The Outlook for Cable Stocks

MSOs Seen As Surpassing Satellite In Key ROIC Metric

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TakeAway

While cable stocks have quieted down in the wake of the Comcast/TWC merger announcement, the sector's return on investment capital is expected to outperform the satellite sector by 2017.

After an unprecedented run over the past several years, fueled mainly by deal speculation, cable stocks have begun to pull back in the wake of the Comcast/Time Warner Cable merger announcement.

But as the consolidation frenzy has died down, some believe the sector still has room for growth, based on a return to fundamentals.

In a 104-page report, Moffett Nathanson principal and senior analyst Craig Moffett detailed how cable is providing strong returns on invested capital (ROIC). And though the satellite sector was in front by a wide margin in 2013, the picture should change dramatically over the next three years.

Strong broadband growth and improving video customer losses will help cable operators edge out satellite companies in terms of ROIC by 2017, the report said.

"The question mark here is regulatory," Moffett wrote. "The past 10 years have been about the capital markets figuring out that cable's infrastructure is dominant. The next 10 years will be about Washington figuring out that cable's infrastructure is dominant."

ROIC is a fairly simple calculation — net operating profit less adjusted taxes divided by total invested capital, or the money needed to run the business.

Basically, ROIC shows just how much investors get back for every dollar a company spends on capex. So a company with a 35% ROIC basically gives investors back 35 cents for every dollar spent on capital expenditures.

The satellite sector — mainly DirecTV and Dish Network — had an industry-average ROIC of 33.4% last year, well ahead of cable's 19%, according to Moffett. The gap is a bit narrower when Comcast's NBC Universal programming arm is taken out of the mix; without NBCU, the cable sector ROIC in 2013 was about 24.5%.

The satellite sector also came out on top in terms of individual company performance. DirecTV's ROIC was 36.9% in 2013, and Dish was close behind with a 27.3% ROIC.

In the cable sector, Comcast (minus NBC Universal) led its competitors on a ROIC basis — 32.6%, according to Moffett, followed by TWC (19.9%), Cablevision (15.4%) and Charter (14.5%).

While ROIC valuations are nothing new, they have taken a back seat to other valuation metrics as a growing deal frenzy swept the stocks over the past two years.

The four publicly traded cable operators gained 116% in value between Dec. 30, 2011, and Dec. 31, 2013, a run that was characterized primarily by a belief that the industry was poised for another round of consolidation. But that run has tapered off in the weeks following No. 1 MSO Comcast's $69 billion offer for No. 2 Time Warner Cable. Cable stocks have fallen about 8% since the Feb. 13 announcement, and Moffett said he believes now is the time for investors to focus on fundamentals.

"Judging by the performance of Charter and Cablevision post the Comcast/TWC deal, I would say the air has come out of the M&A balloon," said Pivotal Research principal and senior media & communications analyst Jeff Wlodarczak. Those stocks are down 14.2% and 4.4%, respectively, since Feb. 13. Although M&A can't be totally written out of valuations, Wlodarczak

added that he believes investors “will start to focus on fundamentals,” especially at Charter.

Noting that because falling equipment costs, added efficiencies from upgraded plant and the movement of functionality to the cloud have lowered capital costs, Wlodarczak said, “I would argue, despite rising programming costs, that returns are getting better.”

But he added it is important to view those returns in context: “For example, Charter is in investment/RGU growth mode, so they are likely to temporarily look worse.”

Moffett agreed, adding that it makes sense that a company in the early growth stages would have a depressed ROIC.

“If [Charter’s] plan works as promised, their ROIC should rise nicely over the next few years,” Moffett said in an email message.

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