Communications Sales & Leasing Inc (CSAL) $19.55 December 2015

Ticker:	CSAL	Current Price:	$19.55
Action:	Long	FD Market Cap (M)	$2,930
Expected Timeframe:	2-3 years	Enterprise Value(M):	$6,436
Target Allocation	2.5-4%	Target Price:	$32
Asset Class:	Common Equity	Investment Type	Value

Investment Overview/Background

Communications Sales & Leasing (CSAL) represents an attractive investment at current prices. Thanks to a confusing spin-off investors have run away from Windstream and CSAL over fears of too much leverage, a declining revenue base, and unclear corporate structure. Throw in a high-yield debt market that has begun to crack, single customer concentration and it should be no surprise that CSAL is down more than 30% since the spin.

This is an overreaction though and CSAL has the cash flow to support, and likely raise, the dividend. The agreement with Windstream is rock solid, and as long as investors can get comfortable with Windstream's trajectory and turnaround, there is little risk to CSAL's main source of cash flow. Outside of that, CSAL is looking to diversify their revenue stream and they have more than 100 potential deals in the pipeline right now. As deals are signed, customer concentration risk should wane and the market will likely re-rate CSAL from a distressed name selling as though it is a company on the verge of default, to a cash flow machine that will reward shareholders for years to come.

The spin-off of the properties, which became CSAL, took place in April 2015 and the goal was to reduce debt at Windstream parent and lower cost of capital through financial engineering. The stated goal was achieved as Windstream was able to reduce debt by $3.4 billion right after the spin, while maintaining a 20% stake in the CSAL spin.

While debt is reduced, Windstream swapped out debt/interest for lease payments. Further reduction of debt and continued focus on stabilizing revenues/margins is of utmost importance.

Windstream

Windstream's ability to stabilize the business is paramount to an investment in CSAL. Overall, the spin-off has been received poorly and investors were quick to sell a business like Windstream due to declining cash flows, poor communication, and a leveraged balance sheet. Peering under the hood though shows something different. While certainly not a growth name, Windstream shows stabilizing metrics, dedication to debt reduction, and a new management team that "gets it." The old management team was looking to grow their way out of revenue decline and expanded into a number of highly capital intensive segments.

The new management team is keeping things simpler. With all the carnage that has taken place in the debt and equity markets, management views opportunistic capital allocation as a top strategy. While this may seem obvious, it wasn't the case before. Simply put, Windstream is looking to reduce debt via asset sales (Data Center sales and CSAL stake), reduce interest expense by using secured debt capacity (lower cost of capital), and buying back shares. It is basic blocking and tackling.

Below is a quick overview of Windstream's segments and my expectations for revenue growth/decline.

Enterprise

The Enterprise segment is currently Windstream's best division, growing customers and margins at the same time. In 2014 Enterprise revenues were $1,886 million and I estimate that this segment will grow >4% in 2015. As of September 30, 2015, the Enterprise segment had more than 25,100 customers (ARPU of more than $75,000). The 3-5 year plan is to double margins, and while this will require some capital spending each year it should pay off quickly.

Consumer & Small Business-ILEC

This segment is under siege as large cable companies attack the historically sticky customer base. The largest decreases are occurring in voice-only segments, which have seen 16% declines in revenues during 2015, a trend that is largely consistent with past trends. Over the past five years or so, cable companies have expanded into regions that telcos, like Windstream, normally operated without significant competition. The increase in competition, and the general decline of land lines, has led to this segments decline. These expansions are largely done as the more populated areas, and thus higher-returning for cable companies, have seen the bulk of expansion. In the Q3 2015 10Q, Windstream notes "We do not expect significant additional cable expansions into our service areas during 2015, but we could experience some increased competition from high-speed Internet offerings of wireless competitors."

On a positive note, increased high-speed internet usage (especially in the rural areas Windstream operates in) is offsetting some of the voice-only decline. Also helping this division is bundled packages such as Windstream's Kinetic rollout. Net-net I believe this segment will see 2-5% revenue declines going forward largely from landline voice declines.

Small Business-CLEC

This is another segment that is shrinking. As of September 30, 2015 there were 108,900 Small Business CLEC customers, a 14.6% decrease from a year ago. Overall, revenue has matched the loss of customers and I have modeled in a 13-15% decline in revenues going forward, largely consistent with previous trends.

Regulatory & Other

The primary mover of this segment is the Universal Service Fund revenues and Connect America Fund revenue (CAF). The Connect America Funds are the largest contributors here, with CAF-1 and CAF-2 providing $95 million each of revenue. This revenue is spent immediately on capital expenditures. I have factored in zero growth/decline for this segment.

Capital Expenditures

While CapEx is not a segment per se, it is of tremendous concern to Windstream investors. According to a number of investors I have spoken with, the higher than expected capital expenditure guidance is concerning. The headline number masks a true figure that provides for both growth and maintenance expenditures. Management of Windstream provides capital expenditure guidance in their corporate presentation, details of which can be seen below.

Table 1. Capital Expenditure Guidance 2015

	CapEx ($mm)
Success Based	$165
CAF-1 broadband Investments	$95
Broadband (VDSL2+)	$50
Project WINterstate (Carrier Long-Haul Expansion	$35
Data Center Expansion	$35
IT Projects	$30
On-Net Expansion	$20
IPTV & Fiber to the Home	$20
CAF-2 broadband investments	$95
Total Strategic	$545
Maintenance	$420
Total Capital Expenditures	$965

Whether or not the Maintenance number is true does not matter. For this analysis, as it pertains to CSAL, I am only concerned with total cash capex. For 2015, the headline number expanded from $850 million to more than $965 million. For those worried about increasing capex spend, this >11% jump was a cause for concern. However, a few items drove the increase, the largest two were the Connect America Fund spend (CAF-1 and CAF-2). Both CAF-1 and 2 will see about $95 million of spend per year. This is reimbursed directly to Windstream. So while CAF spend is pushed through the capex line, the expenses are reimbursed dollar for dollar as revenue. This is, for all practical purposes, free money for Windstream to build out their network and provide better service to the 17% of their customers who rely on Windstream, and Windstream only, for high-speed internet and TV.

Windstream also announced the sale of their Data Center assets on October 19, 2015. While Windstream sold a segment that generated ~$41 million of OIBDA and more than $122 million of revenue on an annualized basis, the multiple of 14x OIBDA was clearly in the best interest of shareholders. The initial reaction was positive as investors believed that the vast majority of proceeds would be used to pay down debt. However, the Q3 2015 results indicated that management would use a portion of the proceeds to fund “Project Excel”. Investors likely saw this increase in capex as another sign of never-ending capex.

I believe that Project Excel will be of good use as it essentially pulls forward capex from 2017/2018/2019 and accelerates spending. Net-net the sale of the Data Centers funded about $300 million debt repayment and capex that should prove to be highly accretive.

After going segment-by-segment, I believe that revenue will decrease by low-single digits going forward as voice declines are eclipsed by gains in Enterprise and stabilization in other segments as new technology is deployed and competes with cable. My expectations are shown below. While there are a number of estimates embedded in the model below, the key number to watch is revenue. I have modeled in 3% declines to revenue and excluded Connect America Funds from revenue figures and capex to provide an ongoing sustained FCF figure.

Table 2. Windstream Model Dichotomy Calculations and Management Guidance

	2015 Estimate	2015 Pro Forma	2016	2017	2018
Revenue	$5,707.1	$5,567.6	$5,400.6	$5,238.5	$5,081.4
COGS	$2,896.0	$2,826.0	$2,662.5	$2,577.4	$2,495.0
Gross Margins	50.7%	50.8%	50.7%	50.80%	50.90%
Gross Profit	$2,919.1	$2,849.6	$2,738.1	$2,661.2	$2,586.4
SG&A	$860.0	$850.0	$850.0	$850.0	$850.0
Merger/Restruct Costs	$81.8	$16.8	$20.0	$20.0	$20.0
Rent	**$650.0**	**$650.0**	**$654.0**	**$658.0**	**$658.0**
EBITDA	$1,327.3	$1,332.8	$1,214.1	$1,133.2	$1,058.4
EBITDA Margins	23.26%	23.94%	22.48%	21.63%	20.83%
Interest Expense	$390.0	$343.0	$305.2	$293.2	$277.0
CapEx	$965.0	$775.0	$690.0	$556.7	$556.7
Taxes	$20.0	$20.0	$30.0	$30.0	$30.0
FCF	-$47.7	$194.8	$188.9	$255.3	$198.7
FCF/Share	**-$0.48**	**$2.00**	**$2.07**	**$2.80**	**$2.18**
Total Debt	$5,637	$5,062	$4,462	$4,273.10	$4,017.80
Debt/EBITDA	**4.25**	**3.80**	**3.68**	**3.77**	**3.80**

The take home message, at least for investors in CSAL, is that modest revenue declines do not impact rent payments, or the viability of the business. As a reference point, modeling in 6% revenue declines (about double what has occurred) arrives at Debt:EBITDA of 4.7x in 2018. In this scenario, which I consider a bear case scenario, free cash flow for Windstream is -$65 million, but this deducts all capital expenditures. If CSAL decided to fund $50 million of the capital expenditures, Windstream's cash flow position would be pretty much neutral. Now, obviously this would simply be swapping short term liabilities for a rental liability, but there are plenty of options for Windstream to remain in good standings with their creditors, CSAL included.

Table 3. Debt of Windstream Dichotomy Calculations In Millions

	Principal	Interest Expense 2015	Pro Forma Debt 2015	Pro Forma '15 Interest Expense	Pro Forma Debt 2016	Est '16 Interest Expense
Senior Secured Tranche B5	$579.70	$23.19	$579.70	$23.19	$579.70	$23.19
Revolver	$785.00	$31.40	$785.00	$31.40	$785.00	$31.40
2017 Notes 7.875%	$942.30	$74.21	$642.30	$50.58	$42.30	$0.00
2020 Notes 7.75%	$700.00	$54.25	$700.00	$52.50	$650.00	$50.38
2021 Notes 7.75%	$920.40	$71.33	$920.40	$71.33	$920.40	$71.33
2022 Notes 7.5%	$493.50	$37.01	$493.50	$37.01	$493.50	$37.01
2023 Notes 7.5%	$540.10	$40.51	$540.10	$40.51	$540.10	$40.51
2023 Notes 6.375%	$700.00	$44.63	$700.00	$44.63	$700.00	$44.63
6.75% Midwest Notes	$100.00	$6.75	$100.00	$6.75	$100.00	$6.75
Total	**$5,761.00**	**$383.27**	$5,461.00	**$357.90**	$4,811.00	**$305.19**
Cost of Debt	6.65%		6.55%		6.34%	

I believe that Windstream's debt load will decrease and free cash flow will remain positive for at least the next few years. With that in mind, investors can assign a fair value to CSAL.

Valuation

Effectively, CSAL is a bond of Windstream and an obligation that Windstream needs to pay in order to run the business. Given the long term cash flows that are contractually guaranteed, it makes little sense for CSAL to trade at such a discount to Windstream's corporate debt As of October 2015, Windstream's debt has an effective cost of 8.4% (ie: assigned interest rate divided by current trading values of the debt). And yet, CSAL has an 11.8% yield.

Even if we apply a discount to CSAL's dividend, a 9% dividend yield would achieve a fair value of $26.66/share, some 20% higher than current values. The walk from revenue to free cash flow can be found in the table below.

Table 4. CSAL Free Cash Flow Calculations

In thousands	PF 2015	2016	2017	2018
Revenue	$682,364	$686,427	$690,427	$693,677
G&A	$25,000	$25,125	$25,251	$25,377
CLEC Costs	$23,700	$23,700	$23,700	$23,700
EBITDA	$633,664	$637,602	$641,476	$644,600
Interest Expense	$222,575	$225,624	$228,673	$228,673
CapEx	$25,000	$25,000	$25,000	$25,000
Taxes	$1,194	$1,206	$1,218	$1,230
FCF	$384,895	$385,772	$386,585	$389,697
Shares Outs	150,558	150,558	150,558	150,558
FCF/Share	$2.56	$2.56	$2.57	$2.59

That valuation ignores any sort of diversification by CSAL though, and in my opinion, represents the downside protection that is available to investors today. I believe CSAL will announce an acquisition that will diversify earnings streams and eliminate some of the concern around Windstream's economic condition. As diversification continues, CSAL should re-rate in-line with other REITs. Currently, industrial REITs offer dividend yields of 4.4% and while I certainly do not expect CSAL to re-rate to that low of a yield, it does highlight the tremendous valuation discrepancy. The table below shows my expectations for potential diversification scenarios that are 10% and 20% accretive to free cash flow.

Table 4. Diversification Examples for CSAL

	2016 FCF	93.5% Payout Ratio	Yield Target	Implied Share Price
Current FCF	$385,772	$2.40	9%	$26.62
10% Diversification	$424,348	$2.64	8.1%	$32.53
20% Diversification	$462,925	$2.87	7.2%	$39.93

The calculations above assume that a 10% diversification in free cash flow results in a 10% decrease to yield. This is obviously just a guess. However, the upside should be obvious. If CSAL can grow free cash flow by only 10% and dividend payments are $2.64 a 9% yield would get a price target of $29.33/share.

If we assume that the 20% Diversification scenario is achieved by the end of 2017, shareholders would receive a minimum of $4.80 in dividends and perhaps as much as $5.51. Add that to the implied share price of $39.93 and the total return would exceed 110% over the next two years.

What Happens if Windstream Goes Bankrupt?

The short thesis against CSAL is straight-forward: investors believe that Windstream is a melting ice cube and cash flows will soon turn negative as capital expenditures fail to decrease and revenue declines accelerate. In my model, it takes considerable effort to generate negative free cash flows by 2018, more than 6% per year declines and no cut to capital expenditures. Meanwhile, CSAL investors sit in a position that easily covers rent through 2018. However, let's assume that Windstream revenue declines accelerate, management refuses to cut capex, and ultimately, bankruptcy is filed. What happens then?

Give the intertwined nature of the assets and the companies; this would hardly be clean and straightforward. I do not pretend to know what would happen as bankruptcy is an evolving process that depends on a myriad of factors. A good example of a potential scenario is Getty Real Estate.

Getty Real Estate was the REIT spin from Getty Petroleum Marketing (Marketing). Getty Real Estate owned some 788 properties that Marketing rented from Getty Real Estate in a triple net-lease structure. On December 5, 2011 Marketing filed for bankruptcy and rejected the master lease. This was bad news for Getty Real Estate. In 2012 Getty Real Estate owned 946 properties, of which, Marketing was the tenant of 788 of those. The rejection was overturned only a month later. Marketing was ordered to meet the obligations of fixed rent and real estate taxes. Getty Real Estate did accrue for some unpaid real estate taxes and environmental liabilities (Getty Petroleum operated oil terminals, gas stations, and automotive repair facilities).

Since the bankruptcy of Marketing, Getty Real Estate has transitioned fairly well. They sold a number of properties, re-leased other properties, and are receiving distributions from Marketing thanks to their unsecured claim against the estate. Getty Real Estate has diversified revenue streams and currently the name yields 5.75%. It should be noted that Marketing is liquidating. If Windstream were to file for bankruptcy, I believe a restructuring is more

likely with equity and unsecured debt holders taking a haircut. With more than $1.2 billion of unsecured debt, there is plenty of room for haircuts before CSAL leases get chopped.

And to repeat this one more time – the outcome of any bankruptcy by Windstream is filled with unknowns. I think precedent cases show that there is plenty of downside protection for CSAL investors. The table below shows potential haircuts to revenue and the impact to FCF for CSAL investors.

Table 3. Distribution Cut based on 2016 Expectations

	Base	10% Cut	20% Cut
Revenue	$686,427	$617,784	$549,142
G&A	$25,125	$25,251	$25,377
CLEC Costs	$23,700	$23,700	$23,700
EBITDA	$637,602	$568,834	$500,065
FCF	$385,772	$317,003	$248,234
FCF/Share	$2.56	$2.11	$1.65

In a situation where the CSAL lease is cut by 20%, and no revenue diversification occurs, CSAL still generates $1.65/share in free cash flow. Applying a 10x multiple arrives at a fair value of $16.50/share. This is a situation that I think is very remote – Windstream declares bankruptcy and the master lease is negotiated very aggressively against CSAL.

Conclusion

The market is currently pricing CSAL at a wide discount to Windstream's unsecured debt, a price that makes no sense. Based on my analysis, I believe Windstream is not in danger of going bankrupt anytime soon and the company should be free cash flow positive for the next three years at least. As such, it makes little sense for CSAL to trade with a >14% FCF yield, a price that effectively assumes CSAL goes away in 5 years.

The management team at CSAL will likely announce a new deal that will diversify revenue streams and bring new investors in. As CSAL's fortunes rise, so too does Windstream. As Windstream delevers, the risk at CSAL decreases as well. Even in a worst case scenario, if Windstream were to liquidate, I believe CSAL could re-lease the properties and investors of CSAL would be made whole.

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