Telecom's New Star Has a Lot to Prove

WinStar's local network, which could foil the Baby Bells' monopolies, has caught the eye of long-distance players, analysts—and short-sellers. ■ BY JULIE CRESWELL

You may not have heard of WinStar Communications, but it's a perfect example of what the creators of the Telecom Act of 1996 envisioned. The six-year-old telco is a former ski-apparel firm that is now building a wireless local network designed to win a portion of the $47 billion business market from the Baby Bells. It has gained the attention of industry players: Lucent is backing the company in a $2 billion equipment and finance deal, and long-distance provider Williams Communications bought a 2% stake in WinStar's network, to create a full-service telco.

Many on Wall Street have cheered the stock too, despite the fact that the company, valued at $1.7 billion, won't be profitable until well into the next decade. The stock soared more than 56% in 1998, to $39, and after a heavily hyped year-end briefing, most analysts boosted their price targets. (Salomon Smith Barney's Jack Grubman says the stock could hit $52 in the next 12 months.)

CEO Bill J. Rouhana Jr.

WinStar is the most heavily shorted mid-cap stock in America	Percent of shares held by shorts 12/31/98
WinStar Communications	24.7%
Ann Taylor Stores	21.1%
Agouron Pharmaceuticals	20.5%
CMGI	18.7%
E*Trade Group	18.5%

FORTUNE CHART / SOURCE: SHORT ALERT

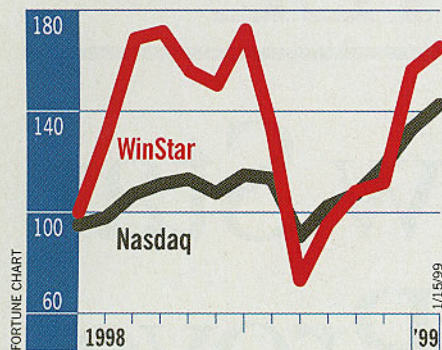
On the surface, WinStar has a winning formula: industry attention, analyst praise, and promising technology. The company is planting radio antennas the size of dinner plates on rooftops, which will send signals to other antennas in their line of sight. The network—based on a technology known as "fixed wireless"—will provide voice, data, and Internet access at much higher speeds than the Baby Bell's traditional copper-wire networks. While the deployment of fixed wireless technology has a reputation for being expensive, the cost of equipping a building has dropped from $20,000 to around $6,500. WinStar operates in 30 cities and sold an estimated $257 million in phone service last year.

Understandably, this collection of radios and base stations has caught the eye of long-distance players in this ever-consolidating industry. WinStar's local network would nicely complement the networks being built by Qwest, Level 3, and Williams, which are designed to speedily deliver data and video files over the Internet. The rumor mill has also linked WinStar with suitors such as AT&T and British Telecom. The acquisition question leads to a frustrated sigh by WinStar CEO Bill J. Rouhana Jr. and a canned speech about how any fair offers will be taken to the shareholders. But it's clear that Rouhana hopes that doesn't happen—he loves the limelight and wants to run the company himself.

Beneath all the buzz a maelstrom rages. Short-sellers have picked up 25% of its outstanding shares. In fact, the company ended 1998 as the largest short in the mid-cap arena. Well-known hedge fund manager Manuel Asensio, who runs Asensio & Co., claims that WinStar's network is inferior to its competitors' and that its management is too promotional. He snorts "So what?" when WinStar

INSIDE: Lucent vs. Cisco: A battle over the future of telecom ... Cool company! Critical Path wants *your* e-mail ... Gurley on the Big Fat Website ... The Dreyfuss Report on the ultimate tech nightmare ... Alsop's formula for digital nirvana

PHOTOGRAPH BY MARC ROYCE



hypes that it owns the largest share of licenses in the 38-gigahertz frequency—a band of frequency once thought to be unusable but now sought after, thanks to fixed wireless technology. At this high a frequency, he says, radio signals can't travel as far—so radios have to be placed closer together, which increases construction costs. Companies with licenses in a lower spectrum will deliver the same service for a lower price, he says.

The real issue, however, is WinStar's management. Questions about Rouhana's background and WinStar's history have kept more than a few investors at bay. Sure, there are plenty of successful CEOs who have stepped into industries in which they have little or no background (read: MCI WorldCom's Bernie Ebbers). But Rouhana has made some critical missteps along the way.

In 1993, WinStar, then a $11.3-million-a-year apparel maker, bought a majority stake in a small telco called Communications Gateway Network. In its early years only the company's beauty-aids division made money. (It has since been sold off.) In 1995 shareholders raised questions about Rouhana's compensation plan and various business transactions conducted with another company he owned. Furthermore, some of WinStar's early money came from some sweepstakes: According to numerous complaints, consumers who had filled out forms thinking they might win vehicles or exotic vacations ended up with their long-distance switched over to WinStar—a practice known as slamming. An FCC inquiry led to WinStar's paying $80,000 in 1996, without admitting any wrongdoing. WinStar says it has cleaned up its act. Slamming complaints are way down, and WinStar has changed its compensation plan and terminated its contracts with businesses owned by Rouhana.

Still, the taint of those incidents lingers on. Consider one of WinStar's biggest competitors, Teligent, a three-year-old telco in Vienna, Va. The two companies' technologies and strategies are fairly similar, but Teligent is more highly regarded for one main reason: Alex Mandl, the former president and COO of AT&T, is its CEO. "Put the two CEOs together, and one looks like a professional while the other looks like a used-car salesman," quips one analyst who has a buy on both stocks. The only reason this matters is that in building its network of radio dishes, WinStar is moving away from low-margin businesses, like reselling long-distance service, to a strategy that mimics Teligent's.

Some analysts do side with Rouhana, believing that his plan is a winner, since he has a head start over any future competitors. Rouhana also assures them that the spectrum his company owns is no less powerful than his competitors'. "All fixed wireless spectrums have a tremendous advantage over fiber-optic cables," he says. "The differences between the spectrums are minor."

Still, WinStar's plan to build a global network of dishes will burn through lots of cash even while losses mount. So Rouhana's missteps will be closely scrutinized. Even if Rouhana's ethically murky days are behind him, in an industry as cutthroat as this one, he'll have to work hard to gain credibility and turn WinStar into something other than a money pit.

LUCENT VS. CISCO, ROUND ONE

The Battle to Control Telecom

Back in September, when we speculated on the companies that Lucent Technologies might put in its shopping cart, we called Ascend Communications a must-get. In January, Lucent went out and got it, agreeing to buy the maker of data-networking gear for $20 billion. The acquisition touches off a fascinating clash with its new archrival, Cisco Systems. At stake: the future of telephone service.

Lucent (1998 revenues: $30.1 billion) bought Ascend, in part, to hang on to customers like AT&T and the Baby Bells, which are retooling their networks to carry information in the language of the Internet. Since Ascend makes computers and software that control phone networks as well as routers that carry traffic on the Internet, the combined outfit can help the phone companies bridge the gap from telecom to datacom. The deal also gives Lucent pull with the new breed of long-distance carriers, which it has had trouble courting. Says CEO Richard McGinn: "We do no business with Level 3, UUNet, and PSINet." Ascend deals with all the young turks.

The deal comes just as Cisco Systems intensifies its attack on the telecom market. Though it's the leading maker of datacom equipment, Cisco gets about a third of its $8.5 billion in revenues from phone companies and vows to increase those sales by 100% a year. From Cisco's vantage point, phone companies are saddled with costly billing systems that can charge by the second and keep track of who makes a call, when it begins and ends, and how many phone companies have a hand in its delivery.

Cable TV and other companies entering the phone business, Cisco argues, might not want to spend billions to build a metered billing system, preferring to charge a flat fee—or even, suggests Cisco CEO John Chambers, make phone ser-

Lucent's McGinn and Ascend CEO Mory Ejabat are taking on Cisco.

MARC ASNIN—SABA

vice free for people who subscribe to Internet and video services. A phone call would take up only 1% of the bandwidth available to a household on a reengineered cable system, so the cable operator could afford to make voice free without breaking a sweat.

What does Lucent think of this brave new world? "It's rubbish," says McGinn. "A multi-hundred-billion-dollar-a-year business isn't going to go away." In his view, however low their costs might fall, phone companies will base the price of a service on its value to the customer. As phone networks begin to carry video and data, customers who buy large bundles of services might pay a very low price for voice, but those who don't, won't.

With the deal due to close this spring, Lucent and Cisco seem locked in a fight that promises to grow ever more bitter. As Chambers says, "It will be fun to look back three or four years from now and see who's right." —*Andrew Kupfer*

COOL COMPANY

Critical Path's Doug Hickey, Wayne Correia, and David Hayden in their San Francisco offices.

TIMOTHY ARCHIBALD (2)

Why These Guys Want To Handle the World's E-Mail

When systems engineer Wayne Correia met bushy-haired David Hayden at a Silicon Valley business dinner two years ago, he found him, well, odd. "[Hayden] had been reading a history of the postal service and books on Egyptian civilization and said [that] there needs to be a global postal service for the Internet. I thought he was a nut," Correia says.

But that didn't deter him from going into business with Hayden, a McKinley Group co-founder who had just sold the Magellan search engine to Excite. In October 1997, the two founded Critical Path with a simple, audacious mission statement: "We handle the world's e-mail." Using a network built by Correia, the company handles the backbone operations of e-mail accounts provided by Internet service providers and portals, like E*Trade and Planet Direct. So far, Critical Path manages seven million e-mail boxes—a business that should generate $5 million in revenue this year. (The company has yet to make a profit.)

Now the company is expanding into the corporate arena. Deals with telco US West and domain-registry outfit Network Solutions could give Critical Path 30 million new boxes to manage this year. It already hosts more than twice as many corporate e-mail boxes as its closest rival, USA.NET, a former ISP-turned-e-mail host based in Colorado Springs. It also overshadows rivals like IBM, Wiltek, dotOne Corp., HarvardNet, and sundry hardware providers that offer e-mail hosting.

Why is e-mail outsourcing so hot? Companies look to outsourcers because hosting themselves is expensive. E-mail management is also a time-consuming task for corporate technology departments that must upgrade, back up, and check system security. The outsourcers are eager to claim this area of the desktop since e-mail boxes are a beachhead for a variety of messaging services, like certified document delivery and scheduling. Venture capitalists recognized this and began investing in Critical Path in April 1998. Since then, investors have spent $42 million to build Critical Path's network, data centers, and headquarters in San Francisco's trendy SOMA district. Benchmark Capital, a backer, brought in a new CEO—Douglas Hickey, a former telco exec with MFS and Frontier Corp. Critical Path's top brass avoid questions about an IPO, but a spokeswoman admits deep pockets "put us in a position to go public."

The timing seems good. Analysts see e-mail outsourcing as a nascent but potentially lucrative field. The Gartner Group in Stamford, Conn., estimates that between 10% and 15% of all U.S. businesses now outsource part of their e-mail system; 65% are expected to do so by 2001. With the number of e-mail boxes worldwide expected to quadruple in the next two years to one billion, it turns out that Critical Path isn't a quirky business—even if its founder seems eccentric. —*Jane Hodges*