SBC's Acquisition of AT&T Changes the Landscape, Unleashing a Host of Industry Issues

By Brian Washburn
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The second-largest incumbent local carrier, fresh from an acquisition that turned it into the largest wireless carrier, has now bid to acquire the largest interexchange carrier. Regulators have basically shrugged at the prospect of SBC acquiring AT&T to become even bigger than titan carrier Verizon. While observers are still digesting the issues that represent the tip of the iceberg, plenty of hurdles and industry implications can already be extrapolated that will challenge SBC and AT&T, as well as the ripple effect it will have on other carriers.

Analytical Summary

At the end of January 2005, SBC Communications announced that it planned to acquire AT&T in a $16 billion stock swap, creating a national communications provider with local-to-global reach. SBC is the second-largest incumbent local exchange carrier behind Verizon, and it owns a 60% stake in the largest wireless carrier, Cingular Wireless, which completed its merger with AT&T Wireless in October 2004. AT&T is the largest interexchange carrier in the U.S., with a vast list of global enterprise customers, a global IP network, and the number one telecom brand name in the world. SBC hopes the deal will close in 2006 following all of the requisite regulatory, antitrust, and shareholder approvals.

Current Perspective Text

SBC's announcement at the end of January 2005 of its intention to acquire AT&T in a stock swap has unleashed a torrent of speculation about what the merger means to the two companies, to the domestic telecom industry, and to competing global carriers. A look behind the scenes shows some of the more interesting highlights in regards to what the two major carriers — and the telecom industry at large — will face, as the merger proposal grinds through the regulatory process and other carriers plot out new paths to respond to this major change in the competitive landscape.

Running the Numbers: The financials of each company suggest SBC is getting a deal, especially because it basically plans to swap stock to acquire the company at its current market value, while the norm in telecom mega-mergers has been to value a carrier being acquired at a premium, in some cases as high as 20%-35% over its market value. In 2004, SBC had $40.79 billion in revenue and $5.9 billion in net profit. SBC's debt load mushroomed to $26.96 billion following its part in the cash acquisition of AT&T Wireless by Cingular. For its part, in 2004, AT&T had $30.24 billion in revenue and $2.28 billion in net profit, excluding one-time charges. AT&T has $10.77 billion in aggregate debt, but also has $3.7 billion in cash and cash equivalents. The aggregate financials of SBC-AT&T could boost the company to a revenue size rivaling Verizon, which is currently the biggest U.S. carrier, with $71.28 billion revenue and $13.12 billion net profit in 2004.

Based on past trends, in 2005, AT&T projects its top-line revenue may shrink by almost $4 billion, and its net profit could drop well below $2 billion. If the merger is completed in early 2006, as SBC hopes, the combined SBC-AT&T would be slightly larger than Verizon. Between AT&T's pile of cash, its solid profitability, and the expectations of ambitious cost savings from a combined SBC-AT&T, SBC is getting a great deal. The initial integration costs in 2006 should partly be offset by cost savings SBC expects to realize from the Cingular-AT&T Wireless merger. SBC expects the Cingular-AT&T Wireless merger to lower annual costs by $1 billion in 2006, and by $2 billion or more in 2007. SBC-AT&T also expects to reduce annual costs by $2 billion or more, starting in 2008. But projections assume that everything generally goes according to plan. Once they're merged, AT&T's revenue slide should slow, since SBC would no longer compete with AT&T to win away its accounts. But AT&T's long-haul business will probably continue to slide – with some sectors such as consumer long-distance more vulnerable, and other sectors such as enterprise sales proving more robust – as Verizon, BellSouth, and Qwest grow in the long-haul business, either on their own or through their own acquisitions or partnerships.

The Branding Challenge: SBC-AT&T faces a basic, yet crucial crossroads in terms of branding. It would be a mistake of global proportions for SBC to drop the AT&T name. But the company has also invested heavily in trying to build SBC into a national brand name, though it's still a work in progress. The best choice for the joint company would be to keep the AT&T brand, or to keep separate names for its in-region local versus its domestic and international long-haul operations. Another option would be to adopt an entirely new name. One precedent is Verizon, which needed to drop the geographically hamstrung "Atlantic" part of the Bell Atlantic name when the carrier joined forces with GTE to become a national player. United Online is another example; the ISP has a corporate name, but the actual services are sold under its popular Juno and NetZero brands. The question of what to do with the Cingular brand adds another dimension, since SBC could also use the AT&T Wireless name – except that 40% Cingular stakeholder BellSouth should block any SBC move to re-brand the Cingular joint venture under the AT&T enemy brand.

San Antonio vs. Bedminster: While services and financials work together, there seems great potential for “soft” problems emerging as executives try to see eye to eye between New Jersey and Texas. But to find a model of a telecom carrier that has a one-company, two-headquarters structure, SBC and AT&T need look no further than Verizon, a mirror image of the prospective SBC-AT&T. The former Bell Atlantic part of Verizon is based on the east coast, but the former GTE headquarters of Verizon, which among other things handles much of the carrier's long-haul business networks and enterprise services, is in Texas.

Is “Anything Goes” the New FCC Policy?: So far, regulators haven't reacted unfavorably to the prospect of a combined SBC-AT&T entity. The merger of SBC and AT&T will beat Verizon as the largest telecom provider in the U.S. But if an SBC-AT&T merger is now “thinkable” to the FCC, other Tier 1 providers have incentive to see how much further they can push the bar set by the current pro-big business FCC. In other words, if bigger is better now, then Tier 1 carriers – whether incumbent local carriers, interexchange carriers, cable providers, or wireless providers – might as well go shopping. Comcast could choose to forget its Disney ambitions and get (back) into the wireless business; BellSouth and Qwest could brainstorm merger ideas. MCI appears to be talking to several providers already, while Verizon could shop around for just about any Tier 1 IXC, and could even try to wrest AT&T from SBC if it desired. By the end of the year, it's possible that the “new” competitive telecommunications market in the U.S. will be on track to have as few as three or four major carrier competitors, with smaller niche players hanging on if they can, or getting bigger through their own acquisitions. These mega-carriers can cite the cable TV market, which is similarly consolidated to a few major providers and many small ones, among its sector competitors.

Completing the Shift from Peers to Competitors: Though Qwest has been the most visible of the major incumbent local carriers operating out of their traditional regions, SBC has also been working to establish beach-heads in other incumbent local providers' territories. But SBC's efforts to establish a CLEC presence in some select markets pales in significance compared to what a merger with AT&T means. AT&T is the single biggest competitor to incumbent local providers in virtually every market, from consumers to multinational enterprise customers. If SBC acquires AT&T, it should send a clear message that the carrier as a whole is now the enemy of its peers – Verizon, Qwest, and BellSouth. For the past 20 years since the Bell breakup, it hasn't been hard to find stories of engineers from different local carriers getting together to compare technical notes, since they were peers facing similar wireline challenges. It couldn't last forever, since the local carriers were already bumping up against each other in the long-distance market, but a combined SBC-AT&T will probably hasten the end of this engineering-solution cross-pollinating.

Cingular’s Joint Ownership: A particularly difficult question is what will happen to the BellSouth/SBC relationship, since BellSouth holds a 40% minority stake to SBC's 60% in Cingular Wireless. If SBC-AT&T and BellSouth are to be rivals, they may want to unravel the joint venture, or at least the wireless brand name. BellSouth can use its stake as a negotiating card for any number of possible concessions from SBC. The least imaginative would be to split Cingular's network or its customer base into two parts, and set a permanent wireless network sharing arrangement between them.

Overlapping Services' Loose Threads: While SBC and AT&T have highly complementary businesses, they also have overlapping lines of business that may be a challenge to convert. For SBC, the largest integration hurdle is its existing long-haul business, much of which runs on WilTel's infrastructure. WilTel shouldn't give up its signature customer, representing more than half its revenue, without a fight. AT&T still has its national base of UNE-P local/long-distance residential and small business customers, which on the residential side at one point reached 4.5 million lines, and while sliding, is still estimated at more than 4 million lines. It also has a nationwide DSL relationship with Covad, and an as-yet undefined base of business services inside SBC territory that AT&T delivers across access infrastructure other than SBC's (e.g., through third-party CLEC copper or fiber transport and access facilities).