WorldCom: Preliminary Prognosis

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In the May 2002 issue of *BCR*, (pp. 36–40), we concluded that while the Chapter 11 bankruptcy process would give competitive local exchange carriers (CLECs) considerable latitude in reducing onerous contractual and debt obligations, it does little to fix businesses with massively negative EBITDAs.

Fast-forward to July, and along comes WorldCom. WorldCom is a major player, not a CLEC, so its prospects are different. With the caveat that this is a fluid situation with many possible outcomes, here is our prognosis, based on one of the authors' (Weingarten's) experience as a bankruptcy court trustee. (Note: Michael Weingarten is not related to Reid Weingarten, counsel for Bernie Ebbers.)

■ **Sooner or later, WorldCom will need to file for bankruptcy:** Of course, it is possible that WorldCom will do everything in its power to avoid bankruptcy. Having drawn down a $2.65 billion credit line, WorldCom can cover its obligations at least temporarily.

However, we think bankruptcy is inevitable. WorldCom's banks have already filed papers to recover the $2.65 billion, based on fraudulent misrepresentations; other credit lines have been terminated and new ones are unlikely. Trade creditors are moving rapidly to COD terms. By the time this article goes to press, a filing is likely.

■ **The bankruptcy judge may call for a trustee or an examiner:** In most bankruptcies, the company's officers and board remain in possession of the company and its operations, and are referred to as the "debtor-in-possession" (DIP). However, when a bankruptcy judge finds that the debtor is unfit to serve as DIP (credible evidence of criminal activity at the company is a good reason), the judge typically calls for the appointment of a trustee to replace the debtor (on a fiduciary basis). As an intermediate step, the judge may appoint an examiner who doesn't control the company but who is directed to examine what has been going on.

In the case of WorldCom, there is ample evidence to support the appointment of a trustee. It's by no means a certainty, but we wouldn't be surprised to see one appointed.

■ **A trustee will clean house:** If a trustee is named, there will be drastic changes at the top. When you are appointed trustee, you must make certain that key functions are loyal to you and not to prior management. You also need to make the point to all concerned—creditors, vendors, employees—that you are not to be trifled with. So, as soon as possible, you fire top management and replace them with people you can trust and who have no loyalty to the old regime. You also replace your outside auditor (at WorldCom, this originally was Andersen, more recently KPMG) and outside counsel. You then strike alliances with middle management to stabilize operations, offering incentives for good performance.

With a new top management team in place, the WorldCom trustee would conduct a thorough forensic accounting review. This will help the trustee deal with a blizzard of subpoenas from governmental agencies and private lawsuits. It also is needed to facilitate a reorganization or sale of the company at the highest possible price—if prospective investors don't believe the numbers, they will discount their bids substantially.

■ **A trustee or DIP needs to determine which options will result in the highest return to creditors, with lowest risk:** Irrespective of who is in charge, an immediate task will be to diagnose what factors forced the company into bankruptcy and determine the degree to which these are fixable via bankruptcy.

At one extreme, it may be possible for the company to reorganize in its entirety, continuing to operate most if not all of its businesses but jettisoning unneeded contracts and reducing debt obligations pursuant to a court-approved reorganization plan. At the other extreme, the trustee/DIP may determine that the company cannot operate cash positively, even with bankruptcy protection. In such cases, the trustee/DIP would convert the case to a Chapter 7 and liquidate the assets. Or the trustee/DIP may determine that the company's assets are best sold off in pieces.

■ **A Chapter 11 reorganization of WorldCom in its entirety may make sense:** WorldCom is in far better shape financially than the CLECs we looked at in May. Even after we adjust WorldCom's financials for the fraudulent $3.8 billion misstatement, WorldCom had pretax income of –3.1 percent, with positive EBITDA of 17.8 percent. So if we cut expenses by a mere 3 percent, the company breaks even. That's a much easier task than reducing Rhythms' costs by a factor of nine or 10.

Is breakeven in the cards? With the caveat that we have limited detail on company operations and there may be more hidden bombshells, back-of-the-envelope calculations suggest that successful reorganization is possible.

Paradoxically, one reason for optimism is the $3.8 billion expense pool. If, as has been suggested, the $3.8 billion represents five quarters of long-term contractual obligations for capacity that WorldCom had not used, then in bankruptcy, it should be a straightforward process to reject most or all of these obligations going forward.

Let's assume, for example, that some portion of the $3.8 billion consists of 20-year dark fiber indefeasible rights of use (IRU) leases or similar arrangements entered into in 1999 during the dot-com euphoria. At this point, these leases would run for an additional 17 years at a contractual price probably 10 times higher than today's market, for capacity that WorldCom apparently doesn't need.

In Chapter 11, the company has the power to reject the contracts, and the remaining 17 years of IRU obligation are then computed on a net present value basis, and converted into a pre-bankruptcy petition for an unsecured claim on the company. As a result, this expense obligation is extinguished from the P&L going forward.

The impact of rejecting these unwanted leases could be sizable. The $3.8 billion incurred over five quarters translates

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into $3 billion per year, and is 8.9 percent of WorldCom's sales. At the extreme, if we can reject all these long-term contracts (this undoubtedly is overly optimistic), then pretax earnings go from –3.1 percent to +6 percent. EBITDA goes from 17.8 percent to 26.7 percent. Not bad for a legal maneuver.

In addition, let's assume that there are outstanding leases for capacity that WorldCom does need, and which may not be part of the $3.8 billion pool. If the current market price for this capacity is, say, one-tenth the value at the time of the contract, WorldCom might be well advised to reject these contracts as well, and enter into less-costly new contracts.

Interest payments probably also will be reduced as the result of a bankruptcy reorganization. WorldCom's current interest expense is 5 percent of revenues. In any reorganization, we anticipate that the note holders and bank lenders will end up converting a substantial portion of their debt into equity. This would reduce WorldCom's interest payments proportionately.

In conclusion, WorldCom looks to be tailor-made for a bankruptcy fix, using the power of the bankruptcy process to reject contractual obligations

■ **Selling the Company May Also Be Attractive:** Alternatively, one could sell WorldCom as a whole. The purchasers with the deepest pockets are the RBOCs. Their potential concerns about antitrust and long-distance approval must have been eased somewhat when FCC chairman Michael Powell told the *Wall Street Journal* that he would favor waiving regulatory hurdles to deal with what he saw as an emergency situation. This makes bidding on WorldCom much more attractive to SBC, Verizon or Bell South: On top of buying assets, customers and tremendous scale advantage, an RBOC buyer would gain a huge regulatory victory in the bargain.

Will the RBOCs make bids high enough to justify selling rather than reorganizing? It is certainly in their financial power to make an offer that creditors can't refuse. It will be interesting to see if the FCC and Justice Department give them the hunting license to do so.

As of press time, however, we believe that reorganization probably would generate a better return than selling the company. If WorldCom can be reorganized in a manner that lets it run profitably, its market cap could rebound to as much as $40 billion (it was worth $35 billion as late as January 2002).

In contrast, bidders for telecom service provider assets have become accustomed to paying 5–10 cents on the dollar for assets. For WorldCom's $100 billion of assets, this means bids on the order of $5 billion to $10 billion. With a bidding war, maybe this would rise to $20 billion. That's nice, but not as much as the potential upside to a reorganization.

■ **Selling divisions piecemeal is problematic:** The basic rationale for holding separate auctions for different parts of a company is a belief that there are different purchaser categories that want different assets, so splitting up the company into piece parts will maximize creditor value. We don't believe this is the case with WorldCom.

A logical breakup would separate WorldCom into three pieces: consumer voice, business voice, and local access (MFS/Brooks) plus data (UUNet).

Numerous parties probably would be interested in the UUNet/MFS/Brooks operation. However, it is unclear that the MCI consumer/small business voice division would attract a lot of attention. The business is running at breakeven (even before restating for the effects of the $3.8 billion pool). It therefore won't be worth much to anyone—particularly since consumer LD is considered to be a declining business.

Business voice probably would be of greatest interest to the ILECs, but they probably would prefer to bid on the company as a whole. As a result, the bids for business voice probably would be relatively low.

Net-net, we don't believe that piecemeal division will result in a much higher aggregate bid than selling the business as a whole—and could potentially be even less than an RBOC bid for all of WorldCom.

Now For The Bad News

So far, we've focused on the good news. The downside is that shareholders will get hurt. Depending on the ability to reorganize successfully, WorldCom will probably be worth $10–40 billion in the near future. Against this, we have noteholder/bank debt of $30 billion, and trade payables of perhaps $5 billion currently plus an additional $10 billion after rejection of contractual obligations, with shareholders who thought their shares were worth $35 billion last January. Altogether, that's $80 billion of claimants for a piece of WorldCom—substantially more than the company is worth.

Interestingly, WorldCom does not appear to have any significant level of secured debt. The bondholders are not secured, and surprisingly, neither are the bank lenders. Therefore, we have $35 billion–$45 billion unsecured claims on the company that might return 10–15 cents on the dollar in the case of a liquidation, and a much higher payoff (but still less than 100 percent) if there is a successful reorganization.

Given the large amount of outstanding claims, augmented by the need to reject contracts as a part of reorganization, we don't see how there will be much left to give to shareholders (which is why the shares were trading at 12 cents a share as of mid-July). Key employees will do better. To retain talent, the company will need to issue new stock warrants replacing the old worthless ones.

Conclusion

Net-net, we're cautiously optimistic about the prospects for WorldCom, but we also see the possibility for a great deal of damage to shareholders. The biggest uncertainty is the inability to foresee what other bombshells are still out there that we don't know about.

That having been said, a WorldCom bankruptcy would be charting new territory for the telecom industry. Until recently, we really never had telecom bankruptcies; our service providers were too well-funded to fail.

The recent CLEC bankruptcies were sufficiently small that a white knight with cash could dictate terms relatively quickly and easily. In contrast, WorldCom will be a good old-fashioned brawl, with lots of fights taking lots of time. WorldCom is likely to be a nasty case that could take a couple of years before a reorganization plan is confirmed.

Assuming clever management, however, the outcome could be positive. We wish the employees of WorldCom (at least the honest ones) all the best□

Companies Mentioned In This Article

WorldCom (www.worldcom.com)
Arthur Andersen (www.andersen.com)
KPMG (www.kpmg.com)