I. Business Overview

a. Iowa Telecommunications Services, Inc. (IWA) provides local landline telephone and data services to residential and business customers in rural Iowa, Minnesota, and Missouri. They service 423 communities and are the sole wireline services provider to 67% of their customers. About 70% of their access lines service residential customers – the other 30% servicing businesses.

b. IWA’s service offerings are broken down into five revenue generating segments: Local Services, Network access services, Toll services, Data and Internet Services, and Other services.

i. Local Services: “Basic local services enable end user customers to make and receive telephone calls within a defined local calling area for a flat monthly fee.” (2008 10K)

   1. Other services include enhanced communications services – call waiting, call forwarding, caller ID, voice mail, and three-way calling.

   2. IWA sees bundling these services as a way to improve margins and increase revenue per customer.

   3. $71MM or 29% of 2008 revenues.

ii. Network Access Services: “We bill access charges to other carriers for the use of our facilities to terminate or originate long distance calls on our network. These fees relate to interexchange long distance, or toll calls, that involve more than one company in the provision of the service. Network access charges compensate us for the services we provide to other carriers for completing toll calls for our customers.” (2008 10K)

   1. Fees charged to other telecommunication services providers to use the IWA wireline network.

   2. $89MM or 36% of 2008 revenues

iii. Toll Services: Long distance services.

   1. $23MM or 9% of 2008 revenues.

iv. Data and Internet Services: “Data and Internet services consist largely of revenues generated by our dial-up and DSL Internet access services as well as for providing enhanced data solutions to customers.” (2008 10K)

   1. Basic internet services.

   2. $35MM or 14% of 2008 revenues.
v. Other services and sales: “Other services and sales consists largely of revenues generated by the sale, installation and maintenance of the customer premise voice and data equipment, satellite and cable video, inside line care, and leasing of office space.” (2008 10K)

1. The everything else segment
2. $28MM or 12% of 2008 revenues.

II. Investment Thesis

a. Financial Condition

i. Iowa Telecommunications, since its IPO in 2004, has consistently allocated a significant portion of its cash flows in the form of dividend payments to its common stock share holders with yields ranging from 7% to 16.5%. IWA has declared a quarterly cash dividend of $0.41 a share for the past 16 quarters, any cuts to which potentially serving as a catalyst for declines in share price.

ii. Short-term

1. Cash on hand of $11.6M. Current liabilities, excluding the amount of their outstanding revolving credit facility due, exceed current assets by $11.3M. IWA’s working capital deficit is not in and of itself alarming; with $61M in funds available to them through their revolver, but their continued borrowing against it compounds their long term debt obligations.

iii. Long-term

1. Debt-to-equity ratio at 3.25 with almost all long term debt maturing in the same year. Three senior secured term facilities at $477.8M with $427.8M outstanding on top of the $100M revolver all come due in 2011. Assuming IWA were able to maintain free cash flows at $70M for the next three years (FCF08 - $60M) while continuing their stated network expansion via business acquisitions at an average net cash loss of $23M (net cash loss on acquisitions for 2008 - $39M), they would need to borrow an additional $5M from the revolver to maintain both their annual $52M dividend payout and a positive cash balance in 2011, when $577.8M comes due or expires. Debt refinancing would certainly be an option at that point, with capital markets presumably more attractive, but I don’t think pushing back their debt obligations given their obsolete business model will serve as a legitimate solution.

b. Business Strategy

i. Iowa Telecommunications has adopted a very conservative approach to the expansion of their business. They operate a telephone landline network, providing local, long distance, and some DSL internet to their communities. The majority of their revenues come from the fees charged to other telecommunication services companies that use their network to complete long distance calls. The
penetration rates for their services on their own networks have stagnated, along with the revenues their existing services generate. The only viable option they have to growing their business is through the acquisition of more landline networks, an obsolete and expensive technology when it comes to telecommuting.

ii. The acquisitions of landline networks accompany with them capital expenditure spending. IWA spends about 10% of their net property, plant, and equipment, or $30M a year on capital expenditures, on top of what it costs to fuel the minimal top line growth they experience. IWA’s tight working capital and significant dividend payouts prevent them from investing in recent technologies like wireless service, yet alone current technologies. IWA can’t compete with new technologies because their technologies are obsolete, they can’t invest in new technologies because of their tight cash flows, and it could prove very costly to them, in the form of capex, to significantly expand their network. IWA’s focus on rural America affords them some competitive advantage for the time being, but industry trends seem to point in the other direction.

c. Industry Trends

i. The evidence seems to suggest that American families are beginning to switch from landline to wireless telephone services. 17.5% of American households, compared to 4.2% in 2004, are now “wireless only” households according to estimates for the first half of this year by the National Center for Health Statistics. Iowa in particular had one of the highest percentages for wireless households at 22.2%. If our economic climate worsens, I would expect this trend to continue as people tighten their consumption and run leaner households. This trend away from residential landline use, especially in rural areas, will negatively impact IWA’s business.

ii. Not only have rural households been switching from landlines to cell phones, but big wireless providers have also focused their attention on rural America. Verizon plans on rolling out their new 4G wireless broadband network “throughout the country including places where Verizon doesn’t offer service today” said their CFO. This followed Verizon Wireless’ expansion of its high –speed wireless network in Iowa and the more than $24M invested last year in enhancing that network. AT&T announced last year that it had invested $45M into setting up its 3G network in Iowa, with more than $15M in upgrades to follow this year. Even smaller players like Qwest Communications have plans in the works to provide “super high-speed” fiber-optic Internet services throughout Iowa with speeds 30% greater than those offered by IWA.

iii. With the big telecom players aggressively expanding their superior services and networks to rural America, with the specific Iowan expansion in mind, IWA won’t be able to compete. IWA already
operates in an extremely mature market (landline telecom), where any growth is more or less bought. IWA losing customers to services with better technologies at comparable prices is a huge concern because of IWA’s already dwindling potential market.

iv. Apart from traditional means of gaining broadband access, I.B.M earlier this year indicated that they were working with rural electric companies to offer high-speed Internet services over power lines.

v. Obama’s stimulus package allocated $7.2B towards the expansion of broadband internet services to rural America, essentially making it cheaper for companies to expand their networks into rural areas. This movement towards providing high speed internet to rural America, either through innovate technologies, government assistance, or the expansion of wireless coverage will prove costly to the business operations of Iowa Telecommunications.

vi. IWA operates in, for all intensive purposes, a zombie industry. The landline telecom story died with the cell phone. IWA’s plans to expand their market share in this industry seemed reasonable just five years ago because of their essential monopolist control over the majority of their network coverage area. The increasing trend towards wireless households, with Iowa leading the charge, the planned expansion of 3G and 4G networks to rural areas by larger telecom providers like AT&T and Verizon, the push and increased funding by the government to expand the reaches of broadband to the likes of rural Iowa, and the innovation that is making broadband accessible to everyone in the U.S all serve to increase IWA’s competition in the future. With no technological advantage and marginal at best pricing leadership, I fully anticipate substantial deterioration in their business operations.

III. Valuation

a. With a market cap at close to $400M, Iowa Telecommunications is trading at a multiple of 17 times earnings, compared with multiples of 11.75 and 13.71 for industry leaders AT&T and Verizon respectively. The industry average is around 12 times. Considering IWA’s bleak growth prospects and impending debt situation I think investors are paying 17 times earnings for their seemingly stable dividend (yield currently at 13.14%). Any cuts to this payout could result in multiple declines. IWA at 13.71 times earnings (VZ’s PE) would result in a 20% decline in stock price, and even then IWA’s growth prospects seem significantly overvalued.

IV. Key Stats

a. Share Price: $12.30
b. 52 week range: $9.94 - $20.99
c. Market Cap: $394M
d. P/E: 17.11
e. Div (yield): $0.41 (13.14%)
f. Debt to Equity: 3.25

V. VAR
a. Karen Smith (Verizon), Amy Grundman (AT&T), and Joanna Hjelmeland (Qwest)
i. Progress of wireless expansion into rural America? Great Plains? Iowa?
   1. Waiting on responses from Verizon, AT&T, and Qwest, will update as they become available
ii. What initiatives is your company taking to ensure telecommunications services for rural America? How is that different from your company’s past stance? What has changed?
   1. Waiting on responses from Verizon, AT&T, and Qwest, will update as they become available
iii. What advantages can your company provide to rural America over their incumbent landline telephone service?
   1. Waiting on responses from Verizon, AT&T, and Qwest, will update as they become available
b. Investigated per month pricing for IWA servicing plans (not listed on website)
i. I found that there was no significant cost savings associated with IWA services. Tiered service plans were in line with those offered by Verizon and AT&T ranging from $30 - $70 per month. According to customer reviews, internet speeds were almost half of advertised levels (e.g. 800 KB/s instead of 1.5 MB/s.)