the telecomm analyst[SM]

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Strong Buys

Dominating VPNs Leads To A Check Point Strong Buy

By Erik Dellith

The Telecomm Analyst[sm] *combed through research submitted to the Multex.com database this week, looking for Strong Buys. This column is intended as a starting point for investment ideas in the telecommunications industry, not as an ending point. The opinions expressed in this column are those of the firms mentioned, and not necessarily those of the author, The Telecomm Analyst, or Multex.com. In order to be included in this column, a stock must receive a firm's highest rating, and the valuation methodology must be included in the report.*

CHECK POINT SOFTWARE TECHNOLOGIES (CHKP): On June 27, CIBC World Markets upgraded its recommendation to a Strong Buy on the shares of Check Point Software Technologies. The company's increasing market share, continued strong demand for its products, and the stock's compelling valuation, are among the reasons for the upgrade from Buy. The analysts point to data released recently by Datamonitor that indicates Check Point's market share increased from 52% to 62% during 2000 for the VPN market. Moreover, CIBC quotes the Datamonitor report, which suggests Check Point's equipment will continue to face solid demand; in particular, "Datamonitor believes Check Point equipment will continue to lead the market for gateways solutions." The analysts also cite research findings released recently by Infonetics that the company is doing very well in different segments of the VPN market. Quoting from the CIBC report, "Additional research …suggests that Check Point is dominating the VPN market with a 70% market share of the VPN software segment ($269 million in 2000) as well as 40% of the VPN appliance market ($520 million in 2000) which targets high end users." Furthermore, based on CIBC's channel checks in the U.S. and Europe, Check Point's products still face solid demand in the market. The analysts expect good sequential earnings gains in coming quarters and they believe market demand for Check Point's next generation products will lead to year-over-year growth of about 50%. For these reasons, the analysts reiterate their 12-month price target of $90, based on a price-earnings valuation. CHKP closed at $49.60 on June 28.

Publishing Staff: *Eric Lopkin, Publisher; Paul DeMartino, Managing Editor; Isabelle Sender, Editor, Robin Barrett, Web Designer; Louis Soran, Production Associate, David Allikas, Consulting Editor, Shannon Swingle, Consulting Editor*

MCLEODUSA (MCLD): UBS Warburg reiterated its Strong Buy on the shares of McLeodUSA, largely because UBS Warburg's estimated floor value for MCLD is well above the stock's current level. The analysts point out that there has been growing investor concern regarding the ability of CLECs to meet their cash flow targets, especially in light of recent pre-announcements for telecom and equipment companies. As a result, the stocks of CLECs like McLeodUSA have suffered. The analysts believe that the company's gross margin improvements, along with cost controls to keep SG&A expenses in check, should significantly boost McLeodUSA's cash flow. The company has also taken other steps, including hiring more salespeople, to enhance its growth going forward. According to the analysts, "Over the course of the next few quarters, we look for the salesforce, including the new hires, to increase its productivity and drive revenue growth." Moreover, the company has successfully penetrated certain key markets, and UBS Warburg believes there is more room for growth. McLeodUSA's beefed up sales team should prove positive for further expansion. Not surprisingly, UBS Warburg currently views MCLD as being undervalued. The estimated price floor of $6.40 is only 11.4 times 2003's estimated EBITDA, and the analysts give MCLD a 12-month price target of $12. MCLD ended trading on June 28 at $4.25.

Teletrends

Qwest Held Accountable For Accounting

By Jeffrey R. Hirschkorn

One of the more interesting occurrences in the telecom market happens to be the way companies book financial entries. Of particular concern are questionable accounting practices at some of the nation's major telecom companies, and that has prompted a flurry of analyst reports from the investment-banking community. Last week, Simon Flannery, a highly respected telecom analyst at Morgan Stanley, advised clients that Qwest Communications International (Q) engaged in accounting practices that could dampen future growth rates in sales and profit. Thus, he downgraded the stock to Neutral from Buy.

Mr. Flannery isn't a newcomer to the Street. He has been around for 12 years and has been a recipient of The Wall Street Journal's All-Star Analysts award two times. In fact, he is one of 25 analysts who follow Qwest stock.

However, other analysts interviewed by us failed to elaborate on the potential violations at Qwest Communications. "Based on a preliminary analysis, I don't believe Qwest has done anything improper from an accounting standpoint," said Drake Johnstone, telecom analyst at Davenport & Co., a Richmond, Va.-based brokerage firm.

Trying to nip the negative analyst report in the bud, Joe Nacchio, Qwest's chief executive officer, called an unusual mid-day conference call. Before he could get a word in, shares of Qwest declined 9%, wiping out $4.8 billion in market capitalization and angering many stockholders. Following the bearish report, Mr. Nacchio defended the company's accounting practices. He did admit that Morgan Stanley warned him of the report, but he was unnerved by the analysis and called the note "a challenge to its integrity."

More damaging to Morgan Stanley was Mr. Nacchio's vow not to work the investment bank again. Morgan recently led a team of investment banks in underwriting the shares in a stock transaction. While Mr. Flannery found alleged faults with the accounting practices of Qwest, Lehman Brothers rushed to the scene and denounced the Morgan report. Again, Lehman saw the opportunity to pick up the investment-banking business that Morgan has reportedly lost by the damaging report.

Blake Bath, a telecom analyst for Lehman Brothers, said the accounting issues raised by Morgan Stanley "do not represent real economic impacts." He recommended that the Street take advantage of the slight drop in Qwest's shares. On June 20, shares of Qwest experienced a decline following Mr. Flannery's downgrade of the company. Mr. Flannery believed that the company quietly wrote off $2.1 billion in tangible assets. On the contrary, Lehman Brothers' Mr. Bath contends that the assets written off relate to non-cash items and have no impact on his strong fundamental view of the company.

"The accounting 'issues' raised by another sell-side house yesterday do not represent real economic impacts to Qwest, with most being non-cash items and/or immaterial in the cash sense," wrote Mr. Bath, in a report entitled Buy Qwest on this Dip — Accounting Issues Not Real. "This has no impact on our strong fundamental view of Qwest, and current trading levels present a strong buying opportunity."

Jeffrey R. Hirschkorn is Managing Editor of the Wall Street Reporter Magazine. Send comments to jeffh@wallstreetreporter.com.

Vital Statistics
Qwest Communications (Q)

Market Cap:	$49.9 billion
Shares Outstanding:	1.66 billion
Recent Price:	$30.03 (6/26/01)
52-Week Range:	$59.87-$28.39
Earnings Projections	
2001 EPS:	$0.55
2002 EPS:	$0.79

Upgrades & Downgrades

'Stunning' Shortfall Sends Shares Lower for Tellabs

By Emily Burg

WILLIAMS COMMUNICATIONS GROUP (WCG): On June 22, analysts at Merrill Lynch reduced their rating on the shares of this telecom infrastructure and services company to Neutral from Accumulate, following the firm's downgrade of shares of Level 3 Communications (LVLT).

The analysts are concerned with the further slowing of the economy and think the marketplace for bandwidth remains difficult. "In our view, the space has simply too many competitors for comfort," they wrote. The space is crowded by major incumbents, like AT&T (T) and WorldCom (WCOM), as well as a host of other players, like Qwest Communications (Q), Level 3 and Global Crossing (GX). This suggests that pricing dynamics will stay inherently difficult.

However, the analysts recognize that Williams is demonstrating operational progress in the terrestrial long-haul wholesale space. Williams has an impressive network capability and has made significant progress in executing its finance plan. However, as its levels of debt and equity are depressed, Williams has minimal margin for error.

While funding is in place to carry Williams through to 2003, the analysts are not comfortable retaining a positive investment rating, given that the company needs to generate approximately $2 billion in 2004 to be comfortably cash positive. The shares closed at $2.65 on June 26.

TELLABS (TLAB): Analysts at S.G. Cowen Securities downgraded their rating on the shares of this telecom-equipment company to Neutral from Buy on June 20, after Tellabs slashed its second quarter and revenue estimates.

Tellabs now projects that its second quarter earnings before restructuring and other charges will break even. The analysts had expected quarterly earnings of $0.31 per share. Tellabs' revenues are now expected to come in at about $500 million, well below the previously guided range of $780 million to $820 million and the firm's estimate of $807 million.

Based on this "stunning" shortfall, the analysts have significantly lowered their estimates for the next two years. For the second quarter, they expect break-even earnings on $500 million in sales. For 2001, they now forecast EPS of $0.32 on $2.3 billion in sales, versus their previous estimate of $1.50 on $3.5 billion in sales. Furthermore, based on management's statement that this weakness is likely to carry forward for several quarters, the analysts lowered their 2002 estimate to EPS of $0.38 on sales of $2.5 billion, from EPS of $1.97 on $4.3 billion in sales.

The analysts think it may take 12 to 18 months before new product revenue will become strong enough to offset weakness in Tellabs' core business. What's more, visibility in Tellabs' core business remains very low. The analysts wrote that they maintained their Buy rating on Tellabs for the past few months because they believed that the company's new products had the potential to compensate for the decline in growth of its core TITAN 5500 product. But with the massive drop in sales, they realized that the revenue contribution required to make up for this shortfall is not likely to materialize before the second half of 2002. As such, the analysts don't foresee a meaningful recovery in the shares of Tellabs for several quarters. The shares closed at $16.83 on June 26, up from a new 52-week low of $15.69 on June 21. Research about TLAB was accessed 3,097 times, and 141 new documents were added to the Multex.com database during the week of June 18 to 24.

CIENA (CIEN): In a June 20 report entitled "The Optical Flu," analysts at Merrill Lynch downgraded their intermediate rating on the shares of this optical-networking company to Neutral from Accumulate.

They still expect CIENA to grow 40% to 60% faster than the optical systems market, but since the optical market will decline in 2001 and remain flat in 2002, CIENA cannot gain enough to offset the forecast market declines. Given the pronounced weakness in optical systems, the analysts have lowered their fiscal year 2001 earnings estimates to $0.72 from $0.74 and lowered their fiscal year 2002 estimates to $0.90 from $1.00.

The analysts wrote that once CIENA works through some of its recent contract wins, it will likely encounter the same problems plaguing other optical-system suppliers, such as customers canceling or delaying orders. However, once the optical market turns around, the analysts expect that CIENA will be among the first companies to rebound, which is why they maintain their long-term Buy rating on the shares, which closed at $39.90 on June 26. Research about CIENA was accessed 2,980 times, and 91 new documents were added to the Multex.com database during the week of June 18 to 24.

Executives Zero In

Roxio

William Christopher Gorog,

President and Chief Executive Officer

Interviewed by George S. Mack

William Christopher Gorog
Roxio

Today, your hard drive is probably loaded down with heaps of data, music and programs brought in by the Internet. Add to that the huge files you've created from your digital camera and PowerPoint presentations, and it doesn't take a rocket scientist to figure out that your old floppy disk drive is almost useless for storage and transport. Roxio (ROXI) makes software that enables a compact disk recordable (CD-R) drive to copy loads of data onto a CD so you can re-use it, archive it or share it with others. The Milpitas, Calif.-based company is profitable and has grown revenue at a rate of more than 80% annually in the past five years. Roxio dominates the CD recording sector, with more than a 70% market share globally, and today virtually 100% of PCs manufactured with CD-Rs are shipped with Roxio software. On May 11 of this year, the company was spun out of Adaptec's (ADPT) Software Products Group as a stock dividend. Back in September, while Roxio was preparing to become a separate company, media veteran William Christopher Gorog was chosen as the company's president and chief executive officer. I spoke with him via telephone on June 8, 2001.

[THE TELECOMM ANALYST — GEORGE S. MACK] Chris, I don't think a lot of people understand the extent of this market. How big is it?

[WILLIAM CHRISTOPHER GOROG] There are currently about 50 million CD recordable drives in the market. Analysts are projecting that by the end of this current calendar year there will be about 100 million drives in use. So that's another year of 100% growth in the sector. And then between 2001 and 2004, analysts are projecting that that figure will grow from 100 million to 400 million CD recordable drives. Basically in the next three to three-and-a-half years, you will have 300 million to 350 million new consumers coming into this space. So it's a pretty exciting place to be.

[GSM] At first, I was under the impression that this software was something that only teen-aged boys were using. What are people burning onto CDs?

[WCG] That's a great question, because the understandable assumption is that it's all about music — all about Napster, etc. Certainly music and electronic downloads have been a growth driver, but if you don't know much about this space, I'm sure it would be very surprising for you to know that data burning would be the primary purpose, and it accounts for 42% of CD-R use. That would include people burning PowerPoint presentations to a CD to take on the road instead of lugging a heavy laptop with them. They are also backing up their hard drives onto CDs to archive data, spreadsheets and tax records. They are effectively using the CD as a replacement for floppy disks. The next category is music, with about 32% of the use. Then on the heels of that are digital photo applications, which are about 17% and growing very fast as a share of usage. The balance is video, which is obviously the next big grower.

[GSM] Can you re-record or rewrite over that CD?

[WCG] Well, of course. That's the difference between a CD-R and a CD-RW. A CD-R is a CD recordable drive, where once you've recorded or burned it, that's it. But a CD-RW device allows you to rewrite.

[GSM] Are your products capable of copying DVDs?

[WCG] You've hit a very important subject. DVD recording for the consumer is right around the corner. In fact, Roxio will debut its first DVD recording software for the consumer within the next 12 months. Over the course of the next decade, this is going to be hugely important. Today, the CD is the dominant medium for recording, and we really see quite a long life for the CD; however, when it's eventually replaced, it will be replaced by the DVD. For the consumer, the value of being able to burn to an optical disk is really great, because you've got tremendous storage capability, and the media itself is very inexpensive. George, the DVD has almost eight times the capacity of the CD. So don't think of DVD only as a medium for video. It will be for all other uses as well — data, music and photo — but with a lot more capacity.

[GSM] For a long time, you couldn't buy a dubbing VCR in the United States. The media and entertainment companies wanted to make it difficult for people to copy from one tape to the other using a single machine. And, of course, we've just been through the Napster thing.

[WCG] There's a body of law in America called "fair use," which basically says if you buy copyrighted material, you have the right to make copies of it for your own use — and even to share with others. In other words, you can buy a VCR and make a tape of [the television program] "Friends," because you're time shifting, and you want to view it later. You can even give it to your girlfriend so she can view it. That's completely legal. However, if you buy a thousand VCRs, set them up to duplicate [the movie] "Jurassic Park" and then start selling the copies, that's illegal. We're in the same category. We're a recordable device that the huge majority of our consumers obviously use properly and legally. Of course, there will always be some who don't.

[GSM] What are your sources of revenue today?

[WCG] George, we distribute our products through three channels. The first is through OEMs [original equipment manufacturers]. Last year, about 60% of our gross revenue came from PC manufacturers and external drive manufacturers that license the right to bundle Roxio's software into their CD recordable drives. But when you're working with our software, you are in a Roxio branded experience — our brand is not invisible. Last year, 40% of our revenue came from the retail sector, where people who had our software on their PCs went down to Best Buy (BBY) or CompUSA or someplace else to buy a more robust, deluxe version of our software so they can do more things. This year, we think the OEM-retail split will be about 50-50. Lastly, we distribute our software by making it available at a very low level of functionality through some of the Internet media players, like Microsoft's (MSFT) Windows Media Player, for which Roxio provides the plug-in. We also provide the plug-in for RealNetworks' (RNWK) RealJukebox.

[GSM] I've heard that Microsoft's Windows XP, which is supposed to be released in late October, will have your software incorporated, but that you will not be paid for it. Did I understand that correctly, or am I wrong?

[WCG] No, you're correct. This is actually a fairly classical arrangement among Silicon Valley technology companies. We're providing a bit of our technology in exchange for not only branding attribution within Windows XP but really what we think is going to be a terrific way to broaden our installed base. So if you think about the statistic that I started with, then by the end of this year, there will be 100 million CD recorders in the marketplace and our current market share is 70 million of those with our software on them. With Windows XP shipping, basically we're going to piggyback Microsoft's very broad and deep distribution capabilities by getting a very low-level functionality of our burning software into the hands of a lot of consumers.

[GSM] How does that help you to piggyback when you're not getting paid?

[WCG] The whole point is to provide an upgrade path so that the consumer goes out and buys our retail upgrade product. George, there's one important thing I'd like to point out about that relationship, and that is that this year 50% of our gross revenue will come from retail. All of those people already have a lower level of our software, and they wouldn't buy the upgrade unless they have a CD recorder. The software we've provided Microsoft is a much lower level than we are providing to the PC manufacturers. It's a way for us to broaden our installed base so we can market upgrades.

[GSM] Will the consumer be able to upgrade via Internet download?

[WCG] Not through Microsoft Windows XP, but they certainly will be able to do it via our Internet site.

[GSM] Do you have the same type of relationship with Apple Computer (AAPL) that you have with Microsoft?

[WCG] No, we do not. However, we do have market share leadership of CD recording software for Apple. Our Mac product is called Toast. Before Apple's introduction of its new OS (operating system), we had a virtual 100% market share in the Apple market. We still have a very robust business there. Any review that you might pick up and read that compares Apple's new OS and its iTunes and iMusic capabilities refers to our Toast software as what the customer really needs and wants. We expect to have a vital business in the Mac space.

[GSM] You were just spun out of Adaptec as a stock dividend on May 11. Currently, we're not in a real hot period for newly traded issues of stock. So why did you decide that you needed to be a separate public company — especially at this time?

[WCG] First, the original decision was made in a more robust stock market [laughing]. But we didn't change our mind because of the decline in the market. The two powerful drivers for this decision were as follows: Plain and simple, the first reason is that it was intended to be a shareholder value creation event. Despite current market conditions, it has generated wealth for the shareholders by splitting us off. So mission accomplished there. But secondarily, and more importantly from an operations point of view, Roxio really was a very different animal inside Adaptec, whose business is really related to connectivity and ends up being very hardware oriented. Roxio was about 12% to 15% of Adaptec's gross revenue, but we were a very fast-growing software business within this slower-growing connectivity hardware-oriented business. So you really had some operationally difficult issues coming up,

Vital Statistics
Roxio (ROXI)

Market Cap: ....$192.6 million
Shares Outstanding: ....16.5 million
Recent Stock Price: $11.67 (06/27/01)
52-Week Range: ....$14.90 — $10.90
Price to Estimated (2001) Revenue: 0.33x

EPS		Revenue in millions	Years end in Mar
11999A:	$0.15	$43.1	
2000A:	$0.82	$77.8	
2001A:	$1.23	$121.9	
2002E:	$0.83	$135.2	

Source: Morgan Stanley

particularly since Roxio was a smaller percentage of Adaptec's overall gross revenue. In other words, all the metrics around which Adaptec wanted to run its business ended up unfavorably influencing how Roxio was running its business.

[GSM] What do you mean? How was it hurting you to be a part of Adaptec?

[WCG] I'm talking about things like R&D budgets and marketing budgets. Roxio now has a consumer product that needs to be marketed like an Adobe Systems (ADBE) or Intuit (INTU). Those companies are really run on different economic metrics. That's why it was done.

[GSM] On May 10, the day before you spun out of Adaptec, you were sued by Gracenote, which owns the CDDB database. My understanding is that you've said there's no merit to the case, and you're going to defend yourself vigorously. My question is, was that a coincidence that you were sued the day before your spinout?

[WCG] [Laughing] I ask you to form your own conclusions. I don't think it was a coincidence. I think Gracenote was trying to bring pressure to bear, but it didn't work. It was basically trying to hold us up. Gracenote is a company that has a free database that it assembled through the goodwill of thousands of people throughout the country. These people uploaded their databases into this free database that was to be gleefully shared among Internet surfers. Now Gracenote is trying to commercialize it by charging people licensing fees. It's got its customers in a big uproar. It's very interesting that after Roxio was named in this suit — a nuisance suit from our perspective — we had more than 100 e-mails from consumers who were enraged that Gracenote was, in effect, trying to privatize this public and free database. We don't think that company's claim has any merit, and we're obviously defending ourselves.

[GSM] Chris, I understand you have an opportunity to get into something called DRM, or digital rights management. Are you serious about it?

[WCG] We're hugely interested in helping content owners commercialize the process of burning CDs. The model for distributing content is changing. Ten years from now, the dominant form of audio and video distribution will be a customer going on the Internet and accessing exactly what he or she wants, downloading it and burning it onto a disk. A few days ago [June 4, 2001], we announced an agreement with EMI Group (London: EMI). The agreement is about how we can help create the whole transaction model around that. Are we serious about that? We're deadly serious about it, and we think it's a huge part of Roxio's future.

Telecom Insight

When Going Wireless, is it Access Point or Peer-to-Peer?

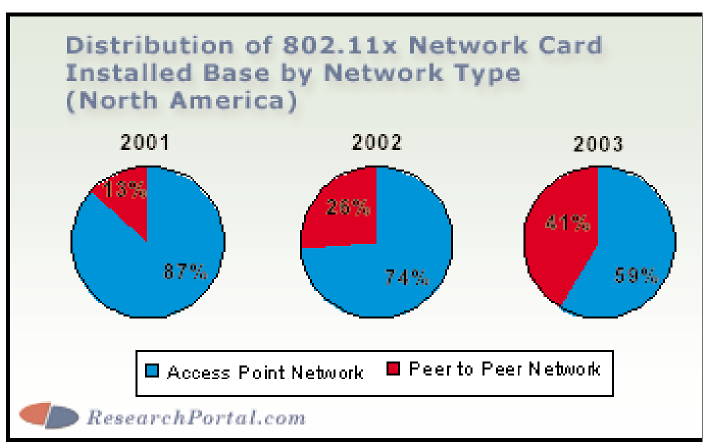
By Research Portal

Wireless LANs using the 802.11x standard will see explosive growth over the next few years in North America. But what type of network environment will these 802.11x cards utilize? Will it be Access Point or Peer-to-Peer?

The type of network that these 802.11x network cards utilize will shift during the next few years in North America. Currently, the vast majority (87%, or 11.5 million) of 802.11x cards are utilized in an Access Point network. The remaining 13%, or 1.7 million, are utilized in a Peer-to-Peer network. By 2003 these percentages will be 59% and 41%, respectively. The distribution of network types that 802.11x cards will utilize will become more equitable in the next two years. However, due to the explosive growth in the overall use of 802.11x wireless LANs both Access Point and Peer-to-Peer networks will see dramatic increases. How fast will these North American installations grow by 2003? 802.11x cards using Access Point networks will jump to 63.7 million while their Peer-to-Peer counterparts will reach the 44.3 million mark.

Below is a look at the evolving distribution of 802.11x wireless LAN installations in North America through 2003.

For additional information please visit ResearchPortal.com.

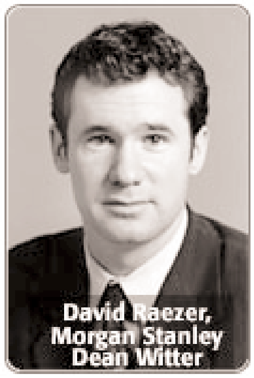


Analyst's Spotlight

David Raezer, Morgan Stanley

Interviewed by March Truedsson

The Telecomm Analyst[sm] *recently spoke with David Raezer, who covers communications software companies for Morgan Stanley about Amdocs (DOX). The stock recently closed at $55, down 37% from its 52-week high. (The shares closed at $53.70 on June 26.) Morgan Stanley has done investment-banking work for Amdocs, but the analyst doesn't own stock in the company.*



[THE TELECOMM ANALYST — MARCH TRUEDSSON] What does Amdocs do?

[DAVID RAEZER] Amdocs provides customer-care and billing and directory system software solutions to telecommunications companies. Amdocs' software replaces its clients' legacy systems, which were built to handle only local and long-distance services, and provides a host of new services, such as customer profiles, billing event creation and order placement. These developments increase the client's cost savings while also reducing churn.

[MT] What has been happening with the company recently?

[DR] Amdocs recently signed a five-year, $200 million outsourcing deal with Bell Canada (BCICF) to provide its convergent billing solution. This will help streamline Bell Canada's disparate back-office billing systems. The company is also developing add-on modules to its software that will assist customers that are looking to upgrade their wireless networks to third-generation voice and data networks (3G).

[MT] What is the makeup of Amdocs' customer base?

[DR] Sixty percent of Amdocs' revenues come from wireless carriers such as Verizon (VZ) and U.S. Cellular (USM), while the rest comes from wireline customers, including BellSouth (BLS) and Deutsche Telekom (DT). Telecommunications carriers are currently experiencing a trend of convergence. This allows carriers to have a greater picture of their consumers' needs and demands, and provides the consumer with a single bill for such charges as pager, cell phone, and Internet access.

[MT] What is your rating on this stock?

[DR] I rate the stock a Strong Buy, with a price target of $80. My revenue estimate for 2001 is $1.7 billion and, for 2002, $2.3 billion. I anticipate earnings per share of $1.33 in 2001 and $1.86 in 2002.

Analyst Coverage

David Raezer, Analyst, Morgan Stanley

Education: BA, Harvard University
Industry covered: Communications software
Companies covered: Amdocs (DOX), Comverse Technology (CMVT), Muse Technologies (MUZE), OpenWave (OPWV).

The Dismal Science

Is That It?

By Erik Dellith

The U.S. economy slowed more than initially believed in the first quarter. With the second quarter quickly drawing to a close, many companies are pre-announcing disappointing earnings, thereby suggesting that the economy's easing continued well through the first six months of this year.

While the Federal Reserve aggressively cut interest rates earlier this year, the most recent move was not as large. Indeed, the 25 basis-point decline on June 27 was half the size of each one of the five previous cuts since the start of 2001.

Does the Fed's recent move indicate that the worst of the slowdown is finally over? Has the rate of deterioration stopped and conditions essentially bottomed out?

The short answer is: perhaps. But even if conditions are not getting worse, keep in mind that there is nothing to say they will improve dramatically anytime soon. Allow me to explain.

Sluggish Growth And Previous Cuts

The U.S. economy grew 5% last year, according to the Department of Commerce (DOC), markedly faster than the average annual growth rate in the post World War II era. Despite 2000's impressive run, economic growth slowed substantially in the second half of the year, as business demand for new equipment and the like fell through the floor.

Indeed, according to the government, quarterly GDP growth increased at an annual rate of 2.2% in the third quarter, followed by only 1% in the final three months of the year, as gross private domestic investment, especially spending on equipment and software, slowed and then reversed course.

Conditions remained exceptionally soft through the first three months of this year, but the really important fact is that as the government received more data and made some recalculations, it turns out that economic activity slowed more than previously thought. Initially, the DOC reported the economy expanded by 2% in the first quarter. Then, it revised some numbers, as more information became available, and found that growth increased by only 1.3%. Now that everything is essentially in and accounted for, it turns out that the economy expanded by an annual rate of only 1.2% in the first quarter. During that time, company spending on equipment and software continued to fall.

It is quite apparent, then, that the overall economy in general, and the telecommunications and technology sectors in particular, have had momentum going in the wrong direction for some time. Based on the myriad earnings warnings that we have already seen for the second quarter, it is also apparent that little has changed of late. Or has it?

The Fed has repeatedly pointed to the lackluster outlook for corporate profits, and the corresponding decline in capital investment, among the factors underlying its rationale for the interest-rate cuts. But, if it seems that little has really changed, why not keep cutting rates aggressively? Well, some stuff has changed, and the outlook is no longer as bleak as it was. Don't misunderstand here, significant downside risks still exist (after all, the Fed did cut rates), but not to the same extent.

Rising Hopes

Although economic conditions in the U.S. are still quite weak, there are some reasons to believe growth will rebound later this year. Let's start with the Fed's interest-rate cuts thus far. Right at the beginning of the year, the Fed slashed short-term rates by 50 basis points, to 6%. Over the course of the next six months, the central bank lowered rates even more; the federal funds rate currently stands at 3.75%.

In general, it takes between six and 18 months before a change in interest rates fully makes its way through the economy. With this in mind, we should start seeing the benefits of the earliest cuts. Moreover, the U.S. economy should reap the benefits of the rate cuts as the year continues, and growth will likely rebound in the fourth quarter, once more of the cuts reverberate through the economy.

Furthermore, the refund checks from the Bush tax plan are scheduled to be mailed out later this summer. This will provide American taxpayers (and consumers) with an extra $300 each. Since personal consumption accounts for roughly two-thirds of GDP, the stimulative fiscal policy should provide a nice boost to spending.

Impact On Telecom

Basically, we've concluded that the current economic situation is south of perfect, but there is a good chance that things will improve as the current year draws to a close and the new one begins. But, what does this mean for the telecom sector?

As a consistent reader of this column knows, I believe that overall economic growth will rebound before the telecom sector. With the overall economy really coming back to life in the fourth quarter, it will probably take another quarter or so for the telecom sector to follow.

Part of the reason for this lies in the fact that companies will likely wait to see a protracted rebound before they start ramping up their technology. Management will want to make sure that the increase in new orders they are seeing has some staying power and is not just an anomaly that will quickly reverse course before they start bulking up corporate capital spending.

Telecom has been one of the hardest hit areas during the current economic downturn, and the near-term outlook is still quite soft. However, given the combination of monetary and fiscal factors set to stimulate the overall economy later this year, the intermediate- to long-term outlook for telecom is considerably more rosy.

Top Picks

Exodus Communications

Prime Takeover Candidate, Or the Next Fallen Giant?

By Ben Mattlin

In late June, the shares of Santa Clara, Calif.-based Exodus Communications (EXDS), a former competitive local-exchange carrier (CLEC) turned Web-hosting services provider, tumbled 29% in a day, the fourth straight day of 20% or more declines. The ostensible reason: The company, burdened by $3 billion in debt, which it took out to build up a worldwide network of data centers, cut its sales estimates for the quarter by some $35 -$45 million and warned of a cash net loss of $140 million.

Within hours, analysts across the nation downgraded the stock as emphatically as if management had admitted to being Martians. The notable exception was Legg Mason Wood Walker's Todd Weller, who kept his Strong Buy rating, despite considerable pressure to jump ship.

Readers of this column may be familiar with Exodus. Last November, I dubbed it the leading Web hosting service. "Its client base is stacked with Internet glitterati," I wrote and noted that it had beaten expectations for 16 consecutive quarters and 1999 sales had surged 359%. The company seemed well positioned for continued growth, since Web-hosting services were becoming essential, core elements of e-commerce and network data communications. The company was dominating the field through its growing infrastructure of secure data centers where business customers store their servers.

But earnings per share in the first quarter this year came in at a loss of $0.22, far worse than the preceding quarter's loss of $0.13 per share. It now appears that the second quarter of 2001 will show losses widening to $0.26 per share. Even Mr. Weller, the counter-consensus bull on the stock, now anticipates that losses for the year will spread to $0.89 per share from last year's loss of $0.50 a share; for 2002, however, he anticipates a per-share loss of $0.35.

"While we clearly missed the significant decline in Exodus, we hesitate to throw in the towel with the stock at these levels and a lot of the bad news out there," Mr. Weller said. "We continue to believe in the value proposition of Web-hosting services, as well as Exodus's leading position in this marketplace. While the stock could see some further near-term weakness, driven by further downgrades from our competitors, we believe that at the $2 level, Exodus's shares have a very favorable risk/reward ratio." Mr. Weller reiterated his Strong Buy for risk-tolerant investors, with a lowered 12-month target of $6. The shares closed at $2.11 on June 26, recovering from a new 52-week low of $1.18 on June 21.

Other observers noted that, at such a depressed valuation, the company makes a likely takeover target. For large telephone carriers such as Verizon Communications (VZ), SBC Communications (SBC) or BellSouth (BLS), which may want to diversify their revenue sources, picking up Exodus at a discount could make a cost-effective way to expand Web-hosting offerings and the customer base. An established telecom carrier could not only leverage this customer base but also better withstand a prolonged slowdown in the Web-hosting business. It's certainly happened before. The U.K.'s Cable & Wireless (CWP) is in the process of acquiring Digital Island (ISLD), an Internet audio/video company, and No. 2 long-distance carrier WorldCom Group (WCOM) is slated to buy Intermedia Communications (ICIX) and gain control of its Digex (DIGX) Web-hosting subsidiary.

The simple reason for the problems at Exodus is the soft economy. Its customer base is shrinking, and remaining customers are spending less. There's never a good time for this sort of downturn to occur, of course, but the timing could not have been worse for Exodus. The economic slowdown, clearly most severe among Internet-related and other high-tech companies, hit in the middle of the company's heated borrowing and building to beat rivals to the Web-hosting punch.

The Telecomm Couch

Working with the Histrionic Personality

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In our continuing series on dysfunctional personalities, we would like to reiterate that there is a great deal of overlap among them. Even though they are generally maladaptive in the long term, oftentimes, in the short term they can be assets.

Since [at the time this was written] we're watching championship professional basketball on television, I can't help but draw an analogy with the player who is talented enough to play on one of the teams, but not as a starter. His role is to come into the game for a short time to give the first team player a rest — and hopefully to block a few shots or score a three-pointer or two and then sit down. If the coach played him every game, all year long, his team would not be in the play-offs.

The substitute's limitation is not all encompassing or manifested all the time, but it is usually present enough to make the difference between a starter and a benchwarmer. I think you get the idea.

When it comes to personalities, a case in point is the histrionic personality.

Words that depict this personality are dramatic, excessively emotional, attention-seeking, conceited, a clotheshorse, a dreamer, or a romanticist. Sometimes these characteristics can come together, and people with histrionic personalities can be charming and charitable, very empathic and loyal. You may recall the narcissist as having some of these qualities too. The difference is that the narcissist demands it, and the histrionic is a little softer and hopes you will give it.

Half of Hollywood is probably made up of this personality type: "I love you, dahling." (They just met!) "We are old friends." (They just met!) "We've known the president for years." (They never met the president!) People with histrionic personality types can be inappropriately seductive and sexually provocative, as well as immature, shallow, fragile, dependent, easily bored and very impressionable. Living and working with this personality type is usually never dull.

Their flare for the dramatic leads to exaggeration and miscommunication. A scratch is a gaping wound. A six-figure income makes them a millionaire. They are the first to see a new play or wear the latest fashion or receive an invitation. This is broadcast, sometimes not too subtly, to garner reaction, attention or adulation. Usually it's harmless, but this behavior can generate contempt, and people with this personality type wouldn't have a clue as to why.

As in all personality disorders, their behavior is a coping mechanism developed over the years to ward off painful inadequacies. There is some suggestion in professional literature that some personality types are genetically based, but experience is an indelible factor.

As we have mentioned in all our articles, the key to understanding personality types is to appreciate the core inadequacies. See through the pomp and circumstance, and you'll have a better understanding of these people and how to relate to them.

To identify the histrionic personality, look out for the characteristics we have enumerated. Be objective. The primping and preening and theatricality are done for a reason — usually a sad reason — so be understanding.

When histrionic personality types cry wolf, don't fall for it. Trust your own intuition. Don't be taken in by their exaggerations. Learn to more accurately discount what they say and do and work with them to clarify more realistic communication. The goal is to get straight answers or descriptions and not to have conflict.

Beware of their seductiveness. If it is their helplessness, it's tempting to rescue them. But don't. If it's sexual, head for the exits! Stay professional, set appropriate limits, ignore the provocation and focus on the decorum and work.

Don't be tempted to exploit them. Histrionic personalities are very impressionable. If you give them the wrong idea, they'll take it as you did not intend. If you intended to give them the wrong idea, they'll take it as intended. To exploit their vulnerabilities is wrong.

It's okay to pay a compliment, but be sincere and respectful and professional. It's better to keep it focused on the impersonal — say, the job performance — as opposed to anything intimate.

In summary, because of their core inadequacy, people with histrionic personalities require, perhaps more than others, reassurance and recognition. They desperately want to be admired, cared about and heard. If they feel slighted, put down, or misunderstood, they can become "hysterical" or overly dramatic. If you find yourself with a person in this situation, call a time-out. Let things cool down. Take a break and come back to work things out when their emotions are somewhat under control Statements such as "I understand you are upset," "I care about you and your opinions and want to work out our differences," can help diffuse the situation. They will feel listened to, understood and appreciated. (Something we would all like!).

If you can tap into that, occasionally pre-empting them to recognize and reward them, you are communicating with them at that core level. Then you may elicit their positive qualities of cooperation and loyalty as mentioned above. If you can work with them, they can be good friends and productive, creative employees.

Letters to the Editor

Glad To Be of Service!

James Rhodes writes: Your advice has cost me $20,000 and growing. Thanks a lot.

James: Thank you for writing. What advice? The purpose of the Telecomm Analyst is to act as a source for investing ideas, and a weekly overview of recent news and research. We don't give advice here. — Paul DeMartino

Exodus Didn't Fall That Far.

Tom Ward writes: Um, I think the finer points of punctuation were lost on either your team or the Legg Mason folks with regard to EXDS. From your summary: 'Legg Mason stated "Specifically, the company indicated that [the revenues of the second quarter of 2001] would be approximately $315 million below our estimate of $350 million." A mere 90% shortfall.'

I think Legg Mason should have but a comma after "$315 million". In other words, the shortfall is 350-315 = 35, or (35/350)x100 = 10%.

enterwhenready@msn.com writes: It's 10%. Big difference. Please correct.

Thanks for writing. The problem lay with both Legg Mason and us. The quote is what Legg Mason said, but they should have put a comma after $315 million. Our mistake was not catching their mistake and reading it as if revenues came in at $315 million below expectations. Fortunately, though the 90% is actually 10%, the rest of the report is accurate. – Eric Lopkin