Strategic Report for Sprint Nextel

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TABLE OF CONTENTS

Executive Overview

Sprint Nextel is facing a complicated situation. Still contending with merger issues, and spinning off the smaller entity Embarq, Sprint must decide how to become a power player in wireless telecommunications. It's pitted against Verizon and Cingular, which are stronger opponents by their sheer numbers alone, but also possess connections to local telecoms that fortify their positions in the market. Sprint has a recent acquisition of a precious piece of bandwidth, a wide swath within the 2.5Ghz band. In the struggle to find a radio frequency to broadcast signals, 2.5Ghz is considered one of the most optimal for the upcoming WiMAX race into fourth generation cellular technology. Sprint Nextel has a superior position in that regard, but it still faces possible competition through people using less efficient bands, and merely optimizing the use of the bands they already use. Looking forward, Sprint's strategy must find a way to maximize any profit they can incur from this differential asset, while maintaining Sprint's current business of mostly low-tech customers using merely second-generation technology.

Company History

Ancient History

United Telecom was founded in 1899 by Cleyson Brown. It was formed in Abilene, Kansas as a competitor to the monopoly Bell System. The first long-distance line was formed the next year, and two years after that, Cleyson and his brother Jacob Brown chartered the Brown Telephone Company. In 1903, they and 14 other Kansas telephone companies formed the Union Telephone and Telegraph Company. In 1925, Cleyson Brown formed United Telephone and Electric, and used it to slowly take control of the stocks of 68 other companies (although not all telephone companies.)

The great depression led to a significant decrease in customers, and in April 1933, the United companies were forced to reorganize, and Cleyson Brown was forced to surrender control. United Telephone and Electric, however, recovered quickly, and was reformed in 1939 into United Utilities, and gained third position in the national telecommunications market by the 1950s.

Carl “Skip” Scupin, hired by Cleyson Brown in 1921, became president of United Utilities in 1959. He changed the system of sales to subsidiary-based service (that is, individual, smaller companies running local lines) with nationwide advertising (a system still common today). The company went through a rapid growth period in this time, with revenues increasing at 10% per year for a decade.

In 1964 Scupin retired to become Chairman of the board, and the then-vice president Paul H. Henson filled his place. Henson’s methods presented a compromise between Brown’s original method of centralization and Scupin’s ideals of subsidiaries. He kept the subsidiaries in control of service, but merged the engineering and accounting into a national program. Between 1964 and 1966, Henson sought to acquire a much vaster service, and doubled the size of the United telephone system. Between 1967 and 1969, the company again doubled through new additions in Florida, Texas, and North and South Carolina.

After reaching this goal of quadruple expansion, Henson decided the time was ripe for the company to truly become a telecommunications company, rather than just a phone company, and began expanding into television, telecommunications equipment, and computer time-sharing. The name was changed from United Utilities to United Telecommunications.

United then partnered with GTE, which had recently acquired the newly formed company named Sprint. In 1986, the partnership was complete, and they merged into a single company in 1989, under the Sprint name. This name lasted until Sprint bought Nextel, and changed its name to Sprint Nextel on December 15, 2004.

Modern History

Currently, Sprint Nextel is the third largest telecommunications provider in the country, behind Cingular and Verizon (in terms of customers). It has roughly 60,000 employees, and a market capitalization of over $68 billion. In 2004, their revenues were over $27 billion, had an income loss of about $1 billion, and total assets of over $41 billion.

The most important aspect of Sprint Nextel's modern history is the merger with Nextel. Nextel was founded by Morgan O'Brien as Fleet Net. In 1993, it was named Nextel, and quickly gained market share in wireless communications. Nextel merged with Dial Call and OneComm in 1994, and began using iDEN technology in 1996. iDEN, or Integrated Digital Enhanced Network, is a fairly low-band wireless network (800 MHz – 1.5 GHz) that allows communication over phones in addition to modem and point-to-point (or two-way radio) communication. Although this was the mainstay of Nextel's service, and still is for the unfortunate customers that have Nextel phones, Sprint is currently planning obsolescence for the technology, and will be bringing the customers to Sprint's other networks.

At the time of the merger, which was completed in the end of 2005, but only given full DOJ approval February 6 of 2006, Sprint was the number three telecommunications

provider in America, and Nextel was number 5. The acquisition of Nextel was likely not for their iDEN capabilities, since Sprint is not planning on using that in the future. Speculation is that Sprint is using Nextel is for its holdings of 2.5 Ghz bandwidth. Sprint acquired roughly 35% of this band from FCC when it was originally auctioned, and MCI-WorldCom acquired roughly another 35%. When MCI-Worldcom was broken up, it lost the rights to these frequencies, and the newly formed Nextel bought up the majority of the share. When Sprint bought Nextel, along with other acquisitions over time, they gained control of 80%. The 2.5 Ghz frequency has a few unique characteristics which will covered in the following section.

The next most important event in recent history is the spin-off of Embarq. Embarq (which is expected to spin-off this quarter) is a collection of local telecommunication land-line companies that will consist of around 20,000 employees (to Sprint Nextel's 60,000). The spin-off is evidence that Sprint-Nextel is planning to focus on winning the wireless race. Since Sprint now has very limited connections to land lines, they are free from the cannibalization risk of quickly adopting wireless technology that Cingular and Verizon share as well as competing against local telecoms.

Technological History

The "cellular revolution" is a misnomer, it has been closer to an evolution; a vast number of competing technologies are constantly both upgrading and dying off. The history of the technologies is measured on a scale of "generations," which is loosely based on the improvements made every 10-15 years. The benefit of such a system is that it's very easy to understand in terms of how fast things are developing, the problem is that some technologies developed later are actually inferior to its previous generations. It's also important to note that these generations are marked based on the American availability of the technology, despite most advances being available in Japans and

sometimes Europe first. Generally, however, a clear progression of capabilities can be traced across the generations. The First Generation (1G) technology came with the advent of the Advanced Mobile Phone System (AMPS) by Bell Labs. This was an analogue-only signal that provided basic point-to-point calls. Second generation (2G) found the first digital connection, upgrading the abilities of a cell-phone somewhat allowing for a clearer connection in some areas and the advent of text messages (a significant advance when it came to Europe, earlier). Third generation (3G) introduced media content with the cell phone, including pictures, music, and blackberries. And the next generation, 4G, which is only now available in parts of Japan and about to be born in America, allows for broadband internet over cellular technology, and the first true reliance on digital signal rather than analogue.

Five Forces

Internal Rivalry

Sprint is a member of the Wireless Telecommunications industry. Cingular Wireless, Verizon Wireless, Sprint, and T-Mobile USA combined controlled 90% of the top ten companies' subscribers in 2005, showing a high concentration. By the end of 2005, wireless will have 210 million subscribers, 17% more than in 2004, the total number of minutes increased 30%, and the revenues increased from $102 billion to $109 billion. Cingular and Verizon, the two largest, are tied to wireline companies while Sprint Nextel and T-Mobile are not.

Competition within the groups consists of a great number of different characteristics including pricing, package deals, reliability, data services, and bandwidth. In terms of package deals, family plans are a particular mainstay of Cingular's business, and form a strategy of theirs to promote branding. Beyond simple price is the reliability of

different networks. Although this is largely based on the different technologies involved, the end-user is sensitive

The key to Sprint Nextel's position is their control over the 2.5Ghz frequency (as mentioned in the History, this is a set of bands that allows Sprint Nextel and virtually no one else to provide high-speed internet over cell phones). This unique ability allows them to sell devices that others in the telecommunications industry cannot. The problem is that Sprint does not actually sell these products, it partners with LG, Samsung, and Nokia, which sell them. But since no other telecom company can offer such capabilities, Sprint Nextel has the ability to capture rent from these other companies. So while Sprint Nextel is not in that particular business directly, and this is technically a question of supplier power, the entire Sprint Nextel profits are highly correlated with the electronic device industry and I wish to follow up on the five forces for that as well as telecommunications.

As Sprint Nextel moves their sponsored products into more powerful cell phone technology (the broadband capabilities especially), they inevitably begin competing with other types of technology; in other words, the concept of convergence, a concept which they have bet their fortune on, depends greatly in the interdependencies of cell phones, blackberries, PDA's, portable audio and video players, and even hand-held gaming devices. All of these products may, in time, might all become contenders for the single space in buyers' pockets. In this industry, the internal rivalry is intense and dynamic. Every company has their own strategies for increasing demand for their products, which can increase market share and/or increase the total market. The demand for these products is highly variable, and the entire extent of the market has yet to be determined. The major players are Apple (although only because of the iPod),

Sony, and the companies allied with Sprint Nextel, Nokia, LG, and Samsung. Internal rivalry poses a strong threat to Sprint Nextel (via their partners) if only because of the risk and uncertainty of this market.

Within telecommunications, Verizon and Cingular are the major rivals against Sprint Nextel in wireless (the majority of their business with $12 Billion in annual revenue), with AT&T and local companies playing in the land line industry (Sprint Nextel had a $6 Billion annual revenue from this market, but it isn't clear how that will stand after Embarq leaves with a third of Sprint Nextel's workforce). All players here tend to compete within a set amount of customers, and vie for market share. Sprint Nextel's survival will depend on their ability to market the usefulness of their latest technological leap.

Substitutes and Complements

The wireline telecommunications industry doesn't face many potential substitutes. That ability to talk over the phone is unique, and while the internet has brought some substitutes, email and instant messaging tend to compete more with regular mail than phone service. The one question in this is VoIP (Voice over Internet Protocol), or whether long-distance calls can be routed through the internet in a way that the average customer can understand. This technology is a way to invent around long-distance calling, but Sprint Nextel can capture much of the revenue from this idea through offering local internet service regardless. Wireless technologies are more prone to substitutes, since they come with higher costs, but a cell phone is such a unique device that it doesn't show any sign of being replaced by other communication technologies.

The substitutes and complements of electronic devices is obviously a much stranger situation, and provide a strong force against Sprint Nextel. Since their success rides on the success of wireless broadband cell phones, these devices must prove to be the most efficient (or at least popular) method of providing information, entertainment, and organization to customers. Sprint Nextel calls this revolution the "third screen," as in the next stage in content delivery after the television and the home computer, and the competition includes everything from the iPod to the Sony PSP to the Blackberry.

Entry

Entry into the telecommunications market is extremely limited, due to the massive fixed costs and the credible threats of Cingular and Verizon. The wireline component is even more entrenched (due to the cost of "last mile" wiring, and some analysts contest that even while Sprint Nextel is exiting this market, its relative impenetrability will yield some profits. This is not a significant force against Sprint Nextel

Another type of entry issues exist in this particular market, however. The possibility of the big telecommunication companies from entering into specific technologies also poses an interesting question. The most relevant of which is, of course, the question of whether or not Sprint Nextel's unique bandwidth can be entered or duplicated. Since this is so core to the future of the business, this issue will be revisited in the Strategy Issues section.

Supplier Power

Supplier power is not likely to be a strong force against anyone in either market. Most businesses, telecommunications as well as other device manufacturers, build their products from parts manufacturers that are easily interchangeable. The evidence for

this is that many, but not all, electronics companies (such as Sony and Samsung) produce the parts that others buy. If the vertical integration can exist or not exist between competing companies, then it is not likely to be the only determinant of success. The one potential exception is Intel, which manufactures chips, and is moving quickly into the WiMAX arena, building chips specifically for that purpose. Intel is by far the most powerful player in the chip market, and may be able to exert some influence on the pricing of wireless services dedicated to computers. Another interesting point is that the ultimate supplier of spectra, which is really what the wireless communications market is, is the government. But since the government sells the spectra to the companies through auction, it maintains no power whatsoever.

Buyer Power

Buyer power is the most difficult force to assess, and the most important. Within simple cell phone users, switching costs are fairly low, and buyers show low brand-loyalty (this is evidenced by the success of Sprint Nextel's latest sales campaigns). These companies all try to maintain customers through complicated plans that reward loyalty, but it has not proven as successful as similar programs like airline miles.

Sprint Nextel has power over the companies that sell the phones that go with the plans due to their much-mentioned bandwidth monopoly. They can extract profits in this regard since any electronics company can make the technology for wireless broadband, but only the ones with Sprint Nextel's license can use it. The question then is how much this will affect customer loyalty, which has yet to be seen.

Financial Analysis

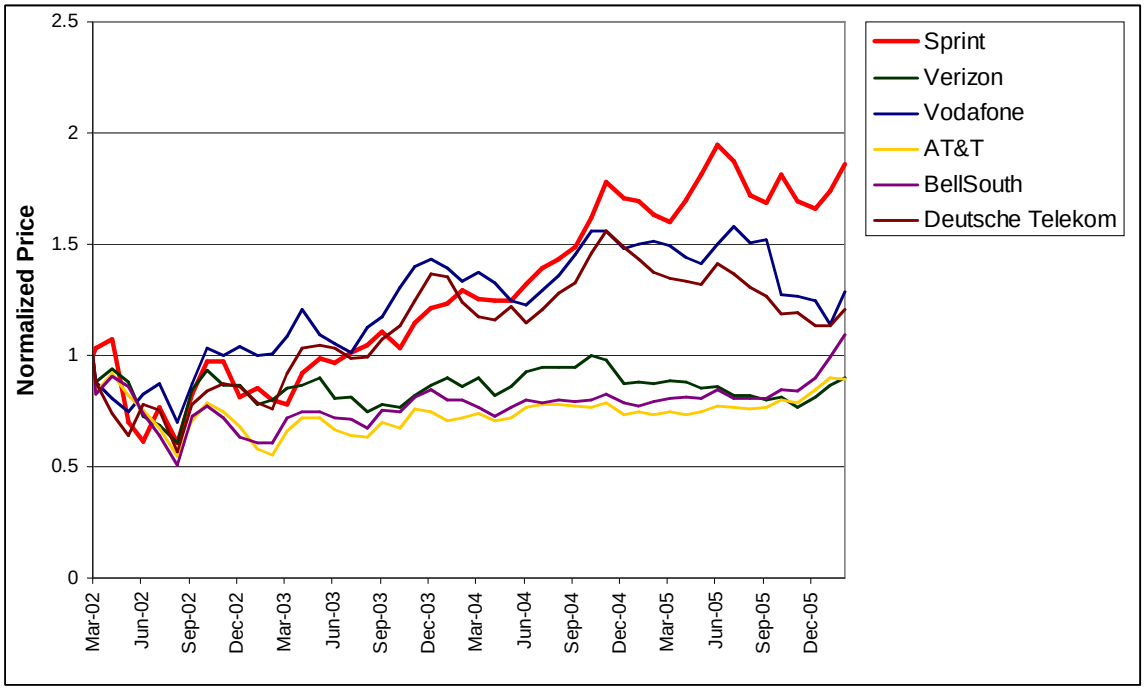
Analysis of Sprint Nextel is skewed by Sprint's recent acquisition of Nextel. All relative measures become less meaningful in this awkward adjustment stage, and for the next

few years, the regular tools for understanding their finances will be hindered. The merger cost Sprint just under $40 Billion, which is risky considering some analysts value all the current synergies at only $12 Billion[i]. The combined entity of Sprint Nextel has $35 Billion in annual revenue, 80,000 employees, and nearly 50 million wireless subscribers. Sprint has performed well against its competitors, although in telecommunications, diversified communications, and wireless communications, it's tricky to separate the performance of individual sections of the business. Another difficulty in measuring Sprint's performance is that many of its main competitors, including Cingular and T-Mobile aren't public companies. And the final complication is the difficulty in placing Sprint in an industry. They are categorized generally in telecommunications, but can be placed specifically in several industries, and even then, the wireless segment of their business is the one which is most relevant, since it is the only growing segment and the local segment will be spun off as Embarq. Nevertheless, within these groups, and within Sprint's own history, we can find some useful analytics.

Looking first at the basic industry comparison (in this case diversified communications), we can immediately see how Sprint compares to other companies in general. Sprint is clearly one of the largest companies, at about the same size as Cingular, and half the size of Verizon. In the stock chart below we can see the recent stock trends affecting the main players in this industry. T-Mobile is a subsidiary of Deutsche Telekom, and Cingular is a joint venture of AT&T and BellSouth, so while we can't track those companies directly, we have some idea of their performance here. Sprint is indeed the most successful stock of the group, nearly doubling in the past 4 years, while no one else has topped a sustained 30% gain. What's also apparent is how

highly correlated the variations of these stocks are, which can be seen by the concurrent peaks and valleys in the stocks (especially in mid-2002).

Chart 1: Stock Comparison



The DuPont Analysis obscures as much as it shows at first glance because Sprint's finances are working on two separate levels. Sprint never had a great Return on Equity, seen from the mediocre 10% number for 2003 (the current industry average). In 2004, the number drops into the negative simply because of a drop in income. If we check Chart 1, we can see that oddly this doesn't reflect a drop in investor confidence. In fact, in 2003, Sprint shoots ahead of many of its competitors. For an explanation we turn to Table 2, and notice that the only loss of profit (in the main segments) is from long

Table 2: DuPont

		Taxes	Financing	Operations	Avg. Prof.	Turnover	Solvency	ROE
2005	Sprint	0.61	0.68	0.12	0.05	0.48	2.20	0.05
	Verizon	0.70	0.83	0.17	0.10	0.45	4.33	0.19
	Cingular	3.44	0.06	0.26	0.05	0.43	N/A	N/A
2004	Sprint	0.63	4.52	-0.01	-0.04	0.65	3.15	-0.08

	Verizon	0.77	0.81	0.18	0.11	0.43	4.67	0.22
	Cingular	0.01	15.93	0.46	0.08	0.36	N/A	N/A
2003	Sprint	-2.56	-0.56	0.03	0.05	1.23	1.63	0.10
	Verizon	0.65	0.63	0.11	0.04	0.86	4.98	0.09
	Cingular	2.24	0.23	0.28	0.15	0.62	N/A	N/A

distance. Investors didn't heed this as a bad omen for two reasons. The first is that the loss represented an increase in one-time costs to the long-distance infrastructure, and not a decrease in revenue. The second reason is that analysts aren't optimistic about long distance in the future regardless, due to increasing cell phone and VoIP use. In 2005, the ROE went into positive numbers, as the income for long distance did the same, but didn't reach even the low 2003 amount. The reason for this is that Sprint acquired Nextel through mostly equity (less than $1 Billion cash was used in the $37.8 Billion deal[ii]), which nearly doubled the amount of Sprint's common stock in 2005.

Table 3: Sprint Segmentation

(millions)	2005		2004		2003	
	Revenue	Income	Revenue	Income	Revenue	Income
Wireless	22,328	2,173	14,647	1,552	12,690	634
Long Distance	6,834	512	7,327	-3,589	8,005	-1,442
Local	6,527	1,758	6,421	1,736	6,486	1,820
Total	34,680	1,785	27,428	-1,012	26,197	1,290

In a more detailed look at the DuPont results, we can bring Cingular into the mix, although it becomes slightly complex as Cingular isn't a publicly traded stock, but instead a joint venture of AT&T and BellSouth, who own 60 and 40 percent, respectively. This unusual arrangement is likely to create all sorts of skewed results, and it seems likely that the outliers of Cingular's 2004 financing multiple and 2005 and 2003 taxes are some result of this, rather than underlying financial situations.

Nevertheless, it's interesting to note that Cingular has a continually decreasing average profitability, and turnover that's decreasing, but not as quickly as Verizon and Sprint.

By going into the five component separation of Table 2, we can see that Verizon's main advantage is solvency. The explanation of this radical difference comes simply to the common stock. Verizon has had only $277 Million in common stock over these three years, while Sprint has had between $3 and $6 Billion. Of course, much of the Sprint stock, as mentioned earlier came from recent equity used to purchase Nextel (that is, Nextel's shares converted to Sprint shares), so Sprint is expected to enact stock buy-back programs.

If we go straight to the raw data in table 4, we can understand the difficulty of Sprint's position against Verizon and Cingular in its fundamentals. In terms of pure income and assets, Verizon is the undeniable powerhouse. Sprint and Cingular are also vastly less profitable, on average, than Verizon, which only has about double their revenue, but about quadruple their profits. But considering Verizon's stock performance, investors and analysts seem to retain confidence. It seems that despite fundamentals, Sprint maintains some long-term strategic advantage that Verizon doesn't have, something which investors respond to. The question is then whether this advantage will truly pay out, and eventually turn into sales and profit, or if the gamble will fail.

Table 4: Raw Data[iii]

(thousands)		Net Income	EBT	EBIT	Sales	Avg. Assets	Avg. Equity
2005	Sprint	1,785,000	2,906,000	4,257,000	34,680,000	71,950,500	32,729,000
	Verizon	7,397,000	10,607,000	12,787,000	75,112,000	167,044,000	38,620,000
	Cingular	1,824,000	531,000	8,974,000	34,433,000	80,778,500	N/A
2004	Sprint	-1,012,000	-1,603,000	-355,000	27,428,000	41,998,000	13,317,000
	Verizon	7,831,000	10,112,000	12,496,000	71,283,000	165,963,000	35,513,000
	Cingular	1,528,000	143,000,000	4,893,000	19,565,000	53,884,000	N/A
2003	Sprint	1,290,000	-504,000	897,000	26,197,000	21,360,057	13,113,000

Verizon	3,077,000	4,761,000	7,558,000	71,283,000	166,718,000	33,466,000
Cingular	2,254,000	1,005,000	4,343,000	15,483,000	24,833,000	N/A

Strategic Issues and Recommendations

Sprint Nextel's key lies in the one area in which its competitors have a barrier to entry: the WiMAX spectrum. As mentioned before, Sprint does not own the entire spectrum, but they own roughly 80% of the rights as of their acquisition of Nextel, and the government prevents any other players from infringing on these rights without Sprint's consent. The only possible method of entry is by inventing around the technology, and achieving the same bandwidth through other means. If that is an unreasonable proposition, however, then two questions become readily apparent: how can Sprint Nextel maximize the profit of this unique position, and can they use it to gain a foothold into longer-term wireless positions.

The first relevant issue is whether the other 4G technologies, the WiMax imitations are viable enterprises. A report published by Alcatel, a consulting group for telecommunications companies, states 8 requirements for the formation of a 4G network, and all of them are possible and/or underway at Verizon and Cingular except for having a "sufficient spectrum[iv]." Other analysts seem to suggest that 3G networks can expand close to the level of 4G bandwidth on current technology, but with increasing costs[v]. The COO of Sprint Nextel, Len Lauer believes that Sprint's advantage will give them 2 years of 4G ahead of the competitors.[vi] One thing that is certain is that a powerful position in 4G technologies requires a strong 3G presence (the carrier switches low-bandwidth uses to the lower generation technology to maximize their 4G capabilities), but this should be no problem on Sprint's current path as Sprint's EV-DO (their current 3G network) offering is over 150 million customers[vii], while Verizon's is 148 million[viii]. And Sprint's plans for the future of 3G are a technology called EV-DO

Revision A, which will be implemented in the first quarter of 2007. Sprint also plans to include 220 million people in the U.S. by the end of the third quarter of 2007. Speeds on these networks increase from 2Mbps to 3Mbps (at peak)[ix]. Pandora Group therefore believes that Sprint Nextel has a strong advantage in the upcoming bandwidth competition, and we look next at how to maximize that potential.

The next issue is how exactly Sprint Nextel can capture the profits. This question is difficult as it assesses the implicit question of convergence. For WiMax to truly become effective Sprint Nextel must work with computers as well as home media centers effectively. Sprint Nextel has already forged a lasting partnership with Intel in providing assistance with computer-related products, but the next step is home media.

> "The Bells are just starting to build ultra-fast fiber networks to homes and neighborhoods to offer voice, data, and video. But the Bells have wireless to grab back the lead -- and cable doesn't. "Cable executives are petrified," says one media investment banker. That's why Comcast (CMCSA), Time Warner Cable (TWX), Cox, Charter, and BrightHouse Networks (Advance/Newhouse's cable holdings), have formed a consortium to assess their wireless options. For now, they'll likely buy wireless services from a partner rather than purchase a wireless operator outright. That's a ripe opportunity for Sprint Nextel."

Soon after that report, Sprint in fact made an alliance with cable companies. The joint venture, has a combined initial financial commitment of $200 million, $100 million of which will be committed by Sprint and $100 million of which will be committed collectively by the cable companies[x]. Len Lauer, the COO of Sprint Nextel stated recently that, "our focus for that will primarily be on mobility, but it may also apply in competing with cable and DSL modems because if you've got a service that is running at a couple of meg per seconds and price it attractively, you could compete with the cable modem and DSL company[xi]." But these negotiations are still a means to a further

end. If Sprint Nextel cannot secure a long-term advantage, it will eventually lose against the larger capital and muscle of Cingular and Verizon.

The major hurdle which faces wireless communications companies in the future is piracy. The switch to 4G requires a switch to complete IP technology[xii], which essentially means that information will no longer be proprietary, so phone companies will have a hard time keeping cell phone users from downloading ring tones from any website rather than the ones they pick. Since ring tones and music represent a large portion of the income from these markets ($5 monthly average revenue per user, out of $61[xiii]), their loss presents a challenge to telecoms. But it also presents an opportunity for Sprint Nextel. Another problem that most telecoms will face is that this architecture inherently allows for easy VoIP, which allows customers to bypass land lines. Eventually, VoIP will pose a risk even against wireless technology, but only as WiMAX becomes a reality and the bandwidth and range are both achieved. Sprint's strategy then should be to control the access to such a technology and limit the capability of VoIP as a wireless system as long as possible, since it would surely cripple them. But at the same time use their aforementioned alliances with cable companies to promote local VoIP use as much as possible. While such an endeavor would risk cannibalization for Cingular and Verizon (considering their ties to the Bells), it poses significantly less threat to Sprint Nextel, which is spinning off some of their land line capabilities in Embarq. Sprint will then place itself in an unassailable position where it can strike at the larger companies without fear of competition.

Post Scriptum

Pandora Group is proud that during the revisions for the last draft of this paper, April 10th, Sprint Nextel issued a press release stating that their VoIP investment with cable

companies had quadrupled in the past year and that they plan on three more cable partnerships to expand this investment as much as possible.

> Sprint (NYSE:S) today announced that it now serves more than one million VoIP (voice over Internet Protocol) subscribers for the cable industry, a fourfold growth in the past year. Additionally, in its ongoing effort to bring competition and customer choice to large and small communities across the U.S. through cable partnerships, Sprint has signed VoIP agreements with several new cable companies, including WEHCO Video, NPG Cable, Inc. and Shrewsbury Electric and Cable Operations (SELCO). These new partnerships reinforce Sprint's leadership in enabling cable companies to enter the voice services business.[xiv]

This statement indicates that Sprint has in fact taken the suggestions that Pandora Group was proposing, and the paper was subsequently revised in good faith as if the press release were not issued.

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