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Deals & Deal Makers: Too Much Telecom? Start-Up's Woes Unsettle Investors

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GST. Adelphia. CapRock. Covad. Digital Teleport. FirstWorld. Intermedia. RSL. US LEC.

And dozens more.

In recent years, start-up telecommunications companies have been multiplying like rabbits. Build a fiber-optic network, and good things will come, the reasoning goes, and why not? With communications volume soaring, investors have snapped up tens of billions of dollars of junk bonds to finance the upstarts in hopes of getting in on the next WorldCom Inc. or McCaw Cellular Communications.

But now there are signs that, even when it comes to telecommunications, there may be too much of a good thing, underscoring again how risky it can be investing in the latest hot sector.

A recent bankruptcy-reorganization filing by GST Telecommunications Inc. has sent tremors through the market and left investors worrying that there's more bad news to come from other cash-strapped telecom companies.

Until now, investors figured that even in a worst-case scenario, upstarts like GST could sell their assets, such as fiber networks and switching equipment, to a bigger player for at least what they cost, leaving everyone whole.

But before GST could find a buyer or raise new capital, it defaulted on its $1.2 billion in bonds, and its Chapter 11 bankruptcy reorganization filing has left its bonds trading for just 14 cents on the dollar. Even more troubling: although GST's assets were listed as being worth $1.1 billion, at one point the company tentatively agreed to sell nearly all those assets to Time Warner Telecom Inc. for only $450 million. However, protests from other potential buyers prompted GST to decide to auction itself off to the highest bidder later this month.

"If one of the biggest ones to get in trouble gets sold for 40% of the assets they've invested in, that punctures the balloon," says Henry S. Miller, vice chairman and head of restructuring at Wasserstein Perella & Co. Now, "you have all these guys with partially completed systems, whose value is questionable."

GST's auction could set a new, much lower benchmark for valuing these fledgling telecom companies. And GST's problems have left investors wondering which of the other cash-strapped start-ups might follow in its footsteps.

In general, the young telecom companies are trying to cash in on the opening of markets that until recently were controlled by the regional Bell operating companies, and on the boom in data communications over the Internet. The firms include competitive local exchange carriers (known as CLECs), such as GST, that offer local phone service and data communications; companies such as Covad Communications Group Inc. that provide high-speed Internet access; and companies including DTI Holdings Inc.'s Digital Teleport Inc. that lay fiber-optic cable to provide intercity data transmission.

The business plans of these telecom upstarts usually call for them to lose hundreds of millions of dollars over the first few years as they build expensive networks, relying on the junk-bond markets for capital in the interim.

But that model hasn't been working so well lately. For one thing, the bond market has tightened the money spigot for young telecom companies, with cautious investors now inclined mainly to fund companies with solid track records and stronger **credit** statistics. Moreover, many companies have disappointed investors by failing to meet their business targets.

GST, which operates a fiber-optic network and local and long-distance phone service mostly on the U.S. Pacific Coast and in Hawaii, took on heavy debt, ran up larger losses than investors had expected, shifted its business strategy several times, and suffered heavy turnover in top management. An effort by the Vancouver, Wash., company to find new capital to meet its cash burn rate failed.

Other telecom companies recently have lowered their outlooks for revenue, cash flow, new subscribers or the time required to begin earning profits. Among them: Adelphia Business Solutions, a publicly traded unit of Adelphia Communications Corp., CapRock Communications Corp., FirstWorld Communications Inc., Intermedia Communications Inc., NorthPoint Communications Group Inc., US LEC Corp., Viatel Inc. and Covad.

"It's becoming increasingly more difficult for early-stage companies," says Romeo Reyes, high-yield telecom analyst at Jefferies & Co. "There's a fair amount of skepticism among investors about whether or not the companies can grow into their capital structures."

To be sure, many upstart telecom companies continue to attract new investor funding. Investors received some good news Aug. 8 when telecom giant Verizon Communications Inc. announced it was merging its digital subscriber line assets with upstart NorthPoint, one of a handful of companies that have raised lots of money from bond investors to build networks for high-speed Internet access. Stocks and bonds of a few competitors, including Covad, rallied in response.

But the telecom landscape is littered with troubled firms. Even so-called smartmoney investors have been burned. Private-equity funds have poured money into the sector over the past year, but many of their investment targets have since gone off the rails.

Take FirstWorld Communications. High-powered buyout firm Texas Pacific Group bought about 20% of the company from Enron Corp. for $129 million in February. FirstWorld went public in March at $17 in a deal underwritten by Lehman Brothers Inc., and the stock quickly more than doubled to $37. But in July, FirstWorld's stock plunged to about $3 after the company announced that revenue would fall far below expectations, its chief executive resigned, and it said it would change its business strategy. The Texas Pacific investment is valued at roughly $33 million now. A spokesman for Texas Pacific noted that FirstWorld is moving away from the Internet-access business to focus on data centers, which FirstWorld says it expects will be more profitable.

CapRock, meanwhile, sold 4.5 million new shares to investors at $19.50 each on June 19 in an offering led by Salomon Smith Barney Inc. and Bear Stearns & Co. Less than three weeks later, the company said it had lost a major contract and warned it would lose three times what analysts had expected in the second quarter. Its shares fell $5.9375 to $12, and are now trading at a little over $8.

Investors in hot sectors like telecommunications can be persuaded to suspend their disbelief and plow money into upstarts experiencing soaring growth rates. But at Intermedia, revenue has recently been going down, not up. The company had second-quarter revenue of $247 million, down 5% from the quarter before, the number of new lines it installed fell 39% from the first quarter, and its sales force is turning over at a 50% annual rate, "above the 30% industry average," says a research note from Merrill Lynch & Co.

Intermedia blamed the slowdown in line installation on lack of cooperation from BellSouth Corp. Like many of the upstarts, Intermedia depends on the regional Bell companies to bring it the last mile to the customer. A BellSouth spokesman in Atlanta said, "We treat our CLEC customers with parity in terms of the service we provide to each of them and . . . to our own retail customers."

Bonds of young telecom companies have fallen sharply since the GST filing, and other bad news. The average yield on the $27 billion in junk bonds outstanding from North American CLECs has jumped to 10.2 percentage points above Treasury bonds, up from 8.7 percentage points on May 5, UBS Warburg says. Bonds from CapRock, e.spire Communications Inc., Logix Communications Enterprises Inc., Pathnet Inc. and many others are all trading at 60 cents or less on the dollar, implying that bondholders believe there's a significant chance of not getting their money back.

The situation is attracting the attention of the distressed-debt community. Restructuring specialists are looking for the next company to need a debt workout, while investors are scrutinizing the companies to separate the truly troubled from those merely guilty by association.

"I think that's going to be a big area of restructuring work going forward," says Tom Benninger, head of the restructuring group at Donaldson, Lufkin & Jenrette Inc. "All the restructuring people are keeping their eyes on it."

The telecom firms facing cash shortfalls are either "likely to attract strategic equity or will be forced to file for bankruptcy in the near term," says Aryeh Bourkoff, high-yield telecom analyst at UBS Warburg LLC. "That bifurcation is giving investors and analysts pause."

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