The death of the CLEC... has been greatly exaggerated

Although last year was tough for competitive local exchange carriers, they still have a FIGHTING CHANCE

by STEVEN WEINBERG and CHARLIE RANSFORD

Everything changes. The competitive local exchange carrier industry continued its transformation during 2000—a transformation that claimed a few victims and was busy with mergers and acquisitions. But despite the general negative impression among some investors, the CLEC industry continued to grow in terms of revenue, access lines and equipment deployment. Total revenues have increased 34% from 1999 to 2000, and CLECs now serve more than 16 million access lines.

Last year, the CLEC industry experienced some losses. As with any rapidly developing industry, this is to be expected; however, a corrective period does not doom the sector. Quite the contrary. The CLEC business is about competition, and competition is about survival of the fittest. Therefore, the individual failures of a select number of CLECs will ultimately lead to a stronger, more robust and increasingly innovative industry (Table 1).

CLEC hiccups
As the capital markets soured in April 2000, so did the fortunes of many CLECs. The first to go was GST Telecommunications, one of the initial CLECs that was

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<thead>
<tr>
<th>Table 1: 2000 competitive industry snapshot</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Companies identified</strong></td>
</tr>
<tr>
<td><strong>Telecom service revenue</strong></td>
</tr>
<tr>
<td><strong>Total revenue</strong></td>
</tr>
<tr>
<td><strong>Network route-miles</strong></td>
</tr>
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<td><strong>Buildings served</strong></td>
</tr>
<tr>
<td><strong>Voice switches installed</strong></td>
</tr>
<tr>
<td><strong>Voice switches planned</strong></td>
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<tr>
<td><strong>Data switches installed</strong></td>
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<td><strong>Data switches planned</strong></td>
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<tr>
<td><strong>Access lines</strong></td>
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Source: New Paradigm Resources Group
formed in 1994. GST had 1999 revenues of $322 million, 363,000 access lines, 15 voice switches and 4200 route miles of fiber optics.

Then the dominoes began falling. ICG Communications, another first-generation CLEC, announced a revenue shortfall for the year, citing equipment failures, and then filed for bankruptcy in the fourth quarter of 2000. American MetroCom, Axessa, Net-Tel, and OpTel have also filed for bankruptcy. Covad Communications, e.spire, Mpower, and US ILC filed earnings warnings.

Tiny UBNetworks never really got the ball rolling and announced it would almost certainly have to close its doors after its Nortel Networks vendor financing was not renewed. Prism, backed by technology company Comdisco, began the process of shutting its doors during the fourth quarter of 2000. Picus Communications in Virginia began scaling back operations; 2nd Century Communications laid off 25% of its workforce. Network Access Solutions laid off 23% of its workforce. Jato Communications, also a data provider, has substantially scaled back its planned footprint.

During the second quarter of 2000, CapRock Communications lost one dark fiber sale, resulting in revenues one-third less than expected and the eventual downfall of the company.

For a period of time, it seemed as though a CLEC per week was announcing its troubles.

However, this industry has evolved through a number of phases, and this is not the first time the financial markets have hiccupped and given the CLECs indigestion. Indeed, the CLECs will weather the transition to the next phase of their industrial development and emerge even stronger. Unfortunately, however, investors have short memories.

**M&A games begin**

It seemed that the CLECs that were not going out of business in 2000 were busy in the merger and acquisition arena.

Time Warner bought GST's assets at auction for $690 million. Start-up LS Communications took control of Axessa's New Orleans switch, and, in addition, R&B Communications, a small carrier in Virginia, was acquired by CFW Communications, another small carrier in Virginia.

RCN entered the Midwestern market with its purchase of 21st Century Telecom in Chicago, and Allegiance Telecom strengthened its DSL presence in the same city with its purchase of InterAccess. Mpower (formerly MGC) acquired St. Louis start-up Primary Network, and NewSouth acquired Florida-based UniversalCom.

The national ISP Big Net acquired US MidTel, and Netstream acquired tiny Harbor Bay. Able Telecom, a networking company with a CLEC subsidiary, was acquired by Bracknell Corporation, an infrastructure services provider. ChoiceOne Communications created a network spanning the Great Lakes from New York to Wisconsin with its purchase of US Xchange, and Gabriel Communications and TriVergent combined to create a network across the Ameritech, BellSouth and SBC territories.

XO Communications, formerly Nextlink, acquired ISP Concentric Networks. Covad bought DSL upstart BlueStar for $202 million, a price considerably lower than BlueStar's planned $1 billion IPO price. Covad, in turn, received a $150 million infusion from SBC Communications, sparking its own takeover rumors.

Perhaps the biggest event in the CLEC merger and acquisition arena was WorldCom's announced takeover of Intermedia. After international regulators killed WorldCom's proposed merger with Sprint, expressing concerns over monopolization of the Internet backbone, the second largest long-distance carrier was still hungry for a bigger piece of the Internet pie. As a result, in the third quarter, WorldCom announced a $6 billion takeover of Intermedia, the
largest domestic independent CLEC with 207 data switches, 29 Class 5 switches, 637,000 access lines and $1.1 billion of revenue in 2000. The deal is expected to close during the second quarter of 2001.

However, WorldCom is not purchasing Intermedia for its CLEC assets. Intermedia controls 85% of Digex, its Web hosting subsidiary, which is part of what WorldCom believes will grow from a $3 billion industry today to $176 billion in 2004.

Therefore, Intermedia, which receives 14% of its revenues from Digex, was caught in the middle. WorldCom has already announced that it would divest 60% to 80% of Intermedia’s CLEC assets once the merger is complete. The assets WorldCom does keep should transition smoothly into the powerhouse’s network. WorldCom has vast experience integrating acquired CLECs, such as its earlier acquisitions of MFS and Brooks Fiber.

**On the bright side**

Not all was dark and gloomy for CLECs in 2000. In fact, it is more accurate to say that the capital markets did not dry up. Rather, Wall Street became more selective about which business plans were funded.

Capital investment recipients include RCN, which received $1.65 billion; FiberNet, $84 million; CoreComm, $360 million; McLeodUSA, $1.3 billion; Net2000, $475 million; Actel Integrated Communications, $75 million; Ionex, $150 million; Omniplex, $10 million; TelePacific, $154 million; and Integra, $211 million.

In each case, the funded company is now able to expand its network, furthering CLEC industry growth. RCN entered the Northwest and Midwest markets. FiberNet started building its nationwide last-mile network. CoreComm entered the Michigan market with its purchase of Voyager.net.

McLeodUSA purchased both CapRock and SplitRock. Net2000 Communications is using its money to expand its network and hire more staff. Actel is expanding into the Southeast; Ionex will now expand into 36 markets. Omniplex and TelePacific Communications purchased equipment. Integra is expanding throughout the U.S. West region.

**A vote of confidence**

While these financial ills and mergers and acquisitions could be seen as a loss for the CLEC industry, they are, in truth, gains.

The CLEC business is first and foremost about competition, and competition is a Darwinian process of survival of the fittest.

Important lessons can be learned from those who have failed. The best examples include:

- Do not be overzealous in the quest to become a super carrier.
- Manage growth and keep debt in check.

In fact, CTSI, a CLEC serving Tier 3 communities in Pennsylvania, Ohio, New York and West Virginia, announced that it is curbing its expansion plans to put current operations in order. The end result for CTSI will most likely be efficient operations and happy customers—a strategy from which all carriers could learn.

In capital market environments, financially strong carriers have been able to buy in-place assets instead of building their own. The newsworthy Time Warner and McLeodUSA deals for GST and CapRock, respectively, show that some companies tend to buy when economic distress disables their weaker siblings.

The relentless construction and deployment of communications assets suggest strong support for the CLEC model, as it relates to the building of technologically innovative networks. The competitive networks have helped erode long-distance prices and brought high-speed data services such as DSL that would not have been realized had they been left to the incumbents’ own devices. The incumbents have tried to hold off the assault by controlling the last mile, but the competitors are resilient.

Many companies such as ATG and PacTel are experimenting with wireless loop technology. Winstar and Teligent have been providing services with point-to-point and point-to-multipoint technology for a few years.

CityNet is deploying fiber in sewer pipes, leading directly into buildings and eliminating the incumbent from the equation, and cable overbuilders such as Everest and Grande Communications are

**Continued on page 78**
building fiber to the curb. In addition, the emergence of the building LECs (BLECs) market has created yet another viable marketplace for competition.

Therefore, what doesn’t kill the competitive providers only makes them stronger as they adapt to their environment.

The future
While the CLEC model is hardly dead or even seriously wounded, CLECs must learn from those before them (Figure 1). There is no single access solution that fits all carriers, and competing technologies can co-exist. For example, cable access could pan out for the residential market while DSL and wireless technologies will compete for the business market. Regardless, some important lessons can be learned:

- The importance of the last mile has been re-emphasized.
- Cable telephony has not achieved wide-scale functional operability.
- There is not one type of access pipe to guarantee success.
- Bundled services must be complimentary, otherwise a back-office nightmare is created.

Still, the CLEC market is growing. Total revenues have increased 34% from 1999 to 2000 (Figure 2), and CLECs now serve more than 16 million access lines. And while many investors may point to the stock market and decry “The industry is dead,” it is important to remember that the oldest CLEC is only four years young and most are even younger.

In addition, these carriers often do not expect individual markets to become EBITDA-positive for the first 36 months of operation. Currently, there are 150 competitive carriers serving some 1500 distinct cities. We are still a few years away from seeing this young industry collectively going cash flow-positive.

Last year was undoubtedly one in which the CLEC industry experienced some losses. As with any rapidly developing industry, this is to be expected. However, a corrective period does not doom the sector—quite the contrary. Instead, the individual failures of a select number of CLECs will ultimately lead to a stronger, more robust and increasingly innovative industry.

The truth in this statement will be borne out over the next 12 to 36 months, and in 2001, these providers will regroup and get their feet back under them before they attempt to run again.

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AT&T breaks up... again

by Steven Weinberg and Charlie Ransford

Competition and technological innovation led to one of the biggest communications stories of the year: the second breakup of AT&T.

AT&T has experienced tremendous growth in its wireless and data segments, and it even created a wireless tracking stock last year. However, when writing about the AT&T breakup, much of the popular media have failed to note that AT&T is the largest facilities-based CLEC, serving more than 2.1 million access lines. Local services, which are part of AT&T’s Business Services segment, figure to have revenues of $14.5 billion in 2000, dwarfing any of the other CLECs.

Back in 1999 when AT&T announced its intentions to take over MediaOne, the company predicted that its long-distance revenues would shrink from 60% of total revenues to 30% of total revenues by 2004. At the time, AT&T was trying to be a cable provider, a wireless provider, a data provider, a CLEC, and, of course the world’s largest long-distance provider in a rapidly declining market. In fact, the commoditization of long-distance led directly to AT&T’s downward spiral. The purchase of MediaOne and TCI was AT&T’s way of trying to bypass the incumbents’ lock on last mile connectivity. Ironically, AT&T had previously tried to enter the cable TV market, but a consent decree issued in 1958 prevented it from doing so.

Unfortunately, the technology for cable has yet to be perfected, and as a result some view cable purchases as costly mistakes. While Black Hills FiberCom, Knology and RCN are all providing cable and telephony service, the difference is that these companies are building hybrid fiber/coax networks. That is, fiber optics piggyback coaxial cable in their networks. AT&T is simply trying to provide telephony over coaxial cable.

The breaking up of AT&T will allow the company to put more focus on the local segment, further enhancing its position. No longer will the company be distracted by cable operations and long-distance take rates. The CLEC operation will be left to compete for the incumbents’ customers, concentrating on one area of service. AT&T, like many CLECs in 2000, learned it cannot be the super carrier, offering a salad bar of services. And like the CLECs, AT&T learned the hard way about overextending itself.

AT&T’s disappointing cable telephony foray shows that the problem of securing first-mile and last-mile access has the potential of undoing any player, large or small.