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What happens to Sprint if the deal is blocked?

May 6, 2019 by Jonathan Chaplin

The deal review doesn't seem to be going Sprint's way. The agencies could still approve the deal as it has been proposed. If they don't, the companies could offer an alternative structure that passes muster. We offered thoughts on workable alternatives in a report we wrote two weeks ago (LINK). T-Mobile may prefer to walk away than accept the alternatives we suggested. It is worth considering what happens to Sprint if they end up in this situation.

Pigs might fly

Sprint might prosper as an independent company. ARPU could stabilize. A trend of rising churn could reverse. Management could find yet more costs to rip out, after a decade of cost reductions. We think the prospect of this happening without a substantial infusion of new capital is remote enough for us to ignore it in this note.

If Sprint can't turn itself around with internal resources, then Softbank has to make a decision. Their options fall into three broad categories: find a new deal, double down, or walk away.

Find another deal

Sprint made a valiant attempt to find another deal in the beginning of 2018, after their first round of discussions with T-Mobile fell apart. They failed, and ended up returning to T-Mobile, hat-in-hand, willing to accept a worse deal than they had been offered months before. Things have changed for better and worse. Sprint is in worse condition, which will scare off some suiters. They will also be more desperate, which may help get a deal done.

Comcast and ***Charter*** are not going to buy Sprint. Both companies had discussions with Sprint in early 2018, and both came away adamant that they had no appetite for an acquisition. We have met with both management teams this year and they have reiterated this view. I don't think they are bluffing.

The big cable companies could show more interest if Sprint restructured; however, we doubt it. Sprint's capital structure is a problem, but the bigger problem is the state of the business and the challenge of turning it around. The cable companies have expressed interest in 2.5GHz spectrum though.

There is another version of this deal, that could be more viable, that we discuss below.

Altice isn't in a position to buy Sprint at present, with leverage of 5x and a sharply undervalued equity. Their European parent isn't in a position to help at the moment either; they are shedding assets in an attempt to cut leverage, rather than looking for assets to buy.

Unlike Comcast and Charter, we suspect Altice would be interested in acquiring Sprint, on the right terms. Altice management has plenty of experience with wireless and with troubled assets. And they either have greater confidence in their abilities or a higher tolerance for risk than their cable brethren.

There is another version of this deal that we contemplate below too.

DISH is in much the same position as Altice: they might well be interested in owning the asset, but don't have the means just now. They tried to buy Sprint once before (though we suspect not really)[1], and they lost out to Softbank. Like Altice, DISH is capable of big, bold moves. But they are over-levered, with big capital requirements ahead to build out a new network. The last thing they need right now is Sprint's debt and their free cash flow losses. Moreover, Sprint's network wouldn't do much to further DISH's ambitions of a new, state-of-the-art, hyper efficient 5G network. Finally, DISH needs an operating partner, and Sprint hasn't exactly covered themselves in glory as operators of wireless assets.

DISH is more likely to show up as a bidder for Sprint or its spectrum in a Chapter 11 or liquidation process. They have a good deal of experience in these processes. If the deal is blocked and if Sprint's debt securities veer towards distressed territory, we wouldn't be surprised to see DISH or Echostar, or some other entity controlled by Ergen, buying bonds.

Someone else could acquire Sprint. The tech giants always crop up on lists of possible suitors. While some of the companies may be interested in the spectrum, we doubt any would have the stomach for taking on Sprint's debt and its failing business. As with the industry insiders, outsiders are more likely to show up following Chapter 11 or in liquidation.

Double Down

We see two ways this could happen: Softbank could invest the cash required for Sprint to finally deploy their spectrum and close the network gap, or they could pursue another asset to combine with Sprint. We think the second path is more likely than the first, mostly because we don't think the prospects of Softbank making a decent return on new capital injected into Sprint, in its current state, are great.

Softbank investing more cash seems unlikely. We haven't done the work to figure out how much capital would be required to fix Sprint. Pierre has estimated it could cost $20BN, based on the magnitude of the spending gap between Sprint and peers over the last few years and the way Softbank caught up with its peers in Japan earlier in the decade. DISH believes they can build a brand new virtualized 5G network from the ground up for $10BN. $10BN seems optimistic for a network that needs to support 55 million subscribers at the outset; $20BN seems more realistic; but both are plausible.

And then there are operating losses. We estimate that Sprint will consume close to $1BN of cash this year, and the losses will likely grow if churn and ARPU continue their current trajectory. If the turn-around takes three years, operating losses could consume another $5BN, taking the total capital required to $15 – $25BN – let's call it $20BN all-in, for the purposes of this thought experiment.

Sprint has $13BN of debt maturing over the next 3 years. They have plenty of liquidity: about $5BN in cash; another $7BN of spectrum note capacity; and $2BN under the revolver. If the business holds together, they should be able to meet maturities and cover operating losses for three years. And if the capital markets hold together, they might be able to refinance maturing debt. They don't have any spare capacity to invest more in the business though.

Sprint is trading at close to 8x "real" EBITDA today, which is rich for a distant number four that is losing revenue and burning cash. It would still be rich at close to 7x if the deal was blocked and the stock fell to $4. It would need to fall closer to $2 before the multiple would dip below 6x, putting it in more reasonable territory. $20BN in new capital would take it right back to 8.5x. I can't imagine anyone wanting to put this amount of new capital into Sprint with its current capital structure.

Softbank has been adamant that they will not put new capital in. They may be bluffing, but given the facts above, we doubt they are. We would imagine there are better places around the world for Softbank or the next Vision fund to invest $20BN. Even for Softbank, it would only make sense to put new capital into Sprint in a restructuring.

We have asked some of our clients that invest in distressed debt about the prospect of Softbank striking a deal with bondholders to engineer a quick restructuring in which some or all of Sprint's debt would be equitized and Softbank would inject new capital to fund the turn-around. It seems it is possible, but it would be extremely difficult to secure agreement among such a large group of bondholders who probably have very different views of the value of Sprints assets.

Merging Sprint into another asset would make much more sense. It would have to be a company that brings either financial capacity or assets that would make it easier and cheaper to fix Sprint. The obvious choices are the companies we discussed above – Cable and DISH. We have outlined the reasons why we don't think the Cable companies would buy Sprint, but there is nothing stopping Softbank from acquiring a cable company. They came close at the beginning of last year.

Charter would bring the most strategic value, but it would be a very big deal for Softbank. Charter would give them access to the best terrestrial network covering 40% of the country. Sprint could deploy its 2.5GHz spectrum rapidly and cheaply across the Charter footprint using the strand mounted small cells that they have developed with Altice. Within two years Sprint could have the most capacity rich 5G network in 40% of the country, coupled with the best terrestrial broadband network. With that combination, they ought to be able to double their market share in wireless, while continuing to take share in the terrestrial broadband market and in the enterprise market.

Charter and Comcast have collaborated on many strategic initiatives, including wireless. If Sprint can continue to collaborate with Comcast after acquiring Charter, they could have the dominant wireless 5G network in 80% of the country. They would have to share the spoils in the Comcast footprint with Comcast, but the upside for Sprint in the Comcast footprint could still be considerable.

Sprint made an offer for Charter last year that we believe nominally valued Charter at $540, with half of the consideration in cash and half in Sprint stock. We believe that Charter was receptive to the price and even to taking Sprint equity; they just didn't like the value Sprint wanted to ascribe to its equity in the exchange ($10). Sprint may be able to return with a more compelling offer now.

An acquisition of Altice would bring something different. Altice's terrestrial footprint is tiny and the synergies would be tiny, but Sprint would gain a management team that understands wireless and understands how to fix troubled assets. This would be far less compelling than an acquisition of Charter, but if the New Sprint with a new management team could convince Comcast and Charter to partner with them on a network build, it could be very compelling indeed.

It wouldn't be an easy transaction to structure. The Altice team likes control. Softbank likes control. Sprint has a larger market cap, but they probably won't if the T-Mobile deal is blocked. It's complicated, but possible.

We would imagine Softbank would be more open to a deal that doesn't require them to inject more cash. Charter generates much more cash that could be used to help fund the turn-around of the mobile business.

They may be less open to an all equity deal than Altice though. Altice may be willing to take equity as payment, but the Company would still need new capital from somewhere to help fix the mobile business.

Softbank has options, and potentially very good options, if they are willing to double down.

Walk Away

Softbank could simply refuse to put more cash into Sprint and they may have no interest in investing more in US infrastructure assets. If left to its own devices, Sprint might survive for three years; perhaps longer if the credit markets are accommodating. We suspect a restructuring would be inevitable sooner or later.

Restructuring may not be enough. With the revenue they have today, Sprint will likely burn close to $1BN. If the debt is all wiped out, they would generate around $1.5BN in cash flow, but that cash flow could disappear very quickly if subs and ARPU continue to fall. Another $5 in lost ARPU would wipe out $1.5BN in cash flow, and losing $5 in ARPU is probable; Sprints lead offer for much of the last two years has been 5 lines for $100 yielding just $20 in ARPU. Their current ARPU is $50, which is $4 higher than T-Mobile's. They could wipe out the same amount of cash flow by losing 2.5MM subs which, if their network continues to lose ground relative to peers, they could easily lose in two years.

Without new capital Sprint may well face liquidation in the next five years. The prospect of new capital increases significantly after Chapter 11, but the potential buyers of Sprint may just choose to wait to buy the assets they want in liquidation.

What to buy and sell

Based on the thoughts laid out above, the most likely path ahead for Sprint either passes through restructuring or an acquisition. We obviously wouldn't want to own Sprint into a restructuring process, and we would rather own the target if Sprint or Softbank make an acquisition. Charter and Altice are the most likely targets in the event of an acquisition. We like these businesses, based on their organic opportunities; they don't need a deal; but a deal is a nice free option. Options are great, especially when they are free.

Click here for our global multiples excel: LINK

Click here for a summary of this weeks' research and a pdf of our global multiples: LINK

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1. We believed at the time that DISH was mostly interested in Clearwire and their 2.5GHz spectrum. We suspected that they went after Sprint in an attempt to get Softbank to agree to sell them some of the spectrum.