Internet Infrastructure — Networks
United States

Third-quarter preview. Concerns about sufficient returns on capital and access to funding continue to weigh on valuations. This overhang may dampen positive indicators of execution. However, preannouncements suggest that the companies we cover will meet or modestly exceed estimates.

October 16, 2000

Preview comments on Covad, Mpower, PSINet, and WebEx. All should meet or exceed expectations.

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Covad's results should be in line with analyst day guidance

Covad recently released upwardly revised guidance for line adds, margins, and revenues, reflecting solid improvements in provisioning and higher ARPUs due to the increased sale of value-added services and retail offerings. As a result, we expect the company's third-quarter results to be consistent with its most recent guidance.

Mpower should meet recently lowered guidance

In addition to meeting its recently lowered guidance guidance, we are looking for the company to offer 2001 financial projections based on the impact of its recent provisioning challenges. Despite this increased visibility, we believe that it will take a few before investor confidence is restored.

PSINet should meet recently lowered guidance

PSINet's recently released more conservative third-quarter guidance, reflecting the company's new commitment to executing and restoring investor confidence by meeting financial targets. Although we expect the PSINet to meet expectations, we remain cautious. Investors remain concerned about upcoming capital needs and the company's already-high debt levels.

WebEx should exceed our conservative estimates

For the third quarter, we expect upside to our projections, which we believe are conservative. However, we think that consensus estimates are also conservative, and thus, some expectation of upside is already reflected in current price levels. This will be WebEx's first quarter as a public company, and we believe that investors will be looking for evidence of execution, such as exceeding guidance and highlighting important customer wins.

Valuation comparison

				3Q00E	
Ticker	Rating	Reporting Date	Time	Revenue	EBITDA
COVD	MO	17-Oct	4 p.m.	$74	($112)
MPWR	MO	17-Oct	morning	$31	($56)
PSIX	MO	2-Nov	morning	$426	($11)
WEBX	MO	19-Oct	4 p.m.	$7	($18)

Table of contents

The prices in this report are based on the market close of October 13, 2000.

Covad Communications (COVD; $10.06): Market Outperformer

Reporting October 17 after the market close. Conference call 5 p.m. EST.

Covad preannounced third-quarter lines installed of 200,000, well ahead of our initial 185,000-line estimate, reflecting better-than-expected provisioning. We expect revenues of approximately $73 million and EBITDA losses of approximately $112million. Despite the negative group sentiment, which continues to cast a shadow on the DSL space, we consider Covad a leader in terms of DSL provisioning and its ability to broaden its portfolio of services. We are optimistic about Covad's near-term stock performance, but we remain cautious long term in light of the pessimism of the capital markets, which present a major obstacle to the company's ability to raise the approximately $1 billion in additional capital that it will need after early 2002.

Estimates

Covad recently announced that it expects to report sequential revenue growth in the third quarter of approximately 27%, or revenues of $74 million, and an EBITDA-loss increase to approximately $112 million (-152% margin) from a loss of $88 million in the second quarter. These forecasts compares with our estimates of revenues of $73 million and an EBITDA loss of $112 million. The company announced that it expects to have had more than 200,000 lines installed by quarter's end, well ahead of our estimate of 185,000 (see Exhibit 1).

Exhibit 1: Third-quarter estimates for Covad
$ millions

Estimates[1]	2Q00A	3Q00E
Revenues	$58	$74
qoq % growth	*39%*	*27%*
EBITDA	($88)	($112)
% margin	*-151%*	*-152%*
Lines Installed (000s)	138	200

1) Covad estimates reflect recent pre-announcement

Source: Company data, GS Research estimates.

Key metrics

We do not expect any surprises given Covad's recent preannouncement. However, we will focus on additional metrics, such as blended ARPU, line mix, and collocations. We are interested in blended ARPU, as it is reflective of two factors, line mix and ARPU trends in the company's residential, business, and direct services. For the third quarter, we expect blended ARPU to decline approximately 5% sequentially. This decline reflects an increased mix toward residential lines, which generate ARPUs of approximately $40 versus $70 for business lines and $200 for direct business lines. For line mix, we are closely watching the company's progress in its direct and value-added offerings, as we believe that these services present greater long-term opportunities than the company's wholesale offerings. We expect Covad's installed lines to be comprised of approximately 3% business direct, approximately 44% business wholesale, and 37%

residential. We expect the company to have 2,700 revenue-ready collocations by the end of the quarter, up from 2,600 at the end of the second quarter (see Exhibit 2).

Exhibit 2: Key metrics for Covad

Metrics	2Q00A	3Q00E
Collocations	2,600	2,700
Blended ARPU	$77.06	$73.01
% Lines business direct	0%	3%
% Lines business wholesa	70%	60%
% Lines residential whole:	30%	37%

Source: Company data, GS Research estimates.

Recent events

In addition to upwardly revising its line estimates, Covad recently announced a financing and a partnership with SBC. It also completed a $500-million convertible offering and $150-million equity investment from SBC. These reduce the company's funding requirements to approximately $1.0 billion, funding the company into 2002. Covad also announced a strategic agreement with SBC that we believe enhances Covad's scale and strategic positioning. Under the terms of this agreement, Covad will gain access to Project Pronto, enabling the company to offer DSL over shared lines at a cost of only $5.75 in 13 SBC states. In addition, Covad will have access to lines served from SBC's remote remote terminals, which should accelerate its penetration and improve the economics of its residential offerings. SBC also agreed to purchase $600 million in services from Covad over the next six years, with approximately 30% of the lines sold under this agreement being business lines.

Company profile

Covad is one of the largest providers of high-capacity Internet and network access and services using DSL technology. We expect Covad to continue to execute its strategy to leverage its early-mover advantage into a foundation from which it can provide services beyond simple access. We believe that this is a sound strategy, as it allows the company to (1) capitalize on the current supply-constrained environment for broadband connectivity and (2) capitalize on the market opportunity for broadband-enabled enhanced services.

Key risk

Evolving the company's business plan is the greatest long-term risk. We believe that Covad's strategy to evolve into an end-user-centric or value-added wholesale model will create longer-term value and avoid commodity-type returns. However, this transition will require additional resources for and focus on sales, customer support, and billing.

Valuation

We have set a $24 price target for year-end 2000. Our price target is based on our discounted cash flow (DCF) analysis and supported by comparable-company relative analysis. As a result of the early stage of development, we have employed a DCF model with a terminal year of 2010, a discount rate of 15%, and a terminal multiple of 11 times, which implies a 6% perpetual growth rate of free cash flow. Our price target would require Covad to trade at 13 times estimated 2000 revenues and 6 times estimated 2001 revenues, compared with the current group averages of approximately 7 and 3, respectively.

Mpower Communications (MPWR; $6.50): Market Outperformer

Reporting October 31 before market close. Conference call at 10 a.m. EST.

We recently removed MPower from our US Recommended List and now rate it a Market Outperformer as a result of substantial near-term obstacles that the company is facing in executing its business plan. MPower recently lowered its guidance after its inability to provision SDSL in scale. As a result, for the third quarter, we expect the company to generate revenues of $38 million, an EBITDA loss of $56 million, and lines installed of 235,000. Furthermore, we expect the company to offer guidance for 2001 financial projections based on the impact of its recent provisioning challenges. Despite this increased visibility, we believe that it will take several quarters before investor confidence is restored, particularly given the already highly skeptical market.

Estimates

We expect Mpower's third-quarter results to be in line with our recently revised guidance. We expect the company to generate revenues of $38 million, representing sequential growth of 23%, an acceleration from second-quarter growth of 21%. We expect an EBITDA loss of $56 million, representing a margin of -147%, which compares with second-quarter EBITDA margin of -106%. These greater EBITDA losses should be due to additional spending for (1) the company's prematurely large sales force, which was deployed in new markets that were unexpectedly delayed in opening, and (2) the additional costs for retrofitting the company's network with POTS equipment to mitigate the difficulty of providing an integrated service over SDSL lines. We also expect the company to have installed 235,000 lines at the end of the quarter, representing sequential growth of 17% (see Exhibit 3).

Exhibit 3: Financial estimates for Mpower
$ millions

Estimates	2Q00A	3Q00E
Revenues	$31	$38
qoq % growth	*21.4%*	*23.2%*
EBITDA	($33)	($56)
% margin	*-106.3%*	*-146.5%*
Lines Installed (000s)	201	235

Source: Company data, GS Research estimates.

Key metrics

ARPL and margins of services delivered over DSL lines have improved. Therefore, we will be looking at the percentage of Mpower's installed base that is represented by DSL lines. For the third quarter, we expect approximately 2.4% of the company's installed base to be DSL, up from 1.6% in the second quarter. We will also be watching growth in the company's markets, which we expect to increase from 28 in the second quarter to 32 in the third (see Exhibit 4).

Exhibit 4: Key metrics for Mpower

Metrics	2Q00A	3Q00E
% DSL Lines	1.6%	2.4%
Markets	28	32

Source: Company data, GS Research estimates.

Recent events

The company's recently lowered guidance was due to its inability to provision SDSL in scale. This provisioning issue was compounded by slower-than-expected deployment of POTS equipment, which Mpower chose to deploy as an alternative solution to meet near-term demand. The company issued lower revenue and higher expense expectations due to (1) unexpected network modification costs and (2) costs associated with its prematurely large sales infrastructure. We continue to have confidence about the long-term attributes of Mpower's strategy. However, we recently downgraded our rating as a result of limited visibility regarding when current provisioning difficulties can be overcome.

Company profile

Mpower is one of first providers of bundled voice and data services to the SME market. The company is leveraging its position as last-mile owner to increase its range of application offerings. At June 31, 2000, Mpower had 537 collocations, 201,000 lines in service, and a direct sales staff of 325.

Key risks

Execution remains the greatest near-term risk. The challenge of provisioning SDSL loops remains the greatest near-term risk. Furthermore, the company's POTS overlay to deliver voice over separate lines has taken more time and expense than initially anticipated. As a result of these execution difficulties, we believe that the company could still be vulnerable to competitors with greater scale and presence.

Valuation

Mpower is trading near year lows of approximately 4 and 2 times estimated 2000 and 2001 revenues, respectively, representing significant discounts to group averages of approximately 8 and 4. These discounts primarily reflect investor uncertainty about the company's ability to overcome near-term obstacles to its integrated services strategy. Furthermore, we expect this discount to narrow only modestly until the company can demonstrate improved visibility with regard to its provisioning and ability to enter new markets.

PSINet (PSIX; $6.81): Market Outperformer

Reporting November 2 before market close. Conference call at 11 a.m. EST (800-230-1059).

PSINet's CFO recently released revised pro forma guidance, which we believe is intended to be conservative, reflecting the company's new commitment to executing and restoring investor confidence by meeting financial targets. We expect the company to generate $426 million in revenues and a loss of $11 million in EBITDA. This guidance represents a meaningful reduction from prior consensus. As a result, PSINet stock continues to face heavy pressure amid continued execution and financing concerns. (The company needs approximately $600 million in additional financing and already is highly leveraged, with approximately $3 billion in debt.)

Estimates

For the third quarter, we expect the company to generate consolidated revenues of $426 million, representing sequential growth of 53%. We expect these revenues to be comprised of 26% corporate networking services, 13% carrier, 10% Web hosting, 10% e-commerce, and 41% consulting. We expect the company to generate an EBITDA loss of $11 million, representing a margin of -2.5%, an improvement from the second-quarter EBITDA margin of -4.2% (see Exhibit 5).

Exhibit 5: Financial estimates for PSINet
$ millions

Estimates	2Q00A	3Q00E
Revenues	$278	$426
qoq % growth	*24.9%*	*53.0%*
EBITDA	($12)	($11)
% margin	*-4.2%*	*-2.5%*

Source: Company data, GS Research estimates.

Key metrics

In addition to overall revenue growth, we will be focused on a number of metrics that, we believe, indicate the company's focus on corporate customers, value-added services, and hosting. Although we do not have formal projections for many of these metrics, we are looking for quarter-over-quarter improvements that demonstrate positive trends. In the second quarter, the company reported business accounts of 102,000 (up 3.1% sequentially), business access average new contract revenues of $9,800 (up 34.2%), managed hosting new contract revenues of $240,000 (up 95.1%), hosting customers of 31,000, revenues per gross square foot of $2,500, and gross hosting square footage of 320,000 (see Exhibit 6).

Exhibit 6: Key metrics for PSINet

Metrics	2Q00A	2Q00A
Business Accounts	98,900	102,000
% change	*na*	*3%*
Business Access Avg. new contract revenue	$7,300	$9,800
% change	*na*	*34%*
Mangaed hosting Avg. new contract revenue	$123,000	$240,000
% change		95%
Hosting Customers	32,400	31,000
% change		-4%
Hosting Centers	8	9
% change		13%
Revenue per gross sq. ft.		
% change		
Gross Square Footage		
% change		

Source: Company data, GS Research estimates.

Recent events

PSINet held an analyst conference on September 15 at which it dramatically reduced estimates for its consulting and access businesses and announced that it anticipates additional cash requirements of $600 million in 2001. These announcements triggered a significant decline in PSINet's value, reflecting concerns about the company's ability to (1) execute on growth initiatives and (2) gain sufficient access to capital. As a result, we expect investors to be closely watching PSINet's ability to meet or exceed pro forma guidance, implement cost controls, raise sufficient capital, and, perhaps most importantly, explore strategic alternatives.

Company profile

PSINet is one of the last remaining independent ISPs focused on the business market. We believe that PSINet's global network presence, hosting center initiatives and diversified product offering create an attractive set of assets. Despite its strategic value, PSINet's diversified service offering is also accompanied by increased execution risk. However, we believe a majority this risk is currently reflected in the stock, providing investors with a reasonable risk reward scenario.

Key risks

PSINet continues to struggle with execution issues, failing to meet internal as well as external expectations over the past few quarters. Contributing to this issue is the integration of more than 60 acquisitions over the past two years, including the acquisition of Metamor. PSINet's ability to employ internal financial tools and provide attainable guidance continues to be one of the company's greatest risks. This risk is heightened by a need for additional capital in 2001, which will vary in magnitude based on the company's ability to meet its recently revised guidance.

Valuation

Our price target for year-end 2000 is $20. Our price target is based on our DCF analysis and supported by comparable-company relative analysis. As a result of the early stage of development, we have employed a DCF model with a terminal year of 2010, a discount rate of 17% and a terminal multiple of 9 times. We have also used a 20% public market discount. Our price target would require PSINet to trade at 4 times estimated 2000 revenues and 2 times estimated 2001 revenues, compared with the group averages of 13 and 10, respectively.

WebEx (WEBX; $46.50): Market Outperformer

Reporting October 19 after market close. Conference call at 5 p.m. EST (416-620-2412).

We project that WebEx will generate third-quarter revenues of $6.7 million and an operating income loss (excluding stock-based comp) of $17.8 million. We believe that our model is conservative and expect modest upside, as we have assumed no increase in sales headcount and assume churn exceeding current rates. However, we believe that overall consensus estimates are also conservative; thus, some expectation of upside is probably reflected in current price levels. As this will be WebEx's first quarter reporting as a public company, we believe that investors will be looking for evidence of execution, such as exceeding guidance and the highlighting of important customer wins.

Estimates

We project that WebEx will generate third-quarter revenues of $6.7 million, representing 48% sequential growth. We estimate an operating income loss (excluding stock-based comp) of $17.8 million, representing an operating income margin of -265%. As mentioned earlier, we believe that our model is conservative and expect modest upside, as we have assumed no increase in sales headcount and are using churn assumptions that exceed current rates. Furthermore, as WebEx is a relatively early-stage, rapidly growing company, we believe that more aggressive sequential growth is feasible, given (1) the company's small base of revenues ($4.5 million in the second quarter) and (2) our estimate of absolute incremental revenue growth of only $2.2 million, slightly less than the company's second-quarter incremental growth of $2.3 million (see Exhibit 7).

Exhibit 7: Financial estimates for WebEx
$ millions

Estimates	2Q00A	3Q00E
Revenues	$5	$7
qoq % growth	105%	48%
Op. Income (ex. stock-based comp)	($14)	($18)
% margin	-315%	-265%

Source: Company data, GS Research estimates.

Key metrics

As this will be WebEx's first quarter reporting as a public company, the company does not have a history of disclosed metrics. However, we do expect the company to provide metrics, such as number of direct customers, number of indirect customers, number of ports sold, and percentage of revenues derived from direct sales (versus revenue-haring agreements). The distinction between direct customers and indirect customers is that direct customers purchase and use WebEx meeting services, while indirect customers either resell WebEx's services or leverage the capabilities of the company's platform to deploy their own services. Currently, the majority of WebEx's revenues are derived from direct customers, such as Oracle, Shell, and Motorola.

However, eventually, we expect an increase in the number of indirect customers, which would indicate the adoption of WebEx's platform as a foundation for third-party developed, real-time services.

Recent events

We recently initiated coverage of WebEx with a Market Outperformer rating. Although the company is at a nascent stage of development, we believe that the unparalleled functionality of its services based on proprietary technologies will allow the company to rapidly penetrate a robust market that is expected to grow from $2.1 billion in 1999 to $19.2 billion in 2003 (IDC). Longer term, we believe that the open architecture standards of WebEx's unique communications infrastructure could facilitate the development of new third-party applications and services, potentially establishing the company's platform as the predominant standard for Web-based, real-time business communications.

Company profile

WebEx delivers a suite of Web-based interactive communication services that are unrivaled in their real-time, multimedia, and collaborative capabilities (such as spontaneous application sharing, Web co-browsing, document sharing, live video, and desktop remote control). These capabilities are enabled by a real-time information switching platform that marries the scalability, reliability, and security of switched networks with the multimedia capabilities of the Internet. Currently, customers are using these services to enhance sales, training, marketing, partner management, and product development functions. WebEx's marquis customer base includes software designers (Oracle), portals (Yahoo!), communications service providers (Global Crossing), and equipment makers (Motorola), to name a few.

Key risks

WebEx's competitive advantage depends on the proprietary nature of its network architecture. However, this advantage could be undermined for a variety of reasons—for example, if the patents are successfully challenged, not adequately broad enough, or not granted in all the countries in which the company conducts business. Despite these risks, we believe that the sophistication of WebEx's applications and network would take considerable expertise and resources to replicate.

Valuation

On an enterprise value to estimated 2001 sales multiple, WebEx is trading slightly above the shares of other comparable early-stage, high-growth companies, at approximately 21 times estimated 2001 revenues, compared with the group average of 17. We believe that this premium is justified by the company's high, albeit conservative, long-term growth rate of more than 100%. As a result, on an estimated 2000 revenue multiple to long-term growth rate basis, the stock trades in line with its peers at approximately 0.2 times. Because WebEx is an early-stage company experiencing rapid growth, we believe that relative price to revenues is the most appropriate comparative valuation benchmark. Other approaches, such as DCF and

EBITDA multiples, will become more appropriate as the company successfully executes its model and becomes more mature. As a result, we believe upside exists to current price levels if the company exceeds current estimates—a scenario that, in our opinion, is likely given that we consider our model conservative.

Goldman, Sachs & Co. or an affiliate has managed or comanaged a public offering of the following companies' securities in the past several years: Covad Communications Group, Inc., Mpower, and WebEx Communications, Inc. Goldman, Sachs & Co. or an affiliate makes an over-the-counter market in Covad Communications Group, Inc. common stock; Mpower common stock; WebEx Communications, Inc. common stock. Goldman, Sachs & Co. or an affiliate has rendered significant corporate finance services to the following companies or one of its affiliates within the past 12 months: Covad Communications Group, Inc. and Mpower. Goldman, Sachs & Co. or an affiliate may deal as principal in any of the securities mentioned.

Stock ratings:

RL: Recommended List
LL: Latin America Recommended List
TB: Trading Buy
MO: Market Outperformer
MP: Market Performer
MU: Market Underperformer

Third-quarter estimate overview

$ millions, except where indicated otherwise and metrics data

Covad Communications

Estimates [1]	2Q00A	3Q00E	Metrics	2Q00A	3Q00E
Revenues	$58	$74	Collocations	2,600	2,700
qoq % growth	*39%*	*27%*	Blended ARPU	$77.06	$73.01
EBITDA	($88)	($112)	% Lines business direct	0%	3%
% margin	*-151%*	*-152%*	% Lines business wholesale	70%	60%
Lines Installed (000s)	138	200	% Lines residential wholesale	30%	37%

MPower

Estimates	2Q00A	3Q00E	Metrics	2Q00A	3Q00E
Revenues	$31	$38	% DSL Lines	1.6%	2.4%
qoq % growth	*21.4%*	*23.2%*	Markets	28	32
EBITDA	($33)	($56)			
% margin	*-106.3%*	*-146.5%*			
Lines Installed (000s)	201	235			

PSINet

Estimates	2Q00A	3Q00E	Metrics	2Q00A	2Q00A
Revenues	$278	$426	Business Accounts	98,900	102,000
qoq % growth	*24.9%*	*53.0%*	*% change*	*na*	*3%*
EBITDA	($12)	($11)	Business Access Avg. new contract revenue	$7,300	$9,800
% margin	*-4.2%*	*-2.5%*	*% change*	*na*	*34%*
			Mangaed hosting Avg. new contract revenue	$123,000	$240,000
			% change		95%
			Hosting Customers	32,400	31,000
			% change		-4%
			Hosting Centers	8	9
			% change		13%
			Revenue per gross sq. ft.		
			% change		
			Gross Square Footage		
			% change		

WebEx

Estimates	2Q00A	3Q00E	Metrics	1Q00A	2Q00A
Revenues	$5	$7			
qoq % growth	105%	48%			
Op. Income (ex. stock-based comp)	($14)	($18)			
% margin	-315%	-265%			

(1) Covad estimates reflect recent preannouncement.

Source: Company data, GS Research estimates.