Discussion Following the Remarks of Mr. Allen

Discussion

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QUESTION, PROFESSOR KING: Clive, you have delivered a fine address. I have several questions, but after my first one I will turn it over to others.

One of the things that you mentioned, which was very important, was the idea of a mesh between corporate cultures. One of the things we see in today’s world is that many times the people aspects of these mergers are the glue that holds them together. If you don’t have that, they do not work. What you are doing is trying to preserve the uniqueness of Bay Networks so that it is a valuable asset in a changing world. How does Nortel do it uniquely, distinguishing it from other companies which have not done it?

ANSWER, MR. ALLEN: I am not sure we have done it entirely yet, but we are trying. In 1978, we made a key purchase. We recognized the convergence of voice and data in industry, and so we purchased a couple of data processing companies, one called Data 100 in Minnetonka, Minnesota and the other called Sycor in Ann Arbor, Michigan. We had only planned on purchasing one of those companies. It is a very long story why we ended up buying both companies, and it made the competition between Coke and Pepsi look small-time. When we bought the first one, we then found ourselves buying the other one as well. Then, we tried to combine these companies, and what happened was very, very dramatic. Things went all over the place, and the end result was, in 1980, we wrote off about $200 million associated with those acquisitions. So, hopefully, some of us who are still around after that event remember that you have to be very careful.

What we have done with respect to Bay Networks is recognize that we have been a leader in our area of technology for many years. We introduced digital switching to the world in the 1970s. We are clearly a world leader. That made us grow very significantly. And, we recognize now that we are making a very important acquisition. It is a very substantial $9.1 billion acquisition. The acquisition was diluting the ownership, as I mentioned earlier, and it was very important that our voice people subscribe to the evolution in technology and what was happening with that technology. So we have, I think, worked very hard in the intervening period of time to bring people together. We have re-jigged various parts of the business. We have moved some of our data business into what was the Bay Networks operation and we have moved pieces of Bay Networks into some of our other operations. We made the President and Chief Executive Officer of Bay Networks the President of Nortel reporting to the Chief Executive Officer, but we gave him a
very senior role. We had Bay Networks, as re-jigged, remain as a separate entity, and it continues to be a separate business entity, in effect, along with our four other lines of business. We have done a considerable amount of careful work to bring together these two groups of people.

We have subsequently done surveys on how this is going, and the response across the board is very, very positive. As many of you are aware, the most significant thing in an acquisition is not so much making it, it is integrating it after it has been made. And the business cultures, particularly where they are different, have to be worked on to make sure that everything does not go down the drain.

QUESTION, MR. ATKEY: Clive, that is a fascinating story of the evolution of Northern Telecom into Nortel Networks and how it has become a global player but, in a Canada/U.S. context, can we still call Nortel Networks a Canadian company? You have substantial non-Canadian shareholding; you have, I understand, more employees outside of Canada than inside Canada; and you have an increasing sphere of influence outside Canada. How long will it be before we say Canada has lost Nortel Networks?

ANSWER, MR. ALLEN: Well, I am not sure that one needs to remain a Canadian company or an American company. If you look at companies like Coca-Cola, Proctor & Gamble, and a variety of other U.S. companies, most of their sales are outside of the United States, and I think that is to the advantage of those companies, to the shareholders of those companies, as well as to the country of origin of those companies.

In the case of Nortel, bear in mind that this is a difficult business in which to survive in Canada. Canada has fewer telephones than the state of California. I know of no company in our business that could survive on the amount of business that is available in Canada alone. R&D costs associated with a new product can now run into billions of dollars. You saw yesterday from David Burn’s presentation that we spent over three billion dollars Canadian in R&D. In U.S. dollars, I expect this year our R&D expenditures will be about $2.7 billion. That is more than we sell in Canada. And, while we have a high percentage of our sales, approximately fifteen percent in R&D, we need to spend these monies in order to be a technology leader.

So, yes, at this point in time, and actually for many years, less than ten percent of Nortel’s sales have been in Canada. Over fifty percent of Nortel’s revenues are in the United States, and there is another approximately forty percent in other parts of the world.

What were the alternatives available to us at the start of my career with Nortel as we went off into this worldwide exercise? We could have remained just a Canadian company and, in effect, died because we could not afford the R&D to be competitive. We could have been a clone of some other company,
I suppose, but we could not have existed solely on the basis of Canadian revenues. Ericsson cannot exist on the basis of the Swedish market.\textsuperscript{1} So, I think Canada can be proud that we have survived and have succeeded very well in a global environment. The number of opportunities we provide to Canadian engineering and science graduates is just amazing. I think we take something like one-third or one-quarter of the graduate students in the electrical sciences in Canada, and we would like to have more if there were more. So, we are a company of the world.

QUESTION, MR. ATKEY: Clive, I have a follow-up question that relates more to your sister company, Bell Canada, that most Canadian of companies, twenty percent of which is now owned by an American company. Are you not describing a trend that is going to spill over into public policy and legislative change in Canada where we will no longer insist on majority ownership of our telecommunications carriers, and where Bell Canada, just as Nortel Networks, will become a company of the world with majority non-Canadian ownership?

ANSWER, MR. ALLEN: Well, what the people in Ottawa have to recognize, and they are a little slower than the rest of us, is that it is becoming a global economy. We had a very interesting discussion yesterday with respect to the Internet and how you control things happening on the Internet when they impact on your country but they originate elsewhere. I am not quite sure that we have all the questions, let alone any of the answers at this point in time.

But that is the way the world is evolving. If we deal out of the picture a fair number of the bureaucrats, we are probably not going to be all that badly off, frankly. It will be truly a market economy that no one will be able to really control.

QUESTION, MR. WOODS: That was a very, very interesting discussion, and the word that stuck out for me was “courage.” This morning I pulled out a document from a Queen’s Symposium in Electronic Commerce from the International Perspective, held in November. A lawyer at Fraser Milner in Ottawa, Lou Letterman, organized it, and he talked about Nortel. It is kind of ironic that I was just reading this early this morning, or rereading it, but we heard something about the bureaucrats maybe being a little bit behind.

Here is a quote from The Financial Post about the reaction to the merger. “They are fundamentally unclear,” that is, Nortel is fundamentally unclear, “as to their direction,” says an analyst. “People are not sure if Nortel is going to be able to make the leap from voice to data into convergence, and that’s networking, or even if that’s necessary.”

\textsuperscript{1} Ericsson is a world-leading supplier in the telecommunications and data communications industry.
So, picking up on your comment about the reaction in the stock markets and in the media, I wanted to ask you if you could go back to the item of courage and vision and tell us a little bit more about the risk element in making these kinds of decisions.

The second question is with respect to bureaucracy and government. You are talking about looking for commonalities and putting together new teams to deal with new opportunities. Is it possible to foresee, at least in some aspects, some kind of partnerships with the government in Ottawa, square kilometers surrounded by reality, where things could work, or is that just out of the question?

Finally, about the new economy and the things that Peter Drucker talks about, are we moving away from economies based on scarcity? There are a lot of quotes about the new electronic commerce, and these devices just open up opportunities to such a degree that the old ideas about scarcity are going to be turned on their head.

ANSWER, MR. ALLEN: With respect to courage, I think one has to take courage in everything that one does.

Sometimes one feels that one is betting the company on it. For example, in the 1970s, with a new senior management and new directives, new imperatives and a new approach to things – we had just gone public at that point in time – we started to do the work that resulted in the introduction of the first digital switches, the DMS in public switching, and the SL1 in private switching. We put a lot of money into those, and our focus was on those. If those products had bombed, then we would have probably bombed with them. They did not bomb; they took the world by storm. They helped to destroy, I am pleased to say, companies like ITT that had large telecommunications operations. It changed the whole direction, I think, of what is now Lucent Technologies – in those days, it was Western Electric. These were very dramatic moves. They were clever, timely, and well-executed, and they took us from being a very local player with really no sales outside of Canada to speak of at that point in time, except for some limited activities in a few countries like Turkey, to a position where, ten years later, we had probably forty-five percent of the U.S. public switching market. This was all because of those decisions. Had we not made them, we would have disappeared long ago. Because we made them and made them successfully, we succeeded.

Looking at another company, because I think all of the survivors have had successes, Ericsson in Sweden was in a rather sad state ten or twelve years ago. Their central office switching equipment was not doing well, and there was a lot of chaos in that company. Then, there was the evolution of the

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cellular business, which was largely driven in the Scandinavian countries. At a time when there was virtually nothing in the way of cellular services in North America, the Scandinavians had increasingly larger cellular operations. They were pioneers in that technology, and they were very successful. Today, Ericsson is really, essentially, a cellular company, and that has been the success of it. If that had bombed, then I think they would not be around either.

So, those are moves that one has to make. I believe that Lucent has tried to do what we have done for $9.1 billion, but they have an enterprise that was not as attractive to us as our purchase, and theirs cost over $20 billion. I think it has been necessary for them, and necessary for us, to do these things.

There is a company that was only started ten or twelve years ago in California called Cisco. This company, while it has sales revenues less than half ours, has a market value that is probably two to three times greater than ours. As someone remarked yesterday, you could take all of the General Motors and the Fords and the Chryslers and put them all together with all of their assets, revenues, profitability, and history, and they would not have a market capitalization that is as large as that of Cisco.³

So, these market values are not based on revenues, but on the way people see things going and the momentum associated with these operations. I think what we have done is extraordinarily astute. It is too bad we could not have developed this technology ten years ago. But, having said that, we have had so many other priorities that we have to work with, that we have had to evolve our product line in part by acquisition.

Question two was on collaboration with governments. Yes, we collaborate with governments. I think we certainly collaborate with the Canadian government in terms of doing the amount of R&D in Canada that we do, disproportionate to our sales. Well over fifty percent of our R&D is done in Canada, principally in Ottawa, but elsewhere as well, and that contrasts with under ten percent of our revenues. We have done a variety of projects with other governments. We have a cooperation agreement with the Australian government. We have done things in other parts of the world as well, including the British Isles.

QUESTION, MR. WOODS: These sessions always whet my appetite to do some reading, which is one of the side effects of coming to Professor King’s seminars. This is a quote from Paul Homer: “The world isn’t defined by scarcity and limits on growth, which would be the old economics. Instead it’s a playground of nearly unbounded opportunities where new ideas beget new products, new markets, and new possibilities as well.”

I am just talking about what Peter Drucker calls the "post-capitalist economies" – where the old ideas of scarcity of land and so on are just blown right away. It is a different approach than the nuts and bolts of doing the day-to-day business at Nortel. Ultimately, what I like about the word “courage” is that it reminds us we are not just talking about technology as something on your desktop. It is ultimately human beings who have the guts to do this or that. So, that is not so much a question, but could you offer any comment on that kind of approach to the new economy?

ANSWER, MR. ALLEN: Vision takes many forms, but in the private sector, one always has to be responding to perceived and reasonably early needs of the marketplace. That is what we try to respond to, and of course we plan well ahead. We plan evolutions of things. Our PBX system, the largest selling PBX system in the world, was the first digital system. This is the office switchboard that we first introduced in 1976. We have evolved that product so that the 1999 product is not the same as it was in 1976, but it is probably upgradeable from a 1976 to a 1999 product by having an “ever-green” approach. Our competitors have tended to introduce new products every four or five years with products that have generally not been compatible with previous products. Ours have evolved, and I think that is part of a visionary approach that says we try and get it right at the start, and then we follow up on it. At this point in time, with the move to data, we are seeing the need to restructure networks that, in some instances, were put in place fifty, sixty, or even seventy years ago.

QUESTION, MR. McNIVEN: I have a strategy question. You mentioned Ericsson and its interest in, essentially, things cellular. What is the strategic take on when you have voice and data, and then you have wire and wireless, if you will, and you have wired and cable?

COMMENT, MR. ALLEN: And you have wired data too. And you have unwired or non-wired data.

COMMENT, MR. McNIVEN: But, the wired-wireless and the wired-cable, are those easily similar challenges, if you will, to voice-data?

ANSWER, MR. ALLEN: I do not think so. I think the data switch versus the voice switch is quite a dramatic change. To move something from being wired to being non-wired is really just drawing on radio frequencies to get it from one place to another. It just does not go there on its own without a medium for carrying it. That is a known approach, using known technologies, which obviously evolve or are enhanced and refined, but it is not the same breakthrough need as we had in voice versus data.

QUESTION, MR. McNIVEN: What about the cable side?

ANSWER, MR. ALLEN: Well, cable is wired so, it is just –

COMMENT, MR. McNIVEN: It involves different switches.
COMMENT, MR. ALLEN: Yes, they are different switches. Of course, cable only goes one way and it does not really switch. This is what makes it so remarkable. Imagine you having a piece of equipment that is so large that it occupied this entire room. These days it is over in a corner of this room, and it has a hundred thousand different telephone calls coming into it at the same time. It moves them around and switches them and sends them off on different tracks to any part of the world. That is just absolutely remarkable.

What do they do in a cable station other than make the signal fuzzy? They grab something out of the air, amplify it, and pull it out with different frequencies on a cable. Then you have a unit, which is the television set, that breaks those up into the various things. It is just not the same complexity at all.

QUESTION, MS. JEFFREY: I wanted to raise again the question of foreign ownership. I agreed with Ron Atkey that it is something that is definitely going to be on the political agenda. I think we all understand that. But I was struck by your colleague’s chart yesterday about the big spenders on R&D in Canada. I was struck by how many of those companies, at least at the time the statistics were gathered, were in fact majority Canadian companies. We are talking about Newbridge Networks, Nortel, Corel Corporation, Bombardier, and Magna International, and it seems to me that there is a linkage here between the ownership of the company and whether or not significant benefits accrue to the country in which that company originates.

I think we see that with R&D. I know we see this on the cultural side, for example, when you look at where most of the recording artists that later become big stars get their starts. You see quite a disproportionate funding of those artists and start-up for those artists with Canadian companies. They later go on to larger U.S. distributors or whomever because it helps them reach a global marketplace. With respect to Nortel Networks, as you move into a greater global presence from your august background in Canada, how does that affect your vision and outlook on R&D spending and your sense of the contribution that comes back to Canada?

Secondly, I would like to pursue the foreign ownership question again and see whether you disagree that there is some relevance here.

ANSWER, MR. ALLEN: Nortel had its origins in Canada and continues to have a major presence in Canada and continues to have a major presence in Canada and continues to have a major presence in Canada and cannot be expected to be confined to Canada. My own view is that neither Northern Telecom or the other companies you have mentioned owe blind allegiance to Canada. The business was started in Canada many years ago. Canada has provided a good environment for us, but this is also true of the United States, the United Kingdom, and elsewhere. As a corporate policy, with a few minor exceptions, we basically refuse to take gov-
ernment grants or loans. We have done it ourselves. We like the R&D tax credits in Canada. But a major beneficiary of our R&D activities in Canada is the Canadian government with all of our R&D employees in Canada paying substantial income taxes.

What is not realized in Ottawa, and in many other places, is that Canada has to remain attractive for any company to remain there. With the high tax situation in Canada, as discussed yesterday, we have great difficulty keeping our people in Canada. We send our people down to work on projects in Dallas or Silicon Valley or wherever, and then we cannot bring them back. We cannot afford to do it because they would expect to be tax-equalized. So, if the government wants to retain us there to the extent we are there now, it really has to make it attractive for us and for the resources upon which we draw.

With respect to Newbridge Networks and Corel, if Northern Telecom had not been in Ottawa with its R&D, there would have been no Newbridge in Ottawa; there would have been no Mitel; there would have been no Corel; because the founders of those companies and about a hundred other companies were started by former employees of Northern Telecom or our R&D subsidiary, Bell Northern Research.

So, I think that the question becomes one of what do we as a company do? We have to find markets where they are. It should be attractive to governments and attractive to the population, the taxpayers, if we find those markets around the world. What we are doing with our success in the United States and overseas is pumping a lot of money into Canada that would not otherwise be there. But I do not think that Canada owns us, and I do not think they should expect us to remain there just because we were born there.

We tend to see ourselves as business people with a Canadian-headquartered company, but one which serves markets around the world, and we are going to do what we have to do to respond to those markets.

QUESTION, MR. DELAY: Do you see the next generation telephone companies, as they are called, such as Nextel, Level (3) Communications, or Qwest, as becoming monumental companies ten to fifteen years from now?

ANSWER, MR. ALLEN: Yes. I think they are already monumental companies if you look at their market capitalization. They have done extraordinarily well and, for instance, where did WorldCom come from all of a sudden? We see companies like WorldCom come along and take over the first of the major alternative carriers in the United States, MCI. WorldCom has been around seven or eight years, whereas MCI dates back now approximately thirty years. Nortel supplies Qwest, Teligent, and a lot of other companies that are putting in state-of-the-art networks. They have an advantage in that they are leapfrogging the traditional carriers because they can put in net-
works, as these are, with our equipment. These networks are optimized for voice and data, rather than, because of substantial investment, transforming a traditional supplier from a voice to a data company.

QUESTION, MR. DELAY: Now that those companies have become that large, and they are now leapfrogging into Asia and Europe, are these good acquisitions for Canada if Canada wishes to develop monumental companies that grow very fast?

QUESTION, MR. ALLEN: When you say good acquisitions, do you mean a company in Canada goes out and acquires those?

COMMENT, MR. DELAY: Yes, I was thinking of that.

ANSWER, MR. ALLEN: As a Canadian investor, do you think we have investors like that? The tragedy, if you want to know, is that Canadian investors are so conservative they will not even consider doing these things in Canada. There are obviously a few courageous investors, but basically, we do not have this same entrepreneurial spirit in Canada.

QUESTION, MR. WOODS: I am just curious. This is going back to one of your footnotes. Do you know whatever happened to that undertaker in Kansas City, Strowager? Is it true that he dug himself out and buried the opposition?

ANSWER, MR. ALLEN: He ultimately died, and I understand one of his competitors handled the funeral arrangements. It is an interesting story, and it is an accurate story, that of Strowager and the Strowager switch. I remember doing deals in the U.K. in the 1970s, and they still spoke of the Strowager switch, though it had changed somewhat. I remember once in the 1970s again going to a Bell Canada operation in Ottawa where they had almost every generation of switch, going back about forty or fifty years. You could see the history of the evolution of this equipment. They had the old telephone switches with operators. They had relegated that to handling long distance calls at that time where operator assistance was required. So, the equipment works forever.

COMMENT, PROFESSOR. KING: You have left us with a lot to think about, Clive. I am amazed at the amount of technical knowledge that we have here. We have raised some issues, and we thank you for it.