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Ron Gone?
With or without its chief, Deutsche Telekom might be nearing the end of its misery
By Rhea Wessel

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Overspending, too much debt, bad decisions and bumbling management. Those are all ailments afflicting Deutsche Telekom. And they've spelled disaster for the German giant's shareholders.

Since peaking two years ago, Telekom's shares, which trade in Europe on the Frankfurt bourse, and its American depositary receipts, which change hands on the Big Board, have plummeted nearly 90%. In fact, the fall has been so precipitous -- from about $100 to around $11 for the ADRs, each of which represents one share -- that DT, despite its many problems, could now be a bargain for investors with patience and strong stomachs.

Telekom, the world's No. 3 telecommunications group, has 100 million phone customers and is a leading provider of Internet services and high-speed access lines in Europe. And its beleaguered brass is finally dropping the growth-at-any-cost strategy followed since the former monopoly, once 100% state-owned, was partially privatized in 1996.

After going public, the Bonn-based behemoth went on a spending binge, scooping up companies around the world. Leveraged to the hilt, it has $62 billion in long-term borrowings. (All dollar figures in this article are based on a recent exchange rate of 92 U.S. cents per euro.) Thus it's desperately trying to shape up, in part by trimming capital investment.

Two of DT's biggest headaches are VoiceStream Wireless, the U.S. company for which Telekom chief Ron Sommer shelled out $30 billion last year, and the third-generation wireless-phone licenses for which he gave the German government $7.8 billion in 2000. Now, even Sommer acknowledges that there won't be any market for those services until 2004, and that prediction might be optimistic.

Sommer, a man of no small ego -- open the Frankfurt telephone directory, and his visage stares back at you -- paid premium prices to foster his dream of creating a global powerhouse. Consequently, says Thomas Ross, a San Francisco-based tech-fund manager for Dresdner RCM, "Deutsche Telekom is relatively well-positioned against the other [telecoms] in Europe and in the U.S. In order to get there, though, it suffered a severe case of business hubris and overpaid horrendously."

Meeting the company's stated goal of slashing debt to $46 billion by the end of 2003 is doable, but won't be easy without a dilutive stock offering -- which Sommer has ruled out.

The company's hopes of raising cash by selling some of its German cable assets to Liberty Media for $5.06 billion were dashed in February by antitrust authorities, who considered the sale anticompetitive because U.S.-based Liberty already had substantial cable holdings in Germany.

Deutsche Telekom -- which wouldn't make top executives available for this story -- has put off indefinitely the initial public offering of its wireless arm, T-Mobile. In the weak telecom-share market, the deal would fetch far less than the $9.2 billion DT had sought.

Last week, when DT unveiled details of its plan to sell $4.6 billion of bonds in the U.S., it not only had to offer hefty yields; it also had to take the unusual step of promising buyers another half-percentage point in annual interest if Moody's cuts its debt rating from its current Baa1. That's quite possible in light of the rating service's trimming its outlook on Telekom Thursday to "negative" from "stable," which hammered DT's paper.

The decision came a day after Deutsche Telekom reported dismal results for the first quarter. The company had a larger-than-expected loss of $1.66 billion, or 43 cents a share, versus a deficit of $329 million, or 12 cents , a year earlier. Revenues were up 15%, to $11.75 billion. while cash flow, as measured by Ebitda (earnings before interest, taxes, depreciation and amortization), rose 4.4%, to $3.48 billion. In part, the loss reflected $920 million in write-downs in the value of companies newly consolidated into Telekom, plus its 2% stake in troubled France Telecom. An additional villain: competition in the fixed-line sector. This has hurt the T-Com unit, which produces 40% of DT's revenues and has costs higher than those of some rivals.

For the full year, the analysts' consensus is that DT will post a loss of about 27 U.S. cents a share, compared with a deficit of $1.28 a share in 2001. Nevertheless, the company still has fans.

A big plus for Telekom is its strong operating cash flow -- probably $14.6-$15.5 billion this year. Next year, company officials say, revenue should rise 10%, and analysts foresee a modest profit; the consensus estimate is seven cents a share.

"The current sentiment is worse than the actual picture of Deutsche Telekom," says Frank Heise, a fund manager at Union Investment in Frankfurt, who thinks the shares could climb 50% in the next 12 months. Christoph Vogt, a portfolio manager at Warburg Asset Management in Hamburg, sees the stock hitting 28 euros ($25.76) in the same span, if DT, as he expects, starts showing signs of revival.

In the optimists' view, things have gotten so bad that DT is being forced to take steps to remedy them. The most dramatic would be Sommer's ouster, something company critics have urged. His departure surely would lift Telekom shares in the short run. (A possible successor: Klaus Esser, who headed Mannesmann before Vodafone took it over.)

But whether Sommer will go is unclear. For one thing, 43% of Deutsche Telekom still is owned by the German government, and he has the support of key politicians, including Chancellor Gerhard Schroeder. For another, the public float is overwhelmingly held by small investors. Institutions, which typically drive changes at underperforming concerns, own few of the shares.

On the other hand, shareholders are voters,and some have been financially devastated by the stock's slide and outraged by DT's recently disclosed plans to cut its dividend 40%, to 37 cents a share, while boosting pay for Sommer and other insiders. And Berlin doesn't want to see the value of its own holding slip to zero.

Sommer's fate aside, whether DT revives hinges mainly on how its businesses perform and its balance sheet fares. And Telekom finally seems to be moving in the right direction on both.

In its basic fixed-line business, Telekom is expected to boost results via cost-cutting that might involve job reductions. And it will lower debt-servicing costs with refinancings, plus paydowns of obligations with money raised by jettisoning what Chief Financial Officer Karl-Gerhard Eick said last week would be a "multitude" of noncore assets. Telekom recently agreed to sell its 25% stake in an Indonesian cellphone outfit for $332 million, and it's likely to unload other Asian assets and European real estate. And Sommer had pledged to find a buyer for the cable networks, although a deal might not go through until next year and could fetch less than what Liberty offered.

As for VoiceStream, critics say that, with about 7 million subscribers, it's too small to compete successfully in the U.S., where it is dwarfed by rivals such as Verizon Wireless, with over 29 million subscribers, and Cingular, with almost 22 million. But DT can point to some positive signs: In the first quarter, VoiceStream was cash-flow-positive for the first time, its voice-service base is slowly expanding and its small data-transmitting business is ramping up rapidly. Still, some analysts say Deutsche Telekom should dump VoiceStream. AT&T Wireless and Cingular have been mentioned as likely suitors.

If VoiceStream improves, it will boost DT's long-term value. If it doesn't, it will be sold, probably at a bargain-basement price. That could be the gaffe that finally shoves top management out the door.

Sure, Telekom's risky. But at 20% below its 1996 IPO price, it might not be a bad bet. With or without Ron Sommer.

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