structure to monitor its network, with operational staff responding to service failure alarms as and when they occurred. By consolidating these operations, the Network Management Centre offers Esprit an instant snapshot of high quality information on network performance across its pan-European network.

5/Addressable Market

The 1997 Esprit Annual Report put the value of the European telecommunications service industry at $200 billion. According to the FT the target market of Esprit is the $20 billion European business telecom market.[163]

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[158] FT (10/9/97)
[159] Ibid
[160] 1997 Annual Report (p5)
[161] Annual Report 1998, p36
[162] Press Release (24/2/99)
[163] FT (10/9/97)

In 1995 the journal, Telecommunications, stated that Esprit was targeting businesses with call bills of over $5,000 a month.[164] As stated in the "mergers" section Esprit also started targeting smaller enterprises from 1997.

According to its 1997 Annual Report Esprit was providing telecommunications to three targeted segments: Retail; Wholesale; and Service Providers/Reseller Services. Within the retail market the company began to incorporate smaller enterprises into its plans, not least via its acquisitions. In the 1997 fiscal year its customer base rose from 511 to 2,350 - an increase of 360 percent.[165]

6/Share History

In March 1997 Esprit made the transition from a private enterprise to a publicly traded company. It did this via a simultaneous launch on the Nasdaq and Belgium based Easdaq exchanges, something only one other company had done previously. The sale of 4.75 million American Depository Shares ("ADSs"), representing 33.25 million ordinary shares, in its Initial Public Offering (IPO) raised net proceeds of approximately £32.1 million.[166]

Its shares were initially offered at around $12 and for most of 1997 struggled to stay above $5. Towards the end of the year they started to rise and this continued throughout 1998, interrupted only by the fall of the market in the summer of that year. In the 52 week period prior to the share's suspension from Nasdaq in March 1999 its value ranged from $11.75 to $59.13. On its last trading day it stood at $47.50 by which time it was moving in line with the GTS share price due to the all-paper offer which had by then been agreed between the two companies.[167]

7/Company/Financial Data

Table 2 below shows the increase in the number of Esprit's employees between 1995 and 1998. Table 3 shows a steady rise in turnover for the same period. Table 4 reveals the increasing losses of the company as it spent heavily on its network.

Table 2 - **Number of Employees**	
1995	68
1996	105
1997	230
1998	554
Source: Annual Report (1997 p23, 1998, p18)	

[164] Telecommunications (June 1995)
[165] Annual Report 1997, p6
[166] Annual Report 1997
[167] CBS.marketwatch 9/6/99

Table 3 - **Turnover** (£millions)	
1995	14.0
1996	24.9
1997	45.5
1998	82.6 (19.7 of this from acquisitions)
Source: Annual Report (1997 p10, 1998, p7)	

Table 4 - **Profit (Loss)** (£millions)	
1995	(2.4)
1996	(5.1)
1997	(10.9)
1998	(42.4)
Source: Annual Report (1997 p10, 1998, p7)	

8/Strategy

The ambition of Esprit is evident within the 1997 Annual Report within which both the Chairman, Walt Anderson and the COE, David Oertle in their respective "Letters to Shareholders" indicated their goal of making the company Europe's "leading" independent telecommunications service provider.

As with GTS, Esprit placed considerable importance upon establishing its own network - freeing it from having to negotiate agreements with national carriers. In the same report David Oertle stated that:

> "The development management and control of our network is key to our European strategy. Retaining control over critical elements of our infrastructure will reduce transmission and other operating costs as a percentage of revenues. In addition, development of the Esprit Telecom network will reduce our reliance on other carriers, giving us greater control over margins" [168]

More concisely, in an interview with the FT he stated that, "we believe it is necessary either to own or control your own network infrastructure if you are going to be one of the significant long term players in Europe".[169]

Apart from enhancing its independence, a key point of its strategy identified within the 1997 Annual Report was to broaden the Esprit portfolio through acquisitions (in

[168] 1997 Annual Report, p3
[169] FT (19/12/97)

this instance Telecom Europa and Swift Global), thereby enabling it to increase its market share, in particular within the SME sector. The company's focus upon the SME market was noted by the journal, Telecommunications, which suggested that, "Esprit's strategy is based upon a 5 year plan to build its own network and to focus tightly on particular market segments".[170]

When dealing with the business sector, Esprit has consistently emphasised its customer focus via the concept of "partnership". In its marketing booklet "The Alternative Approach to Telecoms", it offers the following definition of its approach:

> "partnership is a significant stage beyond the traditional supplier/customer relationship. It means that your supplier really knows your business, understands your business goals and works in tandem with you to achieve them" [171]

Using this philosophy, Esprit has claimed to offer consultative expertise via its provision of telecom services, providing its business clients with useful management information . It has pointed out that only one percent of its customers have a telecoms or IT manager and that part of its service is to fill this role, reporting to the Managing Director or Financial Director. In effect, it offers its clients the ability to out-source that part of the management information function which is related to telecommunications.

In focusing upon the needs of the business customer, Esprit drew attention to its role in assisting its clients to integrate the increasing amount of business conducted electronically. As Esprit's marketing material put it, "Telecommunications technology will continue to converge with computer technology, facilitating seamless communication between electronic devices and applications".[172] Paradoxically, it was this very convergence, together with Esprit's technological sophistication, which made it such an attractive target for GTS (the evidence for such convergence is looked at in the section on GTS' strategy).

Esprit has also emphasised the importance of its consultative approach within one of its major niche markets - that of the hotel industry. In one of its press releases announcing the addition of another major hotel to its customer base it stated that:

> "Over the last six years Esprit Telecom has built up an in-depth knowledge of the hotel telecommunications business, as well as an extensive customer list that includes five star luxury hotels, budget hotels, national and international chains, and independents"[173]

Towards the end of 1998 Esprit indicated that it was moving into the growing "carriers' carrier" market via the creation of an independent business unit called Esprit Telecom networks. The new unit quickly achieved 16 customers, with the company

[170] Telecommunications (Sep. 1998)
[171] The Alternative Approach to Telecoms, Esprit, (1999, p6)
[172] The Alternative Approach to Telecoms, Esprit, (1999, p15)
[173] press releases (24/2/99)

announcing that it anticipated that 25 percent of revenue would soon be derived from leasing out its network.[174]

9/Competitors

In reviewing the new arrivals in the UK telecoms market in 1998, the FT mentioned, in addition to Esprit, ACC Long Distance, COLT, Worldcom, RSL Communications and Teleport. [175] In noting Esprit's interest in SME's, the journal, Telecommunications grouped the company alongside Viatel as those particularly active in this sector.[176]

In France the awarding of a single digit prefix to Esprit in early 1998 brought it into competition with France Telecom, together with the other companies allocated new prefixes such as Omnicom (itself now part of GTS), Infotel, MFS-Worldcom, RSL Com and COLT. [177]

With Esprit's move into the "carriers' carrier" market, it started to compete for market share with HER (part of its new parent company, GTS) and WorldCom.[178]

10/Other Threats

As was discussed earlier one of the main threats to the company seemed to arise from internal differences between the board members. Under such circumstances, another threat - that of take-over - was made more difficult to fight off.

As with GTS, Esprit's concern with constructing its own network, and its move into the carriers' carrier market left it open to the accusation that it was risking leaving itself with over-capacity. Many observers have predicted a state of over supply within the European market, with Jeremy Boardman, telecoms specialist at N.M. Rothschild indicating that "when prices collapse as a consequence, owning infrastructure will not seem so attractive" [179] (for a fuller discussion of this issue, see GTS Profile: other threats).

[174] FT (13/11/98)
[175] FT (2/1/98)
[176] Telecommunications (Sep. 1998)
[177] FT (16/2/98)
[178] FT (13/11/98)
[179] Quoted in FT (2/1/98)