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Flush with Cash and Ready to Buy, Investors Take Aim at Fiber-Rich Operators

Key Points:

- Major infrastructure funds have been acquiring mid-sized fiber transport operators to gain exposure to the telecom market.
- Strategic buyers have also been active in the market as they look for scale and market expansion.
- The increase in mergers and acquisitions (M&A) has pushed valuations for telecom operators to levels that were unthinkable a couple of years ago.
- Investors are now turning their attention to smaller regional/rural operators with strong cash flows, fiber assets, and attractive organic growth prospects.
- Given all of the money chasing a finite number of companies, it should remain a sellers' market for the foreseeable future.

Introduction

M&A activity in the telecom market has been red hot, driven by the explosion in cloud computing, consumers' insatiable demand for data, and new technologies including 5G wireless networks, IoT, and autonomous vehicles (*Exhibit 1*). Thus far, most deals have included mid-sized fiber transport companies. These deals can top several billion dollars and offer investors broad exposure to the enterprise and wholesale fiber markets. Now that most of the available companies have been acquired, investors are turning their attention to regional/rural operators who have made strategic investments in fiber. For example, in August alone, private equity (PE) firm Grain Management announced three deals: acquisitions of Summit Broadband, Hunter Communications, and Ritter Communications.

The money flowing into the U.S. telecom market over the last few years has helped drive up telecom valuations, particularly as large strategic buyers, infrastructure funds, and private equity sponsors look for growth opportunities, scale, and revenue diversification. Valuations could still climb, creating a sellers' market for the foreseeable future.

In this report we cover the reasons why network owners are selling, the various investor types in the market, and lessons learned from executives who've gone through an acquisition.

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EXHIBIT 1: Notable Telecom Acquisitions

Date	Buyer	Synergies		Enterprise Value / EBITDA
		Seller	Price / Multiple	Comments
August 2019	Grain Management	Hunter Communications	Not Disclosed	<ul style="list-style-type: none"> • Largest privately held fiber network in Oregon • Voice and data enterprise business
August 2019	Grain Management	Ritter Communications	Not Disclosed	<ul style="list-style-type: none"> • 45,000 plus customers across TN, MO and AR • Residential triple play and cloud, networking, and internet enterprise services
May 2019	EQT Infrastructure and Digital Colony Partners	Zayo	\$14.3B / 11.1x EBITDA	<ul style="list-style-type: none"> • Lower multiple as compared to other transactions • 130,000 route miles in North American and Europe
April 2019	Cable One	Fidelity Communications	\$525.9M / 11.7x EBITDA	<ul style="list-style-type: none"> • Strategic buyer looking to expand its footprint and gain scale • Fidelity has 114K residential and 20K business customers
January 2019	Macquarie Infrastructure Partners / Uniti Group	Bluebird Networks	\$319M / 10.4x EBITDA	<ul style="list-style-type: none"> • Bluebird operates 6,500 route miles • Bluebird will acquire Uniti's Midwestern fiber network (2,500 miles)
November 2018	Cable One	Clearwave	Not Disclosed	<ul style="list-style-type: none"> • Strategic acquisition to add capacity and scale in an adjacent market • Clearwave has 2,400 route miles and 2,700 on-net businesses, towers and data centers
March 2018	AMP Capital	Everstream Solutions	Not Disclosed	<ul style="list-style-type: none"> • Enterprise fiber provider in the Midwest • 10,000 route miles
February 2018	Antin Infrastructure	FirstLight Fiber	Not Disclosed	<ul style="list-style-type: none"> • FirstLight provides datacenter connectivity to 8,000 locations with a 14,000 route mile network • Clients include national cellular operators, wireline carriers and large enterprises

Source: CoBank

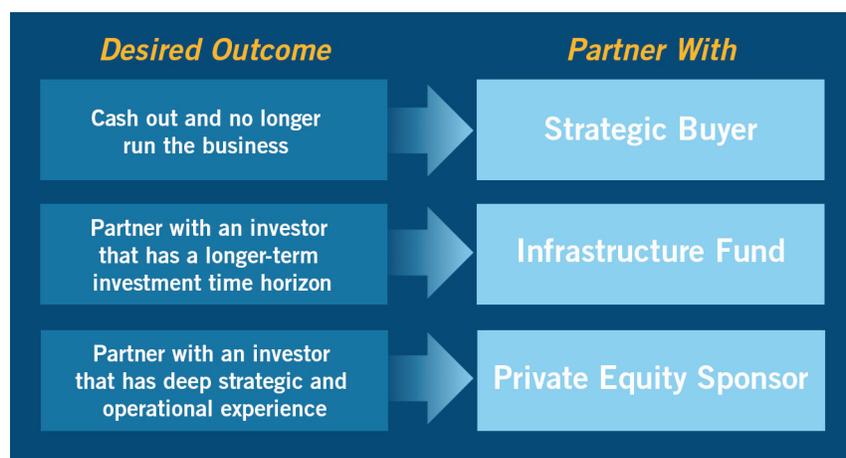
Motives for Selling**Portfolio diversification**

Some owners have a disproportionate amount of wealth tied up in their companies, and selling a part of their equity diversifies their portfolios and is a good way to limit downside risk. High valuations have motivated some owners to sell now and we've seen more outright sales versus partial sales.

Capital constraints

Given the increasing demands on telecom networks, fiber has proven to be a good investment. And according to some of the customers we've spoken with, having access to new sources of capital would enable them to accelerate their network builds and create shareholder value.

EXHIBIT 2: Partnership Strategies



Source: CoBank

A typical rural fiber build takes approximately two years to complete, another two years to generate meaningful cash flow, and a total of six to seven years for the investment to reach its hurdle rate. But these investments do create some cash flow and debt challenges. Many small operators have limited borrowing capacity and are unable to fund multiple projects simultaneously. This choke point becomes a barrier to enterprise value creation.

Partnering with a PE sponsor or infrastructure fund may provide new sources of capital and enable operators to invest in value-creating projects that otherwise would not be possible.

Who is Buying?

Recently, the most interested and active buyers are: 1) Infrastructure funds, 2) PE sponsors and 3), strategic buyers. Why are they buying? The answer is, of course, it depends. Also, it's important to understand which of these buyers a telecom owner should partner with (*Exhibit 2*).

Infrastructure funds

Infrastructure funds typically have longer-term investment time horizons and lower return requirements compared to some PE sponsors. For example, an infrastructure fund may be satisfied with a 10% to 15% annual return over a five-to-10 year timeframe while PE

sponsors may demand much higher returns. On the management front, infrastructure funds are typically not as actively involved in strategic planning compared to PE sponsors. Since infrastructure funds have already targeted mid-sized fiber transport companies, smaller telecom properties with significant fiber assets may become a priority. Infrastructure funds are good for owners who are looking to raise capital, but still want some level of input over strategy and the day-to-day operations.

Private equity

PE sponsors usually have operational experience in the industries they invest in. On the positive side, having another pair of (experienced) eyes on the business can help ensure good decision making, but it can also lead to friction between management and owners. PE investment time horizons tend to be shorter than a typical infrastructure fund (think five-to-seven years maximum). PE sponsors are good for owners who are looking to raise capital, and want to leverage the expertise and connections PE managers can offer.

Strategic buyer

Strategic buyers are heavily influenced by synergies such as taking redundant costs out of a business, gaining scale, and offering more services. On average, synergies reduce the multiple paid on a target company by ~25% (*Exhibit 3*). Selling to a strategic buyer means the company post-merger will look a lot different than it did pre-merger. Strategic buyers tend to eliminate redundant positions and may replace most of the management team. Also, if the buyer used equity to acquire the target – or if less than 100% of the company was sold – legacy shareholders will have significantly less control over the combined company versus what they had pre-acquisition. Strategic buyers are good for owners who want to cash out and give up control of their business.

EXHIBIT 3: Power of Synergies

Acquirer	Target	Synergies	Enterprise Value / EBITDA	
		(% of Revenue)	Pre-Synergy	Post-Synergy
Cincinnati Bell	Hawaiian Telecom	3.3%	5.6x	5.1x
Consolidated Communications	FairPoint Communications	6.6%	5.9x	4.9x
Frontier Communications	Verizon	12.1%	5.9x	3.7x
Consolidated Communications	Eventis	7.6%	7.3x	5.6x
Frontier Communications	AT&T	16.0%	5.9x	4.8x
Consolidated Communications	SureWest	14.2%	6.3x	4.8x
Century Link	Qwest	5.8%	5.1x	4.5x
Windstream Communications	Iowa Telecom	12.7%	8.7x	6.8x
Windstream Communications	Lexcom Communications	11.3%	5.9x	4.9x
Frontier Communications	Verizon	7.6%	4.5x	3.4x
Windstream Communications	D&E Communications	16.9%	5.2x	3.7x
CenturyTel	Embarq	7.6%	4.5x	3.8x
Consolidated Communications	North Pittsburgh	6.9%	7.6x	6.6x
CenturyTel	MadisonRiver Communications	8.7%	8.4x	7.2x
Citizens Communications	CTE Commonwealth	13.6%	7.0x	5.5x
Windstream Communications	CT Communications	16.7%	10.1x	6.7x
Average		10.5%	6.5x	5.1x

Source: Charlesmead Advisors

What Investors Want

Investors are looking for companies that generate consistent cash flows, have invested in fiber, and offer attractive organic growth prospects. The network doesn't need to be all fiber, as investors can value the company using a sum-of-the-parts analysis. For example, they may apply a mid-single digit multiple for copper network assets, a slightly higher one for hybrid fiber coax (HFC), and the highest one for fiber. Within the fiber network, residential line valuations will be on the low end with enterprise/wholesale valuations on the high end. The other factor to consider is regulatory support commitments, specifically A-CAM (Alternative Connect America Cost Model). For example, having a predictable eight-year government funded cash flow stream is very attractive and something that investors are seeking out, albeit with the knowledge there are specific build-out strings attached.

Networks that are physically near an investor's other companies can be an important consideration if they are able to integrate network operations across their portfolio. This could increase the amount an investor is willing to pay. Conversely, for small and remote rural operations, cash flow generation will be a major consideration given the limited synergies and organic growth opportunities.

Lessons Learned

We spoke to a number of telecom executives who've recently been involved in M&A to get their perspective.

At the onset, they recommend talking to trusted contacts who have been through an M&A transaction. Then assemble a list of five to six strategic advisors to interview and pick one with extensive experience in rural/regional telecom deals. From there, add legal and other financial advisors to the deal team. For management participation,

bring on a small number of key managers to represent operations, finance, strategy, etc. The tighter the inner circle, the less chance of leaks, which can negatively impact employee productivity.

Most of the executives we spoke with believe that sellers have leverage given the number of investors courting them. This enviable position has enabled operators to negotiate favorable terms regarding board seats, employee retention, managerial control, etc.

The executives expressed two schools of thought regarding how to engage with investors. Some think that talking to a wide range of investors is prudent for securing the best deal. They believe that by shopping around, the seller will have more leverage and therefore can negotiate the best deal. Others think that taking a more defined approach and sticking with a specific goal – say an outright sale of the company – is more efficient, saving time and money.

Conclusion

With consumer data traffic and cloud computing growing annually at 30% and 35%-59% respectively,¹ and new data applications emerging with 5G networks, it's no wonder investors have an appetite for telecom

networks. Increased investor demand coupled with limited options are pushing valuation multiples higher. And for the foreseeable future, we don't expect this appetite to abate. As a result, companies that do not have access to enough capital to fund material growth can unlock value by partnering with an investor. The reality is, financing capital investments exclusively with debt has its limitations. Alternatively, for owners who are looking to cash out, selling now and taking advantage of attractive valuations should be considered. Operators who are contemplating a partial or outright sale are advised to proceed carefully. And if in-house M&A expertise is not available, companies should partner with a trusted advisor who is familiar with the investor community and has direct experience with recent private telecom transactions. ■

References

¹ Novet, Jordan. "Amazon's cloud business reports 35% growth in the third quarter trailing estimates," CNBC, October 24, 2019. Accessed Nov. 6, 2019. <https://www.cnbc.com/2019/10/24/aws-earnings-q3-2019.html>

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