

# The Rise of WorldCom

In 1983, WorldCom was a small reseller of long-distance telephone service. By 2001, the company generated sales of \$40 billion, making it the second largest producer of telecommunications services in the industry, behind AT&T. WorldCom entered 2001 as the number two provider of long-distance phone services in the United States, with 19 percent of the market, the largest single carrier of Internet data in the country, with an estimated 37 percent of the market and a dazzling array of strategic assets, including a 300,000-mile fiber-optic network that has global in its reach.

The Worldcom was very much the creation of its swaggering cowboy CEO, Bernie Ebbers, whose strategy for growth was quite simple: acquire competitors. An apparently savvy dealmaker, over seventeen years Ebbers acquired some sixty other telecommunication service providers, capping off the spree with the acquisition of MCI Communications, which at the time was larger than WorldCom and the number two long-distance telephone company in the nation. Ebbers's deal making was financed by a combination of WorldCom stock and debt. As long as the stock continued to rise—and it increased by a staggering 7,000 percent during the 1990s—WorldCom could use its “currency” to buy other companies in the industry. In addition, WorldCom borrowed large amounts of money from the debt markets, some \$30 billion by late 2001. The debt markets proved only too willing to lend to WorldCom given the company's glittering growth prospects.

Driving the buying spree were two strategic objectives that were central to the WorldCom's business model: (1) the desire to reap scale economies in order to drive down cost and (2) the desire to capture and retain customers by bundling together telecommunications services, such as long-distance service and Internet access, and selling them under a single contract. Ebbers reasoned that the scale economies would come from assembling a nationwide and international network to transmit data and voice traffic. The costs of assembling such a network are primarily fixed and include the costs of laying fiber-optic networks and installing switches. Once the network has been built, the costs of sending additional traffic down the network are virtually zero. This gives the company with the largest volume of traffic a huge cost advantage, because it can spread the fixed costs of building and maintaining its network over a very large volume, driving down the average costs of serving each customer.

In addition, Ebbers believed that customers would want only one telecommunications service provider, and one bill, for all services they used, including long-distance and local phone service Internet access, and wireless phone service. By assembling a company that could provide all of those services to consumers in a single bundle with a single bill, Ebbers believed that WorldCom would have a competitive advantage in the marketplace that would help it to increase volume more rapidly than rivals and thus better realize potential scale economies.

WorldCom grew through acquisition, as opposed to organically, because it was quicker to grow this way and cheaper to use a mix of WorldCom's high-flying stock and long-term debt to buy competitors than to build the network entirely on its own.

Moreover, when WorldCom made an acquisition, it applied a fairly standard formula: cut the overheads, eliminate any duplication, and drive the traffic of the acquired customers through WorldCom's network to realize scale economies.

The strategy seemed to work well until 2000, when WorldCom made a bid to acquire Sprint for \$115 billion. Sprint was the number three long-distance company in the United States with 8 percent of the market, operated the second largest data network in the country with 16 percent of the market, and was one of the largest providers of wireless service in the United States. The acquisition made perfect strategic sense. It would enable WorldCom to reap additional scale economies and bundle wireless service with its long-distance and Internet access service. Unfortunately for WorldCom, antitrust authorities in both the United States and the European Union thought that it would also give WorldCom substantial monopoly power, and both indicated that they would oppose the acquisition. The U.S. Justice Department claimed that the acquisition would create an unacceptable level of concentration in the long-distance phone business, with AT&T and WorldCom controlling 80 percent of the market after the acquisition. The Department of Justice also claimed that the acquisition would result in the monopolization of high-speed Internet data lines, creating a company that controlled 53 percent of Internet traffic, giving the expanded WorldCom the ability to discriminate against rivals and "irrevocably tip the market" toward a monopoly outcome.

In mid-2000, WorldCom announced that in the face of opposition from antitrust authorities, it would abandon the acquisition. This proved to be a turning point in the company's fortunes. During the next two years the company's stock plummeted from over \$50 a share to under \$1. A number of factors contributed to the implosion in the stock price. First, a price war erupted in the long-distance telephone service business. A combination of slowing growth and the entry of new competitors, particularly the Baby Bells that had been allowed by the 1996 Telecommunications Act to start offering long distance telephone service. Second, in the data area, many of WorldCom's largest customers were other telecommunications providers, particularly new companies that had entered the market in the aftermath of 1996 act. By mid 2001, many of these companies were in trouble. They had taken on too much debt to build out their own networks ahead of demand and now were unable to generate the cash flow to meet their debt to build out their own networks ahead of demand and now were unable to generate cash flow to meet their debt obligations. As they crumbled into bankruptcy, WorldCom lost business that it had counted on to generate its own growth and service its debt commitments. It also started to lose customers who had come with the acquisition of other carriers, such as MCI, and complained that the quality of customer service had declined markedly under WorldCom.

The net result was that by 2002, WorldCom was looking at declining revenues and steep losses, a far cry from the double-digit earnings growth it had been predicting eighteen months earlier. Suddenly the company was struggling to generate the cash flow required to service its debt.