THE BIRD THAT FLEW INTO THE GROUND

January 19, 2004 **William A. Friedlander**

I want to relate to you a parable about a great mythical bird. The myth, of fairly current origin, says that a new bird will appear and soar to heights greater than any flying creature ever known. Just as people begin to believe that this bird is, indeed, unique in avian history, it will be transformed from a beautiful soaring creature into something more like a Pelican diving for dinner. But, instead of splashing into the water, it will fly into the ground and destroy itself. You will all recognize the name of this once noble bird. It was called Broadwing.

It began on a raw windy day in January of 1986. I received a call in my office from Dwight Hibbard, then CEO of Cincinnati Bell. He wanted to visit me. I asked him if I needed to have any special files out - or just my checkbook. He chuckled and said neither would be needed.

The next day he appeared and, after a few preliminaries, asked me to join the Board of the company. I was flattered, told him I'd get back to him in the next day or two and, as soon as he left, called my attorney.

Now, in 1986, attorneys weren't as sensitive as they are now to their clients serving on boards and I was told that while it would expose me to liability, it was not the kind of company that was wild and wooly and attracted law suits like iron filings to a magnet.

I had also checked with the company's legal counsel and learned of their good policy on covering board member's with D&O, Directors and Officers liability insurance. I agreed to stand for election at the next shareholder's meeting three months hence. A photographer came to take my picture for the proxy statement. I must have looked competent and trustworthy as, in April, I was swept into office with better than 98% of the votes. Only Idi Amin, Sheik Khomeni and Saddam Hussein did better that year.

I was now on board for a ride that lasted sixteen and a half years, that exposed me to some of the brightest and most competent board members and managers I'd ever met and that put me at the table with, among others, Jack Grubman, Salomon Smith Barney's top telephone industry analyst who made $17,000,000 a year for telling Salomon's clients to get on the "telephone train" ride. He helped the firm attract huge investment banking fees but he forgot that his clients came first.

He simply didn't mention that the train was headed for a crash even though, with his sources of information, he was uniquely qualified to know.

Incidentally, it was Grubman who hyped AT&T (which he really didn't like) so that his boss, Sandy Weil, would use his clout to get Jack's daughter into the "right" Kindergarten. Apparently, in Manhattan's upper echelons, if you don't start with an exclusive kindergarten you won't get into the proper primary and secondary private schools and will miss your shot at an Ivy League institution. But I digress.

Cincinnati Bell was, when I joined its board, a rather conventional phone company staffed by officers who had grown up as part of the AT&T Empire. And, apart from Dwight Hibbard, most of them would have been happy to stay in that world. It had grown complacent over a hundred years of protection from competition; one where staff promotions were based on longevity rather than merit, and where innovation at half speed was considered good business.

Imagine if the telephone you bought today was still the one you would find in the stores ten years from now. That was the product cycle of Western Electric, Ma Bell's manufacturing arm (now an independent company called Lucent). Of course in the eighties AT&T and it's subsidiaries didn't sell you a phone, they rented it to you for the 2004 equivalent of $5 a month, a neat 100% return a year. They were well made and long lasting. You can still buy an eighty-year-old Western Electric phone on eBay and it works just fine.

The company even had its own lingo. For example, while you and I would express a whole number and decimal, say, 12 point 2, telephone people said 12 dot 2. They also had more acronyms than the Navy, my favorite being POTS for "plain old telephone systems". Yet, for all their stodginess, they ran a very reliable system.

This world began to unravel in 1983 when the Justice department convinced a Judge and jury that the company violated the anti-trust statutes and should be broken up; that competition would drive down long distance telephone rates. This it ended up doing though there are many who still believe that the government broke up the most reliable service the American people had ever been offered and that the trade off wasn't worth the disarray of competition.

While almost all hearing this paper are old enough to remember the break up, I would suggest it might be a bit tougher to remember the names of the seven companies that were created and distributed to A T& T shareholders.

Give up? OK. From east to west they were:

Nynex, Bell Atlantic, Bell South, Ameritech, Southwest Bell, U.S. West and PacBell.

Twenty years later only Bell South still exists. Nynex was acquired by Bell Atlantic - now called Verizon - and Ameritech and PacBell were merged into Southwest Bell - now called SBC while US West became Quest. Are you keeping up?

The original seven were given the local phone business in their areas but not the profitable and less regulated long distance revenues, which would be left with Ma Bell and would be opened up to MCI, Sprint and dozens of smaller players. MCI was later renamed WorldCom and is now operating in bankruptcy once again under the name MCI. Federal district court Judge Harold Green enforced the court order and thus became the most powerful single person in corporate America for he controlled the telecom playing field over the ten years that he ruled AT&T and its progeny.

However, Cincinnati Bell and Southern New England Bell though effectively controlled by AT&T, still had outside shareholders. The judge couldn't figure out how to handle these "hybrids" and decided to leave them alone. They were thus protected from the spin off rules and, because of this freedom, earned the nickname of the "Switzerland's" of the telephone business.

Dwight Hibbard decided that, to prosper in the new world, with the freedom we had been given to move into new arenas, we would need to attract a different breed of manager. He wanted men and women who were risk takers.

One of his early picks was a bright young mind, John LaMacchia. He directed the first non-telephone business in the company's history. Called CBIS for Cincinnati Bell Information Systems, its mission was to diversify the company's earnings base away from POTS. It started as a small division in the company in 1984 to develop software for cell phone billing.

John and his successors went on to build the country's largest specialized billing system at a time when the number of cell phones was increasing geometrically and complex algorithms were required to calculate bills when one phone call was often handled by two or more carriers, each of whom charged different rates.

By the end of the eighties Dwight decided to diversify further. He had met Dave Lahey, an impressive mid level officer at Procter and Gamble, and persuaded him to give up the safety and security of Procter for a potentially lucrative contract with us.

Lahey soon brought over two more Procter executives, Jim Orr and Dave Daugherty. Together they started Matrixx Marketing with a plan to build a suite of services built around fast growing 800 number dialing. Five years later we proudly claimed it to be the nation's leading telemarketer with more employees than the rest of the company combined.

By 1989 we were succeeding beyond expectations. In June of that year we pointed out that, had one invested in Cincinnati Bell at the end of 1983 when divestiture had been ordered, they would have had an 820% return while our "peer group" the seven RBOCs (the acronym for the original seven Regional Bell Operating Companies) would have returned 400% and the S&P 500 a mere 140%.

The annual report that year featured a beautiful multicolored window on the cover in recognition of Dwight's oft-repeated vision to build a company that would resemble a "stained glass window" each division of the company fitting together to make a beautiful whole.

In 1990 the window developed a small crack as management assumed that the world would continue to beat a path to our door and started to acquire companies faster than its lawyers could write and review contracts.

In 1993 the window shattered completely as the company reported a loss of $60 million and the fourth year of negative comparisons. Our return AD (after divestiture) was back with our peer group and we stopped bragging in shareholder reports.

In early '94 the Board received an anonymous letter from a shareholder. After enumerating our failures he said:

"I feel Cincinnati Bell has gone from an image of a safe, solid, stable and conservative company to an image of a risky, changeable and inconsistent one. It has gone from a company that always made money to one that is losing money." <end quote>

He was right. The unraveling started in the early nineties with a couple of forays that had great promise.

First John LaMacchia decided that we had something to offer to the world's largest phone company, NIT, Nippon Telephone and Telegraph. He was in Tokyo every couple months working to convince them that our billing software was a quick way to get their hands around the knotty problem of accounting for and collecting the revenue from their fast growing wireless business. The Board believed we had a good chance to land a contract that would increase the company's top line by more than 20% much of which would flow directly to the bottom line. It would, in one stroke of the pen, take us from the national to the global stage in cellular billing. And, at two dollars per year per customer, a 100 million Japanese cell phone users - and growing fast - was definitely not the minor leagues.

But it never happened. In spite of all the hype and the hope it seemed that NITs engineers persuaded their top brass that it would be a huge loss of face if an American company ended up selling the world's premier telco a wireless billing system. John assured them that it would take them a year or more to develop their own software instead of licensing ours. NIT decided the delay was worth it given the shame of the alternative. For us it was a loss of momentum and an expensive write off of large investments in software unique to the Japanese market.

On a parallel track was an attempt to gain a foothold in the lucrative federal government market. To hit the ground running we bought our way into the business by purchasing a company in Virginia that was already doing business with the IRS and the Agriculture Department. I'm not certain just what we were trying to sell. It was software but not billing software. And it was secret even though I never thought of either agency as part of our National Security apparatus. . . And, like NIT, it was filled with promise. We paid sixty million dollars to assume the contracts and get non-compete agreements from the management. We renamed it CBIS Federal and were assured it had a bright future. But within six months we were in trouble as the IRS decided not to renew the contract that we'd been assured was a "no brainer".

Three months later the Department of Agriculture sued us for "non-performance" of our contract. We couldn't get the IRS to tell us why they quit; only that their legal counsel advised them not to answer questions. As for Agriculture we went to arbitration where it was judged that we had done what we were hired to do - but we still lost their future business.

It appeared that the company was guilty of failure to exercise adequate due diligence if nothing else. The Board looked inward and understood what the "no-brainer" phrase meant. We sold CBIS Federal and licked our wounds.

The 1993 Annual Report began: “We know that 1993 was a disappointment to Cincinnati Bell shareowners . . . Because of charges at CBIS, primarily related to our decision to exit the Federal business, we lost $56.8 million or 93 cents per share."<end quote>

This loss compared to a gain of $30 million the year before and $90 million four years previous in the banner year of 1989. The company had clearly over reached and was paying the price. The directors told management to consolidate the gains and make them work. Slow down the acquisitions. Quit straying too far in an attempt to keep growing at supersonic speed.

They listened. Hibbard, along with LaMacchia and Orr, cut expenses; concentrated on building the businesses we had and, turned the ship around. In 1996 Cincinnati Bell earned $185 million, ... more than double the previous record year. For the first time in the company's history, non-telephone businesses provided more than half of the revenue. The shareholders were, once again, happy campers and, in a 1996 Wall St. Journal survey, the company was saluted for having one of the best performing stocks in the US and later added to the Forbes Platinum List of the best big companies in the US.

Two years later, after a great deal of study and debate, we decided, that our investors and employees would be better off if we separated the telephone and non-telephone businesses. The rationale was that the parts would be worth more than the whole; that stock incentives to employees could be more directly tied to their performance, and finally, that shareholders could keep both or sell the one that didn't suit their needs.

First we established a company to receive the non-telephone businesses. To name it we started with our airport code, CVG, after Covington KY where the airport is (sort of) located. We checked with the stock exchange and discovered the symbol was available so we grabbed it. Then came the hard part; finding a name that would tie to the symbol and be clear in fifty states. And that, dear listener, is how Convergys was born.

The stained glass window, which had been repaired from its shattered state at the end of 1993, would now be disassembled with two of the three panes, CBIS and MATRIXX being spun off to shareholders. Members of the Board were divvied up between the new and old companies. I chose to stay with Cincinnati Bell for it had, I believed, a better chance of turning into a fast mover by acquisition. We also had a fine young CEO, Rick Ellenberger, who had trained with MCI and knew the phone business both local and long distance.

I didn't have to wait long for results. This sleeping dog decided to awaken, growl and become a tough Doberman.

In March of 1999 the '98 Annual Report was released. On the cover was a simple statement in bold black type: "The New Cincinnati Bell. We will Surprise You."

What had begun in November 1998 with the spin off Convergys was followed the next month with the purchase of an 80% interest in the local wireless business that was owned by AT&T. We then began negotiations to purchase one of the top five national fiber optic networks and, in November of '99, we finalized it with the purchase of IXC Communications based in Austin TX. In fitting with the diversified nature of the company we looked for a new national identity.

And so Broadwing was born. It was a name made up by a PR company that had checked it in fifty states and found, not surprisingly, that no one had reserved it. We chose the red tailed hawk as the visual symbol and the '99 annual report had a close up of a hawk's eye on the cover.

The market caught up with the excitement and promise of high speed data networks where we envisioned revenue increases of 30% a year- compared to 4 to 5% for the local telephone business. The stock, which had more than doubled in 2000, had now grown eight times over since the low point in 1993. Those were heady days indeed.

In the middle of the year the Board eliminated a dividend that had been paid for over 100 years, firmly convinced as we did so that we could earn greater returns on the money by reinvesting it. We also cited the bogey of double taxation of dividends to help defuse shareholder complaints.

The company had paid a great deal to jump on the fast track. Debt climbed to $2.1b from $400m the year before while interest expense drove share earnings down to 24 cents in 2000 from $1.10 in '99. Broadwing's financial types began talking about EBITDA the new, supposedly "most accurate" method of reporting "true" earning power. It came before interest, taxes, depreciation and amortization and was a lot easier to find in our reports than simple earnings.

The 2000 annual report was also long on colorful pages with headings that excited the readers with "We're Innovative. Great ideas get top priority." Or "We're Accountable. While others make empty promises, this world-class team delivers." And best of all: 'We're Fast. We're Aggressive. We don't just enter a market. We attack it." Kevin Mooney, the CFO reported the fact that the company had surpassed $1 billion in revenues and added that "our financial vision was to be a $5 billion company by 2004".

The mailing of this first Broadwing annual report in March of 2000 coincided perfectly with the end of the greatest bull market in history. It was three years after Federal Reserve Chairman Greenspan coined the phrase "irrational exuberance" in describing the market. Speculation had come to dominate rational investing and stock prices had less and less connection to earnings. The fallout was horrible.

It quickly became clear that the hi-tech telecom industry, which accounted for much of the froth in the late nineties, was going to lead the decline in 2000. Corning Glass a true blue chip and the largest supplier of fiber optic cable saw its stock tumble from 113 to one and a half while Global Crossing, the darling of international investors went from 64 to zero when it declared bankruptcy. WorldCom, the largest telco in the US was of course buried by its criminal activity but it would have been taken down to low single digits even if had been pure.

Broadwing, whose stock had topped 40 in early 2000 declined to one and a half in 2002 as rumors of bankruptcy seemed credible to many. The great bird that had soared high, nosed over and flew into the ground. Rick Ellenberger, the fine CEO who had led us into the promising world of Broadband resigned in embarrassment.

The broadband investment of three billion was sold for under $200 million and the Broadwing name went with it. The company survived - barely - and is now back where I started with it in 1986 . . . A very good provider of plain old telephone service called Cincinnati Bell. But now it has $2 billion in debt and no ammunition with which to make acquisitions. Its revenues will grow at less than 5% a year and it is vulnerable to a takeover. If that happens the headquarters will move to an Atlanta or a Chicago and we will lose a major employer and a significant contributor to Cincinnati civic and charitable agencies.

What put us in this position? The Broadwing board was filled with bright men and women, each with no less than twenty years of business experience, who had asked tough questions and received forthright answers. What had we missed when we decided to enter the broadband business?

Perhaps we ignored the law of supply and demand: that when ten well funded companies are racing to bury fiber and equally important, when the technology allows it to double and then redouble its carrying capacity in four years, that when all that happens prices are likely to collapse.

Perhaps an additional factor was that we believed what we read: that the growth of the Internet, which used broadband lines, would match or exceed the supply of fiber. I recall reading a paper by an MIT professor who was adamant on the point and urged the industry to lay more lines more quickly or risk losing business to satellites.

We drew some solace in knowing that Broadwing was clearly not an Enron or a WorldCom. The audit committee, which I had chaired from 1994 until 2001, spent a lot of time making sure that we had honest employees, good controls and clean audits. There was never a hint of fancy accounting or executive's having loans forgiven or corporate jets or side deals that accountants ignored. We were the stewards of a clean ship and the Captain and crew were honest.

These words had hardly left the printer when the Enquirer of January 8th featured an article by its chief business writer, Mike Boyer, headlined: "Broadwing Chicanery Alleged". In it Boyer quotes an attorney who is suing the company on behalf of shareholders alleging that our CEO and CFO made false statements. This attorney in turn cites allegations of accounting fraud made by "unidentified former executives." Until I see evidence from an objective source I don't believe it and I'm sticking to my "clean ship" metaphor.

Just as railroads in the 1800s and autos in the 1920's overbuilt and believed their own press, the broadband industry thought they were destined for a decade of growth. Our industry's leadership fell into what I call a "positive feedback loop".

The original promise of a great new technology draws capital and competition. As the industry grows (in terms of dollars going in - not coming out) it creates a bubble of sideline businesses that supply the end users. In turn there are magazines and books published devoted to the exciting future. It's truly infectious and totally believable!

It feeds on itself as more capital is drawn in to fund second tier companies. There may not be proven demand for their services but the investment bankers, who earn fat fees don't really care. The loop feeds on itself until it strains credibility past the breaking point. A large mutual fund decides to cash in, the word spreads and the positive feedback loop turns negative.

The cookie crumbled and, almost four years later, it's still crumbling. The WSJ of December 9th 2003 reported that, while global crossing was expected to emerge from bankruptcy that day, Cable and Wireless placed its US arm in chapter 11. Those of us who made the critical decisions based them on the environment we were in and, I believe, we exercised sound judgment. It may not look it in hindsight but it was very clear at the time.

Now we say. "That won't happen to us again." And it probably won't. But it will happen to other boards in other industries ten or fifteen years down the road. They will become dazzled by a new idea that seems too good to miss. Consultants, for a whopping fee, will come out, study the situation for a week, submit a book replete with colored charts and projections of profits that seem almost certain . . . and tell you to call your investment bankers "and quick".

Those future boards will be peopled with optimists who haven't been through a debacle yet for if they had they wouldn't have been picked for the board in the first place. These optimists will reason that, for the good of the shareholders they must grab the brass ring this time around or a competitor will, and the positive feedback loop will begin again.

And, as long as man looks to the sky he will see great birds soaring higher and higher... and every now and then one will fly into the ground.
