The BITTERSWEET SMELL of Success

Some CLECs have managed to weather the economic meltdown

BY TERRY BARNICH AND GREG MYCIO

An oxymoron, according to Webster's dictionary, is a figure of speech in which contradictory ideas are combined. For many, especially the investing public, the topic "CLEC success stories" qualifies as a painful example of the term.

Indeed, in the first three months of 2002, success in the absolute sense for the competitive telecom sector appears elusive at best. Readers of America's Network are intimately aware of the carnage that has befallen the competitive local exchange carriers: tens of billions in market cap evaporated, innumerable bankruptcies and fears of continuing weakness across the sector. But through it all remains a $53.2 billion competitive local exchange industry (Table 1). Some companies are doing some things right. It's just that the implosion of the telecom stock index has caused a fog, obscuring a lot of operational success.

Financially speaking, success today in the competitive telecom sector equates to survival. Nonetheless, some companies do not spend every waking moment in the search for outside investment. Of the 165 facilities-based competitive carriers, a few dozen are working to actually execute on their business plans. These carriers are going about their business, building and operating telecom companies.

Based on a range of operating criteria, NPRG believes that four CLECs in particular that merit mention as CLEC success stories. While this is not an exclusive nor exhaustive list, and we believe other competitive carriers will survive the present shake out and remain viable businesses into the foreseeable future, these four appear to have the best mix of factors necessary to continue operations at a high level.

Table 1: CLEC Revenue Breakdown for 2001

<table>
<thead>
<tr>
<th>Revenue category</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Switched local service¹</td>
<td>$9.49 billion</td>
</tr>
<tr>
<td>Long-distance²</td>
<td>$2.95 billion</td>
</tr>
<tr>
<td>Dedicated access and private line</td>
<td>$10.11 billion</td>
</tr>
<tr>
<td>Data³</td>
<td>$24.85 billion</td>
</tr>
<tr>
<td>Total CLEC service revenue</td>
<td>$47.39 billion</td>
</tr>
<tr>
<td>All other revenue⁴</td>
<td>$5.79 billion</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>$53.18 billion</td>
</tr>
</tbody>
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Notes:
1 Includes Resale Revenues.
2 Includes Resale Revenues.
3 Includes all data and data-related services (e.g., frame relay, ATM, Internet access, DSL and other enhanced data and Web-related services).
4 Includes miscellaneous telecom revenues (e.g., reciprocal compensation) as well as non-telecom related revenues (e.g., network development).

Source: New Paradigm Resources Group Inc.

HOW TO MEASURE IT

Success in the present telecom environment means two things more than anything else: surviving today and surviving tomorrow. We know who has survived, so our analysis focuses on

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future prospects. To assess companies' fitness for the future, NPRG has applied eight criteria (Table 2).

Cash life is the minimum number of quarters before cash and cash equivalents are exhausted by cash burn. For companies in need of immediate cash infusion, all other considerations are secondary.

Independent of considerations about cash burn and cash life, there is a consideration of financial security. If the company has a secure source of guaranteed funding, a short cash life is not necessarily a severe constraint.

The effectiveness of each company's strategy needs to be evaluated based on considerations of service offering mix (long-distance, data services, transport), revenue driver trends (reciprocal compensation, customers residential, business, carriers) and markets (geography, number of competitors).

Regarding revenue growth, it could be argued that "no growth" or "negative growth" is acceptable during a period of restructuring or cash conservation. But in general, a company that is still able to grow, even in this period, should receive a bonus from this category.

Even though current negative EBITDA may be due to investments that will lead to better financial performance in the future, today's performance is, nonetheless, today's performance — and gains are better than losses.

In assessing the quality of management, a high rating is given to officers with direct operating experience in entrepreneurial communications companies.

As for the quality of customer base, some are "higher quality" than others because of their high per-unit revenue or low likelihood of churn, for example.

Back-office issues have strongly impacted competitive carrier profitability. Quality operations support systems (OSSs) are those that consist of a complete set of functionality (from order entry to provisioning to network management to billing) using mature software products.

FOUR WHO BEAT THE ODDS
Using these criteria, NPRG has selected the following competitive carriers as CLEC success stories (in alphabetical order):

- Allegiance Telecom Inc.
- CTSI
- ITC/DeltaCom
- Time Warner Telecom

ALLEGIANCE TELECOM INC.

Early on, publicly held Allegiance (NASDAQ: ALGX) focused on small- and medium-sized business (three to 24 access lines) in major metropolitan areas. It has since added enterprise customers, as well. One of the few CLEC favorites among investment banking analysts, the company offers local exchange, local access, domestic and international long-distance, enhanced voice, data and Internet services.

Allegiance, which began life through a "smart-build" strategy, has been purchasing dark fiber and is deploying complementary electronics across a number of its markets. In December 2001, the company began providing service in West Palm Beach/Boca Raton, Fla., marking the completion of its 36th and final market in its national build-out. This gives Allegiance access to almost 60% of the nation's business market. Exhibiting considerable growth, Allegiance's access line count of 1,005,900 at the end of third quarter 2001 was up a whopping 101% over a year earlier.

The company's financial position is strong. The company was able to avoid the bankruptcy fate of many of its peers largely because of its relatively small debt load. At the end of third quarter 2001, Allegiance had $538 million in cash and equivalents on hand, enough for approximately 5.5 quarters. And because the company's network build-out is completed, its cash burn rate is falling precipitously. According to Investment Bank Legg Mason Wood Walker, Allegiance's gross margin was a solid 54.1% as of third quarter 2001. Also heartening about the carrier is its third quarter 2001 revenue growth of 69% over same quarter 2000.

Allegiance's management team, led by chairman and CEO Royce Holland, has always been highly regarded, a clear advantage for the company moving forward. Moreover, the company shows particular strength with regard to its OSS, which is built around a MetaSolv base and helps Allegiance bond with incumbents. In addition, the company is developing a new billing system.

Last, but by no means least, Allegiance has exhibited a high degree of success in its early 2002 acquisition of WorldCom's Intermedia Business Internet assets for approximately $4 billion. Over time, companies such as Allegiance likely will continue to take advantage of good deals on assets being thrown off by mergers and bankruptcies, making them even stronger in the process.

Allegiance's attributes are straightforward and strong: a built-out network, strong management and OSS, and the prospect of selling a wider array of value-added services to larger enterprise customers.

CTSI INC.

CTSI is the CLEC division of Commonwealth Telephone Enterprises, Inc. (OTC: CTCO). In 1997, C-TEC Corporation spun off RCN Corp., and
Cable Michigan and then renamed itself Commonwealth Telephone Enterprises.

The newly named company began to operate as a stand alone “rural LEC, urban CLEC” enterprise. CTE is organized into two principal operating segments: Commonwealth Telephone Company (CT), the nation’s 10th largest independent incumbent LEC, and CTSI, a CLEC that began operations in 1997.

Much of CTSI’s strength comes from its status as a competitive independent operating company (CIROC). CIOCs as a group are in a strong strategic position, gaining financial strength and operating expertise from their ILEC parents or siblings. In CTSI’s case, however, the CLEC is rapidly catching up with the ILEC. With 108,702 lines across its New York-Pennsylvania territory, CTSI has almost a third of ILEC CT’s 327,000 lines, and about 25% of Commonwealth’s overall access line count.

A key part of its parent company’s rising stock price during 2001 has been the fact that CTSI began curbing its expansion plans during the latter part of 2000, enabling both CLEC and parent to avoid the cash crunches of many over-expanded competitive carriers during 2001.

On the financial side, Commonwealth is 46% owned by Level 3 Communications and was carrying a manageable $263 million in debt along with $43 million in cash and equivalents as of third quarter 2001.

CTSI had third quarter 2001 revenues of almost $19 million, representing respectable 14% growth over the previous year’s third quarter, an increase that would have been much bigger 41.5% had operations in certain markets not been discontinued. CTSI’s third quarter 2001 EBITDA was a positive $5.7 million, meaning that the CLEC is posting a gross margin of more than 30%. The company’s solid margin appears to stem from its discontinuing of unprofitable operations during late 2000 and into 2001.

The bottom line regarding CTSI’s success is quite clear: good strategic positioning, positive EBITDA, decent margins and no foreseeable snags on the horizon.

ITC DeltaCom Inc.

Publicly traded ITC DeltaCom (NASDAQ: ITCD) provides service to medium-sized and major businesses in the southern US and is a regional provider of broadband transport services to other communications companies. The company has been sharply reducing its capital spending by limiting its market expansion and trimming its employee base. These cost-cutting measures are expected to result in slower revenue growth for the company.

However, it has attempted to diversify its revenue stream by adding data services to its product mix. In a move to conserve capital, ITC DeltaCom revised its business plan in September 2001. The company is taking several actions including the following:

- Increasing its focus on its retail service offerings while maintaining its broadband transport operations at current levels;
- Reducing planned capital expenditures by approximately $150 million through the end of 2003; and
- Immediately reducing annualized operating expenses by approximately $22 million through the end of 2003, which will result in the company’s current work force.

ITC DeltaCom believes that its improved strategy moving forward will enable it to become cash flow positive in 2002. With reduced capital expenditures, the company remains fully funded through 2003. In addition, according to estimates from Morgan Stanley, ITC DeltaCom has a little more than $750 million in debt. Moreover, the investment bank estimates 2001 EBITDA of $45 million, rising to $101 million in 2003, suggesting that the company’s cost containment and operational efficiency efforts are taking effect.

Near the end of 2001, ITC DeltaCom announced that it was rolling out a new account management system and building on its edocs-based billing platform to enable Internet billing and online customer account management. Along with other announced improvements to its back-office, these moves will help ITC DeltaCom in its quest for operational efficiencies.

To wrap up ITC DeltaCom, the important points are: a fully funded business plan, estimated EBITDA positive for 2001, and increasing operational efficiencies and cost containment.

Time Warner Telecom's Herda: Leads the way

TIME WARNER TELECOM INC.

Publicly held Time Warner Telecom Inc. (NASDAQ: TWTC) is 44% owned by AOL-Time Warner. It targets medium-sized to large businesses, generally those with more than 100 employees. Time Warner Telecom also targets smaller customers in buildings already served by its fiber network. The company is nationally focused and serves 44 markets. For the first nine months of 2001, the company had revenues of $564 million, representing significant year-over-year growth of almost 60%.

The company’s largest customers are WorldCom and AT&T, each of which represents about 10% of Time Warner Telecom sales. Among its list of customers are the Department of Defense, Hewlett-Packard, Duke University, Shell, IBM, Sprint, UUNet, and Level 3. Early in 2002, the company announced a five-year contract with the Kennedy Space Center. Time Warner Telecom increased its network significantly and gained a presence in 15 western states with the acquisition of most of the network assets of GST Telecommunications Inc. The acquisition
significantly accelerated the company’s growth plans at an attractive price and helped to expand Time Warner Telecom’s footprint into western US markets without overlapping existing operations.

Time Warner Telecom is much vaunted for its extensive build-out of facilities, enabling it to bypass incumbent facilities. In fact, at the end of third quarter 2001, it owned 80% of its total access lines. This has been, and will continue to be, a significant advantage for the company going forward.

On the financial side, the company is fully funded and had $380 million in cash at the end of third quarter 2001, along with $750 million in available credit. Time Warner Telecom had third quarter 2001 EBITDA of $37 million. On the debt side, the company likely had less than $800 million in debt at year-end 2001, among the lowest of its CLEC peer group. As it doesn’t look likely to build out any new metro fiber networks, Time Warner Telecom looks to be in very good financial shape going forward.

On the OSS side, the company is still working on integrating GST’s back-office with its existing plant, but its overall situation looks solid. And on the management side, Time Warner Telecom has consistently scored high, led as it is by president, CEO and chairman Larissa Herda, among competitive telecom’s most highly regarded executives.

Time Warner Telecom has a number of solid attributes: a strong fully funded business plan, ownership of its network, relatively little debt, and a strong management team.

LESSONS TO LEARN
The first impression in assessing CLECs is to jump to the conclusion that success is based on unique attributes: a special business plan, an exclusive funding source and one-of-a-kind assets. Indeed, a defensible advantage can go a long way toward creating a success story in any industry.

However, what these four CLEC success stories — Allegiance, CTSI, ITC^DeltaCom, and Time Warner Telecom — show us is that strong focus is key to success in the harsh CLEC climate of 2002: Focus on profitable markets; focus on the business plan; a focused determination to achieve overall operational efficiency, be it through aggressive application of back-office systems or the shuttering of less profitable markets; geographic focus.

In other words, these companies are showing that the CLECs are beginning to move into the real world, where achieving success requires a viable plan and disciplined execution. It’s simple, but as these four competitive carriers show, it’s putting the concept into practice that counts.

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