BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

December 13, 2018 | www.btnresearch.com

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

SBA Communications Corp (SBAC)- SELL

We are starting SBAC at a 2- (Weak) rating on Earnings Quality and a SELL rating for the stock. The areas of contention are obvious such as it's a REIT that pays no dividend and it has a debt load of 7.4x EBITDA. Debt is an area that investors are often overly benign about or overly concerned with and it is difficult to time when the change in sentiment could happen – ask Valiant Pharmaceuticals investors. Taking on debt and rolling it over is a key part of SBAC's operating model to generate its growth. Some areas of accounting policy are actually conservative and definitely higher quality than its peers. We'd give it a higher EQ score if it didn't owe so much debt and used cash flow toward debt reduction instead of buying back its stock at all-time highs.

The stock is 23x AFFO (Adjusted Funds From Operation of $7.38 per share). Every 20bp of higher debt costs, would cut 17-cents off AFFO per share (about 2.3%) and SBAC has $500 million to $2 billion of debt coming due each year so there is exposure to rising rates. The company touts growth rates of 8%-10% per share, but much of that is due to acquisitions and share repurchases. Organic growth is closer to 4%-5% via rent increases, additional rent from clients adding more systems to existing towers, less the churn. The basic problem we see is rising interest rates alone can hurt cash flow growth at SBAC. If they divert cash flow toward debt over share repurchases, growth slows further. A lower growth rate could bring down the valuation multiple and with this much debt, the equity will be penalized much more from that reassessment:

- Many of the Non-GAAP metrics used to measure results have some short-comings. We believe several ongoing costs and required capital spending should not be left out.

- Growth via acquisition is expensive. Without making acquisitions and building new towers, growth at SBAC is about 3 percentage points lower.

- Cash flow from overseas is not fully available to service debt. SBAC does not repatriate earnings from foreign operations. SBAC reports net debt to EBITDA of 7.4x, but over 16% of the EBITDA is overseas. The effective debt ratio rises for every dollar not available from full company EBITDA. We think the ratio may be above 8x.

- The debt and interest expense are in US Dollars, but with a rising percentage of EBITDA in foreign currencies especially in Brazil – FX is a wildcard here.

- When isn't buying stock viewed as a good use of capital at SBAC? They issued shares to make an acquisition in 2017 at $130/share but also paid $160-$170 per share for repurchases.

- Shareholders are unlikely to receive a dividend in the near future with large NOLs shielding income from REIT required payouts.

- Acquisition accounting is more conservative than peers – 15-year depreciation lives vs. 20 and all intangibles are amortized over 15-years too.

The Basic Cash Flow and Growth Model

	3Qs 2018	3Qs 2017	2017	2016	2015
Cash Ops	$624	$592	$819	$743	$723
Capital Exp.	$105	$106	$147	$140	$209
Acquisitions	$404	$161	$442	$277	$610
Free Cash Flow	$115	$324	$230	$326	($95)
Repurchases	$454	$523	$855	$546	$601

The company does not pay a dividend even though it is a REIT. It has $1 billion in past Net Operating Losses (NOLs) that can be used to offset income and shield it from the REIT requirements of paying out 90% of its income. The company generates positive income in the $100-$130 million range. So, under the current situation, investors are unlikely to receive a dividend for probably 6-8 more years.

The company is not able to cover all its spending now. Acquisitions are a regular use of capital and they help drive growth. SBAC breaks down its sources of growth in its supplemental financial reports. For 2018, the company expects 6.9% revenue growth comprised primarily of 2.3% from acquisitions and new construction, 3.6% from colocation (adding more equipment to existing towers), and 1.4% for rent escalations net of churn offset by some FX headwinds.

In addition, the company's share count is declining with the repurchases. That is driving growth per share. Looking at the company's reported AFFO per share, it has been rising at nearly 10% y/y in the last four quarters. Adjusting for the growth due to lower share count, the growth is closer to 5%-6%.

On the surface, SBAC does not generate enough cash flow to internally fund its basic model. In order to generate 10% growth, it needs to buy back shares and make acquisitions. Eliminating those two items, the underlying growth rate falls to about 4%. Are investors going to pay 23x for 4% growth? We'd argue that is unlikely. Moreover, if the company diverted $500 million from acquisitions and repurchases toward a dividend, the yield would only be 2.4% on current prices. Even that may not be enough to support the current stock price.

Some of the Non-GAAP Metrics Used to Measure SBAC's Results Appear Too High

We have no problem with a company adding more information and data to enable investors to more fully understand the operating results. However, we do have a problem when the metrics omit ongoing payments. SBAC uses two non-GAAP metrics – AFFO and Adjusted EBITDA.

The company is better than other REITs we have seen. SBAC does report maintenance capital spending as a deduction to AFFO. However, it does not include capital spending related to colocation, new building, or acquisitions. Those are sort of key in our view because those payments made in cash the prior year are creating the higher cash flow this year. If that spending did not occur, reported results would already be lower. At a minimum, the colocation upgrade spending should be deducted as that is being viewed as part of the organic growth. Here are some of the other components to capital spending at SBAC. We agree that refurbishing the headquarters is more of a one-time item and left that out of 2015:

	2017	2016	2015
New Building	$69	$69	101
Upgrades	$43	$38	$61
Maintenance	$30	$28	$29
Gen. Corp	$5	$5	$5
Cap Exp	$147	$140	$196

The company is only deducting maintenance and general corporate spending in AFFO. In addition, the company prepays many ground leases and amortizes the cost over time. In AFFO, it is adding that expense back as a non-cash item. We would argue that it certainly was a cash expense and it is a recurring item. It should also not be added back in our view. Here is what the company spent in this area in recent years. Some of that is new construction related, but others are extending current leases and may also include buying land under existing sites.

	2017	2016	2015
Land Buyouts	$49	$62	$84
Extending Ground Leases	$19	$14	$16
Acquisitions	$67	$76	$100

The same with non-cash compensation. Employees are being paid with stock and the company is obviously paying cash every year to repurchase shares and prevent dilution. That is a recurring cash item too when considering the full situation.

AFFO is essentially defined as net income plus depreciation and amortization to become FFO – Funds from Operation. That FFO then gets non-cash adjustments made and one-time items are added or subtracted along with a maintenance capital spending to reach AFFO:

	3Qs 2018	2017	2016
FFO	$492	$745	$709
AFFO	$655	$841	$745

We think a case can be made to subtract acquisition-related costs and decommissioning costs as those occur every year too. However, if we only include ground leases, full compensation paid, and the upgrade capital spending, already AFFO declines about 13%.

	3Qs 2018	2017	2016
AFFO	$655	$841	$745
Ground Lease	$20	$31	$35
Non-cash Comp.	$32	$38	$33
Augment/Upgrades	$35	$43	$38
Adj. AFFO	$567	$728	$639

Now the company's cash flow looks a little lower and the multiple goes to 26.5x AFFO for 4-5% growth.

EBITDA is a similar metric that also adds back interest expense among other non-cash items. It also does not factor in any capital spending. We are going to argue that the ground leases and equity compensation are recurring expenses and should not be added back to EBITDA.

	TTM 9/18	2017	2016
EBITDA	$1,312	$1,240	$1,148
Ground Lease	$28	$31	$35
Non-cash Comp.	$41	$38	$33
Adj. EBITDA	$1,243	$1,171	$1,080

That's not a huge change, but SBAC uses EBITDA to calculate its debt ratios. They report that Net debt to EBITDA is currently 7.4x. They deduct all cash from the debt of $9.8 billion and divide by the $1.3 billion in EBITDA. We are going to argue that EBITDA should be $1.24 billion. We are also going to argue that of the $160.9 million in cash it is netting against debt, $24.5 million is restricted and in escrow accounts to pay property taxes and leases. So, we are going to use a net debt figure of $9.69 billion and EBITDA of $1.24 billion, which makes the ratio 7.8x.

Other Issues with Debt

When debt levels are at 7.4x EBITDA and adjusting for some minor recurring costs it is approaching 8x, investors should be concerned about how much flexibility SBAC has. We would argue that repaying debt will start to become a bigger use of internally generated cash flow sooner than later. That would have negative implications for acquisitions and growth as well as share repurchases. The adage about debt as a problem for a stock is

"Investors don't care about it until they do." Thus, we cannot time when investors may have greater concern. But the problems could develop in the near-term.

The first problem we see is a sizeable portion of the debt rolls over each year. The AFFO we outlined above has already enjoyed lower interest rates to help bolster results:

	2017	2016	2015
Debt	$9,405	$8,875	$8,555
Debt growth	6.0%	3.7%	8.7%
Int. Expense	$324	$329	$322
Int. Exp. Growth	-1.7%	2.1%	10.2%

The company has called out lower interest rates as a help for the decline in interest expense in 2017 even as the debt figure grew. That's reversing now:

	3Qs 2018	3Qs 2017	3Qs 2016
Debt	$9,829	$9,050	$9,031
Debt growth	8.6%	0.2%	6.4%
Int. Expense	$278	$237	$251
Int. Exp. Growth	17.2%	-5.4%	5.3%

Already, SBAC is seeing higher interest rates impact results and that is how interest expense rose 17.2% vs 8.6% debt growth in 2018. That should continue to be an issue as SBAC is still issuing more debt since its cash flow is not covering the acquisitions, capital spending, and share repurchases. Also, there is a sizeable amount of scheduled maturities in the coming years, these exclude quarterly term loan payments:

Maturities	in millions
2019	$920
2020	$500
2021	$700
2022	$2,260
2023	$1,335

The interest rates on the next three maturities are 2.898%, 3.156%, and 2.877%. We would not be surprised at all if the rates on new debt and rolled over debt increases for SBAC. That is going to hurt reported AFFO and free cash flow. Both can be cut by 10% if the average interest rate rises about 80-85bp. Assuming the term loan is refinanced before 2025, the entire debt load will need to be refinanced by 2024. This could be a significant headwind. Assuming debt becomes $10-$11 billion, SBAC could see interest expense of $440-$594 in a few years assuming a 100-200bp increase vs. $324 million in 2017. AFFO is about $800-$900 million so a potential $150-$200 million headwind from rising interest expense could be significant and cause investors to look at the debt more closely.

The company has already taken the steps to issue shorter-term debt to save on interest expense. And, it has already issued several debt offerings secured by the cash flow of specific pools of towers. If the term length is extended on roll-over or less securitization is used – those could pressure rates upward too. Their unsecured 5-year senior notes were issued at 4.875% vs. 5-year securitized tower notes issued at about 3%. In other words, the bump in rates could be steep.

We also noticed that like American Tower, SBAC does not expect to repatriate foreign earnings. From the 10-K:

> *"The Company does not expect to remit earnings from its foreign subsidiaries. Undistributed earnings of the Company's foreign subsidiaries amounted to approximately $102.2 million at December 31, 2017. Those earnings are considered to be permanently reinvested and the Company could be subject to withholding taxes payable to various foreign countries."*

It has intercompany notes set up whereby the foreign operations can pay interest and principal that matches up with scheduled corporate debt servicing. However, in the case of countries like Brazil – the largest foreign subsidiary – it doesn't collect revenues in US dollars.

> *"For the year ended December 31, 2017, approximately 18.6% of our total cash site leasing revenue was generated by our international operations, of which 13.6% was generated in non-U.S. dollar currencies, including 12.7% which was denominated in Brazilian Reals."*

Thus, there is exposure to FX swings. These are real costs for SBAC that appear often. The company's review is that a 10% move in the Brazilian Real costs it about 2.8% of operating income. In recent years, the amount of FX going through the income statement has been about +/- $10 million in operating income plus depreciation:

FX Impact	3Qs 2018	2017	2016
Revenue	-$21	$17	-$10
Op Inc + Dep.	-$12	$10	-$6

The bigger issue we see is leaving the profits in foreign markets, then the amount of consolidated cash flow being viewed as available to service the debt is overstated. For the nine months ended 9/30 for 2018, domestic site leasing produced $787.2 million in operating income + depreciation. The international site leasing produced $153.4 million. Of the total company, the international produced 16.5% of this proxy for EBITDA. Those operations are paying their intercompany notes which is servicing some of the corporate debt. But all the EBITDA is not going toward that and the surplus is not coming back to the US. So, when SBAC touts that it has $1.3 billion in EBITDA to service debt – that may be overstating the figure.

We do not have the numbers necessary to completely fill in this picture. It's not 16.5% of EBITDA, but what if it's 5%? That would be $66 million. Suddenly, net debt to EBITDA is 7.8x instead of 7.4x. Adjusting for the items such as ground leases that we did above along with a 5% of EBITDA – the ratio becomes 8.2x.

In our view, the effective leverage here is higher than it appears, and it already looks high. We think the company has two potential headwinds in rising interest expense sapping AFFO and potentially needing to divert free cash flow toward debt repayment, which would reduce growth. Under either situation, we believe the multiple on the stock declines and it could take years for SBAC to reach 5x debt to EBITDA like its competitors have.

The Share Repurchases

Management is very clear with its use of capital. It sees growth via acquisition as important, intends to shield income with NOLs to avoid paying a dividend, and repurchase shares when cheap. Two references from the 10-K:

> *"The amount of future distributions will be determined, from time to time, by the Board of Directors to balance our goal of increasing long- term shareholder value and retaining sufficient cash to implement our current capital allocation policy, which prioritizes investment in quality assets that meet our return criteria, and then stock repurchases, when we believe our stock price is below its intrinsic value.*

Stock Repurchase Program. We currently utilize stock repurchases as part of our capital allocation policy when we believe our share price is below intrinsic value. We believe that share repurchases, when purchased at the right price, will facilitate our goal of increasing our Adjusted Funds From Operations per share."

Our first question is, "does the stock look cheap?" It's 23x cash flow! In 2017, the company issued shares at basically $130 per share to make an acquisition. Now, it's buying shares at $170 because $170 is cheap? When we adjust the AFFO for items like ground leases and non-cash compensation, we think the cash yield here is under 4% at the current stock price. Yet the repurchases remain heavy despite the rising stock price:

	3Qs 2018	2017	2016	2015
Avg Share	$160-170	$110-160	$100	$110
Repurchase	$454	$855	$546	$601

As we noted earlier, share repurchases and acquisitions are fueling AFFO per share growth of about 10%. Without these items, growth here is closer to 4%. That is not going to justify the valuation of 23x cash flow.

What this looks like is some of the MLPs from 2015-17. Organic growth is very modest, but with good counterparties and no income taxes, the cash flow can support a high debt load and a large dividend (in the case of SBAC – a large share repurchase program). However, growth requires heavy capital investment and there's no spare free cash flow so that means raising more external capital. That raises the cash needs and in order to keep the stock prices high – the MLPs continually boosted their dividends, pushing up cash needs again.

That model didn't work very well when the stock prices were retreating with oil and the MLPs were still needing to raise capital to complete new projects. If they didn't fund the growth, the shares were repriced lower to reflect a decreasing growth rate.

SBAC has some of those same issues. The debt cost may increase faster than organic growth and crimp cash flow. Debt is higher than the peers – 7.4x EBITDA (or closer to 8x by our adjustments) vs. 5.0x at American Tower and 5.1x at Crown Castle. If they stop repurchasing shares, the AFFO/share growth slows further, and the valuation of the stock may decline. It is also why we believe more of the capital spending should be viewed as required, which lowers AFFO for this company. If they make it truly discretionary such as new builds, upgrades, or even some of the acquisitions and not spend it– the overall growth rate slows and that becomes a negative catalyst for the stock.

Acquisition and Depreciation Accounting is More Conservative than Peers

One area that we did like to see with SBAC is they stand out with more conservative assumptions on assets. It depreciates towers and related PP&E over 3-15 years. By comparison, Crown Castle is at 20 years or the term of the ground lease. American Tower uses up to 20 years. This actually punishes SBAC's income more. It has been reporting periods of falling depreciation due to equipment values being fully expensed:

> *"Depreciation, accretion, and amortization expense increased $4.9 million for the year ended December 31, 2017, as compared to the prior year. On a constant currency basis, depreciation, accretion, and amortization expense decreased $2.5 million. These changes were primarily due to a decrease in domestic site leasing depreciation associated with assets that became fully depreciated since the prior year period, partially offset by additional international site leasing depreciation associated with an increase in the number of towers we acquired and built since January 1, 2016.*
>
> *Depreciation, accretion, and amortization expense increased $5.8 million for the three months ended 9/30/2018. On a constant currency basis, depreciation, accretion, and amortization expense increased primarily due to an increase in the number of towers we acquired and built since July 1, 2017, partially offset by the impact of assets that became fully depreciated since the prior year period."*

It would not impact EBITDA or AFFO which add back depreciation. Given that SBAC does not intend to pay a dividend and is offsetting income with NOL's to avoid paying one, we believe that by having a larger depreciation expense actually helps management with that goal as more depreciation lowers income.

All three of the tower companies make acquisitions and end up with sizeable intangible assets as well. Both Crown Castle and American Tower put some of the intangibles into goodwill which is not amortized. Only SBAC amortizes all of its intangibles and does so over 15 years. Again, this does not hurt AFFO or EBITDA, but is a more conservative accounting policy than the others.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.