June 2023

Slowdown in M&A Activity Does Little to Dent Private Valuations for U.S. Communications Companies

Jeff Johnston
Lead Economist, Communications

Inside…

Key Points:

- The feverish pace of M&A activity in the U.S. communications market has seen a considerable slowdown over the last 12 months.
- Concerns related to the economic environment, rising interest rates and supply chain delays have all played a role in the slowdown.
- Despite this weakness, valuations for private communications companies remain healthy.
- Supporting these company valuations are their attractive growth prospects, dominant market share position and high brand equity, as well as government financial support for new network builds.
- Looking ahead, we expect M&A activity to pick up once the aforementioned headwinds subside, as the consolidation theme for private communications companies still has a long way to go.

Introduction

Over the last several years, the communications industry has seen a tremendous number of mergers and acquisitions (M&A). Large international infrastructure funds raised billions of dollars and were eager to invest in the digitization trend sweeping across the U.S. Private equity sponsors also got into the game as they looked to gain exposure to the industry's tailwinds and attractive investment returns. All of this private money chasing a finite number of opportunities drove valuations for datacenters and broadband operators to record levels. And while the industry is still in a growth phase, factors including higher interest rates, economic concerns and an unprecedented amount of impending federal grants are having a negative impact on M&A activity.

In this report, we will review the current state of the communications M&A market and private company valuations, and look at what investors and strategic buyers are likely thinking about over the long term.

Hungry for broadband

Major infrastructure funds such as EQT Infrastructure and Macquarie Infrastructure Partners have raised billions of dollars as they look to gain exposure to digital infrastructure. With the rapid growth in digital applications and technologies, these types of investments are looking more attractive compared to traditional infrastructure investments in roads, bridges and airports. For example, the rapid growth of ChatGPT *(Exhibit 1)* and associated generative artificial intelligence (AI) applications that are garnering billions of dollars in investment. The impact these applications will have on the communications and datacenter markets is significant. One ChatGPT inquiry is believed to require 50-100 more energy resources than one Google search. This kind of step-function increase in energy resources will require significantly more computing and storage capabilities within datacenters. However, it will also result in more traffic going over fiber networks and the need for edge computing, which also increases the demand for fiber connectivity.

All of this capital and associated industry tailwinds have driven up EBITDA multiples for public communications companies by 80% since 2009 *(Exhibit 2).* In the private markets, valuations have also soared and bidding activity on companies for sale has been very active. Recently, however, the market has changed notably.

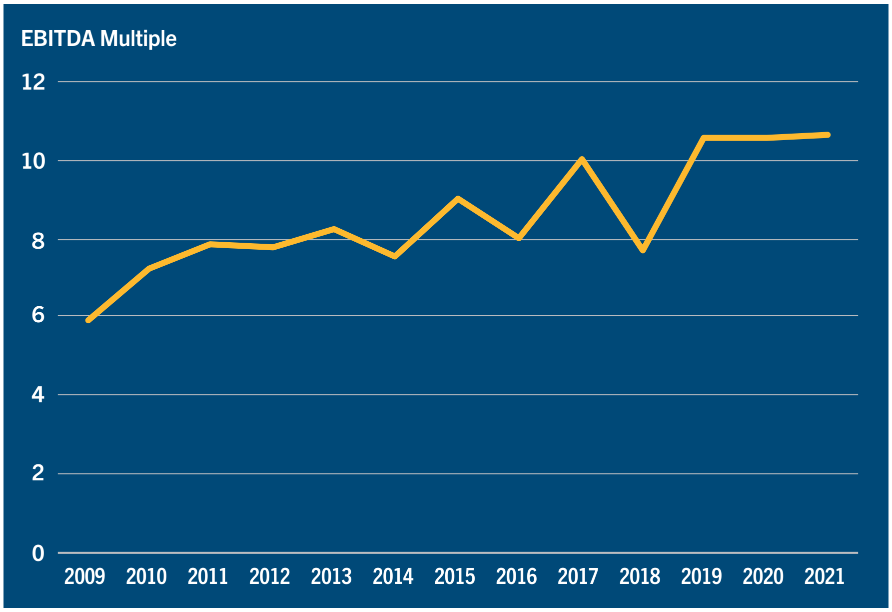
EXHIBIT 1: Time for Online Services to Reach One Million Users

Service	Launched	
Netflix	1999	3.5 years
Kickstarter*	2009	2.5 years
Airbnb**	2008	2.5 years
Twitter	2006	2 years
Foursquare***	2009	13 months
Facebook	2004	10 months
Dropbox	2008	7 months
Spotify	2008	5 months
Instagram***	2010	2.5 months
ChatGPT	2022	5 days

*one million backers
**one million nights booked
***one million downloads

Source: DataCenter Knowledge

EXHIBIT 2: Public Cable Operator EBITDA Multiple



Source: S&P Global

Current situation

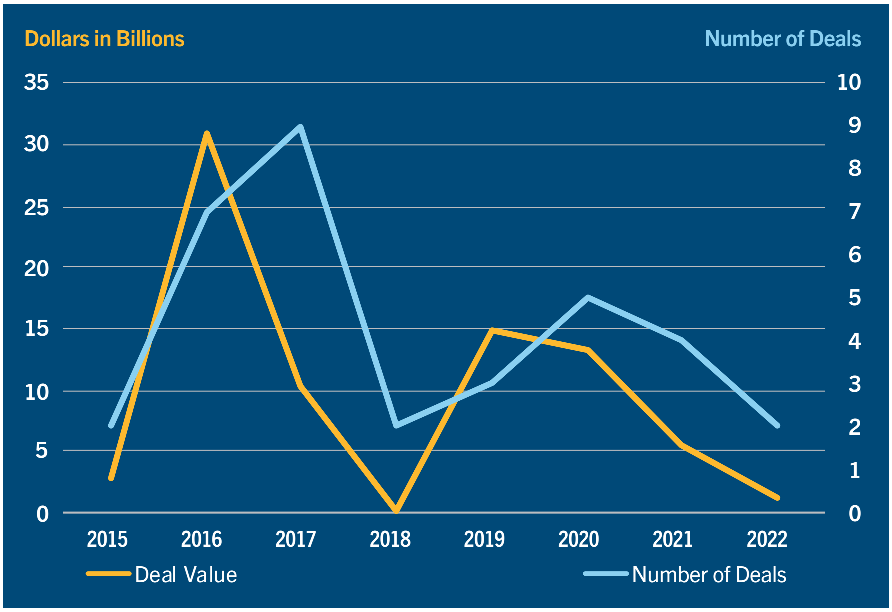
M&A activity in the communications industry has slowed in the past 12 months, and we believe there are several reasons for this – some technology-specific and some more macro in nature. For example, the fiber transport market has seen a significant reduction in the value and number of deals starting in 2020 *(Exhibit 3)*. We think this has more to do with the lack of networks available for sale than the current business and economic conditions. The cable industry, too, has seen a meaningful reduction in deals over the past year *(Exhibit 4)*. We believe interest rates, tightening credit, supply chain challenges and government broadband grant programs are playing a role.

Interest rates and credit

The Federal Reserve has aggressively increased the federal fund rates in a trajectory that we have not seen since the 1980s. As a result, borrowing costs have grown significantly in a very short period, and the risk that the economy will enter a recession has increased. During times of economic uncertainty, investors and strategic buyers can become more cautious in deploying capital. We think the current economic uncertainty is causing some trepidation among buyers, despite the multiple tailwinds the industry enjoys.

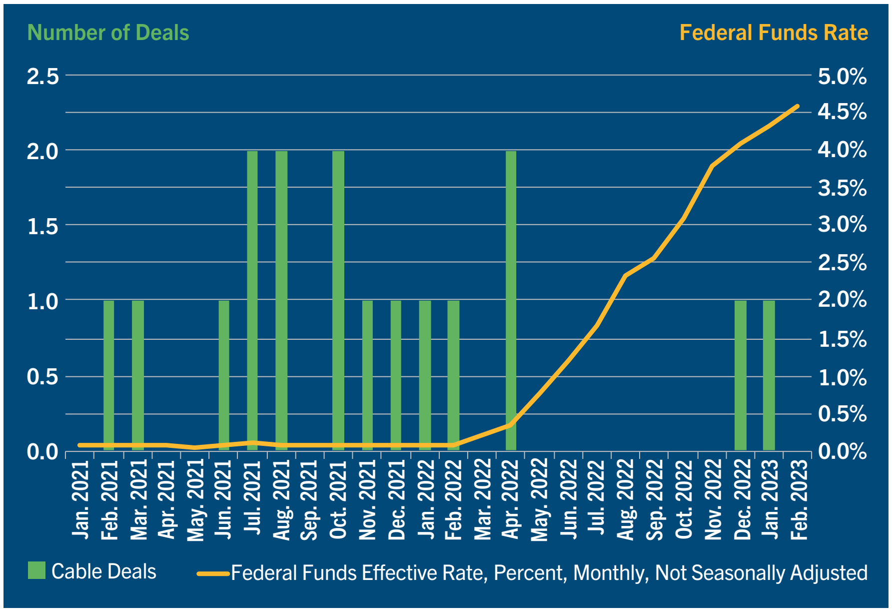
M&A activity has also been impacted by higher borrowing costs and tightening of credit conditions. As banks move to conserve capital and maintain adequate liquidity in

EXHIBIT 3: Fiber Network Sales, U.S.



Source: S&P Global

EXHIBIT 4: Cable Operator M&A



Source: S&P Global

the face of weaker economic activity, they are making less capital available for investing and acquiring assets. Moreover, with higher borrowing costs, the business case for acquiring an operator looks different now than it did 12 months ago. This is likely leading to a widening in bid-ask spreads between buyers and sellers and pushing out purchase transactions.

Supply chain

The labor market remains incredibly tight across several sectors of the economy, and the broadband industry is not immune to this tightness. According to the Fiber Broadband Association, the broadband industry will need an additional 205,000 workers through 2026. And with over 1.6 job openings for every person looking for work, filling this gap will be a challenge. As a result, workforce shortages are forcing companies to pay more for labor with sign-on bonuses and increased wages. It's not just labor that is getting more expensive; equipment is too. Corning, a major supplier of optical cabling, said it just finished the largest price increase for its communications products in 30 years. And if that isn't enough to deal with, securing access to deploy fiber on utility poles stemming from skirmishes between ISPs and the pole owners (telecom operators and electric companies) is slowing down fiber deployments.

So why do we think supply chain challenges are affecting M&A activity?

Institutional investors, such as infrastructure funds and private equity sponsors, have a predetermined time horizon for how long they plan to own acquired companies. Many of these strategies are centered on buying an operator, injecting capital to improve or expand the network (which typically takes 5 to 10 years) and then selling it for a gain. Given the aforementioned supply chain issues, it makes sense that institutionally owned operators are not hitting their build plans, and their cost structure is higher than what they originally modeled. These issues have likely pushed out planned sale dates, which also influences how quickly some institutional owners can turn over their portfolio with new acquisitions.

Government programs

The Infrastructure Investments and Jobs Act, authorized the Broadband Equity Access and Deployment (BEAD) Program to provide an unprecedented amount of funding to bridge the digital divide. The program earmarked more than $42 billion for building networks in unserved and underserved markets, which is likely causing some hesitancy in the M&A market, albeit to a lesser extent than the previous factors. Investors may be hesitant to buy a network in an underserved market that may wind up being overbuilt with fiber funded with BEAD money. Alternatively, a BEAD recipient could represent increased competition via an edge-out strategy after or while it is building out its BEAD market. Conversely, would-be broadband buyers could be waiting to see how the program allocates the BEAD money and then go on the offensive to acquire BEAD recipients, as these grants have a lot of value to investors.

Valuations and expectations

Despite the slowdown in M&A activity, private market valuations for communications companies have remained relatively stable. Admittedly, the lack of deals and associated mark-to-market updates complicate the picture somewhat, but EBITDA valuations generally range from the high teens to the upper 20s.

We believe private market valuations are performing better than their publicly traded counterparts for a number of reasons. First off, many smaller rural communications providers offer service in less competitive markets and typically have high brand equity within the community.

This makes them the dominant player in the market, owning the majority of market share. Secondly, private communications providers typically have attractive growth opportunities as they expand into unserved and underserved markets, often with financial support from state and federal government agencies. And lastly, privately held competitive fiber companies (fiber over builders) are typically lean organizations with a good network cost structure – no linear video assets to manage – and target high-growth, vulnerable markets where the incumbent has a neglected or inferior network to fiber. Historically, competitive fiber companies have performed quite well in these markets and thus now enjoy a healthy multiple.

Looking ahead, we expect transaction volume in the communications M&A market to pick up once the economy is more certain and companies are able to execute their plans with greater precision. The reality is that market consolidation still has a long way to go, especially in underserved and unserved markets. Institutional investors have raised a lot of money that is waiting to acquire U.S. communications assets. The numerous tailwinds driving the digitization of our lives and the economy make owning these assets very attractive to infrastructure funds, private equity sponsors and strategic buyers looking to gain scale or enter new markets.

Conclusion

M&A in the communications industry has seen a significant decline over the last 12 months thanks to economic uncertainties, rising interest rates and supply chain challenges that have delayed network builds and upgrades. These delays have also pushed out some institutional investors' timing for turning over their asset base, which has a compounding effect on M&A (fewer sales of existing assets lead to fewer acquisitions of new assets). However, despite the slowdown in M&A activity, we have not seen an associated drop in private company valuations. In fact, valuation multiples appear to be stable despite the relative illiquidity of current market conditions. Looking ahead, we do expect M&A to pick up as consolidation in the private U.S. communications market still has a long way to go given the large number of small rural operators that offer attractive investment opportunities.

Sources used

Schneider, Howard and Saphir, Ann. "Banks tighten credit terms, see loan demand drop, Fed survey shows," *Reuters*, 8 May. 2023. https://www.reuters.com/business/finance/banks-tighten-credit-terms-see-loan-demand-drop-fed-survey-shows-2023-05-08/

Feuer, Will. "The U.S.'s $42.5 Billion High-Speed Internet Plan Hits a Snag: A Worker Shortage," *The Wall Street Journal,* 23 April. 2023. https://www.wsj.com/articles/high-speed-internet-plan-worker-shortage-be83a843

Dano, Mike. "Amid price increases, Corning hints at a fiber dip," *LightReading,* 1 Feb. 2023. https://www.lightreading.com/opticalip-networks/amid-price-increases-corning-hints-at-fiber-dip/d/d-id/783000

Tracy, Ryan. "Fights Over Rural America's Phone Poles Slow Internet Rollout," *The Wall Street Journal,* 12 March. 2023. https://www.wsj.com/articles/fights-over-rural-americas-phone-poles-slow-internet-rollout-e26621b8

CoBank's Knowledge Exchange Division welcomes readers' comments and suggestions. Please send them to KEDRESEARCH@cobank.com.