CLECs: The View Post-Bankruptcy

Michael Weingarten and Bart Stuck

Is Chapter 11 a viable strategy for salvaging at least some of the CLECs?

With the rampant CLEC bankruptcy filings over the past 12 months, two obvious questions come to mind:

1.) As compared to more successful early CLECs/CAPs such as TCG and MFS, why did the current generation get into trouble?

2.) To what extent can Chapter 11 represent the basis for rejuvenating a failing enterprise?

We thought that it would be useful to share our thoughts with *BCR* readers, particularly because one of us (Weingarten) spent six years in a previous lifetime as a U.S. bankruptcy court trustee and has lived through the drill (most recently at Monitor, advising Telia on the bankruptcy purchase of Agis's assets). This analysis will exclude intercity/undersea carriers such as Global Grossing, a related but different issue.

Starting Point: The Critical Criteria

We have three general criteria for judging whether a company can be restructured successfully in bankruptcy. The first is the *ability to generate positive EBITDA cashflow from operations*.

Many of the companies that wind up in bankruptcy started out with a solid core of profitable business accounts and/or a good business model, but got into trouble by expanding into areas with negative marginal returns. When this occurs, the ability to jettison non-performing leases and contractual obligations (to focus on profitable core businesses) represents a constructive use of the bankruptcy process.

The second criterion is the *ability to revamp capital structure* by renegotiating debt service to supportable levels. To the extent that a secured lender's or bondholder's alternative to debt restructuring is to liquidate assets at cents on the dollar, they may accept deals in which principal and interest payments are reduced substantially or even eliminated entirely (if the lenders are willing to convert their loans into equity). If so, then positive EBITDA combined with low debt service can translate into positive profit before taxes (PBT) and, therefore, overall profitability.

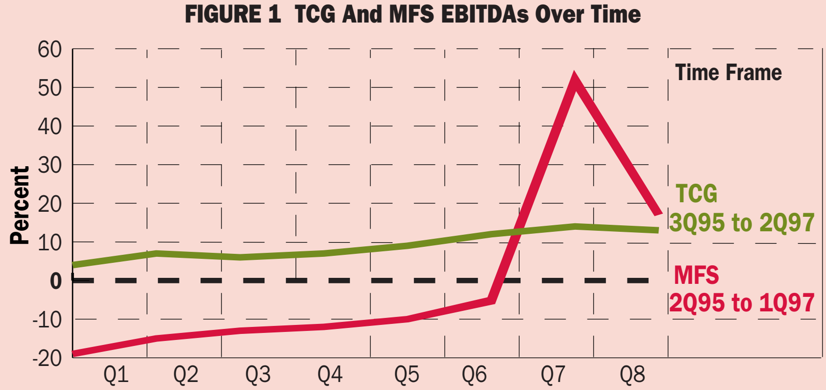
Debt renegotiation works well when the liquidation value of a company is substantially less than the company's value on an ongoing basis; the latter depends on whether the restructured company can be made cash-positive going forward.

The third criterion is the *ability to retain customers*. It doesn't help to cut costs to reduce your sales breakeven, if your customers abandon you in droves. In our experience, customers tend to shy away from dealing with Chapter 11 companies when:

1. There is a mission-critical service.
2. A long time would be required to switch to alternative suppliers in case of service interruption.
3. The potential cost savings of going with the Chapter 11 company do not represent a meaningful savings to the customer.
4. The customer must put down substantial deposits—which could be lost if the vendor liquidated.
5. The service or good in question cannot be delivered immediately in its entirety.

Conversely, customers tend to stick with vendors through Chapter 11 when they feel that they are not permanently dependent on the company's continued existence.

FIGURE 1 TCG And MFS EBITDAs Over Time



Source: SEC filings, Signal Lake estimates

Michael Weingarten (mikew @ signallake.com) and Bart Stuck (barts @ signallake.com) are managing directors of Signal Lake, a venture capital fund. Weingarten also is managing director of Telecom Advisory Services at Monitor Group (Cambridge MA), a leading international strategy consulting firm. They were assisted in their CLEC analysis by William Chu, a Signal Lake associate.

TABLE 1 Operating Percentage Comparison: MFS/TCG (Pre-Acquisition) vs ILEC 2000 Average

Costs as a % of Revenues	RBOC (2000)	TCG (last 4 qtrs)	MFS (last 4 qtrs)
Operations	28%	57%	59%
SG&A	20%	31%	27%
Total	48%	88%	86%

Source: FCC, SEC filings (average of latest four quarters)

TABLE 2 CLEC 2001 EBITDAs Arrayed (By CLECCategory)

Fiber-ring oriented CLEC		DLEC		Wireless CLEC	
Time Warner	16%	Covad	(103%)	WinStar	(30%)
McLeodUSA	5%	NorthPoint	(380%)		
XO	(20%)	Rhythms	(918%)		
Allegiance	(22%)				

Source: SEC filings (average of latest four quarters)

Triaging CLECs From An EBITDA Perspective

Looking first at the operating cashflow issue: The CLEC business model has been to cherry-pick high-density business accounts in order to offset the huge scale advantage the LECs enjoy. This has been a winning strategy—by the mid-1990s, TCG and MFS (now owned by AT&T and WorldCom, respectively) were able to generate positive EBITDAs that improved over time with increasing scale (Figure 1).

However, even in the "good old days," TCG and MFS had high operations and sales, general and administrative (SG&A) costs compared to an average figure from current RBOCs (Table 1). Thus, the CLEC business model can only work if you are a focused cherry-picker, not if you plan to compete with RBOCs across the board.

Fast-forwarding to the present, there's a sea of CLEC red ink. Table 2 shows recent EBITDAs for three DSL providers (DLECs), four fiber-ring oriented CLECs and one wireless CLEC (we would have liked to have included Yipes, but it's privately held).

It's important to note that the CLECs listed in Table 2 and subsequent exhibits are in various stages with regard to their financial status. Three of them—XO Communications, Time Warner Telecom and Allegiance—had not filed for bankruptcy as of press time last month, although XO was undergoing a restructuring. Two DLECs—NorthPoint and Rhythms—had their assets liquidated as a result of bankruptcy proceedings, while the third major DLEC, Covad, exited bankruptcy at the end of last year, and McLeod USA emerged from bankruptcy last month.

The Gory Details

To see whether bankruptcy offers a viable way out for the remaining CLECs—whether or not they have filed to date—let's look at what elements of CLECs' cost structures have caused so much trouble. Despite improvements over time, the DLECs and wireless players remained substantially EBITDA negative, as have the fiber CLECs with the exception of Time Warner and McLeod.

Interestingly, if we exclude the DLECs, Figure 2 (p. 38), shows that much of the EBITDA variation across CLECs comes from differences in SG&A costs as a percentage of sales (a 41-percent point range on Figure 2), not operations costs (15-percent point variability). This suggests that customer marketing and support costs play a more critical role in overall EBITDA than is generally understood.

What's going on? Two important drivers appear to be *customer size and overall scale*. As seen in Table 3, the new CLECs (with the exception of Time Warner) typically have customers that are much smaller than TCG and MFS. This would appear to be the result of multiple entrants chasing maximum revenue growth from a finite target base (downtown businesses), and being forced to move down-market due to the scarcity of larger customers.

It also is the result of expanding into smaller markets (metropolitan serving areas—MSAs) with, on average, smaller customers. With respect to scale per MSA, a number of the new CLECs are equivalent to TCG and MFS circa 1997, while others are substantially smaller.

As seen in Figure 3 (p. 39), the impact of differential customer size and scale on EBITDA is striking. Looking first at *customer size* (horizontal axis, all charts), SG&A was 34 percentage points lower for CLECs whose average customers were large ($2,000/month) than for CLECs with average customers of medium size ($200–$2,000/month—Figure 3a, horizontal shaded bar).

Small customers and small markets are disastrous for CLECs

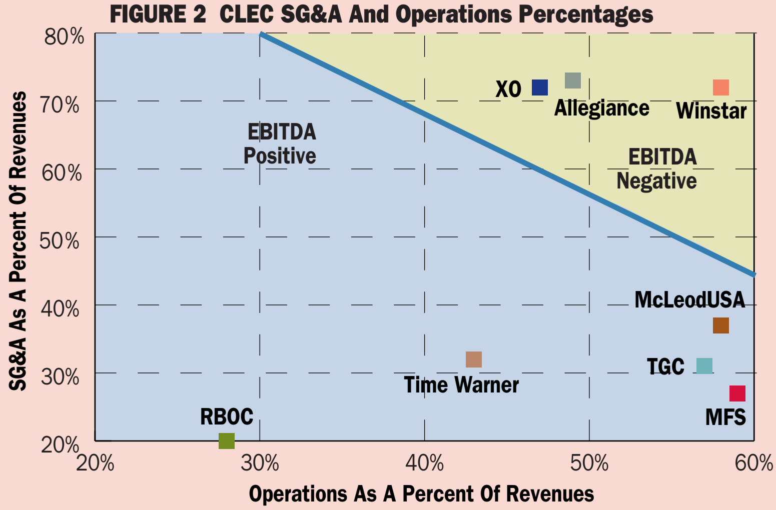
TABLE 3 Key Driver Statistics For New vs Old CLECs

	Average Account Size (Revenue/Month)	Account Density (Revenue/MSA/Month)
TCG	Well over $10,000	$1,500K
MFS	Well over $10,000	$2,400K
Time Warner	Well over $10,000	$1,300K
McLeodUSA	~$300	$1,000K
XO	~$1,000	$1,700K
Allegiance	~$300	$1,400K
WinStar	<$2,000	$891K
Covad	<$60	$317K
NorthPoint	<$150	$73K
Rhythms	<$100	$65K

Source: SEC filings, Signal Lake estimates

Consolidation could improve CLEC EBITDA

FIGURE 2 CLEC SG&A And Operations Percentages



Source: SEC Filings (latest four quarters)

However, operating costs accounted for an equal share of revenues (53 percent) in the large- and medium-size customer segments (Figure 3b, horizontal shaded bar). A major outlier is McLeod, which outperforms against its medium customer size in SG&A.

Now look at the effect of trying to serve a base of small customers. The average difference between operating with medium and small customer size is 240 percent for SG&A (Figure 3a, horizontal shaded bar) and 210 percent for operations (Figure 3b, horizontal shaded bar). So selling to smaller customers hurts a great deal, due to much higher SG&A costs, as well as higher operations costs.

The trend is similarly dramatic when we look at scale, as measured in *revenues per MSA* (vertical axis, all charts, shaded bar). CLECs that had large scale per MSA had SG&A costs 29 percentage points below the level borne by medium-scale CLECs (Figure 3a, vertical shaded bar). Furthermore, their operating costs were 29 percentage points lower than medium-scale CLECs (Figure 3b, vertical shaded bar).

And again, there's an enormous gulf between the medium and small when it comes to scale. The difference between medium and small MSA scale is 356 percentage points for SG&A and 242 percentage points for operations.

The result of combining the two drivers (each of which appears to be roughly equal in importance) is shown in Figure 3c. Here, the shaded cells demonstrate where the optimal EBITDA is to be gained, and not surprisingly, it's with large customers in large markets. A CLEC with large customer size and high MSA scale runs at an EBITDA profit of 16 percent (averaging TCG's, MFS's and Time Warner's figures). This is 42 points better than a medium/medium CLEC (average of Allegiance and WinStar), and 665 points better than a low/low CLEC (average of NorthPoint and Rhythms.)

Given this assessment of CLEC EBITDA drivers, to what degree would they be improved by a Chapter 11 filing? The answer is: Not much.

Where CLECs have over-expanded into too many unproductive MSAs (defined by low overall scale or poor customer account mix), one can use the bankruptcy process to pull back to those MSAs that are productive. Beyond that however, filing a bankruptcy petition won't magically improve customer mix or overall scale. So net-net, we don't see Chapter 11 by itself as a solution for negative EBITDA.

That having been said, we do see the benefit of CLEC consolidations as a means for improving EBITDA. From Figure 3c, if a consolidation process transforms a medium-customer size/medium-scale CLEC into a medium-customer size/high-scale CLEC, this would increase EBITDA by 16 percentage points.

TABLE 4. Debt To Capitalization Ratios; Interest Cost % By Company

	Debt to Capitalization	Interest Expense as a % of Revenues
TCG	58%	18%
MFS	35%	9%
Time Warner	86%	25%
McLeodUSA	76%	13%
XO	96%	37%
Allegiance	54%	14%
Covad	129%	29%
WinStar	101%	43%
NorthPoint	67%	78%
Rhythms	108%	214%

Source: SEC filings (latest four quarters)

Triaging CLECs From A Capitalization Perspective

Looking next at the capitalization issue: Compared to TCG and MFS's relatively modest long-term debt-to-capitalization ratios, the current crop of CLECs have 1.5 to 2 times higher debt levels. As a result, the interest cost as a percentage of sales averages approximately 50 percent, compared to 18 percent for TCG (Table 4) This makes even modestly EBITDA positive companies with debt levels lower than their peers—e.g., McLeod—unprofitable on a PBT basis

Clearly, the ability to renegotiate debt service as part of the bankruptcy process can represent an important boost for a CLEC. With telecom liquidation values hovering in the 5–10 percent of outstanding debt range, there is substantial incentive for debtors to cut deals giving them some equity upside.

However, debt restructuring arguably is a boost, not a standalone cure. Persuading my debtors and equipment leaseholders to convert all of their debt into equity—making my debt service costs zero—won't matter much if my EBITDA is -50 percent.

Paradoxically, if "bad" CLECs with excessive debt succeed in restructuring this debt via bankruptcy, this will put substantial pressure on more

It doesn't do any good to get rid of your debt if you still can't earn any money

FIGURE 3 CLEC EBITDAs
Arrayed By Revenues Per MSA And Average Customer Size

FIGURE 3a SG&A As A Percent Of Revenues

Scale (Annual Revenues)	Low <$200	Medium $200–$2,000	High $2,000+	
High $750M+		McLeodUSA: 37% XO: 72%	TCG: 31% MFS: 27% Time Warner: 32%	40%
Medium $250M–$750M	Covad: 63%	Allegiance: 73% Winstar: 72%		69%
Low <$250M	NorthPoint: 291% Rhythms: 559%			425%
	304%	64%	30%	Avg.

Account Size (Revenue/Customer/Month)

FIGURE 3b Operations As A Percent Of Revenues

Scale (Annual Revenues)	Low <$200	Medium $200–$2,000	High $2,000+	
High $750M+		McLeodUSA: 58% XO: 47%	TCG: 57% MFS: 59% Time Warner: 43%	53%
Medium $250M–$750M	Covad: 140%	Allegiance: 49% Winstar: 58%		82%
Low <$250M	NorthPoint: 189% Rhythms: 459%			324%
	263%	53%	53%	Avg.

Account Size (Revenue/Customer/Month)

FIGURE 3c EBITDA As A Percent Of Revenues

Scale (Annual Revenues)	Low <$200	Medium $200–$2,000	High $2,000+	
High $750M+		McLeodUSA: 5% XO: -20% AVG. = -8%	TCG: 12% MFS: 13% Time Warner: 24% AVG. = 16%	7%
Medium $250M–$750M	Covad: -103%	Allegiance: -22% Winstar: -30% AVG. = -26%		-52%
Low <$250M	NorthPoint: -380% Rhythms: -918% AVG. = -649%			-649%
	-467%	-17%	16%	Avg.

Account Size (Revenue/Customer/Month)

Source: SEC Filings, Signal Lake estimate

Business customers will be risk-averse about CLECs

"fiscally responsible" CLECs to file Chapter 11, in order to have a level playing field. It therefore will be interesting to see what happens to Time Warner Telecom and Allegiance.

Triaging CLECs From A Customer Perspective

Coming up with a positive EBITDA business model combined with low debt service is great, but it won't mean anything if the restructured CLEC can't hold onto customers and gain new ones.

Unfortunately for CLECs, this won't be an easy task once they file for bankruptcy. The average business telecom bill runs around 2–3 percent of sales. That's not all that much money for a mission-critical service with non-trivial time required to switch from one vendor to another. As a result, a rational business customer can and should be increasingly risk-averse about buying from a CLEC. Filing for bankruptcy will only make matters worse for the CLEC.

Conclusion

Bankruptcy is a useful tool for restructuring debt service, and as a vehicle for well-funded players to buy assets of failed enterprises cheaply. However, by itself, bankruptcy will do little to cure the CLEC inability to run EBITDA-positive, except to the extent that the pre-petition CLEC had grossly over-expanded into unprofitable MSAs (Covad may be an example here). Nor will bankruptcy help stabilize existing customers or attract new customers. So, the utility of filing Chapter 11 to make a dog CLEC into a sustainable enterprise is limited.

What will work? Given that the telecom service-provider sector is running dead last in S&P's industry survey, thinking about upsides is an admittedly optimistic exercise. However, we think that the necessary solution is for a broad consolidation of the CLEC industry by a small number of well-financed owners who will buy failed assets for cents on the dollar and who can retain/attract customers.

Our candidate consolidators would include telecom players like AT&T (which purchased NorthPoint's assets) or LBOs like Forstmann Little, which invested post-petition in McLeod and is proposing to invest in XO (in both cases protecting their pre-petition investments). The end result needs to be a consolidation down to one or two large CLECs in each MSA, resulting in an endgame local oligopoly that retains some degree of competition□