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Diversification: The How and Why for Rural Telco Operators

By Jeff Johnston
Lead Economist, Communications

Inside…

Key Points:

- With regulated revenues in decline and rural local exchange carriers (RLEC) reliance on declining state and federal USF support, revenue diversification has become critically important.
- Investments in fiber for wholesale, enterprise and residential applications are helping offset the downward trend in the access line market.
- Opportunities in the rural tower leasing market are expected to increase thanks to AT&T's FirstNet build, and the numerous coverage holes in Sprint and T-Mobile's networks.
- Edge-outs and M&A have also proven to be effective diversification strategies.
- Time is of the essence for RLECs that have yet to diversify but opportunities exist for them to pivot their business model and leverage their local presence, experience, and customer-centric philosophy.

Introduction

Many RLECs face secular headwinds in their core business thanks to declining regulated revenues. These revenues have been under pressure for years given a variety of factors, particularly with the shift away from landline service in favor of wireless. And it's not just an issue for rural LECs; incumbent local exchange carriers, or ILECs, are also under pressure. (*See Exhibit 1.*) Per S&P Global Markets, year-over-year (YoY) wireline revenue at a core group of 10 publicly traded telcos dropped 4.2 percent in the September quarter. EBITDA weakness for the group was even worse with YoY declines of 4.8 percent.

Large telcos have the scale to make significant, transformational investments to address these secular headwinds. For example, AT&T is pursuing a vertical integration approach via its acquisition of Time Warner. Verizon, on the other hand, is doubling down on its network leadership position and is trying to disrupt the fixed broadband market.

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Rural LECs don't have the scale to buy content, and are therefore motivated to look for alternative strategies. Progressive rural LECs have been able to alter their revenue mix by exploiting diversification opportunities. (*See Exhibit 2.*)

In this report, we look at some of the revenue diversification strategies that have been adopted in addition to emerging opportunities. Specifically, these include fiber-to-the-X, wireless tower leasing, edge-outs and M&A.

Fiber-to-the-X

With increasing demand from data centers, the enterprise market, and wireless operators, investing in fiber has proven to be a good long-term bet for operators. And based on where these industries are headed, the demand for fiber will only increase. For example, upcoming 5G wireless networks will require greater cell site densification and as a result, fiber will be deployed deeper into networks to connect these cells to the core. And expanded wireless footprints from the likes of AT&T, Sprint and T-Mobile should boost the rural backhaul market (more on that below). Also, as edge computing grows in popularity, the need to have data center locations closer to where applications and data are being consumed will increase. This too will result in fiber being deployed deeper into networks.

EXHIBIT 1: U.S. ILEC Revenue and EBITDA, Q3'18

Revenue ($M)	Q3'17	Q2'18	Q3'18	YOY % Change
AT&T Inc.	19,745	18,659	18,812	-4.7%
Verizon Communications Inc.	7,662	7,453	7,376	-3.7%
CenturyLink Inc.	6,033	5,902	5,818	-3.6%
Frontier Communications Corp.	2,251	2,162	2,126	-5.6%
Windstream Holdings Inc.	1,498	1,444	1,421	-5.1%
Consolidated Communications Inc.	363	350	348	-4.2%
Cincinnati Bell Inc.	256	297	300	17.3%
TDS Telecommunications Corp.	179	174	176	-1.3%
Hawaiian Telcom Holdco Inc.	91	89	87	-4.3%
Alaska Communications	57	60	58	2.7%
Total	**38,134**	**36,590**	**36,522**	**-4.2%**

EBITDA ($M)	Q3'17	Q2'18	Q3'18	YOY % Change
AT&T Inc.	5,306	5,197	4,857	-8.5%
Verizon Communications Inc.	1,614	1,463	1,470	-8.9%
CenturyLink Inc.	2,109	2,111	2,228	5.6%
Frontier Communications Corp.	914	884	878	-3.9%
Windstream Holdings Inc.	327	344	332	1.4%
Consolidated Communications Inc.	137	136	134	-2.7%
Cincinnati Bell Inc.	77	80	82	7.3%
TDS Telecommunications Corp.	63	57	59	-6.7%
Hawaiian Telcom Holdco Inc.	26	22	23	-10.7%
Alaska Communications	13	17	15	12.0%
Total	**10,586**	**10,310**	**10,077**	**-4.8%**

EBITDA Margin ($M)	Q3'17	Q2'18	Q3'18	YOY % Change
AT&T Inc.	27%	28%	26%	-1.1%
Verizon Communications Inc.	21%	20%	20%	-1.1%
CenturyLink Inc.	35%	36%	38%	3.3%
Frontier Communications Corp.	41%	41%	41%	0.7%
Windstream Holdings Inc.	22%	24%	23%	1.5%
Consolidated Communications Inc.	38%	39%	38%	0.6%
Cincinnati Bell Inc.	30%	27%	27%	-2.5%
TDS Telecommunications Corp.	35%	33%	33%	-1.9%
Hawaiian Telcom Holdco Inc.	28%	24%	26%	-1.9%
Alaska Communications	23%	28%	25%	2.1%
Total	**28%**	**28%**	**28%**	**-0.2%**

Source: S&P Global Market Intelligence

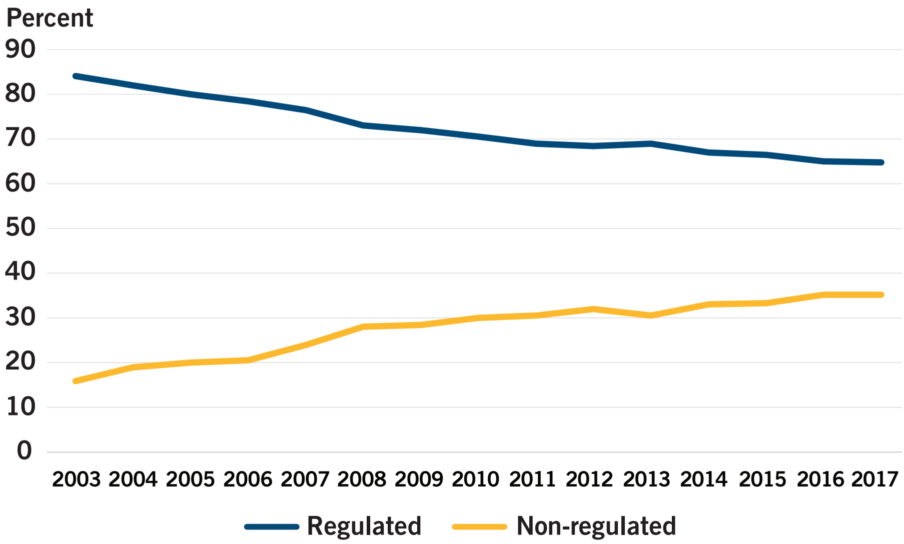
Solarus

Solarus, based in Wisconsin, has excelled at expanding its fiber footprint from anchor tenant applications. For example, in markets where it provides backhaul for a wireless tower, Solarus looks to parlay and expand that fiber asset into an enterprise service and then into a residential broadband service. This "land and expand" strategy can be very attractive given the right competitive environment.

Solarus sees fiber-to-the-home (FTTH) as a strategic, long-term growth driver for the business. Twenty years ago having a triple play bundle (voice, data, video) over coax/copper was all that was needed. But as video margins have turned negative[1], and vMVPDs (virtual multichannel video programming distributor) grow in popularity, FTTH is emerging as a critical broadband architecture for the company. Currently, 60 percent of Solarus' broadband network consists of fiber, and it expects to deploy fiber deeper into the network over the next 3-5 years. These fiber investments will better position Solarus to compete with leading competitor Charter Communications and provide a scalable data network that can meet the needs of future broadband applications.

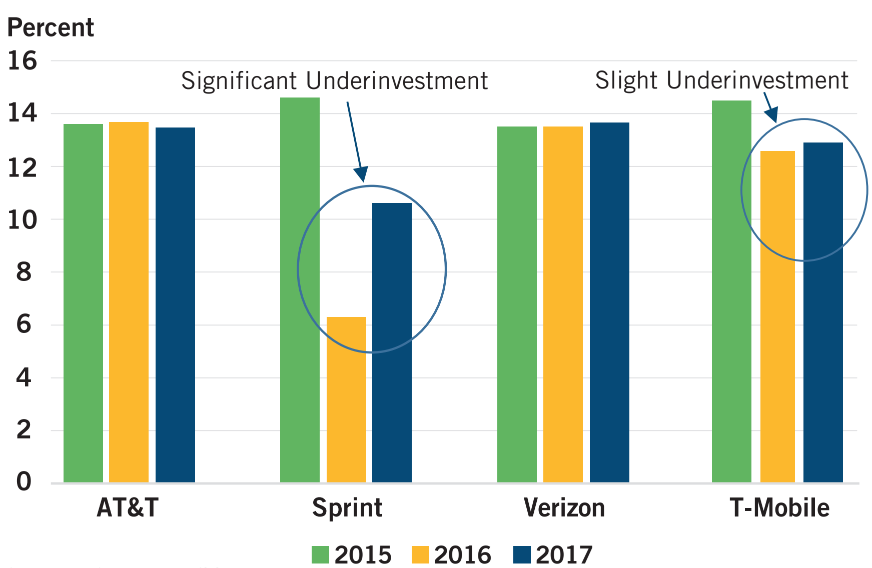
For rural operators considering investments in video and broadband, Solarus recommends to avoid making capital investments in video given the aforementioned issues. Instead, supporting vMVPD applications to compliment a fiber broadband data service is a better approach. Rural operators can't compete with large MSOs in the video market. Therefore, investing in fiber broadband networks that enable services that consumers want makes good business sense.

EXHIBIT 2: Rural Telco Revenue Mix



Source: Telergree via telecompetitor.com

EXHIBIT 3: CapEx as a Percent of Revenue



Source: Company filings

EXHIBIT 4: Estimated Rural Wireless Coverage in the U.S. by Service Provider
Form 477, Centroid Method, December 2016

Provider	Number of Blocks	POPS in those Blocks	% Total Rural U.S. POPs	Road Miles in those Blocks	% Total U.S. Rural Road Miles
U.S. Total	4,937,330	56,094,554	100.0%	4,518,876	100.0%
AT&T	4,507,660	54,201,991	96.6%	3,929,354	87.0%
Sprint	2,269,266	36,023,381	64.2%	1,476,921	32.7%
T-Mobile	3,370,160	44,544,057	79.4%	2,679,681	59.3%
Verizon Wireless	4,313,593	52,264,691	93.2%	3,721,479	82.4%

Source: FCC

Tower Leasing

As wireless carriers look to expand their coverage footprints, many rural operators are well-positioned to offer tower leasing services. For example, AT&T is in the process of building out its rural network to meet the mandated coverage requirements for FirstNet, the nationwide public safety network it has been contracted to build. FirstNet is a strategically important initiative for AT&T, so rural operators should expect to see RFPs for new tower sites over the coming years.

Also, if the Sprint-T-Mobile merger gets approved, NewCo – the combined company – will need to deploy a good bit of capital to build out its rural coverage footprint. Over the last several years, Sprint has underinvested in its network and T-Mobile hasn't spent at the same rate as AT&T and Verizon. (*See Exhibit 3.*)

In addition, both T-Mobile and Sprint's rural coverage footprints are significantly smaller than AT&T and Verizon's. According to the FCC, as of 2016, Sprint's network covered 64.2 percent of rural POPs[2], with T-Mobile coming in at 79.4 percent. This compares to penetration levels at AT&T and Verizon of 96.6 percent and 93.2 percent respectively. (*See Exhibit 4.*)

NewCo management has promised to aggressively invest in its network to compete with AT&T and Verizon. Therefore, given the current state of T-Mobile and Sprint's rural networks, major investments will be needed to reach parity with the competition. This spells opportunity for RLEC's that own wireless assets – towers, in particular – or who are willing to build out macro cell equipment/towers. These network builds also present some risk to rural operators as they could increase competition in their markets. However, the national operators will not be deterred, so for rural operators, partnering with them is still the right decision.

M&A

Acquiring strategic assets that are accretive to the bottom line is a strategy that many rural operators have adopted. For example, Fidelity Communications, which is based in Sullivan, Mo., was purchased by the Davis family in 1940. Management realized long ago that diversification was going to be critical to its long-term success. As a result, Fidelity acquired five cable and phone companies over the last two decades. Today, Fidelity has a thriving residential and enterprise wholesale business that is generating stable cash flows, enabling it to be opportunistic when attractive deals come up.

There has been a good bit of M&A over the last several years, and today's options are not nearly as plentiful as they once were. For companies looking to gain scale through M&A, proximity to current plant assets is becoming of greater importance. Reason being, it's harder to realize merger synergies with assets that would still require a lot of standalone operations versus ones that can be easily folded into existing operations.

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EXHIBIT 5: WOW Edge-Out Subscriber Metrics

	Jun. 30, 2017	Sep. 30, 2017	Dec. 31, 2017	Mar. 31, 2018	Jun. 30, 2018	Sep. 30, 2018
Homes Passed	75,000	96,200	104,800	107,400	116,600	122,200
Total Subscribers	16,900	22,700	26,400	28,600	30,900	33,700
Penetration	23%	24%	25%	27%	27%	28%
HSD RGUs*	16,800	22,600	26,200	28,300	30,600	33,400
Penetration	22%	23%	25%	26%	26%	27%
Video RGUs	9,700	12,500	14,400	15,200	16,100	17,200
Penetration	13%	13%	14%	14%	14%	14%
Telephony RGUs	3,700	4,500	5,200	5,600	6,000	6,400
Penetration	5%	5%	5%	5%	5%	5%
Total RGUs	30,200	39,600	45,800	49,100	52,700	57,000

Source: Company Filings
*Note: RGU (Revenue Generating Unit)

Despite these headwinds, there are opportunities in the fiber market. However, companies looking to acquire fiber assets should be aware that valuations are being stretched, thanks in large part to foreign money flowing into infrastructure funds. It appears that multiples for fiber assets are up about 30 percent over the last 12 months.

Edge-outs

Some rural operators have had success with edge-outs in adjacent markets where the cost and competitive environment is favorable. This involves "teeing off" an existing fiber ring that is next to the market being entered. Having the existing network nearby makes the cost to deploy service much cheaper than if an entirely new network were to be overbuilt. Hence, the term "edge-out". Typically, smaller operators will look to exploit opportunities where larger broadband providers have a tarnished brand because they've not upgraded their network and/or offer poor customer service. To demonstrate the success of this strategy, one needs to look no further than what WOW has accomplished. WOW is an overbuilder and edge-outs are the cornerstone of its growth strategy. On its last earnings call, the company stated that it reached penetration levels of 32.9 percent and 26.7 percent for edge-out nodes deployed in 2016 and 2017 respectively. WOW has had much success in growing its HSD (High Speed Data) customer base. (*See Exhibit 5.*) Margins on data customers are much higher versus video customers, and the pricing power that operators enjoy with their broadband service makes growing this part of the business critically important.

For operators who would rather take a more conservative approach, edge-outs are also being done wirelessly. Instead of incurring the capital costs of laying new fiber, some operators have opted to enter the market with a fixed wireless service. By leveraging nearby fiber networks, fixed wireless gives operators a low-cost/low-risk option from which they can gain valuable market insights that will drive future network plans.

Conclusion

Time is of the essence for rural LECs who have yet to make investments in some of the aforementioned opportunities. As proximity to existing plant assets becomes a larger consideration for M&A – coupled with the secular headwinds facing regulated revenues – multiples for these standalone businesses will compress.

Fiber investments should be pursued whenever the business case is justified. The lines between fixed and mobile communications are beginning to blur which should increase the value of fiber assets. Also, 5G and IoT will bring incremental demand for fiber and tower assets.

Rural operators should prioritize enterprise broadband opportunities over wholesale deals with national wireless operators as the margins and pricing power characteristics are more favorable.

Lastly, operators need to stay vigilant and take advantage of edge-out opportunities. Smaller markets that are neglected by tier-one broadband operators can be great opportunities for rural operators to expand their broadband business.

References

[1]According to Telergree's 2017 Alliance Benchmarking Report as reported on telecompetitor.com.

[2]POP stands for Points of Presence. In wireless, this generally refers to the number of people in a specific area - in this example, it's census blocks.

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