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Must-see TV

Evan Lorenz writes:

It's been a great year for the stock market but a mixed year for stocks. Since the start of 2021, the S&P 500 has rallied by 23.8%, almost triple the 8% compound annual return logged over the past half-century. However, only 60.4% of the issues in the blue-chip index are trading above their 200-day moving average while, in the tech-heavy Nasdaq Composite, just 29.8% of constituents clear that hurdle.

Whatever the technical meaning of a ragged advance-decline line might be, it beckons the value hunter. So far this year, telecommunications providers like AT&T, Inc. (a former *Grant's* pick not to click) and cable companies like Charter Communications, Inc. have sold off in the teeth of rising competition and saturated end markets. While we still have our doubts about Ma Bell, we find much to like in the cable sector. In preview, *Grant's* is bullish on Comcast Corp.

While cell-phone stalwarts like Verizon Communications, Inc., T-Mobile U.S., Inc. and AT&T, and cable giants such as Comcast, Charter and Altice U.S.A., Inc., are nobody's idea of glamour issues, the six companies collectively sport an $909.3 billion market cap and likely fill a place in your ETF. Readers of this analysis may or may not choose to buy a single share of Comcast, but each will discover how to lower his or her monthly cell-phone bill.

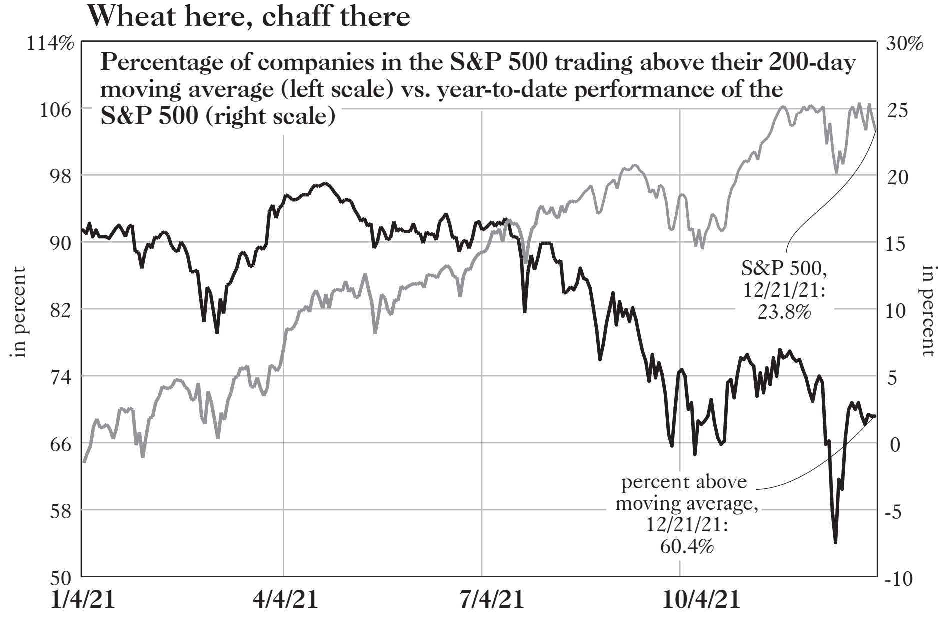
Yes, consumers continue to cut the cord as they opt to stream movies and shows over the internet—cable TV is, in fact, in terminal decline—but that isn't why Comcast and Charter have underperformed the market. In the third quarter, Comcast lost 1.5 million video-package subscribers, Charter 0.3 million, reducing their respective totals to 18.5 million and 15.9 million.

"This is offset by one major fact," observes Jeffrey Wlodarczak, who rates Comcast a buy for Pivotal Research Group: namely, that content costs consume most of the cable operators' revenue. "[A]fter taking into account [the cost of set-top boxes]," he figures, "there is effectively no return in video, and most cable operators are better off just having a consumer take data services."

A more pressing concern than video profit margins is that the broadband internet market is nearing saturation and that growth will inexorably slow down. Depending on which Wall Street research report you pick up, broadband penetration ranges between 85% and 89% of American households today. This concern was hammered home on Oct. 28, when Comcast, the cable bellwether, lowered its guidance for net broadband additions.

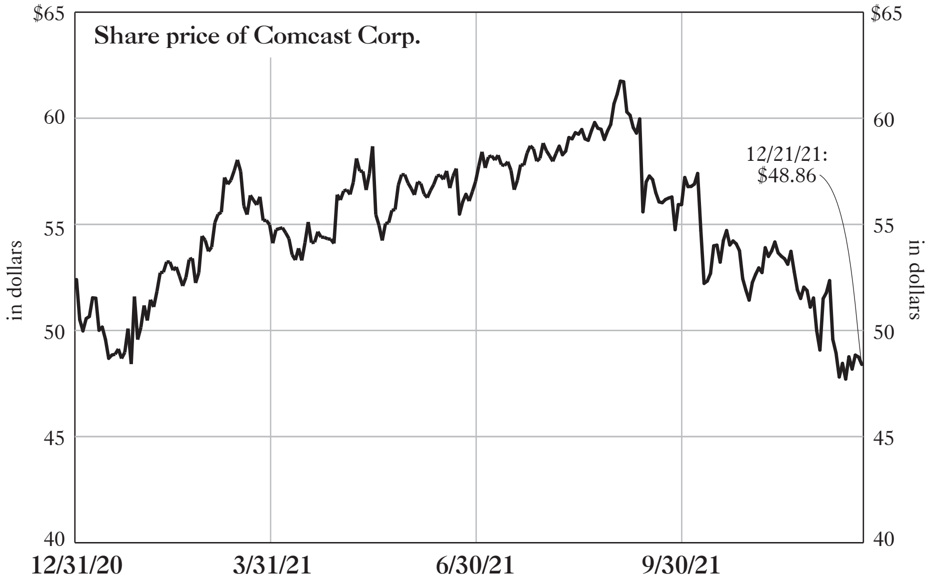
Competition is hotting up, too. This year, Verizon and AT&T announced plans to expand their own broadband footprints via high-speed fiber optics nationwide. T-Mobile, which lacks a wireline footprint but boasts the country's fastest 5G network, has been pushing its fixed wireless access offering, which provides consumers with the internet over its cellular network. "We're staring

Wheat here, chaff there



source: The Bloomberg

Tune it in



source: The Bloomberg

at a pretty competitive environment, and we'll continue to do so," Dave Watson, CEO of Comcast's cable unit, told investors at the UBS Global TMT Virtual Conference on Dec. 7.

The cable industry has made hay for two decades by picking off AT&T's and Verizon's DSL subscribers (a.k.a. digital subscriber lines, or internet-over-telephone lines), who pay top rates for subpar download speeds. That pool of easy pickings has gotten smaller, and the phone companies are investing in faster service offerings.

These fears appear to have metastasized in Altice, the smallest of the big three publicly traded cable companies. Some 13,100 of its residential broadband customers defected in the third quarter, and Altice CEO Dexter Goei recently warned of additional customer losses in the fourth.

Verizon, via its Fios broadband offering, has Altice in the crosshairs, and Altice is responding by building its own fiber-to-the-home network. The high cost of such investment raises the specter of a profit-crimping, industry-wide arms race. Year to date, Altice's share price has collapsed by 58.5%, valuing the cable operator at 9.6 times consensus 2022 earnings.

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This is not Mr. Market's first bout of anxiety over the cable industry. In the third quarter of 2017, Comcast attributed a slowdown in net broadband additions to a step-up in competitive pressures. "As it turned out, their diagnosis was wrong; their market share never wavered in 2017," Craig Moffett, who rates Comcast a buy and is one-half the eponym of MoffettNathanson, LLC, wrote to his clients in September. "The real issue was slower new household formation. When new household formation recovered in 2018, so too did cable stocks."

While house prices have rallied like cryptos in 2021, household growth has been stuck in neutral, down from its 1%-plus pace in recent years, owing both to supply-chain difficulties hobbling new construction and to virus-related worries.

Covid has distorted the communications market in other ways. For one, the rise of virtual classes has interrupted the seasonal migration pattern of college students and their predictable cancellation of cable service in the summer and synchronous return in the fall. This may have contributed to the weak third-quarter broadband additions and to strong levels of customer retention industry-wide.

The government's pandemic-relief programs further muddy the water. The Emergency Broadband Benefit Program, a $3.2 billion pool to help struggling Americans access the internet, began disbursing funds in May 2020. Recipients confounded lawmakers by applying more than two-thirds of the money so far expended to pay for cellphone plans, not high-speed internet via cable. Industry commentary suggests that broadband additions have been especially weak among the lower-income households that the EBB promoters had hoped to reach.

The decline and fall of Altice may yet prove an augury for cable as a whole, but so far those problems appear more company-specific than endemic. Altice assembled its assets through a series of acquisitions, including Suddenlink Communications in 2015 for $9.1 billion and Cablevisions Systems Corp. in 2016 for $17.7 billion. To generate a return on those outlays, management hiked prices on broadband offerings, making itself vulnerable to the likes of Verizon, which is bundling Fios with mobile-phone plans.

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Competition isn't a one-way street, of course. Comcast and Charter are rapidly expanding their mobile-phone offerings at prices (including device subsidies, taxes, fees and freebies like subscriptions to Netflix) that are generally lower than those of every operator except T-Mobile, according to Moffett. In the third quarter, measured year over year, Comcast enlarged its mobile-customer count by 1.1 million to 3.7 million, Charter by 1.1 million to 3.2 million. (FYI: Cable companies disclose customer counts by household, while telcos break out customers by the total number of mobile lines.)

Cable has the edge in this contest, if economics and precedent count. In order for Verizon or AT&T to win new high-speed customers, the telcos must build expensive fiber networks, then spend years gathering enough customers to redeem their fixed costs. Nor, after thus encumbering themselves, would they find it easy to compete with the broadband prices already on offer from the cable companies.

Comcast and Charter, by contrast, incur a variable cost to add a new mobile customer. In 2011, the pair sold a quantity of wireless spectrum to Verizon in exchange for cash and wholesale access to Verizon's mobile network. Last year, Verizon recut its deals with the pair, giving even more attractive economics. (Altice has signed a separate mobile virtual network-operator deal with T-Mobile at what appear to be less generous terms.)

Comcast Corp. at a glance
all figures in USD millions except per share data

	TTM*	2020	2019	2018	2017
revenue	$113,757	$103,564	$108,942	$94,507	$85,029
operating income	19,914	17,493	21,125	19,009	18,018
net income	14,482	10,534	13,057	11,731	22,735
earnings per share	3.11	2.28	2.83	2.53	4.75
shares outstanding	4,665	4,624	4,610	4,640	4,786
cash	11,806	11,740	5,500	3,814	3,428
debt	97,217	103,760	102,217	111,743	64,556
total assets	277,061	273,869	263,414	251,684	187,462

* The 12 months ended Sept. 30, 2021.

source: company reports

This makes sense from a game-theory perspective: The first phone company to extend the cable companies such a deal will benefit even if it leaves the rest of the phone field worse off. While Verizon loses a few dollars of Ebitda for each subscriber who defects to cable, it gains wholesale revenues for each customer that ditches AT&T and T-Mobile in favor of Comcast or Charter.

However, mobile competition from cable does pose a threat to the phone companies' profit pool. "At a time when seemingly every other industry in America is raising prices, the wireless industry continues to be mired in an interminable [average revenue per user] slump," Moffett advised his readers the other day. "Retail post-paid ARPU growth returned to negative territory in Q3."

Cable doesn't have to raise a single cell-phone tower to provide customers with nationwide coverage, but Comcast and Charter are building Wi-Fi antennas and cell towers on top of their existing cable infrastructure in areas of high mobile-phone usage. This peels off the most profitable portions of mobile wholesale revenues that would otherwise be paid to Verizon while relying on Verizon's network to provide service in less utilized, and, therefore, less remunerative, cell sites.

"Comcast already has positive wireless margins with substantial customer-acquisition costs," Kyler Hasson, a portfolio manager at Delta Investment Management who holds positions in Charter and Altice, tells me. In the third quarter, the cable giant reported $51 million in Ebitda from its mobile-phone efforts.

Cable has already taken over markets formerly dominated by the telcos. "I remember launching voice over IP in 2004 against wireline telephone companies, and there was virtually no competition on wireline voice at that time," recalled Thomas Rutledge, the CEO of Charter, at the UBS Global TMT Virtual Conference earlier this month. "The average phone bill in the New York area…was about $72 with taxes and fees for wireline. I was selling that for $13.…[Today] the two biggest phone companies in America of that product [i.e., fixed wireline] are us and Comcast."

An added benefit to cable is the demonstrated loyalty of customers who, purchasing more than one product, pay less than they would if they bought each service separately.

"[I]t would not surprise us if consensus telco Ebitda/free-cash-flow expectations are 25%-plus too high in the medium to long term," says the previously quoted Wlodarczak. "Ironically, it [was] hard not to have a feeling of déjà vu when cable entered the wireline market and a few quarters after starting, the telcos were proclaiming they were not seeing much effect, even though cable eventually became the incumbent fixed-phone operator in the U.S."

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Which brings us back to the two big cable companies. Each has its pros and cons. Charter is a cable pure play that's priced at a premium multiple: 20.7 times next year's earnings. Comcast derives one quarter of Ebitda from non-cable businesses (on which, more later) but trades at a more than 25% discount to Charter: 13.2 times next year's guesstimate. Comcast is leveraged at 2.4 times Ebitda compared with Charter's 4.2 times (both measured on annualized third-quarter figures).

Comcast traces its roots back to 1963, when Jerrold Electronics sold its American Cable Systems unit to Ralph Roberts and business partners Daniel Aaron and Julian Brodsky for $500,000. Over the following 58 years, Comcast has expanded through a combination of organic growth and acquisitions to become the largest cable operator in the United States, with 34 million customers versus 31.9 million for No. 2, Charter.

The Roberts family still controls the company. Brian, Ralph's son, is the current CEO and chairman. The 25.5 million shares he owns represent 0.6% of the total outstanding with a market value of $1.2 billion. His super-voting "B" shares confer 33.3% of the voting rights.

In the three months ended Sept. 30, the cable unit accounted for 52% of revenues and 75% of Ebitda. NBCUniversal, which encompasses cable networks (including USA, SyFy, MSNBC and CNBC), broadcast channels NBC and Telemundo, film studios (including Universal Pictures and DreamWorks Animation) and theme parks, generated 32% of third-quarter sales and 14% of Ebitda. The remaining 16% of sales and 10% of Ebitda come from Sky, a European satellite TV broadcaster with 23 million customers and a cable network.

Telco competition is nothing new for Comcast. At the recent UBS conference, Watson noted that 40% of the cable giant's operations already face fiber telco competition and that announced capacity expansions will bump that figure up to 55% over time. Despite disappointing guidance of around 300,000 net customer additions in the fourth quarter, Comcast has told investors that cable Ebitda will increase by 7% to 8%, year over year, in the December quarter.

The non-cable units are not so high quality as the core business, but, at the current valuation, you arguably are getting them for free. Like AT&T's DirecTV unit, Comcast's Sky business is in secular decline, albeit at a slower rate of melt than DirecTV. In the third quarter, revenues fell by 0.7%, year over year, in local currencies, but the unit should continue to generate free cash flow for years.

The outlook for NBCUniversal is hazier. On the one hand, the film studios (24% of the unit's third-quarter revenues) and theme parks (14%) are businesses that should (and could) produce long-term growth and will likely recover as the virus recedes. On the other, the cable networks and broadcast TV channels are losing out as consumers cancel their cable TV packages. Comcast has launched Peacock, its own streaming offering, but the service is subscale today. "The media business is troubled," Moffett tells me, "but it is still cash-generative."

Using that cash to reward shareholders looms large in the bull case. Management has told the Street that it will maintain the current 2.4 times leverage ratio. Next year, analysts estimate that Comcast will generate $15.8 billion in free cash flow, which, after paying out $4.6 billion in dividends, leaves $11.2 billion for buybacks versus a market cap of $223 billion. Year to date, the company has repurchased $2 billion's worth of stock and has quickened the pace of buybacks from $1.5 billion in the third quarter from $0.5 billion in the second. Cash balances could get a bump of perhaps $20 billion in 2024 when Comcast has the right to put its 33% stake in streaming service Hulu to Walt Disney Co.

Interestingly, the bear case for Comcast also relates to the surfeit of cash. The worry is that management will acquire a business inferior to the cable operations, like Sky. In a sense, investors have already lodged their complaints. Thus, the stock trades at a deep discount to the market multiple and, since Comcast announced the satellite acquisition on April 25, 2018, has generated a 57.4% return, including reinvested dividends, or little more than half of the 113.9% jump in Charter's share price.

Despite getting the cold shoulder from investors, Comcast is well-liked by the Street, with 28 of the 37 analysts following the stock rating it a buy and only one a sell. Short interest sums to just 1.5% of the float. Insiders, however, have sold 949,642 shares over the past 12 months for proceeds of $52 million. Not a good look there, Team Comcast.

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