Frontier Communications' Shares Not Wired for Success

D.A. Davidson argues that the regional telecom's acquisition of Verizon's rural lines will be bad for the stock.

TUESDAY, DECEMBER 8, 2009

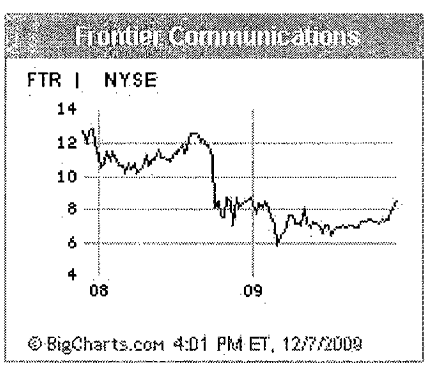
Frontier Communications (FTR: NYSE)
By D.A. Davidson & Co. ($8.43, Dec. 7, 2009)

WE ARE DOWNGRADING SHARES of the rural telecom provider to Underperform from Neutral.

We expect Frontier Communications (ticker: FTR) to close its acquisition of Verizon Communication's (VZ) rural lines in the spring and for Verizon shareholders to control 67% to 71% of Frontier's stock after the acquisition. With 50% of Verizon's stock held by retail shareholders, and two recent bankruptcies of other stocks that have been distributed by Verizon, we would expect significant selling of Frontier after the distribution.

Is the rural Verizon franchise too damaged? Frontier has secured regulatory approval in three states so far, and will have hearings in the remaining five states over the next two months. The to-be-acquired properties lost 3.3% of their lines sequentially and 11.5% on an annual basis. Verizon only had 7,000 net adds for high-speed data in the quarter (on an embedded base of 1.05 million), and only 4,000 video net adds on an embedded base of 103,000. Frontier expects the acquisition to close in the second quarter of 2010.

Frontier refinanced $564.4 million of 9.25% debt and $83 million of 6.25% debt with cash and a new offering of $600 million of 8.125% debt in October. Frontier still needs to finance $3.3 billion of new debt for the Verizon transaction. We expect Frontier to have to pay 8% to 9% for the additional debt.



We met with Frontier's management on Dec. 4, and they remain confident that they will be able to find $500 million of synergies after they close the acquisition of Verizon's rural lines in the spring. The synergies represent 21% of cash operating expenses and exclude any force reductions from the unionized field service or call center workforce. Frontier has not given shareholders a detailed breakdown for the savings but expects to gain efficiencies in the accounting and regulatory systems that it will acquire.

Frontier has a good track record with running a lean organization and has the highest third-quarter 2009 earnings before interest, taxes, depreciation and amortization (EBITDA) margins (55%) of any of the major rural or urban local telecom companies.

However, we expect investors to be skeptical that Frontier will be able to achieve its planned savings since 74% of the acquired workforce will be unionized, and Frontier is not planning any cuts in this workforce. Also, the systems savings in accounting and payroll will take time to achieve without any disruption.

We also expect much of the distributed Frontier stock to be sold quickly by the Verizon shareholders due to the recent track record of stocks distributed by Verizon going bankrupt (Idearc and Fairpoint Communications). Any shareholder that is confident that Frontier can achieve its synergy targets should at least move to the sidelines and avoid the stock turbulence in the spring, and then revisit the stock at lower levels.

Our price target of $6.25 per share is based on a 12% yield on the new 75 cents per share annual dividend that will be put in place when the Verizon transaction closes. We expect the stock to fall to this level due to the technical selling pressure from the new shares issued to Verizon holders and investor skepticism that Frontier can achieve its planned synergies. Since this is 23% below current prices, we are moving the stock to an Underperform rating.

-- Donna Jaegers, CFA

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