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INITIATION REPORT

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October 29, 2018

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Alaska Communications Systems

(NASDAQ/ALSK)

BUY - Current Price $1.42 /Price Target: $3.00

Alaska Communications is the incumbent phone company in the state of Alaska.

The Last Frontier of Telecom Value

- We initiate coverage of Alaska Communications shares with a Buy rating and a $3 price target.
- It is the incumbent phone company in much of Alaska and was originally the City of Anchorage municipal telephone utility, taken private in a private equity buyout in the 1990s.
- It has dramatically restructured in the last few years, selling its wireless business and using the proceeds to shrink debt to a reasonable 3.1x EBITDA.
- The company also operates one of two redundant undersea fiber links to the lower 48, metro fiber networks in Anchorage, Fairbanks and the North Slope.
- In recent years, nearly all free cash flow has gone to upgrade its Anchorage and Fairbanks networks with fiber.
- After decades of losing share to the only other facilities-based telecom company in the state – cable company General Communication (GLIB.A – not covered) – ACS is growing again and regaining market share.
- The stock has attracted activist investors, with whom management has been cooperating, increasing the likelihood of a sale.
- The company has two tailwinds for financial results over the next few years:
  - The state economy is just exiting a brutal, multi-year recession driven by a collapse in oil prices. Oil prices have largely recovered, and the energy sector and state government are seeing renewed financial health.
  - Second, revenue from rural health care was 9% of total revenue last year but is expected to be down 30% this year. We believe that regulatory changes will allow the company to return to growth.
- Over the last decade, most small publicly traded rural phone companies have been acquired, with FairPoint and Hawaiian Telcom selling most recently. The state motto of Alaska is "the last frontier" and in many ways, Alaska Communications is the last frontier in a wave of telecom consolidation going back a half a century.
- Should the company be sold, we expect a significant premium with a sale above $5 per share.

Please find Important Disclosures beginning on Page 19.

Alaska Communications Systems Group, Inc.
600 Telephone Avenue
Anchorage, Alaska 99503
(907) 297-3000
http://www.acsalaska.com/

Rating	BUY
Target Price	$3.00
Ticker Symbol	ALSK
Market	NASDAQ
Stock Price	$1.42
52 wk High	$2.91
52 wk Low	$1.39
Shares Outstanding:	53.2 M
Public Market Float:	47.2 M
Avg. Daily Volume	110,896
Market Capitalization:	$76 M
Institutional Holdings:	44.0%
Dividend Yield:	0.0%

Earnings Per Share Normalized to exclude unusual items

FYE - December	2017	2018E	2019E	2020E
1Q - March	($0.01)	($0.10) A	$0.02	$0.02
2Q - June	($0.05)	$0.06 A	$0.03	$0.03
3Q - September	$0.01	$0.05	$0.02	$0.02
4Q - December	($0.06)	$0.06	$0.03	$0.03
Year	**($0.12)**	**$0.08**	**$0.09**	**$0.09**
P/E	-12.2X	17.5X	15.5X	16.1X
Revenue ($mm)	**$226.9**	**$224.1**	**$219.4**	**$222.0**
EV/Rev	1.1X	1.1X	1.1X	1.1X
EBITDA ($mm)	**$56.5**	**$54.3**	**$57.3**	**$57.9**
EV/Rev	4.3X	4.5X	4.3X	4.2X

Senior Executives

Edward J. Hayes, Jr.	Chairman
Anand Vadapalli	CEO
Laurie M. Butcher	CFO
Leonard A. Steinberg	General Counsel

Common Ownership Profile

Shareholder	Shares ('000)	% of Total
Aegis Financial Corp.	2,842,018	5.3%
Gilder, Gagnon, Howe & Co. LLC	2,375,968	4.5%
Renaissance Technologies LLC	2,107,410	4.0%
The Vanguard Group, Inc.	1,883,666	3.5%
BlackRock Fund Advisors	1,751,355	3.3%
Directors and Officers	6,026,309	11.3%

Capitalization

Market Value Basis (MMs)	**10/25/2018**	**%**
Total Debt	$180	74.0%
Market Value of Equity	76	31.0%
Less: cash	-12	-5.0%
Enterprise Value	**$244**	**100.0%**

Book Value Basis ('000)	**06/30/2018**	**%**
Total Debt	$180	39.8%
Other Liabilities	108	23.8%
Book Value of Equity	165	36.4%
Total Capital	**$452**	**100.0%**

Source: Company reports, Metastock and Dawson James estimates.

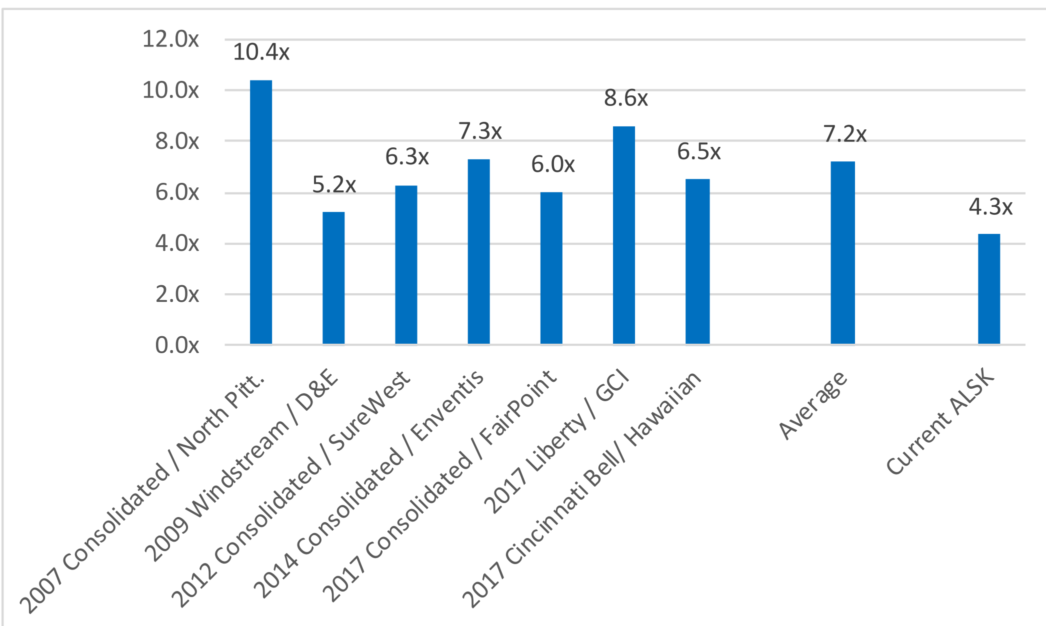
The Last Frontier in Telecom Industry Consolidation

We initiate coverage of Alaska Communications Systems (ACS) with a Buy rating and a $3 target price. Since its formation in 1998, the company has gone through several transformations. Most recently, it is starting to benefit as the state economy recovers from a severe recession, and we expect headwinds in its rural health care business to turn to tailwinds as current regulatory uncertainty is resolved. We value ALSK shares at 5.7x 2020E EBITDA. This is nearly a 50% discount to comps.

Our thesis is predicated on an improving revenue and EBITDA outlook and the fact that the stock is valued significantly lower than its peers – 4.3x versus 10.4x. The company has attracted renewed interest from activist investors and the board has responded. One of their responses aligns management bonuses to the share price, with $3.15 goal three years out. One of the repeated refrains of these investors is that the company should sell itself. While we dislike public sales processes as we have seen them backfire, destroying shareholder value (see INAP circa 2015-2016), we do believe that the board is open to a sale.

The rural telecom industry has consolidated from well over a dozen public companies 20 years ago, to one small cap company – Alaska Communications – and five larger consolidators. Thus, we view Alaska Communications as the last frontier in this long-term consolidation wave. The table below lists valuations for comparable telecom transactions since 2009. The average sale price was for 7.2x EBITDA versus just 4.4x presently for ALSK. Its in-state rival, quad play cable company GCI (GLIB.A – not covered) was sold last year for 8.6x, although we think GCI is much better positioned due to dominant market share, a larger fiber network and its statewide wireless business.

Activists Are Urging ACS to Join the Wave of Consolidation



Source: Company reports

Alaska is a Small, Extremely Rural State

While Alaska has a few small cities, it also has a large number of small, rural communities spread out over vast distances most of which are only accessible by boat or plane. Roughly 55% of the population lives in metro Anchorage, with a population of roughly 400,000. Anchorage is much like any other small U.S. city with tall buildings downtown, several sizable shopping malls and highways stretching out to affluent suburbs. Anchorage is the major transportation hub for the state. The seaport dominates the downtown with rail lines serving the port. Alaska is also served by Ted Stevens International airport, which is a major airline cargo hub for trade with Asia. Elmendorf Air Force Base and the Army's Fort Richardson are also located in Anchorage. To the north are a number of suburbs within easy driving distance, including Wasilla, Eagle River and Palmer. The only other cities with populations above 10,000 are Fairbanks, in the central part of the state, and Juneau – the state capital - which sits on the coastal strip of land adjoining British Columbia. Each has a population of around 30,000. There are 25 more cities or towns with populations above 1,000 with about 15% of the population, but otherwise, roughly one quarter million people, or one-third of the state lives in small rural communities.

There are six military bases in Alaska, three Army and three Air Force with a total of about 26,000 personnel. This is a major source of employment in Alaska. In addition to providing telecom services to the military, military personnel are important consumers of consumer telecom services in Alaska. Thus, when a major deployment occurs, as happened during the Afghan and Iraqi wars, ACS and GCI can experience meaningful declines in cell phone or other types of subscriptions.

And of course, Alaska brings weather extremes with winter temperatures of negative 40 F not uncommon in Fairbanks and with five feet of snow in a year not uncommon. In 2012, Anchorage braved almost 12 feet of snow. These temperatures stress outside telecom plant, requiring specialized equipment such as heaters for electronics cabinets, frequent repairs and frequent replacements. This increases operating costs, cuts margins and increases required maintenance capx. And winter darkness is a constant. In Deadhorse, the sun will set this year on November 23rd just after lunch at 1:05 PM. It won't rise again until next year when it comes up at 12:37 PM on January 18th. They get their sunlight back in the summer with all daylight and no darkness from May 19 until July 29. But, despite popular misconceptions, Alaskans cannot see Russia from their backyards.

Brrrrrr – Alaska Can be Cold, Dark and Snowy

	Average Snowfall	Record Low	Average Low	Average High
Anchorage	76"	-35°	14°	62°
Deadhorse	35"	-60°	-25°	54°
Fairbanks	65"	-62°	-15°	73°
Juneau	87"	-22°	25°	63°

Source: Company reports

These weather extremes also impact how telecom is used in Alaska. During the cold winter period, broadband and a good video subscription are a must, so Alaskans will pay a premium for their service. However, many Alaskans are avid outdoorsmen (and women), and they use the long summer daylight hours to get in as much hunting and fishing as they can. So they often just cancel some services outright over the summer, especially if they are going to spend time at a hunting or fishing camp.

This weather pattern also makes it harder and more expensive to recruit specialized talent into the state from the lower 48, especially for roles like software programmers and welders (as well as CEOs). So Alaskan companies often have to pay a premium for talent.

ACS Was Originally the Anchorage Municipal Phone Utility

Alaska Communications was originally formed in 1998 by former managers of Alaska-based Pacific Telecom and California private equity firm Fox Paine & Company. In May 1999, the company acquired Century Telephone's Alaska properties and the City of Anchorage's municipal phone utility Anchorage Telephone Utility. CenturyTel's Alaska properties were the incumbent provider of local telephone services in Juneau, Fairbanks and more than 70 rural communities in Alaska. ACS paid $265 mm to the City of Anchorage for the telephone utility and another $430 million to CenturyTel for total consideration of $695 million. By comparison, today the company has an enterprise value of $245 million. At year-end 1999, the company served 325,000 access lines. This number is now down 70% due to competitive losses, wireless substitution and conversion of second lines used for dial-up modems and fax machines to broadband internet connections. However, they have added 50,000 broadband connections.

In December 2010 the company announced that COO Anand Vadapalli would take over from CEO Liane Pelletier, effective February 1, 2011. Pelletier was well respected by her peers in the U.S. telecom industry. She had served as CEO since 2003 growing EBITDA by over 100% even as revenue was essentially flat. During this time, the wireless segment grew, while the wireline segment suffered from competitive losses. In our visits to ACS' retail stores and discussion with customers during her tenure we were unimpressed with the company's direction as it seemed to be more run more like a utility and less like a competitive enterprise. When Vadapalli took over as CEO Pelletier was replaced as chair by five-year board veteran Edward Hayes, who was previously the CFO of Pillar Data Systems until its July 2011 acquisition by Oracle.

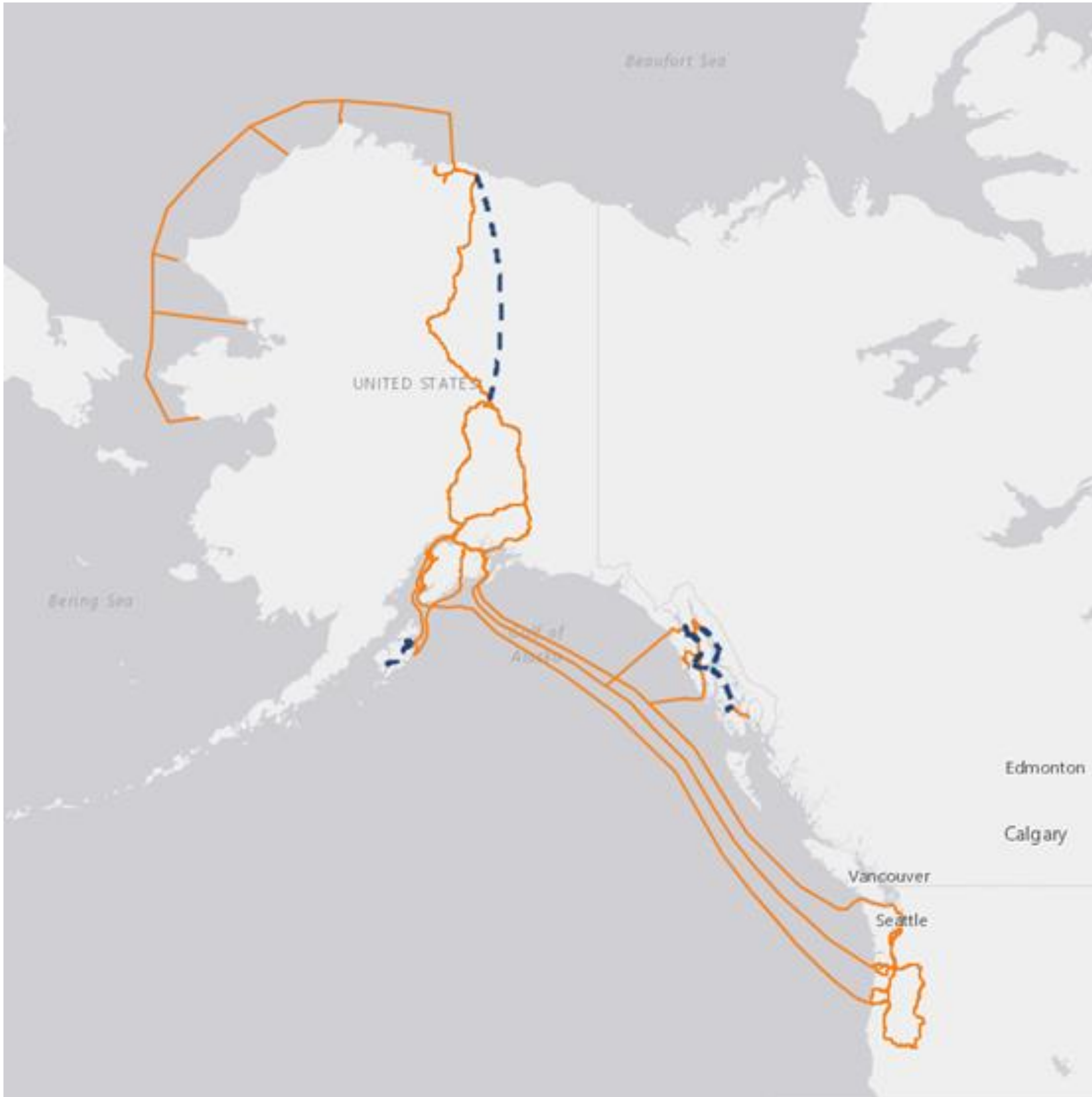
ACS faces a tough competitor in the form of statewide cable provider General Communication (GCI). General Communication has upgraded its cable plant to offer high definition video, gigabit speed high-speed internet access and, wireless services. It also owns Denali Media, which owns KTVA – the CBS affiliate in anchorage, and several smaller broadcasters around the state. GCI has dominant market share in business with about a 70% market share and most of the residential customer base. ACS and GCI both operate redundant fiber cable links between Alaska and the lower 48. GCI was acquired last year by John Malone's Liberty organization in a deal that merged certain Liberty media assets with GCI to form a new, larger cable/media company call GCI Liberty and trading under the new symbol GLIB.A. There is a widespread belief that this transaction was a precursor to Liberty selling GCI to Charter (the second largest cable operator in the U.S.). We would view such a sale positively for ACS as GCI's Alaskan management team have been aggressive competitors with a laser focus on the state, whereas Charter is more about merger savings and raising rates. To a lesser extent, AT&T also operates a fiber network in the state, but its focus is serving the Alaskan operations of its large national corporate and government customers. In wireless AT&T is the largest provider, followed by GCI and new entrant Verizon.

When Vadapalli took over, the wireless business was 41% of revenue and 50% of EBITDA but the business was at risk. Most if not all of the company's EBITDA came from a roaming agreement with Verizon, which did not operate a network in Alaska. When Verizon customers took their summer vacations to whale watch and hike Denali National Park, they utilized the ACS network. This was a lucrative arrangement for ACS, but it was easy for Verizon to calculate that it could build and operate a limited wireless network in the Alaskan tourist areas to serve its own customers, for far less than it was paying ACS. At the time, there were three wireless network operators in Alaska, with AT&T dominating with about a 50% market share, followed by GCI at 30% and ACS at 20%. In response to the impending threat of competition from Verizon, GCI and ACS announced an innovative merger between their wireless networks to form wholesale network operator AWN or Alaska Wireless Network. But the two remained competitors at the retail level with their own brands and retail stores.

In June 2013 Verizon turned on its wireless network, offering data services only, but picking up significant traffic that otherwise would have gone to AWN. In May 2014, when VoLTE technology and phones became available, the company began offering voice services and opened one retail store in Fairbanks and one in Anchorage. In 2015, ACS threw in the towel on wireless with GCI buying ACS's stake in AWN for $300 mm and ACS shuttering its retail store network. This allowed ACS to exit an unprofitable business and significantly deleverage from 4.5x to 3.1x, giving it one of the least leveraged balance sheets in the industry.

The company's network consists of a fiber network stretching from the North Slope of Alaska all the way down to Anchorage and Homer in the south and then to redundant undersea fiber optic cables connecting Juneau, Washington and Oregon. In 2015, the company partnered with Quintillion to acquire ConocoPhillips' fiber network on the North Slope and build a fiber network connecting ACS's existing Anchorage-to-Fairbanks fiber with the North Slope. In January 2018, Quintillion activated its undersea fiber network connecting the coastal cities of Nome, Kotzebue, Point Hope, Wainwright, Prudhoe Bay and Utqiaġvik (formerly called Barrow) and ACS leases capacity on this network to serve its customers. This network makes ACS a very competitive provider to the state and federal governments in Alaska, as well as to large corporations – mainly oil companies – operating in the state.

Alaska Communications Owned and Leased Fiber Serves Most Population Centers



Source: Company reports

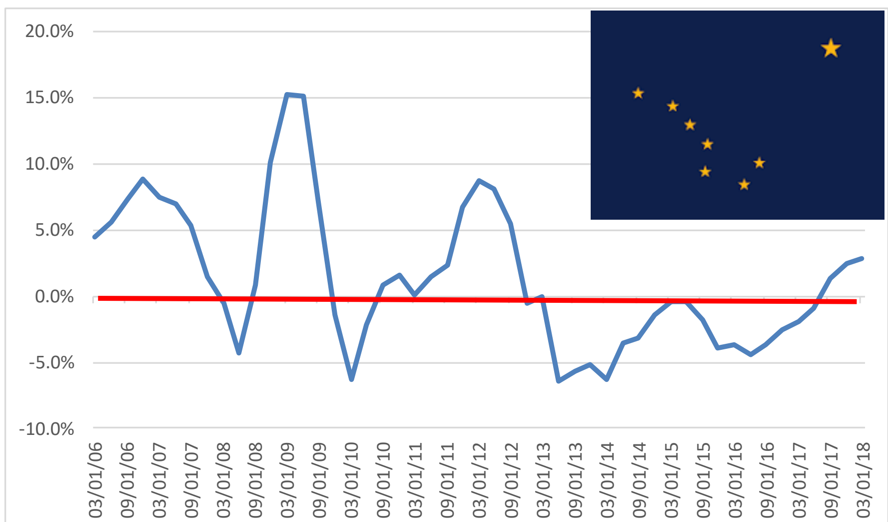
Two Major Headwinds Becoming Tailwinds

The first headwind has been the state economy. Alaska's economy is closely tied to the price of oil. Oil prices bottomed in early 2016 with the WTI benchmark falling below $27 per barrel in February. It had peaked at just over $127 four years earlier in March 2016. The Alaskan economy entered a recession with negative GDP growth in the fourth quarter of 2012, continuing negative for the next 19 straight quarters. Major oil companies cancelled projects and laid off workers. Since many of these workers hail from the lower 48, the state's population actually declined with outmigration totaling 29,297 people over the past five years, according to Census Bureau data.. With fewer people, there is less demand for services. So both business and consumer demand for telecom services was negatively impacted.

Oil Price Crash…

Source: Company reports

…Drove Alaska into Recession



Source: Company reports

The state government was also negatively impacted since most of its revenue comes from oil and gas royalties. This caused them to cut budgets and lay off workers. But even worse, the state cut the Alaska Permanent Fund annual dividend. Since the Trans-Alaska Pipeline was finished in 1977 the state has invested its revenue in this fund, paying out investment income as dividends to residents in the form of an annual check. The fund now has $65 billion. During the recession, the state suffered a budget shortfall and Governor Walker and the legislature spent over a year looking for solutions. The Permanent Fund dividend is sacrosanct in Alaska with every resident man, woman and child (except criminals) receiving a payment each October. This payment hit a record high of $2,072 in 2015 but was cut to $1,022 the following year in a deal between the governor and the legislature to ease the state's financial situation. Governor Walker became extremely unpopular as a result, and he recently ended his re-election campaign less than three weeks before the election.

But things are turning around. For the last three quarters, through 1Q 2018, growth has been positive, accelerating to 2.8% in that quarter. The Trump administration has approved drilling in the Alaska National Wildlife Refuge (ANWR), a new natural gas pipeline is nearing final approvals and energy sector activity is picking up. ConocoPhillips is increasing its oil production on new discoveries. Just last week, Hillcorp was approved for drilling on an artificial island in the Arctic Ocean. This renewed energy activity is likely to benefit investments ACS has made in recent years including its purchase of ConocoPhillips fiber network in the North Slope, building fiber connecting the North Slope to Fairbanks, leasing capacity on the new Quintillion undersea fiber network and leasing satellite transponder space on Eutelsat satellites.

With a 30% Decline in Rural Health Care Revenue This Year, We See Upside Potential

Rural health care funding has been a significant negative issue for rural telecom providers in the last two years, particularly those in Alaska. In 2017, the company generated $21 mm in revenue from rural health care or 9% of its revenue. It has guided to a 30% reduction to $15 mm in 2018. In its 1Q 2018, the company's CFO cited two reasons. 1. An expected reduction in rates ordered by the FCC and 2. A shortfall in funding. We expect both of these headwinds to moderate into 2019.

Under the Communications Act of 1996, the FCC set up a $400 mm program in 1997 to fund access to broadband telecom services for rural health care providers. This is particularly important in Alaska where many remote villages have no doctor and are not accessible by road. Thus, the ability to connect with a doctor in Anchorage or Fairbanks remotely, and to send large medical files, such as X-rays, was effectively the only way villagers could access healthcare.

However, in 2017, the FCC finally received requests exceeding its $400 mm budget and so it limited funding to 92.5% of requests for the 2016 funding year ended June 30, 2017. Requests surged even higher the following year, so the threshold was set at just 84.4% of requests. This implies that requests were $474 mm, or 19% over the budget cap.

In June of this year, the FCC increased the budget to $571 mm, and announced that it would now index funding to inflation going forward. Not only should this fully fund existing services, but it should also allow for new rural health care broadband connections since the budget is $97 mm higher than requests in the prior year. As of ACS's most recent 10Q, the FCC had not granted final approval for ACS's rural health care customers funding requests, but in July it did approved the requested rates. ACS termed this a major step forward.

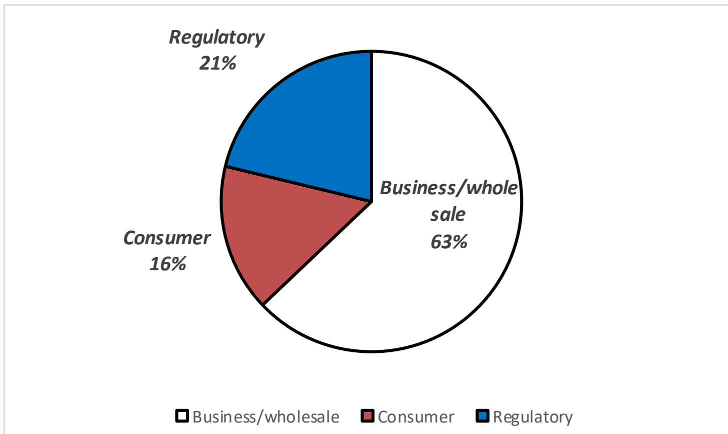
We recently discussed this issue with the company's CEO and he also sounded a note of caution around the arcane rules associated with the program. The FCC has issued a notice of proposed rulemaking (NPRM), to clarify the rules and a final order could be issued any day now that the comment period on the NPRM has ended. With more straightforward rules, telecom companies can commit to offering services to rural health care providers without having to worry about the uncertainty that, after they have already rolled out service and started booking receivables, the regulators disallow the contracts for reimbursement.

So what has previously been a negative, should be a positive. Assuming that the company gains more clarity on the rules and allowable rates under the program, we would expect it to ease its current cautious stance. Longer term, with the size of the national fund up 43%, they should enjoy the benefits of market expansion.

ACS is Mainly About Serving Business Customers

Alaska Communications provides both voice and data services to business and residential customers, but the focus is clearly on broadband and managed services to business and government customers. In 2Q 2018 business and wholesale represented 63% of revenue whereas the consumer business represented 16% of revenue. Regulatory revenue, which are revenues associated with its other businesses but are composed of government subsidies, were 21% of revenue.

ACS is Mainly About Service Businesses, Other Telecom Carriers and Government



Source: Company reports

ACS' business and wholesale segment serves 70,000 voice lines with an average monthly revenue of $25 and 15,000 broadband lines with average monthly revenue of $370. Voice lines are declining about 3% per year with revenue rising slightly. The number of broadband lines has been roughly flat despite the recession, but ACS is getting higher revenue per line. As is the case across the industry, ACS also provides a number of specialized services not captured in traditional line counts.

The company has been investing heavily in connecting business locations in Anchorage and Fairbanks with fiber and since 2011 has increased its SG&A spend. At the time, management noted that they had just 20% market share in a market growing 5% and by offering competitive network and good service at competitive rates, they could increase market share. This has largely worked. GCI mainly connected to business customers with its coaxial cable network and enjoyed high rates due to years of passivity by ACS. In the words of Woody Allen, "showing up is 80% of life" and ACS was failing to show up. When the company started showing up, it generated business and wholesale revenue growth of 11.0%, 12.0% and 9.4% in 2014, 2015 and 2016 before slowing last year.

In wholesale, ACS performs well in state and federal contracts, including military contracts with the six military bases in state. It had a far smaller market share among the state government and energy industry but has been winning some contracts even as GCI remains the dominant player. One area where ACS is growing is connecting wireless cell site locations to the internet with fiber for Verizon and AT&T. As wireless users consume more bandwidth, each cell site needs a fatter pipe. When ACS sold the wireless business to GCI, it also sold its wireless backhaul contracts. It is slowly winning these back as they come up for renewal. ACS has two advantages in that its operating systems, as a legacy phone company, are more like those of AT&T and Verizon, and ACS does not compete with those companies' wireless business as GCI does.

Managed IT services is also key to ACS's strategy. Its underlying fiber network powers IT services for its customers and ACS can also provide a full suite of IT services. In 2010 the company acquired 49% of local IT services company Tekmate, and in 2014 it acquired the rest. For the year 2017, managed services were just 1.9% of revenue but by having these services, we believe that ACS can improve its competitive positioning for its core network services as customers increasingly buy IT and connectivity together. Managed and IT services revenue was up 12.5% through the first half of 2018 and has generally been a strong performer since the acquisition.

ACS has built out its Business Technology Center in Anchorage. This facility is a state-of-the-art center for demonstrating technology. It is located in the company's flagship retail store location (the only one it kept when it exited wireless) across from its Anchorage headquarters. ACS partners heavily with the major enterprise technology providers, particularly Microsoft for which it is a gold partner, and is an important sales and support channel in remote Alaska for them. It offers Microsoft's Office, Skype conferencing and cloud services. For security, it sells Baracuda and Watchguard. For IT services it sells and supports all of the major vendors including Cisco, Dell, HP, Juniper, Avaya, Polycom and Mitel.

The center is also a great marketing resource. Its main purpose is to bring IT managers in to demonstrate the array of hardware and software technologies it supports. At night, it makes its facilities (with 24 and 32 seat meeting rooms) available for meeting of non-profit associations. ACS garners the good will of allowing organizations like the United Way to use its facilities. More importantly, the board members of these organizations are often local titans of industry, so ACS can bring them in and showcase its advanced technology. In some cases, ACS is probably still viewed as the stodgy phone company it once was, so hosting these meetings gives it a good chance to reset its image, and hopefully soften up target customers for future sales calls.

Consumer Revenue Returns to Growth

Its consumer segment serves 27,000 voice lines at an average monthly rate of $31 and 33,000 broadband lines at an average rate of $66. Our model goes back to 2006 when there were 200,000 voice lines and 200,000 broadband lines in service indicating the toll competition and technological substitution has taken on the traditional phone business. In voice, wireless has replaced landlines. In broadband, ACS's DSL technology with quaint speeds of 5 megabits per second have been overtaken by GCI's warp speeds of a gigabit per second. For ACS, it did not make economic sense to connect homes with fiber, as it would not have justified the return with a business broadband line fetching more than six times the monthly revenue and oftentimes cheaper capx to connect a business. Its broadband speeds were so slow in most cases that customers could not successfully access services like Netflix and requested so many service calls that they were unprofitable. So ACS began telling customers where it could not offer at least 10 megabits per second speeds that it did not have broadband service in their neighborhood, ceding the market to GCI.

But ACS has managed to find enough consumer niches that it has been able to grow its consumer revenue for the first two quarters of this year. Under the Connect America Fund II (CAF II) program, in 2016 the FCC awarded it $19.7 mm in funding over ten years to build broadband to 31,500 homes in rural areas of the state. Of these, roughly 25,000 had no broadband service available. homes and has since built out to 9,000. For 2,000 of these homes it is using wireless technology using 5 GHz unlicensed spectrum and hardware from an Israeli manufacturer called Radwin. ACS has also built fiber to residential apartment buildings and with either ethernet copper cabling or wifi, has been able to win back market share from GCI. Many of these apartment buildings are near military bases and are occupied by the troops and their families. Another part of the consumer turnaround has been technological innovations to cut operating costs:

- 80% of customer bills are now electronic
- 50% of new orders are on line
- 30% of trouble tickets are on line

We See Modest Acceleration in Free Cash Flow Ahead

Our business and wholesale segment forecast calls for:

- Access line declines of roughly 4% through 2020. For 2Q the decline was 3.6%.
- Broadband connections growth of 1.8% this year, accelerating to 2.6% and 2.8% over the next two years as the state economy accelerates
- Revenue decline of 1.2% in 2018 moderating to -1.0% next year and returning to growth of 2.1% in 2020.

Our consumer forecast calls for:

- Access line declines of 13.2% this year, 15.7% in 2018 and 18.7% 2020. For the 2Q, the decline was 13.0%. In short, we just don't see landline phones coming back.
- Broadband connections actually declined 3.6% in 2Q with a still heavy concentration of slow DSL lines, but with the economy coming back and the CAF II investments, we see growth rebounding to 1.0% this year and roughly 4% over the next two years. Broadband lines generate about twice the monthly revenue as voice lines, so its not a bad tradeoff.
- Revenue decline of 1.8% this year, accelerating to 7% next year before moderating to 1% in 2020. Despite the fact that growth was positive 2.1% and the company is taking a number of innovative steps, we are still more pessimistic that ACS can continue to buck industry-wide trends for phone companies to post declining revenue growth.

Our consumer forecast calls for:

- Access line declines of 5.6% this year and 5.4% in 2012 and 2013. For the first nine months of this year the decline was 4.6%.

- Broadband connections growth of 1.0% this year, growing 4% annually over the next two years as the state economy recovers.
- Revenue decline of 1.8% this year, 7.3% next year and moderating to 0.9% next year.

Our consolidated forecast calls for:

- Voice access line declines continuing in the 6% to 7% range.
- Broadband connections growing 1.2% this year, accelerating to 3.5% over the next two years.
- Revenue down 1.2% this year and 2.1% next year flipping to 1.2% growth in 2020. Our $224 million estimate for this year is under the low end of guidance of $225 mm, so we may be conservative.
- EBITDA of $54.3 mm also below the low end of guidance, down 3.8% before growing 5.4% next year and 1.1% in 2020.
- This implies free cash flow of $5.0 mm with our capx forecast of $35 mm. We do see capx declining modestly to $34 mm over the next two years, resulting in free cash flow of $5.5 mm and $6.2mm in 2019 and 2020, respectively. While this moves in the direction wanted by activist investors, it will likely not be enough to fully satisfy them. It does however, give the board cover to resume a token dividend.

Even at Twice the Current Price, ALSK Would Trade at Half the Value of Comps

We value ALSK shares at 5.7x our 2020 EBITDA forecast. Today it trades at 4.3x trailing EBITDA, versus 10.4x for comps. Our comp set includes a mix of higher valued fiber companies, and lower valued RLEC stocks, but ALSK trades at a significant discount to all of them. We think that ACS is similar to Cincinnati Bell and Consolidated, but better positioned than Frontier, Windstream and CenturyLink. Including fiber players Zayo and Cogent in our comp set is probably a bit optimistic, but ACS is becoming much more of a fiber carrier since it stepped up fiber capx five years ago. ACS and other rural phones essentially get free money from the government in the form of subsidies, which should be a positive for investors. However, this revenue is declining, and since the market tends to penalize companies with declining revenue, these subsidies tend to hurt their multiples. Fiber players get few if any subsidies but trade at higher multiples. We would also note that ACS faces far less competition than any of the comps with GCI being its only true competitor, in our opinion. On a blended basis, we think our mix of RLEC and fiber comps best reflects what ACS is.

The 5.7x multiple implied in our $3 valuation implies a 46% discount versus our comp set, taking into account the illiquidity, lack of strategic importance to potential acquirers and lack of geographic diversification of ACS. On the other hand, while the state economy has been a negative, we see this turning positive. And, ACS shares are a likely takeover target.

Our $3 Target Implies a 5.7x EBITDA Multiple on our 2020 EBITDA Estimate

Company Name	Fiscal Period	Price	Shares Outstanding	Market Value	Enterprise Value	Sales	EBIT	EBITDA	Enterprise Value/ Sales	Enterprise Value/ EBIT	Enterprise Value/ EBITDA
Alaska Comm Systems Gp	06/30/2018	$1.43	53.2	76.1	245.0	227.2	22.2	57.6	1.1x	11.0x	4.3x
ALSK @ 2020E	12/31/20	$1.43	53.2	76.1	245.0	222.0	20.3	57.9	1.1x	12.1x	4.2x
ALSK @ target on 2020E	12/31/20	$3.00	53.2	159.6	328.5	222.0	20.3	57.9	1.5x	16.2x	5.7x
Consolidated Communications I	06/30/2018	$12.43	71.3	885.7	3,222.2	1,059.6	72.3	364.2	3.0x	44.6x	8.8x
Cincinnati Bell Inc.	06/30/2018	$13.94	50.2	699.2	2,175.9	1,288.5	89.3	282.3	1.7x	24.4x	7.7x
Zayo Group Holdings, Inc.	06/30/2018	$30.80	246.5	7,591.3	13,163.2	2,604.0	443.5	1,190.9	5.1x	29.7x	11.1x
Cogent Communications Holdin	06/30/2018	$51.78	46.5	2,405.3	2,910.8	485.2	72.1	148.0	6.0x	40.4x	19.7x
Windstream Holdings, Inc.	06/30/2018	$4.25	42.9	182.5	10,763.6	5,852.9	427.7	1,897.7	1.8x	25.2x	5.7x
Frontier Communications Corpo	06/30/2018	$4.58	105.8	484.6	17,487.6	9,128.0	1,287.0	3,471.0	1.9x	NM	NM
CenturyLink, Inc.	06/30/2018	$21.07	1,080.1	22,758.2	59,368.2	17,656.0	2,280.0	6,216.0	3.4x	26.0x	9.6x
Average									**3.3x**	**31.7x**	**10.4x**
ALSK discount									**66%**	**62%**	**59%**
ALSK discount @ target on 2020E									**55%**	**49%**	**46%**

Source: Company reports and Dawson James estimates

Battle of the Activists

Alaska Communications shareholder base includes two activist shareholders. Management has reached an agreement with TAR Holdings where it increased its board size from six to eight, adding two new independent board members. It has recently attracted another activist – 22 NW out of Seattle.

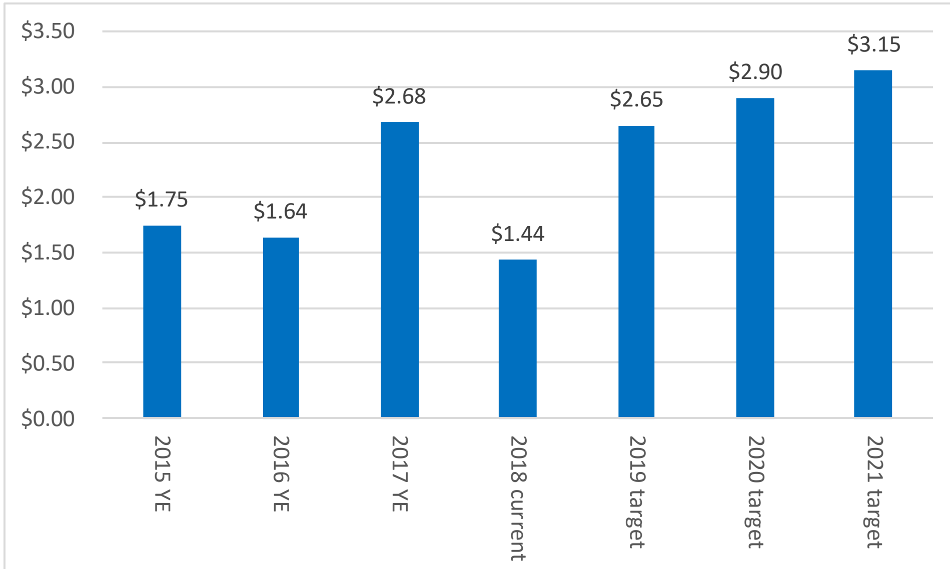
The activists seem to have three main objections:

1. Capital spending has not generated an adequate return on investment.
2. Management compensation, mainly the CEO, is too high.
3. The company should put itself up for sale.

On the capital spending argument, we tend to disagree. Management seeks a 15% to 20% IRR and three-year return on capital spending, but if one looks at the consolidated results, it doesn't look like they are generating these returns. We would note that just under half of capx is maintenance capx to replace hardware, software and vehicles. Given the harsh Alaskan climate, outside plant and vehicles do not last as long as they do in the lower 48. A bit over half of capx is success based, where ACS builds network to go after new business opportunities. Had this number been held to zero over the last decade, and the company's network was limited to basic phone service and 5 megabit per second DSL, we think revenue would be far lower than it is now. We would also have seen the same sharp drop in regulatory revenue that we have seen, or perhaps steeper since much of it is tied to customers or lines and if losses had been even greater, the decline in regulatory revenue would have been even worse. So while underlying IRR on success capx is likely greater than 15%, one has to first adjust for the structural and regulatory declines in revenue.

On the management compensation issue, the data does back up the activist investors to some extent, and the board has seemed to agree given recent changes to management comp. We consider the closest comp to ACS to have been Hawaiian Telcom which was acquired earlier this year. But for the three prior years their CEO, Scott Barber, received less than half the total compensation as Anand Vadapalli, ACS's CEO. We do think that a significant adjustment needs to be made for the fact that Mr. Barber was living in paradise, with a view of Waikiki out of his office while Mr. Vadapalli has to work in subzero temperatures with short daylight hours most of the year. So there's that, but it probably does not tell the whole story.

Management Comp is Now Tied to Getting the Stock Price Higher



Source: Company reports

So the board just cut the CEO salary by 8% and other management by 7% and changed their incentives. Customer services metrics are now gone. New metrics on stock price and free cash flow and the stock price are in. We're not sure these metrics properly incent management to invest for the long term, which even a buyer would presumably want. To goose cash flow, he can slash capx, forestalling growth opportunities. He can also step up his investor relations promotional activity. We have seen CEOs who have spent considerable time presenting at multiple investor conferences per month, and we always wondered how they were running the business. The new metrics require that management get the stock price to $2.65 in a year, $2.90 in two years and $3.15 in three years. These levels are certainly reasonable given our estimates and comparable valuation levels, but stock prices are often outside of management's control. In some ways, we think the focus on these new metrics embodies the critiques investors like Warren Buffet have made that the market is too short-term focused.

The third critique is that management should sell the company. We strongly disapprove of companies publicly announcing that they are up for sale, as this tends to hurt efforts to retain and attract customers and provides an easy opening for competitors to poach the best performing employees, who now must worry about their own job stability. And worse, if the process does not yield a buyer, as happened with INAP in 2015, investors will assume that the due diligence process uncovered negative factors, causing them to sell. We think a better alternative is to let potential buyers know that the company is amenable to a sale, but not announce it publicly.

We are also skeptical that there are willing buyers who will be acceptable to regulators. Alaskan telecom regulators are certainly aware of what happened in Hawaii when a financial buyer purchase Hawaiian Telcom in 2017. The buyer levered the company and ceased network investments. This caused its competitor to do the same enjoying an increase in free cash flow. But the Hawaiian economy was hurt because the local telecom providers were not investing in the technology needed to remain competitive in the global economy. So we think that a financial buyer would be unlikely to gain approval. A strategic buyer, on the other hand, likely would as the sale of GCI to Liberty was approved last year. We discount speculation that a large company like Verizon or AT&T would want to buy ACS. Both are scaling back their rural network ownership and if Verizon was interested, we think they would have bought ACS when it still had a wireless network. Frontier, Windstream and CenturyLink are too big and are each distracted with either their own recent mergers, poor performance, or both. Consolidated and Cincinnati Bell look like good fits. But Consolidated is still digesting FairPoint and Cincy Bell just closed on Hawaiian. The remote location of Alaska is likely a negative for strategic buyers, as having telecom network in Alaska is not essential to serve their customers, as it is for example, to have network in New York and Los Angeles. It is also harder to generate operating synergies with such a remote location. But the same was true of Hawaiian, and Cincinnati Bell bought it mainly for the overhead synergies, not the operating synergies. We view ACS as similarly attractive.

Overall, our bullishness on ALSK stock is tied to its strategic positioning and several fortuitous trends likely to benefit revenue, EBITDA and free cash flow growth. Management is suddenly uniquely incented to drive the stock price higher, and investors may be rewarded with a takeover premium over the next two years. Therefore, we initiate coverage with a Buy rating and $3 price target.

Alaska Communications Services Income Forecast

Dollars in thousands, except per share data			2018E					2019E					2020E		
Fiscal years ended December 31	1QA	2Q	3Q	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR
Revenue	**55,972**	**54,090**	**53,626**	**56,269**	**219,957**	**55,656**	**55,480**	**54,465**	**56,774**	**222,374**	**56,286**	**56,188**	**55,070**	**57,524**	**225,068**
YoY growth	-1.3%	-7.6%	-5.4%	2.4%	-3.1%	-0.6%	2.6%	1.6%	0.9%	1.1%	1.1%	1.3%	1.1%	1.3%	1.2%
Seq growth	1.9%	-3.4%	-0.9%	0.0%		-1.1%	-0.3%	-1.8%	0.0%		-0.9%	-0.2%	-2.0%	0.0%	
Cost of services, non-affiliates	25,833	24,340	24,132	25,321	99,626	25,045	24,966	24,509	25,548	100,068	25,329	25,285	24,782	25,886	101,281
As a percent of revenue	46.2%	45.0%	45.0%	45.0%	45.3%	45.0%	45.0%	45.0%	45.0%	45.0%	45.0%	45.0%	45.0%	45.0%	45.0%
Selling, general and administrative	16,012	16,227	16,088	16,881	65,207	17,253	16,644	16,340	17,032	67,269	17,449	16,856	16,521	17,257	68,083
As a percent of revenue	28.6%	30.0%	30.0%	30.0%	29.6%	31.0%	30.0%	30.0%	30.0%	30.3%	31.0%	30.0%	30.0%	30.0%	30.3%
Depreciation and amortization	8,787	8,923	8,988	9,040	35,739	9,073	9,118	9,196	9,261	36,649	9,294	9,339	9,417	9,482	37,533
Loss on disposal of assets	(3)	-	-	-	(3)	-	-	-	-	-	-	-	-	-	-
Earnings from equity methods investments	-														
Operating income	**5,343**	**4,599**	**4,418**	**5,027**	**19,387**	**4,284**	**4,751**	**4,420**	**4,932**	**18,388**	**4,215**	**4,707**	**4,350**	**4,899**	**18,171**
Operating margin	9.5%	8.5%	8.2%	8.9%	8.8%	7.7%	8.6%	8.1%	8.7%	8.3%	7.5%	8.4%	7.9%	8.5%	8.1%
Interest expense	(3,504)	(3,504)	(3,504)	(3,504)	(14,016)	(4,014)	(4,014)	(4,014)	(4,014)	(16,055)	(4,014)	(4,014)	(4,014)	(4,014)	(16,055)
Interest income	14	-	-	-	14	-	-	-	-	-	-	-	-	-	-
Other, net	104	-	-	-	104	-	-	-	-	-	-	-	-	-	-
	(3,386)	(3,504)	(3,504)	(3,504)	(13,898)	(4,014)	(4,014)	(4,014)	(4,014)	(16,055)	(4,014)	(4,014)	(4,014)	(4,014)	(16,055)
Pretax Income	1,957	1,095	914	1,523	5,489	271	738	406	918	2,333	201	694	336	885	2,116
Taxes	(112)	383	320	533	1,124	95	258	142	321	816	70	243	118	310	741
Tax rate	-5.7%	35.0%	35.0%	35.0%	20.5%	35.0%	35.0%	35.0%	35.0%	35.0%	35.0%	35.0%	35.0%	35.0%	35.0%
Non-controlling interest	32	32	32	32	128	30	30	30	30	120	30	30	30	30	120
Net income - continuing ops	**2,101**	**744**	**626**	**1,022**	**4,493**	**206**	**510**	**294**	**627**	**1,636**	**161**	**481**	**249**	**605**	**1,495**
Net income margin	3.8%	1.4%	1.2%	1.8%	2.0%	0.4%	0.9%	0.5%	1.1%	0.7%	0.3%	0.9%	0.5%	1.1%	0.7%
Diluted shares outstanding	53,857	53,882	53,907	53,932	53,895	53,957	53,982	54,007	54,032	53,995	54,057	54,082	54,107	54,132	54,095
Seq change	1,409.0	25.0	25.0	25.0		25.0	25.0	25.0	25.0		25.0	25.0	25.0	25.0	
EPS diluted	**$0.04**	**$0.01**	**$0.01**	**$0.02**	**$0.08**	**$0.00**	**$0.01**	**$0.01**	**$0.01**	**$0.03**	**$0.00**	**$0.01**	**$0.00**	**$0.01**	**$0.03**
YoY growth	-400.1%	-125.8%	95.3%	-133.7%	-171.4%	-90.2%	-31.6%	-53.1%	-38.8%	-63.6%	-22.2%	-5.8%	-15.6%	-3.6%	-8.8%

Source: Company reports and Dawson James estimates

Alaska Communications Services EBITDA Forecast

Dollars in thousands			2018E					2019E					2020E		
Fiscal years ended Dec. 31	1QA	2QA	3Q	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR
Net income	**(5,394)**	**3,402**	**2,754**	**3,428**	**4,190**	**847**	**1,415**	**1,006**	**1,523**	**4,790**	**791**	**1,379**	**950**	**1,503**	**4,623**
Interest expense	3,913	3,401	3,401	3,401	14,116	3,919	3,919	3,919	3,919	15,675	3,919	3,919	3,919	3,919	15,675
Loss on extinguishment of debt					-					-					-
Interest income	(7)	(24)	-	-	(31)	-	-	-	-	-	-	-	-	-	-
Depreciation and amortization	9,028	8,197	8,300	8,348	33,873	8,378	8,420	8,492	8,552	33,842	8,582	8,624	8,696	8,756	34,658
Loss on impairment of goodwill					-					-					-
(Gain) loss on disposal of assets	(3)	44	-	-	41	-	-	-	-	-	-	-	-	-	-
Earnings in Tekmate	(72)	131	40	40	139	40	40	40	40	160	40	40	40	40	160
Earnings in AWN	-	-													
Gain on asset sale	-	-			-					-					-
Pension	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
AWN distributions received	-	-			-					-					-
AWN receivable	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Income tax expense	(632)	1,418	-	-	786	-	-	-	-	-	-	-	-	-	-
Stock based comp	242	325	325	325	1,217	700	700	700	700	2,800	700	700	700	700	2,800
Long-term incentives		-	-	-	-	-	-	-	-	-	-	-	-	-	-
Earthquake costs	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
AWN transaction costs	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Adjusted EBITDA	**7,075**	**16,894**	**14,820**	**15,542**	**54,331**	**13,884**	**14,493**	**14,157**	**14,733**	**57,267**	**14,031**	**14,662**	**14,305**	**14,917**	**57,916**
EBITDA margin	12.6%	28.4%	28.0%	27.9%	24.2%	25.4%	26.3%	26.4%	26.3%	26.1%	25.3%	26.3%	26.4%	26.3%	26.1%
YoY Growth	-50.5%	15.3%	13.6%	7.4%	-3.8%	96.2%	-14.2%	-4.5%	-5.2%	5.4%	1.1%	1.2%	1.0%	1.2%	1.1%
Capital expenditures	(8,680)	(8,401)	(10,000)	(8,000)	(35,081)	(5,000)	(7,000)	(12,000)	(10,000)	(34,000)	(5,000)	(7,000)	(12,000)	(10,000)	(34,000)
Milestone billings		-	-	-	-	-	-	-	-	-	-	-	-	-	-
Amortization of deferred AWN rev.	(511)	(516)	(522)	(522)	(2,071)	(522)	(522)	(522)	(522)	(2,088)	(522)	(522)	(522)	(522)	(2,088)
North Slope Acquisition			-	-	-	-	-	-	-	-	-	-	-	-	-
Tax refunds	574	(4)	-	-	-	-	-	-	-	-	-	-	-	-	-
Cash int expense	(1,536)	(3,810)	(3,401)	(3,401)	(12,148)	(3,919)	(3,919)	(3,919)	(3,919)	(15,675)	(3,919)	(3,919)	(3,919)	(3,919)	(15,675)
Free cash flow	**(3,078)**	**4,163**	**897**	**3,619**	**5,031**	**4,443**	**3,053**	**(2,284)**	**293**	**5,504**	**4,591**	**3,221**	**(2,136)**	**477**	**6,153**

Source: Company reports and Dawson James estimates

Important Disclosures:

Source: FactSet Data Systems

Price target and ratings changes over the past 3 years:
Initiated – Buy – October 29, 2018 – Price Target $3.00

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VALUATION

Our $3.00 price target is based on a multiple of 5.7x our 2020 EBITDA estimate.

RISK FACTORS

1. The Alaskan economy is very cyclical with longer and more extreme economic cycles than the lower 48 economy, generally driven by oil prices. A collapse below $27 per barrel sent the state economy into a severe recession several years ago, and a similar collapse would again likely have negative impacts on the state economy and on the company's results.
2. ACS is much small than its primary competitor GCI Liberty which also has considerable cash resources. While GCI appears to be preparing for a sale to a larger cable company, should it decide to step up its competitive response, it would likely damage ACS's financial results.
3. The company has faced two activist campaigns in recent years. Some of the responses the board has taken may tend to incent management to take more of a short term approach, for example foregoing new customer activations that may require capital spending or deferring necessary maintenance capx.

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3) **Sell**: the analyst believes the price of the stock will decline by at least 20% over the next 12-18 months and should be sold.

The following chart reflects the range of current research report ratings for all companies followed by the analysts of the Firm. The chart also reflects the research report ratings relating to those companies for which the Firm has performed investment banking services in the last twelve months.

	Company Coverage		**Company Coverage**	
Ratings Distribution	# of Companies	% of Total	# of Companies	% of Total
Market Outperform (Buy)	35	92%	10	100%
Market Perform (Neutral)	3	8%	0	0%
Market Underperform (Sell)	0	0%	0	0%
Total	**38**	**100%**	**10**	**100%**

Analyst Certification:

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