Testimony of Jack B. Grubman
House Committee on Financial Services
Hearing regarding WorldCom
July 8, 2002

Good afternoon, Mr. Chairman. My name is Jack Grubman. Thank you for your invitation to testify before the Committee today. I am a managing director in the U.S. Equity Research Division of Salomon Smith Barney. My area of research is the telecommunications services sector and I am the firm's senior telecommunications services analyst. I have been a telecommunications analyst on Wall Street since 1985. I began to cover WorldCom's predecessor company, LDDS, in 1990 and have covered the company called WorldCom since 1995.

Let me say at the outset that I am saddened by the events that have brought us here. WorldCom is a company that I have believed in wholeheartedly for many years. I am sorry to see investors suffer losses. I am sorry to see employees laid off. And I am distressed by the apparent fraud that the company announced 13 days ago. In addition, in hindsight, I regret that I was wrong in rating WorldCom highly for too long, though in this regard I note that I surely would have downgraded the company much earlier had I known the truth about its financial performance. Finally, I want to commend this Committee for stepping quickly to the plate to begin assessing what went wrong and what should be done to prevent such conduct in the future.

Let me also say that I am aware of speculation that I had advance knowledge about WorldCom's $3.8 billion earnings misstatement before my June 21 downgrade of the company. As I will describe in some detail in this statement, that speculation is categorically false. My

June downgrade -- actually my *fourth* downgrade of WorldCom since March 2002 -- was based solely on publicly available information. I had no advance knowledge of WorldCom's $3.8 billion accounting fraud.

The work of a research analyst. As an equity research analyst for the past seventeen years, my job has been to make judgments about the future prospects of companies in the telecommunications industry. Assisted by my research team, I render opinions and make forecasts about the industry and individual companies using publicly available information to develop financial models, earnings estimates, and price targets for the companies we follow. I also analyze industry trends, and seek to forecast the impact on individual stock prices of such variables as the overall health of national and local economies, regulatory policy and the supply and demand balance for telecommunications services. And, like all research analysts, I talk regularly to company managers, customers, suppliers, competitors and investors.

The importance of audited financial statements. The pivotal starting point for my work and the work of other analysts is the information publicly released by a company -- in particular, its audited financial statements and other SEC filings. Analysts must rely on the accuracy and completeness of such public SEC filings. Neither I nor any other analyst has the ability to conduct independent audits of the companies we follow. Analysts do not have access to internal company information such as audit trails, internal account entries, invoices or the like. In short, analysts are not auditors. Like ratings agencies and investors, we rely -- and are supposed to rely -- on the assurances of those whose job it is to prepare and certify a company's financial statements. If the public financial information on which we rely is wrong, our ultimate judgments about a company will be flawed. Our judgments are only as good as the public information on which they are based.

In the case of WorldCom, I relied on the accuracy of its audited financial statements and other SEC filings just as I have relied on such documents for every other public company I have ever covered.

Let me say once again: I had no advance knowledge of any kind about WorldCom's accounting fraud. I first heard about it when it was reported late in the day of June 25 on CNBC.

My evaluation of WorldCom. As I said at the outset, I found WorldCom's announcement of accounting fraud to be extremely disturbing. WorldCom was, after all, a company I had rated highly for a number of years.

For the past seventeen years, I have held a consistent thesis that the newer, more nimble and entrepreneurial telecom companies such as WorldCom could successfully compete with and even outperform the entrenched industry giants. This thesis did, in fact, unfold for competitive long-distance providers such as WorldCom during the decade and a half after the 1984 AT&T divestiture. And I thought that passage of the Telecommunications Act of 1996 would allow my thesis to unfold with equal force in local telephone markets. More recently, in the mid-1990s, I amplified my thesis to include the notion of global spheres of influence where the most successful companies in the industry would be those that combined entrepreneurial drive with a scale and scope of "end-to-end" network assets and operations.

From the late 1990s, until a few months ago, I believed that WorldCom was the company best positioned in terms of assets, earnings and business model to outperform the industry over the long term. During that period, various factors led to my positive views about WorldCom, including its ownership of an unparalleled array of "end-to-end" network assets on a global basis. As I noted in an April 9, 1998 research report, after WorldCom's merger with MCI, the company was the second largest long-distance carrier in the U.S., the largest Internet service provider in the world, the second largest carrier of international voice traffic in the world, the largest Competitive Local Exchange Carrier in the U.S., Western Europe, and Japan, and the largest U.S. provider of overseas private line networks. Moreover, it also had an impressive base of corporate customers, and reported consistently healthy profit margins. Finally, both WorldCom and MCI had the entrepreneurial culture of competitive upstarts, as compared to the slower, more staid incumbents like the regional Bells, with their monopoly birthright.

Others were bullish on WorldCom as well. WorldCom was a widely followed and widely held stock. Many others shared my bullish view of WorldCom, including other major Wall Street analysts, and sophisticated investors. Citigroup, the parent of my own company, invested over $300 million in WorldCom bonds. During the 1990s, WorldCom was one of the very best performing stocks in the broad Standard & Poor's 500 index.

Downgrading WorldCom during the past three months. However, beginning in March of this year, my published views on WorldCom became increasingly negative, as WorldCom disclosed the existence of an SEC accounting inquiry, reduced its earnings estimates, changed CEOs, suffered multiple rating agency downgrades, and drew closer to a restructuring that would likely have diluted the equity of existing shareholders.

On March 18, 2002, I increased -- which is to say worsened -- my risk rating on WorldCom from "medium" to "high" partly in response to a recently announced SEC accounting inquiry. On April 21, I downgraded WorldCom two levels from "buy" to "neutral," in response to the company's announcement of reduced earnings. On May 9, I further increased my risk rating on WorldCom from "high" to "speculative." I also lowered my stock price targets several times during April, May and June and warned investors that the SEC inquiry was "overhanging" WorldCom's stock.

Thus by June 21, 2002, when I downgraded WorldCom again, this time one level, from neutral to "market underperform," I had already made several significant negative changes to my published views on the company, including especially my April 21 rating downgrade from "buy" to "neutral" and my risk rating changes from "medium" to "high" to "speculative."

June 21 downgrade of WorldCom -- reasons. My June 21 downgrade from "neutral" to "market underperform" was appropriate both in substance and timing. My research team and I undertook our review of WorldCom the week of June 17 in the ordinary course of business. As a matter of course, near the end of each quarter, we make a practice of reviewing all companies we cover to update our earnings model in preparation for what we call our "Model Book," which we publish in anticipation of quarterly earnings. Our review of WorldCom was undertaken in that context. During the same end-of-quarter review, we revised earnings estimates and in some instances revised risk ratings for several other companies as well.

Our downgrade was fully justified by the facts, as I explained in my June 21 research note. Standard & Poor's had further downgraded WorldCom's debt on June 17, and Moody's followed suit on June 20. In addition, I had concerns about (i) our reduced estimates of the company's earnings, (ii) continued softness in corporate spending on telecom services, (iii) the details and components of the $5 billion credit facility the company was seeking to negotiate, (iv) our view that the company would be compelled to recapitalize its balance sheet to reduce the level of its debt in a manner that would severely dilute the equity of current shareholders, and (v) WorldCom's high relative valuation given its then current condition, compared to AT&T.

June 21 downgrade -- approval process. My June 21 downgrade went through Salomon Smith Barney's standard approval process. During the week of June 17, while I was in China, my research staff became convinced by the factors cited above that a downgrade was appropriate. They discussed their views with me, and I agreed. We then sought clearance from Management of the Research Department, as is required at SSB any time a ratings change is proposed. Following a conference call on June 21, senior executives in Research Management approved the downgrade. We also submitted the report for clearance to the firm's Supervisory Analysts, whose approval is required for any research report published by SSB.

June 21 downgrade -- blast voicemail. In short, my June 21 downgrade was a measured, deliberative action, taken in accordance with standard SSB compliance procedures, and based entirely on publicly available facts -- not on any knowledge or suspicion about the announcement WorldCom was to make four days later. Even so, after publishing the note I became concerned that the market might interpret it too negatively, and I thus sent out a "blast voicemail" on June 24 to make clear that I believed the company would stay solvent, that it had substantial assets and a lot of customers, and that I expected things would stabilize. This is obviously not the sort of communication one would send out if he had advance warning that the wheels were coming off this company 24 hours later.

Others downgraded at similar times. My gradual downgrades of WorldCom between March and June were consistent with the actions of many other Wall Street firms as such as Goldman Sachs, Lehman Brothers, Bear Stearns, Merrill Lynch and J.P. Morgan and Sanford

Bernstein -- a pure research house that does no investment banking. Sanford Bernstein and Bear Stearns did not move off their "buy" ratings until after the company's announcement of accounting fraud.

The role of WorldCom's fraud in my analysis. It is critical to understand that, but for WorldCom's fraud, I would have seen a more dire picture much earlier. My positive view of WorldCom depended on the continuation of WorldCom's healthy profit margins. If I had seen how badly and quickly those margins eroded, it would have shaken my overall view of WorldCom's long-term prospects and I would undoubtedly have downgraded WorldCom much earlier than April 2002.

One remarkable aspect of this fraud by WorldCom is that the company went to great lengths to create the appearance of transparency with respect to its purported capital expenditures. WorldCom appeared to meet the guidance for capital expenditures it had put out at the beginning of 2001, masking any hint that operating expenses were being improperly recorded as capital expenditures. Moreover, in each of its regular analyst calls, WorldCom provided what appeared to be a detailed breakdown of its capital expenditures in various categories, instilling in analysts and investors a false sense of confidence in those capital expenditure numbers. Moreover, WorldCom made no attempt to hide its cash outlays. And its consolidated margins for "earnings before interest, taxes, depreciation, and amortization" (EBITDA) were in line with those of its chief competitor. These facts taken together all helped ensure that WorldCom's mishandling of expenses would not be uncovered by analysts, investors or ratings agencies.

Interactions with management. Before closing, I'd like to briefly address two additional issues that have been the subject of considerable comment. The first concerns my relationships with management of the many companies I cover. I make a point of trying to develop good working relationships with management. Sometimes, working relationships of this kind include a social element, whether an occasional dinner or other outing, as is true in virtually all walks of life. Some think such relationships are inappropriate for research analysts. Respectfully, I disagree. As I see it, part of my job is to know how an industry is developing and to engage in a serious, active dialogue with the people who make the decisions in order to put SEC filings and audited financials into context and to assess management's capability to execute its plans. There's no question that you have to manage these relationships carefully, and it is critical not to let your own judgment get clouded. But if you strike the right balance, your opinions will be more informed.

Relationship with investment banking. The second issue concerns my relationship with investment banking. It is the nature of the business that companies seeking to raise capital by issuing securities look for a firm with both strong investment banking ability and a strong research reputation. This should never mean that a research analyst alters his genuinely held view about a company in order to win investment banking business, but it does mean that companies looking to issue stocks will naturally be more inclined to choose underwriters whose research analyst is a credible voice to investors and who tends to have a positive view of the company. Conversely, if a company knows that the research arm of a firm views it negatively, the company will generally go elsewhere, since these negative views will undermine the potential success of the underwriting.

In my case, as I outlined above, I have had a consistent investment thesis for more than a decade, which guided my view of which companies were likely to be the winners and losers in the telecom future. As you would expect, when I form a favorable opinion on a particular company, the investment bankers have found it easier to convince that company to retain our firm for investment banking transactions, and the converse is true as well. The investment bankers found my opinions on many (but not all) CLECs, WorldCom and Global Crossing helpful to gaining investment banking business, but found my views on companies like 360 Networks, Sprint, and many of the regional Bells to be an impediment. Through it all, I have listened to investment bankers, when appropriate -- as I listen to all market participants, as appropriate -- in order to understand companies and the factors that drive their performance, but I have always formed my own independent opinions. Right or wrong, I have always called them as I saw them.

Conclusion. Research analysts at Salomon Smith Barney are taught from the day they start that the integrity of their research product is their lifeblood. We are taught that the analyst's most valuable asset is his reputation with investors. We are taught that any analyst who squanders that reputation with investors to curry favor with any interested party is pursuing a fool's errand. I certainly have made mistakes. In retrospect, I regret staying with my point of view for too long. For most of the last decade, I was right and I was roundly praised, and now I've been wrong and am being roundly criticized. That is the nature of this business. Through it all, I have always written what I believed. I have always called the shots as I have seen them.

Thank you for the opportunity to appear today and I will be happy to answer any questions.