EYE ON THE STREET
Every Thursday

Broadband battle could halt tech stocks' climb

NEW YORK — Onward and upward, the Nasdaq is back on its blissful record-setting trajectory again, as though investors in its fabulous tech stocks will never have another worry.

The index has not even dipped as much as 10% this year to rest after 1999's 86% climb or fret over Fed Chairman Alan Greenspan's rising concern over speculation and surge of paper wealth.

By David Henry

Sure, it feels good to imagine the trend continuing, but logic says the future won't always be so smooth. What might go wrong, aside from an economic slowdown or unpredictable political or financial shock? A sudden cooling and breakup of hot stocks in a key tech sector, such as broadband telecommunications.

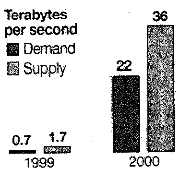
A plausible scenario for just that is clear if you can escape the fever for fiber optics for a minute. What is shaping up is a bloody price war among long-distance broadband carriers who are customers of fiber-optic equipment companies such as JDS Uniphase, Sycamore, Corning, SDL, Nortel and Cisco. If the carriers are wounded in the war, they'll cut back on orders. The cutbacks wouldn't necessarily be devastating to the equipment companies. But the slightest hiccup in revenue could be awful for their stocks, which have been bid up as though nothing will ever go wrong.

Ironically, the odds of a brutal price war are being increased by technological advances of the equipment companies, the same advances that have made the stocks' stories sparkle. The equipment includes new generations of fiber and devices that break up beams of light into colors and send them over longer distances with fewer amplifiers, dramatically increasing the carriers' capacity and the chances for a glut of bandwidth.

Indeed, no new infrastructure has ever been built with the cost of additional capacity falling as rapidly as for the Internet backbone. One carrier, Level 3 Communications, says its cost of moving bits of information is falling 80% a year. The firm plans to win business by cutting prices ahead of its competitors again and again.

Price pressure

Demand for long-distance telecommunications capacity is expected to grow dramatically, but so is supply. Expect predatory pricing by carriers to upset investors, delight customers.



Source: Renaissance Strategy, Boston

By Quin Tian, USA TODAY

The result: "There is going to be a lot of red ink in the industry," says P. William Bane, a telecommunications consultant with Mercer Management, who accurately foresaw similar overbuilding in wireless communications capacity five years ago.

If you want to hear the predatory plans of Level 3, go to www.level3.com and listen to CEO Jim Crowe's discussion with stock analysts of "Silicon Economics." He plans to be a victorious low-cost producer who keeps installing the latest lasers and pushing the latest fiber through tubes that his company has buried all over the nation.

Sure, demand will increase as the carriers cut prices. But the journey to eventual balance with supply is full of pitfalls for the stocks involved. While supply of Internet backbone is being added with technological ease and low cost, the tools to enable potential demand are lagging, Bane says. Fiber pipes are one thing, but "it is going to take some years for the new software architecture to be put in place" in an installed base of computers and appliances that will use the supply to make video conferencing, video-on-demand and virtual tours of houses commonplace. Also, the demand is being held up by slower technological development of the "last mile" between the Internet backbone and business and residences.

Roger Wery, who knows the carriers through his consulting work at Renaissance Strategy, says, "In private, the bottom line is that everybody is keen to generate the killer combos of applications (of bandwidth) to fill those pipes." Just how much of a glut develops depends on how aggressively carriers light fiber. At a minimum, he expects "drastic reductions" in pricing and stops and starts in equipment orders.

Equipment companies might be able to ease some of that volatility if they can get orders from Asia and South America, Wery says. Europe is already being criss-crossed with fiber.

Before long, the equipment stocks will be as risky and volatile as those of suppliers to the cyclical semiconductor industry, says Fred Hickey of *The High-Tech Strategist*. "The orders can just stop," he says. Stocks will plunge, and the shares of companies that do not come up with the next generation of equipment won't recover. And, perhaps some investors will remember that once upon a time investors did not pay premiums for companies at high risk of obsolescence.

Insurer, Dutch bank bid for Aetna

Wellpoint, ING behind $10B deal

By Julie Appleby
USA TODAY

A California health insurer and a Dutch investment bank are making a bold bid to take over Aetna US Healthcare.

Wellpoint Health Networks and ING Group made the $10 billion cash-and-stock offer to Aetna's board last week, the day before Aetna's CEO resigned in the face of declining stock value.

Aetna confirmed the offer Wednesday, but said its board is reviewing the proposal.

If the deal goes through — and one consumer group says it will appeal to the Justice Department to block it — Wellpoint would become the nation's largest health insurer, with more than 28 million customers.

Dutch investment bank ING would take over:

▶ Aetna Financial Services, which sells retirement and investment products, and

▶ Aetna International, which sells life, health and financial services in emerging markets.

At about $70 a share, Wellpoint and ING would be getting a bargain, analysts say.

After all, Aetna paid $8.9 billion just for U.S. Healthcare in 1996.

"(Wellpoint) would get a good price and a tremendous business platform," says Greg Crawford, analyst with Fox-Pitt Kelton in New York.

Aetna's shares rose 11⅞ Wednesday to $53. In May, Aetna stock was nearly $100, but its price has fallen sharply in recent weeks.

Wellpoint fell 5⅝ at $61⅞.

Both companies have critics. Aetna has been lambasted by doctors for what they say are restrictive contracts and miserly payments.

Like other insurers, it has been hit with patient class-action lawsuits.

Some hospitals have criticized Wellpoint for not paying them enough.

Jamie Court of Consumers for Quality Care says his organization will ask the U.S. Justice Department to block the deal, saying it will reduce choice for patients, employers, doctors, nurses and hospitals.

"This deal would mean that the seven giant companies that control this market would be reduced to six," Court said.

Worries about market share dominance caused the Justice Department in June to order Aetna to sell business in Texas in order to complete a $1 billion merger with Prudential.

The current offer would give Wellpoint access to a broader range of products.

About three-quarters of Wellpoint's 7.3 million members are in preferred provider plans, which have fewer restrictions than HMOs.

Aetna has about 21 million members, with about half in health maintenance organizations, which have stricter rules.

Contributing: Del Jones.

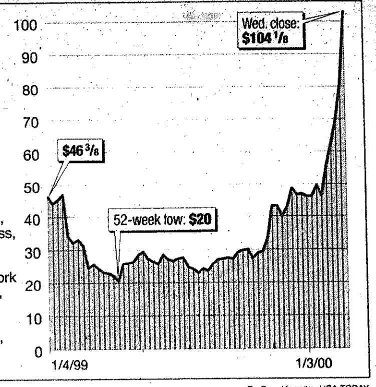
3Com plan: Divide, conquer

Uphill battle coming after Palm spinoff

By Deborah Solomon
USA TODAY

About 3Com

Headquarters: Santa Clara, Calif.
Chairman and CEO: Eric Benhamou
1999 revenue: $5.8 billion
1999 net income: $404 million
1999 employees: 13,027
Stock symbol: COMS
Description: Computer networking products
Products/services: Broadband access, business telephone systems, cable access, carrier class IP telephony, consulting services, home networking, hubs, modems, network interface cards, network management & control, networking kits, notebook PC cards, remote access, routers, service and support, switches, terminal servers, video communications, wireless solutions



Sources: www.investor.com, 3Com, www.hoovers.com

By Gary Visgaitis, USA TODAY

PALO ALTO, Calif. — As 3Com prepares to spin off its Palm Computing division today, investors are snatching up the stock of the parent company, boosting its price to more than $104 a share Wednesday.

That's in sharp contrast to where 3Com traded just seven months ago. Then, it hovered around $23 while its closest competitors, Cisco Systems and Nortel Networks, dazzled the market with strong earnings and lofty stock prices.

Since then, 3Com's stock has soared more than 350% as investors scrambled to get a piece of the company, which will own 90% of Palm stock for about six months. After that, 3Com plans to distribute Palm shares to 3Com stockholders and no longer own a piece of the hand-held computer firm.

While the IPO, priced Wednesday at a higher-than-expected $38 a share, is giving 3Com a boost, industry watchers say there are underlying problems with the company's business.

The company faces significant challenges in its core networking business and has been rapidly losing market share to competitors. Inventory problems, slower-than-expected sales and falling prices for some of its main products have plagued 3Com.

It had a disappointing second quarter, reporting a decrease in sales for its two main business lines and positive growth in just one: sales of Palm hand-held computers. Network systems, such as switches, hubs and routers, fell 12% from the same quarter a year earlier, and sales of personal connectivity devices, such as modems and network interface cards, fell 14%.

Company officials have warned investors of sluggish sales for the near future.

The slowdown for 3Com comes at a time when networking firms are experiencing blockbuster growth, as customers snatch up products for next-generation networks.

Cisco has recorded eight straight quarters of more than 40% growth, and rivals such as Juniper Networks are valued in the tens of billions of dollars.

The Palm spinoff should help 3Com refocus on networking, but industry watchers say the company has to go after high-growth markets to survive.

Its success has been hampered by delays in shipping equipment, such as its high-speed switches, and dependence on older technology products, such as analog modems, which have seen their prices slashed in recent years and sales flattened. While consumers used to buy expensive modems off the shelves, most computers now come bundled with a 56K modem, which 3Com sells to PC makers for a much lower price.

Many in the industry say 3Com's woes began with its $7.3 billion purchase of U.S. Robotics, which it bought in 1997 for its modem and network interface card business. It got the Palm division as part of the deal, but the merger "created a lot of indigestion" as the two firms tried to mesh, says Michael Wolf, networking analyst with Cahners In-Stat.

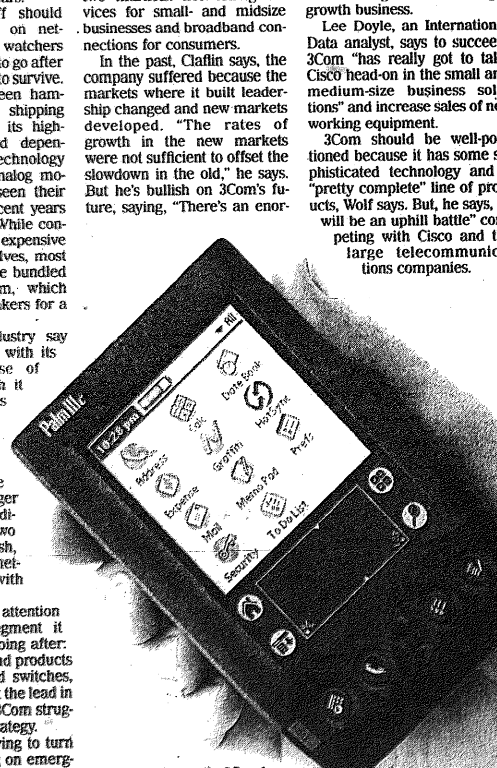
It pulled 3Com's attention away from the segment it should have been going after: high-margin, high-end products such as routers and switches, Wolf says. Cisco took the lead in that market, while 3Com struggled to define its strategy.

Now, 3Com is trying to turn the tide by focusing on emerging markets with strong growth and is targeting two markets: networking devices for small- and midsize businesses and broadband connections for consumers.

In the past, Claflin says, the company suffered because the markets where it built leadership changed and new markets developed. "The rates of growth in the new markets were not sufficient to offset the slowdown in the old," he says. But he's bullish on 3Com's future, saying, "There's an enormous opportunity to leverage the surviving 3Com" into a high-growth business.

Lee Doyle, an International Data analyst, says to succeed, 3Com "has really got to take Cisco head-on in the small and medium-size business solutions" and increase sales of networking equipment.

3Com should be well-positioned because it has some sophisticated technology and a "pretty complete" line of products, Wolf says. But, he says, "it will be an uphill battle" competing with Cisco and the large telecommunications companies.



Lucent to spin off network division

By Shawn Young
USA TODAY

NEW ORLEANS — Lucent Technologies is spinning off its slowest-growing division in a bid to repair its damaged stock price and focus on the more glamorous and promising parts of its telecommunications equipment-making business.

Lucent said Wednesday that it will split off its enterprise networking division — which includes its company switchboard, or PBX, operations; Systimax, which makes cabling systems for corporate campuses; and its local-area network, or LAN-based, data business.

That division brought in about $8 billion of Lucent's $38 billion in revenue last year and does business with 90% of *Fortune* 500 companies. But it has been growing at about 8% a year, making it a laggard compared to other parts of Lucent. Lucent shareholders will get stock in the new company by Sept. 30.

Says Paul Sagawa at Sanford Bernstein:

"This is spectacular for Lucent shareholders. . . . It makes the remainder of Lucent a true growth stock."

Lucent CEO Richard McGinn says the growth rate of the networking division and "not in line with Lucent's high growth opportunities." He says the new company, which has no name yet, will be better off on its own because it can focus on its own market and set its own priorities.

It competes for research and development money and other resources with fast-growing and alluring projects such as optical networking and wireless communications.

Shares of Lucent, the most widely held stock in the US, rose 8¾ to $68⅝ Wednesday. The shares until recently had hovered in the $50s after the company reported disappointing first-quarter earnings.

Skeptics say Lucent still too focused on older technologies and its growth rate in recent years is not sustainable in the future. Adds analyst Gregory Geiling of J.P. Morgan: "The pop in their today stock largely unjustified," because