Definition of Ratings:
Buy: at least 20% undervalued
Hold: appropriately va
Sell: at least 20% overvalued

Industry
Broadband – CLECs: SELL

Companies:
Allegiance Telecom (ALGX): Hold

Choice One Communications (CWON): Hold

DSL.net (DSLN): Sell

Electric Lightwave, Inc. (ELIX): Sell

Focal Communications (FCOM): Hold

Mpower Holding Corp.(MPWR): Sell

RCN Communications (RCNC): Sell

US LEC Corporation (CLEC): Sell

CLECs play smash 'em, crash 'em:

Most Competitive Local Exchange Carriers (CLECs) are smashing into the debt wall but some could make it to the finish line of profitability

Recommendation: SELL

February 6, 2002

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Portfolio Manager: Javier Fernandez

Overview:

The market for CLECs sector of the broadband industry is poor and getting worse. Companies must have a fully funded business plan, solid management, corporate focus, and cash reserves to survive the bone-dry capital markets. Some issues that may survive the industry-wide bankruptcy carnage are ALGX, CWON, and FCOM.

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Recommendation

We are initiating coverage of the small to mid-cap competitive local exchange carriers (CLECs) sector of the Broadband industry with a SELL recommendation. Key drivers for our recommendation are as follows:

- "Survival of the Fittest": The recent economic downturn effectively eliminated the companies with a huge appetite for capital but no corresponding revenues. Some viable industry players remain, but most still face a credit crunch and are not expected to survive much longer.
- The regional Bell operating companies (RBOCs)[1] have the resources to squeeze out most CLECs over time. This is a minimum efficient scale (MES) business, and most RBOCs are comfortably over the threshold of MES. Most CLECs are not. Collectively they control only 6.7% of the market, versus 80% for RBOCs. While CLECs often serve high profit customers, the infrastructure is more expensive/user than for RBOCs.
- A regulatory climate that is fickle. Recent policy initiatives, such as the Tauzin-Dingell bill in the House, have made it clear that policymakers may have pulled their welcome mat to competition that was laid out in the Telecommunications Act of 1996.
- Bandwidth forecasts have slowed considerable from a year ago. We expect this market to continue to have non-hyper growth for the next 2-3 years.

An investment in a few notable exceptions of the CLEC market is similar to a diversified investment in any venture market—while it is likely that most of the portfolio companies will fail, the gains from the few that do succeed may offset losses from the many failures.

Calendar of Upcoming Key Events[2]

February 8 – RCN: Q4 2001 Earnings Release

February 11 – Choice One Communications:
Q4 2001 Earnings Release and Conference Call

February 19 – Allegiance Telecom:
Q4 2001 Earnings Release and Conference Call

[1] RBOCs is a holdover term from the period of ATT's monopoly of the entire phone system. Today the term refers to the predominant local carriers broken apart from ATT: Verizon (NYSE:VZ), SBC (NYSE:SBC), Bell South (NYSE:BLS), and Qwest Communications (NYSE:Q).

[2] Bloomberg. 2/2/2002.

Background & History[3]

The Communications Act of 1934, intended to create an affordable and universal telephone service, established telecommunications as a regulated industry. This act designated AT&T as the sole provider of telephony services. This protection led to AT&T's dominance of the industry. In 1984, the breakup of AT&T led to the creation of many "baby Bells" also known as Regional Bell Operating Companies (RBOCs).

The Telecommunications Act of 1996 sought to further encourage competition in the telephone industry by allowing for the formation of Competitive Local Exchange Carriers (CLECs). The incumbent market players were required to allow access to the telephone network and sell capacity to these competitive players. As a result, broadband service must be provided by a CLEC, although RBOCs have formed their own subsidiaries to compete in this market. CLECs "rent" a portion of the lines that have already been installed by the RBOCs in the "final mile" to the customer's home or business, and connect into their own equipment at each switching office (a "co-location"). In some situations (high density business locations, for instance), the CLEC can wire the business completely end to end, from the customer to the inter-exchange carrier (IXC) such as Sprint or MCI WorldCom.

In the absence of "killer" applications that would utilize broadband technology, the market for CLECs has emerged much differently than experts had originally predicted. Although residential users continue to install the service, the bulk of the demand has come from users who need high-speed access to the Internet to access corporate networks from residences and remote offices. The consumer competition has intensified as both cable TV providers and telephone companies furiously work to capitalize on providing this service.

Most of the approximately 1100 new CLEC ventures created due to the 1996 act went bankrupt with the 2000 general economic downturn and restoration of rational valuation and growth plans. [4] Our analysis focuses on the approximately 50 remaining organizations, including both those that did not experience and those that have recently emerged from bankruptcy.

Description of Broadband Technology

Broadband is a general term to describe a network that allows for high-speed transmission of voice or data. Digital and fiber-optic technologies are essential to maintain a "fat pipeline" of data transmission. Broadband essentially refers to the full potential of a pathway to a home or small business. After the "pipe" is in place and large enough to handle data traffic efficiently, the customer obtains. The end

[3] "Telecommunications: Wireline" 31 May 2001. Standard & Poor's
[4].Ibid.

user (business/consumer) typically experiences broadband in one of the following formats:

- Residential: DSL, Cable Modems.
- Business: DSL, Wireless, Satellite, T1/T3/OCN, Frame Relay, ATM.

Our focus is on CLECs, which either hook into the "final mile" of wiring at the RBOCs switching office (residential model), or run the cable from their customer directly into interexchange services (long distance, etc).

DSL Overview

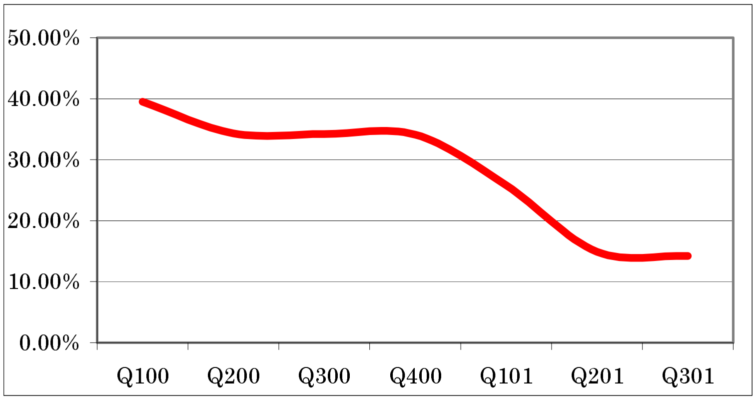
Digital Subscriber Line technology (DSL), converts existing telephone lines into access channels for both multimedia and high-speed data communications. DSL is able to transmit more than 6 Mbps downstream and 640 Kbps upstream and as much as 1.1 Mbps in both directions.[5]

Current Industry Trends

- Consolidation of services: Most experts believe the industry is moving towards a bundled service provision model. This would include multiple voice lines, data lines, as well as various ancillary services that add to the bottom line profitability of the company (e.g. phone cards, web hosting services, and e-commerce applications). Going with a CLEC goes "against the grain" of a preference for a single bill by businesses and consumer's alike.
- Higher prices & lower adoption rates (see figure 1.): in the residential arena, cable broadband prices rose 12% in 2001 from an average of $39/month to $44/mo. DSL prices rose 10% from an average of $47.18 to $51.67.[6] This trend is due to consolidation and consequent decreased competition. Decreased adoption rates accompanied increased prices. We believe the decreased adoption rate is due to near-saturation of the technophile segment of the market. While the adoption rate may be slower, the number of users will increase. We believe the higher prices are due to the service provider's need to improve short-term cash flow in order to cover fixed costs and pay off interest expense. Because of the overall economic slowdown and consequent slower subscriber growth rate, higher rates are required in the sort term to show acceptable margins. An improved economy will lead to higher growth projections, and the service provider's will be able to lower rates and maintain adequate margins due to better economies of scale. In addition, competition will also force rates lower in the long term.

[5] www.acceleration.net
[6] Cyberatlas.com. Jan,17, 2002.

Figure 1. Broadband Subscriber Growth (from previous quarter)



[7]

- Constant change seeded by recent regulatory changes and ongoing market instability.

- The "High-Yield Heroin binge" is over[8]. The easy money financed by junk bonds has produced a slew of CLEC addicts that did not survive. The companies that are left have been able to complete their network build-out and have sufficient cash reserves to make it to profitability.

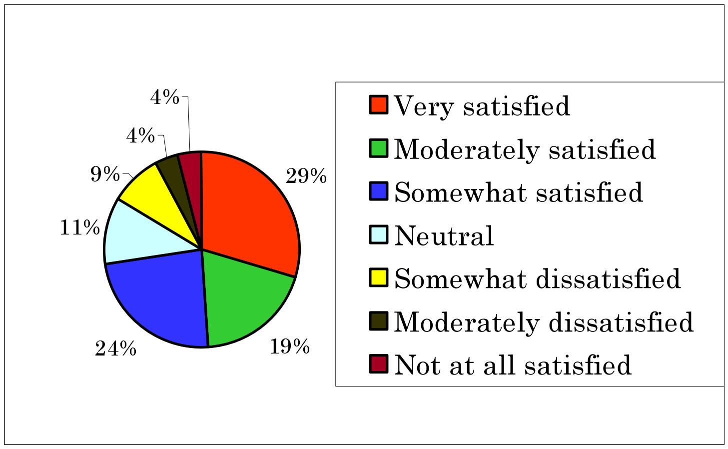
Industry Forecast

We believe the future of the industry is dependent upon the following:

Application Development: Just as a garden hose is useless without water, a "fat" pipeline is useless without a need for speed. Consumers and businesses do not demand a conduit for information without a need for the information. The presence of a "killer app" that demands a broadband connection is the driving force behind demand, not vice-versa. Businesses experience an exponentially growing need for information presented in new and increasingly bandwidth-intensive ways. Consequently, this is not an issue in the commercial market. However, in the home market, there is no single "killer app" driving demand. While popular applications requiring a broadband connection, such as Napster, exist, the most popular home application by far is e-mail, which does not require a broadband connection. Consumers are relatively satisfied with dial-up service (see figure 2). However, clearly broadband represents the future of data transmission for the home. While growth may be somewhat stagnant at this point, the development and consequent demand for bandwidth intensive media applications in the home market will decrease consumer satisfaction with current service offerings, and eventually drive the broadband market. However, we value this as an upside option rather than a key metric due to the implied high discount factor in time uncertainty.

[7] Cahners In-Stat Group, 12/01.
[8] "Busy Telecom upstart goes cold turkey on more junk," WSJ, 6/18/02

Figure 2. Satisfaction of Dial-Up Users



Competition from New Technologies (Wireless): High-speed wireless connections are a nascent technology that poses some competitive risk. However, for the foreseeable future, businesses in particular will grow their wireless network inside the office but still use broadband connections to access the IXCs.

Regulation: The current favorable regulatory environment shields CLECs from much of the downside experienced by RBOCs, who are required to provide service to all users in their territory. Of course, the cost of providing service to the users far from the switch is much higher than the associated revenues. In traditional telecom practice, the users located close to the switch subsidize these costs. Current regulation does not require the CLECs to provide service to the cost-inefficient customers, allowing these organizations to "cherry pick" the low-hanging fruit from the RBOCs. We believe this environment will provide favorable spawning grounds for these organizations to gain momentum, and in the event of future regulatory shifts, remain competitive in an open market. Successful passage of the Tauzin-Dingell Bill, however, would spell the end of most CLECs since the Baby Bells would start restricting access to their facilities as they geared up to battle cable.

Seller's market?: An open market will also cause these companies to become prime acquisition targets if they do become profitable, an upside option we do not feel is currently incorporated into this industry's valuation. If a CLEC survives and thrives, at that point RBOCs will have a strong incentive to acquire these businesses, especially when they are located in a competing RBOC's territory since regulators probably won't allow in-market acquisitions.

Bubble Economy Valuation: Many of these companies are emerging from bankruptcy. We feel this process was inevitable with the overall economic downturn. Valuation measures and growth targets reasonable before March 2000 were simply unrealistic in a typical economic climate. We believe the remaining companies do not need to portray unrealistic growth targets in order to receive capital (because there is no capital available this is not an issue). Those companies with solid management and rational growth targets will thrive in today's marketplace and remain competitive with typical cyclical changes in the telecom industry.

Competitive "Squeeze" Tactics: Commercial CLECs have a greater opportunity to escape the RBOC squeeze. The "squeeze" comes from CLECs who are at a competitive disadvantage because they are resellers of an RBOC product, and thus are subject to imposed rate increases and delaying tactics by the RBOCs in anything they do. CLECs in this situation have an extra layer of risk compared to companies that establish their own networks to tie into the IXCs.

We are more confident of firms long term viability if they have already installed a separate system in specific, high traffic markets. Once they reach profitability, they stand the chance of constantly "cherry-picking" the most profitable customers away from RBOCs. This is a lucrative market that can grow from its existing 6-7% of the market to 25% of the business market.

Industry Challenges & Analysis

Characteristics

- Regulatory environment extremely important.
- Constant change due to technology and regulation instability.
- Intense competition
- Technological changes leading to constantly decreasing prices
- Decreasing entry/exit barriers
- Low buyer/supplier power

Key Success Factors

We believe that key factors that will determine the success of the CLECs going forward are the following:

- Focus on medium-large business: While broadband service is available to 81MM homes via cable and 55MM via DSL. In the US, only 10% of these households are actually signed on for high-bandwidth service. Only 6% of small businesses currently have broadband service. One key driver for this low penetration rate is that the price of broadband is roughly double that of dial-up access. Another, and perhaps more important driver is that currently there are very few home applications that require broadband, and consumers appear relatively satisfied with traditional telephone-line based data connections (see Table 2). The number one application of home users is e-mail, a non-bandwidth intensive application.[9]

9 "After Global Crossing, Is There Any Hope for Broadband?", 2/5/02. Business2.0.

While we believe the home and small business markets could prove to be a lucrative one in the far future, we believe that CLECs focused on a market with an immediate need will make it past the current glut.

- Regulation: The Tauzin-Dingell bill, which would have killed the CLEC industry by giving increased control to the RBOCs, did not pass in 2001 and we think it is effectively dead for this session of congress. Although the current administration does not have strong anti-monopolistic policies, we do not expect judicial or regulatory actions to tilt the scale one way or another. We believe that the Powell-led FCC supports a competitive marketplace, which is essential for future success of the CLECs. This variable is one of the great unknowns in the debate over long-term viability of this industry.

- Business needs create switching: Clearly, the demand for broadband is highly correlated to the availability of applications that require high-speed data transmission. Customers are more likely to consider a change in service providers when they seek to add additional services. If broadband penetration rates are falling off, then so too are the opportunities to steal a customer away from an RBOC. The presence of applications creates the demand.

- Viability of alternative technologies: Unforeseen advances in wireless and other types of broadband technologies have the potential to have a major negative impact on the success of the CLECs. The vast rise in the application of wireless technologies after September 11 for short-run by companies like ALGX, line of sight data transfer indicates that given the opportunity, technology will outstrip the challenges faced by final mile provisions to both residences and businesses.

- Solid management, reasonable business models: While the market recently experienced an economic downturn, we believe that organizations with solid management skills and reasonable business models have a chance at success. Having a fully funded business plan is critical over the next 6 months since the debt markets are all but dried up, with no rain in the forecast.

- Competition: The RBOCs are not sitting by idly watching the show. They would love nothing better than a rewrite of legislation that would effectively destroy the CLEC industry (the Tauzin-Dingell bill being the recent example). The CLECs themselves also tend to be highly concentrated in the northeast or major business markets like Denver, Atlanta, or Dallas. This suggests strong competition between multiple CLEC firms and an RBOC competing for long-term contracts and services.

Also, see ARS, Inc. Jan. 01.

Company Descriptions

Symbol	Name	Price	Mkt Cap	EPS (ttm)	52-wk Range
ALGX	ALLEGIANCE TELE	3.63	418.3M	-3.82	1.88 - 22.10
CLEC	US LEC CORP	3.34	87.1M	-2.83	2.16 - 8.375
CWON	CHOICE ONE COMM	1.7	68.6M	-7.23	1.03 - 10.26
DSLN	DSL.NET INC	0.8	51.8M	-1.81	0.14 - 1.69
ELIX	ELECTRIC LIGHTW	0.43	22.1M	-3.37	0.23 - 3.625
FCOM	FOCAL COMMS CP	5.19	25.8M	-2.41	5.38 - 439.6875
RCNC	RCN CORP	1.68	163.5M	-14.03	1.01 - 7.30

The following seven companies are representative of the 50 or so small to mid-cap companies remaining in the CLEC sector:

Allegiance Telecom (ALGX): HOLD

Allegiance Telecom, Inc. provides voice, data, and Internet services to business, government, and other institutional users in major metropolitan areas across the United States. For the nine months ended 9/30/01, revenues increased 92% to $365.1 million. Net loss increased 60% to $306.2 million. Results reflect an increase in the number of customers and lines installed, offset by an increase in personnel expenses. Allegiance Telecom has a strong management team, and fully funded business plan and has avoided many of the excesses that caused other CLECs to fold.[10]

Choice One Communications (CWON): HOLD

Choice One Communications Inc. offers voice and broadband data telecommunications services primarily to small and medium-sized businesses in second and third tier markets in the northeastern and Midwestern United States. The Company provides service to 34,220 clients for 177,614 access lines, including 3,795 data lines in 26 markets in 11 states. For the nine months ended 9/30/01, revenues rose from $38.6 million to $125.4 million. Net loss applicable to Common rose 36% to $218.7 million. Revenues

[10] "Telecom sector taking cues from Bells" CBSMarketwatch.com 12/21/01.

reflect the addition of new customers through market expansion. Higher loss reflects higher depreciation and interest costs. CWON has a fully funded business plan.

DSL.net (DSLN): SELL

DSL.net, Inc. provides high-speed data communications, Internet access and related services to small and medium-sized businesses, primarily using digital subscriber line (DSL) technology. The Company primarily targets select second- and third-tier cities for the deployment of its own local DSL equipment. As of March 15, 2001, the Company had installed equipment in over 375 cities. In first-tier cities and certain other markets where the Company has not deployed its own equipment, it utilizes the local DSL facilities of other carriers to provide service. For the nine months ended 9/30/01, revenue totaled $30.9 million, up from $10.7 million. Net loss rose 38% to $104.7 million. Results reflect strong demand from businesses, offset by higher network and depreciation costs.

Electric Lightwave, Inc. (ELIX): SELL

Electric Lightwave, Inc. is a facilities-based competitive local exchange carrier that provides a broad range of wireline telecommunications products and services in the western United States. Enhanced broadband data services are also offered in selected cities. The Company markets to retail customers that are primarily communications-intensive businesses and to wholesale customers that are primarily communications providers, as well. For the nine months ended 9/30/01, revenues fell 3% to $176.3 million. Net loss rose 22% to $125.3 million. Results reflect a reduced number of wholesale long distance minutes processed and higher non-cash costs. ELIX is currently seeking capital in order to maintain their growth rate.

Focal Communications Group (FCOM): HOLD

FCOM is a national broadband communications provider, offering data, voice and Internet infrastructure services to large corporations, ISPs, content service providers, ASPs and VARs. As of October 9, 2001, the Company offered service in a total of 22 markets, which encompass a total of 53 metropolitan statistical areas (MSAs). Nearly half of the Fortune 100 use Focal's services. For the nine months ended 9/30/01, revenues rose 49% to $249.2 million. Net loss before extraordinary item totaled $148.1 million, up from $71.7 million. Results reflect a greater number of lines in service and new interconnection agreements, offset by increased network expenses. Focal managed to avoid bankruptcy, and recently received a new infusion of cash, fully funding its business plan.[11]

RCN Communications Corp.(RCNC): SELL

RCN Corporation delivers bundled communications services to residential customers over its own network. As of year-end 2000, the Company was operating in 8 metropolitan areas. In addition, the Company provides communication services to commercial customers. For the nine months ended 9/30/01, revenues rose 40% to $333.3 million. Net loss applicable to Common before extraordinary item rose 88% to $1.12 billion. Revenues reflect growth in average service connections. Higher losses reflect $470.9 million for the write-off of goodwill and special charges, and an increase in preferred dividends.

[11] "Focal focused on surviving shakeout" 11/08/01. CBSMarketwatch.com

US LEC Corp. (CLEC): SELL

US LEC Corp. is a provider of integrated telecommunications services, including local, long distance, data, Internet and enhanced services to customers in selected markets in 15 states. US LEC is also certified to provide telecommunications services in nine others. The Company primarily serves telecommunications-intensive commercial customers. As of September 30, 2000, US LEC reported over 74,600 business trunks, over 24,000 ISP/ESP trunks and over 22,500 business lines. For the nine months ended 9/30/01, revenues rose 56% to $127.1 million. Net loss applicable to Common fell 13% to $59.5 million. Results reflect growth in end customer revenues. Net loss was partially offset by higher expenses as a percentage of revenues and the absence of a $23.7 million income tax benefit.

Summary of Company Financials Quarter ending 9/30/01[12]:

Income Statement	ALGX	CLEC	CWON	DSLN	ELIX	FCOM	RCNC	Average
Total Revenue	$135,137,000	$45,983,000	$48,792,000	$11,724,000	$50,319,000	$85,121,000	$116,347,000	$ 70,489,000.00
Cost Of Revenue	$65,714,000	$23,276,000	$31,005,000	$19,191,000	$31,553,000	$41,318,000	$156,836,000	$ 52,699,000.00
Gross Profit	$69,423,000	$22,707,000	$17,787,000	($7,467,000)	$18,766,000	$43,803,000	($40,489,000)	$ 17,790,000.00
Operating Expenses								
Research And	$0	$0	$0	$0	$0	$0	$0	$ -
Selling General And Administrative Expenses	$90,775,000	$31,046,000	$43,190,000	$8,076,000	$18,171,000	$48,292,000	$15,093,000	$ 36,377,571.43
Non Recurring	($175,000)	$0	$0	$0	$0	$25,706,000	$0	$ 3,647,285.71
Other Operating Expenses	$71,144,000	$8,753,000	$22,544,000	$6,354,000	$20,375,000	$27,447,000	$73,188,000	$ 32,829,285.71
Operating Income	($92,321,000)	($17,092,000)	($47,947,000)	($21,897,000)	($19,780,000)	($57,642,000)	($128,770,000)	$ (55,064,142.86)
Total Other Income And Expenses Net	$4,508,000	$654,000	$827,000	($14,000)	($76,000)	$339,000	$26,976,000	$ 4,744,857.14
Earnings Before Interest And Taxes	($87,813,000)	($16,438,000)	($47,120,000)	($21,911,000)	($19,856,000)	($57,303,000)	($101,794,000)	$ (50,319,285.71)
Interest Expense	$18,724,000	$2,984,000	$13,761,000	$0	$25,868,000	$17,861,000	$48,182,000	$ 18,197,142.86
Income Before Tax	($106,537,000)	($19,422,000)	($60,881,000)	($21,911,000)	($45,724,000)	($75,164,000)	($149,976,000)	$ (68,516,428.57)
Income Tax Expense	$0	$0	$0	$0	$705,000	$0	$36,000	$ 105,857.14
Equity Earnings Or Loss Unconsolidated Subsidiary	$0	$0	$0	$0	$0	$0	($3,956,000)	$ (565,142.86)
Minority Interest	$0	$0	$0	$0	$0	$0	$5,251,000	$ 750,142.86
Net Income From Continuing Operations	($106,537,000)	($19,422,000)	($60,881,000)	($21,911,000)	($46,429,000)	($75,164,000)	($148,717,000)	$ (68,437,285.71)
Nonrecurring Events								
Discontinued Operations	$0	$0	$0	$0	$0	$0	$0	$ -
Extraordinary Items	$0	$0	$0	$0	$0	$11,493,000	$75,482,000	$ 12,425,000.00
Effect Of Accounting Changes	$0	$0	$0	$0	$0	$0	$0	$ -
Other Items	$0	$0	$0	$0	$0	$0	$0	$ -
Net Income	($106,537,000)	($19,422,000)	($60,881,000)	($21,911,000)	($46,429,000)	($63,671,000)	($73,235,000)	$ (56,012,285.71)
Preferred Stock And Other Adjustments	$0	($3,350,000)	($9,720,000)	$0	$0	$0	($38,405,000)	$ (7,353,571.43)
Net Income Applicable To Common Shares	($106,537,000)	($22,772,000)	($70,601,000)	($21,911,000)	($46,429,000)	($63,671,000)	($111,640,000)	$ (63,365,857.14)

[12] Source: SEC Filings

Statement of Cash Flows	ALGX	CLEC	CWON	DSLN	ELIX	FCOM	RCNC	Average
Net Income	($106,537,000)	($19,422,000)	($60,881,000)	($21,911,000)	($46,429,000)	($63,671,000)	($73,235,000)	$ (56,012,285.71)
Cash Flow Operating								$ -
Depreciation	$75,820,000	$8,753,000	$23,451,000	$6,402,000	$79,022,000	$34,140,000	$0	$ 32,512,571.43
Adjustments To Net	$12,841,000	($35,975,000)	$8,390,000	$8,501,000	$1,247,000	$7,803,000	$0	$ 401,000.00
Changes in Operating								$ -
Changes In Accounts Receivables	($14,340,000)	$51,357,000	($6,979,000)	($2,507,000)	$22,987,000	($30,333,000)	$0	$ 2,883,571.43
Changes In Liabilities	$8,107,000	$9,770,000	$6,189,000	($6,861,000)	($15,419,000)	$6,022,000	$0	$ 1,115,428.57
Changes In Inventories	$0	$0	$0	$0	$0	$0	$0	$ -
Changes In Other Operating Activities	($1,626,000)	($4,535,000)	($2,196,000)	$336,000	$4,108,000	($5,351,000)	$0	$ (1,323,428.57)
Cash Flows From Operating Activities	($25,735,000)	$9,948,000	($32,026,000)	($16,040,000)	($35,440,000)	($51,390,000)	$32,428,000	$ (16,893,571.43)
Cash Flow Investing								$ -
Capital Expenditures	($88,385,000)	($10,526,000)	($22,733,000)	($1,152,000)	($10,683,000)	($27,682,000)	($49,337,000)	$ (30,071,142.86)
Investments	$11,247,000	$0	$79,000	$0	$0	$0	$101,943,000	$ 16,181,285.71
Other Cashflows From Investing Activities	($12,790,000)	$0	$5,778,000	$4,589,000	$519,000	$0	($40,504,000)	$ (6,058,285.71)
Cash Flows From Investing Activities	($89,928,000)	($10,526,000)	($16,876,000)	$3,437,000	($10,164,000)	($27,682,000)	$12,102,000	$ (19,948,142.86)
Cash Flow Financing								$ -
Dividends Paid	$0	$0	$0	$0	$0	$0	$0	$ -
Sale Purchase Of Stock	$1,366,000	$0	$6,000	$10,000	$56,000	$15,000	$0	$ 207,571.43
Net Borrowings	$348,489,000	($1,000)	$23,499,000	($2,775,000)	$43,935,000	$4,866,000	$120,374,000	$ 76,912,428.57
Other Cashflows From Financing Activities	$0	($78,000)	$0	$0	$22,000	$0	$0	$ (8,000.00)
Cash Flows From Financing Activities	$349,855,000	($79,000)	$23,505,000	($2,765,000)	$44,013,000	$4,881,000	$120,374,000	$ 77,112,000.00
Effect Of Exchange Rate	$0	$0	$0	$0	$0	$0	$0	$ -
Change In Cash And Cash Equivalents	$234,192,000	($657,000)	($25,397,000)	($15,368,000)	($1,591,000)	($74,191,000)	$164,904,000	$ 40,270,285.71

Balance Sheet	ALGX	CLEC	CWON	DSLN	ELIX	FCOM	RCNC	Average
Current Assets								$ -
Cash And Cash	$475,230,000	$71,116,000	$69,589,000	$10,733,000	$5,285,000	$6,563,000	$435,897,000	$ 153,487,571.43
Short Term Investments	$62,351,000	$0	$0	$0	$0	$0	$718,417,000	$ 111,538,285.71
Net Receivables	$127,046,000	$73,047,000	$33,508,000	$5,476,000	$18,505,000	$92,289,000	$71,555,000	$ 60,203,714.29
Inventory	$0	$0	$0	$0	$0	$0	$0	$ -
Other Current Assets	$10,653,000	$11,173,000	$3,995,000	$1,988,000	$3,603,000	$23,813,000	$17,010,000	$ 10,319,285.71
Total Current Assets	$675,280,000	$155,336,000	$107,092,000	$18,197,000	$27,393,000	$122,665,000	$1,242,879,000	$ 335,548,857.14
Long Term Assets								$ -
Long Term Investments	$954,000	$0	$0	$0	$0	$0	$234,570,000	$ 33,646,285.71
Property Plant And Equipment	$1,005,846,000	$189,739,000	$338,177,000	$40,891,000	$832,704,000	$465,283,000	$2,301,482,000	$ 739,160,285.71
Goodwill	$119,490,000	$0	$330,171,000	$16,626,000	$39,812,000	$0	$69,646,000	$ 82,249,285.71
Intangible Assets	$46,148,000	$0	$52,285,000	$0	$0	$0	$0	$ 14,061,857.14
Accumulated	$14,721,000	$0	$56,818,000	$0	$0	$0	$0	$ 10,219,857.14
Other Assets	$10,420,000	$10,124,000	$6,759,000	$1,095,000	$2,439,000	$22,503,000	$0	$ 7,620,000.00
Deferred Long Term Asset Charges	$20,113,000	$0	$22,381,000	$0	$0	$0	$57,101,000	$ 14,227,857.14
Total Assets	$1,863,530,000	$355,199,000	$800,047,000	$76,809,000	$902,348,000	$610,451,000	$3,905,678,000	$ 1,216,294,571.43
Current Liabilities								$ -
Accounts Payable	$114,797,000	$58,148,000	$63,691,000	$18,735,000	$62,637,000	$67,286,000	$288,876,000	$ 96,310,000.00
Short Term And Current Long Term Debt	$0	$14,062,000	$70,000	$2,938,000	$407,404,000	$10,372,000	$1,569,000	$ 62,345,000.00
Other Current Liabilities	$23,105,000	$6,867,000	$0	$3,979,000	$4,288,000	$0	$0	$ 5,462,714.29
Total Current Liabilities	$137,902,000	$79,077,000	$63,761,000	$25,652,000	$474,329,000	$77,658,000	$290,445,000	$ 164,117,714.29
Long Term Debt	$983,214,000	$135,938,000	$475,000,000	$5,234,000	$454,978,000	$606,237,000	$2,469,537,000	$ 732,876,857.14
Other Liabilities	$12,474,000	$8,622,000	$19,245,000	$0	$195,011,000	$10,844,000	$0	$ 35,170,857.14
Deferred Long Term Liability Charges	$0	$0	$0	$0	$19,639,000	$0	$41,668,000	$ 8,758,142.86
Minority Interest	$0	$0	$0	$0	$0	$0	$55,432,000	$ 7,918,857.14
Negative Goodwill	$0	$0	$0	$0	$0	$0	$0	$ -
Total Liabilities	$1,133,590,000	$223,637,000	$558,006,000	$30,886,000	$1,143,957,000	$694,739,000	$2,857,082,000	$ 948,842,428.57
Stock Holders Equity								$ -
Misc Stocks Options Warrants	$0	$0	$0	$0	$0	$0	$0	$ -
Redeemable Preferred	$0	$212,755,000	$190,681,000	$0	$0	$0	$2,103,405,000	$ 358,120,142.86
Preferred Stock	$0	$0	$0	$0	$0	$0	$0	$ -
Common Stock	$1,148,000	$261,000	$379,000	$32,000	$513,000	$619,000	$97,852,000	$ 14,400,571.43
Retained Earnings	($1,064,612,000)	($155,679,000)	($444,920,000)	($237,650,000)	($615,632,000)	($276,234,000)	($2,518,684,000)	$ (759,058,714.29)
Treasury Stock	($45,000)	$0	($461,000)	$0	$0	$0	($8,309,000)	$ (1,259,285.71)
Capital Surplus	$1,793,617,000	$74,225,000	$538,234,000	$285,613,000	$373,510,000	$192,259,000	$1,400,705,000	$ 665,451,857.14
Other Stockholder Equity	($168,000)	$0	($41,872,000)	($2,072,000)	$0	($932,000)	($26,373,000)	$ (10,202,428.57)
Total Stockholder Equity	$729,940,000	($81,193,000)	$51,360,000	$45,923,000	($241,609,000)	($84,288,000)	($1,054,809,000)	$ (90,668,000.00)
Net Tangible Assets	$610,450,000	($81,193,000)	($278,811,000)	$29,297,000	($281,421,000)	($84,288,000)	($1,124,455,000)	$ (172,917,285.71)

Financial Analysis & Valuation

Fundamental Analysis

All the companies in this sector are currently EBITDA and earnings negative, causing traditional valuation measurements such as P/E and EBITDA to be entirely irrelevent. In order to have some basis of comparison between the companies, we have chose to use the Price-to-Sales ratio as a benchmark:[13]

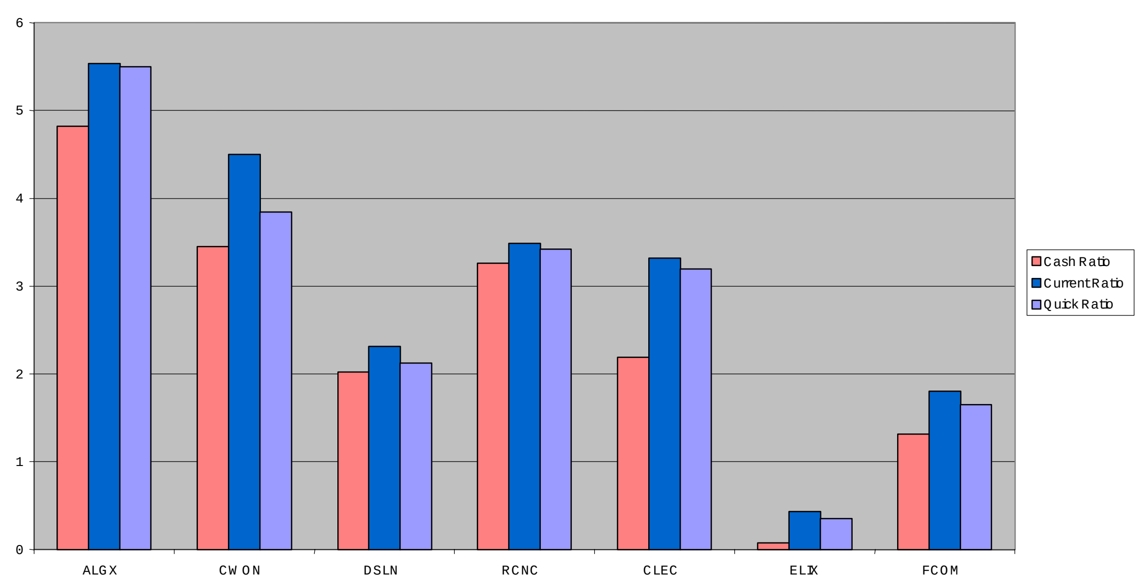
Figure 3. Price to Sales Ratio 2/1/2000

Ticker	ALGX	CLEC	CWON	DSLN	ELIX	FCOM	RCNC	S&P 500	S&P 500 Comm.
Sales	459.3	161.3	153.8	37.2	240.9	311.5	429.9	N/A	N/A
Mkt Cap	633.8	129.0	96.9	64.8	24.1	68.5	206.4	10200997.0	199374.8
Price/Sales	1.38	0.8	0.63	1.74	0.1	0.22	0.48	1.6	2.77

It is clear that these stocks are all trading at either a discount or in some cases a significant discount to both the market (represented by the S&P 500) and to a lesser degree the Communications Services Sector. This discount is likely due to the recent bankruptcy by much of the entire sector. We did not find correlation between P/S and absolute amount of sales, which suggests that current valuations do not measure stability through sales. Other factors rather than size appear to be key valuation factors. For example, companies with an extremely low P/S like ELIX have other extenuating factors (like crushing debt) that adversely affects their value.

We believe the single-most important financial factor that will allow one or more of these companies to survive an economic downturn is liquidity, and a solid debt policy. Most of these organizations, as shown in Figure 4[14],

Figure 4. Liquidity Measurements



[13] Bloomberg. 2/2/2001.

seem to have an acceptable amount of liquidity, which we believe gives those organizations with rational business models and solid management a sustainability that may be undervalued by the market. However, key to future success will be the ability of these companies to1) meet interest payments on their high levels of debt and 2) maintain enough cash to fund operations. As shown in figure 5, With the exception of RCNC, the companies all have a very short time until they run out of cash if they continue operations at status quo. Because short-term profitability is unlikely and they have a high outstanding debt-load, it is unlikely that these companies will find new sources of financing in the bone-dry capital markets. Consequently, we believe the prospect that many of these organizations will again experience bankruptcy is likely.

Figure 5. Cash Flow Ratios.

	ALGX	CLEC	CWON	DSLN	ELIX	FCOM	RCNC
Cash And Cash Equivalents	$475,230,000	$71,116,000	$69,589,000	$10,733,000	$5,285,000	$6,563,000	$435,897,000
Cash Flows From Operating Activities	($25,735,000)	$9,948,000	($32,026,000)	($16,040,000)	($35,440,000)	($51,390,000)	$32,428,000
Cash Flows From Investing Activities	($89,928,000)	($10,526,000)	($16,876,000)	$3,437,000	($10,164,000)	($27,682,000)	$12,102,000
Cash/Cash Flow from Operations & Investing Activites	4.11	123.04	1.42	0.85	0.12	0.08	(9.79)
Debt to Cash Flow	(38.21)	15.08	(14.83)	(0.51)	(24.33)	(12.00)	76.20

We believe companies that have historically managed their debt levels with care are better prepared than most to surviving an economic downturn. In a further analysis, we would also like to examine factors such as number of customers, customer type breakdown, and market share. We feel that these factors, combined with traditional measurements of debt policy and liquidity will provide the key to the concise valuation of the CLEC sector.

[14] Ibid.

Figure 5. Selected Financial Ratios[15]

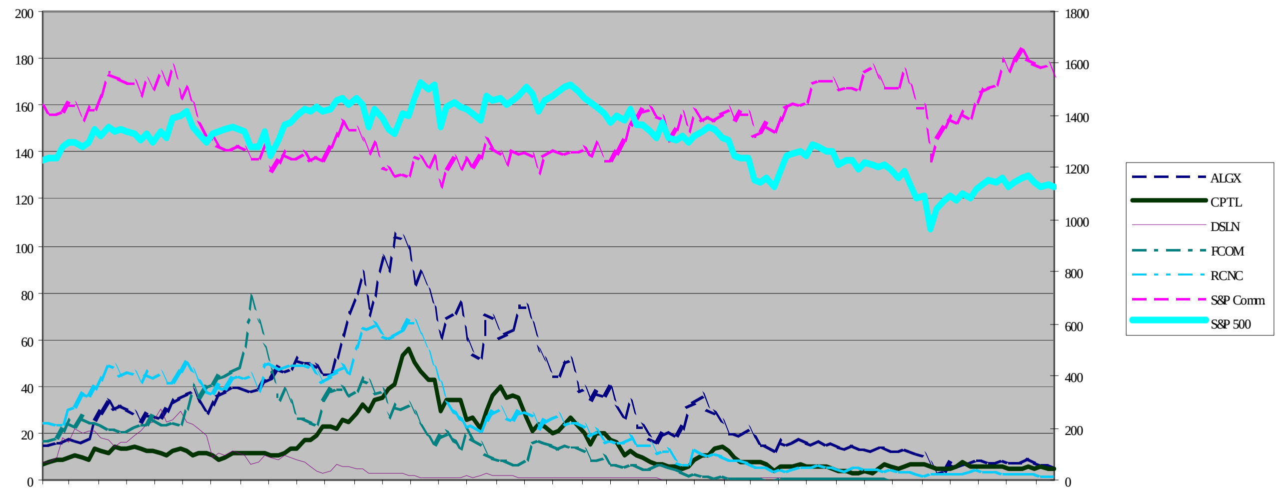
Ratios	ALGX	CLEC	CWON	DSLN	ELIX	FCOM	RCNC	Average
Income Statement								
Gross Margin	$69,423,000	$22,707,000	$17,787,000	($7,467,000)	$18,766,000	$43,803,000	($40,489,000)	$ 17,790,000.00
Operating Margin	(0.68)	(0.37)	(0.98)	(1.87)	(0.39)	(0.68)	(1.11)	(0.87)
Pre-Tax Margin	(0.79)	(0.42)	(1.25)	(1.87)	(0.91)	(0.88)	(1.28)	(1.06)
Net Margin	(0.79)	(0.42)	(1.25)	(1.87)	(0.92)	(0.88)	(1.28)	(1.06)
Fixed Charge Coverage	(4.69)	(5.51)	(3.42)	N/A	(0.77)	(2.56)	(0.52)	N/A
Current Ratio	4.90	1.96	1.68	0.71	0.06	1.58	4.28	2.17
Quick Ratio	4.90	1.96	1.68	0.71	0.06	1.58	4.28	2.17
Working Capital	$537,378,000	$76,259,000	$43,331,000	($7,455,000)	($446,936,000)	$45,007,000	$952,434,000	$ 171,431,142.86
Balance Sheet								
Total Assets/Total Liabilities	1.64	1.59	1.43	2.49	0.79	0.88	1.37	1.46
D/E	1.35	(1.85)	9.25	0.18	(3.57)	(7.32)	(2.34)	(0.61)
Statement of Cash Flows								
Cash Flow from Ops/CapEx	0.29	(0.95)	1.41	13.92	3.32	1.86	(0.66)	2.74
Depreciation/Cash flow from Ops	(2.95)	0.88	(0.73)	(0.40)	(2.23)	(0.66)	-	(0.87)
CapEx/Depreciation	(1.17)	(1.20)	(0.97)	(0.18)	(0.14)	(0.81)	-	(0.64)
Combination								-
Return on Equity	(0.15)	0.24	(1.19)	(0.48)	0.19	0.76	0.07	(0.08)
Return on Average Equity	(0.14)	0.28	(0.70)	(0.39)	0.21	1.19	0.07	0.08
Return on Total Capital	(0.05)	(0.24)	(0.09)	(0.41)	(0.03)	(0.09)	(0.02)	(0.13)
Average Days Receivable	340.65	583.12	224.56	152.66	155.07	330.70	228.52	287.90
Receivables Turnover	1.07	0.63	1.63	2.39	2.35	1.10	1.60	1.54
Inventory Turnover	-	-	-	-	-	-	-	-
Debt to Cash Flow	(38.21)	15.08	(14.83)	(0.51)	(24.33)	(12.00)	76.20	0.20

[15] Ibid.

Stock Price & Indices

Table 6 shows the significant impact of the economic downturn on the health of these stocks. However, it also denotes that these companies have not followed suit with recent activity in the telecommunications services sector, and instead have traded at the bottom. [16]

Figure 6. Historical Stock Prices[17]



Despite our favorable view for the future of the long-term prospects of the industry overall, and the growth potential of stocks in this sector, the market has in the near term fairly priced these securities.

[16] Ibid.

[17] Source: Bloomberg.

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