DIAMOND HILL | CAPITAL MANAGEMENT

The Next Evolution for Cable Providers

October 2021

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The pandemic revealed and enhanced the value of fast, reliable internet connections to consumers and businesses as adoption of digital activities accelerated. This contributed to strong broadband subscriber growth in 2020 for our cable holdings, Comcast and Charter, whose hybrid fiber-coaxial networks allow them to offer superior broadband service in most of their markets. A relatively inexpensive path to upgrading their networks positions both companies well as use cases emerge for faster, more reliable internet connections than can be delivered today.

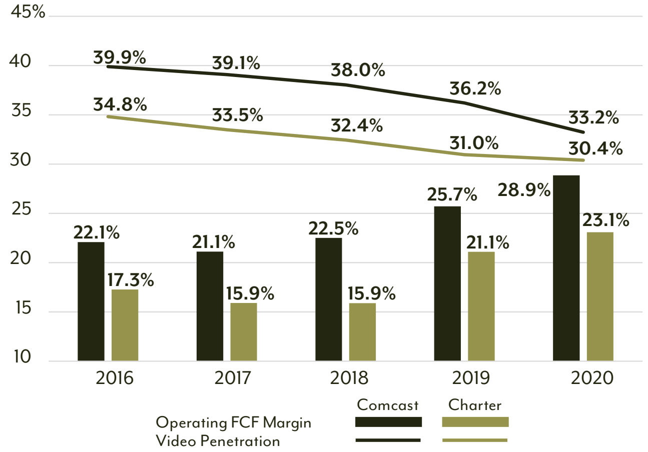
However, risks are materializing around the cable industry's ability to capitalize on this demand. The broadband market is nearing saturation and improving competition from fiber-to-the-home and fixed-wireless broadband offerings will make it more difficult to take market share. Additionally, the FCC may reclassify broadband as a Title II telecommunications service, which provides the potential to regulate pricing. We are comfortable with these risks for Comcast and Charter, as both pursue opportunities to enhance long-term intrinsic value growth. Here, we'll examine two growth opportunities: margin expansion resulting from the shift to a broadband-first model and scaling their wireless businesses.

The Shift to a Broadband-First Model

While cable companies are primarily known for providing video service, the industry has shifted toward embracing a broadband-first model. Broadband is more profitable than video due to lack of programming expenses, lower customer service costs and no need for cable boxes.

As mix shifts from video to broadband, operating profit margin expands and capital intensity declines as demonstrated in Exhibit 1, which contrasts operating free cash flow[1] against video penetration.[2]

EXHIBIT 1: OPERATING FREE CASH FLOW MARGIN VS. VIDEO PENETRATION[1,2]



Source: Comcast & Charter Communications filings.

Comcast and Charter embraced a broadband-first model over the last few years. As broadband grew and cord cutting accelerated, the mix shift toward broadband contributed to inflections in operating free cash flow margins. We believe there is room for further margin expansion, though it will be partially masked by investments in the short term.

Scaling Wireless Service

While cord cutting flatters margins, it leads to a greater proportion of cable customers purchasing only broadband. This creates the risk of cable companies becoming a "dumb pipe" that only differentiates with

[1] Operating Free Cash Flow defined as Adjusted Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) less capital expenditures and cash paid for intangibles, as reported by Comcast for its Cable Communications segment and Charter.
[2] Video subscribers as a proportion of homes passed, as reported by Comcast and Charter.

their internet service. Increased competition from fiber-to-the-home and fixed-wireless broadband offerings would make it difficult for “dumb pipe” cable businesses to maintain pricing power or continue taking market share.

Comcast’s and Charter’s approaches to maximizing customer lifetime value account for this risk by bundling lower-margin secondary services with broadband. Both companies are still attempting to profitably deliver video via skinny bundles and streaming options—but these services are unlikely to materially drive broadband growth. Fortunately, Comcast and Charter found an effective replacement for video as the primary service to bundle with broadband — wireless.

Cable businesses can offer wireless service by capturing in-home traffic on their broadband networks while renting a cellular business’ network to cover the remainder. Comcast and Charter rent Verizon’s network, effectively allowing them to offer premium wireless service to broadband subscribers. Because of the benefits wireless provides to broadband growth, both companies are incentivized to undercut competitors on price to drive scale, a strategy that has been successful thus far. Comcast and Charter launched their wireless services in 2017 and 2018, respectively, and currently have a combined 6.3 million lines.[3] Margins for wireless service are attractive despite the lack of owner economics — Comcast is already profitable while Charter is profitable excluding subscriber acquisition costs.

However, we believe the best is yet to come. Significant growth remains for wireless, with Charter targeting 50% penetration of its broadband subscribers over the long term. Assuming two lines per broadband household, this implies over 60 million addressable lines between both companies – more than a nine-fold increase relative to today. While both companies will optimize for growth over profits for the foreseeable future, we also find wireless’ long-term economics compelling. Enabled by recently purchased spectrum, both companies are planning targeted mobile network builds in areas where they utilize Verizon’s network the most. Charter CEO Tom Rutledge believes these investments could offload up to a third of traffic from Verizon’s network in four or five years.[4] The following quote from Liberty Broadband’s CEO (which owns roughly 30% of Charter) illustrates Charter’s potential opportunity in wireless.

“I think this will be a $1 billion EBITDA business within four years and potentially much more if you think about the combination of what – how much you’re pulling broadband, but just on a standalone mobile basis.” – Liberty Broadband CEO Greg Maffei[5]

What's Next?

We expect the combination of margin expansion (from the shift to a broadband-first model) and scaling the wireless business will enhance Comcast’s and Charter’s long-term intrinsic values. Both companies have additional opportunities to support long-term growth including footprint expansions, enterprise growth and addressable advertising. While we recognize and diligently monitor industry risks, we find they are more than outweighed by Comcast and Charter’s long-term opportunities at their respective valuations.

[3] As of June 30, 2021 – per company reports.

[4] Charter 4Q 2020 Earnings Call.

[5] MoffettNathanson’s Media & Communications Summit, May 12, 2021.

As of September 30, 2021, Diamond Hill owned equity shares of Charter Communications, Inc. and Comcast Corp.