

ITU Telecom World 2003

A Funny Thing Happened on the Way to the Forum

SUMMARY AND INVESTMENT CONCLUSION

The week-long ITU gathering in Geneva represented a stark contrast to the last global event held in October 1999. Gone were the conspicuous excesses of that event with its multi-million dollar company exhibitions, world famous entertainers, and fireworks over Lake Geneva. In its place came a sober, almost introspective display (by those firms that even opted to have a presence this time) and a Forum whose speakers and panelists offered a straightforward assessment of the challenges and opportunities facing the industry and its participants. Clearly, the industry is still enduring some of the aftershocks of the bubble. The fact that four years on roughly 2% of global installed fiber optic capacity is lit should give even the most bullish analyst or investor food for thought. Nevertheless, the tone of Geneva was not one of doom and gloom. Virtually all were in accord that the worst is behind for the industry and that there remain some extremely interesting service platforms and technologies that are only now coming to the market. In this note, we attempt to synthesize some of the key themes that emerged from the Forum sessions and the implications for investors in the telecom sector.

WIRELESS AND MOBILE – STILL THE PLACE TO BE

Four years ago, the hot ticket at Geneva was accessing the Internet via mobile devices. The first Wireless Application Protocol (WAP) phones drew large crowds in the exhibition hall and the Forum featured speaker after speaker extolling what GPRS and 3G would do to enable Internet on the move. At best, the enthusiasm proved premature. Early WAP applications offered little value on purely designed sites at a high cost using cumbersome handsets. But despite setbacks (e.g., European players spending \$110bn for 3G licenses), the wireless sector in general remains healthy and appears well positioned to capture a meaningful share of data and video services revenues. By the end of last year, the total number of wireless users surpassed fixed line subscribers for the first time. In 1991, 5% of telecommunications services revenue worldwide came from mobile and this year the figure will be 42% and by 2005, wireless revenue will surpass wireline.

We believe that mobile services will continue to grab an increasing share of the telecom pie. Operators including NTT DoCoMo are showing the way. In October 1999, DoCoMo had just signed on its one millionth i-Mode subscriber. Today it has 39 million, of which over 1 million come from European partner providers. DoCoMo has quickly learned how to get partners to contribute content and applications to run on i-Mode enabled handsets. Software developers are also becoming active in developing tools needed by content providers. Microsoft introduced its Mobile2Market program to help operators bring new applications to mobile services, as well as its venture with Vodafone for an open standards Web services platform.

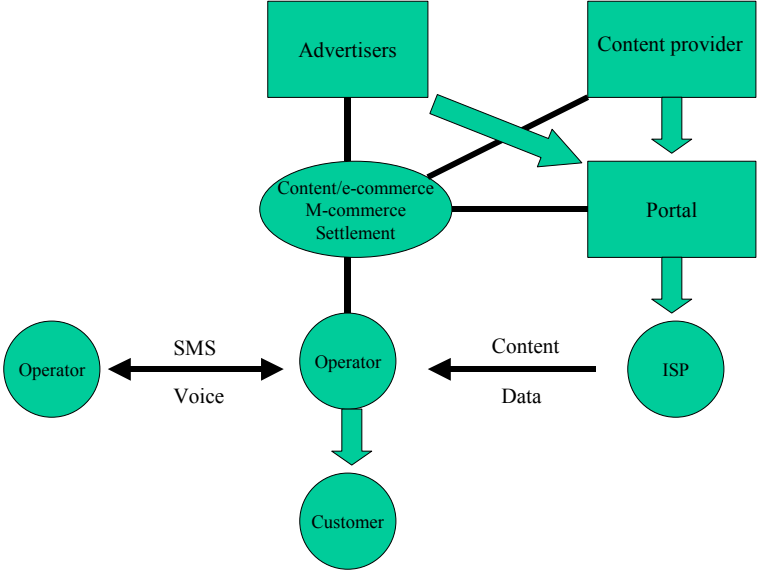
Multimedia messaging services (MMS) are beginning to make a meaningful impact on wireless revenues and ARPUs, particularly in Asia. We believe that with the uptake of quality camera phones, now in Europe and ultimately in North America, it can only be a matter of time before MMS becomes a significant contributor, together with other non-voice applications including music, games, and information services (or, as Vodafone would term it, Infotainment).

We went to Geneva with a fairly negative view of Wi-Fi service and came away with the view reinforced. If the best that one of the largest stand-alone Wi-Fi players in the world can say for the service is, "It's fun", we cannot imagine incumbent wireline operators or mobile operators becoming overly distracted. Yes, there will continue to be roll-outs of public wireless Hot-spots based on 802.11 and succeeding technologies. But we would view it as no more than a (slightly) useful adjunct to what carriers are already planning and implementing in enhancing wire-free connectivity in the home, workplace and public.

CUSTOMER AS KING – THE NEW MANTRA

It was virtually impossible for any speaker or panelist in the many Forum sessions to not address the supremacy of ‘the customer’. Telecommunications companies can no longer be ‘network operators,’ they must be ‘service providers’. Those that best understand and adapt to this nuance will thrive and those that do not will struggle to retain customers – or so the rhetoric suggests. What does this mean in practice? The ideas presented emphasized the need for customer-led solutions and services. Telcos cannot force technology solutions on their customers. It was also commonly agreed that there is no ‘killer application’. The value of any service provided will come in large measure from customization down to the small user segment, in the extreme, down to the individual. Content is important, but will not, in itself, deliver the winning hand. The complexity of the new ‘service provider’ environment can be shown in this highly stylized version of the relationship between operators and content providers and advertisers. The suggestion is that the organization that can best grasp and leverage these complex relationships will not only drive the negotiation process, but also secure incremental revenues by providing billing services on behalf of partners:

Table 1 The Content Value Web



Source: World 2003 Daily, October 15, 2003

Branding is also important as a means of differentiation in a competitive environment. The companies that we believe have already made this transition are again largely found in the wireless world – Vodafone with Vodafone Live!, DoCoMo with i-Mode and Orange with the Orange ‘experience’. In mature or maturing markets the key competencies of network operators will include: Customer needs analysis; customer development plans; organizational segmentation; and customer communication plans. It is difficult to argue the view that only those operators committed to realizing the benefits of customer-centric rather than product or operational focus – growing profits and returns on investment in the absence of customer growth – will ultimately be the most successful market participants. We believe that identifying the organizations best prepared to adopt this approach will be a critical determinate of investment performance.

BROADBAND BONANZA

As in many elements of mobile service, Asia continues to lead the world in broadband development. Telecom World served both as a platform to showcase broadband applications and services and for active debate surrounding the regulatory and political vision needed to support it. Figures released by the ITU just ahead of Telecom World indicated that penetration in Korea has now reached 21% of exchange lines, with 15% reported in Hong Kong. In urban centers in Korea, the estimate is that 60% of households are broadband customers. We believe this bodes well for both US providers and European incumbents. In the past 12 months, European broadband connections are up by 90% (to 17.5 million) versus a gain of 50% in the US. But this still leaves European penetration levels severely lagging at only 2.3% of subscriber lines in the UK, 7.4% in Germany and 4.7% in France.

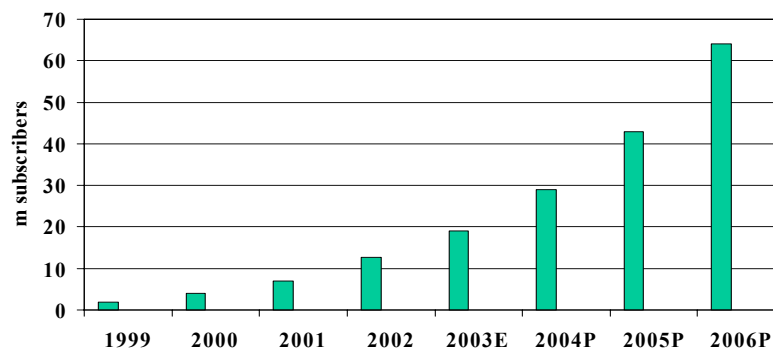
Incumbents in Europe control over 80% of all retail DSL connections and true unbundled access accounts for no more than 5% of the market. This, coupled with a weak cable TV industry in large parts of Europe (ex-Germany, Belgium, the Netherlands and Portugal), is a major retain a positive outlook on many of the European incumbent operators and continue to look for modest revenue gains. Industry forecasts of more than one third of European households connected to broadband service by 2007 appear realistic and we further expect to see European broadband speeds pick up from the current 128-512kbps to those of standard speeds of 8-12Mbps already in use in Japan and Korea. The implications for services over broadband should be evident.

DEVELOPING WORLD – GIANT LEAPS

Geneva always affords the opportunity to hear from the developing world, and this year was no exception. While, inevitably, there were the calls for universal service funding and ways to redress the technology imbalances in the world, there are many success stories over the past four years and prospect for exceptional opportunities ahead we find instructive. Four years ago, the Russian telecom market had annual revenues of 101bn roubles. This year the total is forecast to reach 361bn roubles. In this period, the number of subscribers (fixed plus mobile) has increased from 1.5 million to 35 million and mobile operators alone are currently adding around 1 million subscribers per month. Yet despite this surge, fixed and mobile penetration nationwide are still only about 24%. There is no question that the opening of Russia to foreign direct investment in the telecom sector has been a major contributor to these gains. Over the past four years, \$4bn of foreign cash has gone into the industry. To further the process, next year the plan call for the State to sell a 25% stake in Svayzinvest, the holding company that control regional local exchange companies and Rostelecom, the monopoly long distance operator.

India, on a vastly different scale, has also made giants leaps in the past few years, but remains extremely underdeveloped. The gain in teledensity (penetration) in India from 1990-2003 was 0.6-5.2%. It took Brazil 20 years to install the same absolute number of lines and Malaysia 23 years to add comparable penetration. Mobile will clearly be the engine of continued growth in the Indian market. Annual growth since 1999 has been close to 100%, with the 1.9 million subscribers at the beginning of 2000 having grown to 12.7 million at the end of 2002. Under the below assumptions, total penetration in India would increase to just over 10% by the end of 2006. To drive this to a level comparable to Russia today would require a further 200 million subscribers. The implication for both service providers and equipment vendors is clear.

Table 2 **India Wireless Subscribers**



Source: World 2003 Daily, October 15, 2003

INVESTMENT THESIS

Where does Telecom World 2003 leave us in terms of investment themes? Again, perhaps it is useful to look back before we look ahead. Between the peak in 2000 and the trough at the end of last year, the global telecom sector lost 68.7% of its value. The pain was spread fairly evenly, with the US sector down 73.1%, Asia 69.5% and Europe 66.7%. But we remain perhaps more convinced than ever after Geneva that 2H 2002 did mark a bottom in the fortunes of the sector and that the recovery we have witnessed this year is a legitimate reflection of the improving macro and company dynamics for the group.

Broadband *is* going to matter. This is not simply the substitution of profitable measured usage by a flat rate offer. 3G *is* going to be big. Very big we believe, just not very quickly. We believe more than ever that a global telecom portfolio must include names from, or with high exposure to, the developing world. And we do believe that the winners in the industry will increasingly differentiate themselves through creative, innovative customer segmentation and care, with services tailored to ever-smaller subsets of users. We look forward to Telecom World 2007.

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