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Market Roundup

June 28, 2002

Acquisition Indigestion and Heartburn: WorldCom Cooked Its Books and Perhaps Itself

By Clay Ryder

WorldCom announced earlier this week that almost $3 billion of expenses from 2001 and nearly $800 million in the first quarter of 2002 were wrongly listed on company books as capital expenses, and therefore not correctly reflected in previously released earnings statements. WorldCom indicated that its senior management was shocked by the discovery and the company's BOD promptly fired the CFO and accepted the resignation of its controller. Prior to trading being halted, WorldCom shares plummeted to 9 cents in after hours markets compared with its beginning-of-year share price of $15, and June 1999 high of over $64. The SEC announced it was suing the company to prevent WorldCom from disposing of assets, destruction of documents, and payout to senior officers. The SEC has also ordered WorldCom to file under oath, before Monday's market open, a detailed report of the circumstances surrounding its restatements. The company did not indicate whether former CEO Bernie Ebbers, who left his post a few weeks earlier, was aware of the accounting discrepancies.

Long Distance Discount Service, better known as LDDS, was founded in 1983. Over the years the company acquired several other communications providers, and in 1995 renamed itself WorldCom. While the company continued to grow, we commented at the time that WorldCom was facing the dilemma of integrating dozen of disparate smaller firms and, like eating too much pizza too quickly, was tempting acquisition indigestion. But in 1998 we saw the real chutzpah of the company as it outbid BT for the takeover of MCI, a company that at the time was three times its size, to the tune of $40 billion. At this point WorldCom tried to digest forty-seven companies, including MFS, Brooks Fiber, CompuServe, UUNet, EUNet, and dozens more, but as long as the equities markets continued to provide funding and stock prices held, Ebbers and crew seemed to be rocketing to the top of the data and communications market. However, the chutzpah reached a point where regulators nixed WorldCom's attempted to takeover Sprint. Since that time, the bloom began to wilt upon the rose.

It is ironic that BT with all of its recent troubles would still appear to have been a better home for MCI (as we said four years ago). But perhaps most alarming of all of the economic and potential criminal sanctions that will result from WorldCom's chicanery is the notion that voice and Internet communications are suddenly almost worthless. The cost of a local call would net more than six shares of WorldCom if it were allowed to trade, and the shares of telecom vendors and other carriers will continue to be hit hard, partly due to their

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own shortcoming, but also due to WorldCom's arrogance. Whether or not WorldCom goes bankrupt, is fined out of existence, or its leaders chased out of town on a rail, it is a sad commentary that the potential of telecom deregulation was so badly abused and that along the way it may have unnecessarily tarnished much of the shine of the Internet as well. Of course, the final irony is that one of the largest providers of Internet and telephone service — two services that boast hundreds of millions of users — can't maintain share price that is higher than a single use of one of its basic services: the telephone call. Then again, if WorldCom went bankrupt, perhaps AT&T could buy its assets at a fire sale price to supplement its own network — Oops... been there, done that, haven't we?

IBM Launches the p630: Regatta Features Percolate to Entry Level Products

By Charles King

IBM introduced the p630 this week, a new four-way entry level UNIX server the company claims is targeted at SME, enterprise department, and distributed systems applications. The p630 features IBM's copper/silicon on insulator "server on a chip" Power4 processors running at 1.0 GHz that are similar to those offered on its high end p690 Regatta and the mid-range p670 machines. The p630 also includes self-healing and self-management solutions based on IBM's eLiza initiative including Chipkill Memory, Dynamic Processor Deallocation, and First Failure Data Capture, which the company claims contribute to greater system stability and reliability. The p630 is designed for AIX 5L and offers (Linux affinity), allowing many Linux applications to run after recompilation. Native Linux support is planned for 3Q 2002. Dynamic LPAR, which partitions the system into virtual servers, and Linux in a partition, both of which are key features of IBM's mid- and high-end servers, are planned for incorporation during 4Q 2002, and NEBS 3 compliance is planned for early in 2003. The new server comes in two ultra-dense packaging options, in both rack-mountable (4U) and deskside configurations. Planned availability for the p630 is August 30, 2002, with prices beginning at $12,495.

As with most product launches the p630 incorporates tactical and strategic points of its parent company's overall go-to-market effort. As far as tactics go, the p630 offers yet another chapter in IBM's now familiar story of creating competitive advantage by leveraging higher-end computing functions in lower-end products. This process began with the company's eLiza project, which aimed to migrate self-managing and self-healing capabilities from the company's signature mainframe products into its other server lines. Over the past year, IBM has done just that, with the inclusion of Chipkill Memory, Dynamic Processor Deallocation, and First Failure Data Capture in the p630 offering just the latest example. Is this really such a big deal? To our way of thinking, it is indeed. First, as hardware prices continue to drop and performance continues to increase, reliability offerings provide recognizable, tangible differentiators. Additionally, this effort's impact might be best gauged by considering the number of IT vendors who have incorporated "mainframe-like" features in their servers over the past year, even though only two of those vendors (IBM and HP) have products that qualify as traditional mainframes. Imitation, they say, is the sincerest form of flattery. And, we would add, the clearest evidence that those being imitated are succeeding.

From a more strategic standpoint, it is clear that IBM will use the p630 to continue to hammer away at rival Sun's (and to a lesser extent, HP's) share of the UNIX market. To that end, the p630 reveals IBM's strategy as being at least partly based on delivering products that promise lower prices and higher flexibility than Sun servers, in particular the Sun Fire V480 introduced last week. Is this likely to work? That is unclear at this point, but it does bring up an issue worth considering. Around the time of the V480 launch, a number of observers suggested that Sun was attempting to bolster its entry-level product lines against increasing competition from machines based on Intel's Xeon products, such as the server "building blocks" Intel announced just last week. IBM's p630 introduction suggests that Sun could face a difficult quandary moving ahead as its products are squeezed on one side by increasingly aggressive UNIX vendors and on the other by increasingly powerful Intel-based servers. From where we stand, developments such as the p630 suggest the market is evolving to offer more choices for server customers, more pressure for Sun, and more opportunities for IBM, Intel, and other vendors.

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Congress to Repeal Law of Gravity?

By Jim Balderston

Congressman Howard Berman (D-CA) has proposed legislation that would, if enacted, give copyright holders like the music and movie industry the power to proactively attempt to disrupt peer-to-peer networks whose members are swapping music or video files. Berman's proposed legislation would give these industries legal protection against consequential liabilities when using disruptive methods to combat piracy. The Recording Industry Association of America (RIAA) supports Berman's efforts, and in fact was formulating a series of practices to do much of what Berman's legislation would allow, when they were largely cut off by security concerns in the wake of 9/11. At the time, the RIAA was proposing being given the right to monitor and eavesdrop on certain file swappers. Berman's legislation would allow the copyright holders to do things like flooding file servers with false requests to overload the server, redirection of fileswappers to sites without any content, or distributing dummy files that have no music or content on them. Berman said his legislation was designed to allow copyright holders to engage in activity that might otherwise be illegal under federal, state, or local laws.

This proposed legislation, authored clearly at the behest of the entertainment industry, is surrounded by more than a mere whiff of desperation, it is drenched in it. Sadly, this is yet another indication that despite all proclamations to the contrary, the entertainment industry has no idea of how to realistically come to terms with the reality that millions of people worldwide are going to use the Internet and their computers to view, share, and edit various forms of digital content. Apparently, the entertainment industry thinks that instead of, for instance, devising new business models to cope with this apparent attack on their status quo, they will simply ask the government to give them otherwise illegal tools to force the existing, analog-based business models to continue successfully.

Assuming this legislation passes, what oversight will be in place to prevent the RIAA and its members from abusing these special rights to hack and attack? We suspect none. When one thinks of the checks and balances deployed against government agencies' potential abuse, and how many of the checks have failed historically, we suspect that the abuse of this special privilege could be enormous and frequent. This may also send a message to other industries that they can deal with their own technology-changing markets by demanding their own law-enforcement-like special exemptions to pursue and harass the supposed villains of their specific markets. Make no mistake: we are not in support of copyright violators. However, creating bogus laws in defiance of the market to deal with business challenges makes as much sense as the builder of an aerodynamically challenged aircraft going to Congress to seek repeal of the law of gravity. In short, this idea should not get off the ground.

More Bad News for the Entertainment Industry

By Jim Balderston

The Consumer Electronics Association released Digital America 2002, a report detailing the size, growth, trends, and projections for digital entertainment devices including video recorders, cameras, audio recorders, home networking, online gaming, and other products. The report discusses sales figures from 2001, and projects a record sales volume of nearly $96 billion dollars for 2002. Statistics from 2001 show that consumer electronics did not experience a substantial downturn during the holiday buying season, despite both a slowing economy and the events of 9/11. The report notes beginning in September 2001, DVD players outsold VCRs; a trend that the association says is irreversible. The association also noted that MP3 players and those using other digital compression techniques sold more than 500,000 units in 2001, and the industry expects a 30% increase in sales this year. Almost 1.5 million digital televisions were sold in 2001, and digital TVs outsold analog in the projection TV category for the year. The report also noted increased consumer interest in what it calls the personal video recorder (PVR). The report concluded with a discussion of upcoming challenges, and noted that content providers — the music and entertainment industries — need to embrace

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new technology.

The numbers don't lie. The increasing role of digital entertainment products in the home is not only growing, it is growing at a time when other purchases and consumer confidence are falling and (if the CEA report is correct) the consumer electronics marketplace is going to continue to expand. Evidence to the contrary, this is not especially news for entertainment moguls. Movie and music industry leaders have spent a great deal of time in Washington and the courts trying to halt or slow behavioral trends reflected in the sales of home digital devices. Why? Because these devices and their associated technologies make it easier than ever for consumers to copy and exchange copyrighted material that is the entertainment industry's lifeblood. Industry organizations such as the RIAA have chosen venues where money and lobbying influence can buy victories — but their wins appear short-lived, at best. Consumers are voting with their wallets, and by and large, they wish to use digital content in broader, more creative fashions than the movie and music moguls prefer.

The CEA properly points out that personal recording devices have expanded the market for content providers, and also points to similar battles it fought over the advent of the VCR. In that case, the CEA secured fair use rights and is apparently prepared to do so again on the digital frontier, positioning itself as the protector of the little guy. It seems an unlikely role for a near $100 billion a year industry, but is one that allows the CEA to both play Robin Hood and laugh all the way to the bank. While the entertainment industry goes to Washington or to the courts to try to alter the behavior of consumers, the CEA is offering products that simply follow or support consumer desires. While content providers have been accused of being out of touch with America for the content in movies and music, they also appear to be out of touch with American consumers over how that content can be used. In the end, we regard this as a set of highly and increasingly complex issues that will only be resolved when the principals are willing to explore and pursue business models that find a middle ground between consumer requirements and industry needs. The CEA report suggests that if everyone continues to play the same old game, the electronics industry will likely be the only winner.

Pew Survey Examines Broadband Internet Adoption/Usage

By Charles King

The Pew Internet and American Life Project (PIP) released findings concerning broadband deployment and adoption, and the online behavior of high-speed connection users. The results of the survey were based on data from telephone interviews conducted by Princeton Survey Research Associates between January 29 and February 20, 2002, among a sample of 507 Internet users, 18 and older, who have broadband Internet access. The survey's error ratio is plus or minus 4 percentage points. For the sake of clarity, PIP used the FCC's definition of broadband as any connection that offered upload and download speeds in excess of 200Kps, or about four times the average speed of dial-up access. PIP noted that since the Project began in June 2000, the number of high-speed home users has quadrupled from 6 million to 24 million, an adoption rate on par with the personal computer and compact disk player, and faster than color TV and the VCR.

In general, the Project found three noteworthy areas where broadband users differed from dial-up connection users. First, they were far more likely to create and manage online content such as Web sites and online diaries, to download games and video, and to share files such as photographs with other users. Second, users cited the "always on" nature of broadband connections as helping them to learn new things, pursue hobbies and other interests, and to improve their jobs, their ability to shop, and their ability to find healthcare information. Finally, broadband users are more likely to access the Internet on a given day than dial-up users (82% to 58%), do more things online than dial-up users do (7 to 3) and spend more time online per day than dial-up users (95 minutes to 83 minutes). Additionally, the Project's analysis of the "broadband elite" (those doing ten or more activities per day) suggests that a broadband-enabled lifestyle is emerging whose adherents work more at home, watch less TV, spend more time gathering news online, and shop less in stores.

In one sense, the data from the Pew study is hardly astonishing. Since broadband connections are by definition both persistent (always on) and considerably faster than dial-up connections, it is reasonable to assume that broadband users can visit more Web sites and get more done online than dial-up users in an

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equivalent time. What struck us most about the data collected by PIP was the active role broadband users are taking in their online interactions, sharing information and activities with online friends and communities, which goes well beyond common email exchanges. These activities are considerably different than common and passive activities like watching television, and suggest that broadband technologies may be sparking and helping to sustain new varieties of modern human interaction. That suggestion is supported by the more dedicated online behavior identified among the "broadband elite." For these users, the Internet has evolved from being a simple novelty or diversion into a conduit through which they participate in and enrich their lives. Additionally, the persistent nature of broadband, which is akin to the electrical connections that allow people to follow a nightlight to the bathroom or watch World Cup soccer matches at two a.m., suggests to us that elite broadband users (whose growing numbers are beginning to resemble a snowball rolling downhill) have come or are coming to simply regard Internet connectivity as a natural and predictable part of their daily lives. For early adopters such as these, the Internet has become essentially transparent, which is the point where any technology begins to exert its most serious and lasting changes.

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