MCLEODUSA INC
Form 10-K
March 15, 2004

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2003 **Commission File Number: 0-20763**

McLeodUSA Incorporated

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**42-1407240** (I.R.S. Employer Identification No.)
McLeodUSA Technology Park **6400 C Street SW, P.O. Box 3177** **Cedar Rapids, IA** (Address of principal executive offices)	**52406 3177** (Zip Code)

Registrant's telephone number, including area code: **(319) 364-0000**

Securities registered pursuant to Section 12(g) of the Act:

Class A common stock, par value $0.01 per share
2.5% Series A convertible preferred stock, par value $0.01 per share
(Title of Classes)

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 and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ý

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ý No o

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2003, based upon the closing price of the registrant's common stock on June 30, 2003 is $130,303,547.43.[*/]

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 ý No o

The number of shares outstanding of each of the registrant's classes of common stock, as of March 1, 2004, is:

Class A common stock, par value $0.01 per share: 178,202,252 shares

Class B common stock, par value $0.01 per share: 78,203,135 shares

Class C common stock, par value $0.01 per share: 35,546,879 shares

*/ Solely for the purposes of this calculation, all directors and executive officers of the registrant and all stockholders beneficially owning more than 5% of the registrant's common stock that have representation on the registrant's Board of Directors are considered to be affiliates.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement for the Annual Meeting of Stockholders to be held on May 21, 2004 are incorporated by reference into Part III of this Form 10-K to the extent described therein.

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Information Regarding Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for certain forward-looking statements. Some of the statements contained in this Form 10-K discuss future expectations, contain projections of results of operations or financial condition or state other forward-looking information. These statements are subject to known and unknown risks, uncertainties and other factors that could cause the actual events to differ materially from those contemplated by the statements. The forward-looking information is based on various factors and was derived using numerous assumptions. In some cases, you can identify these so-called "forward-looking statements" by our use of words such as "may," "will," "should," "expect," "plan," "anticipate," "believe," "estimate," "predict," "project," "intend" or "potential" or the negative of those words and other comparable words. You should be aware that those statements reflect only our current views with respect to such matters. Actual events or results may differ substantially. Important factors that could cause actual events or results to be materially different from the forward-looking statements include those discussed under the heading "Business Risk Factors" and throughout this Form 10-K. Except as required under the Federal securities laws and rules and regulations of the SEC, we undertake no obligation to publicly update or revise any forward-looking statements in connection with new or future events or otherwise.

PART I

ITEM 1. BUSINESS.

Overview

McLeodUSA Incorporated (together with its subsidiaries, referred to hereafter as "McLeodUSA," the "Company," "we," "us" or "our") is one of the nation's largest independent competitive telecommunications services providers, offering integrated communications services to homes and businesses in 25 Midwest, Southwest, Northwest, and Rocky Mountain states. Our principal executive offices are located at 6400 C Street SW, Cedar Rapids, Iowa 52406-3177, and our main phone number is (319) 364-0000.

McLeodUSA was founded in 1992 and completed an initial public offering in June 1996. Our Class A Common Stock is currently traded on the NASDAQ SmallCap Market under the symbol "MCLD," and our Series A Preferred Stock is traded on the NASDAQ SmallCap Market under the symbol "MCLDO." In April 2002, we completed a Chapter 11 reorganization pursuant to a plan of reorganization, as more fully discussed below under "Business Chapter 11 Reorganization."

We are a facilities-based telecommunications services provider with, as of December 31, 2003, 38 Asynchronous Transfer Mode switches, 44 voice switches, 663 collocations, 435 Digital Subscriber Line Access Multiplexers, and approximately 3,100 employees. At December 31, 2003, we had approximately 396,000 customers.

We derive our revenue from our core telecommunications and related communications services. These include local and long distance services; dial-up Internet access services; wireless services; high-speed/broadband Internet access services using DSL, cable modems, and dedicated T1 access; bandwidth and network facilities leasing, sales and services, including access services; facilities and services dedicated for a particular customer's use; advanced communications services for larger businesses such as frame relay, private line, and ISDN; and value-added services such as virtual private networks and web hosting. For the year ended December 31, 2003, we derived approximately 65% of our total revenues from local and long distance services; 14% from access services; 12% from private line and data services; and 9% from other sources. Approximately 82% of our competitive communications services revenues were derived from retail sales and 18% from wholesale sales.

We operate our business as a single segment, engaging in the provision of communications services based upon a single, integrated, interconnected communications network in our 25-state footprint. We

review operating results, assess performance and allocate resources on a company-wide, single segment basis.

We maintain a website with the address www.mcleodusa.com. We are not including the information contained on our website as a part of, or incorporating it by reference into, this Annual Report on Form 10-K. We make available free of charge (other than an investor's own Internet access charges) through our website our Annual Report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission.

Business Strategy

Vision Statement:

Our vision is to be a world-class, value-added telecommunications services provider with excellent customer relationships and strong, team-oriented business and operational performance, exhibiting the hallmarks of integrity, accountability, and commitment to excellence while providing a profitable return to our shareholders. In order to execute our vision, we are employing a strategy which consists of:

- delivering simplified products packaged to provide value-added customer solutions;
- engaging in customer oriented thinking;
- providing a low cost, highly reliable, facilities-based network;
- streamlining our business processes and implementing the "right" systems infrastructure scalable for growth;
- employing a highly trained, committed workforce delivering high quality performance;
- promoting teamwork, integrity and accountability in all we do;
- focusing on profitable revenue growth and positive cash flow.

We have strategically focused our business in the following 25-state footprint:

Arizona	Indiana	Minnesota	North Dakota	Texas
Arkansas	Iowa	Missouri	Ohio	Utah
Colorado	Kansas	Montana	Oklahoma	Washington
Idaho	Louisiana	Nebraska	Oregon	Wisconsin

Illinois	Michigan	New Mexico	South Dakota	Wyoming

Over the past year we took significant steps to execute our business strategy, including the following:

Revenue Growth and New Products:

- expanded our residential Preferred Advantage^{SM} local, long distance and Internet services into eight additional states within the Company's 25-state footprint; bringing the total states in which these services are offered to 20;
- launched Preferred Advantage^{SM} Integrated Access, combining voice, data and Internet services over a single, reliable high-speed connection;
- launched Preferred Advantage ADSL (Asymmetrical Digital Subscriber Line), an integrated voice and broadband Internet access solution that combines fast, always-on, cost effective Internet access with local voice service;

- entered into a multi-year wholesale agreement with AT&T Wireless Services and launched the McLeodUSA Preferred Advantage Wireless program offering reliable, high-quality voice calling nationwide fully supported by a StarQuality^{SM} trained and certified customer care team;
- entered into a multi-year agreement with Brightstar Corp., a distributor and provider of value-added services for the wireless telecommunications industry, to provide handset fulfillment and supply chain logistics in support of the McLeodUSA Preferred Advantage Wireless program;
- signed a letter of agreement with Cisco Systems, Inc. to enable the Company to offer to business customers managed customer premise equipment (CPE) services using Cisco equipment;
- announced plans to deploy the next generation of Preferred Advantage^{SM}voice services utilizing Internet Protocol technology, commonly referred to as "VoIP"; and
- entered into a two-year agreement with Vijay Singh, the top PGA Tour money winner in 2003, to represent the Company by wearing its logo and participating in promotions, advertising and sales events.

Operational Improvements:

- completed the StarQuality^{SM} certification program, certifying 100% of the employees who interact with our customers or network;
- launched "Centers of Excellence," an innovative Customer Care program and service model designed to provide a more personalized and streamlined customer service experience;
- improved overall customer satisfaction to 92% from 85% at the end of 2002, and improved billing accuracy to 99.7%;
- continued to enhance our facilities-based platform, successfully improving our customer platform mix, with approximately two-thirds of our customers on our own switching platforms;

- improved overall network quality, significantly reducing our mean times to repair and achieving 99.999% network reliability;

- continued to further reduce cost of service through our ongoing cost reduction program focusing on network optimization including least cost routing and data integrity programs; and

- streamlined processes and managed operations, expenses, cash flow and capital expenditures in line with revenues.

We also restructured our sales organization, executive sales leadership and the process used for sales activity management, which we believe will contribute to profitable revenue growth. We added two experienced sales executives to our team, segmented our sales leadership by channel, and integrated field sales support functions into Service Delivery and Customer Care "Centers of Excellence." In addition to ongoing direct sales initiatives, we have focused on accelerating our overall profitable revenue growth strategy through a variety of business development initiatives and other expanded product offerings.

As we enter 2004, we will continue to focus on providing world-class customer service, increasing our market share, profitably growing our revenue, reducing our cost of service and improving our processes.

Network Facilities

As of December 31, 2003, we operated a network with 663 access nodes collocated in Regional Bell Operating Company ("RBOC") central offices. We serve our customers by using various loop/access unbundled network elements ("UNEs") provided by the RBOCs and aggregating them through our access nodes. In turn, our access nodes are interconnected through approximately 44 service node

locations where our switching/routing systems reside. In a metropolitan area, access node to service node connectivity is based either on our own fiber facilities or on UNE transport from the RBOCs. Our service nodes are located in most of the major metropolitan areas across our footprint. These service nodes are in turn interconnected by our high capacity, inter-city core network. The underlying transport for our core network is based either on our own fiber or on leased capacity from interexchange carriers.

We own and operate all the equipment in our access and service nodes. They provide the service logic and traffic management for all our services.

Products and Services

We offer a complete portfolio of local, long distance, Internet, and advanced communications services principally via our Preferred Advantage product line, which can be sold separately or bundled. These include:

- local calling and features such as caller ID, call transfer, call forwarding, and 3-way calling;

- local data services such as dial-up and dedicated Internet access services, using DSL, cable modem and dedicated T1 technologies;

- long distance voice services such as outbound domestic and international long distance and toll free 800 services;

- bandwidth and network facilities leasing, sales and services, including access services to carriers and wholesale purchasers;

- wireless voice services for business utilizing the nationwide AT&T wireless network;

calling card capabilities;

long distance/inter-LATA data services such as frame relay and private line for large businesses;

advanced communications services such as virtual private networks and web hosting; and

integrated access services which link voice and data lines together on one high-speed connection.

Our service offerings can be categorized into Retail Services and Wholesale/Carrier Services, each of which is discussed in more detail below.

Retail Services Preferred Advantage:

As of December 31, 2003, we provided service, on a competitive retail basis, to about 396,000 customers, primarily small and medium-sized business customers in major metropolitan areas and in second- and third-tier markets in 25 states, and residential customers in second- and third-tier markets in 20 states. Since beginning sales activities in January 1994, we have increased our revenue from the sale of competitive communications services from $4.6 million for the year ended December 31, 1994 to $869.0 million for the year ended December 31, 2003.

We have received state regulatory approval to offer local switched services using our own communications network facilities in each of the 25 states in our footprint. We intend to offer additional local switched services using our own network facilities, either alone or in combination with network elements purchased from existing telephone companies, in selected markets in our 25-state footprint.

We have interconnection agreements with Qwest Communications International Inc. ("Qwest") in all states where Qwest is the incumbent local telephone company, with SBC Communications Inc. (through its subsidiaries) ("SBC") in all states where SBC Midwest Corporation or Southwestern Bell Telephone Company is the incumbent local telephone company, and with Verizon (through its GTE entities) and BellSouth in certain states. These agreements allow us to purchase unbundled network

elements to connect our switching equipment and facilities to customers, and to resell services of these entities. One of our goals is to serve as many customers as economically advantageous using primarily our own network facilities because we believe this will allow us greater ability to control network costs, meet our customer service goals and prepare for possible changes in the regulatory environment.

As of December 31, 2003, we served 65% of our local service customers using our own switching facilities connected to an unbundled local loop network element purchased from an incumbent local telephone company; we served 30% of our local service customers using both local loops and local switching purchased as unbundled network elements from incumbent local telephone companies; and we served 5% of our local service customers through resale of incumbent carrier retail services. This distribution compares to 52%, 33% and 15%, respectively, at the end of 2002 and 36%, 33% and 15%, respectively, at December 31, 2001.

We provide long distance service in some areas by purchasing communications network capacity, in bulk, from national long distance carriers, and routing our customers' long distance traffic over this capacity. In many of our local footprint states, we carry most of our long distance traffic on our own network facilities. Our integrated communications services are described below.

In November 2002, we launched McLeodUSA Preferred Advantage products and services for both business and residential customers. This is our simplified product portfolio consisting of a variety of product and service choices ranging from simple local, long distance and Internet packages to tailored solutions of advanced communications for larger business customers. We continued the introduction of additional Preferred Advantage products and services during 2003.

Residential Preferred Advantage Services. We offer end user residential customers integrated local, long distance, Internet and optional services such as calling card and residential 800 services directly in 20 states within our footprint. Product availability and pricing vary by market. Preferred Advantage products for residential customers include:

- a choice of a variety of local service packages with a broad assortment of features;
- long distance package plans based on anticipated calling patterns, as well as flat rate per minute plans;
- dial-up Internet service and ADSL broadband service; and
- optional services such as voice mail, calling card, wire care, call restrictions, directory listing options, and toll-free numbers.

Business Preferred Advantage Services. In addition to residential services, we offer Preferred Advantage solutions for small to mid-size businesses, including the following:

- a choice of a variety of local service packages with a wide assortment of features;
- long distance package plans based on anticipated calling patterns and flat rate per minute plans;
- three Internet service options (dial-up, DSL, and dedicated high speed);
- integrated access services which link voice and data lines on one high-speed connection;
- optional services including voice mail, calling card, wire care, call restrictions, directory listing options, hunting, conference calling, and other calling, features such as call forward busy/don't answer;
- wireless voice services for business utilizing the nationwide AT&T wireless network; and
- flexible term and volume discount plans.

Large Businesses/Major and Strategic Accounts Preferred Advantage Services. McLeodUSA also serves large, major and strategic accounts that have more complex communications requirements via

the Preferred Advantage "Toolkit" services which offer the ability to tailor customized solutions from a portfolio of services that include:

- a choice of a variety of local service packages with a wide assortment of features;
- long distance package plans based on anticipated calling patterns and flat rate per minute plans;
- dedicated local Preferred Plan using T-1 and/or ISDN access connections;
- three Internet service options (dial-up, DSL, and dedicated high speed);
- optional services including voice mail, calling card, wire care, call restrictions, directory listing options, hunting, conference calling, and other calling features such as call forward busy/don't answer;

- flexible term and volume discount plans; and
- wireless voice services for business utilizing the nationwide AT&T Wireless network;
- inter/intrastate rate per minute plans for long distance;
- enhanced 800 toll-free services;
- frame relay and private line services;
- web hosting and virtual private network services;
- integrated access services which link voice and data lines on one high-speed connection;
- FX 800 connection services.

Wholesale/Carrier Services:

In addition to retail Preferred Advantage services, we provide a wide range of access, private line, network facilities and data services, as well as leased facilities to local and long distance carriers, government agencies, wireless service providers, cable television companies and other carrier-class customers. These services generally include:

- special access services between network facility centers, known as points-of-presence, or "POPs," that provide telecommunications lines that link the POPs of one long distance carrier to POPs of other carriers in a market, allowing these POPs to exchange telecommunications traffic for transport to final destinations;
- end user special access services, that provide telecommunications lines that connect an end user such as a large business to the local POP of its selected long distance carrier;
- long distance carrier special access services that provide telecommunications lines that link a long distance carrier POP to the incumbent local telephone company's local central office;
- private line services that provide telecommunications lines that connect various locations of a customer's operation and are used to transmit voice, video and/or data traffic;
- the sale and lease of network facilities; and
- other carrier access services.

Sales, Marketing and Customer Service

Direct sales personnel located in branch sales offices throughout our 25-state footprint conduct the majority of our sales of integrated communications services to business customers. We use telemarketers to sell these services to smaller business customers, including those located in areas that are geographically remote, and to residential customers. Sales activities in our field sales offices are organized and managed by region.

In 2003, we continued to focus our sales and marketing efforts to target specific prospects and customers located in high potential markets, thereby increasing our opportunity to grow profitable revenue for our business. In addition to physically locating our sales force in these locations, we have also matched our new advertising and direct marketing efforts to these targeted markets to enhance our opportunities for success. Detailed prospecting tools have been developed to identify high potential customer opportunities and increase sales force productivity. Finally, in 2003 we added 250 central offices to the group of central offices where we are actively pursuing new sales. This has been done to expand our sales force's market opportunity, and is based on where our central office profitability studies have identified profitable revenue potential for our business.

Our sales force training emphasizes a customer-focused sales and service approach. For business field sales, we utilize a dedicated account representative who handles initial sales to new customers, and then assign an account team with responsibility to service and maintain the customer throughout their lifecycle with McLeodUSA. Our Customer Service Centers are available 24 hours a day, 7 days a week, and 365 days a year to handle issues and trouble resolution for all of our customers. In 2003, we embarked on an enhanced service model requiring employees who either interact with our customers or touch our network to be StarQuality[sm] certified. These employees are recertified yearly. The goal of this extensive training and certification program is to ensure the highest levels of quality service for our customers.

Also in 2003, we launched our "Centers of Excellence," an innovative Customer Care program and service model designed to provide a more personalized and streamlined customer service experience. By promising end-to-end accountability to our customers, we believe our Center of Excellence concept allows for quick issue resolution, adds value to all interactions, and builds customer loyalty. Each of our Centers of Excellence are staffed with StarQuality certified cross-enterprise workgroups supporting customer communication, order fulfillment, billing accuracy and issue resolution, technical issue resolution, and customer retention. Customers are routed to the appropriate Center of Excellence representatives by way of Integrated Voice Response Unit technology. This technology allows the customer to identify their needs with an automated menu and transfers the call to a representative with skills and tools needed to resolve a specific issue quickly and effectively. We believe this emphasis on a single point of contact for meeting customers' communications needs is very appealing to current and prospective customers. All Call Centers are staffed with StarQuality certified representatives, ready and available 24 hours a day, 7 days a week, and 365 day a year.

We have also developed and installed customer-focused software for providing integrated communications services. This software allows us to provide our customers one fully-integrated monthly billing statement for local, long distance, 800, international, voice mail, paging, Internet access and travel card services, and additional services when available. We believe that our customer-focused software platform is an important element in the marketing of our communications services and provides us a competitive advantage in the marketplace.

Through an agreement with the Yell Group, as discussed under "Business Chapter 11 Reorganization," we use telephone directories as advertising by including detailed product descriptions and information about our communications products in each directory. We believe these telephone directories provide us with a marketing presence in the millions of households and businesses that receive them. We also believe that the telephone directories provide a competitive marketing advantage and strengthen our brand awareness.

In January 2003, McLeodUSA launched a coordinated advertising campaign to ensure that McLeodUSA customers and prospects become fully aware of the advantages of doing business with us. We engaged the New York office of J. Walter Thompson to serve as agency of record for our advertising, and Protocol Marketing Group to manage all direct marketing programs related to our Preferred Advantage products. Our efforts included new print advertising, local billboards and radio spots placed across our key markets, as well as developing new collateral, company signage and bill

inserts to support our sales efforts and direct mail campaigns. We also completely redesigned the McLeodUSA website with our new look and feel. This campaign resulted in a successful relaunch of the McLeodUSA brand across our markets with new corporate positioning focused on our objective to deliver a superior customer experience.

Employees

As of December 31, 2003, McLeodUSA and its subsidiaries had approximately 3,100 employees. We believe that our future success will depend on our continued ability to attract and retain highly skilled and qualified employees.

Executive Officers

The following is a list of our executive officers as of March 1, 2004, together with biographical summaries of their experience. The ages of the persons set forth below are as of December 31, 2003.

Name	Age	Position(s) with Company
Chris A. Davis	53	Chairman of the Board of Directors and Chief Executive Officer
Stephen C. Gray	45	President and Director
G. Kenneth Burckhardt	49	Executive Vice President and Chief Financial Officer and Director
Richard J. Buyens	47	Executive Vice President, Sales
Andreas Papanicolaou	54	Executive Vice President, Network Services
James E. Thompson	43	Group Vice President, General Counsel and Secretary

Chris A. Davis. Ms. Davis has served as Chairman and Chief Executive Officer since April 2002. She joined McLeodUSA as Chief Operating and Financial Officer and a Director in August 2001. Before joining McLeodUSA, Ms. Davis was Executive Vice-President, Chief Financial and Administrative Officer for ONI Systems Corp., a leading optical networking equipment company. Previously she spent seven years, from 1993 to 2000, as Executive Vice-President and Chief Financial and Administrative Officer and a director at Gulfstream Aerospace Corporation. Before joining Gulfstream, Ms. Davis spent 17 years in increasingly senior operating and financial management positions at General Electric Company. She is a director of Cytec Industries, Inc., Wolverine Tube, Inc. and Rockwell Collins, Inc.

Stephen C. Gray. Mr. Gray serves as President of McLeodUSA and has been an officer and a director of McLeodUSA since 1993. Prior to joining McLeodUSA, Mr. Gray served from August 1990 to September 1992 as Vice President of Business Services at MCI, where he was responsible for MCI's local access strategy and for marketing and sales support of the Business Markets division. From February 1988 to August 1990, he served as Senior Vice President of National Accounts and Carrier Services for Telecom*USA, where his responsibilities included sales, marketing, key contract negotiations and strategic acquisitions and combinations. From September 1986 to February 1988 Mr. Gray held a variety of management positions with Williams Telecommunications Company.

G. Kenneth Burckhardt. Mr. Burckhardt joined McLeodUSA as Executive Vice President and Chief Financial Officer in April 2002. He was also named to the McLeodUSA Board of Directors in April 2002. Prior to joining McLeodUSA, Mr. Burckhardt was interim CFO at ONI Systems, a leading optical networking company, from August 2001 through February 2002, and Vice President Finance from May 2000 through August 2001. From 1994 to 2000, he worked at Gulfstream Aerospace Corporation, most recently as Senior Vice President, Finance. From 1977 to 1994, he held various financial management positions at General Electric Company.

Richard J. Buyens. Richard J. Buyens was named Executive Vice President of Sales in October 2003. Prior to joining McLeodUSA, Mr. Buyens served as President Global Services at Ptek Holdings, a provider of multimedia messaging and conferencing services, beginning in 2001. From 1999 through 2000, he served as Senior Vice President Sales at Intermedia Communications. Prior to Intermedia, he had an 18-year career at AT&T, where he progressed through increasingly more important sales, marketing and finance positions, concluding his career there in 1998 with vice president level positions in sales and marketing in the mid-markets customer segment.

Andreas Papanicolaou. Mr. Papanicolaou joined McLeodUSA in August 2002. He was previously with Lucent Technologies where he was the general manager of optical network management beginning in October 2000. Prior to that, from 1997 to mid-2000, he was President of Lucent Digital Video, a Lucent venture that was later sold profitably by Lucent. Prior to Lucent Technologies, Mr. Papanicolaou spent more than 8 years at AT&T as product manager of services and in network planning. He started his career in 1976 at Bell Laboratories where he worked on several projects that helped the telecommunications industry transition from analog to digital technology. For that work he was recognized with the 81st Bell Labs Fellow Award in 1991.

James E. Thompson. Mr. Thompson joined McLeodUSA in December 2002 after nearly eight years (1995 to 2002) with Alticor Inc., parent company of Amway Corporation, where he was Associate General Counsel, International Legal. He was also Chief Legal Officer for the Alticor business unit responsible for mergers and acquisitions, joint ventures and strategic alliances. Prior to Alticor, he was an attorney with Jones, Day, Reavis & Pogue from May 1987 to February 1995 in its Brussels, Belgium and Washington, D.C. offices.

Chapter 11 Reorganization

During 2002 we evaluated our capital structure and 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, or the "Plan," which became effective on that date. The general unsecured creditors of McLeodUSA, except for the holders of all of its outstanding notes, were unaffected by the Chapter 11 proceedings and the Plan. As used in this Form 10-K, the term "Predecessor McLeodUSA" refers to McLeodUSA and its operations prior to April 17, 2002.

Recapitalization. The Plan resulted in the following changes to our capital structure:

- The elimination of approximately $3 billion of indebtedness, including accrued interest, represented by the following notes: $10\frac{1}{2}\%$ Senior Discount Notes, $9\frac{1}{4}\%$ Senior Notes, $8\frac{3}{8}\%$ Senior Notes, $9\frac{1}{2}\%$ Senior Notes, $8\frac{1}{8}\%$ Senior Notes, 12% Senior Notes, $11\frac{1}{2}\%$ Senior Notes and $11\frac{3}{8}\%$ Senior Notes, or collectively, 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 Class A Common Stock for $30 million;

- The investment by two funds affiliated with Forstmann Little & Co., or "Forstmann Little", of $175 million in exchange for (1) 74,027,764 shares of Class A Common Stock, (2) 5-year warrants to purchase 22,159,091 shares of Class A Common Stock for $30 million and (3) 10 shares of 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 Class B Common Stock and 35,546,879 shares of Class C Common Stock, respectively; and

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

The Plan also provided for the distribution of a portion of Class A Common Stock to holders of Predecessor McLeodUSA Class A Common Stock. These holders were entitled to share, together with holders of certain securities claims, in the distribution of 54,775,663 shares of Class A Common Stock. On May 2, 2002, the Bankruptcy Court entered an order establishing a disputed claims reserve of 18,000,000 shares of Class A Common Stock pending resolution of securities claims against McLeodUSA associated with putative securities class action lawsuits. McLeodUSA then commenced the distribution of 36,775,663 shares of 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. Pursuant to the Plan, shares which were unclaimed by April 16, 2003 were cancelled. Upon the final determination of the amount, if any, of allowed securities claims under the Plan, such holders of Predecessor McLeodUSA Common Stock who received shares of McLeodUSA Class A Common Stock may be entitled to additional distributions of Class A Common Stock from the 18,000,000 shares held in the disputed claims reserve.

Fresh-Start Accounting. As of April 17, 2002, we implemented fresh-start accounting under the provisions of AICPA Statement of Position 90-7 ("SOP 90-7"), *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*. Under SOP 90-7, the reorganization equity value of McLeodUSA was allocated to our assets and liabilities, our accumulated deficit was eliminated, and our new equity was issued according to the Plan as if we were a new reporting entity. In conformity with fresh-start accounting principles, we recorded a $1.5 billion reorganization charge to adjust the historical carrying value of our assets and liabilities to fair market value reflecting the allocation of our $1.15 billion estimated reorganized equity value as of April 16, 2002. We also recorded a $2.4 billion gain on the cancellation of debt on April 16, 2002 pursuant to the Plan. For a more detailed discussion of SOP 90-7 and fresh-start accounting, see Item 8. "Financial Statements and Supplementary Data" in this Form 10-K.

Divestitures. Our refocused business strategy and the Plan resulted in divestitures of approximately $1 billion of non-core assets in 2002 as follows:

Illinois Consolidated Telephone Company: On December 31, 2002, we completed the sale of Illinois Consolidated Telephone Company and certain related telecommunication businesses to Homebase Acquisition Corp. for $271 million less the assumption of $20 million of debt resulting in gross proceeds of approximately $251 million. In connection with the transaction, McLeodUSA entered into a series of operating agreements with Homebase Acquisition Corp. and Illinois Consolidated Telephone Company pursuant to which the parties will continue to provide services, such as wholesale long distance, telemarketing and fulfillment, and operator services. Pursuant to the terms of the Plan, $225 million of the net proceeds from the sale of Illinois Consolidated Telephone Company were used to reduce the Term A and Term B loans under McLeodUSA's Credit Agreement, dated as of May 31, 2000, among McLeodUSA, various Lenders and The Chase Manhattan Bank, as Agent, as amended. We retained the balance of the proceeds, after fees and expenses.

Dakota Community Telephone, Inc.: On September 30, 2002, we completed the sale of our non-core operations in South Dakota and certain non-core overbuild competitive local exchange carrier and cable television operations in South Dakota, southwestern Minnesota and northwestern Iowa to PrairieWave Communications, Inc. for approximately $84 million.

Greene County Partners, Inc.: On August 20, 2002, we completed the sale of our interest in the cable television service provider for $16 million in cash and a note receivable of $3 million.

Pubco: On April 16, 2002, we completed the sale of McLeodUSA Media Group, Inc. and its subsidiaries, or collectively "Pubco", to Yell Group Limited for $600 million in cash. In connection with the transaction, we entered into a multi-year Publishing, Branding and Operating Agreement with Yellow Book, a subsidiary of Yell Group. This Agreement has been amended and restated, but continues to provide among other things, 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.

CapRock Services Corp.: On April 8, 2002, we sold our subsidiary, IWL Communications, Incorporated d/b/a CapRock Services Corp., for $21 million in cash.

McLeodUSA Integrated Business Systems, Inc.: On January 24, 2002, McLeodUSA Integrated Business Systems, Inc., a 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 Integrated Business Systems under the name "DataNet," to Inter-Tel Technologies, Inc. for $8 million plus the assumption of certain liabilities. The sale excluded the telecommunications customer premise equipment business conducted in Illinois.

Splitrock: On January 24, 2002, McLeodUSA completed the sale of certain of its internet/data assets (formerly part of Splitrock Services, Inc.) and wholesale dial-up Internet Service Provider ("ISP") customer base to Level 3 Communications, LLC ("Level 3") for approximately $50 million in cash and the assumption of certain operating liabilities. The transaction did not qualify as a discontinued operation under FAS 144 and the results of operations are included in continuing operations. Under the terms of the agreement, Level 3 purchased approximately 350 POPS (points of presence) across the United States, and the related facilities, equipment and underlying circuits, plus the wholesale ISP customer base. The transaction excluded fiber optic cable obtained under the existing IRU agreement with Level 3 and McLeodUSA in the acquisition of Splitrock. The parties also entered into operating agreements enabling McLeodUSA to continue providing service and support to customers in its 25-state footprint.

Telecommunications Industry

The Federal Communications Commission ("FCC,") estimates that the aggregate U.S. telecommunications revenues, including local, long distance, private line, data telecommunications and wireless services, were approximately $302 billion in 2001. Of that total, local services generated approximately $128 billion (over 42%), toll services generated approximately $99 billion and wireless services accounted for approximately $75 billion of revenues in 2001. The communications industry is undergoing substantial changes due to macroeconomic, regulatory, and technological developments, changes in the competitive landscape, and restructuring in the industry.

The market for local exchange services consists of a number of distinct service components, including: switched and dedicated local calling services (including local usage and various features provided by the central office switch); local private line services (in which a transmission path between fixed points is dedicated to the use of a particular customer); and local network access services (in which various local network components are used to originate or terminate local and long distance calls). Other related services include operator services, Internet access, calling cards, publication of "white page" and "yellow page" telephone directories and the sale of business telephone equipment.

Historically, the market for local exchange service has been dominated by incumbent local telephone companies, each of which have been the monopoly provider of these services for its service area. In addition to numerous independent and smaller incumbent local telephone companies, there are now four large local telephone companies SBC, Qwest, BellSouth and Verizon. These large local telephone companies are referred to as "RBOCs" (Regional Bell Operating Companies). The RBOCs have the authority to provide local telephone service, local access service, toll service, and other services.

The Telecommunications Act of 1996 substantially expanded opportunities to compete with incumbent local telephone companies by eliminating state legal prohibitions on competition and requiring large incumbent local telephone companies to allow other providers (competitive local telephone companies) to purchase elements of the incumbent's network in order to offer service to end users. The Telecommunications Act of 1996 also requires all telecommunications companies to allow other telecommunications providers to interconnect with their communications facilities and equipment on reasonable, non-discriminatory terms. In addition, incumbent local telephone companies are obligated to provide local number portability and dialing parity upon request and make their local services available for resale by competitors. Incumbent local telephone companies are also required to allow competitors nondiscriminatory access to poles, conduit space and other rights-of-way. A number of states have taken additional regulatory and legislative action to open local communications markets to competition.

As a result of these and other developments, competitive local telephone companies have gained significant market share since the enactment of the Telecommunications Act of 1996. According to the FCC, as of June 2003, competitive local telephone companies provided 26.9 million, or 14.7% of the approximately 182.8 million in-service local telephone lines used by end users, representing 9% growth in competitive local telephone company market size during the first six months of 2003. About 24% of these lines are served over local loop facilities owned by the competitive local telephone companies.

As a result of regulatory changes, the RBOCs are now permitted to offer long distance services once it has been demonstrated that certain competitive conditions have been met. This is increasing customer expectations that their telecommunications providers will be able to offer them a complete package of services (local, long distance, voice and data). These regulatory changes are causing interexchange carriers to include local services in their product offering. Also, new technologies continue to emerge, which introduce or enhance products or help the industry lower costs. Currently, it is unclear whether such technological advances will fundamentally change the structure of the industry. Some emerging fixed wireless and voice over the Internet ("VoIP") technologies may in the future reduce the industry's dependence on the RBOC copper loops for the last mile to the customer.

The FCC estimates that high-speed (200 kbps or more in at least one direction) data lines connecting homes and businesses to the Internet increased by 18% during the first half of 2003, to a total of 23.5 million lines (or wireless channels) in service.

Competition

The communications services industry is highly competitive. McLeodUSA faces intense competition in all of our markets. Our local exchange business competes with incumbent local telephone companies, which generally dominate their respective local telecommunications markets while also being our largest supplier. Our largest local service competitors, the RBOCs, have gained approval to offer long distance services in all states in our 25-state footprint. Our long distance services also compete with the services of hundreds of other companies in the long distance marketplace in most states. Verizon, SBC, AT&T, MCI and Sprint currently dominate the long distance market. The RBOCs have become important long distance competitors in each state in which we offer service. Our local and long distance services also compete with the services of other competitive local telephone companies in many markets.

Other competitors may include cable providers, providers of communications network facilities dedicated to particular customers, microwave and satellite carriers, wireless telecommunications providers, private networks owned by large end users, municipalities, electrical utilities and telecommunications management companies. Increasingly, McLeodUSA is subject to competition from Internet telephony and other Internet Protocol-based voice telecommunications service providers, which are currently subject to substantially less regulation than competitive and incumbent local telephone companies. Many of our existing and potential competitors have financial and other resources far greater than ours.

Many of our competitors offer a greater range of communications services, or offer them in more geographic areas. For example, while our target market covers 25 states, many of our competitors are national or international in scope. Our inability to offer as wide a range of services as many of our competitors, or to offer them in as many locations, could result in our not being able to compete effectively against them.

Regulation

Our services are subject to federal, state and local regulation. In addition to industry specific regulation (such as FCC and state regulation of our telephone businesses), municipalities and other local government agencies regulate limited aspects of our business, such as use of government owned rights of way, construction permits and building codes. The following description covers some of the major regulations affecting us, but there are numerous other areas of regulation which materially influence our business.

The FCC has jurisdiction over our telecommunications facilities and services to the extent they are used to provide, originate or terminate interstate or international telecommunications. State regulatory commissions retain jurisdiction over the same facilities and services to the extent they are used to originate or terminate intrastate telecommunications. Local governments may require McLeodUSA to obtain licenses, permits or franchises regulating use of public rights-of-way necessary to install and operate our networks. In addition, the licensing, construction, operation, sale and interconnection arrangements of wireless telecommunications systems are regulated to varying degrees by the FCC. Through our subsidiaries, we hold various federal and state regulatory authorizations. We often join other industry members in seeking regulatory reform at the federal and state levels to open additional telecommunications markets to competition, and to preserve existing pro-competitive conditions.

The FCC classifies us as a non-dominant carrier, so our interstate and international rates are not subject to material federal regulation. We must offer interstate services at just and reasonable rates in a manner that is not unreasonably discriminatory, and must maintain geographically averaged interstate rates as required by federal law. The FCC limits the charges that McLeodUSA and other competitive local telephone companies can charge to long distance companies for access to their end user customers, and has a proceeding pending in which it is reviewing all types of intercarrier compensation. The FCC does impose prior approval requirements on transfers of control and assignments of radio licenses and operating authorizations and on discontinuation of services. The FCC has the authority to condition, modify, cancel, terminate or revoke such licenses and authorizations for failure to comply with federal laws or the rules, regulations and policies of the FCC. The FCC may also impose fines or other penalties for such violations.

The FCC has established a "universal service" program that is supposed to ensure that affordable, quality telecommunications services are available to all Americans. The Telecommunications Act of 1996 sets forth policies and establishes certain standards in support of universal service, including that consumers in rural areas should have access to telecommunications and information services that are reasonably comparable in rates and other terms to those services provided in urban areas.

McLeodUSA is required to make contributions to support federal and state universal service goals. Our contribution to federal universal service support programs is assessed against our interstate and international end user telecommunications revenues. The contribution factor for the fourth quarter of 2003 is 9.2% of our interstate and international end user telecommunications revenue. McLeodUSA's contribution to state universal service programs is assessed against our intrastate revenues. Although many states are likely to adopt an assessment methodology similar to the federal methodology, states are free to calculate telecommunications service provider contributions in any manner they choose as long as the process is not inconsistent with the FCC's rules. In 2003, we paid approximately $15.4 million to the federal program and approximately $3.5 million to state programs.

Telephone companies are subject to limitations on the use of customer information the carrier acquires by virtue of providing telecommunications services. Protected information includes information related to the quantity, technical configuration, type, destination and the amount of use of services. A carrier may not use such information acquired through one of its service offerings to market certain other service offerings without the approval of the affected customers. These restrictions may affect the ability of McLeodUSA to market a variety of packaged services to existing customers.

A customer may change its preferred long distance carrier at any time, but the FCC and some states regulate this process and require that specific procedures be followed. When these procedures are not followed, particularly if the change is unauthorized or fraudulent, the process is known as "slamming." The FCC has levied substantial fines for slamming and has increased the penalties for slamming, although no such fines have been assessed against us.

The FCC has implemented changes to its rules for telemarketing activities by telecommunications services providers. The FCC rules require us to implement procedures to avoid calling individuals who have placed their names on a national do-not-call list, limit our use of technologies that improve the efficiency of our telemarketing efforts, limit the hours in which we may place telemarketing calls, limit the number of calls abandoned and limit the time before which individuals are connected to a salesperson. Rules such as these reduce the effectiveness of our telemarketing efforts and result in additional customer acquisition costs.

In addition to providing services as a regulated common carrier, through McLeodUSA Network Services, we provide certain competitive access services as a private carrier on a substantially non-regulated basis. In general, a private carrier is one that provides service to customers on an individually negotiated contractual basis, as opposed to a common carrier that provides service to the public on the basis of generally available rates, terms and conditions. Some of our operations are also subject to federal and state regulatory requirements, including, in some states, bonding requirements, due to our direct marketing, telemarketing and sale of prepaid calling cards.

We provide intrastate common carrier services and are subject to various state laws and regulations. Most public utility commissions subject providers like us to some form of certification requirement, which requires providers to obtain authority from the state public utility commission before initiating service. In most states, we are also required to file tariffs setting forth the terms, conditions and prices for common carrier services that are classified as intrastate. We are often required to update or amend these tariffs when we adjust our rates or add new common carrier services, which may require prior regulatory approval, and are subject to various reporting and record-keeping requirements in these states. Some states impose service quality standards on our local service operations and require us to file reports showing our performance in meeting those standards.

Many states also require prior approval for transfers of control of certified carriers, corporate reorganizations, acquisitions of telecommunications operations, assignment of carrier assets, carrier stock offerings and incurrence by carriers of significant debt obligations. Certificates of authority can generally be conditioned, modified, canceled, terminated or revoked by state regulatory authorities for failure to comply with state law or the rules, regulations and policies of state regulatory authorities.

State utility commissions generally have authority to supervise telecommunications service providers in their states and to enforce state utility laws and regulations. Fines or other penalties also may be imposed for violations.

Generally, state utility commissions or third parties could raise issues with regard to our compliance with applicable laws or regulations which could have a material adverse effect on our business, results of operations and financial condition. Several state utility commissions have reviewed or are actively reviewing the propriety of certain agreements we entered into with Qwest, including Washington, Arizona, and Colorado, and these proceedings may result in fines or other sanctions against us or the imposition of other conditions detrimental to us, including the establishment of discounts available to other competitive telephone companies but not to us. Other states may initiate similar proceedings.

We are required to obtain construction permits and licenses or franchises to install and expand our fiber optic communications networks using rights-of-way. Some local governments, where we have installed or anticipate constructing networks, are proposing and enacting ordinances regulating use of rights-of-way and imposing various fees in connection with such use, including fees based on a percentage of certain revenues related to the use of the right-of-way. In some instances, we have negotiated interim agreements to authorize installation of facilities pending resolution of the fee issue. In some markets, we are objecting to or challenging various fees as improper under state or federal law. In many markets, the traditional local telephone companies do not pay rights-of-way fees or pay fees that are substantially less than ours. We must also negotiate and enter into franchise agreements with local governments in order to operate our video services networks.

The Telecommunications Act of 1996 imposes a number of access and interconnection requirements on all local telephone companies, including competitive local telephone companies, with additional requirements imposed on incumbent local telephone companies. These requirements are intended to ensure access to certain networks under reasonable rates, terms and conditions. The FCC has adopted rules regulating the pricing of the leasing of each separate element of the incumbent local telephone company's network, known as unbundled network elements. The U.S. Supreme Court has upheld both the FCC's authority to adopt such pricing rules, and the specific pricing guidelines created by the FCC. In May 2002, however, a decision by the U.S. Court of Appeals for the District of Columbia ("Court of Appeals") overturned many of the FCC rules regarding which network elements must be separately made available, or unbundled, by the incumbent local telephone companies for lease by competitive local telephone companies.

In 2002, the FCC issued a Notice of Proposed Rulemaking ("NPRM") on Wireline Broadband/Cable Modem Classification Proceedings. The subject of these proceedings is whether cable modem service and telecommunications broadband access to the Internet services should be subject to Title II and *Computer II/III* safeguards. The RBOCs have advocated asking the FCC to determine that their broadband services are "private carriage" only subject to Title I, which would mean that McLeodUSA would not be entitled to use network elements of the broadband network.

On February 20, 2003, the FCC announced a decision to revise its rules requiring the unbundling of network elements by the incumbent local telephone companies as part of its Triennial Review of the 1996 Telecom Act. The FCC released its Triennial Review Order ("TRO") in August 2003 modifying its rules governing availability of RBOC unbundled network elements to competitive carriers. The TRO established new rules governing the availability and pricing for the network elements the RBOCs must provide to competitive carriers, and delegated authority to the states to apply certain of the new rules in individual markets. Several parties filed appeals in different federal appellate courts, which appeals were consolidated in the Court of Appeals.

On March 2, 2004, the Court of Appeals issued a decision overturning many key elements of the TRO, remanding most of the order to the FCC for further action. The Court of Appeals ruled that the

FCC's delegation of final impairment decisions to state agencies was unlawful. The Court also reversed the FCC's nationwide finding of presumptive impairment for mass-market switches, and dedicated transport and loops. The Court directed the FCC to give stronger consideration to intermodal competition when revising its rules on remand. The Court upheld the FCC determination that RBOCs do not have to unbundle loops made up of a combination of copper and fiber or to provide CLECs access to new loops. The Court also upheld the FCC's findings that RBOCs are not required to provide unbundled switching to CLECs for business customers served by high-capacity loops, such as DS-1 or packet switching. State proceedings that had been started to determine whether DS-0 switch ports should remain available as unbundled network elements are being suspended in some states and continued in other states. The FCC has been given 60 days (or until a petition for a rehearing is denied) to implement new unbundling rules, after which those parts of the FCC's TRO that are inconsistent with the Court of Appeals' decision would be set aside. Certain parties have already announced plans to seek a stay and to appeal the Court of Appeals order to the United States Supreme Court. There can be no assurance that our businesses will not be adversely affected by the TRO, continued legal challenges to the TRO, new legislation passed in response to the TRO or any court decisions that result from continued legal challenges to the TRO or current regulations.

The FCC has also opened a Further Notice of Proposed Rulemaking seeking comment on whether the FCC should modify the pick-and-choose rule that permits requesting competitive local telephone companies to opt into individual portions of interconnection agreements without accepting all the terms and conditions of such agreements.

On September 10, 2003, the FCC issued an NPRM on TELRIC. This is a proceeding to review the Total Element Long Run Incremental Cost ("TELRIC") methodology used to determine the prices charged to competitive carriers for unbundled network elements. A change in pricing methodology that materially increases unbundled network element prices would increase our costs and could adversely affect our ability to compete. A decision is anticipated during 2004.

The FCC issued on March 10, 2004 its NPRM on "IP-enabled communications," which includes VoIP. The NPRM asks broad questions regarding the regulatory classifications of various "IP-enabled" services, including different VoIP services; the access charge and other intercarrier compensation implications; the universal service implications; and the other social policy implications such as law enforcement, disability and emergency 911 service issues and suggests, as a general proposition, that economic regulation of various IP-enabled services should be kept to a minimum. Certain RBOCs have advocated positions with respect to VoIP that, if adopted, could inhibit our ability to utilize VoIP and related technologies.

The FCC has enacted local number portability ("LNP") rules that allow consumers to switch providers and keep their existing phone number. In 1996, wireline carriers were required to permit wireline-to-wireline LNP in all U.S. markets. As of November 24, 2003, wireless carriers were required to implement wireless-to-wireless LNP in the top 100 Metropolitan Statistical Areas ("MSAs"), and wireline carriers were required to implement wireline-to-wireless LNP in all U.S. markets. Beginning May 24, 2004, wireless carriers must implement wireless-to-wireless LNP in all U.S. markets.

Regulations applicable to our business are subject to the political process and have changed repeatedly over the past decade. Further material changes in the law and regulatory requirements must be anticipated, including with respect to McLeodUSA's continued access to RBOC network elements and facilities that are necessary for McLeodUSA to provide services to our customers and at what prices. There can be no assurance that our business will not be adversely affected by future legislation, new regulation or deregulation, or by court decisions.

Risk Factors

In connection with the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, set forth below are cautionary statements identifying important factors that could cause actual events or results to differ materially from any forward-looking statements made by us or on our behalf whether oral or written. We wish to ensure that any forward-looking statements are accompanied by meaningful cautionary statements in order to maximize to the fullest extent possible the protections of the safe harbor established in the Private Securities Litigation Reform Act of 1995. Accordingly, any such statements are qualified in their entirety by reference to, and are accompanied by, the following important factors that could cause actual events or results to differ materially from our forward-looking statements.

Executing Our Business Strategy Involves Substantial Risks

There are substantial risks in implementing our business strategy, including:

- difficulties arising from a slower economy, which has adversely affected demand for communications services and may delay revenue growth and the length of time required to achieve profitability and positive cash flow;
- the chance for adverse regulatory, legislative and other governmental developments during the course of implementing our business strategy;
- reputation issues related to our bankruptcy that increase the risk that we may fail to attract customers;
- potential difficulties in retaining quality management to execute our business strategy; and
- we may not have sufficient capital to continue to invest in improved business systems to support a larger enterprise.

One or more of these factors, individually or combined, could affect adversely our ability to conduct our operations.

Financial Information Related to Our Post-Emergence Operations is Limited

Because we emerged from bankruptcy on April 16, 2002, and divested non-core assets in 2002, there is limited operating and financial data available from which to analyze our operating results and cash flows. As a result of fresh-start accounting, a comparison of information reflecting our results of operations and financial condition after our emergence from bankruptcy to prior periods may not be meaningful.

Our Business Does Not Generate Positive Cash Flow

To date, our telecommunication operations have not generated positive cash flow in any quarterly period. While the strategic initiatives we have undertaken to improve our business are designed to result in the telecommunication business eventually generating positive cash flow, there can be no assurance that these steps will be successful in the time and of the magnitude expected. Even if we achieve our targeted level of Adjusted Earnings before Interest, Taxes, Depreciation and Amortization, or "Adjusted EBITDA," we may continue with negative cash flow as a result of capital expenditures and projected interest on the amounts outstanding under the Credit Agreement dated as of May 31, 2000, as amended, among McLeodUSA Incorporated, the lenders party thereto, and JPMorgan Chase Bank, (the "Credit Agreement") and the Credit Agreement, dated as of April 16, 2002, as amended, among McLeodUSA Incorporated, the lenders party thereto, and JPMorgan Chase Bank, as Agent, ("the Exit Facility"). Maintaining access to the amounts that remain available under the Exit Facility is critical in funding our future operations.

We Expect to Incur Significant Losses Over the Next Several Years

If we do not become profitable in the future, we could have difficulty obtaining funds to continue our operations. We have incurred net losses every year since we began operations. McLeodUSA incurred a net loss applicable to its common shares of $300.3 million for the year ended December 31, 2003 and $204.9 million for the period April 17, 2002 to December 31, 2002. We expect to incur significant operating losses during the next several years. If we are unable to generate an operating profit in the future**,** there may be adverse consequences to our business.

We Have a Risk of Inadequate Liquidity

Under the Plan, and under the Credit Agreement and the Exit Facility, our post-restructuring liquidity position is as follows:

- as of the date the Plan was confirmed, April 5, 2002, the Exit Facility commitments were $110 million of which we have drawn $65 million;
- we are required to pay higher interest rates;
- after consummation of the Plan, our operations consist primarily of competitive communications service operations, which have not generated positive cash flow in any quarterly period; and
- during 2004, the Company will need to increase its revenue in order to meet certain restrictive covenants. If we cannot increase revenues we may be required to obtain modifications to the Exit Facility in order to access any unused portion. There can be no assurance that we can obtain such modifications.

Finally, we may need additional capital to expand our business and develop new products, which may be difficult to obtain. Failure to obtain additional capital may preclude us from developing or enhancing our products, taking advantage of future opportunities, growing our business or responding to competitive pressures.

Failure to Raise Necessary Capital Could Restrict Our Ability to Develop Our Network and Services

There can be no assurance that our capital resources will be sufficient to enable us to achieve operating profitability. Failure to generate or raise sufficient funds may require us to delay or abandon some of our plans or expenditures, which could harm our business and competitive position. We expect to meet our funding needs through various sources, including existing cash balances, our Exit Facility, vendor financing and cash flow from future operations. Our estimated aggregate capital expenditure requirements include the projected costs of:

- deploying network assets currently not in service;
- activating and augmenting voice and data switches;
- constructing, purchasing, developing or improving communications assets in our target markets; and
- improving the business infrastructure and systems to support a more efficient telecommunications company.

We also require substantial funds for general corporate and other expenses and may require additional funds for working capital fluctuations.

The Credit Agreement and the Exit Facility each place restrictions on our ability to make capital expenditures and engage in acquisitions.

We may meet any additional financial needs by issuing additional debt or equity securities or by borrowing funds under the Exit Facility. We cannot assure that we will have timely access to additional financing sources on acceptable terms. Our ability to issue debt securities, borrow funds from additional lenders and participate in vendor financing programs are restricted under the terms of the Credit Agreement and the Exit Facility, and there can be no assurance that the lenders thereunder will waive these restrictions if we need additional financing beyond that permitted. If they do not, we may not be able to develop our markets, operations, facilities, network and services as we intend.

Adverse Treatment of Cancellation of Debt Income and Net Operating Losses May Adversely Impact Our Financial Position

We realized substantial cancellation of debt, or "COD," income as a result of the implementation of the Plan. Because we were a debtor in a bankruptcy case at the time we realized the COD income, we were not required to include such COD income in our taxable income for federal income tax purposes. Instead, we were required to reduce certain of our tax attributes by the amount of COD income so excluded. We believe that all of the parent company's net operating loss carryovers, or "NOLs," were eliminated and certain of our other tax attributes (including alternative minimum tax credit carryovers and the tax basis of certain property we own) were reduced or eliminated, as a result of COD income being excluded pursuant to the Plan. Some of the tax attributes of our subsidiaries would be reduced or eliminated if it is determined that such reductions must be applied on a consolidated group basis rather than on a separate company basis.

An "ownership change" (as defined in Internal Revenue Code Section 382 ("Section 382")) occurred with respect to our stock in connection with the Plan. An ownership change generally occurs if certain persons or groups increase their aggregate ownership percentage in a corporation's stock by more than 50 percentage points in the shorter of any three-year period or the period beginning the day after the day of the last ownership change. Section 382 may apply to limit our future ability to utilize any remaining NOLs generated before the ownership change and certain subsequently recognized "built-in" losses and deductions, if any, existing as of the date of the ownership change. Our ability and that of our subsidiaries to utilize new NOLs arising after the ownership change will not be affected.

A bankruptcy exception to the general Section 382 limitations may apply because our historic stockholders and creditors holding "qualified indebtedness" (as defined for purposes of Section 382) prior to the implementation of the Plan own at least 50% of our stock (by vote and value) after its implementation. Under this exception, our ability to utilize our pre-change NOLs would not be limited as described above, but the amount of our pre-change NOLs would be reduced by the amount of interest paid or accrued, during the current and immediately preceding three years, on the Notes in respect of which New Series A Preferred Stock was issued. The NOL adjustment for interest expense would be made prior to the tax attribute reductions described above. Under this exception, if we incur a second ownership change within two years of the change incurred as a result of the Plan, we would be unable to use any of our pre-change NOLs. We believe we qualify for the bankruptcy exception.

Our Bankruptcy and the Financial Difficulties of Other Competitive Communications Providers Could Adversely Affect Our Image and Our Financial Results

The effect, if any, which our bankruptcy proceedings may have on our future operations cannot be accurately predicted or quantified. Many other competitive local exchange carriers, long distance carriers and other communications providers have also experienced substantial financial difficulties over the recent past. These financial difficulties may diminish our ability to obtain further capital and may adversely affect the willingness of potential customers to purchase their communications services from us. They may also create network risk to the extent that supplies of long distance carriers with whom we do business are adversely affected.

Our Common Stock is Subject to Dilution

The issuance of shares of Class A Common Stock or options to management and employees would result in additional dilution of the prior equity interests of the holders of the Class A Common Stock which could adversely affect the market price and the value of Class A Common Stock. Moreover, the exercise of the warrants to purchase Class A Common Stock would result in a further dilution of the prior equity interests of the holders of the Class A Common Stock. There can be no assurance that we will not need to issue additional equity securities in the future in order to execute our business plan if we do not achieve our projected results or for other reasons, which could lead to further dilution to holders of the Class A Common Stock.

Our Class A Common Stock and Series A Preferred Stock Could Be Volatile, Increasing the Risk of Loss to Holders

The market price of our Class A Common Stock and Series A Preferred Stock could be subject to significant fluctuations in response to various factors and events, including the depth and liquidity of the trading market for our Class A Common Stock and Series A Preferred Stock, changes in the regulatory environment and variations in our operating results. In addition, in recent years the stock market in general, and the telecommunications sector in particular, have experienced broad price and volume fluctuations that have often been unrelated to the operating performance of the companies. Broad market fluctuations may also adversely affect the market price of our Class A Common Stock.

The Warrants for McLeodUSA Class A Common Stock Will Not Be Listed and May Have Limited Liquidity

We have not and do not intend to list the warrants to purchase shares of Class A Common Stock on the NASDAQ Stock Market or any national securities exchange. This may make the warrants illiquid and adversely affect the ability of holders thereof to sell warrants.

Risk of NASDAQ Delisting Our Common Stock

McLeodUSA is required to meet certain requirements to ensure continued listing on the NASDAQ SmallCap Market, including that common stock listed on the SmallCap Market maintain a minimum bid price of $1 per share. McLeodUSA currently meets the NASDAQ minimum listing standard bid price. However, there can be no assurance that we will continue to do so. Failure to comply with other quantitative and qualitative listing criteria of the NASDAQ SmallCap Market could also result in the delisting of our common stock. A delisting from the NASDAQ SmallCap Market may adversely affect the liquidity and market price of our common stock.

Election Not to be Subject to Section 203 May Make Us More Vulnerable to Takeovers

The Plan and the terms of our agreement with Forstmann Little required that we opt out of the provisions of Section 203 of the Delaware General Corporation Law in order to complete the restructuring. The election to eliminate the protection provided by Section 203 of the Delaware General Corporation Law may make us more vulnerable to takeovers without giving us the ability to prohibit or delay such takeovers as effectively.

The Loss of Key Personnel Could Weaken Our Technical and Operational Expertise, Hinder the Development of Our Markets and Lower the Quality of Our Service

For various reasons, we may not be able to retain experienced and innovative personnel. The loss of the services of key personnel, or the inability to attract additional qualified personnel, could cause us to make less successful strategic decisions, which could hinder the development of our markets. We could also be less prepared for technological or marketing problems, which could reduce our ability to

serve our customers and lower the quality of our services. As a result, our financial condition could be adversely affected.

Chris A. Davis, our Chairman and Chief Executive Officer, Stephen C. Gray, our President, and G. Kenneth Burckhardt, our Executive Vice President and Chief Financial Officer, each play an important role within our company. Loss of these senior executives or other members of senior management could adversely affect our financial condition.

The Success of Our Communications Services Will Depend on Our Ability to Keep Pace with Rapid Technological Changes in Our Industry

Communications technology is changing rapidly. These changes influence the demand for our services and the competition we face. We need to be able to anticipate these changes and to develop and bring to market new and enhanced products and services quickly enough for the changing market. This will determine whether we can continue to increase our revenue and number of subscribers and remain competitive.

Failure to Obtain and Maintain Necessary Permits and Rights-of-Way Could Delay Installation of Our Networks and Interfere with Our Operations

To obtain access to rights-of-way needed to install, operate and maintain our fiber optic cable and other network elements, we must manage agreements with state highway authorities, local governments, transit authorities, local telephone companies and other utilities, railroa