Research Brief

Diversification Strategy Fails for AT&T

Abstract: In 1997 AT&T began acquiring cable companies for over $100 billion in a bold move to diversify revenue and control access to customers. Its failure highlights the risks of diversification plans.

By Mike Harris

Recommendations

- When considering diversification strategies, use a consistent framework to evaluate the company's ability to execute.

- Capital markets and regulatory conditions significantly impact a company's ability to successfully diversify.

- Rapid assimilation of newly acquired companies is critical to achieve the promised benefits of diversification.
What Happened to Ma Bell?

There are many periods of AT&T's history that could be used to illustrate failed efforts toward diversification. Since the company was broken up in 1984 under a consent decree by Judge Harold Greene, AT&T has made many acquisitions and divestments in computing (NCR), network hardware (Western Electric/Lucent), global communications (WorldPartners, Concert and IBM Global Network Services), and wireless communications (McCaw Cellular). However, only some of these acquisitions were successful.

When C. Michael Armstrong was named chairman and CEO of AT&T in 1997, the company was facing severe competition in its core consumer and business long-distance communications markets. Only its recently acquired wireless business was not stagnant; it was growing at a nearly 13 percent compound annual growth rate (CAGR) (see Figure 1).

Figure 1
AT&T Revenue, 1996-1998

With the prospect of the Baby Bells soon entering the long-distance business, Armstrong placed a $110 billion bet: to acquire substantial cable assets and leverage the company’s broadband access capabilities to deliver digital television services, telephony and data services to households across America. Such a diversification, if successful, would secure ownership of the distribution channel — the all-important "last mile."
After AT&T announced plans to acquire TCI and MediaOne in 1998 and 1999 for a combined $110 billion, the company was responsible for servicing more than $60 billion in total debt — a liability of $2 billion per year in interest payments. AT&T also had to ramp up its capital spending in 1999, 2000 and 2001 to maintain and upgrade these networks to deliver advanced services. Figure 2 shows that in 2000 the total capital expenditure exceeded 22 percent of revenue, which is an unsustainable level of investment.

Figure 2
AT&T Capital Expenditure by Business Unit

![AT&T Capital Expenditure by Business Unit](image)

AT&T's core long-distance business declined more rapidly than anticipated, and investors became impatient. Wall Street was not willing to wait the five years required to upgrade the cable networks and achieve the promised economies of scale. The board decided to split up the company, and in October 2000, Armstrong announced that AT&T Wireless Services and AT&T Broadband would be spun off from the core consumer and long-distance services business.

AT&T Wireless became fully independent in July 2001. In December 2001 AT&T announced that it would spin off its Broadband division and simultaneously merge it with Comcast, in a transaction originally valued at $72 billion. That transaction (now valued at about $30 billion) was completed in November 2002 (see "FCC Approval Clears Way for AT&T-Comcast Merger," TELC-WW-DA-0139).
Strategy vs. Reality

The AT&T strategy of diversifying and acquiring cable and fiber assets to bypass the local exchange carriers and deliver end-to-end services to consumers and businesses was fundamentally sound. The key benefits sought included the following:

- Control distribution channel — Specifically, AT&T sought to wrest control of the last mile from incumbent local exchange carriers.
- Achieve operational efficiency and synergies through increased scale — Network operations, sales, customer care and billing, and brand/marketing initiatives could be combined at lower total cost. Cross-selling between various business units would increase average revenue per user and improve operating margins.
- Manage portfolio of products. By acquiring cable assets, AT&T sought to diversify its revenue stream and offset declining market share and margins in its traditional long-distance business.

The failure of this strategy was in its execution and time frame. The massive debt load of $62 billion had to be restructured, particularly when AT&T's "cash cow" — its consumer long-distance business — declined more rapidly than expected (that debt has been reduced to about $30 billion as of January 2003). AT&T underestimated the immense effort and investment required to develop the technology needed to integrate cable and telephony systems.

As of the third quarter 2002, just 16.5 percent of marketable homes have signed up for cable telephony services, which is just 1,323,000 telephony subscribers compared with a long-distance customer base of more than 50 million (see Figure 3). The primary benefits sought from the cable acquisitions simply have not been met in the rapid time frame required by the market.
Essentially, AT&T assumed a high-risk strategy that would either make or break the company. Unfortunately for AT&T and its shareholders, AT&T quite literally has broken up from the strain. The following factors contributed to its demise:

- Integration across diverse businesses proved extremely difficult. Wireless purchase decisions remain independent of other telephony or cable decisions. The promised benefits of bundling across the various services were never achieved — billing systems integration was prohibitively expensive and organizational barriers remained.

- AT&T overpaid for TCI and MediaOne, and underestimated the time, effort and money required to make those networks viable for telephony. By the end of 2002, just 8 million of 25.1 million marketable homes have the ability to receive cable telephony services, and just over 1.3 million actually subscribe for such services. That equates to about 2 percent of the traditional AT&T long-distance customer base. Such low penetration for integrated services makes it hard to argue that the $110 billion cable acquisitions were worth it.

- The capital required for all AT&T businesses combined (wireless, broadband, core consumer and business long-distance) was more than the rapidly deteriorating telecom debt and equity markets would provide. A record bond offering of $10 billion in November 2001 helped provide the company with liquidity, but the promise of a single integrated communications behemoth proved unattainable.
Investors continued to measure AT&T as a traditional "widows and orphans" stock and expected strong cash flow, stable earnings and continued dividends. This hampered AT&T's ability to invest in the necessary infrastructure needed to deploy integrated services across its wireless and broadband units in lieu of making dividend payments.

AT&T remained an outsider in the exclusive cable business. It needed cooperation from Time Warner and others to pursue its cable telephony business plan, but never received it.

Open access regulations reduced the projected return on investment for acquired cable assets. Lawsuits like the one filed in 1998 by the city of Portland, Oregon, to force AT&T to open its cable routes to alternate Internet service providers (see "AT&T Seeks Appeal of Portland Cable Ruling, EDSV-EU-DA-9921) reduced AT&T's ability to transform its cable assets into integrated broadband communications.

AT&T will survive, albeit in the following three smaller parts:

- AT&T (Business and Consumer Services, retains the "T" NYSE symbol)
- Comcast (56 percent owned by AT&T shareholders)
- AT&T Wireless

AT&T Business Services has been reinvigorated by the spectacular bankruptcies of competitors such as WorldCom and Global Crossing, which sent customers fleeing to AT&T, Sprint and other providers unmarred by accounting irregularities.

Lessons Learned

Lesson No. 1: A Diversification Strategy Requires Many Small Steps, Not Just a Single Massive Leap
The scale of the cable acquisitions and the debt required to fund the acquisitions proved too massive for AT&T to assimilate. The sought-after benefits of distribution control and improved operational efficiency were thwarted by the very size of the integration attempt. The majority of large acquisitions in telecommunications or other industries are failures. Cultural differences and organizational lethargy are often too difficult to overcome. Small acquisitions more effectively bring a company desired new markets or capabilities, with lower risk.

Lesson No. 2: Speed of Execution Is Critical
Even if the long-term strategy is flawless, a plodding execution can sink diversification efforts. The investments in technology integration and change management required to actualize marketing and operational synergies are almost always underestimated. Unanticipated delays and insufficient capital budgets slow the realization of diversification benefits. Delays permit competitors to reposition and give reluctant employees or shareholders the opportunity to sabotage change initiatives. Rapid assimilation of change is required to integrate cultures, product portfolios and sales channels.
Lesson No. 3: Communication and Consensus Are Critical

Proper internal and external communications are critical to the success of any major change effort. AT&T did an admirable job of extolling the benefits of its cable acquisitions. Its press releases, annual reports and executive briefings had consistent messages that reinforced the company’s strategic logic.

AT&T management failed, however, to secure consensus from the rank and file. Armstrong’s autocratic style was contrary to the company’s culture. AT&T’s failure to execute on the integrated communications provider strategy was due, in part, to its inability to share a common purpose and align all its businesses accordingly.

Gartner Dataquest Perspective

In "Should the Telecom Industry Focus or Diversify?" TELC-WW-DP-0288, Gartner Dataquest identifies an approach for communications companies to structure their diversification strategies and track their progress. Two of the strategic objectives discussed, controlling the distribution channel and achieving operational efficiencies, were logical objectives that supported AT&T’s investment in cable assets. Once AT&T decided that it would become a broadband cable provider, however, it lost sight of the following key metrics of success that would have signaled a successful diversification:

- Quantifiable reductions in selling, general and administrative operations expense
- Reduced cost of sales
- Revenue per client growth

By overpaying for the assets and then failing to integrate them quickly enough to achieve the very efficiencies that supported the strategy in the first place, AT&T sealed its fate.

Key Issue

How will strategic alliances and mergers reshape markets?