Unlocking value through altnet M&A: Insights and strategies

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Summary

As market shake-out in the UK altnet sector becomes increasingly evident, we examine the potential for value creation through M&A. We touch on the motivations of likely acquirers, the types of market players, the opportunities and challenges in value creation, some of the factors impacting valuations, and finally some practical considerations based on our experience of supporting clients in the sector.

A divided market: Interest in transactions is on the rise

Since the Future Telecoms Infrastructure Review, published in 2018, and the subsequent launch of the Government's £5bn Project Gigabit gap funding initiative, the UK broadband sector has developed at pace. Recently however, a combination of intense competition, higher than forecast build costs, skilled labour shortages, scarcer funding, and the unfavourable macroeconomic outlook, have started to precipitate a long-predicted market shake-out. On the distress side, this is now evident in recent cases such as the calling in of administrators at Broadway Partners, Trooli's reported struggles to raise new funding amid financial pressures, and workforce cuts at Hyperoptic among others.

At the same time, stronger players continue to successfully attract new investment when sector appetite has supposedly diminished (e.g. Virgin Media, Netomnia, Toob), or consolidate existing investments (e.g. Fern Trading bringing together its Jurassic, Giganet, Swish and AllPoints Fibre assets).

Separately, Ofcom's recent decision to pass Openreach's Equinox 2 pricing plan has caused some rifts in the industry, with altnets on one side and Openreach and its wholesale partners on the other.

A split in the sector is becoming evident, with the well-funded on one side and the less well-funded on the other. Put together, these factors are driving up interest in M&A.

Build or buy: What are the drivers for M&A?

So, what are the drivers and motivations for M&A when historically, many players in the market have been rushing to build their own networks? We see a number of factors at play:

- **Time to market is everything**: Build-out strategies have essentially been ‘land grabs’ to date; the first to market typically wins, subject to running effective marketing campaigns and providing good customer service. The accelerated time to market of acquiring someone else’s network over a network build-out now renders the buy option attractive, especially when experience shows that many builds have exceeded planned timelines and cost budgets.
- **Avoiding real world challenges**: Whilst access to existing passive infrastructure (i.e. ducts and poles) is mandated by Ofcom[1], the practicalities of access can be challenging. In some cases for example, ducts are at full capacity or have collapsed, rendering them unusable. This only adds to build-out delays.
- **Capturing growth and cost synergies**: Key drivers for any M&A transaction are access to growth and cost synergies. For those altnets that have developed promising businesses in their targeted geographies, but still have the appetite and funding to grow, the obvious next step is to expand geographically. With expansion come the benefits of diversification and scale, and less reliance on local markets.
- **Market share**: Strategic acquisitions can remove competitors from the market, thus offering increased market share and avoiding value dilution caused by over-build and weaker penetration levels.
- **Gaining new competences**: Acquisitions may be attractive if they provide access to new technologies, more experienced management teams, skilled employees, product innovations, or supplier contracts which can be leveraged at greater scale.

Whilst these are all strong motivations, M&A is not a strategy in itself. Neither is it without its risks and challenges; deals abound in the telecoms sector where value has failed to materialise, often due to failures to address practical challenges. These same risks apply with altnet deals.

Making moves: Who are the key players and what are their motivations?

We see interest in acquisitions principally from three main types of players:

- **Type 1- Large established telcos**: Where larger players have established strong levels of regional presence (e.g. Virgin Media O2) or national backbones and urban coverage (e.g. CityFibre), there is a clear drive to develop increased coverage at local levels. However, a measured approach is likely to be adopted, with the national challengers not wanting to attract too much attention from Ofcom.
- **Type 2- Mid-scale altnets**: Where established altnets have developed targeted commercial models with some success at the local level, there may be appetite to replicate these in new areas.
- **Type 3- Financial investors seeking distressed acquisitions**: If the price is right and a successful turnaround can be implemented, subsequent exits could deliver significant value upside

if the strategy can be successfully re-focused to signing customers over building the network.

Currently, we are not predicting an appetite from BT to engage in altnet acquisitions, with such moves likely being open to significant scrutiny from the competition authorities.

Getting down to business: Accessing deal value

We see good potential for value creation in the altnets sector, assuming one knows where to look.

'Traditionally', M&A in the telecoms sector has been focused on development of economic value via strategic acquisitions yielding increased market reach, new capabilities, and cost and revenue synergies. In practice, market value tends to be higher (in line with book value) in telcos where sustained growth in economic profit[2] can be evidenced. However, in a complex market, it will be essential to look beyond the basics; timing is important, and this can impact deal value. In a crowded and highly competitive full fibre market, acquisition of the 'right' targets at the 'right' times and the 'right' prices will be essential.

Acquirers will be seeking to buy businesses which provide a good strategic fit across multiple dimensions, where the practicalities of integration offer a good chance of success. Will cultural integration work smoothly? Will product portfolios sit well together and be applicable to different demographics in expanded markets? Will network architectures and supply chains be compatible? Will realisation of cost synergies be feasible within a reasonable timeframe and budget? Strategies to address such questions, realise efficiencies, access new services, and acquire customers, will all need to be supported with appropriate diligence.

Given the capital intensity associated with network build, various opportunities for cost synergies can be expected. Some of the more likely sources are shown below:

Capital expenditure

- Scale economies in supply chains
- Incremental, rationalised network build-out
- Scale economies in network build-out
- Network sharing (active and passive)

Operational costs

- Backhaul aggregation and scale economies
- Workforce efficiency and competency gains
- IT / cloud systems scale economies
- Energy efficiency improvements

To date, the majority of altnets have focused more heavily on the consumer segment. With some exceptions, interest in the business and wholesale segments has tended to be secondary. Consequently, access to revenue synergies may be more limited.

Nevertheless, we see some potential. Whilst many in the market have focused on 'the basics' of providing fibre connectivity and broadband services, some innovators are looking to provide credible value-added services, enabled by cloud, 5G, and other newer technologies. Examples include new carrier services for local and private 5G operators, vertically bundled applications for businesses, and software-defined wide area networks (SD-WANs) for corporates and public sector organisations. We have seen interest in these areas, though little thus far in the way of execution.

Targeted diligence: Market quality and cost efficiency

Rigorous technical, commercial, and financial diligence will be needed to support deals. In our experience with altnets, targets for acquisition can be identified using a framework comprising a number of key dimensions, supported by expert advisory, and stakeholder reviews and decisions[3]:

- **Demand side – assessment of the target's market quality and product positioning:**

1. Addressable market: detailed assessment of areas to ascertain market quality (e.g. demographics, affordability, demand)[4];
2. Products: benchmarking to competitor products, understanding product positioning, establishing the reasons for customer churn levels;
3. Competition: areas assessed based on the scale of market competition, 'land-grab' potential, and risk of overbuild (time to market). Conversely, areas with known competition at the investor and telco levels may be de-selected;

- **Supply side – assessment of the target's strategic designs and cost efficiency:**

1. Cost structure: detailed reviews of technologies, engineering dimensioning, network architectures, definitions of premises passed and connected, and efficiency levels;
2. Technology: consideration of balanced use of technologies, including clustered FTTP and 5G-based FWA for selected non-urban areas.
3. Application of such a framework will vary; practically, different dimensions will carry different weightings according to transaction types.

Realism on valuations: Distressed sellers may need to temper expectations

To date, most altnets have focused on network build over customer acquisition. For some, therefore, the primary value of the business to an acquirer will be what is in the network. Despite significant sums potentially having been spent on marketing and brand building, some altnets don't yet have significant levels of customer penetration to show for it.

For transactions to take place, the more distressed sellers may be forced to accept lower valuations, which may mean prices at not much of a premium to network book value. Whilst this may be a bitter pill to swallow, the reality is that cost-based approaches to value can be expected for under-developed businesses facing funding challenges.

That said, valuation upside potential may be realisable by some. Valuations are likely to be positively impacted where time to market, cost synergies, and intangible value look realisable in a shortened timeframe. In those situations, income-based approaches and assumptions are more likely to drive valuation discussions.

Realising post-deal value: Sharp focus on integration whilst safeguarding customer service

M&A never delivers full value without successful integration and execution, and hence understanding of altnet operational challenges and risks will be key, especially at a time when most can ill-afford diversions from essential operations. For many new altnets, brands are young and fragile, especially with developing competition. Anything which negatively impacts customer service during integration will have a disproportionate impact on value.

Risk in altnet acquisitions will be mitigated where cultural similarities exist, where there are high incidences of cloud-native B/OSS[5] systems, and business processes which may be nascent and well-suited to further development and integration. Operational integration is likely to be most complex with Type 1 deals, reducing progressively with Types 2 and 3.

Summing up: The devil will be in the detail

We are seeing increased interest in M&A in the UK altnet space, driven by a developing polarisation in the market.

On the buy side, we expect all three categories of players to be active – large established telcos, mid-scale altnets, and financial investors.

Identifying and realising value from targets will be challenging though. Factors such as market (customer) quality, take-up levels and rates, target costs, strategic fit, the potential for cost synergies, and the practical and operational aspects of integration will all require detailed diligence to minimise risk.

Where synergies are clear and sellers have options, they will be able to extract value, but in more distressed cases value may amount to little more than the book value of the network.

References and notes

[1] Often referred to as PIA (Passive Infrastructure Access) or DPA (Duct and Pole Access); see: https://www.ofcom.org.uk/__data/assets/pdf_file/0027/154593/volume-1-pimr-final-statement.pdf

[2] Note: calculated in the standard way as NOPAT less a charge on capital employed.

[3] Note: The diligence framework shown focuses on a few key areas. With technical and commercial due diligence engagements, a wider set of dimensions will typically be assessed, including areas such as: management team, detailed investment model, key ratios, business processes, supplier relationships, and others.

[4] Note: Based on market evidence, propensity to buy (take-up) tends to increase in line with the scale of differences between legacy and newly available broadband services. Target areas should align with the scale of altnet build-out at the local level. Typically, this may be in quanta of several thousands of premises, i.e. at the local MSOA or Parish levels.

[5] BSS - Business support systems, OSS – Operations support systems.