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2001 Review: Leading indicators

by **Leon Lazaroff**

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Out of service

The nice word is consolidation. The more appropriate description might be bloodbath.

The number of publicly traded start-up telecommunications companies, known in the industry as competitive local exchange carriers, or CLECs, was cut roughly in half over the last year. David Fore, a **Bear, Stearns & Co.** telecom analyst, says that in the next 12 to 18 months, the number is likely to fall from 22 to about 10. Going back to March 2000, CLECs' market capitalization has tumbled from a high of \$140 billion-\$150 billion to about \$10 billion. No CLEC operates in the black.

The CLECs that ran out of money were forced into bankruptcy for all sorts of reasons: bad business plans, dubious financial schemes and general mismanagement were the most obvious. Some took on too much debt, built oversized networks and were unable to secure enough customers to finance their bonds; bankruptcy became the only option. Others put too much emphasis on reselling or leasing local access to the Bells' network, a failing business plan.

By now the list of the fallen is well known: **GST Communications Inc.**, **ICG Communications Inc.**, **Winstar Communications Inc.**, **Teligent Inc.**, **Advanced Radio Telecom Corp.**, **NorthPoint Communications**, **e.spire Communications Inc.** and **Rhythms NetConnections Inc.** Of course, that roll call does not include a whole cast of would-be long-distance carriers and long-haul broadband providers also forced to seek court protection for their assets.

Turning the corner?

Nevertheless, the year wasn't all bad for telecom startups, a fact that may portend profitability for a fortunate few. **Focal Communications** and **DSL.net Inc.** managed to raise money.



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Though technically not a CLEC, **Covad Communications**, a wholesale provider of high-speed Internet and other data services, received court approval earlier this month to emerge from bankruptcy. ICG and e.spire have been telling investors lately that they expect to emerge from bankruptcy within a few months. And two somewhat less-known startups, **CTC Communications** and **US LEC Corp.**, demonstrated that methodical growth focused on a single region can produce a telecommunications provider with solid, long range potential.

"Some CLECs will survive this recession," said Robert Saunders, a telecom analyst at the **Eastern Management Group**. "But this is about making money — it's about thriving, not just surviving."

But while industry observers seem to agree that two CLECs — **Time Warner Telecom Inc.** and **Allegiance Telecom** — are likely to be around for a while, the remaining startups still have to prove to investors that they operate viable businesses. Just how well companies such as Focal, Covad and CTC perform during 2002 will go a long way toward demonstrating whether this set of companies — which received billions of dollars of financing following the 1996 Telecommunications Act — were just paper tigers or bona fide enterprises.

Five years after the Telecommunications Act spawned the development of the CLECs, the sector still does not have a company operating a profit. Focal President and CEO Robert Taylor argues that local telephone competition is even more difficult than long-distance service, in which companies such as **MCI** took more than 10 years to become profitable. "For anyone to expect that local competition could be built any quicker or any easier was uninformed about the complexity of the issue," he said.

The CLEC story is a battle for the local business and to a lesser extent, the residential customer. The local telephone services market at present is roughly 92% controlled by the four Bell operating companies — **Verizon Communications**, **SBC Communications Inc.**, **BellSouth Corp.** and **Qwest Communications International Inc.**, according to New Paradigm Resources Group Inc, of Chicago. The CLECs charge that part of their undoing has been the product of obstruction on the part of companies long accustomed to operating as virtual monopolies. And the Federal Communications Commission has occasionally agreed. All of the Bells have been hit with fines, though the CLECs charge they are hardly large enough to force companies with \$160 billion market caps to change their evil ways.

"The RBOCs argue that all CLECs are three guys in a truck," says Lawrence Spiwak, president of the **Phoenix Center**, a public policy institute in Washington. "Of course, they say that because don't want anyone coming between them and what has been their monopoly on local customers."

Part of the CLECs' problem has been differentiating themselves from the rest of their brethren. The Bells are fond of portraying all CLECs as being only interested in re-selling access to their

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networks. Therefore, genuine facilities-based CLECs such as Time Warner and US LEC were grouped with companies that have since closed shop.

So when GST collapsed in 1999, nearly all CLECs saw their stock prices drop. The same routine was repeated throughout 2000 with Winstar, NorthPoint and Teligent. Each time another telecom upstart filed for Chapter 11 protection, investors assumed the whole group was ready to bow out in unison. As a result, even the stock prices of Time Warner and Allegiance, the sector's leaders, suffered. "It's just been unfair to lump them all in together," adds Spiwak.

Turning profitable

For those CLECs that survive the recession and even thrive afterward, the challenge will be turning profitable. And for many CLECs, turning profitable can't happen until balance sheets are reorganized to appease impatient bondholders. Gone are the days when CLECs could satisfy investors by simply increasing revenues.

Focal, which concentrates on selling telecom services to Fortune 500-sized companies, wiped out about 55% of its high-yield bonds in October, and in the process made the company easier to be acquired. Led by **Madison Dearborn Capital Partners**, one of the company's original backers, Focal's bondholders agreed to retire \$280 million in bonds in exchange for a 34% stake in the company's restructured equity. While bondholders made out with shares valued at 43 cents on the dollar, the value of the company's common shares were cut by 80% — a steep reduction but not as bad as the reorganization plan proposed by **XO Communications Inc.** which would have wiped out common shareholders altogether.

As part of the reorganization, Focal purchased \$15 million of its bonds, leaving the company with long-term debts of about \$358 million. Taylor says he can live with that amount.

Focal's bondholders also agreed to relinquish their ability to cash out if the company were acquired. In the past, prospective CLEC buyers have backed away from deals because they would have had to pay bondholders in full once a change of control had been completed. "If there is M&A, we wanted to be sure that there [aren't] any barriers to it," Taylor said.

Surprisingly, the future also looks promising for Covad, the once-vilified seller of digital subscriber lines, or DSL, technology. A year ago, CEO Robert Knowling was forced to resign amid veiled accusations from Wall Street bankers and analysts that he had been less than frank about the company's finances. Investors also didn't like Knowling's decision to spend \$202 million to acquire a retail DSL marketer, Blue Star Communications, when the company's business plan was specifically geared to selling services wholesale to avoid direct competition with the Bells.

Charles Hoffman, a former SBC and Sprint executive who took

over the company's CEO position in June, acknowledges that Covad must earn back the support of investors, especially the institutional investors whose backing can make or break a company's share price. "I don't expect that overnight these guys are going to trust us," he said. "We just have to show that our numbers are in, and that they show positive growth."

Fidelity Investments, Hoffman points out, was among Covad's bondholders willing to agree to the recently completed debt-for-equity-and-cash exchange.

For Covad and Focal, not having the pressures of high interest payments could give both companies the chance to demonstrate that their business plans can work. It is a position that both XO and **McLeodUSA Corp.**, two CLECs with high debts and flat revenues, hope to duplicate.

The past year's consolidation process may actually allow the remaining startups a better chance of survival, adds Eastern Management's Saunders. Price wars between CLECs, he said, contributed to the sector's troubles. But consolidation is still not likely to come by way of mergers and acquisitions. More bankruptcies are likely before the sector's size is reduced through deals.

Potential buyers such as the Bells or the country's three main long-distance companies — **AT&T Corp.**, **WorldCom Inc.** and **Sprint Corp.** — have shown that they prefer to buy CLECs in bankruptcy. Verizon's decision to back away from its deal with NorthPoint illustrated that Bells were not about to bail out an industry startup with a multibillion dollar acquisition. Nonetheless, AT&T recently said it would likely buy a facilities-based local telecom provider, i.e. a CLEC, some time in 2002.

"The sector certainly has to get smaller," Saunders said. "In the future, each market will have a dominant Bell company and three or four competitors. But to get to that point, a lot of CLECs will have to fail."

Which ones will probably be known in 2002.

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