SUPERCOMM 2004 MOOD UPBEAT, BUT MAJOR PROJECTS GOING TO BIGGEST SUPPLIERS

OEM Capital would like to provide our views on Supercomm 2004 and on the recent strategic trends in the telecommunications industry.

I think we all saw a lot more smiles at Supercomm this year than in the past few years. The worst of the post-Y2K telecom meltdown hangovers are over, and people are talking about large-scale projects again.

Some of the best news was from SBC, which announced a $6 billion investment program to bring fiber to the home to provide TV, telephone, and Internet services. Competition with cable is driving SBC to make these huge investments, and is sure to drive others to promote FTTH and other broadband services. Coupled with Verizon's announcement of a $5 billion investment (much of which to be spent at Lucent), an enormous amount of equipment will be purchased over the next several years.

Other interesting news came in the form of cooperation, as Motorola/IBM and Hitachi/NEC have formed partnerships to help them take on Cisco.

From these news releases, speaking with industry participants, and other developments, I have formed three conclusions about the strategic landscape in the telecommunications industry.

Cost is main market driver. Cost, not new technology, will be the main driver in all equipment purchasing decisions. Therefore, companies who can compete on a cost basis will be able to survive. Innovative technology will be valued mostly on the ability of that equipment to replace more costly systems. This has helped open the door to more overseas suppliers and contract manufacturers.

Survival of the Fittest. Only the top 3-4 competitors in each sector will be able to survive. Now that Cisco and others are seeing more competition from huge players, the pressure to merge will increase. Although many large telecommunications projects are being announced, the awards will go to only a few players, leaving many companies out in the cold. If a company cannot get a piece of these major contracts, there may still be some valuable niches to be exploited, but the sales growth will not be as attractive.

Customers are looking for one-stop solutions. Customers do not have the time to evaluate every component in the system, so they will look more and more for a singular solution. Until recently, the industry has used the idea of loose partnerships to fulfill this need. However, recent merger activity will put pressure on participants to enter into more formal arrangements or to use M&A as a way to fill out a company's product line.

Some recent examples of M&A activity in the telecommunications industry are:

Cisco 'talking' with Nortel: this would create a huge enterprise juggernaut.

Cisco acquisition of Actona: this is an expansion for Cisco into WAN file access software.

Nortel sale of manufacturing units to Flextronics: Nortel is focusing on design, development, and marketing. Cost pressures and competition are big factors in making this move.

Newport acquisition of Spectra-Physics: this is an example of both bulking up and filling out of a product line.

Tellabs (proposed) acquisition of Advanced Fiber: an example of becoming a one-stop shop.

Bookham acquisition of Onetta: Bookham is looking to (slightly) fill out their product offering as well as to gain access to Onetta's customers.

Conclusion: Opportunities for medium-sized companies to merge, acquire, or to be acquired are still plentiful, but the timing and realization of synergies will become increasingly problematic as time goes by. As consolidation heats up in the industry, the last one to the dance floor will be left out in the cold.

OEM Capital works closely with companies in high tech industries to help identify potential merger and acquisition candidates, and to assist companies with grooming and strategic marketing. Our industry expertise, coupled with our experience and international network of M&A partners (IMAP), are key ingredients in our program to realize premium valuations for our clients.

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COMMENTARY

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