European Towers: Is it too good to be true?

By James Ratzer | August 18, 2019

European tower stocks have undoubtedly been the global telecom companies to own this year with Cellnex up 70% YTD and Inwit up 58%. Asset scarcity, falling bond yields, increasing M&A optionality and favourable accounting changes have all helped. The trend is your friend isn't it? The upwards momentum should continue? We are now only selectively convinced. This week we did a deep dive review on the European tower names (see HERE), and came away with the conclusion that there should still be more momentum in Inwit, but that Cellnex's giddy rise is harder to justify. Other names like Vodafone or Orange also look like alternative ways to play this theme.

The tower model is a simple one. Rent space from landlord. Build tower. Get anchor tenant. Add incremental tenants at high margin. Increase contract value each year. Job done. An arbitrage on owning the infrastructure. While the tower model is indeed extremely attractive, there is a price for everything, even as bond yields fall, and there are arguably a few warning signs on the horizon, that we think aren't necessarily being fully factored in, especially when a company such as Cellnex is trading on a multiple as high as 25x EBITDA.

Longer-term growth for the tower companies will be driven by tenancy growth, but MNOs are desperately keen to save money themselves and finally realising that tower location sites aren't necessarily the differentiator they once were. Hence the existing MNOs are looking to consolidate their existing tenancy locations to save on ground rent and tenancy costs. Vodafone is leading the charge on this through pooling resources with Orange in Spain and Telecom Italia in Italy. For Cellnex, they stand to lose tenancies in both markets, and Wind's tie-up with Fastweb curtails what could have been future demand in Italy. Although political pressure will still remain to build out in rural areas, we believe the MNOs are likely to use new spectrum bands above 3GHz and small cells as the most likely routes to increase capacity, rather than continued macro-site buildout.

Lower bond yields have arguably the biggest support for these stocks, but that isn't a one-way bet in Europe as tower contracts are almost all linked to inflation which means that real growth for these companies is

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actually little changed.

The big unknown that could support the tower thesis is continued consolidation and newsflow around M&A as the European tower market remains very fragmented. So far, this has been seen as a sure-fire way for tower companies to create value, as TowerCos have been able to arbitrage rising multiples, but sellers are increasingly likely to demand a higher multiple, as we saw with Vodafone's disposal at 24x EBITDA in Italy. Increasing scale in the tower market raises the spectre of potential future regulation, and the proposed Inwit-Vodafone transaction will be an interesting test case. This could well force the tower companies to open up to more third party tenancies as an extra source of growth, but it could also lead to greater regulatory intrusion if TowerCo gains too much scale. The EC to date has generally been supportive of network sharing, but the recent Czech ruling shows that it won't tolerate practices that ultimately curtail consumer choice. Just offering space to independent third parties might not be enough in the longer-term. Just ask the electricity grids – monopolies of infrastructure can ultimately lead to RAB-based pricing.

Cellnex is likely to be the leading consolidator in Europe, and if we were investment bankers, we would be encouraging them to issue as much equity as possible at these elevated levels to build a warchest for future deals, especially as the market is willing to award them such a low cost of equity right now.

For Cellnex specifically, we also believe the stock has been supported by the move to IFRS16, as we address this in more detail in our recent note. It remains the only developed market tower company to report EBITDA excluding leases and we do not believe this optical shift, but with no change to underlying cashflow, has yet been fully understood in by the market. We find most people tell us they think Cellnex is trading closer to 18x EBITDA, rather than our calculation of 25x – a sizeable difference. Inwit though which includes leases in guidance EBITDA looks more appealing to us at 20x EBITDA with higher tenancy growth. More details on our Inwit thesis are HERE.

Looking across the rest of the Europe, we believe Vodafone could also offer an attractive way to play the tower theme (see HERE for more details on this idea), and of the other MNOs in Europe with tower value still to be unlocked, Orange might well be the other way to play this (see HERE). Orange is still resolutely committed to its view that its tower assets are strategic, but that is what Vodafone was saying a year ago....The tower business model still has some way to play out, but with increasing valuation disparities now emerging, we

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believe Vodafone or Orange or Inwit represent better ways to play this as an investor rather than through Cellnex which has been the star name to date.

Full 12-month historical recommendation changes are available on request

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