



### *Competitive analysis:*

**Xtera Bargain Shops With Private Funding To Diversify During Consolidation - Gets Bargain on Meriton With Possible Help From BT Reflection on PBT**

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#### **Summary Opinion**

Smaller competitors can still get funding, and Xtera has done so and used it to go "bargain hunting." It needed to, because Xtera needs to increase the size of its addressable market and to diversify its product line in order to reduce risk by expanding beyond its sweet spot of ULH terrestrial and festoon applications.

That's why it bought Meriton, and we think Xtera got it cheap. Meriton has some Tier 1 traction including a public win at BT via Fujitsu, but BT has been moving very slowly on 21CN, we think probably reevaluating some of its technology decisions and deployment progress, including looking again at its PBT deployment - and the timing and size of revenue streams delayed in the process were probably very critical to Meriton from a financial perspective.

While Meriton's ROADM technology may have been the closest fit with Xtera's current portfolio and development program, we think Xtera bought Meriton to try and leverage Meriton's overall portfolio, and did not just buy the company to replace its own ROADM development efforts and gain time to market for that. Expanding its portfolio in the metro, leveraging Meriton's CET - and possibly making other cost efficient acquisitions in the metro if it can afford them could help Xtera on what we think is a quest to expand its revenue potential and prepare for the day when the festoon applications and the minority of terrestrial links that are ULH - which have kept it afloat when the big ULH market many vendors envisioned did not materialize - may not present as good a market opportunity as they do today.

#### **Analysis**

The Meriton acquisition expands Xtera's portfolio beyond its initial ultra long haul play, its successful focus on the niche opportunity in festoon applications, and its later additions to its multi-reach DWDM capabilities - giving it ROADM development and technology, but perhaps as or more importantly also giving it a solution providing Carrier Ethernet transport for the metro.

Festoon applications and some ULH desert crossings, in that order, have been good niche opportunities that kept Xtera alive when the large Ultra Long Haul market vendors once envisioned failed to materialize. But Xtera needs to expand its addressable market opportunity not only for revenue growth, but also to reduce

the risk of any cyclicity in those applications...which represents a potential high long-term risk.

Xtera has the money to achieve that diversification because some smart people that can show revenues, differentiation, and a good story for the future in a market environment blessed with multiple inexpensive acquisition targets can still gain reasonable funding. Xtera gained approximately \$52 million last August, which it has since used to buy what it really needs more than anything in four acquisitions - addressable market opportunity and diversification.

To gain that addressable market opportunity and diversification, it has used that money to create a position for itself in subsea head end as well as festoon applications, it has bolster its service and support capabilities and gained a fixed line proposition in the UK, and now has picked up ROADM and Carrier Ethernet Transport, and some Tier 1 customer inroads from Meriton.

For Xtera, all this translates into more potential customers, more potential revenue, and a degree of insulation from any future downturn in the ULH DWDM market or festoon DWDM applications. We do not expect that the acquisition of Meriton by Xtera will represent a large number of significant short-term cross-sales opportunities. But it will give Xtera some initial Tier 1 penetration in several accounts.

Meriton was probably acquired for a relatively small percent of its total historical capitalization. We think it was probably nearly out of cash. This was not a strategic merger by any means - this was an Xtera-driven acquisition to solve Xtera challenges. But Xtera may have had some unwitting help from BT in making this acquisition cost effective. BT was Meriton's flagship public Tier 1 customer (won via Fujitsu). The pace of BT's deployment seems to have slackened off recently, and the timing as well as magnitude of those revenue streams were undoubtedly critical to Meriton...with any delay potentially putting Meriton into the mode of being receptive to any offers...and in the unfortunate position of having enough competitive overlap with most players in the market to prevent Xtera from having to get in a bidding war.

BT might be discovering that the price of choosing to be on the "bleeding edge" in designing an NGN is that you can potentially "bleed" a bit in the process. BT's apparent and rumored slowdown, Meriton's apparent need to submit to a probably non-lucrative and apparently one-sided acquisition, and Meriton's recent transition from PBT-TE centric marketing to a stance also embracing MPLS have made us wonder if BT might potentially be at least pausing to reflect and take stock of some of its bold technology moves made as part of 21CN and subsequent progress and experience with technologies like PBT-TE. For many reasons, we think this may be true...and that staff additions and changes at BT may have served to re-raise the never complete consensus decision regarding the MPLS vs. PVT debate.

What is important is that Meriton brings completed ROADM development to the table, lending Xtera greater expertise in this area and giving them enhanced time to market, and also giving Xtera a play in Carrier Ethernet Transport and a broader solution for the metro.

Xtera's purchase of Meriton continues the trend of gradual consolidation among second-tier optical equipment providers, a trend that continues to complement that of the Tier 1 vendor mergers. This is the fourth acquisition of companies or assets that Xtera has made since it gained \$52 million in funding from private investors and venture capitalists in August, 2007 (the fixed line enterprise service and first line maintenance organizations from AlanDick UK was also announced in August, followed by the announcement of the acquisition of IP Networking solutions company AscenVision (October 2007) and repeated subsea related solutions of Azea Networks (November 2007). And there is more history of consolidation here, when you consider Meriton acquired in Mahi Networks in 2005, and that Mahi had acquired the remnants of Photuris prior to that.

Xtera's product line historically featured the ability to transmit signals over very long distances without electrical regeneration, and Xtera was an early proponent of the application of Raman amplification. This gained Xtera favor with Long Haul network operators for some niche applications, especially for festoon applications where they offered a less expensive solution than what submarine vendors were offering, and frequently a solution better suited to the task than what Tier 1 Long Haul DWDM vendors were offering. They were probably most closely positioned against the historical Lucent LambdaXtreme - but what is a big enough market opportunity for Xtera to survive in was not necessarily going to be of as much interest to a larger competitor such as Lucent (now Alcatel-Lucent).

The Ultra Long Haul terrestrial market simply never materialized to any great extent, and Tier 1 players were going to go after larger market opportunities. But the festoon market was a much needed boost in helping Xtera ramp up its initial revenues. But this is not a huge addressable market upon which to base long-term growth. Unfortunately, the terrestrial Ultra Long Haul market that it had hoped to cash in on never really materialized to any great extent - and that left Xtera with some good technology, some strong success in a niche application, and a need for greater addressable market opportunity if it was to achieve growth. It is doing that by more strongly addressing submarine applications, and now with this acquisition - gaining ROAM and Carrier Ethernet Transport and a stronger play in the metro. Perhaps more importantly than growth, Xtera has needed to isolate itself from the risk that potential cyclical fluctuation in demand for these festoon builds in future could impose.

Meriton first gained recognition as a multi-degree ROADM pioneer supplier with the 6400 OTP, and obtained wins with Cox Communications and Time Warner Cable, so this purchase gives Xtera a metro ROADM platform with some proof points and existing sales channels and experience targeting the MSOs. Meriton has also been a proponent of Provider Backbone Bridging -- Traffic Engineering (PBB-TE), the technology that emerged as a competitor of T-MPLS - and launched its Carrier Ethernet Transport solution, the 7200 OSP, in an attempt to diversify its product line and address the burgeoning interest in connection-oriented Ethernet transport and in helping operators migrate to carrier class packet transport for the metro.

Meriton's inroads with BT, won thanks to its Carrier Ethernet Transport solution, could conceivably be seen as potentially giving Xtera an entry with the largest operator in the UK, a country where Xtera already has a very strong presence in

particular supplying submarine gear to large UK operators (C&W, FLAG, and Global Crossing - and where it recently bolstered its service and support capabilities through acquisition).

But while this looks feasible on paper, Meriton's contract with BT was won largely due to its partnership with Fujitsu.

Much of Meriton's success in Europe and Asia came thanks to its partnership with Fujitsu. Now that Xtera has decided to compete directly with Fujitsu on several fronts, Fujitsu might not be as keen to work with Xtera on future projects.

However, Xtera has added fixed line support in the UK recently, which might be part of a strategic attempt to keep this relationship going. In addition, for most of 2007 and 2008, Meriton has struggled to announce new customers for its ROADM and CET solutions, so Xtera does not gain strong product sales momentum from Meriton at this time.

And this BT win appears to have been slow to generate revenue for Meriton. The apparent pace of BT's roll out of Meriton gear could be an indication that the British operator might potentially be considering ramping up deployments with other suppliers like Huawei and Ciena, or even potentially that the initial decision by BT to deploy PBB-TE technology on large scale may have been delayed or is under reanalysis - and that rumor has been afloat. Though unconfirmed by BT, we think a reanalysis is very likely at this point. We believe BT always had a good deal of internal contention over some key decisions that were made on 21CN technology, and changes in the team and the desire to reassess things may have reawakened some of that contention.

Meriton has likely been capital constrained, potentially reducing its product development - and this probably led it to decide to accept the offer from Xtera. But can Xtera expect to ramp revenues enough, or will it have enough of its recent private investment to fund successful development both as a Multihaul DWDM/submarine vendor, and as a metro optical vendor?

From the market's standpoint, the initial impact of Xtera's move should be minimal. Meriton's product line does not improve Xtera's scale that much in comparison to competitors like Alcatel-Lucent, Tellabs, Ciena, Adva and Fujitsu.

While this acquisition does not give Xtera product momentum or an easy path to upselling its own portfolio, it does give Xtera technology, expertise, and proof points with which to expand beyond its current niche, reduce the associated risk, and try to build a portfolio that will help it expand its addressable market opportunity. As to the question of whether Xtera have enough capital left or revenue streams to fund enough development to pull together a compelling solution incorporating all or part of Meriton's technology and portfolio - that proof point is one that it will have to establish itself. And if it can show any progress with Meriton, which might have had as much or more problem with timing of revenues than the ability to generate them, it is not entirely out of the question that Xtera might be able to land more funding next year if it chose in order to fuel continued expansion...as they seem to have good inroads in the investment community.

This seems like a logical acquisition in some respects, more from the standpoint of diversification and expansion for Xtera than of expectations of compelling solutions synergies. Whether they succeed or not remains to be seen, but Xtera appears on a mission to do a lot more than add a ROADM to the portfolio - it wants to increase its potential role in more operators' networks.