CSC STRATEGY LETTER NUMBER 45

VSAT and Inmarsat: Did We Just Snatch Defeat FROM THE Jaws of Victory?

When your largest position, Viasat Inc. (Ticker: VSAT), enters into a transformational merger involving regulatory complexity, interesting technology, enough equity issuance to require a shareholder vote, and a conceptual doubling down against what might be called the "Elon Musk-generated low-earth-orbit satellites (LEO) space craze," it elicits a lot of internal navel-gazing. Search through Covestreetcapital.com/Thoughts to satisfy your endless enthusiasm for the subject matter at hand or click here for some background on our thinking.

Here is what your first thought isn't: a massive and quasi intellectual defense of what you were thinking the day before you didn't see this coming. There is where our Decision Process (DP) Spreadsheet gets trotted out. Here were our self-identified 3 key variables:

1. **Can the VSAT-3 constellation be launched and compete effectively vs LEO/terrestrial?**
2. **Following the VSAT-3 EMEA launch, will there truly be a capex inflection point where there is real free cash-flow and it's growing rapidly?**
3. **Will the defense business continue to grow value in the double digits?**

We also establish a "Short" position in an attempt to reverse engineer a failure:

1. **Musk and other LEOs can take share with negative economics even if they are not financially successful.**
2. **Very difficult to "see" ROI in satellite build given overlapping capex programs.**
3. **Satellite event risk.**
4. **International distribution unclear and complicated by recent airline issues and lack of vertical expertise.**
5. **Cash-flow inflection point unclear especially on uncertain future capex spend.**

The first conclusion is self-evident: a lot of life happens off-spreadsheet. This is a bold transaction that did not come out of the blue—our guess is that Viasat would have done this when Private Equity first bailed out Inmarsat in 2019, but at that point VSAT's stock was completely in the toilet and no math would have allowed such a transaction. Our sense, which will be laid in the Proxy documents next year, is that PE realized they had a poor hand when no mathematical calculations provided for a potential play by a non-strategic player; then, when they dumped their prior CEO last February (who will forever be known as the guy who called Viasat's soon-to-be launched VSAT-3 constellation a "mythical beast"), the game was on for an exit. And arguably, *if* this was a deal that should be done, then this was the time to do it as VSAT stock had doubled in the past 12 months while the rest of the industry is a constrained and leveraged mess crouching in the shadows of billionaires spending tens of billions on a vision.

Here are our 48-hour thoughts in regard to this deal and our position in Viasat. The shorter term picture and a 15% dump in the stock is the obvious: the world knew "we" made sense and simply waited 2 years to get invested in the last few months. The first bird of the VSAT constellation would be launched in Q2 2022 followed closely thereafter by the second within the ensuing 12 months, and there would be a massive cash-flow inflection as $900mm of assets in a warehouse 3 miles away from our office gets converted into 40% margin income. Boom—$125.

But funny things sometimes happen on the way to the short-term bank. Without a doubt, the deal complicates the near-term mental outlook for the investment community at large, although the company is insistent that nothing has changed in regard to the amount and timing of free cash-flow inflection. And some basic math suggests that "doubling" the free cash-flow in the same time frame but with 60% more shares is the definition of accretive. But NOBODY likes things more complicated than necessary, and this is an industry fraught with Twitter-based idiocy that passes for legitimate rumor and fact. I was referring to the "space" industry, but to be fair we can think of another industry to which that statement applies.

So, our David Letterman list of things to think about:

1. Does this deal make long-term, strategic sense for VSAT?

This is obviously a tough one to assess, and an answer requires the passage of time. We are going to go with a mostly overwhelming yes. We admit to being anchored by the concept that Mark Dankberg and team Viasat have simply run over the industry both technologically and strategically speaking for over a decade, and if "that guy" says this makes sense and explains why, then why shouldn't we give them the benefit of the doubt? "The customer base essentially asked us to do this deal" is a concept worth thinking about.

There is also clearly the question of "why bother?" Viasat tech would continue to make mince-meat of Inmarsat and most of the rest of the industry on much cheaper "price to bit" math—why not let Inmarsat suffer with the rest? Or why bother—Starlink is going to make mince-meat of anything geostationary orbit (GEO) because the only interest anyone in the world has is low latency bandwidth to be purchased at nearly any price? (Umm..wrong in big way.)—What we also think is that Viasat has realized the hard way that selling bandwidth in an industry-specific way requires industry-specific people who know the players and know how to relationship sell, which many don't even begin to understand. Inmarsat is one of the oldest players in the industry, has material relationships in the "mobility world" (planes, boats, and the general world outside of the US), and can greatly assist, at least in theory, at selling capacity in the new VSAT constellation much more quickly than VSAT could on its own.

This deal reminds us a lot of the VSAT acquisition of WildBlue back in 2009. At the time, Viasat had superior satellite technology but lacked distribution. As Executive Chairman Mark Dankberg recently mentioned in the interview our very own Ben Claremon hosted on the Compounders podcast, the WildBlue acquisition is what got Viasat the distribution organization it needed. Back then, the company's market cap was around $1 billion and the equity value represented a large percentage of its enterprise value. Mark and his team clearly knew what they were doing then and, to some extent, investors need to give Viasat the benefit of the doubt. The company has a successful, long-term track record and is bringing unique assets to the table, including: a technologically advanced ground network, the ability to manage the network in a way that improves the performance of Inmarsat's assets, and a vertically integrated business model that gives Viasat a cost advantage.

One of the other key issues to think about is "the portfolio." VSAT has superior network management skills, and being able to pivot significantly more bandwidth where it is needed in a cost effective way is arguably a point for why the Inmarsat assets are worth a lot more to VSAT than the small handful of other potential suitors, much less a standalone private equity entity. Viasat and Inmarsat are the only two companies today actually deploying a global Ka-band network with a fleet of 10 GEO Ka-band satellites and a total of 19 satellites including other frequencies, and an additional 10 Ka-band satellites to be launched over the next three years. Their fleets also complement each other, with Inmarsat providing a blanket of thin global coverage and Viasat providing dense capacity overlays in high-ARPU regions. There is also a highly complementary end-market focus: B to B, mobility, government, and defense. The US-based rural consumer, which continues to occupy an absurdly disproportionate amount of mental space regarding Viasat, will be less than 20% of the combined entity.

Say it again: being able to point bandwidth where it is needed—on land, toward dense populations, and not toward dolphins—makes a lot of sense, and maintaining varied assets under management works.

Other optionality: L-Band? We would make the case that providing the right bandwidth solution to a customer which encompasses "width," latency, cost per bit, hardware, and network cost is not "LEO vs GEO." It is by definition hybrid. L-Band effectively gives Viasat an entry into the world of IoT (Internet of Things), and while the term has been thrown around for years, its growth continues each year with more and more devices connected to each other in a massive worldwide mesh network. What L-band capability effectively provides Viasat is the ability to roll out small form cheap terminals that can deliver position tracking, remote asset management for pipelines, emergency response, mobile fleet management, and other asset tracking capabilities for which Ka terminals are overmanned and overpriced. For a better description of what this market could look like, look no further than the presentations and valuation of Iridium.

So subject to the fun and games of execution and regulatory approval, we think this deal makes a high degree of commercial sense, but it also represents land grab. Despite the promise of newcomer offerings in LEO, in our view the players who will be capable of commercial materiality in the world of space-based connectivity is inherently limited by the need for scale, the cost of scale, network effects, technological ability, the finite nature of premier geolocation and spectrum rights, and the ability to properly negotiate global regulatory issues, which is a highly problematic mess of national interests that have nothing to do with saving the world through connectivity.

2. Is this a fair price? Are we getting more per share than we gave up?

Equity dilution is never on its face a "good" thing, but can the argument be made here that we are selling stock at X and receiving value at X plus? The management plan just restated on the announcement call:

a. Viasat recommitted to maintaining the SAME free cash-flow inflection point timing.

b. The PER SHARE free cash-flow generation will INCREASE after the deal.

So, if you double free cash-flow and issue 60% more shares, is that the definition of accretive? Let's be very clear about the market's reaction to the deal. Viasat's stock declined despite the fact that the free cash-flow per share of the combined entity actually increases the cash generated to equity holders by 35-40%. That makes sense only if you believe that there is a lot of integration and execution risk associated with the merger. It is not unfair to apply some discount to what management is saying about the merits of the deal. But what the stock is really "saying" is Starlink and the LEO industry is simply going to overrun the entire GEO business model, ergo paying anything over 4x cash-flow (yes—investment banking rule 8—"there is always someone who will pay 4x for anything") is inherently dumb. Is Inmarsat as a standalone run by Private Equity worth what Viasat paid? No. But is it worth the amount paid in the hands of Viasat? Now that has a far greater probability.

The stock price action implies that the market believes Viasat overpaid by an amount between $700 million and $1 billion, an amount which would imply an overall multiple/value for the Inmarsat assets at somewhere around 7.5x forward EBITDA, inclusive of capex synergies. The only publicly traded competitors that exist—Eutelsat, EchoStar, and SES—trade between 5.5-6.5x EBITDA. However, each of those has massive exposure to secularly declining broadcast markets (Eutelsat is 60% broadcast, for example). Is it fair for Viasat to pay a premium over the amount at which inferior assets trade? We would say so. The idea that the premium is too high seems to ignore that Viasat has the ability to vertically integrate and pull forward the filling of its capacity, has optionality on taking hardware in house, and has not baked in anything for their L-band plans.

Lastly, enterprise value to EBITDA is a very crude, not particularly great measure as a blind rule applied blindly. It is particularly useless in people who have highly variable capex business models. If you built an office building but didn't start leasing it until tomorrow, your valuation on current cash-flow looks ridiculous. One year out—genius, you actually paid 6x cash-flow. But the building was generally worth $100mm the entire time. Both companies are sitting on planets worth of "work in progress," non-earning assets. Coincidentally, both have coinciding aggressive launch programs which reinforces both the difficulty of ascertaining "values and multiples" in the short-run and, on the positive side, will exacerbate the free cash-flow gush on the other side of the spend in 2023-25.

3. Can Viasat competently pull this off?

One thing that is abundantly clear after a fair amount of inbound traffic from both the buy- and sell-side of the world is that this acquisition muddies what were perceived to be pristine, light blue waters. In other words, the company was in a position to deliver on its promises of the last few years and all we needed was for the VSAT-3 launches to go off without a hitch. Once that happened, voila, the stock would be $125 and everyone who bought in pre-launch would look like a genius. We would argue that this simplistic narrative missed a lot of potential execution risk that did in fact exist. Just having satellites in the air and bandwidth to sell does not guarantee Viasat, or any satellite broadband competitor for that matter, can actually generate revenue. You need a salesforce, a robust ground network, established relationships, and buyers who trust that you can deliver consistently. The Inmarsat deal helps with a number of those elements but introduces a host of other risks. Specifically, Viasat will have to integrate and manage the combined networks well. It will have to welcome and embrace a bunch of Inmarsat employees who likely considered Viasat an enemy for many years. And, maybe even most importantly, it is going to have to navigate complex regulatory waters given the sensitive nature of a US-based company buying a UK national champion. The market doesn't like deals that have perceived closing risk and this acquisition is by no means a slam dunk. The good news is that this is a deal with a private entity, and thus there is not a "go-shop" period which might rouse all sorts of people to smell the landgrab and act.

Finally, the last additional execution risk comes from the increased debt load. Inmarsat was over-levered and Viasat is assuming that debt in the deal. The company's pitch is that the combined cash-flow profile is quite attractive, especially as the pace of capital expenditures subsides. Therefore, the company should have no trouble going from 5x levered to 4x levered in a reasonably short period of time. However, let's remember how COVID threw a wrench into Viasat's previous de-leveraging plans and the company was basically forced to raise equity last year. Things rarely go exactly according to plan, and with the elevated debt load Viasat will have less margin for error. We know that the company typically embeds a large margin of safety when they make projections, but we certainly don't want to downplay how large a swing this is or the "off the spreadsheet" issues that get exacerbated when you layer on debt.

What is not widely appreciated is how vertically integrated Viasat is versus the competitive space and thus has developed not just internally-generated intellectual property (IP), but it can build its own infrastructure and run high level managed networks services globally. It's not aspirational. The other player who is similarly vertically integrated is Starlink—but we would argue there remains a lot of aspirational issues to climb in building a functional network that can offer promised service at an acceptable price that fits into a model of economic self-sufficiency.

4. Does this de-risk the distribution side of "how do we sell our new capacity"?

When thinking about Viasat's organic plan to capture market share internationally, especially as the company increasingly ventures outside of the Americas, we always had a nagging suspicion that they would need to buy something within Europe—and definitely something in Asia—to get "feet on the ground." Say whatever you will about the "old school" tech that Inmarsat has, but what they do have is a massive, multinational distribution footprint that gets Viasat's impending capacity into the hands of the users who need it, will use it, and are starved for more of it. Perhaps even more important is the fact that the timeline for this to happen moves up, thus de-risking one of the issues we always had: the potential slow pace of market penetration in places where Viasat was a newcomer.

Is this a land grab? Unequivocally, yes. Was it the right land to grab? We will know in 3 years.

5. Don't underestimate the value of being friendly with regulators in the UK and Europe vis-à-vis being seen as an American interloper.

Some of the larger issues that new entrants (read: SpaceX) will have to surmount internationally is the need to play nice with regulators. The FCC has been very encouraging when it comes to LEOs and new entrants in general. However, the European regulators, as well as other international players, see things from a more domestic champion/protectionist bent. Buying a company with a long regulatory history and the requisite "local" position is an intangible that you cannot quantify. But, given the contentious nature of SpaceX's march through all prior regulations in the US, one can't help but notice the defensive maneuver in Viasat's marriage to a long-term UK champion.

We have one other brief thought on this subject. Space sustainability is a topic that Viasat brings up a lot. Primarily that refers to making sure we don't have so many objects in space that they collide and make it impossible to launch new technology into space, or simply maintain the existing infrastructure. The FCC in the US has clearly not been too concerned with this subject, given that it has approved the launch of thousands of LEOs without requiring a cooling off period where regulators could assess changes in collision risk. But, the US does not "own" space and we should assume that Viasat will use the relationships in the UK that come with Inmarsat to push its admittedly self-serving space sustainability agenda.

6. All bandwidth demand is not equal: Internet of Things (IoT) demand is/will be extremely price sensitive and not everyone will be willing to pay or need the least latency.

Everyone likes to talk about LEOs as the be-all and end-all solution in space communications. However, their relative cost per bit, inclusive of ground equipment, doesn't always compare well with those of traditional satcom players. As Viasat and Iridium Communications have pointed out, small, cheap terminals for IoT applications are hard to displace with new LEOs given the immense cost and power budget of a LEO terminal versus an L-band, S-band, or C-band equivalent. Inmarsat is positioned to develop, with Viasat's technological help, additional applications of their L- and S-band satellites. The good news is that Viasat has done much of the work already under the auspice of the military's Blue Force Tracking program. The company even wrote a helpful blog piece about the merits of L-band back in 2019.

7. Viasat is issuing equity again…really?

We will be blunt: we are not huge fans of companies that consistently issue equity. Ideally, companies should be very judicious when it comes to issuing stock and even shrink the share count over the year. Viasat issued equity to seal the recent RigNet deal and now is essentially giving away 37% of the company to Inmarsat's owners. Now, we do subscribe to the idea of owning a smaller piece of a much bigger pie. But, if you are going to issue this many shares, you better be confident about how much. To be fair, we have argued for…20 years?...that Viasat at its core has a disproportionately high ratio of propeller head to HP-12, and has not been optimally run on a capital management basis despite the ownership and Board presence of allegedly superior beings. (See below.)

8. Who is going to run the combined company in 3 years?

It's not "not an isue." Mark Dankberg seems like he will tinker and lead the industry until death—he is 66. Rick Baldridge, the Company's operating CEO, is 63. We don't know team Inmarsat. We would strongly argue for a COO for the new company who can develop the chops for longer term leadership.

9. Let's be very cynical about this deal and short it.

Prior to the deal, renowned investor Seth Klarman and the Baupost Group owned 22% of Viasat and have been there a long time. They have "Observer" status on the Board. One can argue they also have a man crush on Mark Dankberg, think long-term, and are fully supportive of this deal. Could one argue that this is a way for the largest and frustrated shareholder to see an exit as a smaller player in a larger and more liquid company? As it stands, "Baupost selling stock" would be a big fat negative. As part of a bigger company—less so. It could also be argued that Baupost is terrific at private deal sourcing in a variety of asset classes but has no special "oomph" in public equities.
The same principle applies to Viasat management. A bigger company lessens dependence on management who arguably are in the 7th inning of their career—Buffett, Malone, Diller, et al aside.

This was a completely defensive deal that suggests LEO, Starlink, Kuiper, etc. is truly a force to be reckoned with. And, as LEO rapidly establishes credibility in military and commercial circles, Viasat-like asset bases are simply being devalued from the spreadsheet assumptions made 4 years ago.

Viasat grossly overpaid and diluted shareholders as it felt that this asset in other hands would be a competitive long-term problem. It also realized that despite an acknowledged growth in demand, just putting capacity in the air doesn't sell capacity, particularly in non-US markets.

The much ballyhooed cash-flow inflection point was/is always a line in the sand. Isn't the spending on VSAT-4 now showing up? Isn't the financial valuation exercise always about terminal value because we never see interim cash-flow? And is having confidence in a terminal value for assets that die in 15 to 20 years a problematic exercise?

The Europeans will kill or delay the deal or force something to be divested that ruins the math and logic of the deal and Viasat eats a $200mm break-up fee and the public investment case is shredded.

We conclude—sometimes wrong, rarely in doubt.

We own this in size, we bought more on the dip. We think there are a variety of events here that over-ride the "concerns"—like world-class assets being launched in 2022 with big financially positive consequences. These don't disappear because of a "deal." We think the defense business is crazily misunderstood and undervalued and worth "mid 50's" growing at double digits, but it is not a candidate for separation anytime remotely soon—if ever. It is annoyingly messier as we seemed on the tipping point of success from an 18 month portfolio basis. We have had worse things happen to us.

Jeffrey Bronchick, CFA

Principal, Portfolio Manager
Cove Street Capital, LLC