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# WHY AT&T ISN'T CLICKING

A slow start in the information business is spoiling its triumph in long distance

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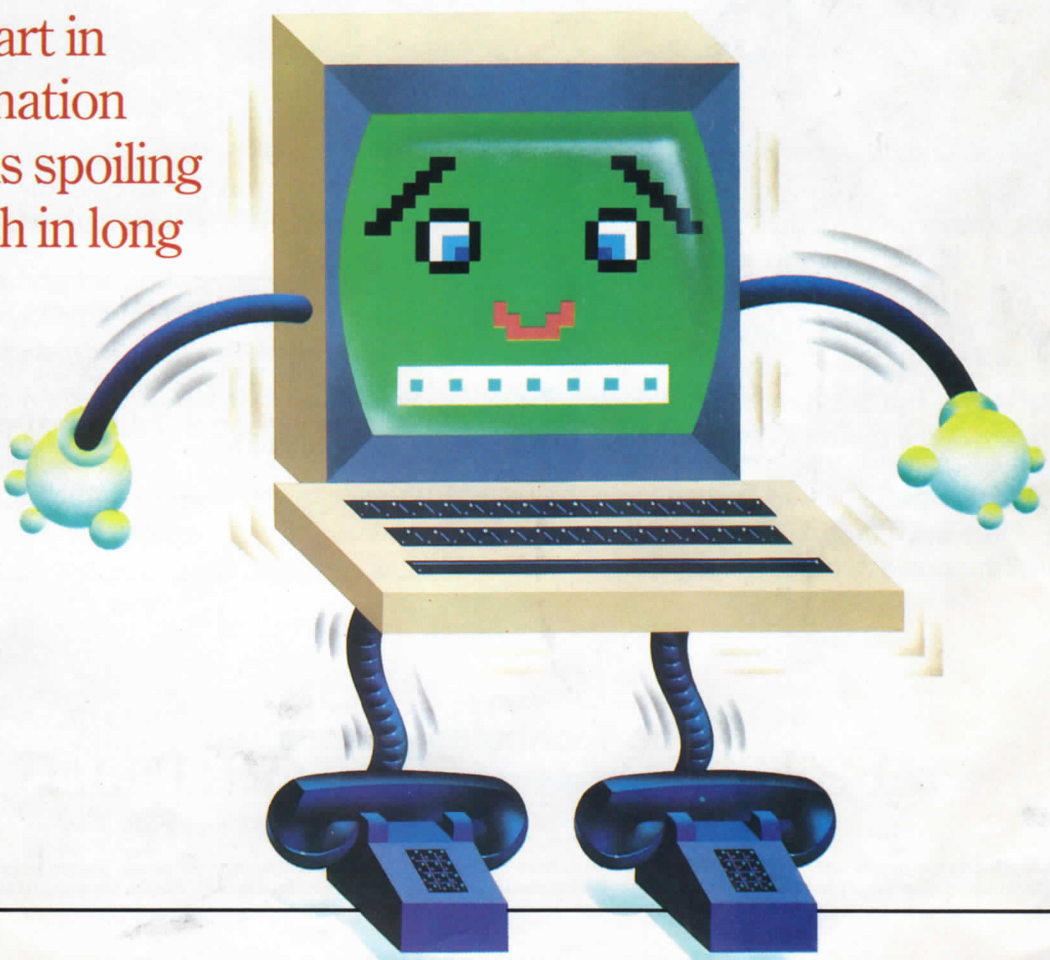


Cover Story

# WHY AT&T ISN'T CLICKING

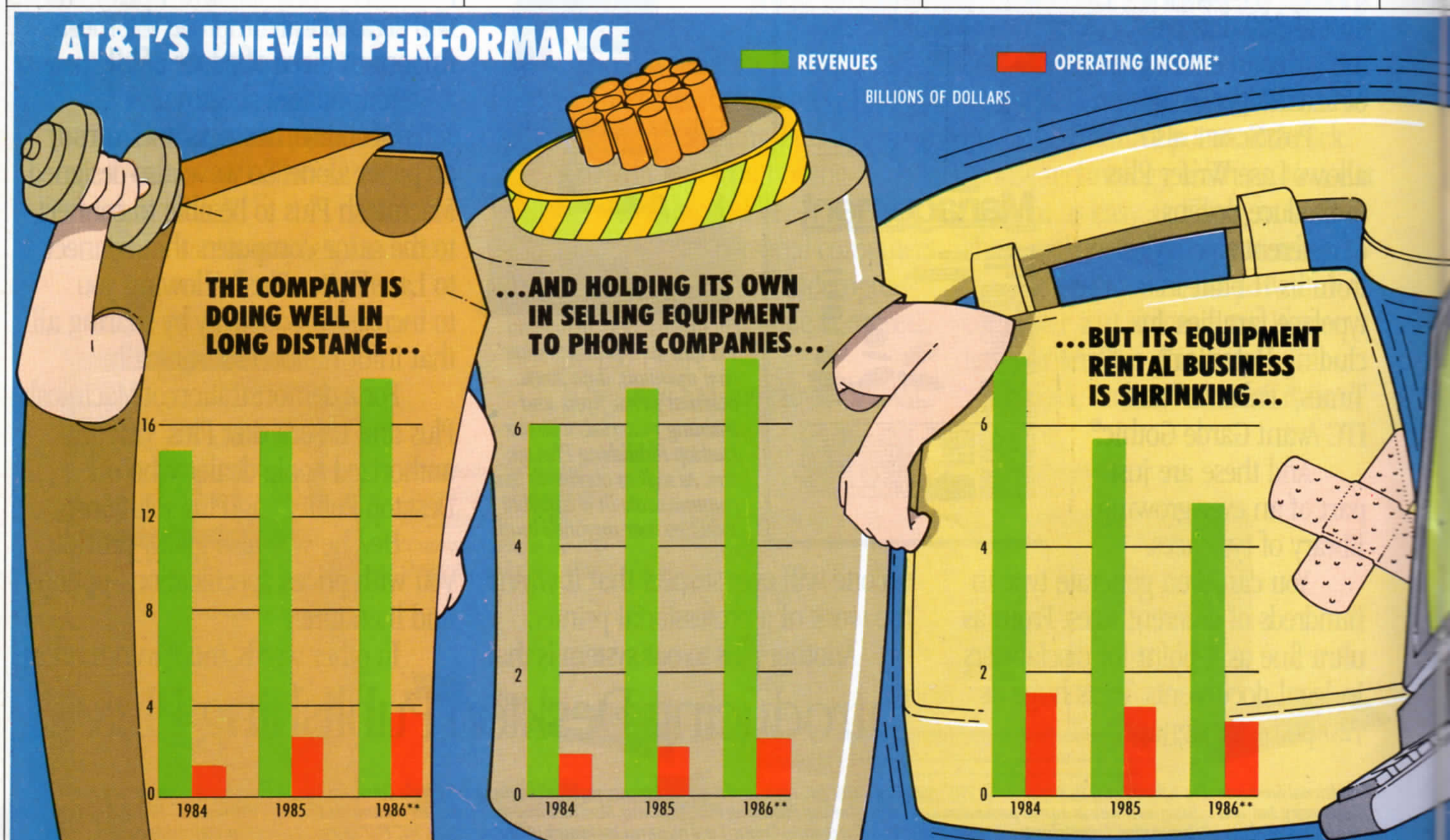
## ITS FLASHY NEW INFORMATION BUSINESSES ARE DRAGGING DOWN PROFITS

Talk about a hard sell. Instead of old magazines strewn on a coffee table, visitors to AT&T's divisional headquarters in Berkeley Heights, N. J., are entertained by futuristic color TV monitors placed next to nearly every seat in the lobby. Each of the touch-sensitive screens promotes American Telephone & Telegraph Co.'s technological prowess. Press a spot on one and discover the wonders of the 3B20D, a minicomputer that "never stops working." Press another and learn about the world of Unix, AT&T's much-heralded computer software system. The message is clear: AT&T is now a high-tech powerhouse, not just a big utility.

Yet AT&T's results tell a far different story. Its regulated long-distance operation is stronger than ever. In the two years since its breakup, AT&T has also continued to do well selling equipment to the Bell phone companies. But the part of AT&T that was supposed to lead the $35 billion company to new heights is instead dragging down these traditional businesses. Sales of computers and phone systems to businesses and consumers racked up estimated operating losses of $1.6 billion in 1985, and profitability seems years away. Overall net earnings, projected by AT&T at $2.1 billion for 1984, fell far short that year and in 1985. In brief, it's turning out to be a lot harder than anyone expected for AT&T to transform itself into an Information Age superstar.

Part of the reason is bad timing: AT&T moved into computers just as the industrywide slump started. More troubling, it has been slow in learning to think like a free-market competitor. Its costs are too high. And many staffers say the company seems directionless.

**GLACIAL PACE.** Even AT&T's rosy first quarter betrayed its problems. The 50% profit increase was from long distance and a change in pension-fund accounting. Margins on product sales fell substantially. "AT&T is in real trouble, much graver than people realize," says a former high-level executive, an AT&T veteran who seems genuinely concerned about the company. "The question is, will they evolve into anything other than a long-distance supplier and anything the old Western Electric can produce?




ROGER GORMAN

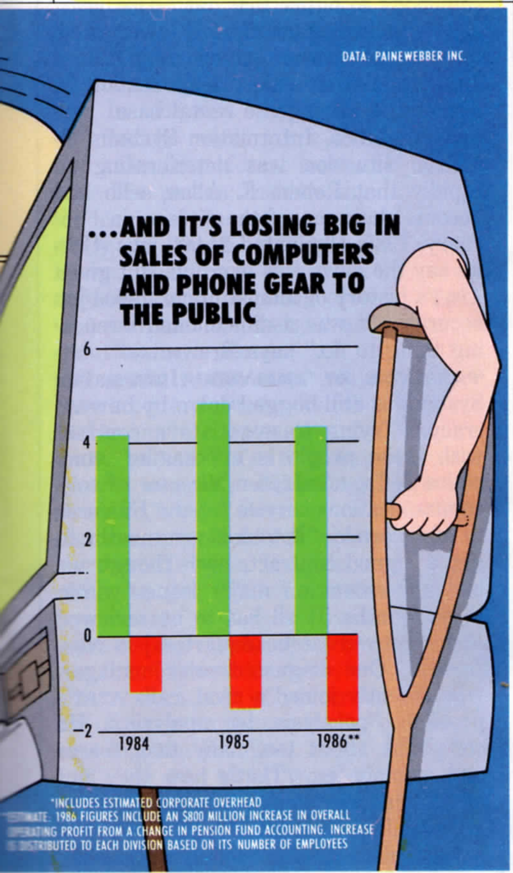
The cards are stacked against them. They don't have the management talent and resolve to get it done."

Some observers are more optimistic. They cite the marketing savvy AT&T has picked up while taking its lumps—plus its financial strength and the unmatched technology of AT&T Bell Laboratories. But computer customers aren't waiting for AT&T to get its act together. And the company faces a long-term threat from the Baby Bells. By 1990 they may be freed from most restrictions of the breakup. Then they could eat away at AT&T's long-distance business and make their own equipment instead of spending billions on AT&T's.

THE CLIFF ROBERTSON ADS HELP KEEP LONG-DISTANCE RIVALS AT BAY

The task of solving these problems will fall to James E. Olson, who is expected to move into the CEO's office at AT&T's Manhattan headquarters when Chairman Charles L. Brown retires in August. Olson's promotion from president and chief operating officer, though not public yet, is considered virtually guaranteed and may be announced after the next board meeting on May 21.

Many AT&T-watchers welcome the change. Rather than face an uncertain fate in a Justice Dept. antitrust suit, Brown made the courageous decision to break up the Bell System, then managed the divestiture well. But a Bell executive says that taking apart the close-knit company "took so much out of Charlie that I don't think he had the heart to continue the destruction at the new AT&T—even when it was warranted." Cost-cutting has proceeded at a glacial pace. "There's no hard-nosed management at AT&T," says one former executive. "Nothing happens when people don't produce results."




Brown argues that "any business, and this one in particular at this juncture in history, makes progress in increments." He adds: "Whatever you do, if the earnings are not as good as expected, people say you should have done something else." One "something else" that critics mention is infusing AT&T's 333,000 employees with a vision to replace the old corporate theme of public service. In an annual series of executive meetings a few months back, Brown gave a speech that one insider says "boiled down to little more than, 'Be the best that you can be.' People thought that was a little ludicrous. It's not the kind of corporate philosophy that people can latch on to."

Outgoing and energetic, the 60-year-old Olson is likely to be more forceful. "At least some decisions will be made," says Edward Goldstein, formerly corporate vice-president for strategic planning at AT&T and now an industry consultant. But Olson's critics note that he headed AT&T's troubled equipment operations before stepping into the president's slot last June. In his 42 years with AT&T, Olson's forte has been operations; most observers expect him to focus more on cost-cutting than strategic planning.

Few experts foresaw AT&T's problems. It seemed that the company's executives had pulled a coup by spinning off the slow-growth, capital-intensive local phone companies while retaining Bell Labs, the profitable long-distance arm, and the $13 billion Western Electric Co., the world's largest maker of communications equipment. Management wanted to keep as much of these traditional businesses as possible while moving AT&T into faster-growth areas: the international market and integrated computer and phone systems. The betting was that, after taking a year to overcome the chaos of the breakup, AT&T would be off and running.

In long distance, saturation advertising featuring actor Cliff Robertson, plus a raft of new services and lower prices, has kept rivals such as MCI Communications Corp. and GTE Sprint Communications Corp. on the run. The company's long-distance market share, expected by some to drop as low as 60% by 1990, has stabilized at around 80%. Its long-distance operations are well managed, too. Analyst Jack B. Grubman of PaineWebber Inc., a former AT&T accounting manager, expects operating profits from AT&T Communications Inc. to hit $3.6 billion this year, up 50%.

The story is similar at AT&T Network Systems, Western Electric's successor as supplier of equipment to phone companies. In the late 1970s the company fell behind Canada's Northern Telecom Ltd. in digital switching technology. By 1983, Northern sold almost all the digital switches in the U. S. By last year, however, AT&T's impressive research and manufacturing let it draw even with Northern in the $4 billion U. S. market.

**TOO MANY SALESMEN.** The company was counting on similar success in advanced phone equipment and computers. At divestiture, it still had a 25% share of the $3 billion market for business phone systems. It owned a huge amount of phone equipment rented to businesses and homes. And it had been building computers into its switching systems for years. "We felt we were the equal of anybody in our knowledge of processors," recalls William M. Ellinghaus, who retired as AT&T's president in 1984.

But troubles mounted from day one. The marketing of these high-tech systems fell to AT&T Information Systems, a division created after the Federal Communications Commission ruled that AT&T had to separate competitive equipment sales from regulated long-distance operations. So AT&T had two sales forces calling on major customers—one from AT&T Communications, the other from Information Systems. "It was a terribly inef-

OLSON: SUPPORTERS SAY THE CHAIRMAN-TO-BE WILL SPEED DECISIONS AND CUT COSTS. CRITICS NOTE THAT HE HEADED A LAGGING DIVISION

LAWRENCE BARNS

ficient organization that was forced on us," says Brown.

The revenues to support Information Systems' 110,000-employee payroll never materialized. The market for business phone systems, known as PBXs, turned down in 1985 just as computers slumped. That was exacerbated by post-breakup confusion and poor marketing. AT&T salespeople, recalls Nicholas D. Kaltneckar, manager of voice communications at Johnson & Johnson, "didn't know their products that well, and their prices were 40% over the competition." J&J just started buying AT&T PBXs again after a two-year hiatus.

**'DAMN HIGH.'** Alarmed, AT&T "bought market share," recalls the CEO of a large rival. To win a contract at the University of Colorado last July, AT&T underbid many rivals and donated $1.5 million worth of computers to the school's engineering labs. Such tactics, plus a host of top-quality new products, helped increase AT&T's PBX market share from 19.6% in 1984 to 25% in 1985, says Northern Business Information Inc.

However, AT&T set off a price war, and its margins suffered the most. "Their costs were too damn high, every single cost you could name: components, manufacturing, and marketing," says Goldstein, the former AT&T strategic planner. In mid-1984, in a dramatic videoconference beamed to employees nationwide, Olson pledged to cut costs by 20% at AT&T's equipment arm by yearend. Insiders say actual cuts fell far short of that. Meanwhile, the computer side of Information Systems was burdened by slow growth and larger-than-expected losses (page 94).

The only thing forestalling disaster was the division's "embedded base" of phone equipment rented to homes and businesses. But salespeople were encouraged to sell rental systems or replace them with new AT&T gear, even though gross profit margins on rentals topped 50%. Rentals shrank by 19% annually. "If you're losing money on each product you ship and making a lot of money on the embedded base, then why replace the embedded base with new products?" asks a former sales executive. "It seemed to take a long time for somebody to figure that out." This year, AT&T finally began offering lower rates to customers who extend their leases and changed its sales compensation to discourage raiding the rental base.

'The question is, will they ever evolve into anything other than a long-distance supplier?'

By mid-1985, Information Systems' financial situation was deteriorating so rapidly that Robert E. Allen, who had become chairman of the division in February, 1985, eliminated 24,000 jobs. Critics say the move was overdue. But given AT&T's history of almost unparalleled job security, "it was a difficult and wrenching thing to do," says Brown.

**'PARALYSIS BY ANALYSIS.'** Information Systems is still bogged down by bureaucracy. "Trying to negotiate a contract with these people is impossible," complains Jeffrey S. Lipton, director of telecommunications service for the University of Colorado. "It took seven months to get a signed contract, even though we had agreement on major issues within three months. It all has to be reviewed and approved [at headquarters] in New Jersey." One disgusted sales manager, who recently joined a rival, calls AT&T's problem "paralysis by analysis." He complains about too many task forces and committees. "That's how they put off making decisions—they study them to death."

Customers report that AT&T's marketing has improved, though it's not up to that of other big suppliers. Allen, who is expected to succeed Olson as president, concedes that big problems remain: "This is still very much a business in transition. It'll probably be another three years before we feel better about our direction and successes." Still, he denies rumors of new layoffs. He says 1986 results will "absolutely" be better than last year's estimated $250 million operating loss on revenues of $11.5 billion. Analyst Grubman, though, predicts operating losses will double this year.

To speed the turnaround, top officers are pinning high hopes on cooperation between AT&T Information Systems and AT&T Communications, the long-distance unit. The FCC ruled last fall that the divisions could combine some functions. As a first step, AT&T plans to integrate the duplicate sales teams that call on major customers. The idea is to spur sales of both PBXs and computers, given the good rapport the long-distance sales force has with big clients. More important, AT&T is determined to use its communications skills to tie together all of a client's information equipment—from phones to PBXs to computers. "There are a lot of box vendors out there," says Olson. "We are a strategic vendor, who can walk in and do total systems engineering."

Customers welcome the changes. "I'm tired of dealing with two sides" of AT&T, says William T. Houghton, Chevron Corp.'s general manager of communications technology. In fact, he's "disappointed" that he won't get a unified sales team for at least a year. The reason: Insiders say the company is moving gingerly to mesh the sales forces. They have a historic animosity, and infighting over who will lead the merged account teams is fierce.

**NOT MUCH ROOM.** AT&T may have a better future in its other big push, overseas equipment sales. "It's a great growth area, with big money at stake," says Desmond F. Hudson, president of rival Northern Telecom Inc. Olson wants to get 25% of AT&T's equipment revenues from overseas by 1995, up from less than 5% now. To do so, he has set up a host of ventures and strategic alliances in Europe and the Far East.

It's too soon to tell whether the international moves will pay off. Italy's Olivetti, in which AT&T took a 25% stake

The company's bid to grab more of the PBX market set off a price war—and its margins suffered the most

in 1984, sold only 1,000 AT&T minicomputers in Europe last year. But Olivetti has been a good supplier of personal computers that AT&T resells in the U. S., and AT&T's $254 million investment is now worth $1.2 billion. A joint venture with the Netherlands' Philips to sell switching gear has gotten few orders but could make a breakthrough in France soon. Other projects are just getting started, including a venture to produce microchips in Spain. Rivals say AT&T's overseas thrust is poorly focused. But Olson says he's "very optimistic" about long-term success.

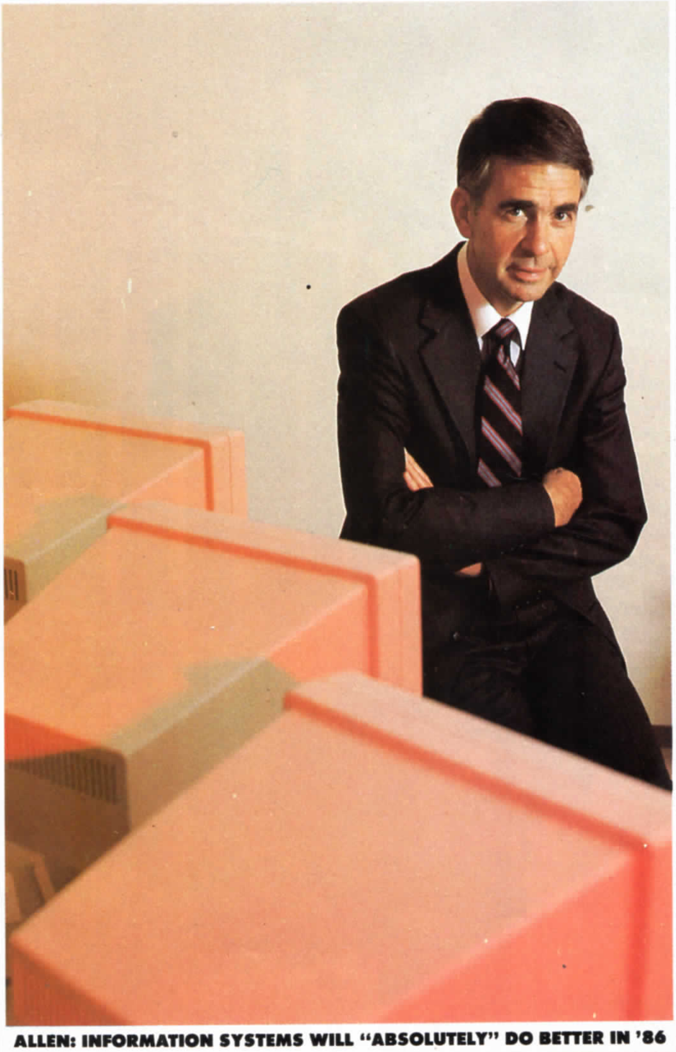
With a payoff in international markets years away and the thrust into computers disappointing, AT&T must rely for the next few years on its workhorse: long distance. But it doesn't have much running room. AT&T's long-distance revenues are expanding at about 8% annually, says Lap Lee, an analyst at Wertheim & Co. He adds: "I just don't see earnings growing rapidly there." Moreover, long-distance profits have begun to exceed the FCC's 12¾% target return on investment—making an FCC-ordered refund possible.

**POT OF GOLD.** Perhaps to forestall that, the company in late April filed for a huge 9.5% average rate cut, effective in June. AT&T says the cut offsets lower fees it will pay to connect to local phone networks, part of an FCC-mandated change in phone-industry pricing. In any case, AT&T's long-distance earnings probably will level off for the next few years.

After that, there could be a resurgence in long distance as new services and lower prices stimulate use of its network. AT&T also is trying to convince the FCC that it deserves a higher rate of return, given the greater risks in a competitive world. Even without that, a request for faster depreciation of equipment—already made to the FCC—would boost profits. The real pot of gold may come when AT&T frees itself from most regulation, perhaps in the early 1990s. Able to price its services at will, and with more freedom to introduce advanced technology, the company should be able to capitalize on an exploding demand for ways to move information.

Ironically, the spun-off Bell companies are the biggest threats to these plans. In trying to redefine their marketing focus after divestiture, the Baby Bells and AT&T hit on the same strategy: selling large customers a package of communications equipment and services. The Bell companies already had the local-network part of the puzzle, and the breakup settlement allowed them to market equipment, as well. Now, with AT&T and others being allowed to bypass local Bell networks with direct hookups to customers, the Baby Bells think they deserve the final piece—long distance. "We'd produce some real competition to AT&T's dominance," says Thomas E. Bolger, chairman of Bell Atlantic Corp. That's something MCI and its smaller brethren may never do.

U. S. District Court Judge Harold H. Greene, who presided over the breakup settlement, could loosen some restrictions on the Bell compa-



LAWRENCE BARNS

**ALLEN: INFORMATION SYSTEMS WILL "ABSOLUTELY" DO BETTER IN '86**

# COMPUTER MARKETING: AT&T KEEPS BANGING ITS HEAD

When American Telephone & Telegraph Co. burst into the computer business in March, 1984, shortly after divesting its regional phone companies, industry analysts predicted an epic battle with International Business Machines Corp. Computers, after all, were the cornerstone of the "new," unregulated AT&T. The analysts' "expectations were almost superhuman," recalls James D. Edwards, president of AT&T's Computer Systems division. They thought "we would somehow overwhelm IBM."

Far from that, AT&T has achieved spotty results in computers. It has done well with some products, such as IBM-compatible personal computers and small minicomputers. But a personal computer that uses AT&T's Unix software is a flop. And the company has been unable to develop a wide market for its large minicomputers (chart). Sums up AT&T Chairman Charles L. Brown: "We've done reasonably well, picking up our share in the computer business, though not as much as we would have liked."

Revenues of $2 billion last year made AT&T the world's ninth-largest computer maker, but analysts estimate that it lost as much as $250 million in the process. Now the experts are rolling back their expectations. "Instead of looking to 1990 for a leading role for AT&T, try 1995 to 2000," says William C. Rosser of Gartner Group Inc.

**SLOW START.** One reason for the setback is the 15-month computer slump. "We probably couldn't have picked a worse time to enter the computer business," says Robert E. Allen, chairman of AT&T Information Systems.

But AT&T's problems go deeper. Despite decades of in-house computer development, it has failed to produce successful commercial systems of its own. It has turned to Convergent Technologies Inc. to build its Unix PC and to startup Counterpoint Computers Inc. for an engineering workstation. Its only truly successful commercial product, the AT&T PC6300, is a clone of the IBM PC built by Italy's Olivetti.

AT&T's slow start on the commercial side has a lot to do with Unix, its operating system software that controls such basic computer functions as storing information on disks and printing it out. There's no standard operating system for the hundreds of thousands of midrange computers now in use. Unix, which runs on 140 different models, was supposed to fill the gap—and help AT&T sell machines. But it has a reputation for being hard to use—and lacks any major advantages to offset that. McKesson Corp., a San Francisco-based pharmaceuticals distributor, is typical of many buyers: It has 400 PC6300s but isn't interested in other AT&T models. "We don't have any applications for Unix at this point," says John W. Fitzgerald, McKesson's vice-president for technical services.

As a result, even though all but the largest of AT&T's minis are regarded as reasonably competitive in price and power, they have limited appeal. Only the regional phone companies, the U. S. government, corporate engineering departments, and universities have bought many. "Unix remains unknown and uninteresting to 80% of commercial data processing customers," says Jean L. Yates, a vice-president at market researcher International Data Corp.

### AT&T COMPUTERS: PHONE COMPANIES ARE THE BIGGEST CUSTOMERS

| Product category | 1985 sales (millions of dollars) To Bell operating companies and AT&T | To others |
|---|---|---|
| Personal computers & small microcomputers | $30 | $603 |
| Minicomputers | 420 | 255 |
| Superminis | 650 | 12 |
| **TOTAL** | **$1,100** | **$870** |

DATA: GARTNER GROUP INC. ESTIMATES

AT&T learned that the hard way. Last March it brought out the Unix PC, a machine that it hoped would serve as an inexpensive introduction to Unix for commercial buyers. Industry watchers figure AT&T sold as few as 5,900 in 1985, instead of the expected 40,000. The lesson, says Edwards, is that customers don't want a whole new set of software for desktop computers—or for any system.

Instead of trying to replace existing computers and software, AT&T now wants to make Unix work alongside the software in existing machines. Unix's major role would be to smooth communications between computers. A new version, due this summer, translates files from different computers for transmission across networks. "We will reach out to the computers that are in place," says Edwards. "That's very different from how AT&T began."

Even if the company can develop the software to make this strategy work, it must vastly improve its approach to customers to compete with the likes of Digital Equipment Corp. and IBM. "It comes down to marketing," says Richard J. Matlack, president of InfoCorp. "There's a lack of marketing tradition and culture in the company."

**'HIT-AND-MISS.'** Even customers who like Unix and praise AT&T's product quality complain about its lack of marketing savvy. "It's kind of hit-and-miss," says James W. Mathis, director of telecommunications for Trailways Corp., a new customer. "On the follow-through, they've got some problems." At Lincoln National Corp., which has ordered 35 AT&T minis, "when it came to Unix, we had to figure it out for ourselves—there was nobody to call," says George F. Modzelewski, an assistant vice-president.

AT&T's marketing is weakest where IBM's is strongest—in large companies. Computer Systems is only one of several product groups in AT&T Information Systems. ATTIS's sales teams on major accounts generally concentrate on telephone switches and have more contacts with telecommunications managers than with data processing departments. The company is trying to solve that problem by combining the ATTIS sales force with that of AT&T Communications Inc., which sells data lines to large IBM customers.

Nobody expects a sudden surge in AT&T's computer business. And the company can't afford to absorb losses forever. "No business—no matter how well funded—can continue without making money," says Edwards.

But many customers would like to see AT&T succeed. "I would love for IBM to have a viable competitor," says McKesson's Fitzgerald. And Edwards says AT&T can fill the bill with "careful planning and a little bit of patience." InfoCorp analyst Grant S. Bushee likens AT&T's computer efforts to the experience of Japanese companies entering U. S. markets: "Their initial attempts were sometimes ludicrous, but they were plodding and determined. They keep banging their heads on it, and they eventually succeed. AT&T is approaching the computer market the same way."

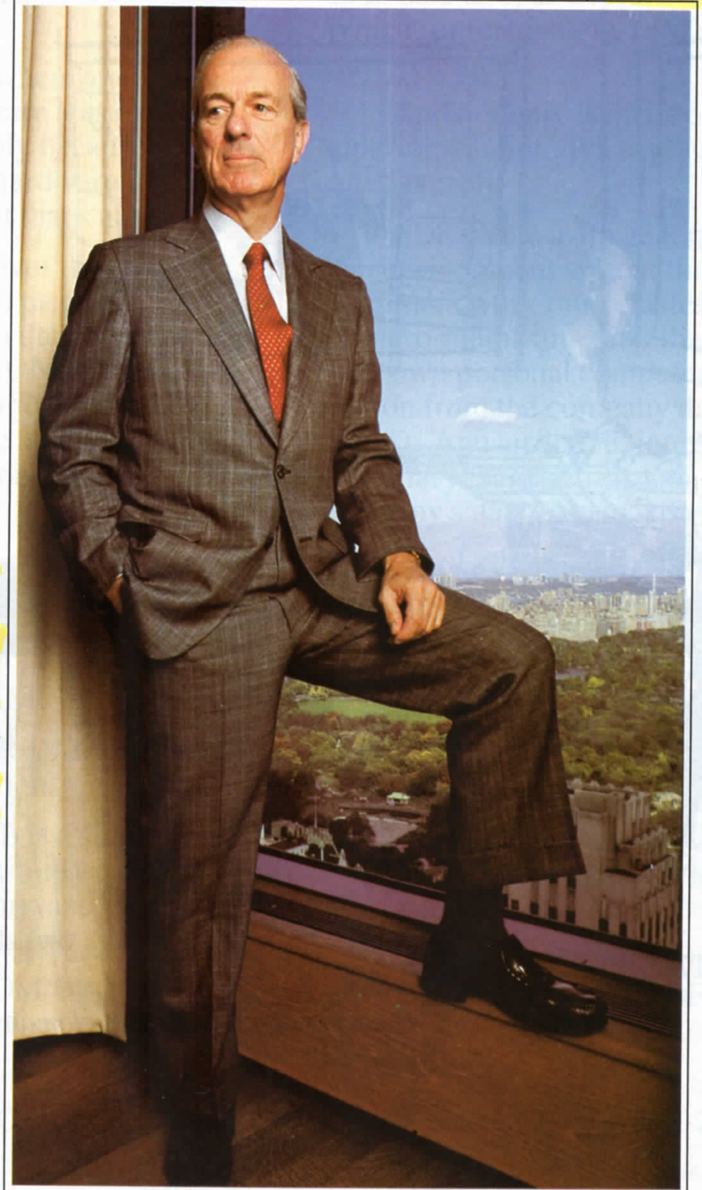
*By Geoff Lewis in New York, with Alice Z. Cuneo in San Francisco* nies as early as next year. Although few observers expect him to act so quickly, they believe the Baby Bells will be permitted to sell long-distance service, at least within their regions, by 1990. One Bell official boasts that even such a partial change would let the seven spinoffs cut AT&T's market share from 80% to 60% in three years. "That'll suck one hell of a lot of profit away from AT&T," says a former high-level AT&T executive.

Trouble with the regionals also threatens to erode AT&T's dominance of another profitable business. AT&T's Network Systems division is the largest seller of equipment to the Bell companies, including Centrex systems, which the Baby Bells use to provide phone service to big companies. At the same time, AT&T Information Systems is trying to sell the same big companies its own PBXs, which do essentially the same thing as Centrex. "We're competing with AT&T, using their equipment and technology, against equipment sold by another division," complains a top official at a Bell regional.

The Bell companies worry that AT&T will withhold advanced technology from them, crippling their ability to compete. Olson counters that he intends to give the Bell companies the best available technology, "and to the extent that AT&T [Information Systems] gets hurt, that's a fact of the marketplace." The regionals aren't convinced, and they're lining up other suppliers. They're also pressing Judge Greene and Congress to let them make their own equipment, primarily through joint ventures with established manufacturers.

**'SERIOUS HARM.'** Any move away from AT&T's equipment will take a while: Only Northern Telecom now sells big-ticket switching gear comparable to AT&T's. But the Baby Bells are already going to Japanese companies for optical-fiber equipment. And the strains promise to get worse. One option, says a Bell executive, is for AT&T to spin off either Network Systems or Information Systems. "They're going to have to do something," he adds, "or in the long run cause serious harm to our relationship."

What are the prospects that AT&T can turn itself around soon? After last year's disappointing earnings of $1.6 billion, or $1.37 a share, up from $1.25 a share in 1984, most



**BROWN: HAS HE AVOIDED TOUGH DECISIONS SINCE THE BREAKUP?**

BOB SACHA

AT&T's cost-cutting plans will be tested soon—when it tries to win a raft of union concessions

Wall Street analysts aren't too hopeful. Once an investor darling, AT&T stock dropped from 25 to 22⅛ in the first quarter, during the biggest bull market in history. The stock got a boost from the surprising first-quarter earnings of 47¢ a share. But analysts say that was mostly because the 9¢ increase from the change in pension-fund accounting—which should continue each quarter for several years—made AT&T attractive to institutions looking for stocks with low price-earnings ratios.

Analysts who are still bullish hope for dramatic cost-cutting this year, and the first test will be upcoming labor negotiations. Contracts with the Communications Workers of America and the International Brotherhood of Electrical Workers, who together represent 196,000 AT&T employees, expire on May 31. AT&T's prime goal is to win lower starting wages for 107,000 clerical employees and operators, who it believes earn 20% to 30% more than counterparts at rival companies.

**HUNGRY TO BUY.** The unions will resist that. They want an employment-security provision that would force AT&T to retrain and relocate excess workers with seniority. Though a strike is unlikely, Wall Street is watching. "Given the problems in the equipment area, AT&T can't afford a bad contract," says Kenneth M. Leon, an analyst at L. F. Rothschild, Unterberg, Towbin.

Once he takes over, Olson could cut other costs. One possibility: writing off a huge chunk of outdated equipment, which would clear the way for improved profits next year. More layoffs could be in store. Also, Olson has "an appetite for an acquisition," says a close associate. Rumors abound that AT&T may gobble up a computer maker, perhaps Digital Equipment Corp. But Olson says he has "no current plans to make a major acquisition of a computer company."

No matter what Olson does, AT&T's transformation into a high-flying technology company will be a long time in the making. Five years from now, it'll probably look much as it does today—with most revenues and profits coming from long distance.

Former President Ellinghaus speculates that ignorance of the challenges that lay ahead may have been AT&T's tragic flaw. "Maybe there was a lot of thinking that because we were so good, with such fine manufacturing and such great R&D, others couldn't compete with us as fast as they did," he says. "It wasn't because we were stupid or arrogant but because we had a lot to learn." Analyst Leon titled a recent report critical of AT&T's performance in high tech *The Wrong Stuff*. So far, he seems to be right.

*By Mark Maremont in New York, with Randy Welch in Denver and John Wilke and Michael Pollock in Washington*