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Covad Communications Group, Inc. (NASDAQ: COVD)

Initiating Coverage: SELL

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KEY CONSIDERATIONS

- Covad is in the intensive care as the economy came down crushing on the company's expansion plans. New managements and a new business plan will attempt to slow expansion in order to preserve cash and achieve profitability in expense of market share.
- Covad ended 2000 with 270,000 total lines in service, an increase of 33.66% from the end of Q3. Over 17,000 line-shared lines were installed, a substantial increase compared to 400 line-shared lines installed in the third quarter.
- Delinquent accounts kept rising as more ISPs are going bankrupt, or they simply stop paying. The number of ISPs for which Covad is not recognizing revenue increased to 19, four of which have filled for bankruptcy protection. The company does not realize revenue from 92,000 lines.
- Covad is still unprofitable and is expected to continue to incur substantial losses for the foreseeable future.

Recent Price	\$2.88
52WK Low	\$1.25
52WK High	\$66.67
P/E	N/A
P/Book	0.77
P/Sales	2.26
Market Capitalization	\$511.85 M
Shares Outstanding	178.03 M
Float	126.40 M
Daily Volume (3-month Average)	7.43 M
EPS	
1999A	-\$2.74
2000E	-\$4.36
2001E	-\$5.40
Current Ratio	4.26
Total Debt to Equity	2.03
LT Debt to Equity	1.98
Total Cash	\$975 M

ONE-YEAR PRICE AND VOLUME GRAPH



COMPANY PROFILE

Covad is a leading provider of broadband telecommunication services to Internet service providers, enterprise, telecommunications carrier and other customers. These services include a range of high-speed, high capacity Internet and access services using DSL technology, and related value-added services. ISPs purchase Covad's services in order to provide high speed Internet access to their business and consumer end-users. Enterprise customers purchase Covad's services directly or indirectly from the company to provide employees with high-speed remote access to the enterprise's LAN. Telecommunications carrier customers purchase services for resale to their ISP affiliates, Internet users and enterprise customers.

This report was prepared by Nicholas Zarkas and Priya Mehrotra.

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COMPANY DESCRIPTION

Covad is a leading provider of broadband communications services to Internet service provider, enterprise, telecommunications carrier 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. Internet service providers purchase the company's services in order to provide high-speed Internet access to their business and consumer end-users.

Enterprise customers purchase Covad's services directly or indirectly from the company 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 the services for resale to their Internet service provider affiliates, Internet users and enterprise customers.

Operating Statistics: As of December 31, 2000, Covad had 274,000 total lines in service. Approximately, 50% of total lines were business lines and 50% were consumer lines. Three percent of total lines were sold directly to end users and the remaining 97% were sold through Covad's resellers.

The Q4 of 2000 Covad installed 17,000 line-shared lines compared to only 400 line-shared lines it installed the previous quarter. The company expects the number of line-shared lines to increase as operational processes continue to improve with the incumbent local telephone companies. At the same time, the success ratio in installing line-shared services varies considerably with the different incumbent local telephone companies.

In the fourth quarter the number of ISPs in which Covad is not recognizing revenue jumped to 19, with four of these ISPs having filled for bankruptcy protection. These four ISPs are Flashcom Communications, Zyan Communications, Relay Point and FastPoint and they account for than 32,500 lines. The total number of lines that Covad does not recognize revenue is approximately 92,000, or 33.5% of total.

In its attempt to redeploy these lines the company created the Covad Safety Net Program. In less than three weeks about 1,500 lines (representing 30% of lines from two ISPs) were redeployed to Covad.net or another ISP. The company will continue to work with additional ISPs in the first quarter of 2001 in order to transition more lines in an effort to maintain end user's broadband connection.

Business Outlook for Q4, 2000: In December the company provided guidance for the quarter ended December 31, 2000. Management said that it expects fourth quarter sales to be between \$60 and \$65 million and capital spending at \$100 million. Covad will take a restructuring charge of up to \$20 million, which will be expensed in the fourth quarter, consistent with the reduction of costs and staff. Due to the restructuring charge EBITDA losses are expected to be in the range of a negative \$180 to \$190 million.

Business Outlook for 2001: Also in December Covad presented its outlook for 2001, during which it expects 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.

Management expects installed lines to be 440,000 to 460,000 at the end of 2001. Sales expected to be \$380 to \$390 million, while EBITDA losses in total are expected to decrease by up to \$100 million to a loss of \$450 to \$470 million, versus current expectations for EBITDA losses of \$550 million.

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.

Also, Covad expects the monthly cash burn rate 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.

The company will focus its new strategy on filling the network, continuing to expand the distribution channels, and adding services attractive to customers that will increase revenue and margins. Covad is also adding new channels, the most recent of which was Covad Integrated Services (formerly known as LaserLink.net), and Covad Business Solutions (formerly know as BlueStar.net). The Covad Integrated Services channel provides a private label service, called Virtual Broadband Service Provider (VBSP) that allows clients the ability to offer full-featured ISP services to their customers. Covad Business Solutions will sell using a direct model that includes web and telesales, along with its direct sales force.

Restructuring: In late December Covad announced that it will fire 400 workers or 14% of its staff, as it tries to reduce costs. These cutbacks are in addition to 400 firings announced in November. Before these announcements Covad had 3,100 employees. These cutbacks are part of the restructuring of its Covad Business Solution division, the former BlueStar.net, as part of an initiative to reduce expenses in 2001 by 20%-30%. Covad aims in streamlining its direct sales, operations, marketing, and support functions, while reducing operating costs. The cost of the restructuring is estimated to be in the \$20 million charge that Covad will take in Q4 (see above at the Q4 business outlook). In addition, the company will close 200 under-performing central offices, leaving it with 1,800, which will continue to provide services covering 40-45% of homes and business in the United States.

Managerial Changes: During the past six months Covad went through some very important managerial changes and it now has new CEO, CFO and Chairman of the Board of Directors. Frank Marshall named the interim CEO and after Charles McMinn, a Covad founder and former CEO, named Chairman of the Board after Robert E. Knowling resigned as Chairman, Chief Executive Officer and President. McMinn will oversee strategic operations and Covad's relationship with the financial community. Marshall will lead Covad's senior management team as interim CEO and will drive the company's day-to-day operations. The company appointed Mark H. Perry as Chief Financial Officer, succeeding the current CFO, Timothy Laehy, who is retiring. Finally, Covad promoted Frank Thomas to the newly created post of Chief Information Officer. Previously, Thomas held the position of vice president, ILEC Relations. He is responsible for all aspects of Covad's Information Systems organization, including strategic planning, software engineering, information technology operations, and quality assurance.

SERVICE OFFERINGS

Covad offers businesses six service offerings under the TeleSpeed brand to connect end-users to its regional data centers. For consumers, the company provides two service offerings called TeleSurfer and TeleSurfer Pro. In 2000 the company introduced two new services, DSL+IP and VBSP. Business customers have also the choice of Virtual Private Network (VPN) technology over DSL. In addition, ISP and enterprise customers may purchase from the company backhaul services in order to connect their facilities to Covad's regional data centers.

Business Services: Telespeed

TeleSpeed services connect individual end-users on conventional telephone wires to DSL equipment in their serving CO and from there to Covad's network serving that metropolitan statistical area. A traditional telephone company's infrastructure consists of numerous COs which are connected by a fiber optic backbone to a regional office that routes local and long distance traffic. Each CO collects the individual telephone wires from end-users' premises in the neighborhood.

Consumer Services: Telesurfer

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 base consumer service. The target market for this service is consumers 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 market for this service is consumers using analog or ISDN connections for web browsers.

DSL + IP offerings: This service currently bundles Internet protocol services with existing TeleSurfer services. Covad plans to offer it with the TeleSpeed services.

VBSP Services: The company plans to offer VBSP services, which 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.

VPN over DSL: In 1999 Covad introduced its 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 within a closed circle of users in different locations. Covad offers two levels of VPN over DSL service.

COVAD BRANCH OFFICE. This service is available for remote or branch offices that require high-speed inter-office connectivity across multiple locations.

COVAD TELEWORKER. This service is available for telecommuters and other remote users who secure access to their corporate network and the Internet from home.

Other Services: Covad also provides a DS3 backhaul service from its regional network to an ISP or enterprise customer site. This service aggregates all individual end-users in a metropolitan statistical area and transmits the packet information to the customer on a single high-speed line. The service utilizes an asynchronous transfer mode (ATM) protocol that efficiently handles the high data rates involved and operates at up to 45 megabits per second. In addition to monthly service charges, Covad impose non-recurring order set-up charges for Internet service provider and RLAN end-users for our DS3 backhaul service. Customers must also purchase a DSL modem for each end-user of the services.

INDUSTRY

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 142 million in 1998 and is forecasted to grow to approximately 502 million by 2003. Internet's popularity with consumers has driven its rapid proliferation as a commercial medium. Businesses are increasingly establishing Web sites and corporate intranets and extranets to expand their customer 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 \$50 billion in 1998 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 multi-media advertising, news and entertainment--and on-line consumer transactions and e-commerce become more widely available and more extensively 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. A large majority of personal computers used in enterprises are connected to local area networks. 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 19.7 million by the end of 1999 and is expected to grow to 30.2 million households by 2002. Only 3.7% of these users currently access the Internet through a broadband connection of any type.

As use of the Internet, intranets and extranets increases, the market size for both small- and medium-sized business and consumer Internet and RLAN access is expected to continue to grow rapidly causing the demand for broadband communications services to also grow rapidly. However, the full potential of Internet and LAN 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. Since 1988, microprocessor performance has improved nearly 80-fold, while the fastest consumer modem connection has improved from 9.6 kilobits per second to 56.6 kilobits per second, a factor of six. 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 networks 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.

The Emergence of DSL Technology

DSL technology first emerged in the 1990s 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 and digital signal processing algorithms and falling equipment prices 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.

Impact of Regulatory Developments

The 1996 Telecommunications Act created a legal framework for competitive telecommunications companies to provide local analog and digital communications services in competition with the traditional telephone companies. The Act eliminated a barrier to entry for competitive telecommunications companies by enabling them to leverage the existing infrastructure built by the traditional telephone companies, which required a \$200 billion investment by these telephone companies and their ratepayers, rather than constructing a competing infrastructure at significant cost.

According to the Act traditional telephone companies are required:

- 1) To allow competitive telecommunications companies to lease telephone wires on a line-by-line basis.
- 2) To provide central office (CO) space for the competitive telecommunications companies' DSL and other equipment required to connect to the leased telephone wires.
- 3) To lease access on their inter-central office fiber backbone to link the competitive telecommunications companies' equipment.
- 4) To allow competitive telecommunications companies to electronically connect into their operational support systems to place orders and access their databases.

In January Covad won a significant decision as the FCC took some control from the regional phone companies, which now must allow as many as two rivals to share a single phone line leased from the local phone giants. The significance of the decision is that it lessens the control of big carriers over the network.

COMPETITION

The markets for business and consumer Internet access and network access services are intensely competitive. We expect that these markets will become increasingly competitive in the future. The principal bases of competition in our markets include:

- Price/performance
- Breadth of service availability
- Reliability of service
- Network security
- Ease of access and use
- Content bundling
- Customer support
- Brand recognition
- Operating experience
- Relationships with Internet service providers and other third parties
- Capital resources.

Covad faces competition from 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.

Traditional Telephone Companies: All of the largest traditional telephone companies have begun offering DSL services. Traditional telephone companies are Covad's biggest competitor as they have an established brand name and reputation in their service areas, the necessary capital to deploy DSL equipment rapidly, own the telephone wires themselves and can bundle digital data services with their existing voice services to achieve economies of scale in serving their customers. Certain of the traditional telephone companies have aggressively priced their consumer DSL services as low as \$19-\$29 per month, placing pricing pressure on Covad's TeleSurfer services. The traditional telephone companies are also in a position to offer service from COs where we are unable to secure space and offer service because of asserted or actual space restrictions.

Cable Modem Service Providers: Cable modem service providers such as AT&T, Road Runner and MediaOne are deploying high-speed Internet access services over hybrid fiber coaxial cable networks. Hybrid fiber coaxial cable is a combination of fiber optic and coaxial cable, and has become the primary architecture utilized by cable operators in recent and ongoing upgrades of their systems. Where deployed, these networks provide similar and in some cases higher-speed Internet access than Covad. They also offer these services at lower price points than TeleSurfer services. The cable modem service providers face a number of challenges that providers of DSL services do not face. For example, different regions within a metropolitan statistical area may be served by different cable modem service providers, making it more difficult to offer the blanket coverage required by potential business customers. Also, much of the current cable infrastructure in the U.S. must be upgraded to support cable modems, a process which is significantly more expensive and time-consuming than the deployment of DSL-based networks.

Competitive Telecommunications Companies: Many competitive telecommunications companies such as Rhythms NetConnections and Network Access Solutions offer high-speed digital services using a business strategy similar to Covad's. Some of these competitors have begun offering DSL-based access services and others are likely to do so in the future. Companies such as Teleport Communications Group, Inc. (acquired by AT&T), Brooks Fiber Properties, Inc. (acquired by MCI WorldCom), MFS (acquired by MCI WorldCom) and NEXTLINK Communications have extensive fiber networks in many metropolitan areas, primarily providing high-speed digital and voice circuits to large corporations. They also have interconnection agreements with the traditional telephone companies pursuant to which they have acquired central office space in many markets targeted by us.

National Long Distance Carriers: Interexchange carriers, such as AT&T, Sprint, MCI WorldCom and Qwest, have deployed large-scale Internet access networks and ATM networks, sell connectivity to businesses and residential customers, and have high brand recognition. They also have interconnection agreements with many of the traditional telephone companies and a number of spaces in central offices from which they are currently offering or could begin to offer competitive DSL services.

Internet Service Providers: Internet service providers such as UUNET Technologies (which was acquired by MCI WorldCom), EarthLink Network, Concentric Network Corporation, MindSpring Enterprises, and PSINet provide Internet access to residential and business customers, generally using the existing public switched telephone network at integrated services digital network speeds or below. Some ISPs such as UUNET Technologies in California and New York, HarvardNet Inc. and InterAccess have begun offering DSL-based services.

On-Line Service Providers: On-line service providers include companies such as AOL, Compuserve, MSN and WebTV that provide content and applications ranging from news and sports to consumer video conferencing. These services are designed for broad consumer access over telecommunications-based transmission media, which enable the provision of digital services to the significant number of consumers who have personal computers with modems. They also provide Internet connectivity, ease-of-use and consistency of environment. Many of these on-line service providers have developed their own access networks for modem connections. If these on-line service providers were to extend their access networks to DSL or other high-speed service technologies, they would compete against Covad.

Wireless and Satellite Data Service Providers: Wireless and satellite data service providers are developing wireless and satellite-based Internet connectivity. Covad may face competition from terrestrial wireless services, including two Gigahertz (Ghz) and 28 Ghz wireless cable systems (Multi-channel Microwave Distribution System (MMDS) and Local Multi-channel Distribution System (LMDS)), and 18 Ghz and 39 Ghz point-to-point microwave systems. The FCC is currently considering new rules to permit MMDS licensees to use their systems to offer two-way services, including high-speed data, rather than solely to provide one-way video services. The FCC also recently auctioned spectrum for LMDS services in all markets. This spectrum is expected to be used for wireless cable and telephony services, including high-speed digital services. In addition, companies such as Teligent Inc., Advanced Radio Telecom Corp. and WinStar

Communications, Inc., hold point-to-point microwave licenses to provide fixed wireless services such as voice, data and videoconferencing.

Potential New Entrants:

Additional competition may come from satellite-based systems, such as:

- Motorola Satellite Systems, Inc.
- Hughes Communications (a subsidiary of General Motors Corporation)
- Teledesic

These three companies and others have filed applications with the FCC for global satellite networks which can be used to provide broadband voice and data services, and the FCC has authorized several of these applicants to operate their proposed networks.

STRATEGY FOR GROWTH

Profitability is the name of the game for Covad in 2001. The previous years the company tried to grab market share and establish its brand name by offering competitive pricing and expanding its installed lines as fast as possible. But that meant big expenses, high cash-burn rates, and huge losses. As the economy turned to the worst in the summer and autumn of 2000 it become extremely difficult for telecom companies to get financial from the capital markets. Cash started to dry up and life become extremely difficult. As losses kept increasing without any sign of profitability in the near future the new management that was installed in the second half of 2000 decided to change course. A wise decision in our opinion, since more conservative expansion will preserve cash and gain valuable time for Covad until better economic times arrive.

Chairman McMinn wants Covad to grow its business with lines that get the company to breakeven and profitability faster. To achieve that, 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 COs and fewer line card purchases for the lowered number of lines installed.

Management expects the slowdown in expansion to reduce the monthly cash burn rate 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.

Furthermore, the company will focus its new strategy on filling the network, continuing to expand the distribution channels, and adding services attractive to customers that will increase revenue and margins. Covad is also adding new channels, the most recent of which was Covad Integrated Services (formerly known as LaserLink.net), and Covad Business Solutions. The Covad Integrated Services channel provides a private label service, called Virtual Broadband Service Provider (VBSP) that allows clients the ability to offer full-featured ISP services to their customers. Covad Business Solutions will sell using a direct model that includes web and telesales, along with its direct sales force.

Covad's most strategic objective is to become the leading provider of DSL service. The key elements of the company's strategy are as follows:

Expand the network and roll out service in targeted metropolitan areas: As of December 31, 2000 Covad had installed 274,000 lines. In 2001 the company plans to expand its installed lines to 440,000 to 460,000. In addition, Covad has recently begun to assess the regulatory and competitive environments in other countries. Towards that end it acquired Loop Holdings Europe, a Danish company that owns preferred shares representing 70% of Loop Telecom, a Spanish full-service broadband service provider for small and medium-sized businesses. In Asia, the company signed an agreement with NTT Communications Corp., ACCA Networks and a Japan-based venture capital firm to provide local broadband network services using DSL to major metropolitan areas in Japan.

Provide pervasive coverage in each metropolitan area: Covad wants pursuing a blanket coverage strategy of providing service in a substantial majority of the central offices in each region that we enter since our Internet service provider customers desire to market their Internet access services on region-wide basis. Blanket coverage is also important to our enterprise customers since most of them desire to offer RLAN access to all employees regardless of where they reside. In addition, we believe our presence in 165 metropolitan statistical areas will allow us to better serve our Internet service provider, enterprise, telecommunications carrier and other customers. These customers are increasingly seeking a single supplier in multiple metropolitan areas.

Establish and maintain relationships with leading ISPs, telecommunications carriers and other DSL resellers: Covad targets Internet service providers, telecommunications carriers and other DSL resellers that can offer their end-users cost and performance advantages for Internet access using its services. It provides connections to Internet service providers, which in turn offer high-speed Internet access using the company's network. Covad, also, provides wholesale DSL and Internet access services for resale by customers such as Prodigy Communications and Juno Online.

Develop a national brand: Covad wants to strength its competitiveness and increase demand for its services by developing a positive brand and image through a combination of television, print and radio promotional campaign on both a national and local basis.

Acquire and enter into business arrangements with network and broadband-related service providers: During 2000 Covad acquired BlueStar Communications Group and Laser Link.Net, Inc. These acquisitions will allow the company to expand its selling capabilities in smaller cities and rural areas, increase its distribution methods, enhance its ability to target small businesses, provide DSL and IP services on a wholesale basis and better serve customers who do not wish to maintain any network facilities.

Line sharing: In late 1999, the FCC required the major local phone companies to provide CLECs with "line sharing." This allows CLECs to provide their services over the same telephone wire used by the traditional telephone companies to provide analog voice services. Line sharing allows provisioning of asymmetric DSL services on the same telephone wire as the existing local phone companies' voice services.

Line sharing is an important opportunity for Covad for three primary reasons. First, line sharing should significantly reduce the monthly recurring charges it incurs for telephone loops. Second, line sharing should reduce the time it takes traditional telephone companies to deliver telephone loops because the telephone loop will already exist. Third, line sharing should resolve lack of telephone loop problems that Covad has encountered when ordering telephone loops in some areas of the country. The company has signed line-sharing agreements with BellSouth, Qwest and Verizon Communications.

ALLIANCES AND PARTNERSHIPS

The Merger with BlueStar. On September Covad acquired BlueStar Communications, which provides broadband and Internet services for small and medium-sized businesses throughout the Southeastern United States. Covad will issued 6.1 million common shares and stock options for the acquisition of all of BlueStar's outstanding common and preferred shares, stock options and warrants, plus assumption of all outstanding debt. Up to 5 million additional shares of common stock may be issued to the BlueStar shareholders if BlueStar meets certain performance targets over the 2001 fiscal year. In addition, as part of the acquisition, Covad funded BlueStar's repayment of a \$26.1 million short-term loan made to BlueStar by Bear Stearns Corporate Lending, Inc. in conjunction with BlueStar's signing a definitive merger agreement with the company.

The purchase of BlueStar gives Covad the possibility to accelerate the national expansion of its network. Furthermore, Covad will add BlueStar's experienced direct sales force and will get access to BlueStar's customer base.

Cooperation with NTT Communications. As part of its international expansion Covad signed an agreement with NTT Communications Corp., ACCA Networks and a Japan-based venture capital firm to provide local broadband network services using DSL to major metropolitan areas in Japan. The agreement calls for Covad to invest \$11.7 million in ACCA in exchange for a 41.8 percent interest in ACCA, which will be accounted for as an equity investment on Covad's balance sheet. The agreement requires no additional financial commitments, and no additional expenses to be incurred.

Acquisition of Loop Holdings Europe. Turning in Europe Covad acquired Loop Holdings Europe, a Danish company that owns preferred shares representing 70% of Loop Telecom, a Spanish full-service broadband service provider for small and medium-sized businesses. The acquisition will cost Covad \$15 million in cash, a note for \$15 million payable in late March 2001 and a note for \$20 million payable in the third quarter of 2002.

Strategic Investment from SBC: Covad received an equity investment of \$150 million from SBC. With that investment SBC acquired 9.4 million common shares of Covad, or an equity stake of 6%. Also, the two companies reached a commercial agreement in which SBC will provide \$600 million in resale revenue to Covad over six years starting October 1, 2000, with approximately \$23 million of revenue in the first year and increasing revenue commitments each year during the life of the contract. Upon a change of control as defined in the contract, SBC's aggregate revenue commitment is reduced to \$100 million during an initial period of the contract, and is terminated after the initial period. This agreement also provides incentives for SBC to sell business lines provided by Covad, and SBC will begin marketing both symmetric business service DSL and asymmetric consumer service DSL provided by Covad throughout the U.S.

KEY RISK FACTORS

- An economic downturn could adversely impact demand for Covad's services.
- Covad's leverage is substantial and will increase, making it harder to respond to changing business conditions. Covad will require a significant amount of cash to service its indebtedness. The ability to generate cash depends on many factors beyond its control. In addition, Covad will need additional funds in the future in order to continue to grow its business.
- Covad's business will suffer if their ISPs and telecommunications carriers as well as other third parties are not successful in marketing and selling the services that Covad offer.
- Covad depends on the traditional telephone companies for the quality and availability of the telephone wires that it is using.
- The failure of traditional telephone companies to adequately provide transmission facilities and provision telephone wires is less likely to impair Covad's ability to install lines and negatively affect its growth rate.
- Rejections of Covad's applications for central office and remote terminal space by traditional telephone companies are likely to delay the expansion of its network and the rollout of its services.
- The markets in which Covad operates are highly competitive and the company may not be able to compete effectively, especially against established industry competitors with better financial capabilities.
- In the future, prices may decrease and that will impair Covad's ability to achieve profitability and positive cash flow.
- If the company fails to manage its growth effectively, that may delay the expansion of its network and service rollout.

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- Charges for unbundled network elements are outside of the company's control because they are proposed by the traditional telephone companies and are subject to costly regulatory approval processes.
 - The Company will suffer if its interconnection agreements are not renewed or if they are modified on unfavorable terms.
 - The company has a history of losses and expects increasing losses in the future.
 - Because of limited operating history the company's business is difficult to be evaluated.
 - Covad's strategy depends on growth in demand for DSL-based services.
 - The broadband communications industry is undergoing rapid technological changes, and new technologies may be superior to the technology that Covad is using.

FINANCIALS

Revenue: Covad derives revenue from the following three sources:

- Monthly recurring service charges for connections from the end-user to the company's facilities and for backhaul services from the company to ISP or enterprise customer.
- Service order set-up and other non-recurring charges.
- The sale of customer premise equipment that the company provides to customers due to the general unavailability of customer premise equipment through retail channels.

In December Covad pre-announced Q4 results saying that sales in 2001 will be lower than what previously expected. Adjusting our financial model we believe that in the Q4 Covad will make \$60,000,000, at the lower end of management's estimation. For fiscal 2000 we expect revenue to \$216,308,000, a 225.3% increase over 1999. We expect revenue to slow in 2001 as Covad turns its attention from rapid expansion and market share to profitability and cash preservation. In fiscal 2001 we anticipate revenue to grow by 72.5% to \$373,174,000.

Cost of Revenue: The cost of revenue consists primarily from the network and product cost. The following factors comprise Covad's network and service costs:

- Monthly non-recurring and recurring circuit fees. The company pays telephone companies and other competitive telecommunications companies non-recurring and recurring fees for services including installation, activation, monthly line costs, maintenance and repair of circuits between and among its digital subscriber line access multi-plexers and its regional data centers, customer backhaul, and end-user lines. As Covad grows its end-user base, in the near future the largest element of network and product cost will be the traditional telephone companies' charge for its leased copper wires.
- Other costs that Covad incurs include those for materials in installation and the servicing of customers and end-users, and the cost of customer premise equipment.

Network and product cost is the biggest expense for Covad at we forecast that in fiscal 2000 will reach \$214.456 million, 99.1% of revenue, and in fiscal 2001 will increase to \$381.418 million, 102.2% of revenue. Network and product cost jumped in Q3 to \$58.122 from \$43.614 million in Q2. The increase in cost is attributable to the expansion of the networks and increased orders resulting from sales and marketing efforts. We expect network and product costs to increase at a lower pace as the company scales back its DSL built up and lowers its sales activity and revenue growth projections.

Selling, General and Administrative: They consist primarily of salaries, expenses for the development of new business, the development of corporate identification, expenses for advertising and promotion of the product, expenses for the establishment of the management team, and sales commissions. Sales, marketing, general and administrative expenses were \$123.538 million as of September 2000, and we estimate will increase \$145.775 million in Q4. SG&A increased 350.2% in 1999 and 228.4% in 2000. This increase is attributable to growth in the number of new employees, continued expansion of sales and marketing efforts, deployment of the networks and building of the operating infrastructure. But we believe that SG&A will only increase minimally in 2001 as the company scales down its operations. In late 2000 Covad announced that it fired 800 of its 3,100 employees and will cut down its expansion plans.

COMPARATIVE ANALYSIS

DSL Lines Installed in the U.S. 12/31/00		
	Number Of Lines	% Of Total Market Share
U.S.A Total	2,429,189	100.0
Covad	274,000	11.3
NAS (NASC)	11,084	0.5
Rhythms	67,000	2.8
Bellsouth	215,000	8.9
Qwest	255,000	10.5
SBC	767,000	31.6
Verizon	540,000	22.2
Others (including DSL.net and Northpoint	300,105	12.2

The DSL Sector: A revisit

DSL is still one of the highest growing industries in the country as in the fourth quarter of 2000 total DSL lines increased to 2,429,189 lines, a 41% over the September 2000 quarter. Covad has the largest market share among the CLECs with 11.3% of total market. According to TeleChoice a leading market strategy consultant firm for the telecommunications industry, ILECs accounted for 78% of the total DSL lines in service, with CLECs owning 21% of the market. ILECs led by SBC and Verizon increased their installed lines by 46%, while CLECs increased by 25%. Residential/business customer base is 80%/20% for the ILECs and 37%/63% for the CLECs.

As the above numbers and expectations for future growth indicate there is strong demand for DSL service. But the bottom line for the CLECs like Covad is that they are well in to the red and continue to be on life support, requiring additional funding in order survive. Demand for high-speed connection to the Internet remains high, but providers of DSL service are in a dire situation, as Northpoint Communications and Digital Broadband proved earlier when they filled for bankruptcy protection. Competition intensifies, additional funding from the equity and credit market is very difficult, more ISPs fail on their payments, and the big telecom companies, the ILECs, are the ones that provide the network.

When Verizon decided not to proceed with a proposal that called for the purchase of a controlling interest in Northpoint, the DSL provider folded, as it was unable to raise more cash to fund its operations. Northpoint required a funding of more than \$800 million in order to continue as an operational concern. The repercussions of Verizon's move showed the DSL industry that local carries are in control of the game.

Additionally, cable modem is a big competitor of DSL and there is always the threat of a new technology emerging before DSL is fully deployed. As the economy weakens competition will intensify and companies will have to fight on pricing in order to remain competitive. DSL providers should pay special attention to bundling various services, or they might give various discounts such as free modem or free installation.



Value Comparison DSL Carriers 02/16/01					
	\$ Price	Market Cap. In millions	Trailing 12 Month Sales in millions	P/S	Gross Margin % (TTM)
Covad	2.88	511.85	226.1	2.26	16.56
DSL.net	1.97	129.93	14.5	9.13	NM
Network Access	1.53	72.51	28.4	2.08	-29.81
Rhythms	1.38	109.46	45.4	2.40	NM

Covad: A Race Against Time

Despite the cutbacks, the layoffs, and the restructuring the reality that surrounds Covad's business is grim. The recently announced cutbacks are aiming in saving time, before the company goes back to the capital markets asking for more funding. As of the end of September it had \$975 million in cash that is enough to last the company by early 2002. Delinquent ISPs increased to 19, while four of them are under Chapter 11 bankruptcy protection. The total number of lines that Covad does recognize revenue is approximately 92,000, or 33.5% of total. The company is trying to move DSL subscribers from these failing Internet service providers to other services, but this will require time and resources. To respond to lost revenue from

delinquent ISPs Covad introduced the Covad Safety Net Program, which gives broadband customers the opportunity to switch away from troubled ISPs to viable ones without occurring a fee.

Furthermore as the economy worsens the threat of more ISPs going bankrupt or simply become unable to continue pay for Covad's services the effect of the redeployment will minimize. At the same time we expect competition to intensify and prices for the major components of both recurring and non-recurring revenues to decrease.

Value Comparison DSL Carriers				
	3Q00 Cash (mil.)	LT Debt/Equity	Quick Ratio	Current Ratio
Covad	\$975.3	1.98	3.98	4.26
DSL.net	\$108.9	0.06	3.14	3.19
Network Access	\$89.2	0.24	2.49	2.58
Rhythms (restricted cash is included)	\$708.1	3.39	7.33	8.06

We believe that the important factors in trying to value Covad's shares are the following:

- **Cash Position:** This metric is very important, as cash is crucial for the company in its expansion plans. The company will need extra funding in 2002 and looking at current market conditions it will be very difficult to attract investors. In its pre-announcement Covad said that monthly use of cash is expected to decline to less than \$60 million by the end of next year from \$75 million in Q3 of 2000. In this burn rate we expect the company will be able to continue operations until at least early 2002. As of the end of the Q3 Covad had \$975.3 million in cash and cash equivalents. That is more than the other CLECs competitors with Rhythms having \$670.2 million in cash and DSL.net having \$108.9 million in cash.
- **Credit quality and viability of its customers:** In the fourth quarter the number of ISPs in which Covad is not recognizing revenue jumped to 19, with four of these ISPs having filled for bankruptcy protection. The total number of lines that Covad does not recognize revenue is approximately 92,000, or 33.5% of total.
- **The Covad Safety Net Program:** In its attempt to re-deploy the lines in which does not recognize the company created the Covad Safety Net Program. The company wants to move these lines from delinquent ISPs to other established and viable telecom providers. The success and the speed with which Covad de-deploys these lines will prove crucial in its viability. Already, about 1,500 lines (representing 30% of lines from two ISPs) were redeployed to Covad.net or another ISP. The company will continue to work with additional ISPs in the first quarter of 2001 in order to transition more lines in an effort to maintain end user's broadband connection.

INVESTMENT OPINION

Covad is the leading independent provider of DSL broadband access to Internet service providers, enterprises and telecommunication carriers in the country. As of the end of 2000 it has 274,000 lines in service, owning an 11.3% market share in the total DSL market. The company's metrics establish it as a leader among CLECs, in an industry that is growing fast. The new management is attempting to slow down the expansion and turn its attention to profitability. It wants to limit the cash-burn rate and achieve breakeven as soon as possible. Maybe, Covad only needs money and time, but it lacks both of these ingredients. On the other side the ILECs have both.

Covad's shares have lost 95.6% since March 1, 2000 when it closed at \$66.25, but we still do not think they represent an investment opportunity. We assign these shares a SELL rating and we recommend investors to follow a wait-and-see approach, as the company fights to survive.

Covad Communications, Consolidated
Statement of Operations
(in thousands except per share data)

	1Q00A	2Q00A	3Q00A	4Q00E	1Q01E	2Q01E	3Q01E	4Q01E
Revenues	41,807	58,160	56,341	60,000	72,000	84,960	97,704	107,474
Cost of revenues								
Network and product costs	31,349	43,614	58,122	81,371	87,880	96,669	108,269	121,261
Gross Profit (Loss)	10,458	14,546	-1,781	-21,371	-15,880	-11,709	-10,565	-13,787
Operating expenses								
Sales, marketing, general and administrative	89,171	102,462	123,538	145,775	116,620	125,949	134,766	145,547
Depreciation, amortization and def. Compensation	21,968	45,113	54,298	56,300	59,300	61,300	63,300	65,300
Total operating expenses	111,139	147,575	177,836	202,075	175,920	187,249	198,066	210,847
Loss from operations	-100,681	-133,029	-179,617	-223,446	-191,800	-198,958	-208,631	-224,634
Interest expense and other income	-6,544	1,551	-15,219	-20,546	-22,600	-24,860	-27,346	-30,081
Net loss	-107,225	-131,478	-194,836	-243,991	-214,401	-223,818	-235,977	-254,715
Basic and diluted net loss per common share	-0.73	-0.86	-1.25	-1.49	-1.25	-1.30	-1.37	-1.48
Shares Outstanding	146,900	153,400	155,900	163,695	171,880	172,052	172,224	172,396
Margin Analysis as % of Revenues								
Sales, marketing, general and administrative	213.29%	176.17%	219.27%	242.96%	161.97%	148.25%	137.93%	135.42%
Network and product costs	74.99%	74.99%	103.16%	135.62%	122.06%	113.78%	110.81%	112.83%
Operating Margin	-240.82%	-228.73%	-318.80%	-372.41%	-266.39%	-234.18%	-213.53%	-209.01%
Net Margin	-256.48%	-226.06%	-345.82%	-406.65%	-297.78%	-263.44%	-241.52%	-237.00%
Gross Margin	25.01%	25.01%	-3.16%	-35.62%	-22.06%	-13.78%	-10.81%	-12.83%
Growth %								
Total Revenue		39.12	-3.13	6.49	20.00	18.00	15.00	10.00
Gross Profit (Loss)		39.09	-112.24	1,099.93	-25.69	-26.27	-9.77	30.50
Operating Expense		32.78	20.51	13.63	-12.94	6.44	5.78	6.45
Net Loss		22.62	48.19	25.23	-12.13	4.39	5.43	7.94
EPS		17.81	45.35	19.24	-16.31	4.29	5.33	7.83

Covad Communications, Consolidated
Statement of Operations
(in thousands except per share data)

	12/1997 (A)	12/1998 (A)	12/1999 (A)	12/2000 (E)	12/2001 (E)
Revenues	26	5,326	66,488	216,308	362,138
Cost of revenues					
Network and product costs	54	4,562	55,347	214,456	414,079
Gross Profit (Loss)	-28	764	11,141	1,852	-51,941
Operating expenses					
Sales, marketing, general and administrative	2,374	31,043	140,372	460,946	522,882
Depreciation, amortization and deferred compensation	365	7,403	42,370	177,679	249,200
Total operating expenses	2,793	43,008	238,089	853,081	1,186,161
Loss from operations	-2,767	-37,682	-171,601	-636,773	-824,023
Interest income (expense)					
Net interest expense and other income	155	-10,439	-23,796	-40,758	-104,888
Net loss	-2,612	-48,121	-195,397	-677,531	-928,911
Preferred Dividends	0	0	-1,146	0	0
Net loss available to shareholders	-2,612	-48,121	-196,543	-677,531	-928,911
Basic and diluted net loss per common share	-0.53	-5.62	-2.74	-4.36	-5.40
Weighted Average Shares	4,097,319	8,562,802	71,765,208	155,500	172,000
Margin Analysis as % of Revenues					
Sales, marketing, general and administrative	9130.77%	582.86%	211.12%	213.10%	144.39%
Network and product costs	207.69%	85.66%	83.24%	99.14%	114.34%
Operating Margin	-10642.31%	-707.51%	-258.09%	-294.38%	-227.54%
Net Margin	-10046.15%	-903.51%	-293.88%	-313.23%	-256.51%
Gross Margin	-107.69%	14.34%	16.76%	0.86%	-14.34%