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INDUSTRY TREND: Facilities Based IT Service Providers Are Filing For Bankruptcy

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MIRUS' CORPORATE RECOVERY SERVICES

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In 2001 there were more than 50 ASPs, ISPs, Call Centers and Web Hosting companies that filed for bankruptcy in the United States. What do all of these companies have in common? Facilities. All of the facilities that these companies built-out came with commitments to pay rent and to make payments on furniture, fixtures and equipment. When the going gets tough they can lay off workers, but they can't lay off an empty building or a leased web server. In the heady days of the Internet economy, many companies followed the advice of investors and analysts that told them to "get big fast". Market share was the first priority, profits be damned. The problem for the facilities-based services company is that growing such a business is capital intensive, requiring huge outlays of cash for build-outs, servers, and communication systems. In the current environment, these companies now face declining revenues and no access to capital.

With a seemingly unlimited supply of investment capital and equipment financing available in 1999 and 2000, it was easy to build up the infrastructure, but scaling down is hard to do. Scaling down means paying off, or negotiating settlements on real estate and equipment lease obligations. But the equipment leasing companies like Comdisco and IBM aren't interested in taking pennies on the dollar unless ordered by a judge, and consequently, bankruptcy is often the only viable option for these facilities-based service companies that need to downsize.

While most companies across the sector have been affected, some of the highest profile failures have included Exodus Communications, USinternetworking, Breakaway Solutions, FutureLink and ENVISIONeT Computer Services.

Exodus Communications, a Web hosting and monitoring services firm filed a voluntary petition for reorganization under Chapter 11 on September 26, 2001 and is now in the process of being acquired by Cable and Wireless. At the time of filing, the Company had outstanding liabilities, mostly to bond holders, of $4.45 billion, according to court filings. Jay Slattery, an analyst with Technology Business Research pointedly said, "Their business model was essentially building ahead of demand…There was this expectation that the demand for data center space was going to continue to grow exponentially. So when this demand didn't materialize, they were stuck with all of these data centers."

USinternetworking (USi), one of the United States' largest ASPs, filed for Chapter 11 bankruptcy protection on January 7, 2002 as part of a planned restructuring aimed at reducing the Company's $120 million debt and providing it with new funding. Boston-based Bain Capital Partners LLC will invest up to $106 million in USi, and become its sole owner. Reactions to USi's filing and to Bain's cash infusion have not been overly positive. According to several industry analysts, although most of USi's problems surround issues such as over-investment in technology infrastructures and application service portfolios, significant changes also need to be made in operations and execution. Even with the recent capital infusion, approximately $65 million in equipment lease obligations still remain and will need to be addressed.

Breakaway Solutions, which provided consulting and ASP solutions, filed for bankruptcy in September 2001. Breakaway's business model was widely criticized as too cost-intensive because it included not only application hosting but also Web integration and professional services. The Company attempted to scale down costs on a number of occasions but ultimately wilted under the weight of its liabilities. In December, Totality Corporation announced the acquisition of specific assets, which included all of Breakaway's revenue-producing customer contracts.

FutureLink filed for Chapter 11 protection in August 2001. Although FutureLink was the first company to call itself an ASP and was billed as an innovator in the managed services market, the Company actually made little ground as a business-to-business provider of application services. The Company has ultimately been forced to liquidate six data centers in the U.S.

ENVISIONeT Computer Services, Inc., an outsourced customer support and call center operation, was successfully servicing the biggest names in the high tech community, including Microsoft and Dell. In the spring of 2001, as demand for home computers and broadband access declined, so did the call volume at ENVISIONeT's five call centers in rural Maine. With long-term leases in place for everything from real estate to computers and office furniture, the Company was unable to "ramp down" and shed excess assets. As a result, the Company was forced to file for Chapter 11 protection in June 2001 and was ulti-

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mately sold to Microdyne Inc; a division of electronics and defense conglomerate L-3 Communications Holdings (NYSE: LLL) in September 2001.

DO YOU WANT BUTTER ON THAT?

The problems faced by ASPs, Call Centers and the like are not unlike those faced by theaters operating in the motion picture industry. Over the past five years, cinema chains across the country participated in an industry-wide infrastructure build-up to meet (or perhaps create) anticipated demand. Oversaturation of various markets, pricing pressures with distributors and significant debt burdens led to the eventual restructuring of the industry.

Because of the capital required for expansion, firms in the industry were forced to look towards bankruptcy as the most viable means of reorganization. General Cinemas, Carmike Cinemas, CinemaStar, Edwards Theatres Circuits, Loews Cineplex Entertainment and Regal Cinemas have all filed for bankruptcy in the past several years. Carmike Cinemas Inc., which announced on January 3, 2002 that a bankruptcy court had confirmed its reorganization, used bankruptcy to terminate leases and close more than 130 unprofitable theaters, as well as restructure rents at other theaters to make them more profitable. Others look to sales out of bankruptcy to continue as going concerns. Currently, General Cinemas is in the process of being acquired by AMC Entertainment and Edwards Theatres Circuit is in the process of selling a majority stake to Philip Anschutz and Oaktree Capital Management.

ANYTHING WORTH DOING IS WORTH DOING RIGHT.

If bankruptcy is the decided course of action, pre-planning a company's bankruptcy process will provide the greatest possibility for a successful outcome. If sufficient new capital to restructure the business is unavailable, then an asset sale will be required to either generate capital (through divestitures) for a restructuring plan or to generate capital to pay off creditors. One example is Covad Communications, which filed for Chapter 11 in August 2001 with a pre-packaged debt conversion offer on the table that retired its debt, giving bondholders 19 cents on the dollar and preferred stock in the company. Rather than raise capital and then re-negotiate debt, the Company went to creditors early while slashing expenses. This contrasts with many telecom companies that waited too long to restructure and ran headfirst into the insolvency wall at high speed. If the debtor isn't cash flow positive at the time of filing and wants to restructure under Chapter 11, they will need debtor-in-possession ("DIP") financing. The time to arrange for DIP financing is before the filing – not after.

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