

244 Fifth Ave., 2<sup>nd</sup> Fl., Ste. 2801 • New York, NY 10001 • Tel: (212) 726 1408 • Fax: (413) 215 0880**Covad Communications Group, Inc. (NASDAQ: COVD)**

Initiating Coverage: HOLD

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**KEY CONSIDERATIONS**

- Covad has levered his first mover advantage by establishing the largest network coverage in the DSL market. Covad's network as of December 31, 2000 covered 40% of homes and 45% of business in the United States.
- Recent regulatory changes concerning line sharing should make installation of DSL lines less expensive and less time consuming than before.
- Covad faces stiff competition not only from other competitive telecommunications companies but also from the entire broadband universe such as cable modem service providers, traditional telephone companies, and national interexchange carriers.
- Covad's acquisition of BlueStar Communications represents a fundamental shift of strategy from a wholesaler provider to a mixed wholesaler/retailer provider, which adds additional risk to the stock.
- Covad had to reduce revenue for the third quarter of 2000 by \$21.8 million due to insolvent ISP customers.

Recent Price	\$2.94
52WK Low	\$1.25
52WK High	\$66.67
P/E	N/A
P/Book	0.78
P/Sales	2.31
Market Capitalization	\$523.06M
Shares Outstanding	178.03 M
Float	126.40 M
Daily Volume (3-month Average)	9.27
<b>EPS</b>	
1998A	\$(5.62)
1999A	\$(1.83)
2000E	\$(4.17)
Current Ratio	4.26
Total Debt to Equity	2.03
LT Debt to Equity	1.98
Total Cash	\$975.0M

**ONE-YEAR PRICE AND VOLUME GRAPH****COMPANY PROFILE**

Covad is the leading national broadband service provider of high-speed Internet network access utilizing Digital Subscriber Line technology (DSL). It offers DSL, and dial up services through Internet Service Providers, telecommunications carriers, enterprises affinity groups and ASPs to small and medium sized businesses and home users. DSL services offer end-users a secure always on connection to the Internet using the existing copper line. Covad services are currently available across the United States in 120 of the top Metropolitan Statistical Areas (MSAs). Covad's network currently covers more than 47 million homes and businesses and its target is to reach approximately 45 to 50 percent of all US homes and businesses by the end of 2000.

This report was prepared by Juan Carlos Arandia, and David R. Rivas, PhD.

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## THE COMPANY

Covad Communications is one of the leading providers of broadband communications services, which it sells to businesses and consumers directly or through Internet service providers, enterprises, telecommunications carriers and other customers. These services include a range of high-speed, high capacity Internet and network access services using digital subscriber line (DSL) technology, and related value-added services. Covad sells these services directly to business and consumer end-users through its sales force, telesales and through its website. Internet service providers purchase Covad services in order to provide high-speed Internet access to their business and consumer end-users. Branded virtual service providers purchase turnkey broadband or dial-up services from Covad and sell these services to their existing customers or affinity groups. Enterprise customers purchase DSL services directly or indirectly from Covad to provide employees with high-speed remote access to the enterprise's local area network (RLAN access), which improves employee productivity and reduces network connection cost. Telecommunications carrier customers purchase Covad's services for resale to their Internet service provider affiliates, Internet users and enterprise customers.

As of December 31, 2000, we believe Covad has one of the nation's largest DSL networks based on their 2,000 operational central offices that pass through more than 47 million homes and businesses. Covad has announced also that it plans to close approximately 250 central offices. When these closings are completed, their network will pass more than 40 million homes and businesses. As of December 31, 2000, Covad had 274,000 DSL based high-speed access lines in service and had received orders for services from more than 250 Internet service providers, enterprises, and telecommunications carrier customers, including AT&T Corporation, XO Communications (formerly NEXTLINK Communications, Inc and Concentric Network Corporation), Earthlink, Inc., UUNET Technologies (an MCI WorldCom company) and Verio, Inc., which was acquired by Nippon telephone and Telegraph.

As of December 31, 2000 Covad had deployed its network in a total of 120 metropolitan statistical areas, but Covad plans on reducing this number to 109 metropolitan statistical areas in 2001. When Covad completes this planned closure of central offices, it expects that its network will pass 40% of home and 45% of businesses in the United States. Covad is also developing a variety of services that are enhanced or enabled by its network and is entering into business arrangements with broadband-related service providers in order to bring a variety of value-added service offerings to its customers and end-users.

## SERVICES AND SOURCES OF REVENUE

Covad offers six business-grade services under the TeleSpeed brand to connect its customers' end-users to its regional data centers and two consumer-grade service offerings called TeleSurfer and TeleSurfer Pro. On March 2000 Covad also introduced two new services- DSL+IP and VBSP. Covad also offer business consumers Virtual Private Network (VPN) technology over DSL.

- **TELESPEED SERVICES** - The TeleSpeed service connects individual end-users on conventional telephone wires to Covad's DSL equipment in its serving central office and from there to the network serving that metropolitan statistical area. The particular TeleSpeed service available to an end-user depends in large part on the user's distance to the central office. Prices for end-user services may vary depending upon the performance level of the service. Prices also vary across regions and for high volume customers that are eligible for volume discounts.
- **TELESPEED 144** - The TeleSpeed 144 service operates at up to 144 kilobits per second in each direction, which is similar to the performance of an ISDN line.
- **TELESPEED 192** - This service provides one and a half to three times the performance of ISDN lines at similar or lower price points to heavily-used ISDN lines.

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- **TELESPEED 384** - This service provides three to six times the performance of ISDN lines at similar price points to heavily used ISDN lines.
  - **TELESPEED 768** - This service provides one-half the bandwidth of a T1 data circuit at substantially less than one-half of the monthly price that is typical for T1 services. The target market for the TeleSpeed 768 service is small businesses needing moderate speed access to the Internet but who have previously been unable to afford the price of such service. The service also competes favorably from a price/performance standpoint with traditional fractional T1 and frame-relay services for these same customers.
  - **TELESPEED 1.1** - This service provides over two-thirds the bandwidth of a T1 data circuit at less than one-half the monthly price that is typical for T1 service. The target market for the TeleSpeed 1.1 service is small businesses needing T1-level access to the Internet, which have previously been unable to afford the price of such service. The service also competes favorably from a price/performance standpoint with traditional fractional T1 and frame-relay services for the same customers.
  - **TELESPEED 1.5S** - This service provides bandwidth comparable to a T1 data circuit at less than one-half of the monthly price that we estimate is typical for T1 service. The service also provides the highest performance of any TeleSpeed service to stream video or other multimedia content to end-user locations.
  - **TELESPEED REMOTE** - TeleSpeed Remote provides high-speed network access for end users located in remote regions to their corporate networks. This service is targeted towards businesses that want high-speed remote office connections at a lower cost than ISDN or frame-relay services.

#### **TELESURFER SERVICES**

- **TELESURFER ADSL** - This consumer-grade service is an asymmetric service, offering up to 608 kilobits per second downstream and up to 128 kilobits per second upstream. This service is the basic consumer service. The target market for this service is a consumer using either dial-up analog or ISDN connections for web browsers.
- **TELESURFER PRO ADSL** - This is a premium consumer-grade asymmetric service, offering up to 1.5 megabits per second downstream and up to 384 kilobits per second upstream. The target markets for this service are consumers using analog or ISDN connections for web browsers.

#### **OTHER SERVICES**

- **DSL+ IP** - This service currently bundles Internet protocol services with Covad's existing TeleSurfer services. Covad also plans to offer it with its TeleSpeed services. The additional Internet protocol services include end-user authentication, authorization and accounting, Internet protocol address assignment and management, domain name service and Internet protocol routine and connectivity.
- **VBSP** - This additional service provides a complete solution for organizations and businesses that want to offer broadband Internet services to their customers without having to develop their own Internet capabilities. Covad provides Internet service to end-users under the brand name of their customers. Covad Internet services will be a turnkey solution that includes registration, connection and Internet software, web sites, network authentication, electronic mail, billing and reporting, news and personal web-space for end-users and end-user service and technical support.
- **VPN Over DSL** - In August 1999 Covad introduced the VPN over DSL service. This service uses the public Internet backbone or a private data network, combined with DSL connections, as a channel for sharing information and applications with in a closed circle of users in different locations.

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## MANAGEMENT

On November 1 Covad announced the resignation of Robert E. Knowling, Jr. as Chairman, CEO and President. The Board of Directors named Frank Marshall as interim CEO and Charles McMinn as Chairman of the Board. Frank Marshall has served on the Board of Directors since 1997 and will lead Covad Senior Management Team and will be responsible for day-to day operations. Marshall was previously Vice President, General Manager of Cisco Systems Core Business Unit and prior to this he served for three years as Vice President of Engineering at Cisco. Charles McMinn was one of Covad's founders and CEO of the Company from 1996 until Knowling's appointment in 1998. McMinn has over 20 years of experience in creating, financing, operating and advising high technology companies. He is currently the Chairman, CEO and a co-founder of Certive Corporation, a provider of outsourced services to small businesses over DSL lines. Covad is a strategic investor in Certive. Covad has stated that it is initiating an executive search for a chief executive officer of the company.

## RECENT ACQUISITIONS

- **LaserLink.Net** - On March 9, 2000 Covad acquired LaserLink.net, which is now called Covad Integrated Services. The acquisition enables Covad to broaden its addressable market by increasing service available to the company's existing Internet Service Providers and to expand the number of channel partners that sell its broadband access service. Through this acquisition, Covad enabled businesses and organizations to become "Virtual Broadband Service Providers" and deliver complete broadband Internet services to their end-users through company branded access and services.
- **BlueStar Communications Inc.** - On September 25, 2000, Covad completed its acquisition of BlueStar Communications, now called Covad Business Solutions, a provider of broadband and Internet services for small and medium-sized businesses throughout the Southeastern United States. Through this acquisition, Covad intends to gain entrance into the 2<sup>nd</sup> and 3<sup>rd</sup> tier markets of the Southeastern U.S. This acquisition also represents a fundamental change in strategy by switching from a pure wholesale provider to a mixed retail/wholesale provider of DSL. We further discuss the risks involved of this strategic change in the Key Risk Factors section of this report.
- **Loop Telecom** - On September 8, 2000 Covad bought a 50% voting interest in Loop Telecom, a Spanish full-service broadband service provider for small and medium-sized businesses. Loop currently offers broadband connectivity services in major metropolitan areas and is expanding nationally. Loop has established its own backbone network and will incorporate a DSL-based local access component as local loop unbundling is implemented next year. Loop's network will be extended to serve the entire Iberian Peninsula. Loop was incorporated in 1999 and is based in Barcelona, with offices in Madrid, Bilbao, Valencia and Seville.

This acquisition is very attractive since the Spanish data market is currently growing at a 25 percent compounded annual growth rate, one of the highest in Europe. This represents an even greater market opportunity for Covad and Loop, because less than five percent of the data transmission is done through new generation networks such as DSL. Many factors are driving the market, including liberalization of the telecommunications market by the European Union and Spain's telecommunications regulatory body CMT (Comision de Mercado de las Telecomunicaciones – Telecommunications Market Commission).

## IMPORTANT RECENT EVENTS

- **Market Turmoil** - Due to the difficulty accessing the capital markets during 2000 and the inability to generate sufficient revenues to be self-funding, several players in the DSL communications industry have been hit severely causing many to file for Chapter 11. Some of these companies

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include Northpoint Communications, a direct Covad competitor, which has recently filed for bankruptcy on January 16, 2001. Other players affected include several ISPs, many of which are Covad's customers. The problem began in September and has been the major story in the DSL industry for the past four months. Covad had to reduce revenue for the third quarter ended September 30, 2000 by \$10.4 million to \$56.3 million compared to the \$66.7 million reported on October 17. EBITDA losses for the quarter were increased by \$4.9 million to \$(125.3) million compared to the \$(120.4) million previously reported, due to related reductions to estimates of provisions for doubtful accounts concerning five ISP identified as troubled ISP. As of December 31, 2000, 19 ISPs, which account for approximately 92,000 of Covad's 270,000 installed lines were experiencing severe shortfalls in operating capital and were not able to stay current in their payments. Four of these 19 ISPs, Flashcom, Zyan Communications, Relay Point and Fastpoint, have filed for bankruptcy protection. As of December 31, 2000, these four ISPs represented more than half of the 92,000 lines served through the 19 troubled ISPs. Covad states that it hopes to collect payments, but there is no assurance that payments will be ultimately collected.

- **Covad Safety Net Program** - In light of these events Covad announced on December 11, 2000 its introduction of the Covad Safety Net Program. This program provides Covad broadband customers an opportunity to maintain Covad service while switching ISPs. The program is available to customers of financially distressed ISPs. Covad is directing this program towards saving the 92,000 lines in question from the troubled ISPs. On January 8, 2001 Covad announced that in less than three weeks, approximately 1,500 lines (representing 30 percent of lines from two ISPs) were transitioned to Covad.net or another ISP through the Covad Safety Net program. Covad will be working with additional ISPs in the first quarter of 2001 to transition more lines in an effort to maintain end-user's broadband connections. While it is still early to determine the success of this program, we regard it as a swift move by the management team to try to stabilize the Company's customer base. We believe the success of this program will be critical in achieving the expected deployed DSL lines for fiscal year 2001.

## INDUSTRY OUTLOOK

High-Speed connectivity has become important to small- and medium-sized businesses and consumers due to the dramatic increase in Internet usage. According to International Data Corporation, the number of Internet users worldwide reached approximately 196 million in 1999 and is forecasted to grow to approximately 502 million by 2003. The popularity of the Internet with consumers has driven the rapid proliferation of the Internet as a commercial medium. Businesses are increasingly establishing Web sites and corporate intranets and extranets to expand their consumers reach and improve their communications efficiency. Consumers are increasingly using the Internet to carry out commercial transactions. International Data estimates that the value of goods and services sold world wide via the Internet will increase from \$111 billion in 1999 to over \$1.3 trillion in 2003. Accordingly, to remain competitive, small-and medium-sized businesses increasingly need high-speed Internet connections to maintain complex Web sites, access critical business information and communicate more effectively with employees, customers and business partners. Broadband connections are also becoming increasingly important to businesses and consumers as rich Internet content—such as multimedia-media advertising, news and entertainment—and on-line consumer transactions and e-commerce become more widely available and widely used.

The demand for broadband communications services for RLAN access is also growing rapidly. Over the past ten years, high-speed local area networks have become increasingly important to enterprises to enable employees to share information, send e-mail, search databases and conduct business. Enterprises are now seeking to extend this same high-speed connectivity to employees accessing the local area networks from home to improve employee productivity and reduce operating costs. The number of home office households on the Internet grew from 12.0 million at the end of 1997 to an estimated 27 million by the end of 1999 and is expected to grow to 30.2 million households by 2002. At the beginning of the year 2000, only 3.7% of these users accessed the Internet through a broadband connection of any type.

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As use of the Internet, intranets and extranets increases, we expect the market size for both small- and medium- sized business and consumers Internet and RLAN access to continue to grow rapidly causing the demand for broadband communication services to also grow rapidly. However, the full potential of Internet and local area network applications cannot be realized without removing the performance bottlenecks of the existing public switched telephone network. Increases in telecommunications bandwidth have significantly lagged improvements in microprocessor performance over the last ten years. According to industry analysts, there are nearly 40 million personal computers in U. S. homes today, and most of them can only connect to the Internet or their corporate local area network by low-speed analog lines. Higher speed connections are available, including:

- **INTEGRATED SERVICES DIGITAL NETWORKS** - An ISDN line provides standard interfaces for digital communication network and is capable of carrying data, voice, and video over digital circuits. ISDN protocols are used worldwide for connections to public ISDN networks or to attach ISDN devices to compatible PBX systems.
- **T1 LINE AND FRACTIONAL T1** - These are telephone industry terms for a digital transmission link with a capacity of 1.544 megabits per second or portions thereof.
- **FRAME-RELAY** - a high-speed packet-switched data communications protocol.
- **CABLE MODEM** - Internet access over hybrid fiber coaxial cable.

While these services have recently experienced dramatic growth in the U.S., they are frequently expensive, complex to order, install and maintain, and in some cases are not as widely available as DSL technology.

#### **EMERGENCE OF DSL TECHNOLOGY**

DSL technology first emerged in the 1990's and is commercially available today to address performance bottlenecks of the public switched telephone network. DSL equipment, when deployed at each end of standard copper telephone lines, increases the data carrying capacity of copper telephone lines from analog modem speeds of 56.6 kilobits per second, for the fastest consumer modems, and ISDN speeds of 128 kilobits per second to DSL speeds of up to 6 megabits per second depending on the length and condition of the copper line. Recent advances in semiconductor technology have made the widespread deployment of DSL technology more economical over time. We anticipate that equipment prices will continue to fall as a result of continued advances in semiconductor technologies and increases in equipment production volumes.

Because DSL technology reuses the existing copper plant, it is significantly less expensive to deploy on a broad scale than alternative technologies, such as cable modems, wireless data and satellite data. As a result a significant portion of the investment in a DSL network is success-based, requiring a comparatively lower initial fixed investment. Subsequent variable investments in DSL technology are directly related to the number of paying customers.

#### **COMPETITION**

The markets for business and consumer Internet access and network access services are intensively competitive and we expect that these markets will become increasingly competitive in the future. Covad competes with all broadband access and high-speed Internet connectivity providers. Therefore Covad faces competition from a number of different players besides other CLEC's, these include traditional telephone companies, cable modem service providers, competitive telecommunications companies, traditional and new national long distance carriers, Internet service providers, on-line service providers and wireless and satellite service providers. In addition, the traditional telephone companies dominate the current market and have a monopoly on telephone wires. Covad poses a competitive risk to the traditional telephone companies and, as both its competitors and suppliers; they have the ability and the motivation to harm Covad's business.

Before the Telecommunications Act of 1996, building a DSL network from scratch was considered unrealistic because it required a huge initial investment. The Telecommunications Act of 1996 required local phone companies to lease their existing infrastructure – copper wire networks and control centers - to competitors. The passing of the act set removed existing barriers to entry and many DSL telecommunications companies were formed in order to address the growing market opportunity and demand for broadband services. Everything looked great up until the market's severe downturn at the beginning of 2000, where several ISPs had to file for chapter 11. Northpoint Communications, one of Covad's direct competitors, was also affected after a merger with Verizon Communications did not go through, and has recently filed for bankruptcy on January 16, 2001.

Just recently on November, Covad closed a deal with SBC Communications where SBC has committed to buy \$600 million worth of DSL from Covad for their customers and to make a \$150 million equity investment in Covad. This may well be a sign that the local phone companies' will eventually own the DSL market since they have deeper pockets and the advantage of established brand names. Given the fact that the whole broadband industry universe also consists of cable service providers, wireless and satellite service providers we expect major consolidations to take place in the foreseeable future.

The following table illustrates Covad's major competitors.

	<b>Covad</b>	<b>Northpoint</b>	<b>Rhythms NetConnections</b>	<b>Network Access Solutions</b>	<b>Cable Modem Service Providers</b>	<b>Traditional Phone Companies (TPCs)</b>	<b>National Interexchange Carriers</b>
<b>Symbol / Companies</b>	COVD	NPNT	RTHM	NASC	Excite@Home, Road Runner, Cox, Time Warner	Baby Bells	AT&T, Sprint, WorldCom,
<b>Services</b>	Provides DSL services and other value added services directly and indirectly	Provides Internet access and remote network connections using DSL technology	Provides Internet access and remote network connections with high-speed Digital Subscriber Line (DSL) technology	Provides DSL connectivity, sells telecommunications products and equipment made by others and offers consulting services	Provide high-speed Internet access service over hybrid fiber coaxial cable network	Provide local phone service, along with long distance, wireless, cable TV, directories and paging	Provide mainly long distance service, but also provide wireless service, and some local phone service
<b>Strengths</b>	Largest network, strong alliances and strong distribution channels	Strong alliance, Possessed 2 <sup>nd</sup> largest network	Strong alliances	More diversified, Focuses only on direct marketing sales	Have pricing advantage	High brand name, strong reputation, have enough capital, own the phone wires, diversified	High brand recognition, have interconnections agreements with many TPCs and have high number of central offices
<b>Weakness</b>	Depends on third parties for resale of service and for provision of phone wire	Filed for bankruptcy	Also depends on third parties for provision of third parties. Smaller network compared to Covad's. Currently experiencing capital funding problems	Smallest network	Cable network deployment significantly more expensive and time consuming	DSL service may cannibalize existing t-1 connections	Weak customer service & sales and marketing approach to DSL customers relative to pure DSL providers

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## STRATEGIES FOR GROWTH

Given the new developments in the broadband industry Covad has announced a new business strategy for 2001. The plan's objective is to satisfy market priorities and to achieve profitability sooner. The business outlook for 2001 includes an expected improvement in expenses each quarter balanced by line additions optimized for profitability. The majority of the line growth optimization will be attributed to restricting residential orders to higher-margin line shared installations, followed by an aggressive plan for self-installations. In addition, small business lines will take a greater percentage of new lines installed than in the recent past.

- **Cost Cutting Initiatives** - Covad plans to close approximately 250 under productive or not fully built-out central offices, which will significantly reduce its capital expenditures. It also plans on reducing its workforce by approximately 800 employees, which represents approximately 25 percent of its workforce. Covad is closing a facility in Alpharetta, Georgia and consolidating offices in Manassas, Virginia, Santa Clara, California and Denver, Colorado.
- **Reduced Capital Expenses** - Capital expenses are expected to be reduced by \$100 million to approximately \$250 million, versus current expectations of \$350 million, mirroring the recent announcement of holding the network build-out at just over 2000 central offices and fewer line card purchases for the lowered number of lines installed.
- **Lower Cash Burn Rate** - The monthly cash burn rate is expected to decrease down from \$75 million in Q4 2000 to less than \$60 million by the end of 2001. At this lowered rate the company expects its current funding to last into 2002.
- **Develop and Commercialize Value-Added services-** Covad intends to introduce value added services to its customers and leverage the value of the network access it offers today. Offering services such as voice over DSL, DSL plus Internet Protocol (DSL+ IP), and Virtual Broadband Service Provider will allow Covad to bundle service offerings to its customers and improve the quality of content delivery to their end-users as well as reduce costs. Covad has already announced agreements to sell a complete ISP solution through Avon Products and Sony Electronics.
- **Take Advantage of New Regulatory Developments-**In late 1999, the FCC required the major local phone companies to provide Covad, and other competitive local carriers, with "line sharing." This allows Covad to provide its services over the same telephone wire used by the traditional telephone companies to provide analog voice services. Line sharing represents an important opportunity for Covad for three primary reasons:
  1. Line sharing should significantly reduce the monthly recurring charges Covad incurs for telephone loops
  2. Line sharing should reduce the time it takes traditional telephone to deliver telephone loops because the phone loop already exists.
  3. Line sharing should resolve lack of telephone loop problems that Covad has encountered when ordering telephone loops in some areas of the country.
- **Establish and Maintain Relationships with ISPs and other players'** -Covad principally targets Internet service providers, telecommunications carriers and other DSL resellers that can offer their end-users cost and performance advantages for Internet access using Covad service. Covad primarily provides connections to Internet service providers, which then offer high-speed Internet access using its network. In other cases, Covad provides wholesale DSL and Internet access services for resale by its customers. In this way Covad:



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1. Carries the traffic of multiple Internet service providers, telecommunications carriers and other customers in any region, increasing its volume and reducing its costs;
  2. Leverages its selling efforts through the sales and support staff of these Internet service providers, telecommunications carriers and other customers;
  3. Offer Internet service providers, telecommunications carriers and other customers an alternative, since the traditional telephone company typically provides its own retail Internet access services in competition with Covads customers; and
  4. Provide Internet service providers, telecommunications carriers and other customers a high-speed service offering to compete with cable-based Internet access.

## **ALLIANCES AND PARTNERSHIPS**

Covad's alliances are focused on expanding its customer base mostly by extending its distribution channels. Its strategic alliances also intend to increase Covad's technological capabilities to offer new services.

- **Cisco Systems, Inc.** - Covad and Cisco have an agreement since December 7, 1998 stating that Covad will deploy Cisco DSL solutions to corporate telecommuters and small-to-medium sized business. The two companies also agreed to engage in joint engineering activities to support the growth of DSL-based products.
- **AT&T and XO Communications** - Covad received an equity investment of \$25 million from AT&T Ventures, the venture capital arm of AT&T, and \$20 million from XO Communications. Covad also entered into commercial agreement with both companies to provide for the purchase of transport services, marketing and resale of the Company's DSL services, and collocation of the Company's network equipment
- **Qwest Communications International, Inc.** - Covad received a \$15 million equity investment from Qwest, which were used to support the deployment of Covad's network. Covad also entered into commercial agreements with Qwest for the purchase of transport services and resale of Covad's DSL services.
- **Healthon/WebMD** - Covad will become the preferred provider of broadband connectivity to Healthon/WebMD physician subscribers for multimedia content and communications services. Both companies will implement co-marketing programs to offer Covad's Internet connection services with Healthon/WebMD healthcare products and services, including online transactions, e-commerce and multimedia advertising.
- **Micron Electronics, Inc.** - Covad and Micron Electronics agreed to launch an online program that makes is much easier for customers to subscribe to high-speed internet service via DSL.
- **iBeam Broadcasting** - Covad and iBeam will work together to deliver compelling multi-media content and applications to consumers and businesses nationwide. The combination of iBEAM's intelligent content distribution capabilities and Covad's always-on, last mile broadband connectivity will provide content providers, channel partners and end-users with a superior quality streaming audio and video experience.
- **Yahoo! Inc.** - The two companies reached a co-marketing agreement designed to encourage the adoption of broadband services to residential and business Internet users.
- **ICG Communications Inc.** - Covad and ICG will jointly develop Voice over DSL (VoDSL) service offerings by combining their expertise in local service and broadband technology. VoDSL leverages the last mile copper network connected to homes and businesses today to provide integrated broadband data and voice services to the companies' respective multiple channels, including Internet Service Providers (ISPs).

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- **RealNetworks, Inc.** - Covad and RealNetworks announced an agreement to conduct broadband streaming media trials over high-speed DSL lines.
  - **Intervu, Inc.** - Covad launched a broadband content pilot with INTERVU Inc., a leading service provider of Internet audio and video delivery solutions, to optimize the delivery of streaming audio and video utilizing Covad's end-to-end broadband network. The two companies are working together to deliver live and on-demand TV quality video and CD quality audio content to Covad's broadband Internet access end-users.
  - **Diamond Multimedia** - Diamond Multimedia, a division of S3 Incorporated and Covad Communications announced development plans for an online program that will empower consumers to purchase Covad's consumer high-speed Internet access and Diamond's HomeFree ADSL residential gateway from a single destination. Diamond's Digital Dream Home Web site ([www.thedigitaldreamhome.com](http://www.thedigitaldreamhome.com)) will provide a one-stop shopping approach to digital subscriber line access and home networking.
  - **Mac Publishing L.L.C. and Netopia, Inc** - Mac Publishing L.L.C., the premier source for Macintosh information, Covad Communications, and Netopia, Inc., a market leader in providing DSL Internet equipment and E-commerce Web platforms to small and medium-size businesses, have joined forces to launch the MacDSL Center Powered by Covad and Netopia. This will be the premier DSL Web Site targeted at Apple Macintosh and iMac users, and promises to be a one stop shopping center for getting Mac users connected to the Internet at high speeds.
  - **SBC Communications** – On September 11, 2000 Covad and SBC signed an agreement where SBC will sell business lines provided by Covad. SBC will market both symmetric business service DSL and asymmetric consumer service DSL provided by Covad throughout the US. The companies also will work together on network, provisioning and product planning activities needed to support this agreement. The agreement also settled the pending legal matters between both companies. SBC also announced its plan to take a minority ownership interest position in Covad of six percent. This investment would increase Covad's cash balance to over 1.1 billion.
  - **Reliant Energy** - Covad and Reliant Energy announced an agreement on January 22, 2001 stating that Reliant Energy Communications will resell Covad's business-class DSL service to its off-network business customers, including customers who require a tele-worker solution. This relationship offers Covad a tremendous opportunity to tap into a strong business customer base and enables Reliant to continue to provide its customers with business-class broadband services.

## KEY RISK FACTORS

- **Litigations**-Several shareholders have filed class action lawsuits against Covad, its former president and Chief Executive Officer, Robert E. Knowling and its current executive vice president and Chief Financial Officer, Mark H. Perry. The complaints in these matters allege violations of federal securities laws on behalf of persons who purchased Covad's securities. Three other purchasers of its convertible notes have filed complaints alleging fraud and deceit, negligence and violations of state securities laws in connection with Covad's sale of its convertible notes. In addition, a former LaserLink.net shareholder has filed a complaint against Covad in the Supreme Court for the State of New York. He is seeking damages arising out of an alleged failure to register Covad shares that he received in exchange for his LaserLink.net shares. While Covad has strong defenses to and is vigorously defending these lawsuits, the total outcome of these litigations matters is inherently unpredictable and there is no guarantee the Company will prevail. In addition, defending such

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actions could result in substantial costs and diversion of resources that could adversely affect Covads financial condition, results of operations and cash flows.

- **Reduced capital expenditures** - Covad has never previously reduced its capital expenditures and it is uncertain what effect such a reduction will have on its operations, customers and/or end-user relationships, growth prospects and financial results. Even with these capital reductions that the Company is making, it may still not be able to break even on cash-flow basis or EBITDA basis or turn to profitability as planned.
- **Delinquent ISPs** -As of December 31, 2000, 19 Internet service provider customers, which account for approximately 92,000 of its 274,000 installed lines were experiencing severe shortfalls in operating capital and were not able to stay current in their payments. Four of these nineteen Internet service provider customers, Flashcom, Zyan Communications, Relay Point and Fastpoint, have filed for bankruptcy protection. As of December 31, 2000 these four Internet service provider customers represented more than half of the 92,000 lines served through these nineteen Internet service provider customers. With respect to the 19 Internet service provider customers, approximately 50% of their lines are business lines and approximately 50% are consumer lines. Business lines carry a higher profit than consumer lines. Although Covad will continue to try to obtain payments from these customers, it is likely that Covad will not be able to obtain payments from one or more of these customers.
- **Closed capital markets-** We believe that current capital market conditions, particularly for the Internet industry will significantly reduce Covads ability to obtain additional financing on reasonable terms or at all. Covad has already made significant reductions in its capital expenditures in response to these events. If the company experiences continued or prolonged barriers to raise additional financing through the capital markets, it may need to make additional significant reductions in its capital expenditures. Such reductions could have a material adverse effect on Covads' financial condition and business operations and prevent the company from effectively implement its business plan. Such reductions may also adversely affect the relationships with its customers and/or their end-users that may in turn adversely affect its growth and financial results.
- **Change in Strategy** - We believe that Covad's acquisition of BlueStar Communications introduces significant risks to the Company. Covad's strategic shift into retail sales could impact its existing distribution channel by adding channel conflict between the retail and wholesale sides of Covad's business model. BlueStar's acquisition represents a fundamental shift in Covad's business model from a wholesale provider to a mix retail/wholesale provider. By becoming a retail provider in certain markets, Covad will be competing against many of its own distribution channel partners. We expect that some DSL retailer customers of Covad will shift some or all of their DSL line business to competitors. Investors question both the validity of a mixed wholesale/retail business plan for Covad and the company's ability to execute the plan. We expect the stock will not appreciate until Covad can show prove of the validity of its new strategy.

## FINANCIALS

**Revenue** - Covad derives revenue from monthly recurring service charges for connections, service order set-up and other non-recurring charges and from sales of customer premise equipment that Covad provides to its customers. Covad's revenue growth rate has been falling over the past few quarters and was negative for the third quarter of 2000. The negative growth was due to the recent deterioration in the financial condition of several of Covad's Internet Service Provider customers. Covad did not recognize revenue from transactions with 19 Internet service provider customers that occurred during the third and fourth quarters of 2000. The amount of revenue not recognized was \$21.8 million in the third quarter of 2000. Revenue from these transactions will be recognized when cash is received and after all previously recorded accounts receivable have been paid. We expect sequential growth rates in the middle teens for the fourth quarter of

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2000 and for the 2001. We attribute these lower growth rates to Covad's new plan to reduce Central Office Space to 1800 and to keep the network build-out at just over 2000 central offices in fiscal year 2001.

**Gross Profit** – Covad's gross profit had been increasing from the middle teens to the middle 20 percent up until third quarter of 2000. The \$21.8 million not recognized in September 2000 has caused gross margins to become negative and we expect it will turn positive in third quarter of 2001. Covad's consumer-grade services have lower profit margins than its business-grade services. In recent months, the number of orders that Covad has received for consumer grade services have been greater than the number of orders received for business grade services. We expect that the percentage of Covad's revenue derived from consumer services will continue to increase and will likely reduce Covad's overall profit margins. We also expect that Covad will have to reduce prices periodically in the future to respond to competition and to generate increased sales volume.

**Sales, Marketing, General and Administrative Margin** – Sales, Marketing, have increased due to growth in headcount in all areas of the Company, continued expansion of its sales and marketing efforts, deployment of its network and building of its operating infrastructure, offset by SBC's \$20.0 million reimbursement to Covad for general and administrative expenses. Sales, marketing, general and administrative expenses are expected to increase significantly as Covad continues to expand its business, especially given to Covad's new strategy of retail sale through its BlueStar acquisition now called Covad Business Solutions Covad will sell using a direct model.

**Deferred Compensation** – Result of stock options and other awards granted to employees. We expect deferred compensation to decrease in the near future.

**Amortization and Depreciation** – Consists primarily of network depreciation. Increased sequentially in the past due to network and facilities expansion. We expect amortization and depreciation expenses to stabilize in light of Covad's new strategy to reduce capital expenditures.

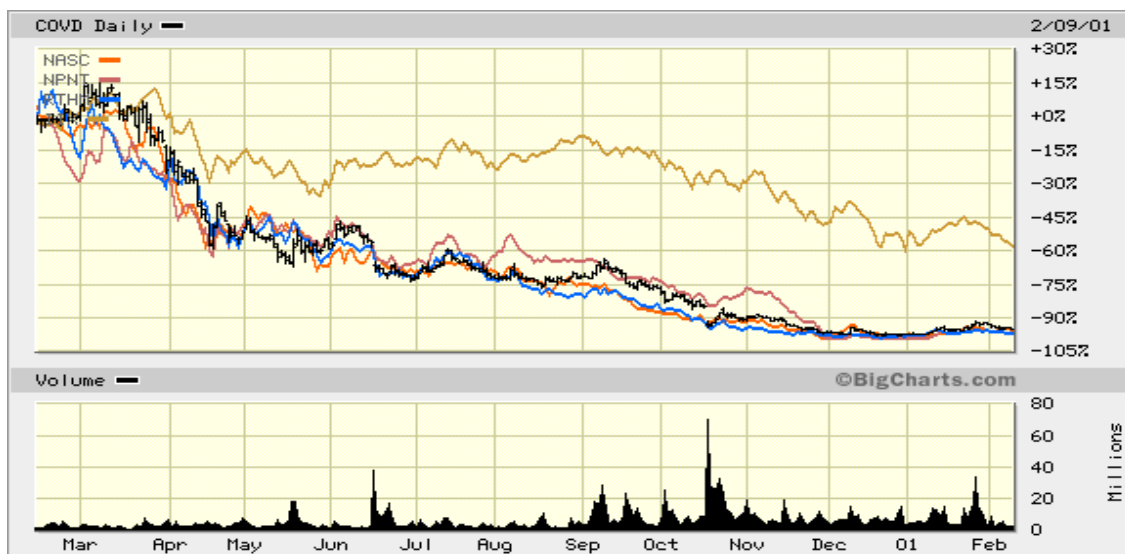
**Net Income** – We expect Covad will maintain a net loss through 2001 and remain unprofitable in the foreseeable future.

**Restructuring Charge** – Management announced a nonrecurring restructuring charge of \$20 million that will be expensed in the fourth quarter of 2000, which is consistent with the reduction of costs and staff announcements made on November 27, 2000

## **A RELATIVE APPROACH TO VALUATION**

Broadband companies such as DSL companies are relatively new and are expected to remain unprofitable during their first years of operations and their future performance is highly unpredictable due to the fast changing nature of its industry. Therefore, traditional valuation methods such as discounted cash flow and price to earnings ratios are not practical in valuing these companies. However, price to sales ratio is a good valuation indicator to use when evaluating these companies. Other relevant metrics to consider are number of subscriber lines deployed, gross margins, and sector leadership.

**Internet Sector** – The graph in the next page shows the high correlation and especially the high volatility of the DSL providers with the Amex Internet Index. We also can appreciate the high correlation between the four major DSL providers and its severe loss in value. This event clearly shows the lack of investor confidence in the DSL sector as a whole. The price of Covad's stock has fallen dramatically from its 52 week high of \$66.250 and is currently trading at \$2.94, which represents a -96% loss in value.



**Value Comparison  
2/12/01**

Stock	\$ Price	Market Cap. In Millions	Trailing 12 Month Sales in Millions	P/S	Gross Margin % (TTM)
Covad	\$2.94	\$523.06 M	\$187.2	2.31	16.56
Rhythms	\$1.41	\$111.93 M	\$43.0	2.45	NA
NetConnections	\$1.63	\$76.96 M	\$27.7	2.72	-29.81
Access Solutions					

**Margins** – Covad has the largest margins representing its greater efficiency. We expect gross margin for Covad to increase to the middle teens in the next couple of years as revenue increases and network costs are spread over more customers.

**Price to Sales** – We believe the price to sales ratio is a key valuation metric and one that is relevant to compare broadband companies. Covad is trading at 2.31X revenues and is the smallest of the three companies compared.

**Cash** – Covad had approximately \$975 million in cash, restricted cash, and marketable securities at November 30, 2000. We believe these funds, should fund the company until year-end 2001.

**Investment Opinion** – Covad is viewed as one of the leading and most focused DSL companies in the broadband industry. This is attributed to its large network, strong alliances and to its strong management team that is quick to respond to new challenges (e.g. Covad's Safety Net Program). Nevertheless these are bad times for all the DSL companies and investors have turned their back to them as they focus on profits. We believe that Covad must prove itself to investors by meeting line and revenue expectations and most

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importantly by being successful with its mixed retail/wholesale strategy. After comparing Covad's price to sale ratio and its gross margin, we believe that Covad is a stronger company compared to its competitors. But given current market conditions we recommend investor to wait before purchasing shares until there is more information about the outcome of Covad's execution of its new strategy associated with BlueStar acquisition. We believe the company is fairly valued in view of the significant risks involved therefore we give it a HOLD recommendation. Looking into the long term though, Covad may be an attractive stock given its leadership position among its peer competitors and the strong market opportunity.

**Covad Communications**

Statement of Operations

(in \$000's, except lines and office counts)

	FY97A	FY98A	FY99A	FY00E	FY01E	1Q00A	2Q00A	3Q00A	4Q00E	1Q01E	2Q01E	3Q01E	4Q01E
Subscriber Lines	26	3922	56554	274000	450000	93000	138000	205000	274000	314000	359000	409000	450000
Central offices	NA	168	1100	1800	1800	1350	1700	2000	1800	1800	1800	1800	1800
<b>Total Revenues</b>	26	5326	66488	218808	385955	41807	58160	56341	62500	72500	85550	102660	125245
Network and Product Costs	54	-4562	-55347	209196	377680	31349	43614	58122	76111	84100	88117	96500	108963
<b>Gross Profit</b>	-28	764	11141	9612	8275	10458	14546	-1781	-13611	-11600	-2567	6160	16282
Sales, Marketing, Gen. & Adm.	2374	31043	140372	460245	496070	85445	102462	123538	148800	134125	119770	123192	118983
Deferred Compensation	295	3997	4768	3108	800	1186	725	697	500	200	200	200	200
Amortization and Depreciation	70	3406	37602	182371	267367	20782	44388	53601	63600	65250	66729	67756	67632
<b>Total Operating Expenses</b>	2739	38446	182742	645724	764237	107413	147575	177836	212900	199575	186699	191148	186815
<b>Operating Income (Loss)</b>	-2767	-37682	-171601	-636112	-755962	-96955	-133029	-179617	-226511	-211175	-189266	-184988	-170533
<b>EBITDA</b>	-2402	-30279	-129231	-450633	-487795	-74987	-87916	-125319	-162411	-145725	-122337	-117032	-102701
Interest Income (expense)													
Interest Income	167	4778	20676	32498	19636	3509	13353	10136	5500	8000	6026	3740	1870
Interest Expense	-12	-15217	-44472	-95562	-144235	-8636	-25590	-26336	-35000	-34200	-35400	-36600	-38035
Net Interest (expense)	155	-10439	-23796	-63064	-124599	-5127	-12237	-16200	-29500	-26200	-29374	-32860	-36165
Other Income	0	0	0	-5231	0	0	13788	981	-20000	0	0	0	0
Income Taxes (Credit)	0	0	0	0	0	0	0	0	0	0	0	0	0
<b>Net Income (Loss)</b>	-2612	-48121	-195397	-704407	-880561	-102082	-131478	-194836	-276011	-237375	-218640	-217848	-206698
Preferred Dividends	0	0	-1146	0	0	0	0	0	0	0	0	0	0
Net loss available to to Common Stockholders	-2612	-48121	-196543	-704407	-880561	-102082	-131478	-194836	-276011	-237375	-218640	-217848	-206698
<b>Earnings Per Share</b>	-\$0.53	-\$5.62	-\$1.83	-\$4.17	-\$5.05	-\$0.69	-\$0.86	-\$1.25	-\$1.63	-\$1.37	-\$1.26	-\$1.25	-\$1.18
<b>Avg. Shares Outstanding</b>	4907	8563	107648	169000	174500	146968	153403	155931	169000	173000	173500	174000	174500
<b>Margin Analysis (%age of revenue)</b>													
Gross Margin	-108%	14%	17%	4%	2%	25%	25%	-3%	-22%	-16%	-3%	6%	13%
S.M.G. & A	9131%	583%	211%	210%	129%	204%	176%	219%	238%	185%	140%	120%	95%
Deferred Compensation	1135%	75%	7%	1%	0%	3%	1%	1%	1%	0%	0%	0%	0%
Amortization and Depreciation	269%	64%	57%	83%	69%	50%	76%	95%	102%	90%	78%	66%	54%
Operating Margin	-10642%	-708%	-258%	-291%	-196%	-232%	-229%	-319%	-362%	-291%	-221%	-180%	-136%
Net Margin	-10046%	-904%	-294%	-322%	-228%	-244%	-226%	-346%	-442%	-327%	-256%	-212%	-165%
<b>Growth</b>													
Total Revenues	NA	20385%	1148%	229%	76%	35%	39%	-3%	11%	15%	14%	14%	10%
Gross Profit	NA	-2829%	1358%	-14%	-14%	34%	39%	-112%	664%	-15%	-78%	-340%	164%
Total Operating Expenses	NA	1304%	375%	253%	18%	45%	37%	21%	20%	-6%	-6%	2%	-2%
Operating Income	NA	1262%	355%	271%	19%	46%	37%	35%	26%	-7%	-10%	-2%	-8%
Net Income	NA	1742%	306%	261%	25%	45%	29%	48%	42%	-10%	-16%	0%	-5%
EPS	NA	956%	-68%	128%	21%	-29%	23%	46%	31%	-16%	-8%	-1%	-5%