



Following in the Footsteps of Terra, Wanadoo Goes Home

When it comes to their Internet divisions, recent moves carried out by France Telecom and Telefónica, its Spanish counterpart, make the two telecom companies look like peas in a pod. During the dot-com boom,

France Telecom and Telefónica flung themselves wholeheartedly into their online adventures, creating subsidiaries known, respectively, as Wanadoo and Terra. Those subsidiaries became independent and developed their own businesses. However, over the last eight months, both France Telecom and Telefónica have decided to put an end to that freedom, buying back shares of their subsidiaries at half their initial trading price. What's involved in this strategy of reincorporating Internet subsidiaries to parent companies? In what ways are the two cases different?

The Stock Market Deal

Barely four years have passed since Wanadoo and Terra were set free by their parent companies. Wanadoo is the more recent of the two prodigal sons to return to its roots. Two weeks ago, France Telecom, in a move valued at 3.9 million euros, launched a takeover offer for Wanadoo, its Internet subsidiary. FT offered minority shareholders 8.86 euros per share, less than half of Wanadoo's initial share price of 19 euros back in July 2000. Apparently FT was following in the steps of Telefónica, which bought back Terra at a price of 5.25 euros per share last summer – a far cry from Terra's initial price of 11.81 euros when it came out on the stock exchange in November 1999.

In both cases, the parent company offered about half the initial offering price when it reintegrated its Internet subsidiary. No wonder Telefónica's decision was highly criticized by minority shareholders in Terra. For the same reason, minority owners of Wanadoo are annoyed at FT. However, Wanadoo's shareholders might have sounder reasons for being unhappy.

Despite similarities, there are significant differences between the two cases. In its days as an independent, Terra never managed to get out of red ink. In contrast, France Telecom's acquisition of Wanadoo doesn't involve

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reducing risk. Wanadoo is a profitable company that has cleaned up its books and has a very promising future. Experts estimate that it will generate sales of 361 million euros this year, far above the 159 million it booked in 2003. Moreover, Wanadoo expects revenues of 400 million euros in 2005.

Shareholders have no right to be unhappy about France Telecom or Telefónica, says José Ignacio López Sánchez, professor at the Complutense University of Madrid. "When an individual [minority shareholder] invests in shares, he must assume the risk. The investments initially made in 1999 and 2000 followed different kinds of financial logic. The market and the environment have evolved. These days, the valuation of companies involved in the Internet is more real and less subject to speculation."

And these days France Telecom has decided that every 40 shares of Wanadoo are worth seven FT shares plus 195 euros or cash payment of 8, 86 euros per share. That's 20% higher than some experts think Wanadoo's shares should be worth.

Parallel Lives, Different Paths

Some other contrasts in the paths taken by the two portals play a role in the current financial situation. First, "Terra started out as a portal, while Wanadoo started out as a portal and an ISP. Second, the French market is different from the Spanish market, in terms of number of Internet users, penetration of technology, and kinds of services offered online," notes López.

Moreover, during its four years of as an independent, Terra suffered from continual changes in management and strategy. In addition, Telefónica set limits on the development of its Internet subsidiary and has even competed against Terra in the most profitable areas, such as DSL access to the Internet. Finally, Telefónica's aggressive policy of international expansion did not produce the results that the company expected.

Terra bet heavily on the Latin American market. As things turned out, that market "was not as homogenous as they thought," says Arturo Rojas, professor at the Autonomous University of Madrid. The crisis in Argentina and the loss of Terra's advertising contract with the Bertelsmann group provided the coup de grace for the Spanish-language portal. Finally, at the end of May 2003, Telefónica launched a takeover offer for its subsidiary, marking the end of Terra as an independent company.

Meanwhile, France Telecom took an opposite approach to Wanadoo, giving its subsidiary free rein to develop its business. Wanadoo became the first European portal to

make a profit. Its best earnings results had an impact on share prices, which have outperformed FT's shares by 48% over the past six months. As a result, some analysts believe that FT, run by Thierry Breton, has not chosen the ideal time to take over the 29% of Wanadoo's shares that it lacks.

Enrique Dans, a professor at the Instituto de Empresa (business school) in Madrid, doesn't agree, suggesting that one has to take advantage of opportunities when they present themselves. "The best moment for buying back shares is when you believe that you have acquired enough outside knowledge operating as an independent; when you believe that the time has come for acquiring the innovation that comes along with that. However, it's no easy task, doing that."

Beyond the issue of timing, the fundamental question is: Why have two of the largest telecom operators in Europe opted to reincorporate their Internet subsidiaries in their business groups?

Reintegration strategy

When it comes to goals and characteristics, the takeover moves by France Telecom and Telefónica have many similarities. López believes that the main goals for the companies have been to contain costs, leaving behind an era of excess and unjustified investment; and to get their hands on cash that has been accumulated since their public share offerings. "In the case of Telefónica, [that cash] is almost enough to finance this takeover." Another goal is to "take advantage of tax credits from losses in previous fiscal years, which you can consolidate only if you have total control."

More specifically, reincorporating Wanadoo is the final step in the strategic plan of managing director Breton, who took over France Telecom in 2002. His goal is to end the excessive decentralization of the group, and deal with the threat of Internet telephony.

Breton's view is that when an organization is too fragmented, it cannot take maximum advantage of group synergies. Lopez agrees that this approach "will generate financial, economic and production synergies. It will increase the value of products and reduce operating costs. Now that irrationality about dot-coms has disappeared among speculators (who lived through the boom), it is important to return to the path of sensibility and good business sense."

Apparently, Terra has already begun to take that path. The process of integrating its Internet subsidiary into the Telefónica structure – which already controls 75.29% – allowed it to close the fourth quarter with a gross profit (EBITDA) of 8 million euros, Terra's first positive

EBIDTA. The company was able to cut its operating costs by 27%, now that it is no longer competing with Telefónica for customers, and focusing instead on content. It has also made cuts in its staff.

Integration means that subsidiaries are sacrificing their innovative capacity, according to Dans. In the case of Terra, "reintegration has meant a significant reduction in costs, but Terra has become a less innovative company." Dans believes that telecom operators "could have established their portals as centers of R&D and kept them operating at a loss. Now, what they want to do is make them profitable; that's another thing altogether." However, not reintegrating subsidiaries also involves problems. "It depends on how long you can stand to burn money at your current rate," he adds.

France Telecom, the former state monopoly, needed to do some belt-tightening to cut the 68 billion euro debt it accumulated during its surge of acquisitions in 2000. Thanks to the financial transformation it has undergone over the past 15 months, FT amortized 24 billion euros and reported its first profits since 2000. With its takeover of Wanadoo, FT hopes to strengthen its already growing cash flow.

Another key reason for FT's move is the threat Internet telephony poses for fixed-line telecom operators. As an advisor to the French firm told *Expansión*, the Spanish business daily, "France Telecom is the only dominant telecom operator that is worried about the threat that voice-over-the-Net will mean over the next 18 to 24 months. Reintegrating a broadband business like Wanadoo is one response [to that threat]."

For López, this is a key reason for reintegration. "Controlling 100% of the growing profits from businesses related to the Internet and broadband means getting into important, strategic sources of revenue (such as music downloads, search engines, television and voice-over-the-Net), etc. When it comes to FT and Wanadoo – unlike Telefónica and Terra – there is an important difference. "Wanadoo comprises the entire Internet business of France Telecom – both the ISP and the Internet portal. It is also the subsidiary with telephony directories, which makes it even more important for FT to recover 100% of this source of revenues. Maybe that's why Wanadoo registered black ink before Terra did."

In Dans' view, if consumers begin to use the flat rate plan for making [Internet] calls, it is better to take part in this new business than stay outside it. That's why he believes France Telecom, by reintegrating its subsidiary, is trying to "understand what is going on, so it can move ahead. It wants to control the business, and count on

people who have experience and knowledge of the Internet, so that it can anticipate change.”

Final Valuation

Dans believes that “the industry has been short on patience.” In both Spain and France, electronic commerce has not taken off as rapidly as expected. In his view, the portals didn’t wait until they acquired important knowledge about consumers’ needs. “They let a valuable opportunity slip away,” he says. On the contrary, companies such as Amazon have had patience, and this has allowed them to accumulate enough knowledge about customers. They know enough about their tastes to sell not only books, but other products such as music CDs.

“The portals have done very little that is innovative,” Dans says. “They knew that telecom operators would sooner or later have access to consumers but they have done very little to get to know customers’ needs; they have focused on short-term business.” If you take a good look, he adds, “the results are not good, considering the opportunities they had.”

Nevertheless, other business opportunities could emerge in the future. In this market, Dans says, “the people who take the upper hand will be those who develop the technology and have the customers.” That could be the telecom companies, in his view. Moreover, taking advantage of their users’ modest knowledge of technology, the telecom companies could provide the access services and become e-commerce intermediaries based on market share – performing the role that the portals were supposed to play.

“In both groups, they are talking about possibly selling [assets]. Now that the market is unregulated, the subsidiary that sells telephone directories is not considered strategic. It can be used to reduce debt, or pay for more strategic assets,” López says.

Experts believe that FT’s next step will be to repurchase its minority ownership in Equant, a business that provides data services.



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