

Winnick's Voyage to the Bottom of the Sea

By ANDY KESSLER

Those who forget history are doomed to testify before congressional committees, and the execs at Global Crossing Ltd. are the latest to earn that dubious distinction. Move over, Enron. Amid allegations of sales fraud and accounting irregularities, the House Financial Services Committee opens hearings today on the accounting practices of everyone's favorite fallen telecommunications giant.

Where did Global Crossing go wrong? The first mistake made by its chairman, Gary Winnick, was to neglect to study the last guys who raced to lay undersea cables—for telegraphs in the mid-19th century. If he had, Mr. Winnick would have realized his venture was flawed from the beginning.

Telegrams

After undersea telegraph messages were first sent between Newfoundland and Ireland in 1866, a half-dozen companies sprang up to relay messages between London and Paris and New York. Half the traffic was for stock trading. These companies charged up to \$5 per word and could transmit 15 to 17 words a minute. Each thought it could generate revenues of \$5 million or more per year. It was easy to raise the \$2 million it took to lay undersea cable and investors, who constantly dashed off telegrams themselves, were all too happy to lend money. Sound familiar?

Unfortunately, it didn't take long for the invisible hand of capitalism—in this case Neptune's invisible trident—to send prices plummeting. There were sharks in the water, and a lot of otherwise strong swimmers never made it ashore.

Nearly 130 years later, a buyout firm, Pacific Capital Group, was presented with a similar deal to finance 8,000 miles of cable between the U.S. and Europe. Not just any cable—Atlantic Crossing 1, or AC-1 as it was called, would use "erbium-doped amplifiers driving wave division multiplexed fiber-optic lines" that could handle 40 gigabits of data each and every second. Pretty cool for 1997. Back then, a T-1 line (1.5 million bits a second) between New York and London cost \$10,000 to \$20,000 a month; L.A. to Seoul was closer to \$50,000. AC-1, at a cost of a few hundred million dollars, could handle the traffic of 10,000 T-1 lines, potentially generating revenue of \$100 million a month.

Pacific Capital was run by none other than Mr. Winnick, a sales guy and cash-flow junkie from Michael Milken's junk-bond crew at Drexel Burnham Lambert. James Stewart, in his book "Den of Thieves," quoted Mr. Milken as asking Mr. Winnick from their office in Century City, Calif., "What do you think it'd cost to buy every building from here to the ocean?" Mr. Winnick wanted to buy the ocean too, and his spreadsheets screamed "Buy," so Global Crossing was founded and AC-1 built.

When you buy out underwear companies or food-processing factories, prices don't change that much. But telecom prices, at least those freed from regulation, always drop. Mr. Winnick was lulled into a false sense of return by a simple regulation, from 1921 no less, that authorizes the Federal Communications Commission to license undersea cable rights. His ace in the hole? He owned licenses for half the traffic.

Figuring he'd need them down the line, Mr. Winnick enticed union leaders and heavyweights in the Democratic Party, most notably Terry McAuliffe, now chairman of the Democratic National Committee, to invest early and often. The strategy worked; he raised \$400 million in Global Crossing's initial public offering and never looked back. Then came his big mistake. Thinking prices wouldn't drop, he ramped Global Crossing up, borrowing billions to crisscross the globe with fiber. Dumb move. He was now trapped in his own debt.



Ismael Roldan

Gary Winnick built Global Crossing on overhyped dreams about the value of undersea cables. If only he'd studied the mistakes of 19th century cable businesses.

Internet traffic did boom: Europeans and Asians began downloading pictures of Anna Kournikova from Yahoo's servers in Sunnyvale, Calif.; PC users in India began calling their families in the U.S. using Internet telephony, the data calls being carried by Global Crossing. Life was good.

The heavy debt, though, meant Global Crossing couldn't cut prices without running the risk of either failing to cover its debt or being unable to raise more capital. Unhappy with the pricing of Global Crossing, AT&T and MCI formed a joint venture to run undersea cable for their own networks. This was the beginning of the end for Global Crossing. From that point on, Mr. Winnick went into stall mode. He started using his \$47 billion market capitalization to buy companies with real cash flow. For good mojo, he spent \$885 million to buy the Global Marine unit from Cable & Wireless, which dated back to the first undersea telegraph cable in 1851.

He then set his sights on buying a real phone company. Qwest beat him to U.S. West, so he paid \$11 billion for Frontier, a phone company in Rochester, N.Y., where the closest body of water is the Genesee River. But now that Global Crossing had a regulated utility with supposedly protected

prices and measurable cash flow, Wall Street poured capital in—\$20 billion before it was all over. And the trap closed tighter.

In 1999, Mr. Winnick hired an ex-Justice Department antitrust biggie and wife of a senator, Anne Bingaman, and paid \$2.5 million over six months to do anti-trust work to lobby away competition. The effort failed, although it wouldn't have mattered.

Late that year, the FCC updated the Submarine Cable Landing License Act, streamlining approval. Since then, trans-Atlantic and trans-Pacific capacity has increased 20-fold. Global Crossing once controlled 50% of U.S.-to-Europe traffic; now it barely controls 15%. Same for the Pacific. That T-1 line between New York and London? Under \$1,000 a month today. You might still build AC-1 today, but your expected return would be a lot lower.

Up to this point, Global Crossing's problems were pretty run-of-the-mill for ambitious start-ups—a flawed idea, bad spreadsheets, gullible investors, greedy investment bankers and excessive Wall Street optimism. I was as guilty as the next investor; I owned equipment companies that sold to Global Crossing. Stupid me.

But then to get out of his jam it appears that Global Crossing got really desperate. Enron-like, the company concocted fake revenues to appease the Street. Global Crossing swapped parts of its network capacity with other carriers like Qwest and EPIK Communications. Each reported revenue immediately and wrote off the new expenses over 25 years. These transactions were cashless, with no economic value. Their accountants would never agree to that, would they? Arthur Andersen gave its blessing. Did Mr. Winnick order this, or was it his revolving door CEOs who know, who cares? He ran the company and he's going down with the ship to where his cables lie on the ocean floor.

Gruesome Ending

The ending was gruesome. When Global Crossing filed for bankruptcy in January, it listed assets of \$22.4 billion and liabilities of \$12.4 billion. At first blush that might look like \$10 billion in value, but most of the assets were worthless goodwill from overpaying for all those acquisitions. Mr. Winnick personally did just fine: He sold \$735 million in stock. But the company carcass is down to bones, and you can count on the class-action sharks and senators to follow the trail of blood until they devour Mr. Winnick as well. Not even Johnnie Cochran can save him now.

This is not to suggest that Global Crossing and the rest of the telecom industry are doomed to penury. The challenge is to make money while costs are dropping 50% per year. It's do-able: Intel thrives in another industry (microchips) with rapid declines in prices.

So too someone will buy Global Crossing out of bankruptcy and do quite well with it. The second or third person to own a hotel makes money. The trick is to match capacity with demand. And demand is vibrant today: Internet traffic keeps doubling, albeit at prices much lower than Mr. Winnick's overly optimistic cash flows projected.

Mr. Kessler, a former hedge-fund manager, is writing a book on technology and markets.