

TC 98-062

1-1/2 KT

TC 98-062

DOCKET NO.

In the Matter of

IN THE MATTER OF THE
APPLICATION OF WINSTAR
WIRELESS, INC. FOR A CERTIFICATE
OF AUTHORITY TO PROVIDE
TELECOMMUNICATIONS SERVICES IN
SOUTH DAKOTA AND FOR APPROVAL
NUNC PRO TUNC OF A TRANSFER OF
ASSETS FROM MIDCOM
COMMUNICATIONS, INC. TO WINSTAR
WIRELESS, INC.

Public Utilities Commission of the State of South Dakota

MEMORANDA

DATE

3/4 98 Filed and docketed;
3/5 98 TC For Filing;
7/21 98 Order Denying COA;
9/3 98 Rocket Case

KELLEY DRYE & WARREN LLP

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March 3, 1998

VIA FEDERAL EXPRESS

Mr. William Bullard, Jr.
Executive Director
South Dakota Public Utilities Commission
State Capitol Building
500 East Capitol Avenue
Pierre, SD 57501-5070

RECEIVED

MAR 14 1998

SOUTH DAKOTA PUBLIC
UTILITIES COMMISSION

Re: Transfer of Assets of MIDCOM Communications, Inc. to WinStar
Wireless, Inc. and Application of WinStar Wireless, Inc. for a
Certificate of Authority

Dear Mr. Bullard:

Enclosed for filing with the South Dakota Public Utilities Commission please find an original and 10 copies of the Application of WinStar Communications, Inc. and WinStar Wireless, Inc. ("WinStar Wireless") for approval of a transfer of assets from MIDCOM Communications, Inc. to WinStar Wireless, and for a Certificate of Authority for WinStar Wireless. Enclosed please also find a duplicate of this filing. Kindly date-stamp the duplicate on receipt and return it in the envelope provided.

Please do not hesitate to contact me if you have any questions regarding this filing.

Very truly yours,



Rebekah J. Kinnett

Before the
STATE OF SOUTH DAKOTA
PUBLIC UTILITIES COMMISSION

RECEIVED

MAR 14 1998

SOUTH DAKOTA PUBLIC
UTILITIES COMMISSION

Application for Approval *Nunc Pro Tunc* of)
a Transfer of Assets from) Docket No.
MIDCOM COMMUNICATIONS, INC., to)
WINSTAR WIRELESS, INC.)

APPLICATION FOR APPROVAL
NUNC PRO TUNC OF TRANSFER OF ASSETS

WinStar Communications, Inc. ("WinStar") and WinStar Wireless, Inc. ("WinStar Wireless") (together, the "Applicants"), by their attorneys, hereby respectfully request the approval of the South Dakota Public Utilities Commission ("Commission") *nunc pro tunc* of a transfer of assets from MIDCOM to WinStar Wireless.¹ In addition, in order to facilitate the seamless transfer of customers from MIDCOM to WinStar, the Applicants respectfully request that the Commission grant WinStar Wireless a Certificate of Authority to provide intrastate telecommunications services in South Dakota.

As described below, the transfer of assets, which already has been completed, was precipitated by voluntary Chapter 11 bankruptcy petitions filed by MIDCOM and two of its subsidiaries with the United States Bankruptcy Court of the Eastern District of Michigan, Detroit

¹ It is our understanding that MIDCOM no longer exists as a corporate entity, and therefore MIDCOM is not a party to this Application. Please be advised that we have not been authorized to represent MIDCOM, and hence we cannot speak or act on its behalf.

Division (the "Bankruptcy Court").² In compliance with the terms of the Bankruptcy Court order dated January 7, 1998, a closing was held on or about January 21, 1998, at which time MIDCOM transferred substantially all of the assets used in the conduct of its business, free and clear of all liens, claims, encumbrances, rights of first refusal, and other interest (except those expressly assumed by WinStar) to a special-purpose, wholly owned subsidiary of WinStar, WinStar MIDCOM Acquisition Corp. ("WinStar Acquisition").³ Simultaneously, MIDCOM's physical assets were transferred to WinStar Wireless, which is also a wholly owned subsidiary of WinStar.⁴ In addition, the customer accounts simultaneously were transferred to WinStar's primary operating subsidiary in each state. In South Dakota, those customer accounts were transferred to WinStar Wireless.

Unfortunately the Applicants were unable to seek the Commission's approval of this transfer of assets prior to its consummation. Therefore, in a good faith effort to comply with the Commission's rules *nunc pro tunc*, the Applicants come now before the Commission to seek approval of the transfer of assets and a Certificate of Authority for WinStar Wireless. In support of this Application, the Applicants provide the following information:

I. ***The Applicants***

WinStar is a publicly held Delaware corporation that is headquartered at 230 Park Avenue, Suite 3126, New York, New York, 10169. WinStar is the ultimate corporate parent of

² These cases are being jointly administered by the Bankruptcy Court as Bankruptcy Case No. 97-59044-S. The MIDCOM subsidiaries involved in the bankruptcy proceeding, Cel-Tech International Corp. and PacNet, Inc., are not telecommunications service providers and do not provide telecommunications services in South Dakota.

³ A copy of the Bankruptcy Court Order is appended hereto as Attachment A. Pursuant to this Order, WinStar acquired substantially all of the *assets* of MIDCOM, not an equity interest, or control of, MIDCOM. Control of MIDCOM remains with the existing MIDCOM shareholders.

⁴ Charts depicting the asset transfer are appended hereto as Attachment B.

the WinStar family of companies. WinStar, through its subsidiaries, operates as a facilities-based and resale provider of wireless private line and switched local and interexchange services throughout the United States. WinStar's customers are predominantly small and medium-sized businesses.

As wireless providers of telecommunications services, WinStar's subsidiaries have been authorized by the Federal Communications Commission ("FCC") to provide radio microwave services in the 38.6-40.0 GHz radio band. Thus, the WinStar family of companies has constructed, or is in the process of constructing, microwave networks for high capacity telecommunications services in metropolitan markets throughout the United States. Further, the WinStar companies are authorized to provide intrastate telecommunications services in 37 states and the District of Columbia.

MIDCOM is a publicly held Washington corporation headquartered at 26899 Northwestern Highway, Suite 120, Southfield, Michigan 48034.⁵ MIDCOM is a reseller provider of intrastate interexchange telecommunications services in 48 states, including South Dakota.⁶ MIDCOM also provides interstate and international telecommunications services pursuant to authority granted by the FCC.

⁵ Copies of MIDCOM's 1996 SEC Form 10-K and September 30, 1997 SEC Form 10-Q are appended hereto as Attachments C and D respectively.

⁶ The Commission granted MIDCOM authority to provide intrastate interexchange telecommunications services in South Dakota on June 19, 1992 in Docket No. TC92-032.

II. *Designated Contacts*

The designated contacts for questions concerning this Application are:

Danny E. Adams
Rebekah J. Kinnett
KELLEY DRYE & WARREN LLP
1200 19th Street, N.W.
Suite 500
Washington, D.C. 20036
(202) 955-9600

Copies of any correspondence should also be sent to:

Robert G. Berger
Russell C. Merbeth
WINSTAR COMMUNICATIONS, INC.
1146 19th Street, N.W.
Suite 250
Washington, D.C. 20036

III. *Request for Approval Nunc Pro Tunc of the Transfer of Assets from MIDCOM to the WinStar Companies*

On November 7, 1997 MIDCOM and two of its subsidiaries voluntarily filed petitions with the Bankruptcy Court seeking protection pursuant to Chapter 11 of Title 11 of the United States Code, 11 U.S.C. § 101 *et seq.* Thereafter, on December 11, 1997 WinStar and MIDCOM entered into an Asset Purchase Agreement ("Asset Agreement") pursuant to which WinStar tentatively agreed to purchase substantially all of the assets and properties of the MIDCOM companies relating to MIDCOM's telecommunications business for approximately \$97 million. By Order dated January 7, 1997 the Bankruptcy Court approved the Asset Agreement and authorized the sale of most of MIDCOM's assets to WinStar.⁷ In order to comply with the

⁷ WinStar began negotiating with MIDCOM in late November and early December of 1997 for purchase of certain MIDCOM assets. WinStar and MIDCOM entered into the Asset Agreement on December 18, 1997. Thereafter, the Bankruptcy Court set a hearing date for approval of the Asset Agreement, established procedures for notification to creditors of MIDCOM regarding the Asset Agreement, and (continued...)

Bankruptcy Court's directive that the closing be held as soon as possible so as to preserve the value of MIDCOM's business as a going concern, the Applicants completed the transaction on January 21, 1998 by transferring substantially all of MIDCOM's assets to WinStar Acquisition. Thereafter, MIDCOM's physical assets, such as telecommunications switches, office furniture, and the like, were transferred to WinStar Wireless. All of MIDCOM's customer accounts in South Dakota also have been transferred to WinStar Wireless.

As a result of the bankruptcy process and the need to act quickly as directed by the Bankruptcy Court, the Applicants did not have an opportunity to apply for and receive the Commission's approval of the asset transfer prior to closing. Accordingly, the Applicants unfortunately were unable to seek prior Commission approval and respectfully request that the Commission permit them to cure this deficiency *nunc pro tunc*.

The transfer of assets was accomplished in a seamless fashion that did not, and will not, adversely affect the provision of telecommunications services to MIDCOM's former customers in South Dakota. MIDCOM's former customers should not experience any adverse effects as a result of this acquisition. The Applicants respectfully request that any former MIDCOM customer wishing to receive the same services at the same rates as they presently are receiving be permitted to receive such services on a grandfathered basis. WinStar will take whatever steps are necessary to ensure that no MIDCOM customer experiences either a material change in service or an increase in rates. Thus, the transfer will not detrimentally impact consumers in South

... (continued)

approved auction procedures. Pursuant to these auction procedures, MIDCOM's assets were offered for sale at auction on or about January 5, 1998. The Bankruptcy Court entered an order approving the sale of MIDCOM's assets to WinStar on January 7, 1998, subject to a 10-day right of appeal by creditors. Creditors' rights of appeal ended on January 20, 1998 and the transaction was completed.

Dakota. In addition, all of MIDCOM's former customers in South Dakota will be notified of this Application, by bill insert, within 30 days of the date of this filing.

IV. *Request for a Certificate of Authority to Provide Intrastate Telecommunications Services in South Dakota*

In order to facilitate the seamless transition of customers from MIDCOM to WinStar, the Applicants respectfully request that the Commission grant a Certificate of Authority to WinStar Wireless that is identical in scope to the authority currently held by MIDCOM. Thus, WinStar Wireless respectfully requests that the Commission authorize it to provide long distance services throughout the state of South Dakota on a resale basis. As set forth above, WinStar Wireless is fully qualified to provide telecommunications services to customers in the state of South Dakota.⁸

The WinStar companies provide intercity services by means of leased fiber optic capacity obtained from other carriers, and through resale of the services of other carriers. At the local level, WinStar holds the largest amount of 38 GHz spectrum in the United States, which it uses to carry high-speed, digital traffic including voice, data and video transmission. The technology employed by the WinStar local network offers capabilities equivalent to those of a fiber optic network, without employing underground cable and conduits. Moreover, the frequency pairs that have been allocated by the FCC to WinStar have enabled WinStar to design high-speed microwave services that are cost-effective and reliable. WinStar has agreed to acquire an aggregate of 47 additional 38 GHz licenses in a series of transactions subject to the approval of the FCC. Upon completion of these acquisitions, WinStar and its subsidiaries will be able to

⁸ WinStar Wireless is a Delaware corporation, and is in the process of qualifying to transact business in South Dakota as a foreign corporation. Copies of WinStar Wireless's Articles of Incorporation and Certificate of Qualification will be forwarded to the Commission under separate cover.

provide local telecommunications services in the 50 most populated Metropolitan Statistical Areas.

WinStar Wireless is financially, managerially and technically qualified to operate as a telecommunications service provider in South Dakota. WinStar Wireless and its affiliates and subsidiaries are authorized to provide intrastate telecommunications services in 37 states and the District of Columbia. Thus, WinStar Wireless, as part of the WinStar family of companies, is fully qualified to provide high quality, reliable and advanced telecommunications services to MIDCOM's former customers.

Importantly, the WinStar companies are managed by a team of experienced personnel, all of whom have extensive backgrounds in telecommunications.⁹ Further, the information contained in Attachments F and G provides a detailed description of WinStar's nationwide operations, and demonstrates WinStar's financial, managerial, and technical qualifications to compete effectively in the market for telecommunications services in South Dakota. Specifically, as of September 30, 1997, WinStar's financials demonstrate that WinStar had over \$300 million in cash equivalents and short term investments.¹⁰

V. *Public Interest Analysis*

Approval *non pro tunc* of the transfer of assets from MIDCOM to WinStar and granting WinStar Wireless a Certificate of Authority is in the public interest. WinStar's acquisition of MIDCOM's assets, including its customer base, avoided any unnecessary interruption in the telecommunications service provided to MIDCOM's customers in South Dakota. Further,

⁹ Biographies of WinStar's top management personnel are appended hereto as Attachment E.

¹⁰ Copies of WinStar's 1996 SEC Form 10-K and third quarter 1997 SEC Form 10-Q are appended hereto as Attachments F and G respectively.

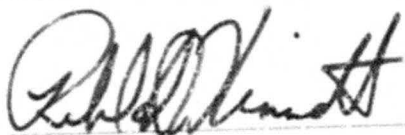
WinStar is fully qualified to provide high quality telecommunications services to MIDCOM's former customers at competitive prices. Therefore, from the perspective of affected customers, the transfer is, and will be, largely transparent, leaving unaltered the quality of service that they expect. In addition, the transfer will allow WinStar to realize significant economies of scale, thereby making it possible for WinStar to introduce new products and services in the state of South Dakota over time.

WHEREFORE, the Applicants respectfully request that the Commission approve the transfer of assets from MIDCOM to WinStar *nunc pro tunc* and grant WinStar Wireless a Certificate of Authority.

Respectfully submitted,

WINSTAR COMMUNICATIONS, INC. and
WINSTAR WIRELESS, INC.

By:



Danny E. Adams
Rebekah J. Kinnett
KELLEY DRYE & WARREN LLP
1200 Nineteenth Street, N.W.
Suite 500
Washington, D.C. 20036

Dated: March 3, 1998

Their Attorneys

57310.41

VERIFICATION

I am authorized to represent WinStar Communications, Inc. and each of its subsidiaries and to make this verification on their behalf. The statements in the foregoing document are true of my own knowledge, except as to matters which are therein stated on information and belief, and as to those matters, I believe them to be true. I declare under penalty of perjury that the foregoing is true and correct.

By: _____

Name: Robert G. Berger

Title: Vice President, Legal/Regulatory

Date: Feb. 26, 1998

Sworn and subscribed to
before me this 26
day of Feb, 1998.

Eleanor M. Willis
Notary Public

Eleanor M. Willis
Notary Public Of District of Columbia
My Commission Expires July 31, 1999

My Commission expires: _____

ATTACHMENT A

NEXT

DOCUMENT (S)

BEST IMAGE

POSSIBLE

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

In the Matter of:

Case No. 97-59044-S

Chapter 11

MIDCOM COMMUNICATIONS, INC., et. al.,

Hon. Walter Shapero

Debtor.

ORDER GRANTING
DEBTORS' MOTION FOR ORDER COMPELLING CERTAIN CARRIERS
TO PROVIDE SERVICE DURING TRANSITION PERIOD

This matter having come before the Court upon the Debtors', MIDCOM Communications, Inc., and its subsidiaries, Cel-Tech International Corp. and Pacnet Inc. (the "Debtors"), Motion For Order Compelling Certain Carriers to Provide Service During Transition Period (the "Motion"), the Court having granted an expedited hearing on the Motion and having approved notice of the Motion to the affected parties by facsimile, and the Court finding that such notice was adequate and sufficient under the circumstances, objections having been raised at the hearing and the Court being otherwise duly informed in the premises;

NOW, THEREFORE, for the reasons stated on the record, and the findings made herein, which are incorporated into the terms of this Order; ^(the "Carriers" as identified in the proof of service to the Motion attached hereto) it is hereby ordered that the Debtors' Motion is granted.

It is further ^{and the Carriers} ordered that the Debtors shall continue to comply with the various Stipulated Orders to Provide Adequate Assurance with individual Carriers, ^{including the written stipulation and Order dated November 26, 1997,} for the Order Granting Debtor's Motion for Order Approving Proposal for Adequate Assurance of

Payment to Carriers Under Section 366 of the Bankruptcy Code (collectively, the "Adequate Assurance Orders");

It is further ordered that, from and after the closing, through the earlier of (a) June 30, 1998, (b) the expiration of the Contracts by their own terms, (c) an order authorizing rejection of a Contract entered prior to June 30, 1998, or (d) such time as the Customer traffic is no longer carried on the Carrier's network (the "Transition Period"), WinStar will make the required payments under the Adequate Assurance Orders for such period on behalf of the Debtors directly to the Carriers, but such payments by WinStar shall not be construed to create a direct contractual relationship between the Carrier and WinStar. Notwithstanding the foregoing, WinStar is a party in interest under Section 1109(b).

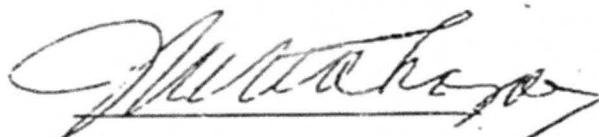
It is further ordered that the contracts ("Contracts") between the Debtors and the Carriers are executory, and subject to the terms of the Adequate Assurance Orders, will continue to govern during the Transition Period. The Debtors will either assume or reject each Contract by June 30, 1998, unless such Contract has expired by its own terms or has been rejected before that date.

It is further ordered that, except for Contracts which terminated by their terms prior to June 30, 1998, should the Debtors fail to assume or reject the Contracts by June 30, 1998, the Contracts shall be rejected effective as of July 1, 1998, unless otherwise agreed by the parties or ordered by the Court.

It is further ordered that, on the earlier of (a) the expiration of a Contract, (b) an order authorizing the rejection of a Contract or (c) July 1, 1998, the Carriers shall be authorized to terminate all services under their Contracts, without the need of a Court order or notice and hearing, and the automatic stay of 11 U.S.C. Section 362 is hereby modified to permit such termination.

It is further ordered that, at the conclusion of the Transition Period, the Debtors or WinStar and the Carriers shall reconcile promptly, and the Carriers and WinStar or the Debtors shall remit promptly to the other party (overpayments to be remitted directly to WinStar), amounts due pursuant to the Contracts, as modified by the Adequate Assurance Orders and this Order.

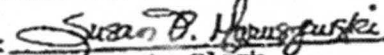
It is further ordered that any notice required to be given by a Carrier under its Adequate Assurance Order shall also be given to WinStar (atten: Ken Schwarz, facsimile number 703-645-5190 and David Alan Miller, facsimile number 212-818-8881) by the same means as required to be given to the Debtors, and the Debtors and or WinStar shall promptly notify the Committee (atten: Larry K. Snider, facsimile number 312-701-7711) thereof.



United States Bankruptcy Judge

A TRUE COPY

CLERK, U.S. BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN

BY: 
Deputy Clerk

Date: **JAN21 1998**

Dated: January 21, 1998

UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION

In the Matter of:

MIDCOM COMMUNICATIONS INC., et al.
a Washington Corporation,

Debtors.

Case Nos. 97-59044, 97-59057,
97-59064, 97-59052

Chapter 11
Hon. Walter Shapero

PROOF OF SERVICE

STATE OF MICHIGAN)
) ss.
COUNTY OF WAYNE)

MaryEllen Leopold, being first duly sworn, deposes and says that she is employed by PEPPER HAMILTON LLP; and that on the 20th day of January, 1998, she served, by telecopy, a copy of Brief in Support of Debtors' Motion for Order Compelling Certain Carriers to Provide Service During Transition Period upon everyone listed below at their respective telecopy numbers:

AT&T Corp Att: Bob Imhoff	732-805-6094
WitTel Inc. and Worddown Network Services Att: Natalie Clay	630-516-6023
Teleport Comm. Group Att: Colleen	303-749-1998
MFS Telecom Inc. Att: Heather Morris	213-489-3712
Qwest Communications Corp. Att: Lisa	303-291-1444
Northern Telecom, Inc. Att: Pat Karsner	972-684-3889
LCI International Telecom Att: Angel	888-524-2070
Consolidated Communications Operator Services Att: Cindy Simpson	217-234-2810
Zero Plus Dialing Inc./USBI Att: Patty Mcznarich	210-692-1887

Howard Levine	503-248-0130
Michael Khoury	313-965-8252
Pat Mears	616-776-7573
Jeffrey Deller	412-392-2128
Timothy Graham	212-922-1637
David Steinberg	732-392-3475
Bill Oberlin	248-208-9225
Jonathan S. Green	313-496-8450
Howard Sher/Stephen Schubiner	248-649-2920
Larry Snider	312-701-7711
Ben Silver	310-479-2690
Jerry Munitz	312-332-2196
John Greco	212-818-8881
Steve Goldman	248-945-1904
Sharon Levine/Bob Towey	973-228-6030

Mary Ellen Leopold
Mary Ellen Leopold
 PEPPER HAMILTON LLP
 100 Renaissance Center - Ste 3600
 Detroit, MI 48243
 313/259-7110

Subscribed and sworn to before me
 this 20th of January, 1998.

Anne M. Kupstas
Anne M. Kupstas
 NOTARY PUBLIC

ANNE M. KUPSTAS
 Notary Public, Wayne County, MI
 My Commission Expires Oct. 27, 1998

**UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN
SOUTHERN DIVISION**

In the Matter of:

MIDCOM COMMUNICATIONS INC., et al.
a Washington Corporation,

Debtors.

Case Nos. 97-59044, 97-59057,
97-59064, 97-59052

Chapter 11
Hon. Walter Shapero

ORDER UNDER 11 U.S.C. §§ 105(a), 363(b), (f), (l) AND (m), 365, AND 1146(c), AND FED. R. BANKR. P. 2002, 6004, 6006, 9014: (A) APPROVING AMENDED AND RESTATED ASSET PURCHASE AGREEMENT WITH WINSTAR COMMUNICATIONS, INC. AND WINSTAR MIDCOM ACQUISITION CORP.; (B) AUTHORIZING (i) SALE OF SUBSTANTIALLY ALL OF DEBTORS' ASSETS FREE AND CLEAR OF LIENS, CLAIMS, INTERESTS AND ENCUMBRANCES, (ii) ASSUMPTION AND ASSIGNMENT OF CERTAIN EXECUTORY CONTRACTS AND LEASES, AND (iii) ASSUMPTION OF CERTAIN DEBTS; AND (C) GRANTING RELATED RELIEF

This matter having come before the Court upon the December 22, 1997 Motion (the "Sale Motion")¹ of Midcom Communications Inc. ("Midcom") and its enumerated wholly-owned subsidiaries, Cel-Tech International Corp. and Pacnet Inc. (the "Subsidiaries"), debtors and debtors-in-possession (Midcom and the Subsidiaries collectively, the "Debtors"), for an order under 11 U.S.C. §§ 105(a), 363(b), (f), (l) and (m), 365, and 1146(c) and Fed. R. Bankr. P. 2002, 6004, 6006, and 9014 authorizing (A) the sale of substantially all of the Assets used in the conduct of the Business of Midcom and its Subsidiaries as sellers (the "Debtors"), free and clear of all liens, claims, encumbrances, rights of first refusal, and other interests (except those expressly assumed by the Purchaser or otherwise expressly stated as obligations of the Purchaser) (the "Sale"), pursuant to and as described in the Amended and Restated Asset Purchase Agreement, dated as of December

¹ Unless otherwise defined, capitalized terms used herein shall have the meaning ascribed to them in the Sale Motion, the Purchase Agreement (as defined hereafter), or the Bankruptcy Code. A copy of the Purchase Agreement as amended is attached hereto as Exhibit A.

17, 1997, as amended, and related Company Disclosure Letter and Purchaser Disclosure Letter (together the "Purchase Agreement"), between the Debtors and WinStar Communications, Inc. ("WinStar"), a Delaware corporation, and WinStar Midcom Acquisition Corp., a Delaware corporation, and its assigns ("Purchaser"); (B) the Debtors' assumption and assignment to the Purchaser of the Assumed Contracts identified or described in the Purchase Agreement, free and clear of liens, claims, encumbrances, rights of first refusal and other interests; and (C) granting related relief; the court having entered the Overbid Procedures Order, pursuant to which, among other things, the Court: (a) ordered that an auction (the "Auction") for the sale of the Assets and the assumption and assignment of certain executory contracts and unexpired leases be held on January 5, 1998; (b) approved certain bidding terms, conditions, and procedures with respect to the Auction; (c) approved the form of the notices (the "Notices") to be given with respect to the Sale Motion and the relief sought therein; (d) directed Debtors to serve the Notices upon various "entities" (as that term is defined in §101 (15) of the Bankruptcy Code); and (e) consistent with Federal Rules of Bankruptcy Procedure 2002(m) and 9008, found and ordered that the notice required by the Overbid Procedures Order was appropriate and reasonably calculated to apprise creditors (including all persons and other entities who have a Claim (as defined in section 101(5) of the Bankruptcy Code) against Debtors' estates) and all other parties in interest (including those entities claiming an interest in the Assets) of the Sale Motion, the Purchase Agreement, and the transactions contemplated therein, and to provide such persons and other entities with an adequate and sufficient opportunity to respond to the Sale Motion, the Purchase Agreement, and the transactions contemplated therein and that such notice constituted sufficient notice under the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure; and hearings on the Sale Motion having been held on January 6 and 7, 1998 (the "Sale Hearing"), at which time all interested parties were offered an opportunity to be heard with respect to the Sale Motion; and the Court having considered (i) the Sale Motion, (ii) the objections thereto, and (iii) the arguments of counsel made, and the evidence proffered or adduced,

at the Sale Hearing; and it appearing that the relief requested in the Sale Motion is in the best interests of the Debtors, their estates, their creditors and other parties in interest; and upon the record of the Sale Hearing and these cases; and after due deliberation thereon; and good cause appearing therefor;

IT IS HEREBY FOUND AND DETERMINED THAT:²

1. The Court has jurisdiction over this Sale Motion pursuant to 28 U.S.C. §§ 157 and 1334, and over the entities which are subject to the terms of this Order, including but not limited to all creditors, all persons and entities who have a claim (as defined in §101(5) of the Bankruptcy Code) against the Debtors or their bankruptcy estates, and all parties in interest, including those entities claiming an interest in the Assets and those entities who are parties to the Contracts. This matter is a core proceeding pursuant to 28 U.S.C. § 157(b)(2). Venue of these cases and the Sale Motion in this district is proper under 28 U.S.C. §§ 1408 and 1409.

2. The statutory predicates for the relief sought in the Sale Motion are sections 105(a), 363(b), (f), (l), and (m), 365, and 1146(c) of the United States Bankruptcy Code, 11 U.S.C. 101 et seq., as amended (the "Bankruptcy Code" or the "Code"), and Fed. R. Bankr. P. 2002, 6004, 6006, and 9014.

3. As evidenced by the affidavits of service previously filed with the Court, and based on the representations of counsel at the Sale Hearing, (1) proper, timely, adequate and sufficient notice of the Sale Motion, the Sale Hearing and the Sale has been provided in accordance with the Bankruptcy Code, Federal Rules of Bankruptcy Procedures, including 11 U.S.C. §§ 102(1), 383, and 385 and Fed. R. Bankr. P. 2002, 6004, 6006, and 9014, the Local Bankruptcy Rules, and in compliance with this Court's Overbid Procedures Order, signed December 19, 1997; (2) such notice was good and sufficient, and appropriate under the particular circumstances, and (3) no other or further notice of the Sale, the Sale Motion, or the Sale Hearing shall be required.

² Findings of fact shall be construed as conclusions of law and conclusions of law shall be construed as findings of fact when appropriate. See Fed. R. Bankr. P. 7052.

4. A reasonable opportunity to object or be heard with respect to the Sale Motion and the relief requested therein has been afforded to all interested persons and entities, including (i) the United States Trustee; (ii) the Creditors' Committee appointed in the case of MIDCOM Communications Inc.; (iii) any and all entities known to have expressed an interest in a merger or acquisition transaction regarding the Debtors or their assets during the past twelve (12) months; (iv) all entities known to have asserted any lien, claim, encumbrance, right of first refusal, or other property interest in or upon any of the Assets and Contracts which are to be sold or assigned pursuant to the Purchase Agreement; (v) all entities who had filed a notice of appearance and request for service of papers in these cases; and (vi) all parties to executory contracts or unexpired leases proposed to be assumed and assigned under the Purchase Agreement.

5. Each Debtor (i) has full corporate power and authority to execute the Purchase Agreement and all other documents contemplated thereby, and the sale of the Assets of the Business by the Debtors has been duly and validly authorized by all necessary corporate action of each of the Debtors, (ii) has all of the corporate power and authority necessary to consummate the transactions contemplated by the Purchase Agreement, (iii) has taken all corporate action necessary to authorize and approve the Purchase Agreement and the consummation by such Debtor of the transactions contemplated thereby, and (iv) requires no further consents or approvals, other than those expressly provided for in the Purchase Agreement or otherwise explicitly set forth herein, to consummate such transactions.

6. On January 5, 1998, the Debtors conducted an auction pursuant to this Court's Overbid Procedures Order, and the Debtors having received no other bid for the Assets complying with the terms of the Overbid Procedures Order which was higher and better than Purchaser's bid (as contained in the Purchase Agreement), at the conclusion of the Auction the Debtors determined that Purchaser has made the highest and best offer to purchase the Assets.

7. Approval of the Purchase Agreement and consummation of the Sale at this time are in the best interests of the Debtors, their creditors, their estates, and the public, particularly the Debtors' numerous customers who rely upon the Debtors' service.

8. The Debtors have demonstrated both (i) good, sufficient, and sound business purpose and justification and (ii) compelling circumstances for the Sale pursuant to the applicable provisions of the Bankruptcy Code, including 11 U.S.C. §§ 105 and 363 prior to, and outside of, a plan of reorganization in that, among other things:

(A) On the Petition Date, the Debtors were in default under their \$23 million credit agreement with Foothill Capital Corporation ("Foothill");

(B) On the Petition Date, the Debtors were unable to borrow under their existing credit facilities;

(C) The cash generated by the Debtors' operating activities is insufficient to fund the non-discretionary capital expenditure requirements necessary to maintain their present operations and facilities as well as the scheduled debt service requirements of their notes payable and term obligations;

(D) The Debtors do not have the capacity to pursue new development projects which are critical to continued growth and profitability in their competitive industry; and

(E) To solve their immediate financing problems, the Debtors entered into the Order Authorizing Debtors to: (A) Use Cash Collateral; (B) Incur Post-Petition Debt; and (C) Grant Adequate Protection and Provide Other Security with Foothill, as amended by the First Order Amending Order Authorizing Debtors To: (A) Use Cash Collateral; (B) Incur Post-Petition Debt; and (C) Grant Adequate Protection and Provide Other Security. This financing allows the Debtors to use their cash collateral and borrow up to an additional approximate \$17 million, subject to various conditions.

If the Sale and related transactions are not approved and consummated promptly, the Business could deteriorate to the point where the Purchaser could terminate the Purchase Agreement, thereby relegating the Debtors to a disorganized liquidation that would achieve far less value for creditors than the transactions contemplated by the Purchase Agreement or a sale involving a significantly reduced purchase price.

9. The Debtors diligently and in good faith marketed the Assets of the Business to secure the highest and best offer therefor. In that regard, the Debtors sought bids for all of their Business and Assets. The terms and conditions set forth in the Purchase Agreement, and the Sale to the Purchaser pursuant thereto, represent a fair and reasonable purchase price and constitute the highest and best offer obtainable for the Business and the Assets.

10. A sale of the Assets is the only viable alternative for preserving and capturing the value of the Assets and ensuring the continuation of the Business. The Debtors cannot continue to operate the Business for the time required to confirm and consummate a plan of reorganization without risking an immediate and material decline in the value of the Business and Assets. Thus, the only way to preserve and maximize value is to consummate the Sale and sell the Assets of the Business, thereby insuring an orderly and equitable sale process and distribution of proceeds.

11. Potentially significant and long-term claims against the Debtors' estates will be minimized as a result of the prompt consummation of the Sale, and the concomitant assumption and assignment of the Contracts to the Purchaser.

12. A sale of the Assets of the Business at this time to the Purchaser would result in the highest possible purchase price therefor. Thus, unless the Sale to the Purchaser is concluded expeditiously, as provided for in the Sale Motion and under the Purchase Agreement, the value of the Business and Assets will decline and the Debtors, their estates and their creditors may realize little or no value for the Business or the Assets.

13. Similarly, with each passing day, the probability increases that the Debtors' customers will procure alternative service for their needs. To preserve the value of the Assets of the Business, preserve the jobs of many of the Debtors' employees, and preserve and maximize the value of the Debtors' estates for the benefit of all interested parties, the Debtors must be authorized to consummate the sale expeditiously.

14. All interests (as hereafter defined) shall attach to the proceeds of the Sale. The cash proceeds of the Sale paid to the Debtors at the Closing will be distributed to make the "cure payments" and other payments required under this Order, and the balance of the proceeds shall be distributed to Foothill Capital Corporation pursuant to the First Order Amending Order Authorizing Debtors To: (A) Use Cash Collateral; (B) Incur Postpetition Debt; and (C) Grant Adequate Protection and Provide Other Security and the Interim Order, as defined therein and then to the Debtors.

15. The Purchase Agreement was negotiated, proposed and entered into by the Debtors and the Purchaser without collusion, in good faith, and from arm's-length bargaining positions. None of the Debtors or the Purchaser or its affiliates has engaged in any conduct that would cause or permit the Purchase Agreement to be avoided under 11 U.S.C. § 363(n).

16. The Purchaser is an entity purchasing and leasing property in good faith within the meaning of 11 U.S.C. § 363(m) and, as such, is entitled to the protections afforded thereby. The Purchaser will be acting in good faith within the meaning of 11 U.S.C. § 363(m) in closing the transactions contemplated by the Purchase Agreement.

17. The consideration provided by the Purchaser for the Assets of the Business pursuant to the Purchase Agreement constitutes reasonably equivalent value and fair consideration under the Bankruptcy Code and under the laws of the United States, any state, territory, possession, or the District of Columbia.

18. The consideration offered in the Purchase Agreement is the highest and best consideration offered for the Assets of the Business and will provide a greater recovery for the Debtors' creditors than would be provided by any other practical available alternative.

19. The Sale must be approved and consummated promptly in order to preserve the value of the Business as a going concern.

20. The transfer of the Assets to the Purchaser upon the Closing will be a legal, valid, and effective transfer of the Assets and vest the Purchaser with all right, title, and interest of the Debtors to the Assets free and clear of mortgages, security interests, conditional sale or other title retention agreements, pledges, liens, claims, judgments, demands, easements, charges, encumbrances, defects, security interests, options, rights of first refusal, restrictions of all kind and any other interest (including, without limitation, liens, claims, encumbrances and interests (i) that purport to give to any party a right or option to effect any forfeiture, modification or termination of the Debtors' or the Purchaser's interest in the Assets, (ii) in respect of Taxes, or (iii) which arise as a result of any Employee Benefit Plan) (collectively, "Interests").

21. The Purchaser would not have entered into the Purchase Agreement and would not consummate the transactions contemplated thereby, thus adversely affecting the Debtors, their estates, and their creditors, if the Sale of the Assets of the Business to the Purchaser and the assignment of the Contracts to the Purchaser were not free and clear of all Interests.

22. The Debtors may sell the Assets of the Business free and clear of all Interests because, in each case, the requirements of the Bankruptcy Code, including one or more of the standards set forth in 11 U.S.C. § 363(f)(1) - (5) have been satisfied or such sale otherwise is authorized pursuant to 11 U.S.C. § 105. Those (A) holders of Interests, (B) non-debtor parties to Contracts and (C) other parties in interest who did not object, or who withdrew their objections, to the Sale, the Sale Motion or the assumption and assignment of Contracts are deemed to have consented to the transactions contemplated in the Purchase Agreement pursuant to 11 U.S.C. §§

363(f) (2) and 365. Those holders of Interests who did object fall within one or more of the other subsections of 11 U.S.C. § 363(f) are adequately protected by having their Interests, if any, attach to the cash proceeds of the Sale ultimately attributable to the property in which they claim an Interest as set forth in this Order.

23. Except with respect to the Assumed Liabilities, neither (A) the transfer of the Assets of the Business to the Purchaser nor (B) the assumption by the Debtors and assignment to and assumption by the Purchaser of the Assumed Contracts will subject the Purchaser to any liability by reason of such transfer or assignment and assumption under the laws of the United States, any state, territory, or possession thereof, or the District of Columbia, based, in whole or in part, directly or indirectly, on any theory of law, including, without limitation, any theory of antitrust or successor or transferee liability or otherwise.

24. The transfer of the Assets of the Business to the Purchaser is a transfer pursuant to 11 U.S.C. § 1146(c) and, accordingly, shall not be taxed under any law imposing a stamp tax or similar tax.

25. The Debtors have demonstrated that it is an exercise of their sound business judgment to assume and assign the Assumed Contracts to the Purchaser in connection with the consummation of the Sale, and the assumption and assignment of the Assumed Contracts is in the best interests of the Debtors, their estates, and their creditors. The Assumed Contracts being assigned to the Purchaser are an integral part of the operations of the Debtors being purchased by the Purchaser and, accordingly, such assumption and assignment of the Assumed Contracts is reasonable, enhances the value of the Debtors' estates, and does not constitute unfair discrimination.

26. The Debtors have, by agreeing to pay from the Purchase Price paid at Closing all costs of cure where there is no dispute as to the amount thereof and the undisputed portion of costs of cure where there is a dispute as to the amount thereof and by escrowing the disputed portion

with interest (which shall follow)

the principal

claimed by the non-Debtor party where there is a dispute, (i) provided adequate assurance that they will promptly cure any default which arises or accrues prior to the Closing Date under any of the Assumed Contracts, within the meaning of 11 U.S.C. § 365(b)(1)(A), and (ii) provided compensation or adequate assurance that they will promptly provide compensation to any party to the Assumed Contracts, other than the Debtors, for any actual pecuniary loss to such party resulting from a default under any of the Assumed Contracts which arises or accrues prior to the Closing Date, within the meaning of 11 U.S.C. § 365(b)(1)(B); and the Purchaser has provided adequate assurance of future performance of the Assumed Contracts, within the meaning of 11 U.S.C. § 365(b)(1)(C).

27. The Sellers have good and marketable title to the Assets;

28. All findings of facts and conclusions of law made herein or announced in open court in connection with the Sale Motion or the Overbid Procedures Order are incorporated herein.

NOW, THEREFORE, IT IS HEREBY ORDERED, ADJUDGED, AND DECREED THAT:

General Provisions

(1) All of the findings of fact and conclusions of law set forth above are incorporated herein by reference, and the Sale Motion as modified by announcements in open court is granted, as further described herein.

(2) All objections, responses, and requests for continuances concerning the Sale Motion or the relief requested therein are resolved in accordance with the terms of this Order and as set forth in the record of the Sale Hearing, and those that have not been withdrawn, waived, or settled, and all reservations of rights included in such objections, are overruled on the merits.

Approval of Purchase Agreement

(3) the Purchase Agreement and the transactions contemplated therein, including the transfer of the Assets by the Sellers to the Purchaser as provided in the Purchase Agreement are approved and authorized under the Bankruptcy Code, including Sections 105, 363 and 365 of the Bankruptcy Code;

(4) the transfer of the Assets by Sellers to Purchaser upon Closing will be a legal, valid, and effective transfer of the Assets notwithstanding any requirement for approval or consent by any entity (as defined in Section 101(15) of the Bankruptcy Code);

(5) the transfer of the Assets by Sellers to Purchaser vests the Purchaser with good and indefeasible title to the Assets free and clear of all Interests, except those expressly assumed by the Purchaser thereunder; and any such Interests which existed prior to the Closing shall attach to the proceeds of the sale (after taking into account any purchase price adjustments, "cure payments" for Assumed Contracts, or indemnification adjustments provided for in the Purchase Agreement) in the same order and priority as existed before the sale.

(6) the transfer of the Assets is in exchange for consideration being paid by the Purchaser that constitutes reasonably equivalent value and fair consideration under the Bankruptcy Code and under the laws of the United States, any state, territory, possession, or the District of Columbia;

(7) except with respect to the Assumed Liabilities, the transfer of the Assets of the Business, and the assumption and assignment of the Assumed Contracts, (including without limitation the Customer accounts and contracts with Customers) does not and will not subject the Purchaser to any liability by reason of such transfers and assignments under the laws of the United States, any state, territory or possession thereof or the District of Columbia based, in whole or in part, directly or indirectly, on any theory of law, including, without limitation, any theory of successor or transferee liability;

(8) the Purchaser is designated as the preassigned telecommunications carrier for all Customers of Sellers as of the Closing Date, and the Purchaser shall have all legal right to implement such designation immediately without Customer consent;

(9) any carrier currently providing network services to Sellers or any sales agent or distributor currently under contract to Sellers is prohibited from interfering with or impairing (i) the

transfer of Customers to Purchaser, (b) Purchaser's continued service after Closing or (m) the transfer of Customers to any underlying carrier designated by Purchaser.*

(10) the Bankruptcy Court retains jurisdiction to interpret and enforce the provisions of the Purchase Agreement, any related agreement to which one or more of the Debtors is party, and this Order, including, without limitation, jurisdiction to (a) protect the Purchaser against any claims or other liabilities related to the transactions contemplated by the Purchase Agreement or otherwise, in accordance with the provisions of the Purchase Agreement, (b) resolve any and all objections to, or disputes among the parties to the Purchase Agreement regarding, all issues or disputes with respect to claims for indemnification or otherwise payable under the Purchase Agreement, provided, however, that in the event the court abstains from exercising, or declines to exercise, jurisdiction with respect to any matter referred to in this Paragraph or is without jurisdiction, such abstention, refusal, or lack of jurisdiction shall have no effect upon and shall not control, prohibit, or limit the exercise of jurisdiction of any other court or arbitral body having competent jurisdiction with respect to any such matter;

(11) the transactions contemplated by the Purchase Agreement are undertaken by the Purchaser in good faith, as that term is used in Section 363(m) of the Bankruptcy Code, and the Purchaser is entitled to the rights and protection granted thereby;

(12) there exist exigent business reasons for the sale of the Assets to the Purchaser;

(13) the sale is in the best interests of the Debtors' estates, their creditors, and their Customers and is otherwise in the public interest;

(14) there has been such notice as is appropriate in the particular circumstances given to all entities required by law to receive notice of the sale and such opportunity for hearing as is appropriate in the particular circumstances;

(15) the Business and the Assets have been adequately marketed and will lose value absent a sale;

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* provided the foregoing shall not ~~preclude~~¹² preclude AT&T and AT&T Wireless from legitimate competition for the business of those customers if their Contracts are not Assumed Contracts;

(15) all of the requirements of Sections 105 and 363 of the Bankruptcy Code for a sale free and clear of interests have been met; and

(17) the Debtors' previous execution and delivery of the Purchase Agreement are hereby authorized, and the Debtors are authorized to consummate, pursuant to the terms of the Purchase Agreement, the sale of the Assets to Purchaser and related transactions (including, without limitation, the payment of amounts to cure defaults under the Assumed Contracts) and to negotiate, execute, and deliver such other and further documents as may be necessary or appropriate to implement and consummate the Purchase Agreement.

Assumption and Assignment to Purchaser of Contracts

(and ATOT and ATOT Wireless
as to them)

(18) Purchaser shall, on or before January 16, 1998, notify Debtors of those Contracts which Purchaser elects to have assumed by Debtors and assigned to Purchaser at the Closing (i.e., the Assumed Contracts);

(19) the assumption by Debtors and assignment to Purchaser of the Assumed Contracts is approved and shall become effective upon Closing;

(20) Sellers shall promptly after the Closing notify all other parties to each of the Contracts whether or not its Contract has been assumed by Debtors and assigned to Purchaser at the Closing;

(21) all defaults of Sellers under the Assumed Contracts arising or accruing prior to the Closing (without giving effect to any acceleration clauses or any default provisions in such contracts of a kind specified in Section 365(b)(2) of the Bankruptcy Code) shall be promptly cured by Sellers from that portion of the Purchase Price paid to Sellers at Closing, and Purchaser shall have no liability or obligation with respect to any default or obligation arising or accruing prior to the Closing;

(22) any actual pecuniary loss incurred by any party (other than the Debtors) to an Assumed Contract resulting from a default by Sellers prior to the Closing Date shall be promptly compensated by Sellers from that portion of the Purchase Price paid to Sellers at Closing, and

Purchaser shall have no liability or obligation with respect to any such loss arising or accruing prior to the Closing;

(23) the amounts to be paid to the parties to the Assumed Contracts by the Debtors shall be: (a) with respect to parties that filed written objections that have not been or are not hereafter resolved, the amount to be ordered by this Court; (b) with respect to parties that filed written objections that have been or are hereafter resolved, the amounts agreed to by the parties and set forth on the record of the Sale Hearing or in a subsequent written agreement between the Debtors and the other party to the Assumed Contract; (c) with respect to parties that failed to file written objections, the amounts set forth in the Notice of Proposed Assumption of Leases and Executory Contracts in Connection With the (i) Proposed Sale of Substantially All Assets of Midcom Communications and Certain Subsidiaries, (ii) Assumption and Assignment of Certain Related Executory Contracts and Unexpired Leases, and (iii) Opportunity to Submit Competitive Bids.

(24) the Purchaser has provided adequate assurance of future performance of the Assumed Contracts within the meaning of Section 365(f)(2) of the Bankruptcy Code; and

(25) the Assumed Contracts shall remain in full force and effect for the benefit of the Purchaser, notwithstanding any provisions in such Assumed Contracts or in applicable law (including, without limitation, those described in Sections 365(b)(2) and (f) of the Bankruptcy Code) that prohibit, restrict, or limit in any way such assignment or transfer;

(26) the Debtors, the Purchaser and its affiliates, and each of their agents and assigns, are authorized to transfer the Debtors' customers' telecommunications services to Purchaser or its assigns without further or prior approval of any regulatory agency or other governmental body and without further order of this Court, and none of them shall have any liability for making such transfers or causing such transfers to be made; provided, however, that Purchaser shall give notice to such Customers, with their normal monthly billings, that their telecommunications services have been transferred to, and are being provided by, Purchaser or its assigns;

Miscellaneous

(27) payment of the Debtors' obligations under the Purchase Agreement, the Escrow Agreement, this Order and as set forth on the record of the Sale Hearing, including any purchase price adjustment and indemnification amounts are immediately payable if and when the obligations of the Debtors arise under the Purchase Agreement, related agreements, this Order, or as set forth on the record of the Sale Hearing and may be paid without further order of the Court.

(28) the Debtors and each other entity having duties or responsibilities under the Purchase Agreement, the related agreements, or this Order, and their respective directors, officers, general partners, agents, representatives, and attorneys, are authorized and empowered to carry out all of the provisions of the Purchase Agreement and other related agreements; to issue, execute, deliver, file, and record, as appropriate, such other and further documents as may be necessary evidencing and consummating the Purchase Agreement and other related agreements; and to take any and all actions contemplated by the Purchase Agreement, the related agreements, or this Order, and to issue, execute, deliver, file, and record, as appropriate, such other contracts, instruments, releases, indentures mortgages, deeds, bills of sale, assignments, leases, or other agreements or documents and to perform such other acts and execute and deliver such other documents, as are consistent with, and necessary or appropriate to implement, effectuate, and consummate, the Purchase Agreement, the related agreements, and this Order and the transactions contemplated thereby and hereby, all without further application to, or order of, the Court or further action by their respective directors, stockholders, or partners, and with like effect as if such actions had been taken by unanimous action of the respective directors, stockholders, and partners of such entities. All such additional agreements, documents, and instruments shall be deemed to be "related agreements" for purposes of this Order. The Secretary or any assistant Secretary of each of the Debtors shall be, and hereby is, authorized to certify or attest to any of the foregoing actions (but no such certifications or attestation shall be required to make any such action valid, binding, and enforceable). The

Debtors are further authorized and empowered to cause to be filed with the secretary of state of any state or other applicable officials of any applicable governmental units any and all certificates, agreements, or amendments necessary or appropriate to effectuate the transactions contemplated by the Purchase Agreement, the related agreements, and this Order, including amended and restated certificates or articles of incorporation and by-laws or certificates or articles of amendment, and all such other actions, filings, or recordings as may be required under appropriate provisions of the applicable laws of all applicable governmental units, or as any of the officers of the Debtors may determine are necessary or appropriate. The execution of any such document, or the taking of any such action shall be, and hereby is, deemed conclusive evidence of the authority of such entity to so act. Without limiting the generality of the foregoing, this Order shall constitute all approvals and consents, if any, required by the general corporation law of the state of incorporation of each of the entities and all other applicable business corporation, trust, and other laws of the applicable governmental units with respect to the implementation and consummation of the Purchase Agreement, the related agreements, and this Order and the transactions contemplated thereby and hereby.

(29) all entities in possession of some or all of the Assets are directed to surrender possession of the Assets to the Purchaser on the Closing Date or at such time thereafter as Purchaser may request.

(30) on the Closing Date, each of the Debtors' creditors is directed to execute such documents and take all other actions as may be necessary to release its liens on or claims against the Assets, if any, as such liens or claims may have been recorded or may otherwise exist.

(31) this Order is and shall be binding upon and govern the acts of all entities including without limitation, all filing agents, filing officers, title agents, title companies, recorders of mortgages, recorders of deeds, registrars of deeds, administrative agencies, governmental departments, secretaries of state, federal, state, and local officials, and all other Persons and entities who may

be required by operation of law, the duties of their office, or contract, to accept, file, register or otherwise record or release any documents or instruments, or who may be required to report or insure any title or state of title in or to any of the Assets;

(32) each and every federal, state, and local governmental agency or department is hereby directed to accept any and all documents and instruments necessary and appropriate to consummate the transactions contemplated by the Purchase Agreement, the related agreements and this Order;

(33) if any Person or entity that has filed financing statements or other documents or agreements evidencing liens on or interests in the Assets shall not have delivered to the Debtors prior to the closing, in proper form for filing and executed by the appropriate parties, termination statements, instruments of satisfaction, releases of all liens or other interests which the Person or entity has with respect to the Assets, the Debtors are hereby authorized and directed to execute and file such statements, instruments, releases and other documents on behalf of the person or entity with respect to the Assets immediately prior to the Closing;

(34) all Persons are enjoined from in any way pursuing the Purchaser or its affiliates to recover any claim which such Person has against the Debtors or the Assets, except with respect to (1) Assumed Liabilities and (2) any claim which is independently assertable against the Purchaser or its affiliates and does not arise directly or indirectly from their dealings with the Debtors or the assignments and transfers contemplated by this Order;

(35) the Purchase Agreement, the related agreements, and all other documents, agreements, and instruments necessary to effectuate and consummate the transactions contemplated by the Purchase Agreement and the Escrow Agreement, together with the terms and provisions of this Order, shall be binding upon and shall inure to the benefit of the Debtors, the Purchaser, and their respective successors and assigns, notwithstanding any subsequent appointment of a trustee for one or more of the Debtors, under any chapter of the Bankruptcy Code,

as to which trustee such documents, agreements, and instruments (and the terms and provisions thereof) otherwise shall be binding;

(36) the Purchase Agreement and any related agreement may be modified, amended, or supplemented by agreement of the Debtors and the Purchaser without further action of the Court, provided that any such modification, amendment, or supplement is not material and substantially conforms to and effectuates the Purchase Agreement;

(37) nothing in this Order shall constitute an assumption or rejection of any executory contract or unexpired lease except, upon the Closing, as specifically provided in this Order, the Purchase Agreement, and the designation of Assumed Contracts. Debtors' ability to assume or reject any other executory contract or unexpired leases shall not be affected by this Order;

(38) Foothill shall not be obligated to provide financing to the Debtors in excess of \$35 million prior to the Closing unless Purchaser provides written evidence satisfactory to Foothill of an agreement with Sprint contemplated by Section 8.3(i) of the Purchase Agreement;

(39) WinStar and the Purchaser shall provide to the Committee and Foothill, through their counsel, all notices they provide to the Debtors at the time such notices are given to Debtors; and Section 9.8(b) of the Purchase Agreement is amended to provide that a notice thereunder shall be given within 20 days after WinStar or the Purchaser learns that a claim has been made against it for which it may seek indemnification; and

(40) notwithstanding any of the terms or provisions of this Order, if the sum of (i) the Debtors' outstanding indebtedness to Foothill which will be due at the Closing, plus (ii) the aggregate amount that must be paid by the Debtors under the Purchase Agreement to cure the Assumed Contracts (which Purchaser shall designate by written notice to the Debtors, the Committee, and Foothill, such written notice to be received by such parties by no later than 10:00 a.m. on January 16, 1998) exceeds \$48.5 million, then, at the Committee's option, the Court shall hold a hearing on

January 16, 1998, at 3:00 p.m., at which time the Committee may request that this Order be set aside and determined to be of no force or effect. If the Committee requests such a hearing, none of the findings of fact, conclusions of law, or any other provision of this Order shall be of any force or effect at the hearing, and all parties shall bear the same evidentiary burdens that they would have borne in connection with the Sale Motion if this Order had not been entered by the Court.

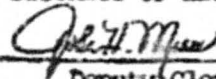
WALTER SHAPERO

THE HONORABLE WALTER SHAPERO
UNITED STATES BANKRUPTCY JUDGE

Dated: January 7, 1998

A TRUE COPY

CLERK, U.S. BANKRUPTCY COURT
EASTERN DISTRICT OF MICHIGAN

BY: 

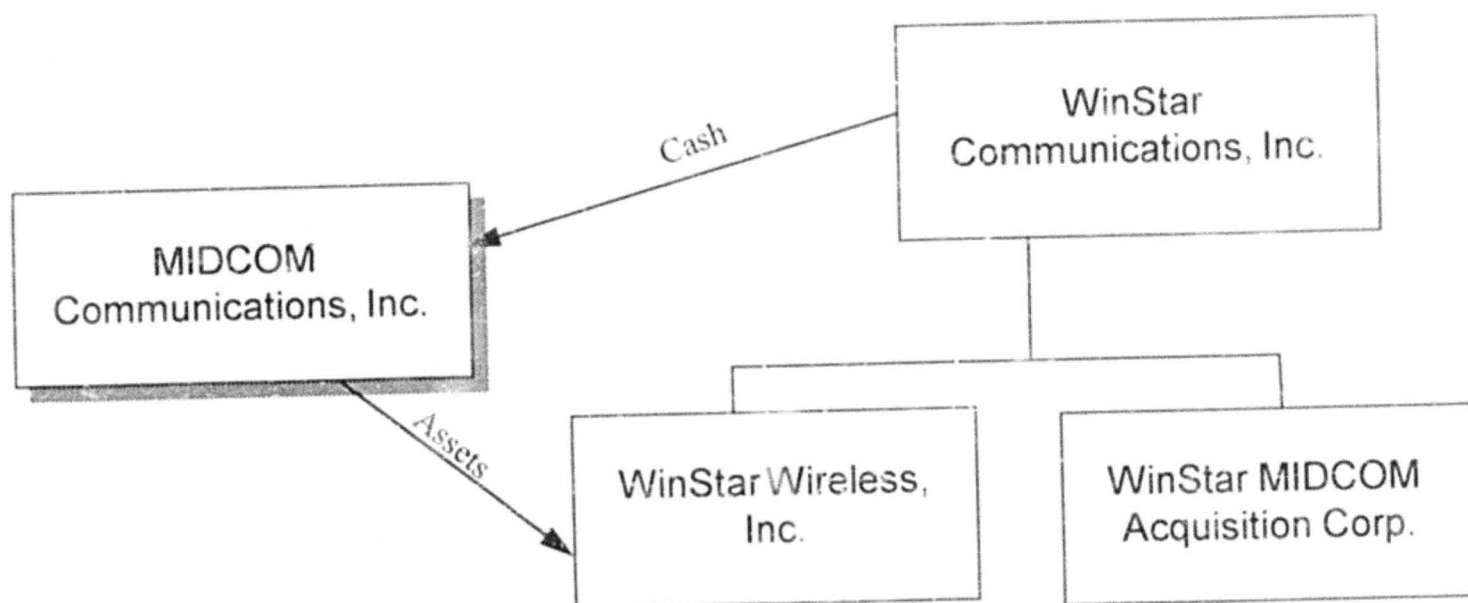
Deputy Clerk

DATE: JAN 07 1998

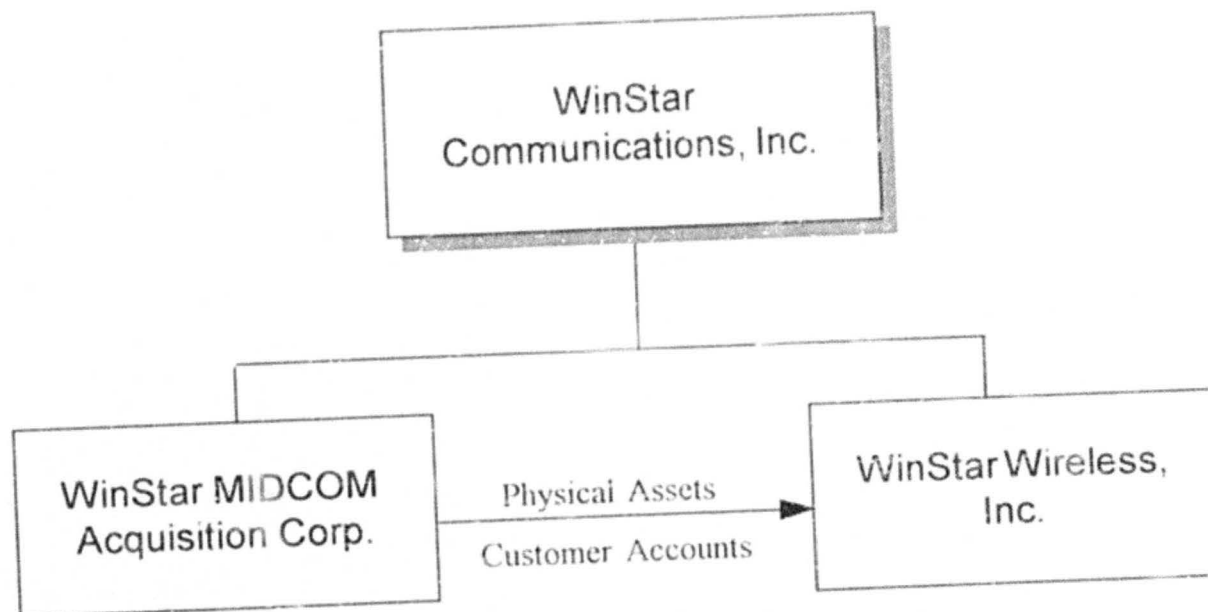
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ATTACHMENT B

ASSET TRANSFER -- STEP 1



ASSET TRANSFER -- STEP 2



ATTACHMENT C

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 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, 1996

OR

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

COMMISSION FILE NUMBER 000-26118

MIDCOM COMMUNICATIONS INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

WASHINGTON
(STATE OR OTHER JURISDICTION OF
INCORPORATION OR ORGANIZATION)

91-1438806
(I.R.S. EMPLOYER
IDENTIFICATION NO.)

1111 THIRD AVENUE
SEATTLE, WASHINGTON 98101

(206) 628-8000

(ADDRESS, INCLUDING ZIP CODE, TELEPHONE NUMBER AND AREA CODE, OF PRINCIPAL
EXECUTIVE OFFICES)

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

NONE

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

COMMON STOCK, PAR VALUE \$0.0001 (SYMBOL: "MCCI")

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (229.405 of this chapter) 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. ☐

As of March 24, 1997, the aggregate market value of the Registrant's Common Stock held by nonaffiliates of the Registrant was \$96,289,947 based on the closing sales price of the Registrant's Common Stock on the Nasdaq National Market.

As of March 24, 1997, the number of shares of the Registrant's Common Stock outstanding was 16,028,038.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive proxy statement relating to its 1997 annual meeting of shareholders, to be held on June 12, 1997, are incorporated by reference into Part III hereof.

PART I

ITEM 1. BUSINESS.

INTRODUCTION

MIDCOM Communications Inc. ("Midcom" or the "Company") provides long distance voice and data telecommunications services. As primarily a nonfacilities-based reseller, Midcom principally utilizes the network switching and transport facilities of Tier 1 long distance carriers, such as Sprint Corporation ("Sprint"), WorldCom, Inc. ("WorldCom") and AT&T Corp. ("AT&T"), to provide a broad array of integrated long distance telecommunications services on a seamless and highly reliable basis. Midcom's service offerings include basic "1 plus" and "800" long distance, frame relay, data transmission services, wireless services, dedicated private lines between customer locations and enhanced telecommunications services such as facsimile broadcast service and conference calling.

Midcom focuses on serving small to medium-sized businesses. The Company estimates that during the fourth quarter of 1996 it invoiced approximately 100,000 customer locations, a significant majority of which were located in the major metropolitan areas of California, Florida, Illinois, New York, Ohio and Washington. The Company believes that the larger long distance carriers, such as AT&T, Sprint, WorldCom and MCI Communications Corporation ("MCI"), tend to focus their sales and customer support efforts on residential and large commercial customers and do not routinely provide significant pricing discounts for small to medium-sized businesses. By purchasing large usage volumes from the facilities-based carriers at wholesale prices, Midcom seeks to offer its customers more favorable pricing than they could obtain from such carriers directly. In addition, the Company believes that businesses in this market segment do not typically have in-house telecommunications expertise and therefore require more assistance with the assessment and management of their telecommunications requirements. As a result, the Company believes that it is able to differentiate its service offerings from the larger carriers in this market segment on the basis of price, breadth of service offerings, customer service and support and the ability to provide customized solutions to the telecommunications requirements of its customers. See "-- Marketing and Sales," "-- Competition" and "-- Customer Concentrations."

Midcom believes that the Telecommunications Act of 1996 (the "Telecommunications Act") will substantially expand its market opportunities. The Telecommunications Act removes substantial legal barriers to competitive entry into the local telecommunications market and directs incumbent local exchange carriers to allow competing telecommunications service providers such as the Company to interconnect their facilities with the local exchange networks, to lease network components on an unbundled basis and to resell local telecommunications services. According to Federal Communications Commission ("FCC") and other industry estimates, in 1995 long distance providers reported revenue of \$72.4 billion while local telecommunications providers reported revenue of \$102.9 billion. See "-- Industry Background," "-- Regulation" and "-- Competition."

Midcom was incorporated in the State of Washington in 1989. Its executive offices are located at 111 Third Avenue, Seattle, Washington 98101, and its telephone number is (206) 628-8000.

FORWARD-LOOKING STATEMENTS

Statements herein concerning expectations for the future constitute forward-looking statements which are subject to a number of known and unknown risks, uncertainties and other factors which might cause actual results to differ materially from those expressed or implied by such forward-looking statements. Forward-looking statements herein include, but are not limited to, those concerning anticipated growth in sales and profitability; deployment of a network of high capacity local and long distance switching facilities; introduction of local and other additional telecommunications services; geographic expansion; increases in sales, customer service and other personnel; improvements in customer service; sales through new sales channels; adequacy of available sources of working capital to implement strategies; negotiation of more favorable carrier supply contracts; and expectations for growth in the telecommunications industry. Relevant risks and uncertainties include, but are not limited to, unanticipated actions by competitors, regulatory or other obstacles which

restrict the Company's ability to implement local or other services, greater than expected costs to open new offices, install switching equipment or execute other aspects of the Company's growth strategy, greater than expected declines in sales, inability to hire and retain key personnel, unfavorable determinations of pending lawsuits or other disputes, inability to obtain more favorable pricing and other terms from suppliers, inability to secure additional sources of working capital if and when needed, inability to manage growth or integrate acquired operations and regulatory changes. Additional risks and uncertainties include those described under "Risk Factors" below and those described from time to time in the Company's other filings with the Securities and Exchange Commission (the "Commission"), press releases and other communications.

THE PRIVATE PLACEMENT

In August and September of 1996, the Company completed a private placement (the "Private Placement") of \$97.7 million in aggregate principal amount of 8 1/4% Convertible Subordinated Notes due 2003 (the "Notes") pursuant to a Purchase Agreement, dated as of August 15, 1996 (the "Purchase Agreement"), among the Company, PaineWebber Incorporated ("PaineWebber") and Wheat, First Securities, Inc. ("Wheat, First," and together with PaineWebber the "Initial Purchasers"). The Notes were sold to qualified institutional buyers pursuant to Rule 144A of the Securities Act of 1933 (the "Securities Act"), certain "accredited investors" pursuant to Regulation D under the Securities Act, and certain non-U.S. persons pursuant to Regulation S under the Securities Act. The Notes are convertible into the Company's common stock, par value \$0.001 per share (the "Common Stock"), at the option of the holder thereof at any time prior to maturity (unless previously redeemed) at a conversion price of \$14.0875 per share, subject to adjustment in certain events.

The net proceeds to Midcom from the Private Placement were approximately \$94.2 million, after deducting the discount to the Initial Purchasers and expenses. The Company used the net proceeds as follows: (i) \$34.0 million to repay in full all obligations under the Company's secured revolving credit facility with Transamerica Business Credit Corporation and certain other lenders (the "Transamerica Credit Facility"), (ii) \$5.0 million to pay the first installment of an \$8.8 million payment in connection with the satisfaction of past shortfalls and reduction of the minimum commitment under the Company's carrier supply contract with AT&T and (iii) \$10.0 million to bring current a number of payment obligations existing prior to the completion of the Private Placement. The balance of the net proceeds has been and will be used for working capital, capital expenditures and general corporate purposes.

INDUSTRY BACKGROUND

The existing domestic long distance telecommunications industry was principally shaped by a 1984 court decree (the "Decree") that required the divestiture by AT&T of its 22 Bell operating companies ("BOCs"), organized the BOCs under seven regional Bell operating companies ("RBOCs") and divided the country into some 200 Local Access Transport Areas or "LATAs." The incumbent local exchange carriers ("ILECs"), which include the seven RBOCs as well as independent local exchange carriers, were given the right to provide local telephone service, local access service to long distance carriers and intra-LATA long distance service (long distance service within LATAs), but the RBOCs were prohibited from providing inter-LATA service (service between LATAs). The right to provide inter-LATA service was given to AT&T and the other interexchange carriers ("IXCs"). Conversely, IXCs were effectively blocked from providing local telephone service.

A typical inter-LATA long distance telephone call begins with the local exchange carrier ("LEC") transmitting the call by means of its local network to a point of connection with an IXC. The IXC, through its switching and transmission network, transmits the call to the LEC serving the area where the recipient of the call is located, and the receiving LEC then completes the call over its local facilities. For each long distance call, the originating LEC charges an access fee. The IXC also charges a fee for its transmission of the call, a portion of which consists of a terminating fee which is passed on to the LEC which serves the call. To encourage the development of competition in the long distance market, the Decree required LECs to provide all IXCs with access to local exchange services "equal in type, quality and price" to that provided to AT&T. These so-called "equal access" and related provisions were intended to prevent preferential treatment of

AT&T and to level the access charges that the LECs could charge IXCs, regardless of their volume of traffic. As a result of the Decree, customers of all long distance companies were eventually allowed to initiate their calls by utilizing simple "1 plus" dialing, rather than having to dial longer access or identification numbers and codes.

The Telecommunications Act is expected to significantly alter the telecommunications industry. The Decree has been lifted and all restrictions and obligations associated with the Decree have been eliminated by the new legislation. The seven RBOCs are now permitted to provide long distance service originating (or in the case of "XOC" service, terminating) outside their local service areas or offered in conjunction with other ancillary services, including wireless services. Following application to the FCC, and upon a finding by the FCC that an RBOC faces facilities-based competition and has satisfied a congressionally-mandated "competitive checklist" of interconnection and access obligations, an RBOC will be permitted to provide long distance service within its local service area, although in so doing, it will be subject to a variety of structural and nonstructural safeguards intended to minimize abuse of its market power in these local service areas. Having opened the interexchange market to RBOC entry, the Telecommunications Act also removes most legal barriers to competitive entry by interexchange and other carriers into the local telecommunications market and directs RBOCs to allow competing telecommunications service providers such as the Company to interconnect their facilities with the local exchange network, to acquire network components on an unbundled basis and to resell local telecommunications services. Moreover, the Telecommunications Act prevents IXCs that serve greater than five percent of presubscribed access lines in the U.S. (which includes the nation's three largest long distance providers) from jointly marketing certain local and long distance services until the RBOCs have been permitted to enter the long distance market or for three years, whichever is sooner. This gives all other long distance providers such as the Company a competitive advantage over the larger long distance providers in the newly-opened local telecommunications market. As a result of the Telecommunications Act, long distance carriers such as the Company will face significant new competition in the long distance telecommunications market, but will also be afforded significant new business opportunities in the local telecommunications market. See "-- Competition" and "-- Regulation."

Legislative, judicial and technological factors have helped to create the foundation for smaller long distance providers to emerge as legitimate alternatives to AT&T, MCI and Sprint for long distance telecommunication services. The FCC has required that all IXCs allow the resale of their services, and the Decree substantially eliminated different access arrangements as distinguishing features among long distance carriers. In recent years, national and regional network providers have substantially upgraded the quality and capacity of their domestic long distance networks, resulting in significant excess transmission capacity for voice and data communications. The Company believes that, as a result of digital fiber optic technology, excess capacity has been, and will continue to be, an important factor in long distance telecommunications. As a consequence, not only have smaller long distance service providers received legal protection to compete with the network-based carriers, they also represent a source of traffic to carriers with excess capacity.

COMPANY STRATEGY

During the second and third quarters of 1996, Midcom recruited a new executive management team with extensive experience and expertise in the telecommunications industry. In May 1996, the Company hired William H. Oberlin as its President and Chief Executive Officer, appointed Mr. Oberlin, Marvin C. Moses and John M. Zmo to its Board of Directors and engaged Mr. Moses and Mr. Zmo as consultants. In December 1996, Mr. Zmo became Chairman of the Company's Board of Directors. These individuals formerly held senior management positions at ALC Communications Corporation ("ALC"), a leading provider of long distance and other services to small and medium-sized businesses. During their tenure at ALC, ALC completed a successful turn-around and experienced profitable growth. From the fiscal year ended December 31, 1991 through the 12 months ended June 30, 1995 (prior to ALC's merger into Frontier Corporation), ALC's revenue increased from \$346.9 million to \$677.1 million and net income increased from \$5.3 million to \$75.0 million. In addition, in July 1996 the Company appointed Daniel M. Dennis to the Company's Board of Directors. Mr. Dennis has served in a number of management positions with MCI for over 25 years.

Midcom's executive management team has developed a restructuring, network and marketing strategy which is designed to address the operational challenges experienced by the Company and increase internally generated sales and profitability. Principal components of the Company's strategy are set forth below. Although the Company believes that its executive management team has the relevant skills and experience necessary to implement this strategy, its ability to do so is subject to a number of risks and uncertainties, and there can be no assurance that this strategy will be successfully implemented or that the intended positive results will be achieved. See "-- Risk Factors."

Operational Restructuring Strategy

Continue to Build Management Team. Midcom will continue to seek opportunities to augment management with individuals who have telecommunications industry experience and expertise. Since May 1996, the Company has appointed more than 10 individuals to key operational management positions. These individuals have extensive experience in the operation of a telecommunications company, including (i) network design, implementation and operation, (ii) marketing and sales, (iii) management information systems and (iv) bill processing and collection. Midcom believes that the experience and depth of this management team will improve the Company's ability to address its current operational challenges and to pursue its transition from primarily a nonfacilities-based reseller of long distance and other telecommunications services to a switch-based provider of integrated telecommunications services.

Integrate and Improve Information Systems. The Company's management team has focused on, and has substantially completed, the consolidation and integration of the Company's multiple information and billing systems and other redundant functions of its acquired long distance operations. The management team will continue to focus on integrating the Company's data transmission and enhanced telecommunications services, enlarging and enhancing the Company's information system and improving its financial reporting and internal controls. The Company believes that these activities will (i) reduce the overhead and maintenance costs associated with its management information systems, (ii) improve the amount and type of information that can be accessed about customers, sales and operations, (iii) increase the speed with which information can be processed and (iv) reduce the Company's working capital investment by shortening the time it takes for the Company to produce and distribute customer bills. See "-- Information Systems."

Renegotiate Carrier Agreements. The Company currently resells network switching and transport facilities of long distance carriers such as Sprint, WorldCom and AT&T. Midcom believes its relationships with these carriers enables it to provide customers a broad array of integrated long distance telecommunications services on a seamless and highly reliable basis. Despite the Company's successful resale of these network facilities, the Company's profitability was reduced as a result of a supply contract with AT&T which provided for higher rates than those obtained from alternative suppliers. However, the Company has entered into a new carrier supply contract with AT&T which provides for more favorable rates. In addition, in the first quarter of 1997, the Company entered into a new carrier supply contract with Sprint which also provides for more favorable rates. The Company believes the successful renegotiation of its supply contracts with AT&T and Sprint and its other carriers will contribute significantly to the Company's ability to offer competitive rates and improve its margins while providing the same level of service to its customers. See "-- Suppliers."

Network Strategy

The Company has acquired six state-of-the-art high capacity switches, three of which have both local and long distance functionality. The Company plans to install these switches in areas of the country where it has a sufficient volume of long distance traffic and where the regulatory environment and market conditions will permit it to provide local service at acceptable margins. The Company believes that, in the cities where it intends to deploy switches, there will be significant local circuit capacity at attractive rates available from competitive local exchange carriers ("CLECs"), ILECs and 38GHz wireless providers. Using its own switches will enable the Company to (i) direct customer call traffic over multiple networks which is expected to minimize costs and improve gross margin, (ii) switch local traffic, thereby increasing the economic viability of entering the market for local telecommunication services, (iii) shield proprietary information regarding its customers from the underlying carriers, thereby increasing customer control, (iv) facilitate access to call data.

records and (v) implement differentiating features and billing enhancements without involving the underlying carrier. See "-- Switching Facilities."

Marketing Strategy

Reorganize and Expand Sales Efforts. To take full advantage of its planned switching network and expanded product offerings, Midcom has reorganized its direct sales force into (i) a national and key accounts group consisting of highly experienced sales personnel focused on larger customers with sophisticated telecommunications requirements and (ii) a general accounts group focused on smaller customers. Both groups will be located in major metropolitan areas where the Company has customer concentrations sufficient to support a sales and marketing presence and where the Company believes it has significant market opportunities and can compete effectively on the basis of price. The Company intends to implement training programs and financial incentives designed to increase the cross-selling efforts of its direct sales force and further integrate the Company's broad array of service offerings. In addition, the Company intends to increase the number of sales representatives from approximately 35 at the end of July 1996 to over 250 by the end of 1997. The Company plans to continue to supplement its direct sales force with its network of resellers and distributors. In addition to its existing non-territorial distributor network, the Company is in the process of developing a new tier of distributors who will be offered long-term financial incentives and who will be required, within selected territories, to market and sell the Company's service offerings exclusively. The Company believes that the long-term financial incentives and exclusive marketing arrangements offered to this new tier of distributors will result in improved performance and increased loyalty to the Company and its service offerings. See "-- Marketing and Sales."

Expand and Enhance Customer Support Efforts. Midcom intends to support its expanded sales efforts and reduce customer attrition by continuing to build an enhanced customer service and support operation. The Company has increased its customer service and support staff from approximately 45 at the end of July 1996 to approximately 60 at the end of 1996 and intends to further increase this staff through 1997 to the extent necessary to support growth in sales. This expanded operation is intended to include (i) a staff of trained customer service representatives available twenty-four hours a day at a number of integrated customer service centers, (ii) trained account representatives assigned and dedicated to individual customers with sophisticated telecommunications requirements and (iii) teams of technical specialists available to develop customized solutions for a customer's telecommunication needs. See "-- Customer Service."

Resell Local Services and Provide a Single-Source Solution. Regulatory changes resulting from the Telecommunications Act significantly expand the number and types of services Midcom is permitted to offer. As a result, Midcom intends to offer its customers local dial tone and a variety of other local telecommunications services primarily in locations where it has a significant sales and marketing presence or where it plans to deploy switching facilities. The Company believes that its large and geographically concentrated customer base of small to medium-sized businesses represents a significant potential market for these additional services. These additional services will afford the Company the opportunity to provide its customers with a single-source solution for local, long distance, wireless and enhanced telecommunications services. The Company believes that bundling these services will provide substantial advantages to its customers, including lower overall costs and a higher level of service due to a single source for ordering, installation, customer service and account management. In addition, Midcom believes that offering a single source for telecommunications services will permit the Company to (i) leverage its significant customer base and increase sales by increasing its share of the telecommunications expenditures of its customers and (ii) improve customer control and retention by strengthening its relationships with its customers. See "-- Industry Background," "-- Regulation" and "-- Competition."

MARKETING AND SALES

Midcom markets its service nationwide through three distinct channels: direct sales, independent distributors and, on a wholesale basis, other resellers.

Direct Sales Midcom believes that direct sales activities are more effective than advertising for securing and maintaining the business of small to medium-sized commercial customers. The Company believes that the face-to-face customer contact afforded by its direct sales activities results in increased customer loyalty, improves cross-selling opportunities and will ultimately have a positive effect on revenue. Accordingly, direct sales activities comprise a substantial portion of the Company's marketing and sales resources. To optimize the Company's selling efforts, the Company intends to increase the number of its direct sales representatives, from approximately 35 at the end of July 1996 to over 250 by the end of 1997, and has reorganized the direct sales force into the following two groups:

National and Key Accounts The national and key accounts group consists of highly experienced sales personnel and concentrates sales efforts on businesses with sophisticated telecommunications requirements. Target customers for the national and key accounts group generally include those which require dedicated access to the Company's long distance points of presence and a high level of customer service and support. In particular, the Company expects that these customers will increasingly require support for data communication applications. Dedicated account representatives will be assigned to each of these customers. In addition, these customers will be supported by technical specialist teams trained to provide customized solutions to their telecommunications problems.

General Accounts The general accounts group concentrates sales efforts on businesses with less sophisticated telecommunications requirements. Typically, these customers do not require dedicated access to the Company's long distance point of presence and utilize only basic "1 plus" and "800" long distance and cellular service and calling cards. Moreover, although the Company provides these customers access to its customer service and support centers, it generally will not assign to them a dedicated account representative.

Each of these groups will be geographically focused, concentrating on major metropolitan areas where the Company has customer concentrations sufficient to support a sales and marketing presence and where the Company believes it has significant market opportunities and can compete effectively on the basis of price. At the end of 1996, the Company's direct sales force was located in Atlanta, Boston, Charlotte, Chicago, Cleveland, Dallas, Detroit, Long Island, Los Angeles, New Haven, New York, San Francisco and Seattle. The Company plans to deploy its direct sales force in additional locations during 1997.

Midcom has experienced a high level of turnover in its direct sales force which has had a negative impact on internally generated sales. The Company believes that, in the past, difficulties experienced with the Company's information systems and changes in senior management contributed to this turnover. However, the Company believes this turnover is now primarily attributable to the intense competition for, and the mobility of, qualified sales personnel endemic to the reseller segment of the telecommunications industry. The Company has restructured the commission arrangements and other financial incentives offered to its direct sales force in order to increase the incentive of its direct sales force to generate new sales, cross-sell the Company's telecommunications offerings and bundle high margin services with lower margin services thereby improving the Company's sales levels and gross margins. In addition, the Company recently began to offer its direct sales force career advancement opportunities to reward individual achievement. For example, through the first quarter of 1997, six sales representatives were promoted from the general accounts group to the national and key accounts group. The Company believes that appropriate financial incentives and opportunities for career advancement, along with the recent additions to the Company's management team and improvements to the Company's information systems, will result in decreased turnover in its direct sales force. However, there can be no assurance that turnover in the Company's direct sales force will be reduced or that any of these other objectives will be achieved.

Distributors Midcom supplements its direct sales efforts by marketing through independent distributors located throughout the country. The Company enters into distributor agreements with, but is otherwise not affiliated with, its distributors. Distributors maintain sales offices and sales staff at their own expense. However, customers provided by distributors belong to the Company, are billed directly by the Company or one of its billing agents and are in most instances supported by the Company's customer service centers.

In the past, the Company's distributor network was not organized according to geographic area or service offerings, and the Company generally granted its distributors a non-exclusive right to solicit customers, required the distributor to maintain a minimum quota and offered a commission on business generated for the Company by the distributor. These non-territorial and non-exclusive distributor arrangements failed to promote distributor loyalty to the Company's service offerings and did not enable the Company to use its distributor network to develop market share in specific geographical areas.

Midcom believes that distributors may have substantial marketing resources and access to a large base of potential customers. Accordingly, in August 1996, the Company began to enhance its then existing non-territorial distributor network of approximately 160 distributors with a new tier of territorial distributors. To improve performance and increase loyalty to the Company and its service offerings, the Company offers its new tier of distributors long-term financial incentives and requires that, within selected territories, the distributors market and sell the Company's service offerings exclusively. By making use of territorial limitations, the Company intends to direct the marketing and sales efforts primarily in cities where it has not developed a significant marketing presence and which are outside the focus of its direct sales efforts. Because distributors cover their own costs, the Company believes that this will be a cost-effective way to increase its market share in these cities. At the end of 1996, the Company's new tier of distributors consisted of 10 distributors and the Company intends to increase its new tier of distributors by engaging approximately 20 additional distributors during 1997.

Wholesale to Other Resellers. At the end of 1996, Midcom offered telecommunications services on a wholesale basis to several small resellers of long distance services. The Company does not have direct relationships with the end users of the services purchased by its resellers. Those customers are not billed by the Company and are not supported by the Company's customer service centers. Although gross margins on sales to resellers are generally lower than the Company's average, sales through this channel enable the Company to (i) enter markets with minimal cost or risk where small resellers have already built strong direct customer relationships, (ii) increase the volume of services purchased by the Company from facilities-based carriers, thereby obtaining higher volume discounts from those carriers and (iii) spread the costs of acquiring, installing and integrating the Company's switching facilities over a larger revenue base.

CUSTOMER SERVICE

Midcom strives to provide superior customer service and believes that personal contact with potential and existing customers is a significant factor in customer acquisition and retention. The Company's goal is to have frequent contact with prospects and customers both through its direct sales representatives as well as its customer service representatives.

At the end of July 1996, Midcom's customer service and support staff consisted of approximately 45 employees located at one of the Company's six customer service centers. To support the planned expansion of Midcom's sales efforts, Midcom added 15 customer service representatives to its customer support staff during 1996 and intends to further increase this staff through 1997 to the extent necessary to support growth in sales. In addition, Midcom has reorganized its customer service and support efforts. This reorganization has involved the consolidation and integration of Midcom's service centers so that each is capable of supporting all of Midcom's service offerings. Moreover, the Company's customer service department has been organized into two groups, each with its own management and reporting structure. One group consists of customer service representatives, available twenty-four hours a day at a number of integrated customer service centers, who primarily respond to customer calls. The other group consists of account representatives who are dedicated to the Company's higher volume customers and take proactive measures to pursue opportunities to cross-sell the Company's various service offerings to such customers and address their telecommunications needs before they arise. The account representatives also coordinate customer access to teams of technical specialists trained to provide customized solutions to the customer's telecommunications problems. To ensure that customer service representatives and account representatives have the knowledge required to support the Company's broad range of service offerings, Midcom intends to allocate a portion of its customer service resources to training programs for its customer service staff. In addition, Midcom intends to establish a small group of customer service and technical specialists who are available exclusively to the direct sales

representatives, customer service representatives, account representatives and distributors. The Company believes that these changes will improve the level of customer service and support provided to its customers.

PRODUCTS AND SERVICES

Midcom, primarily through contractual arrangements with facilities-based carriers, offers small to medium-sized businesses a wide variety of telecommunications services including basic "1 plus" and "800" long distance, frame relay data transmission services, wireless services, dedicated private lines between customer locations and enhanced and other value-added telecommunications services. The Company also plans to provide local telecommunications services in the newly opened local telecommunications market, and to develop new products and services. Each of these services is discussed below.

Long Distance. Historically, substantially all of Midcom's revenue has been generated by basic "1 plus" and "800" long distance services. Midcom's success as a provider of these basic services has depended on the volume discounts it has been able to negotiate with underlying carriers and its ability to direct customer call traffic over the transmission networks of more than one carrier. As the Company expands its network of switching facilities, it will increasingly have the ability to choose among the transmission networks of different carriers to take advantage of the most favorable rates to different destinations at different times of the day.

Data Transmission. Through its wholly-owned subsidiary, PacNet Inc. ("PacNet"), Midcom offers data transmission services primarily using its own frame relay switches and a fiber optic transmission network which, at the end of 1996, connected over 40 cities in the Western United States. PacNet is a member of the UNI-SPAN(R) consortium of frame relay data network providers. Members of the UNI-SPAN(R) consortium are permitted to contract for access to frame relay networks of other members at favorable rates. In addition to cost savings, the consortium enables the Company to provide end-to-end connectivity to its customers on a nationwide basis.

Private Line Services. Midcom provides data transmission service on private line facilities on a point-to-point basis. This enables high volume users to send and receive voice and data transmissions between locations on a highly reliable and cost effective basis.

Enhanced and Other Services. Midcom offers a variety of enhanced and other value-added services, including the following:

- **Fax Broadcast and Fax Mailbox.** Through its wholly-owned subsidiary, Advai Data Corporation ("Advai"), Midcom offers facsimile-related services that allow a user to send a facsimile to many destinations simultaneously (Fax Broadcast) and to store and retrieve facsimiles in a manner similar to electronic mail (Fax Mailbox).
- **Travel Cards.** Midcom's travel cards offer low-cost long distance service through various flat-rate pricing or per-call fees.
- **Conference Calling.** Midcom offers a full-featured teleconferencing service that allows for connection of multiple locations simultaneously.
- **Custom Billing.** Midcom provides many of its direct-billed customers billing and management reports with a level of detail and features that the major carriers generally provide only to their higher volume customers. In addition, the Company's customers can choose to have one centralized bill sent each month to their principal place of business or individual bills sent to branch offices, with a master copy sent to the principal place of business. The Company believes that its value-added billing capability enables its customers to manage their telecommunications costs more effectively, helps differentiate the Company's services from services offered by the larger long distance carriers and will continue to be an important factor in its ability to successfully compete in its targeted market.

Wireless Services. Midcom offers wireless services in the Pacific Northwest through Cel-Tech International Corp. ("Cel-Tech"), its wholly-owned subsidiary. Outside the Pacific Northwest, there is a proliferation of wireless opportunities that the Company intends to pursue aggressively in order to provide wireless services in the major markets it serves.

Local Service. Midcom is evaluating opportunities created by the Telecommunications Act to offer local telecommunications services either on a resale basis or over its proposed network of switching facilities. The Company intends to offer local services in large cities where it has (i) deployed high capacity switches, (ii) a significant customer concentration and (iii) a sales and customer support presence. The Company believes that targeting larger cities for local service will be advantageous due to the availability of multiple local circuit capacity alternatives to the ILECs and more favorable and less time consuming interconnection negotiations with the ILECs. The Company's ability to enter into the local telecommunications market may be impaired by certain logistical challenges. Prior to selling local services to its customers, the Company must complete a number of operational, marketing and regulatory tasks, including the negotiation of interconnection agreements with local circuit providers, the development of billing, provisioning and customer service capability and the creation of a local marketing, pricing and sales strategy. However, despite these logistical challenges, the Company believes that introducing local services will enable it to leverage its extensive customer base by increasing the number of service offerings available to its existing customers.

New Services. Midcom intends to increase its efforts to develop new telecommunications services based on evolving technologies and changing industry standards. There can be no assurance, however, that the Company will have the ability or resources to develop such new services, that new technologies required for such services will be available to the Company on favorable terms or that such services and technologies will enjoy market acceptance.

Midcom markets its products under a number of registered and common law service marks, including Infinity(R), Logical(R), ADNET(TM), Cel-Tech(TM), Adval(TM), MIDCOM(R), PakLink(R), Elite(TM), Network Observer(TM), Custom Point(TM) and Infinity Point(TM), as well as various registered logos.

SWITCHING FACILITIES

A key element of the Company's operating strategy is to deploy a national switching network. The Company believes that successful implementation of its strategy to increase switching capacity will improve its ability to direct customer call traffic among networks owned by other long distance carriers in order to take advantage of the most favorable rates to different destinations at different times of the day. The Company expects that this will minimize costs and have a positive impact on gross margin. In addition, the Company expects that deployment of switches will enable the Company to (i) switch local traffic, thereby increasing the economic viability of entering the market for local telecommunications services, (ii) shield proprietary information regarding its customers from the underlying carriers, thereby increasing customer control, (iii) facilitate access to call data records and (iv) implement differentiating features and billing enhancements without involving the underlying carrier.

High Capacity Switches. In the first quarter of 1997, the Company acquired six state-of-the-art high capacity switches, three of which have both local and long distance functionality. At the date of this Report, the Company was in the process of installing these switches in Atlanta, Chicago, Dallas, Los Angeles, New York and Seattle. The Company believes that, in these locations, its volume of long distance traffic and the regulatory and market conditions will permit it to provide local services at acceptable margins. Moreover, the Company believes that there will be significant local circuit capacity at attractive rates available from CLECs, ILECs and 38GHz wireless providers in these locations. The Company estimates that it will take at least until the second quarter of 1997 to install and fully integrate these switches, at an aggregate cost of approximately \$15.0 million. The Company anticipates employing on-site technicians at each switch location to provide switch service and support. In addition, the Company is working to establish a remote service center staffed with approximately four technicians capable of monitoring and providing limited service and support for each of its switches twenty-four hours a day. The Company estimates that this service center will cost approximately \$1.5 million to \$2.0 million to establish and will be operational in the second or third quarter of 1997. There can be no assurance, however, that these switches will be installed or fully operational, or that a remote service center will be installed and operational, within anticipated deadlines and budgets, or that the Company will not encounter technical, operational or other problems in the installation or operation of this sophisticated switching and monitoring equipment.

Frame Relay Data Switches. In addition to voice switches, PacNet, a wholly-owned subsidiary of the Company, offers data transmission services primarily using its own frame relay switches and a fiber optic transmission network which, at the end of 1996, connected over 40 cities in the Western United States. PacNet is a member of the UNI-SPAN(R) consortium of frame relay data network providers. Members of the UNI-SPAN(R) consortium are permitted to contract for access to frame relay networks of other members at favorable rates. In addition to cost savings, the consortium enables the Company to provide end-to-end connectivity to its customers on a nationwide basis.

Limited Capacity Switches. The Company previously owned and operated limited capacity switches in nine locations, most of which were acquired through acquisitions of other telecommunications service providers. As a result of limitations inherent in these switches and the Company's plans to install a state-of-the-art high capacity switch network, the Company removed these switches from service during the third quarter of 1996. The Company may utilize these limited capacity switches to complement the planned deployment of high capacity switching facilities; however, there can be no assurance that this will be feasible.

ACQUISITIONS

Midcom experienced rapid growth through the end of 1995. A significant portion of this growth, particularly in 1995, was attributable to acquisitions of customer bases and of other telecommunications service providers. These acquisitions were intended to (i) enhance Midcom's sales force capability, (ii) broaden its service offerings, and (iii) increase its customer base and revenue.

The Company's acquisitions resulted in revenue growth and increased customer concentrations in certain metropolitan areas which, in turn, increased the Company's ability to control transmission routing for customers in those areas in order to lower costs and improve gross margin. However, these acquisitions placed significant demands on management resources and disrupted the Company's normal business operations. For a number of reasons, the Company was not able to consolidate and integrate the sales and marketing, customer support, billing and other functions of certain acquired operations as quickly as anticipated. Pending such integration, it was necessary for the Company to maintain billing systems and other functions of certain acquired operations, which caused inefficiencies, added operational complexity and expense, increased the risk of billing delays and financial reporting difficulties and impaired the Company's ability to cross-sell the various products and services offered by certain acquired operations. In addition, the Company often experienced high initial customer attrition from acquired customer bases. The Company believes this occurred as a result of difficulties encountered in transitioning acquired customer bases to the Company's services and systems, a process which often prompts customers to consider competitive alternatives in the telecommunications marketplace. Also, where the Company did not acquire the sales channel associated with an acquired customer base, there was often a period of enhanced exposure to competitors as the Company's sales force became familiar with its newly acquired customers and established relationships with the appropriate customer contacts. In addition to problems associated with integration, consolidation and customer attrition, certain of the Company's acquisitions have resulted in disputes between the Company and the sellers of the acquired operations. See "Item 3. Legal Proceedings."

The Company's current strategy is to generate growth primarily through internal sales and marketing efforts, rather than through the acquisition of customer bases or other telecommunication service providers. Although growth through acquisitions is no longer central to the Company's growth strategy, the Company will consider, on a selective basis, acquisitions which the Company believes will contribute to its infrastructure, create synergies or which otherwise have strategic value to the Company. There can be no assurance that there will not be adverse consequences to the Company from its past or future acquisitions. Further, there can be no assurance that the Company will be able to identify attractive acquisition candidates in the future, that acquisitions pursued by the Company will be completed, or that, if completed, such acquisitions will be beneficial to the Company. As of the date of this Report, the Company has no commitment or agreement to make any acquisitions. Further, the Company is prohibited from making any acquisitions without the prior approval of its lenders. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

INFORMATION SYSTEMS

Telecommunication service providers generally must record and process massive amounts of data quickly and accurately in order to bill customers in a timely manner, verify billings from third party carriers, service customer accounts, respond to customer inquiries and otherwise support operations. These tasks require sophisticated, high capacity and reliable management information and billing systems.

In late 1993, Midcom began the development of a proprietary information system, referred to as "Keystone," designed to integrate its customer information system, billing system and financial reporting system. The billing module used in Keystone was designed to replace the Company's existing billing system. The Company began using the Keystone billing module for a portion of its customers in February 1995. Due to difficulties encountered during the implementation of Keystone and required modifications to Midcom's customer data base, which delayed full implementation of the Keystone billing module, the Company continued to bill most of its customers under its prior billing system until late April 1995. At that time, the Company completed the conversion to the Keystone billing module.

The Company estimates that in 1995 the number of call data records processed by the Company grew from approximately 20 million to as many as 35 million per month, each of which had to be identified with the appropriate customer for proper billing. This growth was attributable in large part to customers of acquired customer bases and operations. Difficulties encountered during the implementation of Keystone were compounded by this rapid growth and contributed to operational difficulties. Partly as a result of these operational difficulties, the Company was not able to consolidate and integrate the sales and marketing, customer support, billing and other functions of certain acquired operations as quickly as anticipated. Pending such integration, it was necessary for the Company to maintain billing systems and other functions of certain acquired operations, which, among other things, caused operational inefficiencies, added complexity and expense to the billing and financial reporting process and increased the risk of billing delays and financial reporting difficulties.

During the second, third and fourth quarters of 1995, difficulties in implementing the new billing system caused an increased number of calls to be billed later than expected by the Company. Delays in billings contributed to a significant increase in customer invoice adjustments and bad debt expense in the fourth quarter of 1995. In addition, in the process of reconciling unbilled accounts as of December 31, 1995 with amounts ultimately billed, the Company discovered that certain reports generated by its new information management system for recognizing unbilled revenue for the third quarter of 1995 failed to fully reflect all discounts that were properly included in the bills subsequently sent to the Company's customers. Primarily as a result of this failure, reported revenue was overstated for the third quarter of 1995 and the Company's Quarterly Report on Form 10-Q for that period had to be amended to restate reported results. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Restatement of Results for the Third Quarter of 1995."

In connection with the audit of Midcom's 1995 Consolidated Financial Statements, Midcom's independent auditors identified two conditions which were characterized as material weaknesses in its internal financial controls. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Past Material Weaknesses." In response to the recommendations of the Company's auditors, the Company hired additional finance and accounting personnel, curtailed acquisitions, reorganized its financial reporting functions to improve communications between senior management and the finance department and established the policy of billing substantially all customer call traffic in a financial reporting period before revenue for the period is reported, thereby eliminating the need to estimate any material portion of revenue. As part of the Company's operational restructuring, the Company's management team has focused on, and has substantially completed, the consolidation and integration of the Company's multiple information and billing systems and other redundant functions of its acquired long distance operations. In addition, the management team will continue to focus on integrating the Company's data transmission and enhanced telecommunications services, enlarging and enhancing the Company's information system and improving its financial reporting and internal controls, and it intends to increase the number of information systems personnel from approximately 18 full-time employees and seven independent contractors at the end of July

1996 to approximately 50 full-time employees by the end of 1997. As a result of these and other restructuring efforts, on March 13, 1997 Midcom's independent auditors reported to the Company's Audit Committee that the material weaknesses identified in connection with the 1995 audit have been corrected.

Although Midcom has experienced difficulties in the implementation of its management information system, it is now able to provide many of its direct-billed customers billing and management reports with a level of detail and features that the major carriers generally provide only to their higher volume users. The Company is currently able to collect numerous multiple call data items for each phone call placed by a customer, including customer name, call origination point, call destination point, billing code, minutes, date, time and rate code. From this data, the Company can organize the customer's monthly phone calls into a wide variety of report formats. These reports can include: (i) state/international codes, (ii) date and hour distributions, (iii) type of service ("1 plus", "800", etc.), (iv) frequently called numbers, area codes, cities or states, (v) calling card summaries, (vi) graphic presentation of data and (vii) color-coded long distance calling activity maps. In addition, the Company's customers can choose to have one centralized bill sent each month to their principal place of business or individual bills sent to branch offices, with a master copy sent to the principal place of business. The Company believes that its value-added billing capability enables its customers to manage their telecommunications costs more effectively, helps differentiate the Company's services from services offered by the larger long distance carriers and will continue to be an important factor in its ability to successfully compete in its targeted market.

In light of the volume of financial data to be processed, the reliance upon timely receipt of call data records from suppliers, the anticipated rate of growth of the Company, the demands on key financial personnel, the potential for turnover in key finance and accounting positions, the challenges associated with the integration of acquired businesses and other factors, there can be no assurance that the Company will not encounter additional billing delays, other internal control weaknesses or other difficulties in future financial reporting.

SUPPLIERS

Midcom purchases from facilities-based carriers the long distance telecommunications services that it provides to its customers. The Company has entered into multiple-year supply contracts with Sprint, WorldCom and AT&T for long distance telecommunication services. In addition to its contracts with its major suppliers, the Company has from time to time acquired access to telecommunications services on a short-term basis from a number of other suppliers. In 1994, 1995 and 1996, Sprint, WorldCom and AT&T were collectively responsible for carrying traffic representing approximately 97%, 67% and 74% of the Company's revenue, respectively, and for those periods no single carrier was responsible for carrying traffic representing more than 46%, 31% and 31% of the Company's revenue, respectively.

To obtain favorable forward pricing from certain of its suppliers, the Company has committed to purchase minimum volumes of a variety of long distance services during stated periods whether or not such volumes are used or, in one case, to pay a surcharge equal to a percentage of the Company's shortfall from a specified quarterly minimum volume. As of September 30, 1996, Midcom's minimum volume commitment under its supply contract with AT&T, its largest supply contract, was \$117.0 million. The Company estimates that, as of September 30, 1996, it would have been in shortfall of its minimum commitments to AT&T by approximately \$27.6 million based on then-applicable contract requirements. However, on October 31, 1996, the Company and AT&T executed a Release and Settlement Agreement pursuant to which substantially all disputes between the Company and AT&T were resolved. Also on October 31, 1996, the Company and AT&T executed a new carrier contract pursuant to which the Company's minimum commitment to AT&T was reduced to \$13.7 million for the eighteen month period immediately following execution of the contract, of which approximately \$10.0 million remained as of the date of this Report. In addition, the new carrier contract provides for more favorable pricing for certain network services provided by AT&T. In consideration for the terms of the settlement and the new rate structure, the Company is required to make two payments to AT&T in the aggregate amount of \$8.8 million. The first payment of \$5.0 million was made on November 6, 1996. The second payment of \$3.8 million will be due within 30 days of Midcom announcing quarterly gross revenue in excess of \$75.0 million, or upon completion of a change in control. In addition, in the first quarter of 1997

the Company entered into a new carrier supply contract with Sprint which also provides for more favorable rates. The Company's minimum volume commitments to all of its carriers as of March 15, 1997 aggregated approximately \$92.0 million, to be used over the next three years. See Note 15 of Notes to Consolidated Financial Statements. There can be no assurance that the Company will not incur additional shortfalls in the future or that it will be able to successfully renegotiate, or otherwise obtain relief from, its minimum volume commitments in the future. See "Risk Factors -- Minimum Volume Commitments and Shortfalls."

Because of Midcom's commitments to purchase fixed volumes of use from certain of its suppliers at predetermined rates, the Company could be adversely affected if a supplier were to lower the rates it makes available to the Company's target market without a corresponding reduction in the Company's rates. Similarly, the Company could be adversely affected if its suppliers failed to adjust its overall pricing, including prices to the Company, in response to price reductions of other major carriers. See Note 15 of the Notes to Consolidated Financial Statements.

Each month, Midcom receives invoices from its suppliers. In those areas in which the Company intends to direct call traffic through its own switches, it will receive bills directly from the ILECs for access charges. Due to the multitude of billing rates and discounts which suppliers must apply to calls completed by the Company's customers, and due to routine logistical issues such as the addition or termination of customers, the Company regularly has disagreements with its suppliers concerning the sums invoiced for its customers' traffic. The Company pays its suppliers according to its own calculation of amounts owed as recorded on computer tapes provided by its suppliers. The Company's computations of amounts owed are frequently less than the amount shown on the suppliers' invoices. Accordingly, the suppliers may consider the Company to be in arrears in its payments until the amount in dispute is resolved. Although these disputes have generally been resolved on terms favorable to the Company, there can be no assurance that this will continue to be the case. In accordance with generally accepted accounting principles, the Company records as an expense amounts in dispute that correspond to the aggregate amount that the Company believes it will be required to pay and adjusts that amount as the underlying disputes are resolved.

Midcom, like all other long distance providers, is dependent upon LECs for call origination (carrying the call from the customer's location to the long distance network of the IXC selected to carry the call) and termination (carrying the call off the IXC's network to the call's destination). The Company's ability to maintain and expand its business depends, in part, on its ability to obtain telecommunications services on favorable terms from facilities-based carriers, and the cooperation of both IXCs and LECs in initiating and terminating services for its customers in a timely manner (the process of initiating service for a customer is referred to as "provisioning"). FCC policy currently requires all common carriers, including IXCs, to make their services available for resale and to refrain from imposing unreasonable restrictions on such resale. The Telecommunications Act further requires all ILECs both to offer their services for resale at wholesale rates and to allow access to unbundled network elements at cost-based rates. The ILECs are also required by the Telecommunications Act to provide all IXCs, including the Company, with equal access for the origination and termination of long distance calls. If any of these requirements were eliminated, the adverse impact on the Company could be substantial. Access charges represent a substantial portion of the Company's current cost of service. The FCC, however, has undertaken to reform its universal service and access charge rules by May 1997 in order to rework the current universal service subsidy system and to move access charges toward the economic cost of originating and terminating long distance traffic. The level at which the FCC sets access charges and universal service contributions could have a material adverse effect on the Company's business, financial condition and results of operations. Moreover, implementation of a new access charge structure and repricing of local transport could place many interexchange carriers, including the Company, at a significant cost disadvantage relative to larger competitors. The FCC has also imposed on facilities-based interexchange carriers the obligation to track the payphone-originated tollfree and access code calls which they carry and to compensate payphone service providers for such calls, initially on a per-phone, and, commencing in October 1997, on a per-call basis, in amounts reflective of soon to be deregulated local coin rates. See "Regulation."

COMPETITION

The long distance telecommunications industry is highly competitive. Midcom believes that the principal competitive factors in this industry include pricing, customer service, network quality, value-added services and the flexibility to adapt to changing market conditions. A number of the Company's current and potential competitors have substantially greater financial, technical, marketing and other resources than the Company, and there can be no assurance that the Company will remain competitive in this environment. The Company's ability to compete may also be impaired by its leveraged capital structure and limited capital resources.

The long distance telecommunications industry is significantly influenced by the marketing and pricing activities of the major industry participants, including AT&T, MCI, Sprint and WorldCom. While the Company believes that AT&T, MCI and Sprint historically have chosen not to concentrate their direct sales efforts on small to medium-sized businesses, these carriers control approximately 85% of that market. Moreover, AT&T, MCI and Sprint have recently introduced new service and pricing options that are attractive to smaller commercial users, and there can be no assurance that they will not market to these customers more aggressively in the future. AT&T and, as an interim measure, the structurally separate interexchange affiliates of the RBOCs have recently been reclassified as non-dominant carriers and, accordingly, have the same flexibility as the Company in meeting competition by modifying rates and service offerings without pricing constraints or extended waiting periods. These reclassifications may make it more difficult for the Company to compete for long distance customers. See "-- Regulation." In addition, a significant number of large regional long distance carriers and new entrants in the industry compete directly with the Company by concentrating their marketing and direct sales efforts on small to medium-sized commercial users. Activities by competitors including, among other things, national advertising campaigns, telemarketing programs and the use of cash or other forms of incentives, contribute to significant customer attrition in the long distance industry.

The Company contracts for call transmission over networks operated by suppliers who may also be the Company's competitors. Both the IXC's and LEC's providing transmission services for the Company have access to information concerning the Company's customers for which they provide the actual call transmission. Because these IXC's and LEC's are potential competitors of the Company, they could use information about the Company's customers, such as their calling volume and patterns of use, to their advantage in attempts to gain such customers' business. The Telecommunications Act has strengthened the rules which govern the privacy of customer proprietary information by expressly prohibiting telecommunications carriers which receive proprietary information from resale carriers for purposes of providing telecommunications services to those resale carriers from using such information for their own marketing purposes. In addition, the Company's future success will depend, in part, on its ability to continue to buy transmission services and access from these carriers at a significant discount below the rates these carriers otherwise make available to the Company's targeted customers.

Regulatory trends have had, and may have in the future, a significant impact on competition in the telecommunications industry. See "-- Regulation." As a result of the Telecommunications Act, the RBOCs are now permitted to provide, and are providing or have announced their intention to provide, long distance service originating (or in the case of "800" service, terminating) outside their local service areas or offered in conjunction with other ancillary services, including wireless services. Following application to and upon a finding by the FCC that an RBOC faces facilities-based competition and has satisfied a congressionally-mandated "competitive checklist" of interconnection and access obligations, an RBOC will also be permitted to provide long distance service within its local service area. The entry of these well-capitalized and well-known entities into the long distance service market could significantly alter the competitive environment in which the Company operates.

The Telecommunications Act also removes most legal barriers to competitive entry into the local telecommunications market and directs ILECs to allow competing telecommunications service providers such as the Company to interconnect their facilities with the local exchange network, to acquire network components on an unbundled basis and to resell local telecommunications services. Moreover, the Telecommunications Act seeks to facilitate the development of local telecommunications competition by requiring

ILECs, among other things, to allow end users to retain their telephone numbers when changing service providers and to place short-haul toll calls without dialing lengthy access codes. In response to these regulatory changes, AT&T, MCI and many of the Company's other long distance competitors have announced plans to enter the local telecommunication market.

While the Telecommunications Act opens new markets to the Company, the nature and value of the resultant business opportunities will be dependent in large part upon subsequent regulatory interpretation of the statute's requirements. While the FCC has promulgated rules implementing the local competition provisions of the Telecommunications Act, these rules have been appealed and key provisions have been "stayed" pending the outcome of the appeals. Various state regulatory authorities are currently in the process of implementing the remaining FCC rules. The Company anticipates that ILECs will actively resist competitive entry into the local telecommunications market and will seek to undermine the operations and the service offerings of competitive providers, leaving carriers such as the Company, which are dependent on ILECs for network services, vulnerable to anti-competitive abuses. No assurance can be given that the local competition provisions of the Telecommunications Act will be implemented and enforced by federal and state regulators in a manner which will permit the Company to compete successfully in the local telecommunications market or that subsequent legislative and/or judicial actions will not adversely impact the Company's ability to do so. Moreover, federal and state regulators are likely to provide ILECs with increased pricing flexibility for their services as competition in the local market increases. If ILECs are allowed by regulators to lower their rates substantially, engage in aggressive volume and term discount pricing practices for their customers, charge excessive fees for network interconnection or access to unshared network elements, or decline to make services available for resale at discounted wholesale rates, the ability of the Company to compete in the provision of local service could be materially and adversely affected.

The Company believes that, principally due to its economies of scale and personalized service, it is able to differentiate its service offerings from the larger carriers in its targeted market segment on the basis of price, breadth of service offerings, customer service and support and the ability to provide customized solutions to the telecommunications requirements of its customers. As a result, the Company believes that it competes favorably in this market segment. The Company also believes that its ability to compete in this market segment will increasingly depend on its ability to offer on a timely basis new services based on evolving technologies and industry standards. However, there can be no assurance that new technologies or services will be made available to the Company on favorable terms.

REGULATION

The terms and conditions under which Midcom provides communications services are subject to government regulation. Federal laws and FCC regulations apply to interstate telecommunications, while particular state regulatory authorities have jurisdiction over telecommunications that originate and terminate within the same state.

Federal

Midcom is classified by the FCC as a non-dominant carrier and therefore is subject to relaxed regulation. Historically, the FCC has generally either excused or presumed compliance by non-dominant carriers with many of the statutory requirements and regulations to which dominant carriers are subject, including most reporting, accounting and record keeping obligations. However, a number of these requirements are imposed, at least in part, on non-dominant carriers such as the Company whose annual operating revenues exceed \$100 million. The FCC retains the jurisdiction to impose fines or other penalties on, or to act upon complaints against, any common carrier, including non-dominant carriers, for failure to comply with its statutory or regulatory obligations. The FCC also has the authority to impose more stringent regulatory requirements on the Company and change its regulatory classification. In the current regulatory atmosphere, however, the Company believes that the FCC is unlikely to do so. Non-dominant carriers are also subject to a variety of miscellaneous regulations that, for instance, dictate the materials required to document and the procedures necessary to verify a consumer's election to change its preferred long distance telephone provider, mandate disclosure of rate and other data associated with the provision of operator services and require contribution to a

variety of FCC-mandated funds and payment of various regulatory and other fees. There has generally been increased enforcement activity by the FCC and the states with respect to such regulations, particularly with respect to those regulations governing the verification of consumer elections to change long distance service providers.

Among domestic carriers, only the ILECs are classified as dominant carriers, although ILECs currently would only be classified as dominant in their provision of long distance telecommunications services if they were to provide such services other than through structurally separate affiliates. As a consequence, the FCC regulates many of their rates, charges and services to a greater degree than the Company's, although the FCC is currently evaluating proposals to streamline and otherwise relax its regulation of the ILECs. AT&T and, as an interim measure, the structurally separate interexchange affiliates of the RBOCs have recently been reclassified as non-dominant carriers and, accordingly, have the same flexibility as the Company in meeting competition by modifying rates and service offerings without pricing constraints or extended waiting periods. The impact on the Company of the reclassification of AT&T and the RBOC interexchange affiliates as non-dominant carriers cannot be determined at this time, but it could make it more difficult for the Company to compete for long distance customers.

With the passage of the Telecommunications Act, the RBOCs are now free to offer long distance service outside their respective local telephone service areas as well as long distance service bundled with wireless, enhanced and other ancillary services. Following application to and upon a finding by the FCC that an RBOC faces facilities-based competition and has satisfied a congressionally-mandated "competitive checklist" of interconnection and access obligations, the RBOC will be permitted to provide long distance service within its local service area, although in so doing, it will be subject to a variety of structural and nonstructural safeguards intended to minimize abuse of its market power in these local service areas. As a result of the removal of the legal barriers to competitive entry into the local market, long distance carriers like the Company will be allowed to compete with the RBOCs in the provision of local service. It is impossible to predict the impact of RBOC entry into the long distance telecommunications market on the Company's business and prospects, but it could make it more difficult for the Company to compete for long distance customers.

The Company has all necessary authority to provide domestic interstate telecommunications services under current laws and regulations. The Company and one or more of its subsidiaries have been granted authority by the FCC to provide international telecommunications services through the resale of switched services of U.S. facilities-based carriers. The FCC reserves the right to condition, modify or revoke such international authority for violations of federal law or rules, as well as to approve assignments and transfers of control of such international authority.

As the result of a stay of the FCC's order to eliminate the filing of interstate tariffs (which order would have been effective September 23, 1997) issued by the federal district court in Washington, D.C., the FCC has reinstituted the requirement that all interstate carriers file such tariffs pending the court's resolution of the issue. Although the tariffs of non-dominant carriers, and the rates and charges they specify, are subject to FCC review, they are presumed to be lawful and are seldom contested. As an international non-dominant carrier, the Company is required to include, and has included, detailed rate schedules in its international tariffs, and is permitted to make tariff filings on a single day's notice. Prior to a 1995 court decision, *Southwestern Bell v. FCC*, 47 F.3d 1515 (D.C. Cir. 1995), domestic non-dominant carriers were permitted by the FCC to file tariffs with a "reasonable range of rates" instead of the detailed schedules of individual charges required of dominant carriers. In reliance on the FCC's past practice of allowing relaxed tariff-filing requirements for non-dominant domestic carriers, the Company and most of its competitors did not maintain detailed rate schedules for domestic offerings in their tariffs. Until the two-year statute of limitation expires, the Company could be held liable for damages for its failure to do so, although it believes that such an outcome is highly unlikely and would not have a material adverse effect on the Company's operations.

To date, the FCC has exercised its regulatory authority to set rates only with respect to the rates of dominant carriers, and it has increasingly relaxed its control in this area. Thus, the FCC does not regulate the rates of the Company or any other long distance telecommunications provider, including AT&T, although it would regulate the rates charged by any ILEC that elected to provide interexchange services other than

through a structurally separate affiliate. While the FCC continues to cap the prices that dominant ILECs may charge to originate and terminate interstate calls, it has afforded the ILECs a modicum of geographically-restricted pricing flexibility when they face competition in a given market. The FCC has indicated that it will initiate in the near future a comprehensive review of its access charge structure, evaluating embedded costs and subsidies that produce current access charge levels. The FCC is currently conducting a rulemaking procedure to implement the universal service provisions of the Telecommunications Act and will be determining in that proceeding the contributions that telecommunications companies such as the Company will be required to make to support universal service. The FCC also has recently completed a rulemaking proceeding to implement the local competition provisions of the Telecommunications Act. In that proceeding, the FCC has set forth comprehensive national rules and guidelines for states and local competitors to follow that, among other things, govern the interconnection obligations among telecommunications carriers, including interconnection with the local exchange network, and access to a minimum set of unbundled network elements, as required by the Act. The FCC also has set forth pricing methodologies for both the FCC and the states to follow in implementing the Telecommunications Act's requirement that interconnection and access to unbundled network elements be made available by ILECs at cost-based rates with a reasonable profit. The rules adopted by the FCC in implementing the local competition provisions of the Telecommunications Act have been appealed and key provisions, including the pricing methodologies, have been "stayed" pending the outcome of the appeals.

The FCC-styled "trilogy" of access charge reform, universal service and local competition proceedings comprise the FCC's effort to respond to the Telecommunications Act's goal of transitioning telecommunications markets to full competition. The FCC does not expect this framework to be complete until state public service commissions complete their own efforts to implement and supplement the Telecommunications Act's provisions. Until the FCC's "trilogy" of proceedings is completed, and until such state actions are taken, the impact of the FCC's actions on the Company's access arrangements or access charge obligations, or more broadly, on the Company's operations in general, cannot be determined at this time.

The Telecommunications Act grants the FCC authority to forebear from applying any statutory requirement or regulation to classes of carriers or services upon a determination that such application is unnecessary and no longer in the public interest. Utilizing this newly-granted authority, the FCC has already reduced, and has proposed further reductions in, its regulation of non-dominant IXCs such as the Company. While the FCC's proposal to adopt mandatory detariffing has been deferred, the FCC is expected to continue its efforts to reduce the regulation of non-dominant IXCs.

The microwave licenses held by the Company's subsidiary, PacNet, are subject to FCC regulation and licensing. PacNet's licenses are for point-to-point microwave systems operating in the Private Operational Fixed Microwave Service ("OFS"). Such facilities must be constructed and operated in strict conformance with their authorizing licenses and FCC rules and policies and such licenses may not be modified, transferred or assigned without prior FCC approval. OFS licenses may be cancelled or revoked, and fines and other non-monetary penalties imposed on OFS licensees, for failure to comply with FCC requirements. OFS licenses are granted for a fixed five-year term, with the potential for renewal. The majority of PacNet's licenses expire in December 1997 and the balance expire in June 1999. As of the date of this Report, the Company intends to seek renewal of the microwave licenses for each of PacNet's stations and currently anticipates that these licenses will be renewed in the ordinary course of business. However, PacNet has substantially discontinued directing traffic over this microwave system and is in the process of attempting to sell its microwave equipment and related licenses. As a result, the Company does not believe that failure to obtain renewal of microwave licenses upon expiration would adversely affect the Company. See Note 4 to the Notes to Consolidated Financial Statements. Moreover, the Company does not expect the Telecommunications Act to significantly impact the Company's microwave licenses.

State

The intrastate long distance telecommunications operations of Midcom are also subject to various state laws and regulations, including initial certification, registration and/or notification, as well as various tariffing and reporting requirements. Currently, the Company is certified and tariffed, where required, to provide

intrastate service to customers throughout the United States except in Alaska and Hawaii. The Company continuously monitors regulatory developments in all 50 states and intends to obtain the appropriate certificates wherever feasible.

Midcom is currently subject to varying levels of regulation in the 48 states in which it provides intrastate long distance telecommunications service. The large majority of the states require Midcom to apply for certification to provide intrastate long distance telecommunications service, or at least to register or to be found exempt from regulation, before commencing such service. At present, 34 states also require Midcom to file and maintain detailed tariffs listing its rates for intrastate long distance service. Many states also impose various reporting requirements and/or require prior approval for transfers of control of certified carriers, assignments of carrier assets (including customer bases), carrier stock offerings and/or incurrence by carriers of significant debt obligations. Certificates of authority can generally be conditioned, modified, cancelled, terminated or revoked by state regulatory authorities for failure to comply with state law and/or the rules, regulations, and policies of the state regulatory authorities. Fines and other penalties, including the return of all monies received for intrastate traffic from residents of a state, may be imposed for such violations. Except for the request for approval which, as of the date of this Report, was pending in Arkansas with respect to the Company's acquisition of a customer base from Cherry Communications Incorporated ("Cherry Communications"), the Company has secured approval for its acquisitions of the capital stock, customer bases or other assets of other telecommunications service providers. With respect to the Company's acquisition of the customer base from Cherry Communications, the Arkansas Public Utility Commission has held the docket in abeyance pending filing of appropriate tariffs by Midcom to cover rates and services applicable to former customers of Cherry Communications. The Company does not believe that failure to obtain approval in Arkansas prior to completing the acquisition will have a material adverse effect on the Company's business, financial condition or results of operation.

When the Company enters the local telecommunications market, it will be subject to regulation, often as a facilities-based provider, by state public service and public utility commissions in the states in which it provides local exchange service. Virtually all states require local exchange providers to be certified prior to initiating service and to maintain on file with the state commissions detailed tariffs specifying rates, as well as terms and conditions, of service. The Company will be subject to a higher level of regulatory oversight as a local exchange provider than it has been as a long distance carrier. Among other things, the Company will be subject to a variety of additional service quality and consumer protection requirements, as well as requirements to provide emergency, handicapped and subsidized services. The states also impose additional reporting and prior approval requirements on local service providers. Certificates of local authority can generally be conditioned, modified, cancelled, terminated or revoked by state regulatory authorities for failure to comply with state law and/or the rules, regulations, and policies of the state commissions. Fines and other penalties may also be imposed for such violations.

RUSSIAN JOINT VENTURE

In December 1993, Midcom contracted to acquire a 50% interest in Dal Telecom International ("Dal Telecom"), a provider of local, long distance, international and cellular telecommunications services in the Russian Far East. To acquire its interest in Dal Telecom, Midcom committed to make a capital contribution of cash, equipment and services of approximately \$12.7 million. As of December 31, 1995, the Company had invested a total of approximately \$8.2 million in the joint venture but was unable to fund additional contributions. In March 1996, the Company and the joint venture partner agreed to amend the terms of the joint venture to provide that the Company had a 40% equity interest in the joint venture.

The Company's commitment to Dal Telecom required significant amounts of capital resources and management attention given the logistics of maintaining a relationship in Russia. As a result, the Company decided that it was in its best interests to focus on its domestic business and to sell its interest in Dal Telecom. As a result of this decision, the Company wrote down its investment in Dal Telecom to \$2.0 million at December 31, 1995, which was the Company's estimate of the net recoverable value of its investment in Dal Telecom, and recorded a loss of approximately \$6.8 million on impairment of the asset. This estimate was based on market information currently available to the Company and certain assumptions about the future.

operations of Dal Telecom, over which the Company had limited control. There can be no assurance that the Company will be successful in its efforts to sell its interest in Dal Telecom. The Company discontinued recording its share of the income or losses of Dal Telecom as of December 31, 1995. During the third quarter of 1996, the remaining investment of \$2.0 million was written off to loss on impairment of assets, as the Company was unable to locate a purchaser for its interest. See Note 5 of the Notes to Consolidated Financial Statements.

CUSTOMER CONCENTRATIONS

The Company estimates that during the fourth quarter of 1996 it invoiced approximately 100,000 customer locations. Certain Midcom customers receive multiple billing invoices because they have multiple locations. As of the end of 1996, the Company was unable to aggregate the invoices of such customers to determine an exact customer count. During 1994, 1995 and 1996, no one customer accounted for more than 5.0% of Midcom's revenue. Midcom believes that the loss of any single customer would not have a material adverse effect on its business, financial condition or results of operations.

EMPLOYEES

As of December 31, 1996, the Company employed 527 persons on a full-time basis. None of the Company's employees are members of a labor union or are covered by a collective bargaining agreement. The Company has never experienced a work stoppage and considers its employee relations to be good.

DIRECTORS AND EXECUTIVE OFFICERS

The following table sets forth certain information as to the directors and executive officers of the Company.

<u>NAME</u>	<u>AGE</u>	<u>POSITION</u>
John M. Zmo	58	Chairman of the Board and Director
Paul Pfleger	61	Vice Chairman of the Board and Director
William H. Oberlin	52	President, Chief Executive Officer and Director
Robert L. Nitschke	49	Executive Vice President, Operations
Robert J. Chamberlain	43	Executive Vice President, Chief Financial Officer, Treasurer and Assistant Secretary
Paul P. Senio	64	Vice President and Secretary
Steven P. Goldman	37	Vice President, Assistant Secretary and General Counsel
John M. Orzech(1)(2)	42	Director
Scott B. Perper(2)	41	Director
Karl D. Guelich(1)	54	Director
Marvin C. Moses(1)	52	Director
Daniel M. Dennis(2)	49	Director

(1) Member of the Audit Committee.

(2) Member of the Compensation Committee.

John M. Zmo has served as the Chairman of the Company's Board of Directors since December 1996. In addition, he has served as a director of the Company and a consultant to the Company since May 1996. From August 1995 to October 1995, Mr. Zmo was Vice Chairman of Frontier Corporation, a long distance telecommunications provider, and was President, Chief Executive Officer and a director of ALC Communica-

tions Corporation ("ALC"), a long distance telecommunications provider, from August 1988 until its merger with Frontier Corporation in August 1995.

Paul Pfleger has been Vice Chairman of the Company's Board of Directors since December 1996. In addition, he served as the Chairman of the Company's Board of Directors from the Company's formation in 1989 until December 1996, and he served as acting President and Chief Executive Officer of the Company from April 1996 to May 1996. Mr. Pfleger was a founder and currently is Chairman of the Board of Directors of SP Investments, Inc., has been Chairman of the Board of Directors of Interfinancial Real Estate Management Company, a real estate management company, since 1984 and has been its President since April 1993. Pursuant to a shareholder's agreement (the "Shareholder's Agreement") among Ashok Rao, a former officer of the Company, trusts for benefit of family members of Mr. Rao and limited partnerships controlled by Messrs. Pfleger and Orehek, the parties thereto have agreed to vote their shares to elect Mr. Pfleger to the Board of Directors. The Shareholders' Agreement expires on June 7, 1999.

William H. Oberlin has served as President, Chief Executive Officer and a director of the Company since May 1996. Prior to joining the Company, Mr. Oberlin was President and Chief Operating Officer of Frontier Corporation from August 1995 to November 1995 and was Executive Vice President, Chief Operating Officer and a director of ALC from October 1988, July 1990 and July 1993, respectively, until its merger with Frontier Corporation in August 1995.

Robert L. Nitschke has served as Executive Vice President, Operations since October 1996 and Executive Vice President and Chief Operating Officer from October 1995 to October 1996. Prior to joining the Company, Mr. Nitschke was Vice President for U.S. Intelco Holdings, a telecommunications holding company, and President of its subsidiary, USI-Gateway, Inc., a developer of products and services for local number portability, from July 1995 to October 1995, and was Vice President of Operations of its subsidiary, U.S. Intelco Network, a billing aggregation and database and information services provider to local exchange carriers, from September 1989 to July 1995.

Robert J. Chamberlain has served as Executive Vice President, Treasurer and Assistant Secretary since October 1996 and as the Chief Financial Officer of the Company since April 1996. He served as the Company's Senior Vice President of Finance and Administration from April 1996 to October 1996. He also served as a consultant to the Company, advising on financial matters, from January 1995 to May 1995 and from January 1996 to April 1996. Prior to joining the Company, Mr. Chamberlain was the Vice President of Finance and Operations and Chief Financial Officer of ElseWare Corporation, a font technology software developer, from January 1992 to December 1995. Prior to that, Mr. Chamberlain was a partner at KPMG Peat Marwick.

Paul P. Senio has served as Secretary of the Company since 1989, becoming General Counsel in January 1994. He served as Vice President of the Company from January 1994 to September 1994 and again from December 1995 to the present. He served as the Company's Senior Vice President from September 1994 to December 1995. From 1984 to December 1993, Mr. Senio served as General Counsel for Security Properties Inc., a real estate management company controlled by Paul Pfleger.

Steven P. Goldman was appointed Vice President, Assistant Secretary and General Counsel of the Company in March 1997. Prior to that he was with AT&T Wireless Services, Inc. (formerly McCaw Cellular Communications, Inc.), a wireless services provider, as regulatory counsel from August 1989 to December 1991, Regional Vice President and General Counsel from January 1992 to March 1994, and Vice President -- Law from March 1994 to January 1997.

John M. Orehek has served as a director of the Company since January 1993. Mr. Orehek has served as President and Chief Executive Officer of SP Investments Inc., an investment management company, from 1991 to the present. In addition, Mr. Orehek has been a director of IREMCO since 1993. From 1987 to 1991, Mr. Orehek was President of Hallmark Capital Partners, Ltd., a Seattle-based real estate development corporation.

Scott B. Perper has served as a director of the Company since June 1994. Mr. Perper has been a Senior Vice President of First Union Corporation, a bank holding company, and First Union National Bank of North

Carolina since January 1990, and an executive of First Union Capital Partners, the private equity and mezzanine investment arm of First Union Corporation, since February 1989.

Karl D. Guelich has served as a director of the Company since November 1995 and served as a consultant to the Company from March 1996 to April 1996. Since March 1993, Mr. Guelich has been in private practice as a certified public accountant. From June 1964 to February 1993, Mr. Guelich was employed by Ernst & Young LLP, where he served as the Area Managing Partner for the Pacific Northwest offices headquartered in Seattle from October 1986 to November 1992.

Marvin C. Moses has served as a director of the Company and a consultant to the Company since May 1996. From August 1995 to January 1996, Mr. Moses was Executive Vice President and Chief Financial Officer of Frontier Corporation and from January 1996 to April 1996 Mr. Moses was Vice Chairman and Chief Financial Officer of Frontier Corporation. He also was Chief Financial Officer and a director of ALC from October 1988 and September 1989, respectively, until its merger with Frontier Corporation in August 1995.

Daniel M. Dennis has served as a director of the Company since July 1996. Mr. Dennis served in numerous executive positions since joining MCI in 1973, the most recent being president of MCI Large Accounts, a division of MCI, from February 1996 to August 1996. Although Mr. Dennis continues to serve as a consultant to MCI, he has resigned from MCI effective August 1996.

RISK FACTORS

Prospective investors are strongly cautioned that an investment in the Company involves a very high degree of risk. The Company's ability to halt the deterioration of its results of operations and financial condition and successfully implement its operating strategy is subject to an unusual number of material risks and uncertainties. Prospective investors should not dismiss, as "boilerplate" or "customary" disclosure the risk factors set forth below. The contingencies and other risks discussed below could affect the Company in ways not presently anticipated by its management and thereby impair its ability to continue as a going concern and materially affect the value of its debt and equity securities. A careful review and understanding of each of the risk factors set forth below, as well as the other information contained in this Report, is essential for an investor seeking to make an informed investment decision with respect to the Company.

Ability to Continue as a Going Concern; Need for Additional Working Capital

As a result of Midecom's rapid growth, substantial operating losses, billing and collection cycle, acquisition strategy and other factors, the Company has required substantial external working capital. In addition to funds required for day to day operations, the Company's principal working capital requirements include capital expenditures (including those associated with the proposed installation of new switching facilities), interest and principal payable under the Notes and other contingencies and obligations described under "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources." The Notes will mature on August 15, 2003. Interest on the Notes is due semi-annually on February 15 and August 15 of each year, in the aggregate amount of approximately \$4.0 million for each payment. The report of the Company's independent auditors included in this Report with respect to the Company's 1996 Consolidated Financial Statements states that the Company's recurring operating losses and shareholders' deficit raise substantial doubt about the Company's ability to continue as a going concern. The report of the Company's independent auditors with respect to the Company's 1995 Consolidated Financial Statements also stated that the Company's recurring operating losses working capital deficiency and then-existing credit agreement defaults raised substantial doubt about the Company's ability to continue as a going concern. The Consolidated Financial Statements included with this Report have been prepared assuming the Company would continue as a going concern and do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets and liabilities that may result from this uncertainty.

The Company's available sources of working capital at March 14, 1997 consisted of cash flow from operations and approximately \$14.5 million in cash and short-term, investment grade, interest-bearing

securities, which represented the remaining net proceeds from the Private Placement. Prior to completion of the Private Placement in September 1996, the Company had for several months experienced a severe working capital short-fall which required the Company to seek extended payment terms from certain of its suppliers, delay payments to many of its suppliers and other vendors, delay or cancel purchases and take other steps to conserve operating capital. Also, for several months prior to the completion of the Private Placement, the Company was in default of certain financial and other covenants under the Transamerica Credit Facility, although the lenders continued to permit borrowings under that facility. The existence of defaults under the Transamerica Credit Facility also constituted defaults under certain of the Company's capital leases. For these reasons, the auditor's report with respect to the Company's 1995 Consolidated Financial Statements included the going concern disclosure referred to above. In connection with the completion of the Private Placement and the application of the net proceeds therefrom to the repayment in full of all borrowings under the Transamerica Credit Facility, the lenders waived all then-existing defaults and amended the financial covenants under the facility to levels forecasted to be consistent with Midcom's revised business plan. However, the decline in revenue and related gross profit in the last two quarters of 1996, due in significant part to the unanticipated loss of revenue from a customer base which is the subject of a dispute, caused the Company again to be in default of certain financial covenants under the Transamerica Credit Facility. See "Item 3. Legal Proceedings -- Cherry Communications Lawsuit." Due to the existence of these defaults and an insufficient borrowing base to satisfy a \$20.0 million minimum excess availability requirement, no borrowings were available to the Company under the Transamerica Credit Facility and the lenders terminated the facility in January 1997.

In February 1997, the Company entered into a new revolving credit agreement with Foothill Capital Corporation (the "Foothill Credit Facility") which will permit borrowings of up to \$30.0 million (subject to borrowing base limitations) secured by substantially all of the assets of the Company. Borrowings under the Foothill Credit Facility will not be available until satisfaction of a number of conditions, consisting primarily of final documentation of security arrangements which is expected to occur by May 1997. In addition, in February 1997 the Company entered into a lease facility under which approximately \$13.0 million is available for acquisition of capital equipment, which the Company expects to use primarily to finance the purchase of its high capacity switching equipment. See "Item 7. Management's Discussion and Analysis of Financial Condition Results of Operations -- Liquidity and Capital Resources."

As of March 14, 1997, the Company estimated that it will require between \$40.0 million and \$50.0 million in order to fund operating losses, working capital requirements and capital expenditures during the remainder of 1997. The Company believes that it will be able to satisfy the conditions to borrowing under the Foothill Credit Facility by May 1997. Assuming borrowings become and remain available under the Foothill Credit Facility and the Company achieves anticipated revenue growth, the Company believes that the remaining proceeds from the Private Placement together with funds available under the Foothill Credit Facility, leasing facilities and cash flow from operations will be sufficient to fund the Company's expected working capital requirements. However, the exact amount and timing of these working capital requirements and the Company's ability to continue as a going concern will be determined by numerous factors, including the level of, and gross margin on, future sales, the outcome of outstanding contingencies and disputes such as pending lawsuits, payment terms achieved by the Company and the timing of capital expenditures. Furthermore, there can be no assurance that borrowings under the Foothill Credit Facility will become and remain available or that this facility together with the Company's other anticipated sources of working capital will be sufficient to implement the Company's operating strategy or meet the Company's other working capital requirements. If (i) the Company experiences greater than anticipated capital requirements, (ii) the Company is determined to be liable for, or otherwise agrees to settle or compromise, any material claim against it, (iii) the Company is unable to make borrowings under any of its credit facilities for any reason, (iv) the implementation of the Company's operating strategy fails to produce the anticipated revenue growth and cash flows or (v) additional working capital is required for any other reason, the Company will be required to refinance all or a portion of its existing debt or obtain additional equity or debt financing. There can be no assurance that any such refinancing would be possible or that the Company would be able to obtain additional equity or debt financing, if and when needed, on terms that the Company finds acceptable. Any additional equity or debt financing may involve substantial dilution to the interests of the Company's shareholders and

the holders of the Notes. If the Company is unable to obtain sufficient funds to satisfy its cash requirements, it will be forced to curtail operations, dispose of assets or seek extended payment terms from its vendors. There can be no assurance that the Company would be able to reduce expenses or successfully complete other steps necessary to continue as a going concern. Such events would materially and adversely affect the value of the Company's debt and equity securities. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources."

Recent Losses and Anticipated Future Losses

The Company has experienced significant losses since its inception. Net losses for 1994, 1995 and 1996 were approximately \$3.0 million, \$33.4 million and \$97.3 million, respectively. The execution of the Company's restructuring, network and marketing strategy will require the Company to substantially increase its investment in sales, marketing, capital equipment, systems development and other areas. The Company expects that a substantial portion of these expenditures will be made before the Company realizes a significant increase in revenue or an improvement in gross margin. The Company therefore expects that, during at least the first three quarters of 1997, operating costs will increase both in actual dollars and as a percentage of revenue and net losses will continue. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Introduction."

Material Weaknesses in Internal Financial Controls

In connection with the audit of Midcom's 1995 Consolidated Financial Statements, Midcom's independent auditors identified two conditions which were characterized as material weaknesses in its internal financial controls. One material weakness identified by the auditors was the failure of the accounting and finance systems to provide accurate information necessary to monitor the Company's financial position, results of operations and liquidity, as demonstrated by the restatement of the Company's third quarter results and the difficulties in completing the 1995 year-end audit which resulted in numerous material adjustments to preliminary fourth quarter results. Factors identified as contributing to this weakness and requiring immediate attention included insufficient staffing and systems to accommodate significant growth from acquisitions, transitional difficulties associated with major new information and billing systems, inadequate communication between senior management and the finance department and demands associated with the Company's initial public offering. The second material weakness identified by the auditors was the Company's process of estimating unbilled receivables. With respect to this material weakness, the auditors recommended that the Company review and revise, as necessary, all policies and procedures with regard to its reconciliation of unbilled receivables with actual billings to ensure that all unbilled amounts at a reporting date represent properly recorded revenue. As a result of operational and other changes implemented by the Company, on March 13, 1997 the Company's independent auditors reported to the Company's Audit Committee that the material weaknesses identified in connection with the 1995 audit have been corrected. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Past Material Weaknesses" and "-- Information Systems." However, in light of the volume of financial data to be processed, the reliance upon timely receipt of call data records from suppliers, the anticipated rate of growth of the Company, the demands on key financial personnel, the potential for turnover in key finance and accounting positions, the challenges associated with the integration of acquired businesses and other factors, there can be no assurance that the Company will not encounter other internal control weaknesses.

Restatements of Financial Results

It is the Company's practice, which is common in the long distance industry, to include in reported revenue and accounts receivable an amount for unbilled calls equal to an estimate of the amount that will be billed and collected for calls occurring in that reporting period. During 1995, the Company converted its customer billing function for those calls for which it provides direct billing to a new billing system. The Company experienced difficulties in implementing the new billing system which caused an increased number of calls to be billed later than expected by the Company. See "-- Information Systems." Also, in the process of reconciling unbilled accounts as of December 31, 1995 with amounts ultimately billed, the Company

discovered that certain reports generated by its new information management system that were used for recognizing unbilled revenue for the third quarter of 1995 failed to fully reflect all discounts that were properly included in the bills subsequently sent to the Company's customers. Primarily as a result of this failure, reported revenue was overstated for the third quarter of 1995 and the Company's Quarterly Report on Form 10-Q for that period had to be amended to restate reported results. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Restatement of Results for the Third Quarter of 1995." In addition, the Company had previously been required to restate its financial statements for the year ended December 31, 1994 after determining that revenue and accounts receivable had been overstated by approximately \$1.8 million net of reserves as a result of using historical averages of unbilled calls as the basis for its revenue estimates, a practice that the Company discontinued in the first quarter of 1995. In light of the volume of financial data to be processed, the reliance upon timely receipt of call data records from suppliers, the anticipated rate of growth of the Company, the demands on key financial personnel, the potential for turnover in key finance and accounting positions, the challenges associated with the integration of acquired businesses and other factors, there can be no assurance that the Company will not encounter additional billing delays or other difficulties in future financial reporting.

Disputes and Litigation

The Company, its Vice Chairman of the Board of Directors and largest shareholder, the Company's former President, Chief Executive Officer and a director, and the Company's former Chief Financial Officer are named as defendants in a securities action filed in the U.S. District Court for the Western District of Washington (the "Complaint"). The Complaint was filed on behalf of a class of purchasers of the Company's Common Stock during the period beginning on July 6, 1995, the date of the Company's initial public offering, and ending on March 4, 1996 (the "Class Period"). An amended complaint (the "Amended Complaint") was filed on July 8, 1996. In November 1996, the Court granted defendants' motion to dismiss plaintiffs' Amended Complaint without prejudice and plaintiffs refiled a second amended complaint (the "Second Amended Complaint") on December 19, 1996 with limited changes or amendments. In January 1997, the defendants filed a motion to dismiss the Second Amended Complaint claiming a failure by plaintiffs to plead with particularity and a failure to plead facts establishing scienter, both as required under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and the failure to establish tracing to the prospectus relating to the Company's initial public offering, as required under the Securities Act. The Second Amended Complaint alleges, among other things, that the registration statement and prospectus relating to the Company's initial public offering contained false and misleading statements concerning the Company's billing software and financial condition. The Second Amended Complaint further alleges that, throughout the Class Period, the defendants inflated the price of the Common Stock by intentionally or recklessly making material misrepresentations or omissions which deceived the public about the Company's financial condition and prospects. The Second Amended Complaint alleges claims under the Securities Act and the Exchange Act as well as various state laws, and seeks damages in an unstated amount. While the Company believes that it has substantive defenses to the claims in the Second Amended Complaint and intends to vigorously defend this lawsuit, it is unable to predict the outcome of this action. If determined adversely to the Company, this lawsuit could have a material adverse effect on the Company's business, financial condition and results of operations. See "Item 3. Legal Proceedings."

The Company was informed in May 1996 that the Securities and Exchange Commission (the "Commission") was conducting an informal inquiry regarding the Company. The Company has voluntarily provided the documents requested by the Commission. In addition, the Commission has requested the Company's cooperation in interviewing certain current and former Company personnel and the Company is in the process of scheduling such interviews. However, the Company has not been informed whether the Commission intends to commence formal action against the Company or any of its affiliates. The Company is, therefore, unable to predict the ultimate outcome of the investigation. In the event that the Commission elects to initiate a formal enforcement proceeding, the Company and certain of its current and/or former officers could be subject to civil or criminal sanctions including monetary penalties and injunctive measures. Any such enforcement proceeding could have a material adverse effect on the Company's business, financial condition and results of operations. See "Item 3. Legal Proceedings."

In addition, by virtue of its rapid growth, past acquisition activities and large volume of business with suppliers, the Company is involved in litigation or disputes with sellers of acquired operations, suppliers and other third parties. See "-- Acquisitions," "-- Suppliers," and "Item 3. Legal Proceedings."

Although the Company intends to defend its existing litigation and other disputes vigorously, it is unable to predict the nature or timing of any resolution of such matters. If the Company is determined to be liable for, or otherwise agrees to settle or compromise, any claim, it would most likely be required to make a payment in the form of cash, indebtedness or equity securities. Depending on the size, type and timing of any such payment, it could materially impair the Company's limited capital resources or significantly dilute the Company's existing shareholders. See "-- Risk Factors -- Need for Additional Working Capital." In addition, the Company's pending litigation, investigations and disputes could result in substantial legal costs to the Company and divert management's attention from the other business affairs of the Company for substantial periods of time.

Minimum Volume Commitments and Shortfalls

Midcom has entered into multiple-year supply contracts with Sprint, WorldCom and AT&T and short-term contracts with a number of other suppliers for the long distance telecommunication services provided to its customers. To obtain favorable forward pricing from certain of its suppliers, the Company has committed to purchase minimum volumes of a variety of long distance services during stated periods whether or not such volumes are used or, in one case, to pay a surcharge equal to a percentage of the Company's shortfall from a specified quarterly minimum volume. In the past, Midcom has fallen short of its minimum volume commitments with certain carriers and has renegotiated the commitment. For example, in October 1996, Midcom entered into a renegotiated carrier supply contract with AT&T pursuant to which, among other things, the minimum volume commitment was reduced from \$117.0 million to \$13.7 million for the eighteen month period following execution of the contract. In November 1996, the Company paid AT&T \$5.0 million as the first installment of \$8.8 million to be paid in connection with satisfaction of past shortfalls and reduction of the remaining commitment. The Company's minimum volume commitments to all of its carriers as of March 15, 1997 aggregated approximately \$92.0 million, to be used over the next three years. See Note 15 of Notes to Consolidated Financial Statements. There can be no assurance that the Company will not incur additional shortfalls in the future or that it will be able to successfully renegotiate, or otherwise obtain relief from, its minimum volume commitments in the future. If future shortfalls occur, the Company may be required to make substantial payments without associated revenue from customers or the supplier may terminate service and commence formal action against the Company. Such payments are not presently contemplated in the Company's capital budgets and would have a material adverse effect on the Company's business, financial condition and results of operation. See "-- Suppliers."

Because of Midcom's commitments to purchase fixed volumes of use from certain of its suppliers at predetermined rates, the Company could be adversely affected if a supplier were to lower the rates it makes available to the Company's target market without a corresponding reduction in the Company's rates. Similarly, the Company could be adversely affected if its suppliers fail to adjust their overall pricing, including prices to the Company, in response to price reductions of other major carriers. See "-- Suppliers" and Note 15 of the Notes to Consolidated Financial Statements.

Ability to Implement Network Strategy and Enter Local Markets

A key element of the Company's operating strategy is the deployment of dedicated switching facilities and the transition from primarily a nonfacilities-based reseller of long distance and other telecommunications services to a switch-based provider of integrated telecommunications services. See "-- Company Strategy." The Company's ability to implement its network strategy may be impaired by technical, operational or other difficulties encountered in the installation or operation of the Company's sophisticated high capacity switching equipment. See "-- Switching Facilities." In addition, the Company's ability to enter into the local telecommunications market may be impaired by certain logistical challenges. Prior to selling local services to its customers, the Company must complete a number of operational, marketing and regulatory tasks, including the negotiation of interconnection agreements with local circuit providers, the development of a billing,

provisioning and customer service capability and the creation of a local marketing, pricing and sales strategy. See "-- Products and Services -- Local Service" and "-- Regulation."

Ability to Manage Growth

The Company intends to pursue substantial growth in connection with the implementation of its operating strategy. This growth will place significant demands on the Company's management and systems of financial and internal controls and will require an increase in the capacity, efficiency and accuracy of its billing and customer support systems. Moreover, this growth will require an increase in the number of the Company's personnel, particularly sales, customer service and technical personnel. The market for such personnel is highly competitive and there can be no assurance that the Company will be able to attract the personnel required by its operating strategy. Further, the Company will be required to expand, train, motivate and manage its employee base. This will require an increase in the level of responsibility for both existing and new management personnel. There can be no assurance that the management skills and systems currently in place, or to be implemented in connection with the Company's operating strategy, will be adequate or that the Company will be able to assimilate its new employees successfully. Finally, the Company has experienced a high level of turnover in its sales force. The Company believes that this turnover is primarily attributable to the intense competition for, and the mobility of, qualified sales personnel endemic to the reseller segment of the telecommunications industry. Although one objective of the Company's operating strategy is to decrease the level of turnover in its sales force, there can be no assurance that this objective will be achieved. The Company's failure to attract and retain sufficient qualified personnel, to train, motivate and manage such personnel or to otherwise manage its growth could impair its ability to implement its operating strategy and could have a material adverse effect on its business, financial condition and results of operations. See "-- Marketing and Sales."

Dependence Upon Management Team

Midcom's ability to implement its operating strategy is highly dependent upon its ability to retain its senior management team. These individuals are generally in high demand and are often subject to competing employment opportunities. Midcom believes that it will need to retain key management personnel to meet the demands of its business. The loss of William H. Oberlin, the Company's President and Chief Executive Officer and one of the Company's directors, or the other key members of the management team could have a material adverse effect on the Company's business, financial condition and results of operations. See "-- Company Strategy."

Customer Attrition

Midcom's revenue is affected by customer attrition, a problem inherent in the long distance industry. The customer attrition experienced by the Company is attributable to a variety of factors, including the Company's termination of customers for non-payment and the marketing and sales initiatives of the Company's competitors such as, among other things, national advertising campaigns, telemarketing programs and the use of cash or other incentives. In particular, the Company commonly experiences high initial customer attrition from acquired customer bases as these customers are transitioned to the Company's services and systems. Although one of the objectives of the Company's operating strategy is to reduce customer attrition, there can be no assurance that this attrition will not remain at current levels or increase. Failure to reduce customer attrition could have a material adverse effect on the Company's business, financial condition and results of operations. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Customer Attrition."

Rapid Technological Change

The telecommunications industry is characterized by rapidly evolving technology. Midcom believes that its success will increasingly depend on its ability to offer, on a timely basis, new services based on evolving technologies and industry standards. Midcom intends to increase its efforts to develop new services; however, there can be no assurance that the Company will have the ability or resources to develop such new services.

that new technologies required for such services will be available to the Company on favorable terms or that such services and technologies will enjoy market acceptance. Further, there can be no assurance that the Company's competitors will not develop products or services that are technologically superior to those used by the Company or that achieve greater market acceptance. The development of any such superior technology by the Company's competitors, or the inability of the Company to successfully respond to such a development, could render Midcom's existing products or services obsolete and could have a material adverse effect on the Company's business, financial condition and results of operations.

Ability to Integrate Acquired Operations

Midcom experienced rapid growth through the end of 1995. A significant portion of this growth, particularly in 1995, was attributable to acquisitions of customer bases and of other telecommunications service providers. For a number of reasons, the Company was not able to consolidate and integrate the sales and marketing, customer support, billing systems and other functions of certain of these acquired operations. The Company may experience difficulties in the integration and consolidation of customer bases or operations acquired in the future. Pending such integration and consolidation, it may be necessary for the Company to maintain separate billing systems and other functions of the acquired operation, which could cause inefficiencies and additional operational complexity and expense, increase the risk of billing delays and financial reporting difficulties, increase customer attrition and impair the Company's efforts to cross-sell the products and services of the acquired operation. If the Company acquires customer bases or other operations in the future, difficulties encountered in integrating and consolidating such operations could have a material adverse effect on the Company's business, financial condition and results of operations. See "-- Acquisitions" and "-- Information Systems."

Dependence Upon Integrity of Call Data Records

Midcom depends on the timeliness and accuracy of call data records provided to it by facilities-based carriers supplying telecommunications services, and there can be no assurance that accurate information will consistently be provided by the carriers on a timely basis. Failure of the Company to receive prompt and accurate call data records from its suppliers will impair the Company's ability to bill its customers on a timely basis. Such billing delays could impair the Company's ability to collect amounts owed by its customers. Due to the multitude of billing rates and discounts which suppliers must apply to the calls completed by the Company's customers, and due to routine logistical issues such as the addition or termination of customers, the Company regularly has disagreements with its suppliers concerning the amounts invoiced for its customers' traffic. The Company pays its suppliers according to its own calculation of the amounts owed as recorded on the computer tapes provided by its suppliers. The Company's computations of amounts owed are frequently less than the amount shown on the suppliers' invoices. Accordingly, the suppliers may consider the Company to be in arrears in its payments until the amount in dispute is resolved. Although these disputes have generally been resolved on terms favorable to the Company, there can be no assurance that this will continue to be the case. Future disputes which are not resolved favorably to the Company could have a material adverse effect on the Company's business, financial condition and results of operations. See "-- Suppliers."

Dependence Upon Facilities-Based Carriers

Midcom does not currently own a transmission network and, accordingly, depends to a large extent on Sprint, WorldCom, AT&T and other facilities-based carriers for actual transmission of customer calls and other services. Further, the Company, like all other long distance providers, is dependent upon LECs for call origination (carrying the call from the customer's location to the long distance network of the IXC selected to carry the call) and termination (carrying the call off the IXC's network to the call's destination). The Company's ability to maintain and expand its business depends, in part, on its ability to obtain telecommunication services on favorable terms from facilities-based carriers and the cooperation of both IXCs and LECs in provisioning and terminating service for its customers in a timely manner. FCC policy currently requires all common carriers, including IXCs, to make their services available for resale and to refrain from imposing unreasonable restrictions on such resale. Further, the Telecommunications Act requires all ILECs both to

offer their services for resale at wholesale rates and to allow access to unbundled network elements at cost-based rates. The ILECs are also required by the Telecommunications Act to provide all IXCs, including the Company, with equal access for the origination and termination of long distance calls. If any of these requirements were eliminated, the adverse impact on the Company could be substantial. Access charges represent a substantial portion of the Company's current cost of service. The FCC, however, has undertaken to reform its universal service and access charge rules by May 1997, in order to rework the current universal service subsidy system and to move access charges toward the economic cost of originating and terminating long distance traffic. The level at which the FCC sets access charges and universal service contributions could have a material adverse effect on the Company's business, financial condition and results of operations. Moreover, implementation of a new access charge structure and repricing of local transport could place many IXCs, including the Company, at a significant cost disadvantage relative to larger competitors. The FCC has also imposed on facilities-based IXCs the obligation to track the payphone-originated tollfree and access code calls which they carry and to compensate payphone service providers for such calls, initially on a per-phone, and commencing in October 1997, on a per-call basis, in amounts reflective of soon to be deregulated local coin rates. See "-- Regulation."

Termination of Service Under Carrier Supply Contracts

In the past, the Company has, from time to time, been substantially in arrears of its payment obligations to AT&T and other suppliers. See "Item 1. Business -- Risk Factors -- Minimum Volume Commitments and Shortfalls." Although the Company is generally entitled to be given notice of defaults and an opportunity to cure under the terms of its agreements with its interexchange suppliers before such service can be terminated, and although the Company has the ability to transfer its customers' traffic from one supplier to another, provisioning a customer that is not serviced by a Midecom switch to an alternate supplier takes several days. Accordingly, if a major supplier were to decline to continue to carry the Company's traffic, due to non-payment or otherwise, without sufficient notice for the Company to make alternate arrangements, there is a possibility that the customers serviced by that supplier would be temporarily without "1 plus" long distance calling which could have a material adverse effect on the Company's business, financial condition and results of operation. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "-- Suppliers."

Competition

The long distance telecommunications industry is highly competitive. A number of the Company's current and potential competitors have substantially greater financial, technical, marketing and other resources than the Company, and there can be no assurance that the Company will be competitive in this environment. The Company's ability to compete may also be impaired by its leveraged capital structure and limited capital resources.

The long distance telecommunications industry is significantly influenced by the marketing and pricing activities of the major industry participants, including AT&T, MCI, Sprint and WorldCom. While the Company believes that AT&T, MCI and Sprint historically have chosen not to concentrate their direct sales efforts on small to medium-sized businesses, these carriers control approximately 85% of that market. Moreover, AT&T, MCI and Sprint have recently introduced new service and pricing options that are attractive to smaller commercial users, and there can be no assurance that they will not market these customers more aggressively in the future. AT&T and, as an interim measure, the structurally separate interexchange affiliates of the seven RBOCs have recently been reclassified as non-dominant carriers and, accordingly, have the same flexibility as the Company in meeting competition by modifying rates and service offerings without pricing constraints or extended waiting periods. These reclassifications may make it more difficult for the Company to compete for long distance customers. See "-- Regulation." In addition, a significant number of large regional long distance carriers and new entrants in the industry compete directly with the Company by concentrating their marketing and direct sales efforts on small to medium-sized commercial users. Activities by competitors including, among other things, national advertising campaigns,

telemarketing programs and the use of cash or other forms of incentives, contribute to significant customer attrition in the long distance industry.

The Company contracts for call transmission over networks operated by suppliers who may also be the Company's competitors. Both the IXC and ILECs providing transmission services for the Company have access to information concerning the Company's customers for which they provide the actual call transmission. Because these carriers are potential competitors of the Company, they could use information about the Company's customers, such as their calling volume and patterns of use, to their advantage in attempts to gain such customers' business. In addition, the Company's future success will depend, in part, on its ability to continue to buy transmission services and access from these carriers at a significant discount below the rates these carriers otherwise make available to the Company's targeted customers.

Regulatory trends have had, and may have in the future, a significant impact on competition in the telecommunications industry. See "Regulation." As the result of the Telecommunications Act, the RBOCs are now permitted to provide, and are providing or have announced their intention to provide, long distance service originating (or in the case of "800" service, terminating) outside their local service areas or offered in conjunction with other ancillary services, including wireless services. Following application to and upon a finding by the FCC that an RBOC faces facilities-based competition and has satisfied a congressionally-mandated "competitive checklist" of interconnection and access obligations, it will also be permitted to provide long distance service within its local service area. The entry of these well-capitalized and well-known entities into the long distance service market could significantly alter the competitive environment in which the Company operates.

The Telecommunications Act also removes most legal barriers to competitive entry into the local telecommunications market and directs ILECs to allow competing telecommunications service providers such as the Company to interconnect their facilities with the local exchange network, to lease network components on an unbundled basis and to resell local telecommunications services. Moreover, the Telecommunications Act seeks to facilitate the development of local telecommunications competition by requiring ILECs, among other things, to allow end users to retain their telephone numbers when changing service providers and to place short-haul toll calls without dialing lengthy access codes. In response to these regulatory changes, AT&T, MCI and many of the Company's other long distance competitors have announced plans to enter the local telecommunications market.

While the Telecommunications Act opens new markets to the Company, the nature and value of the resultant business opportunities will be dependent in large part upon subsequent regulatory interpretation of the statute's requirements. While the FCC has promulgated rules implementing the local competition provisions of the Telecommunications Act, these rules have been appealed and key provisions have been "stayed" pending the outcome of the appeals. Various state regulatory authorities are currently in the process of implementing the remaining FCC rules. The Company anticipates that ILECs will actively resist competitive entry into the local telecommunications market and will seek to undermine the operations and the service offerings of competitive providers, leaving carriers such as the Company which are dependent on ILECs for network services vulnerable to anti-competitive abuses. No assurance can be given that the local competition provision of the Telecommunications Act will be implemented and enforced by federal and state regulators in a manner which will permit the Company to successfully compete in the local telecommunications market or that subsequent legislative and/or judicial actions will not adversely impact the Company's ability to do so. Moreover, federal and state regulators are likely to provide ILECs with increased pricing flexibility for their services as competition in the local market increases. If ILECs are allowed by regulators to lower their rates substantially, engage in aggressive volume and term discount pricing practices for their customers, charge excessive fees for network interconnection or access to unbundled network elements or decline to make services available for resale at discounted wholesale rates, the ability of the Company to compete in the provision of local service could be materially and adversely affected.

Regulation

Federal and state regulations, regulatory actions and court decisions have had, and may have in the future, negative effects on the Company and its ability to compete. The Company is subject to regulation by the FCC and by various state public service or public utility commissions as a non-dominant or resale provider of long distance services. The Company is required to file tariffs specifying the rates, terms and conditions of its international services with the FCC and is required to file tariffs or obtain other approvals in most of the states in which it operates. Neither the FCC nor the relevant state utility commissions currently regulate the Company's profit levels, but they often reserve the authority to do so. The large majority of states require long distance service providers to apply for authority to provide telecommunications services and to make filings regarding their activities. The multiplicity of state regulations makes full compliance with all such regulations a challenge for multistate providers such as the Company. There can be no assurance that future regulatory, judicial and legislative changes or other activities will not have a material adverse effect on the Company or that regulators or third parties will not raise material issues with regard to the Company's compliance with applicable laws and regulations.

Pursuant to the terms of the 1984 court decree which required AT&T to divest its local exchange operations, the RBOCs were prohibited from providing long distance telecommunications service between certain defined geographic areas, known as Local Access Transport Areas or "LATAs." However, the Telecommunications Act allows for immediate provision by the RBOCs of long distance service outside their respective local telephone service areas as well as long distance service bundled with wireless, enhanced and certain other services. The Telecommunications Act also provides a mechanism for eventual entry by the RBOCs into the long distance market within their respective local service areas. The competition faced by the Company will increase significantly as the RBOCs expand their provision of inter-LATA services.

As a result of a 1994 court decision, the Company became obligated to provide detailed rate schedules in all of its federal tariffs, and the Company could possibly be liable for damages for following an FCC policy which did not require the Company to file such detailed schedules of its domestic charges in the past. The FCC's policy which would have implemented mandatory detariffing by August 1997 has now been stayed pending determination of the issue by the federal district court in Washington, D.C. Also, AT&T and, as an interim measure, the structurally separate interexchange affiliates of the RBOCs have recently been reclassified as non-dominant carriers and, accordingly, have the same flexibility as the Company in meeting competition by modifying rates and service offerings without pricing constraints or extended waiting periods. The reclassifications may make it more difficult for the Company to compete for long distance customers. See "Regulation."

When the Company enters the local telecommunications market, it will be subject to regulation by various state public service and public utility commissions, often as a facilities-based provider. Virtually all states require local exchange providers to be certified prior to initiating service and to maintain on file with the state commissions detailed tariffs specifying rates, as well as terms and conditions, of service. The Company will be subject to a higher level of regulatory oversight as a local exchange provider than it has been as a long distance carrier. Among other things, the Company will be subject to a variety of additional service quality and consumer protection requirements, as well as requirements to provide emergency, handicapped and subsidized services. The states also impose additional reporting and prior approval requirements on local service providers. The multiplicity and volume of state regulations governing the provision of local service make full compliance with all such regulations even more of a challenge for multistate providers such as the Company than compliance with state regulations governing the provision of long distance service. As with the Company's provision of long distance service, there can be no assurance that future regulatory, judicial and legislative changes or other activities will not have a material adverse effect on the Company's provision of local exchange service or that regulators or third parties will not raise material issues with regard to the Company's compliance with laws and regulations applicable to its provision of such service.

Substantial Leverage

The Company is highly leveraged. As of December 31, 1996, the Company's total indebtedness and shareholders' deficit was \$112.1 million and \$69.3 million, respectively. The Company's ability to make scheduled payments of the principal of, or interest on, its indebtedness will depend on its future performance, which is subject to economic, financial, competitive and other factors beyond its control.

Repurchase of Notes at the Option of Holders Upon a Change of Control

In the event of a change of control, each holder of Notes has the right to require that the Company repurchase the Notes in whole or in part at a redemption price equal to 101% of the principal amount thereof, plus accrued interest, if any, to the date of repurchase. If a change of control were to occur, there can be no assurance that the Company would have sufficient funds to pay such redemption price for all Notes tendered by the holders thereof. If the Company is required to pay such redemption price, such payment could have a material adverse effect on the Company's liquidity, results of operations and financial condition. Moreover, the Company's repurchase obligation could have the effect of delaying, deferring or preventing a change of control of the Company and could limit the price that certain investors might be willing to pay in the future for the Common Stock.

Shares Eligible for Future Sale

As of December 31, 1996, there were 15,954,917 outstanding shares of Common Stock (assuming no redemption of the shares owned by the Company's former President and Chief Executive Officer), of which 9,150,437 shares were "restricted securities" subject to restrictions set forth in Rule 144 promulgated under the Securities Act. Of the restricted securities, 5,617,272 shares may be sold under Rule 144, and an additional 2,649,319 shares will be tradable pursuant to Rule 144 upon the expiration of the applicable one-year holding period.

As of December 31, 1996, the Company had reserved for issuance 4,108,816 shares of Common Stock under its Amended and Restated 1993 Stock Option Plan (the "Stock Option Plan") and 256,354 shares of Common Stock for issuance under its Revised and Restated 1995 Employee Stock Purchase Plan (the "Stock Purchase Plan"). Under the Stock Option Plan, as of December 31, 1996 options to purchase 3,693,379 shares of Common Stock were outstanding and options to purchase 212,240 shares of Common Stock were exercisable. At December 31, 1996, warrants to purchase 59,500 shares of Common Stock were outstanding. Also, in March 1997, the Company issued a warrant to purchase 117,000 shares of Common Stock in connection with a capital lease financing arrangement, which warrant is fully exercisable. In addition, the Notes are convertible into Common Stock at the option of the holder thereof at any time prior to maturity, unless previously redeemed, at a conversion price of \$14.0875 per share, subject to adjustment in certain events. If the Notes outstanding as of December 31, 1996 were fully converted, the Company would be obligated to issue to the holders thereof an aggregate of 6,938,279 shares of Common Stock (not including an indeterminate number of shares that may be issued in connection with certain anti-dilution and other provisions).

Certain individuals and entities have certain rights with respect to the registration under the Securities Act of the public offer and sale of certain shares of Common Stock acquired in connection with the formation of the Company and various unrelated acquisition and financing transactions. As of December 31, 1996, holders of approximately 9,040,212 shares of Common Stock were subject to such registration rights. At December 31, 1996, holders of approximately 2,012,000 shares of Common Stock subject to such registration rights had the right to require the Company to register the public offer and sale of their shares under the Securities Act. Notwithstanding such registration rights, the Company voluntarily filed a Registration Statement with the Commission on November 25, 1996 (file no. 333-16681) to register under the Securities Act the public offer and sale of the approximately 1,600,000 shares of Common Stock subject to such registration rights. The Company intends to maintain the effectiveness of this Registration Statement until approximately December 31, 1997. In addition, pursuant to a Registration Rights Agreement between the Company and the Initial Purchasers of the Notes (the "Registration Right Agreement"), the Company has

agreed to register under the Securities Act the public offer and sale of the Notes and the shares of Common Stock issuable upon conversion of the Notes (the "Conversion Shares"), subject to certain conditions and limitations. Pursuant to the Registration Rights Agreement, the Company filed a Registration Statement with the Commission on October 18, 1996 (file no. 333-14427) to register the public offer and sale of up to \$97,743,000 aggregate principal amount of Notes and an indeterminate number of Conversion Shares. The Company is required under the Registration Rights Agreement to maintain the effectiveness of this Registration Statement for a period of three years from the completion of the Private Placement or, if shorter, when (i) all the Notes and Conversion Shares have been sold pursuant to the Registration Statement or (ii) the date on which there ceases to be outstanding any Notes or Conversion Shares.

Sales of substantial amounts of Common Stock in the public market under Rule 144, pursuant to the exercise of registration rights or otherwise, and even the potential for such sales, may have a material adverse effect on the prevailing market price of the Common Stock and could impair the Company's ability to raise capital through the sale of its equity securities.

Control by Principal Shareholders

At December 31, 1996, Midcom's directors and executive officers beneficially owned or had the power to vote approximately 40.0% of the Common Stock. Although such shareholders will not have the ability to control matters requiring shareholder approval, they may have the ability to influence the affairs and management of the Company and the elections of directors. This may have the effect of delaying, deferring or preventing a change in control of the Company and could limit the price that certain investors might be willing to pay in the future for the Common Stock.

Anti-Takeover Considerations

The Company is subject to the anti-takeover provisions of Chapter 23B.17 of the Washington Business Corporation Act (the "WBCA") which prohibits, subject to certain exceptions, a merger, sale of assets or liquidation of a corporation involving a 20% shareholder unless determined to be at a fair price or approved by disinterested directors or two-thirds of the disinterested shareholders. In addition, Chapter 23B.19 of the WBCA prohibits a corporation registered under the Exchange Act from engaging in certain significant transactions with a 10% shareholder. Significant transactions include, among others, a merger with or disposition of assets to the 10% shareholder. Further, the Company's Amended and Restated Articles of Incorporation (the "Articles") require super-majority shareholder approval of certain business combinations and provide for a classified Board of Directors with staggered, three-year terms. Also, the Company has the authority to issue up to 10 million shares of preferred stock in one or more series and to fix the preferences and other rights thereof without any further vote or action by the Company's shareholders. The issuance of preferred stock, together with the effect of other anti-takeover provisions in the Articles and under the WBCA, may have the effect of delaying, deferring or preventing a change in control of the Company and could limit the price that certain investors might be willing to pay in the future for the Common Stock.

Volatility of Stock Price

The market price of the Common Stock has been, and is likely to continue to be, volatile. There can be no assurance that the market price of the Common Stock will not fluctuate significantly from its current level. The market price of the Common Stock could be subject to significant fluctuations in response to a number of factors, such as actual or anticipated variations in the Company's quarterly operating results, the introduction of new products by the Company or its competitors, changes in other conditions or trends in the Company's industry, changes in governmental regulations, changes in securities analysts' estimates of the Company's, or its competitors' or industry's, future performance or general market conditions. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations." In addition, stock markets have experienced extreme price and volume volatility in recent years, which has had a substantial effect on the market prices of securities of many smaller public companies for reasons frequently unrelated to the operating performance of such companies. These broad market fluctuations may have a material adverse effect on the

market price of the Common Stock. See "Item 5. Market for Registrant's Common Equity and Related Stockholder Matters."

Limitations on Dividends

Since its incorporation in 1989, the Company has not declared or paid cash dividends on its Common Stock, and the Company anticipates that any future earnings will be retained for investment in its business. Any payment of cash dividends in the future will be at the discretion of the Company's Board of Directors and will depend upon, among other things, the Company's earnings, financial condition, capital requirements, extent of indebtedness and contractual restrictions with respect to the payment of dividends. In addition, the terms of the Foothill Credit Facility prohibit the payment of cash dividends without the consent of the Company's lenders. See "Item 5. Market for Registrant's Common Equity and Related Stockholder Matters" and "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources."

ITEM 2. PROPERTIES.

As of December 31, 1996, the Company's headquarters in Seattle consisted of approximately 59,000 square feet of office space under a lease that expires on November 30, 2004 and that requires minimum annual lease payments in 1997 of approximately \$1.0 million. In addition, as of December 31, 1996, the Company and its subsidiaries leased an aggregate of approximately 100,000 square feet of space for 17 offices in 10 states. Management believes its present office facilities, together with additional space available under expansion options, are adequate for its operations for the foreseeable future and that similar additional space can readily be obtained as needed.

ITEM 3. LEGAL PROCEEDINGS.

Class Action Lawsuit. The Company, its Vice Chairman of the Board of Directors and largest shareholder, the Company's former President, Chief Executive Officer and director and the Company's former Chief Financial Officer are named as defendants in a securities action filed in the U.S. District Court for the Western District of Washington (the "Complaint"). The Complaint was filed on behalf of a class of purchasers of the Company's Common Stock during the period beginning on July 6, 1995, the date of the Company's initial public offering, and ending on March 4, 1996 (the "Class Period"). An amended complaint was filed on July 8, 1996 (the "Amended Complaint"). In November 1996, the Court granted the defendants' motion to dismiss the Amended Complaint without prejudice and the plaintiffs refiled a second amended complaint on December 19, 1996 (the "Second Amended Complaint"). In January 1997, the defendants filed a motion to dismiss the Second Amended Complaint (the "Second Motion to Dismiss") claiming failure by plaintiffs to plead with particularity and failure to plead facts establishing scienter, both as required under the Exchange Act, and failure to establish tracing to the prospectus relating to the Company's initial public offering, as required under the Securities Act. The Second Amended Complaint alleges, among other things, that the registration statement and prospectus relating to the Company's initial public offering contained false and misleading statements concerning the Company's billing software and financial condition. The Second Amended Complaint further alleges that, throughout the Class Period, the defendants inflated the price of the Common Stock by intentionally or recklessly making material misrepresentations or omissions which deceived the public about the Company's financial condition and prospects. The Second Amended Complaint alleges claims under the Securities Act and the Exchange Act as well as various state laws, and seeks damages in an unstated amount. All discovery proceedings are stayed until defendants' Second Motion to Dismiss is acted on by the Court. While the Company believes that it has substantive defenses to the claims in the Second Amended Complaint and intends to vigorously defend this lawsuit, it is unable to predict the outcome of this action.

SEC Investigation. The Company was informed in May 1996 that the Commission was conducting an informal inquiry regarding the Company. The Company has voluntarily provided the documents requested by the Commission. In addition, the Commission has requested the Company's cooperation in interviewing certain current and former Company personnel and the Company is in the process of scheduling such

interviews. However, the Company has not been informed whether or not the Commission intends to commence a formal action against the Company or any of its affiliates. The Company is, therefore, unable to predict the ultimate outcome of the investigation. In the event that the Commission elects to initiate a formal enforcement proceeding, the Company and certain of its current and/or former officers could be subject to civil or criminal sanctions including monetary penalties and injunctive measures. Any such enforcement proceeding could have a material adverse effect on the Company's business, financial condition and results of operations.

Frontier Lawsuit. On August 19, 1996 the Company was served with a complaint filed in the U.S. District Court for the Eastern District of Michigan by Frontier Corporation ("Frontier"). This complaint names as defendants the Company and eleven individuals, all of whom are former employees of Frontier who resigned their positions with Frontier at various times in the last year. These individuals include William H. Oberlin, the President and Chief Executive Officer and a director of the Company, and nine other employees of the Company. The complaint alleges, among other things, that: (i) certain of the individual defendants, with the acquiescence and active assistance of the Company, have engaged in a systematic strategy to hire key employees and independent contractors of Frontier in violation of various written agreements; (ii) the individual defendants have used confidential information belonging to Frontier in their new employment with Midcom in violation of written agreements and fiduciary duties and (iii) Mr. Oberlin has breached fiduciary duties as a former employee and officer of Frontier and breached obligations under an employment agreement with Frontier. The complaint further alleges that: (i) Midcom is in violation of a non-disclosure agreement between Frontier and Midcom by virtue of its alleged use of confidential information of Frontier obtained through employees hired from Frontier and otherwise; (ii) Midcom has aided and abetted Mr. Oberlin's alleged breaches of fiduciary duties and (iii) Midcom and the other defendants have tortiously interfered in Frontier's contractual relationships with various Frontier employees and contractors. The complaint seeks: (i) that the defendants be preliminarily and permanently enjoined from breaching their respective agreements with Frontier; (ii) that Midcom be enjoined from aiding and abetting certain alleged breaches of fiduciary duties; (iii) an order that the defendants hold all profits which Midcom earns as a result of its hiring of the individual defendants and other Frontier employees as constructive trustees for the benefit of Frontier; (iv) an accounting of all profits realized by Midcom as a result of its hiring of the defendants and other Frontier employees; (v) a declaratory judgment on its various claims; (vi) damages in an unspecified amount; (vii) Frontier's costs, including reasonable attorney's fees, incurred in bringing the action; and (viii) other appropriate relief. The Company intends to vigorously defend this action. Based on the Company's review of the allegations in the complaint and the underlying facts, the Company believes that the ultimate outcome of this matter will not have a material adverse effect on the Company's business, financial condition, results of operations or liquidity.

An affiliate of Frontier has also filed a complaint in the same U.S. Federal District Court claiming \$515,000 for unpaid amounts under a supply agreement. The Company believes this claim to be without substantial merit and is vigorously defending it.

Adnet Lawsuit. On August 1, 1996, a complaint (the "Adnet Complaint") was filed by David and Maria Wiegand, the former shareholders of ADNET Telemanagement, Inc. ("Adnet"), in the Superior Court of the State of California for the County of Orange against the Company, the Company's former President and Chief Executive Officer and other defendants. The Adnet Complaint alleged intentional and negligent misrepresentation, intentional concealment of facts, breach of contract, breach of implied covenants of good faith and fair dealing and violation of California Securities Laws in connection with a merger agreement and related documents (the "Merger Agreement") and the Company's acquisition of Adnet in December 1995 pursuant thereto. The Wiegands sought recovery of monetary damages in an amount which they described as "not yet ascertainable, but potentially [in excess of] \$10,000,000." The Wiegands furthermore sought rescission of the Merger Agreement, restoration of all consideration paid by the Wiegands to the Company pursuant to the Merger Agreement, punitive damages in an amount to be determined at trial and attorneys' fees and other costs and expenses of the lawsuit.

In August 1996, the Wiegands agreed to dismiss the Adnet Complaint without prejudice and not to re-file the Adnet Complaint pending negotiation of a definitive settlement agreement. In December 1996, the

Company entered into a settlement agreement with David and Maria Wiegand (the "Settlement Agreement") pursuant to which the parties mutually agreed not to assert against each other the claims set forth in the Adnet Complaint, claims arising out of the Merger Agreement and the Company's acquisition of Adnet pursuant thereto and claims arising out of David Wiegand's employment with the Company or his employment agreement or non-competition agreement (collectively, the "Claims") until December 31, 1999 and not after March 31, 2000. In addition, the Settlement Agreement provides that all Claims will be released on March 31, 2000 or, if earlier, upon the first to occur of certain Release Events including (a) the issuance of any shares of Common Stock pursuant to the exercise of the Wiegand Option (as defined below), (b) the date on which the average closing sale price of the Common Stock as reported on Nasdaq is at least \$20.50 per share and (c) a change of control of the Company if, in connection therewith, David Wiegand would be entitled to receive at least \$20.50 (in cash or freely tradable securities) per share of Common Stock issuable upon exercise of the Wiegand Option. If a Release Event does not occur prior to December 31, 1999, the Wiegands may assert Claims against the Company provided they do so prior to March 31, 2000. There can be no assurance that a Release Event will occur prior to December 31, 1999 and that the Wiegands will not assert Claims against the Company at that time. In consideration for the Settlement Agreement, the Company pre-paid certain non-compete fees of approximately \$330,000, reimbursed the Wiegands for approximately \$90,000 in legal fees incurred in connection with the Claims and the Settlement Agreement, entered into a consulting agreement with David Wiegand and granted him a fully vested stock option for the purchase of up to 150,000 shares of Common Stock at an exercise price of \$10.00 per share (the "Wiegand Option").

Cherry Communications Lawsuit. In September and December 1995, the Company acquired two significant customer bases from Cherry Communications. The first transaction ("Cherry I") provided for the purchase of long distance customer accounts having monthly revenue for the three months preceding the date of closing of \$2.0 million, net of taxes, customer credits and bad debt. The second transaction ("Cherry II") provided for the purchase of long distance customer accounts having monthly revenue which were to average \$2.0 million per month over the 12 months following the transaction, net of taxes, customer credits and bad debt. The Company is responsible for the underlying carrier costs associated with the customer traffic acquired from Cherry Communications at a rate which would yield to the Company a gross profit on such traffic at an agreed rate. The purchase price payable with respect to Cherry I was a total of \$10.5 million, of which \$5.5 million was paid in cash and the balance was paid by the delivery of 317,460 shares of Common Stock (subject to a possible increase in such number based on the future value of the Common Stock), of which 126,984 shares are held in escrow to be applied to indemnity claims or to cover shortfalls in revenue from the \$2.0 million monthly average. The purchase price for Cherry II was \$18.0 million, of which \$7.0 million has been paid in cash. Additional installments of \$3.4 million were due in February, March and April of 1996, of which \$400,000 of each installment was to be placed in an escrow account for satisfaction of indemnity claims or to cover shortfalls in revenue from the \$2.0 million monthly average. The parties later agreed that the Company could pay up to \$9.0 million of the Cherry II payments either in cash or by delivery of shares of Common Stock. Separately, the Company also agreed to pay Cherry Communications \$40,000 per month per customer base for servicing customer accounts on behalf of the Company. The acquired customer bases have not generated the required minimum revenue levels and Cherry Communications has failed to remit to the Company collections received by Cherry Communications from a portion of the acquired customers. Accordingly, the Company has withheld the final three installment payments for Cherry II (a total of \$9.0 million excluding escrowed sums), payment of invoices for carrier service for the acquired bases (up to \$11.0 million) and accrued customer service charges of \$840,000. Negotiations between Cherry Communications and the Company failed to produce a settlement of these disputes.

Cherry Communications filed a lawsuit against the Company in the United States District Court for the Northern District of Illinois, Eastern Division. In its First Amended Complaint filed on July 18, 1996, Cherry Communications seeks recovery of (i) approximately \$7.2 million plus interest and attorneys' fees alleged to be due and owing under a Reseller/Reseller Agreement for Switched Services between Cherry Communications and the Company, (ii) approximately \$9.0 million plus interest and attorney's fees alleged to be due and owing under the November 1, 1995 Customer Base Purchase and Sale Agreement between Cherry Communications and the Company (the "Cherry II Agreement"), and a Promissory Note executed in connection with the Cherry II Agreement, (iii) customer service charges of \$40,000 per month for each

month of customer service Cherry Communications has provided to the Company under the September 1, 1995 Customer Base Purchase and Sale Agreement between Cherry Communications and the Company (the "Cherry I Agreement"); and (iv) customer service charges of \$40,000 per month for each month of customer service Cherry Communications has provided to the Company under the Cherry II Agreement. It is the position of the Company that Cherry Communications has breached its obligations under the Cherry I Agreement and the Cherry II Agreement by among other breaches (i) failing to sell Midcom customer bases having the average monthly revenues required by the customer base agreements, and (ii) failing to remit to Midcom monies collected from the customer bases. It is also the position of the Company that, as a result of Cherry Communication's breaches of the Cherry I Agreement and the Cherry II Agreement, as amended by certain addenda, that the Company has offsets and counterclaims against Cherry Communications in excess of the sums it has withheld from Cherry Communications. The Company is attempting to negotiate a resolution of the disputes. In the event that a settlement is not reached, the Company intends to vigorously defend the lawsuit filed by Cherry Communications. However, the Company is unable to predict the outcome of this lawsuit. As a result of this litigation, as of September 1, 1996, the Company discontinued booking revenue generated by the customer bases acquired from Cherry Communications.

The Company is also party to other routine litigation incident to its business and to which its property is subject. The Company's management believes the ultimate resolution of these matters will not have a material adverse effect on the Company's business, financial condition or results of operations.

In addition to the proceedings described above, the Company is involved in certain other disputes that arise in the ordinary course of business. See "Item 1. Business -- Suppliers." The Company believes that no current dispute will have a material adverse effect on its financial condition or results of operations.

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

The 1996 annual meeting of Midcom's shareholders was held on October 29, 1996. The following proposals were submitted for approval by the Company's shareholders at the annual meeting:

1. To elect eight directors to hold office for initial terms ranging between one to three years, or until their respective successors are elected and qualified. The proposal passed with the following number of votes:

	<u>AFFIRMATIVE</u>	<u>WITHHELD</u>
CLASS I FOR A ONE-YEAR TERM		
Karl D. Guelich.....	12,916,181	177,264
Scott B. Perper.....	12,916,581	176,864
CLASS II FOR A TWO-YEAR TERM		
Daniel M. Dennis.....	12,916,181	177,264
Marvin Moser.....	12,916,381	177,264
John M. Orzech.....	12,916,781	176,664
CLASS III FOR A THREE-YEAR TERM		
William H. Oberlin.....	12,916,381	177,064
Paul Pfeleger.....	12,916,381	177,064
John M. Zrno.....	12,916,381	177,064

2. To approve an amendment to the Stock Option Plan to increase the number of shares of Common Stock authorized for issuance thereunder by an additional 3,000,000 shares. This proposal passed with 9,524,598 affirmative votes, 1,569,710 negative votes, 135,504 abstentions and 1,863,633 broker non-votes.

3. To approve an amendment to the Stock Option Plan to permit and ratify the grant of options to certain incumbent directors. This proposal passed with 11,557,147 affirmative votes, 1,144,350 negative votes, 138,584 abstentions and 253,364 broker non-votes.

4. To approve an amendment to the Stock Option Plan to create a maximum number of options that may be granted thereunder to any one employee in any three consecutive fiscal years. This proposal passed with 12,621,500 affirmative votes, 80,780 negative votes, 137,804 abstentions and 253,361 broker non-votes.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

The shares of the Company's Common Stock have been quoted on the Nasdaq National Market since July 6, 1995 under the symbol "MCCI." The stock prices below are the high and low sales prices on the Nasdaq National Market as reported in published financial sources for the periods indicated.

	<u>HIGH</u>	<u>LOW</u>
1995		
Third Quarter (from July 6, 1995).....	\$16 3/4	\$11 1/4
Fourth Quarter.....	18 7/8	13 3/4
1996		
First Quarter.....	\$18 1/4	\$7
Second Quarter.....	15 1/4	6 1/2
Third Quarter.....	16	10 1/4
Fourth Quarter.....	14	8 1/2

At March 24, 1997, there were approximately 146 holders of record of the Company's Common Stock.

Since its incorporation in 1989, the Company has not declared or paid cash dividends on its Common Stock, and the Company anticipates that any future earnings will be retained for investment in its business. Any payment of cash dividends in the future will be at the discretion of the Company's Board of Directors and will depend upon, among other things, the Company's earnings, financial condition, capital requirements, extent of indebtedness and contractual restrictions with respect to the payment of dividends. In addition, the terms of the Foothill Credit Facility prohibit the payment of cash dividends without the consent of the Company's lenders.

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following selected consolidated financial data are derived from the Company's 1996 Consolidated Financial Statements. The information set forth below should be read in conjunction with "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Company's 1996 Consolidated Financial Statements and notes thereto contained elsewhere in this Report.

YEARS ENDED DECEMBER 31

(IN THOUSANDS, EXCEPT PER SHARE DATA)

	1992	1993	1994	1995	1996
STATEMENT OF OPERATIONS DATA:					
Revenue	\$27,894	\$66,010	\$111,699	\$203,554	\$148,777
Cost of revenue	14,817	45,363	79,044	139,546	107,950
Gross profit	13,077	20,647	32,655	64,008	40,827
Selling, general and administrative	11,246	18,125	27,697	62,061	65,025
Depreciation and amortization	295	1,881	4,134	13,790	32,687
Restructuring charge	--	--	--	--	2,220
Contract settlement	--	--	--	--	8,800
Loss on impairment of assets	--	--	--	11,830	20,765
Operating income (loss)	1,536	641	824	(23,673)	(88,670)
Interest expense	951	1,368	2,965	2,288	8,726
Other expense (income)	(65)	(249)	871	390	(77)
Income (loss) before income taxes and extraordinary item	650	(478)	(3,012)	(29,351)	(97,319)
Provision (benefit) for income taxes	(4)	51	17	--	--
Loss before extraordinary item	654	(529)	(3,029)	(29,351)	(97,319)
Extraordinary item(1)	--	--	--	(4,067)	--
Net income (loss)	\$654	\$(529)	\$(3,029)	\$(33,418)	\$(97,319)
Per share amounts(2):					
Income (loss) before extraordinary item	\$0.07	\$(0.05)	\$(0.31)	\$(2.42)	\$(6.27)
Extraordinary item(1)	--	--	--	(0.34)	--
Net income (loss)	\$0.07	\$(0.05)	\$(0.31)	\$(2.76)	\$(6.27)
Shares used in calculating per share data	9,930	9,930	9,930	12,101	15,529
SUPPLEMENTAL OPERATING DATA:					
EBITDA(3)	\$1,831	\$2,522	\$4,958	\$1,947	\$(35,218)

AS OF DECEMBER 31

BALANCE SHEET DATA:

	1992	1993	1994	1995	1996
Total assets	\$11,090	\$35,414	\$66,078	\$133,331	\$79,923
Long-term obligations, less current portion	8,618	16,431	34,195	3,691	102,953
Shareholders' equity (deficit)	(6,196)	(6,565)	(6,304)	23,799	(69,284)

(1) Includes \$2,992 of original issue discount and \$1,075 of deferred financing costs written off in the third and fourth quarters of 1995.

(2) Net loss per share is based on the weighted average number of common and equivalent shares outstanding using the treasury stock method. Common stock equivalents are excluded from the calculation of net loss per share due to their antidilutive effect except that pursuant to Commission requirements, for periods prior to the Company's initial public offering in July 1995, common and equivalent shares issued during the twelve month period prior to the initial public offering have been included in the calculation as if they were outstanding for all periods presented using the treasury stock method.

(3) As used herein, "EBITDA" is defined as operating income plus depreciation, amortization and loss on impairment of assets. EBITDA is commonly used to measure performance of telecommunication companies because of (i) the importance of maintaining cash flow in excess of debt-service obligations due to the capital and acquisition-intensive nature of the telecommunications industry, and (ii) the non-cash effect on earnings of generally high levels of both amortization and depreciation expenses associated with capital equipment and acquisitions common in this industry. EBITDA does not purport to represent cash provided by operating activities as reflected in the Company's consolidated statements of cash flow, is not a measure of financial performance under generally accepted accounting principles and should not be considered in isolation or as a substitute for measures of performance prepared in accordance with generally accepted accounting principles. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

INTRODUCTION

Midcom was formed in 1989 and initially operated as an aggregator of long distance telecommunications services. In 1991, Midcom shifted its focus from aggregation to providing telecommunications services and, accordingly, began to (i) enter into volume-based supply agreements with multiple underlying facilities-based carriers, (ii) establish a knowledgeable direct sales force to target small and medium-sized business customers, (iii) obtain the necessary federal and state certifications to provide interstate, intrastate and international service, (iv) build an infrastructure to bill and service a large volume of customers and (v) develop enhanced and value-added products and services to supplement its basic long distance service. Midcom does not provide its telecommunications services through the operation of its own transmission network. Rather, Midcom purchases large volumes of long distance services utilizing transmission networks owned and operated by various other interexchange carriers, and then resells those services to its customers. Midcom, or one of its billing agents, receives monthly records from its underlying carriers which detail the calls made by its customers, then rates the calls and bills its customers.

Subsequent to its initial public offering in July 1995, Midcom completed numerous acquisitions of businesses and customer bases. Although these acquisitions contributed to substantial growth, they placed significant demands on management resources and disrupted Midcom's normal business operations. In particular, the Company was not able to integrate the sales and marketing, customer support, billing and other functions of certain acquired operations as quickly as anticipated. Pending such integration, it was necessary to maintain billing systems and other functions of certain required operations, which increased the Company's overall cost structure and resulted in lower profitability and cash flows. See "Item 1. Business -- Acquisitions." Also, during 1995, the Company was in the process of implementing a new management information system, including the installation of a new billing system. Problems encountered in this implementation process contributed to the Company's operational difficulties. In addition, certain reports generated by the new management information system that were used to estimate unbilled revenue for the third quarter of 1995 failed to fully reflect all discounts that were properly included in the bills subsequently sent to the Company's customers. See "Item 1. Business -- Information Systems." Primarily as a result of this failure, reported revenue was overstated for the third quarter of 1995 and the Company's Quarterly Report on Form 10-Q for that period had to be amended to restate reported results. See "-- Restatement of Results for the Third Quarter of 1995." In addition, the Company's profitability was reduced as a result of the Company's supply contract with AT&T which provided for higher rates than those provided by competitive suppliers, although the Company has entered into a new carrier supply contract with AT&T which provides for more favorable rates. See "Item 1. Business -- Suppliers." These factors contributed to defaults under the Transamerica Credit Facility and caused the Company's auditors to include going concern disclosure in their report on the Company's financial statements for the year ended December 31, 1995. Similar going concern disclosure is included in their report with respect to the Company's 1996 Consolidated Financial Statements. See "-- Liquidity and Capital Resources." The Company's auditors also identified certain material weaknesses in the Company's internal financial controls in connection with the audit for the year ended December 31, 1995. See "-- Past Material Weaknesses."

During the second and third quarters of 1996 Midcom recruited a new executive management team with extensive experience and expertise in the telecommunications industry. This executive management team has developed a restructuring, network and marketing strategy which is designed to address the operational challenges experienced by the Company and increase internally generated sales and profitability. See "Item 1. Business -- Company Strategy." The implementation of the Company's restructuring, network and marketing strategy has required, and will continue to require, the Company to substantially increase its investment in sales, marketing, capital equipment, systems development and other areas. The Company expects that a substantial portion of these expenditures will be made before the Company realizes a significant increase in revenue or an improvement in gross margin. These expected trends will have a material adverse impact on the Company's near term profitability and levels of cash flows. See "-- Liquidity and Capital Resources."

If Midcom successfully implements its operating strategy, it anticipates that, over the long term, (i) revenue will increase as a result of its reorganized and expanded direct sales efforts, the development of a new tier of distributors and reduced customer attrition and (ii) operating expenses will decrease as a result of deploying its network of switching facilities and obtaining more favorable terms from its suppliers. As a result of these expected trends, the Company expects that gross margin as a percentage of revenue will, over the long term, be comparable to other telecommunications providers despite an anticipated increase in costs associated with its larger sales force and customer support efforts. However, the Company's ability to implement its operating strategy is subject to an unusual number of risks and uncertainties, and there can be no assurance that the strategy will be successfully implemented or that the intended positive results will be achieved. See "Item 1. Business -- Forward-Looking Statements" and "Item 1. Business -- Risk Factors."

PRIOR ACQUISITIONS

In 1994, Midcom acquired PacNet, Inc. ("PacNet") and certain assets of American Telephone Network, Inc. ("ATN"). In 1995, Midcom acquired Adval, Inc. ("Adval"), Cel-Tech International Corp. ("Cel-Tech"), ADNET Telemanagement, Inc. ("Adnet") and certain assets of Communique Telecommunications, Inc. ("Communique"). With the exception of ATN, the consideration for these acquisitions was paid primarily in the form of Common Stock and the assumption of certain liabilities. The consideration for ATN was primarily in the form of cash and the assumption of certain liabilities, financed principally through working capital and borrowings under an expired revolving credit facility. In addition to the acquisitions of businesses, the Company has made numerous acquisitions of customer bases, including acquisitions of two significant customer bases from Cherry Communications in September and November 1995. See "Item 1. Business -- Acquisitions" and "Item 3. Legal Proceedings -- Cherry Communications Lawsuit."

To date, all business combinations have been accounted for using the purchase method except for Adval and Adnet which have been accounted for as pooling of interests transactions. The Company's consolidated financial statements for the years ended December 31, 1995 and 1994 and the following Management's Discussion and Analysis of Financial Condition and Results of Operations for 1995 versus 1994 have been restated to reflect the inclusion of the accounts and results of operations of Adval and Adnet in both of those periods. Using the purchase method, the purchase price paid in excess of the fair market value of the assets acquired is recorded as an intangible asset and amortized generally over three years using the straight-line method. During the second quarter of 1996, the Company wrote down certain acquired customer bases and equipment and recorded a loss on impairment of assets of \$18.8 million. A total of \$15.5 million of intangibles associated with acquisitions remained to be amortized as of December 31, 1996. See Note 6 of the Notes to Consolidated Financial Statements.

SUPPLIER RELATIONSHIPS

Midcom has entered into multiple-year contracts with Sprint, WorldCom and AT&T and short-term contracts with a number of other suppliers for the long distance telecommunication services provided to its customers. In 1994, 1995 and 1996, Sprint, WorldCom and AT&T were collectively responsible for carrying traffic representing approximately 97%, 67% and 74% of the Company's revenue, respectively, and for those periods no single carrier was responsible for carrying traffic representing more than 46%, 31% and 31% of the Company's revenue, respectively.

To obtain favorable forward pricing from certain suppliers, the Company has committed to purchase minimum volumes of a variety of long distance services during stated periods whether or not such volumes are used or, in one case, to pay a surcharge equal to a percentage of the Company's shortfall from a specified quarterly minimum volume. Under the Company's agreements with other suppliers, if certain volume levels are not achieved during stated periods, pricing is adjusted going forward to levels justified by actual volumes. In the past, Midcom has fallen short of its minimum volume commitments with certain carriers and has renegotiated the commitment. For example, in October 1996, Midcom entered into a renegotiated carrier supply contract with AT&T pursuant to which, among other things, the minimum volume commitment was reduced from \$117.0 million to \$13.7 million for the eighteen month period following execution of the contract, of which approximately \$10.0 million remained as of the date of this Report. The Company's

minimum volume commitments to all of its carriers as of March 15, 1997 aggregated approximately \$92.0 million, to be used over the next three years. See Note 15 of the Notes to Consolidated Financial Statements. There can be no assurance that the Company will not incur additional shortfalls in the future or that it will be able to successfully renegotiate, or otherwise obtain relief from, its minimum volume commitments in the future. See "Item 1. Business -- Switching Facilities," "Item 1. Business -- Suppliers" and "Item 1. Business -- Risk Factors -- Minimum Volume Commitments and Shortfalls."

CUSTOMER ATTRITION

Midcom's revenue is affected by customer attrition, a problem inherent in the long distance industry. The customer attrition experienced by the Company is attributable to a variety of factors, including the Company's termination of customers for non-payment and the marketing and sales initiatives of the Company's competitors such as, among other things, national advertising campaigns, telemarketing programs and the use of cash or other forms of incentives. In particular, the Company experienced high initial customer attrition from acquired customer bases as these customers were transitioned to the Company's services and systems. The Company believes that this attrition occurred as a result of difficulties encountered in transitioning acquired customer bases to the Company's services and systems, a process which often prompts customers to consider competitive alternatives in the telecommunications marketplace. Also, where the Company did not acquire the sales channel associated with an acquired customer base, there was often a period of increased exposure to competitors as the Company's sales force established a relationship with its new customers. See "Item 1. Business -- Competition" and "Item 1. Business -- Acquisitions." The Company is aware of the significant impact customer attrition has on its business. However, because of numerous acquisitions and lack of historical data concerning its acquired customer bases, the Company has found it difficult to measure customer attrition in a consistently meaningful manner. As a consequence, the Company has not formulated a statistical basis for measuring or reporting customer attrition.

PAST MATERIAL WEAKNESSES

In connection with the audit of Midcom's 1995 Consolidated Financial Statements, Midcom's independent auditors identified two conditions which were characterized as material weaknesses in its internal financial controls. One material weakness identified by the auditors was the failure of the Company's accounting and finance systems to provide accurate information to monitor the Company's financial position, results of operations and liquidity. Factors identified as contributing to this weakness and requiring immediate attention included insufficient staffing and systems to accommodate significant growth from acquisitions, transitional difficulties associated with major new information and billing systems, inadequate communication between senior management and the finance department and demands associated with the Company's initial public offering. The second material weakness identified by the auditors was the Company's process of estimating unbilled receivables. With respect to this material weakness, the auditors recommended that the Company review and revise, as necessary, all policies and procedures with regard to its reconciliation of unbilled receivables with actual billings to ensure that all unbilled amounts at a reporting date represent properly recorded revenue. In response to these recommendations, the Company hired new finance and accounting personnel, curtailed acquisitions, reorganized its financial reporting functions to improve communications between senior management and the finance department and established a policy of billing substantially all customer call traffic in a financial reporting period before revenue for the period is reported. See "Item 1. Business -- Information Systems." As a result of operational and other changes implemented by the Company, on March 13, 1997 the Company's independent auditors reported to the Company's Audit Committee that the material weaknesses identified in connection with the 1995 audit have been corrected. However, there can be no assurance that the Company will not encounter other internal control weaknesses. See "Item 1. Business -- Information Systems" and "Item 1. Business -- Risk Factors -- Material Weaknesses in Internal Financial Controls."

RESTATEMENT OF RESULTS FOR THE THIRD QUARTER OF 1995

Midcom announced on March 4, 1996 that it would issue restated financial statements for the third quarter and nine months ended September 30, 1995 that would lower previously announced results. The restatement was primarily attributable to an overrecognition of revenue and unbilled accounts receivable which occurred during the conversion to a new billing system. In the process of reconciling unbilled accounts as of December 31, 1995 with amounts ultimately billed, the Company discovered that certain reports generated by its new information management system that were used for recognizing unbilled revenue did not fully reflect all discounts that were properly included in the bills subsequently sent to the Company's customers. Primarily as a result of this failure, the Company's Quarterly Report on Form 10-Q for the third quarter of 1995 was amended to report a \$3.3 million reduction in revenue and a \$4.5 million reduction in accounts receivable, consisting of a \$3.8 million reduction in unbilled accounts receivable and a \$0.7 million increase in the allowance for doubtful accounts. The amended 10-Q also reflects a reclassification of \$1.2 million of customer adjustments to revenue to bad debt expense (included in selling, general and administrative expenses on the statement of operations). These adjustments resulted in the net loss for the quarter and nine months ended September 30, 1995 being increased from \$3.8 million and \$8.0 million, respectively, to \$8.3 million and \$12.5 million, respectively. See "Item 1. Business -- Information Systems."

SEASONALITY

Due to its predominately commercial customer base, Midcom tends to experience decreases in customer usage and revenue around national holidays and traditional vacation periods. The Company anticipates revenue from existing customers during the last two quarters of the year to be somewhat lower than during the first two quarters. Historically, however, period-to-period comparisons have been affected more significantly by acquisitions of customer bases and customer attrition than by seasonal factors.

RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, the percentages that certain items bear, except as noted, to total revenue:

	YEARS ENDED DECEMBER 31,		
	1994	1995	1996
Revenue	100.0%	100.0%	100.0%
Cost of revenue	70.8	68.6	72.6
Gross margin	29.2	31.4	27.4
Selling, general and administrative expenses	24.8	30.5	43.7
Depreciation and amortization	3.7	6.8	22.0
Settlement of contract dispute	--	--	5.9
Restructuring charges	--	--	1.4
Loss on impairment of assets	--	5.7	14.0
Operating income (loss)	0.7	(11.6)	(59.6)
Interest expense	(2.6)	(2.6)	(5.9)
Other income (expense)	(0.8)	(0.2)	0.1
Loss before extraordinary item	(2.7)	(14.4)	(65.4)
Extraordinary item	--	(2.0)	--
Net loss	(2.7)%	(16.4)%	(65.4)%

SUPPLEMENTAL OPERATING DATA

EBITDA(1) 4.4% 1.0% (23.7)%

(1) As used herein, "EBITDA" is defined as operating income plus depreciation, amortization and loss on impairment of assets.

1996 COMPARED TO 1995

Revenue. Total revenue in 1996 was \$148.8 million, a decrease of 26.9% from revenue of \$203.6 million in 1995. This decrease is due primarily to customer attrition offset in part by increases in revenue from customer bases acquired in the third and fourth quarters of 1995. The Company expects that during the first six months of 1997, revenue will begin to increase due to sales generated by its direct sales force.

Gross Margin. The Company's cost of revenue consists of the cost of service provided by local and interexchange carriers. Gross margin was 27.4% and 31.4% of total revenue for the years ended December 31, 1996 and 1995, respectively. The decline in gross margin in 1996 is the result of changes in the mix of customers, and an increase in fixed costs as a percentage of overall costs due to the decline in revenue. These factors were offset in part by negotiation of price reductions with some of the Company's major suppliers, the full impact of which is not yet reflected in results of operations.

Selling, General and Administrative Expenses. Selling, general and administrative expenses consist primarily of payroll and related expenses for sales and marketing, customer support and administrative personnel, sales commissions, bad debt expense, billing fees and professional fees. Selling, general and administrative expenses increased to \$65.0 million in 1996 compared to \$62.1 million in 1995. The increase is due to several factors, including an increase in payroll and related expenses due to the hiring of additional personnel, primarily to expand the sales and marketing departments. In addition, legal and other professional fees increased in 1996 over 1995 due to the number of outstanding disputes. See "Item 3. Legal Proceedings." These increases were offset in part by reductions in commissions, primarily to distributors, and certain other marketing expenses. The Company employed 527 and 457 persons on a full-time basis as of December 31, 1996 and 1995, respectively.

Depreciation. Depreciation expense increased to \$6.0 million for 1996 from \$4.5 million in 1995. The increase is due to an increase in fixed assets acquired during 1996 and depreciation of computer systems and equipment related to the Company's management information system which was placed into service in the second quarter of 1995. The increase was partially offset by the reduction in depreciation of limited capacity switching equipment due to the partial write-off of such equipment in the fourth quarter of 1995.

Amortization. Amortization expense increased to \$26.7 million in 1996 from \$9.3 million in 1995. In conjunction with the preparation of the first quarter financial statements, the Company completed a review of its accounting policies and practices, including those relating to intangible assets. Based on certain changes in circumstances that occurred in the first quarter of 1996, including turnover in personnel, reduction in sales force and continuing attrition of acquired customer bases, the Company determined that effective January 1, 1996, a reduction in the estimated useful life of acquired customer bases from 5 years to 3 years was appropriate. The increase in amortization expense is a result of the change in the estimated useful life and amortization of customer bases, non-competition agreements and goodwill resulting from acquisitions completed in the second half of 1995.

Charge Related to Contract Settlement. On October 31, 1996, the Company and AT&T executed a Release and Settlement Agreement pursuant to which substantially all disputes between the Company and AT&T have been resolved. Also on October 31, 1996, the Company and AT&T executed a new carrier contract pursuant to which the Company's minimum commitment to AT&T was reduced to \$13.7 million to be used over the eighteen month period immediately following the execution of the agreement. In addition, the new carrier contract provides for more favorable pricing for certain network services provided by AT&T. In consideration for the terms of the settlement and the new rate structure, the Company is required to pay AT&T \$8.8 million payable in two installments. The first payment of \$5.0 million was made on November 5, 1996, and the remaining balance of \$3.8 million will be due within 30 days of the Company announcing quarterly gross revenue in excess of \$75.0 million, or upon completion of a change in control. The Company recorded a charge of \$8.8 million in the second quarter of 1996 in connection with this settlement.

Restructuring Charges. In March and April 1996, the Company made announcements regarding changes in senior management and the restructuring of its operations in order to reduce expenses to the level of available capital. These actions included the lay off of certain employees and contractors and the closure of six sales offices. As a result, the Company recorded a charge of \$1.6 million during the first quarter 1996 and \$0.6 million during the second quarter of 1996, the major components of which relate to severance and lease cancellation charges. Included in the restructuring charge is approximately \$0.4 million relating to the extension of the time period to exercise outstanding stock options. As of December 31, 1996, \$0.8 million of this restructuring charge remained in accrued liabilities to cover payments to be made in the future.

Loss on Impairment of Assets. The Company periodically reviews the carrying value of its long-term assets in accordance with Statement of Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." To the extent that the estimated future cash inflows attributable to the asset, less estimated future cash outflows, is less than the carrying amount, an impairment loss is recognized. In connection with such a review, in 1996 the Company recorded the following losses on impairments of assets: (i) a \$17.8 million write-down of customer bases, (ii) a \$1.0 million write-off of microwave equipment and (iii) a \$2.0 million write-down of the remaining interest in the Russian joint venture.

Other Expenses. Interest expense increased over 1995 primarily due to an increase in average borrowings outstanding, an increase in average interest rates, and \$1.1 million in fees paid in connection with a temporary bridge loan. At December 31, 1996, the Company had outstanding interest-bearing obligations of \$112.1 million, as compared to \$58.1 million as of December 31, 1995. The increase in debt at December 31, 1996 was primarily due to issuance of the \$97.7 million convertible subordinated notes, net of repayment of outstanding borrowings under a prior credit facility. The Company discontinued recording its share of the income or losses of a Russian joint venture as of December 31, 1995, and during the third quarter of 1996 the remaining investment of \$2.0 million was written off to loss on impairment of assets.

Income Taxes. The Company has incurred losses for all periods presented. No tax benefit has been recorded with respect to these losses due to the uncertainty as to the utilization of the Company's net operating loss carryforward, which totaled approximately \$60.0 million as of December 31, 1996.

Net Loss. The substantial increase in net loss in 1996 over 1995 is attributable to the decline in gross margin, the increase in operating expenses, the \$20.8 million loss on impairment of assets and the restructuring and settlement charges described above.

1995 COMPARED TO 1994

Revenue. Total revenue in 1995 increased 82.2% to \$203.6 million from \$111.7 million in 1994. The increase is primarily attributable to incremental telecommunications services revenue resulting from acquisitions and, to a lesser extent, new sales through the Company's combined sales channels, offset by the impact of attrition. Increased revenue also was partially offset by a decrease in aggregation fee revenue compared to 1994. The decline in aggregation fees is due to the attrition of aggregation customers and the Company's efforts to convert aggregation customers to other Midcom products.

Gross Margin. Cost of revenue grew 76.5% in 1995, primarily as a result of the increase in revenue as discussed above. The gross margin percentage for 1995 increased to 31.4% versus 29.2% in 1994. Telecommunication services gross margin increased to 30.8% in 1995, up from 25.2% in 1994. The higher gross margin in 1995 is attributable to several factors, including (1) acquisitions of customer bases whose mix of customers generally resulted in higher average revenue per minute and acquisitions of higher margin businesses, such as PacNet, (2) negotiation of price reductions with some of the Company's interexchange suppliers as a result of increased traffic volume, and (3) an increase in traffic over the Company's own switches, all of which were acquired or placed in service on or after September 30, 1994. These factors were partially offset by an increase in wholesale revenue as a percentage of total revenue, which carries a lower gross margin percentage, and a decline in aggregation fee revenue as a percentage of total revenue, which has no cost of revenue and the write-off of calls which were not billed during the conversion to the Company's new billing system.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased as a percentage of total revenue from 24.8% in 1994 to 30.5% in 1995. The increase was due to several factors, including a substantial increase in bad debt expense and other adjustments given to customers largely attributable to delays in billing which occurred during the conversion to the new billing system, higher commission rates associated with a telemarketing program for lower volume customers, the addition of personnel and other costs incurred in connection with conversion to the Company's new information processing systems and costs to open sales offices, some of which were closed in the first quarter of 1996. Midcom also incurred additional expenses during 1995 in connection with the maintenance of duplicate billing and information systems, including those of acquired businesses, and to a lesser extent, additional personnel costs. The Company employed 457 and 366 persons on a full-time basis as of December 31, 1995 and 1994, respectively.

Depreciation and Amortization. Depreciation and amortization expense increased as a percentage of revenue during 1995. This increase reflects the amortization of customer bases and goodwill, the depreciation of telephone switching equipment resulting from acquisitions in the second half of 1994 and throughout 1995 and the depreciation/amortization of significant continued capital investment in computer equipment and software development used to support internal systems.

Loss on Impairment of Assets. The loss on impairment of assets recorded in 1995 consists of the following: (i) a \$6.8 million write-down of the Company's interest in the joint venture in Russia to reflect the estimated current value of this investment (see "Item 1. Business -- Russian Joint Venture"), (ii) a \$2.5 million write-off of the Company's current telephone switching equipment as a result of its decision to migrate to a different switching platform (see "Item 1. Business -- Switching Facilities") and (iii) a \$2.5 million partial write-down of the Company's capitalized software for its management information system due to weaknesses identified in the system (see "Item 1. Business -- Information Systems").

Interest Expense. Interest expense increased 78.4% to \$5.3 million in 1995 from \$3.0 million in 1994 primarily due to the increase in average borrowings outstanding in 1995. At December 31, 1995, the Company had outstanding interest-bearing obligations of \$58.1 million, up from \$36.3 million outstanding as of December 31, 1994. The increase in debt was due to the funding of acquisitions and the development of management information systems and purchase of related equipment.

Extraordinary Item. In July 1995, the Company completed an initial public offering which resulted in net proceeds of \$54.2 million to the Company. The Company used the proceeds to pay down various obligations, including \$15.0 million in principal amount of certain subordinated notes. As a result of the early extinguishment of these notes, the Company expensed as an extraordinary item in the third quarter of 1995 the unamortized portion of original issue discount which aggregated approximately \$3.0 million. In addition, in the fourth quarter of 1995, the Company obtained a new credit facility and paid off its prior revolving credit facility. As a result, the Company was required to write-off as an extraordinary item during the fourth quarter unamortized deferred financing costs associated with its prior credit facility totaling approximately \$1.1 million.

Other Expense/Equity in Loss of Joint Venture. Other expense consists mainly of finance charges and other nonoperating expenses. The Company's portion of the loss generated by its Russian joint venture, Dial Telecom, was \$52,000 in 1995 down from \$458,000 in 1994, due mainly to improved operating results of the joint venture.

Income Taxes. The Company has incurred losses for all periods presented. No tax benefit was recorded with respect to these losses due to the uncertainty as to the Company's ability to utilize its net operating loss carry forward which totaled approximately \$19.1 million as of December 31, 1995.

LIQUIDITY AND CAPITAL RESOURCES

The Company has experienced significant losses since its inception, with net losses of approximately \$97.3 million, \$33.4 million and \$3.0 million for 1996, 1995, and 1994, respectively. As a result of these losses, the billing and collection cycle with its customers, prior acquisition strategy and other factors, the Company has required substantial external working capital. Given the Company's billing and collection cycle with its customers and the timing of its payments to its suppliers, the Company generally pays its suppliers from thirty to forty-five days prior to the time it is paid by its customers for the same services. The Company has financed its growth with the proceeds from its July 1995 initial public offering, bank borrowings, subordinated debt, capital leases, cash flow from operations, and the issuance of Common Stock and assumption of indebtedness in connection with acquisitions of businesses and customer bases.

The Company's cash and cash equivalents balance were \$31.0 million at December 31, 1996 versus \$1.1 million at December 31, 1995. During 1996, the Company used \$19.6 million of cash in operations compared to \$5.9 million in 1995 and \$2.1 million in 1994. In 1996, the Company experienced significant operating losses which resulted in a use of cash in operating activities. The Company reduced its unbilled receivables balances from \$26.2 million as of December 31, 1995 to \$5.6 million as of December 31, 1996. This was primarily attributable to a reduction in the backlog of billings which built up during the second half of 1995, and a reduction in the run rate of monthly revenue.

The Company invested \$4.3 million to purchase furniture, equipment and leasehold improvements during 1996, compared to \$6.9 million in 1995 and \$4.2 million for 1994. During 1995, the Company used \$11.4 million in business and customer base acquisitions as compared to \$5.1 million in 1994. Investments of \$2.6 and \$4.2 million were made in the form of advances to a Russian joint venture in 1995 and 1994, respectively. No similar investments were made during 1996.

During 1996, the Company received \$2.9 million in proceeds in connection with the exercise of stock options and the purchase of shares under the Stock Purchase Plan, compared to \$0.4 million received in connection with the exercise of stock options during 1995. In addition, the Company received \$54.2 million in net proceeds from its initial public offering in July 1995, paid \$8.6 million to redeem outstanding preferred stock, and paid \$1.3 million to shareholders of acquired companies.

START

OF

RETAKE

Interest Expense. Interest expense increased 78.4% to \$5.3 million in 1995 from \$3.0 million in 1994 primarily due to the increase in average borrowings outstanding in 1995. At December 31, 1995, the Company had outstanding interest-bearing obligations of \$58.1 million, up from \$36.3 million outstanding as of December 31, 1994. The increase in debt was due to the funding of acquisitions and the development of management information systems and purchase of related equipment.

Extraordinary Item. In July 1995, the Company completed an initial public offering which resulted in net proceeds of \$54.2 million to the Company. The Company used the proceeds to pay down various obligations, including \$15.0 million in principal amount of certain subordinated notes. As a result of the early extinguishment of these notes, the Company expensed as an extraordinary item in the third quarter of 1995 the unamortized portion of original issue discount which aggregated approximately \$3.0 million. In addition, in the fourth quarter of 1995, the Company obtained a new credit facility and paid off its prior revolving credit facility. As a result, the Company was required to write-off as an extraordinary item during the fourth quarter unamortized deferred financing costs associated with its prior credit facility totaling approximately \$1.1 million.

Other Expense/Equity in Loss of Joint Venture. Other expense consists mainly of finance charges and other nonoperating expenses. The Company's portion of the loss generated by its Russian joint venture, Dal Telecom, was \$52,000 in 1995, down from \$458,000 in 1994, due mainly to improved operating results of the joint venture.

Income Taxes. The Company has incurred losses for all periods presented. No tax benefit was recorded with respect to these losses due to the uncertainty as to the Company's ability to utilize its net operating loss carry-forward which totaled approximately \$19.1 million as of December 31, 1995.

LIQUIDITY AND CAPITAL RESOURCES

The Company has experienced significant losses since its inception, with net losses of approximately \$97.3 million, \$33.4 million and \$3.0 million for 1996, 1995, and 1994, respectively. As a result of these losses, the billing and collection cycle with its customers, prior acquisition strategy and other factors, the Company has required substantial external working capital. Given the Company's billing and collection cycle with its customers and the timing of its payments to its suppliers, the Company generally pays its suppliers from thirty to forty-five days prior to the time it is paid by its customers for the same services. The Company has financed its growth with the proceeds from its July 1995 initial public offering, bank borrowings, subordinated debt, capital leases, cash flow from operations, and the issuance of Common Stock and assumption of indebtedness in connection with acquisitions of businesses and customer bases.

The Company's cash and cash equivalents balance were \$31.0 million at December 31, 1996 versus \$1.1 million at December 31, 1995. During 1996, the Company used \$19.6 million of cash in operations compared to \$5.9 million in 1995 and \$2.1 million in 1994. In 1996, the Company experienced significant operating losses which resulted in a use of cash in operating activities. The Company reduced its unbilled receivables balances from \$26.2 million as of December 31, 1995 to \$5.6 million as of December 31, 1996. This was primarily attributable to a reduction in the backlog of billings which built up during the second half of 1995, and a reduction in the run rate of monthly revenue.

The Company invested \$4.3 million to purchase furniture, equipment and leasehold improvements during 1996, compared to \$6.9 million in 1995 and \$4.2 million for 1994. During 1995, the Company used \$11.4 million in business and customer base acquisitions as compared to \$5.1 million in 1994. Investments of \$2.6 and \$4.2 million were made in the form of advances to a Russian joint venture in 1995 and 1994, respectively. No similar investments were made during 1996.

During 1996, the Company received \$2.9 million in proceeds in connection with the exercise of stock options and the purchase of shares under the Stock Purchase Plan, compared to \$0.4 million received in connection with the exercise of stock options during 1995. In addition, the Company received \$54.2 million in net proceeds from its initial public offering in July 1995, paid \$8.6 million to redeem outstanding preferred stock, and paid \$1.3 million to shareholders of acquired companies.

END

OF

RETAKE

In August and September of 1996, the Company completed a private placement (the "Private Placement") of \$97.7 million in aggregate principal amount of 8 1/4% Convertible Subordinated Notes due 2003 (the "Notes"). The Notes were sold to qualified institutional buyers pursuant to Rule 144A under the Securities Act, certain "accredited investors" pursuant to Regulation D under the Securities Act and certain non-U.S. person pursuant to Regulation S under the Securities Act. The net proceeds to Midcom from the Private Placement were approximately \$94.2 million, which were applied as follows: (i) \$34.0 million to repay in full all obligations under the Company's secured revolving credit facility with Transamerica Business Credit Corporation and certain other lenders (the "Transamerica Credit Facility"); (ii) \$5.0 million to pay the first installment of an \$8.8 million payment in connection with the satisfaction of past shortfalls and settlement of other obligations under the Company's carrier supply contract with AT&T and (iii) \$10.0 million to bring current a number of payment obligations existing prior to the completion of the Private Placement. The balance of the net proceeds has been and will be used for working capital, capital expenditures and general corporate purposes.

Interest on the Notes is due semi-annually, on February 15 and August 15 of each year, commencing February 15, 1997, in the aggregate amount of approximately \$4.0 million per payment. Interest payments will adversely affect the Company's liquidity. In addition, in the event of a "change of control" of the Company, as defined in the indenture pursuant to which the Notes were issued (the "Indenture"), holders of the Notes have the right to require the Company to repurchase the Notes in whole or in part at a repurchase price equal to 101% of the principal amount thereof, plus accrued interest, if any, to the date of repurchase. If the Company is required to repurchase the Notes upon a change of control, payment of the repurchase price could have a material adverse effect on the Company's liquidity, results of operation and financial condition. Also, if the Company is in default under the Indenture, holders of the Notes have the right to demand immediate repayment of the Notes. If the Company were required to repay the Notes upon default, such repayment could have a material adverse effect on the Company's liquidity, results of operation and financial condition.

In connection with the resignation of Ashok Rao, the Company's former President and Chief Executive Officer, the Company has elected to repurchase 885,360 shares of Common Stock held by Mr. Rao and certain trusts established by Mr. Rao at a price equal to the fair market value of such Common Stock on the date of Mr. Rao's resignation, as determined by arbitration, to be paid ratably over a period of 36 months. The Company's election to repurchase such shares of Common Stock will adversely affect the Company's liquidity. In addition, the unpaid balance of a promissory note delivered to Cherry Communications in connection with the acquisitions of two customer bases is approximately \$10.2 million, of which \$9.0 million may be paid in cash or by delivery of Common Stock, as the Company may elect, and the remaining \$1.2 million is subject to certain hold-back arrangements. The acquired customer bases have not generated required minimum revenue levels and Cherry Communications has failed to remit to the Company collections received by Cherry Communications from a portion of the acquired customers. Accordingly, the Company has withheld the final three installment payments for the second of the two acquisitions, payment of invoices for carrier services for the acquired bases (up to \$11.4 million) and accrued customer service charges of \$0.8 million. Negotiations between Cherry Communications and the Company failed to produce a settlement of these disputes which are now the subject of litigation. As of September 1, 1996, the Company discontinued booking revenue generated by the customer bases acquired from Cherry Communications which accounted for \$2.6 million of revenue during the third quarter of 1996. See "Item 1. Business -- Legal Proceedings." In addition, in the event of the sale or transfer of the majority of the voting stock of Cel-Tech, a payment of a maximum of \$2.0 million would become payable to Cel-Tech's former shareholder.

The Company's available sources of working capital at March 14, 1997 consisted of cash flow from operations and approximately \$14.5 million in cash and short-term, investment grade, interest-bearing securities, which funds represented the remaining net proceeds from the Private Placement. The report of the Company's independent auditors included in this Report with respect to the Company's 1996 Consolidated Financial Statements states that the Company's recurring operating losses and shareholders' deficit raise substantial doubt about the Company's ability to continue as a going concern. Similar going concern disclosure was included in the report of the Company's independent auditors with respect to the Company's 1995 Consolidated Financial Statements. The Consolidated Financial Statements included with this Report have

been prepared assuming the Company would continue as a going concern and do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets and liabilities that may result from this uncertainty.

Prior to completion of the Private Placement, the Company had for several months experienced a severe working capital short-fall which required the Company to seek extended payment terms from certain of its suppliers, delay payments to many of its suppliers and other vendors, delay or cancel purchases and take other steps to conserve operating capital. Also, for several months prior to completion of the Private Placement, the Company was in default of certain financial and other covenants under the Transamerica Credit Facility, although the lenders continued to permit borrowings under that facility. The existence of defaults under the Transamerica Credit Facility also constituted defaults under certain of the Company's capital leases. For these reasons, the auditor's report with respect to the Company's 1995 Consolidated Financial Statements included the going concern disclosure referred to above. In connection with the completion of the Private Placement and the application of the net proceeds therefrom to the repayment in full of all borrowings under the Transamerica Credit Facility, which aggregated approximately \$34.0 million, the lenders waived all then-existing defaults and amended the financial covenants under the facility to levels forecasted to be consistent with Midcom's revised business plan. However, the decline in revenue and related gross profit in the last two quarters of 1996, due in significant part to the unanticipated loss of revenue from a customer base which is the subject of a dispute, caused the Company again to be in default of certain financial covenants under the Transamerica Credit Facility. See "Item 3. Legal Proceedings -- Cherry Communications Lawsuit." Due to the existence of these defaults and an insufficient borrowing base to satisfy a \$20.0 million minimum excess availability requirement, no borrowings were available to the Company under the Transamerica Credit Facility and the lenders terminated the facility in January 1997.

In February 1997, the Company entered into a new revolving credit facility with Foothill Capital Corporation (the "Foothill Credit Facility") which will permit borrowings of up to \$30.0 million subject to a borrowing base limitation of 85% of eligible billed and 75% of eligible unbilled receivables. Borrowings under this facility will bear interest at a prime rate, plus one percent, and will be secured by substantially all of the assets of the Company. Under the terms of the Foothill Credit Facility, the Company is required to maintain minimum levels of adjusted net worth and is subject to a number of negative covenants which place limitations on, among other things, capital expenditures, investments and additional debt. Other covenants preclude payment of cash dividends and require the Company to obtain the lenders' consent prior to making any acquisitions. Borrowings under the Foothill Credit Facility will not be available until satisfaction of a number of conditions, consisting primarily of final documentation of security arrangements, which is expected to occur by May 1997. In addition, in February 1997 the Company entered into a lease facility under which approximately \$13.0 million is available for purchases of capital equipment, which the Company expects to use primarily to finance the purchase of its high capacity switching equipment.

As of March 14, 1997, the Company estimated that it will require between \$40.0 million and \$50.0 million in order to fund operating losses, working capital requirements and capital expenditures during the remainder of 1997, including an estimated \$15.0 million to acquire and install high capacity switches. The Company believes that it will be able to satisfy the conditions to borrowing under the Foothill Credit Facility by May 1997. Assuming borrowings become and remain available under the Foothill Credit Facility and the Company achieves anticipated revenue growth, the Company believes that the remaining proceeds from the Private Placement together with funds available under the Foothill Credit Facility, leasing facilities and cash flow from operations will be sufficient to fund the Company's expected working capital requirements. However, the exact amount and timing of these working capital requirements and the Company's ability to continue as a going concern will be determined by numerous factors, including the level of, and gross margin on, future sales, the outcome of outstanding contingencies and disputes such as pending lawsuits, payment terms obtained from the Company's suppliers and the timing of capital expenditures. Furthermore, there can be no assurance that borrowings under the Foothill Credit Facility will become and remain available or that this facility together with the Company's other anticipated sources of working capital will be sufficient to implement the Company's operating strategy or meet the Company's other working capital requirements. If (i) the Company experiences greater than anticipated capital requirements, (ii) the Company is determined

to be liable for, or otherwise agrees to settle or compromise, any material claim against it, (iii) the Company is unable to make future borrowings under any of its credit facilities for any reason, (iv) the implementation of the Company's operating strategy fails to produce the anticipated revenue growth and cash flows or (v) additional working capital is required for any other reason, the Company will be required to refinance all or a portion of its existing debt, sell assets, curtail operations or obtain additional equity or debt financing. There can be no assurance that any such refinancing or asset sales would be possible or that the Company would be able to obtain additional equity or debt financing, if and when needed, on terms that the Company finds acceptable. Any additional equity or debt financing may involve substantial dilution to the interests of the Company's shareholders as well as the holders of the Notes. If the Company is unable to obtain sufficient funds to satisfy its cash requirements, it will be forced to curtail operations, dispose of assets or seek extended payment terms from its vendors. There can be no assurance that the Company would be able to reduce expenses or successfully complete other steps necessary to continue as a going concern. Such events would materially and adversely affect the value of the Company's debt and equity securities.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

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REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

The Shareholders and Board of Directors MIDCOM Communications Inc.

We have audited the accompanying consolidated balance sheets of MIDCOM Communications Inc. as of December 31, 1996 and 1995, and the related consolidated statements of operations, shareholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 1996. Our audits also included the financial statement schedule listed in the Index at Item 14(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of MIDCOM Communications Inc. at December 31, 1996 and 1995, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1996, in conformity with generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As more fully described in Note 1, the Company has incurred recurring operating losses and has a shareholders' deficit. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

ERNST & YOUNG LLP

Seattle, Washington
March 21, 1997

MIDCOM COMMUNICATIONS INC.

CONSOLIDATED BALANCE SHEETS

DECEMBER 31,

1996

1995

(IN THOUSANDS, EXCEPT
SHARE DATA)

ASSETS

Current assets:

Cash and cash equivalents	550,962	\$1,083
Accounts receivable, less allowance for doubtful accounts of \$7,802 and \$10,581 in 1996 and 1995, respectively	16,969	51,814
Due from related parties	--	502
Prepaid expenses and other current assets	1,548	2,510

Total current assets 49,479 55,909

Investments in and advances to joint venture -- 2,000

Furniture, equipment and leasehold improvements, net 11,045 13,719

Intangible assets, less accumulated amortization of \$39,532 and \$12,812 in 1996 and 1995, respectively 15,547 60,781

Other assets, net 3,852 922

Total assets \$79,923 \$133,331

LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)

Current liabilities:

Accounts payable	53,179	\$6,624
Carrier accounts payable	17,143	32,534
Accrued expenses	10,006	10,051
Notes payable	9,680	14,576
Interest payable	2,932	335
Current portion of long-term obligations	3,314	41,721

Total current liabilities 46,254 105,841

Long-term obligations, less current portion 99,153 1,844

Other long-term liabilities 3,800 1,847

Commitments and contingencies

Shareholders' equity (deficit):

Preferred stock, \$ 0.001 par value, 10,000,000 shares authorized no shares issued or outstanding -- --

Common stock, \$ 0.001 par value, 90,000,000 shares authorized, 15,803,242 and 15,128,829 shares issued and outstanding in 1996 and 1995, respectively 68,330 62,400

Deferred stock option compensation (1,707) (13)

Accumulated deficit (135,907) (38,588)

Total shareholders' equity (deficit) (69,284) 23,799

Total liabilities and shareholders' equity (deficit) \$79,923 \$133,331

See accompanying notes to consolidated financial statements.

MIDCOM COMMUNICATIONS INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

YEAR ENDED DECEMBER 31,

	1996	1995	1994
	(IN THOUSANDS, EXCEPT PER SHARE DATA)		
Revenue	\$148,777	\$203,554	\$111,699
Cost of revenue	<u>107,950</u>	<u>139,546</u>	<u>79,044</u>
	40,827	64,008	32,655
Operating expenses:			
Selling, general and administrative	65,025	62,061	27,697
Depreciation	5,965	4,481	1,477
Amortization	26,721	9,309	2,657
Restructuring charge	2,220	--	--
Contract settlement	8,800	--	--
Loss on impairment of assets	<u>20,765</u>	<u>11,830</u>	<u>--</u>
Total operating expenses	<u>129,497</u>	<u>87,681</u>	<u>31,831</u>
Operating income (loss)	(88,670)	(23,673)	824
Other income (expense):			
Equity in loss of joint venture	--	(52)	(458)
Other income (expense)	77	(338)	(430)
Interest expense	(8,726)	(5,288)	(2,531)
Interest expense -- shareholders	<u>--</u>	<u>--</u>	<u>(434)</u>
Loss before extraordinary item	(97,319)	(29,351)	(3,029)
Extraordinary item: loss on early redemption of debt	<u>--</u>	<u>(4,067)</u>	<u>--</u>
Net loss	<u>\$ (97,319)</u>	<u>\$ (33,418)</u>	<u>\$ (3,029)</u>
Per share amounts:			
Loss before extraordinary item	\$(6.27)	\$(2.42)	\$(0.31)
Extraordinary item	<u>--</u>	<u>(0.34)</u>	<u>--</u>
Net loss	<u>\$(6.27)</u>	<u>\$(2.76)</u>	<u>\$(0.31)</u>
Shares used in calculating per share data	<u>15,529</u>	<u>12,101</u>	<u>9,930</u>

See accompanying notes to consolidated financial statements.

MIDCOM COMMUNICATIONS INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (DEFICIT)

	NUMBER OF SHARES	COMMON STOCK	DEFERRED STOCK OPTION COMPENSATION	ACCUMULATED DEFICIT	TOTAL SHAREHOLDERS' EQUITY (DEFICIT)
			(IN THOUSANDS)		
Balance at January 1, 1994	8,011	\$502	\$(104)	\$(6,963)	\$(6,565)
Conversion from S corporation to C corporation	--	(7,679)	--	7,679	--
Stock issued in acquisition	114	1,040	--	--	1,040
Compensation attributable to stock options vesting	--	--	20	--	20
Stock option forfeitures	--	(54)	50	--	(4)
Issuance of common stock warrant	--	3,500	--	--	3,500
Distributions by acquired company	--	--	--	(1,266)	(1,266)
Net loss for the year	--	--	--	(3,029)	(3,029)
Balance at December 31, 1994	8,125	(2,691)	(34)	(3,579)	(6,304)
Issuance of compensatory stock options	--	268	--	--	268
Stock issued in acquisitions	500	4,757	--	--	4,757
Compensation attributable to stock options vesting	--	--	21	--	21
Stock issued in initial public offering	5,456	54,182	--	--	54,182
Stock issued in customer base acquisitions	331	5,120	--	--	5,120
Stock issued for exercise of stock options and warrants and employee stock purchase plan	717	442	--	--	442
Distributions by acquired company	--	--	--	(1,269)	(1,269)
Conversion of acquired company from S corporation to C corporation	--	322	--	(322)	--
Net loss for the year	--	--	--	(33,418)	(33,418)
Balance at December 31, 1995	15,129	62,400	(13)	(38,588)	23,799
Stock issued in acquisitions	107	933	--	--	933
Stock issued for exercise of stock options and employee stock purchase plan	567	2,861	--	--	2,861
Issuance of compensatory stock options	--	2,136	(2,136)	--	--
Compensation attributable to stock options vesting	--	--	442	--	442
Net loss for the year	--	--	--	(97,319)	(97,319)
Balance at December 31, 1996	<u>15,803</u>	<u>\$68,330</u>	<u>\$(1,707)</u>	<u>\$(135,907)</u>	<u>\$(69,284)</u>

See accompanying notes to consolidated financial statements.

MIDCOM COMMUNICATIONS INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

YEAR ENDED DECEMBER 31

1996 1995 1994

(IN THOUSANDS)

OPERATING ACTIVITIES

Adjustments to reconcile net loss to net cash used in operating activities:

Net loss	\$(97,319)	\$(33,418)	\$(3,029)
Depreciation	5,966	4,481	1,477
Amortization of intangibles	26,721	9,309	2,657
Amortization of deferred financing costs	896	620	483
Loss on impairment of assets	20,765	11,830	--
Equity in loss of joint venture	--	52	458
Compensation attributable to stock options	862	289	16
Noncompetition payments	--	--	(250)
Loss on sale of assets	53	--	--
Long-term portion of contract settlement	3,800	--	--
Extraordinary item -- write-off of original issue discount and deferred financing costs	--	4,067	--
Changes in operating assets and liabilities:			
Accounts receivable	34,563	(17,784)	(9,811)
Due from related parties	502	138	(606)
Notes receivable	86	390	(348)
Prepaid expenses and other current assets	776	(719)	(1,201)
Other assets	(324)	(142)	11
Accounts payable and accrued expenses	(4,295)	(3,559)	4,062
Carrier accounts payable	(15,391)	16,638	8,236
Accrued interest payable	2,597	228	(869)
Deferred income	--	(67)	(3,229)
Other long-term liabilities	150	1,717	(202)

Net cash used in operating activities (19,592) (5,930) (2,145)

INVESTING ACTIVITIES

Purchases of furniture, equipment and leasehold improvements	(4,309)	(6,884)	(4,187)
Net assets acquired in business and customer base acquisitions	--	(11,407)	(5,089)
Proceeds from sale of assets	692	--	--
Investment in and advances to joint venture	--	(2,625)	(4,190)
Loan to related party	--	--	(1,234)

Net cash used in investing activities (3,617) (20,916) (14,700)

FINANCING ACTIVITIES

Repayment of loans from related parties	--	--	(3,617)
Proceeds from notes payable	333	--	3,485
Repayment of notes payable	(5,229)	(21,628)	(10,592)
Proceeds from long-term obligations	112,743	69,205	34,350
Repayment of long-term obligations	(53,814)	(64,841)	(3,851)
Proceeds from common stock issued for stock purchase plan and stock options	2,861	442	--
Issuance of common stock	--	54,182	--
Preferred stock redemption	--	(8,597)	--
Distributions to shareholders of acquired companies	--	(1,269)	(1,266)
Deferred financing costs	(3,806)	(525)	(1,512)

Net cash provided by financing activities 53,088 26,969 16,997

Net increase in cash and cash equivalents 29,879 123 152

Cash and cash equivalents at the beginning of year 1,083 960 808

Cash and cash equivalents at the end of year \$30,962 \$1,083 \$960

See accompanying notes to consolidated financial statements.

MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

I. NATURE OF OPERATIONS

MIDCOM Communications Inc. ("Midcom" or the Company) provides long distance voice and data telecommunications services. As primarily a nonfacilities-based reseller, Midcom principally utilizes the network switching and transport facilities of Tier I long distance carriers such as Sprint Corporation ("Sprint"), WorldCom, Inc. ("WorldCom") and AT&T Corp. ("AT&T") to provide a broad array of telecommunications services. Midcom's service offerings include basic "1 plus" and "800" long distance voice, frame relay data transmission services, wireless services, dedicated private lines between customer locations and enhanced telecommunications services such as facsimile broadcast services and conference calling. The Company's customers are primarily small to medium-sized commercial businesses.

Risks and Uncertainties

The Company is subject to certain significant risks and uncertainties that may affect the amounts reported in the financial statements. These significant risks and uncertainties include impairment of assets and litigation. Additional information concerning these risks and uncertainties is included in the notes to the consolidated financial statements.

Going Concern and Liquidity

The Company incurred operating losses during each of the three years ended December 31, 1996 and, as of December 31, 1996, had a shareholders' deficit of \$69.3 million. The Company's credit facility at December 31, 1996 was terminated on January 31, 1997. In February 1997, the Company entered into a new credit facility with Foothill Capital Corporation (the "Foothill Credit Facility"). However, borrowings under the Foothill Credit Facility will not be available until satisfaction of a number of conditions, which is expected to occur by May 1997. The consolidated financial statements have been prepared assuming the Company will continue as a going concern and do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets and liabilities that may result from this uncertainty.

Assuming borrowings become and remain available under the Foothill Credit Facility and the Company achieves anticipated revenue growth, the Company believes that its existing cash resources together with funds available under the Foothill Credit Facility, leasing facilities and cash flow from operations will be sufficient to fund the Company's expected working capital requirements. However, the exact amount and timing of these working capital requirements and the Company's ability to continue as a going concern will be determined by numerous factors, including the level of, and gross margin on, future sales, the outcome of outstanding contingencies and disputes such as pending lawsuits, payment terms achieved by the Company and the timing of capital expenditures. Furthermore, there can be no assurance that borrowings under the Foothill Credit Facility will become and remain available or that this facility together with the Company's other anticipated sources of working capital will be sufficient to implement the Company's operating strategy or meet the Company's other working capital requirements. If (i) the Company experiences greater than anticipated capital requirements, (ii) the Company is determined to be liable for, or otherwise agrees to settle or compromise, any material claim against it, (iii) the Company is unable to make borrowings under any of its credit facilities for any reason, (iv) the implementation of the Company's operating strategy fails to produce the anticipated revenue growth and cash flows or (v) additional working capital is required for any other reason, the Company will be required to refinance all or a portion of its existing debt or obtain additional equity or debt financing. There can be no assurance that any such refinancing would be possible or that the Company would be able to obtain additional equity or debt financing, if and when needed, on terms that the Company finds acceptable. Any additional equity or debt financing may involve substantial dilution to the interests of holders of the Company's debt and equity securities.

MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

If the Company is unable to obtain sufficient funds to satisfy its cash requirements, it will be forced to curtail operations, dispose of assets or seek extended payment terms from its vendors. There can be no assurance that the Company would be able to reduce expenses or successfully complete other steps necessary to continue as a going concern. Such events would materially and adversely affect the value of the Company's debt and equity securities.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements include the accounts of MIDCOM Communications Inc. and its wholly-owned subsidiaries, PacNet Inc. ("PacNet"), Cel-Tech International Corp. ("Cel-Tech"), AdVal, Inc. ("AdVal") and Advanced Network Design ("AND") (collectively referred to as "Midcom" or the "Company"). All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company's investment in Dal Telecom International ("Dal Telecom"), a Russian corporate joint venture, was accounted for on the equity method, adjusted to estimated fair value, in accordance with generally accepted accounting principles. During 1995 and 1994, the Company recorded its pro rata share of Dal Telecom's income or loss one month in arrears.

Cash and Cash Equivalents

All short-term investments with a maturity of three months or less at the date of purchase are considered to be cash equivalents.

Revenue Recognition

Resale and transmission revenue and related costs are recognized in the period the customer utilizes the Company's service. At December 31, 1996 and 1995, net unbilled resale revenue totaled \$5,636 and \$26,153, respectively.

Financial Instruments and Concentration of Credit Risk

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts and carrier accounts payable, notes payable and long-term obligations. The fair value of the financial instruments, except long-term obligations, approximates their recorded value based on the short-term maturity of the instruments. The fair value of the long-term obligations approximates their recorded value based on the current rates offered to the Company for similar debt of the same maturities. The Company does not have financial instruments with off-balance-sheet risk.

Financial instruments that potentially subject the Company to concentrations of credit risk are accounts receivable. Concentration of credit risk with respect to receivables are limited due to diversity in geographic locations of customers as well as diversity of industries. The Company continually evaluates the credit worthiness of its customers; however, it generally does not require collateral. The Company's allowance for doubtful accounts is based on historical trends, current market conditions and other relevant factors.

Deferred Financing Costs

Financing costs are capitalized and amortized over the term of the related debt on a straight-line basis which approximates the effective-interest method. Included in other assets at December 31, 1996 and 1995 are deferred financing costs of \$3,419 and \$510, respectively (net of accumulated amortization of \$297 and \$15, respectively).

MIDCOM COMMUNICATIONS INC.

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If the Company is unable to obtain sufficient funds to satisfy its cash requirements, it will be forced to curtail operations, dispose of assets or seek extended payment terms from its vendors. There can be no assurance that the Company would be able to reduce expenses or successfully complete other steps necessary to continue as a going concern. Such events would materially and adversely affect the value of the Company's debt and equity securities.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements include the accounts of MIDCOM Communications Inc. and its wholly-owned subsidiaries, PacNet Inc. ("PacNet"), Cel-Tech International Corp. ("Cel-Tech"), AdVal, Inc. ("AdVal") and Advanced Network Design ("AND") (collectively referred to as "Midcom" or the "Company"). All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company's investment in Dal Telecom International ("Dal Telecom"), a Russian corporate joint venture, was accounted for on the equity method, adjusted to estimated fair value, in accordance with generally accepted accounting principles. During 1995 and 1994, the Company recorded its pro rata share of Dal Telecom's income or loss one month in arrears.

Cash and Cash Equivalents

All short-term investments with a maturity of three months or less at the date of purchase are considered to be cash equivalents.

Revenue Recognition

Resale and transmission revenue and related costs are recognized in the period the customer utilizes the Company's service. At December 31, 1996 and 1995, net unbilled resale revenue totaled \$5,636 and \$26,153, respectively.

Financial Instruments and Concentration of Credit Risk

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts and carrier accounts payable, notes payable and long-term obligations. The fair value of the financial instruments, except long-term obligations, approximates their recorded value based on the short-term maturity of the instruments. The fair value of the long-term obligations approximates their recorded value based on the current rates offered to the Company for similar debt of the same maturities. The Company does not have financial instruments with off-balance-sheet risk.

Financial instruments that potentially subject the Company to concentrations of credit risk are accounts receivable. Concentration of credit risk with respect to receivables are limited due to diversity in geographic locations of customers as well as diversity of industries. The Company continually evaluates the credit worthiness of its customers; however, it generally does not require collateral. The Company's allowance for doubtful accounts is based on historical trends, current market conditions and other relevant factors.

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MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

Furniture, Equipment and Leasehold Improvements

Furniture, equipment and leasehold improvements are stated at cost. Maintenance and repairs are expensed as incurred. When properties are retired or otherwise disposed of, gains and losses are reflected in the consolidated statement of operations. Depreciation and amortization, which includes amortization of assets recorded under capital leases, are computed using the straight-line method over the following useful lives:

Buildings and towers	30 years
Transmission equipment	12 to 15 years
Data processing systems and equipment	3 to 5 years
Switches	5 to 7 years
Furniture, equipment and leasehold improvements	3 to 7 years

Intangible Assets

Intangible assets represent the excess of the purchase price over the estimated fair value of identifiable assets acquired in business and customer base acquisitions. Amounts are allocated primarily to customer bases which are amortized over three years using the straight-line method. Amounts are also allocated to noncompete agreements and goodwill as applicable, which are amortized using the straight-line method over terms ranging from 18 months to 25 years.

The Company periodically reviews the carrying value of its intangible assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. To the extent the estimated future cash inflows attributable to the asset, less estimated future cash outflows, is less than the carrying amount, an impairment loss is recognized.

Net Loss Per Share

Net loss per share is based on the weighted average number of common and equivalent shares outstanding using the treasury stock method. Common stock equivalents are excluded from the calculation of net loss per share due to their antidilutive effect, except that pursuant to Securities and Exchange Commission ("SEC") requirements, for periods prior to the Company's initial public offering, common and equivalent shares issued during the 12-month period prior to the initial public offering have been included in the calculation as if they were outstanding for all periods prior to the Company's initial public offering using the treasury stock method.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from those estimates.

Stock Based Compensation

In 1996, the Company adopted the Financial Accounting Standards Statement No. 123, Accounting for Stock-Based Compensation ("SFAS 123"). SFAS 123 establishes financial accounting and reporting standards for stock-based employee compensation plans. It defines a fair value based method of accounting for an employee stock option or similar equity instrument and encourages all entities to adopt that method of accounting for all of their employee stock compensation plans and include the cost in the income statement as compensation expense. However, it also allows an entity to continue to measure compensation cost for those plans using the intrinsic value based method of accounting prescribed by Accounting Principles Board

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

("APB") Opinion No. 25, Accounting for Stock issued to Employees. The Company has elected to account for compensation cost for stock option plans in accordance with APB Opinion No. 25.

Reclassifications

Certain reclassifications have been made to the prior years' financial statements to conform with the current year presentation.

3. CASH AND CASH EQUIVALENTS

The Company's cash and cash equivalents as of December 31 consist of the following:

	1996	1995
Cash	\$1,194	\$1,083
Commercial Paper	19,878	--
Money Market	9,890	--
	<u>\$30,962</u>	<u>\$1,083</u>

Due to the short-term nature of these investments, changes in market interest rates would not have a significant impact on the fair value of these securities. These securities are carried at amortized cost which approximates fair value.

4. FURNITURE, EQUIPMENT AND LEASEHOLD IMPROVEMENTS

Major classes of furniture, equipment and leasehold improvements, including assets under capital leases, as of December 31 consist of the following:

	1996	1995
Buildings and towers	\$534	\$787
Transmission equipment	3,842	3,747
Data processing systems and equipment	12,133	11,120
Switches	141	--
Furniture, equipment and leasehold improvements	<u>6,974</u>	<u>4,663</u>
	23,624	20,317
Accumulated depreciation and amortization	<u>(12,579)</u>	<u>(6,598)</u>
	<u>\$11,045</u>	<u>\$13,719</u>

The gross amount of furniture, equipment and leasehold improvements recorded under capital leases was \$6,073 at December 31, 1996 and 1995.

Included in furniture, equipment and leasehold improvements are unamortized development costs related to the Company's proprietary management information system. This system was placed in service in May 1995 and is being amortized on a straight-line basis. As a result of billing problems encountered after the system was placed in service, the Company evaluated the system during the fourth quarter of 1995 and determined that the system would require additional enhancements to meet its initial design objectives and that its value had been impaired. As a result, in 1995 the Company reduced the unamortized costs from \$4,471 to \$2,000 and recorded a \$2,471 loss on impairment of the asset.

In the fourth quarter of 1995, the Company determined that it intended to replace certain limited capacity switches, the majority of which were acquired through acquisitions of other telecommunications service providers, with newer switches having increased functionality and capacity. As a result of this decision,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

the Company wrote off these switches and in 1995 recorded a \$2,544 loss on impairment of assets. In June 1996, the Company recorded a \$1,006 loss on impairment of microwave equipment.

5. INVESTMENT IN JOINT VENTURE

In December 1993, Midcom contracted to acquire a 50% interest in Dal Telecom International ("Dal Telecom"), a provider of local, long distance, international and cellular telecommunications services in the Russian Far East. To acquire its interest in Dal Telecom, Midcom committed to make a capital contribution of cash, equipment and services of approximately \$12,700. As of December 31, 1995, the Company had invested a total of \$8,815 in the joint venture but was unable to fund additional contributions. In March 1996, the Company and the joint venture partner agreed to amend the terms of the joint venture to provide that the Company had a 40% equity interest in the joint venture.

The Company's commitment to Dal Telecom required significant amounts of capital resources and management attention given the logistics of maintaining a relationship in Russia. As a result, the Company decided that it was in its best interests to focus on its domestic business and to sell its interest in Dal Telecom. As a result of this decision, the Company wrote down its investment in Dal Telecom to \$2,000 at December 31, 1995, which was the Company's estimate of the net recoverable value of its investment in Dal Telecom, and recorded a \$6,815 loss on impairment of the asset. This estimate was based on market information currently available to the Company and certain assumptions about the future operations of Dal Telecom, over which the Company had limited control. The Company discontinued recording its share of the income or losses of Dal Telecom as of December 31, 1995. During the third quarter of 1996, the remaining investment of \$2,000 was written off to loss on impairment of assets, as the Company was unable to locate a purchaser for its interest.

6. BUSINESS COMBINATIONS

During 1994, 1995, and the first three months of 1996, the Company completed a series of acquisitions from telecommunications companies offering services similar or complementary to those offered by the Company. Certain of these acquisitions included the purchase of substantially all of the operating assets of the acquiree, including customer bases, and in other situations only specific customer bases. These asset acquisitions have been accounted for using the purchase method, with the excess of the purchase price over the net tangible assets acquired being allocated to acquired customer bases, non-compete agreements and goodwill. Revenue generated from the acquired customer bases are included in the accompanying statements of operations from the dates of the acquisitions.

The total consideration paid for these acquisitions was \$89,769 of which \$74,735 was allocated to intangible assets. These acquisitions generally were financed through borrowings under the Company's lines of credit, issuance of debt and stock and assumption of liabilities.

Components of intangible assets at December 31, 1996 and their respective estimated useful lives were as follows:

Customer bases	\$49,986	3 years
Non-compete agreements	3,527	2 to 4 years
Goodwill	1,566	25 years
	<u>\$55,079</u>	

Based on certain changes in circumstances that occurred in the first quarter of 1996, including turnover in personnel, reduction in sales force and continuing attrition of acquired customer bases, the Company determined that effective January 1, 1996, a reduction in the estimated life of previously acquired customer

MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

bases from 5 years to 3 years was appropriate. This reduction in estimated life increased amortization expense by \$10,260 for the year ended December 31, 1996. In addition, the Company wrote down certain acquired customer bases and recorded a loss on impairment of assets of \$17,765 during 1996.

Substantially all of the Company's intangible assets consist of acquired customer bases which are subject to attrition. The estimated useful lives of these customer bases are based on attrition rates considered standard in the industry. If the Company's actual attrition rates were to exceed these estimates, or other unfavorable changes in business conditions were to occur, the value of the related customer bases would be impaired and future operating results would be adversely affected.

In connection with certain previous acquisitions, the Company was obligated to issue or release from escrow additional shares of its common stock or pay additional cash consideration upon the satisfaction of certain contingencies. Such contingencies include, among other things, maintenance of specified revenue levels and satisfaction of general representations and warranties. The contingency periods range from six months to two years. During 1996, the Company issued or released from escrow a total of 106,782 shares of common stock and paid \$1,154 in cash to partially satisfy these obligations. As of December 31, 1996, there were a total of 151,675 shares in escrow that may be released upon the satisfaction of remaining contingencies.

In accordance with applicable accounting standards, the common stock or other consideration issuable under the contingency arrangements has not been included in the determination of purchase price, nor have the shares been considered outstanding for purposes of net loss per share calculations. Additional consideration will be recorded when the outcome of a contingency is determined.

The Company is obligated in certain cases to issue additional shares of its common stock in the event that the market price of such stock, when the shares become registerable, is less than the price at the acquisition dates. In January 1997, the Company issued 49,233 shares of common stock in partial satisfaction of these obligations. Based on the Company's stock price on March 21, 1997, approximately 255,000 additional shares remain to be issued as a result of these obligations.

7. NOTES PAYABLE

At December 31, 1996 and 1995, the Company had \$680 in notes outstanding, secured by a personal guarantee of the principal shareholder of the Company. The notes are due upon 30-day demand, or no later than March 28, 1999. Interest on these notes is payable monthly, at a rate of prime plus 2% (but in no event lower than 9% or greater than 13%) per annum. Warrants to purchase up to a total of 59,500 shares of Common Stock at an exercise price of \$7.44 per share, subject to adjustments in the exercise price related to dilutive activities, were granted to the holders of the notes. The warrants expire on March 28, 1999.

In connection with a customer base purchase agreement, the Company had a noninterest-bearing obligation totaling \$12,000 as of December 31, 1995. The unsecured obligation required monthly payments of \$3,000 from January through April 1996, payable in cash or common stock. The Company paid \$3,000 to the seller in January 1996 and has withheld the remaining payments pending resolution of certain disputes with the seller. Based on the Company's stock price on March 21, 1997, the Company would be required to issue approximately 507,000 shares of its common stock to satisfy this obligation.

At December 31, 1995, the Company had approximately \$2,000 in additional notes payable to sellers of certain customer bases. These notes bore interest at rates up to 10% and were paid in full during 1996.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

8. LONG-TERM OBLIGATIONS

Long-term obligations as of December 31 consisted of the following:

	1996	1995
Convertible subordinated notes payable, maturing on August 15, 2003, interest at 8 1/4%, interest payable semi-annually, convertible into common stock at the option of the holder at any time prior to maturity	\$97,743	\$--
Senior Revolving Credit Facility with Transamerica Business Credit Corporation. Applicable interest rate on outstanding advances at December 31, 1995 was 9%. This facility was secured by substantially all of the Company's assets. The balance was repaid in full in 1996	--	37,428
Note payable secured by assets acquired, interest payable quarterly at the prime rate plus 1%. Balance due in full September 30, 1998	800	800
Note payable secured by certain property and equipment, interest at 5% to 15%, principal and interest payments due in monthly installments through May 31, 1997	27	408
Capital Lease Obligations, interest at 5% to 14.3%, principal and interest payments due in monthly installments through 2002	3,897	4,929
	102,467	43,565
Less current portion	3,314	41,721
	<u>\$99,153</u>	<u>\$1,844</u>

Principal maturities of long-term debt at December 31, 1996 are as follows:

1997	\$3,314
1998	976
1999	142
2000	144
2001	148
Thereafter	97,743
Total	<u>\$102,467</u>

In August and September of 1996, the Company completed a private placement (the "Private Placement") of \$97,743 in aggregate principal amount of 8 1/4% Convertible Subordinated Notes due 2003 (the "Notes"). Interest on the Notes is due semi-annually, on February 15 and August 15 of each year, commencing February 15, 1997. The Notes are convertible into shares of the Company's common stock, at a conversion price of \$14.0875 per share (equivalent to a conversion rate of 70.985 share per \$1,000 principal amount of Notes), subject to adjustment in certain events.

In November 1995, the Company obtained a senior secured revolving credit facility from Transamerica Business Credit Corporation ("Transamerica") and certain other lenders (the "Transamerica Credit Facility") which provided for borrowings of up to \$50,000, subject to certain limitations and financial covenants. The Company was not in compliance with some of these covenants as of December 31, 1995. The Transamerica Credit Facility was further amended in March 1996 to reduce the overall commitment by the lender from \$50,000 to \$43,000. The outstanding balance under the Transamerica Credit Facility was repaid in

MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

full in August 1996 with the proceeds of the Private Placement, and the facility was terminated on January 31, 1997.

On March 26, 1996, the Company obtained a temporary bridge loan of \$15,000 from Transamerica. The bridge loan was secured by substantially all of the Company's assets, bore interest at 12% and was originally due on April 27, 1996. The Company paid an initial loan fee of \$500 and had the right to extend the due date of the loan for 30-day periods upon payment of an additional fee of \$200 for each 30-day extension, with final payment due by September 24, 1996. This bridge loan was repaid in August 1996.

The Company recorded an extraordinary item in the third and fourth quarters of 1995 of \$2,992 and \$1,075, respectively, related to the write off of original issue discounts and deferred financing costs.

9. PREFERRED STOCK

During 1994, the Company issued 859,653 shares of Series A Redeemable Preferred Stock (the "Preferred Stock") to retire shareholder notes payable. The preferred stock was redeemed at \$10 per share in July 1995 with proceeds from the Company's initial public offering.

10. COMMON STOCK

On July 6, 1995, the Company completed the initial public offering of shares of its common stock at \$11.00 per share, which resulted in net proceeds of approximately \$54,182 to the Company after deducting the expenses of the offering. The net proceeds were used to repay indebtedness and redeem all of the outstanding shares of Preferred Stock.

At December 31, 1996, common stock was reserved for the following:

Conversion of the Notes	6,938,279
Exercise and future grant of stock options	4,108,816
Employee stock purchase plan	256,354
Exercise of outstanding warrants	59,500
<u>Total common stock reserved</u>	<u>11,362,949</u>

11. STOCK OPTION PLAN

The Company has a stock option plan which provides for the granting of nonqualified and incentive stock options to purchase up to 4,739,063 shares of common stock. Options granted become exercisable over vesting periods of up to five years at exercise prices determined by the Board of Directors, and generally expire ten years from the date of grant.

Stock options have generally been granted at the fair market value at the date of grant. However, a limited number of options have been granted at less than the fair market value, in which case compensation expense has been recognized over the vesting period based on the excess of the fair market value stock at the date of grant over the exercise price.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

Presented below is a summary of stock option plans activity for the years shown:

	SHARES	EXERCISE PRICE
Options outstanding at January 1, 1994	484,805	\$2.29 - \$5.71
Granted	663,139	\$2.29 - \$9.14
Canceled	(117,460)	\$2.29 - \$9.14
Options outstanding at December 31, 1994	1,030,484	\$2.29 - \$9.14
Granted	740,954	\$1.00 - \$18.50
Canceled	(365,619)	\$2.29 - \$15.75
Exercises	(66,333)	\$2.29 - \$18.50
Options outstanding at December 31, 1995	1,339,486	\$1.00 - \$18.50
Granted	3,545,009	\$3.00 - \$15.50
Canceled	(637,202)	\$2.29 - \$18.50
Exercises	(563,914)	\$1.00 - \$10.50
Options outstanding at December 31, 1996	3,683,379	\$2.29 - \$18.50

At December 31, 1996, a total of 425,437 shares were available for future issuance under the plans.

The following table summarizes information for options currently outstanding and exercisable at December 31, 1996:

OPTIONS OUTSTANDING			OPTIONS EXERCISABLE		
RANGE OF EXERCISE PRICES	NUMBER OUTSTANDING	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE	WEIGHTED AVERAGE EXERCISE PRICE
2.29 - \$6.50	128,215	8.8	\$3.69	89,000	\$3.50
6.51 - \$12.00	3,316,815	9.5	\$8.85	228,532	\$9.70
12.01 - \$18.50	238,349	8.5	\$15.69	57,250	\$16.96
	3,683,379			374,782	

The Company applies APB 25 in accounting for its stock issued to employees. Had compensation cost for the Company's stock options been recognized based upon the fair value on the grant date under the methodology prescribed by SFAS 123, the Company's net loss and net loss per share for the years ended December 31, 1996 and 1995 would have been impacted as indicated in the following table. Note that due to the adoption methodology prescribed by SFAS 123, the proforma results shown below only reflect the impact of options granted in 1995 and 1996. Since option vesting occurs over five years, the proforma impact shown for 1996 and 1995 is not representative of what the impact will be in future years.

	1996	1995
Net loss -- as reported	\$(97,319)	\$(33,418)
Net loss -- proforma	\$(101,549)	\$(34,066)
Loss per share -- as reported	\$(6.27)	\$(2.76)
Loss per share -- proforma	\$(6.54)	\$(2.82)

MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

This fair value of options granted (which is amortized to expense over the option vesting period in determining the proforma impact), is estimated on the date of grant using the Black Scholes option-pricing model with the following weighted average assumptions used for grants in 1996 and 1995:

Expected life of option.....	3 1/2 yrs
Risk free interest rate.....	6.5%
Expected volatility.....	60.0%
Dividend yield.....	--

The weighted average fair value of options granted during 1996 and 1995 is as follows:

	1996	1995
Fair value of each option granted.....	\$4.16	\$7.02
Total number of options granted.....	3,545,009	740,954
Total fair value of all options granted.....	\$14,747	\$5,201

In accordance with SFAS 123, the weighted average fair value of stock options granted is required to be based on a theoretical statistical model using the preceding Black-Scholes assumptions. In actuality, because company stock options do not trade on a secondary exchange, employees can receive no value nor derive any benefit from holding stock options under these plans without an increase in the market price of Midcom stock. Such an increase in stock price would benefit all stockholders commensurably.

12. INCOME TAXES

Components of the Company's deferred tax liabilities and assets as of December 31 are as follows:

	1996	1995
Deferred tax assets:		
Sales reserves and allowances.....	\$2,248	\$1,326
Accrued compensation costs.....	322	--
Provisions not currently deductible.....	1,829	376
Accrued restructuring costs.....	373	--
Contract settlement.....	1,520	--
Tax depreciation different than financial accounting depreciation.....	1,455	--
Intangible tax amortization different than financial statement amortization.....	17,560	1,832
Losses and write-down of foreign joint venture.....	3,769	3,022
Net operating loss carry forwards.....	24,817	7,648
Total deferred tax assets.....	53,893	14,204
Valuation allowance.....	(53,502)	(13,017)
	\$391	\$1,187
Deferred tax liabilities:		
Tax depreciation different than financial accounting depreciation.....	--	(424)
Cash to accrual change.....	(391)	(763)
Total deferred tax liabilities.....	(391)	(1,187)
Net deferred tax liabilities.....	\$--	\$--

MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

On January 1, 1994, when the Company became a C Corporation, a valuation allowance on deferred tax assets was not required due to the net deferred tax liability position. At December 31, 1994, the valuation allowance of \$316 was established for the deferred tax assets in excess of deferred tax liabilities. The valuation allowance was increased \$40,485 and \$13,333 in 1996 and 1995, respectively.

The Company has net operating loss carry forwards for federal income tax purposes available to offset future federal taxable income, if any, of approximately \$60,042 with the following expirations: \$4,536 in 2009, \$8,770 in 2010 and \$46,736 in 2011.

The provisions for income taxes differ from the "expected" income tax benefit as follows for the years ended December 31:

	1996	1995	1994
Computed expected federal tax benefit.....	(34.0)%	(34.0)%	(34.0)%
State taxes, net of federal benefit	(6.0)%	(6.0)%	(6.0)%
Deferred taxes associated with Midcom S Corporation to C Corporation conversion, January 1, 1994.....	--	--	6.8%
Deferred tax asset realization related to acquisitions.....	--	--	16.8%
Change in valuation allowance for net deferred tax assets.....	39.8%	38.0%	10.4%
Other.....	0.2%	2.0%	6.0%
	<u>--%</u>	<u>--%</u>	<u>--%</u>

13. RELATED-PARTY TRANSACTIONS

The largest shareholder of the Company and the Company's former President and Chief Executive Officer jointly own QuestWest Inc. QuestWest Inc., in turn, holds approximately an 85% interest in Quest America Limited Partnership ("Quest LP"). In December 1993, the Company entered into a distribution agreement with Quest LP that entitles Quest LP to a sales commission from the Company at a rate equal to the most favorable rate available to other comparable Company distributors. In October 1995 the largest shareholder sold their interest in Quest LP to a third party and the most favorable rate clause in the distribution agreement was eliminated. During 1995 and 1994, Quest LP received \$295 and \$66, respectively, in net commissions.

Effective May 1996, the Company entered into an employment agreement with William H. Oberlin, the Company's President and Chief Executive Officer. The agreement provides for a base salary of \$25 per month and an annual bonus to be determined each year by the Company's Board of Directors based on certain quantitative and qualitative targets set forth in the Company's annual business plan. In connection with entering into the agreement, the Company granted Mr. Oberlin options to purchase up to 1,214,714 shares of Common Stock pursuant to the Company's Stock Option Plan. The options vest ratably over a five-year period. Mr. Oberlin is entitled to up to two years severance (reduced to one year severance in certain circumstances) in the event of termination. Severance generally equals the sum of the annualized base salary at the time of termination and the average annual bonuses for the fiscal years preceding termination. The agreement also contains a non-interference provision pursuant to which, for a period of six months following termination of employment, Mr. Oberlin has agreed to, among other things, preserve the confidentiality of the Company's customer list and refrain from actively soliciting the Company's customers existing at the date of termination.

Effective May 1996, the Company entered into consulting agreements with Marvin C. Moses and John M. Zmo, each a director of the Company, pursuant to which Messrs. Moses and Zmo have agreed to provide consulting services to the Company with respect to acquisitions, investor and other strategic relations and strategic financial matters. Pursuant to the agreements, the Company is required to pay each of these

MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

individuals a retainer of \$8,333 per month. In addition, in connection with the agreements, the Company has granted to each of these individuals options for the purchase of 253,681 shares of Common Stock pursuant to the Company's Stock Option Plan. The options vest ratably over a five-year period. The agreements terminate after a period of five years beginning on June 1, 1996, unless terminated earlier in accordance with the terms thereof. The agreements may be terminated by either party at any time upon 30 days prior written notice.

In June 1994, the Company entered into an employment agreement with Ashok Rao, the former President and Chief Executive Officer of the Company. The agreement provided for a base salary of \$25 per month. Mr. Rao resigned from the Company in April 1996. In connection with Mr. Rao's resignation, the Company has elected to repurchase 885,360 shares of Common Stock held by Mr. Rao and certain trusts established by Mr. Rao (the "Rao Shares"). See Note 15, below. Under an agreement between Mr. Rao and Paul Pfleger, Vice Chairman of the Company's Board of Directors, pursuant to which Mr. Rao purchased the Rao Shares from Mr. Pfleger, Mr. Pfleger is entitled to receive payments aggregating approximately \$2.2 million out of proceeds received by Mr. Rao from the sale of the Rao Shares to the Company.

14. EMPLOYEE BENEFIT PLANS

401(k) Salary Deferral and Profit Sharing Plan

Prior to February 1, 1996, the Company maintained a 401(k) Salary Deferral and Profit Sharing Plan with its affiliate SP Investments Inc. ("SPII"). Effective February 1, 1996, SPII withdrew from the Retirement Plan. The Company maintains a voluntary defined contribution profit sharing plans covering all eligible employees as defined in the plan documents. Participating employees may elect to defer and contribute a stated percentage of their compensation to the plan, not to exceed the dollar amount set by law. The Company matches 50% of each employee's contribution up to a maximum of the first 6% of each employee's compensation.

The Company's matching contributions to the plan were approximately \$283, \$253, and \$156 for the years ended December 31, 1996, 1995 and 1994, respectively.

Employee Stock Purchase Plan

In December 1994, the Company established an Employee Stock Purchase Plan which became effective upon the successful completion of the Company's initial public offering of common stock. The Company's plan provides that eligible employees may contribute up to 10% of their base earnings toward the semi-annual purchase of the Company's common stock. The employee's purchase price is 95% of the lesser of the fair market value of the stock on the first business day or the last business day of the semi-annual offering period. The total number of shares issuable under the plan is 262,500. There were 3,717 shares issued under the plan during fiscal 1996 at prices ranging from \$8.08 to \$13.66, and 2,429 shares issued under the plan during fiscal 1995 at a price of \$14.61.

15. COMMITMENTS AND CONTINGENCIES

LEASES

The Company leases its office space and certain equipment under terms of noncancelable operating leases, which expire on various dates through 2004. The leases generally require that the Company pay certain maintenance, insurance and other operating expenses. Rent expense under operating leases for the years ended December 31, 1996, 1995 and 1994 was \$3,281, \$2,535, and \$566, respectively.

MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

At December 31, 1996, minimum future lease payments under noncancelable operating leases are as follows:

	OPERATING LEASES
1997.....	\$3,092
1998.....	2,797
1999.....	2,521
2000.....	2,271
2001.....	1,765
Thereafter.....	<u>3,340</u>
Total.....	<u>\$15,786</u>

COMMITMENTS WITH PROVIDERS

Under the terms of carrier contracts executed with AT&T and other carriers, the Company has made commitments to maintain or achieve certain volume levels in order to obtain special forward pricing. Under some of these contracts, the Company guarantees to sell a certain amount of long distance volume within a certain time period or purchase all or a portion of any unused volume. Under others, if certain volume levels are not achieved during stated periods, pricing is adjusted going forward to levels justified by current volumes.

At December 31, 1996, minimum future usage commitments are as follows:

1997.....	\$26,790
1998.....	3,287
1999.....	--
2000.....	<u>75,000</u>
Total.....	<u>\$105,077</u>

As of September 30, 1996, Midcom's minimum volume commitment under its supply contract with AT&T Corp. ("AT&T"), its largest supply contract, was \$117,000. The Company estimated that, as of the last measurement date on September 30, 1996, it would have been in shortfall of its minimum commitments to AT&T by approximately \$27,600 based on then current contract requirements. However, on October 31, 1996, the Company and AT&T executed a Release and Settlement Agreement pursuant to which substantially all disputes between the Company and AT&T have been resolved. Also on October 31, 1996, the Company and AT&T executed a new carrier contract pursuant to which the Company's minimum commitment to AT&T was reduced to \$13,700 to be used over the eighteen month period immediately following execution of the agreement. In addition, the new carrier contract provides for more favorable pricing for certain network services provided by AT&T. In consideration for the terms of the settlement and the new rate structure, the Company is required to pay AT&T \$8,800 payable in two installments. The first payment of \$5,000 was made on November 6, 1996, and the remaining balance of \$3,800 will be due within 30 days of Midcom announcing quarterly gross revenue in excess of \$75,000 or upon completion of a change in control.

At the present time, the Company has achieved or reserved for all of its required volume commitments. There can be no assurance that the minimum usage commitments will be achieved in the future, and if such commitments are not achieved future operating results could be adversely affected.

During the years ended December 31, 1996, 1995 and 1994, the Company relied on three carriers to carry traffic representing approximately 74%, 67% and 97% of the Company's revenue, respectively. The Company has the ability to transfer its customers' traffic from one supplier to another in the event a supplier declines to

MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

continue to carry the Company's traffic. However, such transfers could result in disruption of service to the customers, with a subsequent loss of revenue which would adversely affect operating results.

ACQUISITIONS

In connection with several business or customer base acquisition agreements, the Company is obligated to issue additional consideration upon the satisfaction of certain contingencies.

SHARE REDEMPTION

In connection with the resignation of Ashok Rao, the Company's former President and Chief Executive Officer, the Company has elected to repurchase 885,360 shares of Common Stock held by Mr. Rao and certain trusts established by Mr. Rao (the "Rao Shares") at a price equal to the fair market value of the Rao Shares on the date of Mr. Rao's resignation. The date of resignation and the amount of the restricted security discount to be applied to the value of the Rao Shares have been submitted to arbitration. Once determined, the purchase price is to be paid by the Company in 36 equal monthly installments and will bear interest at a rate of 8% per annum.

REGULATION

Federal

The Company has all necessary authority to provide domestic interstate and international telecommunications services under current FCC regulations. Midcom has filed both domestic and international tariffs with the FCC, and PacNet has, and is only required to file, international tariffs. Pursuant to a 1995 court decision, detailed rate schedules now must be filed in lieu of the "reasonable range of rates" tariff previously accepted by the FCC. In reliance on the FCC's past practice of allowing relaxed range of rates tariffs for non-dominant carriers, Midcom and most of its competitors did not maintain detailed rate schedules. Until the two-year statute of limitations expires, Midcom could be held liable for damages for its failure to maintain detailed rate schedules, although it believes that such an outcome is highly unlikely and would not have a material adverse effect on it. Pursuant to authority granted to it in the 1996 Telecommunications Act, the FCC is considering "mandatory detariffing" for domestic non-dominant carriers. This proposal (which has been stayed by an order of the federal district court in Washington, D.C.) would relieve the Company of its obligation to file tariffs applicable to its domestic interexchange offerings.

State

The intrastate long distance operations of Midcom are also subject to various state laws. The majority of states require certification or registration, which the Company has secured in 47 states and Washington, D.C. Many states require tariff filings as well.

In certain states, approval for transfers of control and acquisitions of customer bases must be obtained. Midcom has been successful in obtaining all necessary regulatory approvals to date, although revisions of tariffs, authorities and approvals are being made on a continuing basis, and many such requests are pending at any one time.

Some states may assess penalties on long distance service providers for traffic sold prior to tariff approval or the state's consent to an acquisition. Such states may require refunds to be made to customers. It is the opinion of management that such penalties and refunds, if any, would not have a material adverse effect on the results of operations or financial condition of the Company.

MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

DISPUTES AND LITIGATION

Class Action Lawsuit. The Company, its Vice Chairman of the Board of Directors and largest shareholder, the Company's former President, Chief Executive Officer and director, and the Company's former Chief Financial Officer are named as defendants in a securities action, filed in the U.S. District Court for the Western District of Washington (the "Complaint"). The Complaint was filed on behalf of a class of purchasers of the Company's Common Stock during the period beginning on July 6, 1995, the date of the Company's initial public offering, and ending on March 4, 1996 (the "Class Period"). An amended complaint (the "Amended Complaint") was filed on July 8, 1996. In November 1996, the Court granted the defendants' motion to dismiss the amended Complaint. The Amended Complaint alleges, among other things, that the registration statement and prospectus relating to the Company's initial public offering contained false and misleading statements concerning the Company's billing software and financial condition. The Amended Complaint further alleges that, throughout the Class Period, the defendants inflated the price of the Common Stock by intentionally or recklessly making material misrepresentations or omissions which deceived the public about the Company's financial condition and prospects. The Amended Complaint alleges claims under the Securities Act and the Exchange Act as well as various state laws, and seeks damages in an unstated amount. Defendants filed a motion to dismiss on August 7, 1996 and filed a reply to plaintiffs' opposition on September 18, 1996. Oral arguments were heard on November 1, 1996. All discovery proceedings are stayed until defendants' motion to dismiss is acted on by the Court. While the Company believes that it has substantive defenses to the claims in the Amended Complaint and intends to vigorously defend this lawsuit, it is unable to predict the outcome of this action.

SEC Investigation. The Company was informed in May 1996 that the SEC was conducting an informal inquiry regarding the Company. The Company has voluntarily provided the documents requested by the Commission. In addition, the SEC has requested the Company's cooperation in interviewing certain current and former Company personnel and the Company is in the process of scheduling such interviews. However, the Company has not been informed whether or not the SEC intends to commence a formal action against the Company or any of its affiliates. The Company is, therefore, unable to predict the ultimate outcome of the investigation. In the event that the SEC elects to initiate a formal enforcement proceeding, the Company and certain of its current and/or former officers could be subject to civil or criminal sanctions including monetary penalties and injunctive measures. Any such enforcement proceeding could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company is also party to other routine litigation incident to its business and to which its property is subject. The Company's management believes the ultimate resolution of these matters will not have a material adverse effect on the Company's business, financial condition or results of operations.

MIDCOM COMMUNICATIONS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (CONTINUED)

16. SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION

	1996	1995	1994
Noncash investing and financing activities:			
Application of related-party accounts receivable to related-party accounts payable.....	\$--	\$--	\$1,234
Conversion of amounts due to related parties to redeemable preferred stock.....	--	--	8,597
Issuance of notes payable and assumption of liabilities for acquisitions of customer bases.....	459	42,591	5,151
Capital lease obligation for equipment.....	--	1,892	2,207
Issuance of notes payable for equipment.....	--	310	--
Issuance of common stock warrants in connection with financing.....	--	--	3,500
Issuance of common stock for acquisitions.....	513	9,877	1,040
Issuance of note payable for settlement of carrier accounts payable.....	3,800	3,590	--
Cash paid for interest.....	5,074	4,128	1,453
Cash paid for income taxes.....	--	25	131

17. RESTRUCTURING CHARGE

In March and April 1996, the Company made announcements regarding changes in senior management and the restructuring of its operations in order to reduce expenses to the level of available capital. These actions included the layoff of certain employees and contractors and the closure of 6 sales offices. As a result, the Company recorded a charge of \$1,620 during the first quarter 1996 and \$600 during the second quarter of 1996, the components of which relate primarily to severance and lease cancellation charges. Included in the first quarter restructuring charge is approximately \$420 relating to the extension of the time period to exercise outstanding stock options. As of December 31, 1996, \$807 of this restructuring charge remained in accrued liabilities.

18. SUBSEQUENT EVENTS

In February 1997, the Company entered into an agreement with Foothill Capital Corporation for a revolving credit facility. Under the terms of the agreement, the Company will be able to borrow up to \$30,000, subject to a borrowing base limitation of 85% of eligible billed and 75% of eligible unbilled receivables. Borrowings under this agreement will bear interest at a prime rate, plus one percent, and will be secured by substantially all of the assets of the Company. Pursuant to the agreement, the Company is required to maintain minimum levels of adjusted net worth and is subject to a number of negative covenants which place limitations on, among other things, capital expenditures, investments and additional debt. Other covenants preclude payment of cash dividends and require the Company to obtain the lenders' consent prior to making any acquisitions. Borrowings under the agreement will not be available until satisfaction of a number of conditions, consisting primarily of final documentation of security arrangements, which is expected to occur by May 1997.

On February 18, 1997, the Company announced that it had awarded a supply agreement to Northern Telecom ("Nortel") for the acquisition of a total of six DMS-250 and DMS-500 local/long distance switching systems. Scheduled for completion by mid-1997, the network will handle local, long distance and value added services. The Company also announced that it had entered into a master lease agreement with Comdisco, Inc. ("Comdisco"), to provide financing for the Nortel switches. The initial financing is approximately \$13,000. In March 1997, a warrant for the purchase of up to 117,000 shares of the Company's common stock was granted to Comdisco in connection with this financing arrangement.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

See "Item 1. Business -- Directors and Executive Officers of the Registrant."

Information concerning compliance with Section 16 of the Securities Exchange Act is incorporated herein by reference to information appearing in the Company's Proxy Statement for its 1997 annual meeting of shareholders to be held on June 12, 1997, which information appears under the caption "Compliance with Section 16(a) of the Exchange Act." Such Proxy Statement will be filed by April 30, 1997.

ITEMS 11, 12 AND 13.

The information called for by Part III (Items 11, 12 and 13) is included in the Company's Proxy Statement relating to the Company's 1997 annual meeting of shareholders to be held on June 12, 1997 and is incorporated herein by reference. The information appears in the Proxy Statement under the captions "Executive Compensation," "Voting Securities and Principal Holders," and "Certain Transactions." Such Proxy Statement will be filed by April 30, 1997.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K.

(a) The following documents are filed as part of this Report:

1. Management Contracts or Compensatory Plans or Arrangements

The following list is a subset of exhibits described below and contains all compensatory plans, contracts or arrangements in which any director or executive officer of the Company is a participant, unless the method of allocation of benefits thereunder is the same for management and non-management participants:

- (a) Revised and Restated 1993 Stock Option Plan. See Exhibit 10.25.
- (b) Amended and Restated 1995 Employee Stock Purchase Plan. See Exhibit 10.26.
- (c) Employment Agreement, dated May 24, 1996, between the Company and William H. Oberlin. See Exhibit 10.109.
- (d) Consulting Agreement, dated May 24, 1996, between the Company and John M. Zrno. See Exhibit 10.110.
- (e) Consulting Agreement, dated May 24, 1996, between the Company and Marvin C. Moses. See Exhibit 10.111.

2. Financial Statements

Report of Ernst & Young LLP, Independent Auditors	51
Consolidated Balance Sheets as of December 31, 1996 and 1995	52
Consolidated Statements of Operations for the years ended December 31, 1996, 1995 and 1994	53
Consolidated Statements of Shareholders' Equity (Deficit) for the years ended December 31, 1996, 1995 and 1994	54
Consolidated Statements of Cash Flows for the years ended December 31, 1996, 1994 and 1993	55
Notes to Consolidated Financial Statements	56

3. Financial Statement Schedules

Schedule II -- Valuation and Qualifying Accounts	79
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All other schedules have been omitted because the required information is included in the financial statements or the notes thereto, or is not applicable or required.

4. Exhibits Filed as Part of This Report

EXHIBIT NUMBER (REFERENCED TO ITEM 60) OF REGULATION S-K)

EXHIBIT DESCRIPTION

3.1	--	Amended and Restated Articles of Incorporation (6)
3.2	--	Bylaws (1)
4.1	--	Form of Common Stock Certificate (1)
4.2	--	See Exhibits numbered 3.1 and 3.2 for provisions of the Amended and Restated Articles of Incorporation and the Bylaws of the Company defining the rights of the holders of Common Stock
4.3	--	Purchase Agreement, dated August 15, 1996, among the Company, PaineWebber Incorporated and Wheat, First Securities, Inc (7)
4.4	--	Indenture, dated as of August 22, 1996, between the Company and IBI Schroder Bank & Trust Company (7)
4.5	--	Registration Rights Agreement, dated as of August 22, 1996, by and among the Company, PaineWebber Incorporated and Wheat, First Securities, Inc (7)
10.1	--	Senior Subordinated Note and Warrant Purchase Agreement, dated as of June 10, 1994, by and among the Company, First Union Corporation and The Robinson-Humphrey Company, Inc (1)
10.6	--	Warrant Agreement, dated as of June 10, 1996, by and among the Company, First Union Corporation and The Robinson-Humphrey Company, Inc (1)
10.7	--	Registration Rights Agreement, dated as of June 10, 1994, by and among the Company, First Union Corporation and The Robinson-Humphrey Company, Inc (1)
10.17	--	Agreement of Formation and Activities of Russian-American Joint Stock Venture "Dal Telekom International," dated as of December 5, 1993, by and among the Company, DalREO, the joint stock company Rostelekom and the state enterprise Rossvyazinform in the cities of Khabarovsk, Blagoveschensk and Petropavlovsk-Kamchatski, as amended, Addendum to Agreement Regarding Reorganization of Dal Telecom International, dated as of December 5, 1993, by and between the Company and DalREO, Amendment to the Agreement on the Joint Venture between the Company and DalREO, dated July 13, 1994; Second Amendment to the Agreement on the Joint Venture between the Company and DalREO, dated September 19, 1994; Proxy with regard to Voting of Shares of Dal Telekom International, dated December 5, 1993 (1)

EXHIBIT
NUMBER
(REFERENCED TO
ITEM 601 OF
REGULATION
S-K)

EXHIBIT
DESCRIPTION

10.21	--	Shareholders Agreement, dated as of June 7, 1994, by and among Paul Pfeleger, Ashok Rao, the trust for the benefit of Siddhartha Rao, the trust for the benefit of Kavita Rao, the trust for the benefit of Divya Rao, the trust for the benefit of Anjali Rao, John M. Orehek, and the Company (1)
10.23	--	Registration Rights Agreement, dated as of December 30, 1994, by and between the Company and Richard W. Stroup (1)
10.25	--	Revised and Restated 1993 Stock Option Plan, adopted by the Board of Directors on December 30, 1993 and the shareholders on December 29, 1993, as amended by the Board of Directors on February 21, 1994, March 28, 1994, January 19, 1995 and March 21, 1995, such amendments being approved by the shareholders on October 7, 1994 and March 30, 1995, and further amended by the Board of Directors on April 25, 1995, July 26, 1995, November 9, 1995, July 25, 1996 and January 9, 1997 (7)
*10.26	--	Amended and Restated 1995 Employee Stock Purchase Plan adopted by the Board of Directors and the shareholders on December 9, 1994 as amended by the Board of Directors on December 13, 1995, December 18, 1996 and March 13, 1997. Exhibit replaces identically numbered exhibit to the Company's Registration Statement on Form S-1, file no. 33-90814.
10.27	--	Employment Agreement, dated as of June 7, 1994, by and between the Company and Ashok Rao (1)
10.30	--	Reseller Service Agreement, dated as of December 31, 1992, by and between West Coast Telecommunications, Inc. and the Company (1)
10.34	--	Software License and Services Agreement, dated as of October 26, 1993, by and between ORACLE Corporation and the Company (1)
10.35	--	Service Agreement, as amended, dated as of February 7, 1995, by and between the Company and ORACLE Corporation (1)
10.36	--	One Plus Billing and Information Management Services Volume Purchase Agreement, dated March 4, 1995, by and between Zero Plus Dialing, Inc. d/b/a U.S. Billing and the Company (1)
10.42	--	Distributor Agreement, dated as of December 28, 1993, by and between the Company and Quest America L.P. Portions of this exhibit have been omitted pursuant to an application for an order granting confidential treatment, which order was granted by the Commission on July 6, 1995. The omitted portions have been separately filed with the Commission (1)
10.50	--	Agreement and Plan of Reorganization, dated as of November 8, 1994, by and among the Company, P.N. Acquisition Corporation, PacNet, Inc. and Richard W. Stroup (1)
10.51	--	Agreement for the purchase of Mid-Com Consultants' Aggregation Customer Base and Aggregation Plans by Mid-Com Communications, Inc., dated as of January 3, 1995, by and between the Company and Mid-Com Consultants, Inc. (1)
10.52	--	Asset Purchase Agreement, dated as of January 20, 1995, by and between the Company and Communique Telecommunications, Inc. (1)
10.60	--	1111 Third Avenue Lease Agreement, dated as of March 8, 1994 (1)
10.61	--	Agreement of Sublease, dated January 1, 1994, by and between Bank of New Zealand and the Company (1)
10.62	--	Real Estate Sub-Lease, dated as of October 1, 1994, by and between Digital Telecommunications, Inc. and the Company (1)
10.66	--	Option Agreement, dated March 6, 1995, by and among Paul H. Pfeleger, Ashok Rao, John M. Orehek and the Company (1)

EXHIBIT
NUMBER
(REFERENCED TO
ITEM 601 OF
REGULATION
S-K)

EXHIBIT
DESCRIPTION

10.67	--	Release and Settlement Agreement, dated January 1995. Portions of this exhibit have been omitted pursuant to an application for an order granting confidential treatment, which order was granted by the Commission on July 6, 1995. The omitted portions have been separately filed with the Commission (1)
10.73	--	Overseas Private Investment Corporation Contract of Insurance against Business Income Loss (1)
10.74	--	Overseas Private Investment Corporation Contract of Insurance against Expropriation/Political Violence (1)
10.75	--	Letter Agreement, dated May 12, 1995, between First Union Corporation and the Company (1)
10.78	--	Registration Rights Agreement, dated as of April 1, 1995, by and among the Company and Darren Narans, Kevin Narans and Steven Tomsic (1)
10.79	--	Stock Purchase Warrant issued on April 1, 1995 by the Company to Darren Narans granting Darren Narans the right to purchase from the Company 12,250 shares of the Company's Common Stock (1)
10.80	--	Stock Purchase Warrant issued on April 1, 1995 by the Company to Kevin Narans granting Kevin Narans the right to purchase from the Company 23,625 shares of the Company's Common Stock (1)
10.81	--	Stock Purchase Warrant issued on April 1, 1995 by the Company to Steven Tomsic granting Steven Tomsic the right to purchase from the Company 23,625 shares of the Company's Common Stock (1)
10.83	--	Letter Agreement, dated June 6, 1995, between First Union Corporation, The Robinson-Humphrey Company, Inc. and the Company (1)
10.86	--	Carrier Transport Switched Services Agreement, dated June 14, 1995 and amended November 1, 1995 by and between Sprint Communications Company L.P. and the Company. Portions of this exhibit have been omitted pursuant to an application for an order granting confidential treatment, which order was granted by the Commission on May 31, 1996. The omitted portions have been separately filed with the Commission (6)
10.87	--	Telecommunications Services Agreement, dated March 27, 1996, by and between Worldcom Network Service, Inc. d/b/a WilTel and the Company. Portions of this exhibit have been omitted pursuant to an application for an order granting confidential treatment, which order was granted by the Commission on May 31, 1996. The omitted portions have been separately filed with the Commission (6)
10.88	--	Customer Base Purchase and Sale Agreement, dated as of September 1, 1995, between Cherry Communications Incorporated and the Company (2)
10.89	--	Master Equipment Lease Agreement, dated as of September 12, 1995, between Keycorp Leasing Ltd. and the Company (3)
10.90	--	Agreement and Plan of Reorganization, dated as of September 29, 1995, among the Company, AV Acquisition Corporation, AdVal, Inc., AdVal Data Corporation, Theodore D. Berns and Donald D. Dean (4)
10.91	--	Credit Agreement, dated as of November 8, 1995, among the Company, PacNet, AdVal, Cel-Tech (the "Borrowers") and Transamerica Business Credit Corporation, as agent (6)
10.92	--	Revolving Note, dated December 20, 1995, in the amount of \$30,000,000 made by the Borrowers to the order of Transamerica Business Credit Corporation (6)
10.94	--	Revolving Note, dated December 20, 1995, in the amount of \$13,000,000 made by the Borrowers to the order of Nationsbank of Georgia, N.A. (6)
10.95	--	Stock Pledge Agreement, dated as of November 8, 1995, made by the Company in favor of Transamerica Business Credit Corporation, as agent (6)

EXHIBIT
NUMBER
(REFERENCED TO
ITEM 601 OF
REGULATION
S-K)

EXHIBIT
DESCRIPTION

10.96	--	Security Agreement, dated as of November 8, 1995, made by the Borrowers in favor of Transamerica Business Credit Corporation, as agent (6)
10.97	--	Letter Agreement, dated March 6, 1996, between the Borrowers and Transamerica Business Credit Corporation, as agent (6)
10.98	--	Letter Agreement, dated March 18, 1996, between the Borrowers and Transamerica Business Credit Corporation, as agent (6)
10.99	--	First Amendment to Credit Agreement, dated March 28, 1996, between the Borrowers and Transamerica Business Credit Corporation, as agent (6)
10.100	--	Promissory Note, dated March 28, 1996, in the amount of \$15,000,000 made by the Company to the order of Transamerica Business Credit Corporation (6)
10.103	--	Agreement and Plan of Reorganization, dated December 29, 1995, among the Company, ADNET Telemanagement, Inc., David Wiegand and Maria Wiegand (5)
10.104	--	Contract Tariff No. 969 effective February 15, 1996 between the Company and AT&T Corp (6)
10.105	--	Second Amendment to Credit Agreement, dated July 26, 1996, among the Company, PacNet, AdVal, Cel-Tech, Advanced Network Design and Transamerica Business Credit Corporation, as agent (9)
10.106	--	Third Amendment to Credit Agreement, dated August 21, 1996, between the Company, PacNet, AdVal, Cel-Tech and Advanced Network Design and Transamerica Business Credit Corporation (10)
10.107	--	Customer Base Purchase and Sale Agreement, dated as of November 1, 1995, between Cherry Communications Incorporated (8)
10.108	--	Distributor Agreement, dated April 4, 1996, between the Company and Tie Communications, Inc (11)
10.109	--	Employment Agreement, dated May 24, 1996, between the Company and William H. Oberlin (12)
10.110	--	Consulting Agreement, dated May 24, 1996, between the Company and John M. Zrno (13)
10.111	--	Consulting Agreement, dated May 24, 1996, between the Company and Marvin C. Moses (14)
10.113	--	Settlement Agreement and Release, dated as of December 27, 1996, among David Wiegand, Maria Wiegand and the Company (7)
10.114	--	Consulting Agreement, dated as of November 25, 1996, between the Company and David Wiegand (7)
10.115	--	Stock Option Agreement, dated as of November 25, 1996, between the Company and David Wiegand (7)
10.116	--	Amendment to Agreement and Plan of Reorganization, dated as of December 27, 1995, among the Company, David Wiegand and Maria Wiegand, amending the Agreement and Plan of Reorganization dated December 29, 1995 among the Company, ADNET Telemanagement, Inc. and David Wiegand (7)
10.117	--	Amendments to Non-Competition Agreements of Maria Wiegand and David Wiegand, dated as of December 27, 1996, among the Company, Maria Wiegand and David Wiegand. Portions of this exhibit have been omitted pursuant to an amended application for an order granting confidential treatment. The omitted portions have been separately filed with the Commission (7)

EXHIBIT
NUMBER
(REFERENCED TO
ITEM 601 OF
REGULATION
S-K)

EXHIBIT
DESCRIPTION

10.118	--	Release and Settlement Agreement, dated October 31, 1996, between the Company and AT&T Corp. Portions of this exhibit have been omitted pursuant to an amended application for an order granting confidential treatment. The omitted portions have been separately filed with the Commission.(7)
10.119	--	Carrier Agreement, dated October 31, 1996, between the Company and AT&T Corp. Portions of this exhibit have been omitted pursuant to an amended application for an order granting confidential treatment. The omitted portions have been separately filed with the Commission.(7)
*11.1	--	Statement re: computation of net loss per share.
21.1	--	List of significant subsidiaries of the Company.(6)
*23.1	--	Consent of Ernst & Young LLP, Independent Auditors.
*27.1	--	Financial Data Schedule
• Exhibit is filed herewith.		

(1) Exhibit is incorporated by reference to an identically numbered exhibit to the Company's Registration Statement on Form S-1, file no. 33-90814.

(2) Exhibit is incorporated by reference to Exhibit 2.3 filed with the Company's Current Report on Form 8-K filed with the Commission on December 18, 1995.

(3) Exhibit is incorporated by reference to Exhibit 10.1 filed with the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1995.

(4) Exhibit is incorporated by reference to Exhibit 2.1 filed with the Company's Current Report on Form 8-K filed with the Commission on October 13, 1995.

(5) Exhibit is incorporated by reference to Exhibit 2.1 filed with the Company's Current Report on Form 8-K filed with the Commission on January 11, 1996.

(6) Exhibit is incorporated by reference to an identically numbered exhibit filed with the Company's Annual Report on Form 10-K for the year ended December 31, 1995.

(7) Exhibit is incorporated by reference to an identically numbered exhibit to the Company's Registration Statement on Form S-1, file no. 333-14427.

(8) Exhibit is incorporated by reference to Exhibit 2.4 filed with the Company's Current Report on Form 8-K filed with the Commission on December 18, 1995.

(9) Exhibit is incorporated by reference to Exhibit 10.1 filed with the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.

(10) Exhibit is incorporated by reference to Exhibit 10.2 filed with the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.

(11) Exhibit is incorporated by reference to Exhibit 10.3 filed with the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.

(12) Exhibit is incorporated by reference to Exhibit 10.4 filed with the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.

(13) Exhibit is incorporated by reference to Exhibit 10.5 filed with the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.

(14) Exhibit is incorporated by reference to Exhibit 10.6 filed with the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.

(b) No Current Reports on Form 8-K were filed by the Company during the fourth quarter of 1996.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized

MIDCOM COMMUNICATIONS INC.

Dated: March 25, 1997

By: /s/ ROBERT J. CHAMBERLAIN

Robert J. Chamberlain
Executive Vice President and
Chief Financial Officer

Pursuant to the requirements of the Securities Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

<u>SIGNATURE</u>	<u>TITLE</u>	<u>DATE</u>
By: <u>/s/ WILLIAM H. OBERLIN</u> William H. Oberlin	President, Chief Executive Officer and Director (Principal Executive Officer)	March 25, 1997
By: <u>/s/ ROBERT J. CHAMBERLAIN</u> Robert J. Chamberlain	Executive Vice President and Chief Financial Officer (Principal Accounting and Financial Officer)	March 25, 1997
By: <u>/s/ JOHN M. ZRNO</u> John M. Zrno	Director	March 25, 1997
By: <u>/s/ PAUL H. PFLEGER</u> Paul H. Pfleger	Director	March 25, 1997
By: <u>/s/ JOHN M. OREHEK</u> John M. Orehek	Director	March 25, 1997
By: <u>/s/ SCOTT B. PERPER</u> Scott B. Perper	Director	March 25, 1997
By: <u>/s/ KARL D. GUELICH</u> Karl D. Guelich	Director	March 25, 1997
By: <u>/s/ MARVIN C. MOSES</u> Marvin C. Moses	Director	March 25, 1996
By: <u>/s/ DANIEL M. DENNIS</u> Daniel M. Dennis	Director	March 25, 1996

**SCHEDULE II: VALUATION AND QUALIFYING ACCOUNTS
(IN THOUSANDS)**

<u>DESCRIPTION</u>	<u>BALANCE AT BEGINNING OF PERIOD</u>	<u>CHARGED TO COSTS AND EXPENSES</u>	<u>CHARGED TO OTHER ACCOUNTS -- DESCRIBE</u>	<u>DEDUCTIONS -- DESCRIBE</u>	<u>BALANCE AT END OF PERIOD</u>
Year Ended December 31, 1994					
Valuation accounts deducted from assets:					
Allowance for doubtful accounts	\$1,167	\$1,505	\$1,948(1)	\$(1,748)(3)	\$2,872
Year Ended December 31, 1995					
Valuation accounts deducted from assets:			\$2,832(1)		
Allowance for doubtful accounts	\$2,872	\$9,874	\$4,406(2)	\$(9,403)(3)	\$10,581
Year Ended December 31, 1996					
Valuation accounts deducted from assets:					
Allowance for doubtful accounts	\$10,581	\$9,781	\$1,217	\$(13,777)(3)	\$7,802

(1) Reserves associated with business and customer base acquisitions.

(2) Primarily charged against revenue.

(3) Written off, net of recoveries.

SECURITIES AND EXCHANGE COMMISSION

EXHIBITS
TO
FORM 10-K

MIDCOM COMMUNICATIONS INC.

MIDCOM COMMUNICATIONS INC.

INDEX TO EXHIBITS

SEQUENTIALLY
NUMBERED
PAGINATION

EXHIBIT
NUMBER

IDENTIFICATION OF EXHIBITS

10.26	Amended and Restated 1995 Employee Stock Purchase Plan adopted by the Board of Directors and the Shareholders on December 9, 1994, as amended by the Board of Directors on December 13, 1995, December 18, 1996 and March 13, 1997. Exhibit replaces identically numbered exhibit to the Company's Registration Statement on Form S-1, file no. 33-90814.
11.1	Statement re: computation of net loss per share.
22.1	Consent of Ernst & Young LLP, Independent Auditors.
27.1	Financial Data Schedule.

MIDCOM COMMUNICATIONS INC.

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K/A
(AMENDMENT NO. 1)

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended DECEMBER 31, 1996

or

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

Commission file number 000-26118

MIDCOM COMMUNICATIONS INC.

(Exact name of registrant as specified in its charter)

WASHINGTON	91-1438806
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

MIDCOM TOWER
1111 THIRD AVENUE
SEATTLE, WASHINGTON 98101

(206) 628-8000

(Address, including zip code, and telephone number, including area code of
principal executive offices)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:
NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:
COMMON STOCK, PAR VALUE \$0.0001 (SYMBOL: "MCCI")

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (229.405 of this chapter) 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. ☐

As of April 28, 1997, the aggregate market value of the Registrant's Common Stock held by nonaffiliates of the Registrant was \$69,332,410 based on the closing sales price of the Registrant's Common Stock on the Nasdaq National Market.

As of April 28, 1997, the number of shares of the Registrant's Common Stock outstanding was 15,224,921.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

See "Directors and Executive Officers of the Registrant" under Item 1 - Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 1996.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), requires the Company's directors, certain officers and persons who own more than ten percent (10%) of the Company's outstanding Common Stock ("Reporting Persons") to file with the Securities and Exchange Commission (the "Commission") initial reports of ownership and reports of changes in ownership of Common Stock and other equity securities of the Company. Reporting Persons are required by Commission regulations to furnish the Company with copies of all Section 16(a) reports.

To the Company's knowledge, based solely on its review of copies of all such reports furnished to the Company and written representations that no other reports were required, all Section 16(a) filing requirements applicable to its officers and directors were complied with except that Messrs. Moses, Oberlin and Zmo failed to report on a timely basis on Form 4 their purchases of the Company's 8 1/4% Convertible Subordinated Notes due 2003 from the Company, and Messrs. Pfeleger, Guelich and Orehek failed to report on a timely basis on Form 4 grants of options received under the Company's Amended and Restated 1993 Stock Option Plan (the "1993 Stock Option Plan").

ITEM 11. EXECUTIVE COMPENSATION.

EXECUTIVE COMPENSATION

The following table shows compensation paid by the Company for services rendered during its fiscal years ended December 31, 1994, 1995 and 1996 to (a) all individuals serving as the Company's Chief Executive Officer during the fiscal year ended December 31, 1996, (b) the four most highly compensated individuals (other than any individual described under item (a) above) who were serving as executive officers of the Company at December 31, 1996 and whose total annual salary and bonus for the fiscal year ended December 31, 1996 exceeded \$100,000, and (c) two additional individuals who would have been included under item (b) above but for the fact that the individual was not serving as an executive officer of the Company at December 31, 1996 (collectively, the "Named Executive Officers")

SUMMARY ANNUAL COMPENSATION TABLE

NAME AND PRINCIPAL POSITION	YEAR ENDED DECEMBER 31	SALARY	BONUS	LONG-TERM COMPENSATION AWARDS	ALL OTHER COMPENSATION(2)
				SECURITIES UNDERLYING OPTIONS(1)	
William H. Oberlin(3) President and Chief Executive Officer	1996	\$182,531	\$--	1,214,724	\$6,343
Ashok Rao(4) President and Chief Executive Officer	1996	142,143	--	--	154,886
	1995	292,500	--	3,000	7,830
	1994	300,000	--	278,775	3,762
Robert N. Nitschke(5) Executive Vice President, Operations	1996	147,270	--	25,000	17,218
	1995	33,987	--	50,000	125
Robert J. Chamberlain(6) Executive Vice President, Chief Financial Officer, Treasurer and Asst. Secretary	1996	84,344	--	75,000	37,379
Jay T. Caldwell(7) Senior Vice President, Revenue Management	1996	98,781	81,612	--	3,157
	1995	97,500	--	15,750	3,207
	1994	100,000	--	5,478	17,289
Eric G. Peterson(8) Executive Vice President and Treasurer	1996	118,036	--	--	13,959
	1995	117,000	--	1,000	4,105
	1994	118,667	--	1,663	4,521

(1) The 1994 amounts include immediately exercisable options granted in March 1995 in lieu of cash bonuses for 1994 to Messrs. Rao, Caldwell and Peterson of 18,375, 1,663 and 1,103 shares of Common Stock, respectively. These options are exercisable at \$2.29 per share and expire on the tenth anniversary of the date of grant.

(2) Unless otherwise noted, amounts included under other compensation are for payments under the Company's 401(k) Plan and payments for term life insurance premiums.

(3) Mr. Oberlin joined the Company in May 1996 and was paid during 1996 at an annual rate of \$300,000.

- (4) Mr. Rao resigned as an officer of the Company in April 1996. Included in other compensation for 1996 are severance payments of \$151,015.
- (5) Included in other compensation for 1996 is a reimbursement of \$13,643 for relocation and moving expenses.
- (6) Mr. Chamberlain joined the Company in April 1996 and was paid during 1996 at an annual rate of \$120,000. Included in other compensation for 1996 are consulting payments of \$34,896.
- (7) Mr. Caldwell resigned as an officer of the Company in April 1997. The bonus paid in 1996 for performance in 1995 consisted of a one-time payment in an amount determined by the Company's board of directors, in its discretion. Included in other compensation for 1996 is a reimbursement of \$15,000 for relocation and moving expenses.
- (8) Mr. Peterson resigned as an officer of the Company in May 1996. Included in other compensation for 1996 are severance payments of \$10,000.

STOCK OPTION GRANTS

The following table sets forth further information regarding grants of options to purchase Common Stock made by the Company pursuant to the Company's 1993 Stock Option Plan during the fiscal year ended December 31, 1996 to each of the Named Executive Officers.

OPTION GRANTS IN 1996

NAME	NUMBER OF SECURITIES UNDERLYING OPTIONS GRANTED ⁽¹⁾	PERCENT OF TOTAL OPTIONS GRANTED TO EMPLOYEES IN 1996	EXERCISE PRICE PER SHARE (\$/SH ⁽²⁾)	MARKET PRICE ON DATE OF GRANT ⁽³⁾	EXPIRATION DATE	POTENTIAL REALIZABLE VALUE AT ASSUMED ANNUAL RATES OF STOCK PRICE APPRECIATION FOR OPTION TERM ⁽⁴⁾		
						0% ⁽⁵⁾	5% ⁽⁵⁾	10% ⁽⁵⁾
William H. Oberlin	1,214,724	36.92%	\$8.00	\$8.00	05/25/06	\$--	\$6,111,467	\$15,487,658
Jay T. Caldwell	--	--	--	--	--	--	--	--
Robert J. Chamberlain	5,000	0.15%	7.00	8.00	04/23/06	5,000	30,156	68,750
	70,000	2.13%	8.00	14.25	06/07/06	437,500	1,064,822	2,027,258
Robert L. Nitschke	25,000	0.76%	12.00	12.00	10/29/06	--	188,668	478,123

(1) Generally under the Company's 1993 Stock Option Plan, twenty percent of the options vest for each full year that the optionee renders services to the Company after the date of grant. The option for the purchase of 5,000 shares granted to Mr. Chamberlain was fully vested at the time of grant. The vesting of options may be accelerated at the discretion of the administrator of the 1993 Stock Option Plan and will accelerate upon the occurrence of certain events resulting in a change in control of the Company. See "1993 Stock Option Plan."

- (2) The exercise price may be paid by delivery of already owned shares, subject to certain conditions.
- (3) The fair market value of the underlying Common Stock on the date of grant is determined by the Board of Directors in accordance with the terms of the 1993 Stock Option Plan.
- (4) Potential realizable value is based on the assumption that the fair market value of the Common Stock appreciates at the annual rate shown (compounded annually) from the date of grant until the end of the option term. Disclosure of these assumed rates of appreciation are mandated by the rules of the Commission and do not

represent the Company's estimate or projection of future Common Stock prices. The actual value realized may be greater or less than the potential realizable value set forth in the table.

The following table sets forth certain information as of December 31, 1996 regarding options to purchase Common Stock held as of December 31, 1996 by each of the Named Executive Officers as well as the exercise of such options during the fiscal year ended December 31, 1996. In addition, the following table reports the values for in-the-money options, which values represent the positive spread between the exercise price of such options and the fair market value of the Company's Common Stock as of December 31, 1996.

AGGREGATED 1996 YEAR-END OPTIONS

	SHARES ACQUIRED ON EXERCISE(1)	VALUE REALIZED(2)	NUMBER OF SHARES UNDERLYING UNEXERCISED OPTIONS AT DECEMBER 31, 1996(3)		VALUE OF UNEXERCISED IN-THE-MONEY OPTIONS AT DECEMBER 31, 1996(4)(5)	
			EXERCISABLE	UNEXERCISABLE(1)	EXERCISABLE	UNEXERCISABLE
William H. Oberlin	--	\$--	--	1,214,724	\$--	\$607,362
Ashok Rao(3)	122,535	891,151	--	--	--	--
Robert N. Nitschke	--	--	10,000	65,000	--	--
Robert J. Chamberlain	--	--	5,000	70,000	7,500	35,000
Jay T. Caldwell(3)	--	--	19,928	18,800	59,306	18,506
Eric G. Peterson(3)	89,165	965,200	1,000	--	--	--

(1) Future ability to exercise is subject to vesting and the optionee remaining employed by the Company.

(2) Calculated on the basis of the closing price of the Company's Common Stock on December 31, 1996, which was \$8.50, less the exercise price. There is no guarantee that if and when these options are exercised they will have this value.

(3) Messrs. Rao and Peterson resigned during April and May 1996, respectively. Mr. Caldwell resigned effective April 1997.

DIRECTOR COMPENSATION

At the time of the Company's initial public offering on July 6, 1995, the 1993 Stock Option Plan provided for the automatic grant of a Nonqualified Option (as defined herein) to purchase 8,750 shares of Common Stock to all non-employee directors of the Company (with certain exclusions that were eliminated as of November 1995) upon their election to the Board of Directors, and an additional option to purchase 4,375 shares of Common Stock each subsequent year, both at a price equal to the fair market value of the Company's Common Stock on the date of grant. Such options vest at a rate of fifty percent (50%) per year and expire ten years after the date of grant. On July 25, 1996, the Board approved an amendment to the 1993 Stock Option Plan to revise the provisions relating to automatic grants of options to purchase shares of the Company's Common Stock to all non-employee directors. Pursuant to the 1993 Stock Option Plan, as amended, non-employee directors are each granted a Nonqualified Option to purchase 50,000 shares of Common Stock upon initial election to the Board of Directors at an exercise price equal to the fair market value of the Common Stock on the date of the grant. Such options vest at a rate of twenty percent (20%) per year and expire ten years after the date of grant. The July 1996 Board action also provided for the grant to each non-employee director then serving on the Board of an option to purchase shares of Common Stock equal to 50,000 minus the number of shares subject to options granted to each non-employee director under the 1993 Stock Option Plan prior to its amendment. The vesting schedule of these additional option grants began on November 9, 1995 with respect to Messrs. Pfeiffer, Orehek, and Perper and on the date of election to the Board for all other non-employee directors at a rate of twenty percent (20%) per year. These options were granted subject to approval by shareholders of an increase in shares available for purchase under the 1993 Stock Option Plan, which approval was obtained at the annual meeting of the Company's shareholders held in October 1996.

EMPLOYMENT AGREEMENT

Effective May 1996, the Company entered into an employment agreement with William H. Oberlin, the Company's President and Chief Executive Officer. The agreement provides for a monthly base salary of \$25,000 per month as well as certain other compensation, subject to annual review by the Board of Directors. In addition, the agreement requires that, on or before August 30, 1996, the Board of Directors formulate and adopt a bonus plan for the year ending December 31, 1996. See "-- Report of the Compensation Committee on Annual Compensation -- President and Chief Executive Officer Compensation." In connection with entering into the agreement, the Company has granted Mr. Oberlin options to purchase 1,214,724 shares of Common Stock pursuant to the 1993 Stock Option Plan. The options vest ratably over a five-year period, with the first twenty percent (20%) installment vesting in May 1997, and are exercisable for \$8.00 per share. In the event that Mr. Oberlin's employment is terminated by the Board of Directors "without cause," or if Mr. Oberlin voluntarily resigns within 180 days of a "change of control" of the Company (as such terms are defined in the agreement), Mr. Oberlin is entitled to two years severance. In the event that Mr. Oberlin's employment is terminated by mutual agreement or if Mr. Oberlin voluntarily resigns under certain limited circumstances, Mr. Oberlin is entitled to 12 months severance. Severance equals the sum of (i) the annualized base salary at the time of termination, and (ii) either the average annual bonuses for the fiscal years preceding termination or, if no bonuses have been established or paid for such period, the annualized base salary at the time of termination. Severance is payable in equal monthly installments, without interest, commencing on the last day of the month of termination. In the event that Mr. Oberlin is entitled to severance, he will continue to receive medical, life, disability and group term life insurance benefits (or the cash equivalent thereof), and options granted to him under the 1993 Stock Option Plan will continue to vest, during the applicable severance period as if his employment had not been terminated. In the event of Mr. Oberlin's death, vesting of options otherwise vesting over the two-year period following his death will be accelerated. The agreement also contains a non-interference provision pursuant to which Mr. Oberlin has agreed, for a period of six months after the termination of his employment, to preserve the confidentiality of the Company's customer list, to refrain from actively soliciting the Company's customers existing at the date of termination and to refrain from soliciting or hiring the Company's executive or management level employees.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

During the fiscal year ended December 31, 1996, the Compensation Committee of the Board of Directors consisted of Messrs. Orehek, Perper and Dennis. None of these individuals has served at any time as an officer or employee of the Company.

From time to time, the Company has engaged in certain transactions with members of the Board of Directors and the Compensation Committee. See "Item 13--Certain Relationships and Related Transactions."

REPORT OF THE COMPENSATION COMMITTEE ON ANNUAL COMPENSATION

The Compensation Committee is composed entirely of non-employee, outside directors and it reviews and approves executive officer salaries and bonuses upon recommendations made by the President and Chief Executive Officer, and administers certain of the Company's compensation plans. The Compensation Committee believes that compensation of its executive officers should be substantially related to the performance of the Company, with performance to be measured by objective considerations such as revenue growth, earnings before income tax, depreciation and amortization, earnings per share and stock price of the Company, as well as other subjective considerations.

The compensation package provided to executive officers consists primarily of (i) base salary, (ii) bonus and (iii) long-term incentives in the form of stock options.

Base Salary. In 1996, it was the goal of the Committee that the combination of base salary and incentive bonus paid to the executive officers of the Company be comparable to cash remuneration paid to executives performing similar duties for companies of comparable size in the telecommunication industry. Although generally available data on the compensation of executive officers in the Pacific Northwest is considered, the experience of the Chief Executive Officer and the members of the Committee and their knowledge of the community and industry practice was the primary basis for this determination.

Base salaries for executive officers other than the President and Chief Executive Officer are determined annually by the President and Chief Executive Officer, and reviewed by the Committee. In determining salary adjustments for executive officers, the President and Chief Executive Officer and the Committee consider (i) the individual officer's historical performance against corporate and individual goals and the scope of his or her job responsibilities, (ii) personal compensation packages provided to executives performing similar duties for companies of comparable size in the Pacific Northwest, (iii) the rate of inflation, (iv) salary adjustments to be awarded to other executive officers of the Company, and (v) other subjective factors.

Bonus. Prior to 1996, bonuses were determined annually by the President and Chief Executive Officer, and reviewed by the Committee. Except for a one-time bonus paid to an officer in 1996 (see "-- Executive Compensation -- Summary Annual Compensation Table"), no bonuses were paid in 1995 or 1996 with respect to performance in 1994 or 1995, respectively. On January 10, 1997, the Board of Directors approved the 1997 Executive Bonus Plan (the "Bonus Plan"). The Bonus Plan establishes three factors to be considered by the Compensation Committee to determine the amount of bonuses paid to the executive officers of the Company. These factors are total revenue, gross margin, and total sales, general and administrative expenses as a percentage of total revenue.

Stock Option Plans. The Compensation Committee is the sole administrator of the 1993 Stock Option Plan. Options to purchase the Company's Common Stock may be granted under the 1993 Stock Option Plan in an effort to align the interest of management with those of shareholders and provide a reward for long-term performance. Historically, options granted by the Company have been granted with an exercise price equal to the market price of the Company's stock on the date of grant. Accordingly, options generally will have value to the holder only if the Company's stock price increases. Outstanding options generally become exercisable at a rate of twenty percent (20%) per year. Options are granted from time to time to executive officers and other management and supervisory personnel based on recommendations of the President and Chief Executive Officer, with the size of grants generally falling within predetermined ranges tied to job grade. At April 28, 1997, shares issuable upon exercise of outstanding options as a percentage of the outstanding shares (assuming options are exercised) of Common Stock was 20%.

President and Chief Executive Officer Compensation. Pursuant to the employment agreement between the Company and William H. Oberlin, the Company's President and Chief Executive Officer (see "-- Employment Agreement"), entered into at the time of his initial engagement by the Company, Mr. Oberlin is entitled to receive a monthly base salary of \$25,000 per month, as well as certain other compensation, subject to annual review by the Board of Directors. In addition, the agreement requires that, on or before August 30, 1996, the Board of Directors formulate and adopt a bonus plan for the year ending December 31, 1996. However, the parties have instead agreed to permit Mr. Oberlin to add an amount equal to his base salary of \$175,000 paid in 1996 to the basis used in 1997 or 1998, as Mr. Oberlin may elect, for purposes of calculating his bonus to be paid in 1998 or 1999, as the case may be. The agreement further provides that for each calendar year starting January 1, 1997, the Board of Directors is to establish a bonus formula structured to pay out one hundred percent of Mr. Oberlin's base salary if the Company meets certain quantitative and qualitative targets set forth in its annual business plan, or a greater or lesser percentage of the base salary in proportion to the amount by which the Company exceeds or falls short of such targets. The Board of Directors has not yet established the quantitative and qualitative measurements upon which the 1997 and 1998 bonuses are to be determined.

Limit on Tax Deduction for Executive Compensation. Beginning in 1994, the federal income tax deduction for certain non-performance based compensation paid to the chief executive officer and the four other most highly compensated officers of publicly held corporations is limited \$1 million per officer per fiscal year. The Committee's present intention is to seek to comply with the requirements to permit the compensation paid to the Company's officers to be deductible, unless the Committee feels that required changes would not be in the best interest of the Company or its shareholders.

COMPENSATION COMMITTEE

John M. Orehek Scott B. Perper Daniel M. Dennis

1993 STOCK OPTION PLAN

Pursuant to the 1993 Stock Option Plan, Nonqualified Options are automatically granted to non-employee directors of the Company, with certain exceptions, as described in "Director Compensation" above.

Pursuant to the 1993 Stock Option Plan, the Company may grant options to purchase shares of Common Stock which are intended to qualify as "incentive stock options" within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended ("Code") ("Incentive Options"), or which do not so qualify ("Nonqualified Options"). The Compensation Committee of the Board of Directors is currently the Plan Administrator for the 1993 Stock Option Plan. Incentive Options may be granted to any employee, including employees who are directors, and Nonqualified Options may be granted to such persons as the Plan Administrator shall select, including employees, consultants and directors of the Company. The Plan Administrator determines the terms and conditions of options granted under the 1993 Stock Option Plan, including the exercise price, provided that the exercise price for Incentive Options must be equal to or greater than the fair market value of the Common Stock on the date of grant, and the exercise price of Incentive Options granted to persons who own more than ten percent (10%) of the Common Stock must be equal to or greater than one hundred ten percent (110%) of the fair market value of the Common Stock on the date of grant.

Unless otherwise provided by the Plan Administrator, options granted under the 1993 Stock Option Plan ("Options") vest at a rate of twenty percent (20%) after the first year and thereafter at twenty percent (20%) per year over a four-year period so that all options are fully vested after five years. Outstanding options vest, at the discretion of the Plan Administrator, upon the occurrence of the liquidation or dissolution of the Company. Options are exercisable for a period of ten years from the date of grant, except that Incentive Options granted to persons who own more than ten percent (10%) of the Common Stock are exercisable only for a period of five years from the date of grant. Options are nontransferable other than by will or the laws of descent and distribution. Notwithstanding a vesting schedule, the 1993 Stock Option Plan provides for the immediate vesting of options upon the occurrence of certain events: (i) the commencement of a tender or exchange offer for Common Stock unless by its terms the offeror would be the beneficial owner of less than 30% of the shares of Common Stock then outstanding, (ii) a merger, consolidation, reorganization or other transaction pursuant to which the persons holding shares of Common Stock immediately prior to the transaction have immediately following the transaction less than 50% of the combined voting power of the outstanding voting equity securities of the surviving entity, (iii) any liquidation or dissolution of the Company or the sale or other disposition of all or substantially all of the assets of the Company or (iv) the accumulation by any person (with certain exceptions) of beneficial ownership of securities of the Company representing 30% or more of the combined voting power of the then outstanding voting securities of the Company. Under certain circumstances, accelerated vesting could have the effect of delaying, deferring or preventing unfriendly offers or other efforts to obtain control of the Company and could thereby deprive the shareholders of opportunities to receive a premium on their Common Stock and could make removal of incumbent management more difficult. On the other hand, accelerated vesting may induce any person seeking control of the Company or business combination with the Company to negotiate on terms acceptable to the Board of Directors.

As of March 31, 1997, the Company had reserved for issuance 4,091,745 shares of Common Stock under the 1993 Stock Option Plan subject to adjustment for stock splits and similar changes in the Company's capitalization. As of March 31, 1997, Options to purchase an aggregate of 3,888,234 shares of Common Stock were outstanding under the 1993 Stock Option Plan and a total of 203,421 shares of Common Stock remained available for grant. As of March 31, 1997, outstanding Options were exercisable at prices ranging from \$2.29 to \$18.50 per share. Shares subject to Options that have lapsed or terminated may again be subject to options granted under the 1993 Stock Option Plan.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

The following table sets forth certain information regarding beneficial ownership of Midcom's Common Stock, as of April 28, 1997, with respect to (i) each shareholder known by the Company to be the beneficial owner of more than five percent of the outstanding Common Stock; (ii) each director of Midcom; (iii) the Named Executive Officers; and (iv) all current directors and executive officers as a group. Except as otherwise indicated, the Company believes that the beneficial owners of the Common Stock listed below have sole investment and voting power with respect to such shares, subject to community property laws where applicable.

NAME AND ADDRESS	AMOUNT AND NATURE OF BENEFICIAL OWNERSHIP	PERCENT OF OUTSTANDING SHARES(1)
Black Creek Limited Partnership (Paul Pfeleger) 1201 Third Avenue Suite 5400 Seattle, WA 98101	5,703,657(2)	37.4%
Madrona Ridge Limited Partnership (John M. Orehek) 1201 Third Avenue Suite 5400 Seattle, WA 98101	2,178,839(3)	14.3
US Online Communications L.L.C. 1201 Third Avenue Suite 5400 Seattle, WA 98101	1,666,667(4)	10.9
William H. Oberlin	431,055(5)	2.8
Jay T. Caldwell	26,085(6)	*
Scott B. Perper	23,937(7)	*
Karl D. Guelich	14,162(8)	*
John M. Zmo	79,130(9)	*
Marvin C. Moses	68,483(10)	*
Daniel M. Dennis	0	*
Robert L. Nitschke	10,000(11)	*
Robert J. Chamberlain	19,000(12)	*
Eric G. Peterson	0	*
All Executive Officers and Directors as a Group (13 persons)	6,916,172(13)	43.2

* Less than 1%

(1) This table is based upon information supplied by directors, officers and principal shareholders. Percentage of ownership is based on 15,224,921 Common Stock outstanding as of April 28, 1997. Beneficial ownership is determined in accordance with the Rules of the Commission, and includes voting and investment power with respect to the shares of Common Stock. Shares of Common Stock subject to options, warrants or other securities which are currently exercisable or exercisable within 60 days of April 28, 1997 as well as shares of Common Stock issuable upon conversion of convertible notes are deemed outstanding when computing the percentage of the person holding such options, but are not deemed outstanding when computing the percentage of any other person. This table assumes that 846,723 shares of Common Stock owned by Ashok Rao and 38,637 shares of Common Stock owned by certain trusts established by Ashok Rao have been redeemed.

(2) Paul Pfleger has sole voting and investment power with respect to 3,993,297 shares by virtue of being the President and sole director of the corporate general partner of this limited partnership. Includes 1,666,667 shares of Common Stock held by US Online Communications L.L.C. (formerly Communications Access L.L.C.) with respect to which Mr. Pfleger shares voting and investment power. See footnote (4) below. Also includes 13,937 shares of Common Stock subject to options exercisable within 60 days of April 28, 1997 and 31,943 shares of Common Stock issuable upon conversion of \$450,000 aggregate principal of convertible notes held by Mr. Pfleger. See "Item 13 - Certain Relationships and Related Transactions."

(3) John M. Orehek has sole voting and investment power with respect to 482,676 shares owned by Madrona Ridge Limited Partnership by virtue of being the President and sole director of the corporate general partner of this limited partnership. Includes 1,666,667 shares held by US Online Communications L.L.C. with respect to which Mr. Orehek shares voting and investment power. See footnote (4) below. Also includes 13,937 shares of Common Stock subject to options exercisable within 60 days of April 28, 1997 and 17,746 shares of Common Stock issuable upon conversion of \$250,000 aggregate principal of convertible notes held by Mr. Orehek. See "Item 13 - Certain Relationships and Related Transactions."

(4) Mr. Pfleger and Mr. Orehek are managers of US Online Communications L.L.C. and share voting and investment power over the shares held by this entity.

(5) Includes 242,945 shares of Common Stock subject to options exercisable within 60 days of April 28, 1997 and 188,110 shares of Common Stock issuable upon conversion of \$2,650,000 aggregate principal of convertible notes which are currently convertible held by a trust established by Mr. Oberlin in which he has a beneficial interest. See "Item 13 - Certain Relationships and Related Transactions."

(6) Includes 26,053 shares of Common Stock subject to options exercisable within 60 days of April 28, 1997.

(7) Scott B. Perper is an officer of First Union Corporation. Does not include 640,484 shares of Common Stock held by First Union Corporation, as to which Mr. Perper disclaims beneficial ownership. Represents 13,937 shares of Common Stock subject to options exercisable within 60 days of April 28, 1997.

(8) Represents 13,937 shares of Common Stock subject to options exercisable within 60 days of April 28, 1997.

(9) Includes 50,737 shares of Common Stock subject to options exercisable within 60 days of April 28, 1997 and 28,393 shares of Common Stock issuable upon conversion of \$400,000 aggregate principal of convertible notes held by a trust established by Mr. Zrno in which he has a beneficial interest. See "Item 13 - Certain Relationships and Related Transactions."

(10) Includes 50,737 shares of Common Stock subject to options exercisable within 60 days of April 28, 1997 and 17,746 shares of Common Stock issuable upon conversion of \$250,000 aggregate principal of convertible notes held by a trust established by Mr. Moses in which he has a beneficial interest. See "Item 13 - Certain Relationships and Related Transactions."

(11) Represents 10,000 shares of Common Stock subject to options exercisable within 60 days of April 28, 1997.

(12) Represents 19,000 shares of Common Stock subject to options exercisable within 60 days of April 28, 1997.

(13) Includes (i) 474,780 shares of Common Stock subject to options exercisable within 60 days of April 28, 1997 and (ii) 283,938 shares of Common Stock issuable upon conversion of \$4,000,000 aggregate principal of convertible notes.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

In June 1994, the Company entered into a Senior Subordinated Note and Warrant Agreement with, and completed the sale of \$14.8 million principal amount of senior subordinated notes (the "Subordinated Notes") to First Union Corporation ("First Union"). Following the sale of the Subordinated Notes, Scott B. Perper, a Senior Vice President of First Union, was appointed to serve on the Company's Board of Directors, and he continues to serve in that capacity. The Company paid First Union a loan initiation fee of \$375,000 in connection with issuance of the Subordinated Notes. During 1995 the Company paid interest on the Subordinated Notes to First Union in the amount of \$782,575. The Company prepaid the Subordinated Notes in full with the proceeds of its initial public offering.

In connection with the issuance of the Subordinated Notes, the Company also issued warrants to First Union to acquire up to 640,484 of the Company's Common Stock at an exercise price of \$5.0001 per share. In July 1995, First Union exercised its Warrants for a total of 640,484 shares of Common Stock. The Company has committed to register the public offer and sale of these shares under the Securities Act under certain circumstances. First Union has certain preemptive rights to purchase additional shares of Common Stock offered by the Company, subject to a number of exceptions. In addition, First Union has certain rights to information concerning the Company until the shares of Common Stock held by it constitute less than one percent of the outstanding Common Stock.

Paul Pfeleger and Ashok Rao, formerly the Company's Chief Executive Officer, President and a director, own 88% and 12%, respectively, of QuestWest Inc. ("QuestWest"), one of two general partners of Quest America L.P. ("Quest LP"). John M. Orehek is the sole limited partner of Quest LP. Messrs. Pfeleger, Rao and Orehek are directors and Messrs. Rao and Orehek are officers of QuestWest. QuestWest holds an 84.995% interest in Quest LP, subject to reduction if Quest LP meets certain earnings and sales targets. In December 1993, Quest LP entered into a distribution agreement with the Company pursuant to which Quest LP is entitled to receive commissions on sales for the Company at a rate equal to the most favorable rate provided by the Company to any of its distributors. Quest LP received \$66,456 in net commissions on 1994 invoices. Effective March 6, 1995, Messrs. Pfeleger, Rao and Orehek granted the Company an option to purchase their entire interests in QuestWest and Quest LP for an exercise price equal to the total amount paid to acquire their respective interests, which then aggregated \$823,170. The parties terminated the option effective October 24, 1995.

In June 1995, Paul Pfeleger and Ashok Rao agreed in writing to indemnify and hold the Company harmless from any costs, expenses or other liabilities incurred by the Company in connection with a claim asserted in June 1995 by an affiliate of the co-general partner of Quest LP that he or an affiliated party is entitled to purchase 3% of the Company's outstanding stock for \$1 million. The Company believes that no such right exists and that this claim is without merit.

In June 1994, the Company entered into an employment agreement with Ashok Rao, then the President, Chief Executive Officer and a director of the Company. In April 1996 Mr. Rao resigned from the Company and pursuant to his employment agreement he is entitled to severance payments of \$25,000 per month for 24 months from April 1996. In addition, pursuant to the terms of a Shareholders' Agreement, the Company has called for the repurchase of all of the shares of Common Stock owned by Mr. Rao and by certain trusts established by Mr. Rao (the "Rao Shares"). The purchase price has been determined by arbitration to be \$6.80/share. The purchase price is payable in 36 equal monthly installments commencing on May 15, 1997 and will bear interest at a rate of 8% per annum from April 18, 1996. Under an agreement between Mr. Rao and Paul Pfeleger pursuant to which Mr. Rao purchased the Rao Shares from Mr. Pfeleger, Mr. Pfeleger is entitled to receive payments aggregating approximately \$2.9 million out of the proceeds received by Mr. Rao from the redemption of the Rao Shares.

In March 1996, the Company entered into a consulting agreement with Karl D. Guelich, which was terminated in April 1996. In May 1996, the Company entered into consulting agreements with Marvin Moses and John Zrno and an employment agreement with Mr. Oberlin. See "Item 11 - Director Compensation" and "Item 11 - Employment Agreement."

On April 4, 1996, the Company entered into an agreement with Tie Communications, Inc., ("Tie"), appointing Tie as an independent distributor for selling the Company's long distance services. Mr. Moses is a director of Tie. Mr. Pfeleger and Mr. Orehek together own 95.2% of Tie. Through June 30, 1996, no commissions have yet been paid to Tie pursuant to this agreement.

On August 22 and September 6, 1996, the Company sold \$97,743,000 aggregate principal amount of 8 1/4% Convertible Subordinated Notes due 2003 (the "Notes") in a private placement (the "Note Placement"). William H. Oberlin, John M. Zrno, Marvin C. Moses, Paul H. Pfeleger and John M. Orehek purchased Notes from the Company in the Note Placement and beneficially own \$2,650,000, \$400,000, \$250,000, \$450,000 and \$250,000 principal amount of Notes, respectively. Mr. Oberlin is the Company's President and Chief Executive Officer as well as a director. Mr. Zrno is Chairman of the Company's Board of Directors. Mr. Pfeleger is Vice Chairman of the Company's Board of Directors. Messrs. Moses and Orehek are directors. The foregoing individuals purchased and own the Notes on the same terms, and subject to the same conditions, applicable to all other holders of the Notes acquired in the Note Placement.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MIDCOM COMMUNICATIONS INC.

Dated: April 28, 1997

By: /s/ ROBERT J. CHAMBERLAIN

Robert J. Chamberlain,
Chief Financial Officer

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ATTACHMENT D

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

☒ [X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934.

For the Quarterly Period Ended September 30, 1997.

OR

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

For the Transition Period from _____ to _____

Commission File Number: 000-26118

MIDCOM Communications Inc.

(Exact name of registrant as specified in its charter)

Washington	91-1438806
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

26899 Northwestern Hwy, Suite 120	48034
Southfield, Michigan	
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (248) 304-1780

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 [X] No []

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

<u>Class</u>	<u>Outstanding at October 31, 1997</u>
Common Stock, \$0.0001 par value	16,193,546

Page 1 of 16 pages
Exhibit Index at Page 16.

MIDCOM COMMUNICATIONS INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 1997

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PART I FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

MIDCOM COMMUNICATIONS INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS)

SEPTEMBER 30, DECEMBER 31,

1997

1996

(Unaudited)

ASSETS

Current assets:		
Cash and cash equivalents	\$1,532	\$30,962
Accounts receivable, less allowance for doubtful accounts of \$6,184 and \$7,802, respectively	20,421	16,969
Prepaid expenses and other current assets	<u>1,820</u>	<u>1,548</u>
Total current assets	23,773	49,479
Furniture, equipment and leasehold improvements, net	24,126	11,045
Intangible assets, less accumulated amortization of \$49,199 and \$39,532, respectively	6,402	15,547
Other assets and deferred charges, net	<u>3,891</u>	<u>3,852</u>
	<u>\$58,192</u>	<u>\$79,923</u>

LIABILITIES AND SHAREHOLDERS' DEFICIT

Current liabilities:		
Notes payable	\$113,872	\$9,680
Line of credit	20,734	-
Current portion of capital lease obligations	14,501	3,314
Accounts payable	8,524	3,179
Carrier accounts payable	25,316	17,143
Accrued expenses and other current liabilities	<u>16,160</u>	<u>12,938</u>
Total current liabilities	199,107	46,254
Long-term obligations, less current portion	-	99,153
Other long-term liabilities	3,800	3,800
Shareholders' deficit:		
Common stock	62,063	68,330
Deferred compensation	(1,321)	(1,707)
Accumulated deficit	<u>(205,457)</u>	<u>(135,907)</u>
Total shareholders' deficit	<u>(144,715)</u>	<u>(69,284)</u>
	<u>\$58,192</u>	<u>\$79,923</u>

See Notes to Unaudited Condensed Consolidated Financial Statements.

MIDCOM COMMUNICATIONS INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	1997	1996	1997	1996
(In thousands, except per share data)				
Revenue	\$24,920	\$30,730	\$74,339	\$124,590
Cost of revenue	<u>18,586</u>	<u>22,292</u>	<u>54,809</u>	<u>89,828</u>
Gross profit	6,334	8,438	19,530	34,762
Operating expenses				
Selling, general and administrative	22,090	15,734	62,646	48,048
Depreciation	1,348	1,653	4,133	4,327
Amortization	924	5,321	9,524	21,857
Settlement of contract dispute	--	--	--	8,800
Relocation of corporate headquarters	2,136	--	4,866	--
Restructuring charge	--	--	--	2,220
Loss on impairment of assets	--	<u>2,000</u>	--	<u>20,765</u>
	<u>26,498</u>	<u>24,708</u>	<u>81,169</u>	<u>106,017</u>
Operating loss	(20,164)	(16,270)	(61,639)	(71,255)
Other expense (income):				
Interest expense, net	3,600	2,049	8,337	5,959
Other expense (income), net	<u>(175)</u>	<u>(60)</u>	<u>(427)</u>	<u>206</u>
Loss before provision for income taxes	(23,589)	(18,259)	(69,549)	(77,420)
Provision for income taxes	--	--	--	--
Net loss	<u>\$ (23,589)</u>	<u>\$ (18,259)</u>	<u>\$ (69,549)</u>	<u>\$ (77,420)</u>
Net loss per share	<u>\$ (1.56)</u>	<u>\$ (1.16)</u>	<u>\$ (4.51)</u>	<u>\$ (5.01)</u>
Weighted average common shares outstanding	<u>15,125</u>	<u>15,681</u>	<u>15,438</u>	<u>15,442</u>

See Notes to Unaudited Condensed Consolidated Financial Statements

MIDCOM COMMUNICATIONS INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)	Nine months ended September 30,	
	1997	1996
Net cash used in operating activities	<u>\$(40,150)</u>	<u>\$(6,591)</u>
Investing activities:		
Purchases of furniture, equipment and leasehold improvements	(7,370)	(1,729)
Net assets acquired in acquisition	(291)	--
Proceeds from sale of assets	<u>33</u>	<u>673</u>
Net cash used in investing activities	<u>(7,628)</u>	<u>(1,056)</u>
Financing activities:		
Borrowings under line of credit	43,735	--
Repayments of line of credit	(23,001)	--
Proceeds from issuance of convertible subordinated notes payable	--	97,743
Proceeds from notes payable	--	333
Repayment of notes payable	(921)	(3,946)
Proceeds from long-term obligations	6,544	15,000
Repayment of long-term obligations, including capital leases	(1,165)	(53,687)
Deferred financing costs	(480)	(3,569)
Repurchase of common shares	(6,544)	--
Proceeds from common stock issued for stock purchase plan and stock options	<u>180</u>	<u>2,828</u>
Net cash provided by financing activities	<u>18,348</u>	<u>54,702</u>
Net (decrease) increase in cash	(29,430)	47,055
Cash and cash equivalents at beginning of period	<u>30,962</u>	<u>1,083</u>
Cash and cash equivalents at end of period	<u>\$1,532</u>	<u>\$48,138</u>

See Notes to Unaudited Condensed Consolidated Financial Statements.

1. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements include the accounts of MIDCOM Communications Inc. and its wholly-owned subsidiaries, collectively referred to as "Midcom" or the "Company." The unaudited interim condensed consolidated financial statements and related notes have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the "Commission"). Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The accompanying unaudited condensed consolidated financial statements and related notes should be read in conjunction with the consolidated financial statements and related notes thereto included in the Company's Form 10-K as filed with the Securities and Exchange

Commission on March 31, 1997.

On November 7, 1997, Midcom and three of its wholly-owned subsidiaries, PacNet Inc. ("PacNet"), Ad Val, Inc. ("Adval") and Cel-Tech International Corp. ("Cel-Tech"), each filed a petition (collectively, the "Petitions") for relief under Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code") in the United States Bankruptcy Court for the Eastern District of Michigan (the "Bankruptcy Court"). Case Nos. 97-59044-S, 59052-G, 59064-G and 59057-S, respectively, with such cases to be jointly administered by the Bankruptcy Court under Case No. 97-59044-S, and are currently operating their respective businesses as debtors-in-possession pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code and subject to the jurisdiction of the Bankruptcy Court. The accompanying unaudited condensed consolidated financial statements have been prepared on a going concern basis, which contemplates continuity of operations, realization of assets and liquidation of liabilities in the ordinary course of business. However, as a result of the filing under Chapter 11 of the Bankruptcy Code and related circumstances, including the Company's leveraged financial structure and losses from operations, such realization of assets and liquidation of liabilities is subject to significant uncertainty. While under the protection of Chapter 11 of the Bankruptcy Code, the Company may sell or otherwise dispose of assets, and liquidate or settle liabilities, for amounts other than those reflected in the accompanying unaudited condensed consolidated financial statements. Further, a plan of reorganization could materially change the amounts reported in such financial statements, which do not give effect to all adjustments of the carrying value of assets or liabilities that might be necessary as a consequence of a plan of reorganization. The appropriateness of using the going concern basis depends upon, among other things, confirmation of a plan of reorganization, future profitable operations, the ability to comply with the terms of any debtor-in-possession credit facility and the ability to generate sufficient cash from operations and financing arrangements to meet obligations.

The information furnished in the accompanying unaudited condensed consolidated financial statements reflects, in the opinion of management, all adjustments, consisting of only normal recurring items, necessary for a fair presentation of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year.

In June 1997, the FASB issued SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("SFAS No. 131"). SFAS No. 131 establishes standards for the reporting of operating segment information by publicly held companies in interim financial reports and annual financial statements. It also establishes standards for related disclosures about products and services, geographic areas, and major customers. SFAS No. 131 is effective for financial statements for fiscal years beginning after December 15, 1997. The adoption of SFAS 131 will have no impact on the Company's consolidated results of operations, financial position or cash flows.

In February 1997, the FASB issued SFAS No. 128, "Earnings per Share" ("SFAS No. 128"). SFAS No. 128 is effective for financial statements for years ending after December 15, 1997. As of December 31, 1997, the Company will be required to change the method currently used to compute earnings per share and to restate all prior periods. Under the new requirements for calculating primary earnings per share (referred to in SFAS No. 128 as basic earnings per share), the dilutive stock options will be excluded. There is no expected impact on primary earnings per share. The Company has not yet determined the impact of SFAS 128 on the calculation of fully diluted earnings per share (referred to in SFAS No. 128 as diluted earnings per share).

2. LIQUIDITY, CAPITAL RESOURCES, BANKRUPTCY FILING AND OTHER SUBSEQUENT EVENTS

The Company has operated at substantial losses since its inception. Net losses were approximately \$69.5 million, \$97.3 million and \$33.4 million for the nine months ended September 30, 1997 and the years ended December 31, 1996 and 1995, respectively. As a result of these losses, significant attrition in certain acquired customer bases, investments in business expansion and various other factors, the Company has required substantial external working capital. As of September 30, 1997, the book value of the Company's assets was approximately \$58.2 million, total debt outstanding was approximately \$149.1 million, and the Company had a negative net worth of approximately \$144.7 million.

In its Quarterly Report on Form 10-Q for the quarter ended June 30, 1997, the Company disclosed that, in addition to borrowings available under its revolving credit facility (the "Foothill Credit Facility") with Foothill Capital Corporation ("Foothill"), and financing available under its capital lease facilities, the Company would require between \$20 million and \$30 million of additional capital in order to fund operating losses, working capital requirements and capital expenditures during the remainder of 1997. In August 1997, the Company obtained an \$8 million bridge loan from Foothill (the "Foothill Bridge Loan"). The Foothill Bridge Loan had an interest rate of 15% per annum and was payable in full on November 1, 1997. In addition, on October 10, 1997, the Company completed a private placement of 875,000 shares of Common Stock. The Company received net proceeds from the private placement of approximately \$5.5 million which were used for working capital purposes in October 1997.

In early September 1997, the Company received a term sheet from a major financial institution for an equity financing ranging from \$10 million to \$50 million. Due diligence with respect to the proposed equity financing commenced immediately with the goal of closing the financing by October 31, 1997. In addition, throughout September and October 1997, the Company continued to pursue other short-term financing. However, at the end of October 1997, the Company had not been successful in its efforts to close the proposed equity financing or obtain additional financing.

On November 4, 1997, as a result of the Company's failure to repay the Foothill Bridge Loan in full when due, Foothill gave notice of a default under the Foothill Credit Facility and ceased making any further advances to the Company or any of its subsidiaries. In addition to the repayment of the Foothill Bridge Loan, the Company was required to make substantial payments to Sprint Communications Company ("Sprint"), and several of the Company's suppliers threatened termination of services.

Faced with the imminent termination of service by the Company's principal long-distance carriers, on November 7, 1997, the Company and three of its wholly-owned subsidiaries, PacNet, Adval and Cel-Tech, filed the Petitions and are currently operating their respective businesses as debtors-in-possession pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code and subject to the jurisdiction of the Bankruptcy Court. The Petitions were filed in order to allow the Company and its subsidiaries to continue operations while obtaining relief from the immediate collection of obligations owed to Foothill, Sprint and other creditors.

The voluntary filing of a petition for relief under the Bankruptcy Code constitutes a default under the Foothill Credit Facility, the Company's equipment lease facilities, the Indenture relating to the Company's \$97.7 aggregate principal amount of 8 1/4% Subordinated Convertible Notes due 2003 and the note payable to Ashok Rao in connection with the redemption of certain shares of Common Stock (see Note 6, "Stock Repurchase," below). Accordingly, approximately \$112.1 million of long-term indebtedness has been reclassified as current liabilities as of September 30, 1997. Since it is not possible to predict the impact of a sale or liquidation of the Company, no other adjustments have been made to the historical carrying values of the assets and liabilities.

The Company has arranged for debtor-in-possession financing (the "Foothill DIP Facility") from Foothill. In connection with the Foothill DIP Financing, the Company incurred a loan fee of \$250,000. The Foothill DIP Facility consists of a revolving credit facility with borrowing availability of up to \$8.5 million, subject to the Company's satisfaction of various terms and conditions, bears interest at prime plus 4% on receivable based advances and 18% on overadvances and expires on January 15, 1997. There can be no assurance that borrowings available under the Foothill DIP Facility will be adequate to meet the Company's working capital needs or that the Company will not require additional debt or equity financing in the future, and there can be no assurance that any such additional debt or equity financing, if needed, would be available to the Company on acceptable terms or at all. In addition, the Company is currently attempting to solicit offers to purchase all or portions of its assets. There can be no assurance that any such transaction will be available to the Company on acceptable terms or at all. The Company is also undertaking aggressive cost-cutting measures, including the lay-off on November 7, 1997 of 170 of its 790 employees. Further cost-cutting measures will be required if the Company is unable to complete a sale of all or part of its business or obtain additional sources of working capital in the near-term. Cost-cutting measures, particularly those affecting the Company's sales and service functions, could have a material adverse effect on the Company's ability to generate revenue.

The Company is required to submit a plan of reorganization to the Bankruptcy Court. The Company is in the process of developing a plan of reorganization, which the Company expects will involve the sale of all or part of its business. There can be no assurance that the Company will be successful in completing a sale of all or part of its business. In addition, there can be no assurance that the Bankruptcy Court will approve the Company's reorganization plan. If the Company is unable to find a buyer for all or part of its business, or if the Company's reorganization plan is not approved, the Company may be forced to liquidate.

3. ACQUISITION OF PHOENIX NETWORK, INC. AND TRANS NATIONAL COMMUNICATIONS

On November 10, 1997, the Company announced that the August 13, 1997 merger agreements with Phoenix Network, Inc. ("Phoenix") and Trans National Communications ("TNC") had been terminated. On October 31, 1997, Phoenix notified the Company of its intent to terminate the merger agreement, effective November 5, 1997, due to alleged material breaches by the Company, including the Company's termination of its agreement with Sprint and the deterioration of the Company's financial condition. In addition, on November 6, 1997, TNC notified the Company of its intent to terminate its purchase agreements with Phoenix that Phoenix had assigned to the Company.

4. RELOCATION OF CORPORATE HEADQUARTERS AND RESTRUCTURING CHARGES

In May 1997, the Company announced its intention to relocate its corporate headquarter functions based in Seattle, Washington to Southfield, Michigan, where the Company's Chief Executive Officer and other key executives maintained offices. During the third quarter of 1997, the Company completed the relocation of various corporate support functions, including human resources, legal, finance and information services, affecting approximately 130 employees, to temporary office space in Southfield. The Company had originally planned to move these corporate support functions to permanent office space in Southfield when it became available in December 1997; however, in light of the recent deterioration of the Company's financial condition, those plans are being re-evaluated.

In June 1997, the Company recorded a restructuring charge of \$2.5 million, consisting primarily of the cost of severance and loss on disposal of assets in connection with the corporate headquarters relocation. This restructuring charge is included in the corporate headquarters relocation expenses reported on the accompanying unaudited condensed consolidated statement of operations for the nine-month period ended September 30, 1997. As of September 30, 1997, \$0.4 million of this restructuring charge remained in accrued liabilities.

During the third quarter of 1997, the Company incurred approximately \$2.1 million of expenses related to the corporate headquarters relocation. If the corporate headquarters relocation is completed as originally planned, the Company now estimates that an additional \$0.8 million of expenses would be incurred in the fourth quarter of 1997.

5. BUSINESS COMBINATIONS COMPLETED IN PRIOR YEARS

On January 27, 1997, in connection with a customer base acquisition completed on July 31, 1995, the Company issued to the assignee of Communications Services of America, Inc. ("CSA") 10,522 shares of common stock valued at \$10.38 per share, and in April 1997, the Company issued an

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

additional 18,536 additional shares to compensate for the decrease in value of the common stock since the closing of the acquisition.

On January 22, 1997, in connection with a customer base acquisition completed in September 30, 1995, the Company issued to the shareholders of Fairfield County Telephone Corporation ("Fairfield") 38,711 shares of common stock valued at \$10.25, and in April 1997 the Company issued an additional 59,631 shares to compensate for the decrease in value of the common stock since the closing of the acquisition.

In January 1997, the Company issued to Richard John 9,457 shares of common stock valued at \$9.38 per share, and in August 1997, the Company issued to Richard John 60,000 shares of common stock valued at \$8.56 per share in connection with the acquisition of Cel-Tech International Corp.

6. STOCK REPURCHASE

In connection with the resignation of Ashok Rao, the Company's former President and Chief Executive Officer, the Company redeemed, in April 1997, 885,360 shares of Common Stock held by Mr. Rao and certain trusts established by Mr. Rao at a price of \$6.80 per share (plus interest at 8% from April 1996), to be paid in equal monthly installments over a period of 36 months, beginning May 1997.

7. STOCK OPTION PLAN

In July 1997, the Company reduced the exercise price of 1.344 million employee stock options with a weighted average exercise price of approximately \$8.85 per share to \$5.19 per share.

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8. NET LOSS PER SHARE

Net loss per share is based on the weighted average number of common and equivalent shares outstanding using the treasury stock method. Common stock equivalents are excluded from the calculation of net loss per share due to their antidilutive effect.

9. DISPUTES AND LITIGATION

BANKRUPTCY FILING On November 7, 1997, Midcom and three of its wholly-owned subsidiaries, PacNet, Adval and Cel-Tech, filed the Petitions and are currently operating their respective businesses as debtors-in-possession pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code and subject to the jurisdiction of the Bankruptcy Court. See Note 1, "Basis of Presentation," above.

SPRINT SETTLEMENT The Company has had a series of ongoing disputes relating to service and billing with Sprint Communications Company ("Sprint"), one of its primary suppliers. For this and other reasons, on September 18, 1997, the Company discontinued its payments to Sprint and, on October 10, 1997, the Company received a notice of default from Sprint. On October 29, 1997, the Company entered into a settlement with Sprint whereby it agreed to pay Sprint \$1,250,000 on October 31, 1997, November 7, 1997 and November 14, 1997; \$4,000,000 on November 21, 1997; and thereafter, so long as Sprint continues to provide service to the Company, weekly payments equal to the lesser of \$2,000,000 or the current amount outstanding. Sprint and the Company agreed to arbitrate the Company's claims against Sprint up to an aggregate of \$5,000,000 and the parties agreed that the Company would transition its traffic to its own or other networks over the ninety day period ending January 29, 1998.

CLASS ACTION LAWSUIT The Company, its Vice Chairman of the Board of Directors and largest shareholder, the Company's former President, Chief Executive Officer and Director and the Company's former Chief Financial Officer were named as defendants in a securities action filed in the U.S. District Court for the Western District of Washington (the "Complaint"). The Complaint was filed on behalf of a class of purchasers of the Company's Common Stock during the period beginning on July 6, 1995, the date of the Company's initial public offering, and ending on March 4, 1996 (the "Class Period"). In April 1997, the Board of Directors of the Company unanimously approved the terms of a settlement of all claims against the Company and all of the individual defendants. The settlement, which is subject to Court approval and which admits no liability or fault, provides for the payment of \$10 million in cash by the Company's insurance carrier, and the issuance of approximately 420,000 shares of the Company's common stock, subject to adjustments depending upon the fair market value of the stock on the date that the settlement is approved by the Court.

SEC INVESTIGATION The Company was informed in May 1996 that the Commission was conducting an informal inquiry regarding the Company. In May 1997 the Company learned that a formal order of investigation had been entered by the Commission. The Company believes that the focus of the investigation is on (i) the accuracy of disclosures in certain documents filed by the Company with the SEC; (ii) whether the Company had maintained adequate books and records and had adequate internal controls; and (iii) whether records had been falsified. The Company has voluntarily provided documents requested by the Commission, is in the process of furnishing additional requested documents, and has cooperated with the Commission in scheduling interviews with certain former Company personnel. The Company is unable to predict the ultimate outcome of the investigation. The Company and certain of its former employees could be subject to civil or criminal sanctions including monetary penalties and injunctive measures. If imposed on the Company, such penalties and injunctive measures could have a material adverse effect on the Company's business, financial condition and results of operation.

FRONTIER LAWSUITS On August 19, 1996 the Company was served with a complaint filed in the U.S. District Court for the Eastern District of Michigan by Frontier Corporation ("Frontier"). The complaint named as defendants the Company and eleven individuals, all of whom are former employees of Frontier who resigned their positions with

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Frontier. Frontier agreed to dismiss all of the individual defendants in the case except William H. Oberlin, the Company's President and CEO. Moreover, in September 1997, the Court dismissed certain causes of action in the context of a summary judgment hearing. The surviving claims are that: (i) Midcom is in violation of a non-disclosure agreement between Frontier and Midcom by virtue of its alleged use of confidential information of Frontier obtained through employees hired from Frontier and otherwise, and (ii) Midcom and Mr. Oberlin tortuously interfered in Frontier's contractual relationships with various Frontier employees and contractors. The complaint seeks: (i) that the defendants be preliminarily and permanently enjoined from breaching their respective agreements with Frontier; (ii) that Midcom be enjoined from aiding and abetting certain alleged breaches of fiduciary duties; (iii) an order that Midcom hold all profits which it earns as a result of its hiring of the individual defendant and other Frontier employees as constructive trustees for the benefit of Frontier; (iv) an accounting of all profits realized by Midcom as a result of its hiring of the defendant and other Frontier employees; (v) a declaratory judgment on its various claims; (vi) damages in an unspecified amount; (vii) Frontier's costs, including reasonable attorney's fees, incurred in bringing the action; and (viii) other appropriate relief. The Company has recently filed a motion to dismiss the action and it awaits a hearing on this motion.

An affiliate of Frontier has also filed a complaint in the same U.S. Federal District Court claiming \$515,000 for unpaid amounts under a supply agreement. The Company believes this claim to be without substantial merit and is vigorously defending it. The Company's motion to dismiss on statute of limitations grounds was granted in part and remaining matters have been transferred to the FCC as a matter of primary jurisdiction.

On November 6, 1997, the Company and Frontier agreed to enter into a settlement pursuant to which Frontier would dismiss all claims against the Company and Mr. Oberlin. The settlement would provide, among other things, that, over the next three years, Midcom will transfer approximately \$40.5 million of long distance traffic to Frontier and Frontier will transfer approximately \$20.25 million of long distance traffic to Midcom. There is some uncertainty as to whether the settlement creates a pre-petition or post-petition claim, which issue is to be decided by the District Court.

CHERRY COMMUNICATIONS LAWSUIT. In September and December 1995, the Company purchased two significant customer bases from Cherry Communications. The first transaction ("Cherry I") provided for the purchase of long distance customer accounts having monthly revenue for the three months preceding the date of closing of \$2.0 million, net of taxes, customer credits and bad debt. The second transaction ("Cherry II") provided for the purchase of long distance customer accounts having monthly revenue which were to average \$2.0 million per month over the 12 months following the transaction, net of taxes, customer credits and bad debt. The purchase price payable with respect to Cherry I was a total of \$10.5 million, of which \$5.5 million was paid in cash and the balance was paid by the delivery of 317,460 shares of Common Stock (subject to a possible increase in such number based on the future value of the Common Stock), of which 126,984 shares are held in escrow to be applied to indemnify claims or to cover shortfalls in revenue from the \$2.0 million monthly average. The purchase price for Cherry II was \$18.0 million, of which \$7.0 million has been paid in cash. Additional installments of \$3.4 million were due in February, March and April of 1996, of which \$400,000 of each installment was to be placed in an escrow account for satisfaction of indemnity claims or to cover shortfalls in revenue from the \$2.0 million monthly average. The parties later agreed that the Company could pay up to \$9.0 million of the Cherry II payments either in cash or by delivery of shares of Common Stock. Separately, the Company also agreed to pay Cherry Communications for servicing customer accounts on behalf of the Company. The acquired customer bases have not generated the required minimum revenue levels and Cherry Communications has failed to remit to the Company collections received by Cherry Communications from a portion of the acquired customers. Accordingly, the Company has withheld the final three installment payments for Cherry II (a total of \$9.0 million excluding escrowed sums), payment of invoices for carrier service for the acquired bases (up to \$11.0 million) and accrued customer service charges of \$840,000. Negotiations between Cherry Communications and the Company failed to produce a settlement of these disputes.

Cherry Communications filed a lawsuit against the Company in the United States District Court for the Northern District of Illinois, Eastern Division. In its First Amended Complaint filed on July 18, 1996, Cherry Communications seeks recovery of (i) approximately \$7.2 million plus interest and attorneys' fees alleged to be due and owing under a Reseller/Reseller Agreement for Switched Services between Cherry Communications and the Company, (ii) approximately \$9.0 million plus interest and attorney's fees alleged to be due and owing under the November 1, 1995 Customer Base Purchase and Sale Agreement between Cherry Communications and the Company.

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(the "Cherry II Agreement"), and a Promissory Note executed in connection with the Cherry II Agreement, (iii) customer service charges of \$840,000. It is the position of the Company that Cherry Communications has breached its obligations under the Cherry I Agreement and the Cherry II Agreement by among other breaches (i) failing to sell Midcom customer bases having the average monthly revenues required by the customer base agreements, and (ii) failing to remit to Midcom monies collected from the customer accounts. It is also the position of the Company that, as a result of Cherry Communication's breaches of the Cherry I Agreement and the Cherry II Agreement, as amended by certain addenda, that the Company has offsets and counterclaims against Cherry Communications in excess of the sums it has withheld from Cherry Communications. The Company is attempting to negotiate a resolution of the disputes. In the event that a settlement is not reached, the Company intends to vigorously defend the lawsuit filed by Cherry Communications. However, the Company is unable to predict the outcome of this lawsuit. As a result of this litigation, as of September 1, 1996, the Company discontinued booking revenue generated by the customer bases purchased from Cherry Communications. In October 1997, Cherry filed a petition for relief under Chapter 11 of the Bankruptcy Code.

DISCOM ARBITRATION Discom Corporation ("Discom"), a former distributor of the Company, in an arbitration proceeding in New York against the Company has filed to increase the amount of its claim against the Company to approximately \$8.0 million purportedly based upon a lost profit and damage analysis of its expert. The Company has not yet had an opportunity to depose Discom's expert, but preliminary indications are that the evaluation is seriously flawed and that the Company's own expert testimony will more accurately reflect the maximum possible damage claim of \$250,000 to \$500,000, which amount has been escrowed by the Company. The Company disputes that any amounts are owed to Discom and it is vigorously defending the case. Arbitration dates were scheduled in August, September and October 1997 with a decision by the arbitration panel expected by the end of fiscal 1997.

OTHER LITIGATION The Company is also party to other routine litigation incidental to its business and to which its property is subject. The Company's management believes the ultimate resolution of these matters will not have a material adverse effect on the Company's business, financial condition or results of operations.

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

FORWARD-LOOKING STATEMENTS AND THE PRIVATE SECURITIES LITIGATION REFORM ACT

Statements herein concerning expectations for the future constitute forward-looking statements which are subject to a number of known and unknown risks, uncertainties and other factors which might cause actual results to differ materially from those expressed or implied by such forward-looking statements. Forward-looking statements herein include, but are not limited to, those concerning the Company's ability to successfully relocate its headquarters and the impact of such relocation on operations; the Company's ability to improve its provisioning process and reduce customer attrition; adequacy of available sources of working capital; the confirmation of a plan of reorganization by the Bankruptcy Court and the Company's ability to continue its operations as a going concern. Relevant risks and uncertainties include, but are not limited to, unanticipated actions by competitors, regulatory or other obstacles which restrict the Company's ability to implement local or other services, greater than expected costs to relocate the Company's executive offices, greater than expected declines in sales, inability to hire and retain key personnel, unfavorable determinations of pending lawsuits or other disputes, inability to secure additional sources of working capital and regulatory changes. Additional risks and uncertainties include those described in the Company's Annual Report on Form 10-K and other filings with the Securities and Exchange Commission, press releases and other communications.

BANKRUPTCY FILINGS AND PROCEEDINGS

On November 7, 1997, Midcom and three of its wholly-owned subsidiaries, PacNet Inc. ("PacNet"), Ad Val, Inc. ("Adval") and Cel-Tech International Corp. ("Cel-Tech"), each filed a petition (collectively, the "Petitions") for relief under Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code") in the United States Bankruptcy Court for the Eastern District of Michigan (the "Bankruptcy Court"). Case Nos. 97-59044-S, 59052-G, 59064-G and 59057-S, respectively, with such cases to be jointly administered by the Bankruptcy Court under Case No. 97-59044-S, and are currently operating their respective businesses as debtors-in-possession pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code and are subject to the jurisdiction of the Bankruptcy Court. The Petitions were filed in order to allow the Company and its subsidiaries to continue operations while obtaining relief from the immediate collection of obligations owed to creditors. The Company's unaudited condensed consolidated financial statements included in this Report have been prepared on a going concern basis, which contemplates continuity of operations, realization of assets and liquidation of liabilities in the ordinary course of business. However, as a result of the filing under Chapter 11 of the Bankruptcy Code and related circumstances, including the Company's leveraged financial structure and losses from operations, such realization of assets and liquidation of liabilities is subject to significant uncertainty. While under the protection of Chapter 11 of the Bankruptcy Code, the Company may sell or otherwise dispose of assets, and liquidate or settle liabilities, for amounts other than those reflected in the Company's unaudited condensed consolidated financial statements included in this Report. Further, a plan of reorganization could materially change the amounts reported in such financial statements, which do not give effect to all adjustments of the carrying value of assets or liabilities that might be necessary as a consequence of a plan of reorganization. The appropriateness of using the going concern basis depends upon, among other things, confirmation of a plan of reorganization, future profitable operations, the ability to comply with the terms of any debtor-in-possession credit facility and the ability to generate sufficient cash from operations and financing arrangements to meet obligations.

RESULTS OF OPERATIONS

	<u>Three months ended</u>		
	September 30, 1997	June 30, 1997	September 30, 1996
(In millions)			
Revenue	\$24.9	\$25.1	\$30.7
Gross profit	6.3	6.9	8.4
Selling, general and administrative	22.1	22.5	15.7
Depreciation and amortization	2.3	5.7	7.0
Operating loss	(20.2)	(23.8)	(16.3)
Net loss	(\$23.6)	(\$26.2)	(\$18.3)
Net loss per share	(\$1.56)	(\$1.71)	(\$1.16)

REVENUE. Revenue for the quarter ended September 30, 1997 decreased by 18.9% from \$30.7 million in the third quarter of 1996 to \$24.9 million. Year-to-date revenue of \$74.3 million represents a 40.3% decrease from the \$124.6 million reported for the same period in 1996. The decrease is attributable to customer attrition in acquired customer bases and loss of revenue from a customer base which is the subject of a dispute, offset by an increase in revenue generated by the Company's internal sales force. Revenue for the third quarter of 1997 decreased slightly compared to the \$25.1 for the second quarter of 1997. This decrease is attributable to pricing pressure on long distance service as well as continued provisioning problems. Due to Midcom's position as a switchless reseller, it has historically been dependent upon its underlying carriers for provisioning of end-user services. Midcom has experienced difficulties in provisioning, in a timely manner, all orders for services that it receives. This has resulted in the loss of revenue and customers. At times, the Company has been unable to provision as many as half of the orders for service it receives. There are a number of potential causes for failing to correctly provision an order in a timely manner—many of which affect other telecommunications carriers to a greater or lesser degree. Such causes include weaknesses in Midcom's own internal systems and procedures relating to order entry and credit, the internal systems and procedures used by underlying carriers, the LECs and others; the nature and time of interactions between Midcom, the underlying carriers, the LECs and others; and the use of PIC restrictions which may make it more difficult to change from one long distance

company to another. Midcom continues to improve its own systems and procedures and to work with its underlying carriers, the LECs and others to reduce incidences of provisioning problems. In addition, Midcom believes that the implementation of its network strategy will substantially improve its ability to correctly provision its orders in a timely manner by giving it better visibility and more control of the entire provisioning process. However, there can be no assurance that the Company will be successful in its efforts to improve its provisioning process.

GROSS MARGIN The Company's cost of revenue primarily consists of the cost of service provided by local and interexchange carriers. Gross margin was 25.4% and 26.3% for the quarter and nine-month periods ended September 30, 1997, respectively, versus 27.5% and 27.9% for the same periods in 1996, respectively. The decline in gross margin is the result of changes in the mix of customers, and pricing pressure on long distance services. These factors were offset in part by negotiation of price reductions with some of the Company's major suppliers. Gross margin decreased from the second quarter 1997 level of 27.3%. This decrease is mainly attributable to decreased margins experienced in the frame relay segment of the business resulting from capacity build out to accommodate future sales as well as increased dependence on off-net services due to the expansion of the geographic area serviced by the Company. As new sales utilize network capacity and services are interconnected to the Midcom network, it is expected that margins will improve.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES Selling, general and administrative expenses consist primarily of payroll and related expenses for administrative, customer support, marketing and direct sales personnel, commissions, professional fees, and bad debt expense. Selling, general and administrative expenses increased to \$22.1 million for the third quarter of 1997 compared to \$15.7 million for the third quarter of 1996. For the nine-month period ended September 30, 1997, selling, general and administrative expenses increased to \$62.6 million from \$48.0 million for the same period in 1996. At September 30, 1997 and September 30, 1996, the Company employed 728 and 452 persons on a full-time basis, respectively. The increase in selling, general and administrative expenses is due to the increase in payroll, commissions, travel and other costs relating to the Company's significantly expanded sales and marketing efforts. The Company also increased customer support staffing in anticipation of higher call volume resulting from the expanded sales efforts and also to improve service quality.

DEPRECIATION Depreciation decreased to \$1.3 million for the quarter ended September 30, 1997 from \$1.7 million for the quarter ended September 30, 1996. For the nine-month period ended September 30, 1997, depreciation decreased to \$4.1 million from \$4.3 million for the same period in 1996. The decrease in depreciation is a result of the Company's write-off, by means of a June 1997 restructuring charge, of certain assets disposed of in connection with the relocation of the Company's corporate headquarters from Seattle, Washington to Southfield, Michigan. The Company is

finalizing the installation of six state-of-the-art high capacity switches at an aggregate estimated cost of \$15.0 million. The Company expects that, as a result of the deployment of these switches, depreciation will increase.

AMORTIZATION. Amortization decreased to \$0.9 million for the quarter ended September 30, 1997 from \$5.3 million for the quarter ended September 30, 1996. For the nine-month period ended September 30, 1997, amortization decreased to \$9.5 million from \$21.9 million for the same period in 1996. The decrease in amortization is primarily a result of the Company's decision in June 1996 to reduce the estimated useful life of acquired customer bases from 5 years to 3 years, which increased amortization in 1996. In addition, certain of these acquired customer bases became fully amortized in June 1996 and again in July 1997, which reduced amortization in 1997.

RELOCATION OF CORPORATE HEADQUARTERS AND RESTRUCTURING CHARGES. In May 1997, the Company announced its intention to relocate its corporate headquarter functions based in Seattle, Washington to Southfield, Michigan, where the Company's Chief Executive Officer and other key executives maintained offices. During the third quarter of 1997, the Company completed the relocation of various support functions, including human resources, legal, finance and information services, affecting approximately 130 employees, to temporary office space in Southfield. The Company originally planned to move these corporate support functions to permanent office space in Southfield when it became available in December 1997; however, in light of the recent deterioration of the Company's financial condition, those plans are being re-evaluated.

In June 1997, the Company recorded a restructuring charge of \$2.5 million, consisting primarily of the cost of severance and loss on disposal of assets in connection with the corporate headquarters relocation. This restructuring charge is included in the corporate headquarters relocation expense reported on the Company's unaudited condensed consolidated operations included with this Report for the nine-month period ended September 30, 1997. As of September 30, 1997, \$0.4 million of this restructuring charge remained in accrued liabilities.

During the third quarter of 1997, the Company incurred approximately \$2.1 million of expenses related to the corporate headquarters relocation. If the corporate headquarters relocation is completed as originally planned, the Company now estimates that an additional \$0.8 million of expenses would be incurred in the fourth quarter of 1997.

OTHER EXPENSES. Interest expense for the quarter and nine months ended September 30, 1997 increased over the corresponding periods in 1996 primarily due to an increase in average borrowings outstanding. At September 30, 1997, June 30, 1997, December 31, 1996 and September 30, 1996, the Company had outstanding interest-bearing obligations of \$149.1 million, \$125.1 million, \$112.1 million and \$112.4 million, respectively. The increase from December 31, 1996 to September 30, 1997 was due primarily to increased borrowings under the Company's revolving credit facility and bridge loan; the note payable to Ashok Rao, the Company's former President and Chief Executive Officer, executed in connection with the redemption of 885,360 shares of the Company's common stock held by Mr. Rao and certain trusts established by Mr. Rao; and increased capital lease obligations incurred in connection with the acquisition of furniture and equipment, including the installation of the Company's new high-capacity switches and other network enhancements.

INCOME TAXES. The Company has incurred losses for all periods presented. No tax benefit has been recorded with respect to these losses due to the uncertainty as to the utilization of Company's net operating loss carryforward.

NET LOSS. For the quarter ended September 30, 1997, the Company reported a net loss of \$23.6 million (\$1.56 per share) compared to a net loss of \$18.3 million (\$1.16 per share) for the same period in 1996. For the nine

months ended September 30, 1997, the Company reported a net loss of \$ 69.5 million (\$ 4.51 per share) versus a net loss of \$ 77.4 million (\$ 5.01 per share) for the same period in 1996. The substantial increase in net loss for the quarter ended September 30, 1997 over the corresponding period in 1996 is attributable to the declines in revenue and gross margin, as well as increases in selling, general and administrative expenses, the relocation of the Company's corporate headquarters, and the increase in interest expense, offset by the reduction of amortization. The decrease in net loss for the nine months ended September 30, 1997 compared to the corresponding period in 1996 is a result of the impairment losses, restructuring charges, contract dispute settlement and higher amortization expense recognized in 1996, offset by higher revenue in 1996 and the increases in selling, general and administrative expenses, the relocation of the Company's corporate headquarters and the increase in interest expense in 1997.

LIQUIDITY AND CAPITAL RESOURCES

The Company has operated at substantial losses since its inception. Net losses were approximately \$69.5 million, \$97.3 million and \$33.4 million for the nine months ended September 30, 1997 and the years ended December 31, 1996 and 1995, respectively. As a result of these losses, significant attrition in certain acquired customer bases, investments in business expansion and various other factors, the Company has required substantial external working capital. As of September 30, 1997, the book value of the Company's assets was approximately \$58.2 million, total debt outstanding was approximately \$149.1 million, and the Company had a negative net worth of approximately \$144.7 million.

In its Quarterly Report on Form 10-Q for the quarter ended June 30, 1997, the Company disclosed that, in addition to borrowings available under its revolving credit facility (the "Foothill Credit Facility") with Foothill Capital Corporation ("Foothill"), and financing available under its capital lease facilities, the Company would require between \$20 million and \$30 million of additional capital in order to fund operating losses, working capital requirements and capital expenditures during the remainder of 1997. In August 1997, the Company obtained an \$8 million bridge loan from Foothill (the "Foothill Bridge Loan"). The Foothill Bridge Loan had an interest rate of 15% per annum and was payable in full on November 1, 1997. In addition, on October 10, 1997, the Company completed a private placement of 875,000 shares of Common Stock. The Company received net proceeds from the private placement of approximately \$5.5 million which were used for working capital purposes in October 1997.

In early September 1997, the Company received a term sheet from a major financial institution for an equity financing ranging from \$40 million to \$50 million. Due diligence with respect to the proposed equity financing commenced immediately with the goal of closing the financing by October 31, 1997. In addition, throughout September and October 1997, the Company continued to pursue other short-term financing. However, at the end of October 1997, the Company had not been successful in its efforts to close the proposed equity financing or obtain additional financing.

On November 4, 1997, as a result of the Company's failure to repay the Foothill Bridge Loan in full when due, Foothill gave notice of a default under the Foothill Credit Facility and ceased making any further advances to the Company or any of its subsidiaries. In addition to the repayment of the Foothill Bridge Loan, the Company was required to make substantial payments to Sprint Communications Company ("Sprint"), and several of the Company's suppliers threatened termination of services.

Faced with the imminent termination of service by the Company's principal long-distance carriers, on November 7, 1997, the Company and three of its wholly-owned subsidiaries, PacNet, Adval and Cel-Tech, filed the Petitions and are currently operating their respective businesses as debtors-in-possession pursuant to Sections 1107(a) and 1108 of the Bankruptcy Code and subject to the jurisdiction of the Bankruptcy Court. The Petitions were filed in order to allow the Company and its subsidiaries to continue operations while obtaining relief from the immediate collection of obligations owed to Foothill, Sprint and other creditors.

The voluntary filing of a petition for relief under the Bankruptcy Code constitutes a default under the Foothill Credit Facility, the Company's equipment lease facilities, the Indenture relating to the Company's \$97.7 aggregate principal amount of 8 1/4% Subordinated Convertible Notes due 2003 and the note payable to Ashok Rao in connection with the redemption of certain shares of Common Stock (see Note 6 to the Company's Unaudited Condensed Consolidated Interim Financial Statements included in this Report). Accordingly, approximately \$112.1 million of long-term indebtedness has been reclassified as current liabilities as of September 30, 1997. Since it is not possible to predict the impact of a sale or liquidation of the Company, no other adjustments have been made to the historical carrying values of the assets and liabilities.

The Company has arranged for debtor-in-possession financing (the "Foothill DIP Facility") from Foothill. In connection with the Foothill DIP Financing, the Company incurred a loan fee of \$250,000. The Foothill DIP Facility consists of a revolving credit facility with borrowing availability of up to \$8.5 million, subject to the Company's satisfaction of various terms and conditions, bears interest at prime plus 4% on receivable based advances and 18% on overadvances and expires on January 15, 1997. There can be no assurance that borrowings available under the Foothill DIP Facility will be adequate to meet the Company's working capital needs or that the Company will not require additional debt or equity financing in the future, and there can be no assurance that any such additional debt or equity financing, if needed, would be available to the Company on acceptable terms or at all. In addition, the Company is currently attempting to solicit offers to purchase all or portions of its assets. There can be no assurance that any such transaction will be available to the Company on acceptable terms or at all. The Company is also undertaking aggressive cost-cutting measures, including the lay-off on November 7, 1997 of 170 of its 790 employees. Further cost-cutting measures will be required if the Company is unable to complete a sale of all or part of its business or obtain additional sources of working capital in the near-term. Cost-cutting measures, particularly those affecting the Company's sales and service functions, could have a material adverse effect on the Company's ability to generate revenue.

The Company is required to submit a plan of reorganization to the Bankruptcy Court. The Company is in the process of developing a plan of reorganization, which the Company expects will involve the sale of all or part of its business. There can be no assurance that the Company will be successful in completing a sale of all or part of its business. In addition, there can be no assurance that the Bankruptcy Court will approve the Company's reorganization plan. If the Company is unable to find a buyer for all or part of its business, or if the Company's reorganization plan is not approved, the Company may be forced to liquidate.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information required by Part II, Item 1, of Form 10-Q is incorporated

herein by reference to Note 9 to the Company's Unaudited Condensed Consolidated Financial Statements included in Part I, Item 1 of this Report.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

The information required by Part II, Item 3, of Form 10-Q is incorporated

herein by reference to Note 2 to the Company's Unaudited Condensed Consolidated Financial Statements included in Part I, Item 1 of this Report and Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources included in Part I, Item 2 of this Report.

ITEM 5. OTHER INFORMATION

On November 10, 1997, the Company announced that the August 13, 1997 merger

agreements with Phoenix Network, Inc. ("Phoenix") and Trans National Communications ("TNC") had been terminated. On October 31, 1997, Phoenix notified the Company of its intent to terminate the merger agreement, effective November 5, 1997, due to alleged material breaches by the Company, including the Company's termination of its agreement with Sprint and the deterioration of the Company's financial condition. In addition, on November 6, 1997, TNC notified the Company of its intent to terminate its purchase agreements with Phoenix that Phoenix had assigned to the Company.

The Company's Common Stock is currently listed on the Nasdaq Stock Market. On November 7, 1997, Nasdaq notified the Company that the Common Stock would be de-listed from the Nasdaq Stock Market effective November 17, 1997. The notice also stated that, because the Company had filed a petition for relief under Chapter 11 of the Bankruptcy Code, the letter "Q" would be appended to the Company's trading symbol effective November 12, 1997. Although the Company intends to pursue available procedural remedies, there can be no assurance that the Common Stock will continue to be listed on the Nasdaq Stock Market after November 17, 1997. If the Common Stock were de-listed from the Nasdaq Stock Market, the liquidity of the Common Stock would be significantly diminished which would likely result in a material decrease in the market price for the Common Stock. These events would materially and adversely affect the Company's ability to obtain financing through the sale of Common Stock or securities convertible into Common Stock and, ultimately, could have a material adverse effect on the Company's business, financial condition and results of operations.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

- | | |
|------|---|
| 10.1 | Amendment Number Three, dated as of September 17, 1997, to Loan and Security Agreement by and among Midcom Communications Inc., Adval, Inc., Adval Data Corporation, Advanced Network Design, Cel-Tech International Corp. and PacNet, Inc., as borrowers, and Foothill Capital Corporation, as lender. |
| 10.2 | Warrant to Purchase 100,000 Shares of Common Stock by Foothill Capital Corporation. |
| 11.1 | Statement re: computation of net loss per share. |
| 27.1 | Financial Data Schedule. |

(b) Reports on Form 8-K

The Company filed Current Reports on Form 8-K on September 12, 1997 and on September 24, 1997. There were no other Current Reports on Form 8-K filed by the Company during the period covered by this Report.

SIGNATURE

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

MIDCOM Communications Inc
(Registrant)

Date: November 14, 1997

/s/ Kevin Smith

Executive Vice President &
Chief Financial Officer
(Principal Financial Officer)

MIDCOM COMMUNICATIONS INC.

INDEX TO EXHIBITS

EXHIBIT
NUMBER
(REFERENCED TO
ITEM 601 OF
Regulation S-K)

EXHIBIT
DESCRIPTION

10.1

Amendment Number Three, dated as of September 17, 1997, to Loan and Security Agreement by and among Midcom Communications Inc., Adval, Inc., Adval Data Corporation, Advanced Network Design, Cel-Tech International Corp. and PacNet, Inc., as borrowers, and Foothill Capital Corporation, as lender.

10.2

Warrant to Purchase 100,000 Shares of Common Stock by Foothill Capital Corporation

11.1

Statement re: computation of net loss per share

27.1

Financial Data Schedule

Exhibit 10.1

AMENDMENT NUMBER THREE TO
LOAN AND SECURITY AGREEMENT

BY AND BETWEEN

MIDCOM COMMUNICATIONS INC.,
ADVAL, INC.,
ADVAL DATA CORPORATION,
ADVANCED NETWORK DESIGN,
CEL-TECH INTERNATIONAL CORP.,
AND
PACNET INC.

AND

FOOTHILL CAPITAL CORPORATION

DATED AS OF SEPTEMBER 17, 1997

**AMENDMENT NUMBER THREE TO
LOAN AND SECURITY AGREEMENT**

THIS AMENDMENT NUMBER THREE TO LOAN AND SECURITY AGREEMENT (THIS "AMENDMENT"), is entered into as of September 17, 1997, by and among FOOTHILL CAPITAL CORPORATION, a California corporation ("Foothill"), with a place of business located at 11111 Santa Monica Boulevard, Suite 1500, Los Angeles, California 90025-33333, MIDCOM COMMUNICATIONS INC., a Washington corporation ("Midcom"), with its chief executive office located at 26899 Northwest Highway, Suite 418, Southfield, Michigan 48034, ADVAL, INC., an Oregon corporation ("AdVal"), with its chief executive office located at 200 Galeria Office Center, Southfield, Michigan 48034, ADVAL DATA CORPORATION, an Oregon corporation ("AdVal Data"), with its chief executive office located at 200 Galeria Office Center, Southfield, Michigan 48034, ADVANCED NETWORK DESIGN, a California corporation ("A.N.D."), with its chief executive office located at 14849 Firestone Boulevard, La Mirada, California 90638, CEL-TECH International Corp., a Washington Corporation ("Cel-Tech") with its chief executive offices located at 12826 SE 40th Lane, Factoria, Washington 98004, and PACNET INC., a Washington corporation ("PacNet"), with its chief executive office located at 26899 Northwest Highway, Suite 418, Southfield, Michigan 48034 (collectively, and jointly and severally, the "Borrowers").

This Amendment is entered into with reference to the following facts:

- A. Foothill and the Borrowers have previously entered into that certain Loan and Security Agreement, dated as of February 27, 1997 (the "Original Agreement");
- B. Foothill and the Borrowers have previously entered into that certain Amendment Number One to Loan and Security Agreement (the "First Amendment"), dated as of April 1, 1997 and that certain Amendment Number Two to Loan and Security Agreement (the "Second Amendment"), dated as of May 29, 1997 (the Original Agreement, as amended by the First Amendment and the Second Amendment, is referred to herein as the "Agreement");
- C. The Borrowers have requested that Foothill make certain additional amendments to the Agreement, inter alia, to extend additional financing in the amount of up to \$8,000,000, as set forth in this Amendment;
- D. Foothill is willing to so amend the Agreement in accordance with the terms and conditions hereof, and

E. All capitalized terms used herein and not defined herein shall have the meanings ascribed to them in the Agreement, as amended hereby.

NOW, THEREFORE, in consideration of the above recitals and the mutual promises contained herein, Foothill and the Borrowers hereby agree as follows:

1. Amendments to the Agreement.

a. Section 1.1 of the Agreement hereby is amended by adding the following new defined terms in alphabetical order.

"Gross Accounts" means 100% of the gross amount of all Accounts, including any unbilled Accounts as calculated in accordance with generally accepted accounting principles, excluding, however, all credit insurance, guaranties, or security therefore.

"Line Block Amount" means (a) from the date on which the Term Loan is first made and until such date as all amounts outstanding under the Term Loan are repaid in full in cash, the lesser of (i) \$10,000,000 and (ii) the sum of \$10,000,000 minus an amount, if any, equal to that portion of the Borrowing Base composed of Borrowers' Eligible Accounts (and only that portion of the Borrowing Base composed of Eligible Accounts) in excess of \$12,000,000, and (b) from and after the date on which all amounts outstanding under the Term Loan are repaid in full in cash, \$0.

"Term Loan" means the term loan made pursuant to, and defined in Section 2.1A hereof.

"Term Loan Commitment Letter" means that certain letter agreement dated as of August 14, 1997 from Foothill to Borrower concerning the provision of certain additional financing to Borrower.

"Third Amendment" means that certain Amendment Number Three to Loan and Security Agreement, dated as of September 17, 1997, between Foothill and the Borrowers.

"Warrants" means those certain warrants, in form and substance satisfactory to Foothill and its counsel in their sole discretion, convertible into and exercisable for 100,000 shares of Midcom's common stock, par value \$0.001 per share, issued to Foothill by Midcom pursuant to the Term Loan Commitment Letter, and any related documents required by Foothill and its Counsel.

b. The following definitions contained in Section 1.1 of the Agreement hereby are deleted in their entirety and the following hereby are substituted in lieu thereof:

"Advances" means the advances, made pursuant to, and defined in

Section 2.1(a)

"Average Unused Portion of Facility" means, as of the first day of any month, the non-negative amount equal to (a) the then Maximum Amount (giving effect to any increases thereof, if any, that have become effective before, or that become effective on, such day), minus (b) the sum of (x) the average Daily Balance of Advances that were outstanding during the immediately preceding month and (y) the outstanding principal amount of the Term Loan on such day.

"Loan Documents" means this Agreement, the First Amendment, the Second Amendment, the Third Amendment, the Disbursement Letter, the Lockbox Agreements, the Pledge Agreement, the Trademark Security Agreement, any Mortgages hereafter delivered by any one or more of the Borrowers to Foothill, the Suretyship Agreement, the Intercreditor Agreements, the Control Agreements, any note or notes executed by any one or more of the Borrowers and payable to Foothill, the Term Loan Commitment Letter, the Warrants, and any other agreement entered into, now or in the future, in connection with this Agreement.

"Maximum Amount" means, subject to increase as set forth below, \$30,000,000 minus the Line Block Amount. From time to time after the date on which all amounts outstanding under the Term Loan are repaid in full, in cash, Borrower may request an increase in the Maximum Amount, on one or more occasions, in increments of \$5,000,000 or an integral multiple thereof, to an amount not to exceed \$50,000,000, such increases to become effective in each instance, prospectively, subject to the prior or concurrent satisfaction of the Maximum Amount Increase Conditions.

"Maximum Foothill Amount" means that portion of the Maximum Amount for which Foothill shall be responsible, exclusive of any participations with Participants. The Maximum Foothill Amount shall be equal to the Maximum Amount until such time as Foothill shall obtain one or more Participants satisfactory to Foothill to provide commitments in respect hereof on terms and conditions satisfactory to Foothill, at which time the Maximum Foothill Amount shall be reduced Dollar-for-Dollar by the amount of commitments so provided by such Participants; provided, however, that in no event shall the Maximum Foothill Amount be less than the lower of \$15,000,000 and 50% of the Maximum Amount.

b. The following definitions contained in Section 1.1 of the Agreement hereby are deleted in their entirety and the following hereby are substituted in lieu thereof:

"Advances" means the advances, made pursuant to, and defined in

Section 2.1(a)

"Average Unused Portion of Facility" means, as of the first day of any month, the non-negative amount equal to (a) the then Maximum Amount (giving effect to any increases thereof, if any, that have become effective before, or that become effective on, such day), minus (b) the sum of (x) the average Daily Balance of Advances that were outstanding during the immediately preceding month and (y) the outstanding principal amount of the Term Loan on such day.

"Loan Documents" means this Agreement, the First Amendment, the Second Amendment, the Third Amendment, the Disbursement Letter, the Lockbox Agreements, the Pledge Agreement, the Trademark Security Agreement, any Mortgages hereafter delivered by any one or more of the Borrowers to Foothill, the Suretyship Agreement, the Intercreditor Agreements, the Control Agreements, any note or notes executed by any one or more of the Borrowers and payable to Foothill, the Term Loan Commitment Letter, the Warrants, and any other agreement entered into, now or in the future, in connection with this Agreement.

"Maximum Amount" means, subject to increase as set forth below, \$30,000,000 minus the Line Block Amount. From time to time after the date on which all amounts outstanding under the Term Loan are repaid in full, in cash, Borrower may request an increase in the Maximum Amount, on one or more occasions, in increments of \$5,000,000 or an integral multiple thereof, to an amount not to exceed \$50,000,000, such increases to become effective in each instance, prospectively, subject to the prior or concurrent satisfaction of the Maximum Amount Increase Conditions.

"Maximum Foothill Amount" means that portion of the Maximum Amount for which Foothill shall be responsible, exclusive of any participations with Participants. The Maximum Foothill Amount shall be equal to the Maximum Amount until such time as Foothill shall obtain one or more Participants satisfactory to Foothill to provide commitments in respect hereof on terms and conditions satisfactory to Foothill, at which time the Maximum Foothill Amount shall be reduced Dollar-for-Dollar by the amount of commitments so provided by such Participants; provided, however, that in no event shall the Maximum Foothill Amount be less than the lower of \$15,000,000 and 50% of the Maximum Amount.

"Obligations" means the Term Loan, the Advances, and all other loans, debts, principal, interest (including any interest that, but for the provisions of the Bankruptcy Code, would have accrued), contingent reimbursement obligations owing to Foothill, premiums (including Early Termination Premiums), liabilities (including all amounts charged to the Loan Account pursuant hereto), obligations, fees or Foothill Expenses (including any fees or expenses that, but for the provisions of the Bankruptcy Code, would have accrued) lease payments, guaranties, covenants, and duties owing by Midcom or any other Borrower to Foothill of any kind description (whether pursuant to or evidenced by the Loan Documents or pursuant to any other agreement between Foothill and any Borrower, and irrespective of whether for the payment of money), whether direct or indirect, absolute or contingent, due or to become due, now existing or hereafter arising, and including any debt, liability, or obligation owing from any Borrower to others that Foothill may have obtained by assignment or otherwise, and further including all interest not paid when due and all Foothill Expenses that any Borrower is required to pay or reimburse by the Loan Documents, by law, or otherwise.

c. The following new Section 2.1A is added to the Agreement as follows:

2.1A TERM LOAN. Foothill has agreed to convert the Overadvance made pursuant to the Term Loan Commitment Letter to a term loan (the "Term Loan") to Borrower in the original principal amount of \$8,000,000 effective upon the satisfaction of the conditions set forth in the Third Amendment. The outstanding principal balance and all accrued and unpaid interest under the Term Loan shall be due and payable on the earlier of (i) November 1, 1997 or (ii) upon the termination of this Agreement, whether by its terms, by prepayment, by acceleration, or otherwise. The unpaid principal balance of the Term Loan may be prepaid in whole or in part without penalty or premium at any time during the term of this Agreement upon 30 days prior written notice by Borrower to Foothill. Without limiting anything in the foregoing, there shall be no Early Termination Premium payable with respect to the Term Loan at any time.

d. Section 2.1(c) of the Agreement is hereby amended and restated in its entirety as follows:

(1) Section 2.1(c) of the Agreement:

(c) Foothill shall have no obligation to make Advances hereunder to the extent they would cause the outstanding Obligations to exceed the lesser of (i) the Maximum Amount and (ii) the Gross Accounts. In addition, Foothill shall have no obligation to make Advances hereunder to the extent they would cause the

outstanding Obligations to exceed the lesser of (x) the Maximum Foothill Amount plus the Syndicated Amount and (y) the Gross Accounts.

e. Section 2.2 of the Agreement is amended and restated in its entirety as follows:

2.2 OVERADVANCES.

(a) If, at any time or for any reason, the aggregate amount of Obligations with respect to Advances owed by Borrower to Foothill pursuant to Section 2.1 is greater than either the dollar or percentage limitations set forth in Section 2.1 (an "Overadvance"), Borrower immediately shall pay to Foothill, in cash, the amount of such excess to be used by Foothill to repay Advances outstanding under Section 2.1.

(b) If, at any time or for any reason, the aggregate amount of all Obligations owed by Borrower to Foothill exceeds the lesser of (i) the Maximum Amount and (ii) the Gross Accounts, Borrower immediately shall pay to Foothill, in cash, the amount of such excess to be used by Foothill to repay Advances outstanding under Section 2.1.

f. Sections 2.3(a), 2.3(b), and 2.3(d) of the Agreement are hereby amended and restated in their entirety as follows:

(a) Except as provided in Section 2.3(b), (i) the Term Loan shall bear interest at a per annum rate of 15.00 percent, and (ii) all other Obligations (except for the Term Loan) shall bear interest at a per annum rate of the Reference Rate plus 1.00 percentage points.

(b) Default Rate. From and after the occurrence and during the continuation of an Event of Default, (i) the Term Loan shall bear interest at a per annum rate equal to 18.00 percent, and (ii) all other Obligations (except for the Term Loan) shall bear interest at a per annum rate equal to Reference Rate plus 4.00 percentage points.

(d) Payments. Interest hereunder shall be due and payable, in arrears, on the first day of each month during the term hereof. Each Borrower hereby authorizes Foothill to charge, and (unless Foothill receives instructions from an Authorized Officer regarding alternative means of payment acceptable to Foothill in respect thereof), Foothill shall charge, without prior notice to Borrower, such interest, all Foothill Expenses (as and when incurred), and all installments or other payments due under the Term Loan or any Loan Document to the Loan Account, which amounts thereafter shall accrue interest at the rate then applicable to Advances.

hereunder. Any interest not paid when due shall be compounded and shall thereafter accrue interest at the rate then applicable to Advances hereunder.

g. The first sentence of Section 2.7 of the Agreement is amended and restated in its entirety as follows:

Foothill shall maintain an account on its books in the name of the Borrowers (the "Loan Account") on which the Borrowers will be charged with all Advances and the Term Loan made by Foothill to the Borrowers or for the Borrowers' account, including, accrued interest, Foothill Expenses, and any other payment Obligations of the Borrowers, in accordance with Section 2.5 and on which the Borrowers will be credited with all payments received by Foothill from any Borrower or for the Borrower's account, including all amounts received in the Foothill Account from any Lockbox Bank.

h. The following new Section 2.8(f) is added to the Agreement as follows:

(f) **Term Loan Commitment Fee.** A one time commitment fee of One Hundred Sixty Thousand Dollars (\$160,000), which is earned, in full, upon Foothill's receipt of a duly executed counterpart to the Term Loan Commitment Letter.

i. The introductory phrase to Section 3.2 of the Agreement is amended and restated in its entirety as follows:

3.2 CONDITIONS PRECEDENT TO ALL ADVANCES AND THE TERM LOAN. The following shall be conditions precedent to all Advances and the Term Loan hereunder:

j. The introductory phrase to Article 5 of the Agreement is amended and restated in its entirety as follows:

In order to induce Foothill to enter into this Agreement, each Borrower makes the following representations and warranties with respect to such Borrower or its assets, which shall be true, correct, and complete in all respects as of the Effective Date, and at and as of the date of making of each Advance or the Term Loan made thereafter, as though made on and as of the date of such Advance or the Term Loan, (except to the extent that such representations and warranties relate solely to an earlier date) and such representations and warranties shall survive the execution and delivery of this Agreement:

k. Section 7.18 of the Agreement is hereby amended and restated in its entirety as follows:

7.18 USE OF PROCEEDS. Use the proceeds of the Advances and the Term Loan made hereunder for any purpose other than (a) to pay transactional costs and expenses incurred in connection with this Agreement, and (b) thereafter, consistent with the terms and conditions hereof, for its lawful and permitted corporate purposes.

2. REPRESENTATIONS AND WARRANTIES. Borrower hereby represents and warrants to Foothill that:

(a) The execution, delivery, and performance of this Amendment and of the Agreement, as amended by this Amendment, are within its corporate powers, have been duly authorized by all necessary corporate action, and are not in contravention of any law, rule, or regulation, or any order, judgment, decree, writ, injunction, or award of any arbitrator, court, or governmental authority, or of the terms of its charter or bylaws, or of any contract or undertaking to which it is a party or by which any of its properties may be bound or affected; and

(b) This Amendment and the Agreement, as amended by this Amendment, constitute Borrower's legal, valid, and binding obligation, enforceable against Borrower in accordance with its terms, except as enforcement may be limited by equitable principles or by bankruptcy, insolvency, reorganization, moratorium or similar laws relating to or limiting creditors rights generally.

3. CONDITIONS PRECEDENT TO AMENDMENT. The satisfaction of each of the following, on or before the Third Amendment Closing Deadline, unless waived or deferred by Foothill in its sole discretion, shall constitute conditions precedent to the effectiveness of this Amendment:

a. Foothill shall have received each of the following documents, in form and substance satisfactory to Foothill and its counsel, duly executed, and each such document shall be in full force and effect:

(1) this Amendment; and

(2) the Warrants.

b. Foothill shall have received an opinion of counsel from counsel to the Borrowers acceptable to Foothill and its counsel.

c. The representations and warranties in this Amendment, the Agreement as amended by this Amendment, and the other Loan Documents shall be true and correct in all respects on and as of the date hereof, as though made on such date (except to the extent that such representations and warranties relate solely to an earlier date);

d. No Event of Default or event which with the giving of notice or passage of time would constitute an Event of Default shall have occurred and be continuing on the date hereof, no shall result from the consummation of the transactions contemplated herein;

e. No injunction, writ, restraining order, or other order of any nature prohibiting, directly or indirectly, the consummation of the transactions contemplated herein shall have been issued and remain in force by any governmental authority against the Borrowers or Foothill; and

f. No material adverse change shall have occurred in the financial condition of the Borrowers, any guarantor, or in the value of the Collateral;

g. All other documents and legal matters in connection with the transactions contemplated by this Amendment shall have been delivered or executed or recorded and shall be in form and substance satisfactory to Foothill and its counsel.

4. **FURTHER ASSURANCES.** Borrower shall execute and deliver all agreements, documents, and instruments, in form and substance satisfactory to Foothill, and take all actions as Foothill may reasonably request from time to time fully to consummate the transactions contemplated under this Amendment and the Agreement, as amended by this Amendment.

5. PAYMENT OF TERM LOAN COMMITMENT FEE.

a. The Borrowers and Foothill hereby acknowledge that (i) the Borrowers have executed and delivered a counterpart of the Term Loan Commitment Letter to Foothill on August 14, 1997, and (ii) Foothill has received such counterpart and has charged the term loan commitment fee specified therein and in Section 2.8(f) of the Agreement, as amended by this Amendment, to Borrower's Loan Account on that date.

6. MISCELLANEOUS.

a. Upon the effectiveness of this Amendment, each reference in the Agreement to "this Agreement", "hereunder", "herein", "hereof" or words of like import referring to the Agreement shall mean and refer to the Agreement as amended by this Amendment.

b. Upon the effectiveness of this Amendment, each reference in the Loan Documents to the "Loan Agreement", "thereunder", "therein", "thereof" or words

of like import referring to the Agreement shall mean and refer to the Agreement as amended by this Amendment.

c. As used in this Amendment, "Third Amendment Closing Deadline" means September 17, 1997.

d. This Amendment shall be governed by and construed in accordance with the laws of the State of California.

e. This Amendment may be executed in any number of counterparts and by different parties on separate counterparts, each of which, when executed and delivered, shall be deemed to be an original, and all of which, when taken together, shall constitute but one and the same Amendment. Delivery of an executed counterpart of this Amendment by telefacsimile shall be equally as effective as delivery of an original executed counterpart of this Amendment. Any party delivering an executed counterpart of this Amendment by telefacsimile also shall deliver an original executed counterpart of this Amendment but the failure to deliver an original executed counterpart shall not affect the validity, enforceability, and binding effect of this Amendment.

[Remainder of page intentionally left blank.]

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be duly executed as of the date first written above.

MIDCOM COMMUNICATIONS INC.,
a Washington corporation

By

Title: President and CEO
ADVAL, INC.,
an Oregon corporation

By

Title: President and CEO
ADVAL DATA CORPORATION,
an Oregon corporation

By

Title: President and CEO
ADVANCED NETWORK DESIGN,
a California corporation

By

Title: President and CEO
CEL-TECH INTERNATIONAL CORP.,
a Washington corporation

By

Title: President and CEO
10

PACNET INC.,
a Washington corporation

By

Title: President and CEO
FOOTHILL CAPITAL CORPORATION,
a California corporation

By

Title:
11

PACNET INC.,
a Washington corporation

By

Title:
FOOTHILL CAPITAL CORPORATION,
a California corporation

By

Title: Senior Vice President
12

EXHIBIT 10.2

THIS WARRANT HAS NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS

AMENDED OR ANY STATE SECURITIES LAWS. NO SALE OR DISPOSITION MAY BE EFFECTED WITHOUT (i) AN EFFECTIVE REGISTRATION STATEMENT RELATED THERETO, (ii) AN OPINION OF COUNSEL FOR THE HOLDER, REASONABLY SATISFACTORY TO THE COMPANY, THAT SUCH REGISTRATION IS NOT REQUIRED, (iii) RECEIPT OF A NO-ACTION LETTER(S) FROM THE APPROPRIATE GOVERNMENTAL AUTHORITY(IES), OR (iv) OTHERWISE COMPLYING WITH THE PROVISIONS OF SECTION 7 OF THIS WARRANT.

MIDCOM COMMUNICATIONS INC. WARRANT TO PURCHASE 100,000 SHARES OF COMMON STOCK (this "Warrant")

MIDCOM COMMUNICATIONS INC., a Washington corporation (the "Company"), hereby certifies that, for value received, Foothill Capital Corporation, a California corporation, or registered assigns, is the registered holder of warrants (the "Warrants") to subscribe for and purchase One Hundred Thousand (100,000) shares of the fully paid and nonassessable Common Stock (as adjusted pursuant to Section 4 hereof, the "Shares") of the Company, at the price of \$8.75 per share (such price and such other prices as shall result, from time to time, from the adjustments specified in Section 4 hereof is herein referred to as the "Warrant Price"), subject to the provisions and upon the terms and conditions hereinafter set forth. As used herein, (a) the term "Common Stock" shall mean the Company's presently authorized Common Stock, par value \$.0001 per share, and any stock into or for which such Common Stock may hereafter be converted or exchanged, (b) the term "Date of Grant" shall mean September 17, 1997, and (c) the term "Other Warrants" shall mean any warrant issued upon transfer or partial exercise of this Warrant. The term "Warrant" as used herein shall be deemed to include Other Warrants unless the context hereof or thereof clearly requires otherwise.

1. Term. The purchase right represented by this Warrant is exercisable, in whole or in part, at any time and from time to time from the Date of Grant through and including September 17, 2002.

2. Method of Exercise; Payment; Issuance of New Warrant. Subject to Section 1 hereof, the purchase right represented by this Warrant may be exercised by the holder hereof, in whole or in part and from time to time, by the surrender of this Warrant (with the notice of exercise form attached hereto as Exhibit A duly executed) at the principal office of the Company and by the payment to the Company of an amount equal to the then applicable Warrant Price multiplied by the number of Shares then being purchased. The person or persons in whose name(s) any certificate(s) representing shares of Common Stock shall be issuable upon exercise of this Warrant shall be deemed to have become the holder(s) of record of, and shall be treated

for all purposes as the record holder(s) of the shares represented thereby (and such shares shall be deemed to have been issued) immediately prior to the close of business on the date or dates upon which this Warrant is exercised. In the event of any exercise of the rights represented by this Warrant, certificates for the shares of stock so purchased shall be delivered to the holder hereof as soon as possible and in any event within thirty (30) days after such exercise and, unless this Warrant has been fully exercised or expired, a new Warrant representing the portion of the Shares, if any, with respect to which this Warrant shall not then have been exercised shall also be issued to the holder thereof as soon as possible and in any event within such thirty-day period.

3. **Stock Fully Paid; Reservation of Shares.** All Shares that may be issued upon the exercise of the rights represented by this Warrant will, upon issuance pursuant to the terms and conditions herein, be fully paid and nonassessable, and free from all taxes, liens, charges, and pre-emptive rights with respect to the issue thereof. The Company shall pay all transfer taxes, if any, attributable to the issuance of Shares upon the exercise of the Warrants. During the period within which the rights represented by this Warrant may be exercised, the Company will at all times have authorized, and reserved for the purpose of the issue upon exercise of the purchase rights evidence by this Warrant, a sufficient number of shares of its Common Stock to provide for the exercise of the rights represented by this Warrant.

4. **Adjustment of Warrant Price and Number of Shares.** The number and kind of securities purchasable upon the exercise of the Warrant and the Warrant Price shall be subject to adjustment from time to time upon the occurrence of certain events, as follows:

a. **Reclassification or Merger.** In case of any reclassification, change or conversion of securities of the class issuable upon exercise of this Warrant (other than a change in par value, or from par value to no par value, or from no par value to par value, or as a result of a subdivision or combination), or in case of any merger of the Company with or into another corporation (other than a merger with another corporation in which the Company is the acquiring and the surviving corporation and which does not result in any reclassification or change of outstanding securities issuable upon exercise of this Warrant), or in case of any sale of all or substantially all of the assets of the Company, the Company, or such successor or purchasing corporation, as the case may be, shall duly execute and deliver to the holder of this Warrant a new Warrant (in form and substance satisfactory to the holder of this Warrant), so that the holder of this Warrant shall have the right to receive, at a total purchase price not to exceed that payable upon the exercise of the unexercised portions of this Warrant, and in lieu of the shares of Common Stock theretofore issuable upon exercise of this Warrant, the kind and amount of shares of stock, other securities, money and property receivable upon such reclassification, change or merger by a holder of the number of shares of Common Stock then purchasable under this Warrant. Such new Warrant shall provide for adjustments that shall be as nearly equivalent as may be practicable to the adjustments provided for in this Section 4. The provisions of this subparagraph (a) shall similarly apply to successive reclassifications, changes, mergers and transfers.

b. **Subdivision or Combination of Shares.** If the Company at any time while this Warrant remains outstanding and unexpired shall subdivide or combine its outstanding

shares of Common Stock, the Warrant Price shall be proportionately decreased in the case of a subdivision or increased in the case of a combination, effective at the close of business on the date the subdivision or combination becomes effective.

c. **Stock Dividends and Other Distributions.** If the Company at any time while this Warrant is outstanding and unexpired shall (i) pay a dividend with respect to Common Stock payable in Common Stock, or (ii) make any other distribution with respect to Common Stock (except any distribution specifically provided for in the foregoing sub-paragraphs (a) and (b)) of Common Stock, then the Warrant Price shall be adjusted, from and after the date of determination of shareholders entitled to receive such dividend or distribution, to that price determined by multiplying the Warrant Price in effect immediately prior to such date of determination by a fraction (i) the numerator of which shall be the total number of shares of Common Stock outstanding immediately prior to such dividend or distribution, and (ii) the denominator of which shall be the total number of shares of Common stock outstanding immediately after such dividend or distribution.

d. **Rights Offerings.** In case the Company shall, at any time after the Date of Grant, issue rights, options or warrants to any person or persons who are at the time of such issuance the holders of equity securities of the Company, entitling them to subscribe for or purchase shares of Common Stock (or securities convertible or exchangeable into Common Stock) at a price per share of Common Stock (or having a conversion or exchange price per share of Common Stock if a security convertible or exchangeable into Common Stock) less than the fair market value per share of Common Stock on the record date for such issuance (or the date of issuance, if there is no record date), the Warrant Price to be in effect on and after such record date (or issuance date, as the case may be) shall be determined by multiplying the Warrant Price in effect immediately prior to such record date (or issuance date, as the case may be) by a fraction (i) the numerator of which shall be the number of shares of Common Stock outstanding on such record date (or issuance date, as the case may be) plus the number of shares of Common Stock which the aggregate offering price of the total number of shares of such Common Stock so to be offered (or the aggregate initial exchange or conversion price of the exchangeable or convertible securities so to be offered) would purchase at such fair market value on such record date (or issuance date, as the case may be) and (ii) the denominator of which shall be the number of shares of Common Stock outstanding on such record date (or issuance date, as the case may be) plus the number of additional shares of Common Stock to be offered for subscription or purchase (or into which the convertible securities to be offered are initially exchangeable or convertible). In case such subscription price may be paid in part or in whole in a form other than cash, the fair value of such consideration shall be determined by the Board of Directors of the Company in good faith as set forth in a duly adopted board resolution certified by the Company's Secretary or Assistant Secretary. Such adjustment shall be made successively whenever such an issuance occurs; and in the event that such rights, options, warrants, or convertible or exchangeable securities are not so issued or expire or cease to be convertible or exchangeable before they are exercised, converted, or exchanged (as the case may be), then the Warrant Price shall again be adjusted to be the Warrant Price that would then be in effect if such issuance had not occurred, but such subsequent adjustment shall not affect the number of Shares issued upon any exercise of Warrants prior to the date such subsequent adjustment is made.

e. **Special Distributions.** In case the Company shall fix a record date for the making of a distribution to all holders of shares of Common Stock (including any such distribution made in connection with a consolidation or merger in which the Company is the surviving corporation) or evidences of indebtedness or assets (other than dividends and distributions referred to in subparagraphs (b) and (c) above and other than cash dividends) or of subscription rights, options, warrants, or exchangeable or convertible securities containing the right to subscribe for or purchase shares of any class of equity securities of the Company (excluding those referred to in subparagraph (d) above), the Warrant Price to be in effect on and after such record date shall be adjusted by multiplying the Warrant Price in effect immediately prior to such record date by a fraction (i) the numerator of which shall be the fair market value per share of Common Stock on such record date, less the fair value (as determined by the Board of Directors of the Company in good faith as set forth in a duly adopted board resolution certified by the Company's Secretary or Assistant Secretary) of the portion of the assets or evidences of indebtedness so to be distributed or of such subscription rights, options, warrants, or exchangeable or convertible securities applicable to one (1) share of the Common Stock outstanding as of such record date, and (ii) the denominator of which shall be such fair market value per share of Common Stock. Such adjustment shall be made successively whenever such a record date is fixed; and in the event that such distribution is not so made, the Warrant Price shall again be adjusted to be the Warrant Price which would then be in effect if such record date had not been fixed, but such subsequent adjustment shall not affect the number of Shares issued upon any exercise of Warrants prior to the date such subsequent adjustment was made.

f. **Other Issuances of Securities.** In case the Company or any subsidiary shall, at any time after the Date of Grant, issue shares of Common Stock, or rights, options, warrants or convertible or exchangeable securities containing the right to subscribe for or purchase shares of Common Stock (excluding (i) shares, rights, options, warrants, or convertible or exchangeable securities described in subparagraphs (f) or (g) of Section 11 hereof or issued in any of the transactions described in subparagraphs (b), (c), (d) or (e) above, (ii) shares issued upon the exercise of such rights, options or warrants or upon conversion or exchange of such convertible or exchangeable securities, (iii) the Warrants and any shares issued upon exercise thereof, and (iv) stock options, and shares of Common Stock issued upon exercise of such options, pursuant to any stock option plan existing as of the Date of Grant), at a price per share of Common Stock (determined in the case of such rights, options, warrants, or convertible or exchangeable securities by dividing (x) the total amount receivable by the Company in consideration of the sale and issuance of such rights, options, warrants, or convertible or exchangeable securities, plus the total minimum consideration payable to the Company upon exercise, conversion, or exchange thereof by (y) the total maximum number of shares of Common Stock covered by such rights, options, warrants, or convertible or exchangeable securities) lower than the fair market value per share of Common Stock on the date the Company fixes the offering price of such shares, rights, options, warrants, or convertible or exchangeable securities, then the Warrant Price shall be adjusted so that it shall equal the price determined by multiplying the Warrant Price in effect immediately prior thereto by a fraction (i) the numerator of which shall be the sum of (A) the number of shares of Common Stock outstanding immediately prior to such sale and issuance plus (B) the number of shares of Common Stock which the aggregate consideration received (determined as provided below) for such sale or issuance would purchase at such fair market value per share, and (ii) the

denominator of which shall be the total number of shares of Common Stock outstanding immediately after such sale and issuance. Such adjustment shall be made successively whenever such an issuance is made. For the purposes of such adjustment, the maximum number of shares of Common Stock which the holder of any such rights, options, warrants or convertible or exchangeable securities shall be entitled to subscribe for or purchase shall be deemed to be issued and outstanding as of the date of such sale and issuance and the consideration received by the Company therefor shall be deemed to be the consideration received by the Company for such rights, options, warrants, or convertible or exchangeable securities, plus the minimum consideration or premium stated in such rights, options, warrants, or convertible or exchangeable securities to be paid for the shares of Common Stock covered thereby. In case the Company shall sell and issue shares of Common Stock, or rights, options, warrants, or convertible or exchangeable securities containing the right to subscribe for or purchase shares of Common Stock for a consideration consisting, in whole or in part, of property other than cash or its equivalent, then in determining the price per share of Common Stock and the consideration received by the Company for purposes of the first sentence of this subparagraph (f), the Board of Directors of the Company shall determine, in good faith, the fair value of said property, and such determination shall be described in a duly adopted board resolution certified by the Company's Secretary or Assistant Secretary. In case the Company shall sell and issue rights, options, warrants, or convertible or exchangeable securities containing the right to subscribe for or purchase shares of Common Stock together with one or more other securities as a part of a unit at a price per unit, then in determining the price per share of Common Stock and the consideration received by the Company for purposes of the first sentence of this subparagraph (f), the Board of Directors of the Company shall determine, in good faith, which determination shall be described in a duly adopted board resolution certified by the Company's Secretary or Assistant Secretary, the fair value of the rights, options, warrants, or convertible or exchangeable securities then being sold as part of such unit. Such adjustment shall be made successively whenever such an issuance occurs, and in the event that such rights, options, warrants, or convertible or exchangeable securities expire or cease to be convertible or exchangeable before they are exercised, converted, or exchanged (as the case may be), then the Warrant Price shall again be adjusted to the Warrant Price that would then be in effect if such sale and issuance had not occurred, but such subsequent adjustment shall not affect the number of Shares issued upon any exercise of Warrants prior to the date such subsequent adjustment is made.

g. Adjustment of Number of Shares. Upon each adjustment in the Warrant Price, the number of Shares of Common Stock purchasable hereunder shall be adjusted, to the nearest whole share, to the product obtained by multiplying the number of Shares purchasable immediately prior to such adjustment in the Warrant Price by a fraction, the numerator of which shall be the Warrant Price immediately prior to such adjustment and the denominator of which shall be the Warrant Price immediately thereafter.

h. Determination of Fair Market Value. For purposes of this Section 4, "fair market value" of a share of Common Stock as of a particular date (the "Determination date") shall mean (i) if shares of Common Stock are traded on a national securities exchange (an "Exchange"), the weighted average of the closing prices of a share of the Common Stock of the Company on the last five (5) trading days prior to the Determination

Date reported on such Exchange as reported in The Wall Street Journal (weighted with Respect to the trading volume with respect to each such day), or (ii) if shares of Common Stock are not traded on an Exchange but trade in the over-the-counter market and such shares are quoted on the National Association of Securities Dealers Automated Quotations System ("NASDAQ"), (A) the average of the last sale prices reported on NASDAQ or (B) if such shares are an issue for which last sale prices are not reported on NASDAQ, the average of the closing bid and ask prices, in each case on the last five (5) trading days (or if the relevant price or quotation did not exist on any of such days, the relevant price or quotation on the next preceding business day on which there was such a price or quotation) prior to the Determination Date as reported in The Wall Street Journal.

5. Notice of Adjustments. Whenever the Warrant Price or the number of Shares purchasable hereunder shall be adjusted pursuant to Section 4 hereof, the Company shall make a certificate signed by its chief financial officer setting forth, in reasonable detail, the event requiring the adjustment, the amount of the adjustment, the method by which such adjustment was calculated, and the Warrant Price and the number of Shares purchasable hereunder after giving effect to such adjustment, which shall be mailed (without regard to Section 13 hereof, by first class mail, postage prepaid) to the holder of this Warrant.

6. Fractional Shares. No fractional shares of Common Stock will be issued in connection with any exercise hereunder, but in lieu of such fractional shares the Company shall make a cash payment therefor based on the fair market value (as determined in accordance with Section 4(h) above) of a share of Common Stock on the date of exercise.

7. Compliance with Securities Act; Disposition of Warrant or Shares of Common Stock.

a. Compliance with Securities Act. The holder of this Warrant, by acceptance hereof, agrees that this Warrant and the shares of Common Stock to be issued upon exercise hereof are being acquired for investment and that such holder will not offer, sell or otherwise dispose of this Warrant, or any shares of Common Stock to be issued upon exercise hereof except under circumstances which will not result in a violation of the Securities Act of 1933, as amended (the "Act"). Upon exercise of this Warrant, the holder hereof shall confirm in writing, by executing the form attached as Schedule 1 to Exhibit A hereto, that the shares of Common Stock so purchased are being acquired for investment and not with a view toward distribution or resale. This Warrant and all shares of Common Stock issued upon exercise of this Warrant (unless registered under the Act) shall be stamped or imprinted with a legend in substantially the following form:

"THE SECURITIES EVIDENCED HEREBY HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR ANY STATE SECURITIES LAWS. NO SALE OR DISPOSITION MAY BE EFFECTED WITHOUT (i) AN EFFECTIVE REGISTRATION STATEMENT RELATED THERETO, (ii) AN OPINION OF COUNSEL FOR THE HOLDER, REASONABLY SATISFACTORY TO THE COMPANY, THAT SUCH REGISTRATION IS NOT REQUIRED, (iii) RECEIPT OF A NO-ACTION LETTER(S) FROM THE APPROPRIATE GOVERNMENTAL

Date reported on such Exchange as reported in The Wall Street Journal (weighted with Respect to the trading volume with respect to each such day), or (ii) if shares of Common Stock are not traded on an Exchange but trade in the over-the-counter market and such shares are quoted on the National Association of Securities Dealers Automated Quotations System ("NASDAQ"), (A) the average of the last sale prices reported on NASDAQ or (B) if such shares are an issue for which last sale prices are not reported on NASDAQ, the average of the closing bid and ask prices, in each case on the last five (5) trading days (or if the relevant price or quotation did not exist on any of such days, the relevant price or quotation on the next preceding business day on which there was such a price or quotation) prior to the Determination Date as reported in The Wall Street Journal.

5. Notice of Adjustments. Whenever the Warrant Price or the number of Shares purchasable hereunder shall be adjusted pursuant to Section 4 hereof, the Company shall make a certificate signed by its chief financial officer setting forth, in reasonable detail, the event requiring the adjustment, the amount of the adjustment, the method by which such adjustment was calculated, and the Warrant Price and the number of Shares purchasable hereunder after giving effect to such adjustment, which shall be mailed (without regard to Section 13 hereof, by first class mail, postage prepaid) to the holder of this Warrant.

6. Fractional Shares. No fractional shares of Common Stock will be issued in connection with any exercise hereunder, but in lieu of such fractional shares the Company shall make a cash payment therefor based on the fair market value (as determined in accordance with Section 4(h) above) of a share of Common Stock on the date of exercise.

7. Compliance with Securities Act; Disposition of Warrant or Shares of Common Stock.

a. Compliance with Securities Act. The holder of this Warrant, by acceptance hereof, agrees that this Warrant and the shares of Common Stock to be issued upon exercise hereof are being acquired for investment and that such holder will not offer, sell or otherwise dispose of this Warrant, or any shares of Common Stock to be issued upon exercise hereof except under circumstances which will not result in a violation of the Securities Act of 1933, as amended (the "Act"). Upon exercise of this Warrant, the holder hereof shall confirm in writing, by executing the form attached as Schedule 1 to Exhibit A hereto, that the shares of Common Stock so purchased are being acquired for investment and not with a view toward distribution or resale. This Warrant and all shares of Common Stock issued upon exercise of this Warrant (unless registered under the Act) shall be stamped or imprinted with a legend in substantially the following form:

"THE SECURITIES EVIDENCED HEREBY HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR ANY STATE SECURITIES LAWS. NO SALE OR DISPOSITION MAY BE EFFECTED WITHOUT (i) AN EFFECTIVE REGISTRATION STATEMENT RELATED THERETO, (ii) AN OPINION OF COUNSEL FOR THE HOLDER, REASONABLY SATISFACTORY TO THE COMPANY, THAT SUCH REGISTRATION IS NOT REQUIRED, (iii) RECEIPT OF A NO-ACTION LETTER(S) FROM THE APPROPRIATE GOVERNMENTAL

**AUTHORITY(IES), OR (IV) OTHERWISE COMPLYING WITH THE PROVISIONS OF SECTION
7 OF THE WARRANT UNDER WHICH THESE SECURITIES WERE ISSUED DIRECTLY OR INDIRECTLY."**

In addition, in connection with the issuance of this Warrant, the holder specifically represents to the Company by acceptance of this Warrant as follows:

- (1) The holder is aware of the Company's business affairs and financial condition, and has acquired information about the Company sufficient to reach an informed and knowledgeable decision to acquire this Warrant. The holder is acquiring this Warrant for its own account for investment purposes only and not with a view to, or for the resale in connection with, any "distribution" thereof for purposes of the Act.
- (2) The holder understands that this Warrant and the Shares have not been registered under the Act in reliance upon a specific exemption therefrom, which exemption depends upon, among other things, the bona fide nature of the holder's investment intent as expressed herein. In this connection, the holder understands that, in the view of the Securities and Exchange Commission (the "SEC"), the statutory basis for such exemption may be unavailable if the holder's representation was predicated solely upon a present intention to hold the Warrant and the Shares for the minimum capital gains period specified under applicable tax laws, for a deferred sale, for or until an increase or decrease in the market price of the Warrant and the Shares, or for a prior of one (1) year or any other fixed period in the future.
- (3) The holder further understands that this Warrant and the Shares must be held indefinitely unless subsequently registered under the Act and any applicable state securities laws, or unless exemptions from registration are otherwise available.
- (4) The holder is aware of the provisions of Rule 144 and 144A, promulgated under the Act, which in substance, permit limited public resale of "restricted securities" acquired, directly or indirectly, from the issuer thereof (or from an affiliate of such issuer), in a non-public offering subject to the satisfaction of certain conditions, if applicable, including, among other things: the availability of certain public information about the Company, the resale occurring not less than one (1) year after the party has purchased and paid for the securities to be sold; the sale being made through a broker in an unsolicited "broker's transaction" or in transactions directly with a market maker (as said term is defined under the Securities Exchange Act of 1934, as amended) and the amount of securities being sold during any three-month period not exceeding the specified limitations stated therein.
- (5) The holder further understands that at the time it wishes to sell this Warrant and the Shares there may be no public market upon which to make such a sale, and that, even if such a public market then exists, the Company may not be satisfying the current public information requirements of Rule 144 and 144A, and that, in such event, the holder may be precluded from selling this Warrant and the Shares under Rule 144 and 144A even if the one(1)- year minimum holding period had been satisfied.

(6) The holder further understands that in the event all of the requirements of Rule 144 and 144A are not satisfied, registration under the Act, compliance with Regulation A, or some other registration exemption will be required; and that, notwithstanding the fact that Rule 144 and 144A is not exclusive, the Staff of the SEC has expressed its opinion that persons proposing to sell private placement securities other than in a registered offering and otherwise than pursuant to Rule 144 and 144A will have a substantial burden of proof in establishing that an exemption from registration is available for such offers or sales, and that such persons and their respective brokers who participate in such transactions do so at their own risk.

b. **Disposition of Warrant or Shares.** With respect to any offer, sale or other disposition of this Warrant, or any Shares acquired pursuant to the exercise of this Warrant prior to registration of such Warrant or Shares, the holder hereof and each subsequent holder of this Warrant agrees to give written notice to the Company prior thereto, describing briefly the manner thereof, together with a written opinion of such holder's counsel, if reasonably requested by the Company, to the effect that such offer, sale or other disposition may be effected without registration or qualification (under the Act as then in effect or any federal or state law then in effect) of this Warrant or such Shares and indicating whether or not under the Act certificates for this Warrant or such Shares to be sold or otherwise disposed of require any restrictive legend as to applicable restrictions on transferability in order to ensure compliance with applicable law. Promptly upon receiving such written notice and reasonably satisfactory opinion, if so requested, the Company, as promptly as practicable, shall notify such holder that such holder may sell or otherwise dispose of this Warrant or such Shares, all in accordance with the terms of the notice delivered to the Company. If a determination has been made pursuant to this subsection (b) that the opinion of counsel for the holder is not reasonably satisfactory to the Company, the Company shall so notify the holder promptly after such determination has been made. The foregoing notwithstanding, this Warrant or such Shares may, as to such federal laws, be offered, sold or otherwise disposed of in accordance with Rule 144 and 144A under the Act, provided that the Company shall have been furnished with such information as the Company may reasonably request to provide a reasonable assurance that the provisions of Rule 144 and 144A have been satisfied. Each certificate representing this Warrant or the Shares thus transferred (except a transfer pursuant to Rule 144) shall bear a legend as to the applicable restrictions on transferability in order to ensure compliance with such laws, unless in the aforesaid opinion of counsel for the holder, such legend is not required in order to ensure compliance with such laws. The Company may issue stop transfer instructions to its transfer agent or, if acting as its own transfer agent the Company may stop transfer on its corporate books, in connection with such restrictions.

8. **Rights as Shareholders; Information.** No holder of this Warrant, as such, shall be entitled to vote or receive dividends or be deemed the holder of Common Stock or any other securities of the Company which may at any time be issuable on the exercise hereof for any purpose, no shall anything contained herein be construed to confer upon the holder of this Warrant, as such, any of the rights of a shareholder of the Company or any right to vote for the election of the directors or upon any matter submitted to shareholders at any meeting thereof, or to receive notice of meetings, or to receive dividends or subscription rights or otherwise until this Warrant shall have been exercised and the Shares purchasable upon the exercise hereof shall

have become deliverable, as provided herein. The foregoing notwithstanding, the Company will transmit to the holder of this Warrant such information, documents and reports as are generally distributed to the holders of any class or series of the securities of the Company concurrently with the distribution thereof to the shareholders.

9. Registration Rights.

9.1.a. The Company covenants and agrees that at any time after receipt of a written request (a "Demand Registration Request") from the holders of this Warrant and the Other Warrants and/or holders of Shares (this Warrant, the Other Warrants, and the Shares are referred to herein, collectively, as the "Securities") (hereinafter, the "Securityholders") constituting at least fifty percent (50%) of the Securities on such date (determined on an as-exercised basis) and then eligible for inclusion in a registration pursuant to this Section 9.1, stating that the Initiating Securityholders (as defined below) desire and intend to transfer all or a portion of the Securities held by them under such circumstances, the Company shall give notice (the "Registration Notice") to all of the Security holders within thirty (30) days of the Company's receipt of such registration request, and the Company shall cause to be included in such registration all Securities requested to be included therein by any such Securityholder within fifteen (15) days after such Registration Notice is effective (subject to the provisions of the final sentence of this Section 9.1(a)). After such fifteen (15)-day period, the Company shall file as promptly as practicable a registration statement and use its reasonable best efforts to cause such registration statement to become effective under the Act and remain effective for one hundred and twenty (120) days or such shorter period as may be required if all such Securities covered by such registration statement are sold prior to the expiration of such one hundred twenty (120)-day period; provided that the Company shall not be obligated to effect any such registration pursuant to this Section 9.1 after the Company has effected one (1) such registration pursuant to this Section 9.1; provided further that to the extent that any Securities requested to be included in the initial registration requested under this Section 9.1(a) are not so included as the result of the provisions of the final sentence of this Section 9.1(a), the Company shall be obligated to effect one (1) additional registration pursuant to this Section 9.1. Each Securityholder making a demand for registration under this Section 9.1 is referred to herein as an "Initiating Securityholder." For purposes of this Section 9, a registration shall not be deemed to have been effected unless a registration statement with regard thereto has been declared effective and, subject to Section 9.3(b) hereof, remained effective for a period of one hundred and twenty (120) days (or such shorter period as is permitted in the second sentence of this Section 9.1). The foregoing notwithstanding, in the event of an underwritten offering pursuant to this Section 9.1, if the managing underwriter of such offering shall advise the Securityholders in writing that, in its opinion, the disbursement of a specified portion of the securities requested to be included in the registration would materially adversely affect the distribution of such securities by increasing the aggregate amount of the offering in excess of the maximum amount of securities which such managing underwriter believes can reasonably be sold in the contemplated distribution, then the securities to be included in the registration shall be included in the following order: (i) first, pro rata among all of the Securities requested to be included therein by the Initiating Securityholder, (ii) second, the Securities requested to be included therein by the other Security holder, pro rata among such Securityholders according to the number of Securities requested by be included by each such Security holder requesting inclusion

therein, and (iii) third, such other securities requested to be included therein by the Company and the holders of such other securities, pro --- among the Company and the holders of such other securities according to the number of securities requested to be included by the Company and each such holder requesting inclusion therein.

b. For purposes of this Section 9.1 the Securityholders who have requested registration of Shares to be acquired upon the exercise of Warrants not theretofore exercised shall furnish the Company with an undertaking that they or the underwriters or other persons to whom such Warrants will be transferred have undertaken to exercise such Warrants and to sell, transfer or otherwise dispose of the shares received upon exercise of such Warrants in such registration.

c. In the event of an underwritten offering pursuant to this Section 9.1, the Company shall be entitled to select the underwriter, provided, that the underwriter so selected shall be subject to approval by the Securityholders requesting registration of the Securities being registered, which approval shall not be withheld unreasonably.

d. Notwithstanding the terms of Section 9.1(a), the Company shall not be required to register the Securities of Securityholders pursuant to Section 9.1, if the Company elects, at its sole option and to the extent that it may legally do so, to purchase such Securities and completes such purchase pursuant to the provisions of this Section 9.1(d). Within fifteen (15) days after receipt of a Demand Registration Request, the Company may elect to purchase all and not less than all of the Securities that would otherwise be subject to registration pursuant to Section 9.1(a) by providing written notice (the "Purchase Notice") to all of the Securityholders setting forth (i) its election to purchase such Securities, (ii) the purchase price of the Securities, and (iii) the closing date for such purchase. The Company shall thereafter purchase all of the Securities requested to be included in such purchase by the Securityholders within fifteen (15) days after the Purchase Notice becomes effective. The purchase price for each Share shall be the fair market value (as defined in Section 4) of a share of Common Stock on the date of the Demand Registration Request, the purchase price for each Warrant shall be (x) the fair market value (as defined in Section 4) of a share of Common Stock on the date of the Demand Registration Request less (y) the Warrant Price. The closing of the purchase of the Securities shall take place on the date set forth in the Purchase Notice, which date shall be not less than fifteen (15) nor more than forty-five (45) days after the date of the Purchase Notice. At the closing, the Company shall deliver to each Securityholder, in cash, the purchase price for the Securities surrendered by such Securityholder.

9.2 a. The Company covenants and agrees with the Securityholders that in the event that the Company proposes after the Date of Grant to file a registration statement under the Act with respect to any of its equity securities (other than pursuant to registration statements on Form S-4 or Form S-8 or any successor or similar forms), whether or not for its own account, then the Company shall give written notice of such proposed filing to all Securityholders promptly (and in any event at least twenty(20) days before the anticipated filing date). Such notice shall offer to such Securityholders, together with others who have similar rights, the opportunity to include in such registration statement such number of Securities as they may request. The Company shall direct and use its reasonable best efforts to cause the

managing underwriter of a proposed underwritten offering (unless the offering is an underwritten offering of a class of the Company's equity securities other than Common Stock and the managing underwriter has advised the Company in writing that, in its opinion, the inclusion in such offering of Common Stock would materially adversely affect the distribution of such offering) to permit the holders of Securities requested to be included in the registration to include such Securities in the proposed offering and the Company shall use its reasonable best efforts to include such Securities in such proposed offering on the same terms and conditions as any similar securities of the Company included therein. If the offering of which the Company gives notice is a public offering involving an underwriter, the right of a Securityholder to registration pursuant to this Section 9.2 shall be conditioned upon such Securityholder's participation in such underwriting and the inclusion of the Securities to be sold by such Securityholder in the underwriting. All Securityholders proposing to distribute Securities through such underwriting shall enter into an underwriting agreement in customary form with the representative of the underwriter or underwriters. The foregoing notwithstanding, in the case of a firm commitment offering on underwriting terms appropriate for such a transaction, other than a registration requested by Securityholders pursuant to Section 9.1, if any such managing underwriter of recognized standing shall advise the Company and the Securityholders in writing that, in its opinion, the distribution of all or a specified portion of the Securities requested to be included in the registration concurrently with the securities being registered by the Company would materially adversely affect the distribution of such securities by increasing the aggregate amount of the offering in excess of the maximum amount of securities which such managing underwriter believes can reasonably be sold in the contemplated distribution, then the securities to be included in a registration which is a primary underwritten offering on behalf of the Company shall be included in the following order: (i) first, the securities the Company proposes to include therein and (ii) second, such other securities (including the Securities) requested to be included, pro rata among the holders (including the Securityholders) of such other securities according to the number of securities requested to be included by each such holder requesting inclusion therein.

b. In the event that a holder or holders of the Company's securities (other than a Securityholder or Securityholders) requests, pursuant to rights granted to such holder or holders, that the Company file a registration statement for the public offering of securities and the Company and the other holders of the Company's securities (including the Securityholders) who have rights to be included in such registration, request to be included in such registration and the managing underwriter of such offering shall advise the Company and the holders requesting inclusion in the offering that, in its opinion, the distribution of a specified portion of the securities requested to be included in the registration would materially adversely affect the distribution of such securities by increasing the aggregate amount of the offering in excess of the maximum amount of securities which such managing underwriter believes can reasonably be sold in the contemplated distribution then, the securities to be included in the registration shall be included in the following order: (i) first, all of the securities requested to be included therein by the holder or holders making the initial request for the registration, and (ii) second, such other securities requested to be included therein by the Company and the holders of such other securities, pro rata among the Company and the holders of such other securities according to the number of securities requested to be included by the Company and each such holder requesting inclusion therein. For purposes of this Section 9.2(b), the Company

agrees to request for inclusion in the registration only that number of securities that the Company intends, in good faith, to sell, if all such securities so requested by the Company were permitted to be included by the managing underwriter in such registration and sold pursuant thereto.

9.3.a. In connection with the registration of Securities on behalf of the holders thereof (such Securityholders being referred to herein as "Sellers") in accordance with Section 9.1 or Section 9.2 above, the Company agrees to:

- (i) enter into a cross-indemnity agreement, in customary form, with each underwriter, if any, and each Seller;
- (ii) subject to the provisions of Section 9.1(a) and Section 9.2(a) regarding reductions by the managing underwriter, include in the registration statement filed with the SEC, the Securities for which requests for registration have been made; provided, however, that promptly after filing a registration statement or prospectus or any amendments or supplements thereto, the Company shall furnish to each Seller copies of all such documents filed including, if requested, documents incorporated by reference in the registration statement; and notify each Seller of any stop order issued or threatened by the SEC and use its best efforts to prevent the entry of such stop order or to remove it if entered;
- (iii) prepare and file with the SEC such amendments of and supplements to such registration statement and the prospectus used in connection therewith as may be necessary to keep such registration statement effective (A) in the case of a registration pursuant to Section 9.1, for a period of one hundred and twenty (120) days, or, in the case of a registration pursuant to Section 9.2, for a period of ninety (90) days, or, in the case of a registration pursuant to Section 9.2, for a period of ninety (90) days or (B) such shorter period as may be required if all such Securities covered by such registration statement are sold prior to the expiration of such periods, and comply with the provisions of the Act with respect to the disposition of all securities covered by such registration statement during such period in accordance with the intended methods of disposition by the Sellers set forth in such registration statement;
- (iv) furnish to each Seller and each underwriter, if any, without charge, such number of copies of the registration statement, each amendment and supplement thereto (in each case including all exhibits thereto), the prospectus included in such registration statement (including each preliminary prospectus) and such other documents as such Seller may reasonably request in order to facilitate the disposition of the Securities proposed to be sold by such Seller;
- (v) use its reasonable best efforts to register or qualify such Securities under such other securities or Blue Sky laws of such jurisdictions as any Seller or any such underwriter reasonably requests in writing and keep such registrations or qualifications in effect for so long as such registration statement remains in effect and do any and all acts and things which may be reasonably necessary or advisable to enable such Seller to consummate the disposition in such jurisdictions of the Securities owned by such Seller;

provided, however, that the Company shall not be required to (A) qualify generally to do business in any jurisdiction where it would not otherwise be required to qualify but for this subsection (v), (B) subject itself to taxation in any such jurisdiction, or (C) consent to general service of process in any jurisdiction;

(vi) notify each Seller, at any time when a prospectus relating to such Seller's Securities is required to be delivered under the Act, of the occurrence of any event as a result of which the prospectus included in such registration statement contains an untrue statement of a material fact or omits to state any material fact necessary to make the statements therein not misleading, and as soon as practicable prepare a supplement or amendment to such prospectus so that, as thereafter delivered to the purchasers of such Securities, such prospectus will not contain an untrue statement of a material fact or omit to state any material fact necessary to make the statements therein not misleading;

(vii) cause all such Securities to be listed on any Exchange or NASDAQ on which similar securities issued by the Company are then listed;

(viii) provide a transfer agent, registrar and CUSIP number for all such Securities not later than the effective date of such registration statement;

(ix) enter into such customary agreements (including an underwriting agreement in customary form) and take all such other actions that the Sellers or the underwriters, if any, reasonably request in order to expedite or facilitate the disposition of such Securities;

(x) make available for inspection by the Sellers and their counsel, any underwriter participating in any disposition pursuant to such registration statement, and any counsel retained by any such underwriter, all pertinent financial and other information and corporate documents of the Company, and cause the Company's officers, directors and employees to supply all information reasonably requested by any such Seller, underwriter or counsel in connection with such registration statement;

(xi) with respect to an underwritten offering, use its reasonable best efforts to obtain a "cold comfort" letter from the Company's independent public accountants in customary form and covering such matters of the type customarily covered by "cold comfort" letters as the sellers or any underwriter may reasonably request;

(xii) with respect to an underwritten offering, obtain an opinion of counsel to the Company, addressed to the Sellers and any underwriter, in customary form and including such matters as are customarily covered by such opinions in underwritten registered offerings of equity securities as the Sellers or any underwriter reasonably request, such opinion to be reasonably satisfactory in form and substance to each Seller; and

(xiii) otherwise use its best efforts to comply with all applicable rules and regulations of the SEC, and make available to its securityholders, as soon as reasonably practicable, an earnings statement covering the period of at least twelve (12)

months subsequent to the effective date of the registration statement, which earnings statement shall satisfy the provisions of Section 11(a) of the Act and Rule 158 thereunder.

b. Any other provisions of this Section 9 notwithstanding, upon receipt by the Securityholders of a written notice signed by the chief executive officer, chief operating officer or chief financial officer of the Company to the effect set forth below, the Company shall not be obligated during a reasonable period of time thereafter to effect any registrations pursuant to this Section 9, and the Securityholders agree that they will immediately suspend sales of shares under any effective registration statement for a reasonable period of time, in either case not to exceed ninety (90) days, at any time at which, in the Company's reasonable judgment, (i) there is a development involving the Company or any of its affiliates which is material but which has not yet been publicly disclosed or (ii) sales pursuant to the registration statement would materially and adversely affect an underwritten public offering for the account of the Company or any other material financing project or a proposed or pending material merger or other material acquisition or material business combination or material disposition of the Company's assets, to which the Company or any of its affiliates is, or is expected to be, a party. In the event a registration is postponed or sales by the Securityholders pursuant to an effective registration statement are suspended in accordance with this Section 9.3(b), there shall be added to the period during which the Company is obligated to keep a registration effective the number of days for which the registration was postponed or sales were suspended pursuant to this Section 9.3(b).

c. The Company may require that each Seller, as a condition registering his, her or its Securities pursuant hereto, to furnish to the Company such information regarding the distribution of the Securities proposed to be sold by such Seller as the Company may from time to time reasonably request in writing.

d. Each Seller agrees that, upon receipt of any notice from the Company of the occurrence of any event of the kind described in subsection (vi) of Section 9.3(a) above, such Seller shall forthwith discontinue disposition of Securities pursuant to the registration statement covering such Securities until such Seller's receipt of copies of the supplemented or amended prospectus contemplated by Section 9.3(a)(vi) above and, if so directed by the Company, such Seller will deliver to the Company (at the Company's expense) all copies, other than permanent file copies in such Seller's possession, of the prospectus covering such Securities current at the time of receipt of such notice. In the event the Company shall give any such notice, the period mentioned in Section 9.3(a)(iii) above shall be extended by the number of days during the period from and including the date of giving of such notice to and including the date when each Seller shall have received the copies of the supplemented or amended prospectus contemplated by Section 9.3(a)(vi) above.

e. The Company shall not file or permit the filing of any registration or comparable statement which refers to any Seller by name or otherwise as the Seller of any securities of the Company unless such reference to such Seller is specifically required by the Act or any similar federal statute then in force.

9.4 All expenses incident to the Company's performance of or compliance with this Warrant, including without limitation all registration and filing fees, fees and expenses relating to filings with any Exchange, fees and expenses of compliance with securities or Blue Sky laws in jurisdictions reasonably requested by any Seller or underwriter pursuant to Section 9.3(a)(v) (including reasonable fees and disbursements of counsel in connection with Blue Sky qualifications of the Securities), all word processing, duplicating and printing expenses, messenger and delivery expenses, fees and disbursements of counsel for the Company and one (1) counsel for the Sellers, independent public accountants (including the expenses of any special audit or "cold comfort" letters required by or incident to such performance) and underwriters (excluding discounts, commissions or fees of underwriters, selling brokers, dealer managers or similar securities industry professionals attributable to the securities being registered, which discounts, commissions or fees with respect to any Seller's respective shares shall be paid by such Seller, and legal expenses of any person other than the Company and the Sellers, but including liability insurance if the Company so desires), all the Company's internal expenses (including, without limitation, all salaries and expenses of its officers and employees performing legal or accounting duties), the expense of any annual audit, the expense of any liability insurance (if the Company determines to obtain such insurance) and the fees and expenses incurred in connection with the listing of the securities to be registered on any Exchange and/or NASDAQ on which such securities issued by the Company are then listed, the reasonable fees and expenses of any special experts (including attorneys) retained by the Company (if it so desires) in connection with such registration and fees and expenses of other persons retained by the Company (all such expenses being herein called "Registration Expenses"), shall be borne by the Company.

9.5 In connection with the preparation and filing of each registration statement under the Act pursuant to this Section 9, the Company shall give the Sellers under such registration statement, their underwriters, if any, and their respective counsel and accountants, the opportunity to participate in the preparation of such registration statement, each prospectus included therein or filed with the Commission, and each amendment thereof or supplement thereto, and will give each of them such access to its books and records and such opportunities to discuss the business of the Company with its officers and the independent public accountants who have certified its financial statements as shall be necessary, in the opinion of such Sellers' and such underwriters' respective counsel, to conduct a reasonable investigation within the meaning of the Act.

9.6 a. In the event of any registration of any securities of the Company under the Act, the Company shall, and hereby does, indemnify and hold harmless in the case of any registration statement filed pursuant to Section 9.1 or Section 9.2, the Seller of any Securities covered by such registration statement, its directors, officers, employees and agents, each other person who participates as an underwriter in the offering or sale of such Securities and each other person, if any, who controls such Seller or any such underwriter within the meaning of the Act against any losses, claims, damages, or liabilities (or actions or proceedings whether commenced or threatened in respect thereof), joint or several, to which such Seller or any such director or officer or employee or agent or underwriter or controlling person may become subject under the Act or otherwise transfer as such losses, claims, damages, or liabilities (or actions or proceedings, whether commenced or threatened, in respect thereof) arise out of

or are based upon any untrue statement or alleged untrue statement of any material fact contained in any registration statement under which such Securities were registered under the Act, any preliminary prospectus, final prospectus or summary prospectus contained therein, or any amendment or supplement thereto, or any omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, and the Company shall reimburse such Seller and each such director, officer, employee, agent, underwriter and controlling person for any legal or any other expenses reasonably incurred by them in connection with investigating or defending any such loss, claim, liability, action, or proceeding; provided, however, that the Company shall not be liable in any such case to the extent that any such loss, claim, damage, liability (or action or proceeding, whether commenced or threatened in respect thereof) or expense arises out of or is based upon an untrue statement or alleged untrue statement or omission or alleged omission made in such registration statement, any such preliminary prospectus, final prospectus, summary prospectus, amendment, or supplement in reliance upon and in conformity with written information furnished to the Company by such Seller for the express purpose of use in the preparation thereof and, provided, further, that the Company shall not be liable in any such case to the extent that any such loss, claim, damage, liability (or action or proceeding, whether commenced or threatened, in respect thereof), or expense arises out of such person's failure to send or give a copy of the final prospectus, as the same may be then supplemented or amended, within the time required by the Act to the person asserting an untrue statement or alleged untrue statement or omission or alleged omission if such statement or omission was corrected in such final prospectus. Such indemnity shall remain in full force and effect regardless of any investigation made by or on behalf of such Seller or any such director, officer, employee, agent, underwriter or controlling person and shall survive the transfer of such Securities by such Seller.

b. In the event that the Company includes any Securities of a prospective Seller in any registration statement filed pursuant to Section 9.3, such prospective Seller shall, and hereby does, indemnify and hold harmless the Company, its directors, officers, employees and agent, each other person who participates as an underwriter in the offering or sale of such Securities and each other person, if any, who controls the Company or any such underwriter within the meaning of the Act against any losses, claims, damages, or liabilities (or actions or proceedings whether commenced or threatened in respect thereof), joint or several, to which the Company or any such director or officer or employee or underwriter or controlling person may become subject under the Act or otherwise, insofar as such losses, claims, damages, or liabilities (or actions or proceedings, whether commenced or threatened, in respect thereof) arise out of or are based upon any untrue statement or alleged untrue statement of any material fact contained in any registration statement under which such Securities were registered under the Act, any preliminary prospectus, final prospectus or summary prospectus contained therein, or any amendment or supplement thereto, or any omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein not misleading, and such prospective Seller shall reimburse the Company and such director, officer, employee, agent, underwriter or controlling person for any legal or any other expenses reasonably incurred by them in connection with investigating or defending any such loss, claim, liability, action, or proceeding, if, and only if, such statement or alleged statement or omission or alleged omission was made in reliance upon and in conformity with written information furnished to the Company through an instrument duly executed by such Seller specifically stating

that it is for use in the preparation of such registration statement, preliminary prospectus, final prospectus, summary prospectus, amendment, or supplement. In no event shall the liability of any Seller hereunder be greater in amount than the dollar amount of the proceeds received by such Seller upon the sale of the Securities giving rise to such indemnification obligation. Such indemnity shall remain in full force and effect regardless of any investigation made by or on behalf of the Company or any such director, officer, employee, agent, underwriter or controlling person and shall survive the transfer of such Securities by such Seller.

c. The Company shall be entitled to receive indemnities from underwriters, selling brokers, dealer managers, and similar securities industry professionals participating in the distribution to the same extent as provided above with respect to information so furnished in writing by such persons specifically for inclusion in any prospectus or registration statement.

d. Promptly after receipt by an indemnified party of notice of the commencement of any action or proceeding involving a claim referred to in this Section 9.6, such indemnified party shall, if a claim in respect thereof is to be made against an indemnifying party, give written notice to the latter of the commencement of such action; provided, however, that the failure of any indemnified party to give notice as provided herein shall not relieve the indemnifying party of its obligations under the preceding subdivisions of this Section 9.6, except to the extent that the indemnifying party is actually prejudiced by such failure to give notice. In case any such action is brought against an indemnified party, unless in such indemnified party's reasonable judgment a conflict of interest between such indemnified and indemnifying parties may exist in respect of such claim, the indemnifying party shall be entitled to participate in and to assume the defense thereof, jointly with any other indemnifying party similarly notified, to the extent that the indemnifying party may wish, with counsel reasonably satisfactory to such indemnified party, and after notice from the indemnifying party to such indemnified party of its election so to assume the defense thereof, the indemnifying party shall not be liable to such indemnified party for any legal or other expenses subsequently incurred by the latter in connection with the defense thereof other than reasonable costs of investigation. If, in the indemnified party's reasonable judgment a conflict of interest between such indemnified and indemnifying parties may exist in respect of such claim, the indemnified party may assume the defense of such claim, jointly with any other indemnified party that reasonably determines such conflict of interest to exist, and the indemnifying party shall be liable to such indemnified parties for the reasonable legal fees and expenses of one counsel for all such indemnified parties and for other expenses reasonable incurred in connection with the defense thereof incurred by the indemnified party. No indemnifying party shall, without the consent of the indemnified party, consent to entry of any judgment or enter into any settlement of any such action which does not include as an unconditional term thereof the giving by the claimant or plaintiff to such indemnified party of a release from all liability, or a covenant not to sue, in respect of such claim or litigation. No indemnified party shall consent to entry of any judgment or enter into any settlement of any such action the defense of which has been assumed by an indemnifying party without the consent of such indemnifying party.

e. Indemnification and contribution similar to that specified in this Section 9.6 (with appropriate modifications) shall be given by the Company and each Seller

with respect to any required registration or other qualification of Securities under any Federal or state law or regulation of any governmental authority, other than the Act.

f. The indemnification required by this Section 9.6 shall be made by periodic payments of the amount thereof during the course of the investigation or defense, as and when bills are received or expense, loss, damage or liability is incurred.

g. If the indemnification provided for in this Section 9.6 from the indemnifying party is unavailable to an indemnified party hereunder in respect of any losses, claims, damages, liabilities, or expenses referred to herein, then the indemnifying party, in lieu of indemnifying such indemnified party, shall contribute to the amount paid or payable by such indemnified party as a result of losses, claims, damages, liabilities, or expenses in such proportion as is appropriate to reflect the relative fault of the indemnifying party and indemnified party in connection with the actions which resulted in such losses, claims, damages, liabilities, or expenses, as well as any other relevant equitable considerations. The relative fault of such indemnifying party and indemnified party shall be determined by reference to, among other things, whether any action in question, including any untrue or alleged untrue statement of a material fact or omission or alleged omission to state a material fact, has been made by, or relates to information supplied by, such indemnifying party or indemnified party, and the parties' relative intent, knowledge, access to information, and opportunity to correct or prevent such action. The amount paid or payable by a party as a result of the losses, claims, damages, liabilities, and expenses referred to above shall be deemed to include any legal or other fees or expenses reasonably incurred by such party in connection with any investigation or proceeding. In no event shall the liability of any Seller hereunder be greater in amount than the dollar amount of the proceeds received by such Seller upon the sale of the Securities giving rise to such contribution obligation. The parties hereto agree that it would not be just and equitable if contribution pursuant to this Section 9.6(g) were determined by pro rata allocation or by any other method of allocation which does not take into account the equitable considerations referred to in this Section 9.6(g). No person guilty of fraudulent misrepresentation (within the meaning of Section 11(f) of the Act) shall be entitled to contribution from any person or entity who was not guilty of such fraudulent misrepresentation.

9.7 If requested by the managing underwriter of an offering for which Shares of such Securityholder have been registered, a Securityholder shall not sell or otherwise transfer or dispose of any Securities held by such Securityholder (other than those included in the registration) during such period following the effective date of such registration as is usual and customary at such time in similar public offerings of similar securities; provided, however, that the Company shall use its reasonable best efforts to cause each holder of a material number of shares of Common Stock to enter into similar "lock-up" agreements in respect of such offering. The obligations described in this Section 9.7 shall not apply to offerings pursuant to a registration statement on Form S-4 or Form S-8 or any successor or similar form.

10. Additional Rights.

10.1 Secondary Sales. The Company agrees that it will cooperate with the holder of this Warrant in obtaining liquidity if opportunities to make secondary sales of the

Company's securities become available. To this end, the Company will promptly provide the holder of this Warrant with notice of any offer to acquire from the Company's security holders more than five percent (5%) of the total voting power of the Company and will cooperate with the holder in arranging the sale of this Warrant to the person or persons making such offer.

10.2. Mergers. In the event that the Company undertakes to (i) sell, lease, exchange, convey or otherwise dispose of all or substantially all of its property or business, or (ii) merge into or consolidate with any other corporation (other than a wholly-owned subsidiary of the Company), or effect any transaction (including a merger or other reorganization) or series of related transactions, in which more than 50% of the voting owner of the company is disposed of, the Company will use its best efforts to provide at least thirty (30) days notice of the terms and conditions of the proposed transaction. The Company will cooperate with the holder in consummating the sale of this Warrant in connection with any such transaction.

10.3. Right to Convert Warrant into Common Stock; Net Issuance.

a. Right to Convert. In addition to and without limiting the rights of the holder under the terms of this Warrant, the holder shall have the right to convert this Warrant or any portion thereof (the "Conversion Right") into shares of Common Stock as provided in this Section 10.3 at any time or from time to time during the term of this Warrant. Upon exercise of the Conversion Right with respect to a particular number of shares subject to this Warrant (the "Converted Warrant Shares"), the Company shall deliver to the holder (without payment by the holder of any exercise price or any cash or other consideration) that number of shares of fully paid and nonassessable Common Stock equal to the quotient obtained by dividing (i) the value of this Warrant (or the specified portion hereof) on the Conversion Date (as defined in subsection (b) hereof), which value shall be equal to (A) the aggregate fair market value of the Converted Warrant Shares issuable upon exercise of this Warrant (or the specified portion hereof) on the Conversion Date less (B) the aggregate Warrant Price of the Converted Warrant Shares immediately prior to the exercise of the Conversion Right by (ii) the fair market value of one share of Common Stock on the Conversion Date.

Expressed as a formula, such conversion shall be computed as follows:

$$\frac{X - A}{Y}$$

Where

- X = the number of shares of Common Stock that may be issued to holder
- Y = the fair market value (FMV) of one share of Common Stock
- A = the aggregate FMV (i.e., FMV x Converted Warrant Shares)
- B = the aggregate Warrant Price (i.e., Converted Warrant Shares x Warrant Price)

No fractional shares shall be issuable upon exercise of the Conversion Right, and, if the number of shares to be issued determined in accordance with the foregoing formula is other than a whole number, the Company shall pay to the holder an amount in cash equal to the fair market value of the resulting fractional share on the Conversion Date. For purposes of Section 9 of this Warrant, shares issued pursuant to the Conversion Right shall be treated as if they were issued upon the exercise of this Warrant.

b. Method of Exercise. The Conversion Right may be exercised by the holder by the surrender of this Warrant at the principal office of the Company together with a written statement specifying that the holder thereby intends to exercise the Conversion Right and indicating the number of shares subject to this Warrant which are being surrendered (referred to in subsection (a) hereof as the Converted Warrant Shares) in exercise of the Conversion Right. Such conversion shall be effective upon receipt by the Company of this Warrant together with the aforesaid written statement, or on such later date as is specified therein (the "Conversion Date"). Certificates for the shares issuable upon exercise of the Conversion Right and, if applicable, a new warrant evidencing the balance of the shares remaining subject to this Warrant, shall be issued as of the Conversion Date and shall be delivered to the holder within thirty (30) days following the Conversion Date.

c. Determination of Fair Market Value. For purposes of this Section 10.3, "fair market value" of a share of Common Stock shall have the meaning set forth in Section 4(h) above.

11. Representations and Warranties. The Company represents and warrants to the holder of this Warrant as follows:

a. This Warrant has been duly authorized and executed by the Company and is a valid and binding obligation of the Company enforceable in accordance with its terms, subject to laws of general application relating to bankruptcy, insolvency and the relief

of debtors and the rules of law or principles at equity governing specific performance, injunctive relief and other equitable remedies;

b. The Shares have been duly authorized and reserved for issuance by the Company and, when issued in accordance with the terms hereof, will be validly issued, fully paid and nonassessable;

c. The rights, preferences, privileges and restrictions granted to or imposed upon the Common Stock and the holders thereof are as set forth in the articles or certificate of incorporation of the Company, as amended to the Date of Grant (as so amended, the "Charter"), a true and complete copy of which has been delivered to the original holder of this Warrant;

d. The execution and delivery of this Warrant are not, and the issuance of the Shares upon exercise of this Warrant in accordance with the terms hereof will not be, inconsistent with the Charter or by-laws of the Company, do not and will not contravene, in any material respect, any governmental rule or regulation, judgment or order applicable to the Company, and do not and will not conflict with or contravene any provision of, or constitute a default under, any indenture, mortgage, contract or other instrument of which the Company is a party or by which it is bound or require the consent or approval of, the giving of notice to, the registration or filing with or the taking of any action in respect of or by, any Federal, state or local government authority or agency or other person, except for the filing of notices pursuant to federal and state securities laws, which filings will be effected by the time required thereby;

e. There are no actions, suits, audits, investigations or proceedings pending or, to the knowledge of the Company, threatened against the Company in any court or before any governmental commission, board or authority which, if adversely determined, will have a material adverse effect on the ability of the Company to perform its obligations under this Warrant;

f. The authorized capital stock of the Company consists of ninety million (90,000,000) shares of Common Stock par value \$.0001 per Share, and 10,000,000 Shares of Preferred Stock, par value \$.0001 per Share, of which approximately 15,161,936 shares of Common Stock, and no shares of Preferred Stock, were issued and outstanding as of the close of business on August 31, 1996. All such outstanding shares have been validly issued and are fully paid, nonassessable shares free of preemptive rights;

g. Except for the Warrants and as set forth on Schedule 11(g) attached hereto and incorporated herein, there are no subscriptions, rights, options, warrants, or calls relating to any shares of the Company's capital stock, including any right of conversion or exchange under any outstanding security or other instrument; and

h. Except as disclosed in the Company's most recent Proxy Statement and Form 10-K, the Company is not subject to any obligation (contingent or otherwise) to repurchase or otherwise acquire or retire any shares of its capital stock or any security convertible into or exchangeable for any of its capital stock.

12. **Modification and Waiver.** This Warrant and any provision hereof may be changed, waived, discharged or terminated only by an instrument in writing signed by the party against which enforcement of the same is sought.

13. **Notices.** Any notice, request, communication or other document required or permitted to be given or delivered to the holder hereof or the Company shall be delivered, or shall be sent by private courier or certified or registered mail, postage prepaid, to each such holder at its address as shown on the books of the Company or to the Company at the address indicated therefor on the signature page of this Warrant.

14. **Binding Effect on Successors.** This Warrant shall be binding upon any corporation succeeding the Company by merger, consolidation or acquisition of all or substantially all of the Company's assets, and all of the obligations of the Company relating to the Common Stock issuable upon the exercise or conversion of this Warrant shall survive the exercise, conversion and termination of this Warrant and all of the covenants and agreements of the Company shall inure to the benefit of the successors and assigns of the holder hereof. The Company will, at the time of the exercise or conversion of this Warrant, in whole or in part, upon request of the holder hereof in respect of any rights to which the holder hereof shall continue to be entitled after such exercise or conversion in accordance with this Warrant; provided, that the failure of the holder hereof to make any such request shall not affect the continuing obligation of the Company to the holder hereof in respect of such rights.

15. **Lost Warrants or Stock Certificates.** The Company covenants to the holder hereof that, upon receipt of evidence reasonably satisfactory to the Company of the loss, theft, destruction or mutilation of this Warrant or any stock certificate and, in the case of any loss, theft or destruction, upon receipt of an executed lost securities bond or indemnity reasonably satisfactory to the Company, or in the case of any such mutilation upon surrender and cancellation of such Warrant or stock certificate, the Company will make and deliver a new Warrant or stock certificate, of like tenor, in lieu of the lost, stolen, destroyed or mutilated Warrant or stock certificate.

16. **Descriptive Headings.** The descriptive heading of the several paragraphs of this Warrant are inserted for convenience only and do not constitute a part of this Warrant.

17. **Governing Law.** This Warrant shall be construed and enforced in accordance with, and the rights of the parties shall be governed by, the laws of the State of Washington.

18. **Survival of Representations, Warranties and Agreements.** All representations and warranties of the Company and the holder hereof contained herein shall survive the Date of Grant, the exercise or conversion of this Warrant (or any part hereof) or the termination or expiration of rights hereunder. All agreements of the Company and the holder hereof contained herein shall survive indefinitely until, by their respective terms, they are no longer operative.

19. Remedies. In case any one or more of the covenants and agreements contained in this Warrant shall have been breached by holders hereof (in the case of a breach by the Company), or the Company (in the case of a breach by a holder), may proceed to protect and enforce their or its rights either by suit in equity and/or by action at law, including, but not limited to, an action for damages as a result of any such breach and/or an action for specific performance of any such covenant or agreement contained this Warrant.

20. Acceptance. Receipt of this Warrant by the holder hereof shall constitute acceptance of and agreement to the foregoing terms and conditions.

21. No Impairment of Rights. The Company will not, by amendment of its Charter or through any other means, avoid or seek to avoid the observance or performance of any of the terms of this Warrant, but will at all times in good faith assist in the carrying out of all such terms and in the taking of all such action as may be necessary or appropriate in order to protect the rights of the holder of this Warrant against impairment.

MIDCOM COMMUNICATIONS INC.

By: /s/ William H. Oberlin

Title: President and CEO

Address: 26899 Northwestern Hwy, Suite 121

Southfield, MI 48034

Dated: as of September 17, 1997

EXHIBIT A

NOTICE OF EXERCISE

To: MIDCOM COMMUNICATIONS INC.

1. The undersigned hereby elects to purchase ___ shares of Common Stock of MIDCOM COMMUNICATIONS INC. pursuant to the terms of the attached Warrant, and tenders herewith payment of the purchase price of such shares in full.

2. Please issue a certificate or certificates representing said shares in the name of the undersigned or in such other name or names as are specified below:

(Name)

(Address)

3. The undersigned represents that the aforesaid shares are being acquired for the account of the undersigned for investment and not with a view to, or for resale in connection with, the distribution thereof and that the undersigned has no present intention of distributing or reselling such shares. In support thereof, the undersigned has executed an Investment Representation Statement attached hereto as Schedule 1.

(Signature)

(Date)

Schedule I

INVESTMENT REPRESENTATION STATEMENT

Purchaser:

Company: MIDCOM COMMUNICATIONS INC.

Security: Common Stock

Amount:

Date:

In connection with the purchase of the above-listed securities (the "Securities"), the undersigned (the "Purchaser") represents to the Company as follows:

(a) The Purchaser is aware of the Company's business affairs and financial condition, and has acquired sufficient information about the Company to reach an informed and knowledgeable decision to acquire the Securities. The Purchaser is purchasing the Securities for its own account for investment purposes only and not with a view to, or for the resale in connection with, any "distribution" thereof for purposes of the Securities Act of 1933, as amended (the "Act").

(b) The Purchaser understands that the Securities have not been registered under the Act in reliance upon a specific exemption therefrom, which exemption depends upon, among other things, the bona fide nature of the Purchaser's investment intent as expressed herein. In this connection, the Purchaser understands that, in the view of the Securities and Exchange Commission ("SEC"), the statutory basis for such exemption may be unavailable if the Purchaser's representation was predicated solely upon a present intention to hold these Securities for the minimum capital gains period specified under applicable tax laws, for a deferred sale, for or until an increase or decrease in the market price of the Securities, or for a period of one year or any other fixed period in the future.

(c) The Purchaser further understands that the Securities must be held indefinitely unless subsequently registered under the Act or unless an exemption from registration is otherwise available. In addition, the Purchaser understands that the certificate evidencing the Securities will be imprinted with the legend referred to in the Warrant under which the Securities are being purchased.

(d) The Purchaser is aware of the provisions of Rule 144 and 144A, promulgated under the Act, which, in substance, permit limited public resale of "restricted securities" acquired, directly or indirectly, from the issuer thereof (or from an affiliate of such issuer), in a non-public offering subject to the satisfaction of certain conditions, if applicable, including, among other things, The availability of certain public information about the Company, the resale occurring not less than one (1) year after the party has purchased and paid for the securities to be sold; the sale being made through a broker in an unsolicited "broker's transaction" or in transactions directly with a market maker (as said term is defined under the Securities Exchange Act of 1934, as amended) and the amount of securities being sold during any three-month period not exceeding the specified limitations stated therein.

(e) The purchaser further understands that at the time it wishes to sell the Securities there may be no public market upon which to make such a sale, and that, even if such a public market then exists, the Company may not be satisfying the current public information requirements of Rule 144 and 144A, and that, in such event, the Purchaser may be precluded from selling the Securities under Rule 144 and 144A even if the one-year minimum holding period had been satisfied.

(f) The Purchaser further understands that in the event all of the requirements of Rule 144 and 144A are not satisfied, registration under the Act, compliance with Regulation A, or some other registration exemption will be required; and that, notwithstanding the fact Rule 144 is not exclusive, the Staff of the SEC has expressed its opinion that persons proposing to sell private placement securities other than in a registered offering and otherwise than pursuant to Rule 144 will have a substantial burden of proof in establishing that an exemption from registration is available for such offers or sales, and that such persons and their respective brokers who participate in such transactions do so at their own risk.

Purchaser:

Date: _____

EXHIBIT 11.1

MIDCOM COMMUNICATIONS INC.

EXHIBIT 11.1 STATEMENT RE: COMPUTATION OF NET LOSS PER SHARE

	Three months ended September 30,		Nine months ended September 30,	
	1997	1996	1997	1996
(In thousands, except per share data)				
Net loss	<u>(\$23,589)</u>	<u>(\$18,259)</u>	<u>(\$69,549)</u>	<u>(\$77,420)</u>
Weighted average shares outstanding	<u>15,125</u>	<u>15,681</u>	<u>15,438</u>	<u>15,442</u>
Net loss per share	<u>(\$1.56)</u>	<u>(\$1.16)</u>	<u>(\$4.51)</u>	<u>(\$5.01)</u>

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ATTACHMENT E

ATTACHMENT E

ATTACHMENT E

MANAGERIAL QUALIFICATIONS

William J. Rouhana, Jr. -- Chairman of the Board of Directors and Chief Executive Officer of WinStar Communications, Inc.; Member of Board of Directors and President of WinStar Wireless Corp.

Mr. Rouhana has been Chief Executive Officer of WinStar Communications, Inc. since March 1994 and Chairman of the Board since 1991. Prior to joining WinStar Communications, Mr. Rouhana was President and Chief Executive Officer of WinStar Companies, Inc., a merchant bank which is a principal stockholder of WinStar Communications, for 11 years, from 1984 through February 1995. Through WinStar Companies, Inc., he served from August 1987 to February 1989, as Vice Chairman of the Board and Chief Operating Officer of Management Company Entertainment Group, Inc., a diversified distributor of entertainment product and, thereafter, until May 1990, he served as Vice Chairman of its Board. Since August 1992, Mr. Rouhana has been a Director of TII Industries, Inc., a telecommunications equipment manufacturing company. From May 1991 through September 1994, he was director of Lancit Media Productions, Ltd., a creator of children's television programming. Mr. Rouhana was in private legal practice from 1977 to 1984, specializing in the finance of entertainment product. Mr. Rouhana is a member of the Board of Governors of the United Nations Association and is a member of Business Executives for National Security (BENS). Mr. Rouhana is a Phi Beta Kappa graduate of Colby College, a Thomas J. Watson Fellow (1972-73) and a graduate of Georgetown University School of Law.

David W. Ackerman -- Executive Vice President of WinStar Communications, Inc.'s Telecommunications Group; Vice President and Chief Operating Officer of WinStar Wireless Fiber Corp.; Member of Board of Directors Wireless of Delaware, Inc.

Mr. Ackerman is a Member of the Board of Directors of WinStar Wireless of Delaware, Inc. Mr. Ackerman has over 21 years of telecommunications experience, much of which is directly applicable to the development and construction of wireless networks. Mr. Ackerman established and operated cellular mobile and paging operations in more than 52 markets. Previously, Mr. Ackerman was Senior Vice President of Mobile Telecommunication Technologies (Mtel.) from 1982 through 1991. Mr. Ackerman held senior management positions at MCI Communications in the areas of new business development, corporate development, product and systems planning, network systems and national accounts engineering. Mr. Ackerman has also held various senior management positions for GTE, Rochester Telephone Company and New York Telephone in operations, planning, development, finance and marketing.

Leo I. George --

Vice President and Assistant Secretary of WinStar Wireless Fiber Corp.; Regulatory Vice President of WinStar Telecommunications Group

Mr. George is Vice President and Assistant Secretary of WinStar Wireless Fiber Corp. He is also the Regulatory Vice President of WinStar Communications, Inc.'s Telecommunications Group. Mr. George specializes in domestic and international telecommunications matters, including radio, television, CATV, satellite and interstate and local telephone companies. Mr. George was Assistant General Counsel of the FCC in charge of legislative liaison with the Legislative and Executive branches of the United States Government. During the formative years of MCI, and for five years thereafter, he was personal counsel to the Chairman of the Board, Mr. William G. McGowan. Mr. George also assisted and advised MCI's President and founder, Mr. John D. Goeken, on new business ventures. Thereafter, he became Chief FCC Counsel for U.S. Telephone until it became a public company and acquired by United Telephone of Kansas City. Mr. George's law practice has been concentrated in matters before the Federal Communications Commission, State Public Utility Commissions, and the United States Circuit Court of Appeals for the District of Columbia Circuit.

Timothy R. Graham --

Executive Vice President -- Business Affairs of WinStar Communications, Inc.; Member of Board of Directors and Secretary of WinStar Wireless Fiber Corp.; Member of the Board of Directors, and President of WinStar Wireless of Delaware, Inc.

Mr. Graham is Executive Vice President of WinStar Communications, Inc. Mr. Graham is also the President, and a Member of the Board of Directors of WinStar Wireless of Delaware, Inc. From October 1991 through September 1994, Mr. Graham served as the President and Corporation Secretary of the primary real estate subsidiary of National Capital Management Corporation, a San Francisco-based company engaged through its subsidiaries in real estate rental, industrial manufacturing, and insurance matters. Mr. Graham has also practiced law as an independent lawyer and has been active in venture capital and merchant banking activities. From January 1987 to July 1989, Mr. Graham was a partner in the law firm of Nixon, Hargrave, Devans & Doyle. Prior to his tenure at Nixon, Hargrave, Mr. Graham practiced at Alexander & Green, a firm which specialized in corporate finance, regulatory and business law. Mr. Graham has served as Securities Law Editor of Barrister Magazine, an American Bar Association publication, has been a frequent lecturer on securities law matters, and has authored a number of publications, including "Public Offerings in the United States by Foreign Companies" and "Financing of Foreign Companies through United States Securities Markets." Mr. Graham is a director of TII Industries, Inc., a telecommunications equipment manufacturing company, and National Capital Management Corporation.

Steven G. Chrust --

Vice President of the Board of Directors of WinStar Communications, Inc.

Mr. Chrust has been a director of WinStar Communications, Inc. since January, 1994 and the Vice Chairman of the Board since January, 1995. He is the founder and President of SGC

Advisory Services, Inc. ("SGC"), a discretionary money-management service firm specializing in the telecommunications and technology sector, since its inception in October 1992. From 1987 to 1992, Mr. Chrust was a director of AMNEX, Inc., an operator services long distance company, and served as its Board Chairman, Chief Executive Officer and President between October 1990 and October 1992. From August 1985 through December 1989, Mr. Chrust served as the Executive Vice President of Executone Information Services, Inc. Mr. Chrust was Director of Technology Research and a shareholder of Sanford C. Bernstein & Co., Inc., a Wall Street investment firm currently handling approximately \$25 billion in client assets, where he was ranked by prestigious financial institutions in the top tier of telecommunications analysts for more than ten years and as number one analyst in that special sector for five consecutive years. He was associated with Sanford C. Bernstein & Co., Inc. from 1970 through 1985. Mr. Chrust has also been a director of American Communications Services, Inc., a fiber based competitive access provider, since November 1993.

Bill Harvey --

Member of Board of Directors of WinStar Communications, Inc.

Mr. Harvey has been a director of WinStar Communications, Inc. since June, 1994. Mr. Harvey founded and serves as President and Chief Executive Officer of New Electronic media Science and Next Century Media, Inc., marketing, media and research consulting companies specializing in the development and application of new technologies for the marketing, entertainment and interactive media industries. In this capacity, Mr. Harvey has worked with the Big 3 networks, several Regional Bell Operating Companies, the seven major film studios, IBM, AT&T, most of the top 20 cable networks, many of the basic cable networks, agencies, videotex companies and advertisers spending over \$12 Billion annually. Mr. Harvey invented the marketing tool known as the Area of Dominant Influence (ADI) for Arbitron and co-founded International Ratings Services, Inc., the first company to provide U.S. movie studios, including Warner Brothers, Columbia and CBS International, with ratings for their television programs broadcast in foreign countries. Mr. Harvey is also the publisher of "The Marketing Pulse," a monthly advertising and media trade newsletter which he has published since 1979.

Steven B. Magyar --

Member of Board of Directors of WinStar Communications, Inc.

Mr. Magyar has been a director of WinStar Communications, Inc. since June, 1993. Mr. Magyar operates a private business which specializes in brokerage services and financial planning services for high net worth individuals and business owners. Prior to 1994, Mr. Magyar worked for Cigna Insurance Company in various sales management positions, both on corporate and operational levels. Mr. Magyar has served on Cigna's strategic business development committee and has been a guest lecturer at New York University. Mr. Magyar is also a Certified Life Underwriter and Chartered Financial Consultant with the American College of Insurance. Mr. Magyar is a member of the General Agents and Managers Association, the National Association of Underwriter and the American Society of CLU & ChFC.

Nathan Kantor --

Member of Board of Directors of WinStar Communications, Inc., Acting Chief Executive Officer of WinStar Telecommunications Group and President and CEO of the ITC Group, Inc.

Mr. Kantor has been a Director of WinStar Communications, Inc. since October, 1994 and Acting Chief Executive Officer of WinStar Telecommunications Group since June, 1994. Mr. Kantor, through the ITC Group, oversees and coordinates all of WinStar Communications, Inc.'s telecommunications activities. Mr. Kantor was part of the management team that built MCI into its current position as the second largest domestic long-distance carrier with annual revenues in excess of \$13 Billion. As President of one of MCI's largest divisions, Mr. Kantor was responsible for marketing, sales, operations and customer service. As the Founder, President and Chief Operating Officer of MCI International, Inc., he was responsible for the development and implementation of MCI's international business strategy. During his 18 years with MCI, Mr. Kantor served in various positions, including the management of all field operations throughout the U.S. Mr. Kantor is currently the President of ITC Group which specializes in the development of emerging competitive telecommunications companies.

David Banker --

Member of Board of Directors, Former CEO, and Consultant to WinStar Communications, Inc.

Mr. Banker has been a director of WinStar Communications, Inc. since January 1992 and was President and Chief Executive Officer from October 1992 through February 1994. He was a director of WinStar Gateway Network, Inc. from May 1992 to February 1994. Since June 1991, Mr. Banker has been Executive Vice President, director and a minority stockholder of Waterford Investment Capital, Inc., a venture capital firm. From June 1986 to July 1991, Mr. Banker was Chief Executive Officer of Buxton Corporation, a manufacturer of consumer goods. From March 1981 to December 1985, he was President and Chief Executive Officer of TMW International, an importer of consumer goods. From 1974 to 1980, he was President and Chief Executive Officer of Lechmere Sales and from 1969 to 1974 he was Senior Vice President of Merchandising of Zayre Corporation.

Doreen F. Davidson --

Executive Vice President - Corporate Development of WinStar Communications, Inc.

Ms. Davidson has been the Executive Vice President of WinStar Communications, Inc. since July, 1991 and was the Company's Chief Financial Officer from July 1991 to February 1994. Ms. Davidson specializes in the areas of mergers and acquisitions, financings, strategic planning, and contract negotiations. Previously, she was Executive Vice President of WinStar Companies, a merchant bank and financial consulting services company. From 1981 to 1986, Ms. Davidson held various positions, including audit manager for worldwide accounts and technical research manager, at KPMG Peat Marwick, independent certified public accountants.

Stuart B. Rekant --

Chief Operating Officer of WinStar New Media, Inc.

Mr. Rekant has been Chief Operating Officer of WinStar New Media, Inc. since June 1994. Mr. Rekant founded Nonfiction Films, a producer of historical documentaries, which is now a subsidiary of WinStar New Media, Inc. Prior to the launch of Nonfiction Films in 1994, Mr. Rekant was President and Chief Operating Officer of U.S. News Productions which he established in June of 1992, transforming U.S. News and World Report's existing video operation into a leading producer of documentary programming for U.S. cable television and international distribution. Prior to joining U.S. News, he had various management responsibilities with prominent media companies, including Miramax Film Corp., Management Company Entertainment Group, Inc., Independent Production Resources, Inc. and Home Box Office, Inc. Mr. Rekant began his career in the entertainment business with the legal department of Columbia Pictures Industries, Inc. in 1975.

William J. vanden Heuvel -- Member of the Board of Directors of WinStar Communications, Inc.

Ambassador vanden Heuvel became a member of the Board of Directors in June 1995. He is currently Senior Advisor to the investment banking firm, Alien & Co., and is of counsel to the law firm Stroock & Stroock & Lavan. He is also a member of the IRC Group, which is a Washington, D.C.-based group of consultants who are former U.S. ambassadors. Ambassador vanden Heuvel was a director of Time Warner, Inc. from 1981 to 1993, and is currently on the board of Zemex Corp., which is listed on the New York Stock Exchange. He also serves on the board of numerous public service and diplomatic organizations, and is Chairman of the Board of Governors and of the United Nations Association. Ambassador vanden Heuvel served as a U.S. Deputy Permanent Representative to the United Nations from 1979 to 1981, and U.S. Ambassador to the European Office of the United Nations and other international organizations in Geneva from 1977 to 1979. He was Special Assistant to U.S. Attorney General Robert F. Kennedy from 1961 to 1964. He is a graduate of Deep Springs College, Cornell University and Cornell Law School, where he was editor-in-chief of the Law Review.

Bert Wasserman --

Member of the Board of Directors of WinStar Communications, Inc.

Mr. Wasserman has been a member of the Board of Directors since June 1995. He joined Warner Communications in 1966 and was an officer of the company from 1970 to 1994. In 1981, he was elected to the Office of the President and the Board of Directors. In 1990, after the Time Warner merger, he was named Executive Vice President and Chief Financial Officer, and was a director of Time Warner, Inc. from 1990 - 1993. Mr. Wasserman serves on various boards, including several investment companies in the Dreyfus Family of Funds, the Chemical Bank National Advisory Board, and Lillian Vernon Corp. He is a graduate of Baruch College and Brooklyn Law School.

Amy L. Newmark --

Executive Vice President of Strategic Planning of WinStar Communications, Inc.

Ms. Newmark has been an Executive Vice President of the Company since April 1995. Ms. Newmark assists in strategic planning, industry analysis, and financial community relations. Ms. Newmark has 17 years of experience in the telecommunications field, including 14 years in the financial community. A magna cum laude graduate of Harvard College and a Chartered financial Analyst, she began her career as a consultant to the telecommunications industry at the Yankee Group and then at the Gartner Group, where she started their telecommunications research service. She then spent 12 years as an analyst covering telecommunications and information services; first at C.J. Lawrence, and then as an independent analyst providing long and short ideas to hedge funds. Most recently, Ms. Newmark has managed Information Age Partners, L.P., an investment partnership specializing in telecommunications and technology companies.

Arthur A. Greene --

General Manager of WinStar Gateway Network, Inc.

Mr. Greene has been General Manager of WinStar Gateway Network, Inc. since January, 1995. Mr. Green brings over 25 years of direct experience in the telecommunications industry. Prior to joining the Company, Mr. Greene, through the ITC Group, was Vice President of Operations of Unitel Communications, Canada's national telecommunications facilities-based carrier with digital fiber optic and microwave networks which is owned by Canadian Pacific United, Progress Communication, Inc. and AT&T. Prior to a successful consulting career, Mr. Greene had an extensive operational and executive management career at MCI Communications, Inc. from 1978 through 1991, reaching the position of Vice President of Network Operations - Western Region.

George S. Simons --

Vice President Engineering and Operations, WinStar Telecommunications Group

Mr. Simons has been Vice President of Engineering and Operations, WinStar Telecommunications Group since July 1994. He has over twenty years of experience in design, implementation and operations with MCI Telecommunications. Most recently, he was Vice President-Technical Services for the national Account Division, where his responsibilities included proposal development, sub-contractor relationships, private network engineering and assistance in product development for MCI's Fortune 500 customers nationwide. Mr. Simons led the technical marketing support efforts for major MCI wins at Merrill Lynch, Citicorp, Bank of America, NASD, Aetna, ITT and also developed MCI's outsourcing strategies. Mr. Simons' career also encompassed positions in network engineering, capital planning, COE and construction, operations management customer service and order entry and fulfillment. In those roles, he had capital budgets responsibility for \$100mm and expense budgets of \$20mm. He established the first large account service center, built the first MCI owned POP in the Northeast, was instrumental in the implementation of equal access in the Northeast, led the effort in negotiating 800 translations with the LEC's, had responsibility for all provisioning in the Northeast Division, and established the first complex bids group within MCI.

M. James Bullen --

**Vice President Systems Engineering, WinStar
Telecommunications Group**

Mr. Bullen has been Vice President Systems Engineering for the WinStar Telecommunications Group since July 1994. He has twelve years of software engineering experience and eleven years of management experience in the development and operations of telecommunications systems including switching systems, network management, intelligent network platforms, electronic messaging, and long distance information systems. From 1991 to 1993, as Director of Systems Engineering with Unitel Communications Inc., he was responsible for the planning, design and implementation of the Business support Systems for the company. In 1990 and 1991, Mr. Bullen was Director of Telecommunications Systems with Pilot Systems Development. From 1980-1988 he held Senior Manager positions at MCI Telecommunications in the areas of switch systems software engineering, network control systems and network systems development and messaging development. Mr. Bullen has a B.S. in Computer Science from Rensselaer Polytechnic Institute.

Barbara A. Garrett --

Vice President, Marketing

Currently Vice President of Marketing for WinStar Telecommunications Group, Ms. Garrett joined WinStar in March 1995. Prior to WinStar, Ms. Garrett spent seven years at Citibank as a Vice President of Marketing and New Business Development. Among her achievements there, she identified and launched segmented credit card products, managed a \$45 million advertising and PR budget, and pioneered a new payment system for the U.S. marketplace using SmartCard technology. Prior to Citibank, Ms. Garrett was with MCI from 1984 - 1988, holding various marketing assignments and obtained her initial marketing training at General Goods between 1981 and 1984. Ms. Garrett holds a B.A. in Economics with honors from the University of Maryland and an M.B.A. from the Wharton Graduate School.

ATTACHMENT F

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549
FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 1996

☐ TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

Commission file number 1-10726

WINSTAR COMMUNICATIONS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State of
Incorporation)

13-3585278
(I.R.S. Employer
Identification No.)

230 PARK AVENUE
NEW YORK, NEW YORK 10169
(212) 687-7577

(Address, including zip code, and telephone number, including area code,
of registrant's executive offices)

Securities registered pursuant to Section 12(b) of the Act: None

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

Check whether the registrant (1) filed all reports required to be filed by
Section 13 or 15(d) of the Exchange Act during the past 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 ☐

Check if disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained in this form, and no disclosure will 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. ☒

Registrant's revenues for its most recent fiscal year: \$68,000,000

State the aggregate market value of the voting stock held by non-affiliates computed by reference to the price at which the stock was sold, or the
average bid and asked prices of such stock, as of a specified date within the past 60 days: As of March 25, 1997, the aggregate market value of such
stock was approximately \$336.6 million.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date: As of March 25, 1997,
the number of shares of Common Stock outstanding was 32,766,706.

DOCUMENTS INCORPORATED BY REFERENCE

The information required in Part III by Items 10, 11, 12 and 13 is incorporated by reference to the Registrant's proxy statement in connection with
the annual meeting of stockholders scheduled to be held on June 30, 1997, which will be filed by the Registrant within 120 days after the close of its
fiscal year.

ITEM 1. BUSINESS

GENERAL

WinStar Communications, Inc. (the "Company") provides a full range of telecommunications services, including local, long distance and Internet access services, as a competitive local exchange carrier ("CLEC"). By exploiting its fiber-quality digital capacity in the 38 GHz portion of the radio spectrum ("Wireless Fiber-TM") and a switch-based infrastructure, the Company seeks to distinguish itself as a facilities-based, value-added provider of high-capacity telecommunications services to small and medium-sized businesses and an attractive alternative to established providers, such as the regional Bell operating companies ("RBOCs"). In October 1996, the Company began offering switch-based local exchange services to end users in New York City and is currently offering or introducing local exchange services on a resale basis in 11 additional major metropolitan areas. During the next several years, the Company intends to introduce its local exchange services in each of the other major metropolitan areas where it is licensed to provide 38 GHz services over four or more 100 MHz channels. Over time, the Company intends to carry a substantial majority of its local telecommunications services traffic over Wireless Fiber and its own switched networks, unlike most fiber-based CLECs, which typically do not carry the majority of their customer traffic over their own networks. The Company also offers a variety of facilities-based broadband, high-capacity local access and digital network services ("Carrier Services") to other telecommunications services providers on a wholesale basis. As of March 25, 1997, the Company had 40 carrier customers, including, among others, Ameritech Cellular Services, MCI Communications, Pacific Bell and Teleport Communications.

The Company is the holder of the largest amount of 38 GHz spectrum in the United States and is utilizing this asset to build local telephone networks for the transmission of voice, data and video traffic in the major metropolitan areas covered by the Company's 38 GHz licenses (the "Wireless Licenses"). The Wireless Licenses, including the 88 licenses acquired by the Company in its January 1997 acquisition of Milliwave Limited Partnership (the "Milliwave Acquisition"), cover an aggregate of more than 100 cities with populations exceeding 100,000 each, and encompass an aggregate population of approximately 172 million. The Wireless Licenses allow the Company to provide Wireless Fiber services in 48 of the 50 most populated Metropolitan Statistical Areas ("MSAs") in the United States. The Company has agreed to acquire an aggregate of 47 additional 38 GHz licenses in a series of transactions, subject to approval by the Federal Communications Commission ("FCC"). Upon completion of these acquisitions, the Company's Wireless Licenses will enable the Company to provide services in the 50 most populated MSAs and will cover cities encompassing an aggregate population of 180 million. Many of the Company's Wireless Licenses allow for the provision of Wireless Fiber services over four or more channels in a single market. The Company believes that the utilization of multiple 38 GHz channels in a single licensed area provides it with advantages over 38 GHz service providers that possess fewer channels, by allowing it to build out city-wide networks of broadband capacity.

The Company has four operating units conducting business primarily through the following wholly owned subsidiaries:

- WinStar Telecommunications, Inc. ("WinStar Telecom") is a CLEC providing competitive local telephone service as an alternative to local telephone companies.
- WinStar Wireless, Inc. ("WinStar Wireless") delivers the Company's Carrier Services to long distance carriers, other competitive access providers ("CAPs"), mobile communications companies, local telephone companies, cable television operators, Internet access providers, end users, and other customers with broadband local telecommunications needs.

- WinStar New Media Company, Inc. ("New Media") acquires rights to, and distributes information services and entertainment content as a complement to the Company's telecommunications activities.

- WinStar Global Products, Inc. ("Global Products") is a nonstrategic, merchandising subsidiary acquired prior to the Company's entry into the telecommunications industry, which distributes consumer products through more than 20,000 individual retail outlets.

The Company was incorporated under the laws of the State of Delaware in September 1990 and its principal offices are located at 230 Park Avenue, New York, New York 10169. The Company's phone number is (212) 687-7577. Each of the Company's principal subsidiaries is incorporated under the laws of the State of Delaware.

TELECOMMUNICATIONS INDUSTRY OVERVIEW

The telecommunications industry is being reshaped by the deregulation of telecommunications markets, growing demand for high-speed, high-capacity digital telecommunications services and rapid advances in wireless technologies, including 38 GHz-based technology. The long distance market has been opened to competition for more than a decade and current deregulation is now allowing new competitors to enter into the local telecommunications markets to compete with the incumbent local exchange carriers ("LECs") in all aspects of local telecommunications services and to offer integrated (i.e., bundled local, long distance and other) telecommunications services. The accelerating growth of local area networks ("LANs"), wide area networks ("WANs"), Internet services and video conferencing and the ongoing revolution in microprocessor power are significantly increasing the volume of broadband telecommunications traffic. The convergence of these factors is creating significant opportunities for competitive telecommunications services providers such as the Company.

GENERAL

The present structure of the telecommunications marketplace was shaped principally by the court-directed divestiture ("Divestiture") of the Bell System in 1984. In connection with the Divestiture, the United States was divided into 194 local access transportation areas ("LATAs") and the Bell System was separated into a long distance carrier, AT&T, to provide long distance services between LATAs, and seven RBOCs, including, for example, Bell Atlantic and NYNEX, to provide local telecommunications services.

While the Divestiture facilitated competition in the long distance segment of the telecommunications market, each LEC initially continued to enjoy a monopoly in the provision of local telecommunications services in its respective geographic service area. The Telecommunications Act of 1996 (the "Telecommunications Act"), however, opens the local exchange services market to competition on a nationwide basis. The Telecommunications Act provides for the removal of legal barriers to competition in the local exchange market and will permit CLECs, such as the Company, to offer, in addition to long distance and other services, a full range of local exchange services, including local dial tone, custom calling features and intraLATA toll services, to both business and residential customers. It requires LECs to allow alternate carriers, such as the Company, to interconnect with their networks and establishes additional procompetitive obligations upon the incumbent LECs. These obligations include allowing unbundled access to the incumbent LECs' networks, resale of local exchange services, number portability, dialing parity, access to rights-of-way and mutual compensation for the termination of switched local traffic. In addition, the legislation codifies the LECs' equal access and nondiscrimination obligations and preempts inconsistent state regulation. The Telecommunications Act also contains certain provisions that ultimately will eliminate the restrictions that currently prohibit the RBOCs from providing interLATA services.

The full extent of the effects of the Telecommunications Act and certain of the FCC's rules thereunder (the "Interconnection Order") on the Company and other telecommunications companies is as yet unknown. The Telecommunications Act and the Interconnection Order contain many provisions that

require enabling regulations, many of which have not yet been promulgated, are not yet final, or are still subject to reconsideration or appeal or both. However, the Company believes that both competition and opportunity in the telecommunications industry will be increased by the Telecommunications Act, as telecommunications providers seek to enter into newly-opened markets quickly. The Company believes that such opportunity is amplified by: (i) growing consumer interest, especially among business users, in alternatives to their existing carriers for improved customer service, and for more capacity in the form of broader digital bandwidth channels to customer premises, better pricing terms and route diversity; (ii) long distance carriers' desire to connect their long distance networks to local origination and termination points at rates lower than available from the incumbent LECs; (iii) a monopoly position and pricing structure in the local exchange services market which historically has provided little economic incentive for the incumbent LECs to upgrade their existing networks or to provide specialized services; (iv) technological advances in data and video services and products requiring greater transmission capacity and reliability; (v) the rapid growth of the Internet and the corresponding increase in demand for local access broadband circuits; and (vi) ongoing regulatory initiatives to allow other providers of local telecommunications services to interconnect their networks with those owned by the incumbent LECs.

38 GHZ TECHNOLOGY

An aggregate of fourteen 100 MHz channels in the 38 GHz portion of the radio spectrum are currently allocated by the FCC in each licensed area, with certain additional 100 MHz channels available for future licensing. Although FCC rules specify that 38 GHz be used for point-to-point transmissions, it has not mandated any particular commercial services for such frequency. Prior to 1993, the 38 GHz portion of the radio spectrum remained largely unassigned for commercial use in the United States due to, among other factors, the lack of available technology to efficiently utilize 38 GHz for commercial purposes. In the early 1990s, however, technology became available which allowed for the commercial provision of wireless telecommunications links between two fixed points. The 38 GHz portion of the radio spectrum was first used on a commercial basis in Europe by providers of personal communications services ("PCS") for the interconnection of their cell sites.

By early 1994, technological advances combined with growing use in Europe led to increasing awareness of and interest in the potential uses of 38 GHz technology in the United States. After Avant-Garde Telecommunications, Inc. (which was acquired by the Company in July 1995 and was the original recipient of many of the Wireless Licenses) received its initial 30 multiple-channel 38 GHz licenses in September 1993 (each license providing for four channels for an aggregate of 400 MHz of bandwidth capacity), other entities, including several large telecommunications companies such as Pacific Telesis, GTE and MCI Communications, sought similar multiple-channel 38 GHz licenses for the provision of wireless local telecommunications services. However, in September 1994, the FCC began to follow new procedures with respect to the granting of 38 GHz licenses, including limiting bandwidth capacity to a single 100 MHz channel per licensee in a particular licensed geographic area and, in November 1995, established a freeze on the issuance of new licenses in this spectrum pending the outcome of a rulemaking proceeding. See "Government Regulation of Telecommunications Operations" elsewhere in this Item 1.

Point-to-point wireless local telecommunications services can be offered in many portions of the radio spectrum. However, 38 GHz has characteristics well suited for the provision of local telecommunications services, including:

RAPID DEPLOYMENT OF ALTERNATIVE LOCAL INFRASTRUCTURE. 38 GHz technology generally can be deployed considerably more rapidly than wireline (because of permit procedures and construction time required for wireline buildout) and many other wireless technologies (because of their infrastructure requirements and, in many instances, the need to follow FCC frequency coordination procedures in connection with wireless facilities).

BROAD BANDWIDTH. The total amount of bandwidth for each 38 GHz channel is 100 MHz, which supports full broadband capability. For example, one 38 GHz DS-3 channel at 45 Mbps can transfer data at a rate which is over 1,500 times the rate of the fastest dial-up modem currently in general use (28.8 Kbps) and over 350 times the rate of the fastest ISDN line currently in general use (128 Kbps). Data transfer rates of a 38 GHz DS-3 channel even exceed the data transfer rates of cable modems (30 Mbps). The broadband capacity of 38 GHz provides improved speed and quality in transmissions, as compared to transmissions that are carried over a "last mile" consisting of copper wire. In addition to accommodating standard voice and data requirements, 45 Mbps data transmission rates allow end users to receive full motion video and 3-D graphics and to utilize highly interactive applications on the Internet and other networks.

EASE OF INSTALLATION. The equipment used for point-to-point applications in 38 GHz (i.e., antennae, transceivers and digital interface units) is typically smaller, less obtrusive and less expensive, and uses less power than equipment used for similar applications at lower frequencies. These characteristics make it relatively easier to obtain the necessary rights ("Roof Rights") required to install 38 GHz transceivers on rooftops and towers and less costly to initiate 38 GHz-based services as compared to most other wireless services.

EFFICIENT CHANNEL REUSE. Certain characteristics of 38 GHz, including the small amount of dispersion (i.e., scattering) of the radio beam as compared to the more dispersed radio beams produced at lower frequencies, allow for the reuse of bandwidth capacity in a licensed area. The ability to reuse capacity allows the 38 GHz license holder to densely deploy its 38 GHz services in a given geographic area, provide services to multiple customers over the same 38 GHz channel, and conserve bandwidth capacity, thereby enhancing the types of services that can be provided and increasing the number of customers to which such services can be provided. Due to the limited dispersion characteristics of 38 GHz, numerous T-1 circuits and/or DS-3 circuits can be placed in close proximity without interfering with each other. The Company believes that the use of multiple 100 MHz channels allows, and in many instances is required, for reuse where multiple DS-3 paths are being densely deployed in a given area. The Company currently utilizes one 100 MHz channel to provide either four T-1 circuits, eight T-1 circuits or one DS-3 circuit depending on the specific radio equipment utilized and its configuration. The specific equipment and capacity deployed are determined by the capacity needed on each link.

38 GHz licenses have been granted by the FCC on a geographic basis and cover areas originally defined by the applicant, allowing the license holder to install and operate as many transmission links as can be engineered in the entire licensed area without obtaining further approval from the FCC. This is a significant difference from the licensing provisions applicable to most other comparable portions of the radio spectrum (i.e., those that are used for most other commercial point-to-point applications), many of which are licensed on a link-by-link basis following frequency coordination. Frequency coordination is often time consuming and problematic at frequencies lower than 38 GHz because such frequencies are widely used and signals at such frequencies are more dispersed. The exclusive right to use a particular channel or channels within a broad geographic area gives the licensee much greater control and flexibility over its network design. A 38 GHz licensee can save costs, ensure interference-free operations and increase quality and reliability by designing efficient 38 GHz networks in advance of their deployment.

TELECOMMUNICATIONS OPERATIONS

The Company believes that in order to effectively compete with incumbent LECs and other telecommunications services providers in its target markets, it must develop a core group of assets, capabilities and resources. The Company has made substantial progress in acquiring and developing these core assets, which include:

TRANSMISSION AND SWITCHING FACILITIES. In October 1996, the Company initiated local switched services in New York City, utilizing its first 5ESS switch, purchased from Lucent Technologies ("Lucent"), and

facilities leased from NYNEX. During the next three years, the Company intends to install Lucent switches to serve most of its major markets. The Company has acquired the necessary Roof Rights to install its Wireless Fiber transmission facilities on approximately 900 buildings nationally and is acquiring Roof Rights to an additional 50 to 75 buildings per month. The Company also has developed monitoring and management systems that will ensure the efficient use of its networks and provide network reliability and transmission quality equivalent to that provided by fiber-optic networks. The Company recently completed construction of a network operating center ("NOC"), which is operating 24 hours a day, 7 days a week, and is currently building a national field service force.

STATE AUTHORIZATIONS. The Company has obtained authorization to operate as a CLEC in 19 states and is in the process of seeking authorization to operate as a CLEC in a number of additional jurisdictions. The Company is authorized to provide its local access and other Carrier Services as a CAP in 31 states and has applications pending for such authorizations in a number of additional jurisdictions.

SALES AND CUSTOMER SUPPORT ORGANIZATIONS. The Company is expending a significant amount of time and capital to build a dedicated, responsive sales and customer support organization in order to ensure that the people and systems necessary to achieve customer satisfaction keep pace with a growing customer base. The Company has a direct sales organization for its CLEC services, currently consisting of more than 240 people located in 12 major cities, and a Carrier Services sales group, currently consisting of more than 70 people.

INFORMATION SYSTEMS. The Company is investing significant capital developing state-of-the-art information systems platforms directed toward the accurate and flexible handling of the billing and customer satisfaction requirements of a diverse customer base purchasing a variety of telecommunications services. The Company believes that its information systems allow it to provide customers with a level of service and responsiveness that many other telecommunications services providers do not offer and that such level of service will become a key factor in customers' choice of telecommunications services providers as the market matures.

EXPERIENCED MANAGEMENT AND OPERATING PERSONNEL. The Company has assembled a management team and hired operating personnel experienced in all areas of telecommunications operations, including more than 200 former officers and employees of MCI Communications and more than 50 former officers and employees of Sprint Corporation, as well as officers and employees from other established telecommunications companies. The Company plans to hire additional experienced telecommunications marketing and operations personnel as appropriate.

STRATEGY FOR TELECOMMUNICATIONS BUSINESS GROWTH

The Company's objective is to become the full-service telecommunications provider of choice to small and medium-sized business customers and a provider of high-quality alternative and broadband facilities to its Carrier Services customers. Key elements of the Company's strategy are to:

EXPAND NETWORK INFRASTRUCTURE. The Company is creating an infrastructure on a city-by-city basis using its Wireless Fiber capabilities, switches acquired by the Company from equipment vendors and facilities leased from other carriers to originate and terminate traffic. Pursuant to its building-centric network plan, the Company is identifying strategically located sites in each metropolitan area to serve as hubs for its network. These hub sites will be connected via Wireless Fiber links to end users. The Company believes that a limited number of hub sites (generally less than a dozen) in each metropolitan area will allow it to address more than 70% of its targeted customers' buildings and to carry the majority of its customers' traffic on its own network instead of the higher cost facilities of other carriers.

EXPLOIT FIRST-TO-MARKET ADVANTAGES. The Company seeks to capitalize on the significant opportunities emerging in the industry as a result of the Telecommunications Act by exploiting a "first-to-market"

advantage as one of the few holders of 38 GHz licenses with an established operating and management infrastructure. The Company believes that its early entrance into its markets provides it with advantages over many potential competitors by allowing it to: (i) establish a customer base prior to widespread competition from other CLECs; (ii) develop a proven, reliable network infrastructure using its own switching capacity ahead of many other CLECs; (iii) develop pioneering expertise in the utilization of 38 GHz for the delivery of telecommunications services and the design and management of 38 GHz-based networks; and (iv) acquire Roof Rights to place its 38 GHz antennae on a large number of buildings on favorable terms and in advance of other wireless service providers.

FOCUS ON SMALL AND MEDIUM-SIZED BUSINESS CUSTOMERS. The Company believes there exists a substantial opportunity to attract a base of small and medium-sized business customers by providing superior customer service and sales support. The customer base initially targeted by the Company consists of businesses typically located in buildings that have more than 100,000 square feet of commercial space and which, in many instances, are not served by CLECs or CAPs. The Company estimates that there are more than 8,000 buildings in this target group, populated by approximately 9.7 million workers using more than 2.1 million phone lines. Over time, the Company intends to expand its target customer base to include the majority of small and medium-sized businesses in the metropolitan areas covered by the Wireless Licenses, which the Company estimates contain approximately 60% of all such businesses in the United States and represent a market opportunity in excess of \$30 billion per year.

MARKET WIRELESS FIBER TO OTHER CARRIERS. The Company markets its Carrier Services to other carriers such as the RBOCs and other LECs, interexchange carriers ("IXCs"), other CAPs and CLECs, providers of PCS and cellular and specialized mobile radio services ("CMRS") providers. The Company believes that its Carrier Services present an attractive, economical method for telecommunications services providers to add a high-capacity extension to their own networks and service territories, especially as they seek to rapidly penetrate new markets opening as a result of the Telecommunications Act. The Company's Carrier Services can also provide cost-efficient route diversity where network reliability concerns require multiple telecommunications paths.

Since the commercial introduction of the Company's Carrier Services in October 1995, the number of carrier customers has increased significantly. Such customers include Ameritech Cellular Services, AT&T Wireless, Bell Atlantic/NYNEX Mobile, Brooks Fiber, Cellular One, PrimeCo Personal Communications, Siemens Stromberg-Carlson, Teleport Communications and Western Wireless. In addition, the Company has entered into multi-year master service agreements with American Communications Services, Electric Lightwave, IntelCom, MCI Communications and Pacific Bell. These agreements establish the framework under which such companies may effect the integration of Wireless Fiber services into their own telecommunications networks. The Company is in the process of negotiating additional master service agreements with other large telecommunications providers, including AT&T.

MARKET WIRELESS FIBER SERVICES AS A SOLUTION TO GROWING CAPACITY SHORTAGES. The Company believes that demand for its Wireless Fiber-based CLEC and Carrier Services will grow because of the expanding volume of data communications traffic resulting from increasing Internet usage and other high-volume data transmission requirements. This type of traffic increasingly requires high-capacity, end-to-end networks that are often difficult to provide economically with older RBOC and LEC infrastructure.

PROVIDE INFORMATION AND CONTENT SERVICES. The Company believes that the ability to deliver information and other content will become an increasingly important factor in the choice of a telecommunications provider by businesses as competition increases and the markets covered by the Wireless Licenses mature. Accordingly, the Company actively seeks opportunities to utilize its information and content services to enhance the marketability of the Company's telecommunications services.

TELECOMMUNICATIONS SERVICES

The Company commenced marketing its local exchange services in New York City in April 1996 on a resale basis and began providing switch-based services in New York City in October 1996. The Company is currently introducing its CLEC services on a resale basis in eleven additional cities: Atlanta, Boston, Chicago, the District of Columbia, Hartford, Los Angeles, Milwaukee, Philadelphia, San Diego, San Francisco and Stamford. Since late 1994, the Company also has focused on the development and marketing of its Wireless Fiber-based Carrier Services. After an initial market-education phase, in which the Company demonstrated the efficacy and reliability of its Wireless Fiber services, principally through the use of field demonstrations and the installation of Wireless Fiber links on a trial basis, the Company began receiving orders for its Carrier Services in 1995.

WIRELESS FIBER

The Company utilizes its Wireless Fiber capacity in connection with its Carrier Services and as an integral component of its CLEC facilities for the origination and termination of local traffic and hubbing of switch sites and other facilities accessed by the Company.

WIRELESS FIBER LINKS. Each Wireless Fiber link currently provides up to eight T-1s of capacity (equivalent to 192 voice lines) or one DS-3 of capacity (equivalent to 672 voice lines). The Company believes that with future developments in 38 GHz technology there will be substantial increases in the capacity of each Wireless Fiber link. The Company's Wireless Fiber links meet or exceed general telephone industry standards, provide transmission quality equivalent to that produced by fiber optic-based facilities, and address the growing demand for high-speed, high-capacity, digital telecommunications services for voice, data and video applications, including traditional local access, Internet access and network interconnection services.

Each Wireless Fiber path consists of transmission links, which are paired digital millimeter wave radio transceivers placed at a distance of up to five miles from one another within a direct, unobstructed line of sight. The transceivers are typically installed on rooftops or towers or in windows. The transceivers currently used by the Company are primarily the Tel-Link 38 Radio Systems supplied by P-Com, Inc. ("P-Com") pursuant to a four-year nonexclusive supply agreement ("Tel-Link Agreement") executed in November 1994, which may be terminated by the Company upon 90 days' notice to P-Com (subject to certain liquidated damages provisions if certain purchase minimums are not met). The Tel-Link Agreement includes provisions whereby the Company pays a higher price per link at the beginning of the contract period, with the excess recoverable by the Company in the form of significantly discounted links once certain volume levels have been achieved. The contract also stipulates certain minimum annual volume levels which must be met in order to maintain the agreed upon pricing structure. The Company has entered into an amendment to the Tel-Link Agreement with P-Com, pursuant to which the requirements for volume discount pricing were revised. The Company has not yet qualified for significant volume discounts. The amendment also added another year to such term, reduced the purchase commitment provisions upon termination, and revised the type of Tel-Links to be provided by P-Com such that a greater proportion of higher capacity transceivers (including DS-3 capable transceivers) will be delivered under the agreement.

Significant features of the Company's Wireless Fiber services include: (i) 38 GHz digital millimeter wave transmissions having narrow beam width, reducing the potential for channel interference; (ii) 100 MHz bandwidth in each channel, allowing for high subdivision of voice and data traffic; (iii) a range of up to five miles between transmission links; (iv) performance engineered to provide up to 99.999% reliability, as tested; (v) transmission accuracy engineered to provide bit error rates of 10 (unfaded); (vi) 24-hour network monitoring by the Company's and Lucent's NOCs; (vii) optional safeguards from link outages by installation of hot standbys that remain powered up and switch "on-line" if the primary link fails;

(viii) optional forward error correction ensuring the integrity of transmitted data over Wireless Fiber paths; and (ix) relatively low cost (installed) for each pair of transceivers comprising a transmission link.

In August 1995, the Company entered into a three-year service contract with Lucent, pursuant to which Lucent has agreed to provide site survey, installation, maintenance and network management services for the Company's Wireless Fiber services 24 hours a day, 7 days a week, as required. The Company also is in the process of expanding its own installation, maintenance and network management capabilities, which expansion includes the hiring of qualified personnel, the development of management and operating systems, and the recently completed construction of a modern, state-of-the-art NOC, which is operating 24 hours a day, 7 days a week. Transmission links in the Company's Wireless Fiber paths are connected via dial-up modems to the NOCs. The NOCs provide the Company with points of contact for network monitoring, troubleshooting and dispatching repair personnel in each MSA. The NOCs provide a wide range of network surveillance functions for each Wireless Fiber path, providing the Company with the ability to remotely receive data regarding the diagnostics, status and performance of its transmission links.

In order to provide quality transmission, Wireless Fiber services require an unobstructed line of sight between two transceivers comprising a link, with a maximum distance between any two corresponding transceivers of up to five miles (or shorter distances in certain areas; as weather conditions may necessitate distances as short as 1.1 miles between transceivers to maintain desired transmission quality). The areas in which such shorter distances are required are those where rainfall intensity and the size of the raindrops adversely impact transmission quality at longer distances. Other weather conditions, such as snow, electrical storms and high winds, have not, in the Company's experience, affected Wireless Fiber services. The establishment of Wireless Fiber may require additional transceivers to triangulate around obstacles (such as buildings). Similarly, to establish Wireless Fiber services covering a distance in excess of five miles or to establish a system of interconnected hub sites, additional transceivers are required to establish a chain whose links are no more than five miles apart at any given point. The cost of additional transceivers where required by weather, physical obstacles or distance may render the provision of Wireless Fiber services uneconomical in certain instances.

The Company must obtain Roof Rights for each building where a transceiver will be placed. The Company's prequalification activities often require the payment of option fees for the buildings that are being prequalified. In connection with the development of its Wireless Fiber capacity for both its Carrier Services and CLEC businesses, the Company has been following a plan pursuant to which it seeks to negotiate, prior to receipt of actual service orders, Roof Rights for the installation of Wireless Fiber links on buildings specifically identified by existing and potential customers in the metropolitan areas covered by the Wireless Licenses, including buildings that can provide interconnection access to IXCs' points of presence ("POPs"), switch locations and local access nodes. As part of the Company's acquisition ("Locate Acquisition") in 1996 of Local Area Telecommunications, Inc. ("Locate"), the Company gained roof access to a number of buildings, including the World Trade Center and other key sites in New York City, which the Company anticipates using in its Carrier Services and CLEC operations.

WIRELESS LICENSES. The Company recently completed the acquisition of the Milliwave Limited Partnership. As a result of the Milliwave Acquisition, the Company obtained 88 channels of 38 GHz capacity, each providing for 100 MHz of bandwidth ("Milliwave Licenses"). The Milliwave Licenses allow for the provision of service in more than 80 major markets. The cities covered by the Milliwave Licenses include many that were already serviceable by the Company under its existing Wireless Licenses, such as Boston, Chicago, Dallas, Los Angeles and New York, thus increasing the Company's aggregate bandwidth capacity in each such city. The Milliwave Licenses also cover many cities that were not previously serviceable by the Company under its existing Wireless Licenses, such as Honolulu, Nashville, Orlando, Raleigh/Durham and Rochester (New York). In 1996, the Company also consummated the Locate Acquisition, acquiring the assets comprising Locate's business as a CAP providing microwave-based local access services to corporations and long distance and other common carriers. Among Locate's key assets are two 38 GHz licenses, each providing 100 MHz of bandwidth, for the New York City metropolitan area, including Long Island.

and Northern New Jersey. As part of the Locate Acquisition, the Company also acquired from Locate certain licenses for the provision of point-to-point services in other portions of the radio spectrum, including, among others, 10, 12, 16 and 18 GHz.

The Wireless Licenses allow the Company to provide Wireless Fiber services in the 47 of the 50 most populated MSAs in the United States, which include more than 100 cities with populations exceeding 100,000 each and encompass an aggregate population of almost 172 million people. The Company has the largest aggregate amount of 38 GHz bandwidth capacity in the United States. The Wireless Licenses (including those acquired in the Milliwave and Locate Acquisitions) allow for the provision of Wireless Fiber services over four or more channels in the following cities:

New York--Manhattan	Boston	Milwaukee
New York--West (NJ)	Atlanta	Cincinnati
New York--Long Island	Houston	Pittsburgh
Los Angeles	Miami	St. Louis
Chicago	Cleveland	Kansas City
Philadelphia	Minneapolis-St. Paul	Buffalo
Dallas	Baltimore	Spokane
San Francisco	Seattle	San Diego
Detroit	Phoenix	Tampa
Washington	Denver	Tacoma

The Wireless Licenses also allow for the provision of Wireless Fiber services over multiple channels in ten additional cities and a single channel in 53 additional cities.

The Wireless Licenses have been granted or acquired since September 1993. The FCC's current policy is to align the expiration dates of all outstanding 38 GHz licenses such that all such licenses mature concurrently and then to renew all such licenses for a matching period. The initial term of all currently outstanding 38 GHz licenses, including the Wireless Licenses, expires in February 2001. While the Company believes that all of its Wireless Licenses will be renewed, based upon FCC custom and practice establishing a presumption in favor of licensees that have complied with their regulatory obligations during the initial license period, there can be no assurance that any Wireless License will be renewed upon expiration of its initial term.

The Company has signed agreements with a number of licensees to acquire an aggregate of 47 additional 38 GHz licenses and associated business operations, including 15 channels in the 50 most populated MSAs in the United States. Upon completion of the acquisitions, which are subject to approval by the FCC, the Company's total population coverage will grow to approximately 180 million, its total channel pops will grow to approximately 650 million, and the Company will have Wireless Licenses in 49 of the 50 most populated MSAs in United States markets. The total purchase price for the licenses will be approximately \$16.0 million, payable in shares of the Company's Common Stock, priced at the time of each closing or in cash at the Company's option, if the market price of the Common Stock is less than \$16 per share.

CLEC AND LONG DISTANCE SERVICES

An integral part of the Company's telecommunications business strategy is the creation of a Wireless Fiber-based infrastructure on a city-by-city basis that will allow the Company to provide a broad range of communications services within cities covered by the Wireless Licenses. The Company believes that its Wireless Fiber capabilities will provide it with a critical economic advantage over many other service providers because of the high costs such service providers encounter in connecting fiber-optic lines to end users.

CLEC SERVICES. In October 1996, the Company initiated local switched services in New York City, utilizing its first 5ESS switch, purchased from Lucent, and facilities leased from NYNEX. The Company currently intends to install, during the next three years, switches provided by Lucent to service most of its major markets. In July 1996, the Company entered into a three-year agreement with Lucent providing for the purchase of the switching systems and related equipment and software the Company will need to build its CLEC infrastructure. Switches will be provided to the Company at discounted prices so long as the Company purchases a minimum number of switches during each year of the agreement.

The Company has commenced a program designed to obtain, by the end of 1999, authorization to operate as a CLEC in virtually every state where the Company has Wireless Licenses, which will allow the Company to file tariffs and provide local exchange services in such states once authorization is granted. The Company currently is authorized through state-specific subsidiaries as a CLEC in California, Colorado, Connecticut, the District of Columbia, Florida, Georgia, Illinois, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New York, Ohio, Pennsylvania, Tennessee, Texas, Utah, Virginia, Washington and Wisconsin, is in the process of seeking authorization to operate as a CLEC in several additional states, and intends to seek such authorization in a number of additional states. The Company has never had an application for CLEC authorization denied. The Company has entered into a number of interconnection agreements with carriers in states that encompass various cities covered by the Wireless Licenses. These agreements are with carriers such as Ameritech Corp. for Illinois and Michigan, Pacific Bell for California, Southwestern Bell for Texas, GTE for California and Tampa, Florida, NYNEX for New York and Massachusetts, Bell South for Florida, Georgia and Tennessee and Bell Atlantic for Pennsylvania, Maryland, the District of Columbia, New Jersey and Virginia and Southern New England Telephone for Connecticut. It also is in the process of negotiating additional interconnection agreements with various local exchange service providers, including incumbent LECs.

In connection with the plan to build its CLEC networks on a city-by-city basis, the Company is hiring numerous engineering, installation, maintenance, customer service and marketing and sales personnel in order to create a direct sales organization which will provide a high level of service to the small and medium-sized business and multiple-dwelling residential market. A sales force has been deployed in New York and in eleven other cities, and the Company currently plans to have a sales force in all metropolitan areas covered by the Wireless Licenses by the end of 1999. The Company also is developing joint marketing, reselling and agency relationships. For example, pursuant to an agreement ("Digex Agreement") with Digex, Inc., a provider of Internet access services to businesses ("Digex"), the Company will purchase from Digex, during the next six years, a minimum of \$5 million of Internet services with the right to purchase additional amounts on a discounted basis. The Company will resell these Internet services under the Company's own brand name, including through the bundling of such services with the Company's other telecommunications services.

The Company seeks to make its CLEC business an attractive choice for potential customers by (i) offering a broad range of telecommunications services that specifically address its target customers' needs, while providing levels of customer satisfaction that exceed those provided by larger competitors and (ii) exploiting the Company's Wireless Fiber service whenever feasible for cost-effective origination and termination of customer traffic, thereby allowing for attractive pricing of services.

LONG DISTANCE SERVICES. As a complement to its CLEC services, the Company offers its business customers long distance services on a resale basis through agreements with major long distance carriers (MCI Communications and U.S. Long Distance) which allow it to utilize their networks. In addition to providing basic long distance service, the Company is able to provide toll-free services, international call-back, prepaid phone cards and certain enhanced services.

The Company's agreements with certain major long distance carriers are for one- to four-year terms and provide the Company with access to long distance carriers' networks at rates which are typically discounted, varying with monthly traffic generated by the Company through each carrier. Generally, the

Company is obligated to generate certain minimum monthly usage through each network and, if such traffic is less than the minimum monthly usage commitment, may be required to pay an underutilization fee in addition to its monthly bill equal to a certain percentage of the difference between such minimum commitments and the traffic actually generated by the Company. The Company has never paid or been required to pay any underutilization charges. During 1995, the Company established a reserve for possible underutilization charges.

The Company continues to provide long distance services to its existing residential customers, though it no longer actively markets such services to that segment of the market, except through certain established affinity programs. As a result of this change in focus, the Company's residential long distance customer base has and will continue to decrease due to attrition.

CARRIER SERVICES

The Company markets and provides wireless broadband, high-capacity local access and other network services primarily to other carriers. Utilizing its Wireless Licenses, the Company offers numerous wireless telecommunications services to support a wide range of local access and dedicated service needs with a high degree of reliability. The technology and service applications in this field are evolving rapidly, and the Company believes that its Wireless Fiber service offerings will expand over time to include a broad range of voice, data and video applications. The Company currently offers its Carrier Services for the following applications, among others:

LOCAL BY-PASS FOR LONG DISTANCE CARRIERS. Long distance carriers can utilize the Company's Wireless Fiber services to connect certain call termination or origination points in a particular licensed area to such carriers' POPs in the licensed area at more economical rates than those generally charged by LECs and to connect two or more of their respective POPs in a single licensed area. Long distance carriers using Wireless Fiber services may benefit from both the lower cost afforded by such services and the wide-band capacity compared to LEC facilities, which, in many instances, are based in part on copper infrastructure and are, therefore, narrow-band. By utilizing the Company's Wireless Fiber services, long distance carriers can avoid the capacity barrier inherent in copper wire connections that typically has prevented them from providing their customers with end-to-end, full digital service available under a fiber-optic or wireless-based system. Wireless Fiber services also may be utilized to provide such carriers with viable, cost-efficient paths to serve as physically diverse routes (redundant and back-up capacity) for traffic in situations where primary routes are incapacitated and/or network reliability concerns demand alternate telecommunications paths.

WIRELESS COMPLEMENT TO CAP AND LEC NETWORKS. CAPs typically compete with LECs by utilizing their own fiber-optic cable rings and leasing the other facilities necessary to complete their networks from the LECs. Due to the large capital investment required to construct such networks, CAPs generally build their networks in limited, densely populated areas and offer services primarily to large customers such as long distance carriers, medium-sized and large businesses, government agencies and institutions. CAPs can utilize Wireless Fiber services to bypass facilities typically leased by them from the LECs. CAPs also can utilize the Company's Wireless Fiber services to facilitate the buildout and enhance the reliability of their own local telecommunications networks and expand their marketing opportunities. The Company believes that the relative ease and low cost of installation of Wireless Fiber services in comparison to fiber-optic facilities can provide CAPs with the ability to expand their networks to reach some customers in areas where demand levels are insufficient to justify the cost and time involved in constructing fiber-optic capacity. CAPs, as well as LECs, also can use the Company's Wireless Fiber services to extend their own networks to provide services to areas within a licensed area to which it is not cost-efficient to run fiber-optic cable or to which such cable simply has not yet been run. CAPs and LECs also may utilize the Company's Wireless Fiber services to provide redundant and back-up capacity to their own existing networks.

BACKBONE INTERCONNECTION AND REDUNDANCY FOR CMRS PROVIDERS. Wireless Fiber services can be utilized by providers of mobile telecommunications services, such as PCS, cellular and specialized mobile radio carriers, for interconnecting traffic (backbone network traffic) between and among cell sites, repeaters and the wired local networks. The Company also anticipates that entities that acquired licenses in the PCS auctions or which will acquire licenses in subsequent PCS auctions conducted by the FCC also will find Wireless Fiber services attractive to carry their backbone network traffic. By utilizing Wireless Fiber services for their backbone network needs, CMRS carriers can maintain greater control over their systems by monitoring traffic carried over the Wireless Fiber services component of their systems, reduce costs of construction of their networks, increase the flexibility of their services and reduce the lead time involved in the provision of services in their respective licensed areas. Wireless Fiber services also can be used by CMRS carriers to provide redundant and back-up capacity for the fiber-optic and/or copper wire portions of their backbone networks.

DEDICATED PRIVATE NETWORK SERVICES. The Company also markets its Wireless Fiber services to businesses, government agencies and institutions with multiple locations within the Company's licensed areas and which generate heavy telecommunications traffic between such locations. These entities can utilize Wireless Fiber services to establish their own independent telecommunications systems for dedicated private network services. Wireless Fiber services present entities with: (i) a method for providing telecommunications connections between their buildings on a cost-effective basis; (ii) a viable alternative to the LECs' networks that frequently use low-capacity copper wire for "last mile" delivery, generally allowing for faster, more reliable data transmissions; (iii) greater control over their local telecommunications traffic and costs; and (iv) greater security because of the private line nature of the Company's Wireless Fiber services.

NETWORK AND INTERNET ACCESS. The ability to access and distribute information quickly has become critical to business and government end users. Data traffic is becoming an increasing portion of overall telecommunications traffic because of the proliferation of LANs, WANs, Internet services and video teleconferencing. The Company's Wireless Fiber capacity enables it to provide high-speed data transmission services to end users.

WAN SERVICES. The Company recently introduced dedicated WAN services. The Company's high-speed data telecommunications services permit businesses to transport data between buildings and between personal computers or workstations. These dedicated services allow personal computers and workstations on one LAN to communicate with personal computers and workstations on another LAN at the same speed at which these LANs operate. The Company's WAN services are offered at a variety of capacities to allow customers to choose the level which meets their needs.

INTERNET SERVICES. The expanding demand for Internet access and the growing importance of audio, video and graphic Internet applications to both businesses and consumers also has created a growing market opportunity for the Company. The Company can offer Internet service providers timely, reliable and affordable access at high-speed data rates. The Company can provide wireless broadband links between customers and their Internet service providers and between Internet service providers' POPs and the Internet backbone. In June 1996, the Company entered into an agreement ("Digex Agreement") with Digex, Inc., a provider of Internet access services to businesses ("Digex"), pursuant to which the Company will purchase Internet services on a discounted basis from Digex during the next six years. The Company will resell these Internet services under the Company's own brand name, including through the bundling of such services with the Company's other telecommunications services. The Company is actively pursuing relationships with other Internet service providers. Pursuant to the Digex Agreement, the Company also has the right of first refusal to provide Digex's local access and/or customer interconnection requirements.

POTENTIAL INTERACTIVE VIDEO APPLICATIONS. The inherent qualities of 38 GHz also may offer substantial opportunities for broadband interactive video applications appropriate for highly customized commercial demands. While the specific service offerings using 38 GHz technology for video applications are still in

development, the ability to commercially utilize certain aspects of this technology appears to be possible. The narrow-beam characteristics of 38 GHz technology, allowing for frequency reuse within a small area, coupled with its broadband capacity and multichannel capabilities may offer a significant market opportunity in the future as the appropriate technologies emerge, although there can be no assurance of the consumer acceptance or commercial viability of such video services. In June 1996, the Company entered into an agreement with Source Media, Inc. ("Source Media") a provider of interactive technology and programming. Pursuant to this agreement, the Company has the exclusive right, in the 38 GHz spectrum, to use Source Media's technology and programming in connection with entertainment and information services the Company may offer.

ADVERTISING AND MARKETING OF TELECOMMUNICATIONS SERVICES

CLEC AND LONG DISTANCE SERVICES

Over the next three years, the Company intends to market its telecommunications services in substantially all markets covered by its Wireless Licenses through direct sales, alternative sales channels television, print and other media. The Company introduced its first series of television commercials and print advertising in the New York City market in November 1996 and intends to utilize media advertising campaigns in each market in which it commences offering its CLEC services, including broadcast media in specific major markets.

The Company is targeting small and medium-sized businesses, especially those in buildings in which the Company's Wireless Fiber capacity can be utilized, for economic competitive advantage, to originate and/or terminate customers' local telecommunications traffic.

The Company also intends to market its services to residences in multiple-dwelling units, such as apartment buildings to enter into the residential segment of the local exchange services market primarily by entering into partnerships and agency arrangements with shared tenant services providers and possibly partnerships or alliances with other telecommunications services providers.

Consistent with its telecommunications marketing strategy of emphasizing small and medium-sized business customers, the Company has, among other things, introduced products and services readily marketable to business long distance customers, including prepaid phone card services and a broad array of toll-free services, including services which allow toll-free calls to be originated nationwide. The Company also offers business customers several flexible billing services such as master account billing (which enables customers to aggregate billing for several locations for management and accounting purposes and to qualify for volume discounts), project accounting codes (which reflect accounting codes of the customer on the billing statement) and computerized call detail reports (which provide call detail to customers on computer disks or tape for direct input into the customer's computer for accounting or rebilling).

CARRIER SERVICES

The Company began marketing its Wireless Fiber services in December 1994. Wireless Fiber services currently are marketed by the Company primarily to long distance carriers, CAPs, CMRS providers and LECs, as well as businesses, government agencies and institutions. The Company also recently began to provide Wireless Fiber services to The City of New York as a back-up disaster recovery system for certain of its facilities, providing the city with redundancy in the event that its land-based telecommunications service fails for any reason.

The Company currently markets or intends to market its Carrier Services: (i) by performing field demonstrations and testing of Wireless Fiber services; (ii) by providing potential customers with Wireless Fiber services at reduced rates, in order to educate such customers about the efficacy and reliability of such services; (iii) by appearing at trade shows and advertising in trade publications; (iv) through national sales

agents and direct sales; and (v) directly to existing and potential customers of the Company's other telecommunications services.

COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY

LOCAL TELECOMMUNICATIONS MARKET

The local telecommunications market is intensely competitive for newer entrants and currently is dominated by the RBOCs and LECs. The Company has been marketing local access and other Carrier Services only since December 1994 and local exchange services as a CLEC only since April 1996, and the Company has not obtained significant market share in any of the areas where it offers such services, nor does it expect to do so given the size of the local telecommunications services market, the intense competition and the diversity of customer requirements. In each area covered by the Wireless Licenses, the services offered by the Company compete with those offered by the LECs, such as the RBOCs, which currently dominate the provision of local services in their markets. The LECs have long-standing relationships with their customers, have the potential to subsidize competitive services with revenues from a variety of business services and benefit from existing state and federal regulations that currently favor the LECs over the Company in certain respects. While legislative and regulatory changes have provided increased business opportunities for competitive telecommunications providers such as the Company, these same decisions have given the LECs increased flexibility in their pricing of services. This may allow the LECs to offer special discounts to the Company's and other CLECs' customers and potential customers. Further, as competition increases in the local telecommunications market, general pricing competition and pressures will increase significantly. As LECs lower their rates, other telecommunications providers will be forced by market conditions to charge less for their services in order to compete.

In addition to competition from the LECs, the Company also faces competition from a growing number of new market entrants, such as other CAPs and CLECs, competitors offering wireless telecommunications services, including leading telecommunications companies, such as AT&T Wireless, future satellite-based providers such as Iridium and Teledesic, and other entities that hold or have applied for 38 GHz licenses or which may acquire such licenses or other wireless licenses, including those in comparable bands such as 28 GHz and 18 GHz, from others or from the FCC. There is at least one other CAP and/or CLEC in each metropolitan area covered by the Company's Wireless Licenses, including, in many such areas, companies such as IntelCom, MCI Communications, MFS Communications, Teleport Communications and Time Warner. Many of these entities (and the LECs) already have existing infrastructure which allows them to provide local telecommunications services at potentially lower marginal costs than the Company currently can attain and which could allow them to exert significant pricing pressure in the markets where the Company provides or seeks to provide telecommunications services. In addition, many CAPs and CLECs have acquired or plan to acquire switches so that they can offer a broad range of local telecommunications services.

The Company currently also faces competition from other entities which offer, or are licensed to offer, 38 GHz services, such as Advanced Radio Telecommunications ("ART"), and BizTel, Inc. The Company also could face competition in certain aspects of its existing and proposed businesses from a number of competitors providing wireless services in other portions of the radio spectrum, such as CellularVision USA, a provider of wireless television services which, in the future, also may provide wireless Internet access and other local telecommunications services, and Associated Communications, a potential provider of wireless CAP and other services. In many instances, these service providers hold 38 GHz licenses or licenses for other frequencies (such as 2, 18 and 28 GHz) in geographic areas which encompass or overlap the Company's market areas. Additionally, some of these entities enjoy the substantial backing of, or include among their stockholders, major telecommunications entities, such as Ameritech with respect to ART and Teleport Communications with respect to BizTel. Due to the relative ease and speed of deployment of 38 GHz and some other wireless-based technologies, the Company could face intense price competition from these and other wireless-based service providers. Furthermore, the

Notice of Proposed Rulemaking ("NPRM") issued by the FCC contemplates an auction of the lower 16 channels in the 38 GHz spectrum band, which have not been previously available for commercial use. The grant of additional licenses by the FCC in the 38 GHz band, or other portions of the spectrum with similar characteristics (such as 2, 18 and 28 GHz), as well as the development of new technologies, could result in increased competition. The Company believes that, assuming the adoption of the NPRM as currently proposed, additional entities having greater resources than the Company could acquire licenses to provide 38 GHz services or comparable services utilizing other bands such as 28 GHz and 18 GHz. In March 1997, the FCC released an order pursuant to which it stated its intention to license up to 1.3 GHz of spectrum in the 28 GHz band in each of 492 separate markets throughout the United States. The Company anticipates that, in the absence of litigation to stay this order, these licenses will be issued pursuant to auctions which may occur as early as the second half of 1997.

The Company also may face competition from cable companies, electric utilities, LECs operating outside their current local service areas and long distance carriers in the provision of local telecommunications services. The great majority of these entities provide transmission services primarily over fiber-optic, copper-based and/or microwave networks, which, unlike the Company's Wireless Fiber services, enjoy proven market acceptance for the carriage of telecommunications traffic. Moreover, the consolidation of telecommunications companies and the formation of strategic alliances within the telecommunications industry, which are expected to accelerate as a result of the passage of the Telecommunications Act, could give rise to significant new or stronger competitors to the Company. There can be no assurance that the Company will be able to compete effectively in any of its markets.

The Company's Internet services also are likely to face significant competition from other Internet service providers as well as from cable television operators deploying cable modems, which provide high-speed data capability over installed coaxial cable television networks. Although cable modems currently are not widely available and do not provide for data transfer rates that are as rapid as those which can be provided by Wireless Fiber services, the Company believes that the cable industry may support the deployment of cable modems to residential cable customers through methods such as price subsidies. Notwithstanding the cable industry's interest in rapid deployment of cable modems, the Company believes that in order to provide broadband capacity to a significant number of business and government users, cable operators will be required to spend significant time and capital in order to upgrade their existing networks to a more advanced hybrid fiber coaxial network architecture. However, there can be no assurance that cable modems will not emerge as a source of competition to the Company's Internet business. Further, Internet access services based on existing technologies such as ISDN and, in the future, on such technologies as ADSL and HDSL will likely provide additional sources of competition to the Company's Internet access services. Additionally, the Company believes that many LECs and CLECs already are promoting other Internet access services.

LONG DISTANCE MARKET

The long distance market has relatively insignificant barriers to entry, numerous entities competing for the same customers and a high (and increasing) average churn rate as customers frequently change long distance providers in response to the offering of lower rates or promotional incentives by competitors. The Company competes with major carriers such as AT&T, MCI Communications and Sprint, as well as other national and regional long distance carriers and resellers, many of whom own substantially all of their own facilities and are able to provide services at costs lower than the Company's current costs since the Company generally leases its access facilities. The Company believes that the RBOCs also will become significant competitors in the long distance telecommunications industry for certain types of services and that Internet service providers also will compete in this market. The Company believes that the principal competitive factors affecting its market share are pricing, customer service, accurate billing, clear pricing policies and, to a lesser extent, variety of services. The ability of the Company to compete effectively will depend upon its ability to maintain high-quality, market-driven services at prices generally perceived to be

equal to or below those charged by its competitors. To maintain its competitive posture, the Company believes that it must be in a position to reduce its prices in order to meet reductions in rates, if any, by others. Any such reductions could adversely affect the Company. In addition, LECs have been obtaining additional pricing flexibility. This may enable LECs to grant volume discounts to larger long distance companies, which also would put the Company's long distance business at a disadvantage in competing with larger providers.

GOVERNMENT REGULATION OF TELECOMMUNICATIONS OPERATIONS

The Company's telecommunications services are subject to varying degrees of federal, state and local regulation. Generally, the FCC exercises jurisdiction over all telecommunications services providers to the extent such services involve the provision of jurisdictionally interstate or international telecommunications, including the resale of long distance services, the provision of local access services necessary to connect callers to long distance carriers, and the use of electromagnetic spectrum (I.E., wireless services). With the passage of the Telecommunications Act, the FCC's jurisdiction has been extended to include certain interconnection and related issues that traditionally have been considered subject primarily to state regulation. The state regulatory commissions retain nonexclusive jurisdiction over the provision of telecommunications services to the extent such services involve the provision of jurisdictionally intrastate telecommunications. Municipalities also may regulate limited aspects of the Company's business by, for example, imposing zoning requirements or permit right-of-way procedures, and certain taxes or franchise fees.

The Telecommunications Act is intended to remove the formal barriers between the long distance and local telecommunications services markets, allowing service providers from each market (as well as providers of cable television and other services) to compete in all communications markets. The Telecommunications Act will permit the RBOCs to compete in the provision of interLATA long distance services. Additionally, the FCC must promulgate new regulations over the next several years to address mandates contained in the Telecommunications Act, which may change the regulatory environment significantly. The Telecommunications Act generally requires LECs to provide competitors with interconnection and nondiscriminatory access to the LEC network on more favorable terms than have been available in the past. However, such interconnection and the terms thereof are subject to negotiations with each LEC, which may involve considerable delays, and may not necessarily be obtained on terms and conditions that are acceptable to the Company. In such instances, although the Company may petition the proper regulatory agency to arbitrate disputed issues, there can be no assurance that the Company will be able to obtain acceptable interconnection agreements.

The Company is unable to predict what effect the Telecommunications Act will have on the telecommunications industry in general and on the Company in particular. No assurance can be given that any regulation will broaden the opportunities available to the Company or will not have a material adverse effect on the Company and its operations. Further, there can be no assurance that the Company will be able to comply with additional applicable laws, regulations and licensing requirements or have sufficient resources to take advantage of the opportunities which may arise from this dynamic regulatory environment.

As required by the Telecommunications Act, in August 1996 the FCC adopted the Interconnection Order. These rules constitute a procompetitive, deregulatory national policy framework designed to remove or minimize the regulatory, economic and operational impediments to full competition for local services, including switched local exchange service. Although setting minimum uniform national rules, the Interconnection Order also relies heavily on states to apply these rules and to exercise their own discretion in implementing a procompetitive regime in their local telephone markets. Among other things, the Interconnection Order: establishes rules requiring incumbent LECs to interconnect with new entrants such as the Company at specified network points; requires incumbent LECs to provide carriers nondiscriminatory access to network elements on an unbundled basis at any technically feasible point at rates that are

just, reasonable and nondiscriminatory; establishes rules requiring incumbent LECs to allow interconnection via physical and virtual co-location; requires the states to set prices for interconnection, unbundled elements, and termination of local calls that are nondiscriminatory and cost-based (using a forward-looking methodology which excludes embedded costs but allows a reasonable cost-of-capital profit); requires incumbent LECs to offer for resale any telecommunications services that the carrier provides at retail to end users at prices to be established by the states but which generally are at retail prices minus reasonably avoided costs; and requires LECs and utilities to provide new entrants with nondiscriminatory access to poles, ducts, conduit and rights-of-way owned or controlled by LECs or utilities. Exemptions to some of these rules are available to LECs which qualify as rural LECs under the Telecommunications Act. The Interconnection Order also requires that: intraLATA presubscription (pursuant to which LECs must allow customers to choose different carriers for intraLATA toll service without having to dial extra digits) be implemented no later than February 1999; LECs provide new entrants with nondiscriminatory access to directory assistance services, directory listings, telephone numbers, and operator services; and LECs comply with certain network disclosure rules designed to ensure the interoperability of multiple local switched networks. There can be no prediction as to the manner in which the Interconnection Order will be implemented or enforced or as to what effect such implementation or enforcement will have on competition within the telecommunications industry generally or on the competitive position of the Company specifically. A number of LECs, as well as the National Association of Regulatory Utility Consumers and others, have filed in Federal court seeking to appeal aspects of the Interconnection Order and to stay some or all of the rules adopted therein. In October 1996, the United States Court of Appeals for the Eighth Circuit granted a stay of effectiveness of certain provisions of the Interconnection Order, including the pricing provisions and the "pick-and-choose" rule, pending court review of the merits of the case. Oral argument on this appeal of the Interconnection Order was held in January 1997. The Company believes that the stay will not adversely affect its CLEC operations and that such stay may positively affect the operations of the Carrier Services business.

The allocation of jurisdiction between federal and state regulators over dedicated circuits that carry both interstate and intrastate traffic (including private line and special access services) poses jurisdictional questions. Although the FCC does not generally rule on the jurisdictional nature of a carrier's traffic, under current FCC practice, non-switched telecommunications services are considered jurisdictionally interstate (subject to FCC jurisdiction) unless more than 90% of the traffic is intrastate in nature. Currently, the Company's dedicated service offerings are primarily jurisdictionally interstate in nature. The Company believes that these services include virtually all service between a long distance carrier's POP and another POP of that long distance carrier or another long distance carrier, and between an end user and a long distance carrier's POP.

The Company currently is not subject to price-cap or rate-of-return regulation and it may install and operate non-radio facilities for the transmission of interstate communications without prior FCC authorization.

In addition, the Company has filed tariffs with the FCC as required with respect to its provision of interstate service. However, pursuant to authority granted to it under the Telecommunications Act, in October 1996 the FCC ruled that non-dominant inter-exchange carriers such as the Company may no longer file tariffs with the FCC and existing tariffs must be withdrawn by September 22, 1997 (although this requirement has recently been stayed by court order). The Company through state-specific subsidiaries also has received certification or other appropriate regulatory authority to provide intrastate non-switched service in 31 states and has applied for authority in a number of additional states.

Some of the Company's services may be classified as intrastate and therefore currently subject primarily to state regulation. In all states where the Company is offering jurisdictionally intrastate Carrier Services or CLEC service, the Company (through its state-specific operating subsidiaries) is certified or otherwise operating with appropriate state authorization. The Company provides intrastate long distance service pursuant to certification, registration or (where appropriate) on a deregulated basis in more than

POP to the recipient of the call). CAPs, such as the Company's Carrier Services operations, provide local access at rates that are discounted from the rates charged by LECs. If the FCC were to mandate reductions in LECs' local access charges, CAPs might be forced to substantially reduce the rates they charge long distance providers, resulting in lower gross margins (which, in the case of the Company, are currently negative). The FCC currently is considering comments filed in response to its NPRM on universal service and access charge reform.

Additionally, providers of long distance services, including the major IXCs as well as resellers, such as the Company, are coming under intensified regulatory scrutiny for marketing activities by them or their agents that result in alleged unauthorized switching of customers from one long distance service provider to another. The FCC and a number of state authorities are seeking to introduce more stringent regulations or take other actions to curtail the intentional or erroneous switching of customers, which could include, among other things, the imposition of fines, penalties and possible operating restrictions on entities which engage or have engaged in unauthorized switching activities. In addition, the Telecommunications Act requires the FCC to prescribe regulations imposing procedures for verifying the switching of customers and additional remedies on behalf of carriers for unauthorized switching of their customers. The effect, if any, of the adoption of any such proposed regulations or other actions on the long distance industry and the manner of doing business therein, cannot be anticipated. Statutes and regulations which are or may become applicable to the Company as it expands could require the Company to alter methods of operations, at costs which could be substantial, or otherwise limit the types of services offered by the Company. See Item 3, "Legal Proceedings."

NEW MEDIA BUSINESS

The Company believes that the ability to deliver entertainment and information content to consumers will play an increasingly important role in consumers' choice of a telecommunications provider. The Company actively seeks opportunities to acquire the rights or means to market and distribute information and entertainment content and services that are marketable to traditional markets and which also can enhance the marketability of the Company's telecommunications services. The Company believes that, in the future, it will be able to bundle content that it controls with various telecommunications services it offers to provide higher-margin products and services.

In December 1994, the Company consummated the acquisition of Non Fiction Films, Inc. ("NFF"), a producer of documentary programming. NFF's productions to date include ten hours of programming for the Arts & Entertainment Network's award winning Biography-Registered Trademark-series and "Divine Magic-TM: The World of the Supernatural," a ten-part series about ancient beliefs, miracles and mysticism.

In April 1996, NFF acquired an 80% equity interest in Fox/Lorber Associates, Inc. ("Fox/Lorber"), an independent distributor of films, entertainment series and documentaries. Fox/Lorber distributes its content to television and home video markets domestically and abroad. Its home video division emphasizes the distribution of foreign and art films and has a home video library of over 100 titles. Its television division emphasizes the distribution of educational and entertainment program series, sports-related programs and documentaries to broadcast and cable stations abroad and in the United States and Canada. Under the terms of an agreement between NFF and the holder of the remaining 20% equity interest in Fox/Lorber, NFF has the right to require such holder to sell, and such holder has the right to require NFF to purchase, the remaining 20% equity interest based upon certain criteria.

From April 1994 through April 1996, the Company acquired an 80% equity interest in The Winning Line, Inc. ("TWL"). The Company has the right to require the stockholders of TWL who own the remaining 20% equity interest in TWL to sell the remaining 20% equity interest based upon certain criteria. TWL operates SportsFan, a multimedia sports programming and production company that provides live sports programming to more than 200 sports and talk format radio stations across the United States, up to 24 hours a day, including stations in 90 of the top 100 United States markets. In addition to its

radio programming, SportsFan has developing interests in television and on-line distribution channels. In addition, in October 1996, TWL acquired certain assets of Major Sports, a producer of sports radio programming, including such programs as "Costas Coast to Coast," "John Madden Sports Quiz" and "Pat O'Brien's Sports Flashback."

In June 1996, the Company entered into an agreement with Source Media, Inc., a provider of interactive technology and programming. Pursuant to this agreement, the Company has the exclusive right, in the 38 GHz spectrum, to use Source Media's technology and programming in connection with entertainment and information services the Company may offer.

In September 1996 and November 1996, respectively, the Company acquired an 80% equity interest in Millennium Marketing, Inc. (which does business as WinStar Interactive Media Sales ("WIMS")) and 100% of Global Media Sales, Inc. ("GMS"). The Company has the right to require the stockholders of WIMS who own the remaining 20% equity interest in WIMS to sell, and such stockholders have the right to require the Company to purchase, the remaining 20% equity interest based upon certain criteria. WIMS is a full-service agency to media sellers, with a focus on the provision of advertising sales representation and/or related consulting services for content-driven interactive media properties. GMS is a seller of advertising for radio content media companies.

The industry in which the Company's new media operation competes consists of a very large number of entities producing, owning or controlling news, sports, entertainment, educational and informational content and services, including telecommunications companies, television broadcast companies, sports franchises, film and television studios, record companies, newspaper and magazine publishing companies, universities and on-line computer services. Competition is intense for timely and highly marketable or usable information and entertainment content. Almost all of the entities with which the Company's new media operation competes have significantly greater presence in the various media markets and greater resources than the Company, including existing content libraries, financial resources, personnel and existing distribution channels. There can be no assurance that the Company will be able to successfully compete in the emerging new media industry.

CONSUMER PRODUCTS

The Company's consumer products business is operated through its subsidiary, Global Products. Global Products designs, markets and distributes personal care products, including hair brushes and certain hair accessories, and bath products, including gels, lotions and bath oils, and home fragrance products, including potpourri and candles. The Company considers this to be a nonstrategic business operation.

MARKETING AND DISTRIBUTION

Global Products' customers are primarily large retailers, including mass merchandisers, discount stores, department stores, national and regional drug store chains and other regional chains. Global Products' customers sell through more than 20,000 individual retail outlets. Its current customer list includes the following national and regional chain stores: WalMart, Revco Drug Stores, CVS, Mervyn's, Target, Ames, Marshalls, Eckerd Drug, Family Dollar Stores, Sally Beauty Supply, Fay Drug, Arbor Drug and American Drug Stores.

A significant portion of Global Products' sales is made by its in-house sales force. The remainder of Global Products' sales typically are made by independent sales representatives who receive a commission from Global Products on all orders generated by them. Independent sales representatives generally carry the product lines of several noncompeting manufacturers and distributors, many of whom are much larger than Global Products.

SOURCING

Global Products currently utilizes a combination of domestic and foreign suppliers and contract manufacturers and internal assembling for its consumer product lines. Global Products generally purchases its hair brushes and combs from foreign manufacturers, and packages these products in its Fairfield, New Jersey facility. Global Products purchases components for its bath and body product line from both foreign and domestic sources, and assembles and packages products in its Fairfield, New Jersey facility. Global Products does not have any binding agreements with any of its manufacturers or suppliers. Therefore, any of such entities can terminate their relationship with Global Products at any time. Global Products does not believe that the termination of any such relationship or relationships would have a material adverse impact on its operations since management believes it would have alternative sources for its products and components at comparable prices. There can be no assurance of this, however, or that, in the event that Global Products were to experience difficulties with its present manufacturers, suppliers and subassemblers, it would not experience a temporary delay in obtaining the products or components it needs elsewhere.

COMPETITION

The consumer products industry is subject to changes in styles and consumer tastes. An unanticipated change in consumer preferences inconsistent with Global Products' merchandise lines could have a serious and adverse effect upon its operations. Global Products' product lines are subject to intense competition with numerous manufacturers and distributors of hair, beauty and bath products. Mass merchandisers, drug store chains, and other mass volume retailers typically utilize freestanding pegboard fixtures or pegboard wall fixtures, as well as in-line shelving and end-cap displays, to display their products. Competition for shelf and wall space for product placement is intense, as many companies seek to have their products strategically placed within the store. Competition also exists with respect to product name recognition and pricing, since retailers and consumers often choose products on the basis of name brand, cost and value. Many of Global Products' competitors have greater product and name recognition than it does, as well as much larger and more sophisticated sales forces, product development, marketing and advertising programs and facilities. Global Products generally competes by attempting to offer quality service and products to its customers at reasonable prices.

EMPLOYEES

As of March 25, 1997 the Company had approximately 1,000 employees. The Company is not a party to any collective bargaining agreements and never has experienced a strike or work stoppage. The Company considers its relations with its employees to be good.

ITEM 2. PROPERTIES

The Company's corporate headquarters are located at 230 Park Avenue, New York, New York 10169. These headquarters are situated in approximately 11,500 square feet of space which the Company subleases for an average rent of approximately \$304,000 per annum. The Company has executed leases for additional office space of approximately 6,000 square feet and 18,000 square feet, each at 230 Park Avenue, for rent of approximately \$188,000 per annum and approximately \$576,000 per annum, respectively. Each of the above-described leases expires in November 2006. The Company maintains leases on other properties used in the operations of its subsidiaries. The Company believes that its insurance coverage on its properties is adequate and that the Company, and each of its subsidiaries, as the case may be, is in compliance with the related leases.

ITEM 3. LEGAL PROCEEDINGS

Gateway, the Company's residential long distance subsidiary, receives inquiries from state authorities with respect to consumer complaints concerning the provision of telecommunications services, including allegations of unauthorized switching of long distance carriers and misleading marketing. The Company believes such inquiries are common in the long distance industry and addresses such inquiries in the ordinary course of business. During 1996, Gateway experienced an increased level of consumer and regulatory complaints, a substantial majority of which arose from the activities of a limited number of independent marketing agents. On May 10, 1996, Gateway adopted a policy of mandatory independent verification for 100% of customer orders received from these agents' programs, and effective June 10, 1996, no longer accepts customer orders from these programs. In December 1996, the FCC and Gateway entered into a consent decree which terminated an inquiry by the FCC into any alleged violations of unauthorized carrier conversions through the use of box programs by some of Gateway's agents. The FCC cited Gateway's efforts in identifying the problems caused by these agents and its proactive response in implementing remedial actions on its own as significant factors leading to the consent decree in lieu of initiating a formal investigation. The Company does not believe that resolution of these issues will have a material adverse effect on the Company, its financial condition or its results of operations.

In June 1996 the Company, as plaintiff, commenced an action for declaratory judgment against Nelson Thibodeaux, a former officer of Gateway, in the Federal District Court for the Southern District of New York, seeking a declaration that the Company has no obligation to Mr. Thibodeaux under stock option agreements granted to him during his employment with Gateway. Further, because the Company believes that any and all claims that may be advanced by Mr. Thibodeaux with regard to his stock option agreements would be frivolous, the Company has notified Mr. Thibodeaux and his counsel of its intention to seek sanctions and such other remedies as may be available against Mr. Thibodeaux and his counsel in the event that Mr. Thibodeaux and his counsel seek to assert any defense to the Company's action. Additionally, the Company seeks monetary damages arising from an alleged breach by Mr. Thibodeaux of the noncompetition and related provisions contained in his employment agreement with the Company. Mr. Thibodeaux answered the Company's complaint in August 1996, denying all of the Company's assertions. The Company intends to diligently proceed with this action.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITYHOLDERS

None.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDERS MATTERS

MARKET PRICE OF THE COMPANY'S COMMON STOCK

The Company's Common Stock has been quoted on the Nasdaq National Market since June 1994 under the symbol "WCIL."

The following table sets forth, for the fiscal periods indicated, the high and low last sale prices of the Common Stock as reported on the Nasdaq National Market. The quotes represent "inter-dealer" prices without adjustment or mark-ups, mark-downs or commissions and may not necessarily represent actual transactions.

PERIOD ENDED	<u>COMMON STOCK</u>	
	<u>HIGH</u>	<u>PRICE LOW</u>
February 28, 1995.....	\$9 1/8	\$5 1/32
May 31, 1995.....	7 1/32	6
August 31, 1995.....	13 3/8	5
November 30, 1995.....	21 13/16	13 1/2
December 31, 1995 (commencing December 1, 1995).....	17 3/8	14
March 31, 1996.....	18 1/2	13 3/8
June 30, 1996.....	32 1/4	16
September 30, 1996.....	29	15 3/4
December 31, 1996.....	23 7/8	16 1/2

The last sale price of the Common Stock on March 25, 1997 was \$11-3/4 per share. As of March 25, 1997, the Company had 32,766,706 shares of Common Stock outstanding held by more than 1,000 beneficial holders.

RECENT SALES OF UNREGISTERED SECURITIES

(a) The following table sets forth certain information with respect to issuances of securities by the Company (other than stock options granted to its employees and others) during the year ended December 31, 1996, without registration of such securities under the Securities Act:

<u>DATE OF SALE</u>	<u>TITLE OF SECURITY</u>	<u>NUMBER OF SECURITIES SOLD</u>	<u>CONSIDERATION RECEIVED AND DESCRIPTION OF UNDERWRITING OR OTHER DISCOUNTS TO MARKET PRICE AFFORDED TO PURCHASERS</u>	<u>EXEMPTION FROM REGISTRATION CLAIMED</u>
4/30/96	Common Stock	8,643	(1)	4(2)
4/30/96	Common Stock	58,800	(1)	4(2)
11/30/96	Common Stock	13,172	(2)	4(2)

(1) Issued by the Company in connection with the acquisition of Fox/Lorber Associates, Inc. by a subsidiary of the Company.

(2) Issued by the Company in connection with the acquisition of Global Media The Sales And Marketing Company, Inc. by a subsidiary of the Company.

(b) The following table sets forth certain information with respect to grants by the Company of stock options to its employees and others during the year ended December 31, 1996, without registration of such securities under the Securities Act:

<u>DATE OF SALE</u>	<u>TITLE OF SECURITY</u>	<u>NUMBER OF OPTIONS GRANTED</u>	<u>CONSIDERATION RECEIVED AND DESCRIPTION OF UNDERWRITING OR OTHER DISCOUNTS TO MARKET PRICE AFFORDED TO PURCHASERS</u>	<u>EXEMPTION FROM REGISTRATION CLAIMED</u>	<u>IF OPTION, WARRANT OR CONVERTIBLE SECURITY, TERMS OF EXERCISE OR CONVERSION</u>
1/96-12/96	options to purchase common stock granted to employees	4,057,000	options granted--no consideration received by the Company until exercise	4(2)	exercisable for periods of five or ten years from grant at exercise prices ranging from \$13.75 to \$31.13

ITEM 6. SELECTED FINANCIAL DATA

The selected financial data presented below for the years ended February 28, 1993, 1994 and 1995, the ten months ended December 31, 1995 and as of and for the year ended December 31, 1996 have been derived from the Company's audited Consolidated Financial Statements included elsewhere in this Report. The selected financial data for the year ended December 31, 1995 has been derived from unaudited consolidated financial statements of the Company. In the opinion of management, the unaudited consolidated financial statement has been prepared on the same basis as the audited Consolidated Financial Statements and includes all adjustments, which consist only of normal recurring adjustments, necessary for a fair presentation of the results of operations for the period. This data presented below should be read in conjunction with Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Company's Consolidated Financial Statements, including the notes thereto, appearing elsewhere in this Report.

	YEAR ENDED FEBRUARY 28,			TEN MONTHS ENDED	YEAR ENDED	
	1993	1994	1995	DECEMBER 31,	1995	1996
				1995		
STATEMENT OF OPERATIONS DATA						
(IN THOUSANDS, EXCEPT PER SHARE DATA)						
Net Sales:						
Telecommunications (1)	\$--	\$8,505	\$14,909	\$13,137	\$14,626	\$33,969
Information services	--	--	473	2,648	2,928	14,650
Other	11,289	7,120	10,185	13,986	15,746	19,429
Total net sales	11,289	15,625	25,565	29,771	33,300	68,048
Operating income (loss):						
Telecommunications	--	(814)	(4,584)	(7,288)	(8,437)	(43,698)
Information services	--	--	(117)	217	322	(1,409)
Other	(3,582)	159	216	681	644	(42)
General corporate	(663)	(1,536)	(944)	(3,861)	(4,761)	(11,373)
Total operating loss	(4,245)	(2,191)	(5,869)	(10,251)	(12,232)	(56,522)
Interest expense	(534)	(744)	(637)	(7,630)	(7,712)	(37,476)
Interest income	75	109	385	2,890	2,935	10,275
Other expenses, net (2)	--	(5,369)	(1,109)	(866)	(1,211)	--
Net loss	<u>\$(4,704)</u>	<u>\$(8,195)</u>	<u>\$(7,230)</u>	<u>\$(15,857)</u>	<u>\$(18,220)</u>	<u>\$(83,723)</u>
Net loss per common share outstanding	\$(0.93)	\$(1.06)	\$(0.42)	\$(0.70)	\$(0.82)	\$(3.00)
Weighted average common shares outstanding	5,066	7,719	17,122	22,770	22,287	27,911
Other Financial Data:						
EBITDA (3)	<u>\$(2,955)</u>	<u>\$(1,845)</u>	<u>\$(5,179)</u>	<u>\$(8,952)</u>	<u>\$(10,723)</u>	<u>\$(49,597)</u>
Capital expenditures	84	307	1,816	8,652	9,003	47,961
		25				

	<u>FEBRUARY 28</u>			<u>DECEMBER 31</u>	
	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1995</u>	<u>1996</u>
BALANCE SHEET DATA					
(IN THOUSANDS, EXCEPT PER SHARE DATA)					
Cash, cash equivalents and short-term investments	\$631	\$719	\$3,156	\$211,701	\$122,487
Property and equipment, net	394	1,301	2,663	15,898	63,287
Total assets	8,943	14,610	29,509	285,363	290,223
Current portion of long-term debt and capital lease obligations	3,858	2,851	332	9,643	23,036
Long-term debt and capital lease obligations, less current portion and discount	1,206	3,084	5,165	240,455	284,339
Common and preferred stock and additional paid-in capital(4)	11,410	22,665	43,518	104,823	75,726
Stockholders' equity (deficit)	1,747	4,719	18,280	21,752	(49,671)

(1) The Company has generated minimal revenues from its Wireless Fiber services.

(2) For the year ended February 28, 1994, principally represents noncash expense of \$5.3 million consisting of the difference between the exercise prices of certain options granted in connection with the Company's initial public offering in April 1991 and the market value of the underlying shares of Common Stock on the date such options became exercisable.

(3) EBITDA consists of loss before interest, income taxes, depreciation and amortization and other income and expense. EBITDA is a measure commonly used in the telecommunications industry and is presented to enhance an understanding of the Company's operating results and ability to service its debt. It is not intended to represent cash flow or results of operations in accordance with generally accepted accounting principles for the periods indicated. See Item 8, "Financial Statements and Supplementary Data."

(4) The Company did not declare or pay any dividends on its Common Stock during the periods covered hereby.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

COMPANY OVERVIEW

The Company provides a full range of telecommunications services as a CLEC, including local, long distance and Internet access services, to small and medium-sized businesses in major metropolitan areas in the United States. By exploiting its Wireless Fiber services and a switch-based infrastructure, the Company seeks to distinguish itself as a facilities-based, value-added provider of high-capacity telecommunications services and an attractive alternative to established providers, such as the RBOCs. The Company also utilizes its Wireless Fiber capacity to provide its Carrier Services, a variety of facilities-based broadband, high-capacity local access and digital network services, to other telecommunications services providers. As a complement to its telecommunications operations, the Company produces and distributes information and entertainment content. The Company also operates a nonstrategic consumer products company.

During the third quarter of 1996, the Company launched its CLEC offering in New York City and has since introduced its local telecommunications services in 11 additional markets. The Company intends to introduce its local exchange services in all of the other major metropolitan areas where it is licensed to provide 38 GHz services over four or more 100 MHz channels during the next several years. The Company

is creating an infrastructure on a city-by-city basis using its Wireless Fiber capabilities, switches acquired by the Company from equipment vendors and facilities leased from other carriers to originate and terminate traffic.

The Company also provides wholesale Carrier Services that enable other carriers to expand their networks or meet end user demand via the Company's digital wireless capacity in the 38 GHz portion of the radio spectrum. The Company is in the process of expanding its Carrier Services business and currently markets these services in its licensed areas to RBOCs and other LECs, IXCs, CAPs and CLECs, PCS and CMRS providers, cable companies, Internet service providers, value-added resellers and systems integrators. Additionally, the Company has signed multi-year master service agreements with a number of large industry customers, including Pacific Bell and Ameritech Cellular Services, each of which has forecasted demand for several thousand circuits, including T-1 circuits (equivalent capacity of 24 voice-grade circuits) and DS-3 circuits (equivalent capacity of 28 T-1 circuits). The Company's wholesale Carrier Services business also will serve a significant portion of the local access needs of the Company's CLEC business, including backbone interconnections of hub, main switch and local node sites, and the origination and termination of local traffic for the Company's local exchange customers.

In connection with the Company's rollout of its local telecommunications services, the Company is developing its business information services. One of the Company's goals in this area is to market an Internet-delivered group of targeted services to small to medium-sized business customers. It is currently anticipated that these services will be sold through the Company's direct sales force and will be structured as tiered-channels of licensed and customized information, which will serve as a one-stop, easy-to-use desktop information resource for the Company's business customers.

The Company has significantly expanded its spectrum holdings during the past year with the completion of the Milliwave Acquisition and the Locate Acquisition. The Company also has entered into certain agreements to purchase an aggregate of 47 additional 38 GHz licenses. Currently, the Wireless Licenses allow the Company to provide Wireless Fiber services in 47 of the 50 most populated MSAs in the United States. The Wireless Licenses currently cover more than 100 cities with populations exceeding 100,000 each, encompass an aggregate population of approximately 172 million people and address approximately 600 million channels pops (population coverage multiplied by the number of 100 MHz channels). Upon completion of all pending acquisitions, which are subject to FCC consent, the Company's total population coverage will increase to approximately 180 million, its total channel pops will grow to approximately 650 million and the Wireless Licenses will allow the Company to provide services in 49 of the 50 most populated MSAs in the United States. See Item 1, "Business--Telecommunications Services-- Wireless Licenses."

REVENUES

Revenues generated by the operations of the Company's telecommunications businesses will represent an increasing percentage of the Company's consolidated revenues as the Company expands into the local telecommunications services market. Factors driving the mix of revenues are as follows:

CLEC AND LONG DISTANCE SERVICES. CLEC revenues are driven primarily by the number of local exchange circuits installed and in service. The Company had installed more than 5,600 CLEC customer lines as of February 28, 1997. Customers generally are billed a flat monthly fee plus a per-minute usage charge or fraction thereof. Revenue growth depends on the introduction of local exchange services in new cities, the purchase and installation of switches to service those areas, and the addition of new customers. Additionally, as bundled services, such as long distance, Internet access and Internet-related services, are purchased by the Company's customers, revenue per circuit would be expected to increase.

The Company intends to develop other anticipated sources of revenue including resale agreements for CMRS, advanced data, broadband data transmission and video conferencing services. The Company believes that as its local exchange services business grows, such business will become the most significant

component of the Company's revenues. Revenues from this segment were \$502,000 in the fourth quarter of 1996, versus \$84,000 in the third quarter of 1996, with approximately half of such revenues generated in the month of December. The Company currently sets prices at a discount to those charged by LECs and anticipates ongoing price reductions for provision of local exchange services.

The Company is first rolling out its local services on a resale basis in each city and plans to follow initial sales with the installation of Lucent 5ESS switches. The first switch went into service in New York City in October 1996, and four additional switches are now under construction in Boston, Chicago, Los Angeles and San Diego. The Company began connecting customers to the New York switch via Wireless Fiber links in January 1997.

Long distance telecommunications services revenues are driven principally by the size and type of the customer base, with the largest percentage of the Company's long distance telecommunications services revenues currently derived from residential customers. Customers are billed on the basis of minutes or fractions thereof. The Company is focusing on the sale of long distance services to small and medium-sized business customers as part of its CLEC business and is not currently marketing long distance services to residential customers on an active basis, except through established affinity group and other targeted programs. As a result, the Company is allowing its revenues from residential long distance service to decline through attrition, as it focuses on its core small to medium-sized business market.

CARRIER SERVICES. Carrier Services revenues are driven primarily by the number and capacity (i.e., T-1s or DS-3s) of Wireless Fiber links in service. A key measure of progress for the Company is its installed and available Wireless Fiber capacity. The Company had more than 90,000 voice-grade equivalent circuits in place as of February 28, 1997. Customers generally are billed at a fixed monthly rate per unit of capacity. Since the Company's local access customers have been, and will likely continue to be, predominantly telecommunications services providers, the addition or loss of several major customers would have a material impact on this business. Another key measure of progress is the number of buildings for which the Company has secured Roof Rights. The Company's Roof Rights have been increasing in number and declining in average cost. As of February 28, 1997, the Company has secured Roof Rights on approximately 900 buildings and is acquiring Roof Rights to an additional 50 to 75 buildings per month.

INFORMATION AND CONTENT. Information and content revenues are generated principally by: (i) sales of content and related services, such as documentaries, sports programming and foreign films, to traditional content customers, such as cable networks and radio stations; (ii) sales of content to new media distribution channels, such as on-line services; (iii) sales of advertising; and (iv) the bundling of content with the Company's telecommunications services. Revenues also are driven by the size and quality of the Company's programming library and the release of new programs, which affects quarter to quarter comparability.

CONSUMER PRODUCTS. Consumer products revenues are generated by a nonstrategic subsidiary and are driven principally by the number of national retailers in the Company's customer base. The Company obtains shelf space through such large retailers, and the addition or loss of several large retailers can have a significant effect on the revenues of the Company's consumer products business. Product sell-through and new product introductions also play an important role in the Company's relationships with its customers.

COSTS

Factors relating to costs are as follows:

CLEC AND LONG DISTANCE SERVICES. Costs associated with the Company's CLEC business include significant up-front capital expenditures for development of the infrastructure required to provide the Company's own local exchange services, including expenditures relating to interconnection (i.e., the use of LEC facilities to terminate calls), purchases and installation of switching equipment, 3.3 GHz radios and

related equipment, site acquisition fees and expenses (including option fees for the prequalification of buildings for Roof Rights) and strategic preplacement of a limited number of radios and related equipment in connection with the Company's building-centric network plan (I.E., hubbing). In addition, the Company is incurring start-up costs related to its CLEC business that will not be capitalized, including costs of engineering, sales office and service personnel, marketing, administrative and other personnel, who will be needed in advance of related revenues. When the Company commences operations in a city, it will initially resell the local exchange services of LECs or other CLECs. The Company will carry more of its traffic on its own facilities as it develops and installs the switches, radios and interconnections required to provide services in a particular city. However, the Company will always carry significant amounts of its traffic over leased facilities at lower margins. The resale of local exchange services typically will result in greater operating costs than the provision of services over the Company's own facilities and such costs will therefore decrease as a percentage of total CLEC operating costs as the Company begins to provide more services over its own facilities. Additionally, site acquisition and switch costs will become a lower percentage of cost per minute of service as more buildings are connected and as the Company increases the number of customers and lines per building. The up front capital costs of establishing the initial infrastructure required for the Company to provide its own local exchange services are substantial and much greater than those relating to the Company's Carrier Services business.

Costs associated with the Company's long distance business include expenses related to minutes purchased from major carriers for resale, and accordingly fluctuate with revenue. Typically, reductions of such costs are achieved through negotiated volume rebates and competitive contract pricing. Generally, the Company is obligated to generate certain minimum monthly usage with its long distance carriers and may be required to pay, in addition to its monthly bill, an underutilization fee equal to a certain percentage of the difference between such minimum commitments and the traffic actually generated by the Company. The Company has never paid or been required to pay any underutilization charges. The Company expects that such costs will be reduced as it installs its own switches.

CARRIER SERVICES. Costs associated with the Company's Carrier Services business include site acquisition (including option fees for the prequalification of buildings for Roof Rights) and equipment related fees and expenses, including costs incurred in connection with the acquisition of Roof Rights and the purchase of 38 GHz radios. In addition, the Company will continue to incur substantial start-up costs related to its Carrier Services business that will not be capitalized, including costs of engineering, sales office and service personnel, and marketing, administrative and other personnel, who will be needed in advance of related revenues. The Company anticipates that the cost per Wireless Fiber link will be reduced as increased traffic is generated in buildings in which the Company already has established service and as the Company qualifies for volume discounts from its principal equipment vendors. The Company also expects that equipment costs will continue to drop as a result of technological improvements and increased competition in the microwave equipment manufacturing industry.

INFORMATION AND CONTENT. The Company's information and content businesses have production, distribution and administrative costs. Film production costs include those related to producing original products and licensing third-party products and are capitalized as incurred and are expensed as productions are completed and distributed. Overhead costs in the production division are also capitalized and allocated to films in progress, and are subsequently expensed as such films are completed and distributed. Other media production costs are expensed as incurred. The distribution and advertising divisions incur royalty costs payable to third-party producers and selling costs, both of which vary directly with sales of acquired product, as well as administrative costs and personnel-related costs, which are primarily fixed in nature and which are expensed as incurred.

CONSUMER PRODUCTS. Costs associated with the Company's consumer products business fluctuate with material and labor component pricing. A large percentage of material components are sourced overseas.

and are purchased in United States dollars. The Company seeks to lower product costs through improved material sourcing.

RESULTS OF OPERATIONS

Revenues of the Company's operating segments are as follows (in millions):

	YEAR ENDED FEBRUARY 28		TEN MONTHS ENDED DECEMBER 31*		YEAR ENDED DECEMBER 31	
	1994	1995	1994	1995	1995	1996
Telecommunications Services:						
Carrier Services	\$--	\$0.1	\$--	\$0.1	\$0.1	\$3.9
Local Exchange	--	--	--	--	--	0.6
Residential Long Distance	8.5	14.8	13.4	13.0	14.5	29.5
	8.5	14.9	13.4	13.1	14.6	34.0
Information and Content	--	0.5	0.2	2.6	2.9	14.7
Consumer Products	7.1	10.2	8.4	14.0	15.8	19.4
Total Revenues	\$15.6	\$25.6	\$22.0	\$29.7	\$33.3	\$68.1

* The Company changed its fiscal year to December 31 from February 28 effective January 1, 1996.

YEAR ENDED DECEMBER 31, 1996 COMPARED TO YEAR ENDED DECEMBER 31, 1995

Revenues increased by \$34.8 million, or 104.5%, for the year ended December 31, 1996, to \$68.1 million, from \$33.3 million from the year ended December 31, 1995. This increase was primarily attributable to increased revenues generated by the Company's telecommunications and information services segments.

The Company's telecommunications services revenues increased by \$19.4 million, or 132.9%, for the year ended December 31, 1996, to \$34.0 million, from \$14.6 million for the year ended December 31, 1995, principally resulting from an increase in revenues from residential long distance telephone services. Revenues from the information and entertainment services segment increased by \$11.8 million, or 406.9%, for the year ended December 31, 1996, to \$14.7 million, from \$2.9 million for the year ended December 31, 1995, due to continued growth of this segment internally and through acquisitions. The revenue increase in 1996 was generated primarily from increased production and distribution of entertainment content, including documentaries, foreign films and multimedia sports programming. Consumer products revenues increased by 22.8% in 1996 resulting from growth of the bath and body products line.

Cost of services and products increased by \$27.4 million, or 110.9%, for the year ended December 31, 1996, to \$52.1 million, from \$24.7 million for the year ended December 31, 1995. As a percentage of sales, cost of services and products in 1996 was 76.5%, compared with 74.2% in 1995, due in part to increased start-up costs for facilities in connection with the rollout of the Company's telecommunications network, in addition to lower profit margins in the consumer products segment.

Selling, general and administrative expense increased by \$48.1 million to \$67.7 million for the year ended December 31, 1996, or 99.4% of revenues, from \$19.6 million, or 58.9% of revenues, for the year ended December 31, 1995. Selling, general and administrative expense increased predominantly in the telecommunications segment as the Company continued to hire sales, marketing and related support personnel in connection with the accelerated roll out of its CLEC operations, and increased spending on related advertising and marketing of services in new and existing cities where the Company offered its services.

For the reasons noted above, the operating loss for the year ended December 31, 1996, was \$56.5 million, compared to an operating loss of \$12.2 million for the year ended December 31, 1995.

Depreciation and amortization expense increased by \$3.5 million or 291.7%, for the year ended December 31, 1996, to \$4.7 million, from \$1.2 million for the year ended December 31, 1995, principally resulting from the Company's acquisition of switches, radios and other telecommunications equipment.

Interest expense increased by \$29.8 million, or 387.0%, for the year ended December 31, 1996, to \$37.5 million, from \$7.7 million for the year ended December 31, 1995. The increase was primarily attributable to \$33.5 million in interest accrued on the Old Notes issued in the 1995 Debt Placement, which is not payable in cash until after 1999.

Interest income increased by \$7.4 million, or 255.2%, for the year ended December 31, 1996, to \$10.3 million, from \$2.9 million for the year ended December 31, 1995. The increase is attributable to short-term investment earnings on the proceeds of the 1995 Debt Placement.

For the reasons noted above, the Company reported a net loss of \$83.7 million for the year ended December 31, 1996, compared to a net loss of \$18.2 million for the year ended December 31, 1995.

TEN MONTHS ENDED DECEMBER 31, 1995 COMPARED TO THE TEN MONTHS ENDED DECEMBER 31, 1994

Revenues for the ten months ended December 31, 1995 increased by \$7.8 million, or 35.5%, to \$29.8 million, from \$22.0 million in the comparable period of the prior year. This increase was attributable to increased revenues in the Company's information and entertainment and consumer products merchandising segments. During the ten months ended December 31, 1995, the Carrier Services business had only nominal revenues. The information and entertainment segment, which reported nominal revenues in the prior year, had revenues of approximately \$2.6 million for the ten months ended December 31, 1995, related primarily to the completion of certain documentary television products. The consumer products segment also experienced an increase in revenue of approximately \$5.6 million, primarily due to the growth in sales volume of its bath and body product line.

Cost of services and products for the ten months ended December 31, 1995 increased by \$5.8 million, to \$20.9 million, from \$15.1 million for the ten months ended December 31, 1994. The increase was principally attributable to the growth in the Company's information and entertainment services and consumer products segments, along with initial expenses in connection with the Company's telecommunications network.

Selling, general and administrative expenses increased by \$7.7 million to \$17.9 million, or 60.1% of revenues, for the ten months ended December 31, 1995, from \$10.2 million, or 46.4% of revenues, in the comparable period of the prior year. The acquisition of Avant-Garde, the original holder of many of the Wireless Licenses) and the consolidation of that entity's results of operations into the Company's financial statements from July 17, 1995 onward, as well as the growth in the administrative infrastructure in the Carrier Services business accounted for approximately 32.7% of the total increase. In particular, expenses were incurred to develop operating systems, to market services to targeted customers and to prepare for future growth in the wireless business. Corporate general and administrative expenses accounted for approximately 28.1% of the total increase because of the hiring of additional personnel and the expansion of the Company's infrastructure to manage future growth in the telecommunications business. Selling and marketing expenses incurred by the consumer products segment to service increased revenues accounted for approximately 26.4% of the total increase.

For the reasons noted above, the operating loss for the ten months ended December 31, 1995, was \$10.3 million, compared to an operating loss of \$3.6 million in the comparable period of the prior year.

Interest expense increased by \$7.1 million to \$7.6 million for the ten months ended December 31, 1995, from \$0.5 million for the ten months ended December 31, 1994, reflecting principally the noncash accretion of interest on the Old Notes.

Interest income for the ten months ended December 31, 1995 increased by \$2.6 million, to \$2.9 million, compared with \$0.3 million for the same period during the prior year. The increase was attributable to earnings on the 1995 Debt Placement, which raised net proceeds of \$214.5 million.

For the reasons noted above, the Company reported a net loss of \$15.9 million for the ten months ended December 31, 1995, compared to a net loss of \$4.6 million in the comparable period of the prior year.

YEAR ENDED FEBRUARY 28, 1995 COMPARED TO YEAR ENDED FEBRUARY 28, 1994

Revenues for the year ended February 28, 1995, were \$25.6 million, up 64.1% from the prior year's revenues of \$15.6 million. During the year ended February 28, 1995, the telecommunications segment reported revenues of \$14.9 million, compared to revenues of \$8.5 million in the year ended February 28, 1994, an increase of 75.3%. Telecommunications revenues consisted almost entirely of revenues generated through the Company's resale of long distance services, and revenue growth resulted primarily from growth in the Company's customer base. The consumer products segment also experienced substantial revenue growth, from \$7.1 million in the year ended February 28, 1994, to \$10.2 million in the year ended February 28, 1995, an increase of 43.7%. This increase was attributable to approximately \$3.6 million in additional revenues from the bath and body product line acquired in the year ended February 28, 1994, as well as growth in the personal care products line. These revenue increases were offset by a reduction of approximately \$1.2 million in revenues from discontinued business lines. The information and entertainment segment generated \$0.5 million in revenues in the year ended February 28, 1995, its first year of operation.

Cost of services and products for the year ended February 28, 1995 increased by \$8.4 million, or 78.5%, to \$19.1 million, from \$10.7 million for the year ended February 28, 1994. The increase is principally attributable to the growth in the Company's long distance telephone and consumer products businesses.

Selling, general and administrative expenses increased by \$5.2 million to \$11.9 million, or 46.5% of revenues, for the year ended February 28, 1995, from \$6.7 million, or 42.9% of revenues, for the prior year. The increase was attributable to increased operating expenses related to the growth of the Company's telecommunications revenues and the consumer products segment, the development of the corporate infrastructure needed to identify, acquire and manage opportunities for the Company's continued telecommunications growth, and start-up expenses associated with the Carrier Services business, offset by a reduction of expenses related to discontinued business lines. The Company also recorded a restructuring charge of \$0.6 million and other nonrecurring charges of \$0.5 million in the year ended February 28, 1995, related to its telecommunications operations. These charges include termination costs for previous executive, management, and staff personnel as well as other charges taken in connection with sales programs and other initiatives implemented by previous management. For the reasons noted above, the operating loss for the year ended February 28, 1995, was \$5.9 million, compared to an operating loss of \$2.1 million in the prior year.

Interest expense decreased to \$0.6 million in the year ended February 28, 1995 from \$0.7 million in the prior year. This improvement was due to the use of approximately \$2.0 million in promissory notes by the holders thereof for the payment of the exercise price of certain warrants.

For the reasons noted above, the Company reported a net loss of \$7.2 million for the year ended February 28, 1995, compared to a net loss of \$8.2 million for the year ended February 28, 1994.

LIQUIDITY AND CAPITAL RESOURCES

The Company has incurred significant operating and net losses, due in large part to the development of its telecommunications services business, and anticipates that such losses will increase over the near term as the Company accelerates its growth strategy. Historically, the Company has funded its operating losses and capital expenditures through public and private offerings of debt and equity securities and from credit and lease facilities, and expects to continue funding its growth strategy, as necessary, through a combination of these financing vehicles. Cash used to fund negative EBITDA during the year ended December 31, 1996 was \$49.6 million, and purchases of property and equipment were \$48.0 million. At December 31, 1996 and 1995, working capital was \$75.6 million and \$214.9 million, respectively, including cash, cash equivalents and short-term investments of \$87.6 million and \$211.7 million, respectively (giving effect to the Milliwave Acquisition). As of December 31, 1996, after giving pro forma effect to the Milliwave Acquisition and the Preferred Stock Placement (as defined below), cash, cash equivalents and short-term investments were \$183.6 million. As adjusted, giving effect to the 1997 Debt Placement (as defined below) (including the application of \$17.8 million of the proceeds therefrom to repay promissory notes of the Company issued in connection with the Locate Acquisition (the "Locate Notes")) cash, cash equivalents and short-term investments were \$456.2 million as of December 31, 1996.

The passage of the Telecommunications Act in February 1996 resulted in opportunities that motivated the Company to accelerate the development and expansion of its telecommunications businesses through increased capital expenditures. Capital expenditures for the years ended December 31, 1996 and 1995 were \$48.0 million and \$9.0 million, respectively. As a result of the acceleration of the development and expansion of the Company's telecommunications business, the Company's current plans are for capital expenditures of an average of approximately \$170 million per year over the next three years. The amount of capital required to execute this plan is a function of the speed at which the plan is executed. The Company may elect to slow the speed or narrow the focus of this expansion in the event that it is unable to raise sufficient amounts of capital on acceptable terms.

A significant portion of the Company's increased capital requirements will result from the rollout of the Company's CLEC business. The Company is building a direct sales force, has opened sales offices in eleven major cities and is in the process of expanding into other metropolitan areas. Additionally, the Company is in the process of ordering and installing switching and other network equipment to be placed in its key markets.

The Company has commitments during 1997 to purchase \$26.4 million of telecommunications capital equipment and, prior to April 8, 1997, to repay the Locate Notes aggregating approximately \$17.8 million.

In February 1997 the Company sold 4,000,000 shares of its 6% Series A Cumulative Preferred Stock and warrants to purchase 1,600,000 shares of Common Stock, pursuant to which the Company and one of its subsidiaries realized net proceeds of approximately \$96 million (the "Preferred Stock Placement"). In addition, in March 1997, the Company and one of its subsidiaries sold an aggregate of \$300 million principal amount of notes, pursuant to which they realized net proceeds of approximately \$290 million (the "1997 Debt Placement").

Management anticipates, based on current plans and assumptions relating to its operations, that the proceeds of the 1997 Debt Placement, together with the Company's existing financial resources and additional equipment financing arrangements which the Company intends to seek, will be sufficient to fund the Company's growth and operations for approximately 24 to 30 months from the date of this Report. In order to provide additional future liquidity to the Company, the Company has obtained a commitment for a \$150 million facility from affiliates of the initial purchasers of the notes sold in the 1997 Debt Placement, which, subject to the Company satisfying various operating and financial criteria, may be drawn by the Company on March 31, 1999. In the event the Company's plans or assumptions change or prove to be inaccurate, or if the Company consummates any acquisitions of businesses or assets (including additional

spectrum licenses, by auction or otherwise), the Company may be required to seek additional sources of capital sooner than currently anticipated.

The Company's subsidiaries have two asset-based working capital facilities with a total of \$9.8 million outstanding thereunder as of December 31, 1996, with terms expiring in 1998 and 1999. Remaining availability under these lines as of December 31, 1996 was approximately \$1.7 million. In addition, the Company's subsidiaries have entered into, and will continue to seek, financing arrangements with respect to equipment, including telecommunications switches, 38 GHz radios and other related equipment. The Company's subsidiary, WinStar Telecom, consummated a \$3.1 million sale/leaseback of its New York City switch in December 1996, and borrowed approximately \$3.3 million from a third party lender in connection with WinStar Telecom's purchase of its Chicago switch from Lucent in March 1997.

FORWARD-LOOKING STATEMENTS

When used in this and in future filings by the Company with the SEC, in the Company's press releases and in oral statements made with the approval of an authorized executive officer of the Company, the words or phrases "will likely result," "expects," "plans," "will continue," "is anticipated," "estimated," "project" or "outlook" or similar expressions (including confirmations by an authorized executive officer of the Company of any such expressions made by a third party with respect to the Company) are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, each of which speak only as of the date made. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include, among others, the following: (a) the Company's ability to service its debt or to obtain financing for the buildout of its telecommunications network; (b) the Company's ability to attract and retain a sufficient revenue-generating customer base; (c) competitive pressures in the telecommunications industry; and (d) general economic conditions. The Company has no obligation to publicly release the result of any revisions which may be made to any forward-looking statements to reflect anticipated or unanticipated events or circumstances occurring after the date of such statements.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements required by Item 8(a) are included in this Report beginning on Page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

PART III

The information required by Items 10, 11, 12 and 13 of Form 10-K is incorporated herein by reference to the Company's Proxy Statement for the Annual Meeting of Stockholders anticipated to be held on June 30, 1997.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) The following documents are filed as part of this Report:

(1) Financial Statements

See Index to Financial Statements and Financial Statement Schedules appearing on page F-1

(2) Financial Statement Schedules

See Index to Financial Statements and Financial Statement Schedules appearing on page F-1

(3) Exhibits

EXHIBIT
NUMBER

DESCRIPTION

- | | |
|--------|--|
| 2.1 | Agreement by and among the Company, New Media, TWL, and the principals of TWL relating to certain financing provided by the Company to TWL and related matters (Incorporated by reference from Exhibit 2.3 to the Company's Annual Report for the Fiscal Year Ended February 28, 1994) |
| 2.2 | First Amendment to Agreement by and among the Company, New Media, TWL and the principals of TWL (Incorporated by reference from Exhibit 2.2 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995) |
| 2.3 | Second Amendment to Agreement by and among the Company, New Media, TWL and the principals of TWL (Incorporated by reference from Exhibit 2.2 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995) |
| 3.1 | Restated Certificate of Incorporation of the Company (Incorporated by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-18 (No. 33-37024)) |
| 3.2 | Amendment to Certificate of Incorporation of the Company effecting name change from "Robern Apparel, Inc." to "Robern Industries, Inc." (Incorporated by reference to Exhibit 3.1(b) to the Company's Registration Statement on Form S-4 (No. 33-52716)) |
| 3.3 | Second Amendment to Certificate of Incorporation of the Company effecting name change from "Robern Industries, Inc." to "WinStar Communications, Inc." (Incorporated by reference to Exhibit 3.1(b) to the Company's Registration Statement on Form S-1 (No. 33-43915)) |
| 3.4 | Certificate of Elimination of Series A, B, C, D and E Preferred Stock of the Company (Incorporated by reference to Exhibit 3.6 to the Company's Current Report on Form 8-K dated February 14, 1997) |
| 3.5 | Certificate of Designations, Preferences and Rights of 6% Series A Cumulative Convertible Preferred Stock (Incorporated by reference to Exhibit 2 to the Company's Current Report on Form 8-K dated February 14, 1997) |
| 3.6 | By-Laws of the Company (Incorporated by reference to Exhibit 3.2 to the Company's Registration Statement on Form S-18 (No. 33-37024)) |
| 3.6(a) | Amendments to the By-Laws of the Company (Incorporated by reference to Exhibit 3.6(a) to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1996) |

**EXHIBIT
NUMBER**

DESCRIPTION

- 3.7 Certificate of Incorporation of WinStar Wireless (Incorporated by reference from Exhibit 7 to the Company's Current Report on Form 8-K, dated February 11, 1994)
- 3.8 By-Laws of WinStar Wireless (Incorporated by reference from Exhibit 8 to the Company's Current Report on Form 8-K, dated February 11, 1994)
- 3.9 Certificate of Incorporation of Gateway (Incorporated by reference to Exhibit 3.5 to the Company's Annual Report on Form 10-K for the Fiscal Year Ended February 28, 1993)
- 3.10 Amendment to Certificate of Incorporation of Gateway effecting name change from "Communications Gateway Network, Inc." to "WinStar Gateway Network, Inc." (Incorporated by reference from Exhibit 3.11 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 3.11 By-Laws of Gateway (Incorporated by reference to Exhibit 3.6 to the Company's Annual Report on Form 10-K for the Fiscal Year Ended February 28, 1993)
- 3.12 Certificate of Incorporation of New Media (Incorporated by reference to Exhibit 3.9 to the Company's Annual Report on Form 10-KSB for the Fiscal Year Ended February 28, 1994)
- 3.13 Amendment to Certificate of Incorporation of New Media effecting name change from "WinStar Interactive Media Company, Inc." to "WinStar New Media Company, Inc." (Incorporated by reference from Exhibit 3.14 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 3.14 By-Laws of New Media (Incorporated by reference to Exhibit 3.10 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1994)
- 3.15 Certificate of Incorporation of WinStar Wireless Fiber Corp. ("Wireless Fiber Corp.") (Incorporated by reference to Exhibit 3.16 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 3.16 Amendment to Certificate of Incorporation of Wireless Fiber Corp. effecting name change from "WinCom Corp." to "WinStar Wireless Fiber Corp." (Incorporated by reference to Exhibit 3.17 the Company's Registration Statement on Form S-3 (No. 33-95242))
- 3.17 Certificate of Merger effecting merger of Avant-Garde into Wireless Fiber Corp. (Incorporated by reference to Exhibit 3.18 the Company's Registration Statement on Form S-3 (No. 33-95242))
- 3.18 By-Laws of Wireless Fiber Corp. (Incorporated by reference to Exhibit 3.17 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 3.19 Certificate of Incorporation of Global Products (Incorporated by reference to Exhibit 3.3 to the Registration Statement on Form S-18 of Global Products (No. 33-12549))
- 3.20 Amendment to Certificate of Incorporation of Global Products to change its name from "Beauty Labs, Inc." to "WinStar Global Products, Inc." (Incorporated by reference from Exhibit 3.19 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 3.21 By-Laws of Global Products (Incorporated by reference to Exhibit 3.4 to the Registration Statement on Form S-18 of Global Products (No. 33-12549))
- 3.22 Certificate of Incorporation of WinStar NFF Inc. ("WinStar NFF") (Incorporated by reference from Exhibit 3.21 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 3.23 By-laws of WinStar NFF (Incorporated by reference from Exhibit 3.22 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 3.24 Certificate of Merger of NFF with and into WinStar NFF, with WinStar NFF as the merger's surviving entity (Incorporated by reference from Exhibit 3.23 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)

EXHIBIT
NUMBER

DESCRIPTION

- 3.25 Amendment to Certificate of Incorporation of WinStar NFF changing its name from "WinStar NFF Inc." to "Non Fiction Films Inc." (Incorporated by reference from Exhibit 3.24 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 3.26 Certificate of Incorporation of WinStar Telecom (Incorporated by reference from Exhibit 3.24 to the Company's Transition Report on Form 10-KSB for the ten months ended December 31, 1995)
- 3.27 By-laws of WinStar Telecom (Incorporated by reference from Exhibit 3.24 to the Company's Transition Report on Form 10-KSB for the ten months ended February 28, 1995)
- 4.1 Specimen of Common Stock Certificate (Incorporated by reference from Exhibit 4.3 to the Registration Statement of Company on Form S-18 (No. 33-37024))
- 4.2 Specimen of 6% Series A Preferred Stock Certificate (Incorporated by reference to Exhibit 3 to the Company's Current Report on Form 8-K, dated February 14, 1997)
- 4.3 EC-A Warrants issued to Everest Capital Fund, L.P. ("Fund") for 130,500 shares of Common Stock and to Everest Capital International, L.P. ("Capital") for 169,500 shares of Common Stock (Incorporated by reference to Exhibit 4.6 to the Company's Registration Statement on Form S-3 (No. 33-95242))
- 4.4 EC-B Warrants issued to Fund for 43,500 shares of Common Stock and to Capital for 56,500 shares of Common Stock (Incorporated by reference to Exhibit 4.7 to the Company's Registration Statement on Form S-3 (No. 33-95242))
- 4.5 EC-C Warrants issued to Fund for 65,250 shares of Common Stock and to Capital for 84,750 shares of Common Stock (Incorporated by reference to Exhibit 4.8 to the Company's Registration Statement on Form S-3 (No. 33-95242))
- 4.6 Form of Warrants issued to purchasers in the Preferred Stock Placement (Incorporated by reference to Exhibit 4.10 to the Company's Current Report on Form 8-K, dated February 14, 1997)
- 10.1 Agreement between the Company and ITC Group (Incorporated by reference from Exhibit 10.9 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 10.2 Lease for 230 Park Avenue, New York, New York facilities (Incorporated by reference from Exhibit 10.10 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 10.3 Lease for additional space at 230 Park Avenue, New York, New York 10169 (Incorporated by reference from Exhibit 10.2(a) to the Company's Transition Report on Form 10-KSB for the ten months ended December 31, 1995)
- 10.4 Lease for 144 Fairfield Road, Fairfield, New Jersey facilities (Incorporated by reference from Exhibit 10.12 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 10.5 Lease for 7799 Leesburg Pike, Tysons Corner, Virginia facilities (Incorporated by reference from Exhibit 10.15 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 10.5(a) Amendment to Leesburg Pike Lease (Incorporated by reference from Exhibit 10.7(a) to the Company's Transition Report on Form 10-KSB for the ten months ended December 31, 1995)
- 10.6 1992 Performance Equity Plan (Incorporated by reference to Exhibit 10.53 to the Company's Registration Statement on Form S-18 (No. 33-37024))
- 10.7 Loan and Security Agreement between Gateway and The CIT Group/Credit Finance, Inc. ("CIT") (Incorporated by reference from Exhibit 10.22 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)

**EXHIBIT
NUMBER**

DESCRIPTION

- 10.8 Guaranty and Surety Agreement between the Company and CIT in connection with Exhibit 10.12 above (Incorporated by reference from Exhibit 10.25 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 10.9 Subordination Agreement between the Company and CIT in connection with Exhibit 10.12 above (Incorporated by reference from Exhibit 10.26 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 10.10 Keepwell Agreement between the Company and CIT in connection with Exhibit 10.12 above (Incorporated by reference from Exhibit 10.27 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 10.11 Agreement between CIT and Zero Plus Dialing, Inc. regarding Escrow and Disbursing Agreement with Texas Commerce Bank and Assignment of Outstanding Accounts Receivable in connection with Exhibit 10.22 above (Incorporated by reference from Exhibit 10.28 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 10.12 Limited Guaranty of the Company in connection with Exhibit 10.19 above (Incorporated by reference from Exhibit 10.38 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)
- 10.13 Executive Incentive Compensation Program (Incorporated by reference from Exhibit 10.40 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)*
- 10.14 Lease for 12 Gardner Road, Fairfield, New Jersey facilities (Incorporated by reference to Exhibit 10.52 to the Company's Registration Statement on Form S-3 (No. 33-95242))
- 10.15 Agreement between the Company, WinStar Wireless and P-Corn, Inc. (Incorporated by reference from Exhibit 10.11 to the Registration Statement on Form S-1 of P-Corn, Inc. (No. 33-88492) on file with the Commission)
- 10.16 Employment Agreement between the Company and Nathan Kantor, together with voting stipulation given by William J. Rouhana, Jr. to Mr. Kantor (Incorporated by reference to Exhibit 10.54 to the Company's Registration Statement on Form S-3 (No. 33-95242))*
- 10.17 Form of Stock Option Agreement between the Company and Nathan Kantor for the purchase of 350,000 shares of Common Stock (Incorporated by reference to Exhibit 10.55 to the Company's Registration Statement on Form S-3 (No. 33-95242))*
- 10.18 Form of Stock Option Agreement between the Company and Nathan Kantor for the purchase of 350,000 additional shares of Common Stock (Incorporated by reference to Exhibit 10.56 to the Company's Registration Statement on Form S-3 (No. 33-95242))*
- 10.19 Employment Agreement between the Company and William J. Rouhana, Jr. (Incorporated by reference to Exhibit 10.57 to the Company's Registration Statement on Form S-3 (No. 33-95242))*
- 10.20 Employment Agreement between the Company and Fredric E. von Stange (Incorporated by reference to Exhibit 10.58 to the Company's Registration Statement on Form S-3 (No. 33-95242))*
- 10.21 Facility Agreement between ML Investors Services, Inc. ("ML") and WinStar Wireless (Incorporated by reference to Exhibit 10.59 to the Company's Registration Statement on Form S-3 (No. 33-95242))
- 10.22 Master Lease Agreement between ML and WinStar Wireless (Incorporated by reference to Exhibit 10.60 to the Company's Registration Statement on Form S-3 (No. 33-95242))
- 10.23 Form of Stock Option Agreement between the Company and ML (Incorporated by reference to Exhibit 10.61 to the Company's Registration Statement on Form S-3 (No. 33-95242))

**EXHIBIT
NUMBER**

DESCRIPTION

- 10.24 Lease Guaranty between the Company and ML (Incorporated by reference to Exhibit 10.62 to the Company's Registration Statement on Form S-3 (No. 33-95242))
- 10.25 Service Agreement between WinStar Wireless and AT&T (Incorporated by reference to Exhibit 10.63 to the Company's Registration Statement on Form S-3 (No. 33-95242)) (confidentiality granted under Rule 406 promulgated under the Act; accordingly, certain information has been omitted from this exhibit and filed separately with the Commission)
- 10.26 Senior Notes Indenture, including form of Restricted Global Senior Note, entered into in connection with the Company's private placement of notes in October 1995 (the "1995 Debt Placement") (Incorporated by reference from Exhibit 2 to the Current Report on Form 8-K, dated October 23, 1995)
- 10.27 Convertible Notes Indenture, including form of Restricted Global Convertible Notes, entered into in connection with the 1995 Debt Placement (Incorporated by reference from Exhibit 3 to the Current Report on Form 8-K, dated October 23, 1995)
- 10.28 Employment Agreement between WinStar Wireless and Leo I. George (Incorporated by reference from Exhibit 10.4 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)*
- 10.29 Employment Agreement between NFF and Stuart B. Rekant (Incorporated by reference from Exhibit 10.5 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)*
- 10.30 Employment Agreement between New Media and Stuart B. Rekant (Incorporated by reference from Exhibit 10.6 to the Company's Annual Report on Form 10-KSB for the fiscal year ended February 28, 1995)*
- 10.31 Registration Rights Agreement among the Company and the former stockholders of the partners of Millwave entered into in connection with the Millwave Acquisition (Incorporated by reference to the Company's Current Report on Form 8-K dated February 17, 1997)
- 10.32 Amended and Restated Credit Agreement among WinStar Global Products, Inc., IBI Schroder Bank Trust Company, as lender, and IBI Schroder Bank & Trust Company, as agent (Incorporated by reference to Exhibit 10.79 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996)
- 10.33 Pledge Agreement by WinStar Global Products, Inc. in favor of IBI Schroder Banker & Trust Company, as agent (Incorporated by reference to Exhibit 10.80 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996)
- 10.34 Subordination Agreement between WinStar Communications, Inc., and IBI Schroder Bank & Trust Company, as agent (Incorporated by reference to Exhibit 10.81 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996)
- 10.35 Amended and Restated Guaranty between WinStar Communications, Inc. and IBI Schroder Bank & Trust Company, as agent agent (Incorporated by reference to Exhibit 10.82 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996)
- 10.36 First Supplemental Indenture (Old Senior Notes) between WinStar Communications, Inc. and United States Trust Company of New York, as trustee (Incorporated by reference to Exhibit 10.83 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996)
- 10.37 First Supplemental Indenture (Convertible Notes) between WinStar Communications, Inc. and United States Trust Company of New York, as trustee (Incorporated by reference to Exhibit 10.84 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996)

**EXHIBIT
NUMBER**

DESCRIPTION

10.38	Senior Notes Indenture, including form of New Senior Note, entered into in connection with the issuance of the New Senior Notes in the 1997 Debt Placement (Incorporated by reference from Exhibit 10.2 to the Company's Current Report on Form 8-K, dated March 27, 1997)
10.39	Guaranteed Senior Secured Notes Indenture, including form of WEC Note, entered into in connection with the issuance of the WEC Notes in the 1997 Debt Placement (Incorporated by reference from Exhibit 10.3 to the Company's Current Report on Form 8-K, dated March 27, 1995)
10.40	Purchase Agreement with respect to the New Senior Notes and the WEC Notes entered into by the Company, WEC and the purchasers thereunder in connection with the 1997 Debt Placement (Incorporated by reference from Exhibit 10.1 to the Company's Current Report on Form 8-K, dated March 27, 1995)
10.41	Registration Rights Agreement entered into by the Company, WEC and the initial holders of the Notes in connection with the 1997 Debt Placement (Incorporated by reference from Exhibit 10.4 to the Company's Current Report on Form 8-K, dated March 27, 1995)
10.42	Security Agreement entered into by WEC and the Trustee in connection with the 1997 Debt Placement (Incorporated by reference from Exhibit 10.5 to the Company's Current Report on Form 8-K, dated March 27, 1995)
10.43	Securities Purchase Agreement entered into in connection with the Preferred Stock Placement (Incorporated by reference to Exhibit 2.7 to the Company's Current Report on Form 8-K dated February 14, 1997)
10.44	Registration Rights Agreement entered into in connection with the Preferred Stock Placement (Incorporated by reference to Exhibit 10.85 to the Company's Current Report on Form 8-K dated February 14, 1997)
21.1	Schedule of Company's Subsidiaries (filed herewith)
23.1	Consent of Grant Thornton LLP, Independent Accountants of the Company
27.1	Financial Data Schedule

- Indicates management contract or compensatory plan or arrangement.

(b) Reports on Form 8-K

1. Current Report on Form 8-K with respect to the acquisition by the Company of certain assets and business comprising the Microwave Division of Local Area Telecommunications, Inc. on October 8, 1996, including the following audited (except as otherwise indicated) financial statements of the acquired business: Balance sheets as of June 30, 1996 and 1995; Statements of Operations for the year ended December 31, 1995 and the six months ended June 30, 1996 and 1995 (unaudited); Statements of Divisional (Deficit) Surplus as of and for the six months ended June 30, 1996 (unaudited) and for the years ended December 31, 1995 and 1994; and Statements of Cash Flows for the year ended December 31, 1995 and the six months ended June 30, 1996 and 1995 (unaudited)

Copies of the exhibits listed above will be made available by the Company to any stockholder upon written request of the stockholder addressed to WinStar Communications, Inc., 230 Park Avenue, Suite 3126, New York, New York 10169, Attention: Investor Relations. Any stockholder requesting a copy of any such exhibit will be charged a copying fee of \$.25 per page.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 31st day of March, 1997.

WINSTAR COMMUNICATIONS, INC. By: /s/ WILLIAM J. ROUHANA, JR.

William J. Rouhana, Jr.
Chairman of the Board
and Chief Executive Officer

In accordance with Section 13 or 15(d) of the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>SIGNATURE</u>	<u>TITLE</u>	<u>DATE</u>
<u>/s/ WILLIAM J. ROUHANA, JR.</u> William J. Rouhana, Jr.	Chairman of the Board, Chief Executive Officer (principal executive officer) and Director	March 31, 1997
<u>/s/ STEVEN G. CHRUST</u> Steven G. Chrust	Vice Chairman and Director	March 31, 1997
<u>/s/ NATHAN KANTOR</u> Nathan Kantor	President, Chief Operating Officer and Director	March 31, 1997
<u>/s/ FREDRIC E. VON STANGE</u> Fredric E. von Stange	Executive Vice President, Chief Financial Officer (principal accounting officer) and Director	March 31, 1997
<u>/s/ WILLIAM HARVEY</u> William Harvey	Director	March 31, 1997
<u>/s/ STEVEN MAGYAR</u> Steven Magyar	Director	March 31, 1997
<u>/s/ WILLIAM J. VANDEN HEUVEL</u> William J. vanden Heuvel	Director	March 31, 1997
<u>/s/ BERT WASSERMAN</u> Bert Wasserman	Director	March 31, 1997
<u>Dennis R. Patrick</u>	Director	
<u>/s/ JAMES I. CASH</u> James I. Cash	Director	March 31, 1997

WINSTAR COMMUNICATIONS, INC.

INDEX TO FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES

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Consolidated Balance Sheets as of December 31, 1995 and 1996	F-3
Consolidated Statements of Operations, Year Ended February 28, 1995, Ten Months ended December 31, 1994 (unaudited), Ten Months ended December 31, 1995 and the Year Ended December 31, 1996	F-4
Consolidated Statements of Stockholders' Equity (Deficit), Year Ended February 28, 1995, Ten Months ended December 31, 1995 and the Year Ended December 31, 1996	F-5
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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors
WinStar Communications, Inc.

We have audited the accompanying consolidated balance sheets of WinStar Communications, Inc. and Subsidiaries as of December 31, 1995 and 1996, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for the year ended February 28, 1995, the ten months ended December 31, 1995 and the year ended December 31, 1996. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of WinStar Communications, Inc. and Subsidiaries as of December 31, 1995 and 1996, and the consolidated results of their operations and their consolidated cash flows for the year ended February 28, 1995, the ten months ended December 31, 1995 and the year ended December 31, 1996, in conformity with generally accepted accounting principles.

GRANT THORNTON LLP

New York, New York

January 24, 1997

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS)

	DECEMBER 31, 1995		DECEMBER 31, 1996	
		HISTORICAL	PRO FORMA	(UNAUDITED, NOTE 2)
ASSETS				
Current assets				
Cash and cash equivalents				
Short-term investments	\$138,106	\$95,490	\$60,573	
	<u>73,495</u>	<u>26,997</u>	<u>26,997</u>	
Cash, cash equivalents and short-term investments				
Investments in equity securities	211,701	122,487	87,570	
Accounts receivable, net of allowance for doubtful accounts of \$800 and \$1,002 respectively	6,515	688	688	
Inventories	8,684	17,649	17,655	
Prepaid expenses and other current assets	7,392	13,615	13,615	
	<u>3,768</u>	<u>16,726</u>	<u>11,726</u>	
Total current assets				
Property and equipment, net	238,060	171,165	131,254	
Licenses, net	15,898	63,287	64,678	
Intangible assets, net	12,556	27,434	167,569	
Deferred financing costs	3,034	13,404	13,404	
Other assets	10,525	10,535	10,535	
	<u>5,290</u>	<u>4,398</u>	<u>4,398</u>	
Total assets	\$285,363	\$290,223	\$391,838	
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)				
Current liabilities				
Current portion of long-term debt				
Accounts payable and accrued expenses	\$8,288	\$19,901	\$19,901	
Current portion of capitalized lease obligations	13,513	32,519	32,630	
	<u>1,355</u>	<u>3,135</u>	<u>3,135</u>	
Total current liabilities				
Capitalized lease obligations, less current portion	23,156	55,555	55,666	
Long-term debt, less current portion	6,081	10,849	10,849	
Deferred income taxes	234,374	273,490	273,490	
	<u>=</u>	<u>=</u>	<u>26,500</u>	
Total liabilities	<u>263,611</u>	<u>339,894</u>	<u>366,505</u>	
Commitments and contingencies				
Stockholders' equity (deficit)				
Preferred stock				
Common stock, par value \$.01; authorized 75,000 shares, issued 29,708 and 28,989, outstanding 27,201 and 28,989, respectively, and pro forma issued and outstanding 32,583 shares	689	--	--	
Additional paid-in capital	297	290	326	
Accumulated deficit	103,837	75,436	150,404	
	<u>(41,311)</u>	<u>(125,034)</u>	<u>(125,034)</u>	
Treasury stock	63,512	(49,308)	25,696	
Deferred compensation	(39,678)	--	--	
Unrealized loss on marketable equity securities	(1,100)	--	--	
	<u>(982)</u>	<u>(363)</u>	<u>(363)</u>	
Total stockholders' equity (deficit)	<u>21,752</u>	<u>(49,671)</u>	<u>25,333</u>	
Total liabilities and stockholders' equity (deficit)	\$285,363	\$290,223	\$391,838	

See Notes to Consolidated Financial Statements

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(IN THOUSANDS, EXCEPT PER SHARE DATA)

	FOR THE YEAR ENDED FEBRUARY 28, 1995	FOR THE TEN MONTHS ENDED DECEMBER 31, 1994	1995	FOR THE YEAR ENDED DECEMBER 31, 1996
	(UNAUDITED)			
Operating revenues				
Telecommunications services	\$14,909	\$13,420	\$13,137	\$33,969
Information services	473	193	2,648	14,650
Other	<u>10,183</u>	<u>8,405</u>	<u>13,986</u>	<u>19,429</u>
Total operating revenues	<u>25,565</u>	<u>22,018</u>	<u>29,771</u>	<u>68,048</u>
Operating expenses				
Cost of services and products	19,137	15,147	20,906	52,136
Selling, general and administrative expenses	11,895	10,196	17,906	67,688
Depreciation and amortization	<u>402</u>	<u>319</u>	<u>1,210</u>	<u>4,746</u>
Total operating expenses	<u>31,434</u>	<u>25,662</u>	<u>40,022</u>	<u>124,570</u>
Operating loss	(5,869)	(3,644)	(10,251)	(56,522)
Other income (expense)				
Interest expense	(637)	(505)	(7,630)	(37,476)
Interest income	385	297	2,890	10,275
Equity in loss of AGT	<u>(1,109)</u>	<u>(766)</u>	<u>(866)</u>	<u>=</u>
Net loss	<u>\$(7,230)</u>	<u>\$(4,618)</u>	<u>\$(15,857)</u>	<u>\$(83,723)</u>
Net loss per share	<u>\$(0.42)</u>	<u>\$(0.28)</u>	<u>\$(0.70)</u>	<u>\$(3.00)</u>
Weighted average shares outstanding	<u>17,122</u>	<u>16,609</u>	<u>22,770</u>	<u>27,911</u>

See Notes to Consolidated Financial Statements

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE YEAR ENDED FEBRUARY 28, 1995
(IN THOUSANDS)

PREFERRED STOCK

	<u>B</u>		<u>C</u>		<u>D</u>
	<u>SHARES</u>	<u>AMOUNT</u>	<u>SHARES</u>	<u>AMOUNT</u>	<u>SHARES</u>
BALANCES AT FEBRUARY 28, 1994	1.20	\$1,204	0.17	\$173	225
Issuances of common stock					
Exercise of warrants					
Conversion of preferred stock	(0.53)	(533)	(0.17)	(173)	(225)
Preferred stock dividend	0.06	62			
Other, net					
Net loss					
BALANCES AT FEBRUARY 28, 1995	<u>0.73</u>	<u>\$733</u>	<u>=</u>	<u>\$--</u>	<u>=</u>

COMMON STOCK

	<u>AMOUNT</u>	<u>SHARES</u>	<u>AMOUNT</u>	<u>ADDITIONAL PAID-IN CAPITAL</u>	<u>ACCUMULATED DEFICIT</u>
BALANCES AT FEBRUARY 28, 1994	\$900	9,843	\$98	\$20,290	\$(17,946)
Issuances of common stock		3,714	37	7,967	
Exercise of warrants		6,105	61	12,738	
Conversion of preferred stock	(900)	485	5	1,601	(62)
Preferred stock dividend				(13)	
Other, net					(7,230)
Net loss					
BALANCES AT FEBRUARY 28, 1995	<u>\$--</u>	<u>20,147</u>	<u>\$201</u>	<u>\$42,583</u>	<u>\$(25,238)</u>

**TOTAL
STOCKHOLDERS'
EQUITY**

BALANCES AT FEBRUARY 28, 1994	\$4,719
Issuances of common stock	8,004
Exercise of warrants	12,799
Conversion of preferred stock	--
Preferred stock dividend	--
Other, net	(13)
Net loss	(7,230)
BALANCES AT FEBRUARY 28, 1995	<u>\$18,279</u>

See Notes to Consolidated Financial Statements

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE TEN MONTHS ENDED DECEMBER 31, 1995
(IN THOUSANDS)

PREFERRED STOCK

	<u>B</u>		<u>E</u>		<u>COMMON STOCK</u>		<u>ADDITIONAL PAID-IN CAPITAL</u>	<u>ACCUMULATED DEFICIT</u>
	<u>SHARES</u>	<u>AMOUNT</u>	<u>SHARES</u>	<u>AMOUNT</u>	<u>SHARES</u>	<u>AMOUNT</u>		
BALANCES AT FEBRUARY 28, 1995	0.73	\$733	--	\$--	20,147	\$201	\$42,583	\$(25,238)
Issuances of common stock					4,447	45	10,639	
Issuance of preferred stock			932	6,000			(360)	
Conversions of preferred stock	(0.15)	(147)	(932)	(6,000)	684	7	6,140	
Warrants and common stock equivalents issued in connection with long-term debt and lease financing							981	
Conversion of long-term debt					539	5	3,410	
Preferred stock dividends	0.11	103						(216)
Issuance of restricted stock					150	2	1,236	
Amortization of deferred compensation								
WinStar Private Exchange Transaction					3,741	37	39,641	
Unrealized loss on investments in marketable equity securities								
Other, net							(433)	
Net loss								<u>(15,857)</u>
BALANCES AT DECEMBER 31, 1995	<u>0.69</u>	<u>\$689</u>	<u>--</u>	<u>\$--</u>	<u>29,708</u>	<u>\$297</u>	<u>\$103,837</u>	<u>\$(41,311)</u>

TREASURY STOCK

	<u>COMMON STOCK</u>		<u>PREFERRED STOCK B</u>		<u>DEFERRED COMPENSATION</u>	<u>UNREALIZED LOSS ON INVESTMENTS IN MARKETABLE EQUITY SECURITIES</u>
	<u>SHARES</u>	<u>AMOUNT</u>	<u>SHARES</u>	<u>AMOUNT</u>		
BALANCES AT FEBRUARY 28, 1995	--	\$--	--	\$--	\$--	\$--
Issuances of common stock						
Issuance of preferred stock						
Conversions of preferred stock						
Warrants and common stock equivalents issued in connection with long-term debt and lease financing						
Conversion of long-term debt						
Preferred stock dividends						
Issuance of restricted stock					(1,238)	
Amortization of deferred compensation					138	
WinStar Private Exchange Transaction	(2,507)	(36,348)	(0.69)	(3,330)		
Unrealized loss on investments in marketable equity securities						(982)
Other, net						
Net loss						
BALANCES AT DECEMBER 31, 1995	<u>(2,507)</u>	<u>\$(36,348)</u>	<u>(0.69)</u>	<u>\$(3,330)</u>	<u>\$1,100</u>	<u>\$(982)</u>

**TOTAL
STOCKHOLDERS'
EQUITY**

BALANCES AT FEBRUARY 28, 1995	\$18,279
Issuances of common stock	10,684
Issuance of preferred stock	5,640
Conversions of preferred	

stock.....	--
Warrants and common stock equivalents issued in connection with long-term debt and lease financing.....	981
Conversion of long-term debt.....	3,415
Preferred stock dividends.....	(113)
Issuance of restricted stock.....	--
Amortization of deferred compensation.....	138
WinStar Private Exchange Transaction.....	--
Unrealized loss on investments in marketable equity securities.....	(982)
Other, net.....	(433)
Net loss.....	<u>(15,857)</u>
 BALANCES AT DECEMBER 31, 1995.....	 <u>\$21,752</u>

See Notes to Consolidated Financial Statements

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)
FOR THE YEAR ENDED DECEMBER 31, 1996
(IN THOUSANDS)

(IN THOUSANDS)

	PREFERRED STOCK B		COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	ACCUMULATED DEFICIT	TREASURY STOCK
	SHARES	AMOUNT	SHARES	AMOUNT			COMMON STOCK SHARES
BALANCES AT DECEMBER 31, 1995	0.69	\$689	29,708	\$297	\$103,837	\$(41,311)	(2,507)
Issuances of common stock			1,383	14	9,619		
Acquisition of treasury shares							(150)
Retirement of treasury shares	(0.69)	(689)	(2,657)	(27)	(42,018)		2,657
Amortization of deferred compensation							
Conversion of long-term debt			555	6	3,878		
Fair value of stock options granted to nonemployees and other, net					120		
Unrealized gain on investments in marketable equity securities						(83,723)	
Net loss							
BALANCES AT DECEMBER 31, 1996	=	\$--	28,989	\$290	\$75,436	\$(125,034)	=

	PREFERRED STOCK B		DEFERRED		UNREALIZED GAIN/(LOSS) ON INVESTMENTS IN MARKETABLE EQUITY SECURITIES	TOTAL STOCKHOLDERS' EQUITY (DEFICIT)
	AMOUNT	SHARES	AMOUNT	COMPENSATION		
BALANCES AT DECEMBER 31, 1995	\$(36,348)	(0.69)	\$(3,330)	\$(1,100)	\$(982)	\$21,752
Issuances of common stock						9,633
Acquisition of treasury shares	(3,056)					(3,056)
Retirement of treasury shares	39,404	0.69	3,330			--
Amortization of deferred compensation				1,100		1,100
Conversion of long-term debt						3,884
Fair value of stock options granted to nonemployees and other, net						120
Unrealized gain on investments in marketable equity securities					619	619
Net loss						(83,723)
BALANCES AT DECEMBER 31, 1996	\$--	--	\$--	\$--	\$(363)	\$(49,671)

See Notes to Consolidated Financial Statements

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

	YEAR ENDED FEBRUARY 28, 1995	TEN MONTHS ENDED DECEMBER 31, 1995	YEAR ENDED DECEMBER 31, 1996
Cash flows from operating activities			
Net loss	\$(7,230)	\$(15,857)	\$(83,723)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	658	1,300	6,307
Provision for doubtful accounts	894	887	1,562
Equity in unconsolidated results of AGT	1,109	866	--
Noncash interest expense	--	6,151	35,040
Decrease in operating assets:			
Accounts receivable	(1,410)	(5,527)	(5,464)
Inventories	(1,729)	(3,159)	(5,056)
Prepaid expenses and other current assets	(440)	(2,479)	(14,167)
Other assets	(91)	(269)	(1,566)
Increase in accounts payable and accrued expenses	1,635	6,306	10,187
Other, net	78	179	186
Net cash used in operating activities	<u>(6,526)</u>	<u>(11,602)</u>	<u>(56,694)</u>
Cash flows from investing activities:			
Investments in and advances to AGT	(7,129)	(5,704)	--
Decrease (increase) in short-term investments, net	--	(73,594)	46,597
Decrease (increase) in other investments, net	--	(7,497)	6,447
Purchase of property and equipment, net	(1,055)	(8,608)	(47,961)
Acquisitions, net	(679)	--	(2,121)
Other, net	<u>(1,925)</u>	<u>(499)</u>	<u>(1,619)</u>
Net cash provided by (used in) investing activities	<u>(10,788)</u>	<u>(95,902)</u>	<u>1,343</u>
Cash flows from financing activities:			
Proceeds from long-term debt, net	1,264	225,796	1,213
Payment of dividends	--	(113)	--
Net proceeds from equity transactions	19,067	11,259	6,295
Proceeds from equipment lease financing	--	6,998	8,345
Payment of capital lease obligations	(251)	(701)	(2,108)
Other, net	<u>(329)</u>	<u>(785)</u>	<u>(1,010)</u>
Net cash provided by financing activities	<u>19,751</u>	<u>242,454</u>	<u>12,735</u>
Net (decrease) increase in cash and cash equivalents	2,437	134,950	(42,616)
Cash and cash equivalents at beginning of period	719	3,156	138,106
Cash and cash equivalents at end of period	3,156	138,106	95,490
Short-term investments at end of period	--	73,595	26,997
Cash, cash equivalents and short-term investments at end of period	<u>\$3,156</u>	<u>\$211,701</u>	<u>\$122,487</u>

See Notes to Consolidated Financial Statements

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

CONSOLIDATION

The consolidated financial statements include the accounts of WinStar Communications, Inc. ("WCI") and its subsidiaries (the "Company"). All material intercompany transactions and accounts have been eliminated in consolidation.

NATURE OF BUSINESS

The Company is the holder of the largest amount of 38 GHz licenses in the United States and utilizes this position to provide facilities-based telecommunications services. The Company plans to offer a full range of telecommunications services as a Competitive Local Exchange Carrier ("CLEC"), including local, long distance and Internet access services, to small and medium-sized businesses in major metropolitan areas in the United States. The Company also offers a variety of broadband, high-capacity local access and digital network services to telecommunications service providers on a wholesale basis. As a complement to its telecommunications services offerings, the Company produces and distributes information and entertainment content. The Company also operates a nonstrategic consumer products company. The Company's telecommunications services are subject to varying degrees of federal, state and local regulation.

To capitalize on opportunities in the telecommunications industry, the Company is pursuing a rapid expansion of its telecommunications services, which will require significant amounts of capital to finance capital expenditures and anticipated operating losses. The Company may elect to slow the speed or narrow the scope of this expansion in the event that it is unable to raise sufficient amounts of capital on acceptable terms.

FISCAL YEAR

The Company changed its fiscal year end from February 28 to December 31, effective January 1, 1996. Accordingly, these financial statements present the year ended February 28, 1995, the ten-month transition period ended December 31, 1995, and the year ended December 31, 1996.

CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents consist of money market fund investments, short-term certificates of deposit, and commercial paper. Exclusive of cash in banks, cash equivalents at December 31, 1995 and 1996 were \$137.4 million and \$84.5 million, respectively, and approximate fair value.

SHORT-TERM INVESTMENTS

Short-term investments are widely diversified and principally consist of certificates of deposit and money market deposits, U.S. government or government agency securities, commercial paper rated "A-1/P-1" or higher, and municipal securities rated "A" or higher with an original maturity of greater than three months and less than six months. Short-term investments are considered held-to-maturity and are stated at amortized cost which approximates fair value. As of December 31, 1995 and 1996, cash, cash equivalents and short-term investments totaled \$211.7 million and \$122.5 million, respectively.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 1—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED) INVENTORIES

Inventories in the merchandising division are valued at the lower of cost or market, principally using the first-in, first-out method.

Film inventories include direct and indirect production costs, which are amortized to expense in the proportion that revenue recognized during the year for each film bears to the estimated total revenue to be received from all sources under the individual film forecast method. Management's estimate of forecasted revenues exceeds the unamortized costs on an individual program basis. Such forecasted revenue is subject to revision in future periods if warranted by changing market conditions.

PROPERTY AND EQUIPMENT

Property and equipment is stated at cost. Depreciation and amortization are generally computed using the straight-line method over the estimated useful lives of the related assets.

CAPITALIZED INTEREST

The Company follows the policy of capitalizing interest expense as a component of the cost of its telecommunications equipment constructed for its own use.

LICENSES AND INTANGIBLE ASSETS

Licenses and intangible assets are being amortized by the straight-line method over their estimated useful lives.

Goodwill represents the excess of cost over the fair value of assets acquired. The Company's policy is to measure goodwill impairment by considering a number of factors as of each balance sheet date including (i) current operating results of the applicable business, (ii) projected future operating results of the applicable business, (iii) the occurrence of any significant regulatory changes which may have an impact on the continuity of the business, and (iv) any other material factors that affect the continuity of the applicable business. The amortization period for goodwill is determined on a case-by-case basis for each acquisition from which goodwill arises based on a review of the nature of the business acquired as well as the factors cited above (see Note 6).

INCOME TAXES

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS 109"). Pursuant to SFAS 109, deferred income taxes are recognized for temporary differences between financial statement and income tax bases of assets and liabilities, loss carryforwards and tax credit carryforwards for which income tax benefits are expected to be realized in future years. A valuation allowance is established to reduce deferred tax assets if it is more likely than not that all, or some portion, of such deferred tax assets will not be realized. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 1--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED) REVENUE RECOGNITION

In the telecommunications segment, revenues are recorded upon placing of calls or rendering of other related services. In the information services segment, revenues from film productions are recognized when a program is accepted by the licensee and is available for broadcast. Revenues from the licensing of film productions are recognized when the license period begins and the film is available for broadcast. Revenues from advertising sales are recognized when the related advertising is broadcast. In the merchandising segment, revenues are recorded upon shipment of merchandise and are presented in the accompanying consolidated statement of operations net of merchandise returns. The Company provides for future estimated returns of merchandise at the time of sale.

NET LOSS PER COMMON SHARE

Net loss per common share is calculated by dividing the net loss by the weighted average number of shares of common stock outstanding. Stock options, warrants and other convertible securities have not been included in the calculation as their inclusion would be antidilutive.

CONCENTRATION OF CREDIT RISK

Financial instruments which potentially subject the Company to concentration of credit risk consist principally of trade receivables. Concentration of credit risk with respect to these receivables is generally diversified due to the large number of entities comprising the Company's customer base and their dispersion across geographic areas. The Company routinely addresses the financial strength of its customers and, as a consequence, believes that its receivable credit risk exposure is limited.

The Company places its cash and investments with relatively few high credit quality financial institutions with approximately \$60 million at one institution. As a result, substantially all of the cash, cash equivalents and short-term investments at December 31, 1996 are uninsured.

USE OF ESTIMATES IN PREPARING FINANCIAL STATEMENTS

In preparing financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

UNAUDITED FINANCIAL STATEMENTS

The unaudited consolidated statement of operations for the ten months ended December 31, 1994 is a condensed financial statement in accordance with the rules and regulations of the Securities and Exchange Commission. Accordingly, the statement omits certain information included in complete financial statements and should be read in conjunction with the information for the year ended February 28, 1995, the ten months ended December 31, 1995 and the year ended December 31, 1996. In the opinion of the Company, the accompanying unaudited consolidated financial statement includes all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the results of operations for the ten months ended December 31, 1994.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 1—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED) RECLASSIFICATIONS

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

NOTE 2—ACQUISITIONS

ACQUISITION OF MILLIWAVE LIMITED PARTNERSHIP AND PRO FORMA BALANCE SHEET

On January 2, 1997, a subsidiary of the Company merged with the corporate shareholders of Milliwave Limited Partnership ("Milliwave"), a large holder of 38 GHz licenses in the United States, covering 160 million people in more than 80 major markets. The merger consideration paid by the Company to the shareholders of the corporate partners of Milliwave was \$116 million (\$40.7 million in cash and 3.6 million shares of the Company's common stock, which had an aggregate market value of \$75 million). Pursuant to a registration rights agreement, the Company agreed to register such shares of common stock for resale prior to January 1, 1998. The merger was treated as a "purchase" for accounting purposes with the purchase price principally allocated to licenses. In addition, approximately \$26.5 million of deferred tax liabilities were recorded in connection with the acquisition, with a corresponding allocation to licenses, which will be amortized on a straight-line basis over 40 years. Milliwave had minimal operations prior to its merger into the Company.

The unaudited pro forma balance sheet has been prepared as if the Milliwave acquisition had been consummated at December 31, 1996. The pro forma financial information should be read in conjunction with the related historical information and is not necessarily indicative of the results that would have been attained had the transaction actually taken place.

Unaudited pro forma results of operations, which reflect the combined operations of the Company and Milliwave as if the merger occurred as of the January 1, 1996, is as follows:

	FOR THE YEAR ENDED <u>DECEMBER 31, 1996</u>
Net Sales	\$66,560
Net Loss	(91,898)
Net Loss Per Share	(2.92)

ACQUISITION OF LOCAL AREA TELECOMMUNICATIONS, INC.

In October 1996, a subsidiary of the Company acquired certain assets of Local Area Telecommunications, Inc. ("Locate"), comprising its business as a competitive access provider of local digital microwave distribution services and facilities to large corporations and to interexchange and other common carriers. The assets acquired included multiple 38 GHz licenses in the New York metropolitan area. The purchase price for such assets was \$17.5 million, which was paid in the form of promissory notes (see Note 7). The acquisition has been accounted for as a "purchase" for accounting purposes, with the majority of the purchase price allocated to licenses, which will be amortized on a straight-line basis over 40 years. The accounts of Locate have been consolidated into the Company's financial statements as of the date of the acquisition.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 2--ACQUISITIONS (CONTINUED)

ACQUISITION OF AVANT-GARDE

Avant-Garde Telecommunications, Inc. ("Avant-Garde" or "AGT") was a privately held company which held 38 GHz radio licenses granted by the FCC in September 1993. Through July 17, 1995, the Company owned 49% of Avant-Garde, which it acquired for \$4.9 million, and accounted for its investment in Avant-Garde under the equity method. For the period from March 1, 1995 to July 17, 1995, and the year ended February 28, 1995, Avant-Garde had net losses of \$1.8 million and \$2.3 million, respectively. On July 17, 1995, pursuant to the terms of a merger agreement, the Company exchanged 1,275,000 restricted shares of its common stock valued at \$5.1 million for the 51% of Avant-Garde that it did not already own. The acquisition of Avant-Garde has been treated as a "purchase" for accounting purposes, with \$12.6 million allocated to the licenses acquired, which are being amortized on a straight-line basis over 40 years. The accounts of Avant-Garde have been consolidated into the Company's financial statements as of the date of the acquisition.

OTHER ACQUISITIONS

During the year ended February 28, 1995, a subsidiary of the Company purchased Non Fiction Films, Inc. ("NFF"), a producer of non-fiction programming for cable television and other media, for \$476,000, consisting of \$200,000 in cash and 28,572 restricted shares of the Company's common stock. The transaction was treated as a "purchase" for accounting purposes, with the purchase price allocated based on the fair value of the assets acquired and liabilities assumed. The excess of the purchase price over the fair value of the net assets acquired, aggregating \$495,000, has been recorded as goodwill. The accounts of NFF have been consolidated into the Company's financial statements as of the date of the acquisition.

During 1996, a subsidiary of the Company acquired 100% ownership or a controlling interest in a number of companies engaged in the production and distribution of entertainment content. These acquisitions were treated as "purchases" for accounting purposes. The aggregate consideration for the acquisitions was approximately \$6.4 million, consisting of \$4.1 million in cash, \$800,000 in notes payable and 100,605 shares of the Company's common stock or share equivalents, valued at \$1.5 million. In connection with these purchases, the Company has made commitments to provide, under certain conditions, up to \$2.0 million in working capital and is obligated to pay contingent consideration, up to a maximum of \$3.5 million, if certain earnings targets are met over the five-year period subsequent to the acquisition. The accounts of the acquired companies have been consolidated with the Company's financial statements as of the date of acquisitions.

Unaudited results of operations for acquisitions other than Milliwave have not been included because they are not material to the consolidated statement of operations of the Company.

NOTE 3--INVESTMENTS IN MARKETABLE EQUITY SECURITIES

The Company treats its investments in marketable securities as available for sale securities. As such, they are carried at market value, with the difference between the historical cost (which is determined on a FIFO basis) and the market value reflected in unrealized gains or losses on marketable equity securities, a component of stockholders' equity. During the year ended December 31, 1996, proceeds of \$6.4 million were realized on the sale of marketable securities, which were sold at carrying value. At December 31, 1995 and 1996, unrealized losses of \$982,000 and \$363,000, respectively, were carried in stockholders' equity. The unrealized loss at December 31, 1996 is considered temporary.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 4—INVENTORIES

Components of inventories are as follows:

	DECEMBER 31, 1995	DECEMBER 31, 1996
	(IN THOUSANDS)	
Finished goods	\$1,433	\$1,514
Raw materials	4,018	7,092
Film inventories	1,941	5,009
	<u>\$7,392</u>	<u>\$13,615</u>

NOTE 5—PROPERTY AND EQUIPMENT

Property and equipment consist of the following:

	DECEMBER 31, 1995	DECEMBER 31, 1996	ESTIMATED USEFUL LIFE
	(IN THOUSANDS)		
Telecommunications equipment and software	\$15,355	\$58,788	5 to 10 years
Furniture, fixtures and other	1,581	4,577	4 to 5 years
Leasehold improvements	540	4,979	Life of the lease
	17,476	68,344	
Less accumulated depreciation and amortization	(1,578)	(5,057)	
	<u>\$15,898</u>	<u>\$63,287</u>	

NOTE 6—INTANGIBLE ASSETS

Intangible assets consist of the following:

	DECEMBER 31, 1995	DECEMBER 31, 1996	ESTIMATED USEFUL LIFE
	(IN THOUSANDS)		
Goodwill	\$2,953	\$13,904	5 to 20 years
Covenants not to compete and other	708	708	5 to 10 years
	3,661	14,612	
Less accumulated amortization	(627)	(1,208)	
	<u>\$3,034</u>	<u>\$13,404</u>	

Licenses are amortized over a 40-year period, in accordance with industry practice. As of December 31, 1995 and 1996, the value of licenses was \$12.6 million and \$27.4 million, net of accumulated amortization of \$256,000 and \$820,000, respectively.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 7--LONG-TERM DEBT

Long-term debt consists of the following:

	DECEMBER 31, 1995	DECEMBER 31, 1996
	(IN THOUSANDS)	
Senior Notes Payable (a).....	\$153,972	\$176,328
Convertible Notes Payable (a).....	76,986	88,164
Other Notes Payable (b).....	<u>11,704</u>	<u>28,899</u>
Total.....	242,662	293,391
Less Current Portion.....	<u>8,288</u>	<u>19,901</u>
	<u>\$234,374</u>	<u>\$273,490</u>

a) In October 1995, the Company completed a \$225 million private placement of debt securities with institutional investors (the "Debt Placement"). The transaction was structured as a units offering with two components, \$150 million of Senior Discount Notes due in 2005 (the "Senior Notes"), and \$75 million of Convertible Senior Subordinated Discount Notes due in 2005 (the "Convertible Notes"), convertible at \$20.625, a 10% premium over the closing price on October 18, 1995, the day of pricing. Both securities accrue interest at 14% per annum, with no interest payable during the first five years, and principal payable only at maturity in October 2005. After five years, both securities require the payment of interest only, in cash, until maturity. In addition, the Convertible Notes, including accretion thereon, will be automatically converted during the initial five-year period if the market price of the Company's common stock exceeds certain levels for thirty consecutive trading days, ranging from \$37.50 per share in the first year to \$44.00 per share in the fifth year.

Under the terms of the Debt Placement, the Company was obligated to consummate an exchange offer with respect to the Senior Notes by April 23, 1996, whereby these notes would be exchanged for new notes (the "New Notes") which would be identical in every respect to the original Senior Notes except that the New Notes would be registered under the Securities Act of 1933. Pursuant to such obligation, the Company filed an offer to exchange the Senior Notes for the New Notes on January 31, 1996, upon which all Senior Notes were subsequently exchanged. The Company was also obligated to, and did, cause to be declared effective a registration statement registering the issuance or resale of the shares underlying the Convertible Notes (the "Conversion Shares") by October 23, 1996. The terms of the Debt Placement also place certain restrictions on the ability of the Company to pay dividends or make other restricted payments, incur additional indebtedness, issue guarantees, sell assets, or enter into certain other specified transactions.

b) Two of the Company's subsidiaries have collateralized asset-based lending agreements with separate financial institutions aggregating \$17 million. Borrowings are limited to varying percentages of accounts receivable and inventory, as defined, and bear interest at rates of .75% to 3%, respectively, in excess of the financial institutions' respective prime lending rates. The terms of such agreements expire in 1999 and 1998, respectively. Such loans are guaranteed by substantially all the assets of the respective subsidiaries, and additionally contain certain limited guarantees of WCI aggregating \$5.2 million. At December 31, 1995 and 1996, the aggregate outstanding balances under these agreements were \$7.4 million and \$9.8 million, respectively.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 7--LONG-TERM DEBT (CONTINUED)

On October 8, 1996, in connection with the purchase of Locate (see Note 2), the Company issued two promissory notes in the aggregate principal amount of \$17.5 million (the "Locate Notes") bearing interest at an annual rate of 8%. Interest on the Locate Notes is payable on a quarterly basis. The Notes are due on the earlier of April 8, 1997, or the day after the date on which the shares into which the Notes may be converted have been registered pursuant to an effective registration statement. The Company may convert the Locate Notes, in whole but not in part, at its election, into that number of shares of the Company's common stock equal to (a) the principal amount and all accrued and unpaid interest on the Locate Notes divided by (b) the average of the closing prices of the Company's common stock for the five days ending on the date on which the Company gives written notice of its decision to convert the Locate Notes. Locate has no rights of conversion. The Company has granted certain registration rights to Locate with respect to such shares of its common stock in the event that the Company elects such conversion. The Company may convert the Locate Notes, and accordingly, in December 1996, the Company filed a registration statement to register such underlying shares. At December 31, 1996, the aggregate amount of the Locate Notes, including accrued interest thereon, was \$17.8 million.

In May 1995, a subsidiary of the Company issued \$7.5 million of five year collateralized convertible notes (the "Notes") bearing interest at a rate of 7%, payable semiannually, with all principal due and payable on May 24, 2000. On December 28, 1995, the note holders converted \$3.75 million of the convertible notes and accrued interest thereon into 539,255 shares of common stock of the Company, and on November 24, 1996, converted the remaining outstanding Notes of \$3.75 million principal amount plus accrued interest thereon into 554,880 shares of common stock of the Company.

Following are maturities of long-term debt for each of the next five years ending December 31,

	(IN THOUSANDS)
1997.....	\$19,901
1998.....	246
1999.....	8,561
2000.....	<u>191</u>
	<u>\$28,899</u>

NOTE 8--FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of the Company's financial instruments classified as current assets or liabilities, including cash and cash equivalents, short-term investments, accounts and notes receivable, and accounts payable and accrued expenses approximate carrying value, principally because of the short maturity of these items. Marketable equity securities are stated at quoted market value.

The carrying amounts of the long-term debt payable to financial institutions issued pursuant to two of the Company's subsidiaries' asset-based lending agreements approximate fair value because the interest rates on these agreements change with market interest rates.

The fair values of capitalized lease obligations approximate carrying value based on their effective interest rates compared to current market rates.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 8--FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED) Estimated fair values of the Company's Senior Notes Payable and Convertible Notes Payable are as follows:

	DECEMBER 31, 1995		DECEMBER 31, 1996	
	CARRYING AMOUNT	FAIR VALUE	FAIR VALUE	CARRYING AMOUNT
	FAIR VALUE			
	(IN THOUSANDS)			
Senior Notes Payable.....	\$153,972	\$153,972	\$176,328	\$179,455
Convertible Notes Payable.....	76,986	76,986	88,164	94,141

NOTE 9--CAPITAL LEASE OBLIGATIONS

The Company leases telecommunications and other equipment through various equipment lease financing facilities. Such leases have been accounted for as capital leases in accordance with Statement of Financial Accounting Standards No. 13, "Accounting for Leases."

Future minimum lease payments on these capital leases are as follows:

YEAR ENDING DECEMBER 31.	(IN THOUSANDS)
1997.....	\$4,727
1998.....	4,485
1999.....	4,074
2000.....	3,065
2001.....	1,203
	17,554
Less amount representing interest.....	(3,570)
Present value of minimum lease payments.....	\$13,984

The carrying value of assets under capital leases was \$8.1 million and \$15.9 million at December 31, 1995 and 1996, respectively, and is included in property and equipment. Amortization of these assets is included in depreciation expense.

NOTE 10--COMMITMENTS AND CONTINGENCIES

A. OPERATING LEASES

The Company's offices, manufacturing and warehousing facilities, along with various equipment and roof access rights, are leased under operating leases expiring in 1997 through 2006. Certain leases contain escalation clauses based upon increases in the consumer price index.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 10--COMMITMENTS AND CONTINGENCIES (CONTINUED) Future minimum lease payments on noncancellable operating leases are as follows:

YEAR ENDING DECEMBER 31,	(IN THOUSANDS)
1997.....	\$6,405
1998.....	5,516
1999.....	5,201
2000.....	4,713
2001.....	4,128
Thereafter.....	<u>34,903</u>
	<u>\$60,866</u>

Rent expense for the year ended February 28, 1995, the ten month period ended December 31, 1995 and the year ended December 31, 1996 was \$500,000, \$1 million and \$4.4 million, respectively.

B. EMPLOYMENT CONTRACTS

Amounts due under employment contracts are as follows:

YEAR ENDING DECEMBER 31,	(IN THOUSANDS)
1997.....	\$3,135
1998.....	2,026
1999.....	1,430
2000.....	<u>305</u>
	<u>\$6,896</u>

C. LITIGATION

The Company occasionally receives inquiries from state authorities arising with respect to consumer complaints concerning the provision of telecommunications services, including allegations of unauthorized switching of long distance carriers and misleading marketing. The Company believes such inquiries are common in the long distance industry and addresses such inquiries in the ordinary course of business. In December 1996, the Federal Communications Commission ("FCC") and WinStar Gateway Network, Inc. ("WGN") entered into a consent decree which terminated an inquiry by the FCC into any alleged violations of unauthorized carrier conversions through the use of contest programs by certain of WGN's agents. The FCC commended WGN's efforts in identifying the problems caused by these agents and cited its proactive response in implementing self-directed remedial actions as a significant factor leading to the consent decree.

In June 1996, the Company commenced an action for declaratory judgment against a former officer of WGN, who had notified the Company of his belief that he was entitled to the issuance of certain shares of common stock of the Company (or payment of the cash value thereof) having an aggregate market value in excess of \$27 million under the terms of stock options granted to him during his employment with WGN. He has based his beliefs on standard antidilution language contained in his stock option agreement. Such language was designed and intended to adjust the number of shares purchasable thereunder in the event of a merger, capital restructuring or other similar event of the Company. As the Company has never been subject to a merger or capital restructuring, the former officer was immediately notified of the Company's

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 10—COMMITMENTS AND CONTINGENCIES (CONTINUED) belief that his claim was without merit in law or fact. To expedite resolution of these issues, the Company currently is seeking declaratory judgment that it has no obligation to the former officer.

The Company is also involved in miscellaneous claims, inquiries and litigation arising in the ordinary course of business. The Company believes that these matters, taken individually or in the aggregate, would not have a material adverse impact on the Company's financial position or results of operations.

D. OTHER

In connection with the purchase of telecommunications equipment including switches and radios, the Company enters into agreements with the suppliers of such equipment. As of December 31, 1996, the Company's noncancellable purchase commitments under these agreements were approximately \$26.4 million.

In connection with the purchase of three 38 GHz licenses, covering certain geographic areas in the metropolitan areas which include Dallas, Baltimore and Philadelphia, the Company has entered into commitments to pay \$498,000 during the year ended December 31, 1997, subject to approval by the FCC of the purchase of the licenses.

NOTE 11—INCOME TAXES

SFAS No. 109 requires the use of the liability method in accounting for income taxes. Temporary differences and carryforwards that give rise to deferred tax assets and liabilities are as follows:

	PRO FORMA WITH MILLIWAVE (NOTE 2) (UNAUDITED)		
	DECEMBER 31, 1995	DECEMBER 31, 1996	DECEMBER 31, 1996
	(IN THOUSANDS)		
Deferred Tax Assets:			
Net Operating Loss Carryforward	\$14,700	\$48,218	\$48,218
Deferred Interest Expense	1,562	10,417	10,417
Allowance for Doubtful Accounts	1,025	433	433
Other	1,015	961	961
Gross Deferred Tax Assets	18,302	60,029	60,029
Valuation Allowance	(18,000)	(58,586)	(28,087)
Deferred Tax Asset Net of Allowance	302	1,443	31,942
Deferred Tax Liabilities:			
Depreciation	(302)	(1,354)	(1,354)
Amortization	=	(89)	(57,088)
Gross Deferred Tax Liabilities	(302)	(1,443)	(58,442)
Net Deferred Tax Liability	\$=	\$=	(\$26,500)

The federal net operating loss carryforward at December 31, 1996 is approximately \$127 million. If not utilized, the net operating loss carryforward will expire in various amounts through the year 2011.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 11--INCOME TAXES (CONTINUED)

Some, if not all, of these losses are subject to a utilization limitation under Section 382 of the Internal Revenue Code. However, the Company believes that substantially all of such losses will be available to offset future income.

SFAS No. 109 requires a valuation allowance against deferred tax assets if, based on the weight of available evidence, it is more likely than not that some or all of the deferred tax assets may not be realized. The valuation allowance at December 31, 1995 and December 31, 1996, primarily pertains to uncertainties with respect to future utilization of net operating loss carryforwards.

The pro forma net deferred tax liability of \$26.5 million was recorded in connection with the acquisition of Milliwave (see Note 2). This deferred tax liability results from the temporary difference between the book and tax basis of the acquired licenses, and relates to the scheduled reversal of the temporary differences through amortization in years 2018 through 2036 that cannot be offset by deferred tax assets existing at January 2, 1997, the date of the Milliwave acquisition.

NOTE 12--STOCKHOLDERS' EQUITY

COMMON STOCK

The authorized capital stock of WCI includes 75 million shares of common stock, \$.01 par value. The holders of common stock of WCI are entitled to one vote for each share held of record on all matters submitted to a vote of stockholders. Although the Company has no present intention of paying any dividends, holders of its common stock are entitled to receive ratably such dividends as may be declared by the Board of Directors out of funds legally available therefor. In the event of a liquidation or dissolution of WCI, holders of its common stock are entitled to share ratably in all assets remaining after payment of liabilities and the liquidation preference of preferred shares. Holders of WCI's common stock have no preemptive rights and have no rights to convert their common stock into any other securities. There are no redemption or sinking fund provisions applicable to the common stock of WCI.

PREFERRED STOCK

The authorized capital stock of the Company includes 15 million shares of preferred stock, \$.01 par value, which may be issued from time to time in one or more series upon authorization by the Company's Board of Directors. As of December 31, 1996, there are no shares of preferred stock outstanding. The Board of Directors, without further approval of the stockholders, is authorized to fix the rights and terms, conversion rights, voting rights, redemption rights and terms, liquidation preferences and any other rights, preferences, privileges and restrictions applicable to each series of preferred stock.

In April 1995, the Company completed a private placement of 932,040 shares of Series E Convertible Preferred Stock ("Preferred Stock E") at a price of \$6.4375 per share, for gross proceeds of \$6 million. Preferred Stock E holders were entitled to dividends at the rate of 9% per annum, payable quarterly beginning on June 30, 1995. During the ten month period ended December 31, 1995, the entire 932,040 shares of Preferred Stock E were converted into 634,228 shares of common stock.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 12-STOCKHOLDERS' EQUITY (CONTINUED) TREASURY STOCK

Included in treasury stock at cost at December 31, 1995 were 2,506,763 shares of common stock and 689 shares of Preferred Stock B which were acquired in the Private Exchange transaction and retired during 1996 (see Note 14).

NOTE 13-STOCK OPTIONS AND STOCK PURCHASE WARRANTS

In 1990, the Board of Directors adopted a non-qualified common stock incentive plan, as amended, pursuant to which options to purchase an aggregate of 150,000 shares of common stock may be granted to key employees of the Company as selected by the Board of Directors. The exercise price for shares covered by options granted pursuant to this plan will not be less than the fair market value of the shares on the date of the grant. In 1992, the Board of Directors adopted and stockholders approved the 1992 Performance Equity Plan ("1992 Plan"), which authorizes the granting of awards up to 1 million shares of common stock to the Company's key employees, officers, directors and consultants. In 1996, the Board of Directors adopted and the stockholders approved an increase in the number of shares available for grant under this plan to 1.5 million. Awards consist of stock options (both non-qualified options and options intended to qualify as "incentive" stock options under the Internal Revenue Code), restricted stock awards, deferred stock awards, stock appreciation rights and other stock-based awards. The plan provides for automatic issuance of 10,000 stock options annually to each director on January 13, at the fair market value at that date, subject to availability. In June 1995, the Board of Directors adopted the 1995 Performance Equity Plan ("1995 Plan") which was approved by the stockholders of the Company at the Annual Meeting of Stockholders in September 1995. The 1995 Plan authorizes the granting of awards of up to 1.5 million shares of the Company's common stock to the Company's key employees, officers, directors and consultants. The 1995 Plan is similar to the 1992 Plan, except that the 1995 Plan does not allow for annual automatic annual director grants. In 1996, the Board of Directors and the stockholders approved an increase in the number of shares available for grant to 3.5 million. In addition to these three plans, the Company has granted options to certain individuals not under any plan. The options are exercisable over a period ranging from immediately to four years, depending on option terms.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 13--STOCK OPTIONS AND STOCK PURCHASE WARRANTS (CONTINUED) The following table summarizes option activity for the year ended December 31, 1996, the ten-month period ended December 31, 1995, and the year ended February 28, 1995.

	NUMBER OF OPTIONS	WEIGHTED AVERAGE EXERCISE PRICE
	(IN THOUSANDS)	
Balance, February 28, 1994	5,018	\$2.08
Granted	2,851	5.76
Exercised	(1,390)	2.36
Canceled	(330)	6.06
Balance, February 28, 1995	6,149	3.85
Granted	3,896	9.13
Exercised	(2,092)	2.35
Canceled	(708)	3.21
Balance, December 31, 1995	7,245	6.90
Granted	4,057	18.55
Exercised	(921)	6.00
Canceled	(669)	12.72
Balance, December 31, 1996	9,712	\$11.43

As of December 31, 1996, options outstanding for 3.8 million shares were exercisable at prices ranging from \$1.50 to \$31.13, and the weighted remaining contractual life was 4.6 years.

The following table summarizes option data as of December 31, 1996:

RANGE OF EXERCISE PRICES	NUMBER OUTSTANDING AS OF 12/31/96	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER EXERCISEABLE AS OF 12/31/96	WEIGHTED AVERAGE EXERCISE PRICE
	(IN THOUSANDS)			(IN THOUSANDS)	
\$1.50 - \$6.00	3,260	3.5	\$4.20	2,766	\$3.97
\$6.06 - \$15.88	3,255	4.5	10.59	1,031	9.21
\$16.00 - \$31.13	3,197	5.4	19.66	466	18.69
\$1.50 - \$31.13	9,712	4.5	\$11.43	4,263	\$6.85

Compensation cost charged to operations, which the Company records for options granted to non-employees, was \$150,000 and \$0 in the year ended December 31, 1996 and the ten months ended December 31, 1995, respectively.

The Company measures compensation in accordance with the provisions of APB Opinion No. 25 in accounting for its stock compensation plans. Accordingly, no compensation cost has been recorded for options granted to employees or directors in the year ended December 31, 1996 or the ten months ended

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 13--STOCK OPTIONS AND STOCK PURCHASE WARRANTS (CONTINUED) December 31, 1995. The fair value of each option granted has been estimated on the grant date using the Black-Scholes Option Valuation Model. The following assumptions were made in estimating fair value:

Dividend Yield.....	0%
Risk-Free Interest Rate.....	6.0%
Expected Life after Vesting Period.....	2.0 Years
- Directors and Officers.....	0.5 Years
- Others.....	66.88%
Expected Volatility.....	

Had compensation cost been determined under FASB Statement No. 123, net loss and loss per share would have been increased as follows:

	TEN MONTHS ENDED DECEMBER 31, 1995	YEAR ENDED DECEMBER 31, 1996
--	--	------------------------------------

(IN THOUSANDS)

Net Loss		
As reported.....		
Pro forma for FASB No. 123.....	\$ (15,857)	\$ (83,723)
	(21,795)	(98,765)
Loss Per Share		
As reported.....		
Pro forma for FASB No. 123.....	(0.70)	(3.00)
The weighted average fair value of options granted during 1996 was \$18.78 per share.	\$ (0.96)	\$ (3.54)

During the initial phase-in period of FASB Statement No. 123, such compensation expense may not be representative of the future effects of applying this statement.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 13--STOCK OPTIONS AND STOCK PURCHASE WARRANTS (CONTINUED)

Warrants to purchase the Company's common stock were issued as follows (warrants in thousands):

	YEAR ENDED FEBRUARY 28, 1994		10 MONTHS ENDED DECEMBER 31, 1995		YEAR ENDED DECEMBER 31, 1996	
	WARRANTS	PRICE/SHARE	WARRANTS	PRICE/SHARE	WARRANTS	PRICE/SHARE
Beginning Balance	5,836	\$0.67-\$3.75	--	--	400	\$12.00-\$13.00
Warrants Issued	1,041	\$2.24-\$3.75	400	\$12.00-\$13.00	--	--
Warrants Exercised	(6,568)	\$0.67-\$3.75	--	--	--	--
Warrants Expired	(309)	\$3.00-\$3.75	--	--	--	--
Ending Balance	--	--	400	\$12.00-\$13.00	400	\$12.00-\$13.00

NOTE 14--RELATED PARTY TRANSACTIONS

SERVICES AGREEMENTS

In connection with the Company's merger with Milliwave, the Company entered into a Services Agreement with Milliwave in June 1996. Under the Services Agreement, a subsidiary of the Company installed radio links and managed Milliwave's communications network. Total fees under the Services Agreement and equipment sales paid by Milliwave to the Company were \$1.5 million through December 31, 1996.

In connection with the Company's purchase of certain assets of Locate, the Company entered into a Services Agreement with Locate in April 1996. Under the Agreement, the Company provided consulting services to Locate regarding the operation of Locate's business. During the year ended December 31, 1996, Locate paid the Company approximately \$352,000 under the Services Agreement.

MANAGEMENT AGREEMENT

The Company and WinStar Services, a wholly owned subsidiary of WinStar Companies, a corporation of which two of the Company's directors are principal officers and stockholders, were parties to a five-year management agreement which provided, as amended, that WinStar Services would render financial, advisory and management services in connection with the capital, acquisition and planning needs of the Company. During the year ended February 28, 1995, an aggregate of \$254,560 was paid to WinStar Services by the Company as management fees and reimbursement of expenses. Additionally, the Company paid \$481,039 in cash and issued notes amounting to \$481,038 in payment of contingent performance fees to WinStar Services during the year ended February 28, 1995. These contingent performance fees related to specific debt and equity financing and investment transactions in excess of \$33.6 million. During the year ended February 28, 1995, all such notes were satisfied when they were used to pay for the exercise of warrants and stock options held by WinStar Services and its affiliates. See "Private Exchange Transaction" below.

The management agreement was terminated as of February 28, 1995.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 14--RELATED PARTY TRANSACTIONS (CONTINUED) PRIVATE EXCHANGE TRANSACTION

On November 29, 1995, the Company acquired, in exchange for the issuance of 3,741,224 shares of its common stock ("Private Exchange"), substantially all of the assets of WinStar Companies, whose assets consisted of (i) all the outstanding capital stock of WinStar Services and WinStar Venture, two wholly owned subsidiaries of WinStar Companies, and (ii) 389,580 shares of the Company's common stock owned by WinStar Companies. The sole assets of WinStar Services and WinStar Venture were 2,117,183 shares of the Company's common stock and other securities of the Company that were exercisable or convertible into 1,429,633 shares of the Company's common stock. Accordingly, the Company issued 3,741,224 shares of the Company's common stock and, in exchange, acquired 3,936,396 shares of common stock and common stock equivalents. All of the Company's common stock and certain of the common stock equivalents received in the Private Exchange were included in Treasury Stock at December 31, 1995 and were retired in 1996. WinStar Companies, WinStar Services and WinStar Venture had no liabilities at the time of the closing of the Private Exchange other than a liability previously assumed by the Company or liabilities for which the Company is being indemnified. No claims for any liabilities have been received by the Company.

The new shares of the Company's common stock issued in the Private Exchange represented that number of shares which had an aggregate market value based upon the average of the closing sale price of the Company's common stock on the 30 trading days preceding November 15, 1995, the date as of which the exchange agreement regarding the above-described transaction was executed, equal to the market value of the Company's common stock (i) transferred by WinStar Companies to the Company, (ii) owned by WinStar Services and WinStar Venture and (iii) underlying certain other securities of the Company owned by WinStar Services and WinStar Venture which were convertible into or exercisable for shares of the Company's common stock, less the aggregate exercise price of such latter securities.

The stockholders of WinStar Companies included several of the Company's current executive officers and directors. Simultaneously with the Private Exchange, WinStar Companies was dissolved and the new shares issued in the Private Exchange were issued directly to the stockholders of WinStar Companies in proportion to their equity ownership of WinStar Companies.

The Private Exchange was considered and approved by a special committee of independent and disinterested directors of the Company and an opinion from an independent investment banking firm that the Private Exchange was fair to the Company and its stockholders was obtained in connection with the Private Exchange.

SGC CONSULTING AGREEMENT

In November 1993 and as subsequently amended, the Company entered into a consulting agreement with SGC Services ("SGC"), a telecommunications consulting firm pursuant to which SGC received a monthly fee of \$17,500 and options to purchase 175,000 shares of the Company's common stock. The President and Director of SGC is currently a Director and employee of the Company. Under this consulting agreement, SGC was entitled to receive a cash fee equal to 5% of the consideration paid in connection with certain transactions introduced to the Company by SGC.

In connection with investments by the Company in Avant-Garde and The Winning Line, Inc. ("TWL"), a producer of sports-related radio programming, both of which businesses were introduced to the Company by SGC, SGC was paid fees by Avant-Garde and by TWL. Additionally, in connection with

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 14--RELATED PARTY TRANSACTIONS (CONTINUED) the Company's acquisition of its equity interest in Avant-Garde, such Director was paid a fee by the principal of Avant-Garde equal to 4.0% of the total consideration received by such principal from the Company in connection with the acquisition. The Company paid no fees to SGC in connection with such transactions, but the fees received by SGC and such Director from Avant-Garde and TWL were credited against the monthly fees payable to SGC by the Company.

Fees and expenses paid to SGC during the year ended February 28, 1995 were \$119,000. The consulting agreement was terminated in January 1995 in connection with the execution of such Director's employment agreement with the Company.

AGREEMENT WITH ITC GROUP, INC.

In May 1994, the Company, WinStar Wireless, Inc. ("WWI") and ITC Group, Inc. ("ITC"), a telecommunications consulting firm, entered into a two-year agreement pursuant to which ITC advised the Company on the operations of its telecommunications business. ITC, together with the management and employees of WWI, developed and implemented a two-year operating plan for the Company's wireless telecommunications business. Pursuant to the terms of the consulting agreement, ITC made its consultants available to the Company and its subsidiaries. The Company paid ITC an annual base consulting fee of \$700,000 for the services of a core management team, as well as supplemental fees at agreed upon rates for additional consulting services rendered by ITC as necessary from time to time. Under the terms of the agreement, ITC provided up to 12 consultants at any given time. During the year ended February 28, 1995 and through September 1995, ITC was paid \$1.5 million and \$1 million, respectively, in fees and expenses in connection with the consulting agreement, the Company granted options to purchase an aggregate of 500,000 shares of its common stock for \$4.41 per share to certain consultants of ITC.

Effective September 5, 1995, ITC's President became President and Chief Operating Officer of the Company and certain core management personnel previously provided by ITC also became employees. Concurrently, ITC ceased providing services to the Company under the consulting agreement, and the Company's obligation to pay any future compensation to ITC under such agreement was terminated.

NOTE 15--SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for interest during the year ended February 28, 1995, the ten months ended December 31, 1995, and the year ended December 31, 1996 was \$621,000, \$1.3 million and \$2.1 million, respectively. During the year ended December 31, 1996, the Company capitalized \$300,000 of interest incurred in connection with the buildout of its telecommunications network. No interest was capitalized in the ten months ended December 31, 1995 or the year ended February 28, 1995.

During the year ended February 28, 1995, the Company completed the following material noncash transactions: (i) the conversion of the Series D and Series E Warrants through the assignment of notes payable and accrued interest; (ii) the satisfaction of approximately \$600,000 in notes payable through the exercise of stock options; (iii) conversions of Preferred Stock Series B, C, and D; (iv) the acquisition of approximately \$740,000 in property and equipment through various capitalized leases; and (v) the issuance of 28,572 shares of its common stock valued at \$200,000, in connection with an acquisition.

During the ten months ended December 31, 1995, the Company completed the following material noncash transactions: (i) the conversion of \$3.75 million of convertible notes plus accrued interest thereon; (ii) the conversion of Preferred Stock Series E; (iii) the acquisition of approximately \$7.5 million in

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 15--SUPPLEMENTAL CASH FLOW INFORMATION (CONTINUED) property and equipment through various capitalized leases; (iv) the Private Exchange transaction (see Note 14); (v) the settlement of the Company's placement expenses from the gross proceeds of the Debt Placement; and (vi) the acquisition of Avant-Garde.

During the year ended December 31, 1996, the Company completed the following material noncash transactions: (i) the conversion of \$3.75 million of convertible notes plus accrued interest; (ii) the acquisition of \$8.6 million in property and equipment through various capitalized leases; (iii) the issuance of 100,605 shares and share equivalents, with a value of \$1.5 million, and \$800,000 in notes payable in connection with certain acquisitions (see Note 2); (iv) the issuance of \$17.5 million in notes payable for the acquisition of Locate; and (v) the acceptance of 150,000 shares of the Company's common stock for payment of stock options exercised. Depreciation and amortization includes amortization of deferred compensation.

NOTE 16--ADVERTISING COSTS

Advertising costs are charged to operations when the advertising first takes place. Advertising expense for the year ended February 28, 1995, the ten months ended December 31, 1995, and the year ended December 31, 1996 was approximately \$200,000, \$500,000 and \$4.3 million, respectively.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 17—BUSINESS SEGMENTS

The Company's business segments are telecommunications, information services, and merchandising. The following table is a summary of these segments for the year ended February 28, 1995, the ten months ended December 31, 1995 and the year ended December 31, 1996:

	TELECOMMUNI- CATIONS	INFORMATION SERVICES	MERCHANDISING	TOTAL BUSINESS SEGMENTS	GENERAL CORPORATE	CONSOLIDATED
	(IN THOUSANDS)					
For the year ended February 28, 1995						
Net sales	\$14,909	\$473	\$10,183	\$25,565	\$—	\$25,565
Operating income (loss)	(4,984)	(157)	216	(4,925)	(944)	(5,869)
EBITDA	(4,560)	(150)	461	(4,249)	(930)	(5,179)
Depreciation and amortization	392	7	245	644	14	658
Capital expenditures	1,329	4	287	1,620	196	1,816
Identifiable assets at February 28, 1995	\$14,594	\$4,219	\$6,911	\$25,724	\$3,785	\$29,509
For the ten months ended December 31, 1995						
Net sales	\$13,137	\$2,648	\$13,986	\$29,771	\$—	\$29,771
Operating income (loss)	(7,288)	217	681	(6,390)	(3,861)	(10,251)
EBITDA	(6,358)	241	923	(5,194)	(3,758)	(8,952)
Depreciation and amortization	930	24	242	1,196	104	1,300
Capital expenditures	7,458	14	529	8,001	651	8,652
Identifiable assets at December 31, 1995	\$36,998	\$20,195	\$10,459	\$67,652	\$217,711	\$285,363
For the year ended December 31, 1996						
Net sales	\$33,969	\$14,650	\$19,429	\$68,048	\$—	\$68,048
Operating loss	(43,698)	(1,409)	(42)	(45,149)	(11,373)	(56,522)
EBITDA	(39,206)	(890)	294	(39,802)	(9,796)	(49,598)
Depreciation and amortization	3,831	469	330	4,630	202	4,832
Capital expenditures	46,632	701	119	47,452	509	47,961
Identifiable assets at December 31, 1996	\$101,380	\$30,133	\$15,248	\$146,761	\$143,462	\$290,223

EBITDA represents operating income (loss) plus interest, taxes, depreciation and amortization.

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 18—QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

The unaudited quarterly financial data for 1996 for the Company is as follows:

	<u>QUARTER ENDED</u>			
	<u>MARCH 31</u>	<u>JUNE 30</u>	<u>SEPTEMBER 30</u>	<u>DECEMBER 31</u>
	(IN THOUSANDS)			
Operating revenues				
Telecommunications services	\$10,217	\$10,356	\$7,384	\$6,012
Information services	771	2,652	4,056	7,171
Other	<u>3,521</u>	<u>3,166</u>	<u>5,857</u>	<u>6,885</u>
Total operating revenues	<u>14,509</u>	<u>16,174</u>	<u>17,297</u>	<u>20,068</u>
Operating expenses				
Cost of services and products	9,052	11,304	13,280	18,500
Selling, general and administrative expenses	9,853	15,659	17,297	24,879
Depreciation and amortization	<u>558</u>	<u>745</u>	<u>1,215</u>	<u>2,230</u>
Total operating expenses	<u>19,461</u>	<u>27,708</u>	<u>31,792</u>	<u>45,609</u>
Operating loss	(4,952)	(11,534)	(14,495)	(25,541)
Other expense				
Interest expense	8,803	9,183	9,233	10,257
Interest income	<u>(3,056)</u>	<u>(2,601)</u>	<u>(2,516)</u>	<u>(2,102)</u>
Net loss	<u>\$ (10,699)</u>	<u>\$ (18,116)</u>	<u>\$ (21,212)</u>	<u>\$ (33,696)</u>
Net loss per share	<u>\$ (0.39)</u>	<u>\$ (0.65)</u>	<u>\$ (0.75)</u>	<u>\$ (1.18)</u>
Weighted average shares outstanding	<u>27,214</u>	<u>27,720</u>	<u>28,133</u>	<u>28,551</u>

The financial data presented above reflects certain reclassifications from the amounts presented in the Company's filings on form 10-Q for the periods ending March 31, June 30 and September 30, 1996. The reclassifications principally relate to the breakout of revenues by operating segment and the reclassification of certain telecommunication network costs from the selling, general and administrative caption to the cost of services and products caption.

NOTE 19—SUBSEQUENT EVENTS TO DECEMBER 31, 1996 (UNAUDITED)

AGREEMENT TO PURCHASE ADDITIONAL LICENSES

On January 28, 1997, the Company executed agreements to acquire 47 additional 38 GHz licenses, subject to FCC approval. The total purchase price for the licenses will be \$16 million, payable in the Company's common stock, which will be priced at the time of closing. The acquisitions are expected to close within approximately one year. In addition, the Company agreed to purchase additional 38 GHz licenses, subject to FCC approval, which may be granted with respect to certain license applications currently on file with the FCC.

ISSUANCE OF CONVERTIBLE PREFERRED STOCK

On February 11, 1997, the Company sold 4 million shares of 6% Series A cumulative convertible preferred stock, par value \$1.01, and 1.6 million warrants to purchase common stock of the Company, par

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

NOTE 19--SUBSEQUENT EVENTS TO DECEMBER 31, 1996 (UNAUDITED) (CONTINUED) value \$1.01, for gross proceeds of \$100 million. The preferred stock earns a 6% annual dividend, payable quarterly in kind, and matures on February 11, 2002.

Two million shares of the preferred stock are convertible beginning on August 11, 1997, at \$25 per share or, if the average closing sale price of the Company's common stock for the preceding twenty trading days is less than \$25, such average closing sale price, while the remainder becomes convertible on February 11, 1998, at \$25 per share or, if the average closing sale price of the Company's common stock for the preceding twenty trading days is less than \$25, such average closing sale price. On February 11, 2002, any preferred stock still outstanding will be automatically converted into shares of the Company's common stock, unless the Company elects to pay, in lieu of conversion, the equivalent value in cash.

The warrants are exercisable at \$25 per share, and expire on February 11, 2002. The Company has the right to call the warrants after February 11, 2001, if the Company's common stock price has exceeded \$40 on each of the previous twenty trading days.

DEBT PLACEMENT

On March 18, 1997, the Company and a wholly owned subsidiary of the Company issued an aggregate of \$300 million of notes in an institutional private placement (the 1997 Debt Placement). In addition, the Company obtained a commitment for an additional \$150 million facility which may be drawn by the Company beginning March 31, 1999, subject to certain operating and financial criteria.

The 1997 Debt Placement consisted of (i) \$100 million of the Company's 14.5% Senior Deferred Interest Notes due 2005 (the "New Senior Notes"), ranking PARI PASSU with the Company's Senior Discount Notes due 2005, and (ii) \$200 million of 12.5% Guaranteed Senior Secured Notes (the "Senior Secured Notes") which were issued by a wholly owned subsidiary and are unconditionally guaranteed by the Company. Interest on the New Senior Notes will accrue and compound semiannually through October 15, 2000, but will not be payable in cash. Interest will be payable on the New Senior Notes each April 15 and October 15 commencing April 15, 2001, through final maturity in 2005. Interest on the Senior Secured Notes is payable semiannually through maturity.

Under the terms of the 1997 Debt Placement, the Company is obligated to consummate an exchange offer with respect to the New Senior Notes and the Senior Secured Notes whereby these notes will be exchanged for new notes (the "New Notes") which will be identical in every respect to the original New Senior Notes and Senior Secured Notes except that the New Notes will be registered under the Securities Act of 1933. The terms of the 1997 Debt Placement also place certain restrictions on the ability of the Company to pay dividends or make other restricted payments, incur additional indebtedness, issue guarantees, sell assets, or enter into certain other specified transactions.

**REPORT OF INDEPENDENT CERTIFIED
PUBLIC ACCOUNTANTS ON SCHEDULES**

Board of Directors
WinStar Communications, Inc.

In connection with our audit of the consolidated financial statements of WinStar Communications, Inc. and Subsidiaries referred to in our report dated January 24, 1997, which is included in this Annual Report on Form 10-K, we have also audited Schedule II for the year ended February 28, 1995, the ten months ended December 31, 1995 and the year ended December 31, 1996.

In our opinion, this schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information required to be set forth therein.

GRANT THORNTON LLP

New York, New York
January 24, 1997

WINSTAR COMMUNICATIONS, INC. AND SUBSIDIARIES
SCHEDULE II-VALUATION AND QUALIFYING ACCOUNTS

<u>COLUMN A</u>	<u>COLUMN B</u>	<u>COLUMN C</u>	<u>COLUMN D</u>	<u>COLUMN E</u>
<u>DESCRIPTION</u>	<u>BALANCE AT BEGINNING OF PERIOD</u>	<u>ADDITIONS CHARGED TO COSTS AND EXPENSES</u>	<u>DEDUCTIONS</u>	<u>BALANCE AT END OF PERIOD</u>
Reserves deducted from assets to which they apply:				
Year ended February 28, 1995				
Allowance for doubtful accounts (a)	<u>\$357,843</u>	<u>\$893,857</u>	<u>\$427,991(b)</u>	<u>\$823,709</u>
Ten months ended December 31, 1995				
Allowance for doubtful accounts (a)	<u>\$823,709</u>	<u>\$887,425</u>	<u>\$911,403(b)</u>	<u>\$799,731</u>
Year ended December 31, 1996				
Allowance for doubtful accounts (a)	<u>\$799,731</u>	<u>\$1,872,164</u>	<u>\$1,670,015(b)</u>	<u>\$1,001,880</u>

(a) Deducted from accounts receivable

(b) Uncollectible accounts receivable charged against allowance

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ATTACHMENT G

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 1997

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE EXCHANGE ACT**

For the transition period from _____ to _____

Commission File Number: 1-10726

WINSTAR COMMUNICATIONS, INC.

(Exact name of small business issuer as specified in its charter)

Delaware 13-3585278
(State or other jurisdiction of (IRS Employer Identification No.)
incorporation or organization)

230 Park Ave., Suite 2700, New York, NY 10169
(Address of principal executive offices)

(212) 584-4000
(Registrant's telephone number)

(Former name, former address and former fiscal year end
if changed since last report)

Indicate by checkmark 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 X No _

State the number of shares outstanding of each of the issuer's classes of common stock, as of November 1, 1997: 33,869,000

FORM 10-Q

WINSTAR COMMUNICATIONS, INC.

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WinStar Communications, Inc.
Condensed Consolidated Balance Sheets
(in thousands)

	December 31, 1996	September 30, 1997
ASSETS		(unaudited)
Current assets		
Cash and cash equivalents	\$95,490	\$273,537
Short term investments	<u>26,997</u>	<u>29,232</u>
Cash, cash equivalents and short term investments	122,487	302,769
Investments in equity securities	688	--
Accounts receivable, net of allowance for doubtful accounts	13,150	26,196
Inventories	5,009	4,954
Prepaid expenses and other current assets	15,969	19,683
Net assets of discontinued operations	<u>3,814</u>	<u>5,015</u>
Total current assets	161,117	358,617
Property and equipment, net	62,572	155,025
Licenses, net	27,434	168,679
Intangible assets, net	12,955	14,998
Deferred financing costs	10,535	21,315
Other assets	<u>4,176</u>	<u>1,330</u>
Total assets	<u>\$278,789</u>	<u>\$719,964</u>
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities		
Current portion of long-term debt	\$19,901	\$1,910
Accounts payable and accrued expenses	29,442	46,961
Current portion of capitalized lease obligations	<u>3,110</u>	<u>6,667</u>
Total current liabilities	52,453	55,538
Capitalized lease obligations, less current portion	10,846	25,172
Long-term debt, less current portion	265,161	650,819
Deferred income taxes	=	<u>26,500</u>
Total liabilities	<u>328,460</u>	<u>758,029</u>
Commitments and contingencies		
Stockholders' equity (deficit)		
Preferred stock	--	42
Common stock, par value \$.01; authorized 75,000 and 200,000 shares, issued and outstanding 28,989 and 33,493, respectively	290	335
Additional paid-in-capital	75,436	252,647
Accumulated deficit	<u>(125,034)</u>	<u>(291,089)</u>
	(49,308)	(38,065)
Unrealized loss on investments	<u>(363)</u>	--
Total stockholders' equity (deficit)	<u>(49,671)</u>	<u>(38,065)</u>
Total liabilities and stockholders' equity (deficit)	\$278,789	\$719,964

See Notes to Condensed Consolidated Financial Statements

WinStar Communications, Inc.
Condensed Consolidated Statements of Operations
(in thousands, except per share data)
(unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	1996	1997	1996	1997
Operating revenues				
Telecommunications services - commercial	\$1,876	\$7,429	\$2,234	\$17,209
Telecommunications services - residential	5,508	1,740	25,723	6,701
Information services	<u>4,056</u>	<u>11,017</u>	<u>7,479</u>	<u>25,693</u>
Total operating revenues	<u>11,440</u>	<u>20,186</u>	<u>35,436</u>	<u>49,603</u>
Operating expenses				
Cost of services and products	9,250	19,621	25,103	48,488
Selling, general and administrative expenses	15,816	41,135	39,062	109,916
Depreciation and amortization	<u>1,158</u>	<u>7,077</u>	<u>2,329</u>	<u>15,474</u>
Total operating expenses	<u>26,224</u>	<u>67,833</u>	<u>66,494</u>	<u>173,878</u>
Operating loss	(14,784)	(47,647)	(31,058)	(124,275)
Other (expense) income				
Interest expense	(9,045)	(22,082)	(26,695)	(53,074)
Interest income	2,570	3,727	8,342	11,052
Other income	<u>=</u>	<u>2,219</u>	<u>=</u>	<u>2,219</u>
Net loss from continuing operations	(21,259)	(63,783)	(49,411)	(164,078)
Income (loss) from discontinued operations	<u>47</u>	<u>(1,500)</u>	<u>(616)</u>	<u>(1,977)</u>
Net loss	(21,212)	(65,283)	(50,027)	(166,055)
Preferred stock dividends	<u>=</u>	<u>(1,535)</u>	<u>=</u>	<u>(3,881)</u>
Net loss applicable to common stockholders		<u>\$ (21,212)</u>	<u>\$ (66,818)</u>	<u>\$ (169,936)</u>
Net loss per share from continuing operations	\$ (0.76)	\$ (1.97)	\$ (1.79)	\$ (5.10)
Net income (loss) per share from discontinued operations	<u>0.01</u>	<u>(0.04)</u>	<u>(0.02)</u>	<u>(0.06)</u>
Net loss per share	<u>\$ (0.75)</u>	<u>\$ (2.01)</u>	<u>\$ (1.81)</u>	<u>\$ (5.16)</u>
Weighted average shares outstanding	<u>28,133</u>	<u>33,188</u>	<u>27,691</u>	<u>32,923</u>

See Notes to Condensed Consolidated Financial Statements

WinStar Communications, Inc.
Condensed Consolidated Statements of Operations
(in thousands, except per share data)
(unaudited)

	For the three months ended September 30,		For the nine months ended September 30,	
	1996	1997	1996	1997
Operating revenues				
Telecommunications services - commercial	\$1,876	\$7,429	\$2,234	\$17,209
Telecommunications services - residential	5,508	1,740	25,723	6,701
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Operating expenses				
Cost of services and products	9,250	19,621	25,103	48,488
Selling, general and administrative expenses	15,816	41,135	39,062	109,916
Depreciation and amortization	<u>1,158</u>	<u>7,077</u>	<u>2,329</u>	<u>15,474</u>
Total operating expenses	<u>26,224</u>	<u>67,833</u>	<u>66,494</u>	<u>173,878</u>
Operating loss	(14,784)	(47,647)	(31,058)	(124,275)
Other (expense) income				
Interest expense	(9,045)	(22,082)	(26,695)	(53,074)
Interest income	2,570	3,727	8,342	11,052
Other income	<u>=</u>	<u>2,219</u>	<u>=</u>	<u>2,219</u>
Net loss from continuing operations	(21,259)	(63,783)	(49,411)	(164,078)
Income (loss) from discontinued operations	<u>47</u>	<u>(1,500)</u>	<u>(616)</u>	<u>(1,977)</u>
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Preferred stock dividends	<u>=</u>	<u>(1,535)</u>	<u>=</u>	<u>(3,881)</u>
Net loss applicable to common stockholders		<u>\$(21,212)</u>	<u>\$(66,818)</u>	<u>\$(169,936)</u>
Net loss per share from continuing operations	<u>\$(0.76)</u>	<u>\$(1.97)</u>	<u>\$(1.79)</u>	<u>\$(5.10)</u>
Net income (loss) per share from discontinued operations	<u>0.01</u>	<u>(0.04)</u>	<u>(0.02)</u>	<u>(0.06)</u>
Net loss per share	<u>\$(0.75)</u>	<u>\$(2.01)</u>	<u>\$(1.81)</u>	<u>\$(5.16)</u>
Weighted average shares outstanding	<u>28,133</u>	<u>33,188</u>	<u>27,691</u>	<u>32,923</u>

See Notes to Condensed Consolidated Financial Statements

WinStar Communications, Inc.
Condensed Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

For the Nine Months Ended
September 30,

	1996	1997
Cash flows from operating activities:	\$(50,027)	\$(166,055)
Net loss		
Adjustments to reconcile net loss to net cash used in operating activities:		
Net loss from discontinued operations	616	1,977
Depreciation and amortization	4,247	17,024
Provision for doubtful accounts	1,067	1,533
Non cash interest expense	24,630	35,825
(Increase) decrease in operating assets:		
Accounts receivable	(1,585)	(14,578)
Inventories	(1,383)	(3,875)
Prepaid expenses and other current assets (12,523)	(995)	581
Other assets		
Increase in accounts payable and accrued expenses	11,603	19,628
Net cash used in discontinued operations	(1,436)	(3,178)
Net cash used in operating activities	(25,786)	(115,683)
Cash flows from investing activities:	(28,468)	(2,235)
Increase in short-term investments, net	(29,618)	(103,885)
Purchase of property and equipment, net	96	(35,428)
Acquisitions	(1,355)	(1,401)
Other, net		
Net cash used in investing activities	(59,345)	(142,949)
Cash flows from financing activities:	(2,687)	319,404
(Repayments) of proceeds from long-term debt, net	5,492	99,691
Net proceeds from equity transactions	967	20,504
Proceeds from equipment lease financing	(1,231)	(2,620)
Payment of capital lease obligations	(970)	(300)
Other, net		
Net cash provided by financing activities	1,571	456,679
Net (decrease) increase in cash and cash equivalents	(83,560)	178,047
Cash and cash equivalents at beginning of period	138,028	95,490
Cash and cash equivalents at end of period	54,468	273,537
Short-term investments at end of period	108,510	29,232
Cash, cash equivalents and short-term investments at end of period	\$162,978	\$302,769

See Notes to Condensed Consolidated Financial Statements

I. Basis of Presentation

WinStar Communications, Inc. ("WinStar") is a facilities-based provider of telecommunication and information services to small and medium-sized businesses throughout the United States. It enables customers to connect with the nation's telephone system through broadband wireless circuits which utilize digital milliwave radio technology to carry voice, data and video traffic to the Company's network of switches. The deregulation of the nation's local and long distance industry, combined with rising demand for broadband services, is creating opportunities for WinStar in the greater than \$100 billion telecommunications market. WinStar's Wireless FiberSM services are being deployed in a phased manner to large metropolitan areas, and are scheduled to reach 30 of the most important telecommunications markets by the end of 1999. The Company currently serves local customers in 16 markets, and plans to have switched telecommunications services available in 21 cities by the end of 1998.

WinStar is the largest holder of radio spectrum in the United States, and is licensed by the Federal Communications Commission to utilize the 38 GHz frequency. WinStar is uniquely positioned to provide broadband connectivity due to the breadth of its spectrum holdings, which equate to 400 MHz to 700 MHz of bandwidth in 41 of the top markets in the country. In total, WinStar's 38 GHz licenses cover more than 125 cities with a population exceeding 100,000, and represent more than 775 million channel pops (number of 100 MHz channels multiplied by the population coverage).

WinStar's Wireless Fiber links function equivalently to optical fiber, but can be deployed with far greater speed and at much lower cost. Local, long distance, Internet and data services are being provided through these links, along with specialized information content for business and education. WinStar also offers a range of facilities-based broadband local access services ("Carrier Services") to other telecommunications companies.

The condensed consolidated financial statements presented herein include the accounts of WinStar and its subsidiaries, including its primary operating subsidiaries, WinStar Telecommunications, Inc., WinStar Wireless, Inc., WinStar New Media Company, Inc. and, as a discontinued operation, WinStar Global Products, Inc. ("Global Products"), (and together with such other subsidiaries, the "Company"). All material inter-company transactions and accounts have been eliminated in consolidation. The accounts have been prepared by the Company without audit.

However, the foregoing statements contain all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of the Company's management, necessary to present fairly the financial position of the Company as of September 30, 1997, the statements of operations for the three and nine months ended September 30, 1996 and 1997, and the statements of cash flows for the nine months ended September 30, 1996 and 1997.

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Wireless Fiber(sm) is a servicemark of WinStar Communications, Inc.

Certain information and footnote disclosures normally included in financial statements have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. These condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 1996, and the Company's quarterly reports on Form 10-Q for the periods ended March 31, 1997 and June 30, 1997.

The unaudited financial statements and related footnotes for the three and nine month periods ended September 30, 1996 reflect certain reclassifications such that they conform to the current period presentation. The results of operations for the three and nine months ended September 30, 1997 are not necessarily indicative of the results of operations for the year ending December 31, 1997.

2. Dividends on Convertible Preferred Stock

Dividends on the 6% Series A Cumulative Convertible Preferred Stock ("Series A Preferred Stock") since its issuance have been paid "in-kind" in additional shares of the Series A Preferred Stock.

3. Net Loss Per Share

Net loss per share has been calculated by dividing the net loss, after consideration of Preferred Stock dividends, by the weighted average number of shares outstanding during each period.

4. US ONE Asset Acquisition

On October 17, 1997 (the "Closing Date"), WinStar Switch Acquisition Corp. ("WSAC"), a wholly owned subsidiary of WinStar Communications, Inc. ("WinStar", and together with WSAC, the "WinStar Parties"), consummated a purchase ("Asset Acquisition") of certain telecommunications assets (the "US ONE Assets") from US ONE Communications Corp. ("US ONE"), US ONE Communications Services Corp. and US ONE Communications of New York, Inc. (each individually a "Seller" and collectively, the "Sellers"), pursuant to the terms of an asset purchase agreement. The Assets included 12 Lucent class 5 switching systems and other non-switch assets. The Asset Acquisition required and received the approval of the United States Bankruptcy Court, District of Delaware, because the Sellers are debtors in possession under Chapter 11 of the United States Bankruptcy Code of 1978, as amended.

The aggregate purchase price paid for the US ONE Assets was approximately \$81.1 million, of which approximately \$61.1 million was paid in cash at the closing and \$20 million is payable by the WinStar Parties in cash and/or shares of the common stock of WinStar, at WinStar's discretion, on the effective date of Sellers' confirmed plan of reorganization.

In order to finance the cash portion of the purchase price and to pay certain expenses, on the Closing Date, WSAC borrowed \$62.25 million (the "Loan") from Solomon Brothers Holding Company Inc. and Credit Suisse First Boston (together, the "Lenders"). The Loan maturity date is April 22, 1998; provided, however, that WSAC must prepay the Loan (or portions thereof) with the proceeds of any sale by it of the US ONE Assets and with proceeds obtained from certain financings. The Loan is guaranteed by WinStar and is secured by the telecommunications switches and related equipment, inventory and software included in the US ONE Assets. Interest on the agreement is payable monthly at variable rates ranging from prime plus 2% to LIBOR plus 3.5%.

5. October 1997 Notes

In October 1997, the Company issued \$100 million principal amount of unsecured, senior subordinated indebtedness (the "October 1997 Notes") ranking pari passu in right of payment with the Company's 14% Convertible Senior Subordinated Notes due 2005 and junior in right to all existing and future senior indebtedness of the Company. The October 1997 Notes bear interest at a rate of 15% per annum. Until March 1, 2002, interest on the October 1997 Notes accrues and compounds semiannually, but will not be payable in cash. Interest on the accumulated amount as of March 1, 2002 will be payable semiannually commencing September 1, 2002. The October 1997 Notes mature on March 1, 2007 and are redeemable by the Company on and after March 1, 2002, at its option, at certain defined prices.

6. Condensed Financial Information of WinStar Equipment Corp. and WinStar Equipment II Corp.

The Company's wholly-owned subsidiaries, WinStar Equipment Corp. and WinStar Equipment II Corp. ("WEC" and "WEC II", respectively), each of which is a special purpose corporation which was formed to facilitate the financing and purchase of telecommunications equipment and related property ("designated equipment"), received \$200 million and \$50 million in gross proceeds, respectively, from the issuance and sale of 12.5% Guaranteed Senior Secured Notes ("the WEC and WEC II Notes") in placements of debt in March and August of 1997, respectively. The use of the proceeds of the WEC and WEC II Notes are to be used to purchase designated equipment and, if such equipment is not purchased within a specified period, WEC and WEC II must apply unused proceeds thereof to redeem the WEC and WEC II Notes, respectively. Both the interest and principal of the WEC Notes are guaranteed by the Company.

WEC and WEC II have no independent operations other than to purchase designated equipment and to lease same to the Company's other telecommunications subsidiaries. Given this operating environment, it is unlikely, in the opinion of management, that WEC or WEC II will generate sufficient income, after the payment of interest on the WEC and WEC II Notes, to pay dividends or make other distributions to the Company.

Summary financial information of WEC and WEC II, which are included in the condensed consolidated financial statements of the Company, are as follows (in thousands):

Balance sheet information at September 30, 1997:

	<u>WEC</u>	<u>WEC II</u>
Current assets	\$159,367	\$47,419
Long term assets	\$47,841	\$2,660
Current liabilities	\$14,788	\$869
Long term liabilities	\$200,000	\$50,000

Statements of operations information for WEC for the three months ended September 30, 1997 and from its inception through September 30, 1997, and for WEC II for the period from its inception through September 30, 1997, are as follows (in thousands):

	<u>WEC</u>		<u>WEC II</u>
	Three Months Ended September 30, <u>1997</u>	Period from March 13, 1997 (Inception) to September 30, <u>1997</u>	Period from August 8, 1997 (Inception) to September 30, <u>1997</u>
Gross revenues	\$740	\$740	\$-
Interest expense	(6,159)	(12,609)	(920)
Interest income	<u>1,306</u>	<u>4,292</u>	<u>391</u>
Net loss	<u>\$ (4,113)</u>	<u>\$ (7,577)</u>	<u>\$ (529)</u>

Separate financial statements concerning WEC or WEC II are not presented because management of the Company has determined that such information would not provide any material information that is not already presented in the condensed consolidated financial statements of the Company.

7. Discontinued Operation - WinStar Global Products, Inc.

On May 13, 1997, a formal plan of disposal for the Company's consumer products subsidiary, WinStar Global Products, Inc. ("Global Products"), was approved by the Board of Directors and it is anticipated that the disposal will be completed within the next twelve months. The Company does not expect to incur a loss on the disposition of Global Products. The disposal of Global Products has been accounted for as a discontinued operation and, accordingly, its net assets have been segregated from continuing operations in the accompanying condensed consolidated balance sheets, and its operating results are segregated and reported as discontinued operations in the accompanying consolidated statements of operations and cash flows. Information relating to the discontinued operations of Global Products is as follows (in thousands of dollars):

	For The Three Months For The Nine Months			
	Ended September 30,		Ended September 30,	
	1996	1997	1996	1997
Operating revenues.....	<u>\$5,857</u>	<u>\$3,635</u>	<u>\$12,544</u>	<u>\$9,910</u>
Cost of services and products.....	4,029	3,015	8,531	7,560
Selling, general & administrative expenses.....	1,482	1,576	3,748	4,124
Depreciation and amortization.....	<u>57</u>	<u>58</u>	<u>188</u>	<u>174</u>
Total operating expenses.....	<u>5,568</u>	<u>4,649</u>	<u>12,467</u>	<u>11,858</u>
Operating income (loss).....	289	(1,014)	77	(1,948)
Interest expense.....	<u>(242)</u>	<u>(208)</u>	<u>(693)</u>	<u>(612)</u>
Net income (loss).....	<u>\$47</u>	<u>\$(1,222)</u>	<u>\$(616)</u>	<u>\$(2,560)</u>

During the three months ended September 30, 1997, the Company recorded a reserve of \$1,500,000 with respect to the operations of Global Products.

Net assets of the discontinued operations of Global Products at December 31, 1996 and September 30, 1997 are composed of the following (in thousands of dollars):

	December 31, 1996	September 30, 1997
Assets:		
Accounts Receivable, net	\$4,499	\$4,278
Inventories	8,606	10,601
Other Assets	<u>2,143</u>	<u>2,596</u>
Total Assets	<u>15,248</u>	<u>17,475</u>
Liabilities:		
Current Liabilities	3,102	3,273
Other Liabilities	<u>8,332</u>	<u>9,187</u>
Total Liabilities	<u>11,434</u>	<u>12,460</u>
Net Assets	<u>\$3,814</u>	<u>\$5,015</u>

8. New Accounting Pronouncement

In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, Earnings per Share, which is effective for financial statements for both interim and annual periods ending after December 15, 1997. The new standard eliminates primary and fully diluted earnings per share and requires presentation of basic and, if applicable, diluted earnings per share. Basic earnings per share is computed by dividing income available to common shareholders by the weighted average common shares outstanding and dilutive potential common shares such as stock options. The adoption of this new standard is not expected to have a material impact on the disclosure of earnings per share in the financial statements.

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

Company Overview

The Company provides a full range of telecommunications services as a CLEC, including local, long distance and Internet access services, to small and medium-sized businesses in major metropolitan areas in the United States. By exploiting its Wireless Fiber services and a switch-based infrastructure, the Company distinguishes itself as a facilities-based, value-added provider of high-capacity telecommunications services and an attractive alternative to established providers, such as the RBOCs. The Company also utilizes its Wireless Fiber capacity to provide its Carrier Services, consisting of a variety of facilities-based broadband, high-capacity local access and digital network services, to other telecommunications services providers. The Company acquires rights to and distributes information services and entertainment content as a complement to its telecommunications operations. The Company also operates a nonstrategic consumer products company, which is treated as a discontinued operation in this report.

During the third quarter of 1996, the Company launched its CLEC offering in New York City and has since introduced its local telecommunications services in 15 additional markets. The Company intends, during the next several years, to introduce its local exchange services in many of the other major metropolitan areas where it is licensed to provide 38 GHz services.

The Company's wholesale Carrier Services business constructs the network that will serve a significant portion of the local access and transport needs of the Company's CLEC business, including the origination and termination of local traffic for the Company's local exchange customers and backbone interconnections of hub and main switch sites.

In connection with the Company's rollout of its local telecommunications services, the Company also provides business information services to its CLEC customers. These services are marketed directly to end users and through the Company's direct sales force.

The Company significantly expanded its spectrum holdings ("Wireless Licenses") during the past 12 months with the completion of several acquisitions and the grant of a number of additional licenses by the FCC. The Company has entered into agreements to purchase an aggregate of 88 additional licenses in the 38 GHz spectrum, and, if granted, pursuant to pending applications, certain additional such licenses, all subject to FCC consent. Currently, the Wireless Licenses allow the Company to provide Wireless Fiber services in 49 of the 50 most populated MSAs in the United States. The Wireless Licenses currently cover more than 100 cities with populations exceeding 100,000 each, encompass an aggregate population of approximately 175 million people and address more than 625 million channels pops (population coverage multiplied by the number of 100 MHz channels). Upon completion of all pending acquisitions, which are subject to FCC consent, the Company's total population coverage will increase to approximately 185 million, its total channel pops will grow to more than 775 million and the Wireless Licenses will allow the Company to provide services in each of the 50 most populated MSAs in the United States.

Revenues

CLEC Services. CLEC revenues are driven primarily by the number of customer lines installed and in service. Customers generally are billed a flat monthly fee and/or a per-minute usage charge. Revenue growth depends on the addition of new customers and the sale of bundled services, such as long distance, Internet access and Internet-related services, and the introduction of such services in new cities.

The Company intends to develop other anticipated sources of revenue including resale agreements for CMRS, advanced data, broadband data transmission and video conferencing services. The Company believes that as its local exchange services business grows, such business will become the most significant component of the Company's revenues. Revenues from this segment were approximately \$6.5 million in the quarter ended September 30, 1997, versus \$4.0 million in the quarter ended June 30, 1997 and \$2.0 million the quarter ended March 31, 1997. The Company has already installed and is operating its own switches in New York City (which serves both New York City and Newark, New Jersey), Boston, Chicago, Dallas/Fort Worth, Los Angeles, San Diego and Washington, DC, with installation of additional switches in Atlanta, Baltimore, Houston, Philadelphia and Phoenix scheduled to be completed by the end of March 1998. In addition, in October 1997, the Company purchased 12 additional recently installed Lucent class 5 switches from US ONE, seven of which are in the following new markets for the Company: San Francisco, Denver, Seattle, Tampa, Minneapolis, Kansas City and Columbus, Ohio.

Carrier Services. Carrier Services revenues are driven primarily by the number and capacity (i.e., T-1s or DS-3s) of Wireless Fiber links in service. A key measure of progress for the Company is its installed and available Wireless Fiber capacity. The Company had approximately 156,000 voice-grade equivalent circuits in place as of September 30, 1997, up from approximately 130,000 at June 30, 1997. Carrier customers generally are billed at a fixed monthly rate per unit of capacity. Another key measure of progress is the number of buildings for which the Company has secured roof rights to install 38 GHz transceivers ("Roof Rights"). The Company's Roof Rights have been increasing in number and declining in average cost. As of October 31, 1997, the Company had secured Roof Rights on over 1,900 buildings.

Residential Long Distance Services. The Company is focusing on the sale of long distance services to small and medium-sized business customers as part of its CLEC business and is not generally marketing long distance services to residential customers on an active basis. As a result, the Company is allowing its revenues from residential long distance service to decline through attrition, as it focuses on its core small to medium-sized business market.

Information and Content. Information and content revenues are generated principally by: (i) sales of content and related services to traditional customers, such as cable networks and radio stations; (ii) sales to new media distribution channels, such as on-line services; (iii) advertising sales; and (iv) the bundling of content with the Company's telecommunications services. Revenues also are driven by the amount and quality of the Company's available program rights during each quarter with some seasonality of sales, which affect quarter-to-quarter comparability.

Three Months Ended September 30, 1997 Compared to Three Months Ended September 30, 1996

Revenues of the Company's operating segments are as follows (in millions):

	Three Months Ended September 30,	
	1996	1997
Telecommunications Services:		
CLEC Services	\$84	\$6,510
Carrier Services	1,792	919
Residential Long Distance	<u>5,508</u>	<u>1,740</u>
	7,384	9,169
Information Services	<u>4,056</u>	<u>11,017</u>
<u>Total Revenues</u>	<u>\$11,440</u>	<u>\$20,186</u>

Revenues increased by \$8.8 million, or 76.5%, for the three months ended September 30, 1997, to \$20.2 million, from \$11.4 million for the three months ended September 30, 1996. These revenues exclude those from WinStar Global Products, which has been reclassified as a discontinued operation. This increase was attributable to increased revenues generated by the Company's CLEC and information services businesses, partially offset by a decrease in carrier services revenues, which were lower as a result of non-recurring construction revenues recorded in the quarter ended September 30, 1996, and the expected decrease in residential long distance revenues.

Revenues from CLEC services, which include all commercial end user customer telecommunication revenues, were \$6.5 million in the quarter ended September 30, 1997, compared to \$4.0 million in the quarter ended June 30, 1997 and \$2.0 million in the quarter ended March 31, 1997. The CLEC business commenced operations in the second quarter of 1996. The Company has since been rapidly installing lines for small and medium-sized businesses, and, as of September 30, 1997, the CLEC business had installed over 51,000 lines, up from approximately 30,000 at June 30, 1997 and 13,000 at March 31, 1997. Customer line orders reached 77,000 lines as of September 30, 1997, up 79.1% from 43,000 as of June 30, 1997. As of September 30, 1997, the annualized revenues from the CLEC business were \$33 million, up from \$3 million annualized as of December 31, 1996.

Revenues from carrier services decreased \$0.9 million to \$0.9 million in the quarter ended September 30, 1997, as compared to \$1.8 million in the quarter ended September 30, 1996. Recurring revenues for billed circuits continue to grow, increasing 27.5% over the quarter ended June 30, 1997. The revenue decrease, however, was the result of non-recurring installation revenue and equipment sales related to contract services provided in the quarter ended September 30, 1996.

WinStar's residential long distance revenues decreased \$3.8 million to \$1.7 million in the quarter ended September 30, 1997, compared to \$5.5 million in the quarter ended September 30, 1996. This decrease was the result of WinStar's focus on its core business of selling communications services to business customers and to other carriers.

Revenues from information services increased by \$6.9 million, or 171.6%, for the three months ended September 30, 1997, to \$11.0 million, from \$4.1 million for the three months ended September 30, 1996, due to continued internal growth and acquisitions.

Cost of services and products increased by \$10.4 million, or 113.0%, for the three months ended September 30, 1997, to \$19.7 million, from \$9.3 million for the three months ended September 30, 1996. As a percentage of sales, cost of services and products in the quarter ended September 30, 1997 was 97.6%, compared with 80.9% in the quarter ended September 30, 1996, as a result of increasing network operating costs from the continued expansion of the Company's local telecommunications business.

Selling, general and administrative expense increased by \$25.2 million to \$41.0 million for the three months ended September 30, 1997, from \$15.8 million for the three months ended September 30, 1996. The Company continued to hire sales, marketing and related support personnel in connection with the accelerated roll out of its CLEC operations, which had approximately 150 employees at September 30, 1996 and over 800 at September 30, 1997. In addition, the Company increased spending on related advertising and marketing of its CLEC services.

Depreciation and amortization expense increased by \$5.9 million for the three months ended September 30, 1997, to \$7.1 million, from \$1.2 million for the three months ended September 30, 1996 principally resulting from the Company's acquisition and deployment of switches, radios and other equipment in connection with its telecommunications network buildout.

For the reasons noted above, the operating loss for the three months ended September 30, 1997, was \$47.7 million, compared with an operating loss of \$14.8 million for the three months ended September 30, 1996.

Interest expense increased by \$13.1 million, or 144.1%, for the three months ended September 30, 1997, to \$22.1 million, from \$9.0 million for the three months ended September 30, 1996. The increase was principally attributable to the proceeds from the Company's issuances of debt in the first and third quarters of 1997. \$13.5 million of the \$22.1 million interest expense for the quarter is not payable in cash until after 1999.

Interest income increased by \$1.1 million, or 45.0%, for the three months ended September 30, 1997, to \$3.7 million, from \$2.6 million for the three months ended September 30, 1996. The increase resulted from the additional interest income earned on the proceeds from the Company's preferred stock and debt placements which were completed in the first and third quarters of 1997.

For the reasons noted above, the Company reported a net loss from continuing operations of \$63.8 million for the three months ended September 30, 1997, compared to a net loss from continuing operations of \$21.3 million for the three months ended September 30, 1996.

Nine Months Ended September 30, 1997 Compared to Nine Months Ended September 30,
1996

Revenues of the Company's operating segments are as follows (in millions):

	Nine Months Ended September 30,	
	1996	1997
Telecommunications Services:		
CLEC Services	\$103	\$12,498
Carrier Services	2,131	4,711
Residential Long Distance	<u>25,723</u>	<u>6,701</u>
	27,957	23,910
Information Services	<u>7,479</u>	<u>25,693</u>
<u>Total Revenues</u>	<u>\$35,436</u>	<u>\$49,603</u>

Revenues increased by \$14.1 million, or 40.0%, for the nine months ended September 30, 1997, to \$49.6 million, from \$35.4 million for the nine months ended September 30, 1996. These revenues exclude those from WinStar Global Products, which have been reclassified as a discontinued operation. This increase was attributable to increased revenues generated by the Company's CLEC, carrier services and information services businesses, partially offset by an expected decrease in residential long distance revenues.

Revenues from CLEC services were \$12.5 million in the nine months ended September 30, 1997, and were minimal in the nine months ended September 30, 1996, as the CLEC business commenced operations in the second quarter of 1996.

Revenues from carrier services increased \$2.6 million to \$4.7 million in the nine months ended September 30, 1997, as compared to \$2.1 million in the nine months ended September 30, 1996. The revenue increase is the result of the growing number of billed circuits, along with installation revenue and equipment sales related to contract services provided.

WinStar's residential long distance revenues decreased \$19.0 million to \$6.7 million in the nine months ended September 30, 1997, compared to \$25.7 million in the nine months ended September 30, 1996. This decrease was the result of WinStar's focus on its core business of selling communications services to business customers and to other carriers.

Revenues from information services increased by \$18.2 million, or 243.5%, for the nine months ended September 30, 1997, to \$25.7 million, from \$7.5 million for the nine months ended September 30, 1996, due to continued internal growth and acquisitions.

Cost of services and products increased by \$23.5 million, or 93.5%, for the nine months ended September 30, 1997, to \$48.6 million, from \$25.1 million for the nine months ended September 30, 1996. As a percentage of sales, cost of services and products in the nine months ended September 30, 1997 was 97.9% compared with 70.8% in the nine months ended September 30, 1996, as a result of increasing network costs from the continued expansion of the Company's local telecommunications business.

Selling, general and administrative expense increased by \$70.8 million to \$109.9 million for the nine months ended September 30, 1997, from \$39.1 million for the nine months ended September 30, 1996. The Company continued to hire sales, marketing and related support personnel in connection with the accelerated roll out of its CLEC operations, which had only 150 employees at September 30, 1996 and over 800 at September 30, 1997. In addition, the Company increased spending on related advertising and marketing of its CLEC services.

Depreciation and amortization expense increased by \$13.2 million for the nine months ended September 30, 1997, to \$15.5 million, from \$2.3 million for the nine months ended September 30, 1996, principally resulting from the Company's acquisition and deployment of switches, radios and other equipment in connection with its telecommunications network buildout.

For the reasons noted above, the operating loss for the nine months ended September 30, 1997, was \$124.3 million, compared with an operating loss of \$31.1 million for the nine months ended September 30, 1996.

Interest expense increased 98.8%, for the nine months ended September 30, 1997, to \$53.1 million, from \$26.7 million for the nine months ended September 30, 1996. The increase was principally attributable to the proceeds from the Company's issuance of debt in the first and third quarters of 1997. \$35.9 of the \$53.1 million interest expense for the nine months is not payable in cash until after 1999.

Interest income increased by \$2.8 million, or 32.5%, for the nine months ended September 30, 1997, to \$11.1 million, from \$8.3 million for the nine months ended September 30, 1996. The increase resulted from the additional interest income earned on the proceeds from the Company's preferred stock placement and 1997 debt placement in the first and third quarters of 1997.

For the reasons noted above, the Company reported a net loss from continuing operations of \$164.1 million for the nine months ended September 30, 1997, compared to a net loss from continuing operations of \$49.5 million for the nine months ended September 30, 1996.

Liquidity and Capital Resources

In February 1997, the Company sold 4,000,000 shares of its 6% Series A Cumulative Convertible Preferred Stock and warrants to purchase 1,600,000 shares of Common Stock (the "Preferred Stock Placement"), pursuant to which the Company and one of its subsidiaries realized net proceeds of approximately \$96 million.

In March 1997, the Company and one of its subsidiaries, WEC, sold an aggregate of \$300 million principal amount of notes (the "1997 Debt Placement"), pursuant to which they realized net proceeds of approximately \$290.5 million. Pursuant to a committed facility obtained by the Company from affiliates of Credit Suisse First Boston Corporation and BT Securities Corporation, in August 1997, WEC II issued the WEC II Equipment Notes, generating proceeds to WEC II of \$50 million, with Company paying fees of approximately \$1.5 million and, in October 1997, the Company issued \$100 million of Senior subordinated Notes ("the October 1997 Debt Placement"), realizing net proceeds of approximately \$94 million.

The \$200 million proceeds of WEC Notes issued in the March 1997 Debt Placement must be utilized for the purchase of designated equipment or for the redemption of the WEC Notes by March 18, 1999, and the \$50 million net proceeds of WEC II Notes issued in August 1997 must be utilized for the purchase of designated equipment or for the redemption of the WEC II Notes by August 8, 1999. See Note 6 of the Condensed Consolidated Financial Statements for a description of the operations of WEC and WEC II and certain restrictions on distributions from these subsidiaries to the Company.

In April 1997, the Company repaid certain indebtedness incurred in the acquisition of the assets of Local Area Telecommunications, Inc., including accrued interest thereon, aggregating approximately \$17.8 million.

In October 1997, in connection with the US ONE Asset Acquisition, the Company borrowed \$62.25 million under a six month credit agreement secured by certain of the US ONE Assets, realizing net proceeds of \$61.25 million. The Company expects to dispose of certain of the US ONE Assets (primarily switches located in markets already covered by the Company's existing switches), and to repay a portion of this borrowing with the proceeds thereof, and to refinance the remainder of the loan by utilizing lease or other financing which the Company believes to be readily available in the near term.

At September 30, 1997, exclusive of the \$94 million net proceeds from the Senior Subordinated Notes issued in October 1997, the Company had approximately \$302.8 million in cash, cash equivalents and short term investments, approximately \$200 million of which is to be used to finance equipment purchases in connection with the Company's rollout of its telecommunications infrastructure.

The Company has incurred significant operating and net losses due in large part to the development of its telecommunications services business, and anticipates that such losses will continue over the near term as the Company executes its growth strategy. A significant portion of the Company's increased capital requirements will result from the rollout of the Company's CLEC business. The Company is building a direct sales force, having opened sales offices serving the fifteen major cities in which it offers CLEC services, and is in the process of expanding into other metropolitan areas. Additionally, the Company is in the process of ordering and installing switching and other network equipment to be placed in its key markets. Historically, the Company has funded its operating losses and capital expenditures through public and private offerings of debt and equity securities and from credit and lease facilities. Cash used to fund negative EBITDA during the nine months ended September 30, 1997 was approximately \$108.8 million, and purchases of property and equipment during the nine months ended September 30, 1997 was approximately \$103.8 million. At September 30, 1997, working capital was \$247.2 million, including cash, cash equivalents and short-term investments of \$302.8 million, as compared to working capital and cash, cash equivalents and short-term investments at December 31, 1996 of \$108.7 million and \$122.5 million, respectively.

The Company's current plans call for capital expenditures of up to \$450 million over 1997, 1998 and 1999 in connection with the execution of its business plan. The amount of capital required to

execute this plan is a function of the speed at which the plan is executed. The Company believes that its existing cash, a limited amount of lease financing that it believes is readily available and receivables financing will provide sufficient capital to finance its planned capital expenditures and to fund its operating capital needs until the Company is generating positive EBITDA, which the Company expects to occur in 1999. In the event this proves to be inaccurate, the Company may elect to slow the speed or narrow the focus of its plan or seek to raise sufficient amounts of additional capital on acceptable terms to implement the plan. In the event the Company's plans or assumptions change or prove to be inaccurate, or if the Company consummates any acquisitions of businesses or assets (including additional spectrum licenses, by auction or otherwise), the Company may be required to seek additional sources of capital sooner than currently anticipated.

The Company has commitments during the next 12 months as follows:

- o To purchase \$22.0 million of telecommunications capital equipment
- o To pay \$20 million in cash or common stock, at the Company's election, in connection with the US ONE Asset Acquisition
- o To pay \$65.2 million in common stock, (or under certain circumstances, cash, at the Company's election), in connection with the acquisition of additional licenses

Forward-Looking Statements

When used in this and in future filings by the Company with the SEC, in the Company's press releases and in oral statements made with the approval of an authorized executive officer of the Company, the words or phrases "will likely result," "expects," "plans," "will continue," "is anticipated," "estimated," "project" or "outlook" or similar expressions (including confirmations by an authorized executive officer of the Company of any such expressions made by a third party with respect to the Company) are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, each of which speak only as of the date made. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include, among others, the following: (a) the Company's ability to service its debt or to obtain financing for the buildout of its telecommunications network; (b) the Company's ability to attract and retain a sufficient revenue-generating customer base; (c) competitive pressures in the telecommunications industry; and (d) general economic conditions. The Company has no obligation to publicly release the result of any revisions which may be made to any forwardlooking statements to reflect anticipated or unanticipated events or circumstances.

PART II. OTHER INFORMATION

Item 2. Changes in Securities

Recent Sales of Unregistered Securities

The following table sets forth certain information with respect to grants by the Company of stock options to its employees and others during the quarter ended September 30, 1997, without registration of such securities under the Securities Act:

<u>Date of sale</u>	<u>Title of security</u>	<u>Number of options granted or shares issued</u>	<u>Consideration received and description of underwriting or other discounts to market price afforded to purchasers</u>	<u>Exemption from registration claimed</u>	<u>If option, warrant or convertible security, terms of exercise or conversion</u>
7/97 - 9/97	options to purchase common stock granted to employees	505200	options granted - no consideration received by the Company until exercise	Section 4(2)	exercisable for periods of five years from grant at exercise prices ranging from \$13.38 to \$17.88
9/26/97	common stock	148926	acquisition purchase price - no discount to market	Section 4(2)	n/a

Item 6. Reports on Form 8-K

- (1) Current Report on Form 8-K filed July 2, 1997.
- (2) Current Report on Form 8-K filed September 11, 1997.
- (3) Current Report on Form 8-K filed October 29, 1997.
- (4) Current Report on Form 8-K filed October 31, 1997.

SIGNATURES

In accordance with requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

WinStar Communications, Inc.
Registrant

By: /s/Fredric E. von Stange

Fredric E. von Stange
Executive Vice President, Chief Financial
Officer and Director

Dated: November 14, 1997

By: /s/Joseph P. Dwyer

Joseph P. Dwyer
Vice President, Finance
(Principal Accounting Officer)

Dated: November 14, 1997

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OF WASHINGTON, D.C.
WASHINGTON, DC

04737

15-122/540
00480

March 2, 1998

KELLEY DRYE & WARREN LLP
1200 19TH STREET, N.W.
WASHINGTON, DC 20036

PAY TO THE
ORDER OF

South Dakota Public Utilities Commission

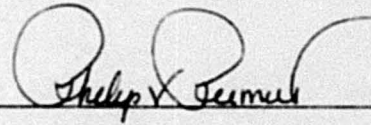
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Two Hundred Fifty And No/100-----

DOLLARS

MEMO

Chg. 68123.001 Filing Fee



⑈004737⑈ ⑆054001220⑆ 2000034690853⑈

South Dakota
Public Utilities Commission
State Capitol 500 E. Capitol
Pierre, SD 57501-5070
Phone: (605) 773-3705
Fax: (605) 773-3809

TELECOMMUNICATIONS SERVICE FILINGS

These are the telecommunications service filings that the Commission has received for the period of:

02/27/98 through 03/05/98

If you need a complete copy of a filing faxed, overnight expressed, or mailed to you, please contact Delaine Kolbo within five days of this filing.

DOCKET NUMBER	TITLE/STAFF/SYNOPSIS	DATE FILED	INTERVENTION DEADLINE
REQUEST FOR CERTIFICATE OF AUTHORITY			
TC98-062	Application by WinStar Wireless for a Certificate of Authority to operate as a telecommunications company within the state of South Dakota. (Staff: TS/KC) "WinStar Wireless respectfully requests that the Commission authorize it to provide long distance services throughout the state of South Dakota on a resale basis."	03/04/98	03/20/98

Important Notice: The Commission is compiling a list of internet addresses. If you have an internet address please notify the Commission by: E-mailing it to Terry Norum at: terryn@puc.state.sd.us Faxing the address to the Commission at: 605-773-3809

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF SOUTH DAKOTA**

IN THE MATTER OF THE APPLICATION OF)
WINSTAR WIRELESS, INC. FOR A)
CERTIFICATE OF AUTHORITY TO PROVIDE)
TELECOMMUNICATIONS SERVICES IN)
SOUTH DAKOTA AND FOR APPROVAL NUNC)
PRO TUNC OF A TRANSFER OF ASSETS)
FROM MIDCOM COMMUNICATIONS, INC. TO)
WINSTAR WIRELESS, INC.)

**ORDER DENYING
CERTIFICATE OF
AUTHORITY**

TC98-062

On March 4, 1998, the Public Utilities Commission (Commission), in accordance with SDCL 49-31-3 and ARSD 20:10:24.02, received an application for a certificate of authority from WinStar Wireless, Inc. (WinStar Wireless).

WinStar Wireless proposes to offer long distance services throughout the state of South Dakota on a resale basis. A proposed tariff was filed by WinStar Wireless. The Commission has classified long distance service as fully competitive.

On March 5, 1998, the Commission electronically transmitted notice of the filing and the intervention deadline of March 20, 1998, to interested individuals and entities. No petitions to intervene or comments were filed. On March 9, 1998, Commission Staff sent WinStar Wireless a request for additional data. Staff never received the requested information. Staff sent a second letter on August 20, 1998, which WinStar Wireless never responded to. A copy of the Commission's September 10, 1998, agenda was electronically transmitted to WinStar Wireless on September 3, 1998. At its regularly scheduled September 10, 1998, meeting, the Commission considered WinStar Wireless' request for a certificate of authority. Commission Staff recommended denying the certificate of authority and closing the docket as WinStar Wireless never sent the requested information.

The Commission finds that it has jurisdiction over this matter pursuant to Chapter 49-31, specifically 49-31-3 and ARSD 20:10:24.02 and 20:10:24.03. The Commission finds that WinStar Wireless has not met the legal requirements established for the granting of a certificate of authority. WinStar Wireless has not, in accordance with SDCL 49-31-3, demonstrated sufficient technical, financial and managerial capabilities to offer telecommunications services in South Dakota. The Commission voted to deny WinStar Wireless' application for a certificate of authority. As the Commission's final decision in this matter, it is therefore

ORDERED, that WinStar Wireless' application for a certificate of authority is hereby denied.

Dated at Pierre, South Dakota, this 21st day of September, 1998.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that this document has been served today upon all parties of record in this docket, as listed on the docket service list, by first class mail, in properly addressed envelopes, with charges prepaid thereon.

By *Rebecca Kaebo*

Date: 9/21/98

(OFFICIAL SEAL)

BY ORDER OF THE COMMISSION:

James A. Burg
JAMES A. BURG, Chairman

Pam Nelson
PAM NELSON, Commissioner

Laska Schoenfelder
LASKA SCHOENFELDER, Commissioner