ON BEYOND INVESTING

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The 411 on Rural Telecom Stocks

In this issue, I discuss three rural telecom stocks, LICT Corp (ticker: LICT), Otelco Inc. (ticker OTEL), and Nuvera (ticker: NUVR). The valuations of these companies, and the regulatory changes in their industry, make them compelling investments.

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Rural telecom companies are interesting because they are in the midst of a transition, and the market does not know how to value that (or the market is just not paying attention to this 'boring' industry). With the US government's help, these companies are transforming from rural telephone providers to rural broadband companies. Their old business was copper cable that provided telephone, internet, and cable TV to their residential and business customers. Their new business is fiber, which can provide the same services but at speeds the modern internet requires. Providing fiber to rural areas is expensive, but the US government has a new program called A-CAM (Alternative Connect America Model), which pays rural telephone companies to provide fiber to their customers. (Note: A-CAM may not be the only program the government uses to provide rural broadband. Another bill that would provide $5bil in funding was just announced). Providing a fiber network is much cheaper if phone lines are already in place, so rural telephone companies are the ideal ones to connect rural America to the internet. Fiber should also be good business for these companies, as it is unlikely that competition comes to these rural areas.

An investor looking at companies in the rural telephone (otherwise known as rural local exchange carrier, RLEC for short) space has a few questions to consider: How fast is the old business declining? What is the potential of the new business? Does the company have a strong balance sheet, and enough cashflow to fund this transition? Finally, an investor must consider management's ability to juggle their varying capital allocation options; maintenance of old business, fiber investments, debt reduction, and returning capital to shareholders. It is also worth considering if the management, who were telephone specialists, are qualified to lead these new broadband-focused companies.

An investor also has to consider how to value these companies that now combine shrinking and growing cash flows. My assertion is that LICT, OTEL, and NUVR are all worth a lot more than the 5x to 6x EV/EBITDA multiples that they are currently trading at.

When considering multiples for the old business you have to keep in mind that this business is declining but it is not going to 0. Many parts of society will always require phone lines, like hospitals, and thus will need the phone network that supports it. Rural areas will also still want phone lines as a back-up communication system when the power is out. While phone line usage is down, and will decline, this will

be a long-lived asset that should provide cashflows for many years to come.

The fiber business is worth a high multiple, in my opinion. Rural fiber networks will provide an essential service, with very little competition. This should also be an area of growth for many years to come, as there are large parts of the country that have a need for these services. While the return on capital may be low for areas that lack population density, this is somewhat offset by the A-CAM payments these businesses will receive. In this report, I use a 10x multiple of what I think the future fiber cashflows will be to value this part of their business. This is a very conservative valuation approach.

The multiples used for valuation also have to consider the balance sheet risk of each company. A declining business without debt is fine. But if a company is seeing declining revenues, and it has a large amount of debt, that can be fatal. On this note, it isn't a coincidence that the company with the worst balance sheet, OTEL, also has the highest proportion of its business in decline. In order to manage this transition from phone line to fiber broadband, companies need the financial flexibility to be able to invest in the future while still maintaining their old business.

To summarize my overall view, the RLEC space offers a great investment opportunity. All companies offer large potential upside, with varying degrees of risk. LICT is the safest investment, and it could still see returns of over 100% over the next 5 years. NUVR offers even higher returns, and I would consider it to be a relatively low-risk investment. OTEL, which I have discussed a lot in past issues, is riskier than I initially thought. Their older business is declining quicker than expected, their new business requires greater upfront investments, and as a result they are not reducing debt as I had previously expected. OTEL could be a homerun, but their new business investments need to work out, or they need to de-risk their balance sheet. Read on for detailed analyses of all three of these potential investments!

Updates

Tesla

Tesla (ticker: TSLA) proved me wrong when it successfully raised $2.2bil of capital on very attractive terms in May. While this raise proved the company could access capital, I still have so many unanswered questions. If it was so easy for them to raise capital, why didn't they do it sooner at much higher stock prices? Why close stores and have public spats with suppliers, when they could have just raised money and used the proceeds to fix both situations? Why did Elon engage in seemingly desperate money raising strategies, such as the Model Y announcement, and promote the nonsensical robotaxi business pivot, when he could have just tapped public markets?

While I don't understand the company's financing strategy, it can't be denied that this raise significantly reduces the company's bankruptcy risk.

Currently, the market is focusing on the company's record sales. Selling more product is generally a good thing, but it may not be if margins were sacrificed to do so. The real question investors need to ask is: were those sales profitable? I think the company likely lost money in Q2, despite the larger than expected volume of sales.

This begs the question: if a company cannot breakeven on their best volume sales quarter ever, what does that say for the longer term viability of that company? Perhaps I will be proven wrong again, but I think the financial results for Q2 and Q3 will show that Tesla is a structurally unprofitable business.

Disclosure: short TSLA

Polaris Infrastructure

While June was a busy month for me, I did duck out for a couple hours to attend the Polaris Infrastructure (ticker: PIF) annual meeting in Toronto. The meeting was very interesting and I was glad I attended.

The first thing PIF's CEO, Marc Murnaghan, addressed was the political risks the company faces in Nicaragua. He was reasonably constructive about the Nicaraguan political situation. He thought that there is a good chance elections will be held in 2020, and if not, then at least by November 2021. Elections would go a long way to quieting the political situation in Nicaragua. That said, the company does not plan to invest anything in that country until things are more certain. When that time comes, PIF will likely build a binary unit that costs $20mil to $25mil and would return up to $10mil in cash per year.

The other operational note was that he expected their Peruvian hydro assets to be operational by the end of October 2019. He also noted that the riskiest parts of the construction of those projects have already been completed. This is excellent news! PIF is only a few months away from substantially diversifying their operations.

The most interesting part of the meeting for me was gaining a better understanding of the capital allocation mindset of Mr. Murnaghan. He struck me as smart and pragmatic. A good example of this was his attitude towards future geothermal projects. His view was that to get a $100mil geothermal project financed by a bank, they'd have to spend about $30mil to prove the project was viable. A similar sized wind, solar, or hydro project would only require an upfront spend of $500k to $2mil before they would be financeable. He felt that the risk-reward was just not interesting enough. In general, Mr. Murnaghan wants his company to be the provider of capital when it is desperately needed. He is looking for more deals like the recent Peruvian hydro deal, where the project is mostly complete, the development has been de-risked, but the owners have run out of money. Apparently, this is a situation he says happens quite a lot in Central America, and he is evaluating many deals like this.

Mr. Murnaghan's perspectives on renewable energy development projects have been shaped by PIF's long history. It is not lost on him that it was the third owners of the San Jacinto geothermal plant that made money, the previous owners lost all their capital in the early stages of the project. From that perspective, it is not really worth valuing PIF based on its project pipeline. I got the sense that Mr. Murnaghan would much rather invest in project deals, under the criteria mentioned above, then try to develop from scratch. He said that returns from both sorts of investments were similar, in the 15% range, but new investments would likely be online quicker than internal development projects, and thus much more attractive from a return on capital perspective.

The goals of the company are to continue to diversify, improve the company's access to capital, and use their capital to opportunistically reinvest. One should view PIF as a renewable energy investment company - an undervalued one at that. I still think fair value is north of $20 per share, versus the current price of $15.25.

On this note, you may have noticed that the shares have rallied nicely over the past 6 months. The CEO's view was that the marketing of their convertible bond deal, which he expects to be cashflow neutral and will provide funds to be used for new deals, introduced them to a lot of institutional investors that were previously unaware of the company. The bid from these new institutional investors likely explains the share price appreciation.

Disclosure: long PIF

Genworth MI Canada

As I had anticipated, the never-ending merger saga of Genworth Financial (ticker: GNW) and China Oceanwide Holdings Group is forcing GNW to sell its 57.1% interest in Genworth MI Canada (ticker: MIC). I had thought that financial pressure could force GNW to sell its MIC stake. In this case, it appears that Canadian regulators were not comfortable, and rightly so, with China Oceanwide owning one of the country's three mortgage insurers.

Under the merger agreement GNW has until November 30th, 2019 to sell its MIC stake.

Weirdly, or should I say in typical Canadian fashion, MIC shares rose 7% on what seemed like obviously bad news. While bullish investors may make the case that a controlling stake in MIC is worth more than book value (the stock now trades at 0.96x book), I certainly don't agree. Given the slowdown in MIC's

insurance writing, the fact that it has already recognized most of the revenue from its insurance book, and the lack of capital on its balance sheet, I would be very surprised if GWN can find a buyer ~~dumb enough~~ willing to spend $2.25bil that would not spot such obvious issues in the due diligence process.

GNW in this instance is a forced seller; if they can't sell MIC then the merger, and possibly the company, will fail (GNW's long-term-care insurance book is a disaster and arguably severely under reserved). If the deal closes, GNW's CEO will receive $16.4mil and the five highest paid executives at GNW will receive a combined $53.2mil. If GNW's MIC stake is the last thing separating these executives from huge pay days, I don't expect them to be particularly price sensitive when selling. That is, if they can sell…

Disclosure: Short MIC

Permanent TSB

There has been some bad macro news for Permanent TSB (ticker: IL0A) lately. To start, it looks like the ECB will be lead by former IMF president, Christine Lagarde. This is disappointing news. She is very likely to run the ECB in the exact same manner as her predecessor, Mario Draghi. In previous speeches, Ms. Lagarde has said that things would be much worse if the ECB had not cut rates into negative territory, despite the impact that has had on European banks. Ms. Lagarde has also stated in the past that she is a big fan of quantitative easing. In a more recent speech given on June 5th, 2019, Ms. Lagarde said that the next downturn will require 'decisive monetary easing'. You can read more about her views in this Financial Post article. I find her appointment to be disappointing on two levels: first,I think negative interest rates and excessive monetary easing are the wrong approach for the economy and are very damaging for society. Second, her appointment suggests that PTSB will continue to receive very meager payments from their vast holdings of floating-rate 'tracker' mortgages that would earn them significantly more money if interest rates went up.

The other bad news is that Boris Johnson is very likely to be the next UK Prime Minister. Mr. Johnson has stated in the past that he would be willing to allow the UK to exit the EU without a deal. The new Brexit deadline in October is rapidly approaching, so his hard brexit statement may be put to the test. The risk of a 'hard brexit' is an overhang for stocks that the market thinks have significant sensitivity to such an outcome, e.g., PTSB (which I would point out has no direct loan exposure to the UK).

While my long-term thesis has not changed, my hope that PTSB would benefit in the short term from higher short-term rates in Europe seems to be gone. In the short-term, it is unlikely that PTSB rallies from here despite the stock's huge long-term potential.

Disclosure: long IL0A

Asta Funding

There was some interesting news out of Asta Funding (ticker: ASFI) this month. The company announced stock buybacks under a 10b5-1 plan, and the stock rallied significantly. As a bit of background, a 10b5-1 plan is typically used by executives that want to sell stock in the company they work for. Under these plans a schedule for future stock sales is laid out, and the plan is then automatically exercised. These plans are done so executives don't actively manage their stock sales and thus don't run into any inside information issues when transacting.

There was confusion when ASFI first announced this deal. Since 10b5-1 plans are almost exclusively used for executive stock sales most investors assumed that the executives were selling into the company's buyback plan (which would be an ethically questionable move). Instead, the 10b5-1 is just about the company's plans to systematically repurchase up to $10.5mil worth of shares.

This is an interesting sign that management and shareholders are now aligned at ASFI, as I had speculated in the V3N2 issue. Repurchasing almost 20% of the company's shares would increase management's ownership, meaning they will get more of the company's cash when they decide to dividend it out.

This information is perhaps more interesting from an academic perspective than from a future return

perspective. Currently the shares are trading at ~$7.50 per share. The company has current assets of ~$7.55 per fully diluted share. The company has another $1.25 of operating assets, but it also has ongoing operating costs that need to be paid. Management has 728k stock options with a $8.16 strike price. They may attempt to buyback enough shares to be sure those options end up in the money. With that information in mind, I think fair value for these shares is somewhere in the $7.50 to $8.20 range, and thus there is not that much upside from here.

Vestas

There was mixed news from the Vestas Q1 2019 earnings report. EBIT (earnings before interest and taxes) margins were very weak at just 2.5%. This is well below the expected 2019 range of 8% to 10%, which the company still guided to. The company explained that weak margins were from transactions agreed to during the price wars faced by the wind power sector in 2018 that are now hitting Vestas' financials. While this may be true, this was not really communicated during the investor day I attended in December, when the company talked of being through the worst of the pricing war. Offsetting this bad news was a 31% jump in the company's order book to €28.3bil.

The other surprising news was that Vestas' CEO, Anders Runevad, stepped down as CEO. Mr. Runevad will be replaced by Vestas board member, Henrik Andersen. Mr. Andersen was CEO of Hempel A/S, a coating manufacturer for marine vessels. Mr. Andersen has been CEO of Hempel for the last 3 years. During his time as CEO sales fell by 5% and EBITDA dropped by 23%. I view this management change as very bad news. When Mr. Runevad joined Vestas the company was on the verge of bankruptcy; now it is the global leader in the wind turbine market. I don't see how replacing him with a person that has no experience in the wind industry and a questionable track record, can be viewed as a positive.

With the stock trading at expensive levels, I am considering selling some of my shares.

Disclosure: long Vestas

Interesting News

If you recall, my favourite investment idea from the Ira Sohn conference that I attended in April 2018 was shorting the credit of Rallye, a holding company that was a majority holder of Groupe Casino, via credit default swaps (CDS) (see issue V2N4). This was not a trade a retail investor could do, but it was very compelling. The investment turned out to be a spectacular success, as Rallye recently entered safeguard proceedings. A CDS buyer earned a return of ~625%, depending on the duration of the contract, and the stock is down ~60%.

An interesting part of this story is that Muddy Waters, an activist short hedge fund, wrote some very bearish pieces about Rallye and its main asset, Groupe Casino, in December 2015. Despite being right, Muddy Waters was viciously attacked in the French press and French regulators started investigating Muddy Waters, rather than investigate the red flags they uncovered at Rallye.

Regulators, not paying attention to the warnings of critics, allowed Rallye to continue operating as it had, and more value was destroyed and jobs were lost as a result. This is unfortunately an all too common story these days. Critics are silenced by the powerful people they are examining and negative information is quickly swept under the rug.

Web Stuff

- *Against the Rules*

Michael Lewis has put out a really interesting podcast series called "Against the Rules". The series explores the death of 'referees' in society. By referee Mr. Lewis means rulekeepers - regulators being a good example. Like everything Mr. Lewis does, the podcast series is fantastic and very interesting. I highly recommend it.

IDEA 1: Lict Corp (Revisited)

Lict Corp | LICT			
Share price:	$16,450	P/E:	11.6x
Market cap:	$329mil	P/B:	2.3x

An investment in Lict Corp (ticker: LICT) is still very compelling. LICT is a an example of the benefits of good management, low debt, and strong capital allocation. Using that formula the company's stock has produced annualized returns of 16.7% since 1985. That return is especially impressive considering how undervalued the stock currently is.

The future for LICT is bright, despite some risks. It's old business lines have seen minimal declines. It will receive large A-CAM payments for the next 11 years, and it has been early in deploying fiber in rural areas. The risk with LICT, other than the illiquidity of the stock which will get worse as the company continues to repurchase shares, is that the CEO and CFO are retiring.

Old Business

LICT's old telephone business line is only seeing small declines. LICT's telephone revenues are declining by ~3.8%, but they are only 6% of total revenues. Being in areas with growing populations, and investing in products that cater to businesses (whose phone line use has been more sticky), LICT has mitigated a lot of the declies its peers are seeing.

LICT has been able to achieve these results by having low levels of debt and by intelligently reinvesting their cash. Since 2012, LICT has been levered less than 2x (net debt divided by EBITDA), and every year they have substantially decreased leverage. They are now at ~0x level, while at the same time investing heavily in their operations. This has been a huge advantage for LICT (as opposed to OTEL, which could only spend money on debt reduction). They have had the financial flexibility to invest in their old business lines to reduce the decline, and they have been able to accelerate the fiber investments where they now have deployed 4,700 miles of fiber.

The value of LICT's old business is still not easy to precisely value. However, in a world where Private Equity (PE) is paying north of 11x EV/EBITDA for companies, it is hard to see the cashflows from LICT's old business, which are only declining minimally, being worth less than 9x.

A-CAM

LICT was well positioned for the A-CAM program. They will receive $30.8mil annually in A-CAM payments for the next 11 years (until 2030). This huge, stable source of cashflow will allow the company to invest heavily in rural broadband. Since the company has no debt, there are no constraints on these investments, and the company has a strong track record of intelligent investments.

To get a sense for what the new broadband business could be worth, let's make a few assumptions. LICT will be required to provide broadband to 27k dwellings by 2030. If you assume 70% of customers sign-up (known as penetration rate), a monthly charge per dwelling of $65 (the average cost of internet in the USA, arguably too low for this fiber offering), and margins of 80%, that would imply LICT would see additional cashflows of $12mil per year! While 80% margins may seem high, broadband margins are typically high and LICT already has the billing systems and staff in place.

Debt

LICT currently has only $2.1mil of net debt - a tiny fraction of the company's yearly EBITDA of ~$58mil. LICT's debt is even lower when you consider the company has various investments that I estimate are worth $50mil.

Leverage this low is unusual for a company with such stable, consistent cashflows. Typically, a small amount of leverage is healthy for such a company, and it would increase shareholder returns.

LICT could do something interesting with their financial flexibility; they could purchase another RLEC and expedite the acquired company's A-CAM investments. Originally, I thought they would buy OTEL for exactly this reason, but that doesn't appear likely now. LICT could also borrow up to $87mil, taking leverage up to ~1.5x, to tender for ~25% of

the company's shares, or pay a large one-time dividend of 25%.

An interesting use of cash recently has been the company's acquisition of spectrum licenses. They bought a total of 57 licences in the recent FCC (federal communications commission) auction.

Valuation

If you take into account the value of LICT's investment assets, the shares are trading at ~5x EV/EBITDA. That is far too low for a safe company with stable long-dated assets. While there is some decline in the old telephone business, the company is growing, and the lack of debt make this company attractive to a Private Equity buyer that could lever up their balance sheet to buy the company. As a result, I think it should be worth at least 9x EV/EBITDA, or $28,900 per share.

Adding the new fiber assets, which could be worth $120mil (10x the yearly cashflow of $12mil) over the next 5 years, would add an additional $6,100 per share. LICT could easily double in price over the next 5 years and it could do even better if the company accelerates their buyback program, or pays a large one-time special dividend.

Risks

Of course there are some risks here. The biggest risk is that the company does not have a full-time CEO. The current CEO, billionaire investor Mario Gabelli, has stepped down and the company has not found a replacement. Their CFO also retired. While I would prefer management continuity, I don't think this is too much of a risk. Mr. Gabellis still owns ~45% of the shares outstanding, and he is leading the CEO search. I would also point out that LICT's business, like OTEL's, has changed from being a telephone company to being a broadband company. Getting a new CEO that is a broadband expert would likely be a positive addition for LICT.

Conclusion

LICT is a rare investment opportunity. It is safe and cheap. I think an investor could easily see appreciation to over $35k per share over the next 5 years, possibly higher if the share price remains low and the company continues to aggressively repurchase shares.

The issue is of course the illiquidity, and the high price per share of over $16k. But for those patient and willing to accept illiquidity, this is a good investment.

Disclosure: long LICT

IDEA 2: Otelco (revisited)

Otelco | OTEL			
Share price:	$14.40	P/E:	5.6x
Market cap:	$49mil	P/B:	3.8x

Otelco (ticker: OTEL) is a stock that I have been enthusiastic about for a while now. My initial thesis, however, has proven to be somewhat wrong. Initially, I thought that OTEL stock was safe, undervalued, and had huge upside. I still believe the company is undervalued, and if things go right, it has a very large upside. It is, however, riskier than I first thought.

The risk with OTEL is the combination of modest leverage (~2.7x debt to EBTIDA) and declining revenues. Originally, I thought that OTEL would use its cashflows to pay down debt, de-risking the company and my investment. That is now changing. With a new CEO, the company has elected to aggressively invest. The company recently announced a capex spend of $5mil in Alabama to increase the speed of its current internet offerings and to deploy fiber. This spend should help mitigate the revenue declines, which are happening a bit quicker than I expected. However, this capex investment may not pay off, in which case the debt will become more of an issue.

I still like OTEL, but it is risky.

Old business

Like the rest of the phone industry, OTEL's phone line business is declining. The bigger issue is that the

rest of OTEL's legacy businesses may also be declining.

OTEL's internet revenues have declined so far in 2019, and that has caused some concern in the stock market. While the phone line declines were expected, it was the internet results that concerned investors. If you were to annualize OTEL's internet performance in 2019 it would show a decline of ~4% year-over-year, and a 3.5% annualized decline over the past two years. This is obviously concerning as investors were expecting the recent fiber investments to grow this business line. If you accept the fact that the legacy internet will continue to decline you could make the argument that 68% of OTEL's revenues were in decline! This is a much larger percentage of revenues at risk than its peers, LICT at 6%, and NUVR at 11%.

I think the internet decline needs some additional perspective. Yes, the internet has declined over the past 3 years, but it is still roughly flat to where it was in 2015. So extrapolating the Q1 2019 results, which seemed worse than expected, may not be correct. It may well be true that their legacy internet business is declining at an alarming rate, but it is too soon to be definitively sure about that.

Whether or not the decline in legacy internet operations is a big concern or not is unclear, but it is clear that new management is very focused on improving those legacy internet offerings to offset decline. In a recent blog post, OTEL stated that the company had been too focused on providing new fiber, partly due to A-CAM requirements, and not focused enough on its current customers. As a result, the company is investing money to increase the speed of its traditional DSL internet, and its cable TV offerings. The plans to improve in Alabama, and the stepping down of the executive that oversaw the Alabama operations (he was also the HR executive), is likely no coincidence.

Spending money to retain customers is a lot easier than gaining new ones, but it does raise a number of questions. How bad is their offering now? Are they more concerned with declining internet revenues than they have previously communicated? We don't know the answers to those questions yet, but we do know that improving existing internet offerings will require additional capex. This is capex that was previously deferred in order to pay down debt. It is risky to invest and hope it produces enough to repay your debt, but it is equally risky to not spend this money to retain customers. Having to make this choice between two risky options is a consequence of excess debt.

A-CAM

The amount of A-CAM funding OTEL should receive is offsetting some of the legacy business issues. The company will receive $17.2mil per year for the next 11 years!

The company will also receive additional government funding bringing the total to ~$23.4mil. Government funding should decrease over time, but I think it will only decline by ~$300k per year. OTEL's phone line network should still receive some type of government funding even after A-CAM is finished. Even in a mostly wireless world, there will still be the need for a fully functioning national phone network.

The A-CAM money does come with some strings attached. As a result of this funding OTEL is expected to provide internet access to ~13k homes by 2030. The company has to weigh how to spend their capex to generate the highest returns while meeting that obligation. Given the rural nature of these dwellings, not all of those customers will be profitable to connect. However, OTEL does have some advantages on this front. It is estimated that it costs $15k to $18k per mile to build a fiber network on an existing copper network. It costs $25k to $35k per mile if an original network is not in place. This gives OTEL a big advantage in building out their rural fiber networks, and should ensure that not much competition would be forthcoming.

Fulfilling A-CAM is part of the reason for the announcement that they will spend $5mil in Alabama, $4mil of which will be on fiber. This raises OTEL's capex spend to over $9mil this year. This advanced capex spend is part of the company's new plan to meet 40% of the 13k dwellings they are obligated to connect by 2020 - well before the 2030 target date.

New business

The new broadband business that OTEL is building up is potentially very valuable. If we make the same assumptions we did with LICT (i.e., 70% penetration rate, $65 per month, and 80% margins), OTEL could be earning $5.5mil in additional cashflows! These cashflows alone would more than justify the company's current market cap of $50mil.

OTEL's new CEO, Richard Clark, has built fiber networks in the past. He had great success building, and selling, such networks when he was the CFO of Firstlight Fiber. If you listen to Mr. Clark it is clear that he brings an analytical, data driven, approach to network building.

OTEL's results from their fiber deployment so far have been very poor. The company has only signed up 30% of the dwellings their fiber network passes. This could be attributable to a lack of marketing spend given the company's focus on debt reduction, or it could mean poor execution or competition. An increase in capex spending, rather than debt reduction, means that their fiber efforts have to be a lot more successful if the company is going to have sufficient cashflow to pay down their debt in the future.

I should also note that OTEL has another interesting business initiative called CAF II funding. This program helps smaller towns fund fiber connections, as governments pay a portion of the money to install a network. These programs are small, but generally quite successful as they have a very high percentage of customers sign-up for such services. OTEL has 3 such programs ongoing and this should also help slow down declining revenue trends.

Debt

OTEL has debt, net of cash, totalling $68mil. This debt costs OTEL ~6.3% (it is 3 month libor + 400bs). The debt has an amortization schedule that requires the company to pay $4.4mil of principle per year.

While the company has done an admirable job of paying down debt, which was north of $100mil in 2016, the cost of reducing debt has been a lack of ongoing investment in their business. This lack of investment is now showing up in declining revenues and requires advanced capex spending now to make up for it.

The current leverage of OTEL is ~2.83x (debt divided by EBITDA), assuming EBITDA will be $24mil (some project EBITDA of more than $25mil, which would reduce leverage to below 2.7x). That level of debt does not seem awful, however it is elevated for a company that has declining revenues. If you assume that future revenue declines are at the same pace as they are now, take into account that cashflows will drop as margins compress given the fixed cost nature of the business, and note that OTEL will paydown $4.4mil of debt per year, a financial model will show that the company will still be ~2.8x levered 5 years in the future. Unless the company can generate solid returns from the capex program, the company will not be able to deleverage.

There are reasons to believe that the company could find other ways to de-lever. A debt reduction, even at a cost of some dilution, would seem to benefit all the major stakeholders. Shareholders could see their stock price appreciate, even with the dilution, as OTEL's heavily discounted multiple of 5x EV/EBITDA increases to be closer to peers at more than 6x. The new CEO would benefit as he would have more room to invest, and less balance sheet pressure to worry about. A transaction like this may even allow the company to save money by refinancing their debt at a lower interest rate. I think a move like this makes a tonne of sense. If you recall from the shareholder survey that I sponsored in the fall, shareholders were very interested in reducing risk. Such a plan would align with those wishes. This is an idea I am exploring in further detail - please reach out to me if you want to be involved or have any thoughts of your own.

Valuation

Currently OTEL is trading at an EV/EBITDA multiple of 4.9x. That is well below its peers NUVR at 6.4x and LICT at ~6x (if you assume a liquidity discount of 20%, it is trading at 5x). All of these companies trade well below the market's EV/EBITDA multiple, which is north of 12x, and well below the multiples that Private Equity (PE) companies traditionally pay for

businesses, 10x.

A multiple below 5x is certainly too low, but if the debt is not reduced it may be an appropriate multiple for OTEL's current businesses. Without reducing debt, and facing revenue declines, my model shows that the company could be trading at the same price 5 years into the future.

However, you also have to consider the new business, which could be worth more than OTEL's total market cap in 5 years. This promising future value deserves a good deal of discount as, so far, the company's fiber efforts have been poor. Whether OTEL has enough current cashflows to fund their more aggressive capex plans is another important consideration.

As I see it, the stock price could be flat for the next 5 years, or more, if the new initiatives provide no benefit. The stock could easily double if the fiber installations are successful. The stock will do really well if the company's capex spend on existing business lines reduces their current revenue declines. At this point it is hard to handicap which outcome is more likely. Some would argue the first, however I think it is still an interesting asymmetric investment and that it is much more likely that the company grows EBITDA through their various initiatives than shrinks it.

I would also, again, highlight that there could be some transaction that would dilute shareholders but de-risk the balance sheet, vastly increasing the probability that this investment works out.

Risk

There are two big risks to note. The first is obviously the risk presented by the company's current debt level. The second big risk is the company's ability to build, and market, their new fiber networks. The current CEO has had experience building out fiber networks, and he seems analytically inclined, but is he capable of marketing these networks to attract new customers? If OTEL's efforts to attract fiber customers continues to be terrible, then an investment in OTEL will be quite disappointing.

The other consideration is the combination of these risks. With higher debt levels than one would like, and an accelerated capex plan, will the company have enough capital left to invest in marketing?

Similarly, would they have enough capital to invest in marketing if these projects didn't see returns in the first couple of years?

Conclusion

An investment in OTEL is riskier than I first thought, but I am still cautiously optimistic. The increased capital spending which has a risky but promising payoff, is riskier than the previous plan that involved aggressively paying down debt. As a result, an investment now will only go well if the company can invest successfully. So far, I like the approach of the new CEO, and think that this has a reasonably good chance of success.

I am hopeful that there could be another option where some type of equity is issued to reduce debt, cut financing costs, and provide more capital for capital investment, while de-risking the investment.

Until such a deal is done, I will be watching this very closely to see the return on their capex spend. If revenues continue to decline, with no offset from fiber investment, this may be a candidate to sell. We shall see.

Disclosure: long OTEL

IDEA 3: Nuvera

Nuvera | NUVR			
Share price:	$19.35	P/E:	10.9x
Market cap:	$100mil	P/B:	1.3x

Nuvera (ticker: NUVR) may be considered the goldilocks of these three rural telco stocks. It offers investors a very good return, with less risk than OTEL, and it is more liquid than LICT.

This company is similar to the others in that it has an old telephone business that is declining, albeit modestly. It has also been investing for many years

in its video and broadband business lines, and these segments have been growing.

One difference is that NUVR recently acquired a company called Scott-Rice Telephone. This deal appears to have been a homerun. The attractive nature of this deal makes NUVR a very interesting investment opportunity.

NUVR does have its own idiosyncratic risks, such as management succession issues, but they also have some idiosyncratic benefits, likes its excellent acquisition of Scott-Rice Telephone Co. The resilient financial performance of NUVR against the backdrop of declines in its legacy business makes this a very interesting investment.

The Scott-Rice Deal

The most notable aspect of NUVR is its recent acquisition of Scott-Rice Telephone company, which closed in the second quarter of 2018.

This deal, so far, appears to be an incredible one. NUVR purchased Scott-Rice from Zayo Group holdings (ticker: ZAYO), a somewhat distressed seller at the time, for $42mil. According to the latest Q1 2019 report, NUVR paid ~4.6x earnings for the company! That multiple is based on the company's reported pro-forma numbers. For a sanity check, if you assume the difference in EBITDA from before the deal until now was a result of this transaction, the deal was at a ~5.2x multiple of EBITDA. Either multiple would suggest a very good price to pay for an acquisition. There is a chance the deal looks even better as Scott-Rice is within the NUVR geographic footprint in Minnesota and the financials thus far do not contain all of the cost-cutting opportunities of such a deal.

The deal gets even better when you consider that NUVR primarily financed the transaction with debt. Of the $42mil paid, $35mil was from the proceeds of debt. From a return on equity (ROE) point-of-view, NUVR is seeing returns north of 100%!

NUVR sees further benefits to the acquisition as they are increasing capex to boost the areas of the Scott-Rice business that were underinvested in by the previous owners.

Old business

Like its peers, OTEL and LICT, NUVR's old business lines are declining. The recent acquisition makes current comparisons difficult, but looking at the 4 years prior to the deal their existing phone business revenues were declining by 3.6% annually. While any decline is a source for concern, this line of business was 26% of revenues in 2014, but only 19% of revenues now.

A huge mitigating factor to these declines has been the growth of NUVR's video and broadband businesses. Using the 4 years prior to the deal, to keep the comparisons simple, NUVR's video business revenues grew by 5.4% annually, and its broadband business by 12% annually! This growth is interesting as it starkly contrasts the declines OTEL has seen. It is also interesting to note that NUVR has achieved growth in these areas despite building out much less fiber than OTEL; 1,611 miles of fiber have been installed currently by NUVR versus 2,204 miles by OTEL.

There are a couple of possible explanations for the divergent performances of OTEL and NUVR's video and data businesses. First, NUVR was not capital constrained and it was able to invest in its legacy business to not only reduce churn but also grow its products. Second, NUVR may have a much more dense customer base, which would require less fiber to be installed, or it may mean that NUVR faces less competition in its coverage areas than OTEL does.

While I am not certain what explains the differences, the fact that NUVR legacy businesses have performed much better than OTEL's can be seen in their different debt costs (libor + 325bps for NUVR vs libor plus 400bps for OTEL), and valuation differences (6.4x EV/EBITDA vs 4.9x for OTEL), despite overall leverage not being that different (2.1x for NUVR versus 2.7x for OTEL).

A-CAM

Like LICT and OTEL, NUVR is receiving significant A-CAM revenues. For the next 11 years NUVR will

receive ~$8.9mil annually.

Due to A-CAM, NUVR is required to provide connectivity to 8,303 dwellings. To estimate what this is worth we use the same assumptions we made for the other companies - 70% penetration rate, $65 per month, and 80% margins. Using these assumptions, A-CAM could provide NUVR an additional $3.6mil per year. Assigning a 10x multiple, this business could be worth $36mil.

Valuation

NUVR currently has a market cap of $98mil, net debt of $56mil, EBITDA of $27mil, and a free cashflow of ~$20mil. By almost any metric, EV/EBITDA of 5.8x, ~5x free cashflow, NUVR is very cheap. Considering that this company was growing EBITDA before the Scott-Rice transaction, you could argue that the legacy business should be valued at a multiple that is only a small discount to the market, say 9x EV/EBITDA, which would imply that NUVR is worth $184mil, or $35.84 per share (it would be $41 at a 10x EV/EBITDA multiple). This analysis does not take into account any cost savings or investment opportunities that the Scott-Rice deal could present. It also does not take into account that NUVR management could find another deal like Scott-Rice.

To the above valuation you could also add the upside from the A-CAM spend. As noted this could be worth as much as $36mil in 5 years' time ($3.6mil per year times a 10x multiple), or $7 per share. In total, NUVR could be worth more than $43 per share in 5 years' time.

Risks

There are risks with NUVR to highlight. One minor risk is the continued integration of Scott-Rice. So far the deal looks like a homerun, but if for whatever reason an issue was found, or revenues declined more than anticipated, the leveraged nature of this transaction could present NUVR with some issues. There is no evidence at all that this is a risk, but it is worth keeping in mind when you think of worst case scenarios.

The biggest risk with NUVR is management succession. The company is a very well-run company, and a lot of that is due to the CEO, Bill Otis, who has been with the company for the past 40 years. Mr. Otis is now retiring. While Mr. Otis is working until a successor can be found, and he will continue to serve on the board of directors after he retires, it is a significant risk to replace such a successful CEO.

It also begs the question, will the company be as successful allocating capital in the future as they were in the past?

Conclusion

NUVR is a really interesting investment. It is cheap, it should be safe, and it still has a lot of upside.

If the company can continue to grow its video and data business lines, while still investing in their A-CAM obligations, the multiple for this company should increase to a more market appropriate level, say 9x, than the depressed multiple at which it currently trades.

Disclosure: Long NUVR

Idea Summary - Prices as of July 12, 2019

Stock	Issue	Action	Initial Price	Current Price	Return
MIC	Feb 2017	Sell	37.54	44.65	⬇-18.9%
MCR	Feb 2017	Buy	2.13	3.93	⬆84.5%
KMI	Mar/Dec 2017	Buy	21.74	21.29	⬇-2.1%
WED	Mar 2017/Jun 2018	Buy	2.68	2.81	⬆4.9%
HCG	Apr 2017	Sell	19.25	22.06	⬇-14.6%
EQB	Apr 2017	Sell	61.99	74.64	⬇-20.4%
ILOA	Apr 2017	Buy	2.80	1.22	⬇-56.4%
MKP	May 2017	Sell	14.18	15.96	⬇-12.6%
CWB	May 2017	Sell	24.25	29.37	⬇-21.1%
CNTE*	June Email	Buy	74.50	47.2	⬇-24.6%
FIH	June 2017	Buy	15.98	13.07	⬇-18.2%
SYTE	June 2017	Buy	11.19	5.30	⬇-52.6%
CAR	July 2017	Sell	32.41	48.87	⬇-50.8%
BRK	July 2017	Buy	174.97	214.10	⬆22.4%
OSS	Aug 2017	Buy	0.225	0.66	⬆193.3%
EMGC	Aug 2017	Buy	0.43	0.20	⬇-53.3%
LB	Sept 2017	Buy	41.61	26.50	⬇-36.3%
BRE	Sept 2017	Sell	16.60	14.70	⬆11.4%
BABB	Nov 2017	Buy	0.67	0.79	⬆17.9%
EIF	Nov 2017	Sell	36.95	38.03	⬇-2.9%
VWS	Jan 2018	Buy	56.40	77.88	⬆37.1%
KML	Jan 2018	Buy	16.80	15.27	⬇-9.1%
OTEL	Feb 2018/Jun 2019	Buy	15.30	14.40	⬇-5.9%
LICT	Feb 2018/Jun 2019	Buy	11,300	16,450	⬆45.6%

3333:hk	Mar 2018	Sell	24.70	21.55	↑ 12.8%
0656:hk	Mar 2018	Sell	17.00	10.60	↑ 37.6%
SVI	May 2018	Sell	2.43	2.86	↓ -15.2%
CHTR	June 2018	Buy	293.21	414.31	↑ 41.3%
LBRDK	July 2018	Buy	75.67	108.49	↑ 43.4%
GLIBA	July 2018	Buy	46.35	64.60	↑ 39.4%
WXMN	Sept 2018	Buy	2.75	6.00	↑ 118.2%
PDN	Sept 2018	Buy	0.20	0.14	↓ -30.0%
FNDM	Oct 2018	Buy	2.95	2.74	↓ -7.1%
CCRK	Oct 2018	Buy	400	340	↓ -15.0%
KEWL	Oct 2018	Buy	79.80	69.50	↓ -12.9%
PIF	Nov 2018	Buy	9.94	15.25	↑ 53.4%
TFSL	Nov 2018	Buy	16.02	18.15	↑ 13.3%
CBK	Jan 2019	Buy	6.69	6.59	↓ -2.4%
ASFI	Feb 2019	Buy	4.96	7.54	↑ 52.0%
TSLA	Mar 2019	Sell	275.43	245.08	↑ 11.0%
WBC	April 2019	Sell	27.51	28.02	↓ -1.9%

*CNTE return includes dividend of $9 per share, KML include 3 for one split and $11.40 dividend

ABOUT

I have 12 years of experience as a trader on a Proprietary Credit trading desk in New York and Toronto and at hedge funds in Toronto. In that time, I traded and invested in all asset categories - bonds, derivatives and equities - globally. Wanting more freedom, I decided to focus on managing my own portfolio and investments. I enjoy reading, learning and thinking deeply about markets and investments. When not investing, I spend time with my wife and son in Toronto.

INVESTING STYLE

My investing style focuses on value; buying good companies well below fair value or finding mispriced securities with a lot more upside than downside. This approach is a disciplined one with a long-term focus. I am opportunistic and focus on areas of the market where recent volatility or apathy may create interesting investments.

CONTACT

I love discussing markets and investing ideas. Please reach out to me with any questions, comments, or thoughts on newsletter ideas or ideas of your own. Reach me at: tim@onbeyondinvesting.com

SUBSCRIPTION

Yearly Subscription Rate: $500 Cad (including GST).

A subscription includes 10 to 12 issues per year.

All issues will have two interesting and actionable investing ideas. Issues also include updates on companies, interesting articles I have been reading and general market musings.

The goal of the newsletter is to give readers a view of markets through the eyes of a portfolio manager. I aim to educate readers on how a portfolio manager approaches markets, evaluates companies, and thinks about investing. Investment ideas provided will reflect my value investing style.

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