



Fibre broadband networks – an investor’s introduction

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In brief

Infrastructure and institutional investors are increasingly turning their attention towards digital infrastructure assets and the global rollout of fibre broadband (in particular fibre to the home (FTTH)) is seen as an essential component of digital transformation and as providing a large-scale pool of investment opportunities.

While the sector was traditionally dominated by telecoms players, recent years have seen an upsurge in interest and deal activity from infrastructure investors and their lenders. We thought it might be helpful to set out some of the considerations.

Investments can take a number of forms; such as individual projects which are underpinned by project finance structures and bank debt or through equity investments in specialist fibre developers. This has led to buoyant M&A activity, with interesting recent examples including the sale of a 50% stake in Covage (an owner of 45 European networks) by Cube Infrastructure to Altice Europe (who are made up of a number of infrastructure funds managed by AXA Investment Managers, Allianz Capital Partners and OMERS Infrastructure) and the sale by TalkTalk of its subsidiary FibreNation (an owner of UK networks) to CityFibre (owned by funds managed by an infrastructure fund and Antin Infrastructure Partners). DLA Piper acted for Cube Infrastructure and TalkTalk on those deals.

This activity and the interest from infrastructure investors is not surprising as they are increasingly categorising this asset class as core infrastructure (in the case of PPP deals where payments are paid or guaranteed by government) or, at the very least as core+ where there are elements of market risk. Depending on how a project is structured, this asset class could tick off many of the criteria these investors are looking for such as (i) high barriers to entry, (ii) long-term and stable returns, (iii) recognised and established technology and (iv) transparent and stable regulatory environments.

Various rollout strategies and business models can be employed for the build and rollout of a fibre network; for example, a mass residential build v enterprise-focussed builds covering metro areas or business parks; targeting defined coverage areas where there is less competition v taking a more wide-spread coverage strategy. The rollout could also be done on an entirely commercial basis or may be established with public support of some kind.

The strategy for network rollout, as well as the inherent characteristics of FTTH fibre builds, can all affect whether an investor achieves a stable, long-term income stream.

The following are some of the factors to consider:

- **Timing considerations** – It takes time to build a fibre network, including building out network coverage to scale to reach more customers. The rollout of a mass residential fibre network can take longer, delaying the provision of access to customers, and therefore the realisation of investment. On the other hand, a more targeted enterprise build or a business park rollout can be more self-contained, and therefore speed up realisation of your investment. Perhaps easiest of all is to incorporate a fibre build into a new residential or business development.
- **15-20 year payback periods** – Fibre networks typically have a lengthy payback period given the high construction costs – perhaps 15-20 years.
- **Asset life** – The expected useful life of a typical optic fibre asset is as much as 20+ years. Such a long tenure leads to the possibility that equity investors could seek to maximise the upside following the repayment of bank debt. While fibre is generally more reliable than the copper alternative, this can still mean that repairs could be required during its lifespan, and it's also likely that significant technology upgrades will be required during the period. Usually these upgrades can be achieved without needing major new civil engineering works (because the equipment used to “light” the fibres can be upgraded without the need for work on the fibre themselves) and this should be modelled as part of the overall project costs.
- **Market risk and subsidies** – Depending on the type of rollout, there may be significant market risk i.e. no assured base of customers for the network after the build is complete – especially if building out a fibre network in areas already covered by incumbent (or other) providers of fibre, where there may be competition. This means that investors will typically have to accept a significant degree of risk when compared with other types of infrastructure asset, such as a power station, where very long-term offtake agreements can be entered into. More targeted fibre network builds; for example, rollouts to business parks, new developments or to specific enterprise locations (e.g. to supermarkets and retail sites), may mean more certainty of income after the build is complete and it may be possible in these cases to get large enterprise customers to sign up for at least medium-term contracts as pre-sales in advance in order to guarantee some income stream which may help with the bankability of a project with lenders. If the build is in a remote or rural area, it may also be possible to obtain a public subsidy of some kind (subject to state aid rules), which can mitigate this risk significantly.
- **Retail competition among fibre providers is based largely on price** – Competition in the retail fibre market is largely commoditised – based on price, and retail prices for the same amount of bandwidth can change, perhaps quite significantly over the life of the asset. Due to long-term payback periods, this can increase the uncertainty of returns. Despite this, the average revenue per user (ARPU) for fibre broadband in Europe has been roughly stable at an average of EUR22 per month between 2011 and 2018.¹ As technology improves, customers expect (and seem likely to continue to expect) greater bandwidths (meaning there will be a need for upgrades to the network infrastructure), but they also appear willing to keep paying a roughly constant amount.
- **Technology obsolescence risk and 5G** – Fibre is the current gold standard and the current focus in many markets is on upgrading networks to full fibre (i.e. FTTH, from the exchange all the way to the end user's premises, rather than fibre to a street cabinet and then legacy copper for the last mile).² It seems unlikely that a newer and better technology will be developed in the next 10-20 years to replace it. That said, 5G mobile technology may represent a threat to elements of the retail broadband market – customers may find they can use 5G instead of a fixed connection to their homes. Although this is a risk to some fibre business models (especially those focussing on the residential market), even 5G will still require much more fibre to be built,³ albeit to serve multiple 5G base stations rather than homes. The trend of rapid increase in demand for fixed bandwidth to homes and offices that has been seen worldwide in recent years may mean that even 5G will not be a suitable substitute for a fixed connection, which will likely always be faster and more reliable than wireless ones.
- **Regulatory dynamics** – The regulatory background is critical to a successful investment and investors will need to understand the position thoroughly as well as any likely changes over time. In the UK, for example, OFCOM has indicated that it will, in most areas of the country (those said to be “potentially competitive”), require Openreach to offer a basic “anchor” broadband service at a regulated price (see our blog on fibre regulation in the UK). The level of this price and the areas in which it applies could have a significant impact on a competing provider's business case. Regulation can also assist with build costs; for example, where an incumbent is obliged to offer access to its ducts and poles at a regulated price, this means a new fibre company can build out their network more cost effectively and quickly (though this of course reduces costs for competing networks too, reducing the advantage that would otherwise be obtained by building a new network). In the EU it may also be possible to take advantage of the (very complex) rules on co-investment so as to enter into a partnership with an incumbent operator to build a new fibre network and then have that new network protected from access regulation (see our blog post on Co-Investment Models for Broadband infrastructure).
- **Wholesale / retail** – The owners of a fibre network will need to decide whether to offer wholesale or retail services, or

both. If they offer retail services they will need to engage a sales and marketing team and invest in customer support. It could be difficult to do this successfully, especially if they are trying to do so over a large area of the country. Offering wholesale services, on the other hand, can eliminate the need for these elements, and can reduce market risk (especially if combined with a medium-term financial commitment from a retail partner). But of course this is likely to mean lower returns overall because some of the value will be captured by the retailer. While some of these features could be new to some investors in the sector, we expect the increasing sophistication among infrastructure investors, coupled with the growing demand for rapid internet speeds to power the digital transformation, will mean that an increasing number of infrastructure investors will seek to enter the market or consolidate their existing interests – particularly through M&A transactions.

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