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# The cell tower business model — Resiliency and growth amid challenged capital markets

**The U.S. capital markets are currently challenged with investors focused on recession and inflation concerns, supply-chain issues and broader global, political and socioeconomic trends.[1] Despite the volatile macro environment, the underlying businesses of tower companies have been largely unaffected by these macro risks. The highly recurring revenue streams, essential nature of the assets, and prudent positioning have largely limited cash-flow volatility.[2] In this briefing, we summarize the tower business model and highlight the potential for investors to benefit from assets with strong, near-term revenue growth opportunities.**

## Cell tower basics

### *What is a tower?*

Cell towers are vertical structures built on a parcel of land, designed to accommodate multiple tenants that co-locate their equipment on the tower and portions of the land underneath. Tenants utilize many different technologies on towers, including telephony, mobile data, broadcast television, machine to machine, radio broadcast and more.[3]

### *What is owned by the tower company?[4]*

The tower company owns the tower structure itself, generally constructed with capacity to support four to five tenants or more. The tower company may own the land parcel, but this could also be operated pursuant to a long-term ground lease or easement. In some cases, the tower company may own power generators to facilitate back-up power for its tower tenants.

### *What is owned by tower tenants?[5]*

The tenants own, operate and are responsible for maintaining their antenna equipment and microwaves, as well as shelters containing base station equipment and HVAC. Typically, the tenants are also responsible for the coaxial cables that connect their communications equipment to fiber networks.

### *Carrier-neutral business model*

Multiple tenants lease space on the tower for their communications equipment. Typical tower tenants include AT&T, Verizon, T-Mobile (collectively the "Big 3 Telecom")[6] and many other national and regional broadband carriers. There are often other potential tenants as well, including new entrants, such as Dish Network, private network operators, government and emergency services agencies, municipalities, radio broadcasters, and fixed wireless service providers.[7]

Tenants generally lease space on the tower via long-term, non-cancelable leases. The initial lease period is typically combined with multiple renewal options, often providing lease terms of 20 to 30 years or more. The tenants' lease rates are broadly dependent on things such as: property location, leased vertical square footage and weight placed on the tower from transmission equipment or backhaul solutions. Because of the critical nature of the carrier coverage, as well as technical challenges and high costs of relocating, tower companies have historically enjoyed lease renewal rates of approximately 96 percent to 98 percent[8] even throughout varied macroeconomic periods.




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## Key revenue drivers

There are three essential factors that drive revenue growth and, ultimately, potential for growth in asset value for tower owners and investors.

### *Annual rent escalators*

Tenant leases typically contain annual rent increases of about 3 percent per year.[9] The contractual growth and compounding effect of rent escalations can help mitigate normalized inflation and interest rate risk.

### *Lease amendments*

When carriers deploy new network technologies, such as 5G, they often need to update equipment on the existing cell towers that they already occupy. This usually allows the tower owner to modify the existing lease to account for the additional weight and/or vertical space the tenant is occupying and provides an opportunity to renegotiate the terms of the lease. In particular, 5G equipment is generally larger and denser, which often leads to significantly increased rent via lease modifications.[10] We believe the opportunity for tower lease amendments for 5G upgrades and antenna reconfigurations will continue to be strong for several years as carriers continue to aggressively deploy their next-generation networks across hundreds of thousands of cell sites in the United States.[11]

### *New tenant leases*

As carriers densify their 5G networks and roll out new generations of mobile broadband, they will need to fill in coverage areas. This is likely to lead to elevated new leasing activity for tower owners. Importantly, adding new tenants to existing towers generally doesn't require much, if any, expense for the tower owner. Therefore, each new dollar of revenue effectively goes straight to the bottom line for the tower owners.[12]

We currently view revenue growth as the largest driver of long-term value creation for private tower asset owners and investors. However, there are numerous factors that help determine the value of a single tower or portfolio of towers. Factors such as portfolio scale, expense reduction and managing cost of debt capital can have meaningful impact on cash flows and value.

Tower valuations are generally derived from Tower Cash Flow (TCF) times a valuation multiplier. TCF is simply the total revenues, primarily from rental income, less operating expenses, such as taxes, utilities, maintenance and insurance costs (TUMI). The multiples applied for a tower's valuation are dependent on many factors including, but not limited to:

- Number and credit quaity of tenants
- Location, age, capacity and structural condition of the tower(s)
- Remaining lease duration and the quality of the contracts
- Terms of the easement or ground lease associated with the site(s)
- Probability of further lease-up
- Real estate taxes, if applicable
- Comparable recent market transactions

We note that in the current private capital markets landscape, scaled tower portfolios are commanding higher valuations compared to single-asset or smaller multi-asset portfolios. There are numerous comparables for recent portfolio transactions in the range of 30–40x forward cash flow.[13] This may present significant near-term opportunities for tower aggregators with dry powder and institutional-level access to robust deal flow.

### Summary of tower sector opportunity

**Steady demand growth**

- **Towers and other digital infrastructure assets serve as the backbone of wireless networks.**
- **Wireless connectivity is a ubiquitous, essential service in our lives, often referred to as the "fourth utility."**
- **Mobile data traffic is nearly doubling every two years,[14] creating strong demand for tower assets. Tower tenant demand is generally not affected by stock market volatility, economic uncertainty, geopolitical events and certain other macroeconomic forces.**
- **Anticipate a long growth runway ahead through existing 4G networks, ongoing 5G deployments, and tomorrow's 6G networks.**

**Tower business model provides stable recurring rental cash flows**

- **Long-term leases with high-quality carrier tenants and others provides significant visibility of growing cash flows through annual rent escalators of about 3 percent.**
- **Towers are simple real estate assets with minimal operating expenses and relatively high operating margins.**
- **Tower tenant churn rates are historically very low due to critical nature of wireless infrastructure assets.**

**Significant growth potential through lease-up & portfolio scale**

- **5G network implementation, more connected devices and growing mobile data usage requires more cell sites to keep people connected.**
- **Carrier 5G upgrades are resulting in lease modifications and increased rental revenue.**
- **5G spectrum will require network densification since 5G signals generally don't travel as far as 4G signals, likely driving new tenants and greater lease revenue to existing towers.**
- **Private networks are driving new entrants to the space (Dish, Amazon, Google, etc.) creating previously unforeseen tenant/income possibilities.**
- **Scaled portfolios are commanding higher valuation premiums compared with single asset or smaller multi-asset transactions, creating opportunities for private tower companies to assemble quality portfolios.**

[1] Houlihan Lokey, *Digital Infrastructure Update,* Q2 2022.
[2] Barclays Equity Research, Global Communications, Tower Co 2Q22 Scorecard, August 25, 2022.
[3, 4, 5, 8] American Tower Corp., *Introduction to the Tower Industry and American Tower,* December 31, 2021.
[6] Company reports (American Tower, Crown Castle International, SBA Communications)
[7, 9, 10, 11, 12, 13] StratCap Investment Management research
[14] *Ericsson Mobility Report,* Q2 2022 Update.