The Sunday Brief: What's an "In-between" Strategy?
18 June 2012

Greetings from Kansas City and Denver (photo taken a few weeks ago from nearby Fraser), where the rarefied air has us thinking about strategy. It's a great time to be in the telecom and Internet industries, especially if you are the challenger/ disruptor. Everything is fair game when 30,000-100,000 lines of code has the promise to change the world. As Marc Andressen proclaimed in a recent article, "Software is eating the world."

Part 1 of this Sunday Brief is focused on the asset-intensive elements of our industry (telecom, data center, Internet backbone). *Part 2* (to be distributed this week) focuses on applications and value-added services. As the distribution schedule implies, you'll have two opportunities to drink up this week, because next week I'll be camping in the Missouri Ozarks with my son (no Internet for four days – gasp!) and, no matter how many times you hit the refresh key, there will be no Sunday morning email on June 24.

Is it a good time to be a communications infrastructure provider? Clearly, some parts of the industry are in better shape than others. Those who focused on delivering world-class colocation services (e.g., Equinix, Terremark, Telx) have done very well. Without the technological advancements of DOCSIS 3.0, most cable companies would be slashing, as opposed to raising, prices. They, too, have done well. And anything related to providing more bandwidth for the applications that run over mobile devices is yielding terrific returns. This includes both public and private companies such as Zayo, Crown Castle, and tw telecom.

There are bright spots – no doubt about it. But strategic plans are not merely about looking at bright skies and mountain peaks – we have to travel an uneven path filled with rocks, currents, and critters. Our shareholders expect more than a simple averaging of highs and lows. What can the infrastructure world (and specifically the wireless and wireline companies) do to earn sustained long-term returns in excess of their cost of capital?

The first focus of the infrastructure providers should be on the assets and utilization that they already have in place and how they will change over the next 3-5-7 years. This is the mundane, not-sexy evaluation of today's and tomorrow's technology and networks *in each geographic region/ area*.

Think about the assets as having three very broad categories:

1. Ones that exist in densely populated areas (e.g., New York City)
2. Ones that exist in less densely populated areas (e.g., Clinton, MO)
3. Centralized operations that support the distribution of content and communication services to #1 and #2 (a.k.a, the Backbone, the Cloud, and centralized support center infrastructure). These assets are likely in a major city, but may also be placed between cities

If the Finance and Accounting staffs could allocate common costs with pinpoint accuracy, we would likely see that a disproportionate return on invested capital is being achieved in metropolitan areas. They likely consume less backbone per user (especially if the data center and other switching assets reside in the specific city) and they have reached a lower unit cost point because of scale economies. There is also a higher propensity to have business traffic balance consumer usage in the metropolitan areas as well, leading to longer utilization periods and higher returns. Trucks have less “windshield time” and retail (store) economics are better.

Centralized operations, on the other hand, should be viewed as logistics centers that focus on customer experience. Think of it in an extreme example: Suppose Verizon Wireless only had two wireless gateways to access all Internet content. To get sports score refreshes, all traffic needed to travel though a router in New York or Los Angeles. That would be terrific if you were in one of those two cities, but what about rabid sports fans in St. Louis, Chicago, or Houston? It would be a miserable customer experience.

Customer support center placement and strategy is another key consideration. Retail stores functioning as high-cost customer support facilities might delight a few customers (see the Cheyenne example below), but do not make the shareholders very happy. Devices that drive down customer service costs, however, (e.g., the iPhone for Sprint in particular) help to offset the subsidy pain. And third party distributors such as Best Buy and Radio Shack are trying to optimize their overall selling mix to earn as high a return per square foot as possible – wireless support may not be their highest priority.

Wireless and wireline companies who look to the centralized operations as critical brand builders will see future investments much differently. Gateways, set-top boxes, and smartphones that can self-diagnose and communicate through an alternate network if they are not performing to pre-defined specifications are but a few examples of how carriers can reduce call volumes and improve service equations. Equal investment in pre-emptive solutions that cure the disease, and not simply monitored Twitter feeds that treat symptoms, is the prescription for a stronger customer experience. It also plays to the engineering strength of most carriers.

That leaves us with the “in between.” It’s the elephant in the room, necessary for “national network status” but unprofitable. Rather than picking on Scottsbluff, Nebraska (last year’s poster child), we’ll go slightly south and west this year to Cheyenne, Wyoming. This capital city is nestled at the intersection of Interstates 80 and 25. As of the 2010 census, the greater Cheyenne area had a population of 92,000. Approximately 80,000 of them have a wireless device. Even with its proximity to Denver, Cheyenne is home to a lot of network infrastructure. If a smaller, “in between” location could be profitable, it would be in Cheyenne.

Cheyenne is break-even or likely unprofitable, however, because, even with 80,000 devices in service, it cannot cover its minimum level of investment. While this hypothesis might be debated for larger wireless providers such as AT&T and Verizon, justifying a dozen or so towers and five retail outlets in close proximity for Sprint’s 10-12,000 post and pre-paid retail customers (2 Radio Shacks, 1 Best Buy, 1 Walmart Supercenter, and one Sprint-branded store provide by CCT Wireless) is simply not possible. T-Mobile has an equal challenge in smaller cities like Cheyenne, especially since their nearest company stores are in Ft. Collins, CO. Cheyenne’s likely near the end of the list for a 4G upgrade for either provider – being a fast (or even slow) follower to Verizon or AT&T in Cheyenne is a losing proposition.

Why should any carrier tackle “in between” challenges alone? Is there really a case to be made for a carrier-owned competitive advantage strategy in Limon, CO (population 1,880), Hays, KS (population

20,500), Emporia, KS (population 24,150), or even Salina, KS (population 48,000)? Those are the largest population centers between Topeka and Denver on Interstate-70, and Emporia is the largest population center between Kansas City and Wichita on Interstate-35.

Carriers need to rethink the middle, especially with 4G deployments on the horizon. Come together, spin off, but do something to alleviate the shareholder of the "in between" burden. Let others who understand the intricacies of small markets take this risk. It's the greatest single way to unlock shareholder value.

If you have a friend who would enjoy getting this brief, please send an email to sundaybrief@gmail.com and we'll get them on the list. Have a terrific week, and Happy Father's Day!

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