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High Demand for Telecommunications Services Expected to Drive Deals Despite Economic Headwinds

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The COVID-19 pandemic shed a spotlight on the need for strong digital infrastructure that allows for reliable phone, video, and internet services. In 2021, telecommunications deals increased with pandemic-driven demand, coincident with the tech-sector boom.[1] More recently, inflation and interest rate hikes cooled the market. Economists and industry professionals are divided as to whether the U.S. economy will fall into recession, with many expressing more optimistic outlooks over the last couple of months. Nevertheless, the telecom industry is expected to be resilient this year.[2] Economic digitalization and federal investment in broadband infrastructure should encourage mergers and acquisitions activity in the telecom industry despite economic headwinds.

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THE DIGITAL ECONOMY RELIES ON TELECOM NETWORKS

Two trends are expected to drive telecom-sector investment now: First, rapid digitalization of the economy; and second, investment in emerging digital markets.[3] Both trends require internet connectivity and will place increasing capacity burdens on existing networks, driving the need for upgrades, efficiencies, and overhauls.

The pandemic pushed the economy online more rapidly than predicted.[4] As much as possible, life in the U.S. reorganized around home offices, video conference calls, streaming platforms, and app-based social connections. Even as COVID-19 subsides, the push for digitalization has continued.[5] Companies have incorporated digitalization into their strategic growth plans, even in the face of economic uncertainty.[6] In fact, digitalization is viewed as a safeguard against market volatility, allowing companies greater flexibility for accessing customers and responding to changing conditions.[7]

Simultaneously, emerging digital markets are driving investment in telecom network improvements. The metaverse promises virtual realities for immersive

gaming, remote work, and e-commerce.[8] Fintech companies are decentralizing banking with digital wallets and buy now, pay later services.[9] Non-fungible tokens (NFTs) are creating new and valuable ownership rights for digital property, driving lucrative blockchain transactions. Other technologies like Web3, DeFi (decentralized finance), and artificial intelligence are leading in venture capital investment.[10]

These technological developments necessitate telecom network improvements. Networks need greater capacity to host increasingly complex online interactions. They need better traffic management to increase efficient use of existing capacity and to reduce latency. Additionally, they need better security systems to protect customer data against ever-increasing ransomware attacks and cybersecurity threats.

Cloud services, 5G, artificial intelligence, and edge computing are increasingly deployed to facilitate these network improvements, which is why continued investment in these technologies is expected this year.[11]

BILLIONS IN FEDERAL FUNDING WILL DRIVE BROADBAND INFRASTRUCTURE DEALS THIS YEAR

Internet connectivity is key to a digital economy. Recognizing this, the federal government committed approximately $65 billion dollars to improve internet access and affordability in rural, tribal, and low-income communities when it enacted the Infrastructure Investment and Jobs Act of 2021.[12] By June 30, 2023, the National Telecommunications and Information Administration (NTIA) will determine how to deploy $42.5 billion dollars of that funding to states and territories through the Broadband Equity, Access, and Deployment (BEAD) program.[13] In addition to broadband infrastructure grants, the bill provided $14.2 billion dollars to help low-income households pay for wireless and internet services.[14]

Federal funding is also being used to support clean tech solutions to combat climate change. The Infrastructure Investment and Jobs Act provided $10.5 billion dollars to the Grid Resilience and Innovation Partnerships (GRIP) program.[15] GRIP will enhance electric grid flexibility in the face of climate change and extreme weather.[16] Funding in the amount of $3 billion is earmarked for Smart Grid projects, including investment in "optical ground wire, dark fiber, operational fiber, and wireless broadband communications networks."[17] Applications for Smart Grid grants were due March 2023.[18]

As more grant applications open this year, funding opportunities will become more concrete. This will stimulate greater investment activity for infrastructure projects, including among smaller regional networks already serving rural communities.[19]

ECONOMIC HEADWINDS WILL DRIVE OPPORTUNISTIC AND STRATEGIC DEALMAKING

The Federal Reserve raised interest rates in 2022 to slow the economy, curb inflation, and fend off the threat of recession.[20] Interest rates are expected to continue rising this year.[21] Capital will become more expensive, further slowing the economy, shrinking profit margins, and decreasing business valuations.[22] In the face of these likely macroeconomic challenges, telecom companies are strategizing to maintain profitability until the market stabilizes. To that end, experts expect more telecom businesses to spin off their non-core assets, as well as engage in joint ventures and alternative forms of financing.

Spinning Off Non-Core Assets

Telecom companies have been spinning off and divesting non-core assets, particularly passive mobile assets, to shore up core business operations. This trend is likely to continue this year.[23] Many telecom businesses are refocusing on 5G, fiber network expansions, and emerging technologies like edge computing that improve network capabilities.[24] They are also separating infrastructure and retail operations.[25] Over the next year, cash-flush and opportunistic dealmakers will try to secure infrastructure assets (e.g., cell towers and fiber networks) because they are the building blocks of a digital economy and reliably drive revenue.[26]

Joint Ventures and Alternative Financing

Other telecom companies are looking to consolidate networks, build out new networks, and unlock cost savings without relinquishing control over retail operations.[27] This year, however, borrowing costs will be higher and declining stock valuations will make stock an unattractive currency.[28] Therefore, some companies are likely to explore joint ventures to accomplish these goals.[29] Earnouts and contingency pay provisions tied to future performance may also be used more widely, as they help buyers and sellers bridge valuation gaps in a volatile economy.[30]

Telecom services are the backbone of the digital economy. The U.S. will continue to digitalize despite economic volatility. While the technologies supporting that backbone are experiencing a "seismic shift[]",[31] the demand for the services they deliver will continue to increase the rest of this year and beyond.[32]

Notes

1. See KPMG, M&A Trends in Technology, Media, and Telecom: A Historic Year for TMT Deal Making (2021), https://advisory.kpmg.us/content/dam/advisory/en/pdfs/2022/q4-tmt-deals.pdf; Telecom M&A: Here Are the Latest Deal Trends Worldwide, Bain & Company (Nov. 10, 2022), https://www.bain.com/insights/telecom-m-and-a-here-are-the-latest-deal-trends-worldwide-interactive/.
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3. See generally, Beena Ammanath, When New Technologies Converge, in The Year in Tech 2023 xi, xi (Harv. Bus. Rev. Press 2022); S&P Global Market Intelligence, supra note 2, at 8.
4. See Ammanath, supra note 3, at xi, xi-xii.
5. See PwC, supra note 2.
6. See id.
7. See Bhaskar Ghosh & Karthik Narain, What Leaders Need to Know About the Cloud, in The Year in Tech 2023, at 65, 66.
8. See generally Janet Balis, How Brands Can Enter the Metaverse, in The Year in Tech 2023, at 3; see also S&P Global Market Intelligence, supra note 2, at 4.
9. See S&P Global Market Intelligence, supra note 2, at 6; PitchBook, Emerging Tech Indicator: Q3 2022, at 4 (Nov. 28, 2022).
10. PitchBook, supra note 9, at 6.
11. See S&P Global Market Intelligence, supra note 2, at 8; Bernard Marr, The Top 4 Telecom Trends in 2023, Forbes (Dec. 9, 2022). Ghosh & Narain, supra note 7, at 65, 66.
12. See Fact Sheet: The Bipartisan Infrastructure Deal, White House (Nov. 6, 2021), https://www.whitehouse.gov/briefing-room/statements-releases/2021/11/06/fact-sheet-the-bipartisan-infrastructure-deal/; James K. Willcox, Infrastructure Law Includes $65 Billion for Improving Internet Access, Consumer Reports (Nov. 15, 2021), https://www.consumerreports.org/internet/infrastructure-bill-includes-65-billion-for-internet-access-a6861027212/.
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14. See Affordable Connectivity Program, FCC, https://www.fcc.gov/affordable-connectivity-program (last visited Jan. 10, 2023).
15. See Grid Resilience and Innovation Partnerships (GRIP) Program, U.S. Dep't of Energy, https://www.energy.gov/gdo/grid-resilience-and-innovation-partnerships-grip-program (last visited Jan. 10, 2023).
16. Id.
17. Grid Deployment Office, U.S. Dep't of Energy, Smart Grid Grants (Dec. 15, 2022), https://www.energy.gov/sites/default/files/2022-12/Smart%20Grid%20Grants%20Fact%20Sheet%20%28December%202022%29_0.pdf.
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19. Technology, Media, and Telecommunications M&A Update: Q3 2022, Deloitte (last visited Jan. 10, 2023), https://www2.deloitte.com/xa/en/pages/corporate-finance/articles/tmt-update.html.
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21. See KPMG, supra note 2, at 2, 8-9.
22. See id.
23. See S&P Global Market Intelligence, supra note 2, at 8.
24. See S&P Global Market Intelligence, supra note 2, at 8; KPMG supra note 2, at 2, 8-9.
25. S&P Global Market Intelligence, supra note 2, at 8.
26. See id.; PwC, supra note 2.
27. See Bain & Company, Global M&A Report 2022: What the Best Companies Did to Win in a White-Hot Market 26, 62 (2022), https://www.scribd.com/document/559324664/Bain-Report-Global-m-and-a-report-2022.
28. See KPMG, supra note 2, at 2, 8-9.
29. See Bain & Company, supra note 27, at 26, 62.
30. See PwC, supra note 2.
31. Bain & Company, supra note 27, at 29.
32. See S&P Global Market Intelligence, supra note 2, at 8.