

Competitive Carriers Join The Establishment

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Oscar Madison is becoming Felix Unger. The rock star is joining the symphony. The rebel is trading in his motorcycle for a minivan. And now competitive carriers are becoming real businesses.

Five years after suffering through telecom's nuclear winter and its aftermath, partly as a result of overly exuberant, speculative network buildouts, competitive carriers now are akin to newly minted MBA-types entering the business world. Generally, they are acting responsibly and more rationally and, perhaps most importantly, with serious long-term intentions. The rise to a responsible, more mature approach to the business has coincided with a degree of health throughout the competitive carrier industry, with a return to top-line revenue growth in 2006 and with expectations of continued, albeit measured, growth moving forward.



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This is hardly a return to the heady heyday of double-digit growth, but collectively, competitive carriers saw 5.2 percent growth in 2006, and they can expect slow, steady 4 percent to 5 percent growth in the years to come, as noted in the "21st Edition of New Paradigm Resources Group's Competitive Carrier Report."

This new stability is a result of the mixing of competitive carriers' historically opportunistic spirit regarding new market entry and their new-found rational approach to network investment. As a result, bankruptcies have been replaced by mergers and acquisitions, competitive carriers are experiencing access line growth while incumbent carriers' access lines are declining, and the competitive carrier industry is leading, rather than following, in new product deployment.

Let's face it, first-generation CLECs spent money like adolescents gaining access to trust funds. The "bright shiny building" approach to network deployment, for instance, epitomized the lack of sophistication in their business models. Early CLEC founders often were driven by short-term objectives, such as cashing out after taking their company public and then moving on. This approach to business did little to contribute to a stable industry.

Therefore, probably most eye-catching is the elimination of "financially troubled" as the default descriptor for competitive carriers. As competitive carriers have adopted more sustainable, "mature build" growth schemes, their stability has not gone unrecognized. Last year was dominated by mergers and acquisitions, rather than the bankruptcies that punctuated years past. Indeed, the last major competitive carrier to enter bankruptcy was McLeodUSA Inc. in October 2005. The company emerged shortly thereafter in January 2006, and in March, barely a year after exiting bankruptcy, McLeodUSA announced plans for an initial public offering.

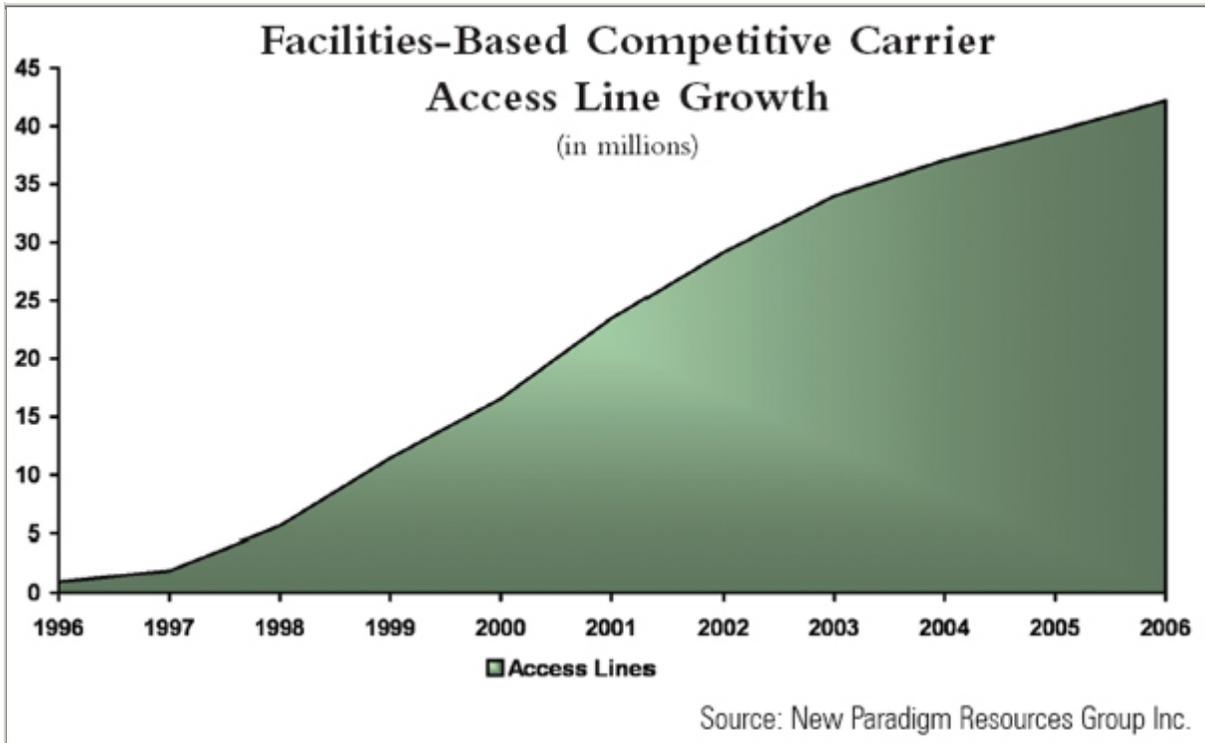


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Now more stable, the industry is attracting suitors, and companies are merging to combine their assets and extend their growth rather than to stave off collapse. Certainly, there are still struggling competitive carriers; though many are at or approaching profitability, a few are still perilously close to collapse.

Of course, it was the ILECs who led the way on the merger front, with their mega-deals changing the carrier landscape. The most notable recent mergers were Verizon Communications Inc.'s

completion of its acquisition of MCI; SBC's completion of its acquisition of AT&T Corp., which resulted in the renamed "new" AT&T; and AT&T's subsequent acquisition of BellSouth Corp.



Competitive carriers, however, merged just as aggressively, using M&A to position themselves to take advantage of the opportunities on the horizon. Some expanded their network footprints. Others added deeper penetration in existing markets, seeking to take advantage of operational synergies. Still others combined complementary services, hoping to increase per-customer billing and secure their futures with new, emerging services.

Among national carriers who sought to add markets to their local footprints, Qwest Communications International Inc. acquired OnFiber Communications Inc., while Time Warner Telecom added Xspedius Communications. These acquisitions allow the acquiring carriers to serve large enterprise customers more efficiently and to compete more effectively for new business by carrying traffic on-net in more markets.

The combination of Choice One, Conversent and CTC to form One Communications broadened and deepened the new company's presence into a solid regional footprint, and the PAETEC-US LEC merger (see xchange's April cover story on this combination) also stands as an example of geographically adjacent carriers expanding their footprints. On a regional basis, these mergers allow One Communications and PAETEC to provide broader on-net service to regional customers while reducing the costs of redundant backoffice operations.

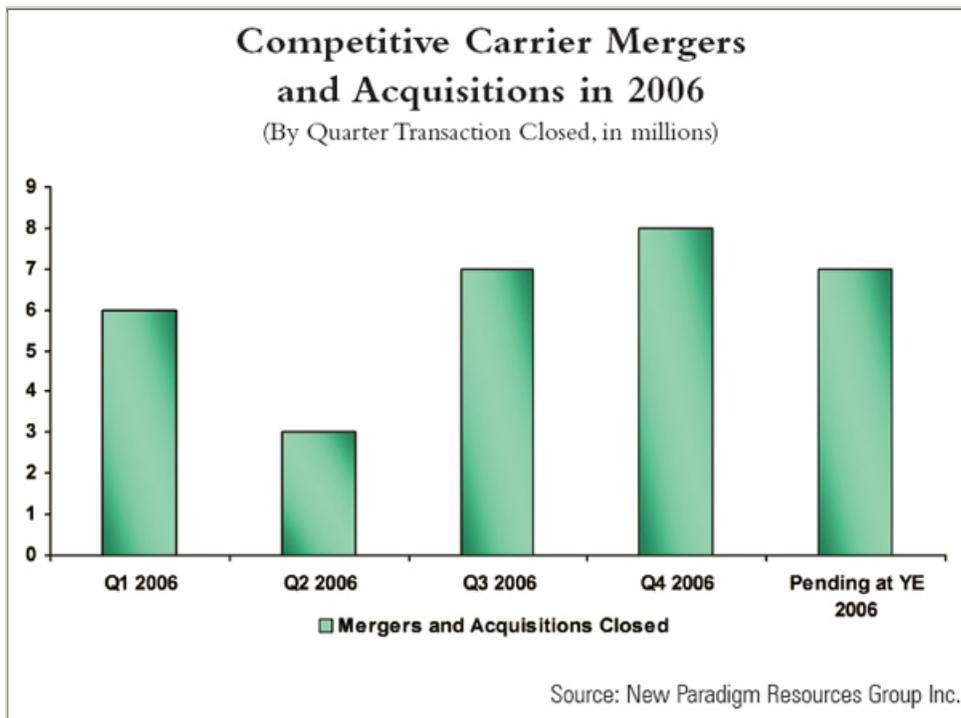
Level 3 Communications Inc.'s buying spree, including acquisitions of Broadwing, ICG, Looking Glass Networks, Progress Telecom and TelCove, served the dual purpose of extending the company's network deeper into metro areas — a strong local presence to combine with the company's nationwide long-distance networks — and broadening its product offerings.

Some mergers featured carriers looking to the future, as in Covad Communications Group Inc.'s acquisition of broadband wireless carrier NextWeb, which enabled the carrier to move into a new

medium, and Integra Telecom's addition of Ethernet services via that company's acquisition of Electric Lightwave. While carrier-grade Ethernet service is just emerging as a significant fast-growth market — one in which competitive carriers play a prominent role — and should continue to produce abundant opportunities in the next several years, broadband wireless services are growth areas of the future.

Obviously, for a variety of mostly sound fiscal and competitive reasons, competitive carriers merged and acquired in 2006, a notable improvement over years gone by. With seven acquisitions announced in 2006 and expected to close in 2007, there's no reason to believe the merger-mania will end any time soon.

Access line growth? It's a phrase that hasn't been uttered among local carriers for years. Faced with cellular phones, the elimination of fax machines, and the passing of second lines for dialup

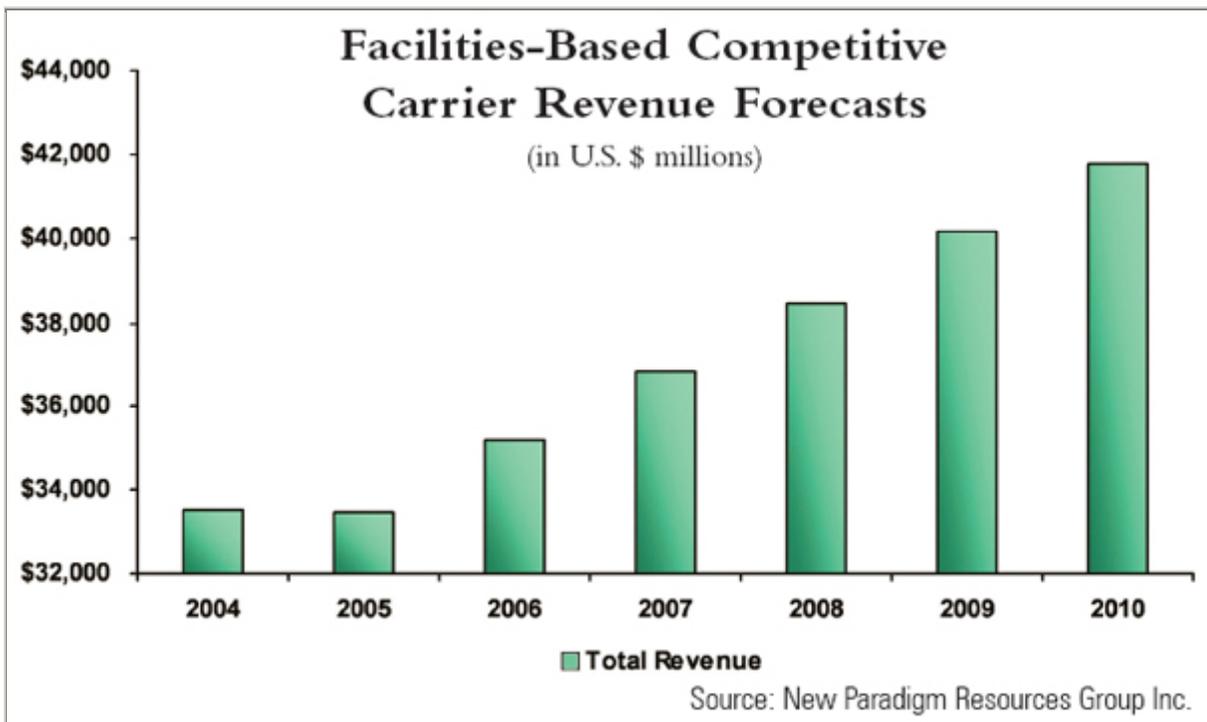


Internet, ILECs are facing continued, ongoing access line declines. Many competitive carriers no longer report access lines — a measure of telephony connections to a home or business that CLECs originally adopted to compare their market penetration to the incumbents, for whom access lines are a historically tracked metric. When they look, however, competitive carriers are seeing something the ILECs are not — access line growth. Though wireless alternatives are impacting competitive carrier line count somewhat, this is more than offset by organic growth as competitive carriers continue to make inroads into incumbent accounts, as well as the advance of cable MSOs' competitive offerings and other VoIP customers.

Can these more robust competitive carriers with their "mature build" strategies succeed in changing the telecommunications industry landscape? Certainly some will fail, but overall, the future looks bright. For carriers with sound, fiscally responsible strategies, opportunities abound amid the challenges. New technologies such as metro Ethernet allow competitive carriers to vie for new business on more equal footing with the incumbents. The lower barrier to entry provided by new switching technology — softswitches — offers greater competitive parity as well.

New opportunities also have opened up as a result of the acquisitions of AT&T and MCI by RBOCs. Where carrier diversity is required, customers who had achieved that via the competitive services of the old AT&T and MCI may now be seeking a non-RBOC alternative. That is, of course, a double-edged sword, as the mergers engender broader competition from the formidably reinforced RBOCs — in-region behemoths with large out-of-region and long-haul networks. Even though some diversity contracts may have opened up, competition for large, national contracts — particularly in the AT&T and Verizon regions — will be much stiffer.

As broader, deeper networks and a variety of service offerings have become characteristics necessary for regional and national carriers to fend off new and existing contenders, we have seen the number of competitive carriers with more than \$1 billion in annual revenue swell to six in 2006. In 2007, the newly merged PAETEC-US LEC will expand the list to seven.



Competitive carriers successfully have returned to growth via more solid market plans than in the past, notably their “smart build” strategies where customers precede buildouts. New services such as carrier Ethernet also have opened up new opportunities for competitive carriers, while bundling has allowed them to begin to grow their per-customer revenue.

Even as they increase customer penetration, competitive carriers are facing pricing pressure, a key to the more moderate revenue growth this market sector can expect. The transition from TDM-based technologies to IP-based technologies has brought with it a customer expectation for lower prices. Bundling, as well, cuts both ways — typically, a discount is included in the service bundle, resulting in lower revenue per product sold, even as average revenue per customer increases.

Competitors also pose a challenge for competitive carriers. As cable companies strengthen their metro fiber networks to offer carrier-grade connectivity to business districts, a traditional telephone company marketplace will see new, well-funded competition. And, as we noted, the old RBOCs are now mega-carriers that market converged in-region/out-of-region services as unified,

bundled offerings under a unified sales force. These stronger RBOC competitors may pose problems to national and regional competitive carriers.

Still, with years of experience under their belts and a more fiscally responsible, measured approach, competitive carriers are well-poised to take advantage of the new opportunities the changing telecom marketplace provides. Whether it involves existing offerings or, notably, the inclusion of newer offerings such as data or wireless, competitive carriers have resumed market growth and are well-positioned to continue that growth for the next several years.

Certainly, the high-flying, double-digit growth days are behind them. But with hard work, ingenuity, a “mature build” philosophy, and an attention to detail — wouldn’t Felix be proud? — competitive carriers can achieve consistent, mid-single digit revenue growth rates for the next

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