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**Great River Policy Paper Series
Rethinking Cable Valuations**

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Rethinking Small Cable Company Valuations

Valuation of cable companies enjoyed significant growth over the last decade as technology allowed the addition of new services at decreasing costs while structured debt arrangements leveraged equity investments. As recently as two years ago (see Appendix 1), cable systems were being sold for almost 10-12 X multiples of cash flow or EBITDA. By increasing the operating efficiencies through regional and central operations, investing in significant infrastructure to deliver triple play and projecting significant growth in bundled revenues, cable companies were able to justify to their equity and debt holders increasingly higher multiples.

More recently investors and debt issuers, both public and private, are re-evaluating these assumptions. At its heart, valuation is about providing a base for future return on investment. Whether gauged by surrogate metrics like subscriber counts, top line revenue or EBITDA, valuation fundamentally depends upon the sustainability and growth of free cash flow—cash flow after debt service and capital expenditures. Over the past decade, sellers have successfully negotiated to capture much of this future upside, a situation made possible by the availability of debt financing to leverage equity returns. As was typical of so much of the recent financial crisis, the rush to justify new technology capital expenditures and “strategic” roll up acquisitions were based on aggressive assumptions about revenue growth. As it turned out, many of these assumptions did not materialize. Competition has increased, capital investment continues as a competitive necessity, margins are shrinking, and instead of growing, free cash flow in many smaller operations is decreasing. Sellers can no longer rely on structured financing to leverage optimistic valuations. Buyers who do not carefully forecast free cash flow on specific systems and anticipate the ongoing shift to digital content will find themselves in financial difficulties. The historic valuation models are no longer valid. It is time to rethink small system valuations.

The purpose of this paper is to provide information about why prior valuations are no longer sustainable for systems becoming available for purchase in the next few years in nonmetropolitan areas. Equity investors, looking for returns 5-8 years from now, must achieve internal rates of return of 15-20% from their investments. Debt levels from prior transactions are no longer sustainable or in many cases even available. In this increasingly maturing industry, conservative revenue growth, increasing margin pressures and planned technological shifts are the watchwords. As a result, investors must use lower multiples for purchase and exit to justify their investments. Sellers must adapt their expectations to this new reality. The market will only proceed after this adjustment is made.

At Great River, we have reviewed numerous sales transactions over the last few years, many available through regional and national brokers. In addition, we have interviewed investors, both large and small, to determine the parameters under which they would participate in purchase or recapitalization transactions. We also surveyed potential purchasers for their current view on pricing, investment and operations. A new picture is emerging of the scale and scope of transactions for the future as well as the participants. Here is what we have found:

Public Company Multiples: Current multiples for public cable companies continue to trade at all time lows. Both Comcast and Time Warner, two dominant Multi System Operators (MSOs) in major metropolitan areas, are trading at all time lows of 5X EBITDA. Even though many point to general market conditions as the reason for these low multiples, these multiples, or something close to them, are likely to continue to keep valuations lower than in prior periods. With economies of scale and scope the keys to successful operation in this capital intensive industry, these larger players are perceived as the least risky investment option and the most robust revenue generators in the industry. Investors and lenders in private companies are likely to continue to point to these valuations as the valuation cap for the industry. Potential sellers need to adjust their expectations accordingly.

The Structured Debt market has changed. Over the last year, the market for debt has changed significantly. Lenders have left the market or have significantly cut back for even large transactions. **The debt previously available for cable transactions is gone.** In addition, debt structure has been revised. No longer can companies borrow on the same multiples of cash flow as in the past. Different financial models and assumptions now govern debt availability. As result, debt, if available, will be available only at significantly lower valuations. Sellers who have been advised not to sell properties or recapitalize but wait for prior markets to return are pursuing an ill advised strategy.

Increased competition from telephone. And the industry is fundamentally changing. Telephone and other land line companies have fully emerged as major competitors offering integrated video and internet services in direct competition to cable. Independent, regional and national telephone companies are adopting IPTV that enables the triple play all over the country. In many areas, including the Upper Midwest, even smaller telcos are merging to create larger independent telephone companies and borrowing money from the US government at very attractive rates to upgrade to deliver the triple play, allowing them to compete with lower prices and increasingly take revenue share from cable operators.

Increased competition from wireless: Emerging competition from wireless providers is also intensifying daily. As late as four years ago there was no 3G competition for data services. Today that is not the case. A recent online industry publication, *Telecompetitor* (June 25, 2009) stated: "The telecom industry will need a full 90,000 gigabits-per-second of last mile backhaul network capacity worldwide to support the growing amounts of data, video and multimedia content being transmitted via mobile networks, according to InStat's 'Big Pipes--The Global Market for Cellular/WiMAX Backhaul' report. According to InStat, 'Traditionally, voice has dominated the traffic going across a mobile operator's network. With voice as the primary traffic component, an operator could meet its backhaul requirements with a couple of T-1's per base station. That has all changed with operators relying on data for revenue growth.'" This is another reason why cash flows will not remain stable over the course of current investors' projections and high multiples cannot be sustained.

Increased competition from 'overbuilders': A third type of competitor that is challenging traditional cable operators is the second cable company that began entering especially smaller markets about ten years ago. Although only a few remain (they have experienced their own form of consolidation), they aggressively move to capture market share and present yet another source of lost revenue. We know—we served as senior management for two of the most successful companies in the industry: *PrairieWave* and *Seren Innovations*.

Bundling services is not sustainable: Bundled voice, video and data systems are beginning to lose local and long distance services to cell phone and mobile devices. As of May 2009 the latest results from the National Center for Health Statistics (NCHS) survey on wireless phone use reveal that just over 20 percent of all US households have now cut the wire and exclusively use cell phones for voice communication. That number is up from 17 percent from the previous survey, and for the first time since the NCHS has been keeping track of wireless phone use, this

number exceeds the percentage of households that rely on landline phones only—down to a little over 17 percent. The demographic data that accompanies the report shows that a variety of customer segments that use broadband live in wireless only households. Over a third of young people aged 18-29 are wireless-only. Over 60 percent of adults that share a house or apartment with roommates, nearly 40 percent of all renters, and 25 percent of Hispanics are wireless-only. The above is further evidence that the cable triple play VoIP phone service will be short lived. Cash flow projections based on bundled subscribers need significant adjustment.

Video margins declining: Although larger MSOs have a source of revenue from the resale of their proprietary content, smaller MSOs do not. Over time pricing of the content has increased, driving down margins to the operators who only distribute content. Even with more attractive pricing through cooperatives, smaller operators have difficulty competing with pricing obtained by major satellite dish companies in their markets.

Cord cutters increasing due to internet video: Cable companies initially saw increased competition for video services from satellite dish. But now consumers are cutting back on their traditional TV cable service in exchange for selecting their own a la carte video programming with their broadband connection. As competition continues to increase for sources of video programming, the revenue model based on bundling multiple channels of video will become less important. During the horizon of current investors, consumers will increasingly find ways to cut costs as they select free and paid content from the internet. Although the cable industry has the advantage of learning from the mistakes of the record industry, content is already becoming 'unbundled' today through services such as Hulu and Netflix. This trend will not decrease, even if MSOs are able to shift their paid content delivery to the internet. Increased access to free video and other sources of paid video will eat into marginal revenue, earnings and cash flow, thus directly impacting valuation of these systems going forward.

Small system operational issues: Many systems outside major metropolitan areas suffer from a variety of operating issues that are accelerating with declining revenues. Waiting to sell these systems, in particular, will only result in significantly lower valuations in the future. These problems include:

Poorly maintained networks with minimal or no broadband upgrades and lackluster customer service. Although costs may be coming down to upgrade infrastructure, significant expenditures are still required either in plant or equipment to deliver upgraded broadband services and increase revenues. Some of the smaller systems we reviewed have many miles of plant, so in many cases, realistic revenues are not enough to justify some or all upgrades. From northern Minnesota and Wisconsin to nonurban Arkansas and Missouri we have undertaken many due diligence trips over the past two years in the exurban central US. We have personally seen neglected systems with wires hanging loose and poorly maintained and uninviting customer service centers. We have witnessed significant complaints from consumers we have met with regarding poor Internet speed and video picture quality and nonexistent customer service.

Declining customer base. Satellite dish and independent telephone companies have made significant inroads in these smaller markets. MSO's currently have little or no marketing underway to challenge competition and their revenues will continue to decline.

Original cost to purchase or upgrade was higher than revenue projections can currently sustain. Significant revenue has been diverted to service debt resulting in slower construction of upgrades, poor service and marketing and lower revenue. Without significant write-offs of debt, these systems will continue to decline. Charter Communications is one example of this phenomenon, where high debt levels have driven it into bankruptcy. As a result of focusing on the debt issues, they have not been able to focus on the many more isolated, non contiguous

properties that they own. The marketing and customer service programs are neglected which hampers increased market penetration, revenues and customer growth.

Even where infrastructure to offer triple play was completed, many systems have poor triple play penetration and unique market situations driving up churn. We recently examined one property which is fully upgraded, but suffers from a higher level of churn due to its location near a US military base.

Dispersed operations, with customer bases too small to support operational staff. We have reviewed potential acquisition opportunities where there are 6000 customers spread over 35 headends. That represents less than 200 customers per system/headend. Because there are no economies of scale, we believe that is it simply infeasible to purchase these systems at current seller anticipated valuations.

Marketplace Validation. All of these factors are converging in the current market place to drive down valuations. Recent transactions reinforce this view.

Grande Communications, recently announced plans to undergo a recapitalization, (June 12, 2009). Prior to this recapitalization, Grande apparently was carrying debt of at least 5 times its EBITDA (see year end 2008 SEC filings) which was clearly unsustainable. Similarly its equity holders were also participating at a very high valuation, at least 12 times EBITDA.

After recapitalization, Grande's valuation is expected to be \$250 million or approximately 6X EBITDA. Rather than treat this as a special case because Grande is an 'overbuilder', it is more important to note how its new valuation recognizes the increasingly competitive landscape, the view that the debt industry will probably not allow more leverage than 2-3 times EBITDA and equity investors are not willing to participate at previous valuation levels. Rather they are basing valuations on realistic revenue growth and costs required to grow revenue and operate systems.

Charter Communications is similarly undertaking a recapitalization. Although public information has not been readily available for this undertaking, it is likely that its equity and debt structure will begin to reflect more realistic valuations illustrated in the Grande case.

What does the new financing marketplace look like for smaller systems?

Many debt underwriters are sitting on the sidelines generally, but in particular in this industry. Some lenders, such as CoBank, have money available for acquisitions. In discussions with these lenders, leverage is available for only 3 to 3.5 times EBITDA. These leverage ratios coupled with covenant requirements translate into an immediate adjustment in overall system valuation downward of at least two to three times EBITDA.

Systems likely to come on the market now and in the next several years are primarily of two types:

- 1) Systems upgraded to deliver triple play services but have not had cash flow to properly market and service customers, either because debt service was previously too high or insufficient capital has been available from the beginning to grow services and revenues.
- 2) Systems not upgraded to deliver triple play services, needing capital to build, as well as market and service customer growth and revenue in the future.

In either case, equity investors are readjusting their financial models to realistically reflect the capital needed to sustain and grow the systems. As a result of the following factors, purchasers are not likely to offer more than 5-7 times EBITDA:

- ✓ increased costs to upgrade, market and service customers,
- ✓ slow revenue growth to accommodate more realistic adoption patterns, including slower growth for phone, declines in video, competition for internet services and multiple channels for voice, data and video;
- ✓ eventually relying on the one 'pipe' revenue model to deliver all services
- ✓ lower leverage from debt sources
- ✓ accepting that the multiples at exit are similar to those upon entry due to the maturity of the industry
- ✓ achieving returns on investment of 15-25% in five to eight years.

Realign Valuations. To maximize valuations sellers must rationalize their view of the systems they offer for sale. As previously noted, with public and private valuations falling to 5-6 times EBITDA for MSOs concentrated in larger metropolitan areas, sellers of other less densely populated systems or which are noncontiguous or both should not expect to receive comparable multiples.

For many years, sellers and brokers have viewed the best market to be synergistic add-ons to larger well established MSOs. However, based on the foregoing factors, at least in the foreseeable future, this strategy is not likely to be successful. Larger MSOs are focusing on their existing large urban markets as they prepare to fight off impending competition from wireless and telephone companies.

Even the smaller regional companies are adopting similar strategies. Our conversations with various regional owners indicate that while they may have an interest in growing, to maintain their markets and margins, they are not likely to grow far beyond their original footprint. Midcontinent, for example, purchased properties from Charter Communications contiguous to their existing operations, so that they could leverage their existing infrastructure. However they are not likely to expand much further and many are likely to have limited access to debt and equity for acquisitions. As a result, the number of traditional strategic buyers is likely to be limited.

New regional entrants may emerge as other possible purchasers. However, their participation will be limited unless sellers make available systems at reasonable valuations that can be rationalized by location with sufficient customers to justify upgrades, technical support and service. Today's buyers must acquire systems with a flexible plan designed to address increasing competition with the adoption of new technologies, the implementation of effective marketing plans, and the ability to adapt their plans as future conditions change. They cannot do so at current system prices. Unless sellers adjust their valuation expectations, they may well find themselves holding systems in a declining market with no ability to stem their losses.

Cable MSO business models only began in the 1960s, and even then only under the protection of monopoly franchise rights. There is no fundamental economic reason why these models should continue indefinitely. Seller expectations based on historic competitive patterns and operating practices without the recognition of current market conditions and technological challenges are now obsolete.

Appendix 1
Cable M&A Transactions 2006-2007

Overbuilders

Year	Company	Sale Price: Multiple of Cash Flow (X)
2007	Everest	9.6
2007	Graceba	7.5
2007	PrairieWave	7.5
2006	Everest	5.8
2006	RCN	7.5
2006	Sigecom	8.2
2006	WOW	9.2
2006	Lennar	11.0
		Median: 8.2

Urban/Suburban

Year	Company	Sale Price: Multiple of Cash Flow (X)
2007	Patriot	9.5
2007	Starstream	9.5
		Median: 9.5

Rural/Small Market

Year	Company	Sale Price: Multiple of Cash Flow (X)
2007	Northland	6.3
2007	James	12
2007	Northland	10.7
2007	Williamette Broadband	10
2007	Suddenlink	10.2
2007	Covington Cable	27
2006	Charter	8.7
		Median: 10

Other

Year	Company	Sale Price: Multiple of Cash Flow (X)
2006	Adelphia	14.8
2006	Cox	9.8
2006	Charter	8.3
2006	Eastern CT Cable	14.1
2006	G-Force	12.4
		Median: 12.4

Source: Waller Capital Partners