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Avaya: Confronted by Revenue Loss and 2017 Debt Wall, Avaya Unlikely to Keep Pace with Increased Competition; Government Contracts Provide Little Insulation from Market Trends

Outlook for Avaya

More competition and substantial debt burden limit Avaya's ability to keep market share in unified communications. Enterprise communications stakeholders are interested in whether Avaya can stabilize its recurring revenue base of IP-enabled and cloud-based communications services, especially given that several key Avaya products with traditionally high market shares (such as private branch exchange, or PBX, systems) are becoming outdated.

Through interviews and analysis of procurement processes, we have found that enterprises are demanding interoperable, IP-enabled communications services that use a subscription-fee model, areas where Avaya is at a competitive disadvantage. We have also found that federal, state, and local government entities are moving - albeit at a slower pace - to demand similar enterprise communications services that utilize this cost model. Such demand is likely to result in more competition on price, quality, and innovation, and a potential continued decrease in Avaya's revenues. Further, Avaya – which has been late-to-market with a cloud-based, subscription-fee offering – already has a substantial debt burden, which combined with persistent revenue loss, will likely weaken its ability to reinvest in competitive products and services.

The government procurement process for enterprise communications does not insulate Avaya from competition. Sources indicate that when public entities upgrade legacy communications systems, they are demanding interoperable, IP-enabled communications services. Avaya holds two General Services Administration (GSA) schedule contracts which do not guarantee Avaya business until an agency places an order. Once an agency places an order, the order can be open to bids from other comparable GSA schedule holders, and telecommunications eligible vendor lists tend to be lengthy. Therefore, each order by each federal agency (or state or local government entity) potentially exposes Avaya to a competitive bidding process.

An industry technical expert we interviewed identified Public Safety Access Points (PSAP) and state universities as markets where Avaya leads, and as public customers who are most likely to shift away from Avaya in the near term. PSAPs are consolidating and transitioning to IP-enabled architecture, and are making new procurements in a more competitive unified communications market. Similarly, as state universities upgrade their IT systems, they are considering more compelling unified communications offerings, such as those by Broadsoft.

Avaya Not Shielded by Government Contracts

Government procurement process potentially exposes Avaya to competitive bidding for each order. The GSA schedule establishes long-term, government-wide contracts with vendors. Indefinite delivery, indefinite quantity (IDIQ) contracts allow an agency to choose from a list of vendors for each order (which can be determined through a competitive bidding process). Through Schedule 70, authorized state and local government entities can purchase from GSA vendors, giving these entities a broader selection of vendors than might be possible individually. Thus, Avaya's GSA contracts do not necessarily secure it business, and can require Avaya to compete with other GSA schedule holders for each order.

Industry technical expert indicates Public Safety Access Points area for potentially significant state level revenue loss; Avaya states in recent earnings call that its contact center offerings are where best profit margins exist. Avaya has a high market share in sales to PSAPs, traditionally providing telephony equipment and system maintenance for contact centers. These offerings have transitioned to IP-enabled contact center software and hardware products, including next-generation 911 (which enables multimedia contact routing such as texts, voice, video, etc.). On its most recent earnings call, Avaya stated its contact center revenue was ~$1.1 billion (this includes products, services, and maintenance), and its contact center offerings are where its best profit margins exist due to lower discounting and higher renewal rates.

PSAPs are consolidating to increase the resources and technological capabilities at each PSAP, which likely exposes Avaya to increased competition as consolidation is leading to new procurements of IP-enabled services. Traditionally, PSAPs are localized, serving a county or municipality. The evolution of IP-enabled communications, budget limitations, and criticism of 911 service have led to consolidation of PSAPs, with the particular design of one PSAP functioning as a shared data and multimedia routing center. The FCC Task Force on Optimal Public Safety Answering Point Architecture reported in January that "this trend towards PSAP consolidations, where it is practicable, and results in efficiency gains, is accelerating as more IP-enabled architecture is deployed and services are shared."

For instance, the City of Tulsa became the primary PSAP for Tulsa County in 2013 due to "advancing technology and limited financial resources," which meant Tulsa County would pay the City of Tulsa $864,600 to provide PSAP services. Whereas before there were two government entities procuring PSAP services, now the City of Tulsa has a substantially larger budget to make new procurements of IP-enabled services that also must integrate other PSAP systems. Ultimately, the PSAP transition to IP-enabled communications and shared services exposes Avaya to the same market trends discussed above.

State universities suffer from same market trends. An industry technical expert noted that Avaya's telecommunications equipment and services contracts with state universities suffer from the same market trends. He mentioned that as higher education institutions upgrade their IT systems, Avaya has less compelling products due to the evolution in telephony. Universities may migrate to their own platforms, but ultimately are likely to dump old telecommunications equipment, as opposed to renewing existing contracts.

Federal government transitioning to cloud. A recent IDC report indicates that in FY 2016, 8.5% of all federal IT spending will be on cloud-based services and that by 2018, cloud spending is expected to be 50% of all government IT spending. The administration codified a "Cloud First" procurement policy in late 2010 which required that "agencies default to [procurement of] cloud-based solutions whenever a secure, reliable, cost-effective cloud option exists." The policy essentially mandates government agencies to transition to cloud-based services to the extent practicable when they upgrade their IT systems (i.e., make new IT acquisitions).

It should be noted that government agencies lag in cloud adoption compared to private enterprises due to drawn out procurement processes, budget uncertainty, and acquisition regulations, among other reasons. However, this push toward government-wide cloud procurement particularly threatens Avaya, as lower cost, cloud-based alternatives to Avaya's legacy telephony products and services abound (such as Microsoft Exchange with Lync or Skype for Business). Additionally, IT system upgrades can entail replacement of Avaya unified communications offerings with more fully integrated all-IP systems.

To alleviate lag in agency adoption, the administration continues to develop programs to accelerate acquisition of cloud services, which suggests government transition to cloud-based services still has momentum. One important program has been FedRAMP, which standardizes cloud procurement requirements (such as cybersecurity) across agencies. Additionally, GSA issued a request for information (RFI) in January soliciting assistance to "help agencies transition to cloud computing technologies and services." These initiatives suggest a clear government procurement move toward cloud-based services. Of note is that Avaya currently has two GSA schedule contracts:

- Connections II, Category CNXII: This IDIQ contract "covers global telecommunications infrastructure for any federal agency's buildings or campuses utilizing a task order-based competitive process." Connections II includes 21 vendors. Avaya's contract expires January 2021.

- IT Schedule 70: This IDIQ contract allows authorized federal, state and local government entities to purchase from GSA vendors. The schedule has 25 categories, some with several subcategories, which list eligible vendors. For example, the "telephone equipment" subcategory has 278 eligible vendors and the "audio/video conferencing equipment" subcategory has 290 eligible vendors. Avaya's contract expires January 2019.

Order value and duration has wide range. Order types could include telecommunications equipment, hourly maintenance costs, or an enterprise communications system. Smaller orders could be valued at several thousand dollars, whereas a bid that Avaya lost went for $14.2 million in 2013, and another bid that Avaya lost went for $34.8 million in 2014. The first bid was to provide an enterprise interactive voice response (IVR) system for the VA in one year with two one-year options to provide maintenance and technical support. The VA ultimately awarded the contract to American Systems Corporation (ACS) because ACS had a better "technical approach" and its bid was $3 million cheaper. The second bid was to provide litigation support services for the Navy for one year, with six one-year option periods. The Navy awarded the contract to Pragmatics, Inc. because Pragmatics had a better staffing approach.

Switch to Cloud Continues to Threaten Avaya

Enterprise migration to subscription-fee cloud and all-IP networking existentially challenges Avaya's traditional revenue model. Avaya is late-to-market in offering cloud-based unified communications services. Avaya's traditional revenue model relied on product sales (such as phones, gateways, servers, endpoints, Ethernet switches, etc.), and associated maintenance and professional services.

In its most recent 10-Q, Avaya outlines how enterprise demand for cloud-hosted communications services continues to significantly decrease Avaya's revenue: "As a result of a growing market trend around cloud consumption preferences more customers are exploring operational expense, or OpEx models, rather than capital expenditure, or CapEx models, for procuring technology." Avaya's CapEx model involves direct or indirect product sales to enterprise customers, whereas the OpEx (or subscription-fee) model consolidates communications technology and servicing costs into a subscription fee. Avaya goes on to describe how the OpEx model hurts product sales by weakening demand for gateways, servers, endpoints, Ethernet switches, etc., and the continuous decline in product sales contributes to "declines in associated maintenance services and professional services revenues."

The market shift to IP-enabled, interoperable communications services opens Avaya to substantial competition. To support its downgrade of Avaya's debt to Caa1, Moody's indicates: "The current capital structure is particularly problematic given the changes underway in the unified communications market. In addition to changes in the architectures of corporate communications systems, the increasing preference for subscription based pricing models hurts [Avaya's] near term revenues, profitability and cash flow." The "architecture changes" are a shift to integrated and cloud communications from discrete telephony and networking systems. Integrated communications make discrete networks (like PBX systems) a less differentiated product, and provide enterprises with a wider range of substitutes.

Avaya's late transition to cloud faces uncertain time horizon, lacks sales force to effectively compete. Two industry technical experts indicate that Avaya doesn't currently have a compelling subscription-fee model product, and Avaya's biggest competitors (Cisco and Microsoft) have substantially stronger enterprise sales forces, placing Avaya at a competitive disadvantage to sell new software and services to enterprises. In its Fiscal Q2 2016 earnings call, Avaya estimates only $15-20 million in revenue per quarter shifting from CapEx to OpEx, as compared to ~$300 million in revenue loss per year. Moody's confirms that "Avaya will need to constantly reinvest in new products and platforms to maintain its position against Cisco, its much larger and better capitalized primary competitor as well as smaller cloud based competitors."

Further, Avaya's cost-savings initiatives may need to reverse course in the near-term, possibly further reducing operating income and profitability. In its most recent 10-Q, Avaya highlights the success of its cost-savings initiatives, which include lay-offs, job relocations, employee benefit cuts, and elimination of real estate costs. Avaya makes clear that the success of its cost-saving programs have enabled it to maintain profitability despite a precipitous decline in revenues; however, in its most recent earnings call, Avaya mentioned the need to expand its direct sales team in order to compete for OpEx business (especially in light of its competitors' enterprise sales forces). Indirect sales represented 72% of sales in Q1 2016, only down 1% from Q1 2015. To compete effectively for cloud-based, subscription-fee customers, Avaya will likely need significantly greater direct sales resources. Therefore, at a certain point, cost-savings initiatives, at least as outlined, could diminish and become less of an offset to decline in revenues, ultimately reducing profitability.

Google AdWords research demonstrates high marketing costs for enterprise communications and further suggests highly competitive market. Search Engine Watch recently analyzed the 100 most expensive Google AdWord keywords in the US by cost per click, and "business phone service providers in my area" ranked #13 at $344.25 per click. Other keywords such as "commercial phone service" and "business phone services" also made the list. Cost per click indicates how much companies are willing to pay for their ad to pop up for certain keywords. Comparatively high marketing costs could be a signal of a highly competitive market for enterprise communications.

Brief Background

Through AT&T/Lucent legacy and several acquisitions, Avaya attained sizable share of unified communications market. Lucent, created by AT&T's divestiture of its telecommunications equipment manufacturing division and Bell Labs, spun off its enterprise communications unit in 2000, creating Avaya. PE firms TPG Capital and Silver Lake Partners purchased Avaya in 2007 for $8.2 billion, and, through Avaya, also acquired Nortel's Enterprise Solutions business in 2009 (IP voice, telephony and data networking equipment) and

Radvision in 2012 (videoconferencing). Avaya reports high market shares in unified communications, telephony systems, unified messaging, contact centers, and voice maintenance services.

Maturities due October 2017 could function as debt wall. On February 12, Moody's downgraded Avaya's debt to Caa1 from B3. Moody's explained: "The downgrade was driven by continued declines in performance as well as concerns about the sustainability of the current capital structure including its ability to refinance $600 million of debt maturing in 2017." As revealed in its recent earnings call, Avaya hired Goldman Sachs and Centerview Partners for possible sale of certain assets, sale of company, and capital restructuring. Avaya's interest in selling its assets suggests some skepticism in its ability to refinance October 2017 maturities, or other longer-term debt.