

Next moves in the wireless endgame

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As the big four wireless carriers position themselves for the long haul, we expect continued efforts by the carriers to maintain growth and avoid the pricing pressures a four way slugfest is likely to bring on. Clearly, some of this will be through efforts to differentiate their product (i.e. AT&T's iPhone) or service offerings (Verizon's claim to superior 3G coverage, for example). Marketing and pricing strategies will also play a big role, as evidenced by the rapid growth of prepaid and/or no contract service plans such as Boost, metroPCS and Cricket. And finally, as we detailed in our September article *The Rise of The Machines*, Machine to Machine (M2M) networking offers an additional growth option to the majors.

In many instances, we expect the majors to pursue these growth initiatives through M&A activity, which to date has been a major part of their toolkit for growth. Because the M2M players remain small, for the moment, let's focus on the potential for larger transactions – in other words, acquisitions of other more or less conventional wireless carriers. Transactions like these offer immediate scale benefits – ranging from marketing cost savings to savings on network equipment and handsets through greater buying power. The transactions also reduce the potential for churn by reducing customer options at the margin in markets where carriers overlap. Finally, the smaller carriers have substantial spectrum assets in addition to their network assets. With the ever increasing consumer demand for faster connectivity, and the limitations that physics imposes, this valuable and limited resource is a key to competitively meeting consumer expectations.

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In the table below we've collected important financial and operating statistics (as of Q3 2009) for a number of relevant wireless firms. In addition to the big four ("The hunters"), we've identified four more smaller carriers ("The hunted") as well as some recently acquired carriers ("The trophies"). In the case of the acquired firms, we have used the last public operating data available prior to their acquisition, and the enterprise value is simply the transaction value. Note: since the Alltel and Rural Cellular transactions were negotiated before the worst of the recent financial crisis hit, they should be viewed in that perspective when comparing their growth rates and valuations.



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	Subscriber s (mm)	Total ARPU	yr/yr Wireless Revenue Growth	EBITDA Margin	Churn	Technology	Spectrum Holdings (\$bb)	Enterprise Value (\$bb)	EV/Sub
The Hunters									
Verizon Wireless	89.0	\$51	5%	39%	1.5%	CDMA	NM	NA	NA
AT&T	81.6	\$51	8%	35%	1.4%	GSM	NM	NA	NA
Sprint	48.3	\$43	-8%	19%	2.3%	CDMA/iDEN	\$19.7	\$25.7	\$532
T-Mobile	33.4	\$47	-2%	29%	3.4%	GSM	NM	NA	NA
The Hunted									
metroPCS	6.3	\$41	30%	29%	5.8%	CDMA	\$2.5	\$4.6	\$730
U.S. Cellular	6.1	\$47	-3%	19%	1.7%	CDMA	\$1.4	\$3.9	\$639
Leap Wireless	4.7	\$40	21%	18%	5.4%	CDMA	\$1.9	\$3.2	\$681
Clearwire	0.6	\$40	13%	NM	3.1%	WiMax	\$4.5	\$4.9	\$8167
The Trophies									
Alltel	13.8	\$56	10%	35%	2.0%	CDMA	\$3.2	\$28.1	\$2036
Virgin Mobile	4.8	\$19	-10%	6%	4.9%	NA	NA	\$0.7	\$152
iPCS	0.7	\$50	7%	16%	2.4%	CDMA	NA	\$0.8	\$1153
Rural Cellular	0.8	\$53	11%	45%	1.9%	CDMA/GSM	\$0.5	\$2.7	\$3380

Note: Alltel figures reflect Q3 2008
Rural Cellular figures reflect Q2 2008

Source: Data compiled from public filings

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Given a free marketplace, for transactions to occur you need a willing buyer and a willing seller – more or less. So, respectively, let’s consider the propensity of each of the larger firms to strike out on the hunt.

In the case of Verizon, the lion is probably still digesting its recent quarry (i.e. \$28 billion Alltel), but may be ready to start hunting soon. They certainly have the wherewithal, and with their CDMA technology all of the hunted save Clearwire are easily digestible. Given the common use of this technology by the smaller carriers, from Verizon’s perspective this introduces a certain amount of fungibility, which it can use to play the respective targets off against each other when negotiating price. However, as the largest carrier, Verizon is most likely to attract unwanted attention from the game wardens (more commonly known as the DOJ and FCC). Because all the potential targets are significantly smaller than Alltel, we believe this risk appears manageable, though there can be no certainty, especially given the greater antitrust sensitivities of the current administration.

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In contrast, AT&T has been quiet on the acquisition front, focusing more on operational issues such as coping with rapid data traffic growth from iPhone sales. Whether from choice or not, this has the effect of having AT&T avoid the technology integration issues that have plagued Sprint with its fundamentally incompatible CDMA and iDen technologies, not to mention the reduced scale benefits. As a

consequence, Verizon benefited from being the only real bidder at the table for Alltel, and for the moment is the only viable bidder for the remaining CDMA systems. But there is a sea change in technology coming: Long Term Evolution (LTE).

LTE (a flavor of 4G) promises to bridge the technological gulf between carriers that adopt it – meaning that from an M&A perspective AT&T will be on a level playing ground with Verizon as carriers adopt this technology. And as this occurs, more bidders means higher prices – for the hunted.

Sprint has focused on bringing in-house its relatively captive affiliates Virgin Mobile and iPCS ...

Sprint, the third largest carrier, is like Verizon also a CDMA carrier in part, but also has its Nextel unit which relies on an incompatible technology called iDEN, and its 57% owned affiliate Clearwire, which relies on a third (also incompatible) technology called WiMax. In their latest M&A efforts, Sprint has focused on bringing in-house its relatively captive affiliates Virgin Mobile and iPCS. In the case of Virgin, Sprint was clearly defending a financially ailing affiliate with a substantial base of “Sprint” subscribers (since Virgin was reselling capacity on Sprint’s network). The transaction was cheap, partially because there was no other logical buyer and also because Virgin needed the deal. With both Virgin and Boost now under the Sprint umbrella, Sprint has the largest “uncontracted” (i.e. pay-as-you go and prepaid) user base of the majors (over 10 million subscribers). This is reflected in their lower overall ARPU and higher churn as compared to the other majors.

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Financially, Sprint is clearly the weakest of the majors. It has the lowest margins, and while it is bigger than T-Mobile and has lower churn, T-Mobile has a rich uncle (Deutsche Telecomm) and Sprint does not. With its substantial debt load and depressed share price, capital is dear for Sprint, so we think it likely to remain on the sidelines until it can get its house in order and raise its share price (i.e. its currency for acquisitions).

T-Mobile is in a similar position to AT&T – temporarily on the sidelines but as the smallest of the big four, clearly needs greater scale. While it would make a good technological fit with AT&T, the sheer scale of the transaction would be very likely to attract regulatory attention. We thus view T-Mobile as a hunter rather than the hunted. While a combination with Sprint would vault T-Mobile just ahead of AT&T in customers, the logistical issues of combining four wireless technologies are daunting, and would blunt much of the advantages of the combination. At the right (i.e. low) price this

deal starts to make sense for them, but clearly this is a very high risk strategy. As the LTE rollout progresses, some of this risk is mitigated, but prices may not be as attractive then either.

What then, of the hunted?

With positive free cash flow, metroPCS's management can negotiate with suitors from a position of strength

...

metroPCS has demonstrated the best growth (30% yr/yr) in the industry through the Great Recession – an impressive feat. It also has a financial engine that makes a decent if unspectacular profit from lower revenue subscribers despite withering churn (the highest of all the firms we examined). How do they do it? In two words, cost leadership. From the point of view of an acquirer, metroPCS brings substantial spectrum holdings and low cost infrastructure to the table, along with a differentiated and growing brand recognized for value pricing. With positive free cash flow, metroPCS's management can negotiate with suitors from a position of strength, and as they transition to LTE they are likely to appeal to a wider audience of buyers. With two substantial uncontracted brands of its own, and operational issues to boot, we do not see Sprint as a likely bidder for the time being. As such, we think the most likely scenario is an acquisition by Verizon in the short term, or AT&T, Verizon or T-Mobile later on when they are up and running with LTE.

As long as both metroPCS and Leap are both independent, potential acquirers can be expected to play them off against one another ...

Leap Wireless markets its Cricket brand of uncontracted wireless service and at first blush looks much like a somewhat smaller version of metroPCS. However, Leap has slightly lower growth (21%) and ARPU and is significantly less profitable, due principally to scale effects. As a consequence, when capex is factored in, the company continues to expend its cash reserves, though their June 2009 secondary did buttress them by \$264 million. With over \$600 million in cash and positive operating cash flow, Leap appears to have adequate resources for its budgeted capital program, and has indicated that it will adjust its capital plans to live within the resources that are available. As it is somewhat more levered than metroPCS, LEAP's ability to issue additional debt is relatively constrained.

From the perspective of a buyer, Leap is somewhat cheaper on a pre-subscriber basis than metroPCS. In terms of the bidding dynamic, Leap's more levered balance sheet is actually an advantage. This is because most of its enterprise value is tied up in debt, and as such (thanks to the miracle of leverage) a small premium in enterprise value translates into a large premium for



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stockholders – the people who get to vote on the deal. In contrast, generating a similar premium for metroPCS's shareholders requires a buyer to bid at a higher premium on an enterprise value basis.

Given this overall backdrop, we believe that Leap is somewhat more motivated to do a transaction sooner, and if recent press accounts that Leap may be shopping for bankers to explore "strategic alternatives" are true this could be the reason. From a technology and spectrum perspective, Leap looks a lot like metroPCS, and we would expect the potential suitors to be identical. As long as both metroPCS and Leap are both independent, potential acquirers can be expected to play them off against one another – a tactic that is likely to work better against Leap (the more "motivated" target) than metroPCS.

While we have considered metroPCS and Leap as potential targets, we would be remiss to not mention that the two firms previously tried to merge (metroPCS offered to acquire Leap in a stock for stock deal in 2007) and a reprise of that scenario is a possibility. While the geographic coverage of the two company's networks is complementary, and the combined firm would enjoy substantial scale advantages compared to the separate firms, we remain skeptical that this combination can proceed. With its substantial debt load and cash needs, Leap is easier for a larger player to digest. We also wonder whether the substantial dilution that a stock for stock deal would impose on metroPCS would make sense for their shareholders. Looking further down the road, the combined firm would also be large enough that it could be substantially more difficult for Verizon or AT&T to get regulatory approval to acquire it, reducing the potential bidding pool by 50%. Assuming that hurdle could be cleared, the merged firm would benefit from bidders playing off Leap and metroPCS against each other.

As such, [U.S. Cellular] would make a very digestible morsel for [Verizon], and boasts a very reasonable cost per subscriber and a clean balance sheet to boot ...

U.S. Cellular is a different animal entirely. Unlike metroPCS and Leap, which specialize in uncontracted service, over 95% of U.S. Cellular's customers are under contracts. In this sense U.S. Cellular is best thought of as a miniature, regional version of Verizon, with a nearly identical business model and technology. As such, it would make a very digestible morsel for them, and boasts a very reasonable cost per subscriber and a clean balance sheet to boot. On the downside, U.S. Cellular is a high cost provider, making margins comparable to Leap or Sprint despite having significantly higher ARPU. Perhaps more damning, especially for Verizon, is



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that from a marketing and branding perspective buying U.S. Cellular (as opposed to metroPCS or Leap) doesn't really get them anything they don't already have.

When this is combined with its flat to shrinking customer base, we think a transaction will come down to price. Given the potential to realize substantial cost synergies across a decent sized customer base, a U.S. Cellular transaction has the potential to create substantial value. How that value gets distributed between buyer and seller will be the chief factor in its willingness to do a deal. However, given that Verizon is large enough that regulators may only allow them one more chance to do an acquisition, we don't expect them to chase this one too strongly. We thus see Sprint, T-Mobile and AT&T as the more likely bidders – down the road when their operational issues and LTE rollouts are complete.

We expect that within 3 years, all of "The hunted" will be hanging on the wall, save Clearwire....

With 57% of its equity owned by Sprint, Clearwire is really just a division of its parent with some outside ownership. Given this substantial stake, and its WiMax technology that is incompatible for everyone, Sprint is the only viable bidder for Clearwire. Given Sprint's financial pressures and their effective control of Clearwire, we think Dan Hesse probably considers the status quo an effective way to finance Sprint's 4G initiative. To the extent that Sprint garners the wherewithal to acquire Clearwire, we believe they would be better served expending it on the other targets discussed here.

In closing, we expect that within 3 years, all of "The hunted" will be hanging on the wall, save Clearwire. If recent press accounts are true, Leap will be the first target in the cross hairs, but it is unlikely to be the last. With the ability to move now before bidding competition heats up, we would expect Verizon to extend overtures to all the hunted (save Clearwire), opportunistically acting before its competitors. If they make a move now, we think it will reduce prices for all the targets by muting bidding competition. Conversely, if we get to the middle of 2011 with no acquisitions done, then things get really messy as you potentially could have four way auctions break out. It could be an interesting next few years, indeed.

By John Stone
Near Earth LLC



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