VERITAS INVESTMENT RESEARCH

July 11, 2017

Cogeco Communications Inc.

BUY – C$85.00

Ticker	Current Price
TSX-CCA	C$82.09

FLASH

Desmond Lau
dlau@veritascorp.com

MAKING A CAISSE FOR MORE U.S. CABLE

The market has not been kind to Cogeco's shares following acquisition announcements, with a 17% decline after the Cabovisao deal, a 15% drop post Atlantic Broadband ("ABB) purchase, and a 5% slide on the day the company acquired Peer 1 Networks. Cogeco's acquisition of MetroCast marks a major departure, as it was the first time in more than 10 years that the company announced a significant acquisition (US$1.4B) and the stock subsequently rose 2.9%. We think that the positive reaction is warranted, as it builds upon sustainable growth and a proven existing blueprint in the US. Overall, we view the transaction favourably for the following reasons:

- **Strategic rationale makes sense** – with little IPTV overlap (8%) in MetroCast's footprint, we believe that moderate investments in network upgrades and marketing can dramatically improve Metrocast's subscriber growth.
- **Valuation is reasonable** – an analysis of precedent transactions and trading multiples of US cable companies suggests that the price paid was fair.
- **Ability to quickly de-lever and grow cash flows** – we estimate that the acquisition will be accretive by about $64 million and aid in the achievable goal to de-lever from 3.6x to 3.0x after 18 months. We estimate that Cogeco trades at a FCFE yield of 10.5% post acquisition vs. 9.1% immediately prior to the deal.

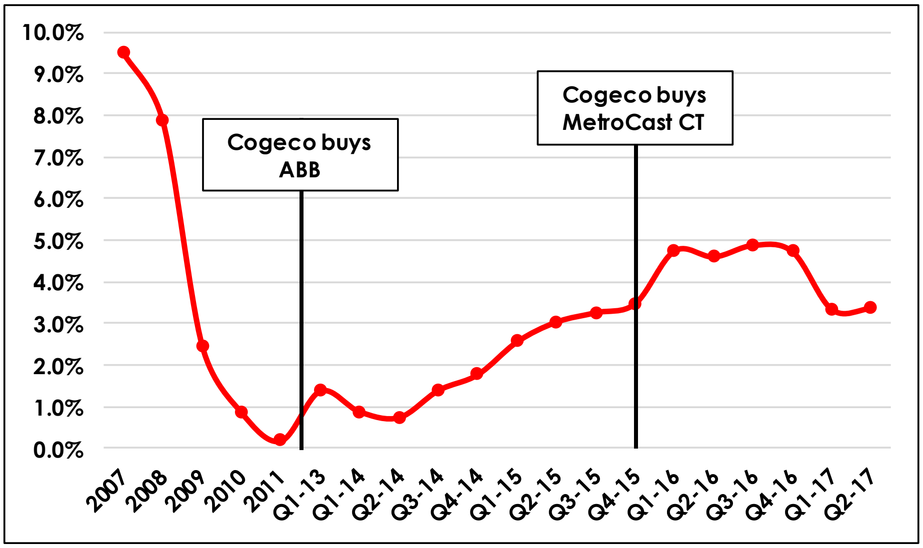
We are maintaining our **BUY** recommendation and increasing our intrinsic value estimate to **$85**. We are valuing the data centre business at an 8x multiple, compared to 13x-14x for precedent transactions, as we believe that it is inevitable that this segment will be sold. We are presuming that the MetroCast acquisition is value neutral; we will update our financial model upon deal close.

GROWTH POTENTIAL & PAST SUCCESS SHOWS PROMISE FOR METROCAST

During the call, management stated that the MetroCast acquisition is all about capitalizing on growth opportunities versus cost synergies. We take a positive view of the growth opportunities at MetroCast, as well as management's ability to execute on its plan for the following reasons:

- **Successful ABB experience a blueprint to follow:** Following the acquisition of ABB, management focused on investing in marketing, pushing product bundling and launching TiVO, which led to the successful turnaround and growth in PSUs from a low of 0.7% YoY growth in 2011 to a sustained 3-5% growth rate over the past 9 quarters (see Figure 1 below). Furthermore, management already has hands-on experience with MetroCast, through its tuck-in acquisition of the Connecticut operations in 2015.

Figure 1
ABB PSU Growth Re-accelerates Following Cogeco Acquisition



Source: Company reports, Veritas estimates

- **Bundling under lower competitive pressure:** Management noted that 55% of ABB customer base had bundled products while MetroCast only has 44%, making for ample opportunity to improve multi-product customers which should increase revenue growth and reduce churn. In addition, IPTV overlap in MetroCast's foot print is significantly lower at 8% compared to ABB's which was 30% when it was acquired in 2012.

- **Demographics are favourable throughout MetroCast's footprint:** the average age in MetroCast's footprint is approximately 8 years older than the national average (low to mid 40s) according to management. Cord-cutters are predominantly within the Millenial demographic, which bodes well for the company's plans to take market share from satellite customers with a bundled TiVo offering.

MetroCast Cable Assets Appear Fairly Priced

We think the acquisition was priced fairly, and refer to the following data points as evidence supportive of our view:

- **Acquisition price sits comfortably within comparable transaction range:** multiples for similar transactions have fetched anywhere from 8.3x to 10.0x over the past 2 years, as can be seen in Figure 2 below. We note that when adjusted for synergies, the multiples of the Time Warner Cable and CableVision acquisitions ranged from 6.1x to 8.3x.

Figure 2
Select Precedent Cable Transactions

Target	Buyer	Date	Implied Multiple	Synergy Adj. Multiple
Time Warner Cable	Charter Comm.	5/26/2015	9.1x	8.3x
CableVision	Altice NV	6/21/2016	8.8x	6.1x
Grande Comm. Networks	TPG Capital	8/15/2016	8.3x	not disclosed
WOW! Lawrence	Midco	1/12/2017	9.2x	not disclosed
General Comm.	Liberty Ventures	4/4/2017	10.0x	not disclosed

Source: S&P CapitalIQ, Company reports, Veritas estimates

- **Valuations in-line with trading multiples:** Although management stated that no synergistic opportunities are expected from the MetroCast acquisition, we note trading multiples have risen appreciably. This is shown in Figure 3.

Figure 3
MetroCast Cable Price In-line with Comparable Company Trading Multiples

Company	2016 EV/EBITDA	Current EV/EBITDA
Comcast Corp	7.9x	8.5x
WideOpenWest Inc.	-	9.1x
Cable ONE Inc	9.9x	10.1x
Charter Communications	6.9x	10.2x
Sky plc	9.6x	11.3x
DISH Network Corp	11.6x	13.7x
Altice USA	-	15.5x
Median	***9.6x***	***10.2x***
MetroCast Cable Assets	-	**9.0x**

Source: S&P CapitalIQ, Veritas estimates

Caisse Gives Stamp of Approval

As a sophisticated third-party investor, the Caisse's $315 million investment in ABB for a 21% equity stake sends several important signals to the market in our view:

- **Affirms reasonable value paid** – the Caisse's stake values ABB at 8.8x, just under the 9.0x paid for MetroCast. Having the pension fund join as an equity partner provides a secondary opinion on the assets and helps to surface some value for the discounted shares.

- **Affirms ABB's strategic direction** – ABB is the 16th largest TV operator in the US, with about 315k cable subscribers, compared to AT&T's 25 million. Given the scale differential, some investors have been skeptical about the M&A strategy. With the Caisse investing directly in ABB though, this is an implicit statement that the pension fund agrees with the approach of further tuck-in acquisitions of smaller markets that have been largely ignored by the wireline players.

- **Potentially reduces further acquisition risk** – as part of its investment, the Caisse gains a Board seat on ABB. According to our discussions with management, the pension fund also receives veto rights for "material acquisitions". We do not know what the threshold is, but believe that these veto rights also offer more protection for Cogeco investors – any major future US cable acquisition has to receive Caisse approval and therefore the likelihood of overpaying or buying bad companies is much lower.

QUICK DE-LEVERAGING EXPECTED

Management has stated that it intends to de-lever from a 3.6x pro-forma debt ratio to about 3.0x 18 months following the deal close. We believe that this goal is highly achievable. As shown in Figure 4, we expect the MetroCast acquisition to be cash flow accretive by $64 million.

Figure 4
Cogeco Pro-forma Leverage
Canadian dollars unless otherwise stated

		Veritas Notes
Existing debt	2,754	
MetroCast acquisition debt	1,443	(US$1.4B purchase price less $315M Caisse stake) * 1.33 exchange
Pro-forma consolidated net debt	4,197	
Pro-forma EBITDA	1,160	$1,000M + $160M MetroCast ($121 * 1.33 exchange)
Pro-forma net debt: EBITDA	**3.6x**	
F17 free cash flow	360	
MetroCast free cash flow	64	$160M EBITDA less $48M capex (15% capital intensity) less after-tax $48M interest. Assumes $1,085 US debt ($1.4B less Caisse stake), 4.5% interest, 27% CDN tax rate
Pro-forma free cash flow	424	
18 months of free cash flow	636	1.5 * $424 million
Pro-forma net debt 18 months post acquisition	3,561	$4,197
Pro-forma EBITDA 18 months post acquisition	1,183	Assumes 2% growth
Pro-forma net debt: EBITDA 18 months post acquisition	**3.0x**	

Source: company reports, Veritas estimates

ANALYST: DESMOND LAU, CPA, CA, CFA
dlau@veritascorp.com
Veritas Investment Research
3110-100 Wellington St., W, TD West Tower
Toronto ON M5K 1E7
416-866-8783