

MCI COMMUNICATIONS CORPORATION

Introduction

In 1982, the Justice department ordered the separation of ATT into local subsidiaries. MCI was one of the main competitors of AT&T and the impact of this new competition on MCI was uncertain. In this case the financial impact of this increased competition will be analyzed.

Analysis of External Financing Needs for MCI from 1983 to 1989

Please see **Exhibit 1 and Exhibit 2**

MCI's external needs will keep increasing over the next few years as the operating margins would shrink because of higher competition & higher access charges. In order to increase its market share, MCI would need to continue investing huge capitals in its network. As per *exhibit 9* of the case, it is anticipated that MCI will increase its market share to 20 % in the next 6 years. The telecom industry is very capital intensive and in 1983 required \$1.15 worth of investment in fixed plant & equipment for each extra \$1 of revenue; that is first you have to build the network before you can sign up customers.

The operating margin is expected to stabilize at 15% by 1990. But they are expected to vary substantially based on competition. It can go up to 22% or go down to 8%.

Types of securities which were issued by MCI (1972-1983)

1. Common Stock
2. Common Stock with warrant
3. Convertible cumulative preferred stock - Cost Around 12.27
4. Debentures – Cost around 15%
5. Convertible debenture – cost around 10%

MCI initially issued equity in 1972 and later it started issuing debentures & convertible debentures. This was because the cost of equity is highest. MCI relied on debentures for a while and then convertible debentures which had lower cost of capital. As its equity stock price continued rising, it converted the convertible debentures to common stock thereby increasing its equity & lowering its liability. This allowed MCI to raise further capital in the future. The convertible bonds provided a cost effective way for MCI to finance a sequence of major capital investments. It allowed MCI to match capital inflows with expected investment outlays. Once the stock price rose MCI forced the conversion and

eliminated the cash flow drain from servicing the debt. The new infusion of equity can in turn be used to support additional debt or convertible financing. For example-

- MCI issued 100 million convertible offering in 1981 with a conversion price of 12.825 while the current price at that time was 10.875.
- By Feb'1983, the stock price had gone above 12.825 and MCI called for conversion. It reduced its leverage.
- It used this new infusion of equity to raise \$400 million in the new convertible offering at conversion price of \$52.

This strategy worked for MCI because it was unable to satisfy its demand for huge capital from the investment grade bond markets (it had no previous track record) or from regular banks. Raising more equity would have diluted the value for existing share holders and the cost of equity would have been very high. The convertible offerings were accepted by investors at a lower coupon than straight bonds because they could get capital appreciation if the MCI stock price goes up.

Analysis of Historical and Proposed Capital Structure

In April 1983, the telecom industry was going through major regulatory changes. AT&T was being divided into smaller companies and equal network access costs were being established. MCI had a good opportunity to increase its market share.

Please see **Exhibit 3** for detailed analysis of Historical and Proposed Capital Structure

It also faced *severe financing challenges*.

- Raising more equity would have diluted the value for existing share holders and the cost of equity would have been very high.
- Raising debt from the investment grade bond markets was not feasible as it had a high leverage of 55-60% and it also did not have a previous track record in the bond market.
- It had already exhausted most of the lines of credit with commercial banks.
- It was using convertible debenture offerings sequentially, to raise capital and infuse equity at a point in future by forcing conversion.

Based on the above points, I recommend that MCI should continue to maintain its historical capital structure of 55 – 60% debt.

Risk with MCI's Capital Structure

The risk with this structure is that in face of increasing competition, its high leverage will limit its staying power. Increasing competition may lead to excess capacity and thereby decreasing the profit potential. In such a scenario the value of bonds will drop sharply and cost of borrowing will go up significantly, making it very difficult to raise new capital. So even if MCI has a very solid strategy for competing against AT&T, its growth may be severely restricted due to capital constraints.

MCI still had to maintain its current capital structure, in 1983, because the bond markets were not receptive to speculative companies. As per *exhibit 8* of the case, it does not have a bond rating at this time. The convertible bond offerings allowed MCI to raise capital now and convert it to equity at a later stage. Its interest coverage in 1983 is 4.2, in comparison to 3.64 AT&T and 2.4 for GTE. After it has increased its market share, MCI can then strive to gain investment grade status by slowly reducing its leverage.

Analysis of Financing Alternative Financing Option for MCI in 1983

Current stock price in April 1983 is \$47.

Please see **Exhibit 3** for an Analysis of Financing Alternative Financing Option for MCI in 1983

(a) \$400 Million Common stock –

- This option would be the *costliest* for the CFO of MCI. Raising more equity would dilute the value for existing share holders and the cost of equity would be very high.
- Please see **Exhibit 3**.

(b) \$500 million of 12.5% 20 year subordinated debentures –

- Cost of debt in this case is 12.5% though MCI can raise \$ 100 million more with this option in comparison to option (a) above. Servicing this debt would be a significant *drain on the cash flow*.
- Please see **Exhibit 3**.

(c) \$600 million Convertible offering @ 7.625% 20 year with conversion at 54 per share

- Using this option MCI can raise \$ 100 million more than option (b) at 4.88% lower rate of interest. It also gives MCI an option to convert it to equity once the stock price reaches 54 (it is currently 47). Based on previous convertible offerings (As per exhibit 6 of case, 1978, 1979, 1980, 1981 and 1982), MCI has been converting it to equity within 18 months because of its high growth. As higher growth is projected for the next few years (*Exhibit 9* of case), MCI is expected to convert this \$600 million offering to equity, thereby reducing its leverage.
- This option allows to finance its current activities and match capital inflows with expected investment outlays in the near future. It also allows MCI the option to eliminate the cash flow drain from servicing the debt once the stock price increases.
- As per **Exhibit 3 attached here**, this offering will provide capital to meet the external financing needs for 1983.

Recommended Financing Alternative

(d) \$1 billion 10 year debenture @ 7.5% with 18.18 warrants at \$ 55 exercisable until 1988.

This option would provide MCI with capital financing for the next 2 years as per Please see **Exhibit 3 and Exhibit 4.**

- The coupon rate is 0.125 lower than in option (c)
- It allows MCI the option of converting it to equity by virtue of *the warrants* which are exercisable until 1988 @ \$55. In addition MCI *can also call these* warrants earlier if the stock price reaches \$55. Similar to option (c) above, based on the growth projections MCI is expected to convert it to equity in the near future and thereby eliminate the cash flow drain from servicing this debt.

Based on the above four alternatives, ***MCI should use the option (d)*** as it provides *more financing* and the *convertible option* thereby *improving its leverage*.

As per the case, the \$47 is the stock market price in April 1983 of the MCI stock.

Assuming that the stock price goes above \$53 by June 1984 (Previous MCI conversions have taken place with-in 18 months), MCI can retire the Mar 1983 Convertible offering of \$400 million at 7.75 in June 1984.

As per Exhibit 3, it will improve its Debt to equity ratio to around 48% to 55% (Line16, Line 18).

IF the company continues to grow and the stock price rises to \$55 by Nov 1985, then MCI can convert this \$1 Billion offering to equity and improve its debt ratio to 20 % (Line 18 – Exhibit 3)

MCI is facing a very competitive environment where a number of new entrants are competing for market share in a capital intensive industry. MCI faces the risk of using excessive leverage, which may cause financial problems later. Excess capacity built by other players may cause the profitability to go down or a stock market crash will excessively increase their cost of borrowing. A change in management may also cause loss of market credibility. The company will have to be very focused on its leverage position. It should improve its leverage as soon as its stock price grows and operating revenue grows enough to allow internal funds for further investments.