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EPOCH DIRECT

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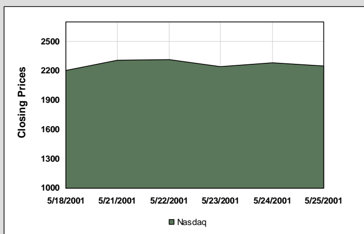
Epoch Indices for the Week

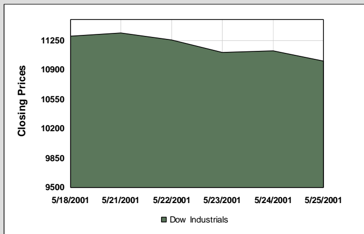
Broadband & IP Svcs:	8.62%
Comm Equipment:	0.50%
Internet:	-0.10%
Software:	3.80%

Market Statistics (5-Day)

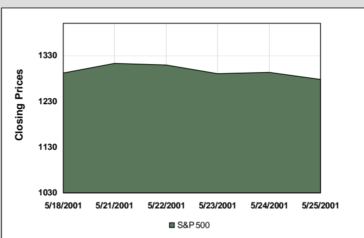
Nasdaq (2.37%)



Dow (-2.62%)



S&P (-1.09%)



Back to the Future: Does the Digital Island Deal Mean It's 1997 Again?

By Mark Langner, Senior 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 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, Cable & Wireless and Digital Island are a "custom fit." C&W needed DI's products, global data assets and technological expertise; DI needed C&W's access to lower-cost capital, global customers and lower-cost infrastructure. Many other traditional "telecom" providers (read: potential bidders) either didn't need what DI had, 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 that the deal was done at only a 9% premium to the price of ISLD stock).

The question for investors is: What can we learn from this deal? Is this the return of the freewheeling 1990s, 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 who will be the consolidatees?

Lets look at these issues separately.

The Next Wave of Consolidation?

As much as I would like to be wildly optimistic about using the C&W-Digital Island deal as a signal that the race is on to acquire quality data-services companies, I am somewhat cautious. I do not doubt that many of these companies have valuable businesses. Their expertise would be additive to more traditional telecom players that have 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 because the cash on its 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 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 that allows the bondholders to redeem the bonds for full price in the case of a takeover -- putting these companies out of reach.

[more]

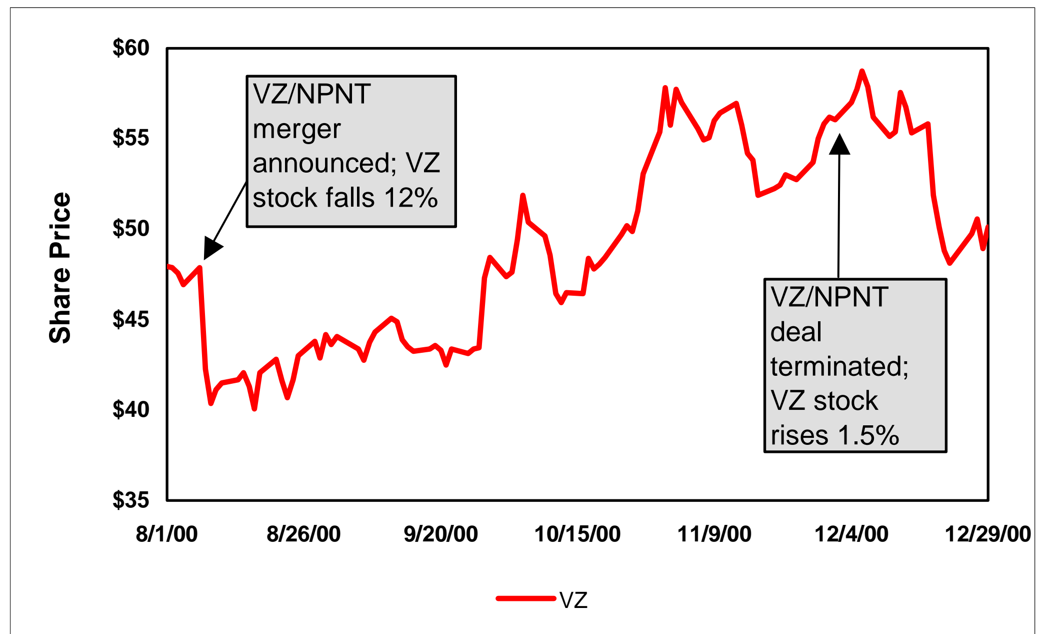
2. **Many Traditional "Telecom" Buyers Are in No Position for an Acquisition Binge:** There are several reasons why the "traditional" purchasers of data service providers are not in the best position to go on an acquisition binge. Some are structural (e.g., pending break-ups for long-distance players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

Even if larger-cap service providers can overcome these structural and regulatory hurdles, they are not in a good position financially to buy 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. The below table shows the ballooning debt of major carriers 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 companies that, in most cases, are still big money losers. While these potential acquisition targets 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.



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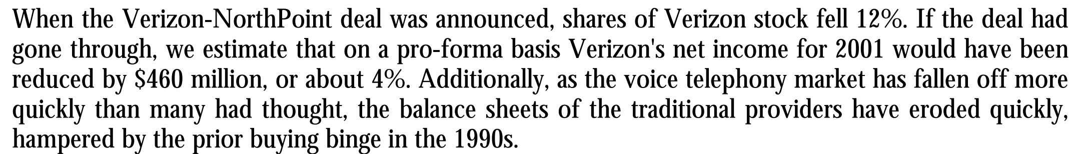

When the Verizon-NorthPoint deal was announced, shares of Verizon stock fell 12%. If the deal had gone through, we estimate that on a pro-forma basis Verizon's net income for 2001 would have been reduced by $460 million, or about 4%. Additionally, as the voice telephony market has fallen off more quickly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

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, though, it pains me to admit that now is probably not the best time for an equity play on these potential takeover names. The more favorable risk-reward return from playing the acquisition card will come from investing in senior debt. Relative to an equity, the potential upside and downside return (and the associated risks) for debt can be gauged more precisely.

In the best case scenario of an acquisition, senior debt holders will be able to redeem their bonds at or above par due to a "101 put" provision. If an acquisition does not happen, the debt holder will continue to receive a steady stream of interest income. In the worst-case scenario of a bankruptcy sale or proceeding, debt investors can guesstimate a floor valuation on their investments 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 are 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 tail off and next-generation data services are ramping, it makes more sense for traditional telecom players to add some of these services to their product lines.

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 acquirers 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 risk that they will be “saved” in the same fashion as C&W’s acquisition of Digital Island.

[more]

What traditional players need are next-generation providers that are not debt laden but are fully funded and close to profitability. Almost all broadband and IP data companies that fit this description are privately held. Why? The simple answer is the perversity of the Wall Street mentality. In the go-go days of 1999, Wall Street frowned upon fully funded and close-to-profitable companies because they forsook rapid revenue growth for balance sheet safety. And while profitability was in sight, their revenue growth rates were deemed too low, and their product lines branded 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 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 from the heavens.

Someone said to me the other day that "disaggregation is dead." That's an easy statement to make in light of the NorthPoint bankruptcy filing and the lack of access to capital for many next-generation providers. I wouldn't go that far, however. 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 this one.

Companies mentioned in this note: Akamai (Nasdaq: AKAM, $10.95), AT&T (NYSE: T, $21.06), Cable & Wireless (NYSE: CWP, $21.05), Digital Island (Nasdaq: ISLD, $3.35), Exodus (Nasdaq: EXDS, $8.88), NorthPoint (OTCBB: NPNTQ, $0.018), StorageNetworks (Nasdaq: STOR, $19.40), Verizon (NYSE: VZ, $53.97), WorldCom (Nasdaq: WCOM, $18.15)

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Top 10 Stocks Bought*

InterNAP (INAP)	11.21%
iBeam (IBEM)	9.79%
Ciena (CIEN)	6.64%
webMethods (WEBM)	5.61%
Niku (NIKU)	5.40%
Interliant	5.13%
Redback (RBAK)	4.34%
Rhythms NetConn. (RTHM)	4.31%
Nuance Comm. (NUAN)	4.14%
Corning (GLW)	4.12%

Top 10 Stocks Sold*

Foundry (FDRY)[2]	-5.70%
Extreme Ntwks (EXTR)	-4.48%
Micromuse (MUSE)	-3.90%
UTStarcom (UTSI)	-3.33%
Harmonic (HLIT)	-3.21%
Interwoven (IWOV)	-3.05%
RF Micro Dev. (RFMD)	-2.76%
eBay (EBAY)	-2.50%
Siebel (SEBL)	-2.37%
VeriSign (VRSN)	-1.87%

*Notes

Percent change from the prior week in the number of technology-related shares held by customers of our brokerage partners.

This Past Week at Epoch

5/23/01 [Genuity Hits the Brakes, Cuts Cap Ex]

5/23/01 [Ceragon Signs Wireless Backhaul Customer in China]

5/22/01 [Revised Earnings Model for Palm]

5/22/01 [Ciena Finally Signs Ma Bell]

5/22/01 [Amazon, Toys R Us Strengthen Ties]

Heard on the Desk

Compiled by the Epoch Partners Equity Capital Markets Team

Retail Investors Are Profit Taking

For the week ending May 18, retail investors were busy taking profits on stocks that showed double digit gains. While the Nasdaq finished the week up 4.3%, all of the stocks on our list of the top 10 stocks sold experienced substantial share price increases. Retail investors concentrated their selling in the communications equipment and software sectors as both experienced notable trading activity. Several of the companies, like RF Micro Devices (Nasdaq: RFMD, $29.83), even hit a 52-week high after the market rally. The most impressive gains came from Harmonic (+31.6%) (Nasdaq: HLIT, $9.64), and Interwoven (+25.8%) (Nasdaq: IWOV, $21.49). eBay (Nasdaq: EBAY, $62.20) was the only company making a repeat appearance on the top 10 sold list this week.

Retail investors were a bit more diversified in the stocks they chose to buy. They picked up shares in communications services, communications equipment and software stocks. Three companies -- webMethods (Nasdaq: WEBM, $31.68), Redback Networks (Nasdaq: RBAK, $15.71) and Rhythms NetConnections (Nasdaq: RTHM, $0.37) -- continue on our top 10 list of stocks bought.

Retail investors showed support for Ciena (Nasdaq: CIEN, $60.34), a stock that Epoch communications equipment analyst, Seth Spalding, speaks highly of -- although not at current prices. In his latest report he writes, “Ciena beat estimates, shipped to a record number of new customers, and showed itself off as the strongest pure-play optical-systems vendor.” Retail investors also loaded up on Corning (NYSE, $21.55), increasing their position by more than 1.5 million shares (+4.1%).

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Company Highlight: Corning (GLW)

Mark Langley, Director, Senior Analyst
John Harmon, CFA, Associate Analyst

Investment Thesis

Corning started a new chapter in its long history in 1996 by divesting non-core, non-strategic businesses in order to focus on three key markets: telecommunications, information display, and advanced materials. Corning has placed particular emphasis on telecommunications (71% of 2001E revenues): in 2000 alone, it launched 16 projects to increase manufacturing capacity and completed 10 acquisitions. At current prices, we think Corning shares are fairly valued, but 2001 will be a challenging year due to weak telecom carrier capital spending.

Company Description

Corning produces a diverse array of products based on glass, ceramics, and polymers, including optical fiber and cable, optical components and modules for telecommunications, glass for flat-panel and other displays, and products using advanced materials for science and environmental applications.

Key Investment Points

- **High-Growth Markets**. Corning is focusing on high-growth markets such as optical fiber, optical components, and glass substrates for flat-panel displays. Corning has the leading market share in two key products for optical communications networks -- optical fiber and optical amplifiers -- and management has responded quickly to alleviate the impact of softening demand.

- **Competitive Advantage**: Corning's competitive advantages arise from its drive to be the low-cost, high-volume leader in key markets, broad product base, and marquee customer list.

- **Change in Direction**. Corning's increased focus on telecommunications has resulted in higher multiples for its stock. With the benefit of a more attractive stock, Corning has become more acquisitive, making 11 acquisitions (including one in science products) in 2000 compared to six in 1999.

- **Telecom Growth Flat in 2001**. Although telecom has recently been Corning's growth engine, we expect flat revenues in 2001 due to the drought in carrier capital spending.

- **Valuation**. We think Corning's stock is fairly valued relative to its peers even though its multiples are historically low. However, we think downward revisions to Street estimates are likely in 2001.

- **Read our full commentary on Corning’s quarterly earnings release**
- **Read our full company report on Corning**

Companies mentioned: Corning (NYSE: GLW, $21.55)

NOTE(S):

1. EPOCH SECURITIES, INC. MAINTAINS A MARKET IN THE SHARES OF THE COMPANY.

2. THE ANALYST(S) INVOLVED IN THE PREPARATION OF THIS REPORT HAS AN INVESTMENT POSITION IN THE SUBJECT SECURITY.

3. EPOCH SECURITIES, INC. HAS BEEN AN UNDERWRITING MANAGER OR CO-MANAGER OF THE COMPANY IN THE LAST THREE YEARS.

4. AMERITRADE, A MINORITY SHAREHOLDER OF EPOCH PARTNERS, HAS BEEN AN UNDERWRITING MANAGER OR CO-MANAGER OF THE COMPANY IN THE LAST THREE YEARS.

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