



Telecom Shocker: Leucadia, tripped up by SBC-AT&T's deal, now must scramble to bolster WilTel's value

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In the annals of investing, few executives have won so much admiration as Ian Cumming and Joseph Steinberg. The founders of Leucadia National, and its chairman and president, respectively, have racked up a 21.2% average annual return over 15 years their tenure. Steinberg and Cumming are often compared to Warren Buffett, not just for their investment smarts, for their folksy shareholder letters disclosing a simple formula for success: buying cheap assets, often with tax advantages, and nursing them back to health. In late 2003, Leucadia bought WilTel, the bankrupt Williams Communications, and its nationwide fiber network for \$780 million. In classic Leucadia fashion, it acquired \$3.4 billion of tax assets too.

Yet over the past several days, Leucadia shares have collapsed to 36, down from a recent high of 47, as SBC Communications announced plans to acquire AT&T. SBC said that it intends to migrate its Internet-based and long-distance services to AT&T and that it expects to close in the first half of '06. That's bad news for Leucadia shareholders: WilTel is SBC's preferred provider for domestic voice and data, an agreement that runs through 2019. In the first half of 2004, SBC accounted for 70% of WilTel's revenue. As a result, WilTel was barred from accessing its \$25 million revolving credit facility since the SBC announcement constituted a "material adverse effect" to its business. The announcement doesn't affect \$360 million of WilTel term loans yet, but consummation of the deal would be "an event of default," Leucadia said. No company likes to see its cost of capital rise, but last week, Fitch downgraded Leucadia debt to junk status.

"It didn't just get divorced, it got dumped," says Scott Cleland, chief executive of the Precursor Group, a tech and telecommunications consultancy. "WilTel becomes one of the commodity overcapacity backbones without a big anchor customer. It's hard to see this as anything but a big negative."

WilTel's options seem limited. True, there will be some compensation -- if SBC migrates its business to the AT&T network, SBC would be required to pay WilTel up to \$200 million in compensation. It will take some time for the merger to clear antitrust regulators and gain approval from states and AT&T shareholders. The Consumers Union has loudly criticized the deal as anticompetitive. Expecting it to be consummated by mid-'06 might be optimistic.

WilTel says it will expand its customer base and "evaluate the impact of consolidation." Yet there are few obvious big customers to replace SBC. WilTel's network is smack in the middle of SBC

territory. Verizon Communications is in talks to buy MCI, and such a deal would obviate the need for WiTel.

A cable company looking to provide telephony could boost revenues. Recent deals aren't encouraging. Comcast, for example, recently signed a 20-year agreement with Level III to use the latter's next-generation network for voice over Internet telephony. Yet the deal was priced at an estimated \$100 million, or just \$5 million a year. And the trouble with networks is there are so many of them, thanks to the tech and telecom bubble. New technology exacerbates the capacity problem. "Anybody with a backbone is on the wrong side of the technology change," says Cleland of Precursor. "Witel's options are limited and diminishing."

Could Leucadia sell WiTel outright? Not without an anchor customer. Verizon, after all, is buying AT&T for its list of revenue-paying Fortune 500 customers. For backbone assets by themselves, prices are less than attractive. TyCom, the network that Tyco spent billions of dollars to build, was recently purchased by VSNL of India for \$130 million.

True, Leucadia has net-operating-losses for tax purposes worth \$3.4 billion. Yet tax credits aren't exactly cash, and they can't be realized without revenue and profits. (Indeed, some argue WiTel hardly made money even when SBC was its biggest client.) Leucadia dexterously acquired WiTel without triggering what's called an ownership change, for tax purposes. A buyer of WiTel can't avoid such a change, which radically diminishes the NOL's value. How much would it be worth to a potential buyer? Robert Willens, Lehman Brothers' tax and accounting analyst, says it is computed by multiplying the buyer's price by the long-term tax-exempt rate published by the Internal Revenue Service -- this month, it's 4.3%. A buyer who paid \$1 billion for WiTel could offset no more than \$43 million of taxable income a year. "You'd never be able to use it all," Willens says drily.

So what's Leucadia worth? Albert Meyer, who runs 2nd Opinion Research in Plano, Texas, was the author of the report on Tyco that first called attention to Tyco's corporate governance and accounting problems. Last fall, Meyer published a report saying that excluding WiTel, Leucadia was worth around \$25 a share. After the company's 3-for-2 stock split, that's \$17.

Meyer's back-of-the-envelope arithmetic sees WiTel with revenues of some \$400 million a year after SBC vanishes as a customer. In the first half of '04, WiTel generated \$717 million of revenues, annualized to \$1.43 billion. Take 30% of that, and you have \$430 million. What's that worth? If you put a multiple of 0.4 times sales -- which is what comparable companies trade for, you get \$172 million, or just \$1.60 per Leucadia share.

Much depends on the shrewdness of Cumming and Steinberg, who adroitly sold 1.2 million of their shares, worth about \$70 million, after splitting the stock and boosting the dividend late last year -- as it happens, just weeks before the SBC announcement. Those shares were purchased by Jefferies, the brokerage firm that has organized a number of bond sales for Leucadia and in whose hedge funds Leucadia is invested. It isn't clear whether Jefferies still owns those shares.

Jefferies declined to comment.

Cumming and Steinberg have made and remade Leucadia countless times, as the nearby illustration shows, with investments in real estate, hotels, banking and insurance operations. Leucadia also owns Symphony Health Services, a copper mine and a winery. Leucadia has a venture with Buffett's Berkshire Hathaway called Berkadia. Yet they are far more secretive than Buffett, who, after all, spends a weekend with shareholders once a year. Leucadia declined to comment.

"The investment case largely resides in the acumen and track record of Cumming and Steinberg, which to date has been excellent," says Curtis Jensen, a fund manager with Third Avenue Funds and a highly regarded value investor. "It's never really paid to bet against them. But WiTel presents some interesting new twists." Third Avenue, which has owned the shares for "at least" five years, is hanging onto them for now.

What happens next? The NOLs may not be worth much to a buyer, but they're still worth a great deal to Leucadia, which can transfer income-producing assets into WiTel. "You can't take two-thirds of somebody's revenues away and have it go smoothly -- they have an opportunity, but have to move extremely quickly," says Craig Dean, principal at AEG Partners, a bankruptcy restructuring advisory firm.

Willens of Lehman agrees: "I believe Leucadia is in the position of having to acquire something." Last year, it lost a bid for Plains Resources, a pipeline company, and abandoned a takeover bid for MCI. This time, the incredibly shrewd Cumming and Steinberg might need some old-fashioned luck, too.