Coming of Age:
The Maturation of the CLEC Sector

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Over the past decade and a half, we have witnessed the CLEC sector mature from infancy and enter adulthood. The evolution in the past few years has been particularly dramatic. This is a sector that has gone from one initially characterized as “crumb-catchers”—scurrying around to catch a few special access dollars here and there—to one that is now comprised of an increasingly diverse set of carriers offering myriad services to a range of customer classes. About the only thing in common among these providers is the continuously evolving competitive threat they represent to incumbents.

Table 1:
Top 10 CLECs
2000 vs. 2008

2000	2008
AT&T Corp.	AT&T Inc.
MCI Worldcom	Verizon Business
Intermedia Communications, Inc.	Level 3 Communications Inc.
McLeodUSA, Inc.	Paetec Communications Inc.
ICG Communications, Inc.	XO Communications
WinStar Communications, Inc.	Qwest Communications International Inc.
GST Telecommunications, Inc.	tw telecom inc.
RCN Corp.	Cox Communications Inc.
GCI, Inc.	One Communications Corp.
e.spire Communications, Inc.	Cavalier Telephone Corp.

Source: New Paradigm Resources Group, Inc.

The Early Years

The CLEC sector as we’ve come to know it was born in the market laboratories of the States.[2] A handful of public utility commissions had the foresight (and guts) to recognize the power of market competition to inject further innovation, provide pricing discipline,

[1] *New Paradigm Resources Group, Inc. (NPRG) is a Chicago-based research and consulting firm focused on identifying, analyzing and forecasting emerging technologies and industry trends, fostering mission critical decision-making processes for service providers, technology developers and financial institutions. The authors are Senior Vice President and Director, respectively, with NPRG and can be reached at cclausen@nprg.com and jkestel@nprg.com or (312) 980-7848.*

[2] The *Telecommunications Act of 1996* simply codified what was occurring within state-level local markets already. The Act did, however, offer the nascent CLEC industry the advantage of raising the battle to the nation-level, alleviating the providers from having to address distinct regulatory issues within each state.

and improve services.[3] Following the Telecom Act of 1996, hundreds of competitive carriers (or "pseudo carriers") sprang up, employing a variety of strategies. Some looked to create a national presence, while others focused deeply on specific metros. Some built out networks of their own, while others relied on services leased from incumbent carriers. In this infancy period, CLECs were all about getting funding and launching their business—and not always about creating a sustainable business model.

Then came an era akin to childhood. The new carriers got to work building their operations, including physical networks. They launched services and added markets, often uncertain of realistic risks and rewards. But as a new type of business in a wholly new competitive environment, everyone was learning and willing to make some mistakes along the way.

Table 2:
Sample Competitive Carrier
Strategies & Outcomes –
The Early Days

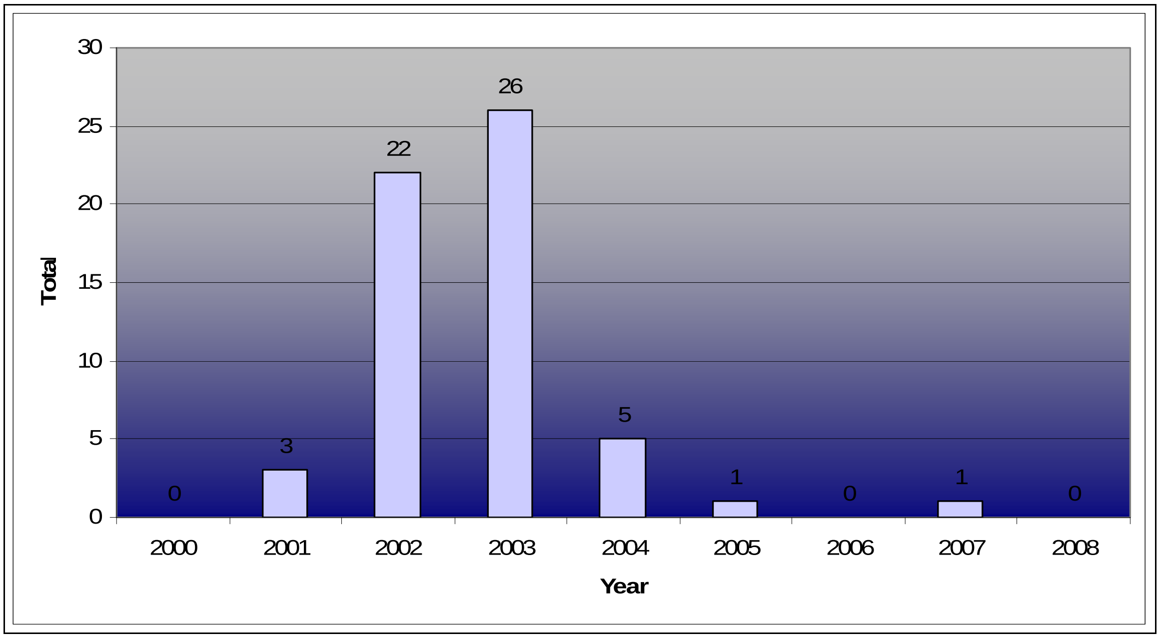
Competitive Carrier	Strategy	Outcome
Teleport Communications Group	CAP, Fiber ring deployment, moving to Class 5 switch deployment	Purchased by AT&T
USN	Pure Resale	Bankruptcy
Focal Communications	Class 5 switch deployment only	Acquired by Broadwing
Advanced Radio Telecom	Class 5 switch deployment coupled with fixed wireless service for transport	Bankruptcy

Source: New Paradigm Resources Group, Inc.

Then the sector went through the difficult, exasperating bubble period that left many industry watchers wondering if the CLECs would survive. Like an adolescent coping with new pressures and some reckless choices, competitive carriers found themselves selling services at rapidly eroding prices, holding overvalued assets, and facing debts coming due for businesses that were now crumbling. A seemingly endless string of bankruptcies ensued, and an industry-wide "crash" left many looking back on their decisions like a remorseful adult reflecting on "youthful indiscretions."

[3] The extent to which each of these consumer welfare objectives have been addressed is a topic for another day.

Figure 1:
CLEC Bankruptcies,
2000 - 2008



Source: New Paradigm Resources Group, Inc.

Coming of Age

In the past few years, the competitive carriers have done a lot of "growing up," both literally and figuratively. Gone are the land grab instincts that characterized the sector's infancy. Thankfully, it is no longer enough for a management team to present a vague business plan to start up service in such-and-such market and expect to receive funding. Gone, too, is much of the mystery about technology and the proper metrics for gauging the sector that left an opening for unscrupulous manipulation.[4] Market participants and investors alike recognize that telecom is a tough business, and operators must be evaluated on business fundamentals and their real prospects for growth, rather than rank speculation. Also behind the sector is the difficult adolescence marked by overcapacity, precipitous price declines, and a crush of business collapse.

Nothing is ever certain in this industry, but the worst appears to have passed for the CLEC sector. And like adolescents facing up to adulthood, the sector as a whole has learned valuable "life lessons" that leave carriers somewhat chastened and, one hopes, wiser.

[4] Our experience in covering WorldCom lead by the now-incarcerated Bernie Ebbers taught us a number of lessons. Perhaps chief among these is that if a carrier disguises or aggregates its numbers to prevent careful analysis by industry analysts, there are, most likely, reasons for investors to be concerned.

One result has been some long-awaited consolidation of the sector. Following years of bankruptcies and then M&A activity, the relative slowdown in acquisitions during 2007 is symptomatic of a new equilibrium in the sector, as deals that "make the most sense" have already been made and there are fewer distressed organizations whose assets are available at a discount. Of the 52 facilities-based competitive companies we covered during 2006, almost half (24) were involved in mergers, acquisitions or divestitures. The trend continued into 2007 but not as dramatically, with five deals in our 40-company coverage universe. Acquiring carriers say they struck when they did to take advantage of a perceived window of opportunity in the financial markets: the cost of credit remained low throughout 2006 and into 2007, and the valuation of sector equities showed strength not seen in years. With credit markets deteriorating, carriers shifted from acquisition to integration mode in the second half of 2007.

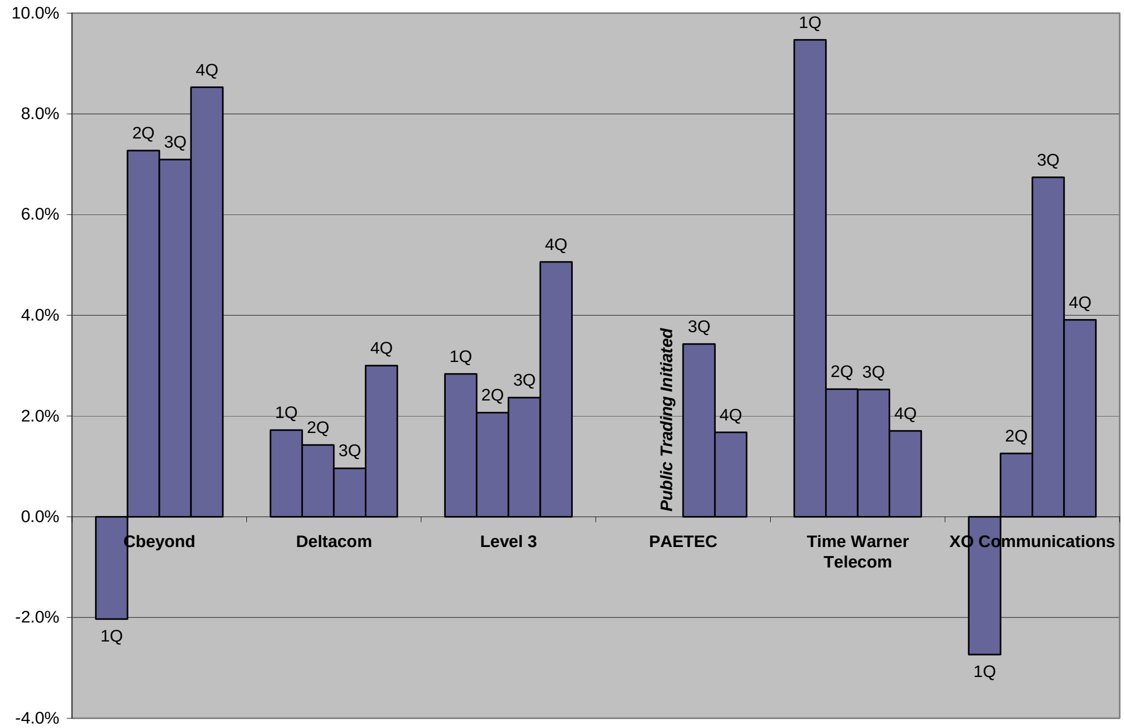
Table 3:
CLEC M&A Activity
2007

Acquiring Carrier	Acquired Carrier	Date of Transaction
NuVox Communications	FDN Communications	May 22, 2007
Windstream Corp.	CT Communications Inc.	May 27, 2007
PAETEC Holding Corp.	McLeodUSA	July 12, 2007 (Announced)
Integra Telecom	Eschelon Telecom	August 31, 2007
Access Integrated Networks Inc.	Birch Telecom Inc.	Nov. 5, 2007

Source: New Paradigm Resources Group, Inc.

Another result has been the relative stabilization of revenue growth. As a whole, the publicly-traded CLECs reported modest but consistent organic revenue growth in the low-to-mid single digits throughout the year (see Figure 1). Recent history suggests that these CLECs should continue to be able to grow sales; the question that remains is how profitable they can become.

Figure 2:
Quarter-over-Quarter Revenue Growth
for Indicator Group of Publicly-Traded CLECs
(1Q2007 to 4Q2007)



Source: Company reports; New Paradigm Resources Group, Inc.

One final result for this discussion is the renewed emphasis on facilities-based strategies. Our past research forecasted that the regulatory arbitrage game played by CLECs dependent on UNE-P and other resale rules was a fragile business model, and that if the regulatory regime changed, those carriers would see their bottom lines negatively impacted. Indeed, that has proven to be the case. From a high-water mark of more than half of all CLEC-delivered access lines in mid-2004, leased network elements that include switched facilities declined to roughly 15% of CLEC-delivered lines by the end of 2007. During the same period, access lines delivered via CLEC-owned facilities have rebounded from barely 20% at the time of the Appeals Court decision to more than 40% today. This figure should continue to rise as carriers to extend laterals on a “success build” basis.

Life as an Adult

Now that CLECs have “grown up” in terms of both physical size (multiple billion-dollar CLECs, more extensive backbone and metro network reach) and business strategy, they are entering adulthood. Competitive carriers are figuring out how to keep growing their paycheck—revenue—while managing their existing debt and keeping costs under control. Many customers and investors remember the carriers’ harrowing behavior as youths and still harbor distrust.

While the CLECs as a whole have learned important lessons, built larger networks and more stable revenue streams, and are focusing on business fundamentals, they are also finding that the environment they operated in is somewhat different than they expected. Large players—particularly Verizon and AT&T, but also large cable MSOs and service companies like IBM and EDS—continue to present new forms of market pressures and drive much of the market's evolution. Whether it's launching new gadgets like the iPhone or Voyager, dominating FCC wireless auctions, or creating partnerships with retailers, the large carriers are still the benchmark. If anything, the market has become more competitive rather than less, and no side is conceding an inch.

Life Strategies

So what do CLECs have to do to keep up and stay competitive? First, they have to become "real companies" and demonstrate that they can turn a profit. In the early years of the sector, it was enough to show that you could deliver some level of service and obtain some customers. No longer. The companies that survive have to show that they can continue to grow revenue, but also deliver earnings to investors. Novel technologies like Metro Ethernet and fixed wireless, sectors that we continue to research and report on, can be a means to that end, but as the past year has shown, companies that bank on those alternatives as ends in themselves will be punished if they don't deliver.[5]

Second, they'll have to continue playing a two-dimensional game. On the one hand, successful CLECs will identify market opportunities where they can match up against their incumbent peers, like in delivering flexible bandwidth to prime office locations, while also differentiating their services. Tough economic conditions may actually play to the CLECs advantage in this regard, as cost-conscious customers begin to explore alternatives to their current service provider. As we've already seen in the recent past, merely offering commoditized bandwidth at falling prices is not a solution in itself, however. On the other hand, CLECs must also differentiate themselves, such as by offering disruptive new technologies that the incumbents are reluctant to embrace or by making their services more easily customizable. Merely playing "me too" against service providers that have greater network reach and economies of scale, and that are the largest source of off-net wholesale services, will not be a winning strategy in the long run.

[5] NPRG has long published an extensive array of industry analysis reports – some running up to 2,000 pages in length – trying to keep up with the ongoing competitive, technological and product evolution that continues today. To embrace the rapidity of change and be able to present our data and analyses on a continuous basis, NPRG has now down away with our "paper" reports and we have now moved to a completely online, dynamic set of *Continuous Information & Advisory Services*[SM] now presenting all the sectors we cover, including the CLECs, in the dynamic delivery format. For more information, please visit http://nprg.com/SERVICES/tabid/281/Default.aspx or call us directly at (312) 980-7848.