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November 7, 2018

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Alaska Communications Systems Group (Nasdaq/ALSK)

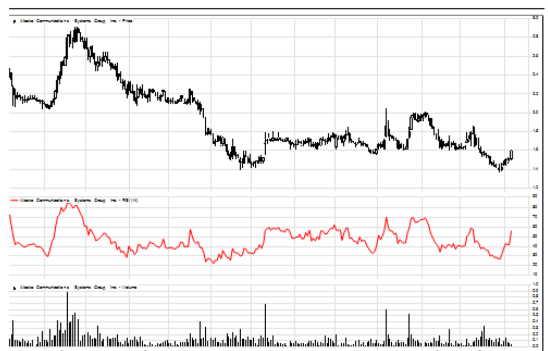
BUY **Current $1.57 / Target:$3.00**

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

3Q Results Provide Fodder for Both Bulls and Bears

- Alaska Communications reported third quarter results which we view positively, but may not be universally well received.
- Revenue was up 2.7% with the core business and wholesale segment up 4.2%.
- EBITDA was up a solid 13% on a 230-basis point improvement in margins, but guidance suggests a weaker 4Q.
- The balance sheet also improved with net debt down 10% YTD as rural health care payments from the federal government finally came in.
- The board approved an increase in success-based capital spending, with total capital spending improved to a range of $37 mm to $39 mm, up from $33 mm to $35 mm previously. The additional spending is to connect new customers to the company's network who have already signed contracts and should generate recurring revenue.
- But some shareholders may view this negatively as they were looking for capital to be returned to shareholders, not increased internal investments.
- We expect improvement in results longer term, with revenue from the recently signed contracts and benefits from a recovering state economy.
- We reiterate our Buy rating and $3 target which values the stock at 5.7x our 2020 EBITDA estimate.

Estimates	2018E	2019E	2020E
Revenue($000s)	**$229,110**	**$220,131**	**$222,860**
1Q March	55,972 A	54,498	55,111
2Q June	59,578 A	54,746	55,419
3Q September	58,229 A	55,181	55,890
4Q December	55,331	55,706	56,440
EPS	**$0.15**	**$0.11**	**$0.11**
1Q March	0.04 A	0.02	0.02
2Q June	0.06 A	0.03	0.03
3Q September	0.03 A	0.03	0.03
4Q December	0.01	0.03	0.03
P/E (x)	10.6X	14.5X	14.9X
EBITDA	$58,870	$57,448	$58,124
EV/EBITDA (x)	4.7X	4.8X	4.7X
Stock Data			
52-Week Range		$1.37 -	$2.91
Shares Outstanding (mil.)			78.4
Market Capitalization (mil.)			$123.1
Enterprise Value (mil.)			$276.0
Debt to Capital			50.7%
Book Value/Share			$2.92
Price/Book			0.5X
Average Trading Volume (3-month) Mill			0.1
Insider Ownership			11.3%
Institutional Ownership			43.0%
Short interest			0.0%



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

3Q Results Provide Fodder for Both Bulls and Bears

Yesterday, Alaska Communications Systems (ACS) hosted its 3Q earnings call to review quarterly results. Overall, the results were solid, tracking better than our forecast. Notably, its business services segment posted 4.2% revenue growth, with management comments suggesting new signed contracts coming on line over the next year. Unfortunately, rural health care revenue has declined sharply, due to federal government funding decisions. ALSK shares remain undervalued, in our opinion, trading at 4.7x 2018 EBITDA versus 6x to 7x for comps, so we continue to rate them Buy.

Perhaps the most noteworthy development was that the board has approved capx for the full year of $37 mm to $39 mm (up from $33 mm to $35 mm) with success-based capx comprising about 66% of total capx this year and maintenance capx only 34%. This is bound to be a controversial decision with a number of activist investors urging the board to devote less capital to capx, and more to buybacks, deleveraging or a dividend. It appears that the board faced a difficult decision and faced with a number of signed contracts requiring investment to connect new customers to the company's network, they elected to increase capx.

The controversy is compounded by the perception among some shareholders that capital spending is not generating adequate returns as consolidated revenue has been only modestly higher in recent years despite sustained capital investment. There are a number of factors that need to be excluded from the return on capital equation including industry-wide declines in copper-based voice and DSL data services, and negative regulatory developments – neither of which is impacted by capx. Excluding these, management has oft stated that capx is driving higher revenue and generating significant returns, although this is difficult to discern from the external results.

The other conundrum facing the board in capital allocation decisions is that Alaska is exiting a severe recession, with activity in the core industry – oil and gas – ramping back up. Connecting new customers requires capital spending. Management also discussed strong growth in wireless backhaul. Recall that the backhaul business was sold to GCI in the sale of the wireless business in 2014. As these contracts with GCI expire, ACS is having good success in winning back these customers for two reasons. First, it has invested extensively in its metro fiber network and this network provides the high bandwidth connections wireless providers need to service the surging demand for wireless data services. Second, two of the three wireless providers in Alaska – AT&T and Verizon – compete with GCI in wireless. So the preference is to use companies they do not compete with for backhaul. Backhaul fiber connections to towers are expensive up front, but offer very high margin long-term revenue streams from very creditworthy customers. So the math works, but the optics do not.

In business services, revenue was up a strong 4.2%. Year-to-date, excluding the decline in rural health care revenue, management noted that this business grew 6.4%. Business broadband connections are relatively flat this year, but ARPU was up roughly 5% YoY in the quarter. Next year, the rural health care comps should at least be neutral. In fact, with the FCC approving a significant increase in the national rural health care budget, we can envision some return to growth. Given their experience over the last year, we cannot imagine that either GCI or ACS is too eager to add more rural health care customers, but this is a vital service providing virtual healthcare to villages with no road connection to the rest of the state and no doctors. We expect that Alaska's Washington representatives with go to bat for rural communities as they have done for decades and that the situation may become more favorable next year. While management did not provide a backlog number or specifics on the contracts it has in hand, we would also expect them to drive solid revenue growth in 2019.

Looking at the breakdown of business services, voice was actually up 7.7% while broadband was down 4.1%, presumably hit by rural health care. Equipment sales were up 148% following 19% and 27% growth in the first and second quarters, respectively. Managed IT was up 45%. Both of these tend to be good leading indicators since customers who buy hardware and IT services generally bundle them with recurring revenue service contracts.

On the consumer side, revenue was down 0.5% following two quarters of modest growth. Again, ACS faces an enormous headwind as consumers continue to cancel their landline voice and slow DSL data connections. GCI's coax/fiber network, with gigabit connections to nearly all of its customers, is a formidable competitor to ACS's copper network. ACS is receiving Connect America Fund (CAF) funds to provide broadband to households who only had dial up, and it is now using fixed wireless connections to increase the size of its addressable market. It is also selling wifi connections into apartment complexes for the many military personnel stationed in the state. So it continues to make valiant efforts in a market where it has a significant disadvantage.

Regulatory revenue was essentially flat, with the CAF funds reflected in this line. Overall, revenue was up 2.7% representing the best growth in the last year. As discussed above, we do expect the rural health care and recessionary headwinds to abate, and revenue from the signed contracts to contribute to continued revenue growth as ACS transitions to its old copper telephone network business to a more modern fiber provider.

EBITDA was up 13.0% on a strong 230 basis point improvement in margins. We do believe that the company is transitioning to higher margin revenue streams with fiber connections, especially backhaul, and with automation of basic functions like ordering and repairs. Net debt is down $18 mm or 10% year to date as the company has now received the rural health care payments that had been booked in receivables. Free cash flow came in at $2.4 mm for the quarter, and $8.4 mm year to date.

Guidance now implies a much weaker fourth quarter in terms of EBITDA and our estimate is now slightly above guidance as we believe there is some conservatism baked in, not wanting to raise guidance given the headwinds and heightened investor focus. We would note that the fourth and first quarters tend to be weaker in Alaska as the tourism industry shuts down for the winter and many businesses suspend service. We also note that the indications of a significant number of new contracts and elevated capx may lead to higher opex as sales people receive commissions and as some of the costs of activating new customers bleeds into operating expenses and not just capx.

We doubt that these results will appease critical activist investors. We think it is interesting that the board, now with two new board members appointed at the urging of an activist investor, approved higher capx. We continue with our Buy rating but given that the quarter had enough to feed the bears as well as the bulls on the stock, we do not see the results significantly moving the stock over the near term.

Alaska Communications Systems Group Income Forecast

Dollars in thousands, except per share data			2018E					2019E					2020E		
Fiscal years ended December 31	1QA	2QA	3QA	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR
Business and wholesale	33,763	37,478	36,365	34,327	141,933	33,820	34,097	34,541	35,076	137,533	34,509	34,845	35,326	35,885	140,565
YoY growth	-2.2%	2.4%	4.2%	3.7%	2.0%	0.2%	-9.0%	-5.0%	2.2%	-3.1%	2.0%	2.2%	2.3%	2.3%	2.2%
Consumer	9,369	9,454	9,258	8,604	36,685	8,278	8,250	8,240	8,230	32,998	8,202	8,174	8,164	8,155	32,695
YoY growth	0.4%	2.1%	-0.5%	-6.7%	-1.2%	-11.6%	-12.7%	-11.0%	-4.3%	-10.1%	-0.9%	-0.9%	-0.9%	-0.9%	-0.9%
Other	12,840	12,646	12,606	12,400	50,492	12,400	12,400	12,400	12,400	49,600	12,400	12,400	12,400	12,400	49,600
YoY growth	-0.2%	-0.2%	0.8%	-1.8%	-0.3%	-3.4%	-1.9%	-1.6%	0.0%	-1.8%	0.0%	0.0%	0.0%	0.0%	0.0%
Revenue	**55,972**	**59,578**	**58,229**	**55,331**	**229,110**	**54,498**	**54,746**	**55,181**	**55,706**	**220,131**	**55,111**	**55,419**	**55,890**	**56,440**	**222,860**
YoY growth	-1.3%	1.8%	2.7%	0.7%	1.0%	-2.6%	-8.1%	-5.2%	0.7%	-3.9%	1.1%	1.2%	1.3%	1.3%	1.2%
Seq growth	1.9%	6.4%	-2.3%	0.0%		-1.5%	0.5%	0.8%	0.0%		-1.1%	0.6%	0.9%	0.0%	
Cost of services, non-affiliates	25,833	26,542	27,220	26,559	106,154	24,524	24,636	24,831	25,068	99,059	24,800	24,939	25,151	25,398	100,287
As a percent of revenue	46.2%	44.6%	46.7%	48.0%	46.3%	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	16,507	16,879	16,599	65,997	16,894	16,424	16,554	16,712	66,584	17,084	16,626	16,767	16,932	67,409
As a percent of revenue	28.6%	27.7%	29.0%	30.0%	28.8%	31.0%	30.0%	30.0%	30.0%	30.2%	31.0%	30.0%	30.0%	30.0%	30.2%
Depreciation and amortization	8,787	8,197	8,352	8,348	33,684	8,378	8,420	8,492	8,552	33,843	8,582	8,624	8,696	8,756	34,659
Loss on disposal of assets	(3)	44	15	-	56	-	-	-	-	-	-	-	-	-	-
Earnings from equity methods investments	-	-	-												
Operating income	**5,343**	**8,288**	**5,763**	**3,825**	**23,219**	**4,701**	**5,266**	**5,303**	**5,374**	**20,644**	**4,644**	**5,230**	**5,276**	**5,354**	**20,505**
Operating margin	9.5%	13.9%	9.9%	6.9%	10.1%	8.6%	9.6%	9.6%	9.6%	9.4%	8.4%	9.4%	9.4%	9.5%	9.2%
Interest expense	(3,504)	(3,401)	(3,286)	(3,286)	(13,477)	(3,738)	(3,738)	(3,738)	(3,738)	(14,951)	(3,738)	(3,738)	(3,738)	(3,738)	(14,951)
Interest income	14	24	36	-	74	-	-	-	-	-	-	-	-	-	-
Other, net	104	(91)	66	-	79	-	-	-	-	-	-	-	-	-	-
	(3,386)	(3,468)	(3,184)	(3,286)	(13,324)	(3,738)	(3,738)	(3,738)	(3,738)	(14,951)	(3,738)	(3,738)	(3,738)	(3,738)	(14,951)
Pretax Income	1,957	4,820	2,579	539	9,895	963	1,529	1,565	1,637	5,694	907	1,493	1,539	1,616	5,554
Taxes	(112)	1,418	774	-	2,080	-	-	-	-	-	-	-	-	-	-
Tax rate	-5.7%	29.4%	30.0%	0.0%	21.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Non-controlling interest	32	40	12	12	96	40	40	40	40	160	40	40	40	40	160
Net income - continuing ops	**2,101**	**3,442**	**1,817**	**551**	**7,911**	**1,003**	**1,569**	**1,605**	**1,677**	**5,854**	**947**	**1,533**	**1,579**	**1,656**	**5,714**
Net income margin	3.8%	5.8%	3.1%	1.0%	3.5%	1.8%	2.9%	2.9%	3.0%	2.7%	1.7%	2.8%	2.8%	2.9%	2.6%
Diluted shares outstanding	52,341	53,888	54,116	54,141	53,622	54,166	54,191	54,216	54,241	54,204	54,266	54,291	54,316	54,341	54,304
Seq change	(107.0)	1,547.0	228.0	25.0		25.0	25.0	25.0	25.0		25.0	25.0	25.0	25.0	
EPS diluted	**$0.04**	**$0.06**	**$0.03**	**$0.01**	**$0.15**	**$0.02**	**$0.03**	**$0.03**	**$0.03**	**$0.11**	**$0.02**	**$0.03**	**$0.03**	**$0.03**	**$0.11**
YoY growth	-408.8%	-219.5%	464.4%	-118.1%	-226.3%	-53.8%	-54.7%	-11.8%	204.0%	-26.8%	-5.8%	-2.5%	-1.8%	-1.4%	-2.6%

Source: Company reports and Dawson James estimates

Alaska Communications Systems Group EBITDA Forecast

Dollars in thousands			2018E					2019E					2020E		
Fiscal years ended Dec. 31	1QA	2QA	3QA	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR	1Q	2Q	3Q	4Q	YEAR
Net income	**2,069**	**3,402**	**1,805**	**539**	**7,815**	**963**	**1,529**	**1,565**	**1,637**	**5,694**	**907**	**1,493**	**1,539**	**1,616**	**5,554**
Interest expense	3,504	3,401	3,286	3,286	13,477	3,738	3,738	3,738	3,738	14,951	3,738	3,738	3,738	3,738	14,951
Loss on extinguishment of debt					-					-					-
Interest income	(14)	(24)	(36)	-	(74)	-	-	-	-	-	-	-	-	-	-
Depreciation and amortization	8,787	8,197	8,352	8,348	33,684	8,378	8,420	8,492	8,552	33,843	8,582	8,624	8,696	8,756	34,659
Loss on impairment of goodwill					-					-					-
(Gain) loss on disposal of assets	(3)	44	15	-	56	-	-	-	-	-	-	-	-	-	-
Earnings in Tekmate	(72)	131	12	12	83	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	(112)	1,418	774	-	2,080	-	-	-	-	-	-	-	-	-	-
Stock based comp	242	325	642	642	1,851	700	700	700	700	2,800	700	700	700	700	2,800
Long-term incentives		-	-	-	-	-	-	-	-	-	-	-	-	-	-
Earthquake costs	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Other	-	-	(102)	-	(102)	-	-	-	-	-	-	-	-	-	-
Adjusted EBITDA	**14,401**	**16,894**	**14,748**	**12,827**	**58,870**	**13,819**	**14,427**	**14,535**	**14,667**	**57,448**	**13,967**	**14,595**	**14,713**	**14,850**	**58,124**
EBITDA margin	25.7%	28.4%	25.3%	23.2%	25.7%	25.4%	26.4%	26.3%	26.3%	26.1%	25.3%	26.3%	26.3%	26.3%	26.1%
YoY Growth	0.8%	15.3%	13.0%	-11.4%	4.3%	-4.0%	-14.6%	-1.4%	14.3%	-2.4%	1.1%	1.2%	1.2%	1.3%	1.2%
Capital expenditures	(8,680)	(8,401)	(8,351)	(12,000)	(37,432)	(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)	-	-	570	-	-	-	-	-	-	-	-	-	-
Cash int expense	(1,536)	(3,810)	(3,472)	(3,286)	(12,104)	(3,738)	(3,738)	(3,738)	(3,738)	(14,951)	(3,738)	(3,738)	(3,738)	(3,738)	(14,951)
Free cash flow	**4,248**	**4,163**	**2,403**	**(2,981)**	**7,833**	**4,560**	**3,167**	**(1,724)**	**407**	**6,409**	**4,707**	**3,335**	**(1,547)**	**590**	**7,085**

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 smaller 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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2) **Neutra**l: the analyst believes the price of the stock is fairly valued for the next 12-18 months;
3) **Sel**l: 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%**

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