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BANDWIDTH DRIVERS

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Back to the Future?

Does the Digital Island/Cable & Wireless Deal Mean It's 1997 Again?

By Mark Langner, Senior Research Analyst

- ***Cable & Wireless Snaps Up Digital Island*** - Wait! Was that a sign from the heavens? Just when it seemed that all hope was lost for data service providers (at least those with big funding gaps), Cable & Wireless stepped to the plate and purchased Digital Island for $340 million in cash.

The acquisition of Digital Island provides Cable & Wireless a stronger presence in the United States and a suite of enhanced managed hosting and content delivery services to bolster its existing offering. Our complete view on the deal can be found in our May 14 note. In many ways, this was a "custom fit" agreement. C&W had needs for the products, global data assets and technological expertise that DI had; and DI needed the access to lower-cost capital, global customers and lower-cost infrastructure that C&W could provide. Many other traditional "telecom" providers (read: potential bidders) either didn't need what DI has, or didn't have what DI needed -- which is why we would be surprised to see an unsolicited second bidder appear for DI (not to mention the deal was done at only a 9% premium to where the stock was trading).

The question for investors is: What can we learn from this deal? Is this the return of the freewheeling 90's when large-cap telcos made huge bids for cable, long distance, and local telecom assets? Should investors buy the beaten-down equity of broadband and IP data services companies ahead of a wave of consolidation? Who will be the consolidators and consolidatees?

Lets take a look at each of these issues separately.

The Next Wave of Consolidation?

As much as I would like to be wildly optimistic, I am somewhat cautious on using the C&W-Digital Island deal as a signal that the race is on to acquire quality data-services companies. There is no doubt in my mind that many of these companies have valuable businesses. Their expertise would be additive to more traditional telecom players that have, to date, been slow to gain traction in many of these markets. However, there are a couple reasons why this trend may be delayed.

1. **Many Next-Gen Service Providers are Too Expensive on an Enterprise Value Basis:** Digital Island was attractive on an enterprise value basis, as the cash on their balance sheet offset much of the debt outstanding, leaving only $49 million in net debt for C&W to absorb in the transaction. Not all of the next generation service providers have as favorable a balance sheet. Even if the debt of the provider is trading at significant discount to par, most bond issues have a "101 put" provision which allows the bondholders to redeem the bonds for full price in the case of a takeover -- putting these companies out of reach.

2. **Many Traditional "Telecom" Buyers are In No Position to Go On an Acquisition Binge:** There are several reasons why the "traditional" purchasers of data service providers are not in the best position to go on an acquisition binge. Some are structural (e.g., pending break-ups for long distance players AT&T and WorldCom), some are legal (e.g., regulatory and anti-trust restrictions on the remaining RBOCs) and some are financial.

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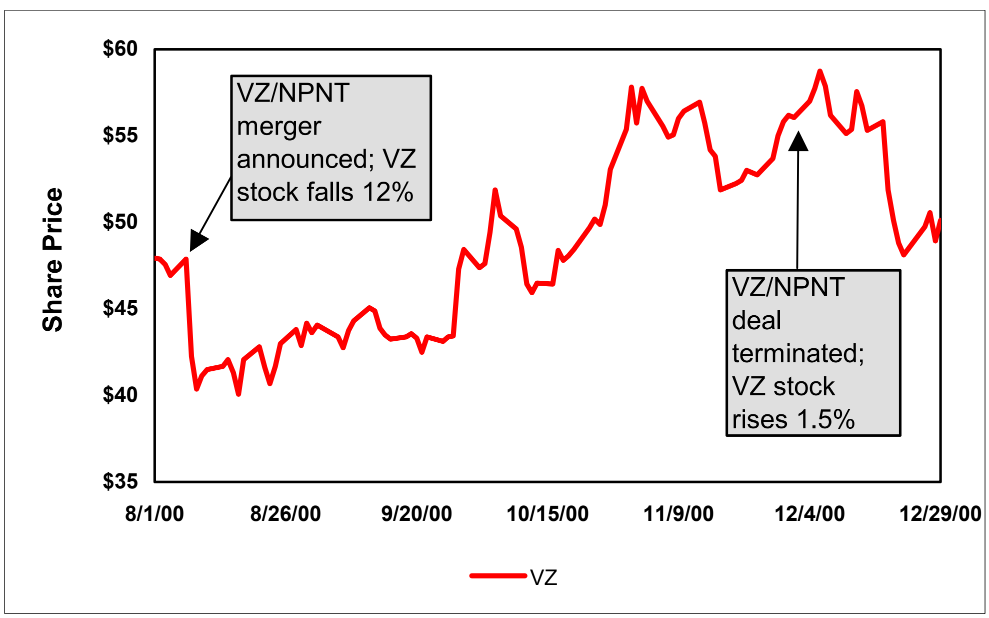
Even if the structural and regulatory hurdles can be overcome, the reality is that financially, these larger-cap service providers are not in a good position to be buying these nascent data service providers. The costs of assimilating the last round of acquisitions (many through the issuance of debt) still overhangs the stocks of many of these companies. The traditional players cannot afford to increase their credit spreads and interest expenses by adding to their existing high levels of debt. As the table below shows, the total debt of the major carriers has ballooned over the past five years.

	As of 1/1/1996			As of 1/1/2001		
Company	Total Debt ($ in millions)	Debt/Total Capitalization	EBITDA / Interest Expense	Total Debt ($ in millions)	Debt/Total Capitalization	EBITDA / Interest Expense
Worldcom	$ 3,391	51%	4.0x	$ 24,896	25%	13.4x
AT&T	$ 28,224	32%	1.6x	$ 65,039	27%	6.2x
SBC	$ 7,352	33%	10.1x	$ 25,962	26%	12.9x
Verizon	$ 8,337	35%	10.2x	$ 57,329	35%	8.3x
Qwest	$ 90	49%	NM	$ 19,066	26%	6.6x

For example, Worldcom's debt has increased 734% since 1996 and AT&T's debt has more than doubled to more than $65 billion. Meanwhile "bread-and-butter" voice revenues are eroding faster than President Bush's approval rating amongst environmentalists.

In addition, these providers cannot afford the earnings dilution necessary to acquire these providers that, in most cases, are still big money losers. While they have solid long-term growth prospects, their revenue streams are not large enough to offset the cost of dilution. The failed merger between Verizon and NorthPoint Communications illustrates this point.



When the Verizon-NorthPoint deal was announced, shares of Verizon stock fell 12%. If the deal had gone through, we estimate that on a pro-forma basis, Verizon's net income for 2001 would have been reduced by $460 million, or about 4%. Additionally, as the voice telephony market has fallen off more quickly than many had thought, the balance sheets of the traditional providers have eroded quickly, hampered by the prior buying binge in the 1990s.

Volume 1 - Issue 1 - May 21, 2001

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Equity Plays for Takeover Targets

Even though a wave of acquisitions is unlikely to immediately materialize, it is never too early to prepare for a future consolidation that is certain to come. As an equity analyst it pains me to admit, though, that at this point in time, equity is probably not the best way to play these names for potential takeovers. Rather, the more favorable risk-reward return from playing the acquisition card will come from being an investor in senior debt. Relative to an equity investor, the potential upside and downside return (and the associated risks) for a debt investor can be gauged more precisely.

In the best case scenario of an acquisition, a senior debt holder will be able to redeem their bonds at or above par due to a "101 put" provision. Even if an acquisition does not happen, the debt holder will continue to receive a steady stream of interest income. And in the worst cast scenario of a bankruptcy sale or proceeding, debt investors can guesstimate a floor valuation on their investment given the asset coverage (based primarily on property, plant and equipment) associated with their position in the company's capital structure.

The C&W-Digital Island deal illustrates this strategy well. At best, an equity investor who picked the absolute bottom of the market for the stock would have made a 172% return on the takeout -- and only 9% from the price at which the stock was trading before the deal was announced. The downside risk for these investors was quite high. If the company failed to close its funding gap, which was very likely given the current capital market conditions, these equity investors could have lost everything. On the other hand, debt buyers enjoyed a much better return as the deal stipulates that they will be able to redeem their bonds for par -- 324% percent from where the debt was trading when the deal was announced.

So if Consolidation is Coming, How Does it Happen?

I have long contended that, at this stage in the development of the data services market, traditional telecom providers were not a great fit for next-generation broadband and IP data service companies. Initially this was both a strategic and a financial consideration. Many of these emerging players would be smothered within the confines of larger bureaucratic organizations, and transactions would be highly dilutive to earnings. Today, as traditional voice revenues begin to tail off, and next generation data services are ramping, it makes much more sense for traditional telecom players to begin looking at adding some of these services to extend their product line-ups.

The problem, however, is that the strongest and most attractive providers (such as Akamai, Exodus, and StorageNetworks) to traditional telecom providers will unlikely be willing to accept the weakening equity from an old-line provider (not to mention that many of these companies trade at 3 or 4x competitors on a revenue basis). Conversely, the prospects of a traditional telecom taking over weaker next generation data providers is low because many of these providers have all of the same costs associated with them as their stronger siblings (e.g., debt laden balance sheets, large losses, high-cost contracts). However, they also have less of what the acquirors need -- data revenues and technical expertise. I expect debt-laden, money-losing service providers with funding gaps to file for bankruptcy, and those assets to be acquired out of bankruptcy -- where it makes sense. Some will just disappear.

This of course makes it difficult to invest on the “take-out” theory that was so popular during the heyday of competitive access providers such as TCG, Brooks, or MFS. The strong players are unlikely to be taken over, and the weak players are too shaky as stand-alone providers for investors to take the risk that they will be “saved” in the same fashion as C&W’s acquisition of Digital Island.

What traditional players need are next generation providers which are not debt laden but are fully funded and close to profitability. Most companies (almost all) that fit this description in the broadband and IP data world are privately held. The reason is simple -- and a perversity of Wall Street mentality. In the go-go days of 1999, Wall Street frowned upon these companies because they forsook rapid revenue growth for balance sheet safety. And while profitability was close at hand, their revenue growth rates were deemed too low, and the product line-ups often thought of as “too pedestrian” to warrant the gaudy DCF valuations that equity investors and investment bankers were looking for in IPO candidates. Companies, such as Megapath in the DSL retail space and iPass in the

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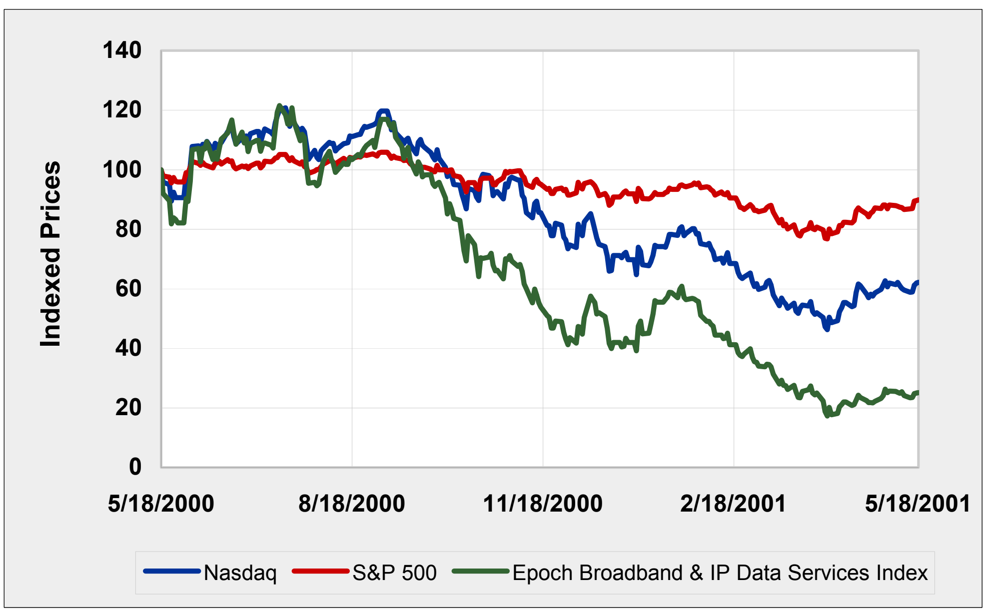
remote access market, fit this description nicely. These guys were the Warren Buffetts of datacom. Today, in what can only be termed "justice," providers that have managed to stay alive through prudent financial planning are actually seeing upticks in their businesses as the shooting "stars" of 1999 fall by the wayside.

Someone said to me the other day, "disaggregation is dead." With the NorthPoint bankruptcy filing and the lack of access to capital for many next generation providers, I think it's easy to make that statement. However, I don't know that I would go that far. The C&W-Digital Island deal does show that the re-aggregation process is beginning. But it also illustrates that, for the time being, it's going to be a slow road, dominated by "custom fit" agreements like the C&W-Digital Island deal for now.

Capital Markets Review

The Epoch Broadband and IP Data Services Index was down 2.1% over the last two weeks to close at 25.1. This decrease compared to a 0.3% increase in the Nasdaq Composite and a 2.0% increase in the S&P 500. The past two weeks saw substantial capital-raising activity in the sector relative to the past few months. The bulk of the activity was concentrated in the high yield and private equity markets. The highlight of the month was WorldCom's record-setting $11.9 billion bond sale, which was completed on May 9. The majority of the proceeds from this largest ever bond sale by a U.S. firm will be used to refinance existing debt. Approximately $2.8 billion of the proceeds will be kept and used for general corporate purposes, which may include acquisitions. On the private equity side, the co-location sector received some notable infusions of venture capital. IXEurope, a neutral co-location services provider in Europe, managed to raise $17.2 million in equity, while EYP Mission Critical Services, a provider of data centers that feature highly reliable power facilities, snagged $57.5 million.



Broadband and IP Data Services Performance

The performance of individual Broadband and IP Data Services stocks was mixed over the past two weeks. The largest percentage gainer was Digital Island, which improved 58% due mostly to its acquisition by Cable & Wireless for $340 million. StorageNetworks came in second for the best stock performance with a 42% gain. The company announced its STORfusion offering that allows service providers to deliver managed storage capabilities based on the company's STORos technology. On a technical basis, shares of StorageNetworks finally broke through their resistance level of $20, a level the stock has not seen since February 19, 2001. On the downside, Equinix, Covad, and 360networks

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were the largest percentage losers over the past two weeks. Equinix was down 26%, Covad was down 23%, and 360networks was down 20%. At $1.20 per share, 360networks is currently trading at its 52-week low. The company reported earnings on May 15 that missed our estimates and disappointed the Street because the company is now facing a funding gap of approximately $300 million.

Company	Ticker	Price Per Share (5/18/01)	Price Per Share (5/4/01)	Change over 2 weeks $	Change over 2 weeks %
360networks	TSIX	$1.20	$1.50	-$0.30	-20.0%
Akamai	AKAM	10.01	10.56	-0.55	-5.2%
Covad	COVDE	1.10	1.43	-0.33	-23.1%
Digital Island	ISLD	3.35	2.12	1.23	58.0%
Equinix	EQIX	1.20	1.62	-0.42	-25.9%
Exodus	EXDS	8.15	9.77	-1.62	-16.6%
InterNAP	INAP	2.87	2.81	0.06	2.1%
Level 3	LVLT	13.75	16.71	-2.96	-17.7%
Loudcloud Inc	LDCL	4.36	4.68	-0.32	-6.8%
StorageNetworks	STOR	21.93	15.40	6.53	42.4%
Median					**-11.7%**

Analyst Notes (click on link)

Loudcloud Reduces Costs While Maintaining Guidance. We believe Loudcloud's cost-reduction initiatives are positive steps toward reducing the potential funding risk associated with its previous financial model. We estimate that the company can achieve over $25 million in cost reductions over two years through today's initiatives, which should take the company through to cash-flow breakeven without additional financing. (5/1/01)

Cable & Wireless Reels in Digital Island. Digital Island announced that it will be acquired by Cable & Wireless in a $340 million cash transaction that values each ISLD share at $3.40. We believe the acquisition is a smart move by Digital Island, as it not only eliminates the company's funding gap but also provides the company with buffer capital to grow its business. The deal could spur other large carriers to expand into the Web-hosting and content-delivery-network sectors through acquisition strategies. (5/15/01)

360networks Does a 180. 360networks reported first-quarter results that missed our financial targets and affirmed our negative view on TSIX stock. Forward visibility for the company's revenue remains cloudy due to a marked reduction in dark-fiber purchases by carriers. The company now faces a funding gap and could face tremendous hurdles in raising the funds needed to fund the business to cash-flow breakeven. We continue to recommend that investors avoid shares of TSIX until these issues are resolved. (5/16/01)

The Week Ahead

Next week we expect Covad to finally file its 10-K report for the year-ended December 31, 2000. Originally, Covad was supposed to file its 10-K the week of May 7. Although we eagerly await the results of the filing, we do not expect much, if any, good news to come out of the report.

In the broader economy, the latter part of the week will be filled with important economic data. The initial jobless claims report is expected on May 24 and the GDP, price deflator, and University of Michigan consumer sentiment estimates should come out on May 25. Economists are expecting 390,000 initial jobless claims, GDP growth of 1.4%, a GDP price deflator of 3.2%, and consumer sentiment of 92.5.

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Industry News (click on link)

5/1/01 Two More Execs Leave as Exodus Restructures

5/1/01 Digital Island Announces Resignation of CFO

5/7/01 Equinix Names CFO Phil Koen as President and COO

5/8/01 CacheFlow Selects Loudcloud for Managed Infrastructure Service

5/9/01 Exodus Quantifies Cost Cutting Measures

5/10/01 Level 3 Signs New Contract with France Telecom

5/11/01 Covad 2000 Financial Results to be Reported and 10-K Files Week of May 21

5/14/01 StorageNetworks Announces STORfusion

5/15/01 Industry Leaders Co-Author Specification for Dynamic Assembly of Web Applications and Content

5/17/01 XO Communications and Akamai Announce Strategic Alliance

Financings

Date	Company	Ticker	Description
5/9/01	WorldCom	WCOM	$11.9 billion in a multi-currency bond sale, the largest ever by a U.S. firm. WorldCom is expected to re-finance $3.1 billion of debt, pay down as much as $6 billion of commercial paper, and use the remaining proceeds for general corporate purposes.
5/10/01	IXEurope	Private	$17.2 million in third round of venture capital, with a post-money valuation of $160 million. Provider of neutral co-location services in eight cities across Europe.
5/15/01	E-Tenna	Private	$7.3 million in first round of venture capital. Develops radio frequency transmission technologies for broadband wireless communications.
5/15/01	EYP Mission Critical Services	Private	$57.5 million in first round of venture capital. Builds and maintains data center facilities that provide "eight nines" of uninterrupted power reliability.

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Comparable Company Analysis

Company	Ticker	Price Per Share (5/18/01)	Enterprise Value *(millions)*	Calendar Year Revenues *(millions)* CY00E	CY01E	Enterprise Value/ CY00E Revenues	CY01E Revenues
Infrastructure							
360Networks	TSIX	$1.20	$3,092	$510.5	$541.2	6.1x	5.7x
Broadwing	BRW	26.76	9,121	2,050.1	2,501.3	4.4	3.6
Covad	COVDE	1.10	638	218.3	362.5	2.9	1.8
Equinix	EQIX	1.20	156	13.0	75.1	12.0	2.1
Exodus	EXDS	8.15	6,793	823.7	1,526.0	8.2	4.5
Genuity	GENU	2.23	2,293	1,179.0	1,540.4	1.9	1.5
Global Crossing	GX	15.60	24,191	3,789.0	6,340.2	6.4	3.8
Globix	GBIX	2.98	503	92.6	151.1	5.4	3.3
Interliant	INIT	1.21	209	158.1	209.1	1.3	1.0
Level 3	LVLT	13.75	8,248	1,185.0	1,665.0	7.0	5.0
Metromedia Fiber Network	MFNX	5.47	4,903	188.1	474.6	26.1	10.3
Median						6.1x	3.6x
Coordinators							
Allied Riser	ARCC	$1.08	$92	$13.7	$41.3	6.7x	2.2x
At Home	ATHM	3.94	2,590	656.8	626.7	3.9	4.1
Median						5.3x	3.2x
Solutions							
Akamai	AKAM	$10.01	$1,106	$89.8	$175.8	12.3x	6.3x
Digex	DIGX	15.01	917	174.7	262.0	5.2	3.5
Digital Island	ISLD	3.35	245	92.6	154.1	2.6	1.6
InterNAP	INAP	2.87	336	69.6	134.1	4.8	2.5
Loudcloud Inc	LDCL	5.25	374	8.2	74.8	45.5	5.0
Navisite	NAVI	2.05	131	73.8	121.9	1.8	1.1
StorageNetworks	STOR	21.93	2,052	48.2	153.3	42.6	13.4
Universal Access	UAXS	4.88	367	51.1	151.6	7.2	2.4
Median						6.2x	3.0x
Overall Median						6.1x	3.5x