

# Outstanding Investor Digest

PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

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Volume XVII Numbers 1 & 2

April 23, 2002

CLIPPER FUND'S JIM GIPSON, MICHAEL SANDLER ET AL.  
"INVESTING LANDSCAPE TODAY RESEMBLES AFGHANISTAN  
WITH MANY LANDMINES WAITING FOR THE UNWARY..."

Since establishing Clipper Fund in February, 1984, Jim Gipson and Michael Sandler have made a habit of outperforming its peers. For example, Clipper Fund's performance over the last five, 10 and 15 years place it among the top 1% of funds in its category followed by Morningstar during that period. And over the most recent five years, its performance placed it first among the funds in its category — both for highest return and lowest risk.

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WEITZ HICKORY FUND'S  
RICK LAWSON

"IF ALL THE GOOD STUFF I'VE SAID IS CORRECT,  
THEN THIS IS THE BEST IDEA I'VE EVER HAD..."

After our initial interview with Weitz Funds' Wally Weitz and Rick Lawson which appeared in our year end edition, we began to research an idea we didn't have the time or space for (believe it or not, we have limited supplies of both). And the more we looked (and believe me, we looked a lot), the more we liked what we saw.

In fact, we liked it so much that we asked Lawson to share his substantial insights about it with you — which he

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LEVEL 3'S  
JAMES CROWE ET AL.  
"SOMEBODY'S GOING TO PUT IT ALL TOGETHER.  
WE FIGURE IT MIGHT AS WELL BE US."

In order to help us get our hands around another idea that was being featured in a prior edition of *OID*, we began in earnest to try to understand Level 3. But in fairly short order, it became apparent that doing so would be far more easily said than done. It would involve learning some of the language of tech and telecom, relearning some economics, reviewing the company's short but very eventful history and acquiring a

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LONGLEAF PARTNERS FUNDS'  
MASON HAWKINS, STALEY CATES ET AL.  
"MOST EQUITIES AROUND THE GLOBE ARE OVERPRICED.  
THEY'VE ALMOST NEVER BEEN SO UNATTRACTIVE..."

Longleaf Partners Funds just keep rolling along outperforming relevant indices for pretty much all periods. And we keep right on listening to whatever Mason Hawkins, Staley Cates and their associates have to say.

In this edition, we're pleased to bring you their latest observations (as bearish as we've ever heard from them) about the relative paucity of opportunity available in stocks

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CLIPPER FUND'S  
JIM GIPSON, MICHAEL SANDLER ET AL.  
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Their letters to shareholders are equally well regarded and are among the most eagerly awaited and best written of mutual fund letters. Gipson, Sandler et al. combine piercing insights with a perspective rarely seen anywhere. Their latest is no exception. We highly recommend it.

CLIPPER FUND  
FIRST QUARTER LETTER — APRIL 2, 2002  
"PUTTING IT ALL IN PERSPECTIVE."

A question more frequently being asked by investors...

"Whom do you trust?" is a question asked more frequently today than at the peak of "irrational exuberance" two years ago. Certainly not the executives and auditors of Enron — now known as the Betty Crocker of Cooked Books. Certainly not the legion of investment bankers, analysts, brokers and executives who fueled the dot-com mania that descended into what Marx termed "the dustbin of history."

Faced with growing scandals and shrinking portfolios, many investors wonder how to put all this unwelcome news into reasonable perspective.

A fraud cycle runs parallel to the business cycle.

Generations of economists have measured the business cycle of booms and busts in economic activity. Less measured but no less real, a fraud cycle runs parallel to the business cycle. Boom times provide enhanced opportunity for a small number of crooks and irresistible temptation for a larger number of the morally marginal.

The classic culprits are not the starving poor stealing a morsel of bread, but the rich and respected who desperately desire more of what they already have. (The president of the New York Stock Exchange went to jail for fraud after the Crash of 1929. More recently, Enron's Kenneth Lay was a wealthy man even without improper behavior.)

J.K. Galbraith described the fraud cycle in the Roaring '20s: "At any given time, there exists an inventory of undiscovered embezzlement in — or more precisely not in — the country's businesses and banks. This inventory — it should perhaps be called the 'bezzle' — amounts at any moment to many millions of dollars. It also varies in size with the business cycle. In good times, people are relaxed, trusting and money is plentiful. But even though money is plentiful, there are always many people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off and bezzle increases rapidly.

In depression, all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved. The bezzle shrinks."

It's good to hang an admiral from time to time....

Fraud makes major news but comprises only a minor part of economic activity. Our modern and highly productive economy simply could not function without a much higher level of trust and integrity than the current

scandals suggest. Wal-Mart, that paragon of retailing efficiency, would collapse if it could not trust its thousands of suppliers to deliver the right goods to the right places at the right times. The media's current focus on the exceptional case of Enron is similar to its focus on the rare crash of a commercial airliner — the million safe flights a month do not merit public notice.

No economic system produces saints, but a good system such as ours punishes sinners and provides reforms when needed. The high level of public outrage suggests that Enron's management and auditors will suffer the likely fate described by the Clint Eastwood Theory of Justice — Hang 'Em High. The likely result of watching that public punishment will be to encourage other executives to behave better and other accountants to audit aggressively. Voltaire expressed the same principle in describing England: "In that country it is good to hang an admiral from time to time to encourage the others."

THERE'S NO WAY TO STOP INVESTORS  
DETERMINED TO DO SOMETHING CRAZY.

A universal determination to avoid facing the obvious facts.

Larceny is one thing, lunacy another. The rise and fall of fortunes in the dot-com craze did have some unseemly elements, notably the conflict of interest when brokerage analysts are paid based on the investment banking revenues they generate from the companies they cover.

The real issue, however, was not deception but a universal determination to avoid facing the obvious facts. The financial press in the late 1990s was filled with articles on the astronomical valuations investors lavished on highly speculative dot-com start-ups. Even the most naive dot-com investor knew at the time that most of these companies were not solid, profitable firms with well-proven business models.

The executives of dot-coms were less naive, but the fact that few of them sold much of their stock at the peak suggests they were as insane as their investors. In contrast to the case of Enron which probably will produce reforms to improve the system, the collapse of dot-com mania may create nothing more than the realization that there is no way to stop investors who are enthusiastically determined to do something crazy with their own money.

The investing landscape today resembles Afghanistan....

During the long boom of the 1990s, many companies looked successful and many investors looked smart. Fewer do today. First to fall were the obvious candidates — the dot-com companies with few sales, no profits, and large negative cash flows. Next came a slightly less obvious group — technology equipment companies whose sales depend on the most volatile segment of the economy, corporate capital spending. Now the problems are spreading to less obvious candidates, particularly those with accounting issues. The investing landscape today resembles Afghanistan with a large number of concealed landmines waiting for an unwary foot.

A major focus for us is avoiding potential losers....

A major part of the value we can add to your portfolio consists of avoiding those potential losers. We address risk by first asking the question of whether we can understand

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## CLIPPER FUND'S

JIM GIPSON, MICHAEL SANDLER ET AL.

(cont'd from preceding page)

the company well enough to value it ... (not the case with many technology firms and, more recently, Enron).

We also use a devil's advocate process to address the potential problems of a company before buying its stock. Last, we buy only with a large margin of safety in case we're wrong — which sometimes we are. As the tide of stock prices goes out, these efforts at risk reduction are intended to keep your portfolio reasonably intact, and certainly not in tatters.

PRICES ARE CLOSER TO BULL MARKET PEAKS  
THAN THEY ARE TO BEAR MARKET BOTTOMS.

Patience is easier to preach than it is to practice.

When it comes to risk, the past is not prologue. The great bull market from August 1982 to March 2000 encouraged the comfortable belief that bear markets are brief and usually mild detours on the road to riches. The idea that equity ownership can be a dead end street filled with potholes for an uncomfortably long period is not part of conventional wisdom, but it should be. Just as the stock market became "irrationally exuberant" in the recent past, it can become irrationally depressed in the future.

That would mean good opportunities for a rational investor with patience, but patience is an easier virtue to preach than practice. Substitute "patient" for "solvent" in Keynes's observation and the issue becomes clear, "Markets can remain irrational longer than you can remain solvent."

It really is different this time....

The four most dangerous words in investing are "It's different this time." Those words were heard widely (and wrongly) to justify the extraordinary prices for favored stocks during the recent peak of irrational exuberance only two years ago. The problem, however, is that in some significant ways the facts today really *are* different from those of yesterday. Three examples follow:

(1) The cause of the recent recession is very different from that of downturns in the past. The classic recession flows from a period of tight monetary policy aimed at reducing inflation in an overheated economy. In this case, the cause was excessive business capital spending, financed in part by public offerings from a speculative stock market. This recession barely touched consumption but fell hard on capital spending — particularly technology equipment.

Even though the recession was not caused by monetary tightening, Federal Reserve Chairman Alan Greenspan hopes its cure will be monetary loosening from the sharp decline in short-term interest rates last year.

A mild change in GDP led to a dramatic decline in profits.

(2) The consequences of the recession have been very different, too. A very mild change in gross domestic product created a dramatic decline in corporate profits. Reported earnings (including write-offs...) for the S&P 500 fell from \$50 in 2000 to \$25 in 2001. Operating earnings (before write-offs) for the same index fell from \$56 to \$39. This was a remarkably bad recession for corporate profits.

Trust gets built slowly, but destroyed quickly.

Less measurable but no less significant, another consequence may be the erosion of trust in equity investing. The decline of equity prices during the last two years has shaken the confidence of many investors.

In some cases, the loss of assets leads to seething anger and bitterness — a feeling Machiavelli captured with the observation that "men will sooner forget the death of their father than the loss of their patrimony." When the loss of assets from a bear market combines with loss of trust from the Enron scandal, the result is rapid erosion of public confidence that took many years to build. Confidence and trust are asymmetrical — they take a long time to build up but only a short time to tear down.

Equity prices today are closer to bull market peaks...

(3) For a value investor the most significant difference this time lies in the prices investors attach to stocks. Equity prices today are much closer to past bull market peaks than to bear market bottoms. The major question confronting investors is whether corporate profits will rise

Bear Bottoms  
S&P Industrials

| Date              | P/E          | Dividend Yield | Price to Book | Price to Sales |
|-------------------|--------------|----------------|---------------|----------------|
| 06/13/1949        | 5.4          | 7.6%           | 0.89          | 0.43           |
| 10/22/1957        | 12.0         | 4.4%           | 1.43          | 0.75           |
| 10/25/1960        | 16.3         | 3.6%           | 1.64          | 0.93           |
| 06/26/1962        | 14.9         | 3.9%           | 1.54          | 0.85           |
| 01/03/1967        | 14.9         | 3.5%           | 1.85          | 0.93           |
| 05/26/1970        | 12.9         | 4.4%           | 1.45          | 0.66           |
| 12/06/1974        | 7.5          | 5.1%           | 1.07          | 0.38           |
| 02/28/1978        | 8.3          | 5.3%           | 1.14          | 0.40           |
| 04/21/1980        | 6.8          | 5.7%           | 1.08          | 0.34           |
| 08/12/1982        | 7.9          | 6.3%           | 0.97          | 0.33           |
| 07/24/1984        | 9.4          | 4.4%           | 1.36          | 0.44           |
| 10/19/1987        | 12.7         | 3.4%           | 1.92          | 0.58           |
| 10/11/1990        | 13.9         | 3.6%           | 2.24          | 0.60           |
| Average           | 11.0         | 4.7%           | 1.43          | 0.58           |
| <b>12/31/2001</b> | <b>29-55</b> | <b>1.2%</b>    | <b>5.80</b>   | <b>1.64</b>    |

Source: ISI Group

far enough and fast enough to justify today's generous level of stock market valuation.

Even in this market, we're finding things to do...

Even in the context of a generously valued stock market, we found opportunities to add value to your portfolio. We began selling stocks such as Target and Office Depot as their prices rose to our estimates of their intrinsic values. We bought shares of Kroger and Safeway, two well-managed but currently neglected supermarkets.

Our most controversial change was the purchase of Tyco during a brief panic over concern that it might become the next Enron. Our contrary belief is that Tyco's problems, while real, are far more modest and manageable than the stock market currently suggests. The cumulative effect of these stock-by-stock buy and sell decisions is the principal way we can add value to your portfolio.

—OID

WEITZ FUNDS'  
WALLY WEITZ & RICK LAWSON  
(cont'd from page 1)

graciously consented to do. (Feature begins on page 9.)

But first, we're pleased to bring you excerpts from a Weitz Funds conference call which occurred February 4th and Weitz's latest letter to shareholders of Weitz Partners Value Fund dated April 2nd. We believe the sentiments, in both to be especially relevant today and hope you do, too.

DEPRESSED TELECOM AREA HAS BECOME A PANIC  
— BUT I LIKE THAT. I'M HOLDING OUT THE BASKET.

The panic in telecom reminds me of cable in '96...

**Wally Weitz:** One way or another, the questions that I got before the meeting have to do with the telecom world. I guess you'd have to say that we're still in a bear market two years later that's focused on tech and telecom. We still have a recession — at least as far as the telecom world is concerned. And we have Enron and various scares about accounting and whether people are really seeing reality when they look at financial statements. Specifically, in the telecom world, there are well-publicized problems of overcapacity in some parts of it and price competition and so on.

And what that all adds up to is a depressed group that recently has become [the victim of] *panicky* selling. Looking at my screen today, it reminded me a lot of October of 1996, when we were at a media conference during a time when cable stocks were falling the same way that telecom stocks have been falling the last few days.

And that turned out to be a *great* time to be buying cable stocks. We'll see about the telecoms.

Our telecom holdings will probably be our best performers.

**Weitz:** Telecom represents a pretty small percentage of Hickory Fund. It's a bigger percentage of Value and Partners. I thought I'd just go through a few of the stocks briefly. Then if somebody wants to dig in deeper, we can do that. But in Value and Partners, the whole group is 16-18% of the portfolio — the vast majority of that being in Citizens, Qwest, TDS and ALLTEL.

And all four of them, I believe, are clearly survivors and have strong enough balance sheets to get them through a tough time for the industry. Citizens and Qwest, in particular, I think, have some misunderstandings about what their business really is that could make them susceptible to a bigger percentage jump when somebody cares. But all of them as a group will probably outperform the rest of the portfolio over the next year or two.

When it gets ugly, like in telecom today, I feel better.

**Weitz:** As for some of our smaller holdings, AT&T really is a cable stock now — with about three quarters of its value represented by Comcast which is going to be taking over its cable properties. We have positions of less than 1% of our portfolio in AT&T Wireless, Sprint and a couple of tiny positions in things like Centennial. AT&T, strangely enough, was our biggest contributor to

performance last year. And that was partly because they spun out the AT&T Wireless — some of which we sold and, regrettably, some of which we kept.

When stocks are collapsing as a group without people discriminating one from another, it's not pretty. But in a sort of a perverse way, I start feeling a lot better — and I'm holding out the basket to buy more.

TOUGH TIMES FOR SERVICE PROVIDERS  
MEANS TOUGH TIMES FOR THEIR SUPPLIERS.

The buyers of fiber are suffering today.

**Shareholder:** Is the fiber market a dead market at this point — particularly for JDS Uniphase and Corning?

**Rick Lawson:** As for the fiber market, I'm not sure that I know enough to be useful. But I'm going to try anyhow. And please understand that this is coming from somebody who spends his time thinking about the services business, not the equipment companies. So I really don't know the details of the equipment companies very well.

All I can say is this: The people who are *buyers* of fiber are, as a group, all suffering today. And there is a belief (and I think it's not unreasonable) that they're suffering because there is an abundance of capacity — if not *overcapacity*, then sufficient capacity to last for awhile.

It's hard to see how the service providers won't turn first.

**Lawson:** And to the extent there's going to be a turn in the market, I don't see how you don't see the turn first on the services side before you do on the equipment side — because until business at the services companies starts to pick up, they're not going to either have the wherewithal or the desire or the ability to aggressively buy equipment. So I'm not very optimistic about the short-term outlook for the equipment companies.

But I have *no* idea about valuation — and I have no idea of whether there's a big enough long-term positive to make it worth the wait. However, at least in the short run, I'm not very optimistic on the equipment companies.

It's easy to understand why the fiber market's depressed....

**Weitz:** Like Rick said, typically, we're not buyers of equipment companies — because we like the service side where there are recurring revenues and so on.

But I think of Qwest. As I've heard them talk over the last several quarters, they've gone from really believing in what they call Qwest Classic [the fiber network part of their business] and thinking there's a great, long-term future in that business to saying, "You know, we still think that there's a great, long-term future. However, not only are we not being rewarded for being in that business, but that part of our business almost seems to have *negative* value in the eyes of Wall Street. So we're going to pull back our capital expenditures from \$7-8 billion to \$4 billion and make sure we have positive cash flow and that people who are worried about viability and so on are satisfied."

And when one company cuts its capital expenditure budget back by \$3 or \$4 billion and you multiply that by all the other telecoms out there, whether it's deserved or not, it probably means less equipment's gonna be bought for awhile.

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WEITZ FUNDS'  
WALLY WEITZ & RICK LAWSON  
(cont'd from preceding page)

QWEST'S PRICE AND STAYING POWER ARE RIGHT.  
SO WE DON'T NEED TO CARE ABOUT THE TIMING.

Qwest's balance sheet will see it through this turmoil.

**Shareholder:** ...Are you still as optimistic about Qwest as you were a few months ago?

**Weitz:** ...The big question mark for *all* different kinds of companies in the telecom world is how competition shakes out, how changes in regulation affect the competition and who can charge how much for what. But I'm a believer that telecom activity in general is depressed because of the recession — and that there are at least many *parts* of the telecom world that are growing secularly and will continue to do that over time.

Qwest, I believe, has a *very* strong balance sheet and *very* strong cash flows from the prosaic part of its business — the RBOC side — that'll carry it through if it takes another year or two or three for the turmoil in the industry to clear.

And its parts add up to a lot more than \$9...

**Weitz:** When that finally happens, the combination of Qwest Classic that I think has *some* value, the RBOC that I think is worth a lot more than \$9, and the new revenue that they'll get from being able to offer long distance inside their territory once they get Rule 271 approval all add up to some number that's a lot higher than \$9.

Now whether when it gets back to \$18 or \$19 the world will look different enough that I'll breathe a sigh of relief and decide it's not so interesting anymore — suggesting that my initial purchase at \$19 was wrong — [or whether I'll continue to hold it], I don't know. But I'm *very* comfortable with it at this point...

[Editor's note: Weitz lays out his investment rationale more extensively in our *OID* Year End 2001 Edition. For his latest thoughts on Qwest, see page 7.]

The price and staying power make the timing irrelevant.

**Shareholder:** It seems like you're looking out two to three years for the turnaround in telecom...

**Weitz:** Let me interrupt you there. I have no *idea* what the time frame is going to be. All I'm saying is that if it takes two or three years, we're prepared to wait for it. [Our stocks have enough staying power to survive for at least that long.] And our stocks seem cheap enough that we can still get a decent annualized return if it takes three or four years. I'm not predicting that it'll take that long — although who knows?

AT&T HAS BECOME A BROADBAND COMPANY  
— WITH A TELEPHONE BUSINESS KICKER.

What's left at AT&T is mostly broadband.

**Shareholder:** When we spoke awhile ago, I believe you said you purchased AT&T for the sum of the parts. Now we've spun off wireless and we're [selling] broadband. We're left with long distance, business and consumer.

There's talk on the Street that BellSouth might be buying their long distance. So I'm not really sure what AT&T is as a company anymore. What is the sum of the parts at this point? And what is AT&T actually doing?

If you take a look at their debt, I believe they're rated BBB — which is fairly close to junk bond status. I thought maybe you could expand on that a little.

**Weitz:** [Chuckles.] Yeah. We're down to the end of the game on that one. I did buy it for the sum of the parts. They've given us one part — which was AT&T Wireless. When they first spun it out, it was worth \$5-6 per share of AT&T. And the part that we sold helped us — and the part that we still have is worth less.

What's left now is broadband — which Comcast has agreed to buy for a third of a Comcast share. And Comcast is a company I really like. I've liked it for a *long* time.

[Editor's note: According to *Portfolio Reports*, Comcast was the second largest purchase in Weitz Value Fund and Weitz Partners Value Fund during the 4th quarter at an average cost of \$35.80.]

I figure the "stub" is worth something above today's price.

**Weitz:** Then you have the stub, I guess. And we were at a conference a few weeks ago. The management of the AT&T telephone part was sort of indignant that people kept calling it the stub — and actually made a *semi*-convincing case that there was really something there beyond what the world was giving them credit for.

I'm not sure that I'm a believer that there's a lot there. If there's about \$12 per share worth of Comcast and a \$16-1/4 price for AT&T, that's a little over \$4 for the telephone part. And I've seen people make the case for what's left being worth \$10 or \$12. I'm not really a believer there. But I've held on to *some* of it, at least. We've sold some of it — but not too much because I figured that it would probably be worth more than \$4 or \$5.

And it's probably not as bad as I'm making it sound...

**Weitz:** But I think it's been a good reminder that when you buy something for the sum of the parts, you better believe not only that the parts have the value that you ascribe to them, but that the value stays the same or grows while you're waiting for the parts to be broken up. There's been some deterioration in the values, I think, while we've been waiting for the distribution.

So when all is said and done, if we were to sell the AT&T that we have right now along with what we got for the wireless, I suspect on balance we'd have a tiny gain overall.

**Shareholder:** I'm trying to get in the head of [AT&T's CEO, Michael] Armstrong, and understand where that leaves the company after selling off all the pieces? Are we talking about that there won't be any AT&T at all in another five years?

**Weitz:** Well, the telephone people think that there's a great, exciting story there. I'm skeptical — but I'm just an outsider looking in. There are parts of their business that are growing. The long distance voice is shrinking, but it's throwing off *enormous* amounts of cash. If they milk that for awhile, they could get several dollars per share of cash in. So it's probably not as bad as I'm making it sound. There is a telephone business there.

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WEITZ FUNDS'  
WALLY WEITZ & RICK LAWSON  
(cont'd from preceding page)

But we're not counting on takeover activity to bail us out.

**Weitz:** And there's talk that some of the RBOCs might want parts of it — that maybe it's an attractive takeover candidate. I don't know what to expect though.

But in this environment, where all the telecom companies are sort of looking over their shoulders and worried about when the telecom recession will end and making sure that they're hunkering down on cap-ex and not really thinking about expanding, I wouldn't expect any major takeover activity to bail us out.

WE THINK THERE'S A LOT TO LIKE AT LIBERTY MEDIA.  
DON'T LOSE SIGHT OF THE FOREST FOR THE TREES.

Liberty Media is more than a sum-of-the-parts story...\*

**Shareholder:** Do you see Liberty Media as a sum-of-the-parts story? And if so, why do the parts seem to be declining so rapidly?

**Weitz:** [Weitz and Lawson have a good laugh.] Well, it's convenient to talk about Liberty Media as a sum-of-the-parts story because there are lots and lots of parts — and some of them have public market values — like News Corp. and AOL and so on. So you can put price tags on a lot of the individual parts of their business, add 'em up and get a number. I think it's more than that, though.

I run the risk of telling you more than you're asking for with Liberty because it's a terrific story. Some of the players are controversial. [Its chairman,] John Malone, was called Darth Vader by a vice president once upon a time. And he plays, I think, honestly — but he plays to win, and he plays hard. He built a cable business as one of the pioneers [in that industry] and used the large number of subscribers as a way to develop cable programming.

And he ended up owning parts of dozens and dozens of cable programming companies, some of the more prominent of which are things like Discovery Communications and so on. In that sense, there's more to Liberty than just isolated things with no relationship to each other.

Malone is reverting to a tried-and-true strategy.

**Weitz:** Malone's also an operator. And after selling the cable properties in the U.S., he's been working on reconstituting cable properties in Europe.... And he's been helping refinance some overleveraged cable operators in other parts of Europe — and probably will end up being the biggest cable operator in Europe.

So it may be more analogous to a Berkshire Hathaway where there's lots and lots of individual parts, but where they can work together and be more valuable because of their cooperation.

(continued in next column)

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But it's easy to lose sight of the forest for the trees.

**Weitz:** We believe as a collection of businesses that it's worth something around \$20. And that number is growing, we think, at *maybe* a 15% or 20% kind of a composite rate. But if you look at each individual part and say, "Well, gee, News Corp. is down" or "Motorola's down" or "Liberty Digital's down from \$50 to \$3" or something, I think you can lose [sight of] the forest for the trees.

SOMEBODY CAN USUALLY FOOL YOU FOR AWHILE.  
THAT'S ONE REASON WHY CHARACTER'S SO IMPORTANT.

If somebody is trying to fool you, they can do it for awhile.

**Shareholder:** According to articles I've read recently, one of the pending casualties or victims of the aftermath of Enron and the new emphasis on restated earnings is putatively the financial services companies. Do you agree?

**Weitz:** Well, when you talk about financial services, you cover such a huge swath of businesses that it's really hard to generalize. I think when you talk about the fallout of Enron and the accounting... The *purpose* of accounting is to show investors what's really happening. But if somebody is trying to disguise that, they can usually get the job done for some length of time....

But I feel comfortable with our financial services companies.

**Weitz:** Banks like Washington Mutual and Golden State and so on, and insurance companies and mortgage companies — anybody that's doing lending has to make some guesses about the creditworthiness of their borrowers. That's always something that we think about when we buy a financial company. And when you're in a recession, the creditworthiness of any given borrower can deteriorate. But I feel comfortable with *our* companies....

Character's most important. But you can always be fooled.

**Shareholder:** When you look at your companies, do you do your own accounting in essence — or do you go by the published reports from *their* auditors?

**Weitz:** We have to start with the published reports. But you can look at a company and see whether what they're saying seems to fit with what their financial reports show. A company that talks about lots of free cash flow, but has their bank account shrink and their debt go up for the year raises some questions. So you can poke further. But we're not able to try to do independent confirmation of insurance reserves or bank loan loss reserves or that sort of thing.

One of the things that we *try* to figure out in a qualitative way is the character of the people we're dealing with. Ultimately, that's the *most* important thing. But you can always be fooled....

And forensic accounting is not one of our strong points.

**Weitz:** There's a well known hedge fund manager named Jim Chanos [of Kynikos Associates] who sniffed out some of the Enron accounting gimmicks early last year. And he does an *incredible* job of what you might call forensic accounting. But that's not our strong point.

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WEITZ FUNDS'  
WALLY WEITZ & RICK LAWSON  
(cont'd from preceding page)

Companies will be facing a big earnings headwind....

**Shareholder:** Do you see a drag on earnings ... that comes from improved accounting practices and the comeuppance of now disclosing the full effect of compensation — whether through options or pension costs and other kinds of things — that maybe those companies have benefited from over the recent period?

**Weitz:** [Chuckles.] Absolutely. Both Rick and I have commented off and on over the last several years about the quality of earnings and the fact that options are not really counted as being an expense to a company even though they can be very dilutive. And pension return assumptions have padded earnings in the past — and that padding goes away in a falling market. There are all sorts of questions that really are not about integrity in the same way that Enron is, but that may subject ordinary, mortal companies that are trying to play more or less fair to a big earnings headwind. And I think that is a problem — and that it'll be a problem going forward.

So we may find that our ideas of normalized earnings levels for individual companies and for the indices like the S&P might have been a little inflated.

Change in goodwill amortization treatment will offset some.

**Lawson:** On the other hand, we have always focused on *cash* earnings — because it's the cash flow companies generate and have available to spend on new things or pay out to shareholders that is most important to us over time.

There is a change in accounting that will affect most companies this year — and that is goodwill amortization is generally going to go away. And to the extent that a company had a big gap between cash earnings and reported earnings as a result of large goodwill amortization charges, that's going to begin to show up on the reported financials, whereas it wasn't showing up previously.

I'm not sure in the long term whether that will be a good thing or a bad thing. But the earnings numbers will suddenly get bigger in some cases.

**Weitz:** Yeah. It shouldn't make a *bit* of difference. But strangely enough, a lot of Wall Street might disagree. If a bank earned \$1.00 after goodwill amortization of 25¢ last year, because of the change in the accounting for goodwill, it'll report \$1.25 this year — and the stock might

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go up 25%. That makes no sense. But maybe that'll be a positive offset to those other things that I was talking about.

[Editor's note: Mario Gabelli suggests that the change in accounting for goodwill will encourage M&A activity because many deals will no longer result in lower earnings. (See our December 24, 2001 edition.)]

WEITZ PARTNERS VALUE FUND  
SHAREHOLDER LETTER — APRIL 2, 2002

QWEST AND ADELPHIA. ARE THEY MISTAKES  
OR JUST IDEAS THAT HAVEN'T WORKED YET?

Major issues have involved accounting and mgn't integrity.

**Wally Weitz:** ...The major issues for the stock market in the quarter revolved around accounting and management integrity. Enron is (so far) the most dramatic case. But dozens of companies have faced questions of whether publicly reported income statements and balance sheets give an accurate picture of the companies' performance and financial health. Two of our companies, Qwest and Adelphia Communications, have been among those questioned, and between them cost our Fund about 3 percentage points of performance in the quarter.

Averaging down has been a double-edged sword...

**Weitz:** Our last letter discussed "averaging down," or buying more shares of a stock that goes down after we first buy it. This tactic has generally worked well for us over the years (with certain unfortunate exceptions). It has worked in our favor, and has considerably enhanced our performance, in cases where the fundamental value of the company was sound, but misunderstood, and where other investors eventually recognized that value and bid the shares up. Averaging down has also compounded investment mistakes in which we were wrong about underlying value, or where value deteriorated.

The jury is still out on Qwest and Adelphia.

**Weitz:** The jury is still out on whether Qwest and Adelphia will turn out to be profitable investments. But we thought it might be helpful to give brief summaries of where we stand on these two stocks at quarter-end. It is very important that shareholders understand that there are many unknowns in each situation, that what we know about the facts of each situation changes daily, if not hourly, and that by the time you read this, we may have bought more shares or sold them all.

QWEST'S STOCK HAS SUFFERED A SHARP DECLINE,  
BUT WE STILL THINK IT'S WORTH MUCH MORE.

Qwest swallowed a whale. That's the good news...

**Weitz:** Qwest is the product of grafting a huge regional bell operating company, or RBOC (US WEST), onto a small, entrepreneurial, competitive long distance telephone company (Qwest "Classic"). One commentator

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**WEITZ FUNDS'**  
**WALLY WEITZ & RICK LAWSON**  
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likened it to a trout swallowing a whale. This feat was possible because in the midst of the internet-related technology stock "bubble," Classic Qwest, as a provider of "broadband connectivity," sold at an outrageously high price and the company used its overvalued stock as currency to buy the RBOC — a move that probably saved Qwest from the fate of many other telecom upstarts.

The inevitable culture clash was exacerbated by the personalities involved. And a severe recession/depression in the telecom industry led to weak operating results and lots of finger pointing.

"Post-Enron" era sensitivity led to strong negative reaction.

**Weitz:** The integrity issue arose when investors began to question its accounting for sales of network capacity to other telecoms. Qwest claims it (appropriately) followed the guidance of its auditors, while critics claimed that regardless of the letter of accounting rules, the company violated the spirit of the rules by allowing investors to misinterpret the quality and repeatability of the resulting reported revenues and cash flows.

"Post-Enron" era sensitivity led to a strong negative reaction by investors, a sharp decline in its stock price, and eventually, questions about its ability to service its debt.

We believe it's worth considerably more than \$8 per share.

**Weitz:** We began doing research on Qwest after it had fallen from \$65 to the mid-30's. When the stock fell to \$20, we decided that the basic business was sound and that the fears and criticisms were overblown, and we began to buy. We bought more shares on the way down, including some under \$7 — and our average cost is now around \$12.

We may never know whether management intentionally misled investors during the tech stock mania. We hope not. But our take is that the company is sound and that it is worth considerably more than \$8 per share. It will take at least several quarters to prove to investors that revenues and cash flows can improve and that legal and financial issues are manageable. However, at this time, we believe the investment will eventually be profitable for the Fund.

IN THE CASE OF ADELPHIA, THE JURY IS STILL OUT.  
 WITHOUT INTEGRITY, NO DISCOUNT IS BIG ENOUGH.

Adelphia — serious conflict of interest issues.

**Weitz:** Adelphia Communications is a more troublesome situation. We have owned Adelphia for many years. In the past, it's been a very profitable investment for us. The Rigas family controls the company. And while they've generally been unresponsive to shareholder suggestions and requests for information, we had considered them competent and honest managers.

It's been disclosed recently, however, that the family owned cable systems and Adelphia securities through private partnerships and that the partnerships had "co-borrowed" with the company, presumably to finance cable systems in which the company had an economic interest. Recent disclosures also appear to indicate that the company has,

in effect, guaranteed loans to the family partnerships for investments that give the family the upside potential while leaving the company exposed to the downside risk.

If true, it raises serious conflict of interest issues.

Without integrity, no margin of safety can be big enough.

**Weitz:** Our dilemma is that we do not know all the facts and that the stock price is well below the underlying asset values as we currently measure them. However, without management integrity, no "margin of safety" can be big enough.

For the moment, we are holding our position, believing that the risk/reward trade-off is in our favor. Our exposure at the end of the quarter was 1.5% of the portfolio, and is smaller now. This is the type of situation we try very hard to avoid.

**WE'RE FINDING OPPORTUNITIES IN CABLE STOCKS.  
 ON THE OTHER HAND, TRAVEL-RELATED STOCKS...**

The remainder of the portfolio did fine...

**Weitz:** The good news is that the other 48 stocks in the Fund, along with cash and short-term securities equal to about 23% of the portfolio, added 3+% to our results in the quarter. Financial Services stocks — banks, mortgage, and insurance companies — enjoyed positive conditions. Interest rates remained low and the "spread" between the cost of funds and yields on assets remained relatively wide. Credit quality problems were not an issue. The main factor keeping financial stock prices subdued was the fear that interest rates have probably bottomed for this cycle.

In cable, babies have been thrown out with the bathwater.

**Weitz:** Media companies enjoyed an improving advertising environment, but the cable stocks were generally weak. There were concerns that cable company growth rates, while still very strong, might be slowing, and there was some late-quarter fallout from Adelphia's woes. We believe that Comcast, Insight, and Charter have very good prospects and managements we trust, and we added to each of them.

Travel-related stocks may be ahead of themselves.

**Weitz:** Travel-related stocks were very strong. Hilton, Host Marriott, and Park Place Entertainment are all top ten positions and each was up sharply during the quarter. These stocks offer a positive case for averaging down, as we bought heavily amid the panic selling in the weeks following September 11.

This group has attracted buying interest because they're showing good earnings "momentum" off a very low base. We like the businesses and think they have good long-term prospects, but because of investor excitement over their recovery, the stocks may be ahead of themselves.

Other of our telecom stocks were greater or lesser laggards.

**Weitz:** Finally, individual sectors of the telecommunications industry turned in very different performances. Wireless companies such as AT&T Wireless and Centennial, in which we have small positions, were generally weak as competition intensified and expected takeover activity did not materialize. Strong, well-financed companies such as Citizens and TDS held up better, but

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WEITZ FUNDS'  
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were mild drags on performance.

DOWNWARD REVALUATION MAY HAVE FURTHER TO RUN,  
BUT WE THINK OUR STOCKS WILL SERVE US WELL.

Downward revaluation may well have further to run.

**Weitz:** We appear to be entering the 3rd year of a general stock market revaluation. As we have discussed in previous letters, a 25-year bull market (roughly 1975-1999) bred considerable enthusiasm for stocks and led to historically high levels of valuation. Deflation of the technology/telecom bubble, a slowdown in many other parts of the economy, and now questions about whether earnings ever were what they appeared to be for many major corporations are causing investors to rethink the prices they're willing to pay for stocks.

To the extent that valuations (the P/E) got too high and earnings (the E) are lower than expected, this revaluation process may well have further to run.

Owning good companies will be more important than ever.

**Weitz:** If this is true, it is not a tragedy and it does not mean that investors should give up on stock investing. It does mean that without the "tailwind" of a bull market, it will be more important than ever to own good companies and to avoid overpaying for them.

We will need patience to stay out of trouble while we wait for the occasional great opportunity. I feel good about our portfolio, and in spite of a few (hopefully temporary) bad actors, I believe our stocks will serve us well over the next several years.

When Weitz was telling us about "Qwest Classic" — Qwest's fiber optic network business — he suggested that if we wanted additional background on that industry that we should speak with Rick Lawson given his familiarity with Level 3. So as soon as time allowed, we did. And we're very pleased to bring you some of what he had to say.

But before we do, here's some background on the company from which Level 3 was spawned — Peter Kiewit and Sons. From its website: "As a result of Peter Kiewit Sons' success in its construction and mining operations, Walter Scott, Jr. looked for related businesses in which to invest the company's excess capital throughout the 1980's and early '90s. This led, in 1992, to the separation of the construction and diversified businesses. The diversified investments, in everything from high-speed fiber optic networks to public/private toll roads to geothermal power plants, garnered superior returns for the company's shareholders, prompting Barron's magazine to pronounce Scott 'one of the shrewdest investors around'.

"When the businesses were separated in 1992, Kiewit's Construction Group retained the Peter Kiewit Sons' name and Ken Stinson was appointed President. He

was named Chairman and CEO in 1993. Walter Scott, Jr. remains on the Kiewit board as Chairman Emeritus."

Meanwhile, Scott continued to serve as the chairman of Kiewit Diversified — a role in which he continues to serve today in its successor company, Level 3.

As regards the genesis of Level 3, an April 19, 1999 article in *The Daily Camera* begins by quoting Level 3 Chairman and CEO James Crowe: "In the later part of 1995, [Kiewit Diversified] chairman Walter Scott, Jr. was at some kind of function with Bill Gates and Warren Buffett. Gates was talking to Scott about the fact that he viewed the Internet as something historic, a real shift.... He told Walter, 'I think this is going to change the nature of communications.'"

From that same article: "Scott took notice. He relayed the insights to Crowe, who at the time oversaw another Kiewit venture, Metropolitan Fiber Systems (MFS), which had built local telephone networks in dozens of cities. After some research, the two discovered that Internet technology, namely Internet Protocol (IP) could become a more efficient, less expensive means of transmitting data — even voice and video."

A January 26, 1999 article in *USA Today* describes that moment as follows: "Crowe's epiphany came when he flipped through an industry newsletter and saw a chart from consulting firm North River Ventures titled, 'Cost to Deliver 42 Page Document.' Faxing it from New York to Tokyo using AT&T cost \$28.83. E-mailing it over the Internet cost 9.5¢. 'That's when I realized this was not driven by cool people on the cover of *Newsweek*,' Crowe says. 'It was driven by economics. When we figured it boiled down to bucks, all of us took notice.'"

Having already built MFS into the largest competitive local exchange carrier and an industry power, he reportedly proceeded to act on his insights by first getting into the internet service provider business in a big way by buying UUNet (for common stock and options) and then selling the combined company to WorldCom in 1996 for \$14.3 billion.

Then, after briefly serving as WorldCom's chairman, Crowe took \$3 billion in cash and assets from Kiewit as seed money, raised an additional \$11 billion by issuing both common stock and debt, and began to pursue his and Scott's vision for the Level 3 network — some of which you'll find laid out by Lawson in the pages which follow. (For additional background on Level 3, see our feature on Level 3's James Crowe et al beginning on page 1.)

We hope that you find Lawson's comments and the Level 3 story as intriguing as we do.

LEVEL 3 DOESN'T HAVE QWEST'S FOOTING.  
AND IT HAS AN UNPROVEN STRATEGY.

**OID:** In his discussion of Qwest, Wally suggested that we should speak with you about that industry and, perhaps, Level 3.

**Rick Lawson:** I'd be happy to. Level 3 is clearly

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RICK LAWSON  
(cont'd from preceding page)

controversial. And if you ask me, "What could go wrong?" and "How low can it go?", the answer's gotta be that a *lot* can go wrong. It could go to zero. That said, I still think it's pretty interesting.

**OID: Agreed on all counts.**

**Lawson:** But I'm getting ahead of myself. The basic business of Level 3 and Qwest is to transport bits of data around the country and the world. At a simplistic level, they do it by building a network or patching one together through some combination of building it and buying it or leasing capacity from others.

However, there are three main differences between Qwest and Level 3. First, obviously, by buying US WEST, Qwest has an existing business that's pretty stable, that's been around forever, that'll be around for a long time, that generates revenue and cash flow today and provides a baseline of activity that you know is there regardless.

**OID: Solid financial funding.**

**Lawson:** That's right. It provides Qwest with a base of funding. Whether it's everything you need and whether it solves all the problems that might come up, I'm not willing to say. But it's something that Level 3 doesn't have. And it's a big help.

**OID: And it gives them the best footing in the industry — talk about everything being relative...**

**Lawson:** Yes. The other major difference is in what I'll call how each company is selling. In the case of Qwest, their basic strategy is to go to the ultimate customers — the big companies that have communications needs — and sell directly to those end users.

By and large, Level 3 is a *wholesaler*. It's more likely to sell to a communications company like AT&T Wireless that then in turn sells its services to *other* customers — both consumer and business customers.

**OID: Which again sounds like an advantage for Qwest.**

**Lawson:** Well, I'm not convinced. That's a point about which reasonable people might differ.

**OID: The reason why I say that is the relative bargaining power of the parties they do business with.**

**Lawson:** That's true. But the question with Qwest is what it takes to sell those big, sophisticated businesses and whether existing competitors like AT&T and Worldcom and the integrators like IBM are in a better position to sell to the end customer — because it's a complicated sell and you need a lot of different kinds of capabilities. And maybe Qwest doesn't have all those capabilities yet. I'm not saying that I know the answer. It's just not clear to me whether or not that's going to be a successful strategy.

**OID: Gotcha.**

**Lawson:** At Level 3, there are real serious questions about whether their strategy will work. However, in theory, at least, their strategy says, "Let's try to sell to wholesalers — to the guys who in turn sell to these big businesses.

And what we need to do to be successful there is to have the best, lowest cost, most sophisticated network. And if we have that, that's all we need to provide. The intermediaries can provide all the other stuff — the software, the services and the sophisticated sales force — that as a new upstart we haven't had a chance to develop. And we don't want to get involved in all of that anyway."

**OID: They'll let others handle the "last mile".**

**Lawson:** That's right. In theory, at least, I think their strategy sounds pretty good under certain circumstances. My concern is whether Level 3 can really talk the big guys into buying its services quickly enough — or whether potential customers have such a strong institutional bias towards doing it themselves that nothing else matters.

**OID: Like flexibility or economics.**

**Lawson:** Exactly.

QWEST'S ROOTS DATE BACK TO THE 1800s.  
LEVEL 3 WAS DESIGNED FROM THE GROUND UP.

**Lawson:** This is a business that's changed very rapidly over the last few years due almost entirely to changes in technology. Back when MCI first started sending voice communications around the country, they used microwave towers to transport information. But these days, everything new is being done on fiber.

And there are various improvements that take place in fiber all the time and various ways to try to make the fiber as useful as possible. But the basic idea is to have a network, put fiber in the ground and put the appropriate equipment at various points on the fiber. And it's that combination of fiber, equipment and support infrastructure that gives them the capability to deliver data.

**OID: And that's what Level 3 and Qwest have done. They both have fiber optic networks...**

**Lawson:** They're both fiber-optic based. So it sounds at first blush like they're pretty similar. But I think both companies would tell you that although they *sound* similar on the surface, there really are a lot of subtleties of exactly how you go about getting prepared to offer these services. And those subtleties add up to pretty big differences in capabilities and cost structures of the resulting network.

For example, Level 3 would argue that it has been very careful in how it's built its network to make it easily upgradeable and inexpensive to add new capacity incrementally when there's more demand. And they would say that as a result, they are able to add new capacity much more cheaply than their competitors can.

**OID: Do you believe that's true?**

**Lawson:** The logic they use to justify that position makes sense to me — at least at the level at which I'm able to understand it. But I'm not a fiber optics engineer. And I haven't visited all their sites and thought deep thoughts about how they've done it all. So I can't prove it.

**OID: But I imagine the fact that Level 3's chairman is Walter Scott, Jr. — chairman emeritus of Peter Kiewit Sons and a Berkshire Hathaway director and that its**

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RICK LAWSON  
(cont'd from preceding page)

**network was built by Kiewit Construction probably gives you some added confidence.**

**Lawson:** Throughout everything that we think about Level 3, the players involved are critical to the judging of the thought process as to how much we believe and how much we don't. Walter Scott, Jr. is definitely a money maker — and has unquestioned integrity. So yes, his involvement is very helpful. And the way they talk about how they've made their decisions and how they've endeavored to get the capability they have gives me some comfort that they did put a lot of thought into it.

Another distinction I might make — and this might not be fair to Qwest, but I don't think it's *totally* unrealistic — is that one of the key assets that Qwest started life with was railroad rights-of-way. Phil Anschutz, who was the driving force behind Qwest, owned a big Western railroad [Santa Fe Southern Pacific] from which he made a lot of money. In effect, he wound up selling the railroad and keeping the rights-of-way.

**OID: And your point?**

**Lawson:** I can't give you rhyme and verse. But what the builders of Qwest's network were doing was working off of railroad rights-of-way. So they probably had a tendency to say, "Hey, we have the rights-of-way. So let's use them."

**OID: Interesting.**

**Lawson:** By contrast, Level 3 started from the perspective of, "Let's think about how to create a network so that it will be in the right place for a long time. And if it means taking a little more time and energy and cost to get all the pieces of rights-of-way where we want them, so be it — because in the long run, that will position us better."

**OID: How can that be so? In an old annual report, Level 3 says that at least 7,800 miles of its network in the United States west of the Mississippi was laid on old railroad rights-of-way.**

**Lawson:** I don't mean to imply that using railroad rights-of-way is a bad thing per se. It's just that *exclusively* using railroad rights-of-way is what concerns me. When you're going however many miles it is, say 500 miles, between Denver and Omaha, on a lot of those miles, you don't really *care* where you are — because you're not that close to where a customer wants to connect to you. But as you get closer to the cities, you want to make sure that you're going to the points that matter most.

So the fact that people use railroad rights-of-way makes sense to me. It's just not a good idea to *exclusively* use it because that was the easiest thing to do.

**OID: But doesn't that also mean that anyone who uses railroad track for their rights-of-way isn't going to be as efficient in terms of how far apart their electronics will have to be, etc.?**

**Lawson:** That's right. But I don't think that they're less efficient just because they used railroad rights-of-way. They're less efficient because they allowed the location of the railroad rights-of-way to dictate where they go.

**OID: But doesn't that bring into question exactly how cost effective upgrading Level 3's network will be on that 7,800 miles?**

**Lawson:** I don't think so — for two reasons: First, when you get closer to cities and you're trying to finish out the architecture, you want to have the flexibility to leave the railroad path when that's appropriate. And it's my impression that Level 3 was more thoughtful about how they did that than other folks were.

If you're going from Los Angeles to Salt Lake City, most of that path is empty nothing. Therefore, as long as the railroad line is sufficiently straight, a network using it for the vast *majority* of the miles makes perfect sense.

So once again, I get a very different sense of how the networks were built and how the respective managements of these companies thought about upgradeability and the long-term marginal cost of adding capacity. At Level 3, they thought, "This is a business where in the long run, you've got to be the low-cost player all the time."

**OID: And it changes quickly.**

**Lawson:** It changes quickly. Therefore, you have to be able to change with a changing environment. So when you ask the Level 3 folks, "What's your cost position relative to the various players in the industry?" — and you start by saying, "Where are you versus the incumbents, the AT&Ts, Worldcoms and Sprints of the world that have long, well established networks?" — their answer is, "Compared to those guys, there really *is* no comparison. Our cost structure is so much better that those guys are no longer really in the game. For the kinds of high-speed, high-bandwidth applications we sell, they *can't* compete."

**OID: Wow.**

**Lawson:** If you then go to the next level and ask, "Where are you versus your emerging competitors — companies like Qwest, Broadwing, Global Crossing and Williams Communications?" — their answer would be, "Well, they're a lot closer. But we think our marginal cost to add new capacity is only something around *half* that of our *next* best competitor. In other words, it would cost it twice as much to add capacity. And it would cost some of our other competitors three to four times as much."

**OID: Whew! Talk about a dramatic difference.**

**Lawson:** And I really, really struggle with how much I'm willing to accept that statement as truth — because if that's really true, it's *very* dramatic.

**OID: Almost staggering, actually. And there again, frankly, absent the involvement of Walter Scott, Jr., I might not believe it.**

**Lawson:** True, but it wasn't Scott who made that statement to me. In any case, it's a very difficult statement for me to independently confirm. However, at least in my mind, it's a key issue in how you think about all of the emerging guys versus the incumbents.

[Editor's note: If Lawson's been bamboozled, he's hardly alone. Here's a quote taken from page 9 of Level 3's 3rd Quarter 2001 Investor Fact Sheet: "On April 3, 2000, the Smithsonian [Institution] cited Level 3 for its historic contribution to the communications industry and inducted

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(cont'd from preceding page)

the company into its permanent collection as a 'Computerworld Smithsonian Laureate'."

The award cited Level 3 for creating a new kind of network infrastructure with the potential to change communications at a fundamental level. Level 3 was cited for creating, "The world's first upgradeable, international fiber optic network to be completely optimized for Internet Protocol technology, helping to stimulate the biggest change in communications technology in 100 years."]

LEVEL 3 HAS A SUPERIOR ARCHITECTURE —  
WHICH GIVES IT SUPERIOR COSTS AND MARGINS.

**OID: Assuming for now that what they say is correct, how has Level 3 created such a dramatic difference in cost and upgradeability between its network and everyone else's?**

**Lawson:** If you were to ask Level 3 that question, they would say, "If you want to upgrade your network, you're going to have to put new pieces of equipment into the network every so often." And depending on how you've constructed the network and what its architecture is, there can be pretty big differences in what is meant by "every so often" — in other words, in how frequently you have to put that equipment in.

You're going to have to install expensive equipment every so many miles. However, depending on how you design the network architecture, the distance between the installations can vary a lot. There's a theoretical maximum distance between installations using current technology. But if you've constructed the network in an inefficient way — if it's not a nice smooth loop, if there are lots of spurs...

[Editor's note: According to comments made during Level 3's Third Annual Investor and Analyst Conference on January 29th, 2001, the current state-of-the-art is about 600 kilometers between electronics — with the next generation expected to approach 1,800 kilometers.]

**Lawson:** In other words, let's say that you want to serve Omaha and Lincoln. Well, if your network goes close to both of them, but not through the center of either, you might need a spur that goes out from your network into Omaha and a spur that goes out from your network into Lincoln. And at that point where the spur goes out, you're likely to need an extra piece of equipment.

So if you have an architecture that has lots of spurs, you'll need lots more pieces of equipment — even though in theory, you wouldn't need it because you don't need to go that far. That's how it's been explained to me.

**OID: And Level 3's network is much more efficient?**

**Lawson:** They claim their network is much smoother and much more efficient because of its architecture. So they can get much closer to the theoretical maximum distance between their installations of equipment and therefore they require far fewer pieces of new equipment for their upgrades. And that creates an enormous difference between their cost of incremental capacity and that of their competitors.

Level 3 will tell you that for every incremental dollar of revenue they add, they need to add between 25¢ and 50¢ of new capital. And at the moment, they're generating gross margins that are greater than 60% — and improving.

[Editor's note: In their 4th quarter conference call, CFO Sureel Choksi said that the company's gross margins had grown to about 70% at the end of 2001 — and that they thought they could get them up to the mid-70s in 2002 and they would trend up to about 80% over the long term.]

**OID: Wow.**

**Lawson:** I'm sure there are other incremental costs. But some of the SG&A is relatively fixed. However, even if you assume on the increment that they're flowing through only 40% of revenue into cash flow, the incremental return on new capital spent is very high.

In other words, for 40¢ of incremental cash flow, it might cost you 25-50¢ of incremental capital. And assuming that the capital has more than a year of life — which seems like a safe assumption to me — you get quite a bit of cash flow relative to that cap-ex.

**OID: I'm going to have to mull all of that over. Might you hold on while I call my broker?**

**Lawson:** Exactly. I don't know what those numbers are for Qwest. I don't think they provide those figures quite as explicitly or talk about 'em. And I don't know what others estimate those numbers to be for them.

**OID: Getting back to Level 3, the great part about those dynamics — assuming they're accurate — is that it helps to answer some questions about funding.**

**Lawson:** That's right. And that's really the crux of the matter in how I can be interested in the stock right now. Its network is basically built.

[Editor's note: Level 3 representatives say they do continue to make add-on type additions to their network when they perceive near-term, high return opportunities.]

**Lawson:** There's an ongoing nut of SG&A that they're spending. There's an ongoing nut of maintenance cap-ex that has to be spent. But if you believe that this is a growth business and that Level 3 is in a position to capture some of that growth, incremental profitability is very high. And you don't have to make very heroic assumptions about future growth to get to some very big numbers.

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THERE'S A BIG MISCONCEPTION OUT THERE.  
THERE'S NOT SO MUCH OVERCAPACITY.

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**OID: You can help me stop hyperventilating by talking about the apparent state of glut in Level 3's industry — about the huge overhang of capacity from the internet bubble.**

**Lawson:** That's another topic that's very controversial — at least in the short run.

**OID: Super.**

**Lawson:** I think that you're absolutely right — that there is a belief that there is a large amount of overcapacity

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RICK LAWSON  
(cont'd from preceding page)

just sitting out there today.

**OID: And there's not?**

**Lawson:** It's hard to measure how much overcapacity there truly is. It's hard to get hard and fast numbers on capacity utilization. When you're dealing with manufacturing widgets, you can go look at the factory and see how big it is, measure the floor space and estimate just how many widgets they might be able to make and how many they're actually making. The math's a lot simpler. However, in Level 3's business, for a whole host of reasons, it's just very hard to get a good answer.

But there are a couple of sort of obvious comments you could make that put some dimensions on whether or not we're likely to have a lot of excess capacity sitting here. The first comment that's very obvious and very true is that an awful lot of money's been spent building capacity over the last few years. There have been lots of new competitors — and they've been using much better technology. So there's no question that quite a bit of capacity's been built. And I think that just in and of itself scares people.

The second comment I would make is that there have been some outside observers who have tried to look hard at how much demand there is on routes between various cities and how much supply there is in order to try to get a sense of whether we have way too much supply or not.

**OID: Don't leave us in suspense...**

**Lawson:** And the conclusion has more often than not been that there are certainly *some* routes that have lots of overcapacity. However, in more places, it looks like there really *isn't* that much overcapacity — and we're getting close to the time when more capacity will be needed.

**OID: Really!?**

**Lawson:** Yeah.

**OID: If that's indeed true, that would suggest that there's quite a misperception out there.**

**Lawson:** Agreed. The other anecdotal comment that I'd make is that if those observers and I are wrong and there is lots of excess capacity sitting around, you'd think that you could go to any supplier and that they'd be able to sell you capacity and get you started tomorrow. Yet the reality seems to be that, by and large, that's not true. If you want capacity today, there's still a very long lead time. You can't just turn it up immediately.

**OID: Really!?**

**Lawson:** Really. And one more thing. What is the goal of these companies? How would they have built their own networks? First, if you're a company in the process of laying down fiber and building a network in the first place, you have an incentive to put a lot of fiber in the ground because that part of the network is relatively cheap. The cost of the fiber is a very small fraction of the total capital cost to provide the service. The fiber — the fiberglass — represents less than 5% of the all-in cost of a lit network.

**OID: Wow.**

**Lawson:** Therefore, the economics would suggest that if you're going to the trouble of putting a bunch of stuff in the ground, then it's really not that much additional money to put extra fiber in the ground at the beginning — which is why there's been so much extra fiber capacity available.

But you don't actually have service until you put all of the electronics around it. That's what costs the bulk of the money. Therefore, you're very unlikely to immediately light every fiber you have. That costs too much. And economically, it doesn't make any sense.

**OID: And I believe that I know what you mean. However, by "lighting" the fiber, you mean...**

**Lawson:** The industry uses the terms "dark fiber" and "lit fiber". Dark fiber is fiber that has been placed in the ground, but that doesn't have any electronics attached to it. So it's useless from a communications standpoint. It's sort of latent capacity. Dark fiber *can* be turned into communications capacity, but it takes more investment and work to get it there. It takes installing all of the equipment at all of the necessary points in order to turn it into a service — which takes time and money, basically.

Lit fiber is dark fiber where all of that stuff has already been done — and you can sell it as a service. So the incentive is to light enough fiber to get started, but wait until there's more demand before spending money on equipment that's not absolutely required today.

**OID: The remaining 95%. That sounds logical.**

**Lawson:** And the industry's not exactly flush with capital today. But even two years ago, when the area *was* a darling of Wall Street and people were throwing money at it, companies would spend the money lighting the *first* fiber. But it wouldn't do them any good to light the second and third one. After all, what would they *do* with it?

**OID: Have an underground light show?**

**Lawson:** That's about it. They'd light the first one and start selling. And only when they'd mostly sold out that one or when it was clear that it would be mostly sold shortly would they go back into the ground and light more. But they wouldn't do it until then.

**OID: Makes sense.**

**Lawson:** So there may be a helluva lot of excess fiber, but there's not a whole lot of excess *lit* capacity. And since lighting it accounts for more than 95% of its total cost, there's not as much excess capacity as people think.

AND EVEN IF I AM WRONG,  
I WON'T BE FOR LONG.

**Lawson:** And finally, there's another related dynamic which I think serves to fill out the whole story — which is the speed at which demand is growing.

**OID: Doesn't George Gilder say technological progress will always be limited by one of three constraints — processing power, software or bandwidth?**

**Lawson:** Yes. And his argument has been for the last 15-20 years that two of those have been improving rapidly

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RICK LAWSON  
(cont'd from preceding page)

and sort of driving each other — the processing power and the software — while bandwidth has been left behind. And that's partly a function of regulatory structure and partly a function of when the technology was really ready to explode. And now it's bandwidth's time. It really is becoming the long-neglected leg of the stool that is finally developing most fully.

**OID:** *And doesn't Gilder suggest that whichever of the three is (are) most abundant will rapidly be used up until the other(s) become the limiting resource(s)?*

**Lawson:** Correct. This is all pretty theoretical stuff. But I don't think it's meaningless in thinking about [laughs] whether you should expect fiber optic capacity to grow and whether if you have a low cost position, that will prove to be valuable.

**OID:** *And confirming whether or not existing capacity is likely to be used up and how quickly.*

**Lawson:** That's right. Incidentally, when I speak of demand, I'm talking about it from the perspective of "bits" — how much information or data gets moved around, not revenue. It's important to be clear on that point.

**OID:** *Yeah. Because as Wally pointed out to us, prices have been rapidly declining at the same time.*

**Lawson:** That's right. And both of those things are happening. But if you do have the number of bits that are being moved growing a lot — and by a lot, I mean in the late 1990s something well north of 100% a year... Even now (again, this is a controversial number) I can't find estimates that are less than, say, 50% a year — which, obviously, is still pretty quick.

**OID:** *That sounds very quick. And presumably, that's in the U.S.*

**Lawson:** That's right. I think worldwide demand is growing even faster, but let's not even go there.

**OID:** *You're no fun.*

**Lawson:** But if you're a single competitor in the business and you were to look at your network and see that you were at, say, 20% of capacity today, you wouldn't build anything new. You'd sell your existing capacity.

But most people tell me that up around 60% of capacity, you'd get pretty nervous because demand spikes up and down — and you never want to run out of capacity because that'll make your customers unhappy.

**OID:** *Because of slow delivery times, etc.*

**Lawson:** That's right. And when I say 60%, I mean 60% of useable capacity — which is equivalent to 30% of total capacity — because these companies must have significant redundancy. So near 60% of useable capacity, they get pretty nervous. And I think that every competitor is probably thinking in a similar kind of way.

[Editor's note: Using today's (Sonet Ring) architecture, a network provider utilizing x% of its total network capacity must set aside an additional x% of its total capacity in case

there are problems in its existing lines. Therefore, when he mentions a figure for capacity utilization, unless he specifies useable capacity, simply divide by 2 to convert into the equivalent total physical capacity.]

The next generation (Mesh) architecture will change that equation. The ratio of useable capacity to total capacity is expected to go from about 50% to around 33%.]

**Lawson:** So if the industry was operating at 30% of useable capacity at the worst of the tech/telecom bubble, but demand is growing 50-100% per year, it doesn't take very many years to need new capacity.

**OID:** *It's certainly hard to argue with you there. And that would be true even if capacity utilization had spiked to 20% and then plunged to 10%.*

**Lawson:** You've got it. So if I'm wrong and the industry has more excess capacity than I think, it's really more a question of timing, not need.

**OID:** *You can be overestimating capacity utilization by 100% and still only be off by a year or so.*

**Lawson:** Right. And for the qualitative reasons I was mentioning earlier, it's just hard for me to imagine that I'm that far off. I don't think the industry ever got to that low a capacity utilization — that it ever even got as low as 30%.

**OID:** *Really!?*

**Lawson:** And even if it did, that was two years ago. So we'd still be running out soon. Also, again, anecdotally, that's exactly what I'm hearing today — that we don't have that much excess capacity in many places today.

Now what could make that picture nasty is if I'm right that demand is growing fast, but six hungry competitors — all desperate to sell new services and all willing and able to add capacity at roughly the same cost — decide to sell it at whatever price they can simply to keep growing somewhat, even though it doesn't make economic sense.

**OID:** *Because they'll compete away the price.*

**Lawson:** That's right. The buyers would be happy, but the guys trying to make a living off of this business would all slowly starve to death.

**OID:** *Like the airline industry.*

**Lawson:** Exactly — which brings me back full circle to why Level 3 having a cost advantage is so important. So it's an interesting industry — because demand is growing so fast. It did have excess capacity, we think. However, even if it did, that problem is likely to be going away, and soon, because so little incremental capital is going into the business today. Meanwhile demand is still growing fast.

And because of its past sins, the industry is very much out of favor with the financial community. So that's a combination that sets up...

**OID:** *Explosive demand and relatively static supply...*

**Lawson:** Exactly. And if you can purchase the asset for less than it cost to build and you're going from a time when people hate it to a time they won't hate it as much — and for the right reasons.... Well, I don't know about you, but to me, that's a very interesting combination.

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PRICES ARE DECLINING RAPIDLY, TOO.  
BUT I THINK THAT'S ACTUALLY GOOD NEWS.

**Lawson:** So the historic pattern has been *dramatic* price decreases. But there's another factor involved — which is an underlying industry-wide cost trend similar to that of the computer industry for a long time.

**OID: Huge declines in the cost of components that comprise about 95% of the average network's cost.**

**Lawson:** That's right — because of improvements in fiber optics technology and electronics technology. In the electronics world, that cost-performance trend is referred to as Moore's Law. But there's a similar kind of dynamic going on in the fiber optics world. Some would argue that it's happening even *faster* in the fiber optics world. The companies making this equipment are making great strides all the time. So the cost structure of the industry is on a *very* rapidly declining curve. Therefore, the question becomes, "Are the price declines we see in the data transport business consistent with the underlying declines in cost — or are prices going down faster or slower than those cost declines?"

**OID: And the answer?**

**Lawson:** The baseline is rapid decline in cost. So you can expect that if supply and demand were in equilibrium, you'd get a correspondingly fast decline in prices. So when prices decline by 30-40% per year, is that fast or not?

**OID: That probably depends on whether you're a buyer or a seller.**

**Lawson:** I think it's arguable that it's *not* fast.

**OID: There goes that theory.**

**But what you're saying is everything's relative.**

**Lawson:** Exactly. The underlying cost structure is declining so rapidly that it's actually showing an *expansion* of margins — which suggests the industry's pretty healthy.

**OID: I'll bet that you're a view-the-glass-as-half-full kind of guy.**

**Lawson:** Level 3 talks about all of this very explicitly from this perspective. They're a believer that demand is

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price elastic — another term that we all learned in our economics classes.

**OID: And that Wally retaught me recently.**

**Lawson:** So if demand is sufficiently elastic and prices are declining, by definition, demand will grow faster than the decline in price — and revenue will increase. Therefore, the question from a theoretical perspective becomes, "Is this the kind of industry and situation where it makes sense that demand would be very elastic?"

**OID: And the answer?**

**Lawson:** My answer to that question is yes — particularly if what we're really talking about is data as opposed to voice. Think about it. If the cost of calling between New York and Omaha is dropping 40% per year, I'm not sure that you and I would talk 40% more every year.

**OID: You can always hope.**

**Lawson:** [Laughs.] There's just so much to say. And we'd run out of hours in the day.

**OID: And have to expand beyond 64 pages.**

**Lawson:** Early in the development of long distance, it might have been different — because it was so expensive that nobody actually talked very long. If you were making a long distance call, you had your little timer out. You worried about whether it was a 3-minute call. And as soon as it was almost three minutes, you hung up.

**OID: And that really wasn't all that long ago.**

**Lawson:** It *wasn't* that long ago. But I think we're rapidly reaching the point where most of us don't even *think* about the price of making a phone call. We just *do* it. Once you reach a certain point, a lower price just isn't going to have as much of an impact on long distance usage.

AS THE PRICE OF SENDING DATA DROPS,  
USAGE WILL INCREASE EXPLOSIVELY.

**Lawson:** On the other hand, the real business of Level 3 and the force driving all this extra demand is the transport of *data*. And I could give you a long dissertation on why we haven't come *close* to finishing *that* trend.

**OID: How about a short dissertation?**

**Lawson:** I can try. Let me give you a little example. Today, I get 100 e-mails a day — at least. And most of them have big attachments. So a lot of data comes to me via an e-mail format. And most of that data is somebody's research report that used to all come in a printed version.

It's the same information whether I get it via e-mail or whether I get it as hard copy. However, when the price of sending that data over the internet dropped enough, it made perfect sense to switch from doing it in the real world to doing it electronically.

**OID: Or in the jargon, to go from "snail mail" to e-mail.**

**Lawson:** You've got it. So that switch is coming along and we're still working on it. However, there are a lot of other switches that haven't happened yet. But they will. For example, if you want to see a movie, you're still likely

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to go to your local Blockbuster store and rent the movie — which means that somebody makes the tape in a factory in Mexico, sends it the hard way in a truck to the store where they have to keep it in inventory just waiting for you to drive there to get it...

**OID: And back — dragging along two tons of metal just for good measure.**

**Lawson:** Exactly. But if it were cheap enough to send the data over the internet, all of those steps would be, in effect, useless. So it would make much more sense for you to get the movie electronically.

**OID: So-called video on demand — which is one of the reasons why you guys like the cable business so much.**

**Lawson:** That's right. And that's a switch that's hardly even begun. However, that's going to happen as the speed at which you get that data increases and the price of sending the data that way drops.

**OID: I don't think there's any doubt about it.**

**Lawson:** And there are also things like video phones and people sending music and videos around, etc. There are all kinds of different applications that will be adopted at various rates by different groups of people. But they're all going to increase as the cost of sending bits drops.

**OID: You'll get no argument here.**

**Lawson:** It's really just a substitution — doing things electronically instead of doing them physically. Instead of getting on an airplane to go to a meeting, you'll have a teleconference with full motion video that has you looking just as much at a presentation as you would sitting in an audience with 500 other people.

**OID: And if you do go, you'll be wired into the internet en route and back.**

**Lawson:** You've got it. And I think that you have the same demand dynamic going on with small businesses and big businesses using the internet more and in new and different ways.

**OID: In terms of explosive unit demand growth, it seems that demand from cable modem usage alone ought to be explosive.**

**Lawson:** That's right. I just heard some numbers that suggest the number of high-speed, residential subscribers — including DSL and cable modems — is likely to grow along from just over 6-1/2 million at year end 2000 to around 11-1/2 million by year end 2001; to up around 18-1/2 million by year end 2002 and to close to 25 million by year end 2003.

So the number of high-speed residential subscribers has already nearly doubled in the course of the last year. And that number is projected to double again in the course of the next two years.

**OID: And presumably usage per modem will grow, too — as users' friends and associates get cable modems,**

**and websites and applications develop to serve consumers with that greater bandwidth.**

**Lawson:** That's right. As people get used to it, they figure out new things to do with it. And as people realize that there are new things to do with it, they develop new applications to take advantage of the new capabilities. So yes, I think usage should grow a lot faster than users.

**OID: Which is no small point. I read an article that suggested that just the volume from people downloading songs from Napster had actually knocked out at least one network temporarily.**

**Lawson:** That's right. When Napster was shut down, it created a temporary slowdown in bit traffic. But all signs seem to suggest we've made it through that valley and that bit traffic is once again at peak levels and growing very rapidly.

So there's a lot of evidence that suggests the use of the internet — the use of bandwidth — is increasing, and that it's increasing very rapidly. People are doing more things with their cable networks. It's much more common for businesses to have a T1 line so that its employees have a faster connection to the internet and can send big files around faster. All of that is happening. And it hasn't stopped happening just because we've had the pricking of the internet bubble and life isn't as easy as it once was.

**OID: Whatever shorts and journalists may be saying — and whatever most investors may be thinking.**

**Lawson:** You've got it.

UNIT DEMAND COULD GROW 1,000-FOLD IN 10 YEARS  
— AND REVENUE MAYBE 20% PER YEAR OR MORE.

**OID: On the other hand, getting a handle on likely revenue growth here seems really tricky — because although you're talking about incredible unit growth...**

**Lawson:** ...prices are declining.

**OID: You read my mind.**

**How rapidly have prices declined historically — something like 30% per year?**

**Lawson:** That's a hard number to really know. Some people would argue that it's been a little higher than that the last year or so.

**OID: And the long-term trend?**

**Lawson:** I don't think this industry has been around long enough to reasonably determine a long-term trend. Given how rapidly all off of this has changed...

**OID: But if you were forced to guess, you think 30%...**

**Lawson:** Yeah, I'd probably guess 30%. Therefore, you have to grow units — which for Level 3 are data bits — a lot. But the industry's growing bits 50% or more annually — probably quite a lot more. The 50% annual unit growth figure I mentioned is over the short run. Over the long run, it's got to be higher than that.

**OID: I hope so. After all, 50% annual unit growth with 30% annual declines in price would only equate to revenue growth of 5%.**

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**Lawson:** Which, of course, wouldn't be so interesting. If unit demand is growing 50% per year — which, of course, is a number that would be huge for most businesses — but the economics aren't there and companies aren't able to make enough money to justify building new supply, prices won't drop 30% per year. Instead, what will happen is that the price will stabilize as existing capacity gets used up.

**OID:** *So if your assessment of supply and demand is correct, market conditions should only get better — at least theoretically.*

**Lawson:** Theoretically, that's right. And what could make it get worse? Enough new capacity being added would do it. But I don't think that's happening anymore — particularly in this awful environment.

And the industry talks about three levels of fiber \* being needed: There's long haul capacity, metro capacity and last mile. And the glut, to the extent it exists, is in long haul. So no new fiber is being laid there.

**OID:** *But isn't that Level 3's primary business?*

**Lawson:** That's the main focus of Level 3's business. But they're also in the business of selling metro fiber — which is the big circular rings that connect the main points of interest throughout a metropolitan area. And that's a market that is much more robust.

But overall, for the industry to grow its revenues by 20-22.5% per year in an environment where prices are falling 30% per year basically requires unit growth of something like 75% per year.

**OID:** *And unit growth would have to be something like 43% per year just to keep revenue from declining.*

**Lawson:** That's right. So obviously, price declines matter. On the other hand, that doesn't trouble me in a world where I believe that there's a lot of demand elasticity.

**OID:** *OK, then. Here's an easy question. What would your long-term annual guesstimates be for unit growth in demand, price declines and revenue growth?*

**Lawson:** Thanks for the softball question. I think about it this way: The historical pattern of cost declines in computers has been something like 30-40% per year. And there's reason to believe that the cost declines in the fiber optic area can be at least as fast — at least for awhile. So let's call it 30-40%. I believe thinking prices will decline at that same rate over time is not such a crazy thought.

**OID:** *Exactly what Crowe suggests.*

**Lawson:** Next, I think, "How rapidly is unit demand likely to grow given that level of cost and price declines?" In the computer area, demand elasticity — in other words, the change in units sold relative to the change in price — has averaged about 2.4. In other words, for each 1% decline in price, unit demand has increased about 2.4%. So for the sake of simplicity, let's just round that up to 2.5.

In that case, as prices fall around 30-40% per year, unit demand should rise roughly 75-100% per year. And revenue should rise something around 20-30% per year.

None of that sounds crazy to me.

**OID:** *No. And it doesn't sound out of line with what Crowe expects either.*

**Lawson:** That's right. I think all of that sounds in the right ballpark. And I really do think you can make a case that this is a pretty attractive business given the current stock price with 20% prospective revenue growth in this industry for a while.

**OID:** *It sure sounds like it. But over what period do you think those numbers are reasonable? Obviously, everything slows eventually.*

**Lawson:** That's true. But I'm thinking in terms of the next 10 years. And those numbers don't scare me over that time frame. I say that incidentally, despite the fact that 100% per year unit growth implies a greater than 1,000-fold increase in unit demand over 10 years.

**OID:** *They might even need new capacity in that case.*

**Lawson:** You bet. So the economics have to work eventually on incremental capacity. And then, if Level 3 is the low-cost producer, it's going to grow a lot faster than the industry.

INTERNET TRAFFIC'S GROWING EVEN FASTER  
— ALONG WITH LEVEL 3'S MARKET SHARE.

**OID:** *All of that sounds a bit hard to believe. But I read an excerpt from a study by Dr. Lawrence Roberts of internet traffic dating all the way back to 1991. And of course, internet traffic is related to, but not the same as, bandwidth usage.*

**Lawson:** That's right. Internet traffic used to be a small fraction of data transport services. But over time, it's become a larger and larger fraction of that market.

**OID:** *If I understood what he said, he concluded that usage has grown at a remarkably steady rate — roughly tripling every year — dating back to 1991.*

**Lawson:** I don't find that surprising.

**OID:** *And believe it or not, one of the few exceptions was April 2000 to April 2001, when it quadrupled.*

**Lawson:** I believe it.

**OID:** *Any idea of how big a fraction of that market it is today?*

**Lawson:** I'm really not sure. However, frankly, if internet traffic is tripling each year, you could have every other type of bandwidth usage not growing at all and still have pretty robust growth in data transport services in relatively short order.

Estimates for future demand growth in this industry are all over the map. But they tend to start at figures that would be a pretty big number for almost any other industry.

**OID:** *What's the range that you've seen?*

**Lawson:** The range Level 3 put out a year ago for growth in unit demand over the next few years was from 60% to 160% per year.

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**OID: Have they ever expressed an expectation for revenue growth?**

**Lawson:** Not to my knowledge. But I get the impression that they think in terms of price reductions between 20% and 40% per year. So I think that may at least give you some insight into what they're thinking.

Furthermore, I think it's important to keep in mind that when we're talking about elasticity of demand, we're talking about demand for the industry as a whole. But when you're talking about an individual company in that industry, the same relationship doesn't necessarily hold — because one company may be gaining market share.

That's a big part of what I think will continue to happen with Level 3. Given its low-cost position and because it's starting out with very little market share, I expect it to grow quite a bit faster than the industry as a whole for a long time. And over time, I expect its market share to get a lot bigger. So to the extent that that's going on, revenue is really going to grow faster than whatever mathematical relationship we're speculating on for the industry as a whole.

**OID: A low-cost provider in a rapidly growing industry — that doesn't sound too shabby.**

**Lawson:** Not at all.

**OID: I also heard Crowe very recently say, "It's quite clear that the industry is underinvesting in capacity."**

**Lawson:** That's exactly right.

**OID: "So", he suggests, "over the next few quarters, we're going to see the market shift from discounting overcapacity to discounting undercapacity. It's in the cards. It's going to happen. You can count on it."**

**Lawson:** I know he said that. And boy, I hope that he's right [laughs] — because if he is right, we're going to make a lot of money.

[Editor's note: It sounds like Federal Reserve Chairman Alan Greenspan agrees. In his testimony on Capitol Hill before the House Joint Economic Committee on April 18th, Greenspan even went so far as to suggest that the lack of investment in the telecommunications area may even serve as a constraint on future economic growth.]

WHEN IT COMES TIME TO UPGRADE OR ADD FIBER,  
LEVEL 3 WILL HAVE AN ENORMOUS ADVANTAGE.

**OID: Level 3 says that one of the reasons why their network is upgradeable is that they put extra conduit into the network when they build it.**

**Lawson:** That's right. Their argument is that if all you were to do was to put your fiber directly in the ground and the technology were to change — as it inevitably will — at some point, you'll determine that you need new fiber in the ground in order to be an efficient competitor. In that case, in effect, you have to start all over again. You have to gear up the whole construction effort and dig up the streets again to put in new fiber.

On the other hand, if the last time you dug the hole,

you thought ahead and put excess conduit in the hole, it's much more cost effective to lay the new fiber. I think they have some kind of compressed air system that pushes the fiber into the conduit. The cost of doing that — if you have that option — is pretty low.

**OID: And that's built into Level 3's network.**

**Lawson:** That's right. Now, everybody would argue that that's a long-term option that's pretty meaningless until the industry's ready to put in the next set of fiber. So it's a good thing if you really think that Level 3 is going to be around long enough. But if you're not convinced that it's going to be around, that option is meaningless.

**OID: That would certainly put a damper on things.**

**Lawson:** [Laughs.] My point is simply that having that capability doesn't save them if the bad environment lasts long enough.

[Editor's note: Level 3 CEO, Jim Crowe, suggests otherwise. He says that even if the current environment persists indefinitely, they're still funded to breakeven.]

**Lawson:** But it's a long-term option that the believers think will be quite valuable later on.

[Editor's note: By way of background, we understand that each conduit can hold multiple fiber cables (which are cables composed of multiple [typically up to 432] fiber pairs). And each of those fibers may be sold or leased individually. But we understand that each wavelength or color on each fiber may be sold or leased individually, too.]

**OID: Why can't somebody else just build an equally cost effective and equally upgradeable network?**

**Lawson:** Well, at this moment, they can't because nobody'll give 'em any financing. So the question is why didn't they do it historically? And why should we believe that Level 3's network is better than anybody else's?

**OID: I'll bite. Why?**

**Lawson:** It gets back to the philosophy of what they were trying to create and the vision of the industry that was in the heads of the various people who were building these networks. I think that it could have been done by other people. However, so many of its competitors took the expedient route — you know, they built part of it and they bought part of the capacity from other folks.

So they say that they have a network, but all they've done is bought a fiber or two from some other competitor. Therefore, when there's a need to upgrade, they don't have the same capabilities in that regard that Level 3 has.

**OID: To what degree do you think Level 3's done that?**

**Lawson:** Everything I can see says that they've been much truer to the vision than everybody else. I'd expect to find that they cut a corner someplace or other. Nobody's perfect. I'm sure there's something they didn't do perfectly.

But whenever you talk to 'em, everything I get back is very consistent — which is, "We think about the long term. We think about an industry that's changing drastically and very rapidly. So you have to be capable of changing with it. And we make our decisions on a net present value basis."

You don't get the same story from others. You hear things like, "We want the best technology" or "We had an

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RICK LAWSON  
(cont'd from preceding page)

existing voice business. So we had to build a network that was partially tuned to that business." And that might make sense in the short run, but it doesn't lead you to the lowest-cost structure over the long run.

**OID: Gotcha.**

**Lawson:** That's a key question. And I can't prove that my premise is correct. But it's all of those kinds of issues that lead me to believe that Level 3 is a lot closer to having it right than the other folks.

**OID: So that presumably Level 3 has a moat.**

**Lawson:** Exactly. And that's the key question here, frankly, in the long run. Does there prove to be a moat in what they're doing or not?

Again, this is a business where there's an up-front nut that you have to spend to get the network. So if you have a network that can be upgraded without going through the right-of-way process or the construction process again, you have a real advantage.

**OID: I wonder how much of an advantage.**

**Lawson:** They believe that when the time is right and it makes sense, to put 12 strands of new fiber into their network throughout the country will cost them \$50 million.

**OID: Wow! That sounds cheap.**

**Lawson:** You bet — given how much of the original \$12 billion or so went to getting to that stage the first time. And I can't answer your question exactly. But I'm sure that \$50 million's a lot smaller than Level 3's first-time cost.

**OID: You left out "helluva".**

**Lawson:** Right. So I don't have any problem thinking that they're going to have an *enormous* advantage vis-a-vis every company that doesn't have excess conduits when the time comes for that next round of fiber. But at this moment, it's only an interesting theoretical question. It doesn't really matter to the investment case right now — because they have to live long enough to get to that point.

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WHAT'S LEVEL 3 WORTH? HOWEVER YOU SLICE IT,  
IT'S WORTH A BIG MULTIPLE OF TODAY'S PRICE.

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**OID: Since you alluded to it earlier, let me ask you the \$64,000 question. And please feel free to laugh. How does one even begin to value Level 3?**

**Lawson:** [Cracks up.] Right. You go through the same process you try to go through for *any* company — which is to look at the situation from different perspectives. One of those is to figure out how much they've spent in order to build the network — which is \$12 billion — and then add their \$2 billion in cash (including their revolving credit facility), deduct their \$6 billion of debt and divide by their 400 million shares outstanding. That works out to around \$8 billion — which on Level 3's 400-or-so million shares

outstanding is something around \$20 per share. So that would imply a value of \$20 per share...

**OID: If it's worth adjusted book value.**

**Lawson:** If it's simply worth adjusted book value. Now, it's a little hard at today's level of cash generation to conclude without question that it's worth adjusted book. But I don't think I'm making a huge leap to say that if this works — if Level 3 has the best network in a business with a lot of very interesting long-term potential — then it should be worth a whole lot *more* than adjusted book value. If you truly have the low-cost position in that kind of business, you're going to have a license to print money long term.

So if you can just establish a comfort level that the business isn't crazy long term — that it's a viable business and that they have a defensible position — I don't feel like I'm reaching at *all* to think about it being worth at *least* what they put into it.

**OID: And between you saying "at least", and what's going on with demand, and their advantages...**

**Lawson:** If you go through a discounted free cash model, obviously that's subject to lots of assumptions. But it shouldn't surprise you — and it doesn't surprise me — that the kind of numbers I settle on in that process are a *lot* higher than book value.

**OID: Just between the two of us and a few subscribers — all of whom happen to be great at keeping a secret — might we ask how much higher?**

**Lawson:** I tend to come up with numbers that are closer to \$50.

**OID: Or two-and-a-half times adjusted book. That doesn't sound outrageous either.**

**Lawson:** No, I don't think so. I don't expect to see it this year, mind you — and it was in a different world, but Level 3's stock at one point did trade at \$130.

**OID: Actually \$132, but who's counting.**

**Lawson:** Fortunately, I didn't own it then.

**OID: And, believe it or not, neither did I.**

**Lawson:** That is hard to believe. But as I said, I tend to come up with numbers today that are closer to \$50. And, believe me, I can justify numbers that are *higher*. But why bother?

**OID: Bother, please.**

**Lawson:** After all, that's really not the question for this stock today. The question is...

**OID: Will they survive?**

**Lawson:** That's the question. And I'm being serious. When you're talking about a sub-\$5 stock and the range of good scenarios are \$20 and up [laughs], the key question is, "What's the probability that one of the good scenarios comes true? And what's the probability that the bad scenario — that the equity turns out to be worth zero — comes true?" At least that's how I think about it.

**OID: Maybe so. But this is investment publishing. So might I ask what range of values you came up with**

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RICK LAWSON  
(cont'd from preceding page)

**when you did your discounted cash flow analysis? Just between us. You can even whisper it to me.**

**Lawson:** [Long pause.] I'd say it's probably... And it's a big range. It's probably \$40 to \$100. And that's today. Last spring, when it was less obvious how much of their existing revenue was going to go away due to the bankruptcies of their clients, the range was even higher.

**OID: Just in case you might have any remaining shred of dignity left, might we ask what it was then?**

**Lawson:** I was thinking between \$80 and \$150. But then they lost a lot of customers. And it became clear that there was a slower build here. So even if it worked, the cash flow was going to come later.

BEFORE DISCOUNTING IT BACK TO THE PRESENT,  
LEVEL 3'S VALUE IN 2010 COULD BE OFF THE MAP.

**OID: What kind of guesstimates assumptions do you use in your discounted cash flow analysis to arrive at your net present value of \$40-100 per share.**

**Lawson:** I need to look back at my notes. But I think I assumed revenue growth of 25-30% per year. I assumed cash flow margins get to 40% in not that long a time. And I assumed it achieves the kind of cap-ex utilization/efficiency that its management talks about — at least for a while.

**OID: Obviously, 25-30% revenue growth sounds aggressive for 99.9% of companies in the world. But for whatever it's worth, it doesn't sound unreasonable at all to me for Level 3. After all, isn't that lower than it's ever been?**

**Lawson:** Yeah, it is. It's been much more than that. But it's hard to say since when any company's starting out, it's easier to report big numbers. But the revenue's weird — and I have to be careful how I talk about it — because there's GAAP revenue and then there's cash revenue. And at Level 3, cash revenue is bigger than GAAP revenue.

**OID: And you're really talking about cash revenue, aren't you?**

**Lawson:** Yeah. That's the way I think about it.

**OID: Don't let me interrupt you. I believe you were telling us your assumptions...**

**Lawson:** I went through a very simple analysis. Basically, I used a revenue growth rate of 25% to 30%, assumed an EBITDA margin of 40% and made some guesstimates about how much cap-ex they would need to invest in order to support that EBITDA. Then, with those assumptions, I projected their cash flows out until 2010.

And when I used revenue growth of 25%, that took revenue out to roughly \$11 billion in 2010. When I used the 30% revenue growth rate, that took it out to roughly \$16 billion.

By that point, enough cash flow is being generated that I assume that the company's debt has gotten paid off. In reality, its debt is probably well past paid off by then.

**OID: Although it would probably be needed to repurchase the shares that they'll issue in their incentive compensation plan, to fund R&D or something else...**

**Lawson:** There'll probably be something else going on at that point. But I didn't try to factor in any of that.

**OID: How many shares outstanding did you assume?**

**Lawson:** I just held it constant at 400 million shares. I basically assumed that they get to a 40% EBITDA margin after stock-based compensation expense. So that expense was already included. In effect, I'm thinking of that as a cash cost, although I understand it's really a share cost. And that gets me — speaking very roughly — to somewhere between \$3 and \$4-1/2 billion of free cash flow.

Then I assumed a multiple to their free cash flow at the end. And I picked 20 or 30 times free cash flow as my guesstimate of an appropriate multiple.

**OID: I can't believe I'm saying this. But I think that sounds reasonable.**

**Lawson:** I think it is. If Level 3 turns out to be the real deal, then I don't think it's at all unreasonable for it to trade at 20 or 30 times free cash flow or more. Companies that are that good tend to command big multiples.

[Editor's note: When we looked at some companies with the characteristics Lawson mentioned (gross margins in excess of 60%, EBITDA margins of 40%+ and rapidly growing revenues), free cash flow multiples of 20-30 times or more and price-to-sales multiples of 7-10 times or more were in fact the norm.]

**Lawson:** Next, I divided by the number of shares outstanding — which, again, I left alone for the reasons that I mentioned earlier. And finally, I discounted the resulting figures back to the present using a discount rate of 15% to get a net present value.

**OID: And the resulting values?**

**Lawson:** From about \$50 to around \$110.

**OID: Just to spare you from being embarrassed alone, let me confess that that's not altogether dissimilar to the kind of numbers that we've been coming up with. So we know you're wrong.**

[Editor's note: Unfortunately, we also know that this idea can't work (at least until we sell it) because we have a full position in Level 3 in the "Emerson Pittance".]

**Lawson:** I think it's important to keep in mind that what we're talking about here is not a normal company. We're talking about a company that may be able to dominate a very high growth business — and, even better, to dominate it because it has a low-cost position.

Obviously, there's lots of stuff we haven't talked about. For one, they'll eventually reach the point where they'll have to start paying taxes — which, of course, would have a negative effect on these values.

**OID: Although it certainly beats the alternatives...**

**Lawson:** Of course, you could argue that they'll find better uses for their money than just letting it pile up.

[Editor's note: Level 3's latest loss carryforward figure

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RICK LAWSON  
(cont'd from preceding page)

was \$1.8 billion as of 12/31/01.]

**OID: And because of the depreciation, won't Level 3's taxable income significantly lag their free cash flow?**

**Lawson:** Oh, yeah. Absolutely. They're going to have very significant tax losses. There's no question about it. And I don't think of that discounted cash flow analysis as being very accurate. But again, at this point, being accurate is not the most important thing.

**OID: Super. You're finally beginning to get the hang of this investment publishing racket.**

**Lawson:** The real drivers have to do with what the revenue growth rate turns out to be — and what kinds of margins they can generate on that revenue.

**OID: Speaking of margins, might I ask why you used an EBITDA margin of 40% and not 30% or 50%?**

**Lawson:** It just falls out of some guesses that I make about what kind of gross margin they'll have and what kind of cost structure inside they'll have to have. That 40% EBITDA margin suggests a gross margin of 60-70%, typical SG&A of 20%, plus another 0-10% of other stuff including their stock-based compensation.

But these are definitely rough guesses.

**OID: Oh?**

**Lawson:** And I don't think about 'em any other way.

**OID: On the other hand, there aren't many companies that you could make that kind of guess about with a straight face. Just the 25-30% revenue growth alone...**

**Lawson:** [Laughs.] That's right.

**OID: And it sounds like you're even feeling virtuous for only using 25-30% for revenue growth.**

**Lawson:** It's true.

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LEVEL 3'S BOND DISCOUNTS GET MY ATTENTION,  
BUT A DETAILED SPREADSHEET WOULDN'T HELP.

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**Lawson:** But at the same time, I also feel pretty silly because these numbers suggest we have a value for the company that is grossly in excess of book value at the same time that its bonds are yielding something up around 26-28%.

**OID: That does sound like quite a contradiction, doesn't it? How many times have you bought the shares of a company — or owned them — where its bonds were trading at 50¢ or less on the dollar?**

**Lawson:** I can't tell you exactly how many times, but it's happened.

**OID: Maybe half a dozen times?**

**Lawson:** That's probably about right.

**OID: How many of them worked out? In other words, how efficient has the bond market been in your personal experience as a predictor of disaster for the company's common shareholders?**

**Lawson:** I don't know. I know what you're asking. And I think it's a reasonable question. But I don't have a good answer for you.

**OID: Do you recall any of those where the company was buying back its bonds?**

**Lawson:** Not right off hand — of those I've owned. Obviously, I could point to some other things where I've seen bond buybacks take place. But I just can't come up with one right now.

**OID: Have you thought about buying Level 3's bonds?**

**Lawson:** I have — but not real seriously. The way we're structured, we've pretty much focused on equity. Our mutual fund prospectuses say we're equity investors, in effect.

**OID: No problem. Our small print says we come out bi-monthly, more or less... And anyway, don't bonds sometimes become very equity-like?**

**Lawson:** They do. But I think that there really are enough subtle differences — like if you get into the bonds of a troubled company, you're much more likely to end up playing on the creditor committee and that kind of thing.

[Editor's note: Other *OID* contributors besides Longleaf Partners buying that issue (see page 58) included Jean-Marie Eveillard's First Eagle Sogen Global Fund and Peter Cundill's Cundill Value Fund. First Eagle purchased 2 million of those bonds between October 31st and January 30th at 51¢ on the \$1 bringing its total ownership to 10 million bonds. Cundill bought 15 million of that same issue at an average cost of 44¢ on the \$1 during the six months ending December 31, 2001.]

**OID: To what degree does it concern you to see a company's bonds trading at 50¢ on the dollar?**

**Lawson:** Oh, it's very much an indicator that you pay attention to. It's the kind of thing that says, "Whatever you think this stock is worth, you better have in your thought process the possibility that it's going to zero — because the bond market's not *that* stupid." It may be off at times. However, you can't ignore it.

**OID: Does your back-of-the-envelope analysis suggest anything about whether or not Level 3 will have what it takes to get through to free cash flow breakeven?**

**Lawson:** Preparing a detailed spreadsheet on this company doesn't make a lot sense to me. You have to make so many assumptions and the range is so large. So I look at spreadsheets that other people have done to see what they might suggest to me. And I think about where some of the assumptions are — you know, on a "bigger than a breadbox" level — in terms of what might be here. But trying to get more precise than that, I think, just doesn't make a lot of sense.

**OID: The reason why I ask you is that I tried to do a very crude spreadsheet to figure out whether it looked**

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RICK LAWSON  
(cont'd from preceding page)

*like they would run out of cash or not. And it looked to me, anyway, like they won't even come close.*

*Have you done anything like that?*

**Lawson:** No. I really don't have a good model of all of that. Obviously, the numbers matter. And it matters if they're going to run out of money. But I think about it like this: I believe there is a chance they run out of money. Therefore, the key variable in my mind is how much revenue they generate. If they can't generate enough, they're going to be in bad shape no matter *what* they do.

However, there are so many different variables here and so many different levers they have the ability to pull that I think it's hard to really tie it down in a way that gives me confidence that I can really describe it accurately. So I don't think I'd gain a lot through the exercise beyond what I get through my back-of-the-envelope analysis. \*

WHAT ARE THE ODDS OF LEVEL 3 BEING A DISASTER?  
NOT HIGH ENOUGH TO STOP IT FROM BEING A BARGAIN.

**OID:** *In that case, let me ask you the question a different way. What do you think the odds are of Level 3 becoming a disaster?*

**Lawson:** That's a question I always ask myself — because obviously it's important. But I find that actually measuring those odds well is very difficult. So the way that I tend to think about that question is, first, is there a chance of it becoming a zero? Is it a possibility?

Then I try to use the probabilities as a way to bracket the value. Let me explain what I mean. If a stock is trading at \$5.00 — and Level 3's is lower than that today — and you wanted to pay no more than 40¢ on the \$1, the expected value would have to be at least \$12-1/2.

And if the low end of my range of values on the success scenarios start at \$20 and go up from there, then all I have to really believe is that there's a 60%+ chance of Level 3 making it to any of those scenarios.

**OID:** *Because a 60% chance of living gives you an expected value of at least \$12 — and the rest is gravy.*

**Lawson:** Exactly. So there's my 40¢ dollar. And I'm pretty comfortable that the chance of it becoming a zero is

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less than 40%. Therefore, I don't need to cut it any finer than that. So I don't.

**OID:** *Then let me ask you a hypothetical question: If you were cornered by a crazed, sleep-deprived newsletter editor — strictly hypothetically speaking — and he asked you to refine the odds of disaster a bit, what would you say?*

**Lawson:** [Laughs.] Strictly hypothetically speaking, I'd probably guess that it's something less than 25%.

**OID:** *And that would most likely be precipitated by...*

**Lawson:** A spiral down into bankruptcy. As a company gets more desperate in its outlook, its ability to generate new revenue gets weaker and weaker — which makes it *more* desperate. And that's a bad combination.

And with these kinds of assets, there's been a little bit of a history that if you go into a death spiral, there's a real question of whether anyone will come along and buy them from you at anything close to book. The debt lenders have found that even though they have a priority position, they're not getting their money back. So if that's what ends up happening, as it spirals down, you should not assume you're going to get much back as an equity holder.

**OID:** *But again, you're not worried so much about the viability of the concept or management's abilities — just whether they'll have the necessary staying power.*

**Lawson:** That's right.

**OID:** *So it could be the second owners that make money.*

**Lawson:** That's right. But I think these owners are further along and have a real business. And some of the companies that look like they're similar really weren't quite as ready to start generating revenue. In those cases, there may *not* be an ultimate business. What might ultimately happen in those businesses is that the lenders pull the plug and write it all down and the equipment turns to rust.

That's not what I expect here. On the other hand, there are enough examples of how other situations have played out that I feel most comfortable thinking of the downside case as a zero, not as a fraction of book value.

THERE IS A RISK HERE OF TECHNICAL DEFAULT,  
BUT I DON'T THINK EVEN THAT WOULD BE SO BAD.

**Lawson:** That's another issue — Level 3's \$6 billion of debt relative to, at the moment, not a lot of cash flow. So they're dependent on the kindness of strangers to a certain extent in that if their lenders get unhappy, it could make their life very difficult. Specifically, they run the risk of not meeting one of their debt covenants in 2002. They believe, and I agree, that those covenants can be renegotiated. But that's a point where I could be wrong.

**OID:** *At what point is that likely to become an issue?*

**Lawson:** Probably halfway through this year. The covenant mandates a certain revenue run rate. However, even people who think Level 3 has good long-term prospects are not convinced that they will have sufficient revenue to meet that particular covenant. So I think there is a real

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risk that they're going to have to renegotiate it.

[Editor's note: Here are the minimum telecom revenue thresholds (for which cash revenues are a good proxy) that Level 3 has to meet or exceed based on its loan covenants (from page 119 of their Q3 1999 10-Q):

|                                     |                |
|-------------------------------------|----------------|
| December 31, 2001                   | \$1.5 billion  |
| March 31, 2002                      | 1.5 billion    |
| June 30, 2002                       | 1.650 billion  |
| September 30, 2002                  | 2.0 billion    |
| December 31, 2002                   | 2.3 billion    |
| March 31, 2003                      | 2.5 billion    |
| June 30, 2003                       | 2.5 billion    |
| September 30, 2003                  | 3.0 billion    |
| December 31, 2003                   | 3.375 billion  |
| March 31, 2004                      | 3.750 billion  |
| June 30, 2004                       | 3.750 billion  |
| September 30, 2004                  | 4.250 billion  |
| December 31, 2004<br>and thereafter | 4.750 billion] |

**Lawson:** Those figures get pretty big after 2002. So Level 3 has to grow revenue to meet those thresholds. And I'm not going to promise you that they'll get there.

But one of the answers the company gives — and it makes a lot of sense to me — is that this is a business that has some cash flow and a management team that's done a lot of things right and is in the process of improving. So the question the banks have to answer is, "Do they want to run this asset or do they want management to run it?"

**OID: Or do they just want to own a bigger stake in the company?**

**Lawson:** Yeah — which is what the negotiation would be about. And that issue is just related to the bank debt — which is only a portion of Level 3's overall debt. However, it's enough to matter.

Incidentally, the covenant everybody worries about is the telecom revenue covenant. But it's clear to me that the revenue covenant is a *cash* revenue covenant — which is helpful because basically it means that if they can grow revenue at actually sort of a reasonable rate in 2002, they *won't* violate it and create a technical default. Plus, I think it's fair to say that there are indications that demand is beginning to perk up a bit.

However, if they actually start to grow revenues sooner than people think — even on the base business — they could still make it *without* any major acquisitions.

**OID: And of course, can't they help themselves to meet the minimum cash revenue threshold by way of an acquisition or two in the interim — like Splitrock?**

**Lawson:** As I understand it, the big asset there was the 350 points of presence [POPs].

**OID: But didn't it also include some revenue?**

**Lawson:** There was some revenue included. But Level 3 hasn't disclosed how much revenue they're going to generate from it. As I understand the numbers, the amount of on-the-books-already revenue that they bought

was not that huge a number. But what they did buy was a number of additional points of presence [POPs] that allow them to increase the percentage of the country that they can serve from something less than 60% to about 80%.

Meanwhile, I believe their Softswitch revenue is running around 30% of their cash revenue. And that's being done on POPs covering only 60% of the country. So if they can suddenly serve an additional 20% of the country, that sounds to me like they ought to be able to raise their revenue significantly just serving their same customers, only in more places, doing things that they wanted to do in those places before, but couldn't.

**OID: And can't they do more of that kind of thing if necessary? You know, a couple hundred million dollars here, a couple hundred million dollars there, before you know it, no debt covenant worries.**

**Lawson:** Probably. I think there are some of those opportunities. But many of the analysts aren't convinced. For example, I've seen one say that they may fall short by \$100 million in Q2 and \$300 million in Q3 based on the way the covenant is calculated.

I'm not going to guarantee you that they'll make it. But I think that the odds are at least in my favor that if they don't make it, they'll be making enough progress and be negotiating early enough with their banks that they'll find a way to work around it.

So I do worry about it. I expect to hear more about it. And I wouldn't be shocked to see a renegotiation. However, I don't view the looming covenant as some kind of automatic death knell for Level 3.

**OID: If they were to run afoul of the revenue covenant, what do you think would be the most likely outcome?**

**Lawson:** I think the most likely outcome would be a renegotiated deal that raises their cost of debt — maybe a fee plus a higher interest rate.

**OID: Could you give us some order of magnitude? Obviously, if the increased rate were high enough, it could conceivably become life threatening.**

**Lawson:** That kind of thing isn't going to be that high. If the banks were to manage to raise Level 3's interest costs a couple hundred basis points, that would be a huge win for the banks. And it just wouldn't matter that much in the long run if we're right about everything else. But I'm not suggesting a couple hundred basis points is anywhere near where it's likely to come out. I just don't know.

**OID: If the lenders were to play hardball, what are the odds that Level 3 could refinance?**

**Lawson:** That's part of the negotiation, of course. You try to find other potential lenders that come at it from a different perspective. In this environment, I'm not counting on it. But...

**OID: But that, too, shall pass.**

**Lawson:** Yeah.

**OID: So at worst, they could live with something that's onerous for a year or two and then refinance it.**

**Lawson:** Right.

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RICK LAWSON  
(cont'd from preceding page)

LEVEL 3'S OTHER ASSETS MAY BE QUITE HELPFUL  
IN HELPING THEM SURVIVE TO SEE THE LONG TERM.

**OID: On that score, should we very briefly touch on their other assets — even if only in passing?**

**Lawson:** Sure. Besides having their network business and close to \$1-1/2 billion in cash, they own interests in two or three other assets that in theory can be monetized. But most of the estimates I've seen are to a large extent based on the current market value of the stocks — of RCN and, more importantly, Commonwealth Telephone. I think the guesstimate of the value of those assets is in the range of \$500 million.

Over time, they should represent an additional source of liquidity if they need it. But I don't view them as being incredibly important from a long-term value perspective. However, those assets might be *quite* helpful from a [laughs] short-term value perspective.

[Editor's note: According to a press release dated April 2, 2002, Level 3 completed the sale of approximately 4.9 million shares of Commonwealth for proceeds of about \$166 million. They still own 4.74 million shares of common and 1 million class B shares.]

**OID: In other words, helping them stay alive to get to the long term.**

**Lawson:** Exactly.

**OID: You mentioned the publicly-traded assets. But they also have an interest in a toll road...**

**Lawson:** ...and a coal mine.

**OID: You sound like you don't think those amount to a hill of beans.**

**Lawson:** I don't know. I just don't think about 'em as being real important.

**OID: Don't they own a 550,000 square foot building in Manhattan, too?**

**Lawson:** That's right.

**OID: And I got the impression that they also own something like 4 million square feet of real estate around the country — including 850,000 square feet of office space that they occupy at their headquarters.**

**Lawson:** Yes. And some of it clearly is excess space that they acquired in the process of developing their colocation business. They have a couple of buildings in the Denver area that they thought they were going to need but don't at their current level of activity. And they're in the process of developing a lot of real estate for their colocation business — some of which they don't need.

But I don't have any sense of how much real value they've got there. I don't assign much of any value to it in thinking about how much the company's worth. However, at a qualitative level, it's clearly a plus.

**OID: Also, I understand that Level 3 has negotiated an agreement with some of its bondholders to be able**

**to repurchase the bonds for stock.**

**Lawson:** Yes. They think about all that stuff from a net present value perspective — in terms of what the best trade-off is to make at any given point in time. And I presume that they're thinking about it well.

**OID: So they're not exactly without levers to pull and resources to call on — at least to some degree — in these very challenging times.**

**Lawson:** And a management team that seems ready and willing to act.

**OID: And you're not worried about Level 3 violating some covenant related to book value...**

**Lawson:** I don't think that's particularly applicable here. And I don't worry about any of their other covenants right now either.

THE LOW-COST POSITION MAY NOT BE ENOUGH.  
THEY NEED OTHERS TO BEHAVE RATIONALLY, TOO.

**OID: What could turn Level 3 into a mistake?**

**Lawson:** Lots of things. I believe that they have a low-cost position. However, they may *not*. I can't prove they do today.

**OID: Ditto for upgradeability, I imagine.**

**Lawson:** That's right. We'll see.

**OID: For whatever it may be worth, I even find it difficult to imagine that they can run new fiber through existing conduit.**

**Lawson:** I believe that. That, I think, is really not that advanced a technology. It's been done before.

**OID: Really?**

**Lawson:** Yeah. I think (and it's pretty easy to check) when they originally installed their fiber in their network that they used a two-step process. I think they began by putting in the conduit and then putting the fiber into it — in which case they've already done it once. But I may be wrong on that. Again, it's pretty easy to check.

[Editor's note: In our process of gathering background material, we saw a Level 3 video that showed fiber being "blown in".]

**OID: How far apart could they perform that process from the surface without digging up the conduit? And how do you do that in the middle of the ocean?**

**Lawson:** They *don't* do it in the middle of the ocean. They've pretty much said, "We're not going after the undersea business because we think it's much harder to upgrade an undersea network."

So they bought enough undersea capacity to meet their own needs, but they don't have the same kind of upgradeable network undersea. Next time there's a technology improvement, they're just going to buy capacity from whoever builds the next one.

That's one of the things that makes sense to me. As you say, how do you do that when you're under the ocean? Well, I don't see how you can. It just doesn't work.

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**OID: How far apart can you do it on normal ground — absent any unusual terrain, geology or whatever?**

**Lawson:** I don't know the answer.

**OID: But presumably, however far it is, it's a helluva lot better than having to dig it up — even if it's only a tenth of a mile.**

**Lawson:** Yeah. But I think it's a lot longer than that.

**OID: When I asked what could turn it into a mistake, you said "lots of things"?**

**Lawson:** That's right. And we can go down the list. For example, their wholesale business model depends on a number of businesses acting rationally.

**OID: Talk about an unrealistic assumption...**

**Lawson:** If you assume they have a low-cost network, the rational thing for a company like AT&T to do when they need the next increment of capacity would be to buy it from Level 3 instead of trying to build it themselves — because it's definitely cheaper for AT&T to do it that way. But that may not actually be their behavior — because they may not think about it that way. They may say, "We have to control it ourselves. We just can't outsource this. It's too central to what we do."

**OID: Although, in that case, wouldn't the discipline of the marketplace severely punish the offender if they did, in fact, eschew the best, lowest-cost alternative?**

**Lawson:** If Level 3 truly has the low-cost position, then companies that don't use them will suffer over the long run. But if too many potential customers think that way, the folks at Level 3 can be right and it won't matter. So having the low-cost network may not be enough. Similarly, although the idea of outsourcing a network might ultimately gain acceptance, it might not happen quickly enough for Level 3.

**OID: Gotcha.**

**Lawson:** There are enough factors between here and there that the low-cost position isn't destiny. Level 3 has to do some other things right, too. And they have to create enough value along the way to get there.

**OID: Is it possible that your 15% discount rate, although it's much higher than what most people use in their discounted cash flow analyses, is too low — given the uncertainty associated with this company and the fact that its bonds are yielding something like 25-30%?**

**Lawson:** Absolutely. I understand why somebody might say that. But you can deal with risk in lots of different ways: You can use high discount rates. You can use risk as a limiter that says, "Don't buy too much of it." Or you can adjust your estimates of value down for the unforeseen events that can take a stock to zero.

In a way, I'm sort of using all of those. I'm using a relatively high discount rate, although maybe it's not high enough. I'm assuming there's a chance that it'll go to zero.

And I'm making it a smaller than normal holding.

AND IF POTENTIAL CUSTOMERS LOSE CONFIDENCE,  
LEVEL 3 WON'T BE ABLE TO MAKE IT EITHER.

**OID: Anything else?**

**Lawson:** One mistake Level 3 already made for sure was that during the internet bubble, they focused their sales efforts on internet companies that would need lots of bandwidth. Well, they were right about the needs, but they were wrong about those companies' ability to pay for it. And that need, in some cases, turned out to be ephemeral.

**OID: And very short lived, too.**

**Lawson:** You've got it. And that's one of the reasons why Level 3's revenue has not been growing this year — lots of those customers have pulled in their horns or gone bankrupt. So by focusing on the wrong set of customers, they've delayed their growth.

What else could go wrong? Well, they could have more of their customers go bankrupt — things could get worse again before they get better. It could take longer to work through this bubble than we think. And even though the underlying demand is growing very rapidly, it may take too long to have enough of that demand see the light of day for Level 3's revenues to grow rapidly enough to cover their fixed nut — which is, after all, pretty big.

**OID: If Level 3 does turn out to be a mistake, what do you think the most likely culprit will be?**

**Lawson:** I think it would revolve around the speed at which revenues grow over the next two or three years. There's enough latent demand, I believe, and their position is good enough that they're going to grow their revenue pretty quickly from here. So it won't be very long — at least from my kind of time horizon, not from the typical Wall Street quarterly time horizon — before it's obvious that they're going to survive and thrive. But if it takes them a lot longer to get the revenue growth than I think, then it could be a painful, slow death — or a quick death because the financial world will pull the plug.

**OID: I thought most of Level 3's debt matured in 2008.**

**Lawson:** That's right. But the problem is that this market has now reached a point of skepticism that says, "We're only going to buy from the good, strong companies."

**OID: Bite your tongue.**

**Lawson:** If you flip over into the category of "You may not live", your ability to sell new services will go away. Therefore, they have to continue to look like they're strong — or they won't be able to make it.

**OID: But haven't some recent announcements about new business given them significant credibility?**

**Lawson:** They've actually had quite a few recent announcements of additional sales to good, interesting companies that hearten. Being able to sell their services to AT&T Wireless, for example, in competition with AT&T is a pretty good sign — even if it's a small deal — because it says, "Here's a child of a competitor that's willing to buy from us instead of their parent." That says a lot to me.

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Plus, they've recently made additional sales to AOL Time Warner, a new sale to Cox, a sale one week earlier to Sony — and a lot of other good names that represent the right kind of customers. So there's evidence that they continue to be able to make those sales.

**OID:** *Based on anecdotal evidence, do you have any sense of how the other fiber optic companies are doing relative to Level 3 in terms of selling new accounts and otherwise growing their revenue?*

**Lawson:** From what I can tell anecdotally and from what's been announced, it looks to me like Level 3 is generally having more success. Williams has announced one deal — and another provider announced one deal. But it looks to me like Level 3 is more than holding its own in terms of what's being announced.

**OID:** *Also encouraging, someone at Level 3 was recently asked if the company's momentum at landing large, new accounts would continue. And they said, "You can bank on it."*

**Lawson:** All I can say is that I've heard that their sales success in the latter half of 2001 was ahead of plan. That said, that's being largely offset by the disconnects resulting from bankruptcies. So I don't know if the metrics we really care about in the short run are ahead of plan. But there are indications that they are making some progress and selling more and more services.

And the most recent financial statements suggest that they're generating big gross margins on the revenue that they're bringing in the door — which is important given the big SG&A nut they're overcoming.

**OID:** *Plus, that big SG&A nut is getting cut way back, too, isn't it?*

**Lawson:** Yes, it is — way back.

[Editor's note: In Level 3's 4th quarter conference call, CFO Sureel Choksi stated that their proforma SG&A expenses had declined to \$240 million for the quarter and that they expected to reduce annualized SG&A expenses to less than \$800 million by the end of the 1st quarter — representing a \$350± million reduction in annualized expenditures since the 4th quarter of 2000.]

**OID:** *In general, I'm very impressed by the things that Level 3's CEO, Jim Crowe, has to say. But a couple of things didn't seem to make sense.*

**Lawson:** Fire away.

**OID:** *Like, "Level 3 has a conservative balance sheet."*

**Lawson:** [Cracks up.] Well, if you think about it in terms of debt to cash flow, you have a hard time making that argument. But if you think about it as debt relative to how much they spent putting the network in the ground, it's not nearly as bad.

**OID:** *How much did they spend putting the network in the ground?*

**Lawson:** That's the kind of number I have to go back

and look up to be sure I have exactly right. But I believe it's about \$12 billion. So if you think of a capital structure with assets of \$12 billion and debt of \$6 billion where they still have \$1-1/2 billion in cash, it doesn't look that bad. I've seen more conservative, but that isn't awful.

For instance, they completed a big debt buyback of their bonds at a very hefty discount in October. I think they lowered their debt by roughly \$1.8 billion and only had to spend about \$700 million in cash to do it. They bought the debt back at something like 40¢ on the dollar.

**OID:** *That sounds smart.*

*Any idea of how much cash they have left?*

**Lawson:** Well, I'm looking at a projection for year end that I think is in the right ballpark that is estimating that they'll have cash of about \$1.5 billion at year end after factoring in their cash losses for the fourth quarter.

[Editor's note: Level 3 reported having \$1.5 billion in cash at year end 2001 (not including \$650 million from available credit lines).]

**OID:** *Crowe goes on: "Level 3 has substantial capital and is prefunded to free cash flow breakeven — the point at which the Company generates more cash than it spends." Does that sound reasonably probable?*

**Lawson:** I believe it does. I think the basis for that statement has to do with this issue of capital expenditure needs in a no-growth environment. They spent a lot of money on cap-ex in the last couple of years. There's just not a lot more that they have to spend unless they're growing the revenue base.

[Editor's note: In a January 7th presentation, Level 3 chairman Jim Crowe states that ongoing, annual base cap-ex should be around \$200 million.]

BACKHOES DON'T FOLLOW MOORE'S LAW  
— AND NEITHER DO RIGHTS OF WAY.

**OID:** *Crowe also says: "Approximately 87% of the Company's expenditures have been invested in its infrastructure — an asset that is increasing in value."*

**Lawson:** What doesn't make sense to you about that?

**OID:** *If the hardware portion of fiber optic networks is declining in value by 30-50% a year, how can Level 3's network be increasing in value?*

**Lawson:** I think you can quibble with his statement along the lines that you're suggesting. And in some ways, they would agree with you. They'd be the first to acknowledge that the equipment they've installed has a relatively short economic life. They would say, "We put a bunch of equipment in today — and we know the technology's going to be better three years from now. So it's not going to be that long before it makes sense for us to just turn off the equipment and just put in new stuff."

But the other way to think about it would be to say, "Let's think about the cash flow that this business will create over its life — and how we want to discount that cash flow. And to the extent that we have a network that's upgradeable and nobody else can make the same kinds of investments, then although we'll continue to have to put new equipment in the ground, our network is becoming

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more valuable because the cash flow it'll be able to generate is growing."

**OID: As an operating network, it's becoming more valuable — even as its replacement cost is falling.**

**Lawson:** That's right.

**OID: Still, isn't that another risk — that Level 3 will have spent \$12 billion for a network that somebody else can replicate today, or soon, for a whole lot less?**

**Lawson:** One of the things that Jim Crowe has always talked about as the concern that keeps him up at night is the possibility that somebody can build "Level 4" — a similar company, but one that's new and different.

My response at the moment is that there's no way anybody's going to do it until the industry looks a lot better and the need looks a lot higher. Longer term, might it happen? It *could*. However, there should be some embedded advantages to having customers and relationships and being able to upgrade your network when you want. That's a better position than starting out from scratch with no revenue and a similar cost structure.

**OID: And as you say, when that time comes, there's probably got to be significant industry demand...**

**Lawson:** That's right. If we get into that kind of environment, I'll have made a lot of money in my Level 3 stock. Under other circumstances, I'd worry about "Level 4". But right now, that's the *least* of my worries.

But here's a *very* rough breakdown of the cost of building their network: The \$14 billion is actually the amount of money that they raised. The amount that they're going to put into hard stuff — construction, fiber, equipment and colocation facilities, etc. — is more like \$12 billion.

I've sort of pieced that together from various sources. They don't give an exact breakdown in the way you or I would like to see it. But they have said that to build the North American intercity network — and by "to build", I mean the construction and the conduits and the first fiber pull — they spent about \$4 billion.

And my guesstimates of what makes up the rest of the \$12 billion is roughly as follows: There's something between \$1-1/2 and \$2 billion of construction and conduits and fiber pull in Europe and U.S. metro markets. And they've spent about \$1 billion on undersea.

**OID: Although that business is clearly underwater...**

**Lawson:** [Laughs.] And I estimate that they spent about \$2 billion or so on colocation space. Then the rest of the cost (and this is sort of a plug figure) is \$4 billion or so that was spent on electronics. Incidentally, my understanding is that the electronics component of the colocation areas — at least the part of the electronics paid for by Level 3 — is relatively minor.

**OID: That sounds important because I imagine the fiber and the hardware depreciate quite rapidly, whereas the replacement cost of the outlays associated with acquiring the rights of way and**

**digging the moats may not depreciate at all. In fact, they may even appreciate.**

**Lawson:** Right. As some wag has said, "Backhoes don't follow Moore's law." And neither do rights of way. That's exactly right.

**OID: Level 3 suggests that they had to obtain nearly one million pages of permits to build their network...**

**Lawson:** ...for the rights of way everywhere they wanted to build. Yeah, I've heard some of their comments about how complicated that whole process was.

**OID: And they say it would be harder and more expensive to acquire those permits and build it today.**

**Lawson:** That's right.

**OID: Do you understand why it would be more difficult and more expensive for anyone else to build their network today than it was when Level 3 built it?**

**Lawson:** There are two issues. One is finance — basically, you can't get it.

**OID: There's no need to get personal.**

**Lawson:** The other is the approvals. And I think what's going to happen there is that all of the various regulatory and government bodies that are necessary to give the approvals have gone through this process once. And they've woken up to the reality that their rights of way are a valuable resource. So they're now more in a mode to try to extract value from it.

**OID: Plus, I imagine they don't need to put up with that headache — because they've already got service.**

**Lawson:** Yeah. And that may even be *more* important — because you're willing to let your streets be dug up once when you don't have any kind of network. But if you're already wired and it's just to create a second network, you're less likely to put up with the headaches.

Now, at some point down the road, if Level 3 is acting too much like a monopolist, the equation will change — and the headaches won't be such a big deal.

**OID: Although if the cost of a commodity is declining by 30% per year, that's probably less of a risk.**

**Lawson:** [Chuckles.] Yeah. That's right.

LEVEL 3 HAS A HUGE COST ADVANTAGE TODAY —  
AND OVER TIME, ITS ADVANTAGE WILL ONLY GROW.

**OID: So it sounds like a new competitor should have at least an \$8-10 billion task before them in any case.**

**Lawson:** I think that's right.

**OID: And that's even assuming that their comment that it would be much more difficult and expensive to get the rights of way today are not true.**

**Lawson:** Exactly.

**OID: And anyone spending that money would not enjoy Level 3's economics because the best that they could hope to achieve — other things being equal — would be duopoly status.**

**Lawson:** That's absolutely right.

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**OID: Meanwhile, Level 3 has developed some proprietary advantages — like ONTAP, among others.**

**Lawson:** That gives them *some* competitive advantage and helps make the lives of their customers better.

[Editor's note: Level 3's management seems to believe that ONTAP gives them an enormous advantage — enabling them, according to Crowe, "to design, activate and test [our network's] capability end-to-end for customers in near real time." He says competitors not only can't match ONTAP's capability, but that they can't replicate it either because their networks are patched together and, thus, don't have uniform technology to the degree Level 3's does.

Also, for whatever it might be worth, Level 3 was the recipient of the 2002 Market Engineering Award for Customer Service Innovation. Here's an excerpt from a press release from Frost & Sullivan dated January 28th.\*

"Level 3's service provisioning system, known as ONTAP, earned the recognition after a comprehensive industry analysis by Frost & Sullivan entitled U.S. Wholesale Private Line Markets.... ONTAP sets unprecedented standards for customer interaction, timely response and/or attention to customer needs."

"The ONTAP process for service activation is a major customer service differentiation that offers a number of benefits to Level 3 and its customers.... Level 3's ability to provision services more rapidly than its competitors should ... be an important advantage in winning new business and increasing service orders from existing customers."]

**Lawson:** But over time, the moat becomes the relationship with the customer and the switching costs the customer would incur in order to switch its business to someone else. They put customers' equipment at a certain site so they can use Level 3's network — and the customer winds up getting intertwined with what Level 3's doing.

**OID: Not to mention the goodwill associated with dealing with a well respected, proven provider.**

**Lawson:** Exactly. And I think that all of that will make it hard for customers to switch off to somebody else. Actually, if there *does* prove to be a moat, I think it'll be analogous to the moat Intel's had for many years in the microprocessor business. Intel became the biggest and sold the most. So it could spend the most on R&D. And it could build the biggest and most efficient factory. So it could make its chips the cheapest. It really boils down to having this huge cost advantage relative to its competitors.

In the case of Level 3, the advantage — if it develops as I hope it does — will be a cost advantage where, because Level 3 has this upgradeable network that's well designed, they're constantly going to be able to add new units of capacity more cheaply than anyone else. There's just a huge difference between what it costs to get into the game and the \$50 million it's going to cost Level 3 to double up. And over time, their advantage will only grow.

Obviously, that won't give them a licence to charge whatever they want. However, it should give them the ability to charge enough to make an awful lot of money.

**OID: And an awful lot more than anyone else.**

**Lawson:** That's right. Others shouldn't be able to make nearly as much. That's the theory of how it should develop over time. But we are very much in the phase now where that's theory. It hasn't been proven.

And that's nothing I'm going to begin to think about until the industry improves.

**OID: Does anybody else have multiple conduits in the U.S.?**

**Lawson:** Level 3 doesn't have a monopoly on multiple conduits, but they have the lion's share of the capacity. They have multiple conduits on their network throughout the U.S., whereas Qwest has only one spare conduit. And Williams has two conduits in maybe two-thirds of its network, but not all of it.

**OID: Do Qwest and Williams have strong presences in so-called metro fiber — in the rings around metropolitan areas?**

**Lawson:** No.

**OID: And I gather that's pretty key.**

**Lawson:** I think it is — if for no other reason than that it allows you to focus your energy on a different part of your business when that's what people want — like today.

There's a debate. Level 3 will tell you that it's a strategic advantage to have a metro network presence. And I think that they're probably right. However, the alternate argument would be that as long as somebody has a metro network, you can resell their network, too.

**OID: But then you get a lower gross margin.**

**Lawson:** Yeah. Plus, it's more cumbersome and a little bit harder to work. And there are times that you just can't do certain things as well when you're combining 'em that way.

ITS ACCOUNTANT MAY BE AGGRESSIVE,  
BUT ITS ACCOUNTING IS SOMETHING ELSE.

**OID: The other reason, I imagine, why people are assuming disaster is because it seems like every other company in their business has either gone bust or is at risk of going bust. There are even fears about Qwest...**

**Lawson:** Yeah — although I would add Broadwing to the list of people who haven't gone down the tubes yet and are still looking like they're competing.

**OID: Does Broadwing have a next generation network?**

**Lawson:** They do. They're one of the five that is playing that game. Global Crossing was another one.

**OID: Does Broadwing have multiple conduits?**

**Lawson:** No. But that's one of those factors that at this point everybody discounts — because if you have extra capacity, who cares because you can't sell what you've got.

**OID: OK. Let's deal with those issues one at a time. First, Arthur Andersen being Level 3's accountant...**

**Lawson:** That's an issue only because it's a fear. People are quite concerned about the accounting throughout the industry. But I get a lot of comfort from the management team and the owners involved. It's sort of

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interesting — if you read the chat boards and look for the issues that come up from the people who don't like them, you don't hear that their accounting stinks. You hear it's a bad business, they've had to change their sales approach, nobody wants to buy their stuff and there's overcapacity. But you don't hear with any credibility whatsoever that their accounting is a problem.

**OID:** *No. In fact, I get the impression more and more that their accounting is actually quite conservative. Am I missing something?*

**Lawson:** I don't think so. I get the same impression.

**OID:** *Like the way they account for sales of dark fiber — although that's not really their choice...*

**Lawson:** Yep.

**OID:** *Also, doesn't Level 3 depreciate its network much more rapidly than anyone else?*

**Lawson:** I think that's right.

**OID:** *And as soon as a customer is categorized as being "at risk", don't they take reserves against sales that are likely to exceed future write-offs?*

**Lawson:** I think that's right. And another place where they're conservative is that the impact of their stock-based incentive compensation program is expensed on their income statement.

**OID:** *Which is almost unheard of, isn't it? Do you know of any other company that recognizes that expense?*

**Lawson:** I don't. And it says two things: First, they tried to pick an incentive compensation plan that they thought actually made sense. And second, in the process of establishing it, they didn't set it up to be hidden by the accounting rules.

I've heard very little that would lead me to be concerned about Level 3's accounting. This management team is very unlikely to play those kinds of games. That's just not the kind of people they are.

**OID:** *And I imagine that they're not the kind of people who would ever take the company private at a sweetheart price or take advantage of shareholders.*

(continued in next column)

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**Lawson:** No. They're not that kind of folks.

**OID:** *Especially given that I gather many of the shareholders are ex-employees of Kiewit Construction — of which Walter Scott, Jr. is Chairman Emeritus.*

**Lawson:** Absolutely. Accounting questions are *always* something that I worry about. But my best way of deciding where I should be focusing is to pay attention to the bears. And on this stock, that's not what they're talking about.

I LISTEN TO THE WHAT THE SHORTS ARE SAYING,  
BUT NONE OF THEIR CONCERNS WORRY ME.

**OID:** *And that's not based on any shortage of bears. The last public figure I'm aware of shows well over 10% of Level 3's shares outstanding sold short.*

**Lawson:** That's right — which is a big number.

**OID:** *Especially given that I understand that there's a lot of insider ownership...*

**Lawson:** If you include all the ex-Kiewit Diversified shareholders, there's an awful lot of Level 3's stock held in hands that are predisposed to be long-term holders. They may not always succeed in that quest, but they'd like to think that way.

**OID:** *What thoughts come into your mind when you find out that there's that much short interest?*

**Lawson:** Well, I've learned over the years that that's an indicator that's important to use as a yellow flag — because the shorts may be wrong, but they're not stupid. So I pay attention to a big number like that.

**OID:** *You say the bears aren't talking about Level 3's accounting. What are their biggest issues?*

**Lawson:** I really think they're related to the problems of the industry — that there's too much capacity. And they suggest that there's little or no demand relative to capacity — and that the demand's not growing. Plus, they suggest that the entire industry has invested so much capital in excess capacity and layered it with so much debt that the whole industry's going to collapse.

**OID:** *And interestingly, that sounds like it's not anything that concerns you very much at all.*

**Lawson:** Even though I have comfort that there's long-term demand growth, I don't deny that there's been a tech bubble and that there's been excess spending in many sectors. What looked like demand from some companies has gone away. I think all of that is true if you're thinking about all of this in the short run.

But from a longer-term perspective, no, I don't worry about those issues.

**OID:** *On the other hand, I understand that given the way their incentive compensation plan works, if their stock outperforms the S&P 500, they can get a multiple of the base level of their award — or it can go to nothing if their stock underperforms that index.*

**Lawson:** That's right.

**OID:** *But given the current stock price...*

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**Lawson:** Given the very low base...

**OID:** *That's right. If the stock price ever reflects your expectations, could you wind up with some much greater than expected dilution from stock awards?*

**Lawson:** Yeah. I think there could be some of that. But the good news is that the awards trickle out over time.

**OID:** *Is there an upper limit on how much they can be multiplied — if the stock rises 10-fold or more?*

**Lawson:** I don't know if there is. And I understand what you're saying. But first of all, the life of the awards is not infinite.

**OID:** *I think it's four years.*

**Lawson:** Yeah. That's the number in my head, too.

**OID:** *And I believe they said the average award life at most companies is something around 10 years?*

**Lawson:** Yeah. I haven't gone through the math to make absolutely sure there isn't some huge liability. But I bet I'd be happy as a shareholder if the stock got to \$40 and I got diluted more than I thought.

**OID:** *It's hard to argue with you there.*

DON'T GET ME WRONG — THERE ARE RISKS HERE.  
BUT WE'VE COVERED THE MAIN ONES I WORRY ABOUT.

**OID:** *Isn't another risk — at least in the short run — that a better funded competitor like Qwest or AT&T tries to keep excess capacity high and prices low to strangle Level 3 before they ever get off the ground?*

**Lawson:** It is. But their ability to do that depends on how much extra capital they can get away with spending and how much financial flexibility they have. And nobody in the telecommunications business has a free pass anymore. Their shareholders won't let them spend capital willy nilly. They want to see free cash flow. Therefore, nobody has that much flexibility today.

**OID:** *An article in Scientific American suggests that bandwidth is likely to become so cheap that it might very well become free. Is that a risk here?*

**Lawson:** Let me answer you this way: It gets back to elasticity of demand — where you don't get much per unit, but you sell an awful lot of units. And that can turn into a pretty nice business.

I can't give you good numbers, but think about the computer business. It's a much more interesting business today from a total size perspective, at least, when the price per MIP is a tiny, tiny fraction of what it was 30 years ago — or maybe 45 or 50 years ago — when the market for computers looked to be maybe six computers worldwide. Compared to those days, processing power is basically free. But the computer business is pretty interesting.

I think you're going to have the same kind of development in bandwidth. Obviously, that doesn't mean

the participants will necessarily make a lot of money. But it creates an environment where they'll have a chance to.

**OID:** *Some have suggested that bandwidth needs can be dramatically reduced with compression technology that uses mathematical algorithms.*

**Lawson:** [Laughs.] I think that primarily applies to the "last mile". But if something like that were to happen — if a brand new technology were to arrive that would mean that everybody at home could have a gigabit connection — that would only be good news for people like Level 3.

**OID:** *But couldn't they do the same thing with the data that's going through Level 3's network — i.e., compress it so much that even if demand is doubling every year, the existing capacity would suffice for an extra three or four years?*

**Lawson:** Anything's possible. But what I think is more likely is that the companies who will benefit most are those with existing infrastructure. I may be wrong, but compression technology sounds to me like something that will make the existing infrastructure more efficient and cost effective and would help speed up the decline in cost.

**OID:** *And therefore, as you've said, accelerate the growth of demand.*

**Lawson:** Exactly. But there's always a risk that a new technology will come along and totally replace the existing infrastructure that's in the ground. However, more often, the new technology winds up getting used by the incumbent to speed them along.

Occasionally, you have a sea change like the one you're now seeing, in my opinion, between the twisted pair that the phone companies have and the technology that the cable companies are using. But that was something that happened almost by accident. That wire was there for a totally different purpose. But over time, it became clear that that cable wire could be used for something different.

**OID:** *What about competition from wireless?*

**Lawson:** In the long run, to say a new technology can't come around is sort of crazy — because new technologies do show up and surprise you. And that's what makes life interesting.

But can you imagine a venture capitalist agreeing to fund a company that's going to compete with Level 3 and Qwest today? I just don't see that happening. And even once the demand shows up, it's going to be a long time before any new technology has a chance to bloom — because nobody's going to fund it for a long time. At some point down the road, maybe. But that doesn't worry me today.

[Editor's note: Interestingly, in the intermediate term, wireless may be good news in at least two ways: First, Crowe suggests that wireless is much more of a customer than a competitor. Second, it may help solve the last mile issue.

Long term, who knows?]

**Lawson:** New technologies like that will come along and get adopted over time. But what that's really doing is driving down the effective cost of long-haul transmission. And if we're right about the elasticity, that should be a good thing.

**OID:** *I gather that Level 3 has at least a couple of*

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**huge write-offs coming in the fourth quarter — as a result of the sale of its Asian operations and workforce reductions...**

**Lawson:** Right. I think those are fair statements. But let me just comment on both of those actions. In the last few months of 2001, management determined they didn't have the right level of employee-based cost structure for today's environment. So instead of waiting for the environment to get better and carrying the extra burden longer, they decided to lay off some people and make do with a smaller cost structure.

And just as is the case in any workforce reduction, there are up-front costs associated with severance benefits, etc. So some of that write-off is actual cash costs and some of it is recognizing previous mistakes in staffing, etc. that required modification in a new environment. Because we're focused on cash flows, we're much more interested in the former.

Of course, you'd rather have them get it right in the first place and not create the cost. But it is what it is.

**OID: Nobody's perfect — present company excepted.**

**Lawson:** You shouldn't talk about yourself that way. They also made a decision to get out of an operation that they were in the process of building in Asia. And in their mind, that had to do with the trade-off between continuing to spend more capital to finish the construction and eventually generate revenue — which on a net present value basis would probably have been the better choice — or making a deal that would allow them to continue to have the capacity, but that would remove the obligation of a bunch of up-front capital and a bunch of operating losses before they reach breakeven.

And in this environment, where people worry about their funding capabilities and everybody cares about how much excess funding capacity they have, they made the conservative decision — to give up the long-term opportunity, hunker down and save more of their capital.

**OID: Better to stack the deck towards survival than higher long-term returns.**

**Lawson:** That's the argument. All I know is what they tell me. But it looks like it was a prudent decision — although it was somewhat disappointing because they do wind up losing some of the money they've already invested getting the Asian network to the point where it is today.

**OID: Does your discounted cash flow analysis exclude that Asian operation or include it?**

**Lawson:** I've excluded it.

**OID: What else could turn Level 3 into a mistake — maybe a very deep, prolonged economic downturn?**

**Lawson:** I think that would just delay the good times.

**OID: What about a wrong-headed regulatory regime that dampens demand for data transport? Obviously, that would be like committing national suicide in the information age. But that's another risk, isn't it?**

**Lawson:** One of the subtleties here that helps Level 3 is the interrelationship of how the cash flow statement works. It's already spent the money to build their network. And cap-ex used to be a huge number. But going forward, cap-ex is only going to be as big as demand dictates. So to the extent that revenue is less than I expect, cap-ex will be lower, too. In other words, cap-ex will decline with revenue.

So it's actually almost easier to reach cash flow breakeven when demand is growing more slowly. Level 3 may not be worth as much because the company's anticipated future cash flows may be less. On the other hand, the downside is probably smaller than it appears.

However, don't get me wrong — there are risks here. I'm not saying there aren't.

**OID: Any others?**

**Lawson:** Those are the main ones I'm thinking of.

THE UPSIDE IN LEVEL 3 IS VERY INTERESTING,  
BUT I WOULDN'T MAKE IT A HUGE POSITION.

**OID: When did you enter the picture on Level 3?**

**Lawson:** I started buying it a little over a year ago.

**OID: And with apologies in advance, may I ask the range of what you paid?**

**Lawson:** Oh, it's higher than where we are today, unfortunately.

**OID: I somehow gathered that.**

**Lawson:** [Laughs.] You seem to know how to find those in my portfolio.

**OID: I've learned to smell the pain — based on personal experience.**

**Lawson:** I bought our first big chunk of Level 3 in the mid-\$20s. And then I bought a little bit at higher prices. Then, I bought another big chunk around \$10. And then, more recently, I bought another big chunk around \$5.

**OID: I think that warrants an ouch.**

**Lawson:** Oh, yeah — absolutely.

**OID: But you don't sound down about it in the least — or even pessimistic.**

**Lawson:** This is one where I knew going in that the range of possibilities was big. So the size of the position has been purposefully kept small. I've let it get a little bigger recently as the stock price has found a new level. But I just don't feel that bad about it yet.

[Editor's note: One manager who was willing to take a slightly bigger percentage position was Bill Miller. As of 3/31/02, Level 3 was Legg Mason Opportunity Trust's sixth largest position accounting for 3.7% of the portfolio.

Incidentally, Portfolio Reports estimates that Level 3 was Lawson's largest purchase for the quarter ended December 31, 2001. During that quarter, Weitz Hickory reportedly purchased an additional 493,300 shares — giving it a total of 1,754,000 shares owned.]

**Lawson:** Obviously, I'm early. And I never like to be

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that early. But I'm not willing to concede defeat yet.

**OID: You actually sound optimistic.**

**Lawson:** There's a lot of reasons to feel that way. First, I think the upside can be very, very large.

**OID: Even from your original cost?**

**Lawson:** Even from my original cost. And I can hold it for a very long time. So I'm not to the point yet where I'm thinking my original cost will prove to be a mistake. Needless to say, I may get there. But I'm not there yet.

**OID: Have you ever seen an idea with the upside of Level 3 and its moat and its caliber of management...**

**Lawson:** Not to mention its downside and uncertainty. It's a real mix.

**OID: In your discounted cash flow analysis, you use a 15% discount rate. Right?**

**Lawson:** That's right.

**OID: So in order to come up with a net present value of \$40 to \$110, it sounds like you would have to be projecting a stock price 7-8 years out of...**

**Lawson:** Between \$150 and \$338 per share.

**OID: From today's price, that implies appreciation of something approaching 5,000-10,000%. Do you realize how ridiculous that sounds?**

**Lawson:** [Laughs.] Oh, yeah. Absolutely.

**OID: Have you ever seen anything like that before — that didn't wind up going bankrupt anyway?**

**Lawson:** No. You're right. It's absolutely ridiculous. But I wouldn't ever want to have this be a huge position. However, if you can find something like this where the odds are reasonably in your favor, but not perfect, and it's a small position, the real risk/reward is pretty interesting.

**OID: Which, I assume, means off the chart.**

**Lawson:** The downside risk here just isn't that awful percentage-wise with a small position. Yet your upside is still very interesting.

**OID: Agreed on all counts.**

**What's the closest equivalent to Level 3 that you've ever seen?**

**Lawson:** [Exhales loudly.] Good question. There's nothing like it that I've ever seen that I can remember.

**OID: Agreed. It's one of the most fascinating ideas that we've ever seen, too — and one of the toughest to cover editorially. There are even lots of things that we didn't get to touch on.**

**Lawson:** There's a lot going on here.

**OID: Thanks for being so generous with your time and your insights.**

**Lawson:** My pleasure.

Following Level 3's fourth quarter earnings release, its acquisition of Corporate Software and CFO Sureel Choksi's appearance at a Merrill Lynch telecom conference, we had a quick follow-up with Lawson. Here's some of what he had to say:

DISCONNECTS SHOW NO SIGN OF ABATING,  
BUT THE ODDS OF DISASTER HAVE DECLINED.

**OID: Did you take anything away from Level 3's fourth quarter earnings release?**

**Lawson:** Not a whole lot. There hasn't really been huge change. I think the one negative I heard that was sort of incremental news to me was that the disconnects were still continuing. They had hoped that they would have six months of disconnects that ran through the second half of 2001. So before the fourth quarter, I would have hoped to hear that disconnects were slowing down — that they had worked through what they thought they were going to have.

Instead, what I heard was that they went at the rate they expected, but that they have another chunk to work through — so it'll be another six months before they're done with 'em. On the margin, that's negative news.

**OID: Of course, 9/11 alone could have done that...**

**Lawson:** True. Lots of things didn't help. And you can see it with Enron, Global Crossing and others. But they hadn't quantified that it was going to continue to run for a while.

So it wasn't particularly surprising. But it was worse than what you might have thought based on what they had said earlier. But I don't think it changes my thesis.

[Editor's note: As we were headed to press, Level 3's President and COO, Kevin O'Hara, announced that they were finally seeing the light at the end of the tunnel — that "while [new] sales were still largely offset by disconnects, we saw our exposure to risky credit quality customers drop [in the first] quarter for the first time in over a year. Our backlog of high-credit-risk customers dropped to about 15% at the end of the quarter from about 25% at the end of the fourth quarter.

"And as [CFO] Sureel [Choksi] described on the fourth quarter call, we thought the rate of disconnects would normalize around the end of ... the second quarter. While we can't predict whether or not we'll get any future surprises like Enron, we feel we've bottomed out. And we continue to believe that we should start to see overall improvement in disconnects toward the end of this quarter."]

**OID: And I understand they also took a little write-off in the fourth quarter — something like \$3.2 billion.**

**Lawson:** Yes. And there's a lot I don't understand about that impairment charge. They actually wrote off more of their network expense than I would have expected. And frankly, it has the feel of big bath accounting.

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**OID: Agreed.**

**Lawson:** But I think it really was a onetime expense. And from my perspective — which is valuing a stream of future cash flows — it really doesn't matter if they take write-downs or they don't. That's really the bottom line — and the reason why I haven't tried to dig into exactly what they wrote off and what it means.

The incentives are for companies to write down as much as they possibly can. That may have been what happened here. I don't view it as particularly significant one way or another. It's just a recognition that they have a lot more inventory of dark fiber and colocation space than they need in today's environment.

**OID: And what about Level 3's acquisition of Corporate Software? You had set the risk of disaster at 25%. Would you modify that probability in light of it?**

**Lawson:** You have to say that whatever you thought before that acquisition, the odds of Level 3's success have improved because one of the drivers of disaster was a blowup with the banks. And basically, it eliminates any near-term risk of Level 3 violating their minimum telecom revenue covenant. So they've at least pushed that back more than a year at a critical time.

I think they've also proven that they can utilize the acquisition route in order to avoid running afoul of the telecom revenue covenant. So I think that clearly reduces the odds of disaster — perhaps from 25% to 20%.

**OID: And as you said before, if it does turn out to be a disaster, the biggest reason is likely to be that people lose faith in the company and customers want nothing to do with 'em.**

**Lawson:** I think those are the most likely reasons. The other issue that we talked about is that they're a wholesaler. And there's some question about whether being a wholesaler is a good long-term strategy. Frankly, at this moment, I think it makes sense. But they have to prove it. And if it turns out that customers would rather do it themselves for whatever reason, then even though Level 3 has better economics, it won't be good enough.

**OID: And based on the evidence so far?**

**Lawson:** There's a lot of evidence so far that people will buy from 'em. So it's going their way.

**OID: Especially the last three or four months — with Verizon, Cox Communications, AOL Time Warner, Microsoft, BellSouth...**

**Lawson:** ...and AT&T Wireless — among others. Yeah, they have good customers coming their way. But they're still relatively small deals.

**OID: But don't they say they're getting a bigger and bigger share of some of these companies' business?**

**Lawson:** I think that's probably true. But people see the original press release and are legitimately skeptical. When they add up the likely first year revenues from most of these deals individually, they're not very big.

**OID: At least in the first year.**

**Lawson:** Correct. It just takes time to work through the process — to prove they can do it and to prove it again and again. And over time, they can do more and more. But it doesn't happen overnight.

**OID: But aren't the odds of your disaster scenario occurring greatly diminished as long as big customers are regularly signing up with 'em?**

**Lawson:** That's right. The sign you're going to be looking for basically is, "Is their revenue growing?"

**OID: And based on the evidence to date?**

**Lawson:** The sales level sounds fine. Unfortunately, the disconnects are still running. So when you add it up, you're not seeing a huge amount of traction — you're not seeing a huge amount of growth. And you probably won't for a little while — which I think will give people pause for at least another couple of quarters.

**OID: But the sales level alone sounds like it would be grounds to mitigate your concerns for now.**

**Lawson:** That's right.

**OID: And I gather that it would also be grounds to mitigate your concerns about the viability of Level 3's wholesale strategy.**

**Lawson:** Yeah. That's right. I'm not worried today. And I don't see any risk of that nature that's imminent. However, if they don't start seeing traction within the next six months or so, you're going to see the spectre of another round of covenant issues with the banks.

**OID: But can't they deal with that via acquisitions? After all, didn't Level 3 acquire Corporate Software's \$1.1 billion of revenues for \$130 million?**

**Lawson:** [Laughs.] Yeah.

[Editor's note: Level 3 originally announced that the acquisition would consist of \$89 million of cash and about \$50 million of Corporate Software debt. But upon closing, they announced the net debt had declined to \$31 million.

It reportedly has over 5,000 business customers in 128 countries — including half the Fortune 500.]

**OID: And there are apparently a lot of companies available on the cheap today in the relevant segments. In fact, I believe that Crowe has said as much.**

**But it sounds like your issues have more to do with the sales and not so much with the disconnects. And presumably, there's reason for that fear to be mitigated — at least for now.**

**Lawson:** I think that's absolutely right.

BANKRUPT COMPETITORS WON'T BE A PROBLEM.  
THEY'RE ACTUALLY MORE OF AN OPPORTUNITY....

**OID: A question I neglected to ask you before but should have: What keeps Level 3 from being run into the ground by bankrupt competitors who no longer have the huge debt service requirements that it does?**

**Lawson:** My answer to that is wrapped around my

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expectation for the growth rate for the demand for bits. Their networks consist mostly of *unlit* capacity. Therefore, if I'm even *close* to right about future demand growth, they'll sell off their lit capacity pretty quickly.

And it's only until those companies run through that existing lit capacity that they'll have an advantage. Their cost to light new capacity is not going to be lower because they got the assets cheap or because they don't have any debt because they'll still have to buy equipment that, again, comprises 95-97% of the total network cost.

**OID: Good answer.**

**Lawson:** And once that lit capacity does get used up, they'll basically be in the same game as everybody else — where cost and capability are a function of architecture and how the network was built.

**OID: Speaking of existing capacity, I imagine that you wouldn't mind if Level 3 bought a big chunk of Global Crossing's assets.**

**Lawson:** It sure wouldn't hurt. And Williams is another possibility, too. There's a lot of consolidation potential. And it would sure be nice if that happened.

**OID: Do you think there's any significant possibility of that?**

**Lawson:** I'm guessing. But yeah, I think there is. What I took away from an April 9th *Wall Street Journal* "Heard on the Street" column was that Level 3 wants its investors to know that it's out looking and might spend some money.

[Editor's note: Here are several interesting excerpts from that article: "Level 3 may soon make a bold but risky move to acquire one or more of its troubled competitors, including possibly Global Crossing, according to people familiar with the situation.

"We have financial dry powder," says Jim Crowe.... "We are not among the walking wounded. The overpessimism in the industry is creating opportunities for us to buy assets. To buy assets makes sense when it [enables us to] acquire customers and lower costs and create cash flow...."

"[C]ould Level 3 afford an all-cash offer? Mr. Crowe believes so. The company has at least \$1.5 billion in cash, \$650 million in undrawn bank lines, a quality network and access to investors with deep pockets. The cash and bank lines could keep Level 3 going until 2006, according to analysts. [Also], Mr. Crowe notes, there are lots of deep-pocketed financial investors who would consider a joint bid. 'It makes sense for them because these are not stand-alone assets....' he says. 'You need to integrate them into an infrastructure. And we have the infrastructure.'

"Mr. Crowe won't be specific about the timing of any bids or specific targets. [But] the deadline for bids for Global Crossing is the end of June.... Level 3 has expressed interest in at least two other telecom companies, Williams Communications and Flag Telecom Holdings Ltd., according to people familiar with the matter....

"[One analyst] suggests that [always evolving

technology may result in] the industry ... never [reaching] a healthy equilibrium [because] players will continue to add capacity [and therefore] prices may never bottom."

"Mr. Crowe disputes this analysis.... 'All capacity is not created equal,' he says. 'A lot of capacity is illusory. It's partly built or it's in the wrong place — that is why some of it is going for pennies on the dollar. Nobody is investing at all. But in six months, the market will change from surplus to shortage.' He also notes that companies like his with proven track records — and no bankruptcy court filings — may fare better with telecom customers. 'We are not like some department store,' he says. 'What we sell is critical to our customers' own business. Customers want stability.'"

**OID: What do you think the odds are that Level 3 comes away with any significant amount of the assets of Global Crossing or Williams?**

**Lawson:** I'd guess that they're probably better than 50/50 that they get *something*.

**OID: Wow. That high!?**

**Lawson:** I think so — although again, that's a guess.

MY EXPECTATIONS ARE SIMILAR TO CROWE'S. HOWEVER, I'D BE HAPPY WITH A LOT LESS, TOO.

**OID: Based on one of the graphs he used in Level 3's 2001 Investor and Analyst Conference, Crowe seems to anticipate cost improvement in the communications area to far exceed that achieved in computing and information storage over the next 20 years.**

**Lawson:** And I would concur. They've been a laggard for a long time.

**OID: In fact, that graph even seems to suggest that the cost improvements will be so dramatic that between now and 2020, they'll be equivalent to the cost improvements achieved by the computer industry during the prior 40 years.**

**Lawson:** If all of that really works, life is going to be beautiful.

**OID: Then, in his commentary, he sounds like he expects cost improvements of 30-40% per year.**

**Lawson:** I think you're right.

**OID: But in their 3-D chart, it looks like he thinks they would maximize Level 3's net present value with cost reductions of 25-30% per year.**

**Lawson:** I've heard Crowe talk about the differences between the theoretical and the realistically achievable levels of price performance improvement. And in this case, the theoretical levels of cost declines are greater than the realistic levels...

**OID: Because of the last mile issue.**

**Lawson:** Because of the last mile issue and because of all the other players in the overall game.

**OID: In other words, the challenge of convincing others in the supply chain that they're part of an industry where prices ought to be declining that fast**

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**and that they should allocate resources accordingly.**

**Lawson:** That's right. So if you understand that it *should* be very fast, but because you can't herd all the cats well enough to have them all move in lockstep with you, it won't grow as fast as it theoretically can.

I don't think that makes the story go away. But I think it takes it to a different kind of environment than one where everything works perfectly.

**OID: But you don't think annual cost improvements of 20-30% per year are in any way pie in the sky.**

**Lawson:** No, I don't.

**OID: And parsing words, I get the distinct impression that Crowe expects elasticity to be 3 or more.**

**Lawson:** I have not specifically asked him that question. But yeah, I think that's probably right.

**OID: Is that realistic? After all, he says that the computer industry has had elasticity of only 2.4.**

**Lawson:** To assume that an industry will grow revenue faster than 20% per year for any length of time is asking an awful lot. But I can imagine an elasticity here that's greater than the computer industry's for a while because this industry isn't as well developed. So obviously, we're talking about pretty big numbers here in terms of unit demand. Anyway, that's the kind of market that I'm thinking about here.

But let me answer your question this way. The value that we're going to come up with either way — whether we assume elasticity is 2.4 or 3.0 — is going to be *wildly* in excess of the current stock price.

**OID: In other words, only in investment publishing is the higher number relevant.**

**Lawson:** Exactly. For me, the relevant question is whether they're going to do well enough for us to be happy buying the stock at \$4 and change.

**OID: But since this is investment publishing, let me observe that elasticity of 3.0 and cost improvements of 20-30% translate into revenue growth of 28-33%.**

**Lawson:** For the industry. And it looks to me like if this works, Level 3 will gain a lot of market share, too.

**OID: So even if we assume elasticity of 2-1/2 times — which would imply industry revenue growth of something between 20% and 22-1/2% — that would be good enough for you.**

**Lawson:** You bet.

**OID: But I gather that in your heart of hearts, you don't see price-performance improvements below 30%.**

**Lawson:** No.

**OID: And in your heart of hearts, you think 2-1/2 times is probably minimum elasticity.**

**Lawson:** Yeah. I think that's right.

**OID: And that elasticity of 3.0 is not overboard at all.**

**Lawson:** Yeah. I think that's right.

**OID: But you don't want to be viewed as wide-eyed...**

**Lawson:** I don't want to be viewed as wide-eyed. And there are too many possible gotcha's here to give full credit to it all.

MY PROFITABILITY ESTIMATES MAY HAVE BEEN LOW.  
IF SO, WE'RE GOING TO DO *BETTER* THAN I EXPECT.

**OID: In one of their conference calls or presentations, someone at Level 3 mentioned that gross margin in the telecom business is not the traditional definition.**

**Lawson:** That's correct.

**OID: Rather, it's the percentage of total revenues retained and not paid out to other network providers. Do you have any sense of what Level 3's gross margin would be if you defined it in the traditional way — as marginal profitability, if you will?**

**Lawson:** Basically, Level 3's cost structure is mostly people doing various kinds of things plus a little bit of electricity and stuff like that. I think I have the answer — and it was in a presentation their CFO made at a conference recently. I heard it second hand, but I'm pretty sure that it's right: On an incremental basis (per incremental dollar of revenue) about 25¢ goes to paying other folks because not all their traffic's on their network. Then, about 5¢ goes for variable operating costs — sales commissions, electricity and things like that. So the vast majority of the operating costs are effectively fixed.

**OID: Didn't you suggest earlier that in your model, you were basically thinking of variable SG&A as being closer to 20¢ per \$1 of sales?**

**Lawson:** That's right. And 5¢ sounds too low to me. However, long term, I would be happy if they were able to get to an EBITDA margin of 40% — which would be sort of 70-80% gross margins and 30-40% other operating costs including sales, etc. So if that 5% truly turns out to be the correct number for marginal SG&A long term, then they're going to do a lot better than what I'm expecting.

But I don't think it stays that flat. They can probably run at that level for awhile. However, over time they're going to have to spend more money.

**OID: And I assume that that's why you wind up sinking back down to your measly \$40-100 valuation.**

**Lawson:** Wouldn't that be awful? But it's just so hard to know what the business is going to look like. Right now, I believe that they've still got more costs in their system today than they need for their current revenue run rate — because, of course they were anticipating faster growth. And now they've cut it back. But still...

So that suggests to me that for some period of time, they're going to be growing into their cost base.

**OID: So maybe that 5¢ of marginal SG&A is for today — until they grow into their existing infrastructure. And then it gets closer to what you're expecting.**

**Lawson:** That's *my* sense. But it's anybody's guess where it's going to end up. I'm comfortable with the idea

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that they have a lot of operating leverage. And that operating leverage will allow them to get to the kind of EBITDA margin that will allow them to be a good business.

NEGATIVE CASH FLOW IS NO BIG DEAL TODAY —  
AND THAT'S WITH THEM SCRAPING THE BOTTOM.

**Lawson:** For now, their actual EBITDA margin is basically negative. They're turning EBITDA positive shortly. But they're not running with any reasonable EBITDA margins right now — because the problem is that they just have too much SG&A.

**OID:** *In their fourth year of operation...*

**Lawson:** And a major industry storm.

**OID:** *And something of an economic storm — not to mention 9/11.*

**Lawson:** That's right.

**OID:** *Given all of the preceding, does that give you any sense of what their negative cash flow is today?*

**Lawson:** They haven't put out guidance for the year yet. My guess is that they sort of scrape along for awhile growing revenue pretty slowly. And as the year goes on, the growth rate picks up a little bit as the amount of churn off their system slows down. Incidentally, that churn is happening because customers are failing, not because the customers don't like 'em. So I think that over time, they just reach a point where the weak customers are all gone.

**OID:** *Where no more weak guys are left to fail.*

**Lawson:** Exactly.

**OID:** *Help me out here. If you were figuring out their negative cash flow starting from their EBITDA, you'd deduct their debt service plus their cap-ex. Right?*

**Lawson:** That's basically right, although there are two other factors — one negative and one positive. The negative factor is that as they wind down the construction of their network, their accounts payable go away. In effect, they pay the bills — which is a bad thing from a cash perspective.

The positive factor is that they continue to generate some sales on a five-year contract basis where, from an accounting perspective, the revenue is recognized each year as it comes along. But Level 3 is paid up front for the entire five years. So they take in more cash than they recognize in revenue. Some of that's gone away because of the way the accounting has changed and the way people are buying, but they're still doing that. And it looks like it's continuing to be a net positive number. So in keeping track of their cash, that should be a good thing above and beyond from what you'd think based on reported EBITDA.

**OID:** *Any idea of order of magnitude of the two? Is one bigger than the other?*

**Lawson:** In the short run, the working capital is probably bigger — something in the hundreds of millions.

But in the long run, the working capital changes go away — and the difference between cash revenue and GAAP revenue stays. So it becomes a bigger deal longer term.

[Editor's note: Level 3's CFO said accounts payable excluding those associated with Corporate Software as of March 31, 2002 were around \$534 million.]

**OID:** *In that case, if you don't mind, I'll just exercise a newsletter editor's prerogative and ignore both.*

*I understand they're saying that recurring cap-ex is \$200 million.*

**Lawson:** Right.

**OID:** *And it looks like they have debt net of cash — even if you disregard their marketable securities — of no more than \$4.7 billion.*

**Lawson:** That sounds about right.

**OID:** *So let's call it \$470 million of debt service — and round it up to \$500 million.*

**Lawson:** Yeah. And I think it's actually less than that in the short run because some of the debt is converts and stuff that doesn't have a big current pay.

**OID:** *So to get to breakeven cash flow, they need to get to something around \$700 million of EBITDA.*

**Lawson:** Not including success-based cap-ex.

**OID:** *No. But since they in effect get reimbursed for their success-based cap-ex in nine months or less, as long as they're not cutting it too close liquidity-wise, maybe we can disregard it for purposes of calculating where they reach breakeven cash flow.*

**Lawson:** I'll buy that.

**OID:** *And in their fourth quarter release, they say that they expect consolidated adjusted EBITDA — which is their term for cash EBITDA — of \$90 million for the first quarter.*

**Lawson:** That's right.

**OID:** *And I believe that they've subsequently said that they're meeting or beating that figure. So if we were just to annualize that first quarter figure — if we were to assume no growth whatsoever — we'd be talking about 2002 EBITDA of \$360 million.*

**Lawson:** Right.

[Editor's note: As we went to press, Level 3 informed shareholders that Consolidated Adjusted EBITDA for the first quarter was \$124 million — and that it expected Consolidated Adjusted EBITDA for 2002 of \$400 million.]

**OID:** *So \$700 million breakeven EBITDA less annualized first quarter EBITDA of \$360 million — does that suggest that their negative cash flow, if you exclude outlays with less than a one-year payback, is at worst \$340 million?!*

**Lawson:** Yeah. I think that's right.

**OID:** *With \$2+ billion in liquidity (including available credit lines) — no matter how you choose to slice it — that doesn't exactly sound like grounds for panic.*

**Lawson:** Agreed.

(continued on next page)

WEITZ HICKORY FUND'S  
RICK LAWSON  
(cont'd from preceding page)

[Editor's note: And their total liquidity gets better for several reasons — including the aforementioned sale of their shares in Commonwealth Telephone and the announced but not yet completed sale of its interest in a California toll road.

And one more thing — in their 2001 10-K, we noticed the following: "On March 9, 2002, legislation was enacted that will enable [Level 3] to carry its taxable net operating losses back five years. As a result, [Level 3] expects to receive a Federal income tax refund of approximately \$120 million after it files its 2001 Federal income tax return carrying back the taxable loss to 1996...."]

**OID: Then, if you assume that their new acquisition — Corporate Software — earns the same \$18 million of EBITDA that it did in 2001 and deduct something for reduced interest income given the \$120 million or thereabouts that Level 3 paid for it, then Level 3's negative cash flow sounds like it would be closer to \$330 million.**

**Lawson:** That sounds about right.

**OID: Based on those figures and your understanding of Level 3's profit dynamics, do you have any sense of how much in incremental sales they would need in order to reach breakeven — at least before allowing for success-based cap-ex?**

**Lawson:** If you think that the incremental cost per \$1 of sales is 30¢ — again, 25¢ paid to other service providers and 5¢ in incremental SG&A and miscellaneous costs — then it should take \$500 million of additional revenue to reach breakeven.

**OID: How hard is that to imagine?**

**Lawson:** I can easily imagine them being at a run rate like that a year from now — or perhaps a year and a half. That wouldn't shock me.

MAYBE I THINK IT'S RISKIER THAN IT REALLY IS.  
BUT I'D RATHER THINK ABOUT IT THAT WAY.

**OID: So for them to say that they're prefunded with a significant cushion doesn't exactly strain credulity.**

**Lawson:** No. You can get there pretty easily, I think. There are probably two reasons why it's been so hard for people to get there. First, the company was running at a higher operating cost nut. And we do need to make sure it's come down and that it's going to *stay* down. Second, the estimates for cap-ex, until recently, were much higher than what they're looking at spending now. People were looking at well over a billion in cap-ex *this* year. If you look at it from that perspective, that makes it much harder to get to breakeven cash flow.

Also, I think nobody has fully internalized this idea of success-based capital per dollar of revenue being as small as they're describing.

**OID: Among other things. Absolutely. I don't think I've ever seen such misinformation and disinformation**

**— and not only on chat boards, but also from people who call themselves journalists.**

**Lawson:** I agree. I'm sort of scratching my head, too.

**OID: The disconnect between perception and reality here is truly mind boggling.**

**Lawson:** I agree. Yet, the rationale for the disconnect is not all that surprising when you look at Enron and Global Crossing and Teligent and Winstar and all of the other emerging telephone companies, broadband players, etc. in distress and/or bankruptcy in various places.

**OID: But instead of focusing on the advantages of there being less competition, most seem to consider it a case of guilt by association.**

**Lawson:** Exactly. But this company at one point said, "We're going to grow in such and such a manner" and later had to say, "We're not going to grow that fast." And they said, "We're going to focus all our efforts on the emerging big hog users of bandwidth such as the dot-coms" and then had to say, "Well, I guess they're all going away. So we have to sell to other people."

Those kinds of things make people uncomfortable. And I understand that.

**OID: I guess we have unusually high tolerance for that kind of sin given our historical proclamation of "bimonthly, more or less" — even more so when there are mitigating circumstances of this magnitude.**

**Meanwhile, those mitigating circumstances — especially the tech wreck, the dot-coms turning into dot-bombs and the telecom meltdown — are a big part of the reason why the stock is priced the way it is.**

**Lawson:** Correct. And then the company says, "There's a bank covenant issue." And that raises all kinds of red flags. So that's understandable.

**OID: Especially when I understand another player in this industry said technical default was not an issue — shortly before declaring bankruptcy.**

**Lawson:** Exactly. So the current panic and lack of perspective is understandable. But I agree with you — at this moment, it doesn't look like they're in serious trouble. However, we're talking about a very early stage business that is not yet fully ensconced in its markets and that's not yet fully penetrating its opportunity.

Here's one way I think about it: If all the good stuff I said about Level 3 is correct, it's the best idea I've ever had. And in that case, it should be at least 20% of my portfolio. However, I haven't let Level 3 get to be much more than 2% of the assets I manage. That's because I'm *not* totally sure that it is. So while my brain can spin a wonderful story, my gut isn't convinced. And in a situation like this, I want to listen to my gut.

As I've said, this is not a slam dunk. It's at a point where things *could* go the wrong way. So it's risky. And maybe I'm just thinking it's riskier than it really is. However, I'd rather think that way.

**OID: A luxury we can't afford in the high stakes world of investment publishing.**

**Thanks again for sharing a truly fascinating idea.**

**Lawson:** My pleasure.

—OID

LEVEL 3'S  
JAMES CROWE ET AL.  
(cont'd from page 1)

passing understanding of a business with more than a few related, albeit discrete, segments — all of which seemed to be rapidly changing. All told, it was by far the most challenging research effort we've ever undertaken.

Having more or less completed our task (to the degree that we could afford to do so without becoming full-time tech and telecom analysts), we realized that the only way we could provide you with sufficient background on the idea (without forcing you to do the same) was to write up some of the events we were using as tutorials ourselves.

This more or less unprecedented effort was made all the more necessary (and, we think, potentially all the more rewarding) by the incredible disconnect between much of what Level 3 has been reporting and what the shorts and even supposedly responsible journalists have been saying\* about it. Absent our digging, we would have suspected that where there's smoke, there must be fire — that so much ado about the company's distress and dire circumstances must be accompanied by some significant amount of actual distress, etc. Instead, what we concluded was that there is basically much ado about nothing — or, at most, very little.

However, please don't take *our* word for it. Between our interview with Weitz Hickory Fund's Rick Lawson (begins page 9) and the pages which follow, you should be well on your way to being able to judge for yourself. We believe that it may also prove helpful in understanding other tech and telecom companies and even companies in other unrelated fields.

The excerpts which follow were selected from comments by Level 3 CEO James Crowe and President and COO Kevin O'Hara at their Third Annual Investor and Analyst Conference which took place January 29, 2001 along with their answers to attendee questions. We hope you find them as informative as we do.

WE'VE HAD TWO THIRDS OF A REVOLUTION.  
BUT NOW, THE THIRD LEG HAS FINALLY BEGUN.

This is the year it all comes together.

**James Crowe:** ...Since the fall of 1997, we've been working on a plan, a series of assets and services. We've been working on metropolitan assets. We've been working on gateways, intercity assets and submarine facilities. All of those are tangible. All of those are visible.

Less visible, but just as important: We've been working on a unique set of operating systems, a unique set of

(continued in next column)

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operations research-based systems to inform our decisions, a Softswitch platform, and a global internet protocol system. And we've been hiring and putting to work what I believe is the finest group of people in the industry.

All of those assets, all of those systems and all of those processes come together now. In the past, while we've discussed much of what we've been doing, necessarily much of what we've presented has been in the future tense. No more. Everything we discuss today is now. This is the year it all comes together. This is the year when the theme of our conference — "Breaking Away" — we think, applies to the set of services and to our financial results.

We've been part of a revolution — well, two-thirds of one...

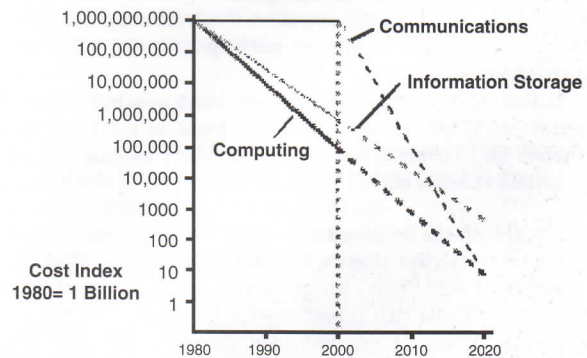
**Crowe:** While the focus of what we are doing is on the present and what we're doing today in the marketplace, I am going to say a few words about Silicon Economics, the relationship between supply and demand and about some of the processes we've developed to inform our decisions. We think it's necessary to understand the interrelationships between all of those — to put what we're going to talk about in the balance of our conference in some kind of context.

And it starts like this: For the last 20 years, all of us, both at the office and at home, have been part of — sometimes more visibly, sometimes less — a revolution just as fundamental as the agricultural revolution or the industrial revolution. It's a different *kind* of revolution. It's a revolution that's taken place in the minds of men and women, but it's been just as fundamental and impactful on the way we live.

(continued on next page)

CHART 1

Information Technologies Have Improved At Very Different Rates



- Computing and information storage have improved exponentially.
- Until recently, communications has improved very slowly.
- Central planning of key communication technologies has stifled innovation.
- The advent of market based technical development has changed communication from a utility to a technology business.
  - IP technology
  - Optical technology

Source: Level 3

**LEVEL 3'S**  
**JAMES CROWE ET AL.**  
 (cont'd from preceding page)

That revolution has been driven in large part by three interrelated technologies — two of them, very visibly: processing information (what we call computing) and storing information (on magnetic media and optical media [like] DVDs, CDs and videotapes). Sometimes less apparently, sometimes more apparently, but in all cases those two technologies have improved at rates that are nothing short of *startling*.

In the case of computing, [those] improvements have come to be known as Moore's Law — that is, a doubling in [its] price performance [ratio] about every 18 months. Storage of information has been a little less dramatic, improving perhaps over the long haul 40-45% per year — although lately, much more rapidly than that.

On that kind of scale, however, moving information — the third leg of the information technology revolution — has been essentially *static* in terms of price performance. **(CHART 1)**

The third leg of the revolution has finally begun....

**Crowe:** It is not the subject of this conference as to the underlying reasons why. My guess is that if we were to run a poll, you might agree that monopoly, rate of return regulation and central planning might have had a little something to do with the static nature of communications technology and prices.

But in any event, about five years ago, literally, all of that changed. It changed with the advent of two major technological breakthroughs — optical technology and internet protocol [IP] technology. And now that combination has enabled an improvement in communications that makes the rates of improvement in computing and in storage of information look slow by comparison.

And that is changing the fundamental nature of our industry. What has been a utility industry with long asset lives — asset lives measured in terms of 14-15 years — and slow moving product developments is now clearly a technology-based industry.

• MOST OF THE EXISTING FIBER WILL NEVER BE LIT — DUE TO OBSOLESCENCE OR CAPITAL CONSTRAINTS.

There's a wide range of opinion about future demand....

**Crowe:** That has fundamental implications for all parts of what we do. It has fundamental implications for the relationships between supply and demand — something we think is misunderstood in the marketplace today. It has fundamental implications for the way companies must manage their businesses. Whole new systems are required to understand the effects of technology on business plans. And finally, it has fundamental implications for the structure of our industry in the marketplace.

First, supply and demand: There's been a debate about the relationships between supply and demand. You can literally find demand projections apart by a factor of 10. We've seen projections that say over the next four years —

(continued on next page)

**CHART 2**

**Currently Funded Sources Of Bandwidth Services Supply**

| 1                    | 2          | 3                            | 4             | 5                            | 6                                   | 7                                  | 8                       | 9              |
|----------------------|------------|------------------------------|---------------|------------------------------|-------------------------------------|------------------------------------|-------------------------|----------------|
| Company              | Lit Fibers | Capacity <sup>1</sup> (Gb/s) | Planned Fiber | Capacity <sup>2</sup> (Gb/s) | Cap-ex <sup>3</sup> Needed To Light | Estimated <sup>4</sup> 2000 Cap-ex | 2000 Cap-ex ÷ Total (%) | Years To Light |
| 360 Networks         | 1          | 320                          | 35            | 56,000                       | \$ 31,360                           | \$795                              | 2.5%                    | 39             |
| AT&T                 | 9          | 2,880                        | 26            | 41,600                       | 23,296                              | 2,532                              | 10.9%                   | 9              |
| Sprint               | 5          | 1,600                        | 15            | 24,000                       | 13,440                              | 1,646                              | 12.2%                   | 8              |
| WorldCom             | 6          | 1,920                        | 18            | 28,800                       | 16,128                              | 2,165                              | 13.4%                   | 7              |
| Qwest                | 4          | 1,280                        | 44            | 70,400                       | 39,424                              | 1,530                              | 3.9%                    | 25             |
| Global Crossing      | 6          | 1,920                        | 20            | 28,800                       | 16,128                              | 668                                | 4.1%                    | 24             |
| GTE (Genuity)        | 2          | 640                          | 22            | 35,200                       | 19,712                              | 480                                | 2.4%                    | 41             |
| Williams             | 2          | 640                          | 118           | 188,800                      | 105,728                             | 854                                | 0.8%                    | 123            |
| IXC (Broadwing)      | 4          | 1,280                        | 92            | 147,200                      | 82,432                              | 105                                | 0.1%                    | 785            |
| Level 3 (Internal)   | 2          | 640                          | 10            | 12,800                       | 7,168                               | 2,600                              | 36.3%                   | 3              |
| Level 3 (Dark Fiber) | n/a        | n/a                          | 170           | 272,000                      | 152,320                             | n/a                                | n/a                     | n/a            |
| <b>Total</b>         |            | <b>13,120</b>                | <b>570</b>    | <b>905,600</b>               | <b>\$507,136</b>                    | <b>\$13,375</b>                    | <b>2.6%</b>             | <b>38</b>      |

|            |   |    |
|------------|---|----|
| Normalized | 1 | 69 |
|------------|---|----|

- (1) Assumed planned fibers lit at 32 wavelengths at 10 Gb/s
- (2) Assumed planned fibers lit at 160 wavelengths at 10 Gb/s
- (3) Total cap-ex needed to light in millions (at \$28 per Gb/s per mile) assuming average route 20,000 mile network
- (4) Level 3 estimates [of 2000 cap-ex to light fiber in millions] based on public disclosure

Source: Level 3

## LEVEL 3'S

JAMES CROWE ET AL.

(cont'd from preceding page)

from the beginning of the year 2000 to the end of 2003 — we may see an increase in demand of 20 times. Others have projected increases in demand up to 10 times that. In fact, some industry observers talk about a doubling in demand every three or four *months*. That would represent a 1,000-fold increase over a three- to four-year period.

More determinable is current supply...

**Crowe:** I'm not going to spend any time with that. You may all have your views. What I *am* going to spend time on, however, is looking at something that we do not think is well examined — and that is the relationship between supply and the underlying capital required to provide that supply given whatever projection of demand that you might find compelling.

This is a bit of a busy slide. So I'm going to work my way through it. (CHART 2) In the first column is the list of companies that in one form or another we consider facilities-based providers of communications services. In the second column is an assessment of the amount of supply in the industry today — the amount of supply determined by taking the fibers that we believe are lit based on various industry sources and multiplying those fibers by today's technology, which is 32 different wavelengths or colors of light on each fiber times 10 gigabits, that is flashing the laser on each one of those colors of light 10 billion times a second. So each fiber carries 320 gigabits — 13,000 gigabits per second in cross section across all of those fibers.

That's *alarge* amount of capacity — *many, many* times the capacity that was in place only a short time ago.

And potential supply using existing fiber is far, far more.

**Crowe:** That's certainly an impressive amount of capacity, but nothing like what we're going to see over the next few years. In Column #4 are the number of fibers either in place today or currently funded — perhaps not completely, but funded in some fashion — about 670 or so by our count.

Now let's take that 670 fibers and multiply that by the technology that's *expected* to be in place over the period now to the end of 2003. And that is 160 different colors of light — 160 wavelengths — on each fiber. And we'll flash the laser 10 billion times a second (10 gigabits) per color of

(continued in next column)

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light per fiber. In the industry, that's called an OC-192 by 160 system. That results in an *amazing* increase in supply if you do that math. For convenience, we've normalized — that is, indexed — the supply at the end of the year 2003 times a multiple of what was in place at the beginning of 2000. And it's about 70 times as much capacity in place if all the fibers were lit as was in place (by this math, at least) at the beginning of 2000. So it's a large increase.

And this is the relationship — a 70-fold increase in supply versus the demand projections of 20 to 200 — that causes a lot of the discussion in the industry today.

But there's something missing — and that's capital...

**Crowe:** But what's missing is described in the next few columns: To light that fiber up using capital assumptions that we believe are pretty aggressive — you can certainly develop your own math, but by our estimate — if the cost of optical equipment would continue to drop at a remarkable rate, it might cost about \$28 per gigabit second per mile to light all that up. And it's a simple extension to say that to have the capacity listed in Column #5, it's going to take about \$1/2 trillion dollars [Column #6] to light it all up.

In the next column, Column #7, is our assessment — and by the way, the footnote refers you to the appendix. We inadvertently left the math out of the inclusion. We'll post that on our website.... But we took the amount of capital that each carrier spent — at least by our estimates — on lighting up intercity capacity (and we think we've been generous in this assessment) and totaled it all up. And we came up with about \$13 billion last year (2000).

The next column [Column #8] shows you the percentage of the capital that it would take to light up *all* of the fiber that carrier owns divided by the amount of capital they spent [in 2000] because I think it's kind of interesting. And the last column [Column #9] is the number of years it would take to light up all of that fiber if we kept cap-ex at the current rates. It's kind of an interesting assessment.

It says that if we kept spending at the current rate, we'd have an increase in supply of about 7 times. What it also says is that much of the fiber out there is *never* going to be lit because it's going to be displaced by *newer* generations of fiber and/or the capital is clearly not there.

And even that seven-fold increase is probably optimistic.

**Crowe:** Incidentally, even that seven-fold increase assumes that all of the fiber is equal, that all of the carriers have equal competitiveness and that all of them have equal access to capital — which is not true. So even *this* assessment — this seven-fold increase — is more than we expect the industry to really have in place.

What's the conclusion? The conclusion is simply that what is clear in the marketplace today — that is, waiting lines for bandwidth-based services that are growing, queues that are growing in order to get high-capacity circuits — is the norm. Also, the relationship between supply and demand that you see in the marketplace today — that is, more demand relatively than supply if the supply is at the right place at the right cost and the right service quality — is going to continue.

And much of the asset that's in the ground today is not ever going to be lit. It's going to be written off. And it's coming like a bow wave in front of the industry....

(continued on next page)



**LEVEL 3'S**  
**JAMES CROWE ET AL.**  
 (cont'd from preceding page)

**WE'VE DEVELOPED A WORLD-CLASS STAFF AND  
 A WORLD CLASS TOOL IN NETWORK OPTIMIZATION.**

Building the network is just the beginning...

**Crowe:** All right, let's change subjects now. Let's talk about that second point that I said was implied by the pace of technical change. We've spent three years and in the range of \$10 billion building a *very* different kind of network. We believe it's a network that has been designed from the beginning to accommodate rapid and, at times, unpredictable change — if not perfectly, then at least better than our competitors.

We've talked about that quite publicly for a long period of time. What we've talked about *less* publicly — what we've talked about in only the most general terms — is the difficulty of properly planning and deploying the literally tens of thousands of network components in the right combination in order to be able to take advantage of that rapidly improving technology.

That statement has many implications. If we get it right, some of the implications are higher absolute capital, lower *unit* capital — that is, per unit of service — shortened economic lives, rapidly decreasing prices and costs, but even *more* rapidly increasing *demand*, higher cash flows and profits. That's the technology industry. It's not the utility industry, but it is the technology industry.

There are many, many trade-offs...

**Crowe:** Those trade-offs — that ability to combine network elements in the right way — is fundamental to what I just described. There are lots and lots of trade-offs. For instance, dropping prices means lower revenue per unit. But if you're in an elastic market — that is, a market where you drop prices and demand goes up more rapidly than prices drop — while you have less revenue per unit, you may have *far* more *absolute* revenue because the number of units scales so quickly.

We can pull less fiber. If we do, it decreases the number of fibers, but it increases expensive electronics. However, that may improve upgradeability and so forth and so on. There are many, many, many trade-offs.

They're too complex for the old method.

**Crowe:** Traditionally, all of those tens of thousands of trade-offs have been done generally by taking a projection of demand done by the sales or marketing group and presenting it to the engineering group, who simply solve for the lowest cost for that single point assessment of demand. Or, at best, there's a development that attempts to maximize profit.

In our view, those kinds of tools are misleading. Given the pace of technical change — given that demand is highly elastic and the more rapidly you deploy technology, the more rapidly you drop potential unit costs, and the more rapidly you drop prices up to a point, the more rapidly demand scales, the more net present value you create — the *only* proper way ... to manage that kind of *very* complicated problem (which I've come to learn is called a

stochastic nonlinear integer optimization problem, stochastic meaning containing a fair number of random elements) in any kind of informed way is to build a very large, nonlinear model.

That's why we've developed Project Max.

**Crowe:** And that's precisely what we've been doing. Many of the skill sets are very, very different from anything that the industry has experienced and developed to date. We've developed such a tool — we call it Project Max. We've spent the last 3-1/2 years working on it. That model, we think uniquely, examines optimal prices by city pair and by service. It looks at demand forecasting. It actually informs our development, our architecture and our deployment of technology in our industry.

Much of what you've heard us talk about ... in terms of the number of conduits we need... That is, we've said publicly that we need about six conduits in order to manage our business properly. It's the same thing with the number of fibers that we have in each generation. We've said that we reserve less than 12 fibers out of each generation of fiber for ourselves. It's the same with our asset lives, the phasing of network elements — all of those and many, many other decisions are informed by the Project Max model we've been developing.

In fact, we believe optimization — operations research, management science — is one of the key expertises and competencies that will be required to manage communications networks in the future. We believe we've developed a world-class staff in this area. At last count, we've got about 25 or 26 advance degree professionals and many others scattered through the organization with expertise in that area. And we've been continuously improving Project Max since it was first developed....

(continued on next page)

**CHART 3**

**Representation Inputs to Mini Max**

|  |                  |
|--|------------------|
| <u>General Input</u>                         |                  |
| Initial Demand                               | \$8,500,000      |
| Initial Price                                | \$200            |
| Annual Price Reduction                       | Variable         |
| Discount Rate                                | 15%              |
| Elasticity                                   | 1.0 to 4.0       |
| <u>Capital Expenses</u>                      |                  |
| Initial Capex Per Incremental Unit           | \$190            |
| Annual Capex Compression Rate                | 30%              |
| Annual Infrastructure Cost                   | \$10,000,000,000 |
| <u>Operating Expenses</u>                    |                  |
| Initial Activation Cost Per Incremental Unit | \$45             |
| Initial Support Per Cumulative Unit          | \$25             |
| Fixed Annual Cost                            | \$315,000,000    |
| Revenue Dependent Opex Cost                  | 18%              |
| <u>Network Expenses</u>                      |                  |
| Initial Network Expense Per Incremental Unit | \$80             |
| Annual Opex & NetEx Compression Rate         | 30%              |

Source: Level 3

LEVEL 3'S

JAMES CROWE ET AL.

(cont'd from preceding page)

OUR BUSINESS PLAN? TO CLIMB THE NPV MOUNTAIN.  
UNFORTUNATELY, THAT'S EASIER TO SAY THAN DO.

To give you a feel for Project Max, here's Mini Max...

**Crowe:** Project Max is, first, proprietary — and, we think, a tremendous advantage. But it's much too large and complicated to present to you. However, because we also think that understanding what we're about is key to making informed decisions about investing in Level 3, we've developed what we call Mini Max. Mini Max is going to be available on our website for investors and analysts. You can plug in your own assessments of a number of variables and see what kind of impact it has on the present value of modeled enterprises at a very high level. It's an NPV (net present value) optimized, discounted cash flow model where prices and demand are related by an elasticity.

It's a new kind of model — where unit costs, unit demand and cost per unit are all related fundamentally by whatever view you might have of the elasticity of demand for communications services.

First, pick your elasticity...

**Crowe:** On the screen is a very summary level description of the kind of input screens that are available in Mini Max. (CHART 3)

In the actual Project Max model, this is obviously something that is *much, much, much* broader and more complicated. I'm not going to go through this. I'll simply point out some of the key notions that you're free to look at, form your own view and see what kind of impact they have on prices and optimization.

You can decide what elasticity is. You can look at anything from 1.0 — that is, for every 1% you drop price, [unit] demand goes up 1% — to 4.0. To put that in perspective, consider that long distance service has elasticity of about 1.4 (for every 1% prices have dropped, [unit] demand's gone up about 1.4%) [whereas] computing's had elasticity of about 2.4. In our view, that's one reason why there's been so much value creation: Prices have dropped rapidly and demand's gone up even *more* rapidly.

The highest *measured* elasticity that we've been able to determine is for core routing. For every 1% Cisco's dropped price, demand's gone up 3-1/2%. In our view, that's not unrelated to the value creation in Cisco's case.

Next, pick your price-performance improvement rate.

**Crowe:** We also have a blank — and you can fill it in — for the rate at which you think price-performance improvements will occur in the capital plant underlying communications. Now in the Mini Max model, it assumes that there's simply one technology. And obviously, there are thousands of different components. But you pick it.

By way of example, at least *many* observers think optical technology is going to double in price performance every nine months. IP's been doubling every 18 months. If you do the math, that says in theory, at least, our business ought to have price-performance improvements in capital at the 80-90% or even 100% level. That's really hard to achieve, but that's the theory.

We also have all of the other metrics you can take a look at and fill in. We're not going to spend a lot of time with the results.

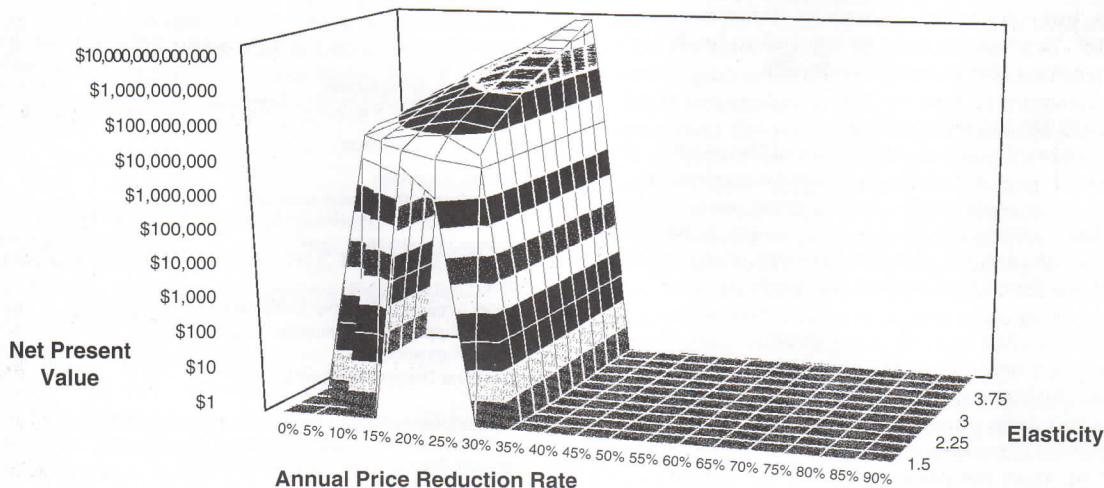
Finally, check out the projected result...

**Crowe:** I do want to take a hard look, though, at one

(continued on next page)

CHART 4

Mini Max Illustrates the Dramatic Effect of Unit Price Decrease and Elasticity of Demand on Value Creation



Source: Level 3

**LEVEL 3'S**  
**JAMES CROWE ET AL.**  
 (cont'd from preceding page)

result. The graph that you see shows the kind of dramatic — and I mean *dramatic* — effect that price drops have on value creation. **(CHART 4)**

Note that on the vertical axis is the NPV (Net Present Value) of the business in accordance with the variables that we've plugged in on the previous slide. By the way, they're not precise to *our* business or *any* business, but they're at least representative — \$10 billion to build a global network, some assessment of elasticity, a cost of capital (which we assumed was 15%). So they're not out in left field. You can look at the resulting NPV. And that's a *log* scale on the vertical axis. So every tick is 10 times the tick before — so every change in color is 10 times the net present value of the previous band of color. Look at the rate at which you create value given any kind of assumption of elasticity.

Our objective is to climb the NPV mountain.

**Crowe:** Note also that if you overdo it, value drops off a cliff. Why? Because if you drop prices more rapidly than demand is going to go up, you *destroy* value. So obviously, the key is to climb that price reduction curve in an optimum way and hit that plateau at the top.

And that's our business plan. You're looking at it. That is a summary level description of what we're all about. We want to climb that value creation [mountain] by dropping prices at the right rate given our view of the elasticities of the many products we sell (they're different for each) and our view of the rate at which price performance is going to improve for each of the components in our network.

Margins/profits can be great, but so is the challenge....

**Crowe:** Some of the implications of what you've just seen and, more broadly, of the Project Max model that we have built and maintain are the clear benefits in a technology industry to rapidly dropping unit prices and driving unit demand at the right rate. Clearly, asset lives are going to be much shorter. Margins and profits, we think, can have the same kind of very high levels we've seen in other technology industries.

What's hard about all of this, of course, is to do so, you've got to have the right systems *internally* — all of the hardware and software systems — that enable you to drop prices and stimulate demand and deliver service. And that's hard. We've been working on it for three years.

Just as important is to have a series of supply chain technology partners and customers who can respond and help us, first, with technology components — deploying 'em at the right rate and the right place — and customers who understand our pricing model and who build pricing drops into *their* prices to stimulate demand with *their* customers.

Mini Max oversimplifies things — for example, elasticity...

**Crowe:** The Mini Max model I've just described — and I want to underline this — is illustrative only. It's the Project Max model that we think has value. We have only a single view of elasticity [in the Mini Max model] whereas various products have different elasticities — they can vary by geography, by time and, of course, by product.

Networks are composed of thousands of different elements — each with different improvement rates — not simply one big element.

No competition is modeled [in the Mini Max model] — and clearly there is competition. And we didn't consider growth constraints. In fact, we're going to spend the rest of the conference talking about our solutions to those growth restraints in internal systems and external systems.

“WHEN A HORIZONTAL MODEL MEETS A VERTICAL ONE,  
 THE HORIZONTAL MODEL WINS EVERY TIME.”  
 — John Chambers, Cisco

A horizontal model beats a vertical model every time.

**Crowe:** Finally, I want to talk about the third implication of what we've just discussed in the Silicon Economics sense — and that is no longer speculative. For some time now, we've been talking about disaggregating what was once a vertical industry. Well, you no longer have to speculate — because you're watching it in the industry today as companies break up, carve up and spin out into much more horizontally-focused elements. And that is what technology is all about.

I can't say it any better than John Chambers of Cisco: “When a horizontal model meets a [vertical] model, horizontal wins every time.” It's just too hard in technology, as opposed to in a utility, to try to be everything to everyone everywhere.

And the evidence is everywhere....

**Crowe:** You can see this disaggregated industry forming around us. It's where the intellectual and financial capital is flowing. **(CHART 5)**

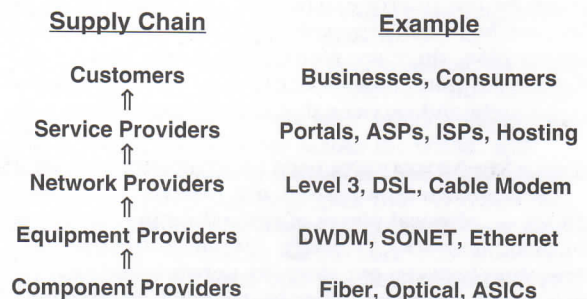
You can see it in the component providers of optical components. Our friends at Corning ... are a clear example of one of the leaders in this area. You can see the system houses — Nortel is here today — who buy the components, combine those components and build breakaway products at the system integration level.

Next are network providers — both access providers and backbone providers (we'll talk about our role in that

(continued on next page)

**CHART 5**

The Disaggregated Communications  
 Supply Chain



Source: Level 3

LEVEL 3'S  
JAMES CROWE ET AL.  
(cont'd from preceding page)

and our belief that we're positioned to be the breakaway company at that level of the horizontal supply chain).

Next up are the service providers — the business service providers and the residential service providers — who in that disaggregated model buy network functionality, from companies with whom they have strategic relationships and build franchises at the home or at the office. And next up, of course, are the end users.

The bottom line: We think we're positioned to break away.

**Crowe:** Let me sum it up this way. The balance of our conference is about the specifics of the internal systems and the products that bring this strategy together and about the external supply chain we're building to bring this strategy together. We think it is clear that in a technology industry, as opposed to a utility industry, demand and supply have a *very* different relationship. And we think it's clear now in communications, as a technology industry, that rapid change and high absolute capital [needs] are going to severely limit supply — and we think you're seeing it in the market today.

We think it's clear you have to have whole new approaches — whole new systems — of a kind that have not been developed in our industry. And we believe that we're leading in that regard. Then, finally, we think that under the pressure of this shift from utility to technology, we are *clearly* seeing a disaggregation in the industry. And we think we're positioned to break away as a result of *all* of those shifts.

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WE'RE NOT JUST A LONG HAUL NETWORK —  
WE'RE LONG HAUL, METRO AND MORE.

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We're not just a multi-conduit, intercity network...

**Crowe:** With that, I'm going to turn the podium over to our president and chief operating officer, Kevin O'Hara, who's going to start the balance of the conference by describing the assets — the network — we've been building over the last 3-1/2 years. Kevin?

**Kevin O'Hara:** When most people think of Level 3, the first thing that comes to mind typically is the intercity fiber that we've deployed and the multiple conduit system that we have for our intercity networks. And while those two assets are *huge* and represent the foundation of the Level 3 business plan, there are many other assets that Level 3 has deployed that allow us to convert those basic facilities into products and services that our customers can buy.

There's a big reason we've been so aggressive in colocation.

**O'Hara:** The first asset is our gateway and colocation facilities — physical pieces of real estate that sit on top of the Level 3 network. Typically, they sit at the point of intersection between our intercity network and our metropolitan networks. They house our transmission equipment, our optronics and our IP equipment. But they're also available to house our *customers'* equipment.

And the significance of this is *huge* — because if you can locate your equipment directly on top of a fiber-optic backbone, you can save approximately 50% of the cost of bandwidth. For our customers, bandwidth typically represents 25-50% of their total operating expense. So being able to push their cost structure down that dramatically is very, very important.

With that in mind, we've been very aggressive in constructing colocation centers. Today, we have more colocation centers in terms of quantity and square footage than any other carrier in the world.

We're trying to connect to as many networks as possible.

**O'Hara:** We're in the broadband backbone business. Since the breakup of AT&T, the distinction between an intercity network and a metropolitan network has been a result of some regulatory decree and not the result of rational economic analysis. Most of the networks that exist in North America today come together at a point called a tandem.

But if you look at where the traffic is aggregated, while it does aggregate at the tandem, it tends to get aggregated much closer to the end user. Our goal is to extend the economics that we bring from the backbone business deeper and deeper into the metropolitan networks — to bring the products and services and benefits that Level 3 brings closer and closer to the customer by connecting to more access networks.

As a result, our backbone business isn't simply an intercity network. It's a combination of intercity facilities and metropolitan facilities. We are not in the access network business, but we *are* in the business of connecting to as many access networks as possible.

We're the broadest and deepest next-generation carrier.

**O'Hara:** I believe that one of the assets that's probably least understood about the Level 3 facilities is our metropolitan networks. Today, we have 15,000 miles of conduit in the metropolitan markets that Level 3 serves. We have 450,000 miles of fiber deployed in the metropolitan markets that we serve. And we believe that 15,000 miles of conduit and that 450,000 miles of fiber is the broadest and deepest footprint of any next-generation carrier.

We connect to as many traffic aggregation points as make sense in those markets. A traffic aggregation point is simply a carrier hotel — a telephone company's central office, a CLEC central office, a data center, a third party colocation facility, and increasingly, the so-called OLEC and DLEC or alternative carrier facilities. It's where traffic gets aggregated and then transported someplace else.

Our goal is to connect to as many of those TAPs [Traffic Aggregation Points] as makes sense. And TAPs, like everything else in our industry, follow an 80/20 rule. We believe that the number of TAPs we'll be connected to by the end of 2001 will have us addressing more than 80% of the locations where the top 100 bandwidth users in the world gather.

And because our customers and our customers' customers are increasingly going to IP-based traffic, we have optimized our metro facilities for IP transport.

The impact of getting onto our own fiber is huge.

**O'Hara:** The intercity network: For the last two years, we've been talking about construction and what we're going

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## LEVEL 3'S

JAMES CROWE ET AL.

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to do. This year, we get to talk about what we've done. Our U.S. intercity network is substantially complete and is carrying traffic today. Our European network's substantially complete and carrying traffic today. Our transatlantic cable — complete and carrying traffic today. Our North Asian cables [since sold] are under construction. And those other undersea cables where we have equity participations are either complete or in service.

The significance of finally getting onto our own fiber is huge. As a result of the new construction and the method of construction — the way we've designed our network — we do enjoy the low-cost position in the marketplace today. So we can price our products and services off of our cost. As a result of migrating onto our own network and off of leased facilities, you'll see improvements in gross margin as we move throughout the year.

As importantly, we now have control over the provisioning intervals for those on-net services that we sell. And you'll see an improvement in our quality of service as a result of our control end-to-end using our own facilities. When the network is fully completed, we will connect to 280 cities around the world.

[Editor's note: Of course, this comment was made prior to the sale of their interest in the Asian network.]

RELATIONSHIPS ARE *VERY*, *VERY* COMPLICATED.  
WE GET SOME *VERY* COUNTERINTUITIVE RESULTS.

Only multi-conduit, upgradeable network in U.S. & Europe.

**O'Hara:** All our networks were constructed with multiple conduits. This makes sure that we can take advantage of changes in fiber optic technology when they make economic sense. It means we can be opportunistic in deploying additional fiber for dark fiber or fiber-related sales. And we have the only network that is multi-conduit and upgradeable in both North America and Europe.

But that's more complicated than it sounds....

**O'Hara:** When we talk about upgradeable networks, we tend to use the conduit example because it's very graphic and it's very easy to understand. However, to design an upgradeable network that takes advantage of changes in technology is very, very difficult. There's an entire series of decisions: "Should I use Technology A or Technology B? Should I light additional strands of fiber or put additional equipment on strands of fiber that I've already put in place? Should I deploy a new generation of fiber or continue lighting old generations of fiber?" And those questions are very difficult to answer.

All carriers except for Level 3 tend to answer those questions in isolation: "How do I satisfy my capacity requirements without regard to some of the other technical decisions? What technology should I deploy without regard to increased fiber versus increased spacing of repeaters?" There's a whole series of things that play off of each other.

If you're out to maximize NPV, answers may be surprising.

**O'Hara:** Under Jack Waters' direction, our engineering

group tends not to look at capacity or technology. They look at NPV. The only thing that matters for how we deploy technology, how we add capacity, and whether we pull a second fiber is whether it yields an increase in net present value — because at the end of the day, that's the only thing that counts.

And what we have found as a result of both Project Max and Mini Max is that the interdependency of all of those relationships is *very*, very complicated. Therefore, when you model those interdependencies, you get some very counterintuitive results.

We've validated a lot of those counterintuitive answers — we're comfortable that a lot of the counterintuitive results that we've gotten out of the model, in fact, are valid. And we believe that it is our understanding of those counterintuitive relationships that best positions Level 3 to further break away starting this year.

AND THE TECHNOLOGY IS CONSTANTLY MOVING  
— FOR EXAMPLE, MPLS, ETHERNET AND MESH.

MPLS will provide the same functionality, but cost far less.

**O'Hara:** Technology is important in our business.

The pace of change in technology is dramatic. The rate of price-performance improvement is dramatic. But not all technologies make sense to deploy in your network at a particular point in time. The only time that we would deploy new technology is if we thought that it would increase the NPV of the enterprise.

One of the technologies that clearly satisfies that criterion is multi-protocol label switching or MPLS. When you move data around a network, there are certain attributes that you want to be able to prescribe into the network to yield a certain quality of service or distinctions in quality of service. And up until very recently, the only way to do that was to use ATM [Asynchronous Transfer Mode]. Now ATM did enable you to get those qualities of service that were necessary for your data flows, but it was *very* expensive.

With MPLS, we have an IP-based substitute for ATM. And as a result of IP being the market-based standard, the cost of providing that functionality over an MPLS platform is *far* less than that of providing it over an ATM platform. We are broadly deploying MPLS in our core as we speak. In fact, most of the network is on an MPLS network today.

Ditto for Ethernet over ATM and SONET....

**O'Hara:** We're seeing a migration from SONET-based technologies to Ethernet technologies. The traffic growth at the edge of the network from the enterprise or from the consumer is increasingly IP. So we're seeing the growth in traffic coming in the form of IP — and we see migration of traditional services moving over towards IP.

Well, on your campus or in your building, for a long time, you've been moving IP over Ethernet. But to move that from your campus or from your location either across town or across the country or across the world, you typically would have had to multiplex that traffic up onto an ATM platform and then multiplex that ATM platform onto a SONET platform, transport your traffic and then do the same thing in reverse at the far end. And while it yielded the type of product that you needed and the type of transport that you needed, it was very expensive.

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Well, now we're seeing Ethernet in the metropolitan areas become a cost-effective substitute. In fact, transporting IP traffic in the metropolitan area today directly over Ethernet can be done at a fraction of the cost of moving it over ATM over SONET. The quality is good today. The cost is literally a fraction of the alternative. So we're deploying that technology today in our metropolitan areas.

Mesh protection will enable more intense network usage.

**O'Hara:** We're starting to see the migration from SONET-based ring protection to mesh protection. When you build a SONET-based network and you set up a certain amount of capacity between Point A and Point B using Route C, you need to set aside the exact same amount of capacity between Point A and Point B on some other route in case you have a cut. So 50% of your network capacity at any point in time is sitting idle just in case of network disruption. **(CHART 6)**

Well, with mesh protection, depending on how many links you have and how many nodes you have, you can go through this statistical modeling and find out that you can reduce that 50% spare capacity — not to zero because you do need capacity sitting there in case of a network disruption — but from 50% down to 33%.

And we're seeing this start to prove in for certain express routes today on the intercity network. However, the key underlying technology is not yet cost effective to deploy on a broad basis. So while you could deploy the technology, if your goal was to maximize NPV, you simply wouldn't be moving rapidly to mesh protection today.

We believe that this is going to prove in the next [couple of] years. But today, it's not cost effective — it's not NPV-increasing — on a broad scale.

WE THINK IT'S CLEAR THAT WE HAVE A UNIQUE ASSET THAT'S UNIQUELY POSITIONED TO HANDLE CHANGE.

The key to deploying the new technology is the OSS....

**O'Hara:** The key underlying technology ... is optical switching. It's the key enabler of cost reductions over time. It's a key enabler to scaling wavelength products over time — both of which represent tremendous opportunities for Level 3.

The technology will prove in from an economic standpoint sometime in the near term. But the key to *deploying* that technology is the operating support systems [OSS]. Whenever you deploy a new technology, you need *software* to enable you to actually provision on top of that platform. You need software to be able to see that platform in the network and manage that platform — see the state or condition of that element at any one point in time to make sure that you're satisfying all of your service requirements.

Well, that software — the so-called OSS — typically lags in introduction into the marketplace. Either the equipment vendors themselves deliver the OSS after they've delivered the platform, or a third party market develops where third party software developers introduce OSS in support of the technology that's been adopted by

the marketplace — or you write it yourself.

Now, it's the OSS that is critical to being able to scale your business and manage the business effectively. We're going to show you a demonstration shortly about an OSS system that Level 3 has developed internally called ONTAP that shows how Level 3 is going to take advantage of not just the underlying technology, but take that technology and use it to help Level 3 scale.

Here comes ONTAP, ethernet, optical switching and mesh.

**O'Hara:** Near term (near term being 2001) we've deployed Ethernet in our metro transport — and will continue to deploy Ethernet in our metro transport networks. We have MPLS routing and provisioning in our core today. We're deploying mesh technology where it increases the NPV of our enterprise — which today tends to be just on the express routes.

We have automated network inventory in place today. And you'll see the ONTAP demonstration shortly. It will be rolled out much more broadly over the course of the year and will allow us to have automated network provisioning.

Midterm, we think that Ethernet-based technologies are going to continue to grow. They started at the enterprise. They've now moved out into the campus and into the metropolitan area. We think that migration is going to continue even into the backbone — into the core of the network — simply because the cost of moving traffic using Ethernet-based technology is so much less than moving it using alternative technologies.

You're going to see end-to-end optical switching. You're going to see end-to-end MPLS-driven routing. And you're going to see cost-effective mesh protection in the next two or three years.

Best of all, we think we're ready for unexpected change.

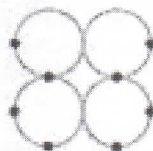
**O'Hara:** But there's a caveat. There's always a "but". Right? It would be perilous to sit here today and think that we can predict with *any* type of certainty or any type of accuracy what technologies are going to prove in three or five years from now. Looking back just five years, many of the technologies that we're deploying weren't even

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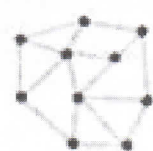
## CHART 6

## Migration from SONET Ring to Mesh Protection

Ring Protection



Mesh Protection



- Ring architectures require 50% of capacity to be reserved in case of failure

- Mesh architectures require approximately 33% of capacity to be reserved for similar protection levels

- While not broadly cost effective today, mesh protection is rapidly improving

- Optical switching is a key enabling technology

Source: Level 3

**LEVEL 3'S**  
**JAMES CROWE ET AL.**  
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contemplated. The goal shouldn't be to try and predict with certainty what's going to happen from technology — because that's perilous. The goal should be to try and build an entire company — the network, the infrastructure and the mindset — that can embrace new technologies — even when they weren't seen coming.

It's really good to have an upgradeable network when you can see out on the horizon that there's *going* to be changes in the fiber. There may even be perfect mirror technology or photonic crystal technology that fundamentally changes the way that you need to deploy your network.

And the only way to take advantage of that — the only way to make sure that you don't create a vacuum for a new entrant to step into — is to build your entire business to be upgradeable. We have *done* that. The multiple conduit network positions us nicely to take advantage of the technology changes regardless of what they may be.

Make that uniquely positioned for unexpected change.

**O'Hara:** In summary, we have more colocation gateways and more colocation square footage than any other carrier in the world. We're the only next generation carrier that has both local facilities, metro facilities, and intercity facilities in North America and in Europe. And because of our network design, we're uniquely positioned to accommodate those changes in technology.

Many people within Level 3 are rightly proud of the accomplishments that they've achieved over the course of the last two years — particularly in the area of network construction. With that in mind, we're going to show you a short video on the construction of our network and its current state.

[Editor's note: The video mentions several interesting points: First, that they're already "on the third generation of single mode fiber" and that "Corning predicts that we can expect a new generation of fiber every 18-24 months — each with better price performance". Second, they emphasize "the speed and ease of blowing fiber cable through pre-installed empty conduits" and apparently show it being done. Third, they emphasize the magnitude and difficulty of building a nationwide network, the enormous number of approvals and permits required when they did it and suggest that "there are *many* more

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regulations and permits required today than there were in the past to put in a telecommunications system".]

We believe it's clear that we have a unique asset.

**Crowe:** When Jack [Waters] says that we've created a network that's unlike any other, he means it. In the appendix of your book, there are a number of slides that describe to the very best of our ability based on public information the actual assets as we understand them in our hands and in the hands of our competitors. There is a description of all — at least all that *we* know of — the intercity facilities-based providers, all the gateway facilities, all of the metro facilities together with the sites from the various documents, financial information, websites, etc. That's in an attempt to help investors understand who actually has what.

We believe that it's clear from examining those voluminous documents that we have a unique asset. In our view, two next generation networks have been built — Level 3's and Qwest's. The other networks in place today are derivative networks composed of parts and pieces put together by swapping, by trading, by purchasing dark fiber and building in certain circumstances.

Those are the facts. Examine them yourself. If we have anything wrong, let us know. We want to make sure that we keep it accurate....

Keep in mind that we're still an infant....

**Crowe:** Keep in mind that ... in '99, we were really a start-up company beginning construction of our network. I reflect back on my experience at MFS where to get to a similar point in development, it took us somewhere in the range of six to eight years. It's a remarkable, remarkable achievement. And it speaks well for the team that we've put together....

IT'S ONE THING TO MODEL IN THEORY —  
 QUITE ANOTHER TO PURSUE IT IN REALITY.

Nobody could have developed Project Max until recently.

**Attendee:** Kevin said that one of the useful things about the Project Max model was that it gave you some counterintuitive results.... What counterintuitive results have you been seeing — and how are you following through on them in terms of your business plan?

**Crowe:** What are some of the counterintuitive results that have come out of Project Max which, the last I looked, was about a 35,000 variable, 15,000 constraint model? Well, we could not solve that model directly only a few years ago. Only in the last few years have the computing power and necessary algorithms been developed.

Again, I'll give a *major* thank you to Arun Netravali and the Bell Labs folks who helped us with some of the preliminary algorithm work. They've received quite a number of Nobel Prize awards in this area and it showed. And we thank them for the help.

Max tells us how many fibers to reserve — and light.

**Crowe:** But that very large model, for instance, is what has caused us to say publicly we have reserved fewer

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LEVEL 3'S  
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than twelve fibers in each of the two generations of fiber that we have either today pulled and lit or announced that we're going to pull — fewer than twelve. The exact number we consider proprietary.

Why? Because we'll light up fewer than four fibers before all of the [significant improvements in fiber] make the next generation a better choice. That is *very* counterintuitive. And, I might add ... it *still* remains a bit controversial. There are carriers who are announcing plans to deploy hundreds of fibers in the face of what we've discussed here today.

We'd tell you, and we're *acting* on this conviction, that in any one generation no more than 12 fibers will be lit. The actual number is something else. We've said we have reserved six conduits. How do we know that number? Again, the *exact* number is not something we'd publicly disclose because Project Max informs that decision.

And it tells us how rapidly we should write off our assets.

**Crowe:** [The periods over which we write off] our assets are *substantially* less. Well, you can imagine that was a bit of a discussion with our accountants who are looking at every other carrier writing off fiber over a period of 20 or 30 years. We're using seven. And the proof is in Project Max.

I could spend a significant portion of your afternoon talking about this subject. It is an area, I believe, that not only will inform *our* decision making, but has broad applicability throughout the industry.

Discounted cash flow models in the good old days....

**Crowe:** I'm talking to an audience here that is perhaps more informed in this area than I am. Businesses in their strategic planning efforts, analysts in valuing corporations, companies and analysts who look at takeover situations — and investors whether they know it or not and although they may use a rule of thumb — without exception, the algorithm (the math) that has driven business more than any other is the discounted cash flow model. You're all expert in its use — and you're all far more expert than I am.

And as you know, discounted cash flow models are developed in a fairly straightforward way. In our industry, at least historically, it hasn't been any different. The marketing and sales groups make an informed projection of unit sales and unit prices, multiplies the two together, and says that's what our revenue's going to be per quarter or per year — over some period of time.

That's generally tossed over a wall to whoever owns or controls or manages the means of production. Factories, or in our case, the network engineering group, say, "Oh, that's what the sales folks say they're going to sell. What's it going to cost us to meet that projection of demand?"

So you've got a point estimate of revenue and a point estimate of the cost of revenue. You project that yearly and subtract one from the other. That's your cash flow. You discount it back at some rate. That's what your company's worth. Divide by shares outstanding, that's what your shares are worth, right? It's obviously a little more difficult than that. It takes a fair amount of judgment.

Otherwise, none of you'd have jobs. But that's the process.

In our industry, NPV-optimized models are the absolute key.

**Crowe:** Now what's wrong with that? Well, what if demand is elastic? What if technology is improving rapidly? What you really ought to look at are millions of combinations of prices and demand. If you lower price, demand goes up. You ought to take that demand and run it through many combinations of networks to see what the lowest or the highest NPV combination is.

None of that was possible until recently. The math was too hard. We believe that NPV-optimized, discounted cash flow models are the absolute key in our industry and will have broad applicability over time as it becomes possible to model whole enterprises and as technology and elasticity demand become important.

And the real-life proof of that is our Project Max model and the Mini Max model which will be available to all of you on our website shortly.... But we've said, and I'll say it again, that it's one thing to model in theory. It's quite another to pursue it in reality and develop all the internal systems and the supply chain relationships that allow you to become a technology business. That's the hard part.

SOMEBODY'S GOING TO PUT IT ALL TOGETHER.  
 WE FIGURE IT MIGHT AS WELL BE LEVEL 3.

Weighted avg price-performance improvement  $\approx$  110-120%±.

**Attendee:** I'd like to ask you a question, if I may, regarding the revenue in '01 as well as '02. From my perspective sitting here and as many others would, we'd look at price times volume to come up with revenue. Within the constraints of talking competitively, could you give us some guidance regarding what is implicit in the revenue number for a weighted average price decrease to come up with those numbers?

**Crowe:** The caveat that you said — "within competitive restraints" — makes me real reluctant to do it. But you can develop the price drops [using our Mini Max model].... Pick your elasticity number. On a blended basis, let's just use computing as a proxy. So we'll just say 2.4 or 2.5.

If you plug in a price performance improvement rate for optical technology... Most in the industry think it's doubling in price performance every nine months at the *component* level. Remember that it's a whole other matter to turn that into bandwidth-based services. But at the component level, price performance improvements are roughly doubling every nine months. IP-based technology is doubling in price performance every 18 months. Two-thirds of our incremental capital investment is in optical technology.... That's what drives an NPV-based model. One-third's in IP.... That's the way it splits out. You can calculate a weighted average improvement rate. I think we've done the math somewhere. And it's something like 110-120% a year.

Our industry is trending toward 60-80%/yr. price drops.

**Crowe:** Now plug that into that Mini Max model and then form some view of the rate at which you can scale — the operating leverage in your op-ex. Pick a number, 50%, 60%, 70%. Plug the number in and see what you come up with. I'm not smart enough to do it in my head. But I can

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assure that the price-performance rate that maximizes NPV is going to be up there in the 40%, 50%, 60%, 70% rate. The higher you pick the rates at which your cap-ex improves and your op-ex improves (and the two are very tightly related depending on elasticity)...

By the way, in that model with its log scale, it's hard to see graduations — because that much [gesturing with his fingers] can be a doubling of price performance. But those are the kinds of trend line price drops — 60%, 70%, 80% — our industry is headed towards.

But that's more easily said than done.

**Crowe:** Now, what's the hard part of that? Building systems internally that allow you to scale and drop prices at that rate — that's really hard. You heard a description. Van Macatee, who runs all of our ops [has] been working 25 years on that problem. And we've spent three years developing systems which we think allow us to lead the industry in scaling internally. And we're nowhere *near* perfect. Fortunately, we get graded on a curve, not an absolute scale. We'd get a C- at best on an absolute scale. But on a curve, we do a whole lot better — because it's *hard* to build those systems.

And we can't do it by ourselves.

**Crowe:** You also have to have the supply chain. It isn't enough for *us* to drop prices. We'd run out of fiber. We'd run out of components. We'd run out of systems. We'd run out of all of the necessary means of production unless *others* in the supply chain viewed the industry the way we do — and our *customers* need to.

Look at computing where that supply chain exists. That's the magic of capitalism, right? In the markets? Intel doesn't direct the hard drive manufacturers and Dell and Gateway. They don't have dictatorial powers.

[Editor's note: Obviously not. That's Microsoft.]

**Crowe:** But those who build microprocessors, those who build hard drives, those who build the motherboards, those who do the assembly (the Dells), those who build operating systems all work together to enable the *remarkable* drop in price and explosion in demand that we've seen in computing.

Somebody's going to do it. It might as well be us.

**Crowe:** And that has to develop in communications. But we are trending towards price-performance rates that make what you've seen in computing look slow because of the math of technology. And we plan to lead the way. *Somebody's* going to do it. We think we've got the lead. So it might as well be us. We're going to work round the clock on the systems, the procedures and the supply chain relationships to push to where we maximize NPV — the [discounted net] present value of our enterprise.

And I'm sorry that I can't be more specific than that, but the price drops which maximize NPV at realistic inputs to those models are *far* greater than what exists in the industry today. So if we don't do it, somebody else will.

IT WON'T BE EASY, BUT WHOEVER BREAKS AWAY IS GOING TO HAVE ONE HECKUVA FRANCHISE.

We're focused on having a single proprietary competence....

**Attendee:** Jim, when you consider a business model where you're contemplating 60-70% price drops, relying largely on your ability for flexible technology, how does the fact that the technology is not necessarily proprietary — that Softswitch and Corning technology is available to your competitors — fit in longer term with you maintaining a low-cost position?

**Crowe:** Great question. What is it that we have a proprietary competence in? That's why we published Mini Max and why I spent a few minutes going over it. It was to give you what we believe is the core competence which will enable communications companies to create value.

It isn't producing optical components — we're not going to be better than Corning at that. It isn't building equipment and systems — we're not going to be better than Nortel at that. And we're not going to be better at building routers than Cisco.

Our proprietary competence is properly integrating tens of thousands of network components at the right rate in a global network with hundreds of thousands of components. You can't *do* that in any traditional way. To do it properly, you have to have some of the internal systems that you saw just a very short description of and you have to have the external supply chain relationships. And those are really, *really* hard.

Whoever breaks away will have one heckuva franchise.

**Crowe:** By the way, what creates the kind of value that an Intel has managed to put together over 20 years — or a Cisco or a Nortel along the way? I'd argue that yes, there's technology. And we believe there's a *lot* of technology in the kind of systems we've built — they're really hard to build. That's why we have a bunch of Ph.D.'s in operations research and management science. But what is *really* hard is the capability to *scale*.

Again, AMD's processor, functionality for functionality, is directly substitutable for Intel's. It's Intel's internal systems that allow them to scale to the tens of millions of units and external supply chains with partners that allow them to lock into that enormous value creation curve.

That's what's coming in our business. We're *focused* on those internal systems which are really hard and those external relationships which are really hard. We've got a head start and that's all you can ask for. The rest is up to us. But I *assure* you, whoever manages to break away at the intercity backbone bandwidth business is going to have a heck of a franchise because of the systems and the interactions that it takes to scale at those kinds of rates. It is *really* hard....

BACKBONE BUSINESS IS A BREAKAWAY BUSINESS.  
ACCESS BUSINESS IS VERY DIFFERENT INDEED.

The access business has been veddy, veddy good to me.

**Attendee:** My question pertains to something that I

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saw in the IP gateway presentation or the video where you guys kept talking about an end-to-end solution. What I remember vividly is somebody sitting at a desk doing a video conference with someone presumably in New York doing a video conference with somebody presumably in San Francisco or something like that with full motion video and a clear picture. And I understand how you guys can drive an end-to-end solution from gateway to gateway. What I don't understand is the last mile between the gateway and the headquarters that we're talking about — unless coincidentally both those headquarters just happen to be built on top of the gateways. Can you talk a little bit about that last mile solution and how it affects the business plan?

**Crowe:** Sure. And that is a key. I and many of my colleagues were in the last mile business over quite a period of time at MFS. It was very good to me personally. My wife thanks our experience at MFS each and every day, as do I. And yet we deliberately chose *not* to be in the access business.

Why? Recall that when Kevin O'Hara made his presentation, he said in spite of all the dust and smoke that resulted from the breakup of AT&T — directed or governed or overseen by a federal judge (actually the program or the process was proposed by AT&T) which divided networks up into rather arbitrary pieces which are still largely present today — in our view, there are only two kinds of networks: there are access networks which connect a customer to a point of traffic aggregation, those TAPs he talked about, and backbone networks.

Backbone networks have some metropolitan pieces and they have some intercity. From our perspective, though, it's end to end. And when we talk about end to end, we're talking about from traffic aggregation point to traffic aggregation point....

Why we're not in the access business...

**Crowe:** Now, why do we do that? We do that because the backbone business is a technology-based business that responds to the kind of dynamic that is fundamental to what we're doing — the dynamic described in Project Max — whereas the access business is still a utility business. It's not a *bad* business, but it's a utility business where the value creation potential is nowhere *near* the kind of scale we hope — with a lot of work on our part — that we enjoy.

That's because, unlike the backbone business, if we decide to move from ATM to MPLS (which we've done) once we decide to do it, we work with market-based providers of technology and stand or fall based on the results.

In the access business, if you want to deploy a technology, you get together with your competitors at the ITU and spend five or ten years negotiating before the standard is deployed. Only then do the hardware and software manufacturers implement. It's centrally planned. It's heavily gerrymandered from a regulatory point of view. And it's still a utility. So we deliberately choose to hook up lots of access providers.

Look at 3G. I'm not saying it's bad technology or low technology, but it's centrally planned. So it takes *years*. And you have to negotiate with your competitors.

We want to position ourselves in a *breakaway* business where, depending on how good we are, we have the opportunity to get supranormal market share and supranormal margins. The access business is very different.

We could never do the access side by ourselves.

**Crowe:** We connect up with *lots* of access providers. That's why we want to be in all those TAPs. That's where we meet access companies by the dozens — CLECs, cable modem providers, wireless providers, ILECs, the RBOCs and Data CLECs.

And that's our answer. If we tried to do it all by ourselves, given the utility nature of the business, it would take far more capital and far more time than we'd ever be able to devote. So we're going to let lots and lots of folks take a shot at it. We'll connect 'em all up. And when you match the demand generated by those *multiple* access providers to the capacity we have on the backbone at the right price, we think the demand and supply [relationship] is good. We walked through that in my presentation. So that's why we're not in the access business.

Another reason why we focus so much on gateways...

**Crowe:** There is some good news though. Unlike the telephone business, the business we're in is not a client-to-client business. Now, what do I mean by that? The telephone business is a black phone over here through local networks and long distance networks to another phone. It was that way for 100 years. So there was an access network of the traditional kind with a phone and a person at both ends. So you had 100% of the traffic on backbone networks that was connected to customers through access networks.

Our *new* business, the IP-based business — the data business which is now more than 50% of demand and will be 60% and then 80% and then 90% and 95% — is a client-to-server business. Yes, at one end is a customer and an access network, but at the other end is a computer generally, sitting in a gateway. So one-half of the traffic in the past that would have gone through an access network now comes from gateways.

That's the reason why we spend so much time and effort building gateways connected to TAPs — so that we can connect access networks to computers or servers. And that's another way of saying what it took us three hours to say. We connect TAPs to computers — with capacity at the right place at the right price.

TWO THINGS STAND BETWEEN US AND OUR FUTURE  
 — INTERNAL SYSTEMS AND SUPPLY CHAIN PARTNERS.

Will limited access limit our future? Great question.

**Attendee:** Given the failure or impending failures of a number of the CLECs, the lack of infrastructure investment by the remaining survivors and the 6-12 month provisioning delays for high-capacity circuits from the ILECs, what's the risk that Level 3 finds itself in a place where you're cutting prices and the elasticity is there, but you don't get the benefit of it because there's a massive capacity shortfall in the access side of the business?

**Crowe:** That's a great question. I said earlier that there were two things that stand between us and the power of the

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model that you can play around with (Mini Max) and which informs all of our decisions (Project Max). One of them is the internal systems — which we've been working on for three years.

The other is the supply chain. By supply chain, we don't mean just technology partners. We also mean customers. And so the answer to your question is that we've worried about that problem for a long time. That's why we've invested in colocation facilities. It's why we walk through the whole notion of traffic aggregation points. It's why we have metropolitan facilities and not just intercity — because we want to have a robust way to touch dozens, maybe *hundreds*, of different kinds of access networks.

There'll be an imbalance. But the shortage will be supply.

**Crowe:** And when you look at the huge rate at which access networks are growing — it's still a utility business ... — and then you match it up with backbone bandwidth at the right price, we think it's a good match.

I walked through the math and showed it to you in that first section. You pick the rate at which you think access speeds are growing, the amount of time that people spend on-line, the number of subscribers, whether you think demand's doubling every 12 months or 18 months, whatever you think it is, and match that up with the capital-constrained supply at the right price — the math that I did earlier.

And I think you'll find that there's an imbalance. But it tends to be more demand than supply at the right price.

The challenge & the opportunity — customer relationships

**Crowe:** To do that, though, you've got to have supply chain partners. You've got to have transparent pricing and relationships with customers — *strong* relationships with business providers and residential providers. That's why we have all that gateway space and metro facility — to build those relationships.

But the point you're making is exactly what we think represents the challenge and the opportunity — relationships with customers....

REGULATION IS A VERY MAJOR MATTER  
— WITH SIGNIFICANT IMPLICATIONS.We're relatively lightly regulated — with one exception...

**Attendee:** Are there any regulatory issues whatsoever that are of any concern to you — or are you pretty well free of regulation at this point?

**Crowe:** Well, as you know, there is no company that's free of regulation. At minimum, we've got to pay taxes and we've got OSHA [Occupational Safety & Health Administration] and a long list. I presume you mean are we free of the burdensome, centrally-planned sort of FCC regulation. And today, we *are* for our backbone business. Yes, there are regulations. You still have to file as a facilities-based carrier. For instance, you've got to apply to be a CLEC if you want to offer Softswitch-based services and terminate them at reasonable costs. You have to have

reasonable costs. And we have to do all of that.

However, for our core business, with one exception, we're *relatively* lightly regulated. And our ability to scale services — drop prices, stimulate demand, create value — isn't government determined, unlike the access piece.

There is one exception. On our Softswitch platform, we offer (3)Connect Modem and (3)Voice. And (3)Voice is a service where we take calls from others who originate them on other networks and terminate the calls — because we have great economics on our backbone and on our terminating infrastructure.

No big regulatory issues at the office.

**Crowe:** The real *tremendous* upside is originating IP traffic right at the customer premises — either from the home or the office. With respect to originating IP traffic at the office, there aren't any particular regulatory barriers. You just need to make sure the move from the old PBXs [Private Branch Exchanges] — the things that businesses had in buildings, you know, the four digit dialing — those PBXs... As the replacement cycle comes around, you're going to see (and we already are because the technology's there) your telephones, or whatever happens to be the device that you talk through, plug right into your local area network like your computer.

And we're positioned very well for that migration. There are no big regulatory issues.

The earth is going to move for voice service to the home.

**Crowe:** The other big bang for the buck — and the opportunity's much *bigger* — is when residential users can pick up a phone and spit IP packets out, but use that phone just like they do today. That has all *kinds* of regulatory issues. And it's going to cause a cataclysm. What you've seen in the inter-exchange with IP and e-mail imploding a lot of the margins in the inter-exchange is coming to the local exchange. It is absolutely inevitable. We're going to see IP-originated traffic [from the home]. And when it does, all the same things you've seen — the same kinds of financial difficulties and turmoil in the backbone business — *will happen*.

It takes a number of things: First, you've got to have a device at the customer premises to put out IP packets. That device has to have the called number. In other words, you can't ask customers to go through a lot of rigmarole. They've got to be able to pick up the phone and dial. So it has to be a relatively *smart* device that knows the called number and tells the network the number that was called.

But when that happens, the 2.2 cents per minute — the largest single cost element in residential voice by far — disappears unless the regulators do something. And the \$25-30 billion dollar access charge regime that is currently in place that supports the whole of the RBOCs implodes.

This is a very major matter with significant implications.

**Crowe:** You can bet that that's going to cause the regulatory regimes, both at the state and federal level, to have nightmares and go into brain cramp. That's going to cause *lots* of turmoil.

And by the way, that's not five years from now. That's on the table. There are a number of players who are working on devices — some of which you can actually buy. There's lots of service providers — major ones who are

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wrestling with some of the issues. You're going to see that.

It doesn't mean we're going to see it all occur overnight. But it's going to *happen*. And the markets will discount it real quickly when it does. That's the last area of regulation that affects us materially, because while we're not going to be the service provider in the local loop, our Softswitch platform is positioned *ideally* to match up with, say, ISPs that want to offer voice to their residential customers — all you can eat, flat rate, at prices that are *far* below anything you've seen today, on platforms that are shared with their internet service.

This is a *very* major matter. And it has significant financial, technical and regulatory implications.

FUTURE ELASTICITY OF DEMAND? NO ONE KNOWS.  
 BUT COMPUTERS SHOULD GIVE YOU SOME IDEA.

Elasticity is only known in hindsight.

**Attendee:** One area that I'd like some more color on is price/demand elasticity. That's obviously a key component. And you mentioned that varies by geography and by product and service. Could you give us a little more color on how it varies and what sort of levels of elasticity that you're seeing now — and also the [sort of levels] you expect in the future?

**Crowe:** With respect to the nature of elasticity of demand in communications, none of us *know* precisely. By definition, elasticity of demand is a *measured* metric — that is, one ought to measure elasticity and the response of demand to price decreases on an historic basis. Projecting elasticity of demand is difficult. Otherwise, we'd all know all of the answers to communications. We'd know precisely how to position and how to invest on your side of the table — and how to deploy services on ours.

And our projections are proprietary.

**Crowe:** We have 100 years of monopoly, 100 years of rate of return regulation and 100 years of central planning in our industry which makes that process difficult. That *still* goes on in large parts of the world.

We think we have some better insight into this today than we did a couple of years ago. And the best answers that we have are product specific — and I most certainly would not disclose to you our views specifically of elasticity of demand product by product, nor city pair by city pair.

While as a generality, we are willing to provide any information to investors that we don't have a real reason not to, that's in the category we have a real reason not to.

But the elasticity of computing should give you some idea.

**Crowe:** However, that is the \$64,000 question on a broad-industry basis. The best generalized answer in my view — and I will give some credit here to Arun Netravali, the president of Bell Labs, and a team that he put together — was done by some economists at Bell Labs. And they've kindly agreed to field questions if you have questions in this area. But I think they would largely view demand

elasticity on a *generalized* basis as analogous to what we've seen in *other* technology industries.

And on a measured basis, elasticity of demand for computing for the last 10 or 12 years has been about 2.4. For every 1% the cost of a compute cycle dropped, the [units] went up 2.4%. If you want to be precise (again, a term I didn't know what it meant all that long ago) that's arc elasticity of demand as opposed to *point*....

IF YOU DON'T HAVE A SERVICE LEVEL FRANCHISE,  
 YOU'D BETTER HAVE A MODEL AS GOOD AS OURS.

Service providers with a franchise have an opportunity.

**Attendee:** As you begin to disruptively price more and more products this year, how do you think competitors will react? And what do you think the pricing environment in the industry is going to look like in 2001?

**Crowe:** Well, I think there are lots of answers, as you would guess, to that question. Those competitors that have strong franchises — either at the residence or at business — who also happen to have networks have a real opportunity to lower their cost structure. I think you're seeing some of that already as companies break apart, spin out pieces and parts and do carve outs.

Companies with strong franchises at the business (say WorldCom, for instance) or at the consumer level have a real opportunity to radically lower their costs without investing a tremendous amount of capital in their network and to focus on what they do well — becoming a service provider. Many already *are* service providers with strong franchises.

We think we've got a major head start....

**Crowe:** There are a number of competitors who are competitive directly in the network business — they've got their hat in the ring. And over the next year or two or three, you're going to get an opportunity to see who wins and who loses — the theme of our conference.

About all I would say is that we have a head start. We've spent a good portion of the day telling you things that we have not publicly disclosed to this point. And we're willing to do so now because #1, we think we've got a major head start. That's all you can ask for in technology....

The company in technology that gets on the [learning] curve first starts attracting the units, the unit cost goes down, they can drop prices — and it's hard for anybody to catch up. A six to eight month head start in a technology industry can mean a 30%, 40%, 50% difference in cost. And when your competitors attempt to drop prices to compete, their *costs* are way, way, way above your *price*. That's technology. So it isn't even *possible* to compete on price in technology industries. That's what created the kind of companies that you've seen in computing and storage.

And #2, we need to build pricing expectations on bandwidth into our customers' models — that's why we're so vocal about it — so that we get elastic responses. If we simply quietly announce pricing, we're not going to *get* the elastic responses that you'd get in a supply chain. Many of those competitors will have to keep up.

(3)Connect Modem shows what happens....

**Crowe:** I guess the best answer I'd have for you is that if you don't have a franchise up at the service level, you'd

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better have a model that can keep up with us because this is the year that we're going to deliver on it. In (3)Connect Modem, you have a real-life example of what happens when you drop prices and have a cost structure that gives you strong margins. In (3)Crossroads, we're just starting. And in (3)Link SM Global Wavelengths, this is the year.

I'd also point out that in technology businesses, you don't have 20 companies each with 5% market share. You generally have a market leader with 60-70% market share in their area of expertise — and everyone else is relegated to what's left. And our goal is to be that market leader — period. I've said it for a long time. That's our goal.

And it is not a future-tense statement today — 2001 is the year in which we put all of what you've seen here to work pursuing that goal.

SOMEBODY WILL GET SUPRANORMAL SHARE.  
 IT'S INEVITABLE. BUT PRICES WILL STILL PLUMMET.

Now hear this: We'd never abuse our monopoly status.

**Attendee:** In the past, you've said that your model was highly leveraged to cornering market share and that, in fact, someday you could actually be investigated by the FCC for having monopoly status. But given the Mini Max illustration, the price/demand elasticity and somewhere after about 25% price declines kind of implodes the model all the way around, how do you reconcile doing business together with the bandwidth traders — a group that might actually *force* those above-plan price declines — with your desire to have the majority market share and which would suggest either there's a lot of people going out of business or getting consolidated?

**Crowe:** I said that tongue in cheek.... I simply said that I looked forward to the day when we had sufficient market share that we'd be *investigated* by the Justice Department — but that we would sail through the investigation because we'd never abuse our monopoly.

Prices should drop a lot more than 25% per year.

**Crowe:** I'll go a step further. It's *inevitable*, in my view — and I don't use the word "inevitable" lightly — that at the backbone services layer, someone's going to get substantial and supranormal market share because of the dynamics illustrated by that Mini Max model.

What I showed you on the Mini Max model, by the way, doesn't imply that 25% or 30% price drops is where you drop over a cliff. If you go through that input table, that assumes technology improves at 30% a year and operating leverage improves at 30% a year — you get enough software so that your people infrastructure spread over all the units that go through your network and all your other operating expense improves at 30% a year. We just picked those randomly because I didn't want to give you a view that you'd then turn around and assume was our view of the *right* numbers for elasticity of demand, improvement in technology, and related improvement in your operating expense.

You pick them. But if you use numbers that are

somewhere near what third parties say the technology can improve at — that is 60%, 70% or 80%... Given 80%, 90% or 100% improvements in technology, even if you had a monopoly, you shouldn't be dropping prices at 25% a year. You should be dropping prices at double or triple that rate.

That's really hard to do. But the 25% on the slide was nothing other than an illustration. And you should not regard it as anything other than that. Pick your own numbers and plug 'em in. Again, *somebody's* going to get that kind of market share.

BANDWIDTH IS NOT A COMMODITY PRODUCT.  
 IN FACT, THERE'S NO SUCH THING. IT'S A CATCH ALL.

I have a good-natured disagreement with Enron's Skilling.

**Crowe:** And I've said publicly over and over again that just as we sell dark fiber on an opportunistic basis, we'll be more than happy to deal with bandwidth traders. In fact, we've said publicly that Enron is a major customer of ours. There are pooling points. They're located in our gateways, in part.

And [even though] they are a customer and we try to be very good natured and non-argumentative with customers, nonetheless, we have a disagreement with Enron CEO, Jeff Skilling. He believes that bandwidth is like pork bellies — that is, it's a commodity which can be freely traded, where demand and supply relationships in the future are set using financial derivatives, where people bet on a forward basis on the relationship between supply and demand and take long and short positions — and that's how supply and demand is set.

Technical commodities are very different....

**Crowe:** My belief is that that's absolutely appropriate for natural resource and agricultural commodities, but it has *nothing* to do with — to coin a poor term — *technical* commodities, if that's what you want to call 'em.

Microprocessors are technical commodities. Yeah, they all look identical. Yeah, they're made by the millions. Yeah, if you compare a microprocessor from AMD to one from Intel, unless you're a computer scientist, you won't be able to tell the difference once they're stuck in a computer. They're a commodity. Yet Intel's historically had supranormal market share and supranormal margins. It's a commodity, but a very *different* kind of commodity — where supply and demand relations are set in that kind of disaggregated supply chain we talked about where at various levels of the supply chain, breakaway companies get supranormal market share.

And I'll repeat what I started the conversation with: Somebody's going to get that kind of market share in the backbone communications business because that's the math of technology — that's how technology industries work and this is a technology industry.

There's no such thing as bandwidth. It's a catch-all....

**Attendee:** I have a follow on to the question about bandwidth trading. Dow Jones announced their intention to publish bandwidth prices this spring. What is your impression of that?

**Crowe:** ...To a certain extent, we in the industry have done a poor job with our lexicon or vocabulary — because

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we say "bandwidth". But let's face it — there's no such *thing*. There are dozens or even hundreds of services that come under the label "bandwidth" that change rapidly. You just heard today about (3)Link SM Global Wavelengths — a service that we weren't even in a position to *offer* a year ago. A year from now, I will assure you that when we stand up, we'll talk about a *new* set of innovative services.

They're changing rapidly — there's a whole collection. And every one has different kinds of characteristics. They're not substitutable in the same sense that agricultural commodities are.

Whatever Dow Jones publishes, it won't change its nature.

**Crowe:** You can't settle a deal that we make with one of our customers by going over to some supplier and saying, "I'd like some of *your* (3)Link Global Wavelength services because Level 3 defaulted. So pick 'em up and go haul 'em over and stick 'em in." It's a very different matter.

So I view that like Dow Jones (from *my* perspective, not theirs I'm sure) choosing to publish a microprocessor index or a dynamic-random-access index. They can *do* it. But it isn't going to change a technical commodity into an agricultural commodity.

However, I freely admit that some of our customers, and apparently Dow Jones, have a different point of view.

PEOPLE MAKE UNECONOMIC CHOICES ALL THE TIME,  
BUT THEY MAKE A WHOLE LOT FEWER OF THEM TODAY.

AT&T and WorldCom will come up with good solutions.

**Attendee:** When you look at what AT&T and WorldCom are going through in terms of price erosion, it seems inevitable that they should want to enjoy the *benefits* of lower-cost bandwidth as opposed to being subjected to the *pain* of it — and that outsourcing to you guys would be a logical choice for them to make.

However, both of them have huge engineering and network management staffs and a long legacy of running that part of the business themselves. Companies make uneconomic choices. And certainly, we've seen some of that occur in the long distance business, as well.

What do you think it's going to take for these guys to recognize the changing industry dynamics and make a wise decision for them and a good decision for you?

**Crowe:** Well, I wouldn't comment directly on any specific company. They're both run by extraordinary management teams. I happen to know a little more about WorldCom than I do AT&T, but I have great respect for Mike Armstrong. I think he's an extraordinary executive wrestling with a big challenge.

In the case of Bernie Ebbers and the team at WorldCom — some of whom I still consider colleagues — their track record of creating shareholder value is out there for everyone to see. They've hit a bump in the road, but Bernie and his team are focused. Let me put it this way: They're the only organization that *maybe* is as focused on shareholder value as we are — although probably not quite as much. However, they are focused as much as any other

team I know.

Things changed quickly. And I'm sure they'll come up with creative, value-creating solutions for their businesses.

My personal portfolio has not benefited from the process.

**Crowe:** On a more general basis, the weakness in the capital markets is unfortunate. A lot of people have been hurt. It was sector wide. It was indiscriminate. It is only now, it seems, that the winners and losers are starting to be sorted out and that the market is making judgments about business plans and funding. Up until just recently, the whole *segment* was affected without any discrimination at all. And I'll tell you — my personal portfolio has not benefited from the process.

But there's an enormous silver lining...

**Crowe:** That being said, there is — as is almost always the case — an *enormous* silver lining. Now, some of it is obvious. We're pre-funded. That helps a lot. We get a lot of attention from technology partners because we pay cash and don't need vendor financing. That's a big deal.

What is also, I think, a real silver lining goes to your question. Yeah, people make uneconomic choices all the time, but they make a whole lot fewer of them today than they did a year ago. The capital markets are enforcing a discipline that didn't exist a year ago — at least generally — throughout the industry.

The views that you've heard today: disaggregation, the supply chain breaking up into horizontal models — I mean that's not new to any of you who've listened to us talk... But up until a *year* ago, I thought it was going to take two, three or four years, frankly, for the major integrated players to start to really come under pressure and break up. Now they're doing it *today*.

And that's in no small part because of the turmoil in the capital markets. I think the capital markets and the discipline enforced on the cost side by the capital markets is going to *accelerate* the process of disaggregation.

They're letting go of their attachments more quickly today.

**Crowe:** That [acceleration] can only be good for us. If we're able to build the systems internally and develop the supply chain relationships externally (what we've been talking about today) so that we can scale at the right rates, it positions us very well. And I think it's all going to happen in the next 12-18 months. I think you're *already* seeing it happen....

BUSINESSES DON'T WANT TO BE IN THE "IT" AREA.  
FRANKLY, NEITHER DO WE.

It's impossible for us to be everything to everyone...

**Attendee:** Right now, you're not gearing most of your sales efforts towards enterprises. But there was a recent contract announcement in the last nine months where, I think, Chase bought a substantial amount of dark fiber from MFN. Can we see some of that sort of relationship forming happening with you? And are you willing to seek out those opportunities?

**Crowe:** Intel is not in the operating system business.

(continued on next page)

## LEVEL 3'S

JAMES CROWE ET AL.

(cont'd from preceding page)

Microsoft has not tried to build microprocessors. It is really hard to build the systems internally and the supply chain relationships to do what we think we can do well — *really* hard. It's impossible, at least for us, at this stage in our development, to try to be everything to everyone everywhere.

If we become so good at producing bandwidth-based services at the right rate, with the right quality and the right price over time, and we have the kind of market share that we think is possible — and if we're so good at that that we can take it for granted — then maybe we'll look at other things to do.

But I don't expect that to happen in any time I have to worry about it. That's going to be on someone else's watch — because we've got all we need on our plate right now.

Businesses don't want to be in communications or IT....\*

**Crowe:** I also don't think it's likely that vertical integration is the right model in technology. I also don't believe that enterprises are going to remain in the business of either communications or information technology broadly. I talk to CIO's as often as I can. And I don't know a single one who doesn't say something like this:

"Computing has been cheap, storage has been cheap and communications or bandwidth's been expensive. So I have to go buy my computers — I have to buy my storage and put it locally — because I can't buy what are now generally thought of as application services. I can't go buy Oracle-tone. I can't go buy Database-tone. I can't go get somebody to [whom we can] outsource the equipment, the operating system management or the database management. Why do I want to be in those businesses? I'm a bank or I'm a manufacturing company. I'm not in the business of running operating systems and databases — except because I *have* to because I can't outsource it."

I'd get out of the IT business if I could.

**Crowe:** There are one million empty or unfilled information technology jobs in the country today — and it's getting worse. That's a result of 20 years of computing being cheap, information storage being cheap, and communications being expensive. We've all had to go buy our *own* because you couldn't centralize information processing and storage. As a business, you want to own the information about your customers and about your transactions.

*I'd get out of the IT business if I could. That's not our*

(continued in next column)

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business — we're a communications company.... We happen to be an Oracle shop. If I could go buy Oracle-tone, I'd do it tomorrow — *if* I could get it at the right reliability and the right price. Let somebody *else* hire database administrators that are hard to get and hire operating system talent that's hard to get.

[Editor's note: Crowe put Level 3's money where his mouth is. On February 25, 2002, they announced the acquisition of Corporate Software — a privately-held firm that sells and licenses software to businesses. And in the conference call announcing the acquisition, he mentioned the preceding service as one that Corporate Software and Level 3 might be very well positioned to offer.]

When service providers start offering voice, watch out...

**Crowe:** What all of that means is this: I think that there are communications companies and then there are going to be service providers — service providers to business and service providers to the home. We already see 'em at the home — that's what AOL and Yahoo are. But when they start offering *voice* services, we're *really* going to see the power of that model.

That's what's coming at the business — and [service providers] are *our* customers, not the end users themselves.

QUESTIONS ABOUT CAPACITY UTILIZATION ARE HARD  
— BECAUSE IT'S NOT REALLY A STATIC FIGURE.

Calculating percentage utilization is not so easy....

**Attendee:** Given your business plan and revenue forecast for 2001, what would you assume to be the average number of fibers lit in your U.S. network and a capacity utilization number on that? Would it be 60% utilized of that fiber lit? What would be the appropriate figure?

**Crowe:** A couple of comments: First, I wouldn't give you the specific number of fibers lit. As I mentioned earlier, we've reserved 12 [or fewer] in any one generation — the exact number we consider proprietary.

Second, the question about capacity is very difficult. What you have to do to answer your question is say, "I have lit this fiber with this equipment which has this capacity. What percentage am I utilizing?" Because all you have to do is swap the equipment out for another kind of equipment and maybe you have *more* capacity.

With those caveats, we are moving from SONET-based protection for reasons that Kevin explained. That move has to be timed properly. You need a very, very strong and carefully thought out model which allows you to say what's the rate at which I want to move from SONET rings to mesh protection — because today it's very expensive.

Today, we'd max out at 40% usage. Mesh will change that.

**Crowe:** And as we move from SONET rings, about 50% of our capacity today is reserved for protection — it just sits there idle. That's a startling figure. What it means is that in the industry as a whole, even if we were *perfect* in utilizing capacity, we'd all have 50% of it sitting there in the form of backup in case we get a cut somewhere else on our ring.

We're moving to a model [how the network is configured architecturally] over time which allows us to reserve only a third of the capacity in mesh. So, hopefully,

(continued on next page)

## LEVEL 3'S

JAMES CROWE ET AL.

(cont'd from preceding page)

that's some answer for you. But if we were very good, we'd move from maximum capacity utilization of 40%, maybe in a ring situation, to maybe 55% or 60% in a mesh format. Those would be very high targets.

"IF YOU REALLY WANT TO MAKE MONEY,  
DON'T BET ON EVENTS. BET ON TRENDS."

— Walter Scott, Jr.

Events? I don't know. But trends tend to stay in place.

**Attendee:** You talked a lot about extending Ethernet into the metropolitan area network, driving down the cost of transmission of data around the metropolitan network significantly and rapidly increasing the provisioning time of those circuits. Can you talk a little about when you expect that to significantly accelerate the data bit transmission over your backbone network?

**Crowe:** Walter Scott, our Chairman, told me something about 10 years ago I'm going to repeat to you. He said, "If you want to make money, don't try to bet on individual events. Trends, on the other hand, tend to stay in place and can create a lot of value."

Your question, I think, has to do with an event. And there could be an event along the way that surprises us all. The general *trend* towards Ethernet-based technology though is more fundamental and we're willing to bet on it in the longer term....

When the phone companies didn't do it, others stepped in.

**Crowe:** I started 20 years ago. And I mentioned that computing and storage have gotten cheaper a lot faster than communications. The result has been this huge arbitrage opportunity between the two. That's why enterprises got into the IT business and why we don't have this robust industry of remote computing and remote storage.

That arbitrage also caused the data communications industry to invent all kinds of ways of moving information because the phone business, whose job it *should* have been to figure out ways to move communications cheaply, didn't. That's why data communications are the fundamental technologies that we are deploying along with all the other new generation carriers.

It didn't come from the phone business. The ITU [International Telecommunication Union] didn't sit down and say, "Well, let's go develop IP or MPLS. Let's get rid of ATM because it's expensive." They didn't even deploy the new generations of optical technology. A start-up — Ciena — did it outside the norm. And today, the ITU has little or nothing to do with the forward views of optics. It's all in the marketplace — just as data developments and technology have been for 20 years.

Ethernet and MPLS will win for a very simple reason....

**Crowe:** Ethernet is a data communications protocol. Here's the math: A 10 gigabit SONET chip set runs a couple hundred bucks — something like that.... In telephone talk, that's an OC-192 chip set. A 10 gigabit *Ethernet* chip set costs a *few* dollars. Today, they're early

— they're Beta. But that's what they're expected to cost — a few dollars versus \$200. Why? Because it's market based as opposed to centrally planned.

And that's the key to understanding — at least in *our* view — what's going on in technology. It isn't the three or four-letter acronym. It isn't, "Yeah, meshing is cool" or "Ethernet's cool" or "MPLS is cool". It's what technologies are market based — where hardware and software manufacturers can develop new ideas without government intervention and without standards bodies — and which ones are centrally planned.

That's why SONET loses and that's why ATM loses — because they're centrally planned. That's why Ethernet wins and IP wins because they're in the marketplace which is messy and difficult, but moves *very*, very quickly. Anytime you see a market facing central planning, that's what happens. And that's what's happening in technology. It's why Ethernet wins.

One thing you can count on is unpredictable change.

**Crowe:** But how rapidly it wins in the local loop is hard to say because it depends on some local loop stuff. Dan Caruso mentioned it eats fiber and you need a lot of fibers for Ethernet. We've got a lot of it, but not *enough*. And how rapidly all of that gets deployed will determine the rate at which Ethernet is implemented.

I'll also give you the caveat that Kevin mentioned. About the time you think you've got all this market-based technology figured out, you're going to get surprised by some entrepreneur — either in a big company or a start-up that gets capital and takes a right hand turn with enough of an advantage over whatever it is that you thought was going to win so that it blows it out of the water, period — which is why it's good to have an upgradeable network.

If we don't start to break away, we'll be very disappointed.

**Attendee:** After listening all day here, it seems to me that given what you said about your cost structure and about your pricing intentions, it would be hard to believe that if that were to happen, you *wouldn't* be the winner. Is that the right way to think? And if not, what is?

**Crowe:** If we (or anyone else for that matter) build the internal systems that allow us to scale (which is hard,) build the supply chain relationships, both with technology partners and with customers who build your pricing and products into their services — business providers and residential providers so that *they* stimulate demand — yeah, I think that's the company that's going to break away. Those are the requirements.

If we do it first, we have that opportunity. I think this next year to 18 months, you're going to be able either to discount our ability to do so into our performance or be very disappointed right alongside us because I assure you that's what we will be.

Let me say it again — the year 2001 is where all of the future-tense statements that we've made for the last three years become present and past. And when we get together at this time next year, if you can't discount in our position in the marketplace much of what you've seen here, talk to Walter Scott and get a replacement for me — because I'll be disappointed....

—OID



LONGLEAF PARTNERS FUNDS'  
MASON HAWKINS, STALEY CATES ET AL.  
(cont'd from page 1)

relative to bonds — both in the U.S. and globally — from their first quarter letter to Longleaf Partners' shareholders.

But first, we're pleased to bring you excerpts from their latest conference call which took place January 31st. As long-time subscribers have learned, Hawkins, Cates et al. rarely get anything important wrong. We believe the comments which follow will prove to be equally prescient.

KMART BANKRUPTCY NO BIG DEAL FOR FLEMING.  
AND 6 TIMES FREE CASH FLOW IS RIDICULOUS.

There's a very big divergence of opinion on Fleming...

**Shareholder:** Two questions: First, have you recovered from Steve Spurrier leaving the University of Florida? And second, could you comment on Fleming relative to Kmart being their largest customer — and Fleming being the largest holding in the Small-Cap Fund?

**Hawkins:** Well, it'll be interesting to see how Steve does with the Washington Redskins. We wish him well. It'll also be fun to get new, energetic blood in Gainesville.

We're going to let Staley talk a little bit about Fleming. However, before we do, I'd like to say that there is a *very* big divergence of opinion here — and we feel very strongly that our position is the correct one. But having said that, I'll let Staley amplify.

**Staley Cates:** When Mason says that there's a "divergence of opinion", he's talking about us and the outside world, as opposed to anything internal.

**Hawkins:** That's right.

Fleming being named a critical vendor is a major plus.

**Cates:** The Kmart bankruptcy was less catastrophic than Spurrier leaving Florida. The market wasn't surprised by the Kmart bankruptcy if you look at where the Kmart bonds had been trading for awhile. But the key factor here — and this happened in the last couple of weeks — was Fleming being named as a "critical vendor". And as such, they continue to sell food to Kmart — especially to Kmart Supercenters — in a way that guarantees them that they get paid on the terms of the original contract, which is only seven days.

Ironically, Kmart's bankruptcy may have helped Fleming.

**Cates:** There are several points here: First, in our opinion, the most broken parts of Kmart are some of their traditional merchandise stores that compete with Wal-Mart that have just been smoked over a long period of time. And a bunch of those stores just need to close.

Fortunately for Fleming, the great, great majority of their business with Kmart is to the Supercenters — which is not just Kmart's traditional merchandise. It's what it sounds like — where you have the huge square footage with food and everything else. And those stores are actually doing pretty well. So we would not expect — at

least at this point — a lot of closings among Supercenters which, again, is where most of the Fleming volume is.

Ironically, because Fleming is a critical vendor — which is basically treated senior on the ladder to everybody other than the debtor in possession financing — we think our position is actually better. And we say that because, although it wipes out the equity holder, Kmart also walks away from a lot of bad leases. And the cash flow that Kmart will save is in the hundreds of millions of dollars — it's a *huge* number — of foregone lease expense. So frankly overnight, they're better able to pay Fleming for supplying them food.

Third, since Fleming is one of the few critical vendors, other vendors may be a little more skittish. So Fleming may have some other opportunities here in terms of supplying Kmart's Supercenters. And Fleming's rebounded strongly since all this happened. It's up over \$20 today. And I think the market may be increasingly realizing that this is not quite so terrible for Fleming.

A multiple of 6 times free cash flow is ridiculous.

**Cates:** Finally, Kmart represents about 25% of Fleming's business. The other 75% is growing organically. This year, we conservatively think it'll grow organically in the mid-single digits. Last year, it grew in double digits. So they're doing a phenomenal job with their core distribution business outside of this high-PR Kmart stuff. They still give earnings guidance of almost \$2.50 of EPS — which is amazing because there's another dollar of excess depreciation and amortization.

So the free cash flow is around \$3-1/2 if there's not yet another meltdown at Kmart. And obviously on today's \$20 price, that's a ridiculous multiple for something that's growing organically the way Fleming is. So we feel okay about it.

Hansen is one of the best partners we've had in Small-Cap.

**Hawkins:** There's no divergence of opinion at Southeastern on Fleming. We are very committed. There's a reason it's one of our largest positions in Small-Cap. We think Mark Hansen is one of the best partners that we've had in Small-Cap. He is doing an exemplary job.

WE DID EXPECT MORE FROM TRIZECHAHN —  
BUT WE EXPECT ITS DISCOUNT TO CLOSE SOON.

TrizecHahn is still cheap. But we're disappointed...

**Shareholder:** Would you discuss TrizecHahn and whether you marked down your values on some of your real estate holdings as you did with the hotels?

**Cates:** TrizecHahn's been a really big disappointment since 9/11. And when I say disappointment, the stock price hasn't been down. But as you know, we're usually talking about values — and our appraised value is down. It's hard to hold it against management. Those terrorist attacks have hurt them directly in two ways:

First, we lost some value because we changed our appraisal of the Sears Tower significantly after what happened 9/11. And that impacts TrizecHahn. They've got a second mortgage on that property. Its economics are like an out-of-the-money call option — it's quite leveraged. So if you change your value, it really hurts the bottom line.

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MASON HAWKINS, STALEY CATES ET AL.**  
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Second, TrizecHahn had over \$200 million invested in the Hollywood & Highland development out in Hollywood which is where the Academy Awards are — and they were trying to redo that whole part of town in conjunction with the city and others. And the combination of cost overruns as well as what tourism has done in the wake of 9/11 has made them write that entire amount to zero. So that's unavoidable damage to our appraisal. And we've watched the appraisal slip down into the mid-to-high \$20s.

But that's still cheap given its \$15-16 stock price. So we're not going anywhere. But we are disappointed at what that value's done.

They'll continue to get increased cash flows...

**Cates:** The office property part hasn't changed significantly. Street rents are obviously bad. And you probably saw the *Journal* article today about how dramatically vacancy rates have changed. But this is more like modelling a bond than a series of street rent changes because of the nature of the long-term leases and whatnot. And most importantly, their leases — even with how bad the office market is — are way, way below market. So they'll continue to roll up and get increased cash flows.

When TrizecHahn becomes a REIT, its price will rise...

**Hawkins:** On the value recognition process at TrizecHahn, we're very sanguine about that. As you know, they're converting to a U.S. REIT. That will go to shareholders in the next 60 days. The cash flows support a dividend in the \$1.70 a share range or so. We think that's extremely conservative. And the cash flows there could get you a dividend north of \$2 within the next year-and-a-half or so.

So when those dividends start coming to shareholders..., that ought to beget [a share price in the] mid-\$20s immediately. So even though we're disappointed on the markdown of our appraisal, it's highly likely that the share price could get to appraisal pretty quickly.

[Editor's note: Although there seems to be no hint of such dividends yet in TrizecHahn's immediate future. According to its 8-K filed March 7th, the dividend estimates for 2002 are 35¢ and \$1.30-\$1.45 for 2003.]

IN LEVEL 3'S BUSINESS AND MANAGEMENT WE TRUST.  
NEVERTHELESS, THE EQUITY MAY BE A LITTLE DICEY.

Level 3's write-off and downgrade were no big shock....

**Shareholder:** I believe that Level 3 Bonds are the

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second biggest position in the Small-Cap Fund. And yesterday or the day before, I noticed that Level 3 common fell by a third. I think it was announced that they may have violated a debt covenant or something. Can you just speak to what happens to the bonds if they go bankrupt?

**Cates:** Sure. We feel wonderful about Level 3 and those bonds. There's been a lot of news on all these companies and then long conference calls in the last couple of days. But we believe that the net of it is this:

First, Level 3 took a huge write-off — literally 99% of which was a noncash charge — for some of the dark fiber in their network that's virtually worthless, plus a huge number for their colocation facilities.

And to put that in perspective, they invested a total of about \$11 billion into all of these different assets. So if you take away that \$3 billion, that writes it down to \$8 billion. And then there's been another \$1 billion or so of accumulated depreciation. So they're at a book value for all that stuff of around \$7 billion. Our appraisal is less than that. So in economic terms, this is just kind of a catch up by the accounting profession.

Second, their bonds were also downgraded — which is not at all surprising in light of first of all, the general Enron environment, second, Global Crossing's bankruptcy

*PORTFOLIO REPORTS* estimates the following were Longleaf Partners Small-Cap Fund's largest purchases during the 3 months ended 3/31/02:

1. FLEMING COS INC
2. LEVEL 3 COMMUNICATIONS 9-1/8s of 5/08
3. PEPSIAMERICAS INC

filing and third, their \$3 billion write-off. So not being overly blase about it, it wasn't a big shock that they got downgraded as well.

Level 3 is head and shoulders above its competitors.

**Cates:** All that matters to us is their cash flow and what that cash flow looks like. That determines the value of the business and, therefore, how the bonds get paid off. And there are two things there: First, we think this business is head and shoulders above its competitors — and we're confident in the people also over the competitors.

Cash = staying power, but the equity may be a little dicey.

**Cates:** Second of all, Level 3's cash position today of \$1.5 billion sees us through a good number of quarters before we think there's a true liquidity problem — in which case we would've gotten basically all of our capital back on the bonds. The possibility of a future liquidity problem is why we think the equity may be a little dicey. And that's why we're in the bonds rather than the equity.

This business and these people can handle this covenant.

**Cates:** As for the covenants, what they said in their press release is that at these rates of revenue — really, I should say at these rates of *decline* in revenue, which we assume keeps declining even though there's anecdotal evidence that things are stabilizing and bottoming a little bit — in the second quarter, they would then bust a bank

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LONGLEAF PARTNERS FUNDS'  
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covenant on their \$1.7 billion line.

And this is where you get into the grey area of do you believe in the business and the people or not? And in both of those cases here, we do. In that same press release, they do believe they can get that thing renegotiated. They also happen to have other different liquidity options.

[Editor's note: The aforementioned covenant appears to no longer be an issue until late 2003 at the earliest as a result of Level 3's acquisition of Corporate Software.]

We really applaud these guys — e.g., their accounting...

**Cates:** We think the ultimate vote of confidence by them is that even though people worry about that cash hoard and the burn rate of the cash, they took \$700 million of that literally very precious cash and bought back these same bonds (that we own) in the fourth quarter. They spent \$700 million of cash to buy about \$1.7 billion of debt at face — therefore, creating for us a lot of extra margin of safety.

So we really applaud those guys in how they *do* things. And their accounting is so conservative, and we think better than so many of these companies, that we applaud that as well. So we'll be staying tuned to how these covenants get either renegotiated or if that bank loan gets redone.

In Walter Scott and Jim Crowe we trust.

**Shareholder:** Do you anticipate that Level 3 will be buying in more debt?

**Cates:** We don't know. Obviously, they wouldn't show their hand on that to anybody. So this is where faith in Walter Scott and Jim Crowe comes in. You've got to think they're looking at that always. There's nothing to suggest their appetite would've gone away. But we don't know anything more than anybody else out there.

Level 3's assets are a lot better than your average network.

**Shareholder:** With respect to the Global Crossing bankruptcy, what will the final endgame be? I've read that it's anticipated there will be fewer carriers. Do you think that Level 3 will be the last one standing?

**Cates:** That's a good and very hard question. I think with regard to Global Crossing, we take some comfort there just thinking that Level 3's assets are a lot better. And

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frankly, that's because it's more of a domestic — and more importantly — *integrated* network as opposed to, say, a worldwide network that's heavy on commodity lanes from different gateway cities to different gateway cities, where there are a lot of different alternatives if you're just trying to buy bandwidth there.

The best indicator — that they continue to win business

**Cates:** As far as who's going to remain standing, that's sure a difficult one. Part of the answer will have to do with if long distance rules change and if there's more blurring between Baby Bells and long distance companies. And then some of it has to do with the fact that even though there's overcapacity *everywhere*... I mean if you just took certain city-to-city routes, there's overcapacity to a level that's just a huge joke.

But the more subtle point within that that's frankly hard to measure is if instead of just looking at one-off lines, if you look at who has truly big networks that cover *all* the different cities — not just one big city to another big city — as well as going to every different metropolitan fiber ring...

And on that basis, I guess the best evidence is that Level 3 continues to win big business — recognizable people like SBC giving them significant chunks. To me, that may be the best way to highlight the quality of their network.

WMI'S UP — AND WE'VE SOLD SOME OF OUR SHARES.  
BUT IT STILL TRADES AT A SIGNIFICANT DISCOUNT.

We trimmed back Waste Management, but we still like it.

**Shareholder:** I believe Waste Management at one point accounted for about 15% of the Partners portfolio — and that it's now down to around 7%. Could you speak about it a bit?

**John Buford:** We trimmed it back when the stock price rose dramatically. And you're right — it was 15% at one point. But had we not trimmed it back, it would've been 30%. It rose quite a bit. So we trimmed it back so we could sleep at night...

It's still an overweighted position — that's how much we like it. But it's a *normal* overweighted position which, for us, is between 5% and 10%. And we don't really like to go over 10% just for diversification reasons.

**Hawkins:** I might add that its price-to-value relationship was less compelling than what we put the money in.

The restructuring plan is going fine.

**Shareholder:** The restructuring plan that they put in place seems to be going forward as you had anticipated?

**Buford:** Yeah. The systems are being rolled out as we speak and should be completed sometime in '02. The marketing, the procurement, the customer service and the best practices, the pilot program that's being run in the Denver area in the Rockies — that's all going as planned. It's slower than anybody would want it to go, but Maury Myers has proven to us and everybody else that will listen that it's better to go slow and do it right than it is to go quicker and have problems with it — because that's kind of

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**LONGLEAF PARTNERS FUNDS'  
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how we got in the soup in the first place. So yes, it's going as planned.

We're in an economic environment that's creating more of an uphill climate than we had six months ago — with special waste volumes and industrial waste volumes off. You're going to see construction volumes, roll-off volumes down. So you have to weigh all of that as well. It's not a robust economy out there that they're operating in. But the restructuring's going fine.

Reinvestment today means higher free cash flow tomorrow.

**Hawkins:** Our appraisal has grown recently. The appraisal's significantly greater than the current stock price. Maury Myers just said in an article in *Waste Age* — he said it back in the late fall — clearly, they're going to generate over \$1 billion of free cash flow in '02. And for the first time on his watch, they're in a position to reinvest that \$1 billion of excess cash flow for shareholders.

I'll let you figure out what that means. We think we know what that means. So, we believe that in the next three years, the value per share is going to accrete very nicely through a growing stream of free cash flow that can be used to help build value per share.

[Editor's note: In their first quarter letter to shareholders, they elaborate: "Waste Management's shares fell 15% during the quarter despite better than expected cash flow numbers and progress in service improvements and cost reductions. While commercial volumes slowed with the economy, overall pricing improved.

"The company has been tainted with recent headlines regarding SEC charges against former management who led the old corporation prior to 1997. The investigation has nothing to do with today's Waste Management, nor its current management team."]

**ECHOSTAR DEAL WOULD DEFINITELY BE A NET PLUS,  
BUT IT'S NOT THE ONLY BUYER INTERESTED IN GMH.**

We're fine whether the deal goes through or not.

**Shareholder:** Could you talk a little bit about GMH? And does the [Echostar] deal need to go through to get to your appraisals — or have you not even put that in there?

**Cates:** On GMH, the deal does *not* need to go through to get to our appraisal — because if you run the math the way we do, we believe that Echostar captures a great deal of synergies that are definitely there if you put these two companies together. We'd still like it to happen because they'd be well-positioned and all the other obvious things.

But we don't think there's a valuation windfall for us as Hughes holders in that deal. We think there is for [Echostar Chairman/CEO] Charlie Ergen. So the value is not a lot different.

Merger would be fine, but there are other potential buyers.

**Cates:** The vote on Wall Street is clearly saying that this deal is *not* going to happen — because the arbitrage spread is just gigantic between Hughes and DISH. We have a hard time understanding that logic just because it looks

like the cable guys'll get a free pass on *their* huge merger — and it's hard to argue then why you would want to make a #2 competitor splinter more.

We do think if something did blow up that way that Hughes would still have a very, very interested buyer in News Corp. for the reasons we've talked about before.

So we don't have any special insight onto Capitol Hill. I guess that's probably a *good* thing. But we do note that the spread's huge....

**TDS IS STILL WAY, WAY BELOW OUR APPRAISAL.  
AND MANAGEMENT IS BUYING BACK SHARES.**

Our TDS appraisal is still way, way above the stock price.

**Shareholder:** Would you discuss Telephone & Data Systems?

**Cates:** Telephone & Data Systems (TDS) has three major assets: a position in publicly-traded U.S. Cellular, some mostly rural wireline telephone companies and a huge position in Deutsche Telekom which they got because they sold some other properties to them last year. Our appraisal still is *way*, way above the stock price.

But as you know, wireless companies of whatever type are being hurt pretty badly right now in the stock market.

*PORTFOLIO REPORTS* estimates the following were Longleaf Partners Fund's largest equity purchases during the 3 months ended 3/31/02:

1. TELEPHONE & DATA SYS
2. AT&T CORP
3. GENERAL MOTORS CL H

And that's basically over concerns that new subscriber additions are way below what Wall Street was hoping for.

But we're not quite so negative because although yes, that's going on, what's interesting at U.S. Cellular is that at the same time, they've really improved obviously their churn a lot and they're just doing a much better job with the base they already have. So even though there are fewer coming in the door than we would hope, there are also fewer going *out* the door than were planned.

So the net result of all that is their margins are up, their EBITDA is up in double digits on a decent sales gain and they're just really clicking along doing well. So basically, our U.S. Cellular value has not changed a lot since we began buying TDS.

TDS's stake in Deutsche Telekom's is undervalued, too.

**Cates:** Deutsche Telekom is another reason that TDS is down because that stock's gone from the high teens to around \$14-1/2 today. (That's the dollar price, not the Euro price.) And it's down a lot because the market's pretty beared up that they will not be able to sell their German cable systems to John Malone for regulatory reasons. But in our view, those cable systems are worth a lot of money to other people, not just Malone.

And it's also kind of a rounding error compared to the value of the other assets at Deutsche Telekom. So even though that's hurt Deutsche Telekom quite a bit in the

(continued on next page)

LONGLEAF PARTNERS FUNDS'  
MASON HAWKINS, STALEY CATES ET AL.  
(cont'd from preceding page)

stock market, we haven't lowered that value either. So the values remain the same.

Mgm't's repurchasing shares. And we're still excited...

**Cates:** Meanwhile, management at TDS — the Carlson family — has done a good job over the years. They can certainly add and subtract and divide. So they see this. And they've repurchased shares — for the intelligent and simple reason that it's cheap. So we're still excited about it.

CAPITAL ALLOCATION AT HLR HAS BEEN FINE —  
AND WE LIKE IT'S ASSETS FINE, TOO — LONG TERM.

In The Telegraph we trust...

**Shareholder:** Might you tell us your thoughts on Hollinger International?

**Cates:** The thing that's hurt Hollinger's stock recently is the terrible performance of their London newspaper — which is a huge trophy property called *The Telegraph*. And there's a short term and a long term there. The short term is how badly that newspaper had done in an ad recession that's pretty well publicized worldwide — not just here.

And you don't want to use this term too loosely because it is overused, but in this case, it's appropriate... The long term is that that asset is a trophy property. And there are a lot of comps out there that give us comfort that our appraisal of that property is right despite the fact that they're having a terrible cash flow performance this year.

Black has never done anything but good capital allocation.

**Cates:** The other long-term thing to focus on is Conrad Black's track record. He's kind of a controversial guy. But as far as running Hollinger, he's never done anything but very good capital allocation. And that ranges from buying just about every property he's ever owned for less than 5 times EBITDA and then selling them all at over 10 times — sometimes when they were no-growth properties that we would appraise at less than that. So he is controversial, but we like having him as a partner.

It's incredibly strong financially — and we like the assets

**Cates:** And since he sold the Canadian papers, there's  
(continued in next column)

Have you gained an investment idea  
from this edition of OID?

Would you like to see  
the most recent stock purchases  
of more than 75 top managers  
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no financial risk here. It's *incredibly* strong financially. And that London paper is the main part of the value. We like that a lot long term despite really bad numbers today.

There's not a lot of reason for Hollinger, Inc. to exist.

**Shareholder:** I noticed two recent insider sales of stock in Hollinger — one for two million shares at \$10 and another for two million shares at \$11.98. What do you think their thinking might have been?

**Cates:** Those insider sales are very confusing — because the news services often don't differentiate between Hollinger Inc. and Hollinger International. There are different things going on at Conrad Black's holding company — which is Hollinger Inc. — which has them moving around shares of what we own, which is Hollinger International. So we don't view it as being significant insider sales of Hollinger International the way we typically

PORTFOLIO REPORTS estimates the following were Longleaf Partners Int'l Fund's largest equity purchases during the 3 months ended 3/31/02:

1. NIPPONKOA INS CO LTD
2. FAIRFAX FINL HLDGS LTD
3. NEWS CORP LTD
4. EZAKI GLICO CO LTD
5. NIPPON BROADCASTING SYS INC
6. FIAT SPA
7. SKY PERFECT COMMUNICATIONS
8. CHECKPOINT SYSTEMS INC
9. TOKYO STYLE CO LTD
10. NEWS CORP LTD ADR

screen all these different companies.

And secondly, it's hard to see exactly what's going on at Hollinger Inc., even though you've got to think that there's not a lot of reason for that entity to exist anymore — because Conrad Black is not a Canadian citizen. It probably makes sense to be selling those shares to either take it private, pay down debt — whatever's going to happen at the Inc. level.

But all we care about is that Black remains committed.

**Cates:** However, all we really care about is that Conrad Black remains *hugely* vested with huge ownership. And if Hollinger, Inc. does get rationalized or goes away somehow, frankly, that'd be just fine with us — because then we'd have Hollinger International as the only entity.

WE DON'T MIND BUYING WHEN THERE'S BAD PRESS.  
THAT'S EVEN BEEN A PRESCRIPTION FOR PROFITS.

We tend to find our best ideas in the worst environments.

**Shareholder:** You've built a large stake in Japan — which has been getting an awful lot of bad press lately. What are your feelings there?

**Andrew McDermott:** On Japan, we don't have any insight into where things will go on a macro basis. But as you know, we tend to find our best ideas in environments where the sentiment is negative. In fact, we started the

(continued on next page)

**LONGLEAF PARTNERS FUNDS'**  
**MASON HAWKINS, STALEY CATES ET AL.**  
 (cont'd from preceding page)

International Fund in '98 to take advantage of almost an identical situation. Everyone was down on Japan and all of Asia at that time. So in '98, we had about a third of the Fund in Japan. And when Japan doubled in 1999, many of our companies reached appraisal and we sold them.

We think we can do very well — e.g., Nippon Broadcasting

**McDermott:** The fact that we're close to a third in Japan today is simply a reflection of the fact that we're finding a lot of companies — almost all of which have extremely strong balance sheets — at incredible prices.

In one case, Nippon Broadcasting, we've purchased the same company that was our best performer in 1999 and 2000. It's back down close to where we bought it the first time after it tripled and then came back.

So we're just excited about what we're finding on a company-by-company level. We only need four or five companies to be successful. So even if the macro environment does stay negative for a long time in Japan, we feel like we can do very well there....

**LONGLEAF PARTNERS FUNDS'**  
**FIRST QUARTER LETTER TO SHAREHOLDERS**

**MOST EQUITIES AROUND THE GLOBE ARE OVERPRICED.  
 THEY'VE ALMOST NEVER BEEN SO UNATTRACTIVE....**

If it's not a telecom stock, it's probably overvalued.

We are pleased to report that all three Longleaf Funds continued to do well in the first quarter, outperforming our baseline annual objective of inflation plus 10% as well as each Fund's respective index. All three Funds continued to earn the highest overall *Morningstar* rating of 5 Stars. That is the good news.

The bad news is that most equities around the globe are overpriced.... In early 2000, ... the rest of the world chased overvalued tech/media/telecom stocks because they were assuming ever larger roles in indices. Today, ... this process has reversed: indices are stagnating as telecommunications stocks drop, but non-tech companies are reaching extended valuations with index-oriented managers racing to "re-weight" portfolios....

No matter how you slice it, U.S. stock market is expensive.

In spite of speculators' lament and the NASDAQ's dramatic decline from its historic peak on March 10, 2000, common stock prices as measured by the S&P 500 continue to present a valuation challenge for prudent investors. The U.S. market is expensive even if the nascent economic recovery proceeds unabated and S&P 500 earnings in 2002 reach levels expected by consensus forecasters.

At the quarter's close the market was trading at [roughly] double its long-term average earnings multiple. Buyers of stocks seem exclusively focused on the rebounding of earnings as opposed to what a probable level

of earnings is worth. Furthermore, the ten-year Treasury's recent 20% plus rise in yield appears to have been ignored completely. Stocks have almost never been as unattractive relative to bonds.

**STOCKS CAN DELIVER VERY DISAPPOINTING RETURNS.  
 EARNINGS GROWTH DOESN'T GUARANTEE ANYTHING.**

Two distinctly different periods for U.S. stocks....

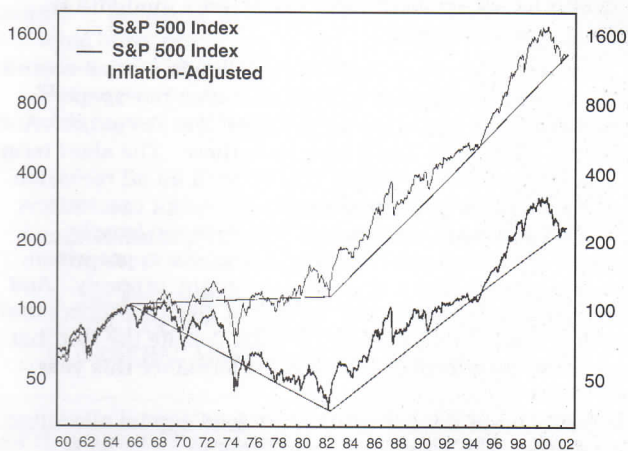
The information that follows is similar to a presentation Warren Buffett gave in Omaha a couple of

(continued on next page)

**Valuation Matters: Two Distinct Periods**

**S&P 500: Nominal vs. Real Price Appreciation\***

through 3/29/02, semi-log, Jan-66=100



\*Consumer price index used to deflate S&P 500 Index. CPI data for March 2002 are a Laffer Associates estimate.

| S&P 500 AVERAGE                 |                  |                  |
|---------------------------------|------------------|------------------|
| ANNUAL COMPOUND RATES OF RETURN |                  |                  |
|                                 | Jan-66 to Jul-82 | Jul-82 to Mar-02 |
| Nominal                         | 0.5%             | 13.1%            |
| Real                            | -6.1%            | 9.7%             |

| S&P 500 EPS GROWTH                       |                  |                  |
|--|------------------|------------------|
| Average Annual Compound Rates of Growth* |                  |                  |
|  | Jan-66 to Jul-82 | Jul-82 to Mar-02 |
|  | 6.0%             | 5.8%             |

\*Earnings at beginning and ending of each period are the 3-yr average earnings below.

| S&P 500 VALUATION METRICS |        |        |        |
|---------------------------|--------|--------|--------|
|                           | Jan-66 | Jul-82 | Mar-02 |
| Closing price             | 93     | 107    | 1,147  |
| 3-yr avg EPS              | 5.36   | 14.01  | 42.66* |
| P/E                       | 17.3   | 7.6    | 26.9   |
| Earnings yield            | 5.8%   | 13.1%  | 3.7%   |
| 10-yr Treasury yield      | 4.7%   | 13.7%  | 5.4%   |

\*Uses 2000, 2001 estimate, and 2002 estimate.

Source: Laffer Associates, S&P, Bloomberg

LONGLEAF PARTNERS FUNDS'  
MASON HAWKINS, STALEY CATES ET AL.  
(cont'd from preceding page)

years ago. Our friends at Laffer Associates have generously provided the graphics for the S&P 500's nominal and real price history.

The data adds meaningful perspective for today's investors and clearly delineates two distinctly different periods for U.S. common stocks. The first began in 1966 when equities were overpriced and lasted sixteen years. The second started in 1982 when stocks were underpriced. Although the data presented uses the U.S. market as a measure, the points generally apply overseas as well.

The graph depicts two line graphs of the S&P 500 Index, each a semi-log graph beginning in 1960 and continuing through March 3, 2002. The first line, which is the upper line on the graph, shows the S&P 500 Index in its actual form, not adjusted for inflation, and represents nominal price appreciation over the period. That graph begins at approximately 70 on the vertical axis, peaks at 1,600 in 1999, and ends at approximately 1,200 in 2002.

The second line, which is the lower line on the graph, shows the S&P 500 Index adjusted for inflation over the period, and represents real price appreciation for the period. The Consumer Price Index was used to deflate the S&P 500 for the effects of inflation. That line also begins at approximately 70 on the vertical axis, peaks at approximately 300 in 1999, and ends at 200 in 2002....

Don't confuse brilliance with a bull market.

The data shows a number of important points.

- Common stocks can deliver extremely disappointing long-term returns. For the sixteen years from January of 1966 through July of 1982, the market declined 6.1% annually after adjusting for inflation. A \$100,000,000 portfolio indexed to the S&P 500 would have dropped to \$35,400,000 in purchasing power.
- Earnings growth does not guarantee good stock performance. In the 1966 to 1982 time period of horrendous returns, earnings grew slightly faster (at 6.0% per year) than they grew from 1982 to 2002 (at 5.8% per year) when the market produced its best-ever results.
- Beginning valuation levels and changes in inflation rates largely determined the market's results over these two periods. In 1966, valuations started above average at a 17.3 P/E and declined to a below-average 7.6 P/E as inflation accelerated. In the last twenty years, undervalued equities greatly benefited as valuation levels exploded when inflation waned.
- Inflation today is close to its 1966 level as reflected in the similar ten-year Treasury yields.
- Equity valuations are much higher today than they were in January of 1966. The current 27 P/E is double the long-term average multiple, even when we divide today's price by the three-year average for the S&P 500's current earnings without downward adjustments for nonrecurring items, pension expenses, and option grants. Compared to bonds, the S&P 500's 3.7% earnings yield, which is the reciprocal of the P/E, is 170 basis points below the ten-year Treasury's 5.4% yield-to-maturity.

NOW'S A GOOD TIME TO LOWER YOUR EXPECTATIONS.  
TODAY'S MARKET WILL LIKELY CHALLENGE INVESTORS.

Finding things to sell is easy; finding things to buy is hard.

These observations do not indicate that we are embracing macroeconomic analysis as part of our investment process. Today's environment does help explain why the cash levels in our portfolios are rising. Several businesses have approached our appraisals and are being sold. Concurrently, Southeastern's analysts are having little success finding qualifying underpriced investments.

Historically when our portfolios' cash levels have risen, we have found qualifiers in a reasonable time. Opportunities emerge in three ways — one-off individual corporate anomalies, increased market volatility, or an overall market decline. Regardless, patience is required.

Thankfully, we don't have to buy indices at today's prices.

We cannot accurately predict for the next 10 years whether productivity will adequately increase, inflation will remain low, or whether the Federal Reserve will maintain our currency's integrity with the successful hard money policies that Paul Volcker and Alan Greenspan have practiced.

We do control, however, what we pay for businesses, and thankfully we are not required to pay the prices of the S&P or any other index. As long as we adhere to our price discipline of paying no more than 60% of appraisal for good businesses with qualified corporate managers, our ability to compound should not be impaired — even if the market's valuation headwinds oppose us.

Now's a good time to lower your return expectations.

A real return of 10% may not seem like a lofty goal for those counting on the returns of the last two decades. Indeed, Southeastern's equity composite for tax-free institutional clients has compounded at 20%+ for the last 20 years, and exceeded the S&P 500 by 500 basis points. However, given today's market valuation levels and quiescent inflation, our partners would be well served to adjust their budgetary and actuarial planning with lower return expectations.

Those investment officers measured only by relative results may happily outperform the S&P or other relevant indices, but could easily be unable to meet their financial obligations because of low or negative absolute performance. We believe that achieving Longleaf's goal of a real, double digit return will not only beat most markets, but will rank highly among most equity investments over the next decade. Someone who achieved inflation plus 10% annually over the 1966 to 1982 period would have surpassed the S&P by 1,600 basis points per year!

The best defense is the best offense — it's a strict discipline.

History tells us that today's market environment will likely challenge investors. Our diligent efforts to find undervalued businesses echo this sentiment, and our cash reserves are increasing. The best defense and offense remain adhering to our strict quantitative and qualitative selection disciplines. We look forward to our mutual success.

—OID

## MICHAEL STEINHARDT

"[A key lesson I learned early that I was able to use throughout my career?] The way that I managed money, I had to be prepared to accept pain. I had to have the discipline to endure losses because to ultimately achieve great returns, one had to be able to stay the course and have the conviction required to take advantage of excess in [financial] markets. And since it's impossible to predict the *end* of excess in markets, one needs that sort of endurance.

"There are *many* examples — a whole *genre* of examples — [I could give you. For example,] in the 1970s, there was a breed of stock called the Nifty Fifty — stocks that people thought were super companies with unique competitive positions that had achieved regular, uninterrupted, substantial rates of growth. So there came a view that no price was too high to pay for these companies. And I shorted some of these companies — the best companies in America. And I certainly didn't short them right at their high. So I had to endure the period between when I started to be short them and the time they topped out — which was very painful. And from that experience, I learned that you have to be able to endure losses.

"[What advice would I give someone fed up with the performance of their mutual funds and their individual stocks? Would I advise them to make their way into a hedge fund?] Not necessarily. I would take the view that involvement in the stock market requires a discipline and a vigor and an education that the average person probably doesn't have. I've tended therefore to be particularly conservative in the advice I've given. When asked the question what to do with one's money, I've often said, 'Keep it in your mattress,' — because I think the myth of getting rich in the stock market has been an attraction to many people, but relatively few people have accomplished that goal. So personally, I would scale down one's expectations.

"Secondly, I would take the view that maybe the risks in the stock market are not made for everyone. Thirdly, if I were going to do it, I would do it only after finding an approach that historically has worked — a money manager or a broker even or someone who has consistently achieved above average returns and has managed to survive bear markets as well — which is not so easily accomplished.

"What's my view of the market today? ...My advice is going to be disappointing, I suspect. I feel that this is a time when there are no clear, attractive alternatives out there. The stock market is too high — and it's vulnerable. I think that bond yields are too low and offer very little.... I think there are times — and that this is one of them — when one should really be conservative. The virtue of conserving capital occurs intermittently, but irregularly, over time. And I think that this is one of those times."

Interview on CNBC — April 2002

## BRUCE BERKOWITZ, LARRY PITKOWSKY &amp; KEITH TRAUNER — FAIRHOLME CAPITAL

"Excesses continue to unravel and accounting fictions continue to be exposed. Some statistical bargains are beginning to surface, but most have the kinds of problems that we assiduously avoid. However, don't be surprised if the depressed industries of today eventually yield our next big winner for 2003 and beyond.

"Most importantly, trends for Berkshire Hathaway, Markel and Mercury [General] are rapidly improving. And 2002 should be a good year for our well-run property/casualty insurance companies. Individuals and corporations who find themselves renewing policies at much higher prices understand why. Our companies ([which are] good underwriters and good investors) are well positioned to benefit from the current 'hard' insurance pricing market and should see large, positive cash flows and healthy profit increases over the next two years. The rebound should be stunning given their accounting for adverse developments, their history of conservative accounting, and the current climate. Last year's extraordinary losses set the stage for [this year or next's] exceptional profits.

"Leucadia is active in the current distressed world — a place where its owner-managers are most comfortable and profitable. With Berkshire, it's liquidating FINOVA. With Jefferies & Co., the company is investing in high yield securities. With White Mountains, the company is participating in the stress of the insurance business. And recently, Leucadia invested \$125 million in Olympus Re, a private Bermuda reinsurer. Leucadia's Joe Steinberg is the Chairman of Olympus and Fairholme's Bruce Berkowitz is the Deputy Chairman....

"At Fairholme, we dream of investors' paradise: a long list of good companies with single-digit P/E's. It has happened before. A good recession or persistent period of psychological gloom would help. In the meantime, we continue to search, research and work hard to identify our next potential winner."

Letter to Clients — April 2002

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