Analyst Corner

By: Drew Weitz · July 2018

A Perspective on Charter Communications (CHTR)

Charter Communications (Charter) is a leading broadband communications company and the second-largest cable operator in the U.S., delivering high-speed internet access, video entertainment and voice communication services to over 27 million residential and commercial customers.

Paradigm Shift

Before delving into a discussion on Charter, specifically, cable investors must acknowledge the evolving competitive landscape. Cable systems were built as video delivery platforms, and that paradigm is so entrenched in consumers' (and investors') minds that many equate the word "cable" to mean "pay-TV." Cable networks actually deliver *connectivity*, delivering video as a product along with broadband internet access and telephony. In recent years, the legacy video product has taken a back seat to broadband internet access as the critical service offering (Charter, for example, has 16.3 million video subscribers vs. 22.9 million high-speed data subscribers.) Broadband is also the core contributor of bottom-line profits. The video business is burdened by the need to license content, often a cable company's single greatest expense (for every dollar Charter charges a video subscriber, it pays more than 60 cents to content providers.) Bundled discounts and varying packages obfuscate the profitability of an individual subscriber, but simple math demonstrates a broadband subscriber's contribution to profits far outweighs that of a video customer. We point this out not to dismiss the issue of declining video customers but, rather, to place video results in their proper context.

Alternative forms of video distribution abound, with no way to put the genie back into the bottle. Indeed, our forecasts across our cable investments assume continued modest declines, but for many households, we believe the traditional pay-TV remains the most efficient aggregator of content. Furthermore, as Charter (and others) opens its platform to incorporate Netflix and other online providers, they are increasingly positioned as the entertainment "operating system" for consumers' households. Customers that prefer to "cut the [video] cord," however, still need fast, reliable broadband service to enjoy streaming services—a product where cable continues to win market share.

Broadband is not without competitors. Unlimited mobile data plans have not disrupted cable's broadband offering, but the wireless companies are experimenting with the next iteration of cellular technology, generally called "5G," as an alternative. 5G has produced terrific results in the lab but faces significant challenges to being deployed in the real world: 5G signals travel much shorter distances from an antenna (requiring a denser network than is currently deployed) and struggle to propagate through obstacles like trees and buildings. Undoubtedly, progress will be made against these challenges but will take significant amounts of time, R&D and significant capital to deploy. Meanwhile, today's cable networks can upgrade speeds to multiples of what's currently in the market, leaving cable in an advantaged position to continue winning broadband market share.

Introducing the Charter Playbook

Turning now to Charter Communications, our investment thesis traces its roots back to 2011 when Charter hired well-regarded industry veteran Tom Rutledge as its new CEO, with a mandate to return the business to growth. The playbook to do so was straightforward, if somewhat counterintuitive. Whereas most cable companies relied on raising prices and tight cost controls to maximize profits, Charter would drive growth by expanding its subscriber rolls. This would require significant infrastructure investments to deliver better products (faster broadband speeds, more compelling video packages, etc.) and increased spending on customer service (insourcing field technicians, bringing call center operations in-house and away from overseas locations). All while eschewing significant price increases. The results speak for themselves: improved cash flows propelled by several years of industry-leading customer-relationship growth.

Second Verse, Same as the First?

With the successes at "legacy" Charter and the backing of investors like John Malone's Liberty Media (which purchased a 27% stake in Charter in May 2013 for $2.6 billion), Rutledge and company set their sights on other cable properties where their playbook could drive value and deliver greater economies of scale for the combined entity. After a protracted pursuit, Charter ultimately won its prize, merging with Time Warner Cable and Bright House Networks in May 2016. The transaction catapulted Charter into its position as the second-largest U.S. cable company, as its customer count and the number of homes that can be connected to the network more than tripled.

Post-close, management got to work harvesting early synergies (eliminating duplicative costs, creating greater marketing efficiency, harmonizing rates paid to programmers, etc.), but the truly transformative benefits of this transaction will come through the application of the "legacy" playbook. In the near term, this means heightened operating expenses and capital investments like those described at legacy Charter but on a larger scale, while also integrating the three companies' billing systems, back offices, etc. An integration of this magnitude takes years rather than quarters and may best be described as "lumpy." That causes fits for short-term investors, but our investment thesis is that after this heightened investment cycle, there is a combined entity capable of delivering significant free cash flow growth. Two years after the deal closed, we believe the company is now poised to begin realizing this potential.

Sticking to Their [Cable] Knitting

Few potential acquisition targets of meaningful size remain, none of which would bring the same magnitude of scale. Charter may pursue bolt-on cable system acquisitions going forward. We wouldn't be surprised if they looked at Fox's regional sports networks (RSNs) to add to their footprint if Disney is forced to divest them as they pursue a purchase of Fox assets. RSNs aside, we think it's highly unlikely Charter would pursue a large vertical integration transaction akin to Comcast (NBC Universal) or AT&T (Time Warner). Instead, we anticipate management to enhance business value per share through continued stock repurchases.

Valuation

Pulling it all together, we believe the Charter playbook will drive solid operating results and cash flow growth for the combined entity. Furthermore, as the business comes down from its investment cycle peak, free cash flow is poised to grow even faster. By 2020, we believe this growth, combined with share repurchases, can produce free cash flow in the mid- to high-$20s per share, with an outlook for continued double-digit growth through at least 2022. We believe the stock, trading around $300, is priced too cheaply relative to that growth profile and compared to our base case business value in the low $400s.

A Post Script on the Liberty "Complex"

We think the investment case for Charter is compelling, but for investors willing to deal with a bit more complexity, the pot can be further sweetened. Liberty Broadband is a holding company that owns 54 million shares of Charter, while GCI Liberty owns 47 million shares of Liberty Broadband (as well as 100% of Alaska telecommunications provider GCI.) Industry pioneer John Malone is chairman of both companies (together, "Liberty"), which combined control 25% of Charter's voting interest, giving Liberty significant influence on the company's development and strategy. Although these are independent companies, we group them together given the overwhelming economic exposure to Charter equity.

Investors typically impose a "complexity discount" on such structures (indeed, we believe GCI Liberty carries a "double discount" since its Charter holdings are twice removed.) However, given Liberty's demonstrated track record of realizing full value in similar situations, we think these discounts present even cheaper opportunities to invest in Charter. At some point, we expect these structures to be collapsed and the discount eliminated—we just can't predict when. In the interim, we believe shareholders of all three companies will benefit from the execution of the Charter playbook and its growth in per-share value.

Drew Weitz, *director of equity research, portfolio manager, joined Weitz Investment Management in 2008 as an equity research analyst. He became co-manager of Hickory Fund in December 2011 and in April 2017 was appointed director of equity research, where he oversees the equity research team and process. He holds a BA in computer science from Carleton College in Northfield, MN. From 2004-08 he was a research associate and research analyst with Ariel Investments, a Chicago-based investment firm.*

As of June 30, 2018, each of the following portfolio companies constituted a portion of the net assets of Value Fund, Partners Value Fund, Partners III Opportunity Fund, Hickory Fund, and Balanced Fund as follows: Charter Communications, Inc.-Class A: 1.2%, 0%, 0%, 0%, and 0%. Comcast Corp.-Class A 2.6%, 1.1%, 0%, 0%, and 2.0%. GCI Liberty, Inc.-Class A: 0%, 0.9%, 2.2%, 3.5%, and 0%. Liberty Broadband Corp.-Series A & C: 0%, 8.5%, 9.4%, 8.3%, and 0%. Liberty Broadband Corp.-Series C: 6.3%, 0%, 0%, 0%, and 2.1%. Portfolio composition is subject to change at any time. Current and future portfolio holdings are subject to risk.

As of June 30, 2018, Charter Communications Operating, LLC (Charter Communications Operating, LLC 4.2% 3/15/28) comprised of 0.8% of Core Plus Income Fund's net assets.

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. The Funds' Prospectus contains this and other information about the Funds and should be read carefully before investing. The Prospectus is available from Weitz Investment Management, Inc. Weitz Securities, Inc. is the distributor of the Weitz Funds.