



September 2020

Rural Broadband Valuations Remain High as Investors Move Down Market for New Opportunities

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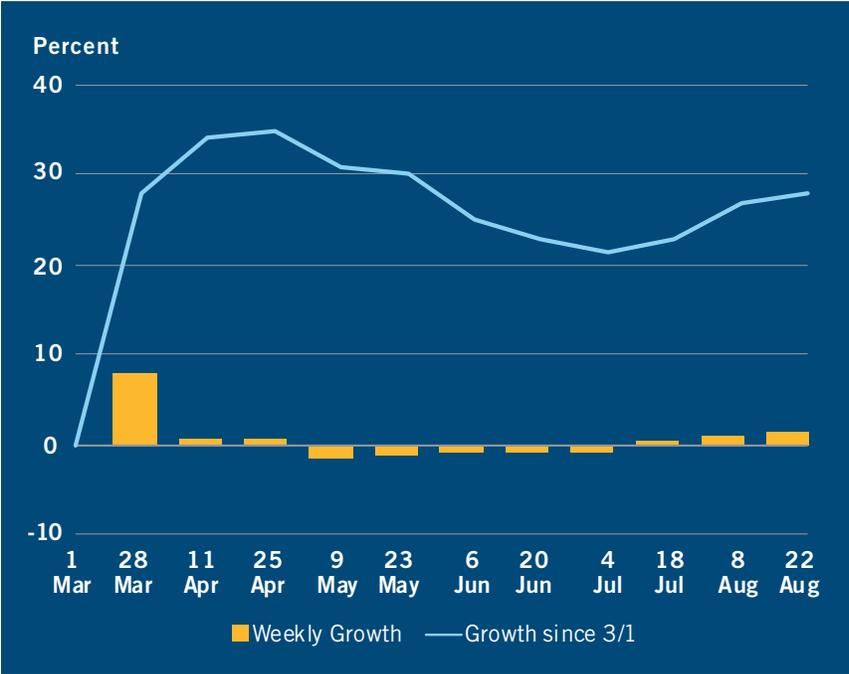
Key Points:

- The abrupt shift in 2020 to working from home and remote learning has significantly increased high-speed data subscriptions, representing a new catalyst for the broadband market.
- COVID-19 has exposed the vulnerability of the underserved and unserved, and as a result, Democratic lawmakers have proposed an \$80 billion plan to bridge the digital divide. The possibility of new government grants will whet investors' appetites for broadband assets.
- Investors are starting to show interest in WISPs thanks to their CAF-II awards, new spectrum-sharing business models, and fiber investments.
- While the high-speed LEO satellite market represents a long-term headwind for valuations and M&A activity, we remain skeptical until the business model is proven.
- Given these and other factors, we believe current broadband valuations should remain elevated for the foreseeable future.

Introduction

M&A activity in the broadband market remains robust as investors look to gain exposure to the secular (long-term) tailwinds behind society's digital transformation. COVID-19 has demonstrated that a high-quality broadband network is essential for Americans to learn and work. Over the last year, investors have moved down market, targeting smaller rural operators who have replaced some or all of their copper networks with fiber. This was expected, as institutional investors and strategic buyers have already acquired most of the mid-tier fiber transport companies. In an interesting development, investors are beginning to move even further down market by showing interest in acquiring wireless internet service providers (WISPs). This report looks at the current state of the broadband M&A market including valuations, target companies, market catalysts, risks, and the impact COVID-19 could have on new sources of government funding.

EXHIBIT 1a: National Upstream Peak Growth, 2020



New Market Catalysts

The growth in data traffic was already booming before COVID-19 upended how people work, live, and learn. For example, the shift to cloud computing, upcoming 5G networks, the growth in the Internet of Things (IoT), and next-generation applications such as autonomous driving vehicles were all expected to fuel significant growth for broadband operators.

The abrupt shifts to working from home and remote learning are new and unexpected catalysts for the market. As a result, data traffic volumes have surged (*Exhibits 1a and 1b*) and broadband customer additions have skyrocketed (*Exhibit 2*). These trends have fundamentally accelerated and changed how people use data services. According to Microsoft’s CEO, the company has seen two years of digital transformation in the two months following the stay at home orders. Companies have had to re-engineer their processes overnight to equip 90% or more of their employees to work remotely. This includes investments in video conferencing technologies, IT workflows, security, and digital collaboration tools.

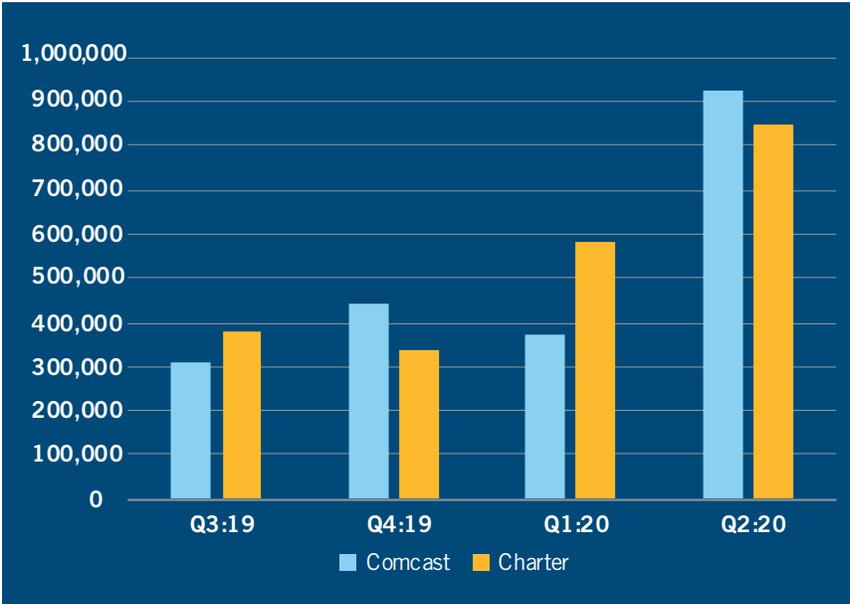
And if you listen closely to what companies are saying, the work-from-home genie is out of the bottle.

EXHIBIT 1b: National Downstream Peak Growth, 2020



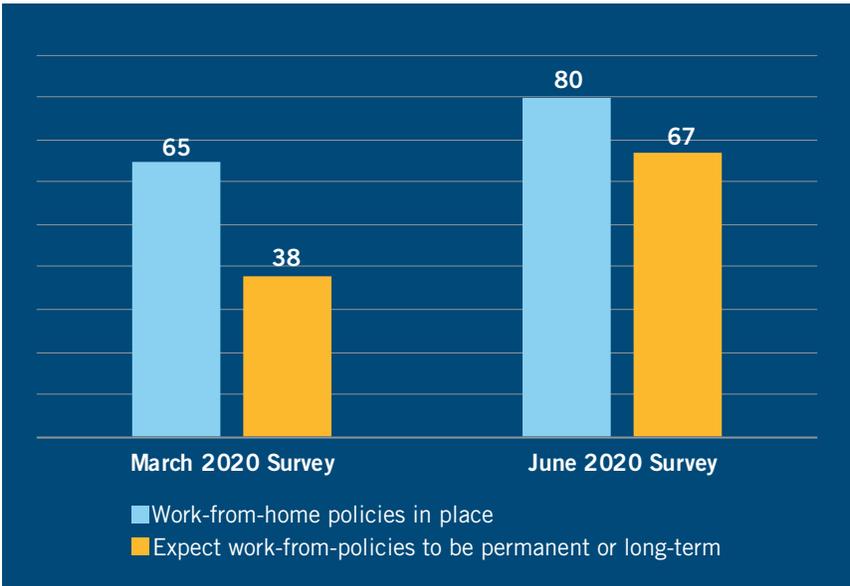
Source: NCTA

EXHIBIT 2: High-Speed Data Customer Additions



Source: Company filings

EXHIBIT 3: Percent of Organizations That Expect Work-from-Home Policies to Remain Permanent or Long-term



Source: 451 Research

Companies are realizing that work done in the office can now be done remotely (*Exhibit 3*). This flexibility not only increases employee satisfaction (and arguably productivity), but also reduces operating expenses. Facebook’s CEO Mark Zuckerberg believes that in five years half of its workforce will work remotely.

Government Funding

COVID-19 also exposed the vulnerability of those without broadband. If this exposure leads to new government financial support, investors’ interest in acquiring broadband service providers should intensify.

Hearing reports of kids doing homework in a McDonalds parking lot, or the sick having to drive hours to the nearest hospital because they don’t have access to telehealth services, has focused Congress on bridging the digital divide. For example, in April Democratic lawmakers introduced a plan to invest \$80 billion over five years to deploy broadband nationwide.

Currently, the largest broadband program is the Rural Digital Opportunity Fund (RDOF) which includes \$20.4 billion to be distributed over a 10 year period. A new \$80 billion program would massively increase federal support, but many hurdles in Washington remain before this becomes a reality. Nonetheless, there is bi-partisan agreement that more must be done.



Federal broadband programs are typically grant based and tied to buildout requirements. Therefore, having a reliable cash flow stream from the federal government gives investors greater certainty about future business operations, which reduces risk. And with less risk, investors may be willing to pay a higher price for a network. As a result, we think COVID-19 and the potential injection of additional federal dollars will help support current broadband valuations and M&A interest.

Moving Down Market

Now that most of the fiber transport operators have been acquired, investors have turned to smaller rural cable and local exchange carriers. But they don't appear to be stopping there, as we've been hearing about investor interest in WISPs.

WISPs have seldom come up as attractive acquisition targets because they're vulnerable to fiber over-builders that can essentially wipe out a WISP's entire business. WISPs have historically used off-the-shelf Wi-Fi gear that operates on unlicensed spectrum. While this is better than nothing, it's no match for a fiber network that offers faster speeds and a much more reliable connection. Additionally, WISP balance sheets tend to be weak and their cash flows have not been overly reliable.

However, the recent CAF-II auction (Connect America Fund Phase 2) awarded many WISPs large grants, which has shored up some of these concerns and enabled them to invest in fiber for backhaul and other opportunities. Couple that with WISPs' ability to build carrier-grade networks via new spectrum-sharing business models (think CBRS) and investors are interested.

Valuation Outlook

Valuations for broadband assets have remained elevated over the last 12 months, thanks in large part to infrastructure funds' insatiable demand for telecom assets. Because these and other investors need to put a large amount of money to work, we don't see valuations coming down anytime soon. For fiber-rich operators, we believe EBITDA multiples in the upper teens, and in some cases even higher, will be the price range that investors and operators can expect for the foreseeable future. Of course, no two deals are the same, so factors such as edge out opportunities, competitive environment, customer profiles, and federal grant commitments all impact the price an investor is willing to pay.

As for WISP valuations, we don't think they will come anywhere near the fiber-based valuations, despite the recent interest in the space. However, we do think fixed wireless will play a larger role in broadband networks as operators look for cost-effective ways to deploy coverage in high-cost areas. This heterogeneous network strategy is made possible by the FCC's decision to allow the shared use of spectrum in the 3.5GHz band. We think multiples for CBRS fixed wireless networks will end up in the low to mid-single digit range.

Risks

For the most part, we think the risk is small for multiples to collapse or for investor interest in the U.S. broadband market to wane. There are simply too many underlying secular tailwinds for things to soften in a material way. However, just like COVID-19 has taught us, disruptive events coming out of left field do happen. To that end, we believe one of the risks for the broadband market are Low Earth Orbiting (LEO) Satellites.

Unlike geostationary satellite constellations that orbit the earth at 22,300 miles, LEO satellites orbit at lower altitudes in the 100 – 1,200 mile range. Because of their proximity to the earth's surface, these satellites promise to deliver broadband speeds in the 1GHz range. In theory, LEO satellites would be a silver bullet solution to bridge the digital divide, and could create competitive headwinds for incumbent terrestrial broadband networks. However, like most new technologies, the devil is in the details.

The LEO satellite broadband industry is backed by heavy hitters in technology. Amazon's Project Kuiper recently secured FCC approval to deploy 3,236 LEO satellites and has committed \$10 billion to the network. And Elon Musk's SpaceX is aggressively deploying its LEO constellation with plans to launch up to 12,000 satellites. Despite the deep pockets behind LEO satellite broadband networks, we remain skeptical that these heavyweights will be able to disrupt the terrestrial broadband market.

It would seem that LEO satellite providers will need to penetrate the urban and suburban markets to justify that capital needed to build and operate the business. Taking share from incumbent broadband providers in urban and suburban markets could prove difficult, as they enjoy high margins with network equipment that is largely amortized. Additionally, new spectrum sharing models and the RDOF should usher in a large number of fixed wireless networks offering carrier-grade performance for high-cost rural areas.

Conclusion

The number of underlying factors fueling investor interest in the broadband market is growing, and the universe of companies they are looking to acquire is expanding. COVID-19 has exposed how vulnerable the underserved and unserved are and because of that, Democratic lawmakers have proposed an \$80 billion plan to bridge the digital divide. This plan is far from becoming a reality, but additional government grants should make the market even more attractive to investors. The abrupt shift to working from home and remote learning have led to huge increases in high speed data subscriptions, and it appears these trends have some serious staying power. Infrastructure funds are still sitting on lots of cash, and given the attractive market conditions we don't see valuations contracting anytime soon.

From a risk standpoint, LEO satellites could reduce valuations and dampen investor interest, but not anytime soon. The business model has yet to play out and even if it does, all the satellite data traffic will still need to travel over a fiber network. Given these and other factors, we believe current broadband valuations should remain elevated for the foreseeable future. ■

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