PROFILE OF SCOTTISH TELECOM (ST)[1]

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1/Origins and Development

Scottish Telecom (ST) was established by Scottish Power (SP) in 1994. Originally the business offered telecoms services to customers in central Scotland. It started with a staff of only nine.[2] ST is an example of a telecoms company which started life as the internal communications arm of one the UK's regional electricity operators. As such, it has at times been portrayed as the Scottish equivalent to the English operator, Energis. Such companies had something of a head start in the telecoms business in that they could use their parent company's existing infrastructure and could benefit from their parent's brand name and sales channels. In releasing its results in 1996 Scottish Power signalled its desire to become a "multi-utility", offering additional services such as gas and telecoms to its 1.7 million retail customers.[3]

By 1997 ST was carving out a definite business niche and was beginning to be seen as an excellent purchase opportunity for a number of the major telecoms operators. In talking about the approaches which had been made to the company in 1997 ST's Managing Director, Rod Matthews, stated that:

> "All the larger companies have requested talks with us…There are undoubtedly other people we will work with but what we are not doing is persuading a larger telecoms company to come and join us"[4]

The company was incorporated in January 1999 and on September 30 1999 acquired the bulk of the businesses of Scottish Power related to telecoms, data and the Internet.[5] In November 1999 Scottish Power floated 49.9 percent of the company on the London Stock Exchange. In the run up to the flotation the company changed its name to Thus.

The main architect of ST during its formative years was Managing Director, Rob Matthews. At the beginning of 1999 he was ousted and replaced by his deputy, Bill Allan, who had only been with the company for two months.[6] The change of post holder was said to be related to "serious differences" over the timing of the flotation of the company, with Mathews proving too cautious in the eyes of his superiors at

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[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] The Scotsman (27/3/99)
[3] FT (10/5/96)
[4] Quoted in The Scotsman (3/9/97)
[5] Thus Prospectus (10/11/99)
[6] The Scotsman (27/3/99)

SP.[7] At the root of his caution was the idea that the telecoms operation offered a tremendous opportunity for cross-selling to SP's existing customer base. As Mathews had stated in 1998:

> "It will be a huge opportunity for Scottish Power. Why should we give any of that benefit away by floating Scottish Telecom?"[8]

By the start of 1999 the issue of when ST was going to float seemed to be SP's most overriding concern. As the Scotsman stated at the time, "Scottish Power's baby has become its prize asset and appears to have outgrown its parent".[9]

Following a successful flotation in late 1999 and a strong performance on the stock market in early 2000, the company's rapid progress was recognised through its admission into the FTSE 100 Index. Within a few months, however, its share price was in decline, it had lost its finance director and it was ejected from the FTSE 100. Worse was to come with a profit warning in late July which further decimated its share price. By November of 2000 the FT was describing the company's high flying days of six month's previously as a "distant dream".[10]

Key Personnel

Rob Matthews

After leaving ST in 1999 Matthews spent a brief spell with Global Crossing Europe, before joining Dutch company Versa Point as CEO in November 2000.

Bill Allan

Bill Allan was appointed Chief Operating Officer of ST in November 1998 and Managing Director in February 1999. Allan has over 25 years' experience in the telecommunications industry. Between 1971 and 1998 he worked for Cable and Wireless plc, holding a number of senior management positions in business strategy and development in the UK, Europe, Asia and other parts of the world. In 1997 Allan was appointed Chief Executive of Cable & Wireless Regional Businesses, with responsibility for a portfolio of business generating £946 million of turnover and £246 million of profit after tax, operating in the Caribbean, Latin America, the Middle East and Indian Ocean. He was a director on the boards of Telecommunications of Jamaica, Entel Panama, the Barbados Telephone Company, and the Barbados External Telecommunications Company. Between 1995 and 1997 Allan was Regional Director for Cable & Wireless North East Asia Region, President and Representative Director of Cable & Wireless Japan, and Chairman of Cable & Wireless Communications Services Limited (Japan). He was also a director on the boards of

[7] The Scotsman (22/2/99)
[8] The Scotsman (27/3/99)
[9] The Scotsman (27/3/99)
[10] FT (9/11/2000)

International Digital Communications (IDC Japan), Sakhalin Electrosvyaz, Sakhalin Telecom, Sakhalin Telecom Mobile, and Nakhodka Telecom.[11]

Ian Russell

Ian Russell was appointed as a Director of ST in April 1995 and as Chairman on September 1 1997. Mr Russell is the Deputy Chief Executive and Finance Director of Scottish Power, positions which he has held since November 1998 and April 1994 respectively. A member of the Institute of Chartered Accountants of Scotland, having trained with Thomson McLintock, Mr Russell has held senior finance positions with Hong Kong and Shanghai Banking Corporation and Tomkins plc. He is also Chairman of Southern Water plc and a non-executive director of Scottish Investment Trust plc and Scottish Knowledge plc.[12]

2/Investors

Originally ST was a wholly-owned subsidiary of SP. In 1997 it was reported that SP had invested £100 million in the company since its launch in 1994.[13] The FT later reported that SP was set to invest a further £50 million during 1997.[14]

As of July 2000 Scottish Power Plc held a 50.10 percent stake in ST. The next biggest shareholder was Goldman Sachs Group LP with 6.48 percent.[15] Directors of the company held only 0.01 percent of the company's equity, distinguishing it from Scottish rival, Atlantic Telecom, whose Directors hold a significant stake.[16]

3/Mergers, Acquisitions and Joint Ventures

It has been suggested that ST's acquisition strategy has been very different from that of its parent, SP, whose approach involved the purchase of utilities which it then tried to make more efficient. ST's priority, on the other hand, has been to fill gaps in its knowledge base.[17] As the Scotsman put it, "its aim is to acquire companies which provide the skills and technologies it does not already possess".[18]

In 1996 there was widespread speculation concerning a possible merger between BT and Cable & Wireless (C&W). Indeed Scotland on Sunday (SOS) stated that, "…reliable sources say the deal, which would create Britain's largest company, is all but concluded".[19] Had the deal gone ahead (which much to SOS's embarrassment it did not) then ST was seen as the main candidate for taking over C&W's Mercury network in Scotland if not the whole of the UK.

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[11] Company Web site
[12] Ibid
[13] FT (29/3/97)
[14] FT (2/10/97)
[15] Hemmington Scott Web site July 2000
[16] Hemmington Scott Web Site 13/11/2000
[17] The Scotsman (27/3/99)
[18] The Scotsman (27/3/99
[19] Scotland on Sunday (31/3/96)

In 1996 ST purchased Teledata (Holdings) Ltd, an interactive services and call centre service provider. The company founded by Bill Dobbie and Angus McSween was bought for £10.2 million.[20] Over the next three years a further four interactive services providers were bought for a total sum of £15.3 million.

In 1997 The Scotsman indicated that ST was poised to become a major player in the mobile phone market following the purchase of Woodend Communications with around 23,000 customers.[21] This was followed by a deal with the company, Martin Dawes, which agreed to transfer its Scottish customers to ST (see below).

In 1998 Demon Internet Ltd, founded by Cliff Stanford, was purchased for £66 million. Following the purchase ST migrated around 50 percent of Demon's Internet service traffic onto its network leading to an increase in ingress revenues.[22]

Soon after the purchase of Demon the value of Internet Service Providers (ISPs) shot up on the stock exchange and the company began to be seen as a valuable asset within ST's portfolio of operations. Scotland on Sunday stated that the company, the second largest web-hosting business in the UK and the fifth largest in the world represented a "bargain basement buy".[23]

In 1997 it had been reported that SP was in talks with Racal over a possible merger of their telecoms interests.[24] In 1999 the FT indicated that Racal Telecom was on the verge of being bought by Energis.[25] If the deal did not go through, however, ST was one of the companies which, it believed, would also be interested. As it turned out, Racal was ultimately taken over by Global Crossing, something which led to new speculation that ST itself might be bought out in a trade sale. Amongst the supposed interested parties, France Telecom was widely tipped.[26] Ultimately, however, such speculation proved just as misplaced as the supposed deal between ST and Racal.

Joint Ventures

In 1995 it was reported that ST had formed an alliance with COLT to deliver long distance calls.[27]

Also in 1995 a link was established between ST and Vodafone as the company entered the mobile market as a service provider.[28] By 1997 ST had 29,000 mobile customers, making it the largest Scottish-based service provider. By this time it was offering services from both Vodafone and Cellnet.[29]

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[20] The Scotsman (6/3/98)
[21] The Scotsman (28/3/97)
[22] Thus Prospectus, 10/11/9, p24
[23] Scotland on Sunday (19/9/99)
[24] The Scotsman (7/11/97)
[25] FT (13/9/99)
[26] The Scotsman (4/10/99, 14/10/99)
[27] FT (29/4/95, 2/11/95)
[28] FT (2/11/95)
[29] FT (2/9/97)

In late 1995 it was reported that ST had concluded a £22 million deal to give it access to the radio technology and software of Ionica which provided fixed-radio access (FRA) services at the 3.4 GHz range of the spectrum. This ST intended to use in tandem with its fixed telephony network to provide services throughout Scotland.[30] Under the deal Ionica agreed to leave the Scottish market to ST. By early 1998 ST was supplying FRA services to around 50,000 homes in Edinburgh and was expanding into Glasgow.[31]

In 1996 Ionica and ST had also teamed up to apply for an additional radio licence in the 10 GHz range for the provision of ISDN services such as Internet access and video conferencing.

With the well publicised demise of Ionica in 1999 ST had little choice but to pull out of the FRA market. A spokesman for the company stated that, "after Ionica went bust we soldiered on for a bit, but eventually decided that it wasn't worth it".[32] This shift in strategy led to an exceptional charge of £43.5 million in the company's accounts for the six months to September 30, 1999.[33] Upon ST's announcement that it was curtailing its fixed radio access services the FT commented that the "ghost of Ionica" had returned to haunt the industry.[34]

In 1997 Racal Electronics was exploring various options for the future of its telecoms and data management subsidiary. One such option was understood to involve an alliance with ST.[35]

Also it 1997 an alliance was announced between ST and Martin Dawes Telecommunications, an independent service provider for mobile phones. The deal would allow ST to offer an integrated package of telecoms products. The principal motivation for ST for entering the agreement was to gain access to Martin Dawes' customer care and billing system, one of the most advanced in the world. The FT pointed to the similarities between this deal and that struck between Vodafone and Energis a few weeks previously.[36]

In 1999 ST, together with BT Scotland, The Royal Bank of Scotland, and NTL announced they were opening the Scottish Internet Exchange (Scotix) using a similar model to that used by Linx in London. The exchange represented a physical point of connection between telecoms companies and ISPs. It was hoped that the exchange would reduce the cost of local Internet access within Scotland.[37]

As of late-1999 ST was providing network support services for a number of Virtual Internet Service Providers (VISPs) including the BBC and Ondigital.[38]

[30] FT (2/11/95)
[31] Scotland on Sunday (4/1/98)
[32] Quoted in The Guardian (25/7/99)
[33] Thus Prospectus, 10/11/99
[34] FT (22/7/99)
[35] FT (18/11/97)
[36] FT (2/9/97)
[37] FT (4/8/99)
[38] Thus Prospectus, 10/11/99, p27

In early 2000 ST teamed up with Nokia to provide Wireless Application Protocol (WAP) access to its Web hosting facilities. The service would be made available to its Demon Internet customers and to the SME market.[39] It claimed to be the first non-mobile operator to allow such access.[40]

In April 2000 it was reported that ST would be collaborating with Oftel in order to test ADSL services using BT exchanges.[41]

When announcing its preliminary results in May 2000 ST indicated that it had entered into an e-commerce initiative with Microsoft and Dell. The agreement involved the joint development of software for the UK business market, as well as strategies aimed at application service provision.[42]

During 2000 ST also worked in collaboration with its former parent, SP, in launching an indirect residential telephone service to SP customers in Scotland and the North West of England. ST also participated in an internet joint venture between SP and the Royal Bank of Scotland.[43]

4/Network

With the launch of ST in 1994 the company started to build upon SP's internal communications system to create a predominantly fibre optic network attached to power lines covering Scotland's main population centres.[44]

Most of the company's current network is located in Scotland and in London with leased capacity joining these two core regions.[45] As at September 30 1999 ST owned 77 percent of its network with the remainder being leased or licensed. The company also has a reciprocal "capacity sharing" agreement with Energis and peering relationships with over 80 other ISPs in the UK.[46]

The company has IP hubs in New York (through the Gemini and Atlantic Crossing cable systems) and Amsterdam (through the GTS cable system).[47] The growth in ST's UK network is indicated in Table 1.

[39] FT (3/3/2000)
[40] Preliminary Report, 2000
[41] FT (5/4/2000)
[42] FT (4/5/2000)
[43] Interim Report, 30/9/2000
[44] FT (29/3/97)
[45] Thus Prospectus, 10/11/99, p36
[46] Thus Prospectus, 10/11/99, p37
[47] Thus Prospectus, 10/11/99, p37

Table 1 - **Route Length of Installed Fibre**	
(Km – as at 31/3)	
1997	1,400
1998	2,200
1999	3,400
2000	5,200
Source: Thus Prospectus (10/11/99), Annual Report 2000	

In 1998 ST announced that it would be investing £35 million in a 1,300km fibre optic and radio network in the Highlands. The area had long been seen as poorly served both by the fixed and mobile telecoms operators.[48]

ST currently has a three phase expansion plan for its UK network which will involve capital spending of around £187.5 million. In addition to its plan for a roll out of its UK network (see table 2) ST also aims to expand overseas, primarily in Europe and the US.[49]

Table 2 - UK Network Information		
(as at 30/9/99)		
	1999	2002 (estimate)
Route Length (nearest 100kms)	3,500	5,700
PSTN switches	6	12
Data Nodes	7	56
Points of Presence	79	140
Points of Interconnect	22	39
Source: Thus Prospectus (10/11/99)		

In 2000 ST claimed that it was on track for the fastest ever roll out of a national network in the UK. It pointed out that its network had been extended by 40 percent over the previous year, with services due to be launched in 11 additional cities in the coming year.[50]

For its voice traffic ST uses mainly Nortel and Marconi equipment. For data traffic it uses Lucent and Cisco ATM and IP routing equipment. For Internet services it relies primarily on Ascend technology.[51] In December 1999 ST announced that it would be the first company in Europe to implement a new technology which would allow it to offer full voice communications over the internet. It intended to do this by installing

[48] FT (10/3/98)
[49] Thus Prospectus, 10/11/99, p39
[50] 2000 Preliminary Report
[51] Thus Prospectus, 10/11/99, p38

Multiprotocol Label Switching (MPLS) software from Lucent Technologies on its internet-based network.[52]

5/Addressable Market

Scotland and the UK

The Scottish telecommunications market, that first targeted by ST, has been estimated to be worth £2 billion a year.[53]

In 1997 ST indicated that it sought to control 10 percent of the residential market within its operating area within three years. At the time BT enjoyed a 95 percent market share.[54] By early 1999 ST had won 6 percent of the corporate telecoms market in Scotland and 4 percent of the market overall.[55] During the year Scotland on Sunday described the company's growth over the previous five years as "staggering".[56]

By the time of its 2000 annual report the company was emphasising that it was concentrating on the whole of the UK, claiming that it was undertaking the fastest ever roll out of a national network. This national outlook was reflected by the dropping of the name, Scottish Telecom, in favour of Thus.

Europe

The proportion of the company's revenues coming from Europe, outside of the UK, was put at 2.4 percent for 2000, up from 2.2 percent in 1999.[57] While still representing only a small part of ST's revenues, the European market would be the next logical step for the company after it consolidates its position within the UK.

According to Bear, Stearns and Co, the European market for voice, data and Internet services is worth more than $175 billion a year.[58] As the number of European connecting to the Internet increases this figure will grow substantially. Dataquest estimate 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.[59] The European data market was expected to be worth $55 billion by the year 2000.[60]

Commerzbank has estimated that the telecoms sector in Europe is growing at eight percent a year. It predicts that the value of the top six territories: the UK, Germany, France , Italy, Spain and the Netherlands will grow from $129 billion in 1997 to $246

[52] FT (17/12/99)
[53] The Scotsman (18/5/97)
[54] FT (16/5/97)
[55] The Scotsman (27/3/99)
[56] Scotland on Sunday (19/9/99)
[57] Preliminary Report, 2000
[58] dowjones.com (13/5/99)
[59] Ibid
[60] FT (27/3/98)

billion in 2005.[61]

Target Market

In the first few years of its development ST seemed content to split its efforts between the residential and the business markets. Its position within SP allowed it to gain access and potentially cross sell to a sizeable residential customer base. More recently the company has sought to define itself primarily as a data provider, concentrating more upon the higher-margin business market. This change of focus was made clear by the company in 2000 when it described itself as changing

> "…from a regional telecoms company into a leading provider of next generation telecommunications and Internet services targeting the UK wide business to business market" [62]

6/Stock Market History

Fund Raising

Prior to its IPO in late 1999 ST's capital expenditure was taken care of by SP. Since the flotation the close financial link has continued with SP providing an unsecured revolving loan facility valued at up to £220 million with a maturity date in 2002. The company's net debt as at the end of its 2000 financial year was just under £244 million.[63] In November 2000, with increasing doubts being expressed about the adequacy of the company's funding, SP announced that it would be lending a further £100 million to ST. [64]

In its interim report for its 2001 financial year the company indicated that in the longer term it anticipated meeting its financing requirements via the debt and capital markets.

Share Performance

With Vodafone and Orange both having enjoyed spectacular runs on the stock market during the first half of 1998 there was a growing feeling that its telecom interests could send SP's shares in the same direction. Indeed its share price jumped 14 percent in a single session after a presentation in which it laid out its telecoms strategy. Lex in the FT was wary suggesting that "…the market may come to regret its exuberant response".[65] It went on to argue that comparisons between ST and Energis were misleading given the limited size of the Scottish market. Of course ST could always expand south of the border building upon Scottish Power's existing English

[61] FT (18/3/99)
[62] Preliminary Report, 2000
[63] Preliminary Report, 2000
[64] FT (9/11/2000)
[65] FT (8/7/98)

customer-base. In Lex's opinion, though, "The tartan appeal may fade south of the border".[66]

Rumours that ST would soon be partially floated preceded its eventual IPO by a number of years. In late 1997 SP "poured cold water" on suggestions that it would shortly be floating off part of ST.[67] In early 1998 ST director, Ian Russell, also indicated that a separate flotation of the company was not regarded as a viable option in the short term.[68] This uncertainty concerning the company's intentions seemed to reflect a lack of consensus among SP's key personnel, with Rob Mathews reluctant to separate ST from its parent. In the end he was ousted from his post a few months before the company was brought to market.

In January 1999 there was renewed speculation that Scottish Power would shortly be floating off part of Scottish Telecom in order to unlock shareholder value.[69] In February 1999 Lex was estimating that the company could have an equity value of between £1 billion and £1.5 billion.[70] In May the FT reported that SP was looking at various options for its subsidiary, including a possible trade sale. It indicated that Goldman Sachs had been brought on board to advise the company "…on the best way of maximising shareholder value". [71]

The FT indicated that in any trade sale Energis would be one of the most likely buyers.[72] The Scotsman made the same point, quoting Mike Grabiner of Energis who stated that, "it is up to Scottish Power what they do with it, but we are very interested in keeping our close relationship with Scottish Telecom".[73]

In September 1999 it was officially announced that a stake of up to 50 percent would be sold by SP. Commenting upon the decision Ian Robinson, CEO of SP stated that:

> "Scottish Power has built Scottish Telecom into a significant internet and telecommunications business. ..The board of Scottish Power believes it is now timely to realise value for Scottish Power shareholders through an initial public offering"[74]

At the time it was reported that the ST flotation would represent the biggest such event in Scottish corporate history.[75] Prior to ST's IPO Goldman Sachs valued it at between £1.9 billion to £2.5 billion using a discounted cash-flow model.[76]

In the run up to the IPO there was speculation in the business press that SP may choose to sell a smaller stake (closer to 25 percent) of ST in order to prevent a rival

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[66] Ibid
[67] FT (30/9/97)
[68] Scotland on Sunday (4/1/98)
[69] FT (27/1/99)
[70] FT (8/2/99)
[71] FT (7/5/99)
[72] FT (25/5/99)
[73] Quoted in The Scotsman (25/5/99)
[74] Quoted in FT (18/9/99)
[75] Scotland on Sunday (24/10/99)
[76] FT (13/10/99)

such as Energis building up a large stake as a prelude to a takeover.[77] As it turned out, however, the eventual sale involved virtually the full 50 percent earmarked by the SP Board as the maximum allocation.

Following the publication of its Pathfinder Prospectus ST increased the price range for its shares by 16 percent following general rises within the sector and a favourable response to its book building exercise. In the month or so following the publication of ST's prospectus the FTSE Telecoms sector increased by 12 percent with Energis, the company seen as "most comparable" to ST by Goldman Sachs, rising by 19 percent.[78] Upon the flotation of ST all of its shares were allocated to institutions with private investors given no chance to participate in the IPO.[79] At a time when telecoms shares were highly sought after this decision did not go down well with many private investors

Through the flotation in November 1999 SP raised £756 million through its sale of a 49.9 per cent stake in ST. Part of this amount was destined to be used in a share buy back programme by SP.[80]

Initially the stock performed well rising from the issue price of £3.50 to a high of £8.44 soon after the start of 2000. The value of the shares was then affected by the general decline affecting the telecoms sector and by mid 2000 was well below the issue price. As of early November 2000 the shares were languishing at around 72p. This dramatic fall had seen the company's market capitalisation go from £3.3 billion at the end of its 2000 financial year (end of March) to £511 million by the beginning of November.[81]

In discussing the stock in August 2000 the FT stated that, "It has been a short, but volatile, ride since it came to market last November".[82] During that time the company had seen itself elevated to the FTSE 100 index only to be ejected almost immediately as its share price started to fall. The share's worst moment came at the end of July 2000 when the company announced a profit warning leading to a one day decline of over 30 percent. The FT described the sudden decline as one of the market's "…most sudden, spectacular falls from grace".[83]

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[77] Scotland on Sunday (24/10/99)
[78] FT (9/11/99)
[79] Scotland on Sunday (19/9/99)
[80] FT (11/11/99)
[81] Hemmington Scott Web site, 13/11/2000
[82] FT (1/8/2000)
[83] FT (1/8/2000)

7/Company Data

Table 3 – **Scottish Telecom – Financial Summary**				
year ended 31 March - £m				
	1997	1998	1999	2000
Turnover	40.3	81.5	166	217
Pre-tax profit	-5.55	-10.2	-9.35	-63.1
Fixed assets	83.9	138	231	347
Source: Hemmington Scott				

Table 3 gives an indication of the rapid progress made by ST with its turnover doubling every year between 1997-99. In its preliminary results for 2000 ST reported turnover of £216.9 million and a loss before tax of £63.1 million.[84] This large increase in the losses for 2000 was partly attributable to the expenses involved in the continuing roll out of the company's network (an expansion which is evident through the growth in the company's fixed assets). A large proportion of the loss, however, was also attributable to the company's withdrawal from the FRA market following the collapse of Ionica.

Ian Russell, finance director of SP indicated in 1996 that he expected the ST subsidiary to achieve turnover of £300 million in five years time with a pre-tax profit of more than £20 million.[85] In terms of turnover, at least, the company looks to be well on target. In terms of profits, however, the estimate now looks rather optimistic, especially in light of the profits warning issued by the company during 2000.

TABLE 4 - **SCOTTISH TELECOM EMPLOYEES**	
1995	141
1996	191
1997	702
1998	1,430
1999	2,336
Figures, as of 31 March	
Source: Scottish Power Annual Report, 1998-99	

The above table shows the growth of ST employees from 1995-1999. For 2000 the number of employees was put at 2,376.[86]

[84] Preliminary Report, 2000
[85] FT (10/5/96)
[86] Hemmington Scott Web site

Table 5 shows the breakdown of ST employees in 1999. As can be seen, most of the company's work force are involved in the call centre side of the business.

TABLE 5 - **EMPLOYEES BY FUNCTION**	
Internet and interactive	606
Data and Telecom	704
Call Centres	1,062
Total	2,372
Thus Prospectus (10/11/99)	

8/Strategy

The company describes its basic strategy as follows:

> "The Company's strategy for growth is to take advantage of the changing nature of the UK telecommunications sectors by integrating and cross-selling the services it currently provides and by developing and offering Internet and data solutions to enable customers to exploit new technologies" [87]

Three key elements are outlined to take this strategy forward

1/ Leveraging and integrating existing business through cross selling
2/ Enabling customers to exploit new technologies (e.g. voice over IP and e-commerce)
3/ Implementing an IP-led strategy to expand the range of services available on its network

Services

In describing its services ST divides its operations into the following areas:

1/Internet and Interactive Services
2/Data and telecom services
3/Call centre services

1/Internet and Interactive Services

The Company offers a variety of Internet services, principally under the "Demon" brand, in the UK and in The Netherlands. As at September 30 1999, ST (including Scotland on Line) had over 260,000 paying Internet customers, approximately 34,000 of whom were in The Netherlands. The Company is the second largest web hosting business in the UK, and, at September 30 1999, had approximately 13,800

[87] Thus Prospectus, 10/11/99

commercial web customers. It has recently launched an e-commerce product to this customer base. The Company also provides free Internet access under its "In2Home" brand, which had approximately 65,000 active registered users at September 30 1999.[88]

ST is a leading provider of a number of interactive information services using premium rate call services and has an estimated 14 percent. of the UK premium rate service provider market. The Company provides sports, weather, financial and other information and competitions and games. Customers make over a million minutes of calls per week to these services, which include the brands "ClubCall" and "Weathercall".[89]

2/Data and telecom services

The Company also offers a wide range of data and telecom services, primarily to business customers. To date these have focused mainly on customers in Scotland. These services include switched direct, indirect and number translation services, as well as capacity and data services, including leased line services. As at June 30 1999, ST provided approximately 14,300 direct lines to its business customer base, which included more than 500 businesses.[90]

In addition, through facilities management agreements, ST manages the telecommunications networks of Scottish Power and its subsidiaries, Manweb and Southern Water, on an arms' length basis.[91]

3/Call centre services

ST provides a full range of call centre services for business customers under the brand "The Call Centre Service". These services include providing call centres on a fully outsourced basis, ranging from telemarketing to customer services, as well as call centre integration and consulting. The Company is a significant provider of call centre services in the UK, deploying over 1,000 agents at September 30 1999 and, in the year to March 31 1999, handling over 2.5 million incoming calls.

Business customers

The company's primary focus has been upon the business market. By 1997 Rod Mathews was claiming that the company had around 200 blue chip corporate customers.[92] By 1999 it had 3,200 indirect business customers using the RouteOne service.[93]

[88] Company Web site
[89] Ibid
[90] Ibid
[91] Ibid
[92] FT (29/3/97)
[93] Thus Prospectus, 10/11/99, p31

Residential Customers

In 1997 ST indicated that it would be entering the residential market, offering householders in Scotland connections to its network via a fixed radio link or through a converter box linked to the BT network. Its FRA network would initially be available within Edinburgh and then throughout different parts of Scotland.[94] By 1999 it had 34,600 indirect residential customers using the brand name, "Gold".[95] This two-pronged strategy involving indirect and FRA customers was remarkably similar to that used by Scottish rival, Atlantic Telecom. With the collapse of its partner company, Ionica, however, ST was forced to withdraw completely from the FRA market, incurring significant losses in the process.

Marketing and Branding

In 1999 ST started using the Thus brand for all parts of its operations although the Demon brand also continued to be used. The company stated that the new identity provided "…a generic brand not limited by geography, service or product".[96] Later, it was reported that the company was also looking into replacing the Demon brand with Thus, although no firm decision had been taken.[97] In particular it was felt that the Scottish Telecom name would limit the company's expansion into England. There may also have been the misperception that ST was somehow related to BT. As Bill Allan, CEO put it "A lot of people think that we are the equivalent of British Telecom in Scotland".[98]

The change to the Thus brand was not universally popular. Professor Griggs of the organisation, Scotland the Brand, for example, pointed out that companies such as Scottish Widows had successfully retained the Scotland label. He commented that:

> "I am quite sad. People lose a lot by giving up their Scottishness. It is a strange decision, and a very non-specific name. They have given up a lot of value"[99]

The New Statesman for its part asked of the company, "Why does it seem to take every step to disassociate itself from its Scottish origins and base?"[100]

Recent Strategic Direction

Over the last year or so the company has increasingly sought to define itself as a data provider to the business market. Commenting upon the interim results for the 2001 financial year, for example, Bill Allan stated that:

[94] FT (29/3/97)
[95] Thus Prospectus, 10/11/99 p31
[96] Thus Prospectus, 10/11/99, p35
[97] Marketing (27/1/2000)
[98] Quoted in FT (4/10/99)
[99] Quoted in The Scotsman (4/10/99)
[100] The New Statesman (20/3/2000)

> "These results reflect the transition of the Company from a regional provider of traditional telecommunications services to a nationwide provider of advanced data and Internet services to corporate and SME customers"[101]

Indicating that the company intended to continue with this shift in focus, Allan outlined that this would be facilitated in the following ways:

1/ A greater emphasis on its business service division, which was showing strong growth.
2/ The restructuring of the company's corporate sales team to service its major nationwide accounts more effectively.
3/ The enhancement of Demon's capabilities making it an increasingly business orientated ISP.

While this increasing emphasis upon the business sector seems partly attributable to the greater margins available in this market, it also seems plausible to suggest that the company moved away from the residential market as a result of the collapse of Ionica. Had ST not formed part of a financially secure utility such as SP it may well have followed Ionica into liquidation. As it turned out the curtailment of its FRA experiment led instead to a new strategic direction.

9/Competition

Scotland

In Scotland, suggested Scotland on Sunday, ST is one of five main players, the others being BT, Atlantic Telecom (AT), Telewest and CableTel. In addition, it also mentioned a number of niche providers such as ACC Telecom, First Telecom (now part of Atlantic Telecom), Interphone and Jydecom.[102]

AT has represented a particularly significant competitor in Scotland not least since it also used a dual FRA and Indirect Access strategy to lure customers away from BT. In describing AT's early development the Scotsman suggested that its activities put "the tiny company in direct head-to-head competition with the giant multi-utility Scottish Power".[103] Unlike ST, however, AT had no connection with Ionica and has continued to successfully roll out its FRA network throughout Scotland. The parallels between the ST and AT seem set to continue for some time with both companies expanding into the English market with an emphasis upon the business sector.

Both ST and AT originally projected a strong Scottish identity, something which BT seemed to try and respond to via its setting up of BT Scotland, with a separate Scottish board in 1998. The new entity inherited a market share of 90 percent for residential, and 80 percent for corporate customers.[104] In a press interview the Director of BT Scotland, Doug Riley, indicated that the move was in response to the

[101] Quoted in interim results 30/9/2000
[102] Scotland on Sunday (19/4/98)
[103] The Scotsman (10/6/97)
[104] The Scotsman (22/8/98)

new mood engendered by the establishment of the Scottish Parliament. When questioned specifically about the two main Scottish rivals (AT and ST) he responded that:

> "I don't mention competitors by name, but obviously I recognise that there is competition here. Am I frightened of it? Well, I sleep OK at night."[105]

It is interesting to note that BT was taken on the *Scotland* label just as ST was considering dropping the term and putting less emphasis upon its Scottish roots.

In 1996 two of Scotland's cable companies, Telewest (Edinburgh) and CableTel (Glasgow) announced that they were in negotiations to link their networks for telephony purposes. The competitive threat to ST was clear and was further forced home by Bart Bonsall, Telewest's Managing Director in Scotland, who stated that, "What we have to do as an industry is make sure that we create the most effective competition for BT and the wireless telephone operators".[106]

UK Competition

An idea of the extent of the potential number of competitors in the UK market was given by BT which indicated that it exists alongside over 200 such competitors.[107] As ST expands into England it is naturally going to have to deal with many of these competitors.

Competition by Sector

Internet Services

In the category of subscription internet services for the business sector ST lists its main competitors as Easynet, PSI Net, BT Internet and UUNet. In the residential sector it lists AOL, Compuserve and BT Internet.

For its commercial web hosting products it considers the main competition to be BT World Web, UUNet, Easynet and Netlink.[108]

There is also a clear competitive threat from the 90 or so free ISPs set up since Freeserve entered the market in September 1998

Interactive Services

According to OFTEL figures compiled in 1999 ST accounts for approximately 14 percent of the interactive services market. The company lists its principal competitors

[105] The Scotsman (22/8/98)
[106] The Scotsman (3/9/96)
[107] Scotland on Sunday (19/4/98)
[108] Thus Prospectus, 10/11/99, p41

as Broadsystem Ltd (part of News International), Greenland Interactive Ltd, IMS Group Plc, Telecom Express, and Telecom Potential Group Plc.

Reporting its interim results for its 2001 financial year the company indicated that revenues in this division were down by 40 percent. This it attributed to, "…strong competition in the premium rate services market which was felt particularly within the competitions operation".[109]

The company also admits that many of its branded services are suffering as competition from the Internet increases.[110] When it comes to customer interaction a telephone service cannot hope to match the visual and audio experience available over the Internet.

Data and Telecom Services

Overall the company sees its main competitor as BT, which remains dominant across the UK market, including ST's target market of the business sector. It also lists Cable and Wireless Communications (CWC) and Energis. For basic services ST mentions BT, CWC, MCI WorldCom and NTL. For advanced telephony and data services it considers BT, CWC and Energis to be its main competitors.[111]

Call Centres

The UK dominates the European Call Centre industry with around 35 percent of the market by agent numbers. By 2000 it is estimated that over 1 percent of the UK workforce will be employed by call centres. Among ST's competitors in this area are Sitel, Ventura, BT Connections in Business and Merchants.[112]

10/Other Threats

Uncertainty in the ISP Market

In common with other ISPs Demon's paid subscriber business has been affected by the emergence of free Internet access providers (starting with Freeserve). By focusing upon business customers, who demand high quality connections, the company hopes to minimise the effect of the trend towards the free access model.[113] ST also responded by establishing its own free access operation, In2Home, which is distributed through Electronic Boutique's retail outlets.[114]

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[109] Quoted in Interim Report, 30/9/2000
[110] Thus Prospectus, 10/11/99, p42
[111] Thus Prospectus, 10/11/99, p43
[112] Thus Prospectus, 10/11/99, p44
[113] Thus Prospectus, 10/11/99, p26
[114] Thus Prospectus, 10/11/99, p28

In its interim report for the 2001 financial year ST also drew attention to regulatory changes which had reduced the proportion of call revenues allocated to ISPs. This was one of the factors which the company referred to in order to explain its decline in gross profit for the period. ST has also recognised that there is considerable uncertainty surrounding the growth of the Internet and whether e-commerce services will ever reach a critical mass.[115]

Of particular relevance to ST is the issue of ISP liability for defamatory content contained on hosted sites. The case of *Godfrey v Demon Internet Ltd* which went against Demon was a clear example of the types of uncertainties which exist in this new business area. At the time of its flotation ST had several other court cases outstanding.[116]

In summary, the ISP sector is currently undergoing a turbulent phase of its development, with a high level of "shake out" widely predicted. Given that ST is heavily exposed to such uncertainty through its Demon division this brings into question the prospects for the company as a whole.

Technological Developments

Until now newly established telecom companies such as ST 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 ST might see themselves being overtaken by technical advances (e.g. by satellite-based systems or third generation mobile). 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" [117]

ST recognises that it operates in a fast moving industry where backing the wrong technology can prove costly. It states that:

> "The telecommunications industry is subject to rapid and significant changes in technology. Thus may choose new technologies that prove to be unprofitable, inadequate or incompatible with technologies of its customers and other carriers"[118]

ST's disastrous experience with FRA technology shows that such statements are not merely to be interpreted as the usual statutory risk warnings evident within company prospectuses.

On a similar theme, the company has also acknowledged that the increasing use of mobile phones could reduce the amount of voice traffic carried on its network.[119] As

[115] Thus Prospectus, 10/11/99
[116] Thus Prospectus, 10/11/99, pp 170-171
[117] FT (18/3/99)
[118] Thus Prospectus, 10/11/99, p118
[119] Thus Prospectus, 10/11/99

mobile phones become more sophisticated with the introduction of third generation features such a risk could become more pronounced.

Profit Warning

At the end of July 2000 the company announced what amounted to a profits warning, leading to an immediate fall of over 30 percent in its share price. Reporting poorer results for the first quarter of its 2001 financial year the company issued the following statement:

> "Due to the lower growth rate in revenues, the cost of investing in future expansion and competitive pressure, ebitda (earnings before interest, tax, depreciation and amortisation) for the full year is expected to be negative"[120]

In explaining the poorer than anticipated results the company focused on BT's Surftime Internet package which had lured away 5,000 of ST's residential customers. The package was not available to Demon users meaning that to use it potential customers had to switch to an alternative ISP. Bill Allan, CEO at ST, described this as a "regulatory void", over which the company had no control.[121]

At the time of the profit warning it was also revealed that the company had previously made an error in forecasting revenues for its interactive division which runs premium rate competitions. All in all the company emerged from the profit warning looking decidedly shaky. This impression was heightened by the fact that for the bulk of the second part of 2000 ST did not have a dedicated Chief Financial Officer.

The City is renowned for refusing to forgive (or to invest in) companies issuing this type of profit warning, making ST's short term prospects look rather bleak. In particular the company could encounter problems in raising future funds on the capital markets. Meanwhile its weak share price limits its fund raising options through, for example, a rights issue. Soon after this episode there was increasing speculation that SP might be happy to reduce its majority stake in the company or to sell out completely.[122] All in all, ST suffered a fairly dreadful first year as a listed company. Given that the whole sector has fallen from grace on the stock market it seems unlikely to make a rapid comeback.

[120] Quoted in FT (1/8/2000)
[121] Quoted in Ibid
[122] FT (9/11/2000)