



TRANSACTIONS

BATTLE FOR BROADBAND

Unleashing value in cable assets depends on the acquirer's business.

AT&T ANNOUNCED a year ago its plans to split into four entities to move faster-growing businesses out of the shadow of long distance. One such business—AT&T Wireless—was completely spun off this summer, and AT&T Broadband was due to follow suit later this year. AT&T Broadband, with 15.3 million subscribers and access to 24.2 million homes, is the largest cable company in the country.

In July, Comcast, the nation's third-largest cable provider, made an unsolicited \$57 billion offer (\$43.5B in stock, \$13.5B in assumed debt) for Broadband. Based on current stock prices, this offer is now worth \$34 billion. In the days since the Comcast offer, other potential buyers, including fellow cable operators, content providers and software provider, Microsoft, expressed interest. Of course, AT&T does not have to sell to anyone, and could continue with its plans for an IPO of Broadband. However, instability in the equity markets and AT&T's need to pare

its hefty debt load make a sale at this stage an attractive alternative. MCG believes that among all the options for Broadband, an acquisition by AOL represents the greatest value for AT&T shareholders over the long run.

Combining with Broadband offers any cable provider two things: operating leverage and pricing power. In 2000, Broadband's EBITDA margin was 21%, versus the industry average of 40%. Thus far in 2001, evidence suggests that cable operators can raise the margins of Broadband to industry levels. After closing on recent systems swaps with AT&T, Comcast revealed that it should boost EBITDA margins from these assets more quickly than originally expected. Comcast claims that it can generate cost savings at Broadband of up to \$2.6 billion per year by consolidating corporate overhead, renegotiating for lower-priced contracts with pro-

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RURAL FUNDAMENTALS

What is the fundamental value of a rural wireline?

OVER THE LAST twenty-four months, the telecommunications industry has witnessed an unprecedented number of rural access line transactions. From early 2000 to 2001, 2.9 million lines changed hands for an estimated \$9.5 billion. In September, Verizon announced that it hopes to sell another 1.2 million rural access lines in Alabama, Kentucky, and Missouri. Market watchers expect these accounts and their related assets to fetch about \$4 billion, or roughly \$3,300 per line. Not coincidentally, this is also the average price for which the 2.9 million lines sold over the past two years. A comparable sales valuation provides a good starting point for potential buyers, but it has considerable limitations because it does not address the underlying economic value of acquired lines. Wise buyers consider the assumptions behind, and uncertainties of, expected cash flows when they determine the price they will pay for telecom customer bases. In this article, MCG pro-

vides a useful alternative to the comparables method by means of a discounted cash flow valuation. It applies not only to rural access lines but also to CLECs, long distance, and data carriers.

Using data provided by the United States Telecom Association, MCG has compiled a per-line cash flow profile for a middle-size rural carrier (about 10,000 to 60,000 lines). Each access line is expected to generate \$800 in revenues in a single year, including line charges, access charges, USF payments, and other services. Depreciation on exchange-related equipment lowers taxable income. EBITDA margins are over 50%. Each line will require \$144 of annual investment for maintenance, yielding free cash flow of just over 20% of revenues. Based on these assumptions, free cash flow from our model rural access line is approximately \$180 per year. MCG assumes that free cash flow will grow 3% annually, barring any accelerated invest-

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EPRISE'S MYSTIFYING MOVE

divine, inc. buys Eprise and its \$50 million in cash for \$43 million.

IF YOU COULD GIVE somebody \$1 and get \$1.25 back immediately, would you do it? divine inc.'s announced acquisition of Eprise Corp. appears to be just such a transaction. divine will acquire 100% of Eprise for stock worth approximately \$43 million when the deal was announced September 18. In doing so, divine gains access to a balance sheet containing a healthy \$50 million in cash and no significant debt. The purchase appears to be a no-brainer for divine, but the mystery lies in what possessed Eprise to enter such a transaction. With \$50 million *in cash* on the company's balance sheet, inquiring Eprise investors should wonder why shares of divine offer a better risk-return scenario than other alternatives.

From divine's perspective, in addition to its \$50 million cash windfall, the combined companies paint an attractive picture. Incorporating Eprise's content management software into divine's portfolio of web services expands divine's expertise and technology solutions and brings 150 new customers ripe for cross selling. divine's management should be able to shave a substantial portion of Eprise's \$7 million quarterly SG & A expense through the combination of sales and support efforts. This should reduce Eprise's monthly cash burn of \$2 million. In addition, despite the generally deteriorating economic environment, Eprise's accounts receivable improved dramatically, from more than \$6 million at year end 2000, to nearly \$3 million as of June 31, 2001, while revenue continued to grow. Revenue increased 14%, from \$7.2 million for the first six months of 2000 to \$8.2 million for the same period in 2001.

divine inc.'s deal for Eprise includes the exchange of 54 million shares of divine Class A stock, or 2.4 shares of divine for each Eprise share. At \$0.80 per share, divine's common stock is not the valuable currency once employed by the tech titans of yore. But the company's continued ability to use its common stock as transactional currency in two recent and relatively large deals is an advantage few other technology firms enjoy.

While most investors have been fleeing any technology related sector in a near panic, divine has embarked on a bargain-hunting acquisition spree. The Eprise deal follows

closely on the heels of divine's purchase of Open Market, another content management provider with 300 customers, in a stock deal worth \$59.3 million. While Open Market, with only \$9 million in cash on the books, does not bring a cash hoard to the table as Eprise does, the company's existing customer base adds considerable cross-selling leverage and enlarges divine's product base. divine has also accumulated various assets in several stages from MarchFirst, a content management provider. The spree goes back several months and includes purchases of content management provider Fracta Networks in August, infrastructure provider Intira Corp. and communications firm eShare Communications in July. On the surface, the combination of all of divine's recent purchases makes it one of the few firms able to offer corporate customers both content management and content delivery.

While the motivation for divine to enter this transaction is obvious, Eprise's rationale is not so clear. Eprise agreed to exchange its \$50 million in cash, \$17 million in annual revenue and 150 customers for \$43 million in divine stock. While the market offers few prospects of capital infusions, Eprise was not in need of cash. At their current burn rate they had over two years worth of financing. The return to shareholders appears higher and less risky under the scenario of Eprise shutting down and paying out the cash. What does Eprise's management know that the market doesn't? Since the deal was announced last month, shares of divine have fallen 38%, lowering the transaction value to \$27 million. According to SEC filings, the penalty for walking away from the deal is \$2 million. Given only publicly available information about the transaction, the devaluation of divine's stock and the relatively small breakup fee, Eprise shareholders should be wondering if their stock is worth more under the divine umbrella.

Editor's note: In the transactions table on page 5, we list the announced value of this deal as \$60.8 million. Our source for the tables is Bloomberg, which calculates the market value of the divine stock using the average price for the 20 trading days preceding the deal announcement.

DEALS IN THE MARKETPLACE: CONTENT

Publishing

Date	Target/Seller	Target/Seller Description	Acquirer	Acquirer Description	Announced Value	Transaction Notes
5-Sep	FT Energy/Pearson (LSE: PSON)	Energy sector titles, databases, conferences	McGraw-Hill Cos. Inc. (NYSE: MHP)	Diversified publishing and information services	Undisclosed	Complete; cash
6-Sep	Gulf Publishing Co.	Energy sector titles	Eurooney Institutional Investor PLC (LSE: ERM)	B2B publishing, conferences, training events	\$10 million	Complete; cash
24-Sep	VentureOne Corp./Reuters Group PLC (NASDAQ:RTRS)	Venture capital-focused publishing	Wicks Business Information LLC	Business publishing, conferences, trade shows	\$30.7 million	Pending; cash
24-Sep	The Industry Standard controlled circulation list	90,000 controlled subscribers	International Data Group	Business publishing, conferences, trade shows	\$900,000	\$10 per subscriber
24-Sep	The Industry Standard paid circulation list	117,000 paid subscribers	Time Inc.	AOL Time Warner's magazine unit	\$2.5-\$3 million	Paid \$500,000 and assumed 2.2 million in estimated liabilities; \$21.2% per subscriber
25-Sep	Student Sports Inc.	High school sports magazines, news, video	Silverstar Holdings Ltd. (NASDAQ: SSTB)	Sports and media business holding company	Undisclosed	Complete

Digital Media

Date	Target/Seller	Target/Seller Description	Acquirer	Acquirer Description	Announced Value	Transaction Notes
30-Aug	NetRadio Corporation (NASDAQ: NETR)	Online distributor of original music and information programming	The Advisory Board, Inc.	Media investment group	\$1.4 million	Pending; cash; acquiring 60% of outstanding shares; 2% TTM revenue
4-Sep	Sandbox.com	Online fantasy sports and direct marketing	SportsLine.com Inc. (NASDAQ: SPLN)	Online sports media, publisher of CBS SportsLine	\$2.7 million	Pending; cash; \$1 million; stock; 1.6 million shares
11-Sep	Teoma Technologies Inc.	Web search software	Aak Jeeves Inc. (NASDAQ: ASKJ)	Web portal	\$4.2 million	Pending; cash; \$1.7 million; stock; 2.5 million shares
12-Sep	MegaDox Corp.	Online content syndication	Wrapure Ltd.	Canadian restaurant chain	Undisclosed	Pending; stock
17-Sep	Athlete.com Inc.	Youth sports information and instruction	BigStar Entertainment Inc. (OTCBB: BGST)	Online retailer of entertainment industry videos and information	Undisclosed	Pending; stock
24-Sep	call.com Inc.	Online financial reporting and broadcasting, including StreetFusion	CCBN.com	Online shareholder communications services	Undisclosed	Pending
24-Sep	LifeMakers Inc. (NASDAQ: LFMN)	Online direct marketing and content	Encore Marketing International (NASDAQ: EMIC)	Direct marketing	\$61.5 million	Pending; cash; \$35 million; 1.7% TTM revenue
2-Oct	Embank.com Inc.	Online college and technical school information	Pinetown Review Inc. (NASDAQ: REVU)	Test preparation and college information	Undisclosed	Complete

Business Information Services

Date	Target/Seller	Target/Seller Description	Acquirer	Acquirer Description	Announced Value	Transaction Notes
1-Oct	The Bluebook International Inc.	Estimation data for insurance and disaster restoration industries	Gama Computer Corp. (OTCBB: GMCP)	Shell company	\$79.7 million	Complete; stock; 10.9 million shares
2-Oct	ShoBall Financial Group/Harcourt Companies Inc. (OTCBB: HRCT)	Financial data and information for Chinese markets	Global Telephone Communication Inc. (OTCBB: GTCI)	IT and telecom holding company	Undisclosed	Pending; stock
3-Oct	Internet AdWatch/Forrester Research Inc.	Tracks online marketing of European advertisers	Evaliant Media Resources LLC	International advertising data	Undisclosed	Complete

Newspapers

Date	Target/Seller	Target/Seller Description	Acquirer	Acquirer Description	Announced Value	Transaction Notes
31-Aug	Penulma Agius-Counter/Pulitzer Inc. (NYSE: PTZ)	Weekly newspaper in Penulma, CA	The New York Times Company (NYSE: NYT)	Media company	Undisclosed	Complete
14-Sep	The Reporter/Gannett Co. (NYSE: GCI)	Daily newspaper in Lansdale, PA	Journal Register Company (NYSE: JRC)	Newspaper publishing company	Undisclosed	Complete; 19,000 circulation, total revenues of \$13 million in 2000

Radio

Date	Target/Seller	Target/Seller Description	Acquirer	Acquirer Description	Announced Value	Transaction Notes
31-Aug	Standard Broadcasting Inc.	15 Alberta radio stations	Newfoundland Capital Corp. Ltd.	Radio, newspapers, specialty magazines	\$25 million	Pending
5-Sep	Winsar Radio Networks assets	Radio programs and services	Franklin Capital Corp. and Sunshine Wireless Co.	Joint venture	\$6.25 million	Complete; cash
5-Sep	Big City Radio Inc.	4 Phoenix radio stations	Hispanic Broadcasting Corp. (NYSE: HSP)	Spanish-language radio broadcasting company	\$34 million	Pending; cash

TV

Date	Target/Seller	Target/Seller Description	Acquirer	Acquirer Description	Announced Value	Transaction Notes
18-Sep	TQS Inc./Quebecor Inc.	French-language cable television network	COGECO/Bell Globemedia IV	Consortium of cable operator and media companies	\$47.4 million	Pending; regulatory approval; joint venture buys 86% stake for cash
12-Sep	CF Television/CanWest Global Communications Corp. (NYSE: CWG)	English-language television station in Montreal, Quebec	CTV Inc.	27 television stations, 33 pay & specialty stations in Canada	\$81.9 million	Complete; divestiture was required by regulators; acquiring 70% stake

Source: Bloomberg, Company Press Releases and MCG Estimates

DEALS IN THE MARKETPLACE: COMMUNICATIONS

Telecom Services

Date	Target/Seller	Target/Seller Description	Acquirer	Acquirer Description	Announced Value	Transaction Notes
28-Aug	BellSouth International Wireless Services	Roaming charge clearinghouse for North & South America	Illuminet Inc.	Signalling and intelligent networks for telecommunications.	\$25 million	Complete; cash; 1.6x revenue
28-Aug	Certain assets of Niclos Inc.	Operations and licenses of GSM network in PA	VoiceStream Wireless Communications Inc.	Wireless communications	\$60 million	Pending; cash for 18,000 customers; \$3,333 per customer
29-Aug	IPCS	Regional wireless carrier	AirGate PCS Inc. (NASDAQ: PCSA)	Regional wireless carrier	\$870 million	Pending; stock; 13.5 million shares
29-Aug	Dorvann Consulting Group Inc.	Wireless network design and implementation	Manchester Technologies, Inc. (NASDAQ: MANC)	Computer hardware, software, networking product integration and resale	Undisclosed	Complete
29-Aug	Allied River Communications Corp. (NASDAQ: ARCC)	Facilities-based integrated communications provider	Cogent Communications Group, Inc.	Internet service provider	Undisclosed	Pending; stock
30-Aug	esquel, Inc.	Prepaid wireless telecommunications	Wolfpack Corp. (OTCBB: WFPK)	Prepaid local and long-distance telecommunications	Undisclosed	Pending
31-Aug	Palladium Communications Inc.	Voice and data communications	USOneStarNet Inc. (OTCBB: USAS)	Educational ISP and e-commerce solutions	Undisclosed	Complete; stock
5-Sep	D Block PCS license/Triad Holdings LLC	Covers 54,000 POPs in Ada, OK	TKO Communications LLC	Cellular telecom	Undisclosed	Complete
17-Sep	C Block PCS license/ConnectBd LLC	Covers 1.1 million POPs in Hartford, CT	Edge Acquisitions LLC	Cellular telecom	Undisclosed	Complete
21-Sep	Kerville Communications Corp.	Holding company with ILEC, CLEC, and wireless businesses	VALOR Telecommunications Enterprises II LLC	Integrated telecom services in the rural Southwest	Undisclosed	Pending
24-Sep	Q-Tel Communications Inc.	Wireless in Alberta Canada	OA Group Inc.	Diversified computer & telecommunications	\$1.57 million	Pending; cash
24-Sep	Illuminet Inc.	Signalling and intelligent networks for telecommunications	Verisign Inc.	Internet infrastructure and transaction security	\$1.2 billion	Pending; stock; 7.8x revenue; 20x EBITDA
24-Sep	ATNG Inc.	Voice and data communications using voice over packet	Puhobotek Diagnostics Inc. (OTCBB: PBDG)	Medical diagnostic and treatment products	\$94.8 million	Complete; stock; 27.8 million shares
2-Oct	Rapid Link Inc.	Assets, customer base, VoIP network	Dial-Tru International Corp. (OTCBB: DTIX)	Facilities-based integrated telecom services	\$2.3 million	Pending; cash; \$2 million; stock; 600K shares
3-Oct	VGL Communications Corp.	Teleconferencing services	Universal Domains Inc. (OTCBB: UDCDF)	Domain name dealing and registration	\$1 million	Pending; stock; 5 million shares
27-Sep	MPB Towers Inc.	Telecom tower leasing	Composite Industries of America Inc. (OTCBB: CIAI)	Home construction	Undisclosed	Pending
3-Oct	Telia Internet Inc./Telia AB	Tier-1 U.S. Internet backbone	Alecon	Internet backbone	Undisclosed	Complete
5-Oct	1414c/PictureTel Corporation (NASDAQ: PCTL)	Teleconferencing services	ACT Teleconferencing Inc. (NASDAQ: ACTT)	Teleconferencing services	Undisclosed	Pending

Internet Service Providers

Date	Target/Seller	Target/Seller Description	Acquirer	Acquirer Description	Announced Value	Transaction Notes
31-Aug	TCCI Rapidnet	Internet service provider	PCNet International Inc.	Internet service provider	Undisclosed	Complete; 2,100 customers
17-Sep	Undisclosed ISP	Internet service provider	MarketCentral.net Corp. (OTCBB: MKTS)	Web-based financial services & products	Undisclosed	Pending; 25,000 subscribers; \$3 million revenue FY2002
24-Sep	Rhythms Telecommunications Inc.	DSL service	MCI Worldcom	Integrated communications	\$40 million	Purchase at bankruptcy auction; \$57.142 per data routing facility; 0.53x revenue for the majority of assets
3-Oct	Reality Networks Inc.	Internet service provider, including wireless and DSL	Dicom Imaging Systems (OTCBB: DICM)	Digital imaging software for the dental industry	\$209K	Pending; stock; 9 million shares
2-Oct	Show Digital Inc.	ISP for the hospitality and convention industries	STSN	ISP for the hospitality and convention industries	Undisclosed	Complete

Security Alarms

Date	Target/Seller	Target/Seller Description	Acquirer	Acquirer Description	Announced Value	Transaction Notes
30-Aug	Edison Select/Edison International	Residential security systems	ADT Security Services/Tyco International	Diversified service and manufacturing	Undisclosed	Complete
6-Sep	DSC Group	Intrusion & fire alarms, home automation, access control	Tyco International Ltd. (NYSE: TYC)	Diversified service and manufacturing	Undisclosed	Complete
15-Sep	A-Link USA	Security alarms	Chubb Securities Americas	International security alarm company	Undisclosed	Complete; North America market entry
15-Sep	Alarm Processing Corp.	Security alarms	Chubb Securities Americas	International security alarm company	Undisclosed	Complete; North America market entry

Source: Bloomberg, Company Press Releases and MCG Estimates

DEALS IN THE MARKETPLACE: TECHNOLOGY

IT Services and Software

Date	Target/Seller	Target/Seller Description	Acquirer	Acquirer Description	Announced Value	Transaction Notes
3-Sep	Axcan Group	Distributed computing and web development consulting	Groups, Silcomp (FR: SILJ)	IT engineering, training, and consulting	Undisclosed	Complete
4-Sep	Century Computer Consultants Inc.	IT consulting services to manufacturing, transportation, pharmaceutical industries	Ciber Inc. (NYSE: CBR)	E-business integrator	Undisclosed	Pending
4-Sep	ICM Education assets/Computer Horizons Corp. (NASDAQ: CHRZ)	Technical and private training services for professional services firms	AlphaNet Solutions	Network design, operation, management and security	Undisclosed	Complete
5-Sep	nSyndicate	E-services provider to broadcasting industry	MediaSpan	Technology services provider to media industry	Undisclosed	Complete
5-Sep	Accountingsolution.com	Financial and accounting ASP	InsyQ Inc. (OTCBB:INSQ)	WAN-based applications and services provider	Undisclosed	Complete; acquiring customer base of 150 accountants and CPAs
5-Sep	E-Med Solutions	Online payment applications for healthcare industry	HSS Inc.	Software and e-commerce applications for healthcare industry	Undisclosed	Complete
6-Sep	Strasource	Managed service provider	SevenSpace	Managed service provider	Undisclosed	Complete
7-Sep	Neomedia Technologies (NASDAQ: NEMO)	Online commerce customer and product personalization systems	FINX Group (NYSE: FXGP)	Diversified holding company	\$1.7 million	Pending; stock: 500K shares
10-Sep	Netrig	Network architecture consulting	Thompson Inc.	Network management and design services	Undisclosed	Pending
10-Sep	Metamor Industry Solutions Inc./PSINet (OTCBB: PSIN)	Public sector IT consulting	Ciber Inc. (NYSE: CBR)	E-business integrator	Undisclosed	Pending
10-Sep	InsuroCity	Online insurance claims application and servicing	Caretek Software Factory Inc.	Property-casualty insurance software	Undisclosed	Complete
10-Sep	California title & escrow ops. of BridgeSpan Inc.	Automated mortgage and real estate solutions	Capital Title Group Inc. (NASDAQ: CTGI)	Title insurance	Undisclosed	Complete
17-Sep	Cynergy	IT support services to retail and hospitality industries	Technology Facility Management PLC	Technology and telecom support services	Undisclosed	Complete
17-Sep	eB Networks/Computer Horizons Corp. (NASDAQ: CHRZ)	Enterprise network design and services	INRANGE Technologies (NASDAQ: INRG)	Storage networking solutions	Undisclosed	Complete
18-Sep	Eptac Corp. (NASDAQ: EPRS)	Content management solutions	dvine Inc. (NASDAQ: DVIN)	Managed applications, services, and technology	\$60.5 million	Pending
18-Sep	Interprise Inc.	Online collateral assessment for real estate and insurance industries	Apparco Software	Knowledge management and e-business software	Undisclosed	Pending
18-Sep	Organic Inc.	E-services development and consulting	Seneca Investments	Investment company	\$29.3 million	Pending; \$0.33 per share
19-Sep	Brava Services	Payroll services in technology industry	eWork exchange	Contract labor procurement, payroll, and management software	Undisclosed	Complete
20-Sep	BTG Inc.	Systems and solutions development for defense and intelligence agencies	Titan Corp. (NYSE: TTN)	Aerospace/defense	\$159 million	Pending; 0.68x revenue
21-Sep	Ballantyne Consulting Group	B2B consulting and project management services	Pomeroy Computer Resources (NASDAQ: PMRY)	IT and network integration services	Undisclosed	Complete
25-Sep	Equifax Digital Certificates operations	Online transaction security and certification	Geonust Inc.	B2B risk management and transaction security services	Undisclosed	Complete
25-Sep	Ezenet	Online transaction processing and financial services industry utilities	Cognitase Inc. (NASDAQ: COGI)	Online transaction processing and solutions	\$54 million	Complete; cash and stock
26-Sep	Capital Commerce Repower/ Subsidary of Flyer Technologies	Information management solutions	Wolters Kluwer North America	Software-based professional information tools provider	Undisclosed	Complete

Data Security and Storage

Date	Target/Seller	Target/Seller Description	Acquirer	Acquirer Description	Announced Value	Transaction Notes
4-Sep	7-View S57 assets/INRANGE Technologies (NASDAQ: INRG)	Network security and monitoring technology	TTI Telecom International	Network management for the telecommunications industry	Undisclosed	Complete; customers transferred under existing service contracts
17-Sep	Cylink Corp. (NASDAQ: CYLK)	Network security, WANs, VPNs	Topspin Partners	Private equity fund specializing in emerging tech	\$3 million	Pending; buying 8.6 million shares from Honeywell subsidiary Pitavac Corp.
24-Sep	SA Navigator Inc./ Subsidary of Western Digital Corp. (NYSE: WDC)	Data network management software	McData Corp. (NASDAQ: MCDT)	Open storage networking	\$29.8 million	Complete; cash; 3x projected 2002 revenues

Source: Bloomberg, Company Press Releases and MCG Estimates

UPCOMING EVENTS

FOLIO: Show New York 2001

October 29-31 at the
Hilton New York
212.586.7000

**Securing New Ground
The New World of
Security**

November 7-8 at the
Roosevelt Hotel in
New York
440.286.4900

**Capital Content
Network Breakfast**

November 8 at the
National Press Club in
Washington, D.C.
800.356.9302

**Southern Newspaper
Publishers Association
Annual Meeting**

November 11-14 at the
The Breakers in
Palm Beach, FL
404.256.0444

**ASCENT
Fall Conference &
Exhibition**

November 11-14 at the
Orlando World Center
Marriott in Orlando,
FL
202.835.9898

**American Business
Media Top
Management Meeting**

November 12-14
at the Fairmont Hotel
in Chicago
212.661.6360

RURAL FUNDAMENTALS

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ment in new technologies, new product development, and corresponding marketing activities.

With expected cash flows of \$180 per line and 3% growth, a buyer's cost of capital would have to be 8.6% or less to justify paying \$3,300 for a rural access line (using a dividend discount model). At that price, the acquirer would still be able to provide lenders, bondholders, and equity investors with their required rates of return. Some of the largest rural carriers in the South and the Midwest—including Alltel, CenturyTel, Telephone & Data Systems, Citizens, and BellSouth—might enjoy a cost of capital low enough to afford a \$3,300 price tag. These companies have investment-grade bond ratings, ranging from BBB to AA-. Currently, the spread to 10-year Treasuries is 170-240 bps, which gives a pre-tax cost of debt of roughly 7.25%. Stock prices for the carriers have not succumbed to the tech/telecom bust the way those of the pure CLECs have. Perhaps most important, the cash flows from the rural lines are fairly stable and therefore less risky than those of other competitive telecom companies.

Smaller carriers and those in more competitive markets have to provide higher returns for their investors because of greater real and perceived risk. Higher returns mean lower acquisition prices. If the discount rate is 12%, the value of the line to the buyer is \$2,040. At 15%, the value is \$1,530, and at 20%, the value is \$1,080.

The preceding analysis values the cash flows of a rural access line as a perpetual annuity. This is reasonable, because rural access lines have low churn, low competition, and highly reliable cash flows. In a more competitive environment, there is more un-

certainty surrounding these factors, and this affects valuation. For example, if we use all of our earlier assumptions about revenues, margins, cost of capital, and so forth but add to the calculation 1% monthly customer churn, the value of the line declines from \$3,300 to \$893. That is because the average life of the customer is now only four years, compared to the perpetual relationship of RLEC customers. Lower revenue growth and smaller margins likewise lower the value of the lines. If price competition drives gross revenue per line down 1% per year (as opposed to our baseline assumption of 3% growth), a line is worth \$1,840 instead of \$3,300. Cash flow margins of 15% instead of 20% reduce the valuation by a quarter. The three factors we have highlighted here—customer churn, revenue per customer, and cash flows margins—are key drivers of value. For RLECs, they are all fairly predictable due to regulatory protections. For competitive telecom companies, including CLECs, long distance and data carriers, these factors vary greatly, resulting in disparate valuations.

Using this basic framework, Verizon's asking price for the rural lines appears reasonable. We come to this conclusion not because there have been other transactions at similar multiples, but because the rural access lines in question probably have little churn or competition, and the big potential buyers have moderate costs of capital. In other words, the fundamentals support the price. But we have also shown that potential buyers in other deals must carefully consider the quality and reliability of the revenue streams they are acquiring. Once we start tweaking our underlying assumptions about cash flows, the valuations change significantly.

When pricing assets or an entire business, it is essential to look at comparable transactions and public market valuations.

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Cash Flow Assumptions for Rural Lines

Per Line Cash Flow Assumptions	Monthly	Annual
Operating Revenues	\$67.00	\$804.00
Operating margin	52.9%	52.9%
Operating Cash Flow (EBITDA)	\$35.44	\$425.32
Depreciation	\$11.00	\$132.00
Tax rate	35.0%	35.0%
Capex	\$12.00	\$144.00
Free Cash Flow	\$14.89	\$178.66
Free Cash Flow Growth Rate	3%	3%

Source: U.S. Telecom Association and MCG Estimates

BATTLE FOR BROADBAND

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grammers, reducing marketing costs, and scaling back telephony-related expenses.

Purchasing Broadband would more than double the size of any existing cable operator, providing it with the much-needed purchasing power to confront giant content providers such as AOL, News Corp., Disney, and Viacom. Disney's ESPN, for example, has raised its rates to cable operators 20% in each of the last three years while cable operators have only been able to raise rates to consumers by 5.8% over the same period.

The combination of Broadband and a content player would further improve this ability to bring down the cost of content through vertical integration. Content providers' programming including libraries of films and television shows would give a cable provider cheap access. In addition, certain content providers such as Disney or Viacom may want to scoop up the pipes that offer distribution to a network of millions of cable subscribers, something that would offset the declining viewership at their broadcast networks of ABC and CBS.

In MCG's view, AOL, as a significant content player and the second-largest cable provider, potentially would unleash the most value from the Broadband assets. AOL could capitalize on synergies offered to content players and the benefits of scale offered to cable providers. Putting Broadband's pipes together with AOL's content allows the combined entity to push high-speed access, existing AOL content, and new offerings to a captive audience. The subscriber bases of Broadband and Time Warner present enormous opportunities of scale and pricing power as the combined company would be three times larger than its nearest competi-

tor. AOL's digital rights and digital production expertise put it in an excellent position to capitalize on the emerging world of digital distribution.

Recognizing the power of this combination, Microsoft is only considered serious about bidding for Broadband to the extent that AOL is involved. In the ongoing browser and Internet access wars being waged between AOL and Microsoft, Broadband has emerged as another battleground. Buying Broadband would help Microsoft contain the growth of AOL and Netscape while providing a new medium through which to distribute its software. Having invested \$5B in AT&T in 1999, however, Microsoft most likely would prefer to see the planned spin-off and IPO of Broadband move forward.

AT&T management maintains there is a high level of interest in Broadband from suitors. Keeping Broadband within the AT&T fold seems neither wise nor probable, given current shareholder sentiment. AOL has the online and offline content offerings and the critical mass in existing cable subscribers that should allow it to maximize the value of Broadband's pipes and subscriber base. Convergence is coming and the combination of AOL and AT&T Broadband epitomizes the blurring lines between media, communications, and technology.

Largest U.S. Cable Companies		
Cable Company	Subscribers (MM)	Market Share
AT&T	15.9	25%
Time Warner	12.8	20%
Comcast	7.7	12%
Charter	6.4	10%
Cox	6.2	10%
Aldelphia	5.7	9%
Cablevision	3.0	5%
Others	6.0	9%

Source: Advertising Age

RURAL FUNDAMENTALS

Continued from page 6

However, investors must also question the assumptions implicit in such valuations. They must ask what revenues, margins, and growth rates are needed to justify the price they are paying. Consider the example of ISPs offering free Internet access. At one time, they were trading at \$500 per subscriber. Once investors realized that the expected ad-

vertising revenues were not going to materialize, comparable valuations quickly gave way to the fundamentals, and prices fell precipitously. MCG does not believe the same will occur with rural telecom, but we still see fundamental analysis as an important tool that helps buyers and sellers understand the value of the lines.

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