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Peak bad news

Evan Lorenz writes:

Now that the S&P 500 has gone to heaven—it's quoted at 36.6 times cyclically adjusted earnings, a level exceeded briefly only in the dot-com boom and the 2021 everything bubble—a familiar question arises: Where can the price-conscious investor find value?

In preview, we find it—or, rather, continue to find it—in the hated cable business. Yes, growth has gone away and competition has hotted up, but Comcast Corp. (CMCSA on the Nasdaq), the No. 1 player by customer count, and Charter Communications, Inc., the No. 2, trade at cheaper multiples than even the despised cigarette companies. In preview, we reiterate our bullish stance on Comcast (*Grant's*, Dec. 24, 2021).

Selling bundles of TV channels may be the first thing that comes to mind when you think of the cable industry, but Comcast and Charter make little to no profit on video packages. Broadband internet connectivity is what generates most of their income. So while the rise in TV cord-cutting has been a drag on overall revenue growth, it has actually lifted operating margins.

Three years ago, T-Mobile U.S., Inc. began marketing fixed wireless access (FWA), or broadband delivered over the phone company's 5G network. As FWA uses a wireless signal, setup is quick, easy and does not require drilling holes in walls to string cables to connected devices. Fixed wireless is a particular boon to rural customers, who have little to no choice when it comes to broadband. The downside is that FWA is typically slower than cable broadband, and data are limited by the overall traffic on a carrier's wireless network. Then, again, the service is priced accordingly: T-Mobile charges $50 per month for FWA while Comcast collects an average of $73.88 for cable broadband.

T-Mobile, America's best 5G network, is the market leader in wireless broadband. It owes its success to the spectrum it acquired with its purchase of Sprint Corp. in 2020. In the second quarter, T-Mobile added 406,000 FWA customers, bringing its total customer count to 5.6 million. Peers Verizon Communications, Inc. and AT&T, Inc. added 517,000 in the same period, bringing their combined FWA subscriber count to 4.2 million.

In addition to FWA, the telcos have been investing heavily in fiber-to-the-home. An end-to-end fiber-optics broadband network is faster than cable, which uses a hybrid of fiber and coaxial cables to deliver data. To augment its fiber networks, T-Mobile announced a $4.9 billion investment in a joint venture with KKR & Co., Inc. in July to acquire Metronet's broadband business, the fifth fiber-acquisition deal that the wireless company has struck. Meanwhile, on Sept. 5, Verizon announced the purchase of Frontier Communications Parent, Inc. for $20 billion.

The benefit of bundling wireless and broadband is twofold. First, both markets are nearly saturated, so broadband provides telcos some much-needed revenue growth. Second, customers who subscribe to both services are strong candidates to renew their subscriptions.

"Fiber and fixed wireless access are winning in the market," Verizon CEO Hans Vestberg crowed on the Sept. 5 call announcing the acquisition of Frontier. "Fiber and fixed wireless access have added well over 100% of the industry's net add growth over the last five quarters."

And, indeed, the second quarter was the worst ever for the cable sector, with Comcast shedding 120,000 broadband customers and 149,000 defecting from Charter. Investors found cold comfort in the fact that those losses were not so bad as Wall Street had expected.

On top of these industry-wide problems, both Comcast and Charter have had to deal with their own shortcomings. Thus, Comcast's Universal theme parks and resorts unit suffered a 10.6% year-over-year decline in second-quarter revenues as the post-Covid surge in travel reversed (results at Walt Disney Co.'s parks unit also disappointed). Lagging such megahits as *The Super Mario Bros.*, last year's highest-grossing animated film, and *Fast X*, revenues at Comcast's studios division fell by 27%.

As a pure play on cable, double-B-plus-rated Charter has no such extracurricular distractions. Its cross to bear is rather its own leveraged balance sheet, with net debt equal to 4.3 times trailing Ebitda in the second quarter versus 2.4 times for single-A-minus-rated Comcast. Debt pairs ill with intense business competition.

Since we had our say on Comcast three years ago, its shares have declined by 10.7%; Charter's have slumped by 50.1%. Over the same span, the S&P 500 has logged appreciation of 26.6% (all figures include reinvested dividends).

So it is that Comcast trades at 10.9 times trailing earnings and 6.7 times enterprise value to Ebitda while Charter trades at 10.1 times earnings and 6.9 times Ebitda. Is cable worse than coffin nails? Altria Group, Inc., which owns the Marlboro cigarette brand, commands a 13.9 times earnings multiple and a 9.7 times Ebitda multiple.

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As bad as this backdrop sounds, the cable companies may have put the worst of the bad news behind them. "FWA has a huge advantage in that it operates based on using excess capacity of the wireless network," Craig Moffett, who rates Comcast and Charter as buys and is one-half of the eponym of MoffettNathanson, LLC, tells me. "So in theory it carries zero marginal costs and therefore is genuinely quite threatening [to cable]." After all, phone companies can theoretically add fixed wireless customers anywhere cable does business at almost no incremental cost.

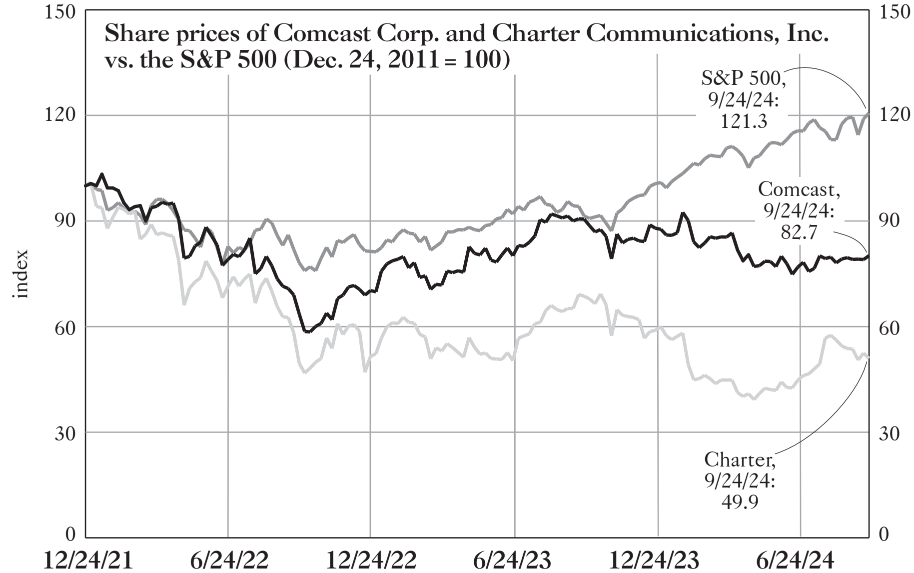
Certainly, there are limits to FWA's growth. "A wired customer typically uses something like 50 to 60 times more data every month than a mobile customer does," Moffett continues, and broadband data usage is growing at a rate of 30%-plus. "So you would only dedicate capacity to FWA if you were awash in excess capacity."

And that is exactly how the telcos are approaching it. On the July 31 earnings call, T-Mobile's president of marketing, strategy, and products, Mike Katz, said his company uses "an excess capacity model. So, we sell fixed wireless in places in the network where we have excess capacity that won't be consumed either now or in the future by normal mobile usage."

At its analyst day last week, T-Mobile acknowledged that there are 1 million customers on its FWA waitlist. The backlog underscores the strong demand for fixed wireless as well as the bandwidth limitations that will likely cap its ultimate size.

T-Mobile, owner of the most unused spectrum, has been the most aggressive telecom in deploying FWA over the past three years. However, peers Verizon and AT&T got a fixed-wireless boost in September 2023 when they acquired their final licenses to the slug of spectrum (called "C-Band" by industry insiders) they had purchased in 2021.

Temporarily out of the picture



source: The Bloomberg

"In 2023, Charter was competing only with AT&T and Verizon with FWA in a maximum of 48% of their footprint because they just didn't have any licenses in the other 52%," Sam McHugh, who rates both cable stocks as sells for BNP Paribas Exane, tells me. "Through the end of 2023, when these licenses were granted, suddenly the other 52% of the Charter footprint is now open for sale, in theory, for AT&T's and Verizon's product. The point is, you've seen a material step up in potential competition in Q1 and Q2 this year, which explains why things got sequentially worse."

At least in the near term, no bandwidth additions are slated to hit the market. For the past 31 years, the Federal Communications Commission has auctioned off blocks of government-controlled wireless spectrum to private operators. A fractious Congress allowed the FCC's auction authority to lapse in March 2023 and has not seen fit to renew it.

Presumably, the FCC will sooner or later regain that authority. Even then, however, much would remain to be done. The commission would have to organize an auction, and the winning bidders would have to build the necessary towers. It would take time and money. The spectrum that the FCC is likely to put up for sale is of the relatively high-frequency variety. It carries lots of data over short distances and has trouble propagating through walls. "Spectrum propagation is a continuum," says Moffett, "with each step up in higher frequency demanding commensurately higher cell-tower density for a given level of coverage." In any case, the towers won't come cheap.

Meantime, data usage continues to grow by leaps and bounds. It's another exogenous constraint on how much spare network capacity the telcos can dedicate to FWA. The telecom companies' heavy investments in fiber seem to confirm their cool attitude toward fixed access. After all, if they could win on FWA alone, why would they be spending billions to build and acquire fiber?

Cable's losses were exacerbated by the June expiry of the Affordable Connectivity Program, a Covid-era government subsidy that provided low-income households up to $30 per month to pay for broadband. This led to higher churn in the second quarter and is expected to cause additional customer losses in the back half of the year.

As almost all Americans have broadband, the market primarily grows through new household formation, and the high cost of housing has crimped that growth. Today, the median house is priced at 5.2 times median household income, matching peak unaffordability in the mid-aughts bubble, and mortgage rates remain relatively high at 6.6%. While there is no relief in sight on the price front, the Fed's cuts to short-term rates will almost certainly reduce 30-year mortgage costs (see the issue of *Grant's* dated Aug. 30 for the reason why).

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Cable companies have a strong hand to play in the battle to lock customers into combined broadband and cell-phone packages. Verizon's fiber offering covers 9% of the U.S. population and will be on its way to 12.5% when, in 2026, Verizon's purchase of Frontier Communications is expected to close. AT&T's fiber network encompasses 12% of the United States, and T-Mobile's just 2%.

In contrast, Comcast and Charter offer cell-phone plans at big discounts to the big three telecom companies in 100% of their cable footprint. They are able to do this because the pair sold spectrum to Verizon in 2011 for cash and perpetual wholesale access to Verizon's network. By selectively adding Wi-Fi and cellular transponders to their cable networks, Comcast and Charter have been able to transmit around 90% of their wireless data on their own cable networks, thus bypassing Verizon and its associated fees.

The duo is winning, too, in the wireless market, which, by revenue, is about twice as large as the cable market. Over the past four quarters, the cable companies have captured an average of 55% of net phone additions and now command 4.9% of the mobile market. If anything, this understates cables' gains. Consider, for example, that 110,000 of Verizon's 148,000 post-paid phone additions in the June-end quarter came from piggybacking second lines on preexisting devices rather than from new customers.

In Europe, resellers, known as "mobile virtual network operators," command 10%–20% of the market. If the cable companies can grow to that level of market share, the telecom companies will be forced to cut mobile rates to match Comcast and Charter, which would lead to a sharp contraction in mobile profits.

To be clear, there are real risks to the cable companies. If fixed wireless broadband can continue to grow at its current rates indefinitely, the cable broadband market would commensurately shrink. If phone companies slash prices on fiber to win market share, cable companies would have little choice but to cut prices and suffer the consequence of lower returns.

However, there is no evidence of this happening yet. "In fact, the fiber overbuilders are struggling with the realities of lower and lower density," Moffett tells me. "The most attractive places to build have long since been built, so they are building in less and less dense locations. The only real lever they can pull to fix the economics is to raise prices. So you're actually seeing the competition raise prices."

Despite the phone companies' success this year, T-Mobile, Verizon and AT&T bumped up prices only on post-paid phone plans in the second quarter and then by just 1.4%, measured year over year; the CPI was up by 3%. Comcast and Charter, in contrast, lifted broadband prices by an average of 3.2% in the June period.

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To capture the bargain prices that cable trades for, Liberty Broadband Corp. made an offer on Monday to acquire the 71% of Charter that it doesn't already own in an all-stock transaction. We prefer Comcast, which, in addition to being less leveraged, has a few near-term, non-cable catalysts up its sleeve.

Comcast divides its operations in three.

1) Connectivity and platforms, which houses the broadband and cable TV operations (86.7% of trailing Ebitda).

2) Contents and experiences, which spans cable networks (including USA, SyFy, MSNBC and CNBC), broadcast channels NBC and Telemundo, the streaming service Peacock, film studios (Universal Pictures and DreamWorks Animation) and the Universal theme parks (16.9%).

3) Corporate and other, the final unit, which is a money-losing potpourri of corporate overheads, the Philadelphia Flyers hockey team and Sky, the European satellite TV broadcaster.

The Paris Olympics should produce a bump in the NBC networks in the third quarter, Laurent Yoon, who rates Comcast a hold for Sanford C. Bernstein & Co., tells me. "It drove subscribers to Peacock, and they increased prices for Peacock." And the studios division looks to be on the mend as *Despicable Me 4* and *Twisters* produced solid results in the box office.

Next year, Comcast is opening a new park, the Universal Epic Universe, in Orlando, Fla., the first major American theme park to debut in more than a quarter-century. While Peacock is showing negative Ebitda, the losses are dwindling, to $348 million in the second quarter from $565 million in the year-ago period.

"Our revenue growth has been a bit below our historical standards," Comcast CFO Jason Armstrong acknowledged at a Sept. 5 Citigroup, Inc. conference. "On the one hand, you'd say, okay, is this the new norm. . . . We don't actually believe that. We believe we can reaccelerate revenue growth."

Over the past three years as its share price has languished, Comcast has spent $33.3 billion buying back its own equity, shrinking the share count by a

Comcast Corp. at a glance

all figures in $ mns except per share data

	TTM*	2023	2022	2021	2020
revenue	$121,113	$121,572	$121,427	$116,385	$103,564
operating income	23,304	23,214	14,041	20,817	17,493
net income	15,091	15,388	5,370	14,159	10,534
earnings per share	3.76	3.71	1.21	3.04	2.28
shares outstanding	3,920	4,148	4,430	4,654	4,624
cash	6,065	6,215	4,749	8,711	11,740
debt	98,128	97,090	94,811	94,850	103,760
total assets	262,555	264,811	257,275	275,905	273,869

*12 months ended June 30, 2024.

sources: company reports, the Bloomberg

cumulative 15.6%. This is in addition to regular dividend payments, which work out to a yield of 3% at current prices.

Perhaps thanks to its undemanding multiple, Comcast has made friends on the Street, with 19 of the 34 analysts covering the stock saying buy against only one advising a sale. Short interest amounts to 1.4% of the equity float. And though insiders have sold 772,555 shares over the past 12 months for proceeds of $32.9 million, the management team still owns 49.7 million shares worth $2 billion.

"The market has taken the pessimism too far and has priced in a future where cable is to shrink 2% in perpetuity," Moffett concludes. "We're not saying that Charter or Comcast is the next Nvidia, but they are really attractively valued stocks where negativity has gone way too far."

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