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## East *meets* West

**How PAETEC and McLeodUSA Plan  
to Create the Country's Largest CLEC**

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McLeodUSA CEO Royce Holland  
and PAETEC Chairman and  
CEO Arunas Chesonis

# East *meets* West

## PAETEC/McLeodUSA Combo Creates Nationwide CLEC By Kelly M. Teal and Khali Henderson

**JUST AS THE** Louisiana Purchase nearly doubled the size of the United States, PAETEC Holding Corp. has added to its territory with its acquisition of McLeodUSA Inc. Whether or not the combination will have the kind of impact on the competitive carrier landscape that the 1803 land deal had on America remains to be seen.

The transaction isn't slated to close until the first quarter of 2008, so, until PAETEC assimilates McLeodUSA and gets down to business, the specifics remain speculation. Opinions differ as to how ably the new PAETEC will compete against the LECs, given its comparably small market share. However, the acquisition is being hailed as good for the industry, as well as the two companies, their employees, their channels and their end users.

On Sept. 17, PAETEC announced it would buy McLeodUSA for \$492 million, plus \$65 million in debt, in an all-stock, tax-free buyout. When closed, PAETEC will grow from serving metro areas in 24 states to 44; it will be in 82 of the top 100 MSAs. "This is like the Louisiana Purchase for them – it gives them everything west of the Mississippi, largely," says Craig Clausen, senior vice president and COO at New Paradigm Resources Group.

The East-meets-West combination is a panacea for PAETEC and McLeodUSA, which in coming together have countered the primary objections each face in the marketplace. "The biggest reason customers don't go with PAETEC and McLeod is one of two things," says PAETEC Chairman and CEO Arunas Chesonis. "Typically, it's because they don't feel safe that we are a large enough company. ... They want to see that you have the scale and can sustain yourself financially in the long term because they are betting their personal careers on it. ... The second thing is that our customers — and agents as well — wanted us to have national coverage. ... We do business in southern California. Not to have Seattle, Portland, Phoenix and Denver on-net hurts when you are trying to do deals with a multilocation focus."

Not only does the move widen PAETEC's footprint, it also catapults the company to the top of the list in terms of CLEC revenue,

surpassing XO Communications. PAETEC is valued at \$1.6 billion, with XO close behind at \$1.4 billion.

The combination of size and profitability gives the company significant free cash flow to organically fill some of the holes in the footprint, says Chesonis, noting as examples that buildouts to Cincinnati, Oklahoma City and Las Vegas — three of the top 50 MSAs — will be facilitated by nearby McLeodUSA or PAETEC facilities.

As sensible as the combination looks on a map, it came as a surprise to many. McLeodUSA last March said it would, for the second time, go public. There was some question as to whether that was the best strategy for a carrier that only a year earlier had emerged from its second bankruptcy. McLeodUSA, once a leading competitor in the industry, had pulled through the telecom nuclear winter of the late '90s, but couldn't seem to get a break, even after everyone else was starting to slough off the freeze around 2004 or 2005. Earnings stayed low, stocks were weak and employee morale, thanks to layoffs and overall uncertainty, was on the skids. After bankruptcy No. 2, though, long-time telecom executive Royce Holland assumed control of McLeodUSA and circumstances began to improve. By early 2007, Holland and McLeodUSA's board apparently viewed the carrier as solid enough to attract investors. So, on March 22, they filed an S1 seeking authority for an IPO, which was expected to be issued in June, but didn't get the green light until the end of August. "Our three major shareholders were enthusiastic about taking the company public and then get financing to do some more acquisitions," says Holland, noting that while it waited for SEC approvals, the company had begun talking to PAETEC, recently merged with US LEC, about buying the company. "We negotiated a deal with PAETEC that made sense to them, which basically rolled their investment into a much bigger entity. ... Our major shareholders think that's a better way to get there quickly than to do it a deal at a time."

PAETEC and McLeodUSA executives already have begun mapping out the integration of McLeodUSA's operations and people. First, it will have to decide whether to keep McLeodUSA's residential

customers — McLeodUSA serves about 150,000 residential lines, even though it no longer solicits consumers. McLeodUSA has shifted its focus to businesses with T1 and higher requirements, but McLeodUSA does have some smaller business POTS customers that PAETEC is not accustomed to serving.

Second, the companies' products and back-office systems are different. While the differences mean back-office integration will be a long time coming, the services are complementary. "PAETEC was focused on medium-to-large enterprise and we aren't quite as strong with very small branch offices or small businesses themselves. So, I think when you put the two companies together, it helps fill out the product set," says Chesonis.

In an effort to add perspective to the potential integration challenges, Chesonis adds: "It's not like we put a large incumbent, union-based company together with a competitor. Culturally, we are similar. Some of the systems are different; McLeod has a lot of homegrown systems. But we are not promising a lot of synergies. We don't need to. We are going to make sure to take our time and do the integration very well. I think the shareholders will be happy with the outcome over the next couple of years."

While systems integration can take some time, organizational integration is likely to move at a rapid pace if the PAETEC/US LEC merger is any indication. The companies' channel programs are one place where such changes are imminent. Chris Bantoft, executive vice president of alternate channels for PAETEC, told PHONE+ the organizations will be combined with the objective of growing the channel to take advantage of the new geography. Specifically, he expects there will be cause to add channel managers. "PAETEC has 46. McLeod has 8, but with the potential within the geography they cover to double that," he says. "When you combine the company, you are going to be close to 60."

Both PAETEC and McLeodUSA CEOs stressed their companies' commitments to the channel: "If you look at the PAETEC history, we have always focused on the agent channel since day one when we founded the business. Six of the eight founders were from the agent community," Chesonis says, noting 35 percent of sales come from the channel.

"When I started at McLeod, job No. 1 was let's go after the high-value T1 customer," says Holland. "No. 2 was to revive the agent channel. McLeod during that period from '02 to '05, let that wither on the vine. ... We were selling probably 5 percent or less of our sales back in the beginning of '06 through the channel. Now, we are about 20 percent."

Both companies are relatively new to the resale channel — just a few years for each company. "I think it's an opportunity to redouble the growth and power up," says Bantoft, noting the advantage for resellers is they can now meet many customers' needs with one company instead of two, three or more. "The network footprint is one of the big advantages this combination brings about."

Also, on the organizational front, PAETEC must ratchet up McLeodUSA employee morale. "It's not a secret that McLeodUSA has been beaten up, the personnel put through the ringer," NPRG's Clausen says. With layoffs, executive turnover and two bankruptcies under their belts, McLeodUSA employees need to feel included and valuable, analysts say. "PAETEC has an opportunity here to come

riding in like a white knight to the McLeodUSA employees," says Brian Washburn, principal analyst for Current Analysis.

It looks like PAETEC has embraced that role. Chesonis and Holland went to McLeodUSA's offices in Cedar Rapids, Iowa; Tulsa, Okla.; and Houston to personally tell employees about the merger. Part of the news was that McLeodUSA employees will be given stock options. In addition, executives expect to cut very few

jobs because of the small overlap (Chicago) in coverage between PAETEC and McLeodUSA. "This merger is not about layoffs. It's about growth. It's about combining two alternatives to the Bells. We're not taking away jobs; we are giving people lots of opportunities," says Chesonis, noting that PAETEC has hundreds of positions open that he hopes will be filled with McLeodUSA talent. "That's when the wind is at your back. It's tough to mess that up."

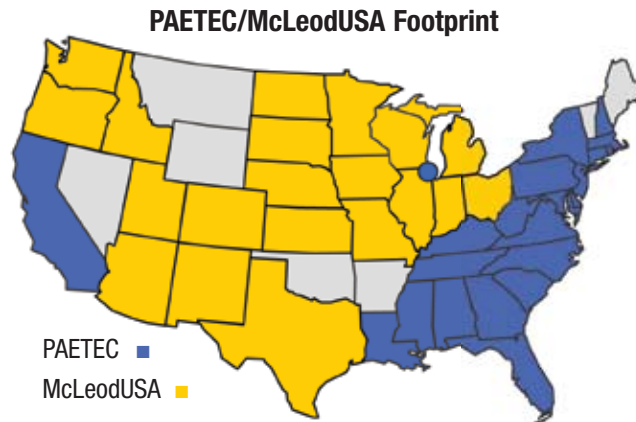
PAETEC executives will hold the top posts of CEO, COO and CFO at the combined company. Holland's role has yet to be decided. "Right now, I am focused on getting this thing integrated, let's get the regulatory approvals and make it successful," he says. He is spirited on by the potential to realize a long-standing dream of developing an alternative to the Baby Bells. "For a while it looked like Worldcom might be able to do that, but things kind of came apart. PAETEC probably has the opportunity to fulfill that mission. So, I am very excited about that. ... Now, I may be off working on my golf game for a few years rather than doing that ... but I will be definitely cheering [Chesonis] on."

How significant a competitor PAETEC will make is up for debate. AT&T Inc. and Verizon Communications Inc. will generate \$29.3 billion and \$17.7 billion respectively over the next five years. Together, PAETEC and McLeodUSA would have earned \$1.6 billion over the last year. "It is a misnomer to describe any CLEC as having equal competitive footing with ILECs when, collectively, all CLECs together hold less than 15 percent of business telecom revenues," says Charlie Reed, an analyst for ATLANTIC-ACM in Boston. In addition, NPRG's Clausen notes, the company still relies on last-mile access from the Bells.

That doesn't mean the new PAETEC won't affect the incumbents, particularly Qwest Communications International Inc. and Sprint Nextel Corp., says Current Analysis' Washburn. The two incumbents have a lot of smaller enterprise customers and PAETEC "is going to be gunning for that increasingly now," he says.

PAETEC's example could spur other CLECs to "find the right sutor" so they can claim nationwide access and put more pressure on the incumbents, Clausen says. Despite that possibility, Clausen and Washburn agree CLEC consolidation is likely to slow. Competitive providers have paired up like starry-eyed teenagers over the past two years (NuVox/FDN, the companies comprising One Communications Corp. and Integra Telecom/Eschelon Telecom are just a few) and those that are left would have to plug specific holes. Analysts are reluctant to say who should unite with whom, but they say further matches would need to provide clear network complements.

Interestingly, PAETEC is likely to be party to more transactions. "We will be careful not to get caught up in the consolidation frenzy, but if you look at the combination now, we will have very low leverage on our balance sheet. ... That gives you a lot of options down the road if you want to do things through acquisition," says Chesonis. +





**PAETEC**