Terra at a Crossroads: Will Telefónica’s Takeover Bid Finally Lead to Profitability?

Last May 28, Telefónica, the largest Spanish telecommunications company and one of the most prominent in Europe and Latin America, launched a takeover bid for 100% of the shares of Terra, its Internet subsidiary. The offer price was 5.25 euros per share, even though four years ago, Telefónica took Terra public at a share price of 11.81 euros. Telefónica’s low offer left the company’s half million minority shareholders dumbstruck.

Short-term, it’s clear we will be hearing much more about this takeover bid. Shareholders have already mobilized to protest what they consider an unfair price, and the CNMV (Comisión Nacional del Mercado de Valores) – the Spanish equivalent of the U.S. Securities and Exchange Commission – is investigating the strange behavior of Terra shares in the hours just before the launch of its takeover bid. But the question that makes people nervous long-term is, what is Terra’s future within the Telefónica group?

With this transaction, Telefónica expects to retake control of its subsidiary and put an end to five years of poor financial results. Over the course of Terra’s existence, the portal has never made any money. On the contrary, during the past fiscal year, Terra lost 2.009 billion euros and its revenues declined by almost 10%. When it comes to operating profits, Terra has been unable to emerge from red ink, showing losses of 120 million euros.

These numbers are especially disconcerting if you take into account that Terra’s European competitors have begun to make money. Wanadoo, the French portal that is a subsidiary of France Telecom, was the first European portal to make a profit, amounting to 30 million euros. Both T-Online, the German portal, and Tiscali, the Italian portal, have followed in its wake. T-Online reported a positive EBITDA of 103.5 million euros, while Tiscali reported an operating profit of one million euros.

Why has Terra failed as Telefónica’s independent operation? One of the company’s biggest mistakes has been to continually change its strategy, says Enrique Dans, professor at the Instituto de Empresa. In addition, during its short existence, the company has had three different top executives and been unable to keep its strongest people. But the coup de grace for Terra was
that its own parent company, Telefónica, started competing against it.

“Telefónica did things very well at the beginning, when it brought Terra onto the stock exchange,” says Dans, adding that “this move provided two benefits. On the one hand, [Telefónica] got [additional] resources. On the other hand, it gave Terra sufficient autonomy to develop the innovative culture that the Internet demands, and which a hierarchical company such as Telefónica wasn’t going to be able to provide.” Nevertheless, over time, this strategy began to change. “After the departure of Juan Villalonga from the presidency of Telefónica and the arrival of Cesar Alierta, [Telefónica] banished innovation in favor of cost containment,” Dans notes.

Little by little, Telefónica was robbing its subsidiary of independence and becoming a competitor in the business of ADSL [service] for connecting to the Internet. Ultimately, Telefónica took over an agreement that Terra had signed with Bertelsmann, the German group, because that agreement depended on Terra remaining solvent.

The Fall of a Giant
In November 1999, Terra made its initial stock offering at the height of the euphoria over Internet technology. The move was a success for Telefónica and for many small Spanish shareholders. By purchasing shares in Terra, they were investing in Spain’s largest company in the new technology sector. Before the bubble burst, Terra shares stood as high as 150 euros; a couple of weeks earlier, its price had been only 4.40 euros per share.

Shortly after that, while Juan Villalonga was president of the Telefónica Group, Terra embarked on an ambitious expansion plan designed to position it as the number one portal of the Spanish-speaking world. When Villalonga left the company in July 2000, Terra had a presence in 42 countries. It had also managed to get into the American and Asian market through its purchase of Lycos, the American firm, for 17 billion euros.

Nevertheless, this strategy never really paid off. “International expansion has been very costly and has not generated profits,” notes Arturo Rojas, professor at the Autonomous University of Madrid. “The Internet market in Latin America was not as homogeneous as they thought.”

Betting on the Latin American market proved to be more complicated than people first believed. According to Emilio Ontiveros, professor of business economics at the Autonomous University of Madrid, “Although this market offers enormous potential, the Argentine crisis hit at the worst moment.” Moreover, “the unique characteristics of each country reduced [the strategy’s] economic reach.”
After the excesses of technology euphoria – which meant a capital outflow of 75 billion euros for Terra – the Internet bust and the arrival of Cesar Alierta to head Telefónica gave rise to a new policy of cost containment. As a result, Terra yielded part of its managerial independence to Telefónica, including its role in the commercialization of ADSL technology.

That concession was too risky, if you take into account that [online] advertising had started its unstoppable downhill slide – and that, as a result, the profitability of portals was going to be based on connectivity and ADSL. With the drop in the advertising market, “providing access services became the key to generating revenues,” says Ontiveros.

The ADSL business appeared like manna from heaven to generate profits. Terra began to commercialize ADSL in 2001, months before its own parent company did so. Ontiveros explains that Telefónica “could not [enter the ADSL market earlier] because of regulatory restrictions.” But once Telefónica overcome those limitations, “Terra’s position became very vulnerable because ADSL was installed on the Telefónica infrastructure.”

At this point Telefónica began to compete with its own subsidiary, offering access service that was cheaper than Terra’s. Terra was left with no alternative but to leave Internet access service to its parent company and to remain as a pure portal. “Conflicts of interest between Terra and its parent company are [the factor] behind the unfeasibility of its business model, which Terra had to face up to,” notes Rojas.

Terra’s definitive loss of independence came after the failure of its agreement with Bertelsmann. The German company was the nexus that permitted the purchase of Lycos by Terra in June 2000. That same fiscal year, Bertelsmann became a business partner of the Spanish company, agreeing to buy services from Terra-Lycos that were valued at one billion euros over [a period of] five years. But Bertelsmann fulfilled only the first 325 million euros of the deal. Then the German company refused to continue its payments, and Telefónica took financial responsibility for the agreement, a move that was essential to keeping Terra afloat.

The Takeover Offer
“In losing its independence, Terra is going to lose its source of innovation,” Dans pointed out in an article published in Universia Knowledge@Wharton. “I wonder if now is the right time to incorporate [Terra] in the parent company.” On May 28, two weeks after Dans made those comments, Telefónica launched its tender offer at a price of 5.25 euros per share. The price raised the ire of many investors, despite the fact that the offer represents a premium of 15% over Terra’s average [trading] price for the past six months. The discontent of shareholders is based on the fact that Telefónica took Terra’s shares public at a price of 11.81 euros.
Shareholders now have to decide whether or not to participate in the offer. If many of them consider it unfair, then the offer will fail. “If Telefónica doesn’t get above 50% of the capital, it will not have managed to change the current situation, and it is reasonable that it will launch another offer with a better price,” says Rojas. Nevertheless, at the moment, it does not appear that such an option is feasible because Telefónica has said that in no case is there going to be an improvement in the offered price.

The goal of Telefónica is to incorporate the subsidiary into the group. “If Telefónica goes above 50% of the capital, it can include Terra in its area of consolidation through its global incorporation. It must go beyond 75% in order to apply to the Ministry of the Economy to incorporate Terra in its consolidated financial results and be able to take advantage of some tax credits,” explains Rojas. He believes that “the expectation that it will not reach 75% – excluding a possible future tender offer – leaves hope for a more attractive price.”

Rojas thinks the response by shareholders “will provide Telefónica with a total ownership in Terra of between 60% and 70% ... In any case,” he adds, “the existence of minority shareholders in Terra will raise problems for managing without interfering with their rights.”

**Suspicious Trading**

Beyond the unhappiness demonstrated by most shareholders and the takeover’s success or failure, the Telefónica offer has raised doubts about the systems that are used to control the use of privileged information in cases such as this one. The CNMV is investigating the surprising growth in contract volume during the hours preceding the official announcement of the offer. In just two hours, trading volume exceeded the total volume of the previous two days, raising share prices by 5.55%. After a temporary suspension of trading, the company closed the day with a rise of 20.58%. Despite the fact that Spain prosecutes this sort of [illegal] activity, “there is a feeling that [the CNMV] cannot count on enough material or human resources” to do that, says Ontiveros.

The point that all shareholders must keep in mind when they accept – or don’t accept – this offer is the future of Terra both within and outside of Telefónica. Wharton management professor Mauro Guillén believes that “obviously, there are advantages, but also there are problems. The advantages have to do with cost reductions. You have to remember that the birth of Terra involved the consolidation in one single company of all the Internet assets that Telefónica had dispersed [throughout its branches] at that time. The logic in doing this was to get ready for eventually appearing on the stock market, following the ‘spin-off’ model of separating assets. In that way, they could maximize the effect on the stock market, raise low-cost capital and increase the combined value of all Telefónica companies. This is what
happened during the Internet boom when Terra shares shot up in price.”

Guillén believes that “there no longer exists the motivation of maximizing the price of each share. Nowadays, what is urgent is to reduce costs, and then integrate [Terra into Telefónica.] The problem is that this is going to be painful, since Terra has been used to not saving. The Internet boom gave it cheap capital and extremely high expectations. Now the moment has arrived to realize adjustments and cuts, and reconsider its business model.”

Dans suggests that "If Telefónica permits Terra to maintain its innovative spirit, the takeover will wind up being a good move. But if it continues with its obsession about cutting costs, it will have made a mistake." Dans believes that “the Internet still lacks innovative vision; we can’t [use] strictly economic criteria [when looking at] the profitability of investments, which we apply to sectors that are already established. Here, we are talking about something completely new.”

Along the same lines, Guillén predicts that that the integration of Terra is going to affect its ability to innovate. "But I believe that integration is better than no integration. At least, after integration [Telefónica] will be losing less money." Conscious of the need to cash in on its investments, Guillen emphasizes that “Terra’s strategy must adapt to new times. It is impossible to make money only through advertising. You have to acquire customers that pay – and you have to make them loyal. Broadband [service] offers [Terra] clear opportunities, but there are few people in Spain or Latin America who want broadband.”

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