BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

FILED[3]

MAY 2 5 2000

Missouri Public
Service Commission

In the Matter of the Application	)	
	)	
of KMC TELECOM V, INC.	)	
	)	
for a Certificate of Service Authority to Provide	)	
Competitive Resold Intrastate Interexchange	)	**Case No.** TA-2000-785
Telecommunications Services	)	
and Non-Switched Local Exchange	)	
Services within the State of Missouri.	)	

APPLICATION FOR CERTIFICATE OF SERVICE AUTHORITY AND FOR COMPETITIVE CLASSIFICATION OF KMC TELECOM V, INC.

Comes now, KMC Telecom V, Inc. ("KMC V," "Applicant" or "Company"), by its undersigned counsel, and hereby applies pursuant to MO. REV. STAT. §§ 392.440 and 392.430: (1) for a certificate of service authority to provide resold intrastate interexchange telecommunications services and non-switched local exchange services throughout the State of Missouri in all areas in which the Commission has approved the competition of interexchange and private line services; and (2) to classify such services and the Applicant as competitive. Pursuant to MO. REV. STAT. § 392.420 and 4 CSR 240-32.010(2), the Applicant also seeks a waiver of certain of the Commission's requirements for basic telecommunications service offerings. In support of its Application, KMC V provides the following information:

I. IDENTIFICATION OF THE APPLICANT

A. CORPORATE INFORMATION

1. KMC V is a privately-held corporation duly organized and existing under and by virtue of the laws of the State of Delaware. The Company was incorporated on March 15, 2000, and is headquartered at: 1545 Route 206 Suite 300 Bedminster, New Jersey 07921 (908) 471-2100. KMC

V is a wholly-owned subsidiary of KMC Telecom V Holdings, Inc. ("KMC Holdings") which is a holding company also incorporated in Delaware. KMC V was organized to provide both domestic and international telecommunications services to small and medium-sized business customers in the State of Missouri and throughout the United States. A copy of KMC V's Articles of Incorporation is appended hereto as ***Exhibit A***.

2. Applicant has requested a Certificate to Transact Business from the Missouri Secretary of State. It is respectfully requested that the Commission docket the instant application as filed pending submission of evidence of the Certificate to Transact Business of KMC V as soon as it is issued by the Secretary of State. A copy of KMC V's Certificate of Authority will be submitted to the Commission as soon as it is available as ***Exhibit B***.

3. The Company has not yet established an office in Missouri, however, the name and address of the Company's registered agent in Missouri for service of process is:

CT Corporation System
120 South Central Avenue
Clayton, Missouri 63105

B. Designated Contacts

4. The designated contacts for this Application are:

Cathleen A. Martin #45682
NEWMAN, COMELY & RUTH
601 Monroe, Suite 301
P.O. Box 537
Jefferson City, MO 65101
Telephone: (573) 634-2266
Facsimile: (573) 636-3306

Brad E. Mutschleknaus
Genevieve Morelli
Peter A. Batacan
KELLEY DRYE & WARREN LLP
1200 19th Street, N.W., Suite 500
Washington, D.C. 20036
Telephone: (202) 955-9600
Facsimile: (202) 955-9792

5. Copies of all correspondence, notices, inquiries and orders also should be sent to the following individual, who is Applicant's initial contact person for all regulatory and compliance

issues:

Tricia Breckenridge
Executive Vice President, Business Development
KMC TELECOM V, INC.
3025 Breckinridge Boulevard
Suite 170
Duluth, Georgia 30096
(770) 935-1230 (Telephone)
(770) 638-6796 (Facsimile)

II. SERVICES

A. PROPOSED SERVICES TO BE OFFERED BY APPLICANT

1. NON-SWITCHED LOCAL EXCHANGE SERVICES

6. KMC V intends to provide non-switched local exchange services to its Missouri business customers. If granted, the Applicant's provision of non-switched local exchange authority will be limited to the provisioning of dedicated, local exchange private line services.

7. Initially, KMC V intends to deliver port wholesale data services. Port wholesaling gives KMC V the ability to provide data switching to Internet service providers by allowing data calls to be terminated through the port wholesale equipment rather than the switch. This enables the Internet service provider to more cost effectively manage its data requirements while, at the same time, increasing the efficiency and capacity of the KMC V Lucent Technologies Series 5ESS(R)-type switch.

8. KMC V's non-switched local exchange network in Missouri will consist of deploying NEBS (Network Equipment Building Standards)[1] compliant Remote Access Server (RAS) equipment in existing (non-ILEC) collocation space such as carrier hotels for interconnection to

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[1] NEBS defines a rigid and extensive set of performance, quality, environmental and safety requirements developed by Bellcore (now called Telcordia Technologies).

ILECs and IXC providers. RAS equipment will interconnect with ILEC networks using Inter Machine Trunks (IMT's). Company has no switches or other facilities installed within the State of Missouri. KMC V has no plans to construct outside plant facility or loop distribution equipment at the current time. Upon completion of negotiations, KMC V will file a copy of its interconnection agreement with the Commission.

2. Resold Interexchange Services

9. In addition to the provision of intrastate non-switched local exchange services, KMC V also seeks to provide all forms of resold interexchange telecommunications services to customers throughout the State of Missouri including, but not limited to: (i) dedicated inbound calling and (ii) dedicated outbound calling. These services will be provided through the resale of the services of Southwestern Bell, Inc., or other underlying interexchange carriers ("IXCs"). The Company may expand its long distance service offerings at a later date to include other interexchange services.

III. Description of Business History

10. KMC V was organized to provide state-of-the-art telecommunications services to customers in the State of Missouri and throughout the United States. A diagram of the Company's corporate structure is appended hereto as ***Exhibit C***. As this diagram will show, KMC V is a wholly-owned subsidiary of KMC Telecom Holdings, Inc. ("KMC Holdings"), and has the following affiliates: KMC Telecom Inc. ("KMC"), KMC Telecom II, Inc. ("KMC II"), KMC Telecom III, Inc. ("KMC III"), KMC Telecom IV, Inc. ("KMC IV"), KMC Telecom of Virginia, Inc. ("KMC VA") (the "Affiliates").

11. KMC V intends to operate as a provider of telecommunications services to customers in the State of Missouri and throughout the United States in Tier III Markets (population from 100,000 to 750,000). Initially, KMC V will target business, government and institutional end-users, as well

as Internet service providers, long distance carriers and wireless service providers. KMC Holdings' objective is to provide its customers with a complete solution for their communications needs. A detailed description of KMC Holdings' products and services, may be found in KMC Holdings' corporate Fact Sheet, which is appended hereto as ***Exhibit D***.

12. As of the date of this filing, KMC V's Affiliates are authorized by virtue of certification, registration, or (where appropriate) on an unregulated basis to provide local exchange and/or interexchange telecommunications services in Alabama, Arkansas, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Hampshire, North Carolina, Ohio, Oklahoma, Puerto Rico, South Carolina, Tennessee, Texas, Virginia, West Virginia, and Wisconsin.

13. In addition to Missouri, KMC V is currently seeking authority to provide local exchange and intrastate interexchange services in Alabama, Arizona, Arkansas, California, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, Nebraska, Nevada, New Hampshire, New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, Tennessee, Texas, Virginia, Washington D.C., West Virginia, and Wisconsin.

14. To date, KMC V has not been denied any requested authority to provide telecommunications services filed in any state, nor has KMC V had its authorization to provide telecommunications services revoked in any state.

15. KMC V has never been under investigation, fined or cited for violation of any consumer protection law or regulation in any state or federal jurisdiction.

16. Neither KMC V nor KMC Holdings, is currently under the protection of the federal bankruptcy laws nor has either company been under such protection in the past.

IV. DESCRIPTION OF THE MANAGERIAL, TECHNICAL AND FINANCIAL ABILITY OF APPLICANT

17. As demonstrated below, KMC V is well-qualified managerially, technically and financially to provide the competitive local exchange and interexchange telecommunications services for which authority is requested in this Application.

A. MANAGERIAL

18. In support of its Application, KMC V submits the following information to demonstrate that it has sufficient managerial and technological telecommunications experience and expertise, as well as the financial stability adequate to ensure its continued provision of quality competitive non-switched local exchange and interexchange telecommunications services within the State of Missouri.

19. KMC V has access to significant capital and substantial technical and managerial expertise. The Company's management team includes individuals with substantive experience in successfully developing and operating telecommunications businesses.

20. KMC V has the adequate internal technical resources to support its Missouri operations. This expertise in the telecommunications industry makes KMC V's management team well-qualified to construct, operate and manage KMC V's local exchange and interexchange networks in Missouri. Specific details of the business and technical experience of KMC V's officers and management personnel are appended hereto as ***Exhibit E***, which also contains the biographies and a brief description of the business experience of key management and operational personnel who will be responsible for KMC V's telecommunications services in Missouri and throughout the United States.

B. TECHNICAL

21. As is evident from the information contained in ***Exhibit E***, KMC V is managed by

persons with substantial technical expertise in designing, constructing and operating telecommunications networks. This wealth of experience will enable KMC V to provide its local exchange customers with advanced, state-of-the-art technology, for its services as described in Section II of this Application.

C. Financial

22. Applicant, through the strength of its parent corporation, KMC Holdings, has access to ample capital to compete effectively in the market and provide telecommunication services in Missouri. Both a description of KMC Holdings' financial qualifications and a copy of KMC Holdings' most recent SEC Form 10-K is attached hereto as ***Exhibit F***.

23. Specifically, as demonstrated in KMC Holdings' Cash Flow Statements appended as part of ***Exhibit F***, KMC V has access to ample capitol to fund the construction and operation of KMC V's telecommunications network in Missouri, and to meet any lease and ownership obligations associated with its provision of local exchange and interexchange telecommunications services in Missouri. In addition, KMC V has attached hereto as ***Exhibit G*** a Guaranty issued by KMC Holdings, guaranteeing KMC V's financial obligations attendant to KMC V's operations as a telecommunications carrier in the State of Missouri.

24. KMC V is a privately-held company and, thus, does not issue annual reports or submit any financial filings with the Securities and Exchange Commission.

V. Repair and Maintenance/Customer Service Information

25. KMC V's customer service representatives are available to assist its business customers with service, maintenance and billing issues. Specifically, KMC V's customer services representatives are prepared to respond to a broad range of service matters, including inquiries regarding: (1) the types of services offered by KMC V and the rates associated with such services;

(2) monthly billing statements; (3) problems or concerns pertaining to a customer's current service; and (4) general telecommunications matters. For service issues, customers may contact KMC V's customer services department 24 hours a day, seven days a week, by calling them toll-free at (888) KMC-THE1. For billing issues, customers may contact KMC V's billing services department between the hours of 8 a.m. and 8 p.m., Monday through Friday, by calling them toll-free at (888) KMC-THE1. Customers wishing to communicate with a KMC V customer service representative in writing can write to KMC V at:

KMC Telecom V, Inc.
1545 Route 205, Suite 300
Bedminster, New Jersey 07921

VI. CLASSIFICATION

26. KMC V requests classification as a competitive telecommunications company within the State of Missouri. Applicant believes that the services that it proposes to provide will be subject to sufficient competition to justify a lesser degree of regulation.

VII. STATEMENTS OF COMPLIANCE AND REQUESTS FOR WAIVER

27. KMC V is willing to comply with all applicable Commission rules, and is willing to meet all relevant service standards, including but not limited to, billing, quality of service, and tariff filing and maintenance. However, consistent with the Commission's treatment of other certificated competitive local exchange telecommunications companies, KMC V requests that the following statutes and regulations be waived for its resold interexchange and non-switched local exchange service offerings, in accordance with MO. REV. STAT. § 392.420 and 4 CSR 240-32.010(2):

STATUTES

MO. REV. STAT. § 392.210.2	--	Uniform System of Accounts
MO. REV. STAT. § 392.270	--	Valuation of Property (Ratemaking)
MO. REV. STAT. § 392.280	--	Depreciation Accounts
MO. REV. STAT. § 392.290.1	--	Issuance of Stocks and Bonds
MO. REV. STAT. § 392.300.2	--	Acquisition of Stock
MO. REV. STAT. § 392.310	--	Stock and Debt Issuance
MO. REV. STAT. § 392.320	--	Stock Dividend Payment
MO. REV. STAT. § 392.330	--	Issuance of Securities, Debts and Notes
MO. REV. STAT. § 392.340	--	Reorganization(s)

RULES

4 CSR 240-10.020	--	Income on Depreciation Fund Investments
4 CSR 240-30.010(2)(C)	--	Posting of exchange rates at central operating offices
4 CSR 240-30.040	--	Uniform System of Accounts
4 CSR 240-32.030(1)(B)	--	Exchange Boundary Maps
4 CSR 240-32.030(1)(C)	--	Records of Access Lines
4 CSR 240-32.030(2)	--	In-State Record Keeping
4 CSR 240-32.050(3)-(6)	--	Public Business Office Information; Telephone Directories etc.
4 CSR 240-32.070(4)	--	Coin Telephones
4 CSR 240-33.030	--	Informing Customers of Lowest Priced Services
4 CSR 240-35.020, .030	--	Reporting of Bypass and Customer-Specific Arrangements
4 CSR 240-35.040	--	Finance Fee

28. The above-referenced rules and statutory provisions have been waived with regard to other interexchange carriers (Case No. TA-98-361) and competitive local exchange companies (Case No. TA-96-347). These rules or statutory provisions are principally designed to apply to non-competitive telecommunications carriers. As a result, it would be inconsistent with the goal and purpose of Section 392.530 to apply them to a competitive telecommunications carrier such as Applicant, and, for this reason, KMC V respectfully requests that the Commission waive the

application of these rules to KMC V.

29. KMC V further requests a temporary waiver of 4 CSR 240-2.060(6)(C). This rule requires that an application for a certificate of service authority to provide interexchange, local exchange or basic local exchange services shall include a proposed tariff with a forty-five (45) day effective date. KMC V finds it impossible at this time to develop tariffs to fully comply with this rule since it has not yet finalized its rates for its interexchange and non-switched local exchange services. At such time as all facts necessary for the development of such tariffs are known to KMC V, the Company promptly will file said tariffs with the Commission in a manner consistent with recent Commission practice in similar cases. All filed tariffs will bear no less than a forty-five (45) day effective date.

30. KMC V will comply fully with all applicable Commission rules except those that are specifically waived by the Commission pursuant to the Applicant's request herein.

31. KMC V has no pending or final judgments or decisions against it or its affiliates from any state or federal agency or court that involve customer services or rates. Appended hereto as ***Exhibit H*** is a verified statement that no annual report or assessment fees are overdue.

VIII. GEOGRAPHIC AREAS

32. The Applicant proposes to offer service throughout those areas of Missouri where the Commission has authorized the provision of competitive intraLATA interexchange telecommunications service, and non-switched local exchange services.

IX. PUBLIC INTEREST

33. KMC V submits that approval of this Application is in the public interest because KMC V is well-qualified – technically, managerially, and financially – to serve the Missouri public as a resold interexchange carrier and provider of non-switched basic local exchange services. Moreover,

permitting KMC V to provide the services described in this Application will expand local and long distance service options for customers in Missouri, and will increase competition in Missouri by expanding the diversity of suppliers and competition within the local exchange telecommunications market -- without any adverse impact on the Commission's goals of universal service and affordable telecommunications services for the residents of Missouri.

34. KMC V's participation in the market for non-switched local and interexchange telecommunications services in Missouri will promote consumer choice by expanding the availability of innovative, high quality, reliable and competitively-priced telecommunications services. Approval of this Application also is likely to compel other local and interexchange telecommunications providers to improve their existing services, increase the quality and efficiency of their operations, and introduce innovative new services of their own. The addition of KMC V to the Missouri telecommunications market makes it probable that consumers of telecommunications services in Missouri will receive the benefits of downward pressure on prices, improved customer responsiveness, and access to increasingly advanced telecommunications technology. Further, KMC V's provision of interexchange and non-switched telecommunications services to the business public in Missouri is consistent with the legislative goals set forth in the 1996 Act and Chapter 392 of the Missouri Revised Statutes.

WHEREFORE, KMC V respectfully requests that the Commission grant it a certificate of service authority to provide resold interexchange telecommunication services and non-switched basic local exchange telecommunications services in Missouri. KMC V also requests classification as a competitive telecommunications company in Missouri. Finally, KMC V requests that the Commission grant waivers of the aforementioned rules and statutory provisions.

Respectfully submitted,

KMC TELECOM V, INC.

By: *Cathleen A. Martin*

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NEWMAN, COMELY & RUTH
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P.O. Box 537
Jefferson City, MO 65101
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Washington, D.C. 20036
Telephone: (202) 955-9600
Facsimile: (202) 955-9792

Its Attorneys

Certificate of Service

I hereby certify that on this 25th day of May, 2000 a true and correct copy of the above and foregoing document was hand-delivered to the Office of Public Counsel, Truman Building, Room 250, Jefferson City, MO 65101.

Cathleen A. Martin

VERIFICATION

Jeannette Barretta ______, Affiant, being duly sworn according to law, deposes and says that:

SHe is the **Assistant Secretary** ____________ of KMC Telecom V, Inc.

That he is authorized to and does make this affidavit for said corporation;

That the facts set forth in this Application are true and correct to the best of her knowledge, information, and belief and that she expects said corporation to be able to prove the same at any hearing hereof.

Jeannette Barretta,
Assistant Secretary
KMC Telecom V, Inc.

[Commonwealth/State] of New Jersey :

: ss.

County of Somerset :

Sworn and subscribed before me this 2nd day of May, 2000.

Arlene Sapperstein
Signature of official administering oath

My commission expires

ARLENE SAPPERSTEIN
NOTARY PUBLIC OF NEW JERSEY
MY COMMISSION EXPIRES SEPT. 27, 2004

DC01/JENKE/111402.2

LIST OF EXHIBITS

EXHIBIT A:	ARTICLES OF INCORPORATION
EXHIBIT B:	AUTHORIZATION TO TRANSACT BUSINESS
EXHIBIT C:	CORPORATE/ORGANIZATIONAL STRUCTURE
EXHIBIT D:	FACT SHEET
EXHIBIT E:	STATEMENT OF MANAGERIAL AND TECHNICAL QUALIFICATIONS
EXHIBIT F:	FINANCIAL QUALIFICATIONS
EXHIBIT G:	FINANCIAL GUARANTY
EXHIBIT H:	VERIFIED STATEMENT

EXHIBIT A

ARTICLES OF INCORPORATION

State of Delaware

Office of the Secretary of State

I, EDWARD J. FREEL, SECRETARY OF STATE OF THE STATE OF DELAWARE, DO HEREBY CERTIFY THE ATTACHED IS A TRUE AND CORRECT COPY OF THE CERTIFICATE OF INCORPORATION OF "KMC TELECOM V, INC.", FILED IN THIS OFFICE ON THE FIFTEENTH DAY OF MARCH, A.D. 2000, AT 4:30 O'CLOCK P.M.

A FILED COPY OF THIS CERTIFICATE HAS BEEN FORWARDED TO THE NEW CASTLE COUNTY RECORDER OF DEEDS.

3194507 8100

001132782

Edward J. Freel, Secretary of State

AUTHENTICATION: 0319174

DATE: 03-16-00

CERTIFICATE OF INCORPORATION

OF

KMC Telecom V, Inc.

FIRST: The name of the corporation is KMC Telecom V, Inc. (the "Corporation").

SECOND: The address of its registered office in the State of Delaware is Corporation Trust Center, 1209 Orange Street, in the City of Wilmington, County of New Castle. The name of its registered agent at such address is The Corporation Trust Company.

THIRD: The purpose for which the Corporation is formed is to engage in any lawful act or activity for which corporations may be organized under the Delaware General Corporation Law.

FOURTH: The total number of shares of stock which the Corporation shall have authority to issue is One Hundred (100) shares of Common Stock, par value $.01 per share.

FIFTH: The name and mailing address of the sole incorporator of the Corporation are as follows:

Tae Hee Kim
Kelley Drye & Warren LLP
101 Park Avenue
New York, New York 10178

SIXTH: The following provisions are inserted for purposes of the management of the business and conduct of the affairs of the Corporation and for creating, defining, limiting and regulating the powers of the Corporation and its directors and stockholders:

(a) The number of directors of the Corporation shall be fixed and may be altered from time to time in the manner provided in the Bylaws, and vacancies in the Board of Directors and newly created directorships resulting from any increase in the authorized number of directors may be filled, and directors may be removed, as provided in the Bylaws.

(b) The election of directors may be conducted in any manner approved by the stockholders at the time when the election is held and need not be by ballot.

(c) All corporate powers and authority of the Corporation (except as at the time otherwise provided by law, by this Certificate of Incorporation or by the Bylaws) shall be vested in and exercised by the Board of Directors.

(d) The Board of Directors shall have the power without the assent or vote of the stockholders to adopt, amend, alter or repeal the Bylaws of the Corporation, except to the extent that the Bylaws or this Certificate of Incorporation otherwise provide.

SEVENTH: The Corporation reserves the right to amend or repeal any provision contained in this Certificate of Incorporation in the manner now or hereafter prescribed by the laws of the State of Delaware, and all rights herein conferred upon stockholders or directors are granted subject to this reservation.

EIGHTH: No director shall be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided, however, that the foregoing shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the Corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or knowing violation of law, (iii) under Section 174 of the Delaware General Corporation Law, or (iv) for any transaction from which the director derived an improper personal benefit.

NINTH: Meetings of stockholders may be held within or without the State of Delaware, as the Bylaws may provide. The books of the Corporation may be kept (subject to any provision contained in the statutes of the State of Delaware) outside the State of Delaware at such place or places as may be designated from time to time by the Board of Directors of the Corporation in accordance with the Bylaws of the Corporation.

IN WITNESS WHEREOF, I do execute this Certificate and affirm and acknowledge, under penalties of perjury, that this Certificate is my act and deed and that the facts stated herein are true, this 15th day of March, 2000.

Tae Hee Kim, Sole Incorporator

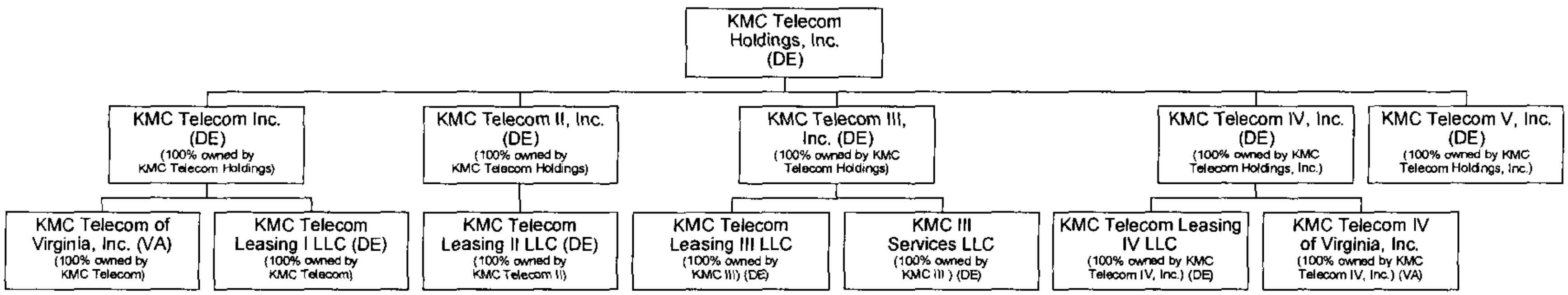
EXHIBIT B

AUTHORIZATION TO TRANSACT BUSINESS IN THE STATE OF MISSOURI

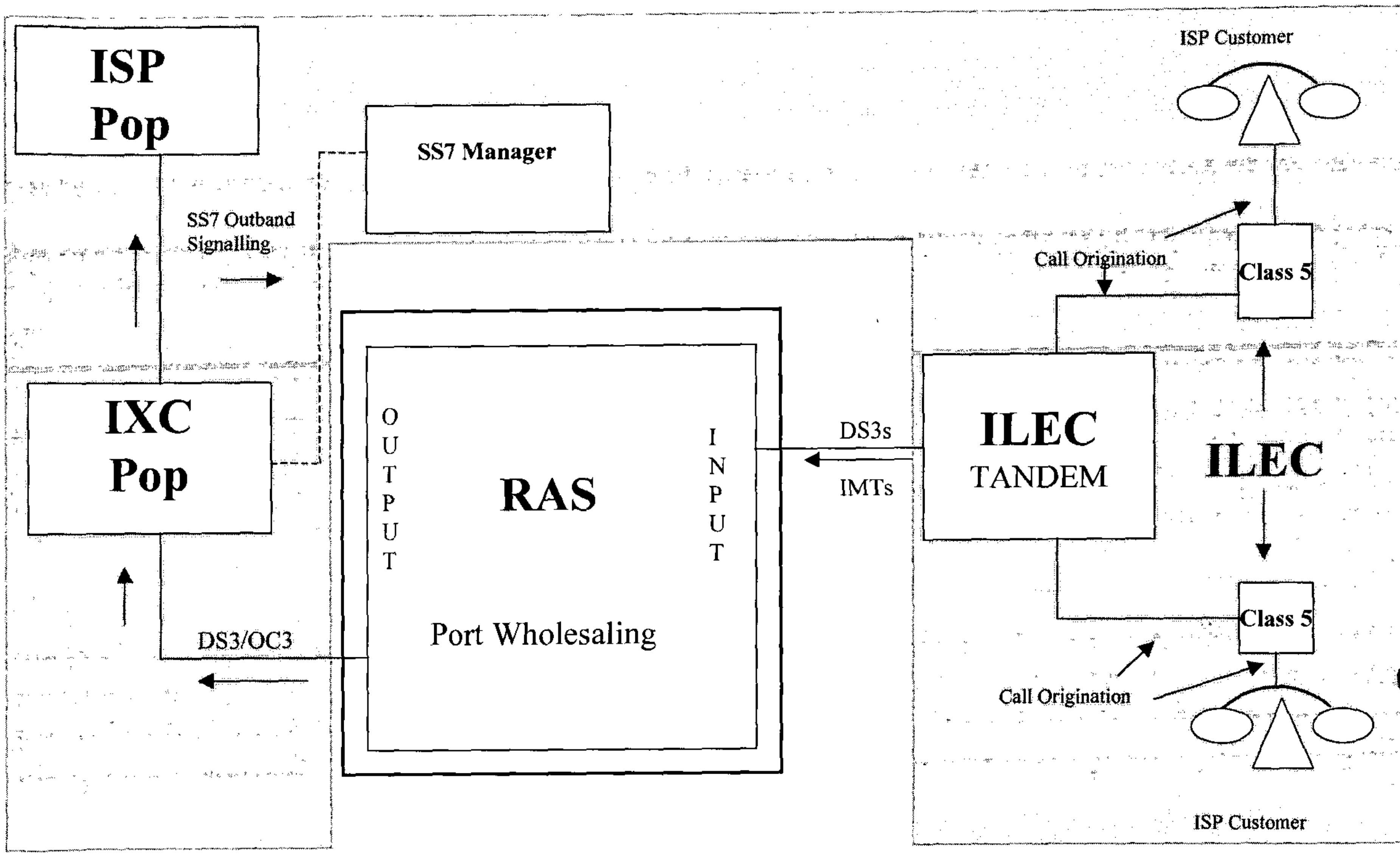
EXHIBIT C

CORPORATE/ORGANIZATIONAL STRUCTURE

KMC'S CORPORATE STRUCTURE



KMC Telecom™



*KMC TELECOM V, INC. NETWORK REPRESENTATION**

*KMC V Network represented by the unshaded areas in the above diagram.

04/26/00

EXHIBIT D

FACT SHEET OF KMC TELECOM HOLDINGS, INC.

FACT SHEET OF KMC TELECOM HOLDINGS, INC.

KMC Telecom, Inc.

www.kmctelecom.com

Creative Solutions With a Hometown Touch ™

Fact Sheet

BACKGROUND

The initial predecessors of KMC Telecom Holdings, Inc., were founded in 1994 and 1995, respectively, by Harold N. Kamine, the Company's Chairman of the Board. These predecessors were merged in 1996 and renamed KMC Telecom Inc. KMC Telecom Holdings, Inc., was formed during 1997 primarily to own, directly or indirectly, all of the shares of its operating subsidiaries, KMC Telecom Inc., KMC Telecom II, Inc., KMC Telecom III, Inc., KMC Telecom IV, Inc., KMC Telecom V, Inc., and KMC Telecom of Virginia, Inc. The principal equity investors in the Company currently include Mr. Kamine, Nassau Capital Partners, L.P., Newcourt Capital, Inc., CoreStates Holdings, Inc. (an affiliate of First Union National Bank), General Electric Capital Corporation and Lucent Technologies, Inc.

COMPANY OVERVIEW

The Company is a facilities-based competitive local exchange carrier providing telecommunications and data services in Tier III Markets (population from 100,000 to 750,000). The markets in which we operate are predominately located in the Southeastern and Midwestern United States. We target business, government and institutional end-users, as well as Internet service providers, long distance carriers and wireless providers. Our objective is to provide our customers with a complete solution for their communications needs. We currently provide on-net local dial tone, special access, private line, Internet access, ISDN and a variety of other advanced services and features.

We are a facilities-based competitive local exchange carrier providing telecommunications and data services in Tier III markets (markets with a population from 100,000 to 750,000). A facilities-based competitive local exchange carrier is one which operates its own network, including switching equipment and transmission lines, rather than one which intends to primarily resell the services of other carriers. We target as customers business, government and institutional end-users, as well as Internet service providers, long distance carriers and wireless service providers. Our objective is to provide our customers with a complete solution for their communications needs. We currently provide on-net local dial tone, Internet access infrastructure, ISDN (or integrated services digital network), long distance, special access, private line and a variety of other advanced services and features.

We currently operate in 34 Tier III markets and have systems under construction in 3 additional Tier III markets. We expect these new systems to be commercially operational by the end of the first half of 2000. During 2000 we will continue to invest in the new Tier III markets. We construct robust fiber optic networks in each of our markets, which we believe allows us to ensure high quality of service, facilitate the delivery of value-added and data services, and effectively control our costs. We currently have Lucent Technologies Series 5ESS(R)-type switches in commercial operation in all of our operational markets and intend to install Lucent switches in any future networks which we may build.

BUSINESS STRATEGY

We intend to become the dominant competitive provider of telephony and data services in the markets that we serve. The principal elements of our business strategy include:

FOCUS ON TIER III MARKETS. We intend to operate in Tier III Markets. We believe that incumbent local exchange carriers tend to focus their efforts on larger markets and generally underserve and underinvest in Tier III Markets. We also believe that there is generally significantly less competition from other facilities-based competitive local exchange carriers in Tier III Markets, which allows us to gain market share more rapidly than we could expect to in Tier I and Tier II Markets. In addition, network construction is less expensive in Tier III Markets than in Tier I and Tier II Markets. We target markets which we believe offer attractive demographic, economic, competitive and demand characteristics. We select target markets from among the approximately 250 Tier III Markets in the United States by first identifying those markets that do not yet have significant, established competitors to the existing incumbent local exchange carrier, and by then reviewing the specific demographic, economic, competitive and telecommunications demand characteristics of such markets to determine their suitability for the types of services which we offer.

COMPREHENSIVE FIBER NETWORKS. We build geographically extensive, full service, facilities-based networks. Prior to both the initial construction of our network backbone and any subsequent network expansion, we perform detailed rate of return analyses to justify the capital expenditures involved. In each of our existing thirty-four markets, we have completed our backbone construction connecting the market's central business district with outlying office parks, large institutions, the locations of long distance carriers' transmission equipment and major incumbent local exchange carrier central offices. In addition, we intend to continue to expand our existing networks in response to anticipated customer demand.

PROVIDE ENABLING INFRASTRUCTURE FOR DATA SERVICES. We intend to serve as a gateway for the provision of sophisticated value-added data services and high speed connectivity to customers in Tier III markets. We believe it is strategically important for us to offer these services because:

- data and internet access is required for businesses to succeed and grow,
- e-commerce is mission critical for many businesses, and
- national service carriers and internet service providers, such as UUNet and Qwest feel it is necessary for them to expand into Tier III markets.

We will provide data services directly to our own customers and will also provide access to Tier III markets for long distance carriers, national service carriers, Internet service providers and other businesses which require broadband access to those markets but which have not constructed their own networks and connections in those markets to enable them to provide it to their own customers.

LOCAL PRESENCE. We intend to capture and retain customers through effective local, personalized sales, marketing and customer service programs. To this end, we:

- establish sales offices in each market in which we operate a network,
- strive to recruit our city directors and sales staff from the local market,
- rely principally on a face-to-face selling approach, and
- support our sales staff with locally based customer service and technical support personnel.

We believe that our "Creative Solutions with a Hometown Touch"(TM) sales approach is very important to customers in Tier III Markets, who do not typically receive focused local sales contact or customer support from the incumbent local exchange carrier. We seek to build long-term relationships with our customers by responding rapidly and creatively to their telecommunications needs.

QUALITY OPERATIONS SUPPORT SYSTEM. We are developing a high quality operations support system to provide us with comprehensive billing, order processing and customer care software for all existing and contemplated services we will market. This system is designed to provide us with a single "flow-through" order form that will entail several components, allowing each order to be tracked from service provisioning through to complete installation. We believe that this system will allow us to quickly address customer concerns and provide us with a competitive advantage in customer service and operations efficiency.

EXPERIENCED MANAGEMENT TEAM. The Company's management team includes individuals with a wealth of experience, collectively, in the telecommunications industry. It is led by Harold N. Kamine, Chairman of the Board of Directors, and Roscoe C. Young, II, the Company's President and Chief Operating Officer. Other members of the team include William H. Stewart, Executive Vice President and Chief Financial Officer, and James L. Barwick, Senior Vice President-Technology.

SERVICES

GENERAL. We have historically provided dedicated access service and have also resold switched services which we purchased from incumbent local exchange carriers. In December 1997, we began providing our own on-net switched services to our customers. For 1997 on-net switched services accounted for 32% of our revenue and resale services accounted for 68% of our revenue. For 1998 on-net switched services accounted for 37% of our revenue and resale services accounted for 63% of our revenue.

PRIVATE LINE AND SPECIAL ACCESS SERVICES. We currently provide various types of on-net dedicated service which permit the transmission of voice and data between two points over circuits dedicated to the requirements of a particular customer. Private line service involves the provision of a private, dedicated telecommunications connection among different locations of the same customer. For these services we offer several types of dedicated circuits that have different capacities. DS-1 and DS-3 circuits are dedicated lines that can carry up to 24 and 672 simultaneous voice and data transmissions, respectively. Special access service involves the leasing, to long distance carriers, of private, dedicated telecommunications lines running along our networks. The long distance carriers use these lines to connect different locations where they have installed transmission equipment within the market, to connect locations where they have installed transmission equipment to the transmission equipment locations of other long distance carriers within the market, or to connect large customers directly to the locations of their transmission equipment. For these services we offer OC3, OC12 and OC48 circuits. These OC-N services provide the fastest transmission available for carriers and large business users.

SWITCH-BASED SERVICES. We have added and continue to add capability to provide local dial tone services and switched access origination and termination services to our networks. Switches are currently in commercial operation in twenty-two of our existing markets and we expect to have a switch in commercial operation in our remaining existing network no later than the second quarter of 1999. Over time, we expect to transition the majority of our customers to our own networks by means of either unbundled network elements leased from the incumbent local exchange carrier or direct connections.

ISDN. ISDN, or integrated services digital network, is an internationally agreed upon standard which, through special equipment, allows two-way, simultaneous voice and data transmission in digital formats over the same transmission line. ISDN permits videoconferencing over a single line, for example, and also supports a multitude of value-added networking capabilities. This service targets sophisticated business customers whose applications require integration of services such as Internet access, video, voice or other communications services, including high speed data transfer. By integrating multiple applications, customers receive increased capability and may not have any increase in costs to achieve that capability. The principal purchasers of this service are currently Internet service providers.

LONG DISTANCE. We offer a full range of long distance products including inter-LATA, intra-LATA, interstate, international, calling card and 800-number services. Most recently we decided to introduce KMC-branded operator services, directory services and prepaid phone cards. We offer these services both on-net and off-net. We offer long distance services on a resale basis by entering into wholesale agreements with various long distance carriers to deliver these services. We believe that many of our customers will prefer the option of purchasing long distance services from us as part of a one-stop telecommunications solution.

CENTREX-TYPE SERVICES. We intend to provide Centrex-type services. By using Centrex-type services instead of a PBX (which requires the customer to purchase and install a switching system on its own premises), customers can substantially reduce their capital expenditures and the fixed costs associated with maintaining a PBX network infrastructure. We currently plan to introduce our ClearStar℠ Advantage service in all of our operational markets during the first quarter of 1999. It has been designed to support multiple applications, ranging from basic access services to services focused on desktop applications. The basic access service will connect to a customer's key system or PBX and will be equipped with up to 14 features including call forwarding, speed dialing and call transfer capabilities. More sophisticated levels of service are designed to replace customers' existing key systems or PBXs. At the high end of service offerings is ClearStar℠ Advantage Plus, a packaged, end-to-end offering which combines all of the basic features with Basic Rate ISDN network access, advanced feature functionality, voice messaging and third party-provided ISDN electronic terminal sets.

NEW ENHANCED DATA SERVICES OFFERINGS. We introduced ISDN services in late 1998. We currently plan to expand our capabilities by introducing additional enhanced data services. We believe that these services will enhance our ability to provide an integrated turnkey solution to our customers' voice, data and video transmission requirements. These enhanced services will include:

- BASIC RATE ISDN. Basic Rate ISDN, or BRI, provides customers the potential of 144 kilobits of digital communications via a single network facility interface. We believe it will be attractive to small and medium size customers, since it provides dial-up access to the Internet, and other dial-up data applications, while simultaneously providing the ability to integrate voice traffic on a single network facility.

- PRIMARY RATE ISDN. Primary Rate ISDN, or PRI, provides customers the equivalent of 1.544 megabits of digital communications via a channelized T-1 type facility, with 23 bearer channels for voice and data communications and a 24th channel providing network signaling and control for the services. We focus our PRI sales efforts on (i) Internet service providers who use Primary Rate ISDN as a means of supporting customer access to their operations, and (ii) end-user customers who use Primary Rate ISDN as a network access facility for PBXs and other premise-based switches.

- PORT WHOLESALE. Port wholesaling is a technology that provides large bandwidth users with data switching capability at the network level, allowing them to acquire capacity as required without investing in data switching equipment. Port wholesaling gives us the ability to provide data switching to Internet service providers by allowing data calls to be terminated through the port wholesale equipment rather than the switch. This enables the Internet service provider to more cost effectively manage its data requirements while, at the same time, increasing the efficiency and capacity of our Lucent Technologies Series 5ESS(R)-type switch.

- HDSL. HDSL is a method of using unconditioned, copper wire pairs for high bit rate data transport for use in the "last mile" connecting our network backbone ring to the customer's premises. We plan to utilize HDSL to provide high bandwidth data and video service to small and medium size customers.

- FRAME RELAY/ATM. Frame relay and ATM are used by some of our data customers as a fast data transport service for wide area networks. Today we resell these services. In the future we intend to provide these services over our own network and utilize a third party provider for transport outside our network.

- CLEAR STAR[SM] ADVANTAGE PLUS. This service provides a customer with Centrex-type functionality from our central office switch to each of the customer's desktops. It is a packaged, end-to-end offering which provides a combination of Basic Rate ISDN network access, advanced Centrex feature functionality, voice messaging, ISDN terminal sets and support for premise wiring configuration.

We plan to remain flexible in responding to evolving customer demands for enhanced data services.

LOCAL NETWORKS

We are able to expand our reach in a market by collocating equipment in an incumbent local exchange carrier's central office and leasing unbundled network elements from that incumbent local exchange carrier in order to reach customers located in buildings which are not directly connected to our own backbone ring. We attempt to place collocation equipment in a sufficient number of incumbent local exchange carrier central offices to allow us to reach approximately 70% of the business customers in a given market, either by means of such unbundled network elements or direct connections to our network. The decision as to whether to collocate in a specific central office is based upon the number of business lines, number and type of businesses, number of households and the location of the central office within the market.

Our networks consist of digital fiber optic communications paths which allow for high speed, high quality transmission of voice, data and video communications. We typically install backbone fiber optic cables containing 48 to 144 fiber strands which have significantly greater bandwidth carrying capacity than other media. Our OC-48 SONET networks support up to 32,256 simultaneous voice conversations over a single pair of glass fibers. We expect that continuing developments in compression technology and multiplexing equipment will increase the capacity of each fiber, thereby providing more bandwidth carrying capacity at relatively low incremental costs.

We monitor our fiber optic networks and electronics seven days per week, 24 hours per day, using a combination of local and national network control centers. Local network monitoring is accomplished by means of an automatic notification system that monitors for any system anomaly. This system provides instantaneous alarms to an on-call network technician whenever an anomaly is detected. The local market technician is trained in network problem resolution and provides on-site corrective procedures when appropriate. A national Network Reliability Center, located in Denver, Colorado, acts as the focal point for all of our operating networks, providing integrated and centralized network monitoring, and correlation and problem management. The Network Reliability Center has access to all operating networks and can work independently of the local systems to effect repair or restoration activities. The Network Reliability Center is currently provided by Lucent Technologies, Inc. on a contractual basis. In the future, we may develop our own national center.

We manage our network systems both locally and centrally. Customer service calls and maintenance are primarily handled through the local offices. In addition, as described above, we contract to provide integrated monitoring of our networks via Lucent's National Reliability Center. This is accomplished by the use of a sophisticated integrated management system that is connected via the public network to all of our locations, including our Duluth, Georgia, operations center. With this system the National Reliability Center is capable of accessing all available information regarding the configuration and operating condition of any network components in use. This proactive monitoring capability is further augmented by a 24 hour a day, seven day a week call center, also provided by Lucent at the National Reliability Center, that receives, tracks and manages all customer calls and issues to satisfactory conclusion. The call center works with the Company's own customer care representatives and engineers in the Duluth facility to ensure that timely and consistent service is provided.

SALES AND MARKETING

We target our sales and marketing activities at three separate customer groups: retail, national accounts and wholesale. Retail customers are composed of business, government and institutional telecommunications and data services end-users. National accounts are usually large corporations which have branches or local offices within our markets, but which make their buying decisions centrally from their corporate headquarters. Wholesale customers typically consist of long distance carriers, wireless service providers and national Internet service providers. As of February 29, 2000, we had approximately 290 employees engaged in sales and marketing activities.

RETAIL CUSTOMERS. We target retail customer segments such as business, government, healthcare and educational institutions. We target all business customers in our markets.

NATIONAL ACCOUNTS. While there are few Fortune 500 companies with headquarters located in our operating cities, there are branches and local offices of large corporations within our market areas. Often these large corporations make their buying decisions centrally, either through their telecommunications or MIS functions, which are normally located at corporate headquarters. Our national accounts sales organization is structured to assist them in determining requirements for their various locations within our markets. We believe that this focus on national accounts will further increase our market penetration with large companies in our cities.

WHOLESALE CUSTOMERS. We currently target the major long distance carriers such as AT&T, MCI WorldCom and Sprint, as well as Internet service providers. We believe that we can effectively compete to provide access to these customers based on price, reliability, technology, route diversity, ease-of-ordering and customer service. Historically, long distance carriers have paid significant charges to incumbent local exchange carriers to access the incumbent local exchange carriers' networks. We provide these services at a discount. In addition, to the extent that incumbent local exchange carriers begin to compete with long distance carriers in providing long distance services, the long distance carriers have a competitive incentive to move access business away from incumbent local exchange carriers to competitive local exchange carriers such as the Company. Wireless service providers, who need network backbone to back haul calls, are an active customer base, as are other competitive local exchange carriers as wholesale users.

SUPPLIERS

LUCENT. We have contracted with Lucent Technologies, Inc., as our primary supplier, to purchase switching, transport and digital cross connect products. Lucent has also agreed to implement and test our switches and related equipment. In addition, Lucent and the Company have entered into an agreement pursuant to which Lucent has agreed to monitor the Company's switches on an on-going basis.

BILLING SUPPORT SYSTEMS IMPLEMENTATION. We have entered into an agreement with Billing Concepts Systems, Inc., to provide the Company with comprehensive billing functionality, including the ability to collect call detail records, message rating, bill calculation, invoice generation, commission tracking, customer care and inquiry, accounts receivable and collections management, and quality/revenue assurance. We anticipate that the agreement with Billing Concepts will result in our ability to produce a single bill covering all of the products and services that we provide to a customer. We have begun implementation of the new system and expect to have it implemented in all of our markets.

OPERATIONAL SUPPORT SYSTEMS IMPLEMENTATION. We have entered into an agreement with Eftia OSS Solutions Inc., to develop operational support systems. These systems will manage service order processing, circuit and asset inventory, telephone number inventory and trouble administration. The operational support system's capabilities will be expanded during the later phases of the project to include workforce management, local number portability management, network management, service bureau interfaces and web-based service inquiry. We anticipate the system will automate operational support activities and provide a means of managing operational performance of our business. We have begun this multi-phased project and will be implementing portions of it over the next twelve to eighteen months.

EMPLOYEES

As of February 29, 2000, we had approximately 1,100 full-time employees. None of our employees are represented by a labor union or subject to a collective bargaining agreement, nor have we experienced any work stoppage due to labor disputes. We believe that our relations with our employees are good.

GEOGRAPHIC AREAS

We have no foreign operations. All of our networks are located in, and all of our revenues are attributable to, the United States.

PROPERTIES.

The Company is headquartered in Bedminster, New Jersey in approximately 10,000 square feet of office space, approximately 7,200 of which it leases from Kamine Development Corp. (an entity controlled by Mr. Kamine, the Company's Chairman of the Board).

The Company also maintains an operations center in an aggregate of approximately 41,000 square feet of leased space in Duluth, Georgia under leases which expire at various dates from June 2001 through February 2003. The Company also owns or leases facilities in each of its existing markets for central offices, sales offices and the location of its switches and related equipment.

For more information, please visit KMC Telecom at www.kmctelecom.com, or contact:

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EXHIBIT E

STATEMENT OF MANAGERIAL AND TECHNICAL QUALIFICATIONS

STATEMENT OF MANAGERIAL AND TECHNICAL QUALIFICATIONS

KMC Telecom V, Inc. ("KMC V"), a Delaware corporation, is a wholly-owned subsidiary of KMC Telecom Holdings, Inc. ("KMC Holdings"), a Delaware corporation. KMC V is technically qualified to operate as a provider of facilities-based local exchange services and resold local exchange telecommunications services in the State of Missouri. Specifically, KMC V will rely upon the expertise of KMC Holdings' management team who oversees the operations of KMC V and its affiliates: KMC Telecom Inc. ("KMC"), KMC Telecom II, Inc. ("KMC II"), KMC Telecom III, Inc. ("KMC III"), KMC Telecom IV, Inc. ("KMC IV"), and KMC Telecom of Virginia, Inc. ("KMC VA").

The following is a list of KMC Holdings' management team:

Roscoe C. Young, II	**President and Chief Operating Officer**
William H. Stewart	**Chief Financial Officer and Executive Vice President**
Paul DiMarco	**Chief Information Officer**
Patricia Breckenridge	**Executive Vice President – Business Development**
Larry Salter	**Executive Vice President – Network Operations**
Martin F. McDermott, III	**Executive Vice President – Marketing Services**
James L. Barwick	**Senior Vice President – Technology and Chief Engineer**
Charles Rosenblum	**Senior Vice President – Human Resources**
Robert Hagan	**Senior Vice President and Assistant Secretary**

Alan Epstein	**Vice President, General Counsel and Secretary**
Marcy Dean	**Vice President, Treasurer and Assistant Secretary**
Joseph P. Sheehan, III	**Vice President and Controller**
Steven Kreider	**Vice President and Assistant Treasurer**
Jeannette Barretta	**Assistant Secretary**

Collectively, the members of KMC Holdings' management team have designed, managed, and/or operated advanced telecommunications facilities throughout the United States. The members of KMC Holdings' management team bring many years of experience and a wealth of knowledge from being associated with a number of a highly successful companies in the telecommunications industry.

Roscoe C. Young, II, KMC Holdings' President and Chief Operating Officer, prior to joining the Company, was Vice President of Network Services for Ameritech, where he led more than 4,000 employees in providing services ranging from ISDN and digital Centrex to dial tone. He previously directed engineering, network services, national account sales, marketing and real estate procurement for MFS Communications as Senior Vice President of that company. He has also been a senior executive with AT&T where he was responsible for sales, marketing, operations, engineering, financial management and human resources. During that time, he was selected by the Reagan Administration to serve as a Special Assistant to Secretary of Defense Caspar Weinberger under the White House Executive Exchange Program.

William H. Stewart, KMC Holdings' Chief Financial Officer and Executive Vice President, was previously employed with Nassau Capital. Mr. Stewart joined Nassau Capital in 1995 and has over eleven in the telecommunications investment industry. While at Nassau Capital, Mr. Stewart led Nassau's investment program in the communications industry, which included investments in Cypress Communications, Crown Castle and Portal Software. Mr. Stewart has served as a Director of KMC Holdings since 1996. He graduated cum laude with a B.S. degree from Villanova University, earned an M.B.A. from New York University, and is a Chartered Financial Analyst.

Paul DiMarco, KMC Holdings' Chief Information Officer, joined the Company in September, 1998, as its Vice President of Information Technology and Chief Information Officer. From May 1995 to September 1998, he served as Senior Vice President and Chief Information Officer with Nycomed Americas, a multi-national pharmaceutical company. From May 1990 to May 1995, Mr. DiMarco was Director of Information Technology for Ortho-McNeil Pharmaceutical Corporation, a major pharmaceutical division within the Johnson and Johnson family of companies. Prior to joining Ortho-McNeil, Mr. DiMarco served for thirteen years with AT&T Corp. in positions of increasing responsibility including District Manager within the Information Technology Organization, National Account Manager, and Manager Technical- Support for the Commercial and Residential Billing System.

James L. Barwick, KMC Holdings' Senior Vice President of Technology and Chief Engineer, has 39 years of experience in the telecommunications industry. Mr. Barwick joined the Company in March 1997. Prior to joining the Company, Mr. Barwick had been self-employed since 1986 as a telecommunications consultant with expertise in equipment application engineering, radio path engineering, analog and digital Mux, switching and transport systems in the long distance carrier and incumbent local exchange carrier areas, technical writing, project management and computer assisted design systems.

Charles Rosenblum, KMC Holdings' Senior Vice President of Human Resources, has over

20 years experience in human resources, primarily in human resources planning, staffing and development. He joined the Company in January 1997. From May 1995 to January 1997 he served as Vice President of Human Resources of Kamine Development Corp. Previously he had held the positions of Director, Management Development with KPMG Peat Marwick and Manager of Management Education with Dun & Bradstreet Corporation. Earlier he had served in various human resource positions with Allstate Insurance Company.

Patricia Breckenridge, KMC Holdings' Executive Vice President of Business Development, joined the Company in April 1995. From January 1993 to April 1995 she was Vice President and General Manager of FiberNet USA's Huntsville, Alabama operations. Previously she had served as Vice President, External Affairs and later Vice President, Sales and Marketing of Diginet, Inc. She was co-founder of Chicago Fiber Optic Corporation, the predecessor of Metropolitan Fiber Systems. Earlier she was Director of Regulatory Affairs for Telesphere Corporation.

Larry Salter, KMC Holdings' Executive Vice President of Network Operations, is responsible for technical evaluation of new equipment, engineering, and network design of KMC Holdings' local networks. He also oversees the company's construction of new fiber optic-based SONET systems, and provides technical support to KMC Holdings' networks. Mr. Salter came to KMC Holdings' after a 26-year career with AT&T where he was involved in the development and management of Internet services, local area networks, secure systems, and a broad range of technical and engineering functions. He also was a Director of AT&T's strategy and business development and new business integration initiatives. Mr. Salter is a graduate of Iowa State University and holds an MBA in finance and marketing from the University of Chicago.

Martin McDermott, III, is KMC Holdings' Executive Vice President of Marketing Services. Prior to entering the CLEC industry, McDermott was President of Management Profiles, Inc., a management consulting firm specializing in new technologies in the communications industry. He also has held senior management positions with several other organizations including American Wireless Communications Corporation, WilTel, the National Telecommunications Network, Mitel and Northern Telecom, Inc. McDermott has served on the Boards of Directors of CompTel, ACTA, and NATA and is the author of The Business of Interconnect, a definitive study of customer premise equipment. He is a frequent industry spokesperson and contributor to industry periodicals on sales, marketing and technology topics.

Joseph P. Sheehan, III, joined KMC Holdings in June, 1998 as Manager of Financial Systems & Special Projects. He was promoted to Director of Financial Systems & Processes in May, 1999 and has recently been appointed to the position of Vice President & Controller effective March, 2000. Mr. Sheehan began his career in telecommunications with AT&T where he held various positions in the Billing Operations and Controller's organizations from 1991 through 1998 and he managed the results of their Data Services and Government Markets groups in their Business Markets Unit. Prior to moving to AT&T Communications, Joseph spent two years with AT&T Capital where he worked in the Finance group of AT&T Credit managing the lease portfolio. Joseph holds a BS in accounting with an information systems minor from the University of Scranton as well as his MBA from the University of Phoenix and began his career with Coopers & Lybrand.

Jeannette Barretta, KMC Holdings' Assistant Secretary, joined KMC in 1997 as its Contract Administrator and was promoted to Assistant Secretary during 1997 and Contract Manager during 1998. Prior to joining KMC, Ms. Barretta worked as a paralegal for KCS Energy Marketing, Inc. Ms. Barretta began her career as a personal injury paralegal with the law firm of Ravich, Koster, Tobin Oleckna and Greenstein.

With such vast technical experience by the members of its management team, in addition to the outstanding team of engineers and network specialists it has employed, KMC Holdings has the adequate technical experience and managerial capability to develop and maintain a successful local exchange operation in the State of Missouri.

EXHIBIT F

FINANCIAL QUALIFICATIONS

FINANCIAL QUALIFICATIONS OF KMC TELECOM V, INC.

KMC V has access to the financing and capital necessary to conduct it telecommunications operations as specified in the Petition. During an initial transition period, KMC V may rely in part upon the sizeable financial assets of its parent company, KMC Telecom Holdings, Inc., ("KMC Holdings"). In support of this Petition, KMC V submits the following financial information of KMC Holdings to demonstrate that it has sufficient access to capital and financial stability adequate to ensure its continued provision of quality local exchange and interexchange telecommunications services within the State of Missouri. In addition to the information below, KMC Holdings' financial statements, consisting of its most recent SEC Form 10-K, is appended hereto as part of this *Exhibit F*. As KMC V's revenues increase through the acquisition of customers, KMC V's revenues will supplant KMC Holdings' financial assistance.

KMC Holdings has financed its capital expenditures with equity invested by its founders, preferred stock placements, credit facility borrowings, notes, and Senior Discount Notes.

On May 24, 1999, KMC Holdings issued original notes in a private offering. Approximately $104.1 million of the proceeds of the offering were used to purchase a portfolio of U.S. government securities which have been pledged to secure the payment of the first six interest payments on these notes. KMC Holdings will use the net proceeds of the offering to complete the 14 additional networks which it plans to construct by the end of the first half of 2000.

In February 1999, KMC Holdings issued PIK Preferred Stock and warrants to purchase common stock for aggregate gross proceeds of $65.0 million to two purchasers. In April 1999, KMC Holdings issued additional shares of PIK Preferred Stock and warrants to purchase common stock to one additional purchaser for aggregate gross proceeds of $35.0 million. In February 1999, its subsidiary which will own the 14 additional networks which KMC Holdings currently plans to construct by the end of the first half of 2000, entered into a secured vendor financing facility with Lucent Technologies Inc. Under this Lucent Facility, the subsidiary will be permitted to borrow, subject to certain conditions, up to an aggregate of $600.0 million, primarily for the purchase from Lucent of switches and other telecommunications equipment. As of September 30, 1999, the Company had no borrowings outstanding under the facility.

In December 1998, KMC Holdings refinanced and expanded its $70.0 million senior secured credit facility with Newcourt Commercial Finance Corporation to a new $250.0 million facility. Under the refinanced and expanded facility, which is with a group of lenders led by Newcourt Commercial Finance Corporation, First Union National Bank, General Electric Capital Corporation and Canadian Imperial Bank of Commerce, KMC Holdings' subsidiaries which own its initial 23 networks are permitted to borrow up to an aggregate of $250.0 million, subject to certain conditions, for the purchase of fiber optic cable, switches and other telecommunications equipment and, once certain financial conditions are met, for working capital and other general corporate purposes.

Net cash provided by financing activities from borrowings and equity issuances was $219.4 million for 1998 and $332.1 million for the nine months ended September 30, 1999. KMC Holdings' net cash used in operating and investing activities was $213.8 million for 1998 and $332.0 million for the nine months ended September 30, 1999.

KMC Holdings made capital expenditures of $9.1 million in 1996, $61.1 million in 1997, $161.8 million in 1998 and $218.5 million in the nine months ended September 30, 1999. KMC Holdings currently plans to continue significant capital expenditures. The majority of these expenditures is expected to be made for network construction and the purchase of switches and related equipment to facilitate the offering of its services.

At September 30, 1999, KMC Holdings had outstanding commitments aggregating approximately $92.8 million related to the purchase of fiber optic cable and telecommunications equipment as well as engineering services, principally under its agreements with Lucent Technologies.

KMC Holdings has received a signed commitment from Lucent to refinance the existing Lucent Facility upon terms which would involve the provision of additional funding to the Company and the resetting of the financial covenants for periods after the fourth quarter of 1999.

KMC Holdings believes that its cash, investments held for future capital expenditures and borrowings available under the Senior Secured Credit Facility and the Lucent Facility, together with the net proceeds from its April 1999 issuance of its PIK Preferred Stock and the proceeds of the offering of the original notes will be sufficient to meet its liquidity needs through the completion of its initial 23 networks and the 14 additional networks currently planned for completion by the end of the first half of 2000. Additional sources of financing may include public or private equity or debt financings by the Company, capitalized leases and other financing arrangements.

Specifically, as demonstrated in its Cash Flow statement, appended here as part of this *Exhibit F,* KMC Holdings has access to ample capitol to fund the construction and operation of KMC V's telecommunications network in Missouri, and to meet any lease and ownership obligations associated with its provision of local exchange telecommunications services in Missouri.

KMC TELECOM HOLDINGS INC

Filing Type:	**10-K**
Description:	**Annual Report**
Filing Date:	**Mar 31, 2000**
Period End:	**Dec 31, 1999**

Primary Exchange:	**N/A**
Ticker:	**N/A**

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

FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO
SECTIONS 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

(MARK ONE)
|X| ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 1999

|_| 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: 333-50475

KMC TELECOM HOLDINGS, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE 22-3545325

(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)
(I.R.S. EMPLOYER IDENTIFICATION NO.)

1545 ROUTE 206, SUITE 300
BEDMINSTER, NEW JERSEY 07921
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES, INCLUDING ZIP CODE)

Registrant's telephone number, including area code: (908) 470-2100

SECURITIES REGISTERED PURSUANT TO SECTION
12(B) OF THE ACT:
None

SECURITIES REGISTERED PURSUANT TO SECTION
12(G) OF THE ACT:
None

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. [X] Yes [ ] No

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

The aggregate market value of the voting common stock held by non-affiliates of the registrant as of March 29, 2000 was approximately $69,982,563, based upon an estimate of the fair value thereof by management of the registrant. There is no established trading market for the voting common stock of the registrant and no sales have occurred within the past sixty days.

As of March 29, 2000, 853,765 shares of the registrant's Common Stock, $0.01 par value, were outstanding. There is no established trading market for the Common Stock.

DOCUMENTS INCORPORATED BY REFERENCE. None.

CAUTIONARY STATEMENT REGARDING FORWARD - LOOKING STATEMENTS

STATEMENTS IN THIS ANNUAL REPORT ON FORM 10-K THAT ARE NOT PURELY HISTORICAL ARE FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933 AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, INCLUDING STATEMENTS REGARDING THE COMPANY'S EXPECTATIONS, HOPES, INTENTIONS OR STRATEGIES REGARDING THE FUTURE. FORWARD-LOOKING STATEMENTS INCLUDE: STATEMENTS REGARDING THE ANTICIPATED DEVELOPMENT AND EXPANSION OF OUR BUSINESS, THE MARKETS IN WHICH OUR SERVICES ARE CURRENTLY OFFERED, OR WILL BE OFFERED IN THE FUTURE, ANTICIPATED CAPITAL EXPENDITURES AND REGULATORY REFORM, THE INTENT, BELIEF OR CURRENT EXPECTATIONS OF THE COMPANY, OUR DIRECTORS OR OFFICERS WITH RESPECT TO OUR FUTURE FINANCIAL PERFORMANCE AND OTHER MATTERS, AND OTHER STATEMENTS REGARDING MATTERS THAT ARE NOT HISTORICAL FACTS. ALL FORWARD-LOOKING STATEMENTS IN THIS REPORT ARE BASED ON INFORMATION AVAILABLE TO THE COMPANY AS OF THE DATE THIS REPORT IS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION, AND THE COMPANY ASSUMES NO OBLIGATION TO UPDATE ANY SUCH FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM THOSE EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS INCLUDE, BUT ARE NOT LIMITED TO, THE FACTORS SET FORTH IN "ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS -- CERTAIN FACTORS WHICH MAY AFFECT OUR FUTURE RESULTS."

PART I

ITEM 1. BUSINESS.

BACKGROUND

The initial predecessors of KMC Telecom Holdings, Inc. were founded in 1994 and 1995, respectively, by Harold N. Kamine, the Company's Chairman of the Board. These predecessors were merged in 1996 and renamed KMC Telecom Inc. KMC Telecom Holdings, Inc. was formed during 1997 primarily to own, directly or indirectly, all of the shares of its operating subsidiaries, KMC Telecom Inc., KMC Telecom II, Inc., KMC Telecom III, Inc., and KMC Telecom of Virginia, Inc. The principal equity investors in the Company currently include Mr. Kamine, Nassau Capital Partners, L.P., Newcourt Capital, Inc., First Union Corp., General Electric Capital Corporation and Lucent Technologies, Inc.

COMPANY OVERVIEW

We are a facilities-based competitive local exchange carrier providing telecommunications and data services in Tier III markets (markets with a population from 100,000 to 750,000). A facilities-based competitive local exchange carrier is one which operates its own network, including switching equipment and transmission lines, rather than one which intends to primarily resell the services of other carriers. The markets in which we operate are predominantly located in the Southeastern and Midwestern United States. We target as customers business, government and institutional end-users, as well as Internet service providers, long distance carriers and wireless service providers. Our objective is to provide our customers with a complete solution for their communications needs. We currently provide on-net local dial tone, Internet access infrastructure, ISDN (or integrated services digital network), long distance, special access, private line and a variety of other advanced services and features.

We currently operate in 34 Tier III markets and have systems under construction in 3 additional Tier III markets. We expect these new systems to be commercially operational by the end of the first half of 2000. During 2000 we will continue to investigate new Tier III markets. We construct robust fiber optic networks in each of our markets, which we believe allows us to ensure high quality of service, facilitate the delivery of value-added and data services, and effectively control our costs. We currently have Lucent Technologies Series 5ESS(R)-type switches in commercial operation in all of our operational markets and intend to install Lucent switches in any future networks which we may build.

BUSINESS STRATEGY

We intend to become the dominant competitive provider of telephony and data services in the markets that we serve. To accomplish this objective we intend to:

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Focus on Tier III markets. We intend to operate in Tier III markets with attractive demographic, economic, competitive and demand characteristics. We believe that incumbent local exchange carriers tend to focus their efforts on larger markets and generally underserve and underinvest in Tier III markets. We also believe that there is generally significantly less competition from other facilities-based competitive local exchange carriers in Tier III markets, which allows us to gain market share more rapidly than we could expect in Tier I and Tier II markets. In addition, network construction, labor and rights-of-way costs are generally lower in Tier III markets than in Tier I and Tier II markets. For example, many Tier III markets permit significant aerial deployment of fiber optic cable which is less expensive than the buried deployment required in many Tier I and Tier II markets. We estimate that approximately 70% of our fiber is deployed aerially. We select target markets from among the approximately 250 Tier III markets in the United States by first identifying those markets that do not yet have significant, established competitors to the existing incumbent local exchange carrier, and by then reviewing the specific demographic, economic, competitive and telecommunications demand characteristics of such markets to determine their suitability for the types of services which we offer. We estimate market demand on the basis of the concentration of potential business, government and institutional end-user customers in the market and the general economic prospects for the area.

Deploy comprehensive fiber networks. We build geographically extensive, full service, facilities-based networks. We believe such networks provide significant operating leverage, facilitate the capture of market share, and are likely to deter other competitive local exchange carriers from attempting to penetrate our markets due to the cost of constructing a competing network of equal capability. Prior to both the initial construction of our network backbone and any subsequent network expansion, we perform detailed rate of return analyses to justify the capital expenditures involved. In all of our operational markets, we have completed our backbone construction connecting the market's central business district with outlying office parks, large institutions, the locations of long distance carriers' transmission equipment and major incumbent local exchange carrier central offices. We intend to continue to expand our existing networks in response to anticipated customer demand.

Provide enabling infrastructure for data services growth. We intend to serve as a gateway for the provision of sophisticated value-added data services and high speed connectivity to customers in Tier III markets. We believe it is strategically important for us to offer these services because:

- data and internet access is required for businesses to succeed and grow,
- e-commerce is mission critical for many businesses, and
- national service carriers and internet service providers, such as Qwest and UUNet feel it is necessary for them to expand into Tier III markets.

We will provide data services directly to our own customers and will also provide access to Tier III markets for long distance carriers, national service carriers, Internet service providers and other businesses which require broadband access to those markets but which have not constructed their own networks and connections in those markets to enable them to provide it to their

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own customers.

Establish local presence with personalized customer service. We seek to capture and retain our retail customers through local, personalized sales, marketing and customer service programs. To this end, we:

o establish sales offices in each market in which we operate a network,

o strive to recruit our city directors and sales staff from the local market,

o rely principally on a face-to-face selling approach, and

o support our sales staff with locally based customer service and technical support personnel.

Most of our existing sales personnel are local residents who have previously worked for the incumbent local exchange carrier or other telecommunications companies. We believe that our "Creative Solutions with a

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Hometown Touch"(R) sales approach is very important to customers in Tier III markets, who do not typically receive focused local sales contact or customer support from the incumbent local exchange carrier. We seek to build long-term relationships with our customers by responding rapidly and creatively to their telecommunications needs.

Employ a national approach to larger accounts. While establishing a local presence to market to retail customers in our markets, we will employ a national approach to large wholesale customers, such as long distance carriers and Internet service providers, through our carrier group and to the headquarters of large corporations with branch offices in our markets through our national accounts sales organization.

Deploy networks rapidly. It is our practice to use innovative "switch-in-a-box" construction and deployment techniques for most of our networks. Using these techniques, transmission, switching and power equipment are pre-installed by Lucent under controlled factory conditions in portable, weatherproof, storm-proof concrete buildings delivered to the Lucent facility by our contractor. The completed buildings are then shipped to the appropriate city for final installation, reducing costs, installation risks and time to market.

Implement a high-quality operations support system. We are developing a high-quality operations support system to provide us with comprehensive billing, order processing and customer care software for all of our existing and contemplated services. This system is designed to provide us with a single "flow-through" order form that will entail several components, allowing each order to be tracked from service provisioning through to complete installation. We believe that this system will allow us to quickly address customer concerns and provide us with a competitive advantage in customer service and operations efficiency. Initial installation of the new operational support systems commenced during the third quarter of 1999, with development and expansion to continue over the next 12 months.

Leverage our experienced management team. Our experienced management team is led by Harold N. Kamine, Chairman of the Board of Directors. Other members of the team include Roscoe C. Young II, President and Chief Operating Officer, William H. Stewart, Executive Vice President and Chief Financial Officer, Tricia Breckenridge, Executive Vice President--Business Development and James L. Barwick, Senior Vice President and Chief Technology Officer.

SERVICES

General. We have historically provided dedicated access service and have also resold switched services which we purchased from incumbent local exchange carriers. In December 1997, we began providing our own on-net switched services to our customers via direct connections to our networks or unbundled network elements leased from incumbent local exchange carriers. On-net switched services and resale services have accounted for the following percentages of our revenues in 1997, 1998 and 1999:

	1997	1998	1999
On-net switched services.......	32%	37%	69%
Resale services................	68%	63%	31%

Private Line and Special Access Services. We currently provide various types of on-net dedicated services which permit the transmission of voice and data between two points over circuits dedicated to a particular customer. Private line service involves the provision of a private, dedicated telecommunications connection of a customer's different locations. For these services we offer several types of dedicated circuits that have different capacities. DS-1 and DS-3 circuits are dedicated lines that can carry up to 24 and 672 DS-0 circuits, respectively. Special access service involves leasing private, dedicated telecommunications lines running over our networks to long distance carriers. The long distance carriers use these lines to connect different locations where they have installed transmission equipment within the market, to connect locations where they have installed transmission equipment to the transmission equipment locations of other long distance carriers within the market, or to connect large customers directly to the locations of their transmission equipment. In addition to DS-0, DS-1 and DS-3 dedicated circuits, we also offer OC3, OC12 and OC48 circuits for these services. These OC circuits provide the fastest transmission available for carriers and large business users.

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Switch-Based Services. We have added and continue to add capability to provide local dial tone and switched access origination and termination services to our networks. Switches are currently in commercial operation in all of our 34 existing markets and we expect switches to be in commercial operation in the 3 additional Tier III markets in which we currently have networks under construction by the end of the first half of 2000.

Long Distance. We offer a full range of long distance products including inter-LATA, intra-LATA, interstate, international, calling card and 800-number services. During the first quarter of 1999, we introduced KMC-branded operator services, directory services, prepaid phone cards and audio-conference services. We offer these services both on-net and off-net. We offer long distance services on a resale basis by entering into wholesale agreements with various long distance carriers to deliver these services. We believe that many of our customers will prefer the option of purchasing long distance services from us as part of a one-stop telecommunications solution.

Centrex-type Services. We provide Centrex-type services. By using Centrex-type services instead of purchasing and installing a switching system on its own premises, a customer can substantially reduce its capital expenditures and the fixed costs associated with maintaining telecommunications equipment. We introduced our ClearStarsm Advantage service in all of our operational markets during the first quarter of 1999. It has been designed to support multiple applications, ranging from basic access services to services focused on desktop applications. The basic access service connects to a customer's internal system and is equipped with up to 14 features including call forwarding, speed dialing and call transfer capabilities. More sophisticated levels of service are designed to replace portions of a customer's existing telecommunications system. At the high end of service offerings is ClearStarsm Advantage Plus, a packaged, end-to-end offering which combines all of the basic features with Basic Rate ISDN network access, advanced feature functionality, voice messaging and Lucent ISDN multi-featured telephone sets.

New Data Services Offerings. Data services represented approximately 9% of our revenue for 1999. We currently plan to expand our capabilities by introducing additional data services in 2000. We believe that these services will enhance our ability to provide an integrated turnkey solution to our customers' voice, data and video transmission requirements. These data services will include:

o Basic Rate ISDN. Basic Rate ISDN, or BRI, provides customers the potential of 144 kilobits per second of digital communications via a single network facility interface. We believe it will be attractive to small and medium size customers, since it provides dial-up access to the Internet, and other dial-up data applications, while simultaneously providing the ability to integrate voice traffic on a single network facility.

- o Primary Rate ISDN. Primary Rate ISDN provides customers the equivalent of 1.544 megabits per second of digital communications via a T-1 type facility, with 23 channels for voice and data communications and a 24th channel providing network signaling and control for the services. We focus our Primary Rate ISDN sales efforts on (i) Internet service providers who use Primary Rate ISDN as a means of supporting customer access to their operations, and (ii) end-user customers who use Primary Rate ISDN as a network access facility for their internal telecommunications systems.

- o Port wholesale. Port wholesaling is a technology that provides large bandwidth users with data switching capability at the network level, allowing them to acquire capacity as required without investing in data switching equipment. Port wholesaling gives us the ability to provide data switching to Internet service providers by allowing data calls to be terminated through the port wholesale equipment rather than the switch. This enables the Internet service provider to more cost effectively manage its data requirements while, at the same time, increasing the efficiency and capacity of our Lucent Technologies Series 5ESS(R)-type switch.

- o DSL. DSL is a method of using unconditioned, copper wire pairs for high bit-rate data transport for use in the "last mile" connecting our network backbone ring to the customer's premises. We plan to utilize DSL to provide high bandwidth data and video service to small and medium size customers.

- o Frame Relay/ATM. Frame relay and ATM, or asynchronous transfer mode, are used by some of our data customers as a fast data transport service for Wide Area Networks. Today we resell these services. In the future we intend to provide these services over our own network and utilize a third party provider for transport outside our network.

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We plan to remain flexible in responding to evolving customer demands for data services.

LOCAL NETWORKS

As part of determining the economic viability of a network in a particular market, we review the demographic, economic, competitive and telecommunications demand characteristics of the market. We estimate market demand using data gathered from long distance carriers, the Federal Communications Commission, local sources, site visits and specific market studies commissioned by us, the concentration of potential business, government and institutional end-user customers and the general economic prospects for the area.

Once we target a market for development, we design a network to provide access to approximately 70% of the business customers in that market either through direct connections to our network or through unbundled network elements leased from the incumbent local exchange carrier. Typically, we construct a "self-healing" synchronous optical network ("SONET") architecture backbone ring to provide coverage of the major business districts, government offices, hospitals, office parks and universities, the principal locations of the transmission equipment of long distance carriers offering services in the area, and the incumbent local exchange carrier's central office(s). Following construction of our backbone network, we expect to build additional loops to increase the size of our addressable market, as required.

During Phase I of our network construction program we completed networks in 8 Tier III markets. We established networks in 15 Tier III markets during Phase II of the program and will add networks in 14 additional Tier III markets during

Phase III. Eleven of the 14 networks to be added during Phase III have been completed and the remaining 3 networks will be completed during the first half of 2000. The markets in which we established or plan to establish markets during each of these phases of the program are as follows:

PHASE I	PHASE II	PHASE III
Huntsville, Alabama	Greensboro, North Carolina	Charleston, South Carolina
Baton Rouge, Louisiana	Winston-Salem, North Carolina	Lansing, Michigan
Shreveport, Louisiana	Tallahassee, Florida	Akron, Ohio
Corpus Christi, Texas	Roanoke, Virginia	Spartanburg, South Carolina
Savannah, Georgia	Ann Arbor, Michigan	Toledo, Ohio
Madison, Wisconsin	Topeka, Kansas	Columbia, South Carolina
Augusta, Georgia	Fort Wayne, Indiana	Monroe, Louisiana
Melbourne, Florida	Eden Prairie, Minnesota	Montgomery,Alabama
	Daytona Beach, Florida	Clearwater/St.Petersburg, Florida
	Fort Myers, Florida	Dayton, Ohio
	Longview, Texas	Biloxi/Gulf Port, Mississippi
	Sarasota, Florida	Johnson City/Kingsport, Tennessee
	Pensacola, Florida	Chattanooga, Tennessee
	Fayetteville, North Carolina	Rockville/Bethesda/Frederick, Maryland
	Norfolk, Virginia	

The following table presents aggregate data as of February 29, 2000, for the networks placed in operation during Phase I and Phase II, respectively, of our network construction program:

	SWITCHED ACCESS LINES IN SERVICE(1)	DEDICATED DS-0 EQUIVALENT CIRCUITS IN SERVICE(2)	ROUTE MILES	ADDRESSABLE COMMERCIAL BUILDINGS(3)	CENTRAL OFFICE COLLOCATIONS
Phase I markets (8 markets)	65,396	136,572	662	14,800	33
Phase II markets (15 markets)	65,342	130,626	757	25,947	52
Total	130,738	267,198	1,419	40,747	85

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(1) Represents all active switched channels we provide to customers either by resale via the incumbent local exchange carrier's network, by unbundled network elements leased from the incumbent local exchange carrier, or by direct connection to our own network.
(2) Represents all active dedicated DS-0, DS-1 and DS-3 circuits we provide to customers expressed on a DS-0 basis.
(3) Addressable by either unbundled network elements leased from the incumbent local exchange carrier or by a direct connection to our own network. We define a commercial building as one with greater than ten employees.

We are continuing to investigate expanding into additional Tier III markets during 2000. Further expansion of our networks, however, will be dependent upon our ability to obtain additional financing.

The construction of a network requires us to obtain municipal franchises and other permits. These rights are typically the subject of non-exclusive agreements of finite duration providing for the payment of fees by us or the provision of services by us to the municipality without compensation. In addition, we must secure rights-of-way and other access rights which are typically provided under non-exclusive multi-year agreements, which generally contain renewal options. Generally, these rights are obtained from utilities, incumbent local exchange carriers, other competitive local exchange carriers, railroads and long distance carriers. The Telecommunications Act of 1996 requires most utilities to afford access to rights-of-way to competitive local exchange carriers on non-discriminatory terms and conditions and at reasonable rates. However, there can be no assurance that delays or disputes will not occur. Our agreements for rights-of-way and similar matters generally require us to indemnify the party providing such rights. Such indemnities could make us liable for actions (including negligence) of the other party.

Our requirements for a planned network are communicated to our engineering group which finalizes the route and completes the network's design. Independent construction and installation contractors are selected through a competitive bidding process. Our own personnel negotiate required contracts and rights-of-way and supervise the construction, installation and testing of network components prior to commencing commercial service. Cable, equipment and supplies required for the networks are available from a variety of sources at competitive rates. The construction period for a new network varies depending upon such factors as the number of backbone route miles to be installed, the relative use of aerial as opposed to buried cable deployment, the initial number of buildings targeted for connection to the network backbone and other factors. Based upon our experience, we believe that a new fiber optic network can be made commercially operational within approximately 6 months after construction commences.

In a typical Tier III market, selected office buildings are connected to our network by network backbone extensions or unbundled network elements leased from the incumbent local exchange carrier. Within each building, customer equipment is connected to Company-provided electronic equipment where customer transmissions are digitized, combined and converted to an optical signal. The traffic is then transmitted through the network backbone to our local central office where it can be routed to its ultimate destination.

We are able to expand our reach in a market by collocating equipment in an incumbent local exchange carrier's central office and leasing unbundled network elements from that incumbent local exchange carrier in order to reach customers located in buildings which are not directly connected to our own backbone ring. We attempt to place collocation equipment in a sufficient number of incumbent local exchange carrier central offices to allow us to reach approximately 70% of the business customers in a given market, either by means of such unbundled network elements or direct connections to our own network. The decision as to

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whether to collocate in a specific central office is based upon the number of business lines, number and type of businesses, number of households and the location of the central office within the market.

Our networks consist of our fiber optic backbones, fiber laterals and unbundled network elements. Our networks allow for high speed, high quality transmission of voice, data and video communications. We typically install backbone fiber optic cables containing 48 to 144 fiber strands which have significantly greater bandwidth carrying capacity than other media. Our OC-48 SONET networks support up to 32,256 simultaneous voice conversations over a single pair of fiber optic fibers. We expect that continuing developments in compression technology and multiplexing equipment will increase the capacity of each fiber, thereby providing more bandwidth carrying capacity at relatively low incremental costs.

We currently offer end-to-end fully protected fiber services utilizing SONET ring architecture which routes customer traffic simultaneously in both directions around the ring to provide protection against fiber cuts. If a line is cut, traffic can simply be reversed and sent to its destination around the other side of the ring. Back-up electronics become operational in the event of failure of the primary components.

We monitor our fiber optic networks and electronics seven days per week, 24 hours per day, using a combination of local and national network control centers. Local network monitoring is accomplished by means of an automatic notification system that monitors for any system anomaly. This system provides instantaneous alarms to an on-call network technician whenever an anomaly is detected. The local market technician is trained in network problem resolution and provides on-site corrective procedures when appropriate. A national Network Reliability Center, located in Denver, Colorado, acts as the focal point for all of our operating networks, providing integrated and centralized network monitoring, and correlation and problem management. The Network Reliability Center has access to all operating networks and can work independently of the local systems to effect repair or restoration activities. The Network Reliability Center is currently provided by Lucent on a contractual basis. In the future, we may develop our own national center.

We manage our network systems both locally and centrally. Customer service calls and maintenance are primarily handled through the local offices. In addition, as described above, we contract to provide integrated monitoring of our networks via Lucent's Network Reliability Center. This is accomplished by the use of a sophisticated integrated management system that is connected to all of our locations, including our Duluth, Georgia, operations center. With this system the Network Reliability Center is capable of accessing all available information regarding the configuration and operating condition of any network components in use. This proactive monitoring capability is further augmented by a 24 hour a day, seven day a week call center, also provided by Lucent at the Network Reliability Center, that receives, tracks and manages all customer calls and issues to satisfactory conclusion. The call center works with the Company's own customer care representatives and engineers in the Duluth facility to ensure that timely and consistent service is provided.

SALES AND MARKETING

We target our sales and marketing activities at three separate customer groups: retail, national accounts and wholesale. Retail customers are composed of business, government and institutional telecommunications and data services end-users and local Internet service providers. National accounts are usually large corporations which have branches or local offices within our markets, but which make their buying decisions centrally from their corporate headquarters. Wholesale customers typically consist of long distance carriers, wireless service providers and national Internet service providers. As of February 29, 2000, we had approximately 290 employees engaged in sales and marketing activities.

Retail Customers. We target retail customer segments such as business, government, healthcare and educational institutions. We target all business customers in our markets as well as local Internet service providers. Each city's local sales staff is responsible for calling on the retail customers in its market.

National Accounts. While there are few Fortune 500 companies with headquarters located in our operating cities, there are branches and local offices of large corporations within our market areas. Often these large corporations make their buying decisions centrally, either through their telecommunications or MIS functions, which are normally located at corporate headquarters. Our national accounts sales organization is structured to assist them in determining requirements for their various locations within our markets.

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We believe that this focus on national accounts will further increase our market penetration with large companies in our cities.

Wholesale Customers. We currently target the major long distance carriers such as AT&T, MCI WorldCom and Sprint, Internet service providers, wireless service providers and other competitive local exchange carriers, through our carrier group. We believe that we can effectively compete to provide access to

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these customers based on price, reliability, technology, route diversity, ease-of-ordering and customer service. We provide competitive pricing for the transport and termination of communications for high volume users of long-distance services, which has historically been provided by the incumbent local exchange carrier. To the extent that incumbent local exchange carriers begin to compete with long distance carriers in providing long distance services, the long distance carriers have a competitive incentive to move traffic away from incumbent local exchange carriers to competitive local exchange carriers like us. Wireless service providers, who need network backbone to transport calls, are an active customer base, as are other competitive local exchange carriers as wholesale users. Revenues from access services may decline in future years due to a change in pricing proposed by the Federal Communications Commission.

Sales Personnel. We establish local sales offices in each market that we serve. Initially, each local sales office is staffed by a City Director and 2 or 3 salespersons, which increases to between 4 and 6 as our operations in the market expand. We seek to hire our sales personnel locally, since we believe that knowledge of, and contacts in, a local market are key factors for competitive differentiation and commercial success in a Tier III market. We believe that this local focus will help to set us apart from the incumbent local exchange carriers, our principal competitors.

City Directors. We seek to hire local, seasoned telecommunications managers, with sales experience, as City Directors. City Directors assist with the initial network buildout and oversee the daily operations of their network, in addition to managing sales staff and market development. Daily operations responsibilities include monitoring provisioning, customer service, pricing decisions and the billing process. A City Director works with senior management in the strategic planning process, including capital expenditures and budget planning. They perform cash flow analysis for fiber connections of new buildings to the network, and participate in planning fiber network extensions in their markets.

SUPPLIERS

Lucent. We have contracted with Lucent, as our primary supplier, to purchase switching, transport and digital cross connect products. Lucent has also agreed to implement and test our switches and related equipment. In addition, Lucent and the Company have entered into an agreement pursuant to which Lucent has agreed to monitor our switches on an on-going basis. Lucent is an investor in our preferred stock and a lender under our Amended Senior Secured Credit Facility.

Billing Support Systems Implementation. In the second quarter of 1999, we installed software developed by Billing Concepts Systems, Inc. to provide us with comprehensive billing functionality, including the ability to collect call detail records, message rating, bill calculation, invoice generation, commission tracking, customer care and inquiry, collections management, and quality assurance. The Billing Concepts software enables us to produce a single bill covering all of the products and services that we provide to a customer. Additional development of the new billing systems will take place over the next 9 months.

Operational Support Systems Implementation. We entered into an agreement with Eftia OSS Solutions Inc. to develop operational support systems. These systems manage service order processing, circuit and asset inventory, telephone number inventory and trouble administration. The operational support system's responsibilities will be expanded during the later phases of the project to include workforce management, local number portability management, network management, service bureau interfaces, and Internet-based service inquiry. The system will automate operational support activities and provide a means of managing operational performance of our business. Initial installation of the new operational support systems commenced during the third quarter of 1999, with development and expansion to continue over the next 12 months.

COMPETITION

Overview. The telecommunications industry is highly competitive. Our principal competitors in Tier III markets will be the incumbent local exchange carriers. In most instances the incumbent local exchange carrier is one of the Regional Bell Operating Companies (such as Ameritech, Bell Atlantic, BellSouth or SBC), one of GTE Corporation's subsidiaries or one of Sprint Corporation's subsidiaries. Incumbent local exchange carriers presently have almost 100% of the market share in those areas we consider our market areas. Because of their relatively small size, we do not believe that Tier III markets can profitably support more than two competitors to the incumbent local exchange carrier.

Other competitors may include other competitive local exchange carriers, microwave and satellite carriers, wireless telecommunications providers and private networks built by large end-users. Potential competitors (using similar or different technologies) include cable television companies, utilities and Regional Bell Operating Companies seeking to operate outside their current local service areas. In addition, there may be future competition from large long distance carriers, such as AT&T and MCI WorldCom, which have begun to offer integrated local and long distance telecommunications services. AT&T also has announced its intention to offer local services using a new wireless technology. Consolidation of telecommunications companies and the formation of strategic alliances within the telecommunications industry, as well as the development of new technologies, could give rise to significant new competitors to the Company.

Both the long distance business and the data transmission business are extremely competitive. Prices in both businesses have declined significantly in recent years and are expected to continue to decline. In the long distance business, we will face competition from large carriers such as AT&T, MCI WorldCom and Sprint. We will rely on other carriers to provide transmission and termination for our long distance traffic and therefore will be dependent on such carriers.

Incumbent Local Exchange Carriers. Our principal competitors for local exchange services are the Regional Bell Operating Companies, GTE Corporation's subsidiaries and Sprint Corporation's subsidiaries. As a recent entrant in the integrated telecommunications services industry, we have not yet achieved a significant market share for any of our services. In particular, the incumbent local exchange carriers: have long-standing relationships with their customers,

- have financial, technical and marketing resources substantially greater than ours,
- have the potential to fund competitive services with revenues from a variety of businesses, and
- currently benefit from certain existing regulations that favor the incumbent local exchange carriers over us in certain respects.

Recent regulatory initiatives allow us, as a competitive local exchange carrier, to interconnect with incumbent local exchange carrier facilities. This provides increased business opportunities for us. However, these regulatory initiatives have been accompanied by increased pricing flexibility for, and relaxation of regulatory oversight of, the incumbent local exchange carriers. If the incumbent local exchange carriers engage in increased volume and discount pricing practices or charge us increased fees for interconnection to their networks, or if the incumbent local exchange carriers seek to delay implementation of our interconnection to their networks, our business, financial condition and results of operations could be adversely affected.

To the extent that we interconnect with and use incumbent local exchange carrier networks to serve our customers, we are dependent upon their technology and capabilities. We will become increasingly dependent on interconnection with incumbent local exchange carriers as switched services become a greater percentage of our business. The Telecommunications Act of 1996 imposes interconnection obligations on incumbent local exchange carriers, but we cannot assure you that we will be able to obtain the interconnection we require at rates, and on terms and conditions, that will permit us to offer switched services at desirable rates, terms and conditions. In the event that we experience difficulties in obtaining appropriate and reasonably priced service from the incumbent local exchange carriers, our ability to serve our customers would be impaired.

Competitive Local Exchange Carriers and Other Competitors. We will compete from time to time with other competitive local exchange carriers. It is likely that in several of our markets we will face competition from two or more facilities-based competitive local exchange carriers. After the investment and expense of establishing a network and support services in a given market, the marginal cost of carrying an additional call is negligible. Accordingly, in Tier III markets where there are 3 or more facilities-based competitive local exchange carriers, we expect substantial price competition. We believe that operations in such markets are likely to be unprofitable for one or more operators.

We expect to face competition in each of our markets. However, we believe that our commitment to build a significant network, deploy switches and establish local sales and support facilities at the outset in each of the Tier III markets which we target should reduce the number of facilities-based competitors and drive other entrants to focus on the resale of incumbent local exchange carrier service or our services or to invest in other markets. We believe that each market will also see more agent and distributor resale initiatives.

We expect to experience declining prices and increasing price competition. We cannot assure you that we will be able to achieve or maintain adequate market share or revenue, or compete effectively, in any of our markets.

REGULATION

Our services are subject to varying degrees of federal, state and local regulation. The Federal Communications Commission exercises jurisdiction over facilities of, and interstate and international services offered by, telecommunications common carriers. The state regulatory commissions retain jurisdiction over the same facilities and services to the extent they are used to originate or terminate intrastate communications. Local governments sometimes impose franchise or licensing requirements on competitive local exchange carriers.

Federal Regulation

We are regulated at the federal level as a nondominant common carrier subject to minimal regulation under Title II of the Communications Act of 1934. The Communications Act of 1934 was substantially amended by the Telecommunications Act of 1996. This legislation is designed to enhance competition in the local telecommunications marketplace by:

- removing state and local entry barriers,
- requiring incumbent local exchange carriers to provide interconnection to their facilities,
- facilitating the end-users' choice to switch service providers from incumbent local exchange carriers to competitive local exchange carriers such as the Company, and
- requiring access to rights-of-way.

The legislation also is designed to enhance the competitive position of the competitive local exchange carriers and increase local competition by newer competitors such as long distance carriers, cable television companies and public utility companies. Under the Telecommunications Act of 1996, Regional Bell Operating Companies have the opportunity to provide in-region long distance services if certain conditions are met and are no longer prohibited from providing certain cable television services. In addition, the Telecommunications Act of 1996 eliminates certain restrictions on utility holding companies, thus clearing the way for them to diversify into telecommunications services.

The Telecommunications Act of 1996 specifically requires all telecommunications carriers (including incumbent local exchange carriers and competitive local exchange carriers (like us)):

- o not to prohibit or unduly restrict resale of their services,
- o to provide dialing parity and nondiscriminatory access to telephone numbers, operator services, directory assistance and directory listings,

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- o to afford access to poles, ducts, conduits and rights-of-way, and
- o to establish reciprocal compensation arrangements for the transport and termination of telecommunications.

It also requires competitive local exchange carriers and incumbent local exchange carriers to provide interconnection for the transmission and routing of telephone exchange service and exchange access. It requires incumbent local exchange carriers to provide such interconnection:

- o at any technically feasible point within the incumbent local exchange carrier's network,
- o that is at least equal in quality to that provided by the incumbent local exchange carrier to itself, its affiliates or any other party to which the incumbent local exchange carrier provides interconnection, and
- o at rates, terms and conditions that are just, reasonable and nondiscriminatory.

Incumbent local exchange carriers also are required under the new law to provide nondiscriminatory access to network elements on an unbundled basis at any technically feasible point, to offer their local telephone services for resale at wholesale rates, and to facilitate collocation of equipment necessary for competitors to interconnect with or access the unbundled network elements.

The Telecommunications Act of 1996 provided for the removal of most restrictions from AT&T and the Regional Bell Operating Companies resulting from the consent decree entered in 1982 providing for divestiture of the Regional Bell Operating Companies from AT&T in 1984. The Telecommunications Act establishes procedures under which a Regional Bell Operating Company can enter the market for long distance service between specified areas within its local service area. The Telecommunications Act of 1996 permitted the Regional Bell Operating Companies to enter the out-of-region long distance market immediately upon enactment, and Regional Bell Operating Companies can provide intra-LATA long distance services. Before the Regional Bell Operating Company can provide in-region inter-LATA services, it must obtain Federal Communications Commission approval upon a showing that facilities-based competition is present in its market, that the Regional Bell Operating Company has entered into interconnection agreements in the states where it seeks authority, that the Regional Bell Operating Company has satisfied a 14-point "checklist" of competitive requirements, and that such entry is in the public interest. To date, the Federal Communications Commission has granted such authority only to Bell Atlantic in New York State. The provision of inter-LATA services by Regional Bell Operating Companies is expected to reduce the market share of major long distance carriers, and consequently, may have an adverse effect on the ability of competitive local exchange carriers to generate access revenues from the long distance carriers.

Federal Communications Commission Rules Implementing the Local Competition Provisions of the Telecommunications Act of 1996. The Federal Communications Commission in 1996 established a framework of national rules enabling state public service commissions and the Federal Communications Commission to begin implementing many of the local competition provisions of the Telecommunications Act of 1996. The Federal Communications Commission prescribed certain minimum points of interconnection necessary to permit competing carriers to choose the most efficient points at which to interconnect with the incumbent local exchange carriers' networks. The Federal Communications Commission also adopted a minimum list of unbundled network elements that incumbent local exchange carriers must make available to competitors upon request and a methodology for states to use in establishing rates for interconnection and the purchase of unbundled network elements. The Federal Communications Commission also adopted a methodology for states to use when applying the Telecommunications Act's "avoided cost standard" for incumbent local exchange carriers to set the prices to be charged to resellers of their services.

The Federal Communications Commission has authority to establish national pricing rules for interconnection, unbundled elements and resale services. The Supreme Court also upheld the Federal Communications Commission's interpretation of the "pick and choose" provisions, which permit carriers to obtain favorable provisions in interconnection agreements. However, the Supreme Court overturned the Federal Communications Commission's rules regarding what network elements must be unbundled by the Regional Bell Operating Companies, and remanded to the

Federal Communications Commission the question of what network elements are "necessary" to competing carriers such as the Company. On November 5, 1999, the Federal Communications Commission issued an order and proposed rulemaking establishing the network elements that must be offered by incumbent local exchange carriers as unbundled network elements. In addition, the Supreme Court's decision creates some uncertainty regarding the legal status of complaints filed at the Federal Communications Commission to enforce interconnection agreements. We cannot assure you that we will be able to maintain interconnection agreements on terms acceptable to us.

On December 9, 1999, the Federal Communications Commission released an order requiring incumbent local exchange carriers to offer "line sharing" arrangements that will permit competitors like us to offer DSL service over the same copper wires used by the incumbent local exchange carriers to provide voice service. The specific prices and terms of these arrangements will be determined by future decisions of state utility commissions, and cannot be predicted at this time. The Federal Communications Commission's ruling may also be challenged in court. We expect, however, that this order, if implemented, will allow us to offer DSL services at a significantly lower cost than is now possible. On March 17, 2000, the U.S. Court of Appeals for the District of Columbia Circuit vacated certain Federal Communications Commission rules relating to collocation of competitors' equipment in incumbent local exchange carriers' central offices. This decision requires the Federal Communications Commission to limit collocation to equipment that is "necessary" for interconnection with the incumbent local exchange carrier or access to the incumbent local exchange carrier's unbundled network elements. We believe that all of the equipment we currently place in collocation arrangements is necessary for these purposes, and therefore our collocation arrangements should not be adversely affected by the court decision. However, any disputes over the "necessary" status of particular items of equipment may have to be resolved by the Federal Communications Commission or by state commissions, and such disputes could result in delays or changes to our collocation plans.

Other Regulation. In general, the Federal Communications Commission's policies encourage the entry of new competitors in the telecommunications industry and are designed to prevent anti-competitive practices. Currently, large incumbent local exchange carriers such as GTE and the Regional Bell Operating Companies are regulated as "dominant" carriers, while competitive local exchange carriers such as the Company are considered "nondominant" carriers. Dominant carriers face more detailed regulatory scrutiny. As a nondominant carrier, we are subject to relatively minimal Federal Communications Commission regulation.

- Tariff. We may install and operate facilities for the transmission of domestic interstate communications without prior Federal Communications Commission authorization. The Federal Communications Commission requires us to file tariffs and periodic reports concerning our interstate circuits and deployment of network facilities, and offer interstate services on a nondiscriminatory basis, at just and reasonable rates. We also remain subject to Federal Communications Commission complaint procedures.

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The Federal Communications Commission adopted an order in 1996 (the "Detariffing Order") which eliminated the requirement that nondominant interstate carriers maintain tariffs on file with the Federal Communications Commission for domestic interstate services. The order provided that, after a nine-month transition period, relationships between interstate carriers and their customers would be set by contract. Several parties requested reconsideration and/or filed appeals of the Detariffing Order. On February 13, 1997, the United States Court of Appeals for the District of Columbia Circuit stayed implementation of the Detariffing Order. If the Detariffing Order becomes effective, nondominant interstate services providers will no longer be able to rely on the filing of tariffs with the Federal Communications Commission as a means of providing notice to customers of prices, terms and conditions under which they offer their interstate services. If we cancel our Federal Communications Commission tariffs as a result of the Detariffing Order, we will need to individually negotiate contract terms with certain of our customers, which could result in substantial legal and administrative expense.

o Access Charges. The Federal Communications Commission has granted incumbent local exchange carriers significant flexibility in pricing their interstate special and switched access services on

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a specific central office by central office basis. Under this pricing scheme, incumbent local exchange carriers may establish pricing zones based on access traffic density and charge different prices for each zone. We anticipate that this pricing flexibility will result in incumbent local exchange carriers lowering their prices in high traffic density areas, which is where our customers are concentrated. The Federal Communications Commission adopted an order on August 5, 1999 granting incumbent local exchange carriers subject to price cap regulation additional pricing flexibility. These changes will reduce access charges and will shift charges currently based on minutes to flat-rate, monthly per line charges. As a result, the aggregate amount of access charges paid by long distance carriers to access providers in the United States may decrease.

The order provides certain immediate regulatory relief to incumbent local exchange carriers subject to price cap regulation and sets a framework of "triggers" to provide those companies with greater pricing flexibility to set interstate access rates as competition increases. The order also initiated a rulemaking to determine whether the Federal Communications Commission should regulate the access charges of competitive local exchange carriers. If this increased pricing flexibility is not effectively monitored by federal regulators, it could have a material adverse effect on our ability to price our interstate access services competitively. A May 16, 1999 order, which was upheld on appeal by the United States Court of Appeals for the Eighth Circuit, substantially increased the amounts that incumbent local exchange carriers subject to the Federal Communications Commission's price cap rules ("price cap local exchange carriers") recover through monthly flat-rate charges and substantially decreased the amounts that these local exchange carriers recover through traffic sensitive (per-minute) access charges. Several parties appealed the May 16th order.

These decisions are likely to have a significant impact on our operations, expenses, pricing and revenue.

Universal Service Reform. The Federal Communications Commission implemented the provisions of the Telecommunications Act of 1996 relating to the preservation and advancement of universal telephone service in 1997. The Federal Communications Commission's universal service principles provide that universal service support mechanisms and rules should not unfairly advantage or disadvantage one provider or technology over another. All telecommunications carriers providing interstate telecommunications services, including us, must contribute to the universal service support fund. On October 8, 1999, the Federal Communications Commission released an order implementing changes to its universal service rules to comply with a recent decision of the Fifth Circuit Court of Appeals. Among other changes, the Federal Communications Commission revised its rules concerning assessment of carriers' intrastate and international revenues for universal service contribution. The Federal Communications Commission narrowed the scope of the contribution base, removing intrastate end-user telecommunications revenues from the assessment, consistent with the opinion of the Fifth Circuit Court of Appeals. The contribution factor for the first quarter of 2000 is 5.877% of interstate and international end-user telecommunications revenues.

State Regulation

We believe that most, if not all, states in which we operate or propose to operate require a certification or other authorization to offer intrastate and local services. Many of the states in which we operate or intend to operate are in the process of addressing issues relating to the regulation of competitive local exchange carriers. We are subject to state tariff filing requirements.

These certifications generally require a showing that the carrier has adequate financial, managerial and technical resources to offer the proposed services in a manner consistent with the public interest.

We have obtained state authority for the provision of our dedicated services and a full range of local switched services and long distance services. In most states, we are required to file tariffs setting forth the terms, conditions and prices for services that are classified as intrastate. We plan to obtain additional state authorities to accommodate our business and network expansion.

Some states also impose reporting, customer service, and quality requirements, as well as unbundling and universal service requirements. In addition, we are subject to the outcome of proceedings held by state utility commissions to determine state regulatory policies with respect to incumbent local exchange carrier and competitive local exchange carrier competition, geographic build-out, mandatory detariffing and other issues relevant to competitive local exchange carrier operations. Certain states have adopted state-specific universal service funding obligations.

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In addition to obtaining state certifications, we must negotiate terms of interconnection with the incumbent local exchange carrier before we can begin providing switched services. Our executed agreements are subject to the approval of the state commissions. State commissions have approved our existing agreements. We anticipate state commission approval of our future interconnection agreements.

We believe that, as the degree of local competition increases, the states will offer the incumbent local exchange carriers increasing pricing flexibility. This flexibility may present the incumbent local exchange carriers with an opportunity to subsidize services that compete with our services with revenues generated from noncompetitive services, thereby allowing incumbent local exchange carriers to offer competitive services at prices below the cost of providing the service. We cannot predict the extent to which this may occur, but it could have a material adverse effect on our business.

We actively participate in various regulatory proceedings before the states, the outcome of which may establish policies that affect our competitive and/or economic position in the local and other telecommunications services markets.

We also may be subject to requirements in certain states to obtain prior approval for, or notify the state commission of, any transfers of control, sales of assets, corporate reorganizations, issuances of stock or debt instruments and related transactions.

Local Government Authorizations. We are required to obtain street use and construction permits and licenses and/or franchises to install and expand our fiber optic networks using municipal rights of way. In some municipalities where we have installed or anticipate constructing networks, we will be required to pay license or franchise fees based on a percentage of gross revenues or on a per foot basis, as well as post performance bonds or letters of credit. We are actively pursuing permits, franchises and other relevant authorities for use of rights-of-way and utility facilities in a number of cities.

FRANCHISES AND PERMITS

The construction of a network requires us to obtain municipal franchises and other permits. These rights are typically the subject of non-exclusive agreements of finite duration providing for the payment of fees or the provision of services by us to the municipality without compensation. In addition, we must secure rights-of-way and other access rights which are typically provided under non-exclusive multi-year agreements, which generally contain renewal options. Generally, these rights are obtained from utilities, incumbent local exchange carriers, other competitive local exchange carriers, railroads and long distance carriers. The Telecommunications Act of 1996 requires most utilities to afford access to rights-of-way to competitive local exchange carriers on non-discriminatory terms and conditions and at reasonable rates. However, there can be no assurance that delays and disputes will not occur. Our agreements for rights-of-way and similar matters generally require us to indemnify the party providing such rights. Such indemnities could make us liable for actions (including negligence) of the other party.

CUSTOMERS

No single customer accounted for more than 10% of our consolidated revenues in 1998 or 1999. Our five largest customers accounted for 11% of our consolidated revenues in 1998 and 8% of our consolidated revenues in 1999. We expect customer concentration to continue to decrease as we expand into additional markets and increase full scale marketing of an integrated service package. In the near term, however, the loss of, or decrease of business from, one or more of our principal customers could have a material adverse effect on our business, financial condition and results of operations.

Although they are not our customers, we did recognize revenue of approximately $9.7 million, or 15.1% of our 1999 revenue, from incumbent local exchange carriers primarily related to reciprocal compensation for terminating local calls from customers of the incumbent local exchange carriers to Internet service providers which are our customers. Of this amount approximately 64% is attributable to reciprocal compensation due to us from BellSouth. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Overview - Revenue" for a discussion of a dispute which has arisen between incumbent local exchange carriers, such as BellSouth, and competitive

local exchange carriers, like us, with respect to the obligation of incumbent local exchange carriers to make reciprocal compensation payments to competitive local exchange carriers with respect to the termination of local calls to Internet service providers.

EMPLOYEES

As of February 29, 2000, we had approximately 1,100 full time employees. None of our employees are represented by a labor union or subject to a collective bargaining agreement, nor have we experienced any work stoppage due to labor disputes. We believe that our relations with our employees are good.

GEOGRAPHIC AREAS

We have no foreign operations. All of our networks are located in, and all of our revenues are attributable to, the United States.

ITEM 2. PROPERTIES.

We are headquartered in Bedminster, New Jersey in approximately 14,000 square feet of office space, approximately 7,200 of which we lease from Kamine

Development Corp. (an entity controlled by Mr. Kamine, the Company's Chairman of the Board). The lease with Kamine Development Corp., which expires in January 2007, provides for a base annual rental of approximately $217,000 (adjusted periodically for changes in the consumer price index), plus operating expenses.

We also maintain an operations center in an aggregate of approximately 104,000 square feet of leased space in Duluth, Georgia under leases which expire at various dates from July 2000 through February 2003. We also own or lease facilities in each of our existing markets for central offices, sales offices and the location of our switches and related equipment.

We believe that our facilities are in good condition, are suitable for our operations and that, if needed, suitable alternative space would be readily available.

ITEM 3. LEGAL PROCEEDINGS.

We are from time to time involved in litigation incidental to the conduct of our business. There is no pending legal proceeding to which we are a party, however, which, in the opinion of our management, is likely to have a material adverse effect on our business, financial condition and results of operations.

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

No matters were submitted to a vote of security holders during the fourth quarter of 1999.

PART II

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

There is currently no established trading market for our Common Stock, $0.01 par value per share. As of March 29, 2000 there were nine holders of record of our Common Stock.

We have never declared nor paid cash dividends on our Common Stock and do not presently anticipate paying any cash dividends on our Common Stock in the foreseeable future. We currently expect that earnings, if any, will be retained for growth and development of our business.

As a holding company, we depend upon the receipt of dividends and other cash payments from our operating subsidiaries in order to meet our cash requirements. Pursuant to the terms of our Amended and Restated Loan and Security Agreement, dated as of February 15, 2000, among our principal operating subsidiaries and a group of lenders led by First Union National Bank, Newcourt Commercial Finance Corporation and Lucent (the "Amended Senior Secured Credit Facility"), those subsidiaries are restricted in their ability to pay dividends on their capital stock. The indentures applicable to our 13 1/2% Senior Notes due 2009 and our 12 1/2% Senior Discount Notes due 2008, respectively, impose certain restrictions upon our ability to pay dividends on our capital stock.

Subject to the foregoing and to any restrictions which may be contained in any future indebtedness which we may incur, the payment of cash dividends on our Common Stock will be within the sole discretion of our Board of Directors, and will depend upon the earnings, capital requirements and financial position of the Company, applicable requirements of law, general economic conditions and other factors considered relevant by our Board of Directors.

On May 24, 1999, we sold $275.0 million aggregate principal amount of 13 1/2% Senior Notes due 2009 to Morgan Stanley & Co. Incorporated, as representative of certain initial purchasers. The sale of the Senior Notes to the initial purchasers was made in reliance upon the exemption from the registration requirements of the Securities Act of 1933, as amended, provided by Section 4(2) of that Act, on the basis that the transaction did not involve a public offering. The initial purchasers agreed that any resales which they made would be made only (i) to qualified institutional buyers as defined in Rule 144A under the Securities Act, (ii) to institutional accredited investors as defined in Rule 501(a)(1), (2), (3) or (7) under the Securities Act, or (iii) outside the United States to persons other than U.S. persons in reliance upon Regulation S under the Securities Act.

On December 16, 1999, one institutional investor exercised 50 warrants to purchase an aggregate of 10 shares of our Common Stock for aggregate gross proceeds of $0.10. The issuance of the shares upon exercise of the warrants was made in reliance on the exemption from registration provided by Section 4(2) of the Securities Act, on the basis that the transaction did not involve a public offering. The Warrant Agreement applicable to the warrants contains representations as to such investor's investment intent and imposes substantial restrictions upon transfer of the securities.

On January 1, 1999, July 1, 1999 and October 1, 1999, the Company granted options to purchase an aggregate of 82,342 shares of its Common Stock to employees of the Company and employees of certain affiliates of the Company under the 1998 Stock Purchase and Option Plan for Key Employees of KMC Telecom Holdings, Inc. and Affiliates. No consideration was received by us for the issuance of the options. The options have various exercise prices with 67,509 exercisable at an exercise price of $125 per share, 2,933 exercisable at an exercise price of $225 per share, and 11,900 exercisable at an exercise price of $250 per share. The issuance of the options was made in reliance upon the exemption from the registration requirements of the Securities Act provided by Section 4(2) of that Act, on the basis that the transaction did not involve a public offering.

ITEM 6. SELECTED FINANCIAL DATA.

The selected financial data set forth below for the years ended December 31, 1995, 1996, 1997, 1998 and 1999 were derived from our audited financial statements and those of our predecessors. The 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 consolidated financial statements and notes thereto included in "Item 8. Financial Statements and Supplementary Data."

	YEAR ENDING DECEMBER 31				
	1995	1996	1997	1998	1999
	(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)				
STATEMENT OF OPERATIONS DATA:					
Revenue	$ -	$ 205	$ 3,417	$ 22,425	$64,313
Operating expenses:					
Network operating costs	-	1,361	7,735	37,336	110,309
Selling, general and administrative	1,591	2,216	9,923	24,534	55,803
Stock option compensation expense	-	240	13,870	7,080	29,833
Depreciation and amortization	6	287	2,506	9,257	29,077
Total operating expenses	1,597	4,104	34,034	78,207	225,022
Loss from operations	(1,597)	(3,899)	(30,617)	(55,782)	(160,709)
Other expense (a)	-	-	-	-	(4,297)
Interest income	-	-	513	8,818	8,701
Interest expense (b)	(23)	(596)	(2,582)	(29,789)	(69,411)
Net loss	(1,620)	(4,495)	(32,686)	(76,753)	(225,716)
Dividends and accretion on redeemable preferred stock	-	-	(8,904)	(18,285)	(81,633)
Net loss applicable to common shareholders	$(1,620)	$ (4,495)	$ (41,590)	$ (95,038)	$(307,349)
Net loss per common share	$ (2.70)	$ (7.49)	$ (64.93)	$ (114.42)	$ (360.88)
Weighted average number of common shares outstanding	600	600	641	831	852
OTHER DATA:					
Capital expenditures (including acquisitions)	$ 3,498	$ 9,111	$ 61,146	$ 161,803	$ 440,733
Adjusted EBITDA(c)	(1,591)	(3,373)	(14,241)	(39,445)	(101,799)
EBITDA(c)	(1,591)	(3,613)	(28,111)	(46,525)	(135,929)
Cash used in operating activities	(779)	(2,687)	(8,676)	(33,573)	(98,293)
Cash used in investing activities	(1,920)	(10,174)	(62,992)	(180,198)	(277,078)
Cash provided in financing activities	2,728	14,314	85,734	219,399	440,156

	AS OF DECEMBER 31,				
	1995	1996	1997	1998	1999
BALANCE SHEET DATA:					
Cash and cash equivalents....................	$ 34	$ 1,487	$ 15,553	$ 21,181	$85,966
Investments held for future capital expenditures..............................	-	-	-	27,920	-
Restricted investments(d)....................	-	-	-	-	88,571
Networks and equipment, net..................	3,496	12,347	71,371	224,890	639,324
Total assets.................................	3,704	16,715	95,943	311,310	886,040
Long-term debt...............................	2,727	12,330	61,277	309,225	811,137
Redeemable preferred stock...................	-	-	35,925	52,033	203,790
Redeemable common stock and warrants.........	-	-	11,726	22,979	46,680
Total nonredeemable equity (deficiency)......	(1,623)	389	(26,673)	(104,353)	(384,4130)

(a) During the second quarter of 1999, the Company recorded a $4.3 million charge to other expense in connection with an unfavorable arbitration award. The net amount due under the terms of the award was paid in full in June 1999.

(b) Excludes capitalized interest of (i) $37,000 for 1995, (ii) $103,000 for 1996, (iii) $854,000 for 1997, (iv) $5.1 million for 1998 and (v) $6.6 million for 1999. During the construction of the Company's networks, the interest costs related to construction expenditures are capitalized.

(c) Adjusted EBITDA consists of earnings (loss) before net interest, income taxes, depreciation and amortization charges, stock option compensation expense (a non-cash charge) and other expense. EBITDA consists of earnings (loss) before all of the foregoing items except stock option compensation expense and other expense. These items are provided because they are measures commonly used in the telecommunications industry. They are presented to enhance an understanding of the Company's operating results and they are not intended to represent cash flow or results of operations in accordance with generally accepted accounting principles. Adjusted EBITDA and EBITDA are not calculated under generally accepted accounting principles and are not necessarily comparable to similarly titled measures of other companies. For a presentation of cash flows calculated under generally accepted accounting principles, see the Company's historical financial statements contained in Item 8 of this Report.

(d) Represents amounts pledged to secure the next five payments of interest on the 13 1/2% Senior Notes.

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

You should read the following discussion and analysis together with the Company's financial statements, including the notes and the other financial information appearing elsewhere in this Report. Due to our limited operating history, startup nature and rapid growth, period-to-period comparisons of financial data are not necessarily indicative, and you should not rely upon them as an indicator of our future performance. The following discussion includes forward-looking statements.

OVERVIEW

General. We are a facilities-based competitive local exchange carrier providing telecommunications and data services in Tier III markets. The markets in which we operate are predominantly located in the Southeastern and Midwestern United States. We target as customers business, government and institutional end-users, as well as Internet service providers, long distance carriers and wireless service providers. Our objective is to provide our customers with a complete solution for their communications needs. We currently provide on-net local dial tone, Internet access infrastructure, ISDN, long distance, special

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access, private line and a variety of other advanced services and features.

We have invested significant capital and effort in developing our telecommunications business. This capital has been invested in the development of our networks, the development and installation of operating systems, the introduction of services, marketing and sales efforts, and an acquisition. We expect to make significant additional capital expenditures to build additional networks, to expand current networks to additional customer buildings, long distance carrier points of presence and incumbent local exchange carrier central offices, and to broaden our service offerings, and we may consummate acquisitions. Proper management of our growth will require us to maintain cost controls, continue to assess market potential, ensure quality control in implementing our services, as well as to expand our internal management, customer care and billing and information systems, all of which will require substantial investment.

The development, construction and expansion of our networks requires significant capital, a large portion of which is invested before any revenue is generated. We have incurred, and expect to continue to incur, significant and increasing operating losses, negative adjusted EBITDA and net cash outflows for operating and investing activities while we expand our network operations and build our customer base. Based on our experience to date and that of our competitors, we estimate that a new network will begin to generate positive EBITDA within 24 to 36 months after commencement of commercial operations. Construction periods and operating results will vary from network to network. There can be no assurance that we will be able to establish a sufficient revenue-generating customer base or gross margins in any particular market or on a consolidated basis.

The facilities-based competitive local exchange carrier business is capital intensive. We estimate that the total initial costs associated with the purchase and installation of fiber optic cable and transmission and switching equipment, including capitalized engineering costs, will average approximately $10.0 million to $12.0 million for the fiber optic backbone and switch in each standard Tier III network, depending upon the size of the market served, the scope and complexity of the network, and the proportion of aerial to underground fiber deployment. Our actual costs could vary significantly from this range. The amounts and timing of these expenditures are subject to a variety of factors that may vary significantly with the geographic and demographic characteristics of each market. In addition to equipment and construction expenditure requirements, upon commencement of the construction phase of a network we begin to incur direct operating costs for such items as salaries and rent. As network construction progresses, we incur costs associated with construction, including

preparation of rights-of-way, and increased sales, marketing, operating and administrative expenses. We capitalize certain direct costs related to network planning and construction costs for new networks.

The initial construction of a network consists of deploying the fiber optic backbone, installing the switch and related electronics and testing the system. This takes approximately 6 months, depending upon the size and complexity of the network. The time required during the construction phase is also significantly influenced by the number of route miles involved, the mix of aerial versus underground fiber deployment, possible delays in preparing rights-of-way, provisioning fiber optic cable and electronic equipment, and required construction permits and other factors, including weather.

Local Services. To facilitate our entry into local services, we plan to install switching equipment in all of our markets. Switches are in commercial operation in all of our 34 operating markets and we expect to be in commercial operation in 3 additional Tier III markets by the end of the first half of 2000. We also intend to install Lucent switches in any future networks which we may build. Once a switch is commercially operational, we offer local dial tone and switched data services such as ISDN, Internet access infrastructure, Local Area Network-to-Local Area Network interconnect and Wide Area Network services, as well as voice mail and other custom calling features.

We expect operating margins to improve as switching becomes operational and switched services are provided on-net, the network is expanded (primarily by adding buildings to the network), and larger volumes of traffic are carried on our network. Although under the Telecommunications Act of 1996, incumbent local exchange carriers are required to unbundle local network elements, thereby decreasing operating expenses by permitting us to purchase only the origination and termination services we need, we cannot assure you that such unbundling will be effected in a timely manner and result in prices favorable to us.

Revenue. Historically, we have derived our revenue primarily from resale of switched services, along with special access, private line and Internet access infrastructure services provided on our facilities. Future revenues will include increasing amounts of on-net services, long distance services and value-added data services, such as ISDN, DSL, Local Area Network-to-Local Area Network interconnect, Wide Area Network services, BRI (or Basic Rate ISDN), PRI (or Primary Rate ISDN) and port wholesale as well as other value-added services such as Centrex-type services, voice mail and other custom calling features. We maintain interconnection agreements with the major incumbent local exchange carriers in each state in which we operate. Among other things, these contracts govern the reciprocal amounts to be billed by us for terminating local traffic of Internet service providers in each state. Incumbent local exchange carriers around the country have been contesting whether the obligation to pay reciprocal compensation to competitive local exchange carriers should apply to local telephone calls from an incumbent local exchange carrier's customers to Internet service providers served by competitive local exchange carriers. The incumbent local exchange carriers claim that this traffic is interstate in nature and therefore should be exempt from compensation arrangements applicable to local intrastate calls. Competitive local exchange carriers have contended that the interconnection agreements provide no exception for local calls to Internet service providers and reciprocal compensation is therefore applicable. Incumbent local exchange carriers have threatened to withhold, and in many cases have withheld, reciprocal compensation to competitive local exchange carriers for the transport and termination of these calls. During 1999, we recognized revenue from incumbent local exchange carriers of approximately $9.7 million, or 15.1% of our 1999 revenue, for such services. Payments of approximately $1.6 were received from the incumbent local exchange carriers during 1999.

We determined to recognize this revenue because we concluded, based upon all of the facts and circumstances available to us at the time, including numerous state public service commission and state and federal court decisions upholding competitive local exchange carriers' entitlement to reciprocal compensation for such calls, that realization of those amounts was reasonably assured. On October 13, 1999, however, the Louisiana Public Service Commission ruled that local traffic to Internet service providers in Louisiana is not eligible for reciprocal compensation. As a result of that ruling, we determined that we could no longer conclude that realization of amounts attributable to reciprocal compensation for termination of local calls to Internet service providers in Louisiana was reasonably assured. Accordingly, we recorded an adjustment to reduce revenue in the quarter ended September 30, 1999, which reversed all reciprocal compensation revenue previously recognized related to Internet service provider traffic in Louisiana for the entire year of 1998 and for the first nine months of 1999. The adjustment amounted to $4.4 million, of which $1.1 million relates to the year ended December 31, 1998 and $3.3 million relates to the nine months ended September 30, 1999.

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Although incumbent local exchange carriers have disputed the entitlement of competitive local exchange carriers to reciprocal compensation for termination of local calls to Internet service providers in jurisdictions other than Louisiana as well, we have determined to continue to recognize amounts due to us for reciprocal compensation for calls in jurisdictions other than Louisiana in which we currently operate systems because we have concluded, based upon all of the facts and circumstances, including numerous state public service commission and state and federal court decisions upholding competitive local exchange carriers entitlement to reciprocal compensation for such calls, that realization of such amounts is reasonably assured. South Carolina has also ruled that incumbent local exchange carriers are not obligated to pay reciprocal compensation for termination of local calls to Internet service providers. As a result, unless that decision is reversed, we will not recognize revenue for such calls in South Carolina for our systems in Spartanburg, Columbia and Charleston. In jurisdictions other than Louisiana and South Carolina we will continue to account for reciprocal compensation with the incumbent local exchange carriers, including the activity associated with the disputed Internet service provider traffic, as local traffic pursuant to the terms of our interconnection agreements. Accordingly, in these jurisdictions, we will continue to recognize revenue in the period that the traffic is terminated.

Currently, over 30 state commissions and several federal and state courts have ruled that reciprocal compensation arrangements do apply to calls to Internet service providers, while four jurisdictions have ruled to the contrary. A number of these rulings are subject to appeal. Additional disputes over the appropriate treatment of Internet service provider traffic are pending in other states. On February 26, 1999, the Federal Communications Commission issued a declaratory ruling determining that Internet service provider traffic is interstate for jurisdictional purposes, but that its current rules neither require nor prohibit the payment of reciprocal compensation for such calls. In the absence of a federal rule, the Federal Communications Commission determined that state commissions have authority to interpret and enforce the reciprocal compensation provisions of existing interconnection agreements, and to determine the appropriate treatment of Internet service provider traffic in arbitrating new agreements. The Federal Communications Commission also requested comment on alternative federal rules to govern compensation for such calls in the future. In response to the Federal Communications Commission ruling some Regional Bell Operating Companies have asked state commissions to reopen previous decisions requiring the payment of reciprocal compensation on Internet service provider calls. Some Regional Bell Operating Companies and some competitive local exchange carriers appealed the Federal Communications Commission's declaratory ruling to the United States Court of Appeals for the District of Columbia Circuit, which issued a decision on March 24, 2000, vacating the declaratory ruling. The court stated that the Federal Communications Commission had not adequately explained its conclusion that calls to Internet service providers should not be treated as local traffic for reciprocal compensation purposes. We view this decision as favorable, but the court's direction to the Federal Communications Commission to re-examine the issue will likely result in further delay in the resolution of pending compensation disputes, and there can be no assurance as to the ultimate outcome of these proceedings.

Operating Expenses. Our principal operating expenses consist of network operating costs, selling, general and administrative expenses, stock option compensation expense and depreciation and amortization. Network operating costs include charges from incumbent local exchange carriers for resale services, termination and unbundled network element charges; charges from long distance carriers for resale of long distance services; salaries and benefits associated with network operations, billing and information services and customer care personnel; franchise fees and other costs, including direct city administration costs. Network operating costs also include a percentage of both our intrastate and interstate revenues which we pay as universal service fund charges. Selling, general and administrative expenses consist of sales personnel and support costs, corporate and finance personnel and support costs and legal and accounting expenses. Depreciation and amortization includes charges related to plant, property and equipment and amortization of intangible assets, including franchise acquisition costs. Depreciation and amortization expense will increase as we place additional networks into service and continue to expand our existing networks.

Interest Expense. Interest expense includes interest charges on our 13 1/2% Senior Notes, 12 1/2% Senior Discount Notes and our Amended Senior Secured Credit Facility. Interest expense also includes amortization of deferred financing costs. Interest expense will increase substantially in future periods as a result of the issuance of the 13 1/2% Senior Notes and increased borrowings under the Amended Senior Secured Credit Facility, discussed below.

1999 COMPARED TO 1998

Revenue. Revenue increased from $22.4 million for 1998 to $64.3 million for 1999. This increase is primarily attributable to the fact that for 1999 we derived revenues from 23 markets during the entire period, as compared to 1998 when we derived revenues from only 8 markets during the entire period, and began to derive revenues from 14 additional markets during the fourth quarter of 1998. In addition, each of our markets from which we derived revenues during 1998 generated increased revenues during 1999.

During 1998 and 1999, we recognized revenue which we believed was due to us from incumbent local exchange carriers for terminating local traffic of Internet service providers. We determined to recognize this revenue because we concluded, based upon all of the facts and circumstances known to us at the time, including numerous state public service commission and state and federal court decisions upholding competitive local exchange carriers' entitlement to reciprocal compensation for such calls, that realization of those amounts was reasonably assured. On October 13, 1999, however, the Louisiana Public Service Commission ruled that local traffic to Internet service providers in Louisiana is not eligible for reciprocal compensation. As a result of that ruling, we determined that we could no longer conclude that realization of amounts attributable to termination of local calls to Internet service providers in Louisiana was reasonably assured. Accordingly, we recorded an adjustment to reduce revenue in the third quarter of 1999, which reversed all reciprocal revenue recognized related to Internet service provider traffic in Louisiana for the entire year of 1998 and the first nine months of 1999. The adjustment amounted to $4.4 million, of which $1.1 million relates to the year ended December 31, 1998 and $3.3 million relates to the nine months ended September 30, 1999.

Although incumbent local exchange carriers, such as BellSouth, have generally withheld payments of amounts due for reciprocal compensation to competitive local exchange carriers such as the Company for calls to Internet service providers and disputed the entitlement of competitive local exchange carriers to reciprocal compensation for such calls in jurisdictions other than Louisiana as well, we have determined to continue to recognize amounts due to us for reciprocal compensation for such calls in jurisdictions other than Louisiana and South Carolina (which is the only other jurisdiction in which we currently operate that has adopted a similar position) because we have concluded, based upon all of the facts and circumstances, including numerous state public service commission and state and federal court decisions upholding competitive local exchange carriers' entitlement to reciprocal compensation for such calls, that realization of such amounts is reasonably assured.

Revenue for 1998 and 1999 included $14.2 million and $19.7 million, respectively, of revenue derived from resale of switched services and an aggregate of $8.2 million and $44.6 million (including, after giving effect to the third quarter 1999 $4.4 million adjustment for Louisiana, $9.7 million of revenue related to reciprocal compensation during 1999), respectively, of revenue derived from on-net special access, private line and switched services. Resale of switched services represented 63.2% of revenue in 1998 and 30.6% of revenue in 1999.

Network Operating Costs. Network operating costs increased from $37.3 million in 1998 to $110.3 million in 1999. This increase of approximately $73.0 million was due primarily to the increase in the number of markets in which we operated in 1999 and the related increases of $27.7 million in direct costs associated with providing on-net services, resale services and leasing unbundled network element services, $19.2 million in personnel costs, $6.5 million in network support services, $6.3 million in consulting and professional services costs, $2.2 million in telecommunications costs, $2.2 million in facility costs, $1.4 million in travel costs and $7.5 million in other direct operating costs.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased from $24.5 million in 1998 to $55.8 million in 1999. This increase of approximately $31.3 million resulted primarily from increases of $20.5 million in personnel costs, $3.9 million in professional costs, $2.9 million in travel related costs, as well as increases in other marketing and general and administrative costs aggregating approximately $4.0 million. These increases were due primarily to the greater number of networks in commercial operation during 1999.

Stock Option Compensation Expense. Stock option compensation expense, a non-cash charge, increased from $7.1 million for 1998 to $29.8 million for 1999. This increase primarily resulted from an increase in the estimated fair value of the Company's Common Stock, as well as the grant of additional option awards during 1999.

Depreciation and Amortization. Depreciation and amortization expense increased from $9.3 million for 1998 to $29.1 million for 1999, primarily as a result of depreciation expense associated with the greater number of networks in commercial operation during 1999.

Other Expense. During the second quarter of 1999, the Company recorded a $4.3 million charge to other expense in connection with an unfavorable arbitration award. The net amount due under the terms of the award was paid in full in June 1999.

Interest Income. Interest income remained consistent from $8.8 million in 1998 to $8.7 million in 1999.

Interest Expense. Interest expense increased from $29.8 million in 1998 to $69.4 million in 1999. The increase resulted primarily from the issuance of the Senior Notes in May 1999, additional accretion on the Senior Discount Notes and increased interest charges related to higher borrowings under the Senior Secured Credit Facility. The Company capitalized interest related to network construction projects of $5.1 million during 1998 and $6.6 million during 1999.

Net Loss. For the reasons stated above, net loss increased from $76.8 million for 1998 to $225.7 million for 1999.

1998 COMPARED TO 1997

Revenue. Revenue increased from $3.4 million for 1997 to $22.4 million for 1998. This increase is primarily attributable to the fact that for 1998 we derived revenues from 8 markets during the entire period, as well as 14 additional markets from which we began to derive revenues at various points during the period, as compared to 1997 when we derived revenues from only 1 market during the entire period, and began to derive revenues from 7 additional markets at various points during the year. In addition, each of our markets from which we derived revenues during 1997 generated increased revenues during 1998. Revenue for 1997 and 1998 included $2.3 million and $14.2 million, respectively, of revenue derived from resale of switched services and an aggregate of $1.1 million and $8.2 million (including $2.9 million of revenue from reciprocal compensation in 1998), respectively, of revenue derived from on-net special access, private line and switched services. Resale of switched services represented 67.6% of revenue in 1997 and 63.2% of revenue in 1998.

Network Operating Costs. Network operating costs increased from $7.7 million in 1997 to $37.3 million in 1998. This increase of approximately $29.6 million was due primarily to the increase in the number of markets in which we operated in 1998 and the related increases of $14.5 million in costs associated with providing resale services and leasing unbundled network element services, $5.3 million in personnel costs, $1.6 million in consulting and professional services costs, $3.4 million in contracted network support costs, and $1.1 million in facilities related costs, $1.0 million in travel related costs and $2.7 million in other direct operating costs.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased from $9.9 million in 1997 to $24.5 million in 1998. This increase of approximately $14.6 million resulted primarily from increases of $8.5 million in personnel costs, $900,000 in professional costs (consisting primarily of legal costs relating to regulatory matters) and $1.2 million in travel related costs, as well as increases in other marketing and general and administrative costs aggregating approximately $4.0 million.

Stock Option Compensation Expense. Stock option compensation expense, a non-cash charge, decreased from $13.9 million in 1997 to $7.1 million in 1998. These charges are directly impacted by changes in the estimated fair value of the Company's common stock. The increase in the estimated fair value of such stock in 1998 was less than the increase in 1997. The expense charge for 1998 includes the net effect of a credit resulting from the termination of the KMC Telecom Inc. stock option plan, which was substantially offset by a charge related to the adoption of the KMC Telecom Holdings, Inc., stock option plan, in September 1998.

Depreciation and Amortization. Depreciation and amortization expense increased from $2.5 million for 1997 to $9.3 million for 1998, primarily as a result of depreciation expense associated with the greater number of networks in commercial operation during 1998, as well as higher amortization of intangible assets.

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Interest Expense. Interest expense increased from $2.6 million in 1997 to $29.8 million in 1998. This increase resulted primarily from the issuance of the Senior Discount Notes during the first quarter of 1998, which generated interest expense of $29.6 million in 1998, as well as the increased expense attributable to the higher level of borrowings under a credit facility in 1998. The Company capitalized interest of $5.1 million related to network construction projects during 1998 and $854,000 during 1997. Net Loss. For the reasons stated above, net loss increased from $32.7 million for 1997 to $76.8 million for 1998.

STOCK COMPENSATION PLAN

During 1996 and 1997 one of our principal operating subsidiaries granted options to purchase shares of its common stock pursuant to its 1996 Stock Plan. On June 26, 1998, the Board of Directors of the Company adopted the 1998 Stock Purchase and Option Plan for Key Employees of KMC Telecom Holdings, Inc. and Affiliates which authorizes the grant of options to purchase common stock of the Company. During the third quarter of 1998, the Company replaced the options to purchase shares of common stock of the subsidiary previously granted under its 1996 Stock Plan, with options to purchase common stock of the Company granted under the 1998 Stock Plan and granted options to certain additional employees of the Company. Upon cancellation of the outstanding options under the 1996 Stock Plan, the Company reversed all compensation expense previously recorded with respect to such options. Additionally, to the extent the fair value of the common stock of the Company exceeded the exercise price of the options granted under the 1998 Stock Plan, the Company recognized compensation expense related to such options to the extent vested. The net effect of the cancellation of the options outstanding under the 1996 Stock Plan and the grant of options under the 1998 Stock Plan resulted in a credit to compensation expense of approximately $600,000 in 1998.

Certain provisions in the stock option awards granted under the 1998 Stock Plan will necessitate that such awards be treated as variable stock compensation awards pursuant to Accounting Principles Board Opinion No. 25. Accordingly, compensation expense will be charged or credited periodically through the date of exercise or cancellation of such stock options, based on changes in the value of the Company's stock as well as the vesting schedule of such options. These compensation charges or credits are non-cash in nature, but could have a material effect on the Company's future reported net income (loss).

LIQUIDITY AND CAPITAL RESOURCES

We have incurred significant operating and net losses as a result of the development and operation of our networks. We expect that such losses will continue as we emphasize the development, construction and expansion of our networks and build our customer base. As a result, there will not be any cash provided by operations in the near future and we will need to fund the expansion of our networks. We have financed our operating losses and capital expenditures with equity invested by our founders, preferred stock placements, credit facility borrowings and the 12 1/2% Senior Discount Notes and the 13 1/2% Senior Notes.

In February 1999, we issued PIK Preferred Stock and warrants to purchase common stock for aggregate gross proceeds of $65.0 million to two purchasers. In April 1999, we issued additional shares of PIK Preferred Stock and warrants to purchase common stock to one additional purchaser for aggregate gross proceeds of $35.0 million.

On May 24, 1999, we issued $275.0 million aggregate principal amount of 13 1/2% Senior Notes due 2009 in a private offering. On December 30, 1999, we exchanged those notes for $275.0 million aggregate principal amount of notes that had been registered under the Securities Act of 1933. Approximately $104.1

million of the proceeds of the offering were used to purchase a portfolio of U.S. treasury securities that were pledged to secure the payment of the first six interest payments on the 13 1/2% Senior Notes.

During the first quarter of 2000, we amended and expanded our $250.0 million senior secured credit facility to a new $700.0 million facility. In connection with the amendment, the $41.0 million borrowed under our prior credit facility with Lucent Technologies, Inc. was repaid and that facility was combined into the amended facility. Under the Amended Senior Secured Credit Facility, our subsidiaries which own our 34 existing networks and the 3 networks which are to be completed by the end of the first half of 2000 are permitted to borrow up to an aggregate of $700.0 million, subject to certain conditions, for the purchase of fiber optic cable, switches and other telecommunications equipment and, once certain financial conditions are met, for working capital

and other general corporate purposes. At March 29, 2000 we had $441.8 million of indebtedness outstanding under the Amended Senior Secured Credit Facility and had an additional $258.2 million in borrowing capacity available thereunder subject to certain conditions. The Amended Senior Secured Credit Facility contains a number of affirmative and negative covenants, one of which requires us to make cash capital contributions to our subsidiaries which are the borrowers thereunder of at least $185 million prior to April 1, 2001.

In March 2000, we received a commitment from Lucent Technologies, Inc. to purchase an additional $100 million of our PIK Preferred Stock which we will apply towards the $185 million requirement referred to above. We currently contemplate raising the $85 million balance through private or public sales of securities in the capital markets.

Net cash provided by financing activities from borrowings and equity issuances was $440.2 million for 1999. Our net cash used in operating and investing activities was $375.4 million for 1999.

We made capital expenditures of $61.1 million in 1997 (including the acquisition of the Melbourne, Florida network for a purchase price of $2.0 million), $161.8 million in 1998 and $440.7 million in 1999. Continued significant capital expenditures are expected to be made in 2000 and thereafter. The majority of these expenditures is expected to be made for network construction and the purchase of switches and related equipment to facilitate the offering of our services. In addition, we expect to continue to incur operating losses while we expand our business and build our customer base. Actual capital expenditures and operating losses will depend on numerous factors, including the nature of future expansion and acquisition opportunities and factors beyond our control, including economic conditions, competition, regulatory developments and the availability of capital.

At December 31, 1999, we had outstanding commitments aggregating approximately $96.5 million related to the purchase of fiber optic cable and telecommunications equipment under our agreements with certain suppliers and service providers.

We believe that our cash, the expected proceeds from our proposed sale of PIK Preferred Stock to Lucent and borrowings available under the Amended Senior Secured Credit Facility will be sufficient to meet our liquidity needs through the completion of our remaining 3 networks currently planned for completion by the end of the first half of 2000, as well as operating losses and capital expenditure requirements for all of our 37 markets for the next 12 months.

However, in the event that our plans change, the assumptions upon which our plans are based prove inaccurate, we expand or accelerate our business plan or we determine to consummate acquisitions, the foregoing sources of funds may prove insufficient to complete all such networks, and we may be required to seek additional financing sooner than we currently expect. Additional sources of financing may include public or private equity or debt financings by the Company, capitalized leases and other financing arrangements.

We will require additional financing before we can begin to implement our plans to expand into any additional Tier III markets. We are exploring a number of alternatives but we cannot assure you that we will be successful in this regard.

We can give no assurance that additional financing will be available to us or, if available, that it can be obtained on a timely basis and on acceptable terms. Failure to obtain such financing could result in the delay or abandonment of some or all of our development and expansion plans and expenditures, which would have a material adverse effect on our business, financial condition and results of operations. Such a failure could also limit our ability to make principal and interest payments on our indebtedness, and meet our dividend and redemption obligations with respect to our preferred stock.

YEAR 2000 COMPLIANCE

We did not experience any material business interruption as a result of the Year 2000 issue. Our own software applications functioned well and we did not experience any problems with the software applications of the local exchange carriers, long distance carriers or others on whose operations we depend or with

which our systems interact. We spent approximately $150,000 in connection with our Year 2000 compliance efforts, which we expensed as incurred. This amount did not include the cost of the new billing software, operational software and financial and personnel software systems which we implemented as a result of the expansion of our business. We will continue to monitor our mission critical computer applications and those of our suppliers and vendors throughout the Year 2000 to ensure that any Year 2000 matters that may arise are addressed promptly.

CERTAIN FACTORS WHICH MAY AFFECT OUR FUTURE RESULTS

We Have Had a Limited Operating History and Have Incurred Negative Gross Profits, Operating Losses, Negative Cash Flow and Negative Adjusted EBITDA

We were formed in September 1997 as a holding company. Our subsidiaries commenced material operations in 1996 and, as a result, we have had only a limited operating history and limited revenues. We have only recently completed the process of building many of our networks. Our prospects must be considered in the light of the risks, expenses and difficulties frequently encountered by companies in the early stage of development. In connection with the construction of our networks we have incurred and expect to continue to incur significant and increasing negative gross profits, operating losses and negative adjusted EBITDA while we expand our business and build our customer base. We can give no assurance that an adequate customer base with respect to any or all of our services will be obtained or sustained.

Our negative gross profits, operating losses, negative adjusted EBITDA, cash used by operations and capital expenditures will increase as a result of the continuation of our expansion strategy. We cannot assure you that we will achieve or sustain profitability or generate positive EBITDA or at any time have sufficient resources to meet our capital expenditure and working capital requirements or make payments on our indebtedness. We must significantly increase our revenues and cash flows to meet our debt service and preferred stock dividend obligations.

Substantial Indebtedness

At February 29, 2000, we had outstanding approximately $938.2 million of indebtedness outstanding. Our indebtedness could have important consequences. For example, it could:

- limit our ability to obtain any necessary financing in the future,
- require us to dedicate a substantial portion of our cash flow from operations to make payments on our indebtedness, thereby reducing the funds available to us for other purposes, including working capital and capital expenditures,
- limit our flexibility in planning for, or reacting to changes in, our

business or the industry in which we operate,

- make us more highly leveraged than many, if not all, of our competitors, which could place us at a competitive disadvantage compared to those of our competitors that are less leveraged, and

- increase our vulnerability in the event of a downturn in our business.

If we fail to meet our obligations there could be a default on our indebtedness which would permit the holders of substantially all of our indebtedness to accelerate the maturity thereof.

In connection with the build-out of our networks and expansion of our services, we have been experiencing increasing negative adjusted EBITDA and our earnings were insufficient to cover fixed charges for 1997, 1998 and 1999. We might not be able to improve our earnings before fixed charges or adjusted EBITDA expense. If we do not, we might not be able to meet our debt service obligations.

We cannot assure you that our cash flow from operations and capital resources will be sufficient to repay our 13 1/2% Senior Notes, 12 1/2% Senior Discount Notes, and the Amended Senior Secured Credit Facility in full or that a substantial portion of our indebtedness will not need to be refinanced. We can give no assurance that we will be able to effect such refinancings.

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You should be aware that our ability to repay or refinance our current debt depends on our successful financial and operating performance and our ability to successfully implement our business strategy. Unfortunately, we cannot assure you that we will be successful in implementing our strategy or in realizing our anticipated financial results. You should also be aware that our financial and operational performance depends upon a number of factors, many of which are beyond our control. These factors include:

- the economic and competitive conditions in the telecommunications network industry,

- any operating difficulties, increased operating costs or pricing pressure we may experience,

- the passage of legislation or other regulatory developments that may adversely affect us,

- any delays in implementing any strategic projects, and

- our ability to complete our networks on time and in a cost-effective manner.

The Amended Senior Secured Credit Facility and the indentures applicable to our 13 1/2% Senior Notes and 12 1/2% Senior Discount Notes contain a number of significant covenants. These covenants limit our ability to, among other things:

- borrow additional money,

- make capital expenditures and other investments,

- pay dividends,

- merge, consolidate, or dispose of our assets, and

- enter into transactions with our affiliates.

Under the Amended Senior Secured Credit Facility, our subsidiaries are required to meet certain financial tests at the end of each quarter. Failure to comply with these covenants could limit our ability to make further borrowings, or could result in a default under the Amended Senior Secured Credit Facility, allowing the lenders to accelerate the maturity of the loans made thereunder. There can be no assurance that we will be able to comply with such covenants in the future.

Our Future Growth Will Require Substantial Additional Capital

Our current plans for expansion will require substantial additional cash from outside sources. We currently anticipate that our capital expenditures for 2000 will be approximately $285.0 million. We also will have substantial net losses to fund. Our substantial cash requirements will continue into the foreseeable future.

We believe that our cash, the expected proceeds from our proposed sale of PIK Preferred Stock to Lucent and borrowings available under our Amended Senior Secured Credit Facility, will provide sufficient funds for us to complete the initial fiber optic backbone and installation of a switch in the remaining 3 networks currently planned for completion by the end of the first half of 2000, as well as operating losses and capital expenditure requirements for all of our 37 markets for the next 12 months. Thereafter, we will require additional financing.

However, in the event that:

o our plans change,

o the assumptions upon which our plans are based prove inaccurate,

o we expand or accelerate our business plan, or

o we determine to consummate acquisitions,

the foregoing sources of funds may prove to be insufficient to complete all such networks, and we may require additional financing sooner than we currently expect.

We will require additional financing, however, before we can begin to implement our plans to expand into any additional Tier III markets. We are exploring a number of alternatives, but we cannot assure you that we will be successful in this regard.

Additional sources of financing may include:

o public or private equity or debt financings,

o capitalized leases, and

o other financing arrangements.

Pursuant to certain provisions of our Series A and Series C Cumulative Convertible Preferred Stock, and our Series E and Series F Senior Redeemable, Exchangeable, PIK Preferred Stock, we may not increase the authorized number of shares of our preferred stock or common stock without the consent of the holders of two-thirds of the shares of those series. We currently have only three million shares of common stock authorized.

Additional financing might not be available to us on acceptable terms, within the limitations contained in our indebtedness, or at all. Failure to obtain such additional financing could result in the delay or abandonment of some or all of our development and expansion plans and expenditures, which would have a material adverse effect on our business prospects.

Because We Are a Holding Company, We Will Be Reliant on Funds from Our Subsidiaries to Repay Our Indebtedness and Our Subsidiaries' Creditors May Have Priority on those Funds

We are a holding company whose sole material asset is the common stock of our subsidiaries. In connection with the Amended Senior Secured Credit Facility, we have reaffirmed the pledge of all of the common stock of our operating subsidiaries that own our 34 existing networks (and the 3 networks planned for completion by the end of the first half of 2000) to the lenders under the

Amended Senior Secured Credit Facility. Our operating subsidiaries, which currently own substantially all of our operating assets, are directly liable to the lenders under the Amended Senior Secured Credit Facility.

We must rely upon dividends and other payments from our operating subsidiaries to generate the funds necessary to meet our obligations, including the payment of principal and interest on the notes. These subsidiaries are legally distinct from us and have no obligation to pay amounts due by us. The ability of our operating subsidiaries to make such payments to us will be subject to, among other things, the availability of funds, the terms of each operating subsidiary's indebtedness and applicable state laws. In particular, the terms of the operating subsidiaries' credit facilities prohibit them from paying dividends and principal and interest on intercompany borrowings unless, among other things, they are in compliance with certain financial covenants. Accordingly, we cannot assure you that we will be able to obtain any funds from our operating subsidiaries.

Claims of creditors of our subsidiaries, including trade creditors, will generally have priority as to the assets of such subsidiaries over the claims of the Company and the holders of our indebtedness and capital stock. We have unconditionally guaranteed the repayment of the Amended Senior Secured Credit Facility.

Our Industry is Extremely Competitive and Many of Our Competitors Have Greater Resources Than We Do

The telecommunications industry is extremely competitive, particularly with respect to price and service. We face competition in all of our markets. Generally, the incumbent local exchange carrier competitor is one of the Regional Bell Operating Companies, one of GTE Corporation's subsidiaries or one of Sprint Corporation's subsidiaries. The incumbent local exchange carriers:

o have long-standing relationships with their customers,

o have financial, technical and marketing resources substantially greater than ours,

o have the potential to fund competitive services with revenues from a variety of businesses, and

o currently benefit from certain existing regulations that favor the incumbent local exchange carriers over us in certain respects.

We do not believe that Tier III markets can profitably support more than two competitors to the incumbent local exchange carrier. Accordingly, we believe that once we have completed the construction of our network backbone and the installation of our switch in a given market, potential new entrants in that market are likely to seek to deploy their capital elsewhere. We will generally continue to build in our markets after initial backbone construction and switch installation. We expect that this demonstration of our commitment to our markets will further deter new entrants.

However, it is likely that in one or more of our markets we will face competition from two or more facilities-based competitive local exchange carriers. After the investment and expense of establishing a network and support services in a given market, the marginal cost of carrying an additional call is negligible. Accordingly, in Tier III markets where there are three or more facilities-based competitive local exchange carriers, we expect substantial price competition. We believe that operations in such markets are likely to be unprofitable for one or more operators.

Potential competitors in our markets include:

o microwave and satellite carriers,

o wireless telecommunications providers,

- cable television companies, utilities, Regional Bell Operating Companies seeking to operate outside their current local service areas, and

- large long distance carriers, such as AT&T and MCI WorldCom, which have begun to offer integrated local and long distance telecommunications services.

Consolidation of telecommunications companies and the formation of strategic alliances within the telecommunications industry, as well as the development of new technologies, could give rise to significant new competitors for us. One of the primary purposes of the Telecommunications Act of 1996 is to promote competition, particularly in local markets. We believe that Tier III markets will also see more agent and distributor resale initiatives.

Recent regulatory initiatives allow competitive local exchange carriers like us to interconnect with incumbent local exchange carrier facilities. This provides increased business opportunities for us. However, these regulatory initiatives have been accompanied by increased pricing flexibility for, and relaxation of regulatory oversight of, the incumbent local exchange carriers. If the incumbent local exchange carriers engage in increased volume and discount pricing practices or charge competitive local exchange carriers increased fees for interconnection to their networks, or if the incumbent local exchange carriers delay implementation of interconnection to their networks, our business, financial condition and results of operations could be adversely affected.

To the extent we interconnect with and use incumbent local exchange carrier networks to service our customers, we are dependent upon the technology and capabilities of the incumbent local exchange carriers to provide services and to maintain our service standards. We will become increasingly dependent on interconnection with incumbent local exchange carriers as switched services become a greater percentage of our business. The Telecommunications Act imposes interconnection obligations on incumbent local exchange carriers, but we cannot assure you that we will be able to obtain the interconnections we require at desirable rates, terms and conditions. In the event that we experience difficulties in obtaining appropriate and reasonably priced service from the incumbent local exchange carriers, our ability to serve our customers would be impaired.

Both the long distance business and data transmission business are extremely competitive. Prices in both businesses have declined significantly in recent years and are expected to continue to decline. In the long distance business we will face competition from large carriers such as AT&T, MCI Worldcom and Sprint. We will rely on other carriers to provide transmission and termination for our long distance traffic and therefore will be dependent on such carriers.

We expect to experience declining prices and increasing price competition. We might not be able to achieve or maintain adequate market share or revenue, or compete effectively, in any of our markets. Any of the foregoing factors could have a material adverse effect on our business, financial condition and results of operations.

The Regional Bell Operating Companies and GTE Companies Have Disputed the Entitlement of Competitive Local Exchange Carriers to Reciprocal Compensation for Certain Calls to Internet Service Providers

Every time a customer of a Regional Bell Operating Company calls an Internet service provider that is one of our customers, we are entitled to receive payment from the Regional Bell Operating Company or a GTE Company. This payment is called "reciprocal compensation." The Regional Bell Operating Companies and GTE Companies object to making reciprocal compensation payments and are seeking to have this changed by legislation, regulation and litigation. The Regional Bell Operating Companies and GTE Companies have threatened to withhold, and in many cases have withheld, reciprocal compensation for the transport and termination of such calls. We recognized revenue of approximately

$2.9 million, or 12.9% of our 1998 revenue, from incumbent local exchange carriers related to reciprocal compensation. We recognized revenue of approximately $9.7 million, or 15.1% of our revenue, related to these calls for 1999. Payments of approximately $135,000 and $1.6 million were received from the incumbent local exchange carriers during 1998 and 1999, respectively.

We determined to recognize this revenue because we concluded, based upon all of the facts and circumstances available to us at the time, including numerous state public service commission and state and federal court decisions upholding competitive local exchange carriers' entitlement to reciprocal compensation for such calls, that realization of those amounts was reasonably assured. On October 13, 1999, however, the Louisiana Public Service Commission ruled that local traffic to Internet service providers in Louisiana is not eligible for reciprocal compensation. As a result of that ruling, we determined that we could no longer conclude that realization of amounts attributable to reciprocal compensation for termination of local calls to Internet service providers in Louisiana was reasonably assured. Accordingly, we recorded an adjustment to reduce revenue in the quarter ended September 30, 1999, which reversed all reciprocal compensation revenue previously recognized related to Internet service provider traffic in Louisiana for the entire year of 1998 and for the first nine months of 1999. The adjustment amounted to $4.4 million, of which $1.1 million relates to the year ended December 31, 1998 and $3.3 million relates to the nine months ended September 30, 1999.

Although incumbent local exchange carriers have disputed the entitlement of competitive local exchange carriers to reciprocal compensation for termination of local calls to Internet service providers in jurisdictions other than Louisiana as well, we have determined to continue to recognize amounts due to us for reciprocal compensation for calls in jurisdictions other than Louisiana in which we operate systems because we have concluded, based upon all of the facts and circumstances, including numerous state public service commissions and state and federal court decisions upholding competitive local exchange carriers entitlement to reciprocal compensation for such calls, that realization of such amounts is reasonably assured. South Carolina has also ruled that incumbent local exchange carriers are not obligated to pay reciprocal compensation for termination of local calls to Internet service providers. As a result, unless that decision is reversed, we will not recognize revenue for such calls in South Carolina for our systems in Spartanburg, Columbia and Charleston.

Currently, over 30 state commissions and several federal and state courts have ruled that reciprocal compensation arrangements do apply to calls to Internet service providers, while four jurisdictions have ruled to the contrary. A number of these rulings are subject to appeal. Additional disputes over the appropriate treatment of Internet service provider traffic are pending in other states.

On February 26, 1999 the Federal Communications Commission issued a declaratory ruling determining that Internet service provider traffic is interstate for jurisdictional purposes, but that its current rules neither require nor prohibit the payment of reciprocal compensation for such calls. In

the absence of a federal rule, the Federal Communications Commission determined that state commissions have authority to interpret and enforce the reciprocal compensation provisions of existing interconnection agreements, and to determine the appropriate treatment of Internet service provider traffic in arbitrating new agreements. The Federal Communications Commission also requested comment on alternative federal rules to govern compensation for such calls in the future. In response to the Federal Communications Commission ruling some Regional Bell Operating Companies have asked state commissions to reopen previous decisions requiring the payment of reciprocal compensation on Internet service provider calls. Some Regional Bell Operating Companies and some competitive local exchange carriers appealed the Federal Communications Commission's declaratory ruling to the United States Court of Appeals for the District of Columbia Circuit, which issued a decision on March 24, 2000, vacating the declaratory ruling. The court stated that the Federal Communications Commission had not adequately explained its conclusion that calls to Internet service providers should not be treated as local traffic for reciprocal compensation purposes. We view this decision as favorable, but the court's direction to the Federal Communications Commission to re-examine the issue will likely result in further delay in the resolution of pending compensation disputes, and there can be no assurance as to the ultimate outcome of these proceedings.

Our management will continue to consider the circumstances surrounding this dispute periodically in determining whether reserves against unpaid balances are warranted. As of December 31, 1999, no reserves are considered necessary by management.

Our interconnection agreements provide for reciprocal compensation. As these expire, the incumbent local exchange carriers are expected to refuse to execute new agreements that provide for reciprocal compensation for such traffic. This is the case for our interconnection agreement with BellSouth, which expired in February, 1999. Upon termination of our interconnection agreements, if we cannot agree on reciprocal compensation with the incumbent local exchange carrier, the matter will be referred for arbitration to the state public utility commissions. If new interconnection agreements do not provide for reciprocal compensation, this could have a material adverse effect on our business, financial condition and results of operations.

There Are Significant Risks in Our Expansion Strategy and a Failure to Manage Our Growth Effectively Could Adversely Affect Our Operations

We must achieve substantial growth in order to meet our payment obligations under our indebtedness. Our networks have only recently become commercially operational and we have only recently deployed switches in our networks. Our success will depend, among other things, upon our ability to:

- assess potential markets,
- design and build fiber optic backbone routes that provide ready access to a substantial customer base,
- achieve a sufficient customer base,
- install facilities,
- obtain required rights-of-way, building access and governmental permits,
- implement interconnection and collocation with the incumbent local exchange carriers,
- obtain unbundled network elements from incumbent local exchange carriers, and
- secure financing.

In addition, we may make additional acquisitions of existing businesses. Acquisitions could divert our resources and management time and would require integration with our management information, payroll and other systems, and with our existing networks and service offerings.

We cannot assure you that any expansions of our networks will be completed on schedule, at a reasonable cost or within our specifications.

Our growth may place a significant strain on our financial, management and operational resources. Our future performance will depend, in part, upon our ability to:

- manage our growth effectively,
- monitor operations,
- control costs, and

o maintain effective quality control.

This will require us to continue to implement and improve our operating, financial and accounting systems, to expand, train and manage our employee base and to effectively manage the integration of acquired businesses.

If we fail to expand in accordance with our plans or to manage our growth, there would be a material adverse effect on our business, financial condition and results of operations. In addition, the establishment of new operations or acquisitions will involve significant expenses in advance of anticipated revenues and may cause fluctuations in our operating results.

There Are Significant Risks Involved in Implementation of Our Business Plan

We are a recent entrant into the competitive local telecommunications services industry. The local telecommunications services market was virtually closed to competition until the Telecommunications Act of 1996 and related regulatory rulings eliminated many barriers to entry. There are numerous operating complexities associated with providing these services. We will be required to develop new products, services and systems and will need to develop new marketing initiatives to sell these services. We have limited experience providing switched access and local dial tone services and we cannot assure you that we will be able to successfully implement our switched and data services strategy.

We are deploying high capacity digital switches in our markets. This will enable us to offer local dial tone and a variety of switched access services and data services. We expect to incur negative gross profits and negative adjusted EBITDA from our switched services in any given market during the 24 to 36 month period after the switch is deployed. We expect operating margins to improve as each network is expanded and larger volumes of traffic are carried on our network. Implementation of our switched and data services is also subject to the ability of our equipment manufacturers to meet our switch deployment schedule. We cannot assure you that all of our switches will be deployed on the schedule that we presently contemplate or that, if deployed, our switches will be utilized to the degree that we presently expect.

Our services may not be profitable due to, among other factors:

o lack of customer demand,

o inability to secure access to incumbent local exchange carrier facilities at acceptable rates,

o competition and pricing pressure from other competitive local exchange carriers and the incumbent local exchange carriers, and

o cost overruns in connection with network build-outs.

The franchises that we obtain may require us to complete the build-out of our network within a period specified in the franchise grant. If we are unable to complete the build-out of a network within the specified period, and unable to obtain an extension of time in which to complete the build-out, our franchise agreement may be terminable by the local authority.

We Must Improve Our Customer Service Systems

Sophisticated information and processing systems are vital to our growth and our ability to monitor costs, bill customers, provision customer orders and

achieve operating efficiencies. Until recently our billing and information systems were produced largely in-house with partial reliance on third-party vendors and these systems have generally met our needs due in part to our low volume of bills and orders. As we expand our services and our customer base, the need for sophisticated billing and information systems has increased significantly. We have recently embarked upon a program to implement a full suite of order management, customer service, billing and financial applications.

These applications include electronic order tracking software developed by Eftia OSS Solutions Inc., software providing comprehensive billing functions developed by Billing Concepts Systems, Inc., and financial software developed by People Soft, Inc. Initial installation of the new operational support systems commenced during the third quarter of 1999, with development and expansion to continue over the next 12 months. The initial installation of the new billing and financial systems was completed during the second quarter of 1999. Additional development of the billing and financial systems will take place over the next 9 months. Our failure to:

- implement the new operational support systems on a timely basis,
- adequately identify all of our information and processing needs, or
- upgrade our systems as necessary,

could have a material adverse effect on our business, financial condition and results of operations.

We Will Be Reliant on Incumbent Local Exchange Carriers for Interconnection and Provisioning

In each of our markets, we rely on incumbent local exchange carriers to originate and terminate all of our switched services traffic until our own switch becomes operational. Although the incumbent local exchange carriers are legally required to "unbundle" their services and permit us to purchase only the origination and termination services we need, thereby decreasing operating expenses, we cannot assure you that such unbundling will be timely or result in favorable prices. The Supreme Court overturned the Federal Communications Commission's rules regarding what network elements must be unbundled by the incumbent local exchange carriers, and remanded to the Federal Communications Commission the question of which network elements are "necessary" to competing carriers such as the Company. On November 5, 1999, the Federal Communications Commission issued an order and proposed rulemaking establishing the network elements that must be offered by incumbent local exchange carriers as unbundled network elements. The Supreme Court's decision also creates some uncertainty regarding the legal status of complaints filed at the Federal Communications Commission to enforce interconnection agreements.

Carrying customer traffic on our own network generates substantially higher margins than reselling (i.e. paying an incumbent local exchange carrier to carry the traffic over its network). We are in the process of bringing our customers on-net, so that their traffic will generate better margins. During 1999 we significantly expanded our internal department that deals with bringing customers on-net. During the next 12 months we expect to begin transmitting our orders to the incumbent local exchange carriers electronically. However, we are dependent on the incumbent local exchange carriers to carry out the conversion process. During 1998 and 1999, 63% and 31%, respectively, of our revenue was from reselling.

We cannot bring a customer on-net unless the incumbent local exchange carrier sends a technician to physically alter its network. Historically, the incumbent local exchange carriers have not stationed a large number of technicians in Tier III markets. We believe that incumbent local exchange carriers are increasing their technical staffs in Tier III markets, but they are still not able to process our orders promptly.

In addition, the incumbent local exchange carriers have a financial incentive to delay this process. Accordingly, we expect to face substantial delays in bringing our resale customers on-net, which will delay our ability to improve our financial results as much as we would like.

The foregoing factors could result in a material adverse effect on our business, financial condition and results of operations.

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There Are Significant Risks of Entry into the Long Distance Business

In order to offer our end-user customers a complete package of telecommunications services, we recently began to offer long distance services. As a new entrant in the long distance business, we expect to generate low gross margins and substantial start-up expenses as we roll out our long distance service offerings.

Long distance telecommunications services involve the origination of traffic from end-user customers to our telecommunications switches. From these, we will rely on other carriers to provide transmission and termination services for our long distance traffic and will therefore be dependent on such carriers. We enter into resale agreements with long distance carriers to provide us with long distance transmission services. These agreements typically provide for the resale of long distance services on a per minute basis (some with minimum volume commitments or volume discounts). The negotiation of these agreements involves estimates of future supply and demand for long distance telecommunications transmission capacity, as well as estimates of the calling pattern and traffic levels of our future long distance customers. Should we fail to meet our minimum volume commitments, if any, pursuant to these resale agreements, we may be obligated to pay underutilization charges or we may lose the benefit of all or a portion of the volume discounts we have negotiated. Likewise, we may underestimate our need for long distance facilities and therefore be required to obtain the necessary transmission capacity in "spot markets" which are often more expensive than longer term contracts. We cannot assure you that we will acquire long distance capacity on favorable terms or that we can accurately predict long distance prices and volumes so that we can generate favorable gross margins from our long distance business. Our success in entering into the long distance business will be dependent upon, among other things:

- our ability to select new equipment and software and integrate these into our networks,
- our ability to hire and train qualified personnel,
- our ability to enhance our billing, back-office and information systems to accommodate long distance services, and
- the acceptance by potential customers of our long distance service offerings.

If our long distance transmission business fails to generate favorable gross margins, or if we fail in any of the foregoing respects, such failure may have a material adverse effect on our business, financial condition and results of operations.

There Are Significant Risks of Entry into the Data Transmission Business

To complement our telecommunications services offerings, we began offering data transmission services in certain of our markets in 1997. We now offer ISDN, Internet access infrastructure, Local Area Network-to-Local Area Network interconnect and Wide-Area Network services and we are developing product applications for DSL, port wholesale, frame relay and ATM services to complement our existing data services. These services are primarily targeted at large and medium sized businesses with substantial data communications requirements. In providing these services, we will be dependent upon vendors for equipment, as well as ongoing training and support and other matters. The success of our entry into the data transmission business will be dependent upon, among other things:

- our ability to select new equipment and software and integrate these into our networks,
- our ability to hire and train qualified personnel,
- our ability to enhance our billing, back-office and information systems to accommodate data transmission services, and
- the acceptance by potential customers of our service offerings.

We cannot assure you that we will be successful with respect to these matters. If we are not successful with respect to these matters, there may be a material adverse effect on our business, financial condition and results of operations.

We Are Subject to Significant Government Regulation Which May Change in an Adverse Manner

Our networks and the provision of switched and private line services are subject to significant regulation at the federal, state and local levels. The telecommunications industry in general, and the competitive local exchange carrier industry in particular, are undergoing substantial regulatory change and uncertainty. We cannot assure you that future regulatory, judicial or legislative changes, or other regulatory activities will not have a material adverse effect on our business, financial condition and results of operations.

The Terms of Our Indebtedness May Restrict Our Corporate Activities

The documents under which our long-term debt was issued contain a number of significant covenants. These covenants limit, among other things, our ability to:

- borrow additional money,
- create liens,
- engage in sale-leaseback transactions,
- pay dividends,
- make investments,
- sell assets,
- issue capital stock,
- redeem capital stock,
- merge or consolidate, and
- enter into transactions with our stockholders and affiliates.

However, the limitations contained in the documents under which our long-term debt was issued are subject to a number of important qualifications and exceptions. In particular, while the indenture applicable to our 12 1/2% Senior Discount Notes and the indenture applicable to the 13 1/2% Senior Notes restrict our ability to incur additional indebtedness, they do permit us to incur an unlimited amount of purchase money indebtedness. If we incur new indebtedness, the related risks that we and our subsidiaries now face could intensify. Any of the foregoing factors could have a material adverse effect on our business, financial condition and results of operations.

We Are Dependent on Third Parties for Our Rights-of-Way and Franchises

We must obtain easements, rights-of-way, entry to premises, franchises and licenses from various private parties, actual and potential competitors and state and local governments in order to construct and operate our networks, some of which may be terminated upon 30 or 60 days' notice to us. We cannot assure you that we will obtain rights-of-way and franchise agreements on acceptable terms or that current or potential competitors will not obtain similar rights-of-way and franchise agreements that will allow them to compete against us. If any of our existing franchise or license agreements were terminated or not renewed and we were forced to remove our fiber optic cables or abandon our networks in place, such termination could have a material adverse effect on our business, financial condition and results of operations.

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The Telecommunications Industry is Subject to Rapid Technological Change

The telecommunications industry is subject to rapid and significant changes in technology, and we must rely on third parties for the development of and access to new technology. We cannot predict the effect of technological changes on our business. We believe our future success will depend, in part, on our ability to anticipate or adapt to such changes and to offer, on a timely basis, services that meet customer demands. We may not be able to anticipate or adapt to such changes and to offer, on a timely basis, services that meet customers' demands. A failure to do so would have a material adverse effect on our business, financial condition and results of operations.

The Future Success of Our Business Depends Upon Certain Key Personnel

We believe that the efforts of a small number of key management and operating personnel will largely determine our success and the loss of any such persons could adversely affect us. We do not maintain so-called "key man" insurance on any of our personnel. We have employment agreements with Mr. Kamine, the Chairman of our Board of Directors, and Mr. Young, our President and Chief Operating Officer, which currently run through December 31, 2002. Our success will also depend in part upon our ability to hire and retain highly skilled and qualified operating, marketing, financial and technical personnel. The competition for qualified personnel in the telecommunications industry is intense and, accordingly, we may not be able to hire or retain necessary personnel. Our failure to hire or retain necessary personnel could have a material adverse effect on our business, financial condition and results of operations.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Market risks relating to our operations result primarily from changes in interest rates. The substantial majority of our long-term debt bears interest at a fixed rate. However, the fair market value of the fixed rate debt is sensitive to changes in interest rates. We are subject to the risk that market interest rates will decline and the interest expense due under the fixed rate debt will exceed the amounts due based on current market rates. We have entered into an interest rate swap agreement with a commercial bank to reduce the impact of changes in interest rates on a portion of our outstanding variable rate debt. The agreement effectively fixes the interest rate on $125.0 million of our outstanding variable rate borrowings under the Amended Senior Secured Credit Facility due 2007. The interest rate swap agreement terminates in April 2004.

The following table provides information about our significant financial instruments that are sensitive to changes in interest rates (in millions):

	Fair Value on December 31, 1999	Future Principal Payments 2000	2001	2002	2003	2004	Thereafter	Total
Long-Term Debt:								
Fixed Rate:								
Senior Discount Notes, Interest payable at 12 1/2%, Maturing 2008....................	$ 275.7	$ -	$ -	$ -	$ -	$ -	$ 301.1	$ 301.1
Senior Notes, Interest payable at 13 1/2 %, Maturing 2009....................	263.5	-	-	-	-	-	275.0	275.0
Variable rate:								
Amended Senior Secured Credit Facility, interest variable (10.26% at December 31, 1999)(a)...........	235.0	-	-	.5	22.5	35.6	176.4	235.0
Interest rate swap: Variable rate for fixed rate........	(3.9)	$ -	-	-	-	-	-	-
Total............................	$ 770.3	$ -	$ -	$ .5	$22.5	$35.6	$ 752.5	$ 811.1

(a) Pay interest rate is based on a variable rate, which at our option, is determined by either a base rate or LIBOR, plus, in each case, a specified margin.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

The following statements are filed as part of this Annual Report on Form 10-K:

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REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Stockholders
KMC Telecom Holdings, Inc.

We have audited the consolidated balance sheets of KMC Telecom Holdings, Inc. as of December 31, 1998 and 1999, and the related consolidated statements of operations, redeemable and nonredeemable equity and cash flows for each of the three years in the period ended December 31, 1999. 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 auditing standards generally accepted in the United States. 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 KMC Telecom Holdings, Inc. as of December 31, 1998 and 1999, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1999, in conformity with accounting principles generally accepted in the United States.

/s/ ERNST & YOUNG LLP

MetroPark, New Jersey
January 31, 2000, except for Note 18
as to which the date is March 28, 2000

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KMC TELECOM HOLDINGS, INC.
CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

	DECEMBER 31	
	1998	1999
ASSETS		
Current assets:		
Cash and cash equivalents	$ 21,181	$ 85,966
Restricted investments	--	37,125
Accounts receivable, net of allowance for doubtful accounts of $350 and $5,551 in 1998 and 1999, respectively	7,539	27,373
Prepaid expenses and other current assets	1,315	1,375
Total current assets	30,035	151,839
Investments held for future capital expenditures	27,920	--
Long-term restricted investments	--	51,446
Networks and equipment, net	224,890	639,324
Intangible assets, net	2,829	3,602
Deferred financing costs, net	20,903	38,816
Other assets	4,733	1,013
	$ 311,310	$ 886,040
LIABILITIES, REDEEMABLE AND NONREDEEMABLE EQUITY (DEFICIENCY)		
Current liabilities:		
Accounts payable	$ 21,052	$ 167,490
Accrued expenses	9,187	37,047
Deferred revenue	1,187	4,309
Total current liabilities	31,426	208,846
Notes payable	41,414	235,000
Senior notes payable	--	275,000
Senior discount notes payable	267,811	301,137
Total liabilities	340,651	1,019,983
Commitments and contingencies		
Redeemable equity:		
Senior redeemable, exchangeable, PIK preferred stock, par value $.01 per share; authorized: -0- shares in 1998 and 630 shares in 1999; shares issued and outstanding:		
Series E, -0- in 1998 and 65 shares in 1999 ($65,004 liquidation preference)	--	50,770
Series F, -0- in 1998 and 44 shares in 1999 ($44,177 liquidation preference)	--	41,370
Redeemable cumulative convertible preferred stock, par value $.01 per share; 499 shares authorized; shares issued and outstanding:		
Series A, 124 shares in 1998 and 1999 ($12,380 liquidation preference)	30,390	71,349

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Series C, 175 shares in 1998 and 1999 ($17,500 liquidation preference)	21,643	40,301
Redeemable common stock, shares issued and outstanding, 224 in 1998 and 1999	22,305	33,755
Redeemable common stock warrants	674	12,925
Total redeemable equity	75,012	250,470
Nonredeemable equity (deficiency)		
Common stock, par value $.01 per share; 3,000 shares authorized, issued and outstanding, 614 shares in 1998 and 629 shares in 1999	6	6
Additional paid-in capital	13,750	--
Unearned compensation	(5,824)	(9,163)
Accumulated deficit	(112,285)	(375,256)
Total nonredeemable equity (deficiency)	(104,353)	(384,413)
	$ 311,310	$ 886,040

See accompanying notes.

KMC TELECOM HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	YEAR ENDED DECEMBER 31		
	1997	1998	1999
Revenue	$ 3,417	$ 22,425	$ 64,313
Operating expenses:			
Network operating costs	7,735	37,336	110,309
Selling, general and administrative	9,923	24,534	55,803
Stock option compensation expense	13,870	7,080	29,833
Depreciation and amortization	2,506	9,257	29,077
Total operating expenses	34,034	78,207	225,022
Loss from operations	(30,617)	(55,782)	(160,709)
Other expense	--	--	(4,297)
Interest income	513	8,818	8,701
Interest expense	(2,582)	(29,789)	(69,411)
Net loss	(32,686)	(76,753)	(225,716)
Dividends and accretion on redeemable preferred stock	(8,904)	(18,285)	(81,633)
Net loss applicable to common shareholders	$ (41,590)	$ (95,038)	$ (307,349)
Net loss per common share	$ (64.93)	$ (114.42)	$ (360.88)
Weighted average number of common shares outstanding	641	831	852

See accompanying notes.

KMC TELECOM HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF REDEEMABLE AND NONREDEEMABLE EQUITY
YEARS ENDED DECEMBER 31, 1997, 1998 AND 1999
(IN THOUSANDS)

Redeemable Equity

	PREFERRED STOCK										
	SERIES A		SERIES C		SERIES D		SERIES E		SERIES F		COM-
	SHARES	AMOUNT	SHARES	AMOUNT	SHARES	AMOUNT	SHARES	AMOUNT	SHARES	AMOUNT	SHARES
Balance, December 31, 1996	-	$ –	–	$ -	-	$ –	-	$ -	-	$ -	–
Conversion of convertible notes payable of Series A Preferred Stock	124	11,519									
Issuance of warrants											
Issuance of common stock and exercise of warrants											133
Issuance of Series C Preferred Stock			150	14,199							
Issuance of Series D Preferred Stock					25	2,299					
Accretion on redeemable equity		7,360		468		80					
Issuance and adjustment to fair value of stock options to employees											
Amortization of unearned compensation											
Increase in fair value of stock options issued to non-employees											
Net loss											
Balance, December 31, 1997	124	18,879	150	14,667	25	2,379	-	-	-	-	-
Conversion of Series D Preferred Stock to Series C Preferred Stock			25	2,379	(25)	(3,379)					
Issuance of common stock											91
Accretion on redeemable equity		11,511		4,597							
Payment of dividends on preferred stock of subsidiary											
Issuance of warrants											
Cancellation of KMC Telecom stock options											
Issuance and adjustment to fair value of stock options to employees											
Issuance and adustment to fair value of stock options to non-employees											
Amortization of unearned compensation											
Net loss											
Balance, December 31, 1998	124	30,390	175	21,643	-	-	-	-	-	-	224

	Redeemable Equity (cont'd)			Nonredeemable Equity (Deficiency)					
	MON STOCK		TOTAL	COMMON STOCK		ADDITIONAL			TOTAL NONREDEEMABLE
	AMOUNT	WARRANTS	REDEEMABLE EQUITY	SHARES	AMOUNT	PAID-IN CAPITAL	UNEARNED COMPENSATION	ACCUMULATED DEFICIT	EQUITY (DEFICIENCY)
Balance, December 31, 1996	$ -	$ -	$ -	600	$6	$ 4,468	$ (1,239)	$ (2,846)	$ 389
Conversion of convertible notes payable of Series A Preferred Stock			11,519						-
Issuance of warrants		2,025	2,025						-
Issuance of common stock and exercise of warrants	10,863	(1,500)	9,363	14					-

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Issuance of Series C Preferred Stock			14,199						-
Issuance of Series D Preferred Stock			2,299						
Accretion on redeemable equity	324	14	8,246			(8,246)			8,246
Issuance and adjustment to fair value of stock options to employees						14,296	(14,296)		-
Amortization of unearned compensation							9,014		9,014
Increase in fair value of stock options issued to non-employees						4,856			4,856
Net loss								(32,686)	(32,686)
Balance, December 31, 1997	11,187	539	47,651	614	6	15,374	(6,521)	(35,532)	(26,673)
Conversion of Series D Preferred Stock to Series C Preferred Stock			-						-
Issuance of common stock	9,500		9,500						-
Accretion on redeemable equity	1,618	135	17,861			(17,861)			(17,861)
Payment of dividends on preferred stock of subsidiary						(592)			(592)
Issuance of warrants						10,446			10,446
Cancellation of KMC Telecom stock options						(26,191)	4,845		(21,346)
Issuance and adjustment to fair value of stock options to employees						27,906	27,906		-
Issuance and adustment to fair value of stock options to non-employees						4,668			4,668
Amortization of unearned compensation							23,758		23,758
Net loss								(76,753)	(76,753)
Balance, December 31, 1998	22,305	674	75,012	614	6	13,750	(5,824)	(112,285)	(104,353)

See accompanying notes.

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KMC TELECOM HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF REDEEMABLE AND NONREDEEMABLE EQUITY
YEARS ENDED DECEMBER 31, 1997, 1998 AND 1999
(IN THOUSANDS)

	Redeemable Equity										
	PREFERRED STOCK										
	SERIES A		SERIES C		SERIES D		SERIES E		SERIES F		COM-
	SHARES	AMOUNT	SHARES	AMOUNT	SHARES	AMOUNT	SHARES	AMOUNT	SHARES	AMOUNT	SHARES
Balance, December 31, 1998 (carried forward)	124	$30,390	175	$21,643	-	$ -	-	$ -	-	$	224
Issuance of Series E Preferred Stock							60	44,829			
Issuance of Series F Preferred Stock									40	34,817	
Stock dividend of Series E Preferred Stock							5	5,004			
Stock dividend of Series F Preferred Stock									4	4,177	
Issuance of warrants											
Reclassification of warrants related to "put rights"											
Exercise of warrants											
Accretion on redeemable equity		40,959		18,658				937		2,376	
Issuance and adjustment to fair value of stock option to employees											
Adjustment to fair value of stock options to non-employees											
Amortization of unearned compensation											
Exercise of stock options											
Reclassification of additional paid-in											

capital deficiency											
Net loss											
Balance, December 31, 1999	124	$71,349	175	$40,301	-	$ -	65	$50,770	44	$41,370	224

	Redeemable Equity (cont'd)			Nonredeemable Equity (Deficiency)					
	MON STOCK		TOTAL REDEEMABLE	COMMON STOCK		ADDITIONAL PAID-IN	UNEARNED	ACCUMULATED	TOTAL NONREDEEMABLE EQUITY
	AMOUNT	WARRANTS	EQUITY	SHARES	AMOUNT	CAPITAL	COMPENSATION	DEFICIT	(DEFICIENCY)
Balance, December 31, 1998 (carried forward)	$22,305	$ 674	$75,012	614	$6	$13,750	$(5,824)	$(112,285)	$(104,353)
Issuance of Series E Preferred Stock			44,829						-
Issuance of Series F Preferred Stock			34,817						-
Stock dividend of Series E Preferred Stock			5,004			(5,004)			(5,004)
Stock dividend of Series F Preferred Stock			4,177			(4,177)			(4,177)
Issuance of warrants		10,606	10,606			749			749
Reclassification of warrants related to "put rights"		(249)	(249)			249			249
Exercise of warrants						1			1
Accretion on redeemable equity	11,450	1,894	76,274			(76,274)			(76,274)
Issuance and adjustment to fair value of stock option to employees						27,286	(27,286)		-
Adjustment to fair value of stock options to non-employees						5,832			5,832
Amortization of unearned compensation							23,947		23,947
Exercise of stock options				15		333			333
Reclassification of additional paid-in capital deficiency						37,255		(37,255)	-
Net loss								(225,716)	(225,716)
Balance, December 31, 1999	$33,755	$12,925	$250,470	629	$6	$ -	$(9,163)	$(375,256)	$(384,413)

See accompanying notes.

KMC TELECOM HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

	YEAR ENDED DECEMBER 31		
	1997	1998	1999
OPERATING ACTIVITIES			
Net loss..	$ (32,686)	$ (76,753)	$(225,716)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization..............................	2,506	9,257	29,077
Provision for doubtful accounts............................	34	370	5,263

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Non-cash interest expense	610	25,356	31,141
Non-cash stock option compensation expense	13,870	7,080	29,833
Changes in assets and liabilities:			
Accounts receivable	(1,330)	(6,591)	(25,097)
Prepaid expenses and other current assets	(346)	(826)	(60)
Accounts payable	2,934	7,449	29,319
Accrued expenses	6,062	2,953	24,227
Due to affiliates	(35)	(47)	-
Other assets	(295)	(1,821)	3,720
Net cash used in operating activities	(8,676)	(33,573)	(98,293)
INVESTING ACTIVITIES			
Construction of networks and purchases of equipment	(59,146)	(148,580)	(318,536)
Acquisitions of franchises, authorizations and related assets	(1,846)	(1,147)	(1,992)
Cash paid for acquisition of Melbourne Network	(2,000)	-	-
Deposit on purchase of equipment	-	(2,551)	-
Purchase of investments, net	-	(27,920)	-
Redemption of investments	-	-	43,450
Net cash used in investing activities	(62,992)	(180,198)	(277,078)
FINANCING ACTIVITIES			
Proceeds from notes payable, net of issuance costs	59,873	938	-
Proceeds from issuance of common stock and warrants, net of issuance costs	9,363	20,446	-
Proceeds from issuance of preferred stock and related warrants, net of issuance costs	16,498	-	91,001
Issuance costs of credit facilities	-	(6,515)	(2,300)
Proceeds from exercise of stock options	-	-	333
Proceeds from issuance of senior notes, net of issuance costs and purchase of portfolio of restricted investments	-	-	158,286
Proceeds from senior secured credit facility, net of issuance costs	-	-	192,836
Repayment of notes payable	-	(20,801)	-
Proceeds from issuance of senior discount notes, net of issuance costs	-	225,923	-
Dividends on preferred stock of subsidiary	-	(592)	-
Net cash provided by financing activities	85,734	219,399	440,156
Net increase in cash and cash equivalents	14,066	5,628	64,785
Cash and cash equivalents, beginning of year	1,487	15,553	21,181
Cash and cash equivalents, end of year	$ 15,553	$ 21,181	$ 85,966
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION			
Cash paid during the year for interest, net of amounts capitalized	$ 766	$ 4,438	$ 29,182

See accompanying notes.

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KMC TELECOM HOLDINGS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 1999

1. ORGANIZATION

KMC Telecom Holdings, Inc. ("KMC Holdings") is a holding company formed during 1997 primarily to own all of the shares of its operating subsidiaries, KMC Telecom Inc. ("KMC Telecom"), KMC Telecom II, Inc. ("KMC Telecom II"), KMC Telecom III, Inc. ("KMC Telecom III") and KMC Telecom of Virginia, Inc. On September 22, 1997, the stockholders of KMC Telecom exchanged all of their KMC Telecom common and preferred stock for equal numbers of shares of common and preferred stock of KMC Holdings. The merger was accounted for as an exchange of shares between entities under common control, and no changes were made to the historical cost basis of KMC Telecom's net assets.

KMC Telecom Holdings, Inc. and its subsidiaries, KMC Telecom, Inc., KMC Telecom II, Inc., KMC Telecom III, Inc., KMC Telecom IV, Inc., KMC Telecom of Virginia, Inc., KMC Telecom Financial Services LLC, KMC Telecom.com, and KMC Telecom Financing, Inc. are collectively referred to herein as the Company.

The Company is a facilities-based competitive local exchange carrier ("CLEC") providing telecommunications and data services to its customers; principally business, government and institutional end users, as well as Internet service providers, long distance companies and wireless service providers, primarily in the Southeastern and Midwestern United States.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

As noted above, effective September 22, 1997, KMC Telecom became a wholly-owned subsidiary of KMC Holdings. The accompanying financial statements include the consolidated financial position and results of operations of KMC Holdings and its subsidiaries subsequent to September 22, 1997. All significant intercompany transactions and balances have been eliminated.

On July 1, 1999, the Company acquired all of the membership interests of KMC Services LLC from Harold N. Kamine, the Chairman of the Board of Directors, for nominal consideration. KMC Services LLC was formed to provide services to the Company and its customers, initially offering a leasing program for equipment physically installed at the customer's premises. The acquisition was accounted for as a combination of entities under common control, and no changes were made to the historical cost basis of KMC Services LLC's assets. During the second quarter of 1999, the Company had reduced the carrying value of its $709,000 loan receivable from KMC Services LLC to an amount equal to the value of KMC Services LLC's net assets at the acquisition date. KMC Services LLC has been consolidated with the Company since July 1, 1999.

Cash and Cash Equivalents

The Company considers all highly liquid investments with maturities of three months or less when purchased to be cash equivalents.

Investments Held for Future Capital Expenditures

In 1998, the Company has designated certain amounts as investments held for future capital expenditures. As of December 31, 1998, the Company's investments held for future capital expenditures consisted of cash equivalents (bank term deposits and commercial paper with maturities of less than 90 days) of $11.2 million and debt securities (U.S. government obligations and commercial bonds due within 1 year) of $16.7 million. All debt securities have been designated by the Company as held-to-maturity. Accordingly, such securities are recorded in the accompanying December 31, 1998 financial statements at amortized cost.

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Networks and Equipment

Networks and equipment are stated at cost, net of accumulated depreciation. Depreciation is provided over the estimated useful lives of the respective assets using the straight-line method for financial statement reporting purposes.

The estimated useful lives of the Company's principal classes of assets are as follows:

Networks:

Fiber optic systems	20 years
Telecommunications equipment	10 years
Furniture and other	5 years
Leasehold improvements	Life of lease

Intangible Assets

Costs incurred in developing new networks or expanding existing networks, including negotiation of rights-of-way and obtaining regulatory authorizations are capitalized and amortized over the initial term of the agreements, which generally range from 2 to 7 years. Costs incurred to obtain city franchises are capitalized by the Company and amortized over the initial term of the franchises, which generally range from 2 to 7 years.

Deferred Financing Costs

The Company capitalizes issuance costs related to its debt. Such costs are amortized utilizing the interest method over the lives of the related debt. The related amortization is included as a component of interest expense, and amounted to $561,000, $2,279,000 and $3,814,000 for the years ended December 31, 1997, 1998 and 1999, respectively.

Other Assets

Other assets are comprised principally of employee loans, security deposits and other deposits and, at December 31, 1998, non-refundable deposits for the purchase of switching equipment.

Revenue Recognition

Revenue is recognized in the period the service is provided. The Company generally invoices customers one month in advance for recurring services resulting in deferred revenue. Unbilled revenue included in accounts receivable represents revenue earned for services which will be billed in the succeeding month and totaled $1,272,000 and $5,305,000 at December 31, 1998 and 1999, respectively.

Net Loss Per Common Share

Earnings per share are calculated in accordance with FASB Statement No. 128, Earnings per Share ("Statement 128"). All earnings per share amounts for all periods have been presented in accordance with the provisions of Statement 128. Diluted earnings per share have not been presented for any period, as the impact of including outstanding options and warrants would be anti-dilutive.

Income Taxes

The Company uses the liability method to account for income taxes. Deferred taxes are recorded based upon differences between the financial statement and tax basis of assets and liabilities.

Advertising Costs

Advertising costs are included in selling, general and administrative expenses and charged to expense as incurred. For the years ended December 31, 1997, 1998 and 1999, such costs were $66,000, $2,769,000 and $4,080,000, respectively.

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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 amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Impairment of Long-Lived Assets

The Company records impairment losses on long-lived assets used in operations or expected to be disposed of when impairment indicators are present and the cash flows expected to be derived from those assets are less than the carrying amounts of those assets. An impairment loss is measured as the amount by which the carrying amount of the asset exceeds the fair value of the asset.
No such events and circumstances have occurred.

Stock-Based Compensation

As permitted by FASB Statement No. 123, Accounting for Stock-Based Compensation ("Statement 123"), the Company has elected to follow Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ("APB 25") and related interpretations in accounting for its employee stock-based compensation. Under APB 25, no compensation expense is recognized at the time of option grant if the exercise price of the employee stock option is fixed and equals or exceeds the fair market value of the underlying common stock on the date of grant, and the number of shares to be issued pursuant to the exercise of such option are known and fixed at the grant date. As more fully described in Note 8, the Company's outstanding stock options are not considered fixed options under APB 25. The Company accounts for non-employee stock-based compensation in accordance with Statement 123.

Segment Reporting

In 1998, the Company adopted FASB Statement No. 131, Disclosures About Segments of an Enterprise and Related Information ("Statement 131"). Statement 131 uses a management approach to report financial and descriptive information about an entity's operating segments. Operating segments are revenue-producing components of an enterprise for which separate financial information is produced internally for the entity's chief operating decision maker. Under this definition, the Company operated within a single segment for all periods presented.

Start-up Activities

In 1999, the Company adopted Statement of Position 98-5, Reporting on the Costs of Start-Up Activities, which requires costs of start-up activities to be expensed as incurred. This statement had no effect on the Company's results of operations or financial position, because the Company expensed such costs in prior years.

Recently Issued Accounting Pronouncements

In June 1998, the Financial Accounting Standards Board issued Statement No. 133 ("Statement 133"), Accounting for Derivative Instruments and Hedging Activities, which will require the Company to recognize all derivatives on the balance sheet at fair value. The Company will be required to adopt Statement 133, as amended by Statement No. 137 which defers the effective date, as of January 1, 2001. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value will be immediately recognized in earnings. The Company has not yet determined what the effect of Statement 133 will be on the earnings and financial position of the Company.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), Revenue Recognition in Financial Statements. SAB 101 provides additional guidance in applying generally accepted accounting

principles to revenue recognition in financial statements. In 1999 and previous years, the Company recognized installation revenue upon completion of the installation. Effective January 1, 2000, in accordance with the provisions of SAB 101, the Company will begin deferring installation revenue over the life of the contract. The Company estimates the effect of this change will be a reduction of revenue of approximately $2.2 million and will be reported as a cumulative effect of a change in accounting principle in the Company's interim unaudited consolidated financial statements for the period ended March 31, 2000.

Reclassifications

Certain reclassifications have been made to the 1997 and 1998 consolidated financial statements to conform with the 1999 presentation.

3. NETWORKS AND EQUIPMENT

Networks and equipment are comprised of the following:

	DECEMBER 31 1998	DECEMBER 31 1999
	(in thousands)	
Fiber optic systems	$ 99,502	$ 164,985
Telecommunications equipment	115,769	421,718
Furniture and fixtures	7,340	21,397
Leasehold improvements	1,177	1,811
Construction-in-progress	11,770	66,380
	235,558	676,291
Less accumulated depreciation	(10,668)	(36,967)
	$ 224,890	$ 639,324

Costs capitalized during the development of the Company's networks include amounts incurred related to network engineering, design and construction and capitalized interest. Capitalized interest related to the construction of the networks during the years ended December 31, 1997, 1998 and 1999 amounted to, $854,000, $5,133,000 and $6,635,000, respectively.

For the years ended December 31, 1997, 1998 and 1999, depreciation expense was $2,122,000, $8,284,000 and $27,723,000, respectively.

4. INTANGIBLE ASSETS

Intangible assets are comprised of the following:

	DECEMBER 31 1998	DECEMBER 31 1999
	(in thousands)	
Franchise costs	$ 1,690	$ 2,015
Authorizations and rights-of-ways	1,455	2,052
Building access agreements and other	480	637
Other	582	401
	4,207	5,105
Less accumulated amortization	(1,378)	(1,503)
	$ 2,829	$ 3,602

5. ACCRUED EXPENSES

Accrued expenses are comprised of the following:

	DECEMBER 31 1998	DECEMBER 31 1999
	(in thousands)	
Accrued compensation	$4,436	$11,423
Accrued costs related to financing activities	380	7,316
Accrued interest payable	162	8,544

Accrued telecommunications costs...............	565	3,794
Other accrued expenses.........................	3,644	5,970
	$9,187	$37,047

6. LONG-TERM DEBT

Senior Secured Credit Facility

On December 22, 1998, KMC Telecom, KMC Telecom II and KMC Telecom of Virginia (the "Subsidiary Borrowers"), refinanced and expanded the Amended and Restated Loan and Security Agreement (the "AT&T Facility") by entering into a Loan and Security Agreement (the "Senior Secured Credit Facility") with Newcourt Commercial Finance Corp. ("Newcourt"), First Union National Bank, General Electric Capital Corporation ("GECC") and Canadian Imperial Bank of Commerce (the "Creditors"). Under the Senior Secured Credit Facility, the Creditors agreed to lend the Subsidiary Borrowers up to an aggregate of $250 million initially to be used for the construction and expansion of fiber optic telecommunications networks in certain markets and for payment of transaction fees and expenses and, subject to the attainment of certain financial conditions, for working capital and general corporate purposes.

The Senior Secured Credit Facility includes a $175 million eight year revolving loan and a $75 million eight and one half year term loan. At December 31, 1998 and 1999, an aggregate of $41.4 and $235.0 million, respectively, was outstanding under this facility.

As discussed further in Note 18, the Subsidiary Borrowers and KMC Telecom III amended, restated and combined the Senior Secured Credit Facility and the Lucent Loan and Security Agreement during the first quarter of 2000.

Borrowings under the Senior Secured Credit Facility bear interest payable at the Subsidiary Borrowers' option, at (a) the "Applicable Base Rate Margin" (which generally ranges from 1.75% to 3.25%) plus the greater of (i) the administrative agent's prime rate or (ii) the overnight federal funds rate plus .5% or (b) the "Applicable LIBOR Margin" (which generally ranges from 2.75% to 4.25%) plus LIBOR, as defined. Interest on borrowings outstanding at December 31, 1999 was based on both the base rate and LIBOR. The Subsidiary Borrowers were being charged a weighted-average interest rate of 9.38% and 10.26% at December 31, 1998 and 1999, respectively. The Subsidiary Borrowers must pay an annual commitment fee on the unused portion of the Senior Secured Credit Facility ranging from .75% to 1.25%.

The Senior Secured Credit Facility contains a number of affirmative and negative covenants including, among others, covenants restricting the ability of the Subsidiary Borrowers to consolidate or merge with any person, sell or lease assets not in the ordinary course of business, sell or enter into long term leases of dark fiber, redeem stock, pay dividends or make any other payments (including payments of principal or interest on loans) to KMC Holdings, create subsidiaries, transfer any permits or licenses, or incur additional indebtedness or act as guarantor for the debt of any person, subject to certain conditions.

The Subsidiary Borrowers are required to comply with certain financial tests and maintain certain financial ratios, including, among others, a ratio of total

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debt to contributed capital, certain minimum revenues, maximum EBITDA losses and minimum EBITDA, maximum capital expenditures and minimum access lines, a maximum total leverage ratio, a minimum debt service coverage ratio, a minimum fixed charge coverage ratio and a maximum consolidated leverage ratio.

The Company obtained a waiver of compliance, for the quarter ended September 30, 1999, with certain financial covenants (related to revenue and EBITDA) contained in the Senior Secured Credit Facility. In addition, the EBITDA covenant was amended for the fourth quarter of 1999 through the fourth quarter of 2000 and the revenue covenant was amended for the fourth quarter of 1999 through the first quarter of 2001 to less restrictive amounts. As of December 31, 1999, the Subsidiary Borrowers were in compliance with the covenants, as amended.

Lucent Loan and Security Agreement

KMC Telecom III entered into a Loan and Security Agreement (the "Lucent Facility") dated February 4, 1999 with Lucent Technologies Inc. ("Lucent") which provides for borrowings to be used to fund the acquisition of certain telecommunications equipment and related expenses. The Lucent Facility provides for an aggregate commitment of up to $600 million, of which $250 million is available at December 31, 1999 to purchase Lucent products. Further, up to an additional $350 million will be available upon (a) additional lenders participating in the Lucent Facility and making commitments to make loans so that Lucent's aggregate commitment does not exceed $250 million and (b) the Company satisfying certain other requirements, the most significant of which is KMC Holdings raising and contributing at least $300 million in high yield debt or equity (other than disqualified stock) to KMC Telecom III. The Lucent Facility places certain restrictions upon KMC Telecom III's ability to purchase non-Lucent equipment with proceeds from such facility. At December 31, 1999, no amounts had been borrowed under the Lucent Facility.

As discussed further in Note 18, the Subsidiary Borrowers and KMC Telecom III amended, restated and combined the Senior Secured Credit Facility and the Lucent Loan and Security Agreement during the first quarter of 2000.

Interest on borrowings under the Lucent Facility is charged, at the option of KMC Telecom III, at a floating rate of LIBOR plus the "Applicable LIBOR Margin", or at an alternative base rate plus the "Applicable Base Rate Margin" (as defined). Such margins will be increased by 0.25% until KMC Telecom III and its subsidiaries have completed systems in fourteen markets.

The Lucent Facility contains a number of affirmative and negative covenants including, among others, covenants restricting the ability of KMC Telecom III to consolidate or merge with any person, sell or lease assets not in the ordinary course of business, sell or enter into any long-term leases of dark fiber, redeem stock, pay dividends or make any other payments (including payments of principal or interest on loans) to KMC Holdings, create subsidiaries, transfer any permits or licenses, or incur additional indebtedness or act as guarantor for the debt of any other person, subject to certain conditions.

KMC Telecom III is required to comply with certain financial tests and maintain certain financial ratios, including, among others, a ratio of total debt to contributed capital, certain minimum revenues, maximum EBITDA losses and minimum EBITDA, maximum capital expenditures and minimum access lines, a maximum total leverage ratio, a minimum debt service coverage ratio, a minimum fixed charge coverage ratio and a maximum consolidated leverage ratio.

Senior Discount Notes

On January 29, 1998, KMC Holdings sold 460,800 units, each unit consisting of a 12 1/2% senior discount note with a principal amount at maturity of $1,000 due 2008 pursuant to the Senior Discount Note Indenture between KMC Holdings and the Chase Manhattan Bank, as trustee (the "Senior Discount Notes") and one warrant to purchase .21785 shares of Common Stock of KMC Holdings at an exercise price of $.01 per share. The gross and net proceeds of the offering were approximately $250 million and $236.4 million, respectively. A substantial portion of the net proceeds of the offering have been loaned by KMC Holdings to its subsidiaries. On August 11, 1998, KMC Holdings exchanged the notes issued on January 29, 1998 for $460.8 million aggregate principal amount at maturity of notes that had been registered under the Securities Act of 1933 (as used below and elsewhere herein, "Senior Discount Notes" includes the original notes and the exchange notes).

The Senior Discount Notes are unsecured, unsubordinated obligations of the Company and mature on February 15, 2008. The Senior Discount Notes were sold at

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a substantial discount from their principal amount at maturity, and there will not be any payment of interest on the Senior Discount Notes prior to August 15,

2003. The Senior Discount Notes will fully accrete to face value on February 15, 2003. From and after February 15, 2003, the Senior Discount Notes will bear interest, which will be payable in cash, at the rate of 12.5% per annum on February 15 and August 15 of each year, commencing August 15, 2003. The Company is accreting the initial carrying value of the Senior Discount Notes to their aggregate face value over the term of the debt at its effective interest rate of 13.7%.

The Senior Discount Notes are redeemable, at the Company's option, in whole or in part, on or after February 15, 2003 and prior to maturity, at redemption prices equal to 106.25% of the aggregate principal amount at maturity, plus accrued and unpaid interest, if any, to the redemption date, declining to 100% of the aggregate principal amount at maturity, plus accrued and unpaid interest as of February 15, 2006.

In addition, at any time prior to April 15, 2000, the Company may redeem up to 35% of the aggregate principal amount at maturity of the Senior Discount Notes with the net proceeds from the sale of common equity at a redemption price of 112.50% of their accreted value on the redemption date.

The indebtedness evidenced by the Senior Discount Notes ranks pari passu in right of payment with all existing and future unsubordinated, unsecured indebtedness of KMC Holdings and senior in right of payment to all existing and future subordinated indebtedness of KMC Holdings. However, KMC Holdings is a holding company and the Senior Discount Notes are, therefore, effectively subordinated to all existing and future liabilities (including trade payables) of its subsidiaries.

Within 30 days of the occurrence of a Change of Control (as defined in the Senior Discount Note Indenture), the Company must offer to purchase for cash all Senior Discount Notes then outstanding at a purchase price equal to 101% of the accreted value thereof, plus accrued interest. The Company's ability to comply with this requirement is subject to certain restrictions contained in the Senior Secured Credit Facility.

The Senior Discount Note Indenture contains events of default, including, but not limited to, (i) defaults in the payment of principal, premium or interest, (ii) defaults in compliance with covenants contained in the Senior Discount Note Indenture, (iii) cross defaults on more than $5 million of other indebtedness, (iv) failure to pay more than $5 million of judgments that have not been stayed by appeal or otherwise and (v) the bankruptcy of KMC Holdings or certain of its subsidiaries.

The Senior Discount Note Indenture restricts, among other things, the ability of KMC Holdings to incur additional indebtedness, create liens, engage in sale-leaseback transactions, pay dividends or make distributions in respect of capital stock, make investments or certain other restricted payments, sell assets of KMC Holdings, redeem capital stock, issue or sell stock of restricted subsidiaries, enter into transactions with stockholders or affiliates or effect a consolidation or merger. The Senior Discount Note Indenture permits KMC Holdings' subsidiaries to be deemed unrestricted subsidiaries and, thus, not subject to the restrictions of the Senior Discount Note Indenture.

The Senior Discount Notes are "applicable high yield discount obligations" ("AHYDOs"), as defined in the Internal Revenue Code of 1986, as amended. Under the rules applicable to AHYDOs, a portion of the original issue discount ("OID") that accrues on the Senior Discount Notes will not be deductible by the Company at any time. Any remaining OID on the Senior Discount Notes will not be deductible by the Company until such OID is paid.

Senior Notes

On May 24, 1999, KMC Holdings issued $275.0 million aggregate principal amount of 13 1/2% Senior Notes due 2009. On December 30, 1999, KMC Holdings exchanged the notes issued on May 24, 1999 for $275.0 million aggregate principal amount of notes that had been registered under the Securities Act of 1933 (as used below and elsewhere herein, "Senior Notes" includes the original notes and the exchange notes). Interest on the Senior Notes is payable semi-annually in cash on May 15 and November 15 of each year, beginning November 15, 1999. A portion of the proceeds from the offering of the Senior Notes was used to purchase a portfolio of U.S. government securities that were pledged as security for the first six interest payments on the Senior Notes.

The Senior Notes are redeemable, at the Company's option, in whole or in part, on or after May 15, 2004 and prior to maturity, at redemption prices equal to

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106.75% of the aggregate principal amount at maturity, plus accrued and unpaid interest, if any, to the redemption date, declining to 100% of the aggregate principal amount at maturity, plus accrued and unpaid interest as of May 15, 2007.

In addition, at any time prior to May 15, 2002, the Company may redeem up to 35% of the aggregate principal amount at maturity of the Senior Notes with the net proceeds from the sale of common equity at a redemption price of 113.5% of the principal amount on such date plus accrued and unpaid interest. Upon a change of control (as defined in the Senior Note Indenture), the Company must offer to purchase for cash the Senior Notes at a purchase price equal to 101% of the principal amount, plus accrued interest. The Company's ability to comply with this requirement is subject to certain restrictions contained in the Senior Secured Credit Facility.

The Senior Notes were guaranteed by KMC Telecom Financing, Inc., a wholly-owned subsidiary. The Senior Notes are senior, unsecured unsubordinated obligations of KMC Holdings and rank pari passu in right of payment with all existing and future unsubordinated, unsecured indebtedness of KMC Holdings and senior in right of payment to all of existing and future subordinated indebtedness of KMC Holdings. However, KMC Holdings is a holding company and the Senior Notes are, therefore, effectively subordinated to all existing and future liabilities (including trade payables), of its subsidiaries.

The Senior Note Indenture contains certain covenants that, among other things, limit the Company's ability to incur additional indebtedness, engage in sale-leaseback transactions, pay dividends or make certain other distributions, sell assets, redeem capital stock, effect a consolidation or merger of KMC Telecom Holdings, Inc. and enter into transactions with stockholders and affiliates and create liens on our assets.

7. INTEREST RATE SWAP AGREEMENT

The Company has entered into an interest rate swap agreement with a commercial bank to reduce the impact of changes in interest rates on a portion of its outstanding variable rate debt. The agreement effectively fixes the Company's interest rate on $125 million of the outstanding variable rate borrowings under the Senior Secured Credit Facility due 2007. The interest rate swap agreement terminates in April 2004. The Company is exposed to credit loss in the event of nonperformance by the other party to the interest rate swap agreement. However, the Company does not anticipate nonperformance by the counterparty.

8. REDEEMABLE AND NONREDEEMABLE EQUITY

KMC Telecom Preferred Stock

On January 21, 1997, certain convertible notes were converted into 123,800 shares of Series A Cumulative Convertible Preferred Stock of KMC Telecom with an aggregate liquidation value of $12,380,000. Effective September 22, 1997, all of the shares of Series A Cumulative Convertible Preferred Stock of KMC Telecom were exchanged for an equal number of shares of Series A Cumulative Convertible Preferred Stock of KMC Holdings.

Pursuant to an agreement with Nassau, all dividends accumulated on the Series A Cumulative Convertible Preferred Stock of KMC Telecom through September 22, 1997 ($592,000) were paid upon the closing of KMC Holdings' issuance of Senior Discount Notes and warrants on January 29, 1998.

Series E Preferred Stock

On February 4, 1999, the Company issued 25,000 shares of Series E Senior Redeemable, Exchangeable, PIK Preferred Stock (the "Series E Preferred Stock")