



ISPAUK

THE VOICE OF THE UK INTERNET INDUSTRY

WHAT LIES AHEAD: ISPA ALTNET GIGABIT BROADBAND INVESTOR REPORT

SEPTEMBER 2022

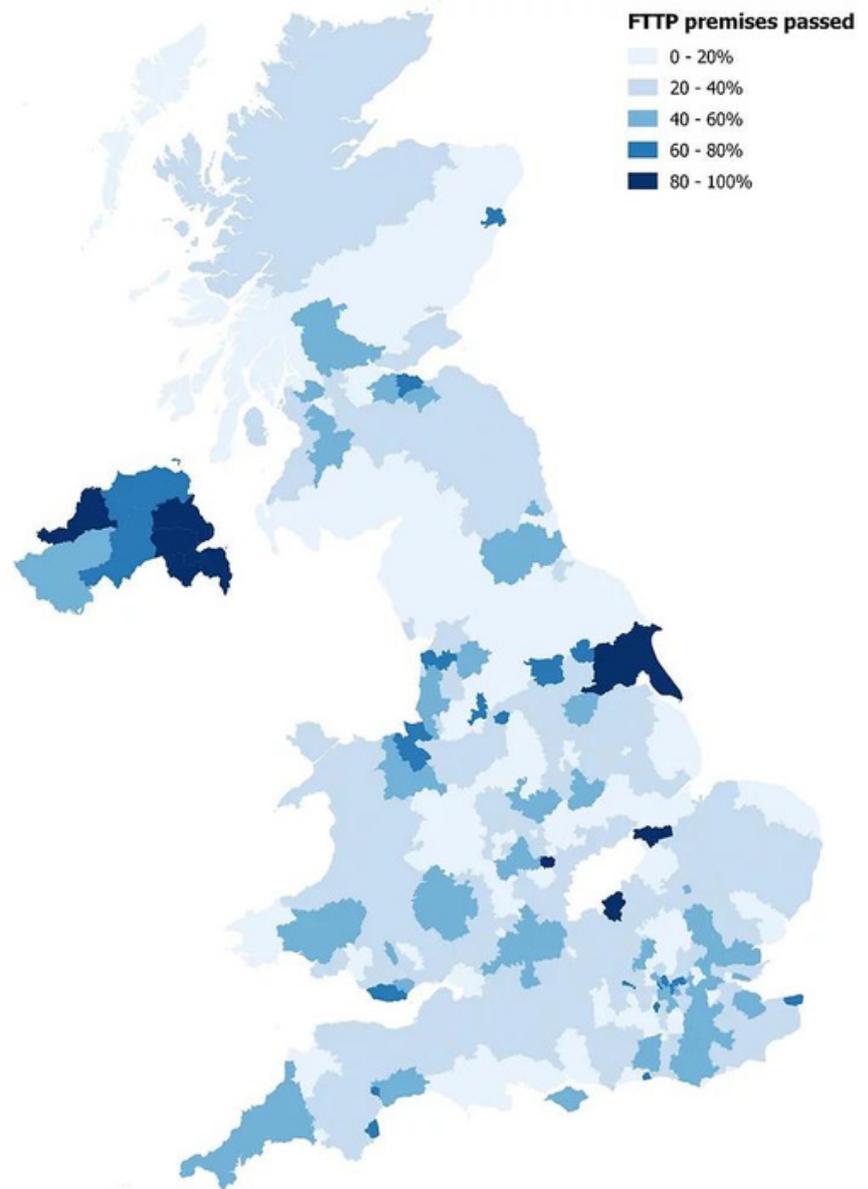
Contents

Introduction and background	2-3
Summary of main findings	4-5
Investment process	6-8
Measuring success	9-10
Value add	11-12
Policy and regulatory	13
Government policy	13-14
Regulation	15
ESG	16
Where next for the ISP market?	17-18
Information on the data	19

Introduction and background

The UK broadband market is at an exciting point thanks in part to the investment and rollout plans of alternative or independent networks (Altnets), the companies helping lead the charge to roll out gigabit capable broadband. The last ten years has seen scores of networks and providers launch to build full fibre, gigabit capable networks across the UK.

A real diversity of supply has seen national networks building wholesale services for ISPs to sell to consumers and businesses; urban-focused operators specialising in high density areas and Multi Dwelling Units; rural operators prioritising some of the harder-to-serve areas; providers focusing on particular parts of the country or particular countries; as well as increased new competition in towns and cities. The range of services and providers available in the UK is almost unrecognisable from ten years ago, and this development has led to discussions around where the market goes next.



© Point Topic

The altnets are building on the strong infrastructure foundations that have helped make the UK a world-leading digital economy. Two main networks – Openreach and Virgin Media O2 – have driven the UK’s broadband for many years, with consumers and businesses able to choose from one of hundreds of ISPs at competitive price for a service that works well. However, since the last superfast broadband rollout in the 2010s the need to upgrade and futureproof the infrastructure has quickly taken over. Both Openreach and Virgin Media are deploying full fibre and gigabit capable broadband nationally and at scale and are a big part of the UK now enjoying 39% full fibre and 70% gigabit capable broadband coverage at the time of writing, up from 9% just 3 years ago, in addition to the altnet push.¹

The ability to access finance has been a key part of the story. Almost uniquely, funding has come overwhelmingly from industry, raising money privately from investors, with public funding only likely to be needed in the hardest to reach areas. More than 30 billion pounds of private investment is being invested, dwarfing the money put aside by government.

Access to finance is not guaranteed, as interest rates rise and the overall economic picture faces challenges, and investors become more selective in their decisions. As the market starts to mature, with more and more fibre in the ground or committed and further rounds of investment being sought, debate has turned to what this maturity means for industry, customers, government and investors. This report will look further at what impact the maturing market means to investors; and how this will ultimately affect altnets, consumers and the market as a whole.

The report is based on interviews with a range of leading altnet investors.² It seeks to provide new insights on where the market will go next, the investment process, key drivers for future investment, how success is measured to the role of value-added services to the impact of government policy and regulation.

¹ <https://labs.thinkbroadband.com/local/index.php?tab=2&election=1#6/51.414/-0.641/>

² See the list of interviewees at the end of this document

Summary of main findings

The broadband market continues to mature and further investment is being sought. As we reach an inflection point, there are several key findings that will fundamentally impact this:

The huge progress made by the sector in a short space of time should be applauded - scores of companies have taken it upon themselves to roll up their sleeves and improve the UK's communications

The market has now reached saturation point, there are unlikely to be many new altnet entrants in the near future.

A period of consolidation is now widely expected and this is generally viewed as a natural, healthy part of market development.

Providers looking for further rounds of investment are likely to find a different landscape to the one in which they raised their original funding. It will take longer to achieve funding and may be harder to come by.

Investors now take a keener interest in the relationship between providers and their customers, building on total homes passed and cost per premises passed to focus on homes connected and average revenue per user (ARPU).

To help secure long-term funding from investors, providers must differentiate their services from competitors. As gigabit speeds cease to be a key determining factor for consumers, providers must think creatively about what they offer to customers.

The impact of consolidation is also likely to mean a greater role for wholesale in the future, and the increase in infrastructure competition of recent years will mean consumers will have a greater choice of options.

Fibre-to-the-Premise (FTTP) take-up will be supported by key developments in the broadband industry, such as Ofcom's introduction of a 'One Touch Switch' initiative by April 2023.

The policy environment can best support fibre rollout by removing red tape and barriers to deployment and the regulator should take a greater account of greater infrastructure competition brought about by the market.

Investment process

There has been significant investment in full fibre networks in recent years. Starting in earnest in early 2010s, billions of pounds has been invested in scores of providers across the UK. This has resulted in money reaching under-invested parts of the country, transforming the infrastructure for generations to come. This investment in infrastructure has been funded by a range of investors and funds. As the market matures, talk is turning to where things go next, with build plans well underway and fewer market entrants emerging as early signs of consolidation start to be felt. In this section, we asked the interviewees questions about what they look for when investing, how open the market is to new entrants, and the impact consolidation is likely to have on investment decisions.



Interviewees were unanimous in their view that the sheer scale and progress of the rollout of full fibre gigabit networks by altnets over the past decade, and the ramping up in recent years, should be applauded as a significant achievement. Companies have just gone out and done it, finding investment and getting on with a huge physical engineering project, one of the biggest since Victorian times. Investors were proud to be part of an infrastructure project that was making a huge difference to peoples' lives and would be doing so for years to come. However, all were clear that we had reached the peak of new entrants and the ballooning of new participants was no longer sustainable.

While investors followed their own investment path, a key early driver for investing in the altnet market was the lack of fibre services in the UK. The opportunity to help fill this gap had to be balanced against the expectation that the incumbent, Openreach, will continue to be the main national network, with significant coverage in a big part of the country by Virgin Media. This means that investors "must consider which network providers have the opportunity to be Openreach's closest competitors, and who could occupy the second (or third) position".

A strong regional presence, particularly in areas where there is less competition such as rural areas, means that a strong regional presence and an ambition to be the leading altnet in an was a strong starting point. This approach has been adapted by Infracapital, who have invested in rural and regional England, Wales and N.Ireland, giving them a unique asset albeit at a higher build cost. A different approach has been adopted for urban areas that are able to accommodate several competing infrastructures, but the overall value of the asset ultimately may not be as high.

The early stages of investment focused on supporting experienced, competent management teams with a clear rollout plan, many whom had experience internationally in more developed fibre markets. For several interviewees, a key determining factor was investment in areas where altnets would be able to compete long-term as one of the three network choices in an area alongside Openreach and/or Virgin Media O2 (depending on the part of the country).

There was consensus that the sheer number of companies building networks is unsustainable and we had reached market saturation. This next phase has been described as a natural and positive state as we move towards a 'landgrab', with bigger and better run operators looking to merge with others.

It was explained that infrastructure is all about scale, with investors looking for teams that can scale up quickly, and mergers and acquisitions help deliver back-end efficiencies and savings. Some of this is happening at a small scale – there are several examples, such as Community Fibre buying Box Broadband – but we are likely to see a lot more in the coming months and years. As more acquisitions are expected, investors will keep a keen eye on price. There will be winners and losers, with some getting their valuation while others will not. Ultimately, the decisions, teams and investment plans already taken and being taken will help decide which camp an operator falls into.



As well as consolidation amongst altnets, there is also likely to be consolidation within the financial community. To date there has been significant investment from a range of funds, but plenty of funds are yet to do so. For example, there are a number of large investor funds that have not invested yet and will be watching the market with interest. Large pension funds, for example, may look to enter from the investment side as some of the smaller funds look to exit. Again, this is seen as a healthy symptom of market development.

All those interviewed had gone down a path of investing in vertically integrated providers. With a few notable exceptions, being both a network and an ISP has been a crucial part of the business case from the outset. Without an anchor tenant ISP the infrastructure ran the risk of being underutilised. For some, particularly in rural areas with less competition, providers wanted to capitalise on their own investment and hard work. As altnets go live in more and more parts of the UK we may start to see a more proactive wholesale market. With TalkTalk using CityFibre and investing in their own altnet, what the other large established ISPs do next will be of real interest to the market. That said, many altnets have demonstrated that you can grow a successful ISP as part of building a network, with some of the longest established altnets having tens of thousands of customers.

All agreed that consolidation would mean a bigger role for wholesale in the future. This would not be without challenges around integration and while there are some initiatives working to address this, the situation remains quite erratic. Overbuild was widely acknowledged to be a big risk in undermining investment, something which will be explored later, but this was factored into investor strategy, with rural and regional areas favoured by many.

“The key things that investors take into account when assessing business include the number of premises passed, the cost and speed of deployment, and penetration on built networks - and critically the ability of the management team to deliver the plan. We’ve focused on backing business which we think can be the leading alternative networks in a particular region”

James Harraway, Infracapital

Measuring success

The earlier section on the investment process touched on how a maturing market is changing how investors are viewing success. A strong management team and good plan are no longer the key determining factors; speed, quality and cost of network build and total homes passed have quickly become key metrics. In an increasingly congested field, investors are now looking at build quality, take up, customer numbers, ARPU and the 'quality' of customers signed up. This section will look more at investors are becoming more sophisticated in measuring success as the market evolves.

Measuring success has evolved in three steps:

1.

At the outset, with few fibre networks rolled out in the UK, investors were looking at the strength of the business plan and management team experience. Fibre networks had been rolled out elsewhere internationally, and the overall maturity of the telecoms and ISP sector from dial up to LLU and cable meant there was plenty of experience. This, combined with the opportunity across the UK to be the prime mover in an area, was enough to gain investment for a reliable yielding asset.

2.

The second stage was to mobilise and build as quickly as possible, focusing on premises passed. Looking at build rates and quality of the asset was possible as more fibre was laid and ready to connect to customers. This meant investors were able to look over the shoulder of operators to check progress and the quality of the asset, be more forensic, as well as compare to others in the market.

3.

Building on this, investors are now able to look more closely at how the asset is being commercialised. Looking at profitability, customer stickiness and ARPU is, and will become even more, central to future funding and demonstrating success.

All agreed that investors were sophisticated in how they measured success. Business plans have long term assumptions on ARPU and the cost of acquiring customers, companies are now demonstrating performance against this. Investors are also realistic and well aware that many customers are tied into long-term contracts that will have to serve their course, for this reason penetration rates are often set to grow over time, starting modest and then ramping up, with ARPU coming over time.

The big question going forward is for operators to prove they can commercialise. For example, are penetration rates delivering? The opportunity for altnets is significant but as we will explore further in the next sections, there is now more competition. While many have first mover advantage, there is a need to differentiate from the more established competition. The customer offering will be an important part of this evolution.

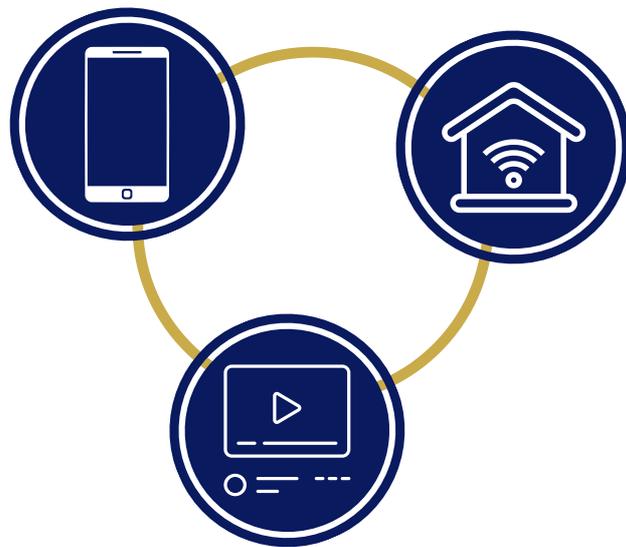
“Speed of deployment and getting into as many homes as possible are important investment KPIs. We also consider that a strong customer service provision will be key in driving future ARPU growth.”

Neil Marvell, Senior Director, DIF Capital Partners

Value add

Consumer broadband is traditionally seen as a highly competitive, low margin business. Broadband has been bundled as a triple or quad play service alongside traditional telecoms services such as phone and mobile to include TV and media services. This situation is evolving as customers shift toward streaming services and home phone usage declines.

At the same time, new full fibre networks will be able to power increasingly connected homes - whether it's 4K streaming, connecting hundreds of devices in the smart home or continuing to support the changing world of work. New outsourced managed services are helping providers offer a comparable offering through TV-as-a-Service or voice.



However, most customers can live their lives online through existing broadband infrastructure quite happily, so what do investors think their providers should be offering customers to make the most out of fast, high-capacity networks and what drives this decision making? This section will look at how investors view the drivers of gigabit networks.

As set out in earlier, investment in fibre networks is seen as a long-term asset. Returns will be made over a long period and the fibre going into the ground will be in place for decades. That said, investors are thoughtful on market demand and the need for drivers to the take up of FTTP. These drivers generally fall into several categories:

Societal shifts: The large-scale deployment of fibre by altnets has coincided with a global pandemic that has seen a shift to home working, more streaming and video calls to stay in touch with friends and family. For many existing FTTC solutions have provided more than adequate, but over time, with these shifts becoming more permanent the need for 24/7 reliability should drive take up.

Demand for data: for a minority there will be a need for reliable fast connectivity to power things like gaming, multiple streams in family homes and hundreds of devices. The wider killer app for most of the population is just not there yet, but over time the average user will need a gigabit connection as more and more data is consumed.

Technological changes: the next few years will see some significant industry milestones that will drive the take up of fibre. A new approach to cross platform switching set to be introduced in Spring 2023 should increase switching onto altnets and fibre networks, more wholesaling, the PSTN switch off will see more and more using IP phones and in the longer-term the copper network will be switched off.

Interestingly, some interviewees viewed fibre like any other utility with others emphasising the need to explore value added services. This fed into a broad consensus that investors do not have strong views on whether altnets should be offering triple and quad play services to their customers. This is a decision often left to the altnet/ISP management teams where there is often a patchwork of services: some offer TV or phone, whereas others that do not.

However, investors were in agreement that while ISPs are able to compete on fibre alone, as the market develops and more fibre is deployed, they will need to look again at their overall offering, be it TV services, smart home and voice. For now the biggest competitive advantage is the reliability and performance of FTTP, this will soon reach a tipping point and value add will be key.

Policy and regulatory

Having looked at what drives decision-making and how success is measured, we turn to a section that impacts on investment decisions and shapes the market, namely government policy and regulation. Telecoms is a long-established, heavily-regulated industry. What the regulator Ofcom and government decides affects both the short and long-term development of the industry and investment decisions.

The increased reliance on broadband has seen it rise up the political agenda, culminating in the 2019 general election campaign where one party was committing to deliver nationwide gigabit-broadband by 2025 – a target that was revised to 85% in November 2020 – the other to nationalise and give it away for free. The policy agenda impacting altnets is significant and ranges from making it easier to deploy networks, public subsidies for rollout, wholesale pricing, the advertising of fibre through to sustainability and supply chains, cyber security, online harms and much more.

Government policy

Overall government ambition was a key theme. Interviewers argued that the Government could do more to help the industry grow faster and support infrastructure development.

For one investor, the Government has shown ambition to deploy to 85%, but they would have liked to have seen this go even further, as close to 100% as possible. All agreed that broadband rollout is a huge infrastructure challenge and the current fibre upgrade is one of the biggest nationwide infrastructure projects in recent times.

Policymakers should focus on removing barriers to ensure all parts of the UK have sufficient access to fast and reliable broadband, including access to sufficient land for providers to build on, and being granted a licence with the right to access land and/or property to install communications equipment (commonly known as ‘wayleaves’).

Interviewees thought there was a limited benefit in some modest subsidies for rollout. The sector has not been short of investment, so unlike other infrastructures and utilities there is generally less need for government to step in, particularly as this entails complicated open access requirements and removing the prime mover benefit.

There was broad agreement that government subsidies would benefit the hardest to reach areas that are expensive and challenging to deploy to. Beyond this, public money runs the risk of disrupting a competitive market. Therefore, government should therefore focus efforts on rural areas, as investors watched how Project Gigabit funding was rolled out.

Supply chain pressures have been a recurring theme, particularly as the world re-opened after COVID-19 and the war in Ukraine, with a whole range of providers in the market for the same materials, workforce, and associated services. A key point from one of the interviews undertaken was the availability of workers to actually undertake building in areas that altnets operate in, arguing that “the Government could relax immigration rules further to prevent a shortage of workers worsening even further”.

In addition, the interviewee added that the Government could play a greater role to ensure that materials are readily available for work to be carried out by providers. This is because investors appreciate transparency and dislike shifting goalposts. This desire for certainty was shared by all respondents, with one saying: “when regulations change, any investor decisions to be made may be put on hold”.

Policymakers, it was argued, could help with demand-side measures to increase awareness of gigabit broadband, and make it easier for consumers to switch. Eyes were focused keenly on the one touch switching rules due to come in force in 2023 that will make it possible to switch between different infrastructures seamlessly.

Moreover, the contentious issue of how fibre is advertised was raised repeatedly, with a feeling that consumers being unaware that their Fibre to the Cabinet (FTTC) service is not as reliable and fast as Fibre to the Property (FTTP). While the ASA looked at the issue some years ago, it was argued, widespread fibre availability meant it was time to look again.

Regulation

There is a sense that the regulator still needs to appreciate how the market has changed. A commonly held view amongst interviewees was that Ofcom doesn't quite have a full grasp of the ambition of the sector as a whole, particularly when it comes to build programmes and the impact on particular regions.

Inevitably, in a market where the former incumbent plays a large role, the dominance of Openreach was raised. It is also believed amongst interviewees that regulators have a natural bias towards larger players that can get things done quickly, and that they would prefer to deal with a single organisation that can build nationwide quickly and efficiently, as opposed to 100 people that can build for the same amount of homes. Ironically, too much competition and diversification (a regulatory goal) complicated things for a regulator set up to foster competition.

It was acknowledged that, had the UK followed a strategy to deploy FTTP sooner, the market for altnets would be much smaller. Many believe that the role of a large former incumbent impacts on competition, be it discounts on pricing or overbuild. This can make it harder for altnets to build in certain areas, putting a dampener on potential investment. However, with scores of altnets in the market having invested billions, there is clearly an investment case for fibre, and investors were fully aware of the market dynamics when investing.



While competition in the market can be seen as a positive thing for the altnet community, overbuild has the potential to have a negative impact on residents within the geographic area, who are likely to experience significant disruption to their day-to-day lives on a practical level. One investor argued that overbuild tends to predominantly take place in urban settings, as altnets are likely to be one of three ISPs competing for customers. This means that investors "tend to think about whether they can make a return of profit by investing in one of those three".

The future regulatory environment should take greater account of how the market has changed in recent years, acknowledging the role of newer entrants in regional and urban areas. While not an immediate priority, regulators and policymakers need to look at the long-term regulatory settlement and the role of wholesaling to minimise competition, without undermining investment already put into FTTP networks to transform rural connectivity.

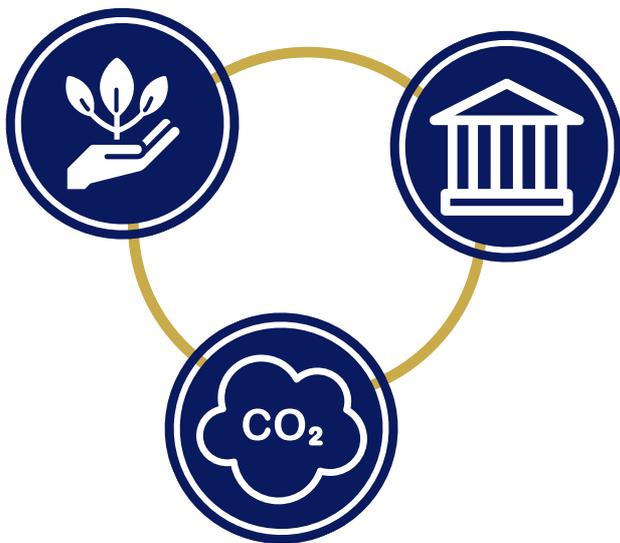
ESG

Investors take great regard in how their decisions and investments impact wider society. Environment, Social and Governance (ESG) has increased dramatically over the past few years, and it is influencing decision-making on investment, mergers, acquisitions, and divestitures. The broadband investor community has been no different, and our interviews found that ESG is prioritised heavily. The broadband sector has a positive case to make, being an infrastructure that promotes sustainable practices that helps lower emissions and helps people access a wealth of public services.

During investment cases, investors mentioned that ESG is brought up, playing a significant role at an investor level. Investors tend to argue that digital inclusion discussions are of vital importance, and that it makes good business sense to have this high on the agenda of both investors and altnets themselves. One area of ESG that investors drew upon is the environmental impact of more employees working from home as opposed to travelling to an office, saving money, and reducing carbon emissions in more rural areas. Enabling people to stay in rural areas or encourage people to live and work in areas they traditionally may not, increasing the size of the rural economy, is one of many benefits of investing in full fibre infrastructure.

For one investor, effective ESG policy should reduce the risk of some of the global supply chain issues that are currently being faced. The geopolitical shift away from relying on supply chains from certain parts of the world that it causing disruption is a case in point of how ESG policies can mitigate future risks.

Investors interviewed were all clear: ESG is not a box ticking exercise. Rather, it underpins decision making at all levels and cascades down to the providers being invested in.



Where next for the ISP market?

To conclude the interviews, we asked investors where they think the broadband market will be in 5 years' time. After several years of investment and deployment, the consensus view was of a healthy and vibrant sector, but the current rate of build and investment could not continue at its current rate.

“We have seen a ballooning of participants that it is simply not practical and I expect to see a slimming down to a considerably smaller number. With the end of the landgrab in sight, investors will become increasingly focused on customer service and retention, profitability and network asset performance”

Charles Cameron, Partner, Cameron Barney

Investors were unanimous in that having passed the peak of new market entrants, a period of consolidation will see fewer altnets on the market. As set out in the first chapter, a series of mergers and acquisitions in the coming years will bring this about. With Openreach building to around 80/85% of the UK and VM 02 stepping up its deployment, this was all but inevitable. Future funding rounds, where altnets will be seeking further investment in part based on build speed and quality, but also customer numbers and revenue, could accelerate some of this.

However, while altnets will reduce in number, for ISPs connecting customers to FTTP networks there was confidence about the future. One interviewee stated their belief that the industry remains healthy, despite consolidation. They argued that “there is likely to be more ISPs than there are today, meaning customers will have far greater choice”. With customers set to benefit from an upgraded infrastructure fit for the next decades, broadband quality will remain good, and that customers will have a lot of choice thanks to more wholesale options.

Despite the optimism, investors agreed that there will be a divide in access to choices for urban and rural settings.

Urban areas will benefit from greater infrastructure competition – possible up to 4 or 5 infrastructure networks in some cases – making use of existing ducts and poles, to serve more densely populated areas. ISPs will be able to benefit from the different infrastructure.

Rural areas – likely to have 1 or 2 infrastructures. Open access will have a bigger role to play, with Openreach subject to such requirements and any publicly funded rollout also required to be open access, meaning opportunities for ISPs to resell to customers.

The overall sense of the UK broadband market from some of the biggest investors in FTTP is an optimistic one. The benefits of deployment are already being felt, and this will become more mainstream as rollout intensifies and the awareness and value of fibre is more widely understood. There will be some challenging times ahead with the cost-of-living crisis, supply chain pressures and consolidation, but with big industry milestones set to be passed – including Ofcom’s One Touch Switch directive and BT’s switch off of the Public Switched Telephone Network (PSTN) by 2025 – there remains huge opportunities to invest in the broadband sector.

Information on the data

The report findings and insight are based on five interviews conducted over Spring/Summer 2022. The interviews focused on 12 questions across four main themes under the Chatham House rule. Any questions, comments or points of clarification should be sent to policy@ispa.org.uk or Andrew Kernahan, Head of Public Affairs, ISPA.

ISPA would like to thank the interviewees for sharing their views.

1. **Oliver Bradley**, Managing Director, Digital Infrastructure Investing
2. **Charles Cameron**, Partner, Cameron Barney
3. **James Harraway**, Managing Director, Infracapital
4. **Neil Marvell**, Senior Investment Director, Infrastructure Equity, DIF Capital Partners
5. **Rob Skinner**, Head of Sustainable Infrastructure, Octopus Investments

This ISPA report has been sponsored by ISPA partner Netgem. Netgem provide an end-to-end TV service in an “as-a-Service” model for ISPs and altnets. With more included content than any other TV service, Netgem always put value first for customers. Giving them access to over 215 channels including their favourites from Freeview such as BBC as well as 100+ HD channels including Premier Sports on top. As for the apps, Netgem never compromise on quality with premium add-ons including BT Sport Ultimate and Prime Video. On top of that, free apps such as TikTok, YouTube 4K and other movie streaming apps are constantly being added.

Authored by



Sponsored by

