Altice: Overlevered And Overvalued

December 02, 2015, 10:40:56 AM EDT By ION Asset Management, SeekingAlpha

Comment

Shutterstock photo

By ION Asset Management :

At the inaugural Sohn Conference in Tel Aviv on October 14, 2015, we presented our short thesis on Altice (ATSVF) (ATCEY) (AMS: ATC), one we continue to have high conviction in. One area of concern for us was a major difference between HOT and Altice reported EBITDA and another was relatively poor operating performance in France and Israel. On October 28, Altice reported Q3 results and attempted to explain the EBITDA discrepancy. Their explanation exposed additional aggressive accounting at the consolidated level beyond what we had already uncovered at the local level. As this note will outline, EBITDA margins might be less impressive than they appear. Paired with the ongoing operating weakness in France and Israel, we are skeptical about Altice's overall strategy and its cost-cutting targets for Cablevision.

Altice has been a telco favorite since its January 2014 IPO. Its Chairman Patrick Drahi employed a strategy of buying cable and phone companies in countries across Europe and Israel and seemingly improved margins in these established, mature businesses at a dramatic clip. In our view, Altice precariously leveraged itself and its subsidiaries to acquire companies at a premium to the sector average. Despite rising content costs and secular headwinds facing the industry, many have believed Altice's ability to create value.

The bull case for Altice rests on its ability to cut costs and improve EBITDA to generate free cash flow. Our view is that Altice hasn't actually cut costs to the extent that it's reported and that it's not as good an operator as some perceive. We note that the CEO of Altice, similar to the CEO of Valeant (VRX), is an ex-investment banker with no relevant operating experience as far as we are aware. More so, it is interesting to highlight that both companies operate in mature industries, yet management set out to re-draw the parameters in which they operate and in turn produce returns well beyond those of peers. We are highly skeptical of such strategies. As history has proven time and time again, investors ultimately come to realize that the outlandish valuations given to many high flying, highly levered companies is entirely unwarranted.

Last month we uncovered examples of aggressive accounting at HOT, Altice's Israeli pay-tv and mobile asset. Although HOT represents just 7% of group EBITDA, it's one of Altice's longest-held assets and the only one with several years of publicly available financial reports - in HOT's case, going back a decade, providing insight to how Altice runs its businesses. This discovery threw into question Altice's oft-praised EBITDA margins. To recap, in 2Q15, HOT reported a 43% EBITDA margin in its IFRS Hebrew disclosures to the Tel Aviv Stock Exchange. However, in Altice's consolidated results and corporate presentation, it boasted a 48% margin, or 500bp higher.

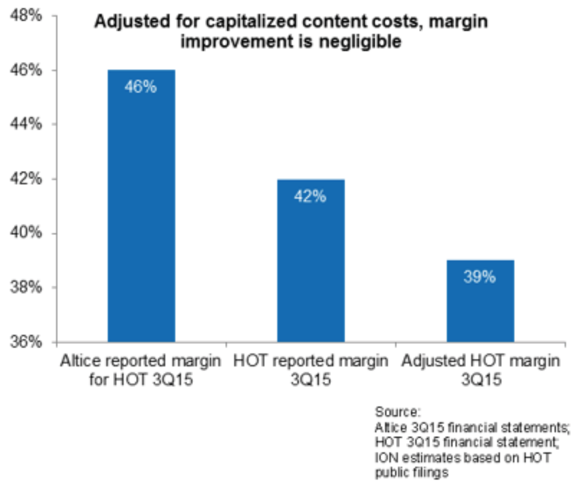
Altice's and HOT's 3Q15 earnings report showed a similar discrepancy but for the first time, Altice attempted to reconcile the difference. Altice noted that beyond the 150bp management fee (which we were already aware of), they capitalized an additional 290bp of content costs. Perhaps, we might have brushed off that explanation had we not known Altice's history of ongoing content capitalization at the HOT level.

When Altice took ownership in 2011, HOT wasn't capitalizing any of its content costs. By 2012 they were capitalizing 6% and by 2014 that level reached 10%. Altice has now disclosed to the market that it capitalizes *additional* content at the Altice level to bring HOT's margins even higher. Applying the 290bp to 2014 annual numbers for which the company discloses content costs, the total level of content capitalization amounts to an astonishing 31% of content costs. But more than that, we fail to understand why Altice is dissatisfied with the level of content capitalization at HOT and capitalizes further content costs at the consolidated level.

(click to enlarge)

In its September 2015 Cablevision acquisition presentation, Altice reported a 900bp increase in HOT's EBITDA margins between 2011 and 2Q15. However when adjusting HOT EBITDA for the capitalization of content costs to compare like for like, we estimate that 2Q15 margin was actually 41%, representing only a 200bp increase. 3Q15 adjusted margin is estimated to be 39%, equivalent to what it was when Altice took control four years ago. We believe this undermines Altice's achievements.

(click to enlarge)



Altice's troubles extend beyond questionable margin expansion. Altice has a serious operating issue on its hands in Israel and in its largest asset, Numericable-SFR in France. Poor customer service and network quality has led to subscriber exodus and worst-in-class levels of customer complaints. Numericable was the only major French operator to lose broadband subscribers in the last 7 quarters (as of 3Q15). On the mobile side, SFR has lost hundreds of thousands of subscribers in recent quarters, losing 88k in 3Q15 alone while its peers gained ~200-700k.

Trends in Israel reflect a similarly alarming pace of subscriber losses. Even in fixed where HOT competes in a duopoly and has the regulatory advantage over its competitor to offer triple-play, it has been steadily losing share. In 3Q15, for the fifth consecutive quarter, HOT reported a decline in its TV and broadband subscriber base to the tune of 10k this past quarter. The mobile business experienced ARPU declines and turned EBITDA-negative despite subscriber growth. Overall in 3Q15, the company reported a 2% decline in revenue, 57% decline in operating profit, and 11% decline in EBITDA compared to 3Q last year.

We question whether cost-cutting has gone too far and begun to alienate customers. Altice has commented in past conference calls that it's taking steps to address these issues but we have yet to see them correct in earnest. For instance, HOT's fixed subscriber losses have increased sequentially each quarter since 4Q14 and their November 12th presentation at the Morgan Stanley (MS) conference highlighted a 41% decrease in incoming customer service calls in Israel in September - however the ~3 week Jewish holiday period started on September 13th this year, but on September

24th last year, making for a very easy comparison this year. French B2C mobile and fixed bases have also eroded throughout 2015. Israel's and France's issues raise concerns for other assets, particularly for Altice's latest acquisition, U.S.-based Cablevision.

Following the rejection of a stunning 14x EBITDA bid for French rival Bouygues in June 2015, Altice turned to the U.S. and announced it was buying Cablevision for 10x EBITDA. Coming on the heels of 4 major acquisitions in less than two years and facing challenging headwinds with management spread too thin, we believe that this acquisition could be the last straw. While there is likely to be some low-hanging fruit, Altice's cost-cutting target of $900m for Cablevision appears extremely lofty, especially considering the high single-digit increase in content costs per year. Cablevision (CVC) also faces intense competition from Verizon (V), which has a fiber network and mobile/triple play offering. We simply don't believe that Cablevision can effectively compete against Verizon and other competitors while slashing headcount and undermining customer service.

(click to enlarge)

One only needs to look at France and Israel to see what happened to the subscriber base once Altice took over. Furthermore, if Cablevision debt continues to trade at current levels, over time Altice will face difficulties covering interest payments. The bond market appears to share this view, having forced Altice to scale back its September 25 bond offering and pay more attractive yields to secure Cablevision financing. A subsequent equity raise for the deal also fell short of Altice's expectations.

We said at the Sohn Conference in Tel Aviv when the stock was trading just below €20 that it was worth ~50% less. Historically, European telcos have traded at a 5.8x EBITDA multiple. A recent rerating in the sector, which we attribute partially to Altice's overpayment for assets, seems unwarranted given the structural headwinds facing the industry. On what we consider to be generous multiples above the historical average, paired with a 15% holding company discount, we derive a fair value for Altice of €10 per share. Considering that holding companies typically trade on a discount of 10-30%, we find a 15% discount appropriate.

In our opinion, Altice's business model is to use cheap debt to fuel a buying spree and then slash costs in their assets to boost margins. We believe that this model is being thrown into doubt. We question Altice's track record of EBITDA improvement and ability to really cut costs to reach synergy targets, and in light of this, we are cynical that the lofty targets for Cablevision can be met. In our view, Altice is significantly overvalued and shares are worth €10. Debt also appears expensive, considering long-term (2024) bonds yield just 7.3% on a structure that is highly levered throughout: Altice Europe and Altice U.S. have 4.6x and 7-7.5x net debt/EBITDA, respectively. Additional highly levered acquisitions or any impairment to free cash flow through higher capex or a failure to reduce opex would be a negative event for bondholders.

Disclaimer: This report represents ION's analysis and opinions, and is based on publicly available market information and regulatory filings by Altice. This is not an offer to buy or sell securities of Altice, nor should it be taken as advice on whether to purchase or sell securities of Altice. ION may have positions, short or long, in the companies discussed in this presentation. For further information, we encourage readers to review Altice's publicly available filings.

See also Vince - Very Risky But Potentially Lucrative Turnaround Candidate on seekingalpha.com

This article appears in: Investing Stocks

Referenced Stocks: ATSVF , ATCEY , VRX , MS , CVC

More from SeekingAlpha

- **Quantum Computers: The Emerging**
- **Alacer Gold: High Risk, Insufficient Reward**

Technology That Will Revolutionize The World

- Hovnanian Enterprises Is Worth A Look

Trending Stories

Coffee Is Still Hot, and This Shop Was Tops in 2015 (Hint: It's N

The Yield Curve Says No Recession

Instant Analysis: GoPro Inc. Faces Class Action Lawsuit Threat

Skyworks Solutions Inc. Manufactures Another Solid Quarter

Will Roper Technologies (ROP) Q4 Earnings Beat Estimates?

Related Stocks Articles   Subscribe

- The Bear Case for Apollo Investment and PennantPark Investment
  2/03/2016 01:09 PM
- Why Shares of IMAX Corporation Plunged in January
  2/03/2016 01:00 PM
- Mattress Firm Poised to Grow With Acquisitions
  2/03/2016 12:52 PM