MERGERS & ACQUISITIONS

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Opinion How buildout of 5G wireless technology fuels M&A

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Middle market merger and acquisition activity in the U.S. technology, media and telecommunications (TMT) sector will be robust at least well into 2019, driven by several factors. This indicates higher M&A valuation for companies in this sector. The telecommunications sector of TMT is served by the highly fragmented specialty contracting services industry, with a large number of participants. In addition to several large multi-national corporations, and numerous regional specialty service providers, there are many privately held companies offering program management, engineering, construction, maintenance, installation and underground facility locating services. Many of these companies are likely candidates for acquisition and/or consolidation by private equity firms and large national players such as Dycom Industries (NYSE: DY), Mastec Inc. (NYSE: MTZ) and Quanta Services Inc. (NYSE: PWR). Consolidation of the carriers and cable companies are driving mergers among specialty contractors, which is leading "bulge bracket" investment banks to establish funds to participate in M&A in this sector.

Photo credit: Bloomberg News

Merger and acquisition activity in the global TMT for the first nine months of 2018 were worth a total of $3.3 trillion, the most since record keeping began nearly four decades ago. Announced deals involving U.S. companies accounted for more than 40 percent of all global M&A activity in the sector. Planned and completed mergers and acquisitions suggest that carriers and cable providers will look for acquisitions that expand their geographic footprints and diversify their customer base, Many service providers are actively building up their content portfolios via acquisitions in an effort to compete with the streaming content providers that threaten their market share by aggressively acquiring new customers—usually from service providers. At the same time, many in the industry believe the FCC is making it easier for carriers to join forces, making it a win-win for both sides.

Notable transactions completed or announced in 2018 included AT&T's acquisition of Time Warner valued at $85.4 billion--which has won final court approval--Disney's acquisition of 21st Century Fox, appraised at $71.3 billion, the $39 billion Comcast offer for Sky, the T-Mobile plan to buy Sprint for $2.5 billion, and private equity firm Novacap's offer to buy Horizon Telecom for $220 million. Increased M&A activity in the US telecommunications industry, a subsector of TMT, will be driven by two major trends:

- Capital expenditures (CAPEX) by the "Big Four" wireless telecommunications service providers for the rollout of fifth generation (5G) wireless technology cellular services. The 5G rollout by Verizon, AT&T, Sprint and T-Mobile requires firms hired for the infrastructure buildout to have the size and financial strength to qualify and deliver on their increased business.

- Consolidation, which is typical in a fragmented industry: the "Big Four" seek support from larger, more financially robust service suppliers and vendors as they roll out 5G.

5G will be the connective tissue that enhances the use of mobile technology, such as the Internet of Things, autonomous vehicles and mobile media in a wide range of industries. The launch of 4G in 2010 contributed more than $150 billion in U.S. GDP growth and resulted in more than 370,000 new jobs, according to Deloitte. Expectations for 5G are well in excess of both those benchmarks.

A new mobile era is emerging with the commercial rollout of 5G, and thousands of companies are part of the 5G ecosystem. Those that will be of particular interest to strategic acquirers and private equity firms include companies providing technology, engineering, software and construction services.

Capital expenditures by Verizon Wireless, AT&T, T-Mobile and Sprint were given a further boost by the Tax Cuts and Job Act of 2018 that lowers corporate taxes and allows expensing of qualified capital expenditures. Verizon and AT&T have recently announced they will allocate $35 billion to $40 billion respectively in CAPEX expenditure for the rollout of 5G wireless network technology.

AT&T revealed plans to be the first major carrier to roll out 5G service in 12 U.S. population centers starting with two in Texas (Dallas and Waco) and Atlanta. AT&T plans to offer smart phones and other devices built specifically for the 5G network.

John Stephens, CFO of AT&T Inc., speaking recently at the Cowen and Company Technology, Media, and Telecom conference, revealed a turn from a fixed 5G wireless path, citing the prohibitive costs of backhaul in urban environments. High bandwidth fixed 5G service with promised gigabit speeds will need fiber backhaul to the core network to meet those commitments. Getting fiber to all of those small cells and 5G access points is very expensive for AT&T. It appears that AT&T will resort to a rollout of “LTE Advance Pro,” or what is referred to as “Gigabit LTE,” a derivative of 4G, or in the current vernacular, “Fake 5G.”

According to AT&T Communications CEO John Donovan, AT&T’s build out of the First Responder Network (FirstNet) covering all 50 states is backed by a $40 billion CAPEX investment, allowing the deployment of AWS and WCS spectrum utilizing the one-touch, one-tower approach. The AT&T 5G deployment is essentially a gigabit LTE service with peak theoretical speeds in the 400 Mbps range.

Verizon Wireless plans to roll out 5G wireless home broadband internet services to consumers starting in Los Angeles and Sacramento. The carrier plans to offer 5G with Fixed Wireless Access, which provides connectivity via wireless mobile networks rather than cable. By the time the network rolls out, Verizon expects to have over 1,000 cell sites up and operating on the 5G global standard. Verizon acknowledges this requires a tremendous investment in fiber--the construction of the largest fiber network in the U.S.

Verizon's doubling-down in fiber is not driven by expanding FiOS, but by the need to densify its network for 5G. But Fiber to the Premise (FTTP) applications will be a benefit of this densification. For its 5G rollout Verizon will need to feed small cells located at approximately 1,000-foot intervals in urban environments. Such small cells will require gigabit capable backhaul, which is best delivered through a deep fiber network. As a result, Verizon is changing its approach to fiber. It is adding many more strands as it lays this fiber, leading to the ability to offer FTTP services through its small cell-laden 5G network. With such a fixed wireless network, Verizon is aiming to be the first U.S. carrier to officially launch commercial 5G technology. Verizon plans to identify two other U.S. cities to receive 5G.. In a recent report, New Street Research said Verizon will have to spend $35 billion in CAPEX for a fixed 5G network.

Construction outside the big four

Federal funding continues to play a role in the buildout in rural areas to "Connect America" with ubiquitous broadband connectivity. The FCC qualified 220 Bidders for Connect America Fund Auction. This $2 billion Connect America Fund Phase II auction will expand wireline and wireless broadband in underserved rural communities. Bidders range from Tier 1 Verizon to rural telcos, electric utilities and wireless companies such as US Cellular and everything in between.

Growth opportunities increase exponentially for vendors that support the expansion of this infrastructure breadth and depth. Additional opportunities exist for those companies with expertise in deploying a mesh of small cells that interoperate with the large cells and/or directly with the backbone fiber network to connect everyone everywhere.

In addition, major telcos and mobile tower companies such as American Tower, will broaden their M&A attention to companies that hold significant urban real-estate assets, as edge computing/small cell planning becomes more strategic.

Everyday is full of opportunities, but an opportunity is full of only so many days

There is another side to this outsized industry opportunity. When the 5G rollout is completed it will likely usher in an industry contraction. Carriers already enjoy enormous clout in each market since the industry has so few participants. The Big Four have greater ability to dictate the terms of engagement, including billing rates, contract and payment terms, not always favorable to suppliers and contractors. Payment terms could easily stretch beyond 60 to 90 days and, as interest rates increase, suppliers and service providers with sales under $100 million will be squeezed, not only to fund growth, but to actually stay afloat. Small to medium sized suppliers and vendors to the industry will face customer concentration.

Deciding when to sell

This schizoid market will impact on the M&A environment for lower and middle market companies participating in the industry in the years ahead. History points to a boom and bust cycle linked to swings in capital investment and introduction of new technology. Customer concentration impacts valuation. The uptick in interest rates expected to accelerate in the coming months tightens the credit markets that help fund transactions.

Determining when a business is ready to sell requires careful consideration of several factors. For buyers, it is important to ensure that contracts are secure with favorable terms, revenue streams are diverse and trending positive, and a strategy is in place and management is competent and reliable. It is also important to pay attention to conditions in the larger market.

For owners planning to sell it may be prudent to initiate a transaction before the roll-out of 5G is completed. Showcasing a strong backlog of contracts or orders will enhance valuation. Strategic initiatives that diversify the customer base beyond the carriers will also improve a company's universe of potential buyers. The convergence of these factors indicates that 2019 may be a good time to consider a sale.