

Edgar Filing: FASTNET CORP - Form 10-Q

FASTNET CORP
Form 10-Q
May 15, 2002

=====

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2002
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934
For the Transition Period from _____ to _____

COMMISSION FILE NUMBER: 0-29255

FASTNET CORPORATION

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

PENNSYLVANIA

(STATE OR OTHER JURISDICTION OF
INCORPORATION OR ORGANIZATION)

23-2767197

(I.R.S. EMPLOYER
IDENTIFICATION NO.)

3864 COURTNEY STREET
TWO COURTNEY PLACE, SUITE 130
BETHLEHEM, PA

(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

18017

(ZIP CODE)

(610) 266-6700

(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)

N/A

(FORMER NAME, FORMER ADDRESS AND FORMER FISCAL YEAR, IF
CHANGED SINCE LAST REPORT)

Indicate by check mark whether the registrant (1) has filed all reports
required to be filed by Section 13 or 15(d) of the Securities Exchange Act of
1934 during the preceding 12 months (or for such shorter period that the
registrant was required to file such reports), and (2) has been subject to
filing requirements for the past 90 days. Yes No

The number of shares of the registrant's Common stock outstanding as of
May 15, 2002 was 25,571,323.

Edgar Filing: FASTNET CORP - Form 10-Q

FASTNET CORPORATION

FORM 10-Q

MARCH 31, 2002

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

Consolidated Balance Sheets - March 31, 2002 (unaudited) and December 31, 2001.....3

Consolidated Statements of Operations - Three Months Ended
March 31, 2002 and 20014

Consolidated Statements of Cash Flows - Three Months Ended
March 31, 2002 and 20015

Notes to Unaudited Consolidated Financial Statements6

Item 2. Management's Discussion and Analysis of Financial Condition and
Results of Operations13

Item 3. Qualitative and Quantitative Disclosures About Market Risk18

PART II. OTHER INFORMATION

Item 1. Legal Proceedings18

Item 2. Changes in Securities and Use of Proceeds18

Item 3. Defaults Upon Senior Securities18

Item 4. Submission of Matters to a Vote of Security Holders18

Item 5. Other Information18

Item 6. Exhibits and Reports on Form 8-K26

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

FASTNET CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

Edgar Filing: FASTNET CORP - Form 10-Q

	MARCH 31, 2002	

	(Unaudited)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 5,690,488	\$
Marketable securities	3,097,427	
Accounts receivable, net of allowance of \$1,101,159 and \$1,135,398	2,902,408	
Other current assets	1,271,306	

Total current assets	12,961,629	

PROPERTY AND EQUIPMENT, net	15,001,084	
INTANGIBLES, net of accumulated amortization of \$4,037,334 and \$3,799,001 ...	8,321,569	
OTHER ASSETS	318,508	

	\$ 36,602,790	\$
	=====	
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt	\$ 1,168,358	\$
Current portion of capital lease obligations	322,115	
Capital lease buyout	--	
Accounts payable	3,186,129	
Accrued expenses	2,328,458	
Deferred revenues	3,688,663	
Accrued restructuring	1,582,849	

Total current liabilities	12,276,572	

LONG-TERM DEBT	1,852,366	
CAPITAL LEASE OBLIGATIONS	34,103	
OTHER LIABILITIES	143,685	
SHAREHOLDERS' EQUITY:		
Preferred stock (10,000,000 shares authorized; 3,406,293 shares issued and outstanding)	1,636,606	
Common stock (50,000,000 shares authorized, 21,528,201 shares outstanding; 20,390,947 shares outstanding)	71,976,280	
Deferred compensation	(63,479)	
Note receivable	(470,313)	
Accumulated other comprehensive income	(2,904)	
Accumulated deficit	(49,780,126)	
Less - Treasury stock, at cost	(1,000,000)	

Total shareholders' equity	22,296,064	

Edgar Filing: FASTNET CORP - Form 10-Q

\$ 36,602,790 \$

=====

The accompanying notes are an integral part of these consolidated financial statements

3

FASTNET CORPORATION AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF OPERATIONS
 (Unaudited)

	THREE MONTHS ENDED MARCH 31,	
	2002	2001
	-----	-----
REVENUES	\$ 4,319,812	\$ 3,660,31
OPERATING EXPENSES:		
Cost of revenues (excluding depreciation)	1,924,856	3,151,18
Selling, general and administrative (excluding depreciation)..	2,277,377	2,761,60
Depreciation and amortization	1,898,547	1,761,95
	-----	-----
	6,100,780	7,674,73
	-----	-----
Operating loss	(1,780,968)	(4,014,42
	-----	-----
OTHER INCOME (EXPENSE):		
Interest income	42,031	306,96
Interest expense	(63,422)	(257,53
Other	(5,303)	(31
	-----	-----
	(26,694)	49,12
	-----	-----
NET LOSS	(1,807,662)	(3,965,30
	-----	-----
Deemed Dividend - Beneficial Conversion Feature	(370,359)	-
NET LOSS APPLICABLE TO COMMON SHAREHOLDERS	\$ (2,178,021)	\$ (3,965,30
	=====	=====
BASIC AND DILUTED NET LOSS PER COMMON SHARE	\$ (0.11)	\$ (0.2
	=====	=====
SHARES USED IN COMPUTING BASIC AND DILUTED NET LOSS PER COMMON SHARE	20,684,713	15,682,61
	=====	=====

The accompanying notes are an integral part of these consolidated financial statements.

Edgar Filing: FASTNET CORP - Form 10-Q

4

FASTNET CORPORATION AND SUBSIDIARIES
 CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Unaudited)

	THREE MONTHS ENDED	
	MARCH 31,	
	2002	2001
	-----	-----
OPERATING ACTIVITIES:		
Net loss	\$ (1,807,662)	\$ (3,960,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,898,547	1,760,000
Amortization of debt discount	2,788	
Amortization of deferred compensation	6,297	4,000
Stock-based compensation expense	6,315	
Provision for doubtful accounts	21,000	
Interest income from note	(6,563)	
Changes in operating assets and liabilities:		
Increase in assets:		
Accounts receivable	(208,630)	(4,000)
Other assets	(789,188)	(250,000)
Increase (decrease) in liabilities:		
Accounts payable and accrued expenses	(392,901)	(89,000)
Deferred revenues	164,806	(14,000)
Accrued restructuring	(189,268)	(1,380,000)
Other liabilities	2,472	
	-----	-----
Net cash used in operating activities	(1,291,987)	(4,870,000)
	-----	-----
INVESTING ACTIVITIES:		
Purchases of property and equipment	(163,251)	(53,000)
Cash acquired in (paid for) business acquisition, net	(380,269)	20,000
(Purchases) sales of marketable securities, net	(800,231)	7,450,000
	-----	-----
Net cash provided by (used in) investing activities..	(1,343,751)	7,120,000
	-----	-----
FINANCING ACTIVITIES:		
Repayments of debt	(288,862)	(25,000)
Repayments of capital lease obligations	(1,656,667)	(72,000)
	-----	-----
Net cash used in financing activities	(1,945,529)	(97,000)
	-----	-----
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(4,581,267)	1,270,000
CASH AND CASH EQUIVALENTS, beginning of period	10,271,755	5,050,000
	-----	-----

Edgar Filing: FASTNET CORP - Form 10-Q

CASH AND CASH EQUIVALENTS, end of period \$ 5,690,488 \$ 6,32
=====

The accompanying notes are an integral part of these consolidated financial statements

5

FASTNET CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

(1) THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BACKGROUND

FASTNET Corporation and its subsidiaries ("FASTNET" or the "Company") have been providing Internet access and enhanced products and services to its customers since 1994. The Company is an Internet services provider to businesses in selected secondary markets. The Company complements its Internet access services by delivering a wide range of enhanced products and services that are designed to meet the needs of its target customer base.

LIQUIDITY AND GOING CONCERN

The Company's business plan has required substantial capital to fund operations, capital expenditures, expansion of sales and marketing capabilities, and acquisitions. The Company modified its business strategy in October 2000, to reduce the Company's cash consumption and maintain operations without any additional funding in the foreseeable future. Simultaneous with the modification of its strategic plan, the Company recorded a charge primarily related to network and telecommunication optimization and cost reduction, facility exit costs, realigned marketing strategy, and involuntary employee terminations. These actions have reduced the Company's cash consumption. In December 2001, the Company recorded an additional charge related to excess data center facilities and office space that the Company cannot use, sublet or terminate.

The Company has incurred losses since inception and expects to continue to incur losses in 2002. As of March 31, 2002, the Company's accumulated deficit was \$49,780,126. As of March 31, 2002, cash and cash equivalents and marketable securities were \$8,787,915. The Company believes that its existing cash and cash equivalents, and marketable securities will be sufficient to meet its working capital and capital expenditure requirements through December 31, 2002. However, the Company may be required or desire to seek additional sources of financing. If additional funds are raised through the issuance of equity securities, existing shareholders may experience significant dilution. Furthermore, additional financing may not be available when needed or, if available, such financing may not be on terms favorable to the Company. If such sources of financing are insufficient or unavailable, or if the Company experiences shortfalls in anticipated revenue or increases in anticipated expenses, the Company may need to idle additional markets and make further reductions in head count. Any of these events could harm the Company's business, financial condition or results of operations.

The Company is subject to those risks associated with companies in the telecommunications industry. The Company's future results of operations involve a number of risks and uncertainties. Factors that could affect the Company's future operating results and cause actual results to vary materially from expectations include, but are not limited to, risks from competition, new

Edgar Filing: FASTNET CORP - Form 10-Q

products and technological change, price and margin pressures, capital availability and dependence on key personnel. See Part II, Item 5 of this form 10-Q for a description of additional factors that may affect the Company's future operating results.

QUARTERLY FINANCIAL INFORMATION AND RESULTS OF OPERATIONS

The accompanying unaudited financial information as of March 31, 2002 and for the three months ended March 31, 2002 and 2001 has been prepared in accordance with accounting principles generally accepted in the United States. In the opinion of management, all significant adjustments, consisting of only normal and recurring adjustments, have been included in the accompanying unaudited financial statements. Operating results for the three months ended March 31, 2002 are not necessarily indicative of the results that may be expected for the full year. While the Company believes that the disclosures presented are adequate to make the information not misleading, these Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and the notes included in the Company's latest annual report on Form 10-K.

PRINCIPLES OF CONSOLIDATION

The accompanying consolidated financial statements include the accounts of FASTNET and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

6

MANAGEMENT'S USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

COMPREHENSIVE INCOME

The Company follows SFAS No. 130, "Reporting Comprehensive Income." SFAS No. 130 requires companies to classify items of other comprehensive income by their nature in a financial statement and display the accumulated balance of other comprehensive income separately from the shareholders' equity section of the balance sheet. For the three months ended March 31, 2002 and 2001, comprehensive loss was as follows:

	THREE MONTHS ENDED	
	MARCH 31, 2002	MARCH 31, 2001
	-----	-----
Net loss	\$ (1,807,662)	\$ (3,965,306)
Unrealized gain (loss) on marketable securities..	(2,904)	10,517
	-----	-----
Comprehensive loss	\$ (1,810,566)	\$ (3,954,789)
	=====	=====

Edgar Filing: FASTNET CORP - Form 10-Q

REVENUE RECOGNITION

Revenues include one-time and ongoing charges to customers for accessing the Internet. One-time charges primarily relate to the initial connection fees and are recognized as revenue over the life of the customer contract. The Company recognizes access revenue over the period the services are provided. The Company offers contracts for Internet access that are generally billed in advance of providing service. These advance billings are recorded as deferred revenues and recognized to revenue ratably over the service period.

Revenues are also derived from the resale of products, including hardware and software, and web hosting services. The Company sells its web hosting and related services for contractual periods ranging from one to twelve months. These contracts generally are cancelable by either party without penalty. Revenues from these contracts are recognized ratably over the contractual period as services are provided. Incremental fees for excess bandwidth usage and data storage are billed and recognized as revenue in the period in which customers utilize such services.

Revenues also include professional services and web design related projects. Revenues from professional services are generally recognized as the services are provided. The Company generally recognizes project revenue using the percentage-of-completion method. The percentage-of-completion method is used over a period of time that commences with an execution of the project agreement and ends when the project is complete. Any anticipated losses on contracts are recorded to earnings when identified. Amounts received or billed in excess of revenue recognized to date are classified as deferred revenues, whereas revenue recognized in excess of amounts billed are classified as unbilled accounts receivable and are included in accounts receivable in the accompanying consolidated balance sheets.

RECLASSIFICATIONS

Certain reclassifications have been made to the prior period to conform to the current period presentation.

(2) ACQUISITIONS

On March 14, 2001, the Company acquired all the assets and assumed substantially all the liabilities of Cybertech Wireless, Inc., ("Cybertech") a provider of fixed wireless Internet services headquartered in Rochester, New York, for 2,000,000 shares of Common stock valued at \$1,875,000. The results of operations from Cybertech have been included in the consolidated financial statements from the date of acquisition. The Company recorded the acquisition using the purchase method of accounting pursuant to APB Opinion No. 16, "Business Combinations." The excess of the purchase price over the fair value of net assets acquired was determined to be \$1,298,690. Based on a valuation by an independent valuation consultant, \$600,000 of the excess purchase price was allocated to developed

7

technology and the remaining \$698,690 was allocated to goodwill, which is not expected to be deductible for tax purposes. The developed technology is being amortized on a straight-line basis over a five-year period. The goodwill was being amortized over a five-year period in 2001, however, in accordance with SFAS No. 142, the goodwill is no longer amortized beginning January 1, 2002. Amortization expense for the three months ended March 31, 2002, was \$30,000. The pro forma information is not presented, as information for Cybertech is immaterial.

Edgar Filing: FASTNET CORP - Form 10-Q

On January 31, 2002, the Company acquired all the assets and substantially all of the liabilities of SuperNet, Inc. ("SuperNet"), an ISP headquartered in East Brunswick, New Jersey. SuperNet provides Internet access to businesses and residential customers, as well as web hosting and colocation services to customers located in the central New Jersey region. The Company recorded the acquisition using the purchase method of accounting pursuant to APB Opinion No. 16. The total purchase price was \$1,593,000, including transaction costs. The purchase price consisted of 1,096,907 shares of the Company's Common stock valued at \$1,064,000, or \$0.97 per share, the fair market value at the date of acquisition. The excess of the purchase price over the fair value of net assets acquired was determined to be \$1,790,945. Based on a valuation by an independent valuation consultant, \$500,000 of the excess purchase price was allocated to customer relationships and the remaining \$1,290,945 was allocated to goodwill, none of which is deductible for tax purposes. The customer relationships is being amortized on a straight-line basis over a five-year period. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," the goodwill will not be amortized. The pro forma information is not presented, as information for SuperNet is immaterial.

The following table lists noncash assets that were acquired and liabilities that were assumed as part of the above acquisitions:

	SuperNet	Cybertech
Noncash assets:		
Accounts receivable	\$ 50,978	\$ 76,827
Other current assets	4,380	101,638
Property and equipment	64,124	1,953,682
Intangibles	1,790,945	1,298,690
	\$ 1,910,427	\$ 3,430,837
Assumed liabilities:		
Accounts payable	\$ 207,569	\$ 1,013,626
Accrued expenses	181,586	306,135
Deferred revenues	77,003	181,083
Debt	--	250,000
Other liabilities	--	13,814
	466,158	1,764,658
Net noncash assets acquired.....	1,444,269	1,665,179
Purchase price paid in stock	(1,064,000)	(1,875,000)
Cash paid (acquired).....	\$ 380,269	\$ (208,821)

On November 1, 2001 the Company acquired all the assets, and assumed substantially all the liabilities of NetReach, Inc., ("NetReach") an internet access, web hosting, web design and web application development company headquartered in Ambler, Pennsylvania for 2,400,000 shares of Common stock valued at \$2,232,000. The selling shareholders may receive up to an additional 690,900 shares of Common stock of the Company contingent upon the achievement of certain revenues and margin targets, as defined, for each of the five consecutive calendar quarters beginning October 1, 2001. The targets related to the contingent consideration were not met in the quarters ended December 31, 2001 and March 31, 2002.

Edgar Filing: FASTNET CORP - Form 10-Q

On April 4, 2002, the Company acquired all the outstanding capital stock of Netaxs, Inc. ("Netaxs"), an Internet access, web hosting and colocation provider located in the greater Philadelphia, Pennsylvania area. The aggregate consideration paid was \$984,690 in cash, the issuance of promissory notes to certain shareholders of Netaxs having an aggregate principal amount of \$2,514,898, and 4,040,187 shares of unregistered Common stock valued at \$4,080,589, \$1.01 per share, the fair value of the Company's Common stock at the date of acquisition. The principal due under the notes will accrue interest at a rate of 7.09% per annum, and the notes are payable in monthly installments through October 2005.

(3) CASH, CASH EQUIVALENTS AND MARKETABLE SECURITIES

The Company considers all highly liquid debt investments purchased with an original maturity of ninety days or less to be cash equivalents.

Management determines the appropriate classification of its investments in debt and equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. As of March 31, 2002, all of the Company's investments are classified as available for sale and are included in marketable securities in the accompanying consolidated balance sheets.

The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion as well as interest are included in interest income. Realized gains and losses are included in other income in the accompanying consolidated statements of operations. The cost of securities sold is based on the specific identification method.

The Company's investments in debt and equity securities are diversified among high-credit quality securities in accordance with the Company's investment policy.

(4) PROPERTY AND EQUIPMENT

As of March 31, 2002 and in the year ended December 31, 2001, property and equipment consists of the following:

	MARCH 31, 2002	DECEMBER 31, 2001
Equipment	\$ 19,998,924	\$ 19,837,983
Computer equipment	2,212,288	2,182,562
Computer software	1,834,223	1,761,833
Furniture and fixtures	669,732	670,620
Leasehold improvements	3,206,761	3,205,532
	27,921,928	27,658,530
Less-Accumulated depreciation and amortization	(12,920,844)	(11,260,630)
	\$ 15,001,084	\$ 16,397,900

Depreciation expense for the three months ended March 31, 2002 and 2001 was \$1,660,214 and \$1,371,789, respectively. The net carrying value of property and equipment under capital leases was \$985,544 and \$1,035,501 at March 31, 2002 and December 31, 2001, respectively.

Edgar Filing: FASTNET CORP - Form 10-Q

(5) INTANGIBLE ASSETS

Intangible assets as of March 31, 2002 are as follows:

	USEFUL LIFE	AMORTIZING		NON-AMORTIZING	
		GROSS CARRYING AMOUNT	ACCUMULATED AMORTIZATION	GROSS CARRYING AMOUNT	ACCUMULATED AMORTIZATION
Customer relationships.....	3-5 years	\$ 3,000,000	\$(1,836,121)	\$ --	--
Developed technology	5 years	600,000	(125,344)	--	--
Goodwill	n/a	--	--	8,758,903	(2,075,000)
Total		\$ 3,600,000	\$(1,961,465)	\$ 8,758,903	\$(2,075,000)

The carrying value of goodwill and other intangible assets are evaluated periodically based on fair values or undiscounted operating cash flow whenever significant events or changes occur which might impair recovery of recorded costs. The Company believes that no impairment of goodwill or other intangible assets exists at March 31, 2002. Amortization of goodwill was \$0 and \$223,496 for the three months ended March 31, 2002 and 2001, respectively. Amortization of other intangibles was \$238,333 and \$166,667 for the three months ended March 31, 2002 and 2001, respectively.

(6) RESTRUCTURING CHARGE

On October 10, 2000, the Company announced a restructuring to its business operations and this restructuring plan provided for the suspension of selling and marketing efforts in 12 of the 20 markets that were operational as of September 30, 2000 (the "Restructuring Plan"). Selling and marketing efforts are now focused on targeted markets located in Pennsylvania, New Jersey and New York. The Restructuring Plan includes redesigning the network architecture intended to achieve an overall reduction in telecommunication expenses. In conjunction with the Restructuring Plan, the Company terminated 44 employees.

The Company has ceased all sales and marketing activities in the 12 closed markets and is negotiating the exit of the facilities, where practicable. Telecommunication exit and termination costs relate to contractual obligations the Company is unable to cancel for network and related cost in the markets being closed. These costs consist of Internet backbone connectivity cost, as well as network and access costs, for services are no longer required in the closed markets. Leasehold termination payments include carrying costs and rent expense for leased facilities located in non-operational markets. The Company is actively pursuing both sublease opportunities as well as full lease terminations (see discussion below regarding additional restructuring charge recorded in December 2001).

During the fourth quarter of 2000, the Company recorded a charge for \$5,159,503. The restructuring charges were determined based on formal plans approved by the Company's management and Board of Directors using the information available at the time. In addition in the fourth quarter of 2000,

Edgar Filing: FASTNET CORP - Form 10-Q

the Company recorded a \$3,233,753 asset impairment charge as a result of the Restructuring Plan.

Throughout 2001, the Company continually reviewed the reserves that were established in October 2000 as part of its Restructuring Plan. In the fourth quarter of 2001, the Company recorded an additional charge of \$1,335,790 related to its excess and idle data centers and administrative offices. The amount of the charge was determined using assumptions regarding the Company's ability to sublet or dispose of these facilities. This decision was made in the fourth quarter of 2001 as the Company experienced significant difficulties in attempting to dispose of or sublet these facilities due to an overall slowdown in the economy and, in particular, the commercial real estate market. The Company is continuing its efforts to dispose of or sublet these facilities. As of March 31, 2002, the total amount of lease payments relating to these excess or idle facilities is approximately \$4,600,000 through 2010. Actual results could differ materially from these estimates. Management believes this provision will be adequate to cover any future costs incurred relating to the restructuring.

The activity in the restructuring charge accrual during the three months ended March 31, 2002 is summarized in the table below:

10

	ACCRUED RESTRUCTURING AS OF DECEMBER 31, 2001	CASH PAYMENTS DURING THE THREE MONTHS ENDED MARCH 31, 2002	ACCRUED RESTRUCTURING AS OF MARCH 31, 2002
	-----	-----	-----
Telecommunications exit and termination fees..	\$ 233,980	\$ --	\$ 233,980
Leasehold termination costs	115,543	(115,543)	--
Sales and marketing contract terminations	52,321	--	52,321
Facility exit costs	1,370,273	(73,725)	1,296,548
	-----	-----	-----
	\$ 1,772,117	\$ (189,268)	\$ 1,582,849
	=====	=====	=====

(7) DEBT

TERM NOTE

In December 2001, the Company entered into a loan agreement with a bank and issued a \$2,300,000 promissory note to the bank (the "Bank Note"). The proceeds from the Bank Note will be used for general corporate purposes. The Bank Note bears interest at LIBOR plus 1.5%, per annum. The Bank Note is payable in consecutive monthly payments of \$95,833 principal and interest with all principal and interest due in December 2003. The Bank Note is secured by substantially all of the assets of the Company. There are certain restrictive financial and non-financial covenants related to the Bank Note including the maintenance of a cash balance of at least \$5,000,000. Interest expense related to the Bank Note for the three months ended March 31, 2002 was \$12,915. Future maturities on the Bank Note as of March 31, 2002 are \$1,150,000 through March 31, 2003 and \$86,250 through December 2003.

Edgar Filing: FASTNET CORP - Form 10-Q

NOTES PAYABLE

In conjunction with the NetReach acquisition, the Company acquired various notes payable in the aggregate of \$760,000 (the "NetReach Notes"). Of the \$760,000 total notes payable, \$525,000 are convertible notes that convert into the Company's Common stock at a conversion price of \$2.00 per share. Additionally, if the closing price of the Company's Common stock is at least \$3.00 per share for any consecutive 30 calendar days, the Company shall have the right to convert all of the outstanding principal and interest due under the convertible notes into unregistered shares of the Company's Common stock at a conversion price equal to \$2.00 per share. The convertible notes bear interest at 8.0% and prime plus 4.0% and mature at various dates in 2003 and 2004. Additionally, several of the convertible notes were issued with warrants to purchase a total of 52,140 shares of the Company's Common stock at exercise prices ranging from \$1.89 to \$7.57. The warrants expire from February 9, 2008 through October 17, 2008. The Company valued the warrants using the Black-Scholes option pricing model and recorded a debt discount of \$29,581 related to the warrants. The discount is being expensed over the terms of the convertible notes.

The remaining balance of \$235,000 of the NetReach Notes are term notes. The term notes bear interest at 8.0% and mature in 2004. Interest expense related to these term notes for the three months ended March 31, 2002 was \$6,600. Future maturities on these term notes as of March 31, 2002 are \$26,400 through March 31, 2003 and \$16,000 through 2004.

In conjunction with the Netaxs acquisition in April 2002, the Company issued promissory notes to certain shareholders of Netaxs having an aggregate principal amount of \$2,514,898. The principal due under these notes will accrue interest at a rate of 7.09% per annum and are payable in monthly installments through October 2005.

(8) DEFERRED COMPENSATION

As a result of stock option termination, \$288,161 of the unamortized balance of deferred compensation was reversed in the quarter ended March 31, 2002.

11

(9) PREFERRED STOCK

As of March 31, 2002 and December 31, 2001 the Company had authorized 10,000,000 shares of no par value Preferred stock. In August 1999, the Company designated and issued 808,629 shares as Series A Convertible Preferred stock ("1999 Series A Preferred"). The 1999 Series A Preferred was convertible at any time into Common stock of the Company at a one-for-one conversion ratio. The holders of the 1999 Series A Preferred had a liquidation preference of \$7.13 per share. In August 1999, the Company sold 666,198 shares of 1999 Series A Preferred to certain investors at \$7.13 per share. The net proceeds from the sale of the 1999 Series A Preferred were \$4,445,108. The 1999 Series A Preferred converted into Common Stock immediately prior to the consummation of the Company's initial public offering.

In August 2001, the Company authorized the issuance of up to 5,494,505 shares of a newly designated Series A Convertible Preferred stock ("2001 Series A Preferred").

On September 5, 2001, the Company sold 2,506,421 shares of 2001 Series

Edgar Filing: FASTNET CORP - Form 10-Q

A Preferred, no par value, at a purchase price of \$0.91 per share to several investors for gross proceeds of \$2,287,109 ("First Closing"). In conjunction with the sale of the 2001 Series A Preferred at the First Closing, the Company issued warrants to purchase 626,605 shares of Common stock at an exercise price of \$1.27 per share. The warrants expire in five years. Additionally, a founder of the Company sold 456,169 shares of Common stock to one of the 2001 Series A Preferred investors for \$0.50 per share for proceeds to the founder of \$228,085.

On November 12, 2001, the Company sold an additional 790,283 shares of 2001 Series A Preferred at a purchase price of \$0.91 per share for gross proceeds of \$712,891 and issued additional warrants to purchase 197,571 shares of Common stock at an exercise price of \$1.27 per share to the same investors involved in the First Closing ("Second Closing"). The same founder noted above sold an additional 143,831 shares of Common stock to the same 2001 Series A Preferred investors for \$0.50 per share for proceeds to the founder of \$71,916. Additionally, the Company issued 109,589 shares of 2001 Series A Preferred to a law firm utilized by the Company in exchange for \$100,000 of professional services rendered, the fair value of the equity issued.

Each share of 2001 Series A Preferred is convertible into the Company's Common stock any time after the earlier of September 4, 2002 or a mandatory conversion event, as defined. In the event a mandatory conversion does not occur, the 2001 Series A Preferred is convertible at the option of the holder any time on or after August 30, 2002. The holders of the 2001 Series A Preferred are entitled to receive dividends at the same rate as dividends are paid with respect to Common stock shares. In the event of any liquidation, dissolution or winding-up of the Company, the holders of 2001 Series A Preferred are entitled to the greater of (i) \$0.91 per share (subject to adjustment for stock splits, stock dividends, recapitalizations and similar events) plus all dividends declared but unpaid or (ii) such amount per share as would have been payable had each share been converted to Common stock immediately prior the event. As of March 31, 2002, the 2001 Series A Preferred had a liquidation preference of \$3,956,045.

The 2001 Series A Preferred stockholders vote together with all other classes and series of stock as a single class. The 2001 Series A Preferred stockholders are entitled to the number of votes, except that the 2001 Series A Preferred stockholders are entitled to a separate class vote with respect to certain matters affecting the 2001 Series A Preferred and certain other fundamental transactions, such as a liquidation, dissolution or winding up of the Company, issuances of certain additional securities and the merger, consolidation with or into, or sale of substantially all of the assets of the Company to another entity equal to the number of whole shares of Common stock into which the shares of 2001 Series A Preferred are convertible. The 2001 Series A Preferred stockholders, as a separate series, are entitled to elect two directors of the Company.

The Company allocated the proceeds from the First Closing to the 2001 Series A Preferred, warrants to purchase Common stock, and Common stock sold by a founder based on the relative fair values of each instrument. The fair value of the warrants issued in the First Closing was determined based on the Black-Scholes option-pricing model using a life of five years, a volatility of 100% and a risk-free interest rate of 4.529%. Accordingly, approximately \$1,802,000 of the 2001 Series A Preferred proceeds was allocated to the 2001 Series A Preferred, \$338,000 was allocated to the warrants and \$148,000 was allocated to the shares of Common stock sold by the founder. The fair values of the warrants and the Common stock have been recorded as Common stock on the accompanying consolidated balance sheets. After considering the allocation of the proceeds based on the relative fair values, it was determined that the 2001 Series A Preferred has a beneficial conversion feature ("BCF") in accordance with Emerging Issues Task Force ("EITF") Issue No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently

Edgar Filing: FASTNET CORP - Form 10-Q

Adjustable Conversion Ratios." The Company recorded the BCF related to the First Closing of approximately \$980,000 as a discount to the 2001 Series A Preferred in the year ended December 31, 2001. The value of the BCF will be recorded in a manner similar to a deemed dividend over the period from the date of issuance to the earliest known date of conversion, September 4, 2002. The Company allocated the proceeds from the Second Closing in the same manner as discussed above. The fair value of the warrants issued in the Second Closing was determined based on the Black-Scholes option pricing model using a life of five years, a volatility of 100% and a risk free interest rate of 3.957%. Approximately, \$517,000 of the 2001 Series A Preferred proceeds from the Second Closing was allocated to the 2001 Series A Preferred, \$264,000 was allocated to the warrants and \$41,000 was allocated to the shares of Common stock sold by the founder. The Company recorded a BCF related to the Second Closing of approximately \$397,000 as a

12

discount to the 2001 Series A Preferred in the year ended December 31, 2001. The value of the BCF will be recorded in a manner similar to a deemed dividend over the period from the dates of issuance to the earliest date of conversion, September 4, 2002. The Company recorded a deemed dividend - BCF of \$370,359 and \$389,405 in the three months ended March 31, 2002 and the year ended December 31, 2001, respectively.

(10) NET LOSS PER COMMON SHARE

The Company has presented net loss per common share pursuant to SFAS No. 128, "Earnings Per Share." Basic net loss per Common share was computed by dividing net loss by the weighted average number of shares of Common stock outstanding during the period. Diluted net loss per Common share reflects the potential dilution from the exercise or conversion of securities into Common stock, such as stock options. Outstanding Common stock options and warrants are excluded from the diluted net loss per Common share calculations as the impact on the net loss per Common share using the treasury stock method is antidilutive due to the Company's losses. The number of shares excluded from this calculation was 1,422,500 as of March 31, 2002.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

THE FOLLOWING DISCUSSION AND ANALYSIS SHOULD BE READ IN CONJUNCTION WITH OUR FINANCIAL STATEMENTS AND THE RELATED NOTES TO THE FINANCIAL STATEMENTS APPEARING ELSEWHERE IN THIS FORM 10-Q. THE FOLLOWING INCLUDES A NUMBER OF FORWARD-LOOKING STATEMENTS THAT REFLECT OUR CURRENT VIEWS WITH RESPECT TO FUTURE EVENTS AND FINANCIAL PERFORMANCE. WE USE WORDS SUCH AS ANTICIPATES, BELIEVES, EXPECTS, FUTURE, AND INTENDS, AND SIMILAR EXPRESSIONS TO IDENTIFY FORWARD-LOOKING STATEMENTS. YOU SHOULD NOT PLACE UNDUE RELIANCE ON THESE FORWARD-LOOKING STATEMENTS, WHICH APPLY ONLY AS OF THE DATE OF THIS QUARTERLY REPORT ON FORM 10-Q. THESE FORWARD-LOOKING STATEMENTS ARE SUBJECT TO RISKS AND UNCERTAINTIES THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM HISTORICAL RESULTS OR OUR PREDICTIONS, INCLUDING, WITHOUT LIMITATION, THOSE FACTORS SET FORTH IN ITEM 5 OF PART II OF THIS FORM 10-Q. THE FORWARD-LOOKING STATEMENTS ARE SUBJECT TO A NUMBER OF RISKS AND UNCERTAINTIES INCLUDING, BUT NOT LIMITED TO, OUR ABILITY TO: SUCCESSFULLY ADJUST OUR OPERATIONS UNDER OUR MODIFIED BUSINESS PLAN; OFFER OUR CUSTOMERS IN THE REGIONS, SERVED BY COMPANIES THAT WE HAVE RECENTLY ACQUIRED A FULL SUITE OF PRODUCTS AND SERVICES THAT WE OFFER OUR OTHER CUSTOMERS; INCREASE OUR ACCESS AND ENHANCED REVENUES AS A PERCENTAGE OF OUR TOTAL REVENUES; EXPAND OUR CUSTOMER BASE; MIGRATE CUSTOMERS

13

Edgar Filing: FASTNET CORP - Form 10-Q

FROM OUR COMPETITORS IF THE INDUSTRY CONTINUES TO CONSOLIDATE AND GROW OUR REVENUES; DECREASE SOHO REVENUES AS A PERCENTAGE OF TOTAL REVENUES; REDUCE OUR COST OF REVENUES; CHANGE OUR INTEREST INCOME AND INTEREST EXPENSE THROUGH REVISED OPERATIONS; AND EFFECTIVELY INTEGRATE OPERATIONS OF COMPANIES THAT WE HAVE RECENTLY ACQUIRED. ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THE RESULTS DISCUSSED IN THE FORWARD-LOOKING STATEMENTS. THE INFORMATION CONTAINED HEREIN IS CURRENT ONLY AS OF THE DATE OF THIS FILING AND WE UNDERTAKE NO OBLIGATION TO UPDATE THE INFORMATION IN THIS FORM 10-Q IN THE FUTURE.

OVERVIEW

We are an Internet solutions provider offering broadband data communication services and enhanced products and services to businesses in the Northeastern United States. Our services included high-speed data and Internet services, data center services, including managed and unmanaged colocation services, web hosting, small office home office (SOHO) Internet access, wholesale ISP services, and various professional services including e-Solutions, web design and development. We focus our sales and marketing efforts on businesses in the markets we serve using the value proposition of leveraging our technical expertise with dedicated customer care. We approach our customers from an access independent position, providing connectivity over a variety of available technologies. These include classic Telco provided point-to-point, ISDN, SMDS, ATM, and DSL. We also offer FASTNET controlled last mile Internet access utilizing wireless transport.

As of March 31, 2002, we provided Internet access and enhanced services to approximately 2,164 enterprise customers, 26,276 SOHO customers, and 7,014 customers using our shared and dedicated web hosting, and colocation services.

OUR HISTORY OF OPERATING LOSSES

We have incurred operating losses in each year since our inception and expect our losses to continue through December 31, 2002 as we seek to execute our revised business plan. Our operating losses were \$14,135,638, \$32,044,023 and \$5,242,373 for the years ended December 31, 2001, 2000 and 1999, respectively, and \$1,780,968 for the three months ended March 31, 2002.

MODIFICATION OF OUR STRATEGIC PLAN

On October 10, 2000, we modified our business plan. This modified plan called for the suspension of selling and marketing efforts in 12 of the 20 markets that were operational as of September 30, 2000. Our selling and marketing strategy is now focused on markets located in Pennsylvania, New Jersey and New York.

Simultaneous with the modification of our business plan, we recorded a restructuring charge of \$5,159,503 primarily related to network and telecommunication optimization and cost reduction, facility exit costs, realigned marketing strategy, and involuntary employee terminations.

Throughout 2001, the Company continually reviewed the reserves that were established in October 2000 as part of its 2000 restructuring plan. In the fourth quarter of 2001, the Company recorded an additional approximately \$1.3 million restructuring charge related to its excess and idle data centers and administrative offices. This charge makes certain assumptions regarding the Company's ability to sublet or dispose of these facilities. This decision was made in the fourth quarter of 2001 as we experienced significant difficulties in attempting to dispose of or sublet these facilities due to an overall slowdown in the economy and, in particular, the commercial real estate market. We are continuing our efforts to dispose of or sublet these facilities. As of March 2002, the total amount of lease payments relating to these excess or idle

Edgar Filing: FASTNET CORP - Form 10-Q

facilities is approximately \$4,600,000 through 2010. Actual results could differ materially from this estimate.

The activity in the restructuring charge accrual during the three months ended March 31, 2002 is summarized in the table below:

14

	ACCRUED RESTRUCTURING AS OF DECEMBER 31, 2001	CASH PAYMENTS DURING THE THREE MONTHS ENDED MARCH 31, 2002	ACCRUED RESTRUCTURING AS OF MARCH 31, 2002
	-----	-----	-----
Telecommunications exit and termination fees..	\$ 233,980	\$ --	\$ 233,980
Leasehold termination costs	115,543	(115,543)	--
Sales and marketing contract terminations ...	52,321	--	52,321
Facility exit costs	1,370,273	(73,725)	1,296,548
	-----	-----	-----
	\$ 1,772,117	\$ (189,268)	\$ 1,582,849
	=====	=====	=====

RESULTS OF OPERATIONS

REVENUES

We classify our revenue into these major categories: revenues from the sale of enterprise level Internet access and enhanced products and services, SOHO Internet access which includes revenues from the sale of Internet access to SOHOs and includes revenue from the sale of wholesale dialup access to customers that use our Dialplex Virtual Private Network (VPN or wholesale Internet access services) to provide service to their subscribers, revenue from hosting services which includes shared web hosting services, dedicated hosting services and colocation services and revenues from e-Solutions, web design and development services. We target our Internet access and enhanced services toward businesses located within our active markets. FASTNET offers a broad range of dedicated access solutions including T-1, T-3, Frame Relay, SMDS, enterprise class DSL services and fixed broadband wireless. Our enhanced services are complementary to dedicated Internet access and include Total Managed Security and the sale of third party hardware and software. Our business plan focuses on the core service offering of Internet access coupled with add-on sales of enhanced products and services as our customer's Internet needs expand. Internet access and enhanced product revenues are recognized as services are provided.

The market for data and related services is becoming increasingly competitive. We seek to continue to expand our customer base by both increasing market penetration in our existing markets and by increasing average revenue per customer by selling additional enhanced products and services. We have had a historically low churn rate with our dedicated Internet customers. We believe as the industry consolidates that we will have opportunities to migrate customers from our competitors as their customers become dissatisfied with the level of service provided by the consolidated organizations. In addition, the recent economic challenges have caused other providers to either cease operations or terminate certain product offerings. We seek to grow our revenues by capturing market share from other providers.

Edgar Filing: FASTNET CORP - Form 10-Q

Our SOHO revenues consist of dial-up Internet access to both residential and small office business customers, and revenue from the sale of wholesale dialup access to customers that use VPN to provide service to their subscribers, SOHO DSL Internet access, and ISDN Internet access. Customers using our SOHO services generally sign service contracts for one to two years. We typically bill these services in advance of providing services. As a result, revenues are deferred until such time as services are rendered. In the future as we execute our business plan, we expect SOHO revenues to decrease as a percentage of total revenues. We have reduced selling and marketing efforts targeted to this customer base in response to increased competition from both free Internet service providers and other providers.

We also offer our customers VPN solutions. VPN's allow business customers secure, remote access to their internal networks through a connection to FASTNET's network. The cost of these services varies with the scope of the services provided.

COST OF REVENUES

Our cost of revenues primarily consists of our Internet connectivity charges and network charges. These are our costs of directly connecting to multiple Internet backbones and maintaining our network. Cost of revenues also includes engineering payroll, creative and programming staff payrolls and the cost of third party hardware and software that we sell to our customers, facility rental expense for in-market network infrastructure, and rental expense on network equipment financed under operating leases.

The following table sets forth statement of operations data as a percentage of revenues for the periods indicated:

15

	THREE MONTHS ENDED	
	MARCH 31,	
	2002	2001
	-----	-----
Revenues	100.0%	100.0%
Operating expenses:		
Cost of revenues (excluding depreciation)	44.6	86.1
Selling, general and administrative (excluding depreciation)..	52.7	75.4
Depreciation and amortization	43.9	48.1
	-----	-----
Operating loss	(41.2)	(109.6)
Other expense, net	(0.6)	(1.3)
	-----	-----
Net loss	(41.8)%	(108.3)
	=====	=====

THE THREE MONTHS ENDED MARCH 31, 2002 COMPARED TO THE THREE MONTHS ENDED MARCH 31, 2001

Edgar Filing: FASTNET CORP - Form 10-Q

REVENUES. Revenues increased by \$660,000 or 18% to approximately \$4.3 million for the three months ended March 31, 2002, from approximately \$3.7 million for the three months ended March 31, 2001. This increase in revenues is primarily a result of an increase in the number of business customers using our dedicated Internet access services. Our dedicated Internet access customer base grew by 130% from 940 as of March 31, 2001 to 2,164 as of March 31, 2002 as a result of the acquisition of the customer bases of NetReach, which we acquired on November 1, 2001, and SuperNet, which we acquired on January 31, 2002. These acquisitions contributed to the increase in revenues through the addition of dedicated Internet access, dial-up, web hosting, colocation and e-Solutions customers to FASTNET's existing customer base, and the growth of our sales of colocation and dedicated hosting services grew by 127% from the first quarter of 2001 compared to the first quarter of 2002. Partially off-setting the growth from these revenue streams was a 15% decrease in the number of shared service web hosting customers from 8,250 as of March 31, 2001, to 6,715 as of March 31, 2002. Also partially offsetting our revenue growth rate was the loss of revenue as a result of the termination of our wholesale dialup service contract with Mircosoft's WebTV. There was no revenue from WebTV in the first quarter of 2002, while revenue from WebTV for the first quarter of 2001 was \$558,000 or 15% of our revenues.

COST OF REVENUE. Cost of revenues decreased by approximately \$1.2 million, or 39%, from \$3.2 million for the three months ended March 31, 2001 to \$1.9 million for the three months ended March 31, 2002. Gross margin improved from 14% for the three months ended March 31, 2001 to 55% for the three months ended March 31, 2002. The decrease in cost of revenues and the improvement in gross margin were primarily due to the reduction in the size and improvement in efficiency of our network and price renegotiations with our network and Internet bandwidth providers. The decision to discontinue service to Microsoft's WebTV also contributed to the reduction in cost of revenues and the increase in gross margin. Offsetting the decrease in cost of revenues is the additional cost of revenues associated with acquisitions made subsequent to March 31, 2001.

SELLING, GENERAL, AND ADMINISTRATIVE. Selling, general and administrative expenses decreased by \$484,000, or 18% from \$2.8 million for the three months ended March 31, 2001 to \$2.3 million for the three months ended March 31, 2002. Contributing to this decrease was a reduction in head count from 122 at March 31, 2001 to 115 at March 31, 2002. Also contributing to this decline in selling, general and administrative expense was a reduction in those expenses that are directly related to head count such as taxes, benefits and insurances.

DEPRECIATION AND AMORTIZATION. Depreciation and amortization increased by \$137,000 or 8%, from approximately \$1.8 million for the three months ended March 31, 2001 to \$1.9 million for the three months ended March 31, 2002. The change is a result of an increase in depreciation expense of \$288,000 related to the additional assets acquired from NetReach and SuperNet off-set by a \$151,000 decrease in amortization expense of goodwill. The decrease in amortization expense is in accordance with SFAS No. 142, which states that goodwill is no longer amortized as of January 1, 2002, which was \$238,333 for the three months ended March 31, 2002 and \$390,163 for the three months ended March 31, 2002.

16

OTHER INCOME/EXPENSE. Interest income decreased by \$265,000, or 86% from \$307,000 for the three months ended March 31, 2001 to \$42,000 for the three months ended March 31, 2002. This decrease in interest income resulted from the lower amount of interest being earned on marketable securities as a result of drawing down the invested proceeds from our initial public offering in February 2000 to fund operating losses and as a result of a decline in return on investments. Interest expense decreased by \$194,000 from \$258,000 for three

Edgar Filing: FASTNET CORP - Form 10-Q

months ended March 31, 2001 to \$63,000 for the three months ended March 31, 2002. The decrease in interest expense is primarily the result of the debt cancellation of capital leases with two vendors and the reduction in investment in equipment financed using capital lease facilities.

CASH FLOWS ANALYSIS

The following table sets forth cash flows data for the periods indicated:

	THREE MONTHS ENDED MARCH 31,	
	2002	2001
Other Financial Data:		
Cash flows used in operating activities	\$(1,291,987)	\$(4,874,92
Cash flows provided by (used in) investing activities..	(1,343,751)	7,128,61
Cash flows used in financing activities	(1,945,529)	(979,84
Net increase (decrease) in cash and cash equivalents...	\$(4,581,267)	\$ 1,273,84

Cash used by operating activities decreased by approximately \$3.6 million from cash used of approximately \$4.9 million for the three months ended March 31, 2001 to cash used of approximately \$1.3 million for the three months ended March 31, 2002. This decrease in cash used in operations is primarily the result of improved gross margin, and the overall reduction in selling, general and administrative expenses.

Cash flows from investing activities decreased by approximately \$8.5 million from cash provided of approximately \$7.1 million for the three months ended March 31, 2001 to cash used of approximately \$1.3 million for the three months ended March 31, 2002. This decrease resulted from the liquidation of marketable securities required to fund our operating losses in 2001.

Cash flows used by financing activities increased by approximately \$1.0 million from cash used of approximately \$1.0 million for the three months ended March 31, 2001 to cash used of approximately \$1.9 million for the three months ended March 31, 2002. The increase in cash used in financing activities is primarily the result of an approximately \$1.6 million payment made to settle a capital lease obligation in the first quarter of 2002.

LIQUIDITY AND CAPITAL RESOURCES

The Company's future liquidity and capital requirements will depend on numerous factors including, but not limited to, risks from competition, new products and technological changes, price and margin pressures and dependence on key personnel. If additional financing is needed, the Company may seek to raise funds through the sale of securities, bank borrowings or otherwise. There can be no assurance that financing will be available to the Company, if at all. The Company believes that its existing cash, cash equivalents and short-term investments will be sufficient to meet its working capital and capital expenditure requirements into 2003.

The business plan we executed at the time of our initial public offering required substantial capital to fund operations, capital expenditures, expansion of sales and marketing capabilities, and acquisitions. We modified our

Edgar Filing: FASTNET CORP - Form 10-Q

business strategy in October 2000. Simultaneous with the modification of our business plan, we recorded a charge primarily related to network and telecommunication optimization and cost reduction, facility exit costs, realigned marketing strategy, and involuntary employee terminations. These actions have and we believe will continue to reduce our cash consumption rate currently and in the future. As of March 31, 2002, we had approximately \$8.8 million in cash, cash equivalents and marketable securities.

During the fourth quarter of 2000, we recorded a charge for \$5,159,503 in connection with our modified business plan, and during the fourth quarter of 2001, we recorded an additional charge for \$1,335,790. Of these restructuring charges, \$1,582,849 has not been paid as of March 31, 2002 and is, accordingly, classified as accrued restructuring. The Company anticipates that the entire amount accrued will be paid in 2002 and 2003. The restructuring charges were determined based on formal plans approved by the Company's management and Board of Directors using the information available at the time. Management of the Company believes this provision will be adequate to cover any future costs incurred relating to the restructuring.

17

ITEM 3. QUALITATIVE AND QUANTITATIVE DISCLOSURE ABOUT MARKET RISK

Our financial instruments primarily consist of debt. All of our debt instruments bear interest at fixed rates. Therefore, a change in interest rates would not affect the interest incurred or cash flows related to our debt. A change in interest rates would, however, affect the fair value of the debt. The following sensitivity analysis assumes an instantaneous 100 basis point move in interest rates from levels at March 31, 2002 with all other factors held constant. A 100 basis point increase or decrease in market interest rates would result in a change in the value of our debt of less than \$50,000 at March 31, 2002. Because our debt is neither publicly traded nor redeemable at our option, it is unlikely that such a change would impact our financial statements or results of operations.

All of our transactions are conducted using the United States dollar. Therefore, we are not exposed to any significant market risk relating to currency rates.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are not involved currently in any legal proceedings that, either individually or taken as a whole, are likely to have a material adverse effect on our business, financial condition and results of operations.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(a) None.

(b) None.

(c) On January 31, 2002, we issued 1,064,000 shares of our Common stock to shareholders of SuperNet in connection with our acquisition of the assets, and substantially all of the liabilities of SuperNet. This sale was made under the exemption from registration provided under Section 4(2) of the Securities Act.

Edgar Filing: FASTNET CORP - Form 10-Q

On April 4, 2002, we issued 4,040,187 shares of our Common stock to shareholders of Netaxs in connection with our acquisition of the assets, and substantially all of the liabilities of Netaxs. This sale was made under the exemption from registration provided under Section 4(2) of the Securities Act. In conjunction with the Netaxs acquisition in April 2002, the Company issued promissory notes to certain shareholders of Netaxs having an aggregate principal amount of \$2,514,898. The principal due under these notes will accrue interest at a rate of 7.09% per annum and are payable in monthly installments through October 2005. This sale was made under the exemption from registration provided under Section 4(2) of the Securities Act.

(d) None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

FACTORS AFFECTING FUTURE OPERATING RESULTS

WE ONLY BEGAN TO IMPLEMENT OUR REVISED STRATEGIC BUSINESS PLAN IN OCTOBER 2000. AS A RESULT, YOU MAY NOT BE ABLE TO EVALUATE OUR BUSINESS PROSPECTS BASED ON OUR HISTORICAL RESULTS.

In October 2000, we announced our revised business plan and strategy in response to changes in market conditions, the low probability of obtaining additional financing for the existing business plan, and competitive factors. Consequently, the evaluation of our future business prospects is difficult because our historical results for the time that we were implementing our revised strategy is limited to 18 months. Our success will depend upon:

18

- o our continued ability to attract and sell additional products and services to our target customers;
- o our continued ability to enter into selected product or service partnerships; and
- o our continued ability to open new markets through the acquisition of ISPs within these new markets.

Our ability to successfully implement our business strategy, and the expected benefits to be obtained from our strategy, may be adversely affected by a number of factors, such as unforeseen costs and expenses, technological change, economic downturns, changes in capital markets, competitive factors or other events beyond our control.

IF WE ARE UNABLE TO SUSTAIN THE COST SAVINGS AND REDUCTION IN CASH CONSUMPTION UNDER OUR REVISED BUSINESS PLAN THROUGHOUT 2002, WE MAY HAVE TO FURTHER MODIFY

Edgar Filing: FASTNET CORP - Form 10-Q

OUR BUSINESS PLAN AND OUR BUSINESS COULD BE HARMED.

If we do not continue to achieve the cost savings and reduction in cash consumption under this plan throughout 2002, then we may need to seek additional capital from public or private equity or debt sources to fund our business plan. Given the existing capital market conditions, it may be difficult or impossible to raise additional capital in the public market in the future. In addition, we cannot be certain that we will be able to raise additional capital through debt or private financing at all or on terms acceptable to us. Raising additional equity capital and issuing shares of Common stock for acquisitions likely will dilute current shareholders. If alternative sources of financing are insufficient or unavailable, we may be required to further modify our growth and operating plans in accordance with the extent of available financing.

IF WE ARE UNABLE TO INTEGRATE THE OPERATIONS WE HAVE ACQUIRED WITH FASTNET, WE MAY NOT REALIZE OUR PLANNED COST SAVINGS.

A key element of our business strategy is to grow through acquisitions, and we must be able to integrate the networks of FASTNET and these acquired operations to gain the efficiencies we hope to achieve. We also must be able to retain and manage key personnel, integrate the back-office operations of these acquired operations into the back-office operations of FASTNET, and expand our consolidated company product portfolio across our increased customer base from these acquired operations or we may not be able to achieve the operating efficiencies we anticipate.

To integrate our newly acquired operations successfully, we must:

- o install and standardize adequate operational and control systems;
- o deploy standard equipment and telecommunications facilities;
- o employ qualified personnel to provide technical and marketing support in new as well as existing locations;
- o eliminate redundancies in overlapping network systems and personnel;
- o incorporate acquired technology and products into our existing service offerings;
- o implement and maintain uniform standards, procedures and policies;
- o standardize marketing and sales efforts under the common FASTNET brand, and, where applicable, maintain the brand name integrity of products and services that continue to be marketed and sold under the brand names utilized by the acquired operations; and
- o continue the expansion of our managerial, operational, technical and financial resources.

The process of consolidating and integrating acquired operations takes a significant period of time, places a significant strain on our managerial, operating and financial resources, and could prove to be even more expensive and time-consuming than we have predicted. We may increase expenditures in order to accelerate the integration and consolidation process with the goal of achieving longer-term cost savings and improved profitability.

The key integration challenges we face in connection with our acquisitions include:

- o acquired operations, facilities, equipment, service offerings, networks, technologies, brand names and sales, marketing and service development efforts may not be effectively integrated with our existing operations;
- o anticipated cost savings and operational benefits may not be realized;
- o in the course of integrating an acquired operation, we may discover facts or circumstances that we did not know at the time of the acquisition that adversely impact our business or operations, or make the integration more difficult or expensive;
- o integration efforts may divert our resources from our existing business;

Edgar Filing: FASTNET CORP - Form 10-Q

19

- o standards, controls, procedures and policies may not be maintained;
- o employees who are key to the acquired operations may choose to leave; and we may experience unforeseen delays and expenses.

WE FACE RISKS ASSOCIATED WITH ACQUISITIONS.

We expect to continue our targeted acquisition and expansion strategy. Future acquisitions could materially adversely affect our operating results as a result of dilutive issuances of equity securities and the incurrence of additional debt. In addition to the equity securities that we have issued to date in connection with our completed acquisitions, we may also be obligated to issue additional equity securities based on earn-out provisions set forth in the acquisition agreements. In addition, the purchase price for many of these acquired businesses likely will significantly exceed the current fair value of the net identifiable assets of the acquired businesses. As a result, material goodwill and other intangible assets would be required to be recorded which would result in significant amortization or other charges in future periods. These charges, in addition to the financial impact of such acquisitions, could have a material adverse effect on our business, financial condition and results of operations. We recorded all business acquisitions under the purchase method of accounting. Effective January 1, 2002 the Company no longer amortizes goodwill and certain intangibles pursuant to Statement of Financial Accounting Standards No.142 "Goodwill and Other Intangible Assets". We cannot assure you of the number, timing or size of future acquisitions, or the effect that any such acquisitions might have on our operating or financial results.

THE FINANCIAL INFORMATION CONCERNING BUSINESSES WE ACQUIRE MAY BE INACCURATE.

A number of the Internet businesses we have acquired did not have audited financial statements, and this may be true for subsequent acquisitions as well. These companies often have varying degrees of internal controls and detailed financial information, and the financial information we are able to provide for recently completed acquisitions may not be audited. Our subsequent audits of those acquired companies may reveal significant issues with respect to revenues, expenses and liabilities, contingent or otherwise.

WE ARE SUBJECT TO RESTRICTIVE COVENANTS THAT LIMIT OUR FLEXIBILITY.

Our loan agreement with First Union National Bank contains customary covenants limiting our flexibility, including covenants limiting our ability to incur additional debt, make liens, make investments, consolidate, merge or acquire other businesses and sell assets, pay dividends and other distributions, make capital expenditures and enter into transactions with affiliates. Failure to comply with the terms of the loan would entitle the bank to foreclose on certain of our assets, including the capital stock of our subsidiaries. The bank would be repaid from the proceeds of the liquidation of those assets before the assets would be available for distribution to other creditors and, lastly, to the holders of FASTNET's capital stock.

In addition, the terms and agreements relating to the sale of our Series A Convertible A Preferred stock contain customary covenants limiting our flexibility, including covenants limiting our ability to incur additional debt, create or issue any shares of capital stock with rights senior to the holders of the Series A Convertible Preferred stock, make distributions or declare dividends, consolidate, merge or acquire other businesses and sell assets, pay dividends and other distributions, effect stock splits, and issue additional equity securities. Such covenants may make it difficult for us to pursue our business strategies.

Edgar Filing: FASTNET CORP - Form 10-Q

Such restrictive covenants may make it difficult for us to pursue our business strategies without the consent of parties to these agreements, which we may not be able to obtain. Our ability to satisfy the financial and other restrictive covenants may be affected by events beyond our control.

WE HAVE A HISTORY OF LOSSES AND ARE UNABLE AT THIS TIME TO PREDICT WHEN WE WILL BE ABLE TO TURN PROFITABLE.

We have incurred net losses since our inception. For the three months ended March 31, 2002 and for the years ended December 31, 2001, 2000 and 1999, we had net losses of approximately \$1.8 million, \$8.5 million, \$31.1 million, and \$5.6 million, respectively.

In order to achieve profitability, we must develop and market products and services that gain broad commercial acceptance by our target customers in our target markets. We cannot give any assurances that our products and services will ever achieve broad commercial acceptance among our customers. Although our revenues have increased each year since we began operations, we cannot give any assurances that this growth in annual revenues will continue or lead to our profitability in the future. Moreover, our revised business plan may not enable

20

us to reduce expenses or increase revenues sufficiently to permit us to turn profitable. Therefore, we cannot predict with certainty whether we will be able to obtain or sustain positive operating cash flow or that our revised business plan will allow us to generate positive cash flow into the future.

IT IS UNLIKELY THAT INVESTORS WILL RECEIVE A RETURN ON OUR COMMON STOCK THROUGH THE PAYMENT OF CASH DIVIDENDS.

We have never declared or paid cash dividends on our Common stock and have no intention of doing so in the foreseeable future. We have had a history of losses and expect to operate at a net loss for the next several years. These net losses will reduce our stockholders' equity. For the three months March 31, 2002, we had a net loss to Common stockholders of approximately \$2.2 million. We cannot predict what the value of our assets or the amount of our liabilities will be in the future.

OUR OPERATING RESULTS FLUCTUATE DUE TO A VARIETY OF FACTORS AND ARE NOT A MEANINGFUL INDICATOR OF FUTURE PERFORMANCE.

Our operating results have fluctuated in the past and may fluctuate significantly in the future, depending upon a variety of factors, including:

- o the timing of the introduction of new products and services;
- o changes in pricing policies and product offerings by us or our competitors;
- o fluctuations in demand for Internet access and enhanced products and services; and
- o potential customers perception of the financial soundness of the Company.

Therefore, we believe that period-to-period comparisons of our operating results are not necessarily meaningful and cannot be relied upon as indicators of future performance. If our operating results in any future period

Edgar Filing: FASTNET CORP - Form 10-Q

fall below the expectations of analysts and investors, the market price of our Common stock would likely decline.

THE MARKET PRICE AND TRADING VOLUME OF OUR COMMON STOCK ARE VOLATILE.

The market price of our Common stock has fluctuated significantly in the past, and is likely to continue to be highly volatile. In addition, the trading volume in our Common stock has fluctuated, and significant price variations can occur as a result. We cannot assure you that the market price of our Common stock will not fluctuate or continue to decline significantly in the future. In addition, the U.S. equity markets have from time to time experienced significant price and volume fluctuations that have particularly affected the market prices for the stocks of technology and telecommunications companies. These broad market fluctuations may materially adversely affect the market price of our Common stock in the future. Such variations may be the result of changes in our business, operations or prospects, announcements of technological innovations and new products by competitors, new contractual relationships with strategic partners by us or our competitors, proposed acquisitions by us or our competitors, financial results that fail to meet public market analyst expectations, regulatory considerations and domestic and international market and economic conditions.

WE MAY BE UNABLE TO MAINTAIN THE STANDARDS FOR LISTING ON THE NASDAQ NATIONAL MARKET, WHICH COULD MAKE IT MORE DIFFICULT FOR INVESTORS TO DISPOSE OF OUR COMMON STOCK AND COULD SUBJECT OUR COMMON STOCK TO THE "PENNY STOCK" RULES.

Our Common stock is listed on the Nasdaq National Market. Nasdaq requires listed companies to maintain standards for continued listing, including either a minimum bid price for shares of a company's stock or a minimum tangible net worth. For example, Nasdaq requires listed companies to maintain a minimum bid price of at least \$1.00. Since February 7, 2000, the date of our Initial Public Offering, our stock price has risen and fallen and has traded below a \$1.00 for varying lengths of time. We cannot provide assurances that we will be able to continue to meet these continued listing requirements. If we are unable to maintain these standards, our Common stock could be delisted from the Nasdaq National Market, where our Common stock currently trades. Trading in our stock would then be conducted on the Nasdaq SmallCap Market unless we are unable to meet the requirements for inclusion. If we were unable to meet the requirements for inclusion in the SmallCap Market, our Common stock would be traded on an electronic bulletin board established for securities that do not meet the Nasdaq listing requirements or in quotations published by the National Quotation Bureau, Inc. that are commonly referred to as the "pink sheets". As a result, it could be more difficult to sell, or obtain an accurate quotation as to the price of our Common stock.

21

In addition, if our Common stock were delisted, it would be subject to the so-called penny stock rules. The SEC has adopted regulations that define a "penny stock" to be any equity security that has a market price of less than \$5.00 per share, subject to certain exceptions. For any transaction involving a penny stock, unless exempt, the rules impose additional sales practice requirements on broker-dealers subject to certain exceptions.

For transactions covered by the penny stock rules, a broker-dealer must make a special suitability determination for the purchaser and must have received the purchaser's written consent to the transaction prior to the sale. The penny stock rules also require broker-dealers to deliver monthly statements to penny stock investors disclosing recent price information for the penny stock held in the account and information on the limited market in penny stocks. Prior to the transaction, a broker-dealer must provide a disclosure schedule relating

Edgar Filing: FASTNET CORP - Form 10-Q

to the penny stock market. In addition, the broker-dealer must disclose the following:

- o commissions payable to the broker-dealer and the registered representative; and
- o current quotations for the security as mandated by the applicable regulations.

If our Common stock were delisted and determined to be a "penny stock," a broker-dealer may find it to be more difficult to trade our Common stock, and an investor may find it more difficult to acquire or dispose of our Common stock in the secondary market.

FUTURE SALES OF OUR COMMON STOCK COULD REDUCE THE PRICE OF OUR STOCK AND OUR ABILITY TO RAISE CASH IN FUTURE EQUITY OFFERINGS.

No prediction can be made as to the effect, if any, that future sales of shares of Common stock or the availability for future sale of shares of Common stock or securities convertible into or exercisable for our Common stock will have on the market price of our Common stock. Sale, or the availability for sale, of substantial amounts of Common stock by existing shareholders under Rule 144, through the exercise of registration rights or the issuance of shares of Common stock upon the exercise of stock options or warrants, or the perception that such sales or issuances could occur, could adversely affect prevailing market prices for our Common stock and could materially impair our future ability to raise capital through an offering of equity securities.

IN THE FUTURE, WE MAY BE UNABLE TO EXPAND OUR SALES, TECHNICAL SUPPORT AND CUSTOMER SUPPORT INFRASTRUCTURE, WHICH MAY HINDER OUR ABILITY TO GROW AND MEET CUSTOMER DEMANDS.

On October 10, 2000, we terminated 44 employees across all departments of the Company. This involuntary termination may make it more difficult to attract and retain employees. If, in the future, we are unable to expand our sales force and our technical support and customer support staff, our business could be harmed since this more limited staff could limit our ability to obtain new customers, sell products and services and provide existing customers with a high level of technical support.

WE FACE SIGNIFICANT AND INCREASING COMPETITION IN OUR INDUSTRY, WHICH COULD CAUSE US TO LOWER PRICES RESULTING IN REDUCED REVENUES.

The growth of the Internet access and related services market and the absence of substantial barriers to entry have attracted many start-ups as well as existing businesses from the telecommunications, cable, and technology industries. As a result, the market for Internet access and related services is very competitive. We anticipate that competition will continue to intensify as the use of the Internet grows. Current and prospective competitors include:

- o national Internet service providers and regional and local Internet service providers, including any remaining viable providers of free dial-up Internet access;
- o national and regional long distance and local telecommunications carriers;
- o cable operators and their affiliates;
- o providers of web hosting, colocation and other Internet-based business services;

- o computer hardware and other technology companies that bundle Internet connections with their products; and
- o terrestrial wireless and satellite Internet service providers.

We believe that the number of competitors we face is significant and is constantly changing. As a result, it is extremely difficult for us to accurately identify and quantify our competitors. In addition, because of the constantly evolving competitive environment, it is extremely difficult for us to determine our relative competitive position at any given time.

As a result of vertical and horizontal integration in the industry, we currently face and expect to continue to face significant pricing pressure and other competition in the future. Advances in technology and changes in the marketplace and the regulatory environment will continue, and we cannot predict the effect that ongoing or future developments may have on us or the pricing of our products and services.

Many of our competitors have significantly greater market presence, brand-name recognition, and financial resources than we do. In addition, all of the major long distance telephone companies, also known as interexchange carriers, offer Internet access services. The recent reforms in the federal regulation of the telecommunications industry have created greater opportunities for local exchange carriers, including incumbent local exchange carriers and competitive local exchange carriers, to enter the Internet access market. In order to address the Internet access requirements of the current business customers of long distance and local carriers, many carriers are integrating horizontally through acquisitions of or joint ventures with Internet service providers, or by wholesale purchase of Internet access from Internet service providers. In addition, many of the major cable companies and other alternative service providers, such as those companies utilizing wireless and satellite-based service technologies, have announced their plans to offer Internet access and related services. Accordingly, we may experience increased competition from traditional and emerging telecommunications providers. Many of these companies, in addition to their substantially greater network coverage, market presence, and financial, technical and personnel resources, also already provide telecommunications and other services to many of our target customers. Furthermore, they may have the ability to bundle Internet access with basic local and long distance telecommunications services, which we do not currently offer. This bundling of services may harm our ability to compete effectively with them and may result in pricing pressure on us that would reduce our earnings.

OUR GROWTH DEPENDS ON THE CONTINUED ACCEPTANCE BY OUR TARGET CUSTOMERS OF THE INTERNET FOR COMMERCE AND COMMUNICATION.

If the use of the Internet by businesses and enterprises for commerce and communication does not continue to grow, our business and results of operations will be harmed. Our products and services are designed primarily for the rapidly growing number of business users of the Internet. Commercial use of the Internet by small and medium sized enterprises is still in its early stages. Despite growing interest in the commercial uses of the Internet, many businesses have not purchased Internet access and related services for several reasons, including:

- o lack of inexpensive, high-speed connection options;
- o a limited number of reliable local access points for business users;

Edgar Filing: FASTNET CORP - Form 10-Q

- o lack of affordable electronic commerce solutions;
- o limited internal resources and technical expertise;
- o inconsistent quality of service; and
- o difficulty in integrating hardware and software related to Internet based business applications.

In addition, we believe that many Internet users lack confidence in the security of transmitting their data over the Internet, which has hindered commercial use of the Internet. Technologies that adequately address these security concerns may not be developed.

The adoption of the Internet for commerce and communication applications, particularly by those enterprises that have historically relied upon alternative means, generally requires the understanding and acceptance of a new way of conducting business and exchanging information. In particular, enterprises that have already invested substantial resources in other means of conducting commerce and exchanging information may be reluctant or slow to adopt a new strategy that may make their existing personnel and infrastructure obsolete.

23

OUR SUCCESS DEPENDS ON THE CONTINUED DEVELOPMENT OF INTERNET INFRASTRUCTURE.

The recent growth in the use of the Internet has caused periods of performance degradation, requiring the upgrade by providers and other organizations with links to the Internet of routers and switches, telecommunications links and other components forming the infrastructure of the Internet. We believe that capacity constraints caused by rapid growth in the use of the Internet may impede further development of the Internet to the extent that users experience increased delays in transmission or reception of data or transmission errors that may corrupt data. Any degradation in the performance of the Internet as a whole could impair the quality of our products and services. As a consequence, our future success will be dependent upon the reliability and continued expansion of the Internet.

WE RELY ON A LIMITED NUMBER OF VENDORS AND SERVICE PROVIDERS, SOME OF WHICH ARE OUR COMPETITORS. THIS MAY ADVERSELY AFFECT THE FUTURE TERMS OF OUR RELATIONSHIPS.

We rely on other companies to supply key components of our network infrastructure, which are available only from limited sources. For example, we currently rely on routers, switches and remote access devices from Lucent Technologies, Inc., Cisco Systems, Inc. and Nortel Networks Corporation. We could be adversely affected if any of these products were no longer available on commercially reasonable terms, or at all. From time to time, we experience delays in the delivery and installation of these products and services, which can lead to the loss of existing or potential customers. We do not know that we will be able to obtain such products in the future cost-effectively and in a timely manner. Moreover, we depend upon a limited number of companies as our primary backbone providers. These companies also sell products and services that compete with ours. Our agreements with our primary backbone providers are fixed price contracts with terms ranging from one to three years. Our backbone providers operate national or international networks that provide data and Internet connectivity and enable our customers to transmit and receive data over the Internet. Our relationship with these backbone providers could be adversely affected as a result of our direct competition with them. Failure to renew these

Edgar Filing: FASTNET CORP - Form 10-Q

relationships when they expire or enter into new relationships for such services on commercially reasonable terms or at all could harm our business, financial condition and results of operations.

WE NEED TO RECRUIT AND RETAIN QUALIFIED PERSONNEL OR OUR BUSINESS COULD BE HARMED.

Competition for highly qualified employees in the Internet service industry is intense because there are a limited number of people with an adequate knowledge of and significant experience in our industry. Our success depends largely upon our ability to attract, train and retain highly skilled management, technical, marketing and sales personnel and upon the continued contributions of such people. Since it is difficult and time consuming to identify and hire highly qualified employees, we cannot assure you of our ability to do so. Our failure to attract additional highly qualified personnel could impair our ability to grow our operations and services to our customers.

WE COULD EXPERIENCE SYSTEM FAILURES AND CAPACITY CONSTRAINTS, WHICH COULD RESULT IN THE LOSS OF OUR CUSTOMERS OR LIABILITY TO OUR CUSTOMERS.

The continued operation of our network infrastructure depends upon our ability to protect against:

- o downtime due to malfunction or failure of hardware or software;
- o overload conditions;
- o power loss or telecommunications failures;
- o human error;
- o natural disasters; and
- o sabotage or other intentional acts of vandalism.

Any of these occurrences could result in interruptions in the services we provide to our customers and require us to spend substantial amounts of money

24

repairing and replacing equipment. In addition, we have finite capacity to provide service to our customers under our current infrastructure. Because utilization of our network is constantly changing depending upon customer use at any given time, we maintain a level of capacity that we believe to be adequate to support our current customer base. If we obtain additional customers in the future, we will need to increase our capacity to maintain the quality of service that we currently provide our customers. If customer usage exceeds our capacity and we are unable to increase our capacity in a timely manner, our customers may experience interruptions in or decreases in quality of the services we provide. As a result, we may lose current customers or incur significant liability to our customers for any damages they suffer due to any system downtime as well as the possible loss of customers.

OUR NETWORK MAY EXPERIENCE SECURITY BREACHES, WHICH COULD DISRUPT OUR SERVICES.

Our network infrastructure may be vulnerable to computer viruses, break-ins and similar disruptive problems caused by our customers or other Internet users. Computer viruses, break-ins or other problems caused by third parties could lead to interruptions, delays or cessation in service to our customers. There currently is no existing technology that provides absolute security, and the cost of minimizing these security breaches could be

Edgar Filing: FASTNET CORP - Form 10-Q

prohibitively expensive. We may face liability to customers for such security breaches. Furthermore, such incidents could deter potential customers and adversely affect existing customer relationships.

WE FACE POTENTIAL LIABILITY FOR INFORMATION DISSEMINATED THROUGH OUR NETWORK.

It is possible that claims could be made against Internet service providers in connection with the nature and content of the materials disseminated through their networks. The law relating to the liability of Internet service providers due to information carried or disseminated through their networks is not completely settled. While the U.S. Supreme Court has held that content transmitted over the Internet is entitled to the highest level of protection under the U.S. Constitution, there are federal and state laws regarding the distribution of obscene, indecent, or otherwise illegal material, as well as material that violates intellectual property rights which may subject us to liability. Several private lawsuits have been brought in the past and are currently pending against other entities which seek to impose liability upon Internet service providers as a result of the nature and content of materials disseminated over the Internet. If any of these actions succeed, we might be required to respond by investing substantial resources or discontinuing some of our service or product offerings, which could harm our business.

NEW LAWS AND REGULATIONS GOVERNING OUR INDUSTRY COULD HARM OUR BUSINESS.

We are subject to a variety of risks that could materially affect our business due to the rapidly changing legal and regulatory landscape governing Internet access providers. For example, the Federal Communications Commission currently exempts Internet access providers from having to pay per-minute access charges that long-distance telecommunications providers pay local telephone companies for the use of the local telephone network. In addition, Internet access providers are currently exempt from having to pay a percentage of their gross revenues as a contribution to the federal universal service fund. Should the Federal Communications Commission eliminate these exemptions and impose such charges on Internet access providers, this would increase our costs of providing dial-up Internet access service and could have a material adverse effect on our business, financial condition and results of operations.

We face risks due to possible changes in the way our suppliers are regulated which could have an adverse effect on our business. For example, most states require local exchange carriers to pay reciprocal compensation to competing local exchange carriers for the transport and termination of Internet traffic. However, the Federal Communications Commission has concluded that at least a substantial portion of dial-up Internet traffic is jurisdictionally interstate, and has adopted plans for gradually eliminating the reciprocal compensation payment requirement for Internet traffic. If the FCC completes its planned elimination of reciprocal compensation payments, telephone carriers might no longer be entitled to receive payment from the originating carrier to terminate traffic delivered to us. The Federal Communications Commission has launched an inquiry to determine an alternative mechanism for covering the costs of terminating calls to Internet service providers. In the interim, state commissions will determine whether carriers will receive compensation for such calls. If the new compensation mechanism adopted by the Federal Communications Commission increases the costs to our telephone carriers for terminating traffic to us, or if states eliminate reciprocal compensation payments, our telephone carriers may increase the price of service to us in order to recover such costs. This could have a material adverse effect on our business, financial condition and results of operations.

Although the U.S. Supreme Court has held that content transmitted over the Internet is entitled to the highest level of protection under the U.S. Constitution, a recently-adopted Pennsylvania statute subjects Internet service providers to fines and potential imprisonment and felony charges for failing to

Edgar Filing: FASTNET CORP - Form 10-Q

25

disable access to child pornography within five days of notification by the state Attorney General's office. We could be subject to this law after it goes into effect on April 20, 2002. Although it is not possible for us to predict the outcome, it is possible that this law could be ruled unconstitutional.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

None.

(b) Reports on Form 8-K

On April 19, 2002, the Company filed a report on Form 8-K relating to the Company's acquisition of Netaxx, Inc.

26

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FASTNET Corporation:

Date: May 15, 2002

/s/ Stephen A. Hurly

Stephen A. Hurly
Chief Executive Officer

Date: May 15, 2002

/s/ Stanley F. Bielicki

Stanley F. Bielicki
Chief Financial Officer
(Principal Financial & Accounting
Officer)

27