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Big Gap in Valuations Puts Private Companies in Broadband Catbird Seat

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Inside…

Key Points:

- The valuation gap between private communication companies – which operate mostly in rural and tier three cities – and public cable companies is the widest we've ever seen.
- EBITDA valuations for private companies (based on recent transactions) are over two times higher than the average valuation for the main publicly traded cable companies. An EBITDA valuation is considered a proxy for a business' possible sale price.
- Several factors are driving this gap, including public equity market dynamics, competition from the large telcos, an attractive competitive environment and growth prospects for private investors, and the unprecedented amount of federal dollars allocated to bridge the digital divide.
- Given the headwinds facing publicly traded cable operators and the tailwinds for their private counterparts, the valuation gap will likely persist for the foreseeable future. This puts many independently owned rural communication providers in the catbird seat when it comes to strategic partnerships and/or outright sale.

Introduction

There has always been a valuation gap between public cable and private communication operators that offer internet, cable and phone services. Public equities are exposed to the whims of the stock market which can have a significant impact on valuations. And given the higher levels of liquidity in public markets, investors can move in and out of companies rather easily, which can increase volatility and (potentially) lower valuations. Conversely, private investors tend to have a much longer time horizon and typically target markets that are less competitive with attractive growth prospects. But the valuation gap that exists today is bigger than anything we've seen. Private valuations remain very strong while their public counterparts' stocks are trading near their 52 week lows *(Exhibit 1).*

In this report we attempt to quantify the valuation gap and the factors driving it, and why it's important to rural operators. We also weigh in on where we think valuations are headed.

Sizing the Gap

For comparison purposes we've selected public companies that have similar profiles to rural operators, or those with significant broadband market exposure: Cable One, WOW, Altice, Comcast and Charter. With its primary markets including non-metropolitan, secondary and tertiary markets, and its de-emphasis on video, we believe Cable One makes a good broadband comparison. WOW is also a good comparison because it focuses on broadband and doesn't have any media assets. Comcast, Charter and Altice were included as they represent the lion's share of the broadband market despite the fact that Comcast's valuation is complicated due to its media assets. On the private side, we analyzed the sales of nine companies involving a mix of fiber-to-the-home (FTTH) and hybrid fiber-coaxial (HFC) providers and local exchange carriers (mix of fiber and copper) where we had sufficient data. The acquirers were both strategic and investors and the deals ranged from $50 million to above $1 billion.

The data showed private valuations are more than 2x the average of public valuations *(Exhibit 2).*

EXHIBIT 1: 52-Week Range and Current Stock Price, March 23, 2022

Source: Yahoo Finance

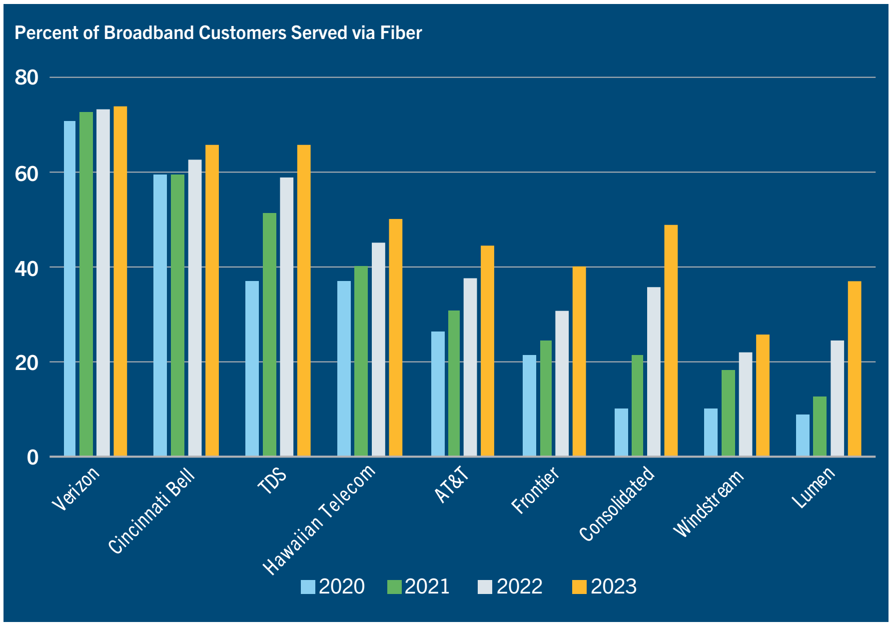
EXHIBIT 2: Public Valuations vs. Private Transaction Valuations

	Enterprise Value/ EBITDA Multiple as of March 15, 2022	Weighted Average EBITDA Multiple for Private Transactions*
Comcast	9.10	22.15
Charter	10.36	
Altice USA	7.64	
Cable One	14.85	
WOW	10.59	

Source: Capital IQ and CoBank

* Weighting was based on acquisition price. Nine fiber/LEC transactions were analyzed from Jan 1, 2021 - March 15, 2022

EXHIBIT 3: Telco Fiber Passings as a Percent of Total Passings



Source: S&P Global

We think there are five factors contributing to the valuation gap: three that are putting downward pressure on public valuations and two that represent tailwinds for the private market.

Downward Pressures on Public Equity

Public Market Dynamics

Equity markets have been under tremendous pressure over the last several months given the rise in inflation and the associated increase in interest rates, the Russian invasion of Ukraine and the Federal Reserve's unwinding of their bond purchases, among other factors. Public equity markets tend to react quicker to market shocks and with much higher volatility than private markets where investors have a longer term time horizon. They are also more sensitive to macro related factors, which are abundant right now. Outside of commodity-related companies, most publicly traded corporations have seen their stocks fall and cable companies are no exception.

Telco and Electric Distributor Fiber Investments

The other factor suppressing public cable valuations are the fiber investments the telcos are making to overbuild their legacy DSL networks *(Exhibit 3)*. Cable operators have dominated the broadband market, taking share from the telcos with their superior HFC networks. Historically, big telco companies like AT&T and Verizon were focused on building their wireless networks and buying their way into the content/media market, neglecting their DSL broadband business in the process. Now things have changed. AT&T is divesting Time Warner and pledging to pass 30 million homes with fiber by 2025. Verizon sold Yahoo and AOL is investing in its One Fiber project with plans to pass an additional 20 million homes over the next 3-5 years.

These and other fiber investments from the likes of Lumen and Frontier Communications are making cable investors nervous. The telcos are slowly becoming a formidable competitor and will certainly take market share from the cable operators. To be clear, AT&T and Verizon have a long way to go before they take meaningful share from the cable operators, but for public equity investors, sometimes even a whiff of competitive headwinds can be a catalyst to compress the multiple.

In addition, electric distributors have been actively building fiber networks. For example, the Rural Electric Cooperative Consortium secured over $1.1 billion in the Rural Digital Opportunity Fund (RDOF) reverse auction. These funds will be used to build fiber networks in unserved and underserved areas.

Fixed Wireless Access (FWA)

Verizon and T-Mobile are aggressively deploying FWA as an alternative to fixed-line broadband. The wireless operators are bundling FWA with traditional wireless service and believe they are well positioned to take broadband share from the cable operators. Verizon expects to cover 50 million homes and 14 million businesses (up from 30 million homes and 2 million businesses covered today) and to have 4 million to 5 million customers by 2025. T-Mobile believes it will add 7 million to 8 million FWA customers by 2024.

EXHIBIT 4: Most U.S. Households Have Limited Provider Options for High-Speed Internet Service

	25 Mbps or Higher	100 Mbps or Higher	500 Mbps or Higher
One Service Provider	28%	45%	51%
Two Service Providers	56%	42%	35%
Multiple Service Providers	11%	6%	5%

Source: S&P Capital IQ

Opinions vary on how disruptive FWA will be to the cable operators. Skeptics point to capacity constraints in wireless networks as a limiting factor in scaling the business, and the belief that a wired connection will always be better than a wireless one. The wireless operators believe that a combination of bundling discounts, the investments they've made in spectrum, and the increased spectral efficiency that comes with 5G standards are the key ingredients they have to grow their FWA business.

Regardless of how it plays out over the long term, know this: public equity investors do not like uncertainty, which is why the FWA threat is making them nervous.

Tailwinds for Private Transactions

Less Competition in Rural America

Rural markets – which is where private investors are investing – are less competitive compared to urban and suburban markets. The lack of competition gives operators more pricing power and better long-term growth prospects. To illustrate this, we note that according to S&P Capital IQ, 45% of U.S. households have access to only one wireline service provider that offers speeds of 100Mbps or higher *(Exhibit 4).* Consumers are gravitating to higher speed plans as our lives become increasingly digital. The lack of service provider options in the 100Mbps range makes for an attractive market opportunity to deploy fiber in markets with one service provider – especially considering that many of these markets are likely being served by legacy HFC networks, which are inferior to fiber. (Note that S&P Capital IQ used the FCC's flawed broadband maps which likely means their analysis understates the lack of service provider options).

Investors know that the first operator to build a FTTH network in an unserved/underserved market can more easily fend off competition. Rural operators are known to offer much better service and have higher brand equity compared to the tier one telcos and cable operators, which makes rural operators' customers "stickier." A first mover advantage with a strong brand makes for an attractive investment opportunity.

Federal Money

The U.S. government is pumping an unprecedented amount of capital into building broadband networks in rural America, and this type of government support can make for a compelling business case for investors. The recently enacted Infrastructure Investment and Jobs Act includes $65 billion for broadband, of which $42.5 billion is for new broadband builds in unserved and underserved markets. Given the high cost nature of these markets, this level of government funding is no doubt fueling investor interest to buy and invest in rural broadband markets.

Looking Ahead

We expect the valuation gap to persist for the foreseeable future as the factors compressing public valuations are not going to dissipate anytime soon. For example, telco fiber investments are just starting and the rhetoric around them will last for several years, potentially putting continued downward pressure on public cable companies' stock prices. Also, with a market backdrop that includes inflation concerns, higher interest rates, Ukraine/Russia war and the risk of a recession (if you believe in the flattening yield curve theory) it's hard to paint a scenario where equity markets rally anytime soon. Conversely, the government is plowing unprecedented amounts of money into bridging the digital divide with private investors showing no signs of waning interest in acquiring and investing in smaller, privately held communication companies. This should put a floor under private valuations for the next several quarters.

All of this is great news for independently owned communication companies. If they wish to sell, it's likely they will have no shortages of investors and strategic buyers willing to pay a premium for their businesses. Conversely, if they don't want to sell 100% of their equity but instead are looking for strategic partners with capital, options should be plentiful as well. This could enable them to upgrade their networks faster and/or enter new markets where the competitive environment is attractive.

Summary

When comparing private deals to public valuations, it's important to recognize that each private deal is unique, and the valuations can vary considerably. But in aggregate, there is no denying that the gap between private deals/valuations versus public valuations is wide, and might be the widest we've ever seen. Private investors – infrastructure funds in particular – have raised billions of dollars to invest, and digital assets are at the top of their shopping list. As consumers/enterprises have quickly adopted a wide range of digital applications, communication assets have become much more attractive investments than roads and airports. Couple that with the unmet communication needs in rural America and the government money flowing into the market, and it's understandable why these assets are garnering so much attention. On the public side, multiple headwinds are emerging for cable operators that are driving down their stock prices, many of which need years to play out. Because of this, public valuations will likely remain under pressure while private valuations should remain high – giving independently owned communication companies more options in strategic partnerships and/or outright sales.

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