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COMMITTED INVESTORS ARE KEEPING LEVEL 3 AFLOAT, BUT RECENT DEALS DRAW A CAUTION FLAG FROM ANALYSTS

As James Crowe walked across the conference stage of the Arizona Biltmore in Phoenix on Jan. 9, his steps echoed loudly off the stage floor against a nearly silent, subdued room of telecommunications executives and analysts. Crowe is chief executive of Level 3 Communications, and his 37-minute talk about the Broomfield-based telecom carrier's strategy, services and its position in its marketplace, about his company's latest financial maneuverings and about the future of network services drew only two questions at its end — both brief, and both tinged with a hint of skepticism. In response, Crowe quipped, "We are either consistent or boring, depending on how you view us." »

He got no reaction from the crowd, but continued,

"We haven't changed our view since we started the company in 1997, we believe, and have believed since that time, that network services and our customers' needs are all converging around a single market protocol, an Internet Protocol."

Crowe's full techno-speak-laced talk about opportunities in soft-switches, changing telephone circuit systems, voice and data networks covered some well-worn territory about broadband expectations that has been Level 3's pitch for most of the past decade. Crowe's predictions of an exploding interest in voice and music access and the advent of making cheap telephone calls over the Internet, as well as a much ballyhooed instant Internet access to video — what he called the "800-pound guerilla" of network traffic — drew only polite and scattered applause.

No press coverage followed the meeting.

Yet despite the tepid response to Crowe at the 16th annual Citigroup telecommunications conference last month, and despite a financial stew the fiber-optic network carrier has cooked up for itself — heavy debt, declining revenues, overcapacity and a puny stock price — investors in the company, from U.S. Bank Corp. to Barclays Bank PLC, are apparently still finding its offerings a dish to savor. The steam rising from the pot, however, is creating a healthy skepticism about the company's future among analysts and other industry observers.

"This company has a core group of believers and investors who feel that pure IP networks are the wave of the future, and they have put a lot of money into a future that has yet to materialize," said telecom analyst Tom Friedberg, who until recently covered the company's every move. "There is no doubt that Level 3 and companies like them are on the cusp of bandwidth demand. The problem is that prices have declined quicker than demand has increased."

The question of whether the company can hold off repaying billions of dollars it raised to build out its more than 23,000 miles of fiber-optic, Internet Protocol networks — which it has laid out along rail rights-of-ways in the U.S. and Europe, and beneath the oceans to connect some 300 cities — has worried some analysts of late. But longtime observers of the company say Crowe's vision of filling the company's big network pipes with lots of traffic from companies like AOL, Google, Yahoo and a host of telephone providers, is still viable — it just needs a little more time to simmer.

Moreover, those observers also say that an infusion of "psychological capital" that Level 3 enjoys from its association and support from the so-called "Old Men of Omaha" — Warren Buffett and his long time associate Walter Scott Jr., Level 3's board chairman — have given the company "an aura of success" that competitors in this tough, financially struggling industry have not come by as easily.

Last month, the company completed a debt swap deal in which a slight majority of the holders of some $1.23 billion in bonds — 54 percent — swallowed a proposal to push back the maturity dates on their notes from 2008 to 2010 — for a higher interest rate. The deal gave Level 3 "a little more breathing room," says Janco Partners analyst Donna Jaegers.

And Level 3's acquisition of WilTel Communications of Tulsa, Okla., from Leucadia National Corp., for some $700 million in cash and stock, has also bought the company a guaranteed — though temporary — stream of revenue amounting to more than a billion dollars over two years. "The purchase is good for Level 3 in the sense that it takes out a competitor and gives them two years of increased cash flow," said Jaegers.

But both those deals have also produced a cautionary warning to investors from Bank of America Securities analysts, who worried in a recent research report that projected revenue growth of the company — a so-called "J-curve" in its financial expectations — might be a risky assumption. The analysts at B of A set off some alarm bells when they recommended during the debt exchange offer that some bond holders might want to avoid tendering their bonds based on the company's continued promises of increasing demand for networks services — and its promises of exponential growth of voice-over-Internet-protocol traffic.

The analysts suggested that those investors adverse to the risk of holding onto the bonds until 2008 should consider selling their notes on secondary markets.

Level 3 did not return a call requesting comment about the debt swap and its WilTel acquisition. But Kevin O'Hara, president of Level 3, on a trip to meet with WilTel employees in Tulsa last month, told a reporter for the *Tulsa World* that Level 3 executives expect that capital markets will begin to demand a return soon on the massive investment that telecommunications companies have made in network infrastructure.

Holders of nearly $700 million of the bond debt due in 2008 opted for Level 3's exchange offer. Analysts for Bank of America said in their report that had Level 3 not convinced a minimum of 52 percent of the bondholders to take the exchange offer, the company likely would have struggled to meet its payments due on the bonds. Still, despite carrying some $6 billion in total debt, Level 3 also managed to sell handily more than $800 million in new notes earlier this year. And though it has acknowledged that prices are declining faster than new demand for its bandwidth — it listed 16 pages of significant risks to investors in a prospectus on 115 million shares it included in the WilTel cash and stock deal — its investors haven't blinked yet.

Bank of America analysts noted also that some of the investors in Level 3 who endorsed the debt exchange are also equity holders. WilTel seller Leucadia National, in fact, is cross-invested in interests held by Buffett's Berkshire Hathaway, another of the links that Crowe's company can benefit from but that raise red flags for outside observers.

Meanwhile, as the fiber-optic carrier pushes itself back from the table to digest

WilTel — a process of integration that may take a couple of years and some $150 million more — some investors and stockholders may be wondering whether the company has also devoured its dessert before the main meal has been served. For most companies that endure the kind of business environment that Level 3 has lived with for several years, the next course might be bankruptcy, said Friedberg.

"Level 3 is ultimately a dream and if the dream doesn't die so much the better," Friedberg said. "They have the wise counsel of the greatest business executives of Omaha who seem to be willing to keep this alive, which has probably kept them in business a lot longer than they would have been otherwise."

That powerful counsel — and the "aura" of respect that goes along with the Omaha executives — goes back to Level 3's origins, which it traces to Omaha-based Kiewit Diversified Group, a subsidiary of Peter Kiewit Sons, a construction, mining and communications conglomerate. Kiewit Diversified hired Crowe in 1997 as president and CEO after the company began exploring the opportunities in network development. They snatched Crowe from WorldCom — and his former protégé Bernie Ebbers — after Crowe built MFS Communications, a network carrier, and sold it to Ebbers in a multi-billion-dollar deal that was supposed to include Crowe's continue participation in the company. Crowe lured several top executives from MFS Communications to Level 3 after the company was spun off from KDG in 1998, and in turn hired Peter Kiewit Sons Inc. to build out its fiber-optic network. Kiewit shared office space and directors with Buffett's Berkshire Hathaway, and the relationship has continued for most of the past decade.

Buffett's timely purchase of $500 million in Level 3 bonds in 2002 — which he later resold — was widely seen at the time as an endorsement of Level 3's business plan. The move was of little surprise to insiders, given Buffett's friendship and association with Level 3's Walter Scott, who also serves on Berkshire Hathaway's board.

Friedberg said Level 3's success has become "almost a civic commitment" on the part of the Omaha players. "Without that, it is not clear that Level 3 would not have gone the way of most of the rest of the industry," Friedberg said.

"I'm not here to say that such a long-term perspective, of trying to be the last man standing, won't ultimately pay off," said Friedberg. "But there has certainly been a lot of capital expended in this company to keep it afloat, when it would have been very easy to put this into a pre-pack bankruptcy and put it on more flexible financial footing."

One of the reasons that may not have happened, Friedberg said, is the support of the "the old men of Omaha." He added, "When you have people like Buffett and Scott, and folks like that, the thinking is, they probably don't want to be associated with a bankruptcy."