

VIATEL PROFILE¹

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Introduction

One of the key influences impacting upon the state of the European telecoms market over the last few years has been a changing regulatory framework. Under the World Trade Organisation Basic Telecom Agreement concluded on February 15, 1997 (implementation date February 5, 1998), 69 countries, which together account for 95 percent of the global telecommunications market, agreed to permit competition from foreign operators. This agreement is set to open up the global market and has come on top of a similar shift in the regulatory structure within Europe.

In an effort to encourage efficiency and competition in the European market the European commission passed a series of Directives which in most member states came into effect from January 1, 1998. This legislation has been supported by various harmonising Directives such as those relating to interconnection and licensing.

Following the deregulation of the international long distance market in the U.S. new entrants built up their share of the market to 56.4 percent by 1997 (compared with 2.7 percent in 1985).² Now many of the same companies (together with even more start-ups) are hoping to do the same within the newly deregulated European market. With further legislation, such as carrier pre-selection due to come into force across most of the European Union in the year 2000, the market, in the eyes of the new arrivals, is looking increasingly appealing.

While the European market has traditionally been highly fragmented and controlled by the incumbents from individual nation states, the new arrivals are much more inclined to see it as a single, borderless entity. The untapped potential of the European market when viewed in these terms has been acknowledged by Salomon Smith Barney who have stated that:

"We think that providers of high bandwidth cross border services are in one of the telecommunications industry's most potentially lucrative segments"³

The opportunities within Europe, particularly for operators with independent, continent-wide networks, has not gone unnoticed by U.S. financiers and investors. Indeed Europe has for the last few years been experiencing an invasion of U.S. telecom companies. Such has been the extent of U.S. activity in Europe that it has

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 Viatel, SEC 10k document, 1998, p3

³ Salomon Smith Barney, Viatel: Total Transformation (6/10/99) p19

started to be noticed by the wider press. The Observer, for example, mused that, "the U.S. telecoms firms are over-financed and over here".⁴ One of the companies it focused on, which, it noted, had incredibly raised over \$1 billion in junk bonds to pay for its European network, was Viatel.

Origins and Development

Martin Varsavsky

Viatel was founded by Martin Varsavsky in 1991. Fortune described Varsavsky's personal history as a true "only in America"⁵ story - despite the fact he grew up in South America and transferred his base to Spain only a few years after starting the company.

Varsavsky was brought up in Argentina where, at 16 years of age, he and his family suffered the trauma of having his 17 year-old cousin murdered at the hands of the Argentinean junta. This prompted his father, a Harvard-trained astrophysicist in charge of the Radio Astronomical Institute in Argentina, to move his family to New York.⁶

The young Varsavsky completed an undergraduate degree at NYU, followed by two graduate degrees at Columbia University. In 1985 he cofounded a biotech company called Medicorp which commercialises research from universities. Before that he had been involved in the start up of a real estate firm, Urban Capital, that developed properties in New York and elsewhere. Fortune, in the course of a fairly scathing article, conceded that both these businesses appeared to be profitable, before going on to cast aspersions as to the viability of Viatel - Varsavsky's first venture into telecommunications.⁷

In 1991, not yet out of his twenties, he started Viatel with an initial investment of \$200,000.⁸ The company was a pioneer in international call-back services (involving the rerouting of calls to minimise costs). It initiated this service in Latin America before expanding both its range of services and its geographic reach, covering North America, Western Europe and the Pacific Rim.⁹

During the early stage of its development Viatel was at times described as an "Argentinean telephone company" due to its focus upon that country.¹⁰ The company had to contend with strong opposition to its operations from the country's indigenous telecoms suppliers and with a government that was ambivalent to its presence. This seems to have further tainted Varsavsky's view of his homeland and in recent

⁴ Observer (17/10/99)

⁵ Fortune (17/2/97)

⁶ Forbes (4/10/99)

⁷ Fortune (17/2/97)

⁸ Forbes (4/10/99)

⁹ Salomon Smith Barney, op cit, p42

¹⁰ El Economista (7/10/94)

interviews he has indicated that he has no interest in pursuing any part of his business in the country.¹¹

In 1993 with the call-back market niche becoming over supplied he began to move the company's focus to alternative services, in particular, the development of a pan-European network (initially based upon leased capacity combined with the company's own switches) in preparation for the liberalisation of the European market. Later still, the company reached the conclusion that the only way forward was to construct its own European network from scratch..

Over the next few years there was a high level of coming and going among senior executives at the company, a level of turnover which Fortune described as "startling".¹² It went on to point out that of the top 10 executives with the company in 1993 only one, Varsavsky himself, was still in place by the time the company held its IPO in October 1996.

At the beginning of 1998 the break with Viatel's early days was completed when Varsavsky also resigned his official positions at the company to concentrate upon a new telecoms company, Jazztel, in Spain. His Spanish ambitions had been hinted at previously when in late 1996 he moved the Planning and Organisation Department of Viatel to Madrid as part of the decentralisation of the company.¹³ Indeed even as early as October 1995 when Varsavsky wrote a letter to Communications Week International, it was signed Martin Varsavsky, Viatel Inc, Madrid.¹⁴

Gary Donahee of Nortel Networks (one of the few people to stand by him when his new Jazztel venture ran into cash difficulties) has described Varsavsky as follows:

"Martin is simply one of the most creative entrepreneurs I've ever met. He's always bombarding me with emails at 11pm and visiting our labs in Ottawa, testing ideas. He constantly asks, Where's the next opportunity? What's the next step?"¹⁵

By late 1997 it seems that Varsavsky had concluded that the next opportunity was in Spain and the next step was to leave Viatel behind and establish Jazztel.

Michael Mahoney

Once Varsavsky had decided to focus upon setting up a new venture in Spain his pre-eminent role at Viatel was given over to Michael Mahoney, another executive not yet in his forties. Mahoney joined Viatel in 1994 as Executive Vice President of Operations and Technology. He was made a Director in 1995, President in 1996, combined with CEO since 1997 and combined with Chairman of the Board since

¹¹ See, for example, Forbes (4/10/99)

¹² Fortune (17/2/97)

¹³ Expansion (11/9/96)

¹⁴ Communications Week International (23/10/95)

¹⁵ quoted in Forbes (4/10/99)

1998.¹⁶ Before joining Viatel he was employed by SITEL Corporation, a teleservices company (1990-1994) and URIX Corporation, a manufacturer of telecommunications hardware and software (1987-1990).

Mahoney's worth within the company is shown by the \$3 million key-man life assurance policy which Viatel have put in place in his name. No other employee is considered worthy of such protection. His importance is also reflected by the extent of his stock options (exercisable and unexercisable) which are valued at between \$3.4 million and \$5.2 million.¹⁷

Mahoney does not, however, represent such a well known figure as Varsavsky and at times he and his management team have been described as rather bland, lacking the type of forceful industry personalities epitomised by Bernie Ebbers (WorldCom) and Joe Nacchio (Qwest). Referring to this "low-profile" approach of Viatel's management, Goldman Sachs have spoken out in their defence, stating that, "we think Viatel's management team is one of the most under estimated in the industry".¹⁸

More specifically Viatel's management has also at times been criticised for failings in the marketing area. However, the company again finds support within the financial community with Ryan, Beck and Co. suggesting that, "senior Viatel management, in our opinion, know what it is doing, and knows the value of broadband and an IP-orientated voice, data, and video network".¹⁹ This idea that it is a company which knows what it is doing was supported by the publication Telecom Business which, in 1999, selected Viatel as one of its "Top 500" award winners based upon its potential for influencing the future shape of the competitive telecoms market.²⁰ In August 2000 Viatel was also selected as the UK's top carrier in a poll of resellers carried out by NOP.²¹

Investors

As already indicated Martin Varsavsky made an investment of \$200,000 in Viatel in 1991. In 1995 George Soros made an initial investment of \$5 million in the company which together with a further \$75 million from additional private investors was used to fund Viatel's move away from the call-back sector.²²

Fortune described Viatel's main outside shareholder as Comsat (followed by the holding by Soros).²³ This holding was subsequently reduced and in its second quarter results for 1999 Comsat reported a pre-tax gain of \$12.6 million from the sale of Viatel stock.²⁴

¹⁶ Viatel, SEC 10k document, 1998, p35

¹⁷ Viatel, SEC 10k document, 1998, p38, p69

¹⁸ Goldman Sachs, Investment Research Note (23/9/99)

¹⁹ Ryan, Beck and Co., Viatel Research Note (20/9/99)

²⁰ PR Newswire (23/8/99)

²¹ Viatel Press Release (9/8/2000)

²² Wall Street Journal (24/6/96)

²³ Fortune (17/2/97)

²⁴ PR Newswire (19/7/99)

Table 1 shows Viatel's main shareholders at the end of its 1998 financial year. Later Varsavsky disposed of a large number of shares and in October 1999 his remaining stake in the company was put at 6.8 percent, worth around \$57 million.²⁵

Table 1 - Beneficial Ownership of Viatel (year-end 1998)	
Martin Varsavsky	15.5 percent
The Capital Guardian Trust	11.6 percent
Directors and Executives*	3.4 percent
* Michael Mahoney, alone, makes up 1.4 percent	
(Source: Viatel, 10k, 1998, p72)	

After company's merger with Destia (see below) the main individual shareholder was Alfred West, that company's founder and dominant shareholder. Following the merger he became Viatel's Vice Chairman. Table 2 also shows that by year-end 1999 Varsavsky was no longer a significant shareholder, while the Directors and Executives of the company held an increasingly important stake.

Table 2 - Beneficial Ownership of Viatel (year-end 1999)	
Alfred West	10.6 percent
Thomas Hicks	9.4 percent
Chase Equity	6.6 percent
College Retirement Equity Fund	5.5 percent
Directors and Executives*	13.9 percent
* Michael Mahoney, alone, makes up 1.2 percent	
(Source: Viatel, 10k, 1999, p86)	

In early 2000 the company raised a total of \$325 million from three venture capital groups (Hicks, Muse, Tate and Furst; Chase Capital Partners; and the Blackstone Group).²⁶

Acquisitions, Mergers and Joint Ventures

Acquisitions

²⁵ Forbes (4/10/99)

²⁶ 1999 Annual Report, p7

On February 27, 1998 Viatel acquired Flat Rate Communications Inc., a long distance communications reseller based in the U.S.. The company was particularly active in the wholesale market, supplying other carriers and resellers. The cost was \$5 million in cash, 375,000 shares and a contingent payment based upon performance over the following year.²⁷

In December 1998 Viatel was thought to be one of the companies which had lost out in the take-over of the telecommunications unit of Eastern Group which was sold to NTL.²⁸

In March 2000 Viatel bought the UK arm of long-distance carrier AT&T in a deal thought to be worth up to \$200 million. The deal was seen as plugging the gap in Viatel's European network, giving the company a national imprint in the strategically important UK market.²⁹ The purchase added 1,700 route kilometres to the company's network.³⁰

Mergers

On August 27, 1999 Viatel announced that it would be merging with Destia Communications in an all stock transaction which was due for completion by the end of 1999. The stock swap was valued at around \$600 million.³¹ Sources within Viatel indicated that the merger would lead to cost savings of \$500 million over five years.³²

Destia, which was formally known as EconoPhone, is a facilities-based provider of domestic and international services in North America and nine European countries. It was founded in 1993 by Alfred West who held 35 percent of its shares at the time of the merger.³³ As well as calling card and prepaid card services it also offers wholesale transmission services and Internet Access. It has also introduced an e-commerce card called the Presto! card in the U.S. and the UK (where it is marketed exclusively through Freeserve). It has operations in the U.S., UK, Belgium, France, Germany and Switzerland. The combined company would have more than 500,000 customers in Western Europe.³⁴

The two companies marked their merger agreement with the launch of the "One World, One Rate" Club, within which members could make calls between or within North America and several European countries for a fixed rate of five cents per minute. Speaking of the new offer, Alfred West, Chairman and CEO of Destia stated that:

²⁷ 1998 Annual Report, p19, p36

²⁸ FT (23/12/98)

²⁹ FT (1/3/2000)

³⁰ 1999 Annual Report, p5

³¹ New York Times (28/8/99)

³² Financial Post (28/8/99)

³³ Salomon Smith Barney, op cit, p17

³⁴ The New York Times (28/8/99)

"...it is designed to break the mould and redefine telecommunications for the new millennium by leveraging both companies' networks - both in the U.S. and Western Europe - for our customer's advantage".³⁵

Following the merger Michael Mahoney of Viatel continued to serve as CEO of the combined company. Alfred West, CEO of Destia took on the position of Vice Chairman with a remit to concentrate upon the development of products and services. Alan Levy, Destia's President and COO became the new COO of the joint company. He should hold few surprises for his new colleagues since he was CFO of Viatel until 1996.³⁶

Part of the rationale for the merger from Viatel's point of view was that it would mitigate its lack of a retail base and the marketing infrastructure to go with it (helping to counter the criticisms mentioned earlier that Viatel was weak on the marketing front). As Ryan, Beck and Co. put it, "what Viatel will get from Destia are customers and marketing beef".³⁷ Goldman Sachs also seemed to approve of the move, suggesting that, "we think the merger makes sense on many fronts".³⁸ Bank of America Securities also liked the deal, suggesting that, "the combined company is ideally positioned to be a premier player in the European market for communications".³⁹

The markets were less convinced, however, with Viatel's shares coming under pressure following the merger announcement. In particular it was felt that Viatel had paid a hefty price to secure its expansion. Credit Suisse First Boston disagreed, arguing that, "in our opinion, concerns about the Destia purchase are ill-founded".⁴⁰ It went on to deny any idea that Viatel paid over the odds for the company, pointing out that the valuation based on sales was less than that paid by GTS for Esprit and Omnicom.

Joint Ventures

In 1994 Viatel signed an agreement with Talkline PS Phoneservice which would give that company access to Viatel's international call-back service.⁴¹

In 1997 Viatel formed a partnership with PSINet an ISP based in the UK to offer corporate Internet access in the main European markets. Under the deal Viatel would offer access to its network and its client-base of corporate customers.⁴²

In June 1998 Viatel signed a co-operation, development and investment with Jazz Telecom SA (Jazztel), an emerging provider of telecommunications services in Spain.

³⁵ quoted in PR Newswire (11/10/99)

³⁶ Ryan, Beck and Co. op cit

³⁷ Ryan, Beck and Co. op cit

³⁸ Goldman Sachs, op cit.

³⁹ Bank of America Securities, Viatel Research Note (27/8/99)

⁴⁰ Credit Suisse First Boston, Viatel Research Note (21/9/99)

⁴¹ Handelsblatt (17/9/94)

⁴² Public Network (July 1997)

Its Chairman, as indicated earlier, is Martin Varsavsky.⁴³ The agreement involved the joint construction of an undersea cable from Spain to the UK, a deal on capacity swaps and the purchase by Viatel of \$6 million of Jazztel's stock. Later Mr Varsavsky further agreed not to sell any of his Viatel stock for a period approaching one year.⁴⁴

In 1998 Viatel used the services of Cignal Global Communications, a start-up company which patented its own method of sending voice over data networks, a system which involves savings of up to 80 percent over conventional practises.⁴⁵ In the course of that year Viatel received 650,000 of Cignal's shares in exchange for transatlantic capacity valued at \$3.25 million. There was also provision made for a further 650,000 shares in exchange for capacity on Viatel's "Circe" network. Mr Mahoney of Viatel also became a Director of Cignal.⁴⁶

On August 6, 1998, Viatel announced that it had signed a pact with 32 telecommunications and Internet service providers to build a transpacific cable system that would connect Japan and the U.S. by mid-2000. The link would be known as the Japan-U.S. Cable Network.⁴⁷

On the same day Viatel announced that it had entered into a commercial relationship with WorldPort Communications involving a capacity swap on the international networks being developed by both parties. In exchange for capacity on the Circe network WorldPort were to give Viatel capacity on its transatlantic link.⁴⁸

Viatel's other involvements in capacity arrangements at the time included the AC-1, GEMINI, CANTAT-3 and TAT-12/13/14 cable systems (all transatlantic) and an interest in the FLAG (Fiberoptic Link Around the Globe) network.⁴⁹

In December 1998 it was reported that Viatel had, along with a number of other resellers and carriers, teamed up with Fibernet plc to create an interconnection hub in London which would enable the participants to bypass traditional interconnection agreements.⁵⁰

In March 1999 a strategic alliance was announced with Lucent through which Viatel's network would be used by Lucent for testing purposes. In particular Lucent would install and trial its ATM data networking switches on the Circe network - which would effectively become a showcase for Lucent's data capabilities in Europe.⁵¹ The agreement also involved provision for the training of Viatel's sales staff in data communications and the cross-selling of advanced data services - the main targets of

⁴³ PR Newswire (7/6/98)

⁴⁴ 1998 Annual Report, p40

⁴⁵ Scotsman (5/11/98)

⁴⁶ Viatel, SEC 10k document, 1998, p61

⁴⁷ Viatel Press Release (6/8/98)

⁴⁸ Viatel Press Release (6/8/98)

⁴⁹ Viatel Customer Pack, Quality, service, value and innovation in international telecommunications, 1999

⁵⁰ Totaltelecom.com (2/12/98)

⁵¹ Lehman Brothers, European High Yield Research (27/9/99)

which would be SMEs.

In 1999 Viatel entered into joint build contracts with Carrier1 and Metromedia for the construction of phase three of its Circe network in Germany. It has also announced that it was seeking similar partners for phases four and five.⁵²

In September 1999 it was reported that Viatel was in partnership talks with Edison SpA of Italy. This followed the granting of Viatel's fixed line telephony licence in Italy in February 1999 and an interconnection agreement with Italia SpA in April.⁵³

As from October 1999 Viatel has described itself as an equity holder and strategic partner of Sonic Telecom Ltd, a privately held company specialising in digital communications over an ATM network.⁵⁴

During 1999 Viatel took a 25 percent share in the trans-Atlantic fibre optic cable being constructed by Level 3. This collaboration, suggested Viatel, was an illustration of "Co-opetition", whereby new entrants would simultaneously compete and co-operate with one another.⁵⁵

During 1999 Viatel also established a strategic alliance with Intira Corporation, a company involved in Internet hosting and "netsourcing". With Viatel providing the bandwidth the two companies aimed to offer Web-based applications to business clients.⁵⁶

Suppliers

In constructing its network Viatel has used the services of four key suppliers: Lucent (fibre optic cable and network management systems), Nortel (network electronics), Alcatel (sub-sea segments) and Bechtel (project management). In doing so it has negotiated tight design and build agreements with these companies which has effectively delegated much of the risk entailed in constructing the network.⁵⁷

Lehman Brothers have also commented upon the "strong relationship" which Viatel enjoys with its suppliers, stating that this gives it considerable scope for future vendor finance facilities.⁵⁸ A similar comment was made by Credit Suisse First Boston who stated that, "Viatel has developed some very strong supplier partnerships in constructing the Circe network".⁵⁹

In June 1998 it was reported that Viatel had signed a contract with Lucent for the supply of 3,600 km of optical fibre cable. Viatel later confirmed its close working

⁵² Ibid

⁵³ AFX Europe (21/9/99)

⁵⁴ PR Newswire (26/10/99)

⁵⁵ 1999 Annual Report, p13

⁵⁶ 1999 Annual Report, p18

⁵⁷ Salomon Smith Barney, op cit, p8, p13

⁵⁸ Lehman Brothers, op cit

⁵⁹ Credit Suisse First Boston, op cit

relationship with Lucent by agreeing to jointly launch data networking services in the first half of 2000.⁶⁰ In constructing its International Network Operation Centre (INOC) in Egham (England) in 1999, Viatel again used Lucent (and Nortel) as its prime suppliers.⁶¹

Wholesale Customers

In 1998 one wholesale customer, LD Exchange.com was pre-eminent - accounting for 10.6 percent of the company's total revenues for that year.⁶²

In 1999 the UK Internet service provider, Internet Technology Group chose Viatel's Circe Cable System to construct its pan-European communications network which it required to improve its business to business operations.⁶³

Also in 1999 the Canadian telecommunications operator Teleglobe announced that it would be using Viatel for the supply of fibre optics for its European network.⁶⁴ Another recent capacity customer was Facilicom.⁶⁵

In 2000 Viatel counted the following companies among its new customers: Tycom, Einsteinet, Pangea, Globix, PSINet, Marconi and Infonet.⁶⁶

Network

In February 1998 Viatel announced the construction of a fresh dig, highly scaleable network, known as Circe, using up to 96 fibre strands. This made it more advanced than the likes of Hermes Raitel's partially completed network operating with 2-4 strands.⁶⁷ Realising that first to market advantages were available Viatel set an "aggressive timetable" for the first stage of Circe, which was completed less than a year after funding was secured in April 1998.⁶⁸ Viatel's planned network is widely seen as its key asset - while its ability to quickly bring the initial phases into operation have won the company considerable praise. The following comments from financial analysts are typical:

"...given the strategic nature of Viatel's Circe network, we believe that Viatel will be a key player in the consolidation of the European telecom market"⁶⁹

"We believe Viatel is best positioned to capitalize on the accelerating growth of the European data and telecom markets with the most extensive high-

⁶⁰ Lehman Brothers, op cit

⁶¹ PR Newswire (13/7/99)

⁶² 1998 Annual Report, p33

⁶³ FT (9/7/99)

⁶⁴ La Tribune (9/6/99)

⁶⁵ Lehman Brothers, op cit

⁶⁶ Viatel Web site

⁶⁷ Ibid

⁶⁸ Annual Report, 1998, p4

⁶⁹ Lehman Brothers, op cit

capacity network in place...No other company is equipped with as extensive a fresh-built fiber network in Europe as Viatel" ⁷⁰

"Viatel's pan-European Circe network is a key differentiating factor which places Viatel at the nexus of the new economy driven by the Internet and the benefits of silicon economics. Viatel's state-of-the-art fiber optic network sets the cornerstone of sustainable competitive advantage" ⁷¹

In total Viatel is investing more than \$700 million in the construction of its Circe Pan-European Network. This 8,700 route-kilometre network (including 312 route kilometres of submarine cable) links over 40 cities within Western Europe. The company claims that it will not only be the largest fresh-build broadband network in Europe, it will also be the lowest cost fibre-optic network, as measured on a gigabit per fibre kilometre basis. ⁷² The roll out of the network is shown in table 3.

Table 3 – Network		
Stage	Operation Date	Route km
1	15/3/99	1850
2	29/9/99	2005
3	1Q2000*	2000
4-5	2Q2000*	2850
Total		8705
*Estimates		
(Source: Lehman Brothers, 1999, p6)		

The network consists of a self-healing, bi-directional SDH ring. It is capable of supporting data services (i.e., ATM, IP and frame relay), multimedia applications and voice telephony. Based upon current technology it will have a minimum of 9.3 terabits per second of capacity. ⁷³

As just indicated the Circe network fully supports ATM as well as IP. This distinguishes it from "purist" IP networks such as that being constructed by Level 3. This reflects the company's belief that, especially given Europe's particular difficulties, IP is not yet capable of providing resilient voice switching. ⁷⁴

Circe employs a uniform architecture consisting of Nortel Telecom's optronics and Lucent Technologies' fibre optic cable. ⁷⁵ The network is controlled via two operations centres based in New Jersey (U.S.) and Egham (England).

⁷⁰ Bank of America, op cit

⁷¹ Goldman Sachs, op cit

⁷² PR Newswire (6/5/99)

⁷³ Viatel Web site

⁷⁴ Salomon Smith Barney, op cit., p9

⁷⁵ Viatel SEC form 10k, 1998, p8

Phases one and two of the network, consisting of over 3,000 kilometres, linking London, Amsterdam, Rotterdam, Brussels and Antwerp, Paris, Amiens, Nancy, Strasbourg, Dusseldorf, Frankfurt and Mannheim are already in service and carrying commercial traffic. The remaining three stages of the network were expected to be completed by June 2000.⁷⁶

The network has involved the acquisition of existing infrastructure as well as the laying of new cable. In Belgium Viatel reached a 20 year agreement with the national rail operator SNCB to lease fibre optic lines over its network. Part of their agreement with SNCB (which was also a share holder in Hermes Railtel) involved the marketing of Viatel's long distance services to the Belgian operator's customers. The tie-up with SNCB was not, however, exclusive; indeed the railway has also reached agreements with Esprit, EUnet Belgium, Mobistar and BT.⁷⁷

More recently Viatel has started to develop its network at the level of the local loop. This it claims it was forced to do because of the incumbents reluctance to comply with EU regulations and open up their local facilities. By the end of its 1999 financial year the company had 22,000 fibre kilometres of local loop assets, spread across various European and US cities.⁷⁸

Stock Market

Fund Raising

At the end of 1994 Viatel raised \$75 million in a private placement with a group of institutional investors. As stated earlier George Soros was one of the investors at this stage. The placement was organised by Morgan Stanley and involved a mixture of stock and junk bonds. It may have been expected that Morgan Stanley would also go on to underwrite the company's IPO in 1996 but in fact it declined and it was Salomon who finally brought the company to market. Fortune saw this as an early warning sign, indicative of the company's worrisome financial condition.⁷⁹ The IPO itself raised \$95 million in October 1996.

In the course of 1998 Viatel raised a total of \$900 million through high yield bonds, funding which was needed for the initial stages of the Circe project.⁸⁰ This was considerably more than the company had anticipated raising originally. The company's success in raising such an amount was an indication of the level of enthusiasm which the markets felt at the time for facility based networks in Europe. As an editorial on Totaltele.com put it, "the U.S. appetite for a piece of European action is tangible".⁸¹

⁷⁶ PR Newswire (29/7/99, 11/10/99)

⁷⁷ L'Echo (1/9/98)

⁷⁸ 1999 Annual Report, p8

⁷⁹ Fortune (17/2/97)

⁸⁰ The New York Times (14/5/99)

⁸¹ Totaltele.com (18/5/98)

In March 1999 the company raised a further \$365 million in high yield bonds to fund stages four and five of its network.⁸² On June 30, 1999, Viatel raised approximately \$200 million through the issuance of an additional 5 million shares of its common stock. This secondary offering was priced at \$47 per share and increased the number of the company's shares outstanding to 32.5 million⁸³ This new equity enabled the company to improve its balance sheet gearing.

This financial restructuring seemed to have the desired affect and soon after the secondary offering Moody's upgraded the rating on Viatel's Senior Notes from Caa1 to B3 with a positive outlook. Following the announcement of the deal with Destia, however, (which involved the assumption of additional debt), Save and Prosper placed the company's Senior Notes on Credit Watch Negative.⁸⁴

Lehman Brothers confirmed that the Circe network was currently fully funded and that the company (combined with Destia) would only need a fresh injection of capital (approximately \$50 million) around the second half of 2001 (funding which in any case may take the form of vendor financing). This outlook would only change, it suggested, if the scope of the Circe network should be enlarged to include, for example, Spain and/or Italy or additional local loop segments.⁸⁵

In total Viatel raised \$600 million of new capital funding during 1999.⁸⁶ In 2000 this was supplemented by \$325 million injected by three venture capital companies (see Investors section, above) and a further \$350 million through the issuance of convertible stock.⁸⁷

Share Performance

Viatel went public in October 1996 with its stock priced at \$12 a share. Within two weeks the price had dropped to \$8.75 and later fell to below \$8 before a slight upturn. Fortune did not seem optimistic about its prospects, stating that, "given the company's problems, it may have even more to drop".⁸⁸ These comments were contained within an article entitled, "Viatel, a cautionary tale", which went on to provocatively ask, "why would a Wall Street wizard like Soros think such a turkey could fly?".⁸⁹ The publication went on to quote Geoff Johnson, Vice-President of Gabelli & Co., who stated that, "when you see companies like this come public, it's the sign of a market top".⁹⁰ Concluding a fairly scathing attack upon Viatel, Fortune pointed out that Varsavsky had used the drop in the company's value to purchase an additional million shares. Such optimism, it warned its readers, was best left to "...the entrepreneurs

⁸² Lehman Brothers, op cit

⁸³ PR Newswire (24/6/99,14/7/99)

⁸⁴ Lehman Brothers, op cit

⁸⁵ Ibid

⁸⁶ 1999 Annual Report, p7

⁸⁷ Viatel Press Release (30/3/2000)

⁸⁸ Fortune (17/2/97)

⁸⁹ Ibid

⁹⁰ Ibid

who run such outfits".⁹¹

Elsewhere, Viatel was also viewed negatively during this period. When Esprit floated in early 1997 it sought to distance itself from Viatel and its languishing share price and chose to compare itself with the better performing Pacific Gateway Exchange.⁹² In August 1997 the stock seemed to confirm the widespread scepticism falling as low as \$4.25.

Thereafter, Viatel's market fortunes began to improve and with the stock trading at around \$11 in mid 1998, Business Week reported one New York money manager who argued that the stock was one of the most under-valued bets on the deregulation of communications in Europe, and that it could rise to \$40 within a couple of years.⁹³ His prediction was well founded and by July 1999 Viatel was trading at over \$55.

As stated earlier, however, the merger with Destia announced in late August 1999 was not well received by the markets. Initially the stock swap (of 0.445 Viatel share for each Destia share) valued Destia at \$18 5/8 per share. Over the next few weeks, though, Viatel's price fell significantly, meaning that the *pro forma* enterprise value of the "new" Viatel was reduced by approximately \$850 million, an amount greater than the original purchase price for Destia. In other words the markets now valued the new group at no more than the original Viatel. Once more the company had fallen from grace on Wall Street. Salomon Smith Barney stated that the merger had clearly been "poorly received" by the markets.⁹⁴ Part of the problem for many investors was that Destia was voice-centric and the bulk (60 percent) of its revenues came from North America. Given the price pressure on long distance calls in the U.S. some commentators saw the deal as a poor one for Viatel.

Other new network builders were also suffering on the stock market around this time. Some of the factors behind a fairly major sell-off within the whole sector were described by Ryan, Beck and Co. who stated that:

“...an interest rate tightening, profit taking, investor hand wringing over bandwidth gluts, and long distance price wars have served to thrust the bulk of the new network infrastructure stocks deep into the dog house”⁹⁵

The Destia deal ensured that Viatel was viewed even more poorly than the sector as a whole at this time.

Its spell in the market's bad books was lengthened by a worrying article in the business press which appeared just at the wrong time for the company. As noted earlier Viatel had already suffered at the hands of Fortune magazine. Now it was a feature in Barron's⁹⁶ which was to undermine the company's credibility. Essentially the article raised questions about the accountancy procedures for capacity sales on

⁹¹ Ibid

⁹² FT (26/1/97)

⁹³ Business Week (22/6/98)

⁹⁴ Salomon Smith Barney, op cit, p3

⁹⁵ Ryan, Beck and Co. op cit

⁹⁶ Barron's (6/9/99)

networks such as Viatel's and more generally reinforced the view that bandwidth prices were set to tumble. The effect of the article was that Viatel's own valuation continued its downward path. In late September 1999 its share price fell below \$24 - bad news, in particular, for those investors who had recently participated in the company's secondary offering at \$47.

Viatel was not, however, without its supporters in the financial sector during this period. Kaufman Brothers, for example, described the sell-off of Viatel shares as "nonsensical" and recommended that investors "aggressively purchase" the stock.⁹⁷ Salomon Smith Barney agreed that the shares had been over sold and argued that, "the recent sharp decline have created an opportunity to buy into an emerging pan-European facilities provider at exceptional value".⁹⁸

A number of brokers also reiterated the point that as Viatel had made the transition from a telecoms reseller (traditionally lowly rated by the markets) to a facilities based operator its shares were due a re-rating. At prevailing prices Viatel was valued in October 1999 at 2.7 times estimated revenue for the year 2000. This compared with corresponding multiples of 13.6 for COLT, 10 for Global Crossing and 5 for Qwest.⁹⁹

At the end of November 1999 the Viatel share price stood at just over \$42, having recovered most of its losses from the previous few months. By March 2000 it reached a record high of over \$70. Thereafter, however, the shares suffered a sharp decline as the telecoms sector fell out of favour with investors. By the end of October 2000 Viatel shares stood at \$8.25.¹⁰⁰ Viatel's bonds also declined in value during this period and by October 2000 were trading at about 50 cents on the dollar.¹⁰¹

As the forgoing discussion clearly demonstrates, Viatel continues to be a volatile share. The company itself accepts as much, stating unambiguously that, "the market price of our common stock is volatile". It goes on to state that:

"In particular, the stock prices for many companies in the telecommunications sector have experienced wide fluctuations which have often been unrelated to the operating performance of such companies. We have been, and are likely to continue to be, subject to such fluctuations"¹⁰²

In July 1999 it was announced that Viatel would be included within the U.S - based Russell 2000 and Russell 3000 indexes which are used as benchmarks for a number of index funds. This inclusion, suggested Mahoney of Viatel, would increase the company's investment appeal, particularly amongst those funds which tracked the indexes.¹⁰³

In July 1999 Viatel announced that it intended listing on the London stock exchange,

⁹⁷ Kaufman Brothers, Viatel Research Note, (22/9/99)

⁹⁸ Salomon Smith Barney, op cit, p4

⁹⁹ Bank of America, op cit

¹⁰⁰ Interactive Investor Web site

¹⁰¹ FT (11/10/2000)

¹⁰² Viatel, SEC form10k, 1998, p41

¹⁰³ PR Newswire (16/7/99)

while retaining its NASDAQ listing. The move would allow it to meet the increasing institutional and retail demand for its stock within Europe. This demand had been confirmed in the company's stock offering in June in which almost 20 percent of the available stock was purchased by 37 European institutions.¹⁰⁴ A year later, however, the company still had not made its appearance on the London market.

Addressable Market

Market Size

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.¹⁰⁵ The long-distance market in Europe has been estimated at \$200 billion a year compared with \$160 billion for the U.S..¹⁰⁶

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 2005.¹⁰⁷ 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.

According to industry sources the European long-distance market for voice services is the largest in the world, with 43 percent of international calling volume originating in Europe.¹⁰⁸ Viatel puts the size of the traditional long distance and international market in Europe at \$220 billion a year.¹⁰⁹ Again the primary area of growth is identified as the digital communications sector, with the company stating that, "the communications industry is expecting unparalleled growth in data in the near term".¹¹⁰

Data networking and the Internet, in particular, are seen as the main generators of future expansion. Traditional telephony, suggests Viatel, will soon be "dwarfed" by this emerging market sector.¹¹¹ By 2001, suggests Viatel, Internet services in Europe will be worth \$100 billion, with annual growth of around 60 percent. On-line sales in Europe, it suggests, are set to grow from less than \$1 billion today to over \$64 billion by 2001. This growth will be attributable, in part, to the increase in the number of Europeans "on-line", a number forecast to rise from 22 million in 1998 to almost 70 million in 2002.¹¹²

This growth of data in Europe is a reflection of an identical trend at the global scale.

¹⁰⁴ PR Newswire (14/7/99)

¹⁰⁵ Observer (17/10/99)

¹⁰⁶ Business Communications Review (July 1999)

¹⁰⁷ Credit Suisse First Boston, op cit

¹⁰⁸ Viatel SEC Form10k, 1998, p2

¹⁰⁹ Annual Report, 1998, p5

¹¹⁰ Viatel SEC Form10k, 1998, p6

¹¹¹ Annual Report, 1998, p9

¹¹² Ibid p9

Credit Suisse First Boston estimate that by 2005, 85 percent of all telecom traffic will consist of data.¹¹³ 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 2004.¹¹⁴

Prior to the partial liberalisation of the European market in 1998 most of the traditional telephony market was in the hands of the incumbents. With the arrival of competition, however, their dominance has been declining. Lehman Brothers estimated that Deutsche Telekom lost 30 percent of its domestic and long-distance market share in the first year of deregulation.¹¹⁵ As for the supply of data, the incumbents with their legacy voice networks are in a much more vulnerable position. It is here where the greatest opportunities exist for new arrivals such as Viatel. Whether it be voice or data, however, the first tactic of the new companies is to attack on price. This has led Lehman Brothers to state:

"Given the rapid decline in telecom prices across the continent, we believe that companies with the most extensive broadband networks, strongest retail presence and successful data and IP service offerings will emerge as the premier telecommunications providers"¹¹⁶

Viatel is also involved in leasing out capacity on its network to other carriers. Lehman Brothers referred to figures from Global Crossing which valued total capacity sales in Europe in 1999 at \$1.8 billion rising to an estimated \$4 billion by 2004.¹¹⁷

Target Market

Viatel lists its market segments as:

- End users
- Resellers
- Incumbents
- International Carriers
- Alternative Carriers
- Internet Backbone Networks
- Value Added Networks and other Service Providers.¹¹⁸

When talking about its "end-users" the company is primarily thinking of small and medium sized businesses. Telecommunications suggested that in addition to the reseller market, Viatel was primarily focused upon the SME sector. In this respect, it grouped the company alongside the likes of Esprit Telecom.¹¹⁹

¹¹³ Credit Suisse First Boston, op cit

¹¹⁴ quoted in Tele.com (25/10/99)

¹¹⁵ Lehman Brothers, op cit

¹¹⁶ Ibid

¹¹⁷ Ibid

¹¹⁸ Viatel SEC Form10k, 1998, p4

¹¹⁹ Telecommunications (Sept. 1998)

Viatel's explains the rationale behind this focus by suggesting that European SMEs (usually defined as businesses with less than 250 employees) account for 66 percent of business employment and 55 percent of total business revenue.¹²⁰ The data requirements of this market segment, it suggests, have been poorly served by the traditional operators and will represent the key market for the Circe network. In a press interview Mahoney of Viatel stated that:

“We decided to focus on the small and medium-sized business market, because we felt that these businesses were not being adequately served. We also recognize the enormous revenue potential it offers in view of the US experience”¹²¹

In the UK Viatel claims to have 4,000 corporate clients, including 300 of the country's largest blue chip companies.¹²²

Company Data

Table 4 - Revenue	
(millions of Dollars)	
1994	\$26.3
1995	\$32.3
1996	\$50.4
1997	\$73.0
1998	\$135.2
1999	\$333.1
(Source: 1998, 1999 Annual Reports)	

Table 4 indicates a steady rise in the company's revenues between 1994-1999. Mahoney has indicated that the company is looking to exceed \$1 billion in revenues by the year 2000.¹²³ On the strength of the 1999 revenues this looked like a somewhat optimistic estimate. With the acquisition of Destia, however, Viatel had pro forma revenues for 1999 of \$600 million,¹²⁴ making the \$1 billion target seem much more achievable.

¹²⁰ Annual Report, 1998, p9

¹²¹ Quoted in Global Telecoms Business (Feb/Mar 1999)

¹²² Viatel Web site

¹²³ Global Telecoms Business (Feb/Mar 1999)

¹²⁴ 1999 Annual Report, p7

Table 5 – EBITDA	
(millions of dollars)	
1994	(11.1)*
1995	(20.3)
1996	(24.6)
1997	(26.6)
1998	(31.8)
1999	(18.0)
* numbers in brackets represent a loss	
(Source: 1998, 1999 Annual Reports)	

Table 5 reveals that the company was increasingly EBITDA negative up to 1998. The results for 1999, however, would indicate that it has turned the corner with EBITDA losses less than they were in 1995.

Employees

As of September 1995 Viatel employed 250 staff, compared with 80 at the beginning of the year.¹²⁵

As of year-end 1998 the company had 488 full-time employees (234 of whom were employed in sales, marketing and customer service). This number did not take into account the increased workforce following the merger with Destia.¹²⁶

The company's most recent annual submission to the SEC put its number of full-time employees at 1,760 (780 of whom were involved in sales, marketing and customer service).¹²⁷

Strategy

Early Days (1991-1993)

Viatal's opening strategy involved the supply of discounted long-distance calls via a system which involved the routing of traffic through a series of switches in London and the U.S. in order to benefit from the cheapest rates available. Such "call-back" operators typically gave non-U.S. customers access to U.S. dial tone for more economical international calls. Viatal pioneered this strategy along with other operators such as International Discount Telephone and Telatlantic.

¹²⁵ Communications Week International (4/9/95)

¹²⁶ 1998, SEC 10k Report, p19

¹²⁷ 1999, SEC 10k Report, p24

Despite the fact that this technique involved the use of tariffs which had been approved by the Federal Communications Commission (FCC) a number of the established international carriers questioned its legality. The ambiguity surrounding the legality of Viatel's strategy of bypassing local telephone monopolies was also a cause for concern among regulators within many of the company's operating territories. Indeed, according to Fortune Viatel was "thrown out" of a number of countries.¹²⁸ Even in the countries of the EU, the rules were "ambiguous" and the company was "...operating on the edges of the European voice market".¹²⁹

In any case the market's appeal to operators such as Viatel was short lived. The call-back strategy started to go astray when intense competition in various countries forced pioneers such as Viatel to price their calls at below cost. With the prospect of negative operating margins Viatel was never going to stand still and remain solely in this market. In a press interview in 1999 Mahoney indicated that the developments within this market niche came as no surprise to the company, stating that:

"Even in 1991 we realized that call-back was an arbitrage opportunity. As is the case of all arbitrage opportunities, over time the market finds a way to reduce the attractiveness"¹³⁰

Implicit in Mahoney's comments was the idea that the company had always set itself a much bigger goal than pure arbitrage. An account of where the company was headed next was given in a Salomon Smith Barney report entitled "Viatel Inc.: Total Transformation".¹³¹ Here the broker described how, encouraged by the imminent deregulation of the European communications market, Viatel began to define its future as a facilities based operator specialising in data. As for the infrastructure component of its strategy the company made its position clear, stating that:

"we believe that control of network infrastructure is critical to becoming a high quality, low-cost provider of communication services..."¹³²

Before emerging as a facility based operator, however, Viatel went through a transitional phase during which it attempted to establish itself in Europe without the financial burden of constructing its own network.

Viatel in transition (1994 - 1997)

During this transitional stage Viatel was essentially a reseller, focusing increasingly upon the European small business sector and reliant upon leased capacity from the incumbents. Using the \$75 million in finance it raised during 1995 Viatel started installing switching nodes in 27 European cities in order to co-ordinate its patchwork of leased lines.¹³³ Viatel was also offering virtual private networks, fax and other

¹²⁸ Fortune (17/2/97)

¹²⁹ Communications Week International (21/2/94)

¹³⁰ Global Telecoms Business (Feb/Mar 1999)

¹³¹ Salomon Smith Barney, op cit.

¹³² SEC 10k Report, 1998, p1

¹³³ Communications Week International (4/9/95), Information Week (22/12/97)

value-added services.

At this stage Communications Week International stated that Viatel was "pushing the boundaries of EC regulations" by providing voice services to "closed user groups" overseas.¹³⁴ These closed groups were a necessity in order to keep Viatel on the right side of the regulators, although there were numerous objections that Viatel was adopting a very loose interpretation of the term. As Alan Levy, Viatel's Executive Vice President at the time put it, "we are a bit progressive in how we are interpreting 'closed user group'".¹³⁵

During this phase Viatel was not offering call back within Europe, although the similarity with its original techniques was still commented upon. Communications Week International quoted the comments of one analyst who stated that:

"Nowadays, their techniques are slicker, but it fits the old definition of call-back in that it uses someone else's dial tone...They're arbitraging U.S. dial tone and UK dial tone, and whenever they put a switch they're arbitraging that dial so that they can offer cheaper rates".¹³⁶

Essentially, then, during this transitional phase Viatel was still living on the edge of regulatory tolerance and seeing how far it could push its luck. When it came to obtaining leased capacity at affordable rates, however, its luck ran out. Mahoney is quite candid that a major part of Viatel's decision to build its own infrastructure was down to its lack of success in obtaining satisfactory capacity agreements with network operators such as Hermes Railtel and WorldCom.¹³⁷

The Third Stage - Network Operator (1998 - present)

By 1998 it was becoming clear that not only would the company need its own network, but that the traffic of the future would primarily consist of data. This has been recognised by Lehman Brothers who, referring to the company's data networking relationship with Lucent, suggested that:

"we believe that data services will ultimately be a core element of the company's strategy as data and internet usage expands rapidly in Europe"¹³⁸

The centrality to Viatel's most recent business plan of data services has also been made explicit by the company. In a press interview with Global Telecoms Business in 1999 Mahoney stated that, "the sleeping giant is data communications".¹³⁹ By building the Circe network (named after the enchantress of Greek mythology) Viatel hoped to bring the giant to life.

¹³⁴ Communications Week International (4/9/95)

¹³⁵ Quoted in Ibid

¹³⁶ Quoted in Ibid

¹³⁷ Totaltele.com (16/2/98)

¹³⁸ Lehman Brothers (27/9/99)

¹³⁹ Quoted in Global Telecoms Business (Feb/Mar 1999)

Commenting upon the company's new strategic direction Salomon Smith Barney stated that, "turning from a voice re-seller into an advanced data capable facilities-based network is one of the most ambitious re-inventions seen in European telecoms". It described the reorientation as "a very high risk strategy". Nevertheless, the broker believed that Viatel had made the right move, suggesting that, "we doubt voice resellers have a long-term business model as prices come down all over Europe".¹⁴⁰ This outlook is reflected in the low stock market ratings which are allocated to such companies

Salomon Smith Barney put the date of the change of strategy at late 1997 when the company underwent a fundamental management change. The key change around this time was the departure of CEO, Martin Varsavsky, who had effectively opted for a parallel data network strategy within Spain via the creation of Jazztel. The fact that the two companies have been close collaborators ever since indicates that the break with Varsavsky was not primarily about disagreements over Viatel's strategic direction.

The rationale behind the current strategy

A key part of Viatel's current approach is the belief that as bandwidth prices fall demand for data services will explode. By having control over their own network they will be able to survive the price falls (which will be particularly noticeable in the voice sector) and ultimately be one of the main providers of the huge bandwidth requirement across Europe. In planning along these lines Viatel is aligning itself with other network builders, such as Level 3 (see separate profile) and those voices within the industry which argue that at the current stage of the information revolution you can never have too much bandwidth. Salomon Smith Barney are advocates of this approach, arguing that:

"...telecommunications is increasingly a virtuous circle in which demand for bandwidth is extensively stimulated by the falling prices caused by new bandwidth capacity. Falling prices are an integral part of the virtuous circle. Alternative networks like Viatel sit at the centre of this circle"¹⁴¹

In explaining their position, frequent reference is made to Moore's Law (an exponential increase in performance per pricing unit) and in the process communications is firmly aligned with the type of dynamics which have driven the computer industry. As Salomon Smith Barney summarise it; "Silicon Economics push computer economics down telephone lines".¹⁴²

Such a new economic model for telecoms only works if demand for bandwidth is shown to be highly elastic. On this score Credit Suisse First Boston refer to Lucent's calculations that the bandwidth elasticity in Europe is around 1.4-1.5, and add that other estimates put the figure as high as three.¹⁴³

¹⁴⁰ Salomon Smith Barney, op cit, p3

¹⁴¹ Salomon Smith Barney, op cit, p19

¹⁴² Salomon Smith Barney, op cit, p20

¹⁴³ Credit Suisse First Boston, op cit

As for the falling prices, which are also a prerequisite for such a model, there is certainly evidence that in the case of Viatel it is taken this part of the equation seriously. In 1999 Viatel was offering an E1 connection between London and Paris for a monthly fee of \$3,500. This compared with WorldCom's price of around \$15,000 and a pre-deregulation figure of around \$36,000.¹⁴⁴ In October 1999 it was announced that Viatel would be offering 5-cents-a-minute long distance calls across Europe (as part of a membership plan).¹⁴⁵

Another element of this price reduction policy is that Viatel aims to maximise its "first to market" advantage - gaining customers and developing their brand identity ahead of the growing number of competitors. Indeed the company has stated quite explicitly that by quickly driving down prices it also hopes to make it economically non viable for further networks to be completed. Ultimately this would shift the supply curve in the company's preferred direction.

There are of course detractors within the industry (and financial markets) who take fright at such price reductions and see them as symptomatic of a trend towards over-supply. This possibly of a bandwidth glut was raised by the Barron's article, mentioned earlier, which contributed to Viatel's declining share price over the summer of 1999. According to Goldman Sachs, however, the article missed the basic point that falling bandwidth prices had already been built into Viatel's business plan. Indeed such a price development formed the "basic tenet" of the company's strategy. Summing up, the brokers stated that:

"In our view, bandwidth demand elasticity and silicon economics more than offset collapsing capacity prices and generally lead to attractive economics"¹⁴⁶

Even if a glut does develop, goes this argument, it will soon be swept up by evolving data applications. Against this back drop Ryan, Beck and Co. quoted techno-guru George Gilder who had previously stated that the bandwidth glut "is not a glitch in the business plan, it is the business plan".¹⁴⁷

Expanding upon the theme, Goldman Sachs saw Viatel (like Level 3, Qwest and Global Crossing) as an "applications enabler" - its emphasis being the provision of the bandwidth to support the new applications which will emerge with the Internet-driven economy. In this respect the company would follow in the footsteps of Intel and Microsoft which provided an earlier generation of businesses with the tools to create their own value-added applications. Similarly, as computing and communications come together companies such as Viatel will also develop into "convergence enablers". As Eurocom see it, "ultimately, Viatel aims to offer all the different services currently converging in broadband pipes".¹⁴⁸

The readiness of Viatel to fill this new role is being made increasingly clear.

¹⁴⁴ Business Communications Review (July, 1999)

¹⁴⁵ Tele.com (25/10/99)

¹⁴⁶ Goldman Sachs, op cit

¹⁴⁷ Quoted in Ryan, Beck and Co. op cit

¹⁴⁸ Eurocom (23/7/99)

Recently the company has shown itself keen to get into hosted applications for business customers, ranging from messaging to complex enterprise resource planning (ERP) applications. The company has also recently indicated that it will be starting DSL trials in various European countries.¹⁴⁹ The announcement of the DSL trials was in line with Credit Suisse First Boston's suggestion that Viatel could get round its lack of local loop presence by teaming up with local broadband operators using wireless or xDSL. They also suggested that various other vertical integration strategies were possible, such as web hosting, and co-location. Other companies, they maintained, such as WinStar in the U.S. and COLT in Europe, were already looking to increase value in this way.¹⁵⁰

In October 1999 Viatel announced that it was launching a wireless local loop (WLL) service on its Circe network.. The service would provide 2 mbits/sec (E1) connectivity using dishes with a range of 20-30 miles. The new service would go under the name of CityConnex, and by offering unitary pricing was aimed at "...shattering the myth perpetuated by incumbent operators that private line connections must be expensive and distance sensitive..."¹⁵¹ In its 1999 Annual Report the company stressed that it was focused on gaining direct access to customers through the deployment of various local loop technologies.

With direct-access innovations such as these Viatel is showing that its ambitions lie at the value-added end of the data spectrum. It is clearly not content to rely solely upon bandwidth sales to other carriers. Paul Smits, President of Unisource, has described the carrier's carrier market as a "penny business".¹⁵² While keeping an eye on that "penny", Viatel is also clearly chasing higher denominations.

Practical Strategic Issues

Looking at the company's contemporary strategy from a less theoretical perspective it has been argued that by Eurocom that Viatel has adopted a three-pronged approach: completing its network, getting licences and completing operational inter-connect agreements.¹⁵³ Allan L. Shaw, Viatel's Chief Financial Officer has confirmed this outlook, stating that

"We have been stating for over a year now that, to succeed in the deregulating environment in Western Europe, new entrants will need to have licenses, interconnection agreements and infrastructure. During the past year, Viatel has proven its ability to implement and execute this three-pronged strategy"¹⁵⁴

The same three-way focus is revealed within the company's 1998 Annual Report within which it is stated that:

¹⁴⁹ Tele.com (25/10/99)

¹⁵⁰ Credit Suisse First Boston, op cit

¹⁵¹ Viatel Press Release (26/10/99)

¹⁵² Quoted in Totaltele.com (16/2/98)

¹⁵³ Eurocom (23/7/99)

¹⁵⁴ quoted in PR Newswire (6/5/99).

"In addition to owning infrastructure, we believe that licenses are interconnections are essential to compete in the new telecommunications market..."¹⁵⁵

With this three sided strategic plan coming together the company has now indicated how it intends to structure its operations. Viatel has intimated that its future revenues are likely to be derived from three distinct areas: wholesale sales, capacity sales and retail sales.¹⁵⁶ To date the company has perhaps been most radical in its treatment of capacity sales, offering its customers the types of IRU's (indefeasible right to use) which only used to be available for submarine links. Indeed it was the company's own inability to secure such long term agreements with the likes of Hermes which prompted it to become a network builder across Europe. In the future European revenues are expected to make up an increasing proportion of total turnover as the company exploits its Circe network and targets most of its resources at this market.

At a more specific level, Salomon Smith Barney outline the company's strategic thrust as follows:

- 1 Benefit from the process of deregulation across Europe
- 2 Establish itself as a low cost communications provider
- 3 Use its network to attract resellers and other carriers
- 4 Leverage its established market presence and local sales channels
- 5 Focus on the value-added retail end of their market, offering a range of services
- 6 Expand through acquisitions, alliances and strategic investments¹⁵⁷

From 1999 onwards the company seemed to be particularly focused upon the last item in this list. The importance of such third party involvements at this juncture in the company's history was recognised by Eurocom which suggested that in the future Viatel could look to expand its network operations through capacity swaps in the U.S. and Southern Europe. In this respect it quoted Glenn Davidson, President of Corporate Communications and External Affairs, who stated that, "We are always looking at alliances with other companies, whether to expand or leverage our network"¹⁵⁸ A similar outlook was expressed within Viatel's 1998 10k submission to the SEC, within which it stated that:

"In addition to systematically expanding through internal growth, we intend to expand our services and network capabilities through acquisitions, investments and strategic alliances"¹⁵⁹

These words have been followed by action, in particular through the merger with Destia and the networking agreement with Lucent.

One of the main perceived benefits flowing from the tie-up with Destia has been the enhancement of Viatel's marketing capability. As stated at the beginning of this

¹⁵⁵ 1998 Annual Report, p4

¹⁵⁶ Ibid, p12

¹⁵⁷ Salomon Smith Barney, op cit, p43

¹⁵⁸ Eurocom, op cit

¹⁵⁹ SEC 10k Report, 1998, p4

profile the company has at times been seen as weak in this area. Perhaps in response to such observations Mahoney has stated that, "marketing is critical to Viatel's success".¹⁶⁰

Competitors

As already discussed above Viatel has a significant "first to market" advantage for its type of advanced, custom built network. This is recognised by Salomon Smith Barney who point out that it announced its European build six months ahead of the likes of Global Crossing.¹⁶¹ Just as importantly Viatel has demonstrated that it is capable of laying its network on schedule, meaning that their advantage moves from the announcement to the implementation stage. Part of this advantage will consist of the company's ability to discourage future network construction by forcing down prices. This seemed to be partly what Mahoney had in mind when he stated that, "as for new players, suffice to say that the window of opportunity is closing rapidly, at least in northern Europe".¹⁶²

When one considers that the number of telecom operators in Europe has risen from 25 in 1997 to more than 300 in 1999, it is easy to see why Viatel is keen to discourage further network construction. Already, though, a number of operators are indeed pursuing similar goals. These companies which Salomon Smith Barney describes as Viatel's "Look alike competitors" are listed as follows:

Eurorings
Ulysses (WorldCom)
Global Crossing
Hermes (GTS)
Esprit (GTS)
Farland (BT) and
Global One (Deutsche Telecom, France Telecom and Sprint)¹⁶³

It stresses, however, that potential competitors take many guises, including a number of incumbents and other operators such as Energis and Cable and Wireless which have announced plans to intensify their European operations. To this list can be added other players "waiting in the wings" such as the cable communication companies, wireless telephone companies and large end-users who have private networks and those utilities which are able to offer communication services over their own rights of way. Viatel itself acknowledges that its potential competitors come from far and wide, listing them as:

- cable communication companies
- wireless telephone companies
- electric and other utilities with rights-of-way
- railways

¹⁶⁰ quoted in Global Telecoms Business (Feb/Mar 1999)

¹⁶¹ Salomon Smith Barney, op cit

¹⁶² quoted in Global Telecoms Business (Feb/Mar 1999)

¹⁶³ Salomon Smith Barney, op cit

- microwave carriers and
- large end-users with private networks ¹⁶⁴

Looking at the competitive environment within Europe more closely, Salomon Smith Barney divide the competition into four tiers (with the most immediate competitive threat posed by the operators within the higher tiers):

Tier one. Dense fibre alternative networks, usually involving fresh dig operations. Viatel fits into this category as do the Global Crossing, Level 3, Colt, KPNQwest, EuroRings and Ulysses (WorldCom) networks. Such networks are quite comparable with the state-of-the-art networks being built in the U.S. by companies such as Level 3 and Qwest.

Tier two. Incumbents linking their own networks with affiliated companies (often the second telecom operator) in other countries. Examples of this tier are Farland and Global One.

Tier three. Networks using less dense fibre - normally in the range of two to four fibres. Hermes and Esprit (both owned by GTS) are the clearest examples of this network type, although the Cable and Wireless network is also included.

Tier four. This final category is for companies such as Williams and IXC which have announced intentions to construct European networks, but who, so far, have not started the construction process. ¹⁶⁵

One of Viatel's main "tier one" rivals in Europe is WorldCom which claims to have the world's largest fibre optic network, called Ulysses, connecting 4,000 European offices and 27,000 U.S. companies. The European part of the network, said to be worth \$1.5 billion, went into operation in July 1998, giving the company a head start on its competitors such as Viatel. The network is, however, patchwork rather than purely fresh build and, in the eyes of some commentators, has been neglected while WorldCom has been busy integrating MCI (with further distractions arising through its unsuccessful attempt to takeover Sprint).

Commenting in mid-1999 the FT suggested that Viatel's "principal competition" to date had come from Hermes Railtel. ¹⁶⁶ Viatel tends, however, to be rather scathing of the network sophistication of this "tier 3" competitor - although this never stopped Viatel trying (unsuccessfully) to purchase capacity from Hermes prior to opting for its own network build. Looking at it from Hermes' point of view it must be acutely aware that a willing customer who it could not satisfy in 1997 is now a key competitor which is changing the very way capacity deals are organised within the industry.

In a press interview in 1999 Mahoney stated that he viewed Carrier1 and COLT as existing and potential partners rather than direct competitors. He went on to add that,

¹⁶⁴ SEC 10k Report, 1998, p35

¹⁶⁵ Salomon Smith Barney, op cit

¹⁶⁶ FT (15/7/99)

“GTS-Esprit and MCI WorldCom are our principal competitors in Europe”.¹⁶⁷

Other Threats

Ineffective Deregulation

As a new operator in a newly deregulated market Viatel is vulnerable to both national regulators who are dragging their feet and incumbents who are surreptitiously engaging in rear guard defensive action. Viatel has acknowledged this danger, indicating that while EU members have been obliged to enact legislation to open up their telecommunications markets, certain obstacles remain. In relation to the removal of national restrictive practises, for example, it has stated that, "in certain cases this has been done on an inconsistent, and sometimes unclear basis".¹⁶⁸ The incumbents, of course, are only too quick to shelter their businesses behind any barriers which remain. As Mahoney of Viatel has put it:

“Liberalization and deregulation do not necessarily mean that the incumbents are going to throw the door open to new entrant carriers”¹⁶⁹

This tendency has also been commented upon by Price Waterhouse Coopers who stated that:

"...a shrewd telco will use what remaining degree of regulatory freedoms it still possesses to buy time while it sets about reshaping itself"¹⁷⁰

So it is no surprise when Lehman Brothers remind us that:

"International Long Distance (ILD) operators continually complain about PTT's intentionally delaying the provisioning of interconnect capacity as it is one of the last remaining mitigants to open competition"¹⁷¹

Business Communications Review offered a comparison of the European and American experiences and concluded that:

"...while regulatory structures differ, the attitude of incumbent carriers is similar no matter where they're found around the globe. The European PTTs are using the same delaying tactics seen in the U.S. during the early 1980s"¹⁷²

Viatel, together with a number of other international resellers have encountered such obstacles in Germany where they have sought legal representation to counter what they see as preferential treatment towards Deutsche Telekom and the imposition of

¹⁶⁷ Global Telecoms Business (Feb/Mar 1999)

¹⁶⁸ SEC 10k Report, 1998, p35

¹⁶⁹ quoted in Global Telecoms Business (Feb/Mar 1999)

¹⁷⁰ quoted in Global Telecom Business (October 1999)

¹⁷¹ Lehman Brothers, op cit, p14

¹⁷² Business Communications Review (July 1999)

various barriers to the new operators.¹⁷³

Reporting a monthly turnover of \$1.75 million in Germany during the first half of 1998 the company indicated that it could have surpassed this figure if Deutsche Telekom had been more forthcoming in providing connections.¹⁷⁴ In a letter dated February 19, 1999, the FCC expressed concern about the interconnection regime within Germany which it saw as an impediment to effective market entry by new operators. While such obstacles are likely to be encountered in the future as the company moves into new territories, it seems fair to say that within its EU heartland the regulatory environment should become more consistent and predictable as the process of deregulation enters a more mature phase.

Litigation

Viatel has not, however, always been the litigating party in such accusations of restrictive practise. Together with 32 other operators, for example, Viatel formed part of a consortium to construct a submarine cable from the U.S. to Japan. On January 7, 1999, Global Crossing, which was constructing a similar cable link, filed a petition with the FCC claiming that the consortium's activities were anti-competitive. As part of its claim it asked the FCC to withhold the consortium's U.S. landing licence. Speaking of the move, Mahoney of Viatel stated that:

"In my view Global Crossing couldn't be further off the mark...I can't think of anything fundamentally more pro-competitive than multiple providers of services on the same route. It would seem, therefore, that Global Crossing is seeking a delay by the FCC for the sole purpose of obtaining a time-to-market advantage".¹⁷⁵

In July 1999 the FCC decided to award the consortium its licence despite Global Crossing's petition.

Accountancy Matters

Another source of uncertainty for Viatel (and one of the themes of the damaging Barron's article mentioned earlier) is the accountancy treatment of capacity sales through IRU ownership agreements. Currently the Federal Accounting Standards Board (FASB) is looking at the possibility of ruling that revenues from such agreements should be spread over its 20 year life span rather than treated as a one off payment (known as FASB66). This would naturally lead to a reduction in reported current year capacity sales and might lead to a negative market reaction. The actual cash flow of the company would not, however, be affected. The first company to comply with the alternative interpretation was Williams which subsequently issued an earnings warning on 2/9/99.¹⁷⁶

¹⁷³ FT (24/2/97)

¹⁷⁴ Handelsblatt (23/8/98)

¹⁷⁵ quoted in PR Newswire (11/1/99)

¹⁷⁶ Lehman Brothers, op cit

Salomon Smith Barney's View

Outlining some of the risks associated with Viatel, Salomon Smith Barney¹⁷⁷ draw attention to five key considerations (which are expanded upon here):

1/ It is a small player in an increasingly competitive market (although the Destia merger will increase its scale): A new arrival such as Viatel may struggle to convince potential customers of its integrity and reliability. In the specific case of Viatel, its "on the edge" operating history may deter communication managers from seeing it as a viable supplier.

Viatel will suffer if European business customers demonstrate either a high level of inertia when it comes to changing suppliers or an active mistrust of the new operators when viewed alongside the established incumbents. This danger is recognised by the company itself, which stated that, "...our targeted customer base may be reluctant to entrust their telecommunications to new operators they believed to be unproven".¹⁷⁸ Furthermore, as Information Week pointed out, that large-volume telecoms users, such as 3M, which spends \$30 million a year on communications in Western Europe, are unlikely to entrust their accounts to anyone other than one of the established incumbents.¹⁷⁹

2/ While its network is an undoubted asset the company has yet to show that it can fill it, in particular with retail rather than wholesale services: Again the Destia merger will help to fill the network. This point was made by brokers Arnold and S. Bleichroeder.¹⁸⁰ However, their comment that, "anything that lets Viatel load its Circe network is good", does seem to have rather an urgent ring to it.

Until now the company has made limited progress in gaining custom at the higher value retail end. In 1998 sales of capacity to carrier customers accounted for 58.3 percent of the company's revenues.¹⁸¹ The previous description of this market as a "penny business", gives some cause for concern that the company is over reliant on a low margin commodity product. Moreover, even within this low margin sector one customer LD Exchange.com was pre-eminent - accounting for 10.6 percent of the company's total revenues in 1998.¹⁸² As the company feels obliged to warn potential investors, "we currently derive a significant portion of our revenues from a relatively small number of carrier customers".¹⁸³ The danger is clear: if a few major customers are lost then this side of the company's business could be seriously affected. And at the moment not much revenue is coming from elsewhere.

As for the Circe network being a valuable asset that is certainly true. The FT has

¹⁷⁷ Salomon Smith Barney, op cit

¹⁷⁸ Viatel SEC 10k Report, 1998, p11

¹⁷⁹ Information Week (22/12/97)

¹⁸⁰ Arnold and S. Bleichroeder, Viatel Research Note (27/8/99)

¹⁸¹ Viatel SEC 10k Report, 1998, p35

¹⁸² 1998 Annual Report, p33

¹⁸³ Viatel SEC 10k Report, 1998, p38

recognised this indicating that Viatel's European network could make it a prime target for one of the continent's incumbents such as France Telecom or Deutsche Telekom as they seek to establish a pan-European presence.¹⁸⁴ The company's plummeting share price during 2000 makes such a takeover all the more feasible.

This leads onto an observation made by Lazard Freres & Co¹⁸⁵ that much of Viatel's market valuation up to late 1999 derived from the scarcity value of its network (and hence its take-over appeal). As other operators complete their own build-outs, however, this value will naturally diminish. Once their principal asset is less unique Viatel will only be able to justify its valuation by successfully executing its business plan and meeting its financial targets. The substantial falls in the share price during 2000 would indicate that, in the eyes of the market at least, Viatel failed to make this progression.

3/ The company is highly geared and the Destia merger will potentially reduce its credit rating: Salomon Smith Barney focused upon Viatel's debt exposure and pointed out that an increase in the U.S. long bond rate (then at 6 percent) of only 100 bps would knock \$15 a share or 21 percent off the company's fair value. It went on to point out that 15 percent of 2000-2005 average operating cash flow would go towards servicing debt, concluding that "certainly debt at this level means that investors are peculiarly vulnerable to macroeconomic effects".¹⁸⁶

Viatel again felt compelled to warn potential investors on this score, stating that, "our substantial leverage could adversely affect our ability to run our business".¹⁸⁷ Such cautionary statements are common in this type of SEC submission, although in Viatel's case the extent of its indebtedness was perhaps a sound reason to take the warning seriously.

4/ U.S. investors face a currency risk: In 1999 movements in the U.S. dollar against European currencies had a detrimental effect upon the company's reported earnings. Such a risk is naturally outside of management's control. The wider reality of currency risks for the company were shown by Viatel's experience in the Pacific Rim where its customer base decreased by over 93 percent in 1998 due to currency fluctuations which made its cost structure uncompetitive.¹⁸⁸

Call-Back Difficulties

Although Viatel no longer focuses upon call reorigination (call-back) it still offers this service in Latin America and the Pacific Rim. Such services have always proved controversial, not least where traffic is diverted from the national carrier and the respective government loses tax revenue. In Argentina, for example, "...the established carriers have advocated strenuously against it and the and the

¹⁸⁴ FT (26/5/99)

¹⁸⁵ Lazard Freres & Co, Viatel Research Note (27/8/99)

¹⁸⁶ Salomon Smith Barney, op cit, p15

¹⁸⁷ Viatel SEC 10k Report, 1998, p32

¹⁸⁸ 1998 Annual Report, p19

government's view has changed from time to time".¹⁸⁹ The source of the government's ambivalence was explained by El Cronista which highlighted its "irritation" at the call back operators since it was losing around \$35 million - \$40 million in tax revenues.¹⁹⁰ Viatel, itself, recognised the uncertainty surrounding the service, stating that, "there can be no assurance that certain of our services and transmission methods will not be or will not become prohibited in certain jurisdictions".¹⁹¹

A Vicious rather than Virtuous Circle?

Perhaps the greatest danger facing Viatel comes from the potential interplay between a number of the dangers just mentioned. At the moment the company is enjoying a "window of opportunity" which is allowing it to establish itself ahead of many of its competitors. Should this window be partially closed by ineffective regulators or intransigent incumbents then the company's "first to market" position is going to rapidly disappear.

If Viatel is indeed caught in this type of pincer movement between slow moving regulators and fast moving competitors lighting up their rival networks, then the company's cash flow vulnerability could become critical. Suddenly it could find itself in a vicious circle of falling prices, increasing competition and declining revenues rather than at the centre of a virtuous circle based upon Silicon Economics. This scenario could prove all the more dangerous should the take-up of data services within Europe lag behind existing estimates.

Surrounded by facility-based competitors, its stock market valuation is going to be severely tested. Without the acquisitive currency to purchase more customers for its network it might experience its own personal glut of capacity which will further undermine its market value. The dramatic fall in its stock price during 2000 would indicate that some of these dangers are already impacting upon the company.

With rival company Iaxis going into receivership, with debts of \$200 million, in September 2000, the reality of the dangers faced by Viatel were forced home. This was followed by reports that another competitor, GTS, was rapidly running out of operating capital. In such an environment Viatel will itself find it more difficult to raise additional capital and may find it equally difficult to fight off any takeover approaches by the more established operators.

¹⁸⁹ Viatel SEC 10k Report, 1998, p4

¹⁹⁰ EL Cronista (10/6/97)

¹⁹¹ Viatel SEC 10k Report, 1998, p4