

MCLEODUSA INC
Form 10-Q
November 14, 2002

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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 September 30, 2002

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period to .

Commission file number 0-20763

MCLEODUSA INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware
(State of Incorporation)

42-1407240
(IRS Employer Identification No.)

McLeodUSA Technology Park
6400 C Street SW
P.O. Box 3177
Cedar Rapids, Iowa
(Address of principal executive office)

52406-3177
(Zip Code)

319-364-0000

(Registrant's telephone number,
including area code)

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 such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes No

The number of shares outstanding of each class of the issuer's common stock as of November 5, 2002:

Common Stock Class A: (\$0.01 par value)	162,499,986 shares
Common Stock Class B: (\$0.01 par value)	78,203,135 shares
Common Stock Class C: (\$0.01 par value)	35,546,879 shares

MCLEODUSA INCORPORATED AND SUBSIDIARIES

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

McLEODUSA INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions, except per share data)

	Reorganized McLeodUSA September 30, 2002	Predecessor McLeodUSA December 31, 2001
	(Unaudited)	
ASSETS		
Current assets		
Cash and cash equivalents	\$ 185.0	\$ 137.1
Investment in available-for-sale securities	0.3	4.5
Trade receivables, net	97.3	150.8
Inventory	0.4	4.4
Prepaid expense and other	27.1	25.2
Assets held for sale	332.7	760.1
	<u>642.8</u>	<u>1,082.1</u>
Property and equipment		
Land and buildings	71.0	59.5
Communications networks	764.9	1,645.8
Furniture, fixtures and equipment	172.2	366.5
Networks in progress	312.1	866.6
	<u>1,320.2</u>	<u>2,938.4</u>
Less accumulated depreciation	88.1	479.4
	<u>1,232.1</u>	<u>2,459.0</u>
Investments, intangibles and other assets		
Other investments	0.4	28.1
Goodwill	244.0	949.4
Other intangibles, net	241.0	158.5
Other	25.0	78.0
	<u>510.4</u>	<u>1,214.0</u>
TOTAL ASSETS	<u>\$ 2,385.3</u>	<u>\$ 4,755.1</u>

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The accompanying notes are an integral part of these condensed consolidated financial statements.
(Continued on the next page)

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MCLEODUSA INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (CONTINUED)

(In millions, except per share data)

	Reorganized McLeodUSA September 30, 2002	Predecessor McLeodUSA December 31, 2001
	(Unaudited)	
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities		
Current maturities of long-term debt	\$ 4.8	\$ 15.7
Long-term debt classified as current		2,978.8
Accounts payable	73.3	81.5
Accrued payroll and payroll related expenses	26.5	23.1
Other accrued liabilities	154.7	357.4
Deferred revenue, current portion	12.2	13.2
Customer deposits	2.9	3.0
Liabilities related to discontinued operations	65.7	130.3
	<u>340.1</u>	<u>3,603.0</u>
Total current liabilities	340.1	3,603.0
Long-term debt less current maturities	941.9	945.5
Deferred revenue, less current portion	14.0	16.4
Other long-term liabilities	54.2	7.1
	<u>1,350.2</u>	<u>4,572.0</u>
	<u>1,350.2</u>	<u>4,572.0</u>
Redeemable convertible preferred stock		
Predecessor McLeodUSA Preferred Series D, redeemable, convertible, \$0.01 par value; 275,000 authorized, issued and outstanding at December 31, 2001		110.4
Predecessor McLeodUSA Preferred Series E, redeemable, convertible \$0.01 par value; 125,000 authorized, issued and outstanding at December 31, 2001		45.7
Reorganized McLeodUSA Preferred Series A, redeemable, convertible, \$0.01 par value; 10,000,000 authorized, issued and outstanding at September 30, 2002	169.4	
	<u>169.4</u>	<u>156.1</u>
	<u>169.4</u>	<u>156.1</u>
Stockholders' equity		
Predecessor McLeodUSA Preferred Series A, \$0.01 par value; 1,149,375 authorized, issued and outstanding at December 31, 2001		
Predecessor McLeodUSA Common, Class A \$0.01 par value; 2,000,000,000 authorized, 627,739,907 issued and outstanding at December 31, 2001		6.3

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	Reorganized McLeodUSA September 30, 2002	Predecessor McLeodUSA December 31, 2001
Reorganized McLeodUSA Common, Class A \$0.01 par value; 1,886,249,986 authorized, 162,499,986 issued and outstanding at September 30, 2002	1.6	
Reorganized McLeodUSA Common, Class B \$0.01 par value; 78,203,135 authorized, issued and outstanding at September 30, 2002	0.8	
Reorganized McLeodUSA Common, Class C \$0.01 par value; 35,546,879 authorized, issued and outstanding at September 30, 2002	0.3	
Reorganized McLeodUSA Preferred Series B, \$0.01 par value; 10 authorized, issued and outstanding at September 30, 2002		
Reorganized McLeodUSA Warrants	22.6	
Additional paid-in capital	953.1	3,843.4
Accumulated deficit	(112.7)	(3,821.6)
Accumulated other comprehensive income		(1.1)
	865.7	27.0
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 2,385.3	\$ 4,755.1

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

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MCLEODUSA INCORPORATED AND SUBSIDIARIES

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)**

(In millions, except per share data)

	Reorganized McLeodUSA	Predecessor McLeodUSA
	Three months ended September 30, 2002	Three months ended September 30, 2001
Revenues:		
Competitive telecommunications	\$ 243.5	\$ 315.9
Other		3.4
Total revenue	243.5	319.3
Operating expenses:		
Cost of service (exclusive of depreciation shown separately below)	154.1	217.1
Selling, general and administrative	79.1	139.8
Depreciation and amortization	75.7	146.8
Restructuring, asset impairment and other charges		2,907.2

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		Predecessor McLeodUSA
Total operating expenses	308.9	3,410.9
Operating loss	(65.4)	(3,091.6)
Nonoperating income (expense):		
Interest income	0.2	0.8
Interest expense, net of amounts capitalized	(10.9)	(65.7)
Other income (expense)	(1.5)	35.5
Total nonoperating income (expense)	(12.2)	(29.4)
Loss before discontinued operations	(77.6)	(3,121.0)
Discontinued operations:		
Income from discontinued operations (Note 5) (including loss on disposals of \$2.9 for 2002)	10.2	12.6
Net loss	(67.4)	(3,108.4)
Gain on exchange of preferred stock		851.2
Preferred stock dividend	(1.2)	(4.8)
Net loss applicable to common shares	\$ (68.6)	\$ (2,262.0)
Basic and diluted income (loss) per common share:		
Loss before discontinued operations	\$ (0.29)	\$ (3.64)
Discontinued operations	0.04	0.02
Loss per common share	\$ (0.25)	\$ (3.62)
Weighted average common shares outstanding	276.3	625.5
Other comprehensive loss, net of tax:		
Unrealized holding losses arising during the period	\$	\$ (3.8)
Less: reclassification adjustment for gains included in net income		10.5
Total other comprehensive loss		(14.3)
Comprehensive loss	\$ (67.4)	\$ (3,122.7)

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

MCLEODUSA INCORPORATED AND SUBSIDIARIES

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)**

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(In millions, except per share data)

	Reorganized McLeodUSA	Predecessor McLeodUSA	Predecessor McLeodUSA
	April 17, 2002 to September 30, 2002	January 1, 2002 to April 16, 2002	Nine months ended September 30, 2001
Revenues:			
Competitive telecommunications	\$ 450.7	\$ 311.4	\$ 945.3
Other			10.1
Total revenue	450.7	311.4	955.4
Operating expenses:			
Cost of service (exclusive of depreciation shown separately below)	273.5	211.2	626.4
Selling, general and administrative	158.6	108.9	371.8
Depreciation and amortization	135.2	126.3	411.2
Reorganization charges, net		1,596.8	
Restructuring, asset impairment and other charges (adjustment)		(6.8)	2,935.4
Total operating expenses	567.3	2,036.4	4,344.8
Operating loss	(116.6)	(1,725.0)	(3,389.4)
Nonoperating income (expense):			
Interest income	0.5	0.4	9.5
Interest expense, net of amounts capitalized	(19.4)	(33.6)	(179.3)
Other income (expense)	(0.4)	2.0	112.6
Gain on the cancellation of debt		2,372.8	
Total nonoperating income (expense)	(19.3)	2,341.6	(57.2)
Income (loss) before discontinued operations	(135.9)	616.6	(3,446.6)
Discontinued operations (Note 5):			
Income from discontinued operations (including net gains (losses) on disposals of \$145.4 and (\$2.9) for the periods January 1, to April 16 and April 17 to September 30, 2002, respectively)	23.2	167.1	33.4
Net income (loss)	(112.7)	783.7	(3,413.2)
Gain on exchange of preferred stock			851.2
Preferred stock dividend	(2.3)	(4.8)	(32.0)
Net income (loss) applicable to common shares	\$ (115.0)	\$ 778.9	\$ (2,594.0)
Basic and diluted income (loss) per common share:			
Income (loss) before discontinued operations	\$ (0.50)	\$ 0.97	\$ (4.25)
Discontinued operations	0.08	0.27	0.05

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	Reorganized McLeodUSA	Predecessor McLeodUSA	Predecessor McLeodUSA
Income (loss) per common share	\$ (0.42)	\$ 1.24	\$ (4.20)
Weighted average common shares outstanding	276.3	627.7	617.8
Other comprehensive income (loss), net of tax:			
Unrealized holding gains arising during the period	\$	\$ (2.1)	\$ (5.6)
Less: reclassification adjustment for gains (losses) included in net income		3.2	23.8
Total other comprehensive income		1.1	18.2
Comprehensive income (loss)	\$ (112.7)	\$ 784.8	\$ (3,395.0)

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

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MCLEODUSA INCORPORATED AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

	Reorganized McLeodUSA	Predecessor McLeodUSA	Predecessor McLeodUSA
	April 17, 2002 to September 30, 2002	January 1, 2002 to April 16, 2002	Nine Months Ended September 30, 2001
Cash Flows from Operating Activities			
Net income (loss) before discontinued operations	\$ (135.9)	\$ 616.6	\$ (3,446.6)
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Depreciation	106.7	108.6	242.2
Amortization	28.5	17.7	169.0
Accretion of interest		4.1	36.1
Loss (gain) on sale of assets	2.5	(6.4)	(121.7)
Non cash reorganization items		1,538.4	
Gain on the cancellation of debt		(2,372.8)	
Restructuring, asset impairment, and other charges (adjustment)		(6.8)	2,926.8
Changes in assets and liabilities, net of acquisitions and dispositions:			
Trade receivables	38.7	14.3	(12.2)
Inventory	0.1	0.9	8.1
Deferred expenses	(0.5)		(0.1)
Prepaid expenses and other	(9.9)	9.3	9.1
Accounts payable and accrued expenses	(25.6)	(43.4)	(245.4)

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	Reorganized McLeodUSA	Predecessor McLeodUSA	Predecessor McLeodUSA
Deferred revenue	(6.1)	1.1	(12.9)
Customer deposits	0.1	0.1	(18.7)
Net cash used in operating activities	(1.4)	(118.3)	(466.3)
Cash Flows from Investing Activities			
Purchases of property and equipment	(38.6)	(37.2)	(553.2)
Other assets	(27.2)	(16.5)	(47.6)
Available for sale securities:			
Purchases			(69.6)
Sales		2.0	129.4
Proceeds from the sale of assets	8.1	19.1	132.8
Proceeds from the sale of businesses	100.0	679.7	
Other	(0.4)		(2.7)
Net cash provided by (used in) investing activities	41.9	647.1	(410.9)
Cash Flows from Financing Activities			
Net proceeds from long-term debt			909.3
Payments on long-term debt	(4.1)	(734.3)	(5.6)
Net proceeds from the issuance of common stock			34.7
Investment by Forstmann Little		175.0	
Payments of preferred stock dividends			(26.3)
Net cash (used in) provided by financing activities	(4.1)	(559.3)	912.1
Net increase (decrease) in cash and cash equivalents from continuing operations	36.4	(30.5)	34.9
Net cash provided by discontinued operations	10.4	31.6	12.8
Cash and cash equivalents			
Beginning	138.2	137.1	15.7
Ending	\$ 185.0	\$ 138.2	\$ 63.4
Supplemental Disclosure of Cash Flow Information:			
Cash payments for interest	\$ 27.4	\$ 16.2	\$ 215.3
Supplemental Schedule of Noncash Investing and Financing Activities			
Capital leases incurred for the acquisition of property and equipment	\$	\$	\$ 9.8
Preferred stock dividends	\$ 2.3	\$ 4.8	\$ 32.0
Gain on exchange of preferred stock	\$	\$	\$ 815.2

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

MCLEODUSA INCORPORATED AND SUBSIDIARIES**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Information as of and for the three and nine months ended September 30, 2002 is unaudited.)****Note 1: Basis of Presentation**

McLeodUSA Incorporated ("McLeodUSA"), a Delaware corporation, through its subsidiaries, provides competitive telecommunications services, including local services, primarily in 25 Midwest, Southwest, Northwest and Rocky Mountain states. McLeodUSA's business is highly competitive and is subject to various federal, state and local regulations. On January 31, 2002, McLeodUSA Incorporated, the parent company, filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court"). On April 16, 2002, McLeodUSA Incorporated emerged from the Bankruptcy Court proceedings pursuant to the terms of its amended plan of reorganization (the "Plan"). The Plan was filed with the Bankruptcy Court on February 28, 2002 and was confirmed on April 5, 2002.

During the period from January 31, 2002 to April 16, 2002, McLeodUSA operated as a debtor-in-possession. The unaudited condensed consolidated financial statements during the period from January 31, 2002 to April 16, 2002, the effective date of the plan ("effective date"), have been prepared in accordance with the provisions of Statement of Position 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code" ("SOP 90-7"). McLeodUSA adopted the provisions SOP 90-7 upon commencement of the Bankruptcy Court proceedings. The condensed consolidated statements of operations for the period January 1, 2002 to April 16, 2002 separately discloses expenses related to the Chapter 11 proceedings as reorganization charges. Interest expense on all of the outstanding senior notes and the preferred stock dividends on the Series A Preferred Stock ceased to accrue after filing by McLeodUSA on January 31, 2002. Interest and dividends ceased by operation of law. See Note 3 for further discussion of the emergence from bankruptcy.

Upon emergence from bankruptcy, McLeodUSA implemented fresh-start reporting under the provisions of SOP 90-7. Under SOP 90-7, the reorganization fair value of McLeodUSA was allocated to its assets and liabilities, its accumulated deficit was eliminated, and its new equity was issued according to the Plan as if it were a new reporting entity. McLeodUSA recorded a \$1.5 billion reorganization charge to adjust the historical carrying value of its assets and liabilities to fair market value reflecting the allocation of McLeodUSA's \$1.15 billion estimated reorganized equity value as of April 16, 2002. McLeodUSA also recorded a \$2.4 billion gain on the cancellation of debt on April 16, 2002, pursuant to the Plan.

As a consequence of the reorganization occurring as of April 16, 2002, the financial results have been separately presented under the label "Predecessor McLeodUSA" for the period January 1, 2002 to April 16, 2002 and "Reorganized McLeodUSA" for the period April 17, 2002 to September 30, 2002.

Interim Financial Information (unaudited): In the opinion of management, the accompanying unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the financial position and results of operations of McLeodUSA. The operating results for the interim periods are not necessarily indicative of the operating results to be expected for a full year or for other interim periods. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted pursuant to instructions, rules and regulations prescribed by the Securities and Exchange Commission ("SEC"). Although management believes that the disclosures provided are adequate to make the information presented not misleading, management recommends that you read these condensed consolidated financial statements in conjunction with the audited consolidated financial statements and the related footnotes included in the McLeodUSA Annual Report on Form 10-K/A for the fiscal year ended December 31, 2001, filed with the SEC on April 19, 2002.

For the three and nine months ended September 30, 2001, and the periods January 1, 2002 to April 16, 2002, April 17, 2002 to September 30, 2002, and the three months ended September 30, 2002, the operating results of businesses held for sale have been reported as discontinued operations in the McLeodUSA Condensed Consolidated Statements of Operations in accordance with Statement of

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Financial Accounting Standards ("SFAS") No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"). Assets held for sale and liabilities related to discontinued operations have been presented separately in the asset and liabilities sections of the condensed consolidated balance sheets.

Prior to the sale of McLeodUSA Media Group, Inc. and its subsidiaries (collectively, "Pubco") on April 16, 2002, McLeodUSA operated predominantly in two reportable segments, Competitive Telecommunications and Directory. Pubco comprised the sole operations of the Directory segment. Accordingly, McLeodUSA now operates in one reportable operating segment, Competitive Telecommunications, and is no longer required to disclose segment information.

Certain prior period amounts have been reclassified to the current year presentation.

Note 2: SFAS 144, Re-Audit Requirement and Officer Certifications

In connection with its reorganization, McLeodUSA completed the sale of certain businesses, including its directory publishing business ("Pubco"), and has entered into an agreement to sell Illinois Consolidated Telephone Company and associated businesses ("ICTC"). In this Quarterly Report on Form 10-Q, based on the requirements of SFAS 144, McLeodUSA is reflecting these businesses and other businesses that were sold or held for sale as discontinued operations. In accordance with GAAP, McLeodUSA is required to present its financial statements for the years ended December 31, 2000 and 2001, and each quarter, reflecting these businesses as discontinued operations. McLeodUSA's former auditors, Arthur Andersen LLP ("Arthur Andersen"), audited McLeodUSA's financial statements for the years ended December 31, 2000 and 2001. Since Arthur Andersen is no longer able to perform audits of publicly traded companies, in order to comply with GAAP requirements related to the financial presentation for discontinued operations, the Securities and Exchange Commission ("SEC") will, in effect, require McLeodUSA's new auditor, Deloitte & Touche LLP ("Deloitte & Touche"), to re-audit McLeodUSA's financial statements for the years ending December 31, 2000 and 2001 to provide McLeodUSA with an audit opinion on such financial statements.

While McLeodUSA believes its financial statements for these years, as audited by Arthur Andersen, complied with GAAP in all material respects when such statements were filed with the SEC, its Chief Executive Officer and Chief Financial Officer have been unable to make certifications required by the SEC with respect to any financial information for the years ended December 31, 2001 and 2000, or any portion thereof, because McLeodUSA anticipates that the results of the Deloitte & Touche audit will differ from the prior audit by Arthur Andersen. Deloitte & Touche has informed McLeodUSA that they have a different interpretation than Arthur Andersen with respect to accounting standards applicable to revenue recognition on certain Indefeasible Rights of Use ("IRU") transactions completed by McLeodUSA during 2001. Deloitte & Touche's interpretation would result in a change in classification of such IRU transactions from sales-type leases to operating leases. Deloitte & Touche has also advised McLeodUSA that the SEC has expressed a position on accounting treatment for IRU exchanges that will be applied retroactively and which differs from previously accepted accounting practices. This pronouncement would apply to one IRU contract for which McLeodUSA recorded revenue in 2001. As a result, the Deloitte & Touche re-audit process as it relates to these identified IRU transactions would likely result in a reduction in 2001 total revenue and gross margin of approximately \$65 million and \$20 million, respectively. These adjustments for the nine months ended September 30, 2001 would be a reduction of approximately \$55 million in revenue and \$19 million in gross margin. Such adjustment would also result in an annual increase in revenue and gross margin of approximately \$3 million in 2002 and going forward through the term of these multi-year agreements. Other adjustments, if any, which could be required as a result of the Deloitte & Touche re-audit, are unknown at this time.

In light of McLeodUSA's reorganization, sale of businesses, and implementation of fresh-start accounting on April 16, 2002, McLeodUSA believes that the expense and effort associated with a re-audit may not be in the best interest of McLeodUSA or its stockholders as it would result in

financial statements that are not comparable to the on-going operations of reorganized McLeodUSA. Therefore, McLeodUSA is considering seeking a waiver of this requirement from the SEC. If required, the Deloitte & Touche re-audits for 2000 and 2001 would be expected to be completed during 2003.

Note 3: Emergence from Chapter 11 Proceedings

Confirmation of the Plan: On April 5, 2002, the Bankruptcy Court confirmed the Plan. The general unsecured creditors of McLeodUSA, except for the holders of all of its outstanding notes (including its 10¹/₂% Senior Discount Notes, 9¹/₄% Senior Notes, 8³/₈% Senior Notes, 9¹/₂% Senior Notes, 8¹/₈% Senior Notes, 12% Senior Notes, 11¹/₂% Senior Notes and 11³/₈% Senior Notes (collectively, the "Notes")), were unaffected by the Chapter 11 proceedings and the Plan. The Plan became effective on April 16, 2002 and resulted in the following:

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The elimination of approximately \$3 billion of indebtedness, including accrued interest, represented by the Notes;

In exchange for the cancellation of the Notes and the unpaid interest thereon, the bondholders received their pro rata share of (1) \$670 million in cash, (2) 10,000,000 shares of Series A Preferred Stock, which is convertible into 15% of Class A Common Stock on a fully diluted basis as of the effective date of the Plan after giving effect to the Plan and conversion of the Class B Common Stock and Class C Common Stock (but prior to the exercise of the warrants) and (3) 5-year warrants to purchase 22,159,091 shares of Reorganized McLeodUSA Class A Common Stock for \$30 million;

The sale of Pubco to Yell Group Ltd. for \$600 million;

Forstmann Little invested \$175 million in exchange for (1) 74,027,764 shares of Reorganized McLeodUSA Class A Common Stock, (2) 5-year warrants to purchase 22,159,091 shares of Reorganized McLeodUSA Class A Common Stock for \$30 million and (3) 10 shares of Reorganized McLeodUSA Series B Preferred Stock;

The conversion of Predecessor McLeodUSA Series D Preferred Stock and Predecessor McLeodUSA Series E Preferred Stock, held by Forstmann Little, into 78,203,135 shares of Reorganized McLeodUSA Class B Common Stock and 35,546,879 shares of Reorganized McLeodUSA Class C Common Stock, respectively; and

The conversion of the Predecessor McLeodUSA Series A Preferred Stock into 33,696,559 shares of Reorganized McLeodUSA Class A Common Stock.

The Plan also provided for the distribution of a portion of Reorganized McLeodUSA common stock to holders of Predecessor McLeodUSA common stock. These holders were entitled to share, together with holders of certain securities claims, in the distribution of 54,775,663 shares of Reorganized McLeodUSA Class A Common Stock. On May 2, 2002, the Bankruptcy Court entered an order establishing a disputed claims reserve at 18,000,000 shares of Reorganized McLeodUSA Class A Common Stock pending resolution of the securities claims against McLeodUSA associated with the putative securities class action lawsuits. McLeodUSA then commenced the distribution of 36,775,663 shares of Reorganized McLeodUSA Class A Common Stock to record holders of Predecessor McLeodUSA common stock as of April 5, 2002, the distribution record date under the Plan. Upon the final determination of the amount, if any, of allowed securities claims under the Plan, such holders of Predecessor McLeodUSA common stock may be entitled to additional distributions of Reorganized McLeodUSA Class A Common Stock from the 18,000,000 shares held in the disputed claims reserve.

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The condensed financial information for the parent company, McLeodUSA Incorporated, for the period January 1, 2002 to April 16, 2002 is as follows (in millions):

Condensed Statement of Operations (Unaudited)

	Predecessor McLeodUSA
	January 1, 2002 to April 16, 2002
Operating expenses:	
Selling, general and administrative	\$ 8.7
Depreciation and amortization	5.1
Reorganization charges, net	1,596.8
Restructuring charge (adjustment)	(6.8)
Total operating expenses	1,603.8

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	Predecessor McLeodUSA

Other operating income (expense):	
Interest income	0.3
Interest expense, net of amounts capitalized	(33.3)
Gain on cancellation of debt	2,372.8
Other income	0.4
Equity in net losses of subsidiaries	(119.8)

Total other operating income	2,220.4

Income before discontinued operations	616.6
Income from discontinued operations	167.1

Net income	783.7
Preferred stock dividend	(4.8)

Net income applicable to common shares	\$ 778.9

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Contractual interest was \$93.6 million for the period January 1, 2002 to April 16, 2002. Contractual dividends were \$8.9 million for the period January 1, 2002 to April 16, 2002.

**Condensed Statement of Cash Flows
(Unaudited)**

	Predecessor McLeodUSA

	January 1, 2002 to April 16, 2002

Cash Flows from Operating Activities	
Net income before discontinued operations	\$ 616.6
Adjustments to reconcile net income to cash used in operating activities:	
Depreciation and amortization	5.1
Accretion of interest on senior discount notes	4.1
Noncash reorganization items	1,538.4
Gain on cancellation of debt	(2,372.8)
Restructuring charge (adjustment)	(6.8)
Gain on the sale of assets	(0.4)
Equity in net losses of subsidiaries	119.8
Changes in assets and liabilities, net of dispositions:	
Prepaid and other assets	6.5
Accounts payable and accrued expenses	8.3
Intercompany receivables	(74.7)

Net cash used in operating activities	(155.9)

	Predecessor McLeodUSA

Cash Flows from Investing Activities	
Purchases of property and equipment	(0.6)
Proceeds from the sale of businesses and assets	680.9

Net cash provided by investing activities	680.3
Cash Flows from Financing Activities	
Proceeds from Forstmann Little investment	175.0
Payments on long-term debt	(730.0)

Net cash used in financing activities	(555.0)
Net decrease in cash and cash equivalents from continuing operations	(30.6)
Net cash provided by discontinued operations	31.6
Cash and cash equivalents:	
Beginning	120.2

Ending	\$ 121.2

Reorganization charges, net: Reorganization charges, net, are comprised of items incurred by McLeodUSA as a result of reorganization under Chapter 11 of the Bankruptcy Code. Charges for the period January 1, 2002 to April 16, 2002 consisted of the following (in millions):

	Predecessor McLeodUSA

	January 1, 2002 to April 16, 2002

Professional fees	\$ 57.5
Severance	0.9
Write-off of deferred financing fees and discounts	53.3
Fresh-start adjustments to fair value	1,485.1

	\$ 1,596.8

Note 4: Fresh-start Accounting

As discussed in Note 1, McLeodUSA adopted the provisions of fresh-start accounting as of April 16, 2002. Independent financial advisors were engaged to assist in the determination of the reorganization equity value or fair value of Reorganized McLeodUSA. The independent financial advisors determined the estimated reorganization equity value of McLeodUSA to be \$1.15 billion. The estimate was based on McLeodUSA's operating profit, cash flow and certain other items for the years 2002 through 2005. The estimate was based on a number of various assumptions regarding the anticipated future performance of McLeodUSA, industry performance, general business and economic conditions and other matters. The assumptions underlying the valuation are described in more detail in the disclosure statement sent to security holders entitled to vote on the Plan and attached as an exhibit to the McLeodUSA Current Report on Form 8-K filed on March 5, 2002 and also in the McLeodUSA Current Report on Form 8-K filed on April 22, 2002.

SOP 90-7 requires an allocation of the reorganization equity value in conformity with procedures specified by APB 16, "Business Combinations," as amended by SFAS 141, "Business Combinations," for transactions reported on the basis of the purchase method. In applying

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SOP 90-7, McLeodUSA had the value of its noncurrent and intangible assets appraised. The fresh-start adjustments were based on the preliminary allocation of the reorganization equity value to the noncurrent and intangible assets. An adjustment was made to the preliminary allocation in the third quarter of 2002 related to entities held for sale. The adjustment impacted inventory, property and equipment, accrued payroll and payroll related expenses, and other accrued liabilities. A reconciliation of the adjustments recorded in connection with

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the debt restructuring, the adoption of fresh-start accounting, and the accounting for discontinued operations at April 16, 2002, including the third quarter adjustments, is presented below (in millions):

	Predecessor McLeodUSA April 16, 2002	Debt Restructuring	Fresh-start Adjustments(g)	Discontinued Operations(h)	Reorganized McLeodUSA April 16, 2002
	(Unaudited)				
Assets					
Current assets					
Cash and cash equivalents	\$ 696.1	\$ (555.0)(a)(e)(f)		\$ (2.9)	\$ 138.2
Investment in available-for-sale securities	0.6				0.6
Trade receivables, net	153.8			(17.6)	136.2
Inventory	14.7			(8.1)	6.6
Prepaid expense and other	18.4			(2.8)	15.6
Assets held for sale				440.5	440.5
	<u>883.6</u>	<u>(555.0)</u>		<u>409.1</u>	<u>737.7</u>
Property and Equipment					
Land and buildings	91.1		30.8	(47.8)	74.1
Communications networks	2,019.1		(1,046.5)	(292.3)	680.3
Furniture, fixtures and equipment	412.0		(184.9)	(57.9)	169.2
Networks in progress	715.1		(348.9)	(3.8)	362.4
	<u>3,237.3</u>		<u>(1,549.5)</u>	<u>(401.8)</u>	<u>1,286.0</u>
Less accumulated depreciation	(716.7)		506.6	210.1	
	<u>2,520.6</u>		<u>(1,042.9)</u>	<u>(191.7)</u>	<u>1,286.0</u>
Investments, intangibles and other assets					
Other investments	22.1		(20.5)	(1.3)	0.3
Goodwill	939.0		(502.9)	(192.1)	244.0
Other intangibles, net	168.8		93.9	(11.2)	251.5
Other	29.4		(4.9)		24.5
	<u>1,159.3</u>		<u>(434.4)</u>	<u>(204.6)</u>	<u>520.3</u>
	<u>\$ 4,563.5</u>	<u>\$ (555.0)</u>	<u>\$ (1,477.3)</u>	<u>\$ 12.8</u>	<u>\$ 2,544.0</u>
Liabilities and Stockholders' Equity					
Current liabilities					
Current maturities of long-term debt	\$ 7.4			\$ (0.3)	\$ 7.1
Accounts payable	83.5			(5.4)	78.1

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	Predecessor McLeodUSA April 16, 2002	Debt Restructuring	Fresh-start Adjustments(g)	Discontinued Operations(h)	Reorganized McLeodUSA April 16, 2002
Accrued payroll and payroll related expenses	31.4			(2.9)	28.5
Other accrued liabilities	185.6			(12.5)	173.1
Deferred revenue, current portion	18.2			(3.0)	15.2
Customer deposits	3.3			(0.4)	2.9
Liabilities related to discontinued operations			7.8	67.9	75.7
Total current liabilities	329.4		7.8	43.4	380.6
Liabilities subject to compromise	3,051.8	(3,051.8)(a)(b)			
Long-term debt less current maturities	1,024.6	(60.0)(f)		(20.8)	943.8
Deferred revenue, less current portion	15.8				15.8
Other long-term liabilities	63.6			(9.8)	53.8
	4,485.2	(3,111.8)	7.8	12.8	1,394.0
Redeemable convertible preferred stock					
Reorganized McLeodUSA Preferred Series A		169.1(a)			169.1
Predecessor McLeodUSA Preferred Series D	112.7	(112.7)(c)			
Predecessor McLeodUSA Preferred Series E	46.6	(46.6)(c)			
	159.3	9.8			169.1
Stockholders' equity					
Predecessor McLeodUSA Preferred Series A		(b)			
Predecessor McLeodUSA Common, Class A	6.3	(6.3)(d)			
Reorganized McLeodUSA Common, Class A		1.6(b)(d)(e)			1.6
Reorganized McLeodUSA Common, Class B		0.8(c)			0.8
Reorganized McLeodUSA Common, Class C		0.3(c)			0.3
Reorganized Preferred Series B		(e)			
Reorganized McLeodUSA Warrants		22.6(a)(e)			22.6
Additional paid-in capital	3,843.2	155.2(b)(c)	(3,042.8)		955.6
Accumulated deficit	(3,930.5)	2,372.8(a)	1,557.7		
	(81.0)	2,547.0	(1,485.1)		980.9
	\$ 4,563.5	\$ (555.0)	\$ (1,477.3)	\$ 12.8	\$ 2,544.0

- (a) To record the discharge of indebtedness, including accrued interest, in accordance with the Plan (\$3,042.9 million), the payment to the holders of the Notes (\$670 million), the fair market value of the warrants (\$11.3 million) and Reorganized McLeodUSA Series A Preferred Stock issued (\$169.1 million) to holders of the Notes.
- (b) To record the conversion of the Predecessor McLeodUSA Series A Preferred Stock, and the accrued dividends thereon (\$8.9 million) to Reorganized McLeodUSA Class A Common Stock.
- (c) To record the conversion of the Redeemable Convertible Series D and E Preferred Stock to 78,203,135 shares of Class B Common Stock and 35,546,879 shares of Class C Common Stock of Reorganized McLeodUSA, respectively.

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- (d) To eliminate Predecessor McLeodUSA Class A Common Stock and record the issuance of Reorganized McLeodUSA Class A Common Stock.
- (e) To record the investment by Forstmann Little (\$175 million), the issuance of 74,027,764 shares of Class A Common Stock of Reorganized McLeodUSA, the fair market value of the warrants issued (\$11.3 million) and the issuance of 10 shares of Reorganized McLeodUSA Series B Preferred Stock.
- (f) To record the prepayment on the term loans (\$60 million) under McLeodUSA's Credit Agreement dated May 31, 2000 (the "Credit Agreement") as required by the Third Amendment to the Credit Agreement dated November 29, 2001 (the "Third Amendment").

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- (g) To adjust the carrying value of assets and liabilities to fair market value.
- (h) To record the assets held for sale in accordance with SFAS 144.

Note 5: Assets Held For Sale

In August 2001, McLeodUSA initiated a broad strategic and operational restructuring to re-focus its business on its core areas of expertise within its 25-state footprint, improve business discipline and processes and reduce its cost structure, all with the goal of eventually developing positive cash flow from operations. A key element of this operational restructuring included selling certain non-core assets, including McLeodUSA Telecom Development, Inc. and McLeodUSA Community Telephone, Inc. (collectively "DTG"), Greene County Partners, Inc., Caprock Services Corp., and McLeodUSA Integrated Business Systems, Inc. ("IBS").

Also in 2001, McLeodUSA initiated a financial restructuring to substantially reduce its outstanding debt. As part of the financial restructuring, McLeodUSA and its senior secured lenders agreed to amend McLeodUSA's Credit Agreement to permit the financial restructuring. The key elements of the financial restructuring included, among other things (1) the sale of Pubco and the use of the proceeds therefrom to make a payment to the holders of the Notes and (2) the sale of McLeodUSA's Illinois independent local exchange carrier and related businesses ("ICTC") upon completion of the restructuring and use of the first \$225 million of net proceeds to prepay the term loans under the Credit Agreement.

For the three and nine months ended September 30, 2001, the three months ended September 30, 2002 and the periods January 1, 2002 to April 16, 2002 and April 17, 2002 to September 30, 2002, the operating results of the businesses listed below have been reported as discontinued operations in the McLeodUSA Condensed Consolidated Financial Statements in accordance with SFAS 144. Assets held for sale and liabilities related to discontinued operations have been presented separately in the assets and liabilities sections of the condensed consolidated balance sheets. The assets held for sale are recorded at fair market value based on the contract value. The liabilities related to discontinued operations represent the liabilities of the discontinued operations as well as the estimated costs to sell.

ICTC: On July 17, 2002, McLeodUSA announced an agreement to sell ICTC, its central Illinois-based independent local exchange carrier, as well as certain related telecommunications businesses to Homebase Acquisition Corp. for \$271 million, reduced by the amount of ICTC debt outstanding at closing of approximately \$20 million. The transaction received early termination under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended. The transaction is subject to Illinois Commerce Commission and FCC approval and certain other customary closing conditions, including completion of senior debt financing by the acquirer. Subject to receipt of all required approvals, the closing is anticipated to occur during the fourth quarter of 2002. There can be no assurance, however, as to the timing of such approvals.

DTG: On September 30, 2002, McLeodUSA completed the sale of its non-core operations in South Dakota and certain non-core overbuild CLEC and cable television operations in South Dakota, southwestern Minnesota and northwestern Iowa to Prairie Wave Communications, Inc. for approximately \$84 million. McLeodUSA recorded a loss of \$2.2 million in connection with the sale.

Greene County Partners, Inc.: On August 20, 2002, McLeodUSA completed the sale of its non-core cable service provider for \$16 million in cash and a note receivable of \$3 million. The sale of Greene County Partners, Inc., resulted in a loss of \$0.5 million.

Pubco: On April 16, 2002, McLeodUSA completed the sale of Pubco to Yell Group Limited for \$600 million in cash. In connection with the transaction, McLeodUSA entered into a multi-year Publishing, Branding and Operating Agreement with Yellow Book, a subsidiary of Yell

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Group, which, among other things, provides for the continued publishing of telephone directories under the McLeodUSA brand. The proceeds received from the sale were used to pay the holders of the Notes. The sale of Pubco resulted in a gain of \$139.9 million and is recorded within discontinued operations in the condensed consolidated statements of operations.

Caprock Services Corp.: On April 8, 2002, McLeodUSA sold its indirect, wholly-owned subsidiary IWL Communications, Incorporated d/b/a CapRock Services Corp., for \$21 million in cash. McLeodUSA recorded a gain on the sale of CapRock Services Corp. of \$7.6 million.

IBS: On January 24, 2002, IBS, an indirect wholly-owned subsidiary of McLeodUSA, sold certain of the assets used in its telecommunications customer premise equipment business in the metropolitan areas of Minneapolis, Minnesota; Cedar Rapids, Des Moines, Dubuque and Waterloo, Iowa; and Denver, Colorado, as well as the data provider business conducted by IBS under the name "DataNet," to Inter-Tel Technologies, Inc. for \$8 million plus the assumption of

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certain liabilities. The sale excluded the telecommunications customer premise equipment business conducted in Illinois and resulted in a loss of \$2.3 million.

The carrying amounts of the major classes of assets held for sale and liabilities related to discontinued operations as of September 30, 2002 and December 31, 2001 were as follows (in millions):

	September 30, 2002 ICTC
Assets held for sale:	
Current assets	\$ 16.6
Property and equipment, net	103.1
Intangible assets	201.4
Other noncurrent assets	0.4
	\$ 321.5*
Liabilities related to discontinued operations:	
Current liabilities	\$ 36.3
Long-term debt	20.6
Other long-term liabilities	8.8
	\$ 65.7

* McLeodUSA has recorded assets held for sale in addition to the businesses above totaling \$11.2 million. The \$11.2 million is comprised of real estate (\$10.2 million) and an equity interest in a partnership (\$1.0 million).

December 31, 2001

IBS

CapRock