

Growing demand for satellite-powered Internet and other digital services to underserved areas are brightening the outlook for Hughes Communications.

Hot Spots in the Sky

by Neil A. Martin

IN NEXT FEW MONTHS, SOUTHWEST AIRLINES, which transports more passengers than any other U.S. carrier, will begin equipping its 540 Boeing 737 jetliners with high-speed wireless Internet systems, similar to what can be found at a Starbucks, McDonald's, malls and many other earthbound "hot spots."

Travelers with Wi-Fi-enabled computers and smartphones will be able to browse the Web, play online music, games and podcasts, and send and receive e-mails while flying over land, water and international borders

Developed over the past three years, the new aircraft-to-satellite service, called Row 44, is the brainchild of a small southern California engineering firm of the same name. It's supplying the equipment and technology for high-speed mobile broadband via a subsidiary of Hughes Communications (ticker: HUGH), the world's largest provider of broadband satellite services.

Pricing for the new service hasn't been fixed yet, but passengers were charged \$2 to \$12 per flight during trial runs on four Southwest Airlines jetliners last year. "We found that our passengers, especially business travelers, were definitely interested in onboard Internet access, and voiced high expectations about its use," says Doug Murri, a senior operations manager with Southwest (LUV) who is overseeing the new service's implementation.

Row 44 is named for the last row of the old DC-10, the least desirable because it was next to the toilet and had

seats that didn't recline and hence needed something extra to enhance a passenger's flight experience. Southwest will begin installing the systems on its 737s soon; the project is expected to be completed by mid-2011.

A number of other airlines are following Southwest's lead by offering some form of Wi-Fi on certain flights, but on a very limited basis. Alaska Airlines is trying out Row 44 on some flights, and says it hopes to install it on most of its planes this year. And, in Europe, a Norwegian air-shuttle service plans to add Row 44 in 2010.

"We think Internet access will become standard service on all airlines in the near future," says Gregg Fialcowitz, Row 44's president. "We are currently in discussion with a number of European, Mideast and Asian airlines that are interested in the service," adds Fialcowitz. "We believe our service will be aboard more than 5,000 airliners within five years."

That's music to the ears of Arunas Sleky, Hughes Communications' vice president of corporate marketing, who sees "broadband on the go" as a new niche market. "It's not just airliners that need Internet connections, but also boats, trains, vehicles and other mobile operations that are beyond the reach of standard, land-based broadband," he says. As a satellite supplier of airline broadband, Hughes receives a monthly fee to maintain the customer-to-satellite connection.

"Row 44 opens up a worldwide opportunity for Hughes to supply our advanced,

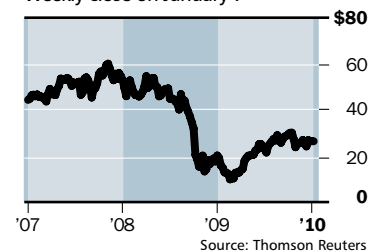
Hughes at a Glance

Ticker	HUGH
Recent Price	\$25.25
Stock Market Value (mil)	\$545
Revenue 2009E (bil)	\$1
EPS 2009E	-\$2.40*
EPS 2010E	\$0.91
P/E 2010E	27.7
LT Debt/Total Capital	71%

E=estimate. *Includes a one-time charge of about \$2.10 a share
Source: Thomson Reuters; Barclays Capital

Hughes Comm (HUGH - Nasdaq)

Weekly close on January 7



The Bottom Line

With limited competition and the markets for satellite TV and Internet services expanding, Hughes has excellent growth prospects. Its stock, now in the mid-20s, could hit 35 in a year.

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broadband satellite technology and services in a new business market," he says. More important, it represents an "emerging, potentially high growth part of our global enterprise business," which generates about half (48%) of the company's \$1 billion-plus in annual revenue.

Few satellite outfits are better qualified to work with large enterprises than Hughes, which in the 1980s invented the VSAT (very small aperture terminal), a two-way ground station with a one-meter satellite dish and modem, making many monster-sized satellite dishes outmoded. VSAT networks provide reliable, rapid transmission of data, voice, video and multimedia to sites in the U.S. and abroad, with coverage by Hughes directly or by one of its many service partners around the globe.

Hughes Communications, which is headquartered in Germantown, Md., near Washington, D.C., has been the leader in providing satellite networks since 1986. That was when Wal-Mart Stores (WMT) chose Hughes to connect all its stores. The giant retailer remains on Hughes' client roster, which now also includes other retail chains, along with major names in the energy, automotive, banking, entertainment and media businesses, as well as government agencies. All in all, the company has shipped more than two million systems, to customers in 100 countries.

Its other key customers include BP, Burger King, the U.S. Social Security Administration, Yum! Brands, Rite-Aid, Barrett Xplore in Canada, GTech, the World Bank and Martins Brazil, to name a few.

While packed with potential, this part of Hughes' business is growing only modestly, at a 1% to 3% yearly pace. However, the other half—providing satellite Internet access to households and small businesses beyond the reach of cable—is expanding at a 10% to 15% annual clip.

That's what appeals to some investors.

Indeed, 10% to 20% of the United States hasn't been wired for land-based broadband cable, which is typically provided by the likes of Comcast (CMCSA), Verizon (VZ) and Time Warner, among others. For residents of such areas, satellite-powered broadband is the only viable alternative.

"Hughes is a growth story, and it's the growth of its consumer business that is driving interest in the stock," says James Ratcliffe, an analyst with Barclays Capital

in New York. He predicts that the company's common, recently trading at 25, could reach 35 within the next 12 months. That would be a nearly 40% gain for the stock, whose 52-week high is 32.

Comments Hughes CEO Pradman Kaul: "Opportunities for future growth are substantial. You don't need to be in Montana to be beyond the reach of cable." The Indian-born executive estimates that as many as 10 million to 13 million households and 3.5 million small businesses are in areas unserved by ground-based broadband technologies in the U.S. And given that broadband has only penetrated about two-thirds of the potential U.S. market, that leaves a lot of room for growth, he adds.

"If burgeoning global demand from video- and Internet-hungry consumer populations of countries like Brazil, Russia, India and China are considered, the bottom-line potential for our consumer broadband service is obvious," he adds.

While cable and phone-company DSL broadband are generally cheaper than satellite service, customers have been willing to ante up because the Internet has become so indispensable. To some degree, this also has helped to insulate satellite outfits like Hughes from the worst of the global recession.

In the third quarter, which ended last Sept. 30, for example, Hughes added a net 17,000 subscribers to its system, a 49% increase—a record for the company—over the number added in 2008's third quarter. That raised the company's total subscribers to 490,000. This was complemented by a 19% increase in service revenues over 2008, fueled by increased demand from Europe and Brazil.

Once a part of General Motors and Boeing, Hughes, the developer of the DirectTV satellite service, was taken over by Rupert Murdoch's News Corp. (NWS, the owner of Barron's) in late 2003 and later became a separate company under the DirectTV banner. One year later, Murdoch sold his interest to SkyTerra Holdings, already a major Hughes investor. SkyTerra formed Hughes Communications as a subsidiary of Apollo Management, a New York private-equity firm. Apollo, which currently holds 58% of the company's shares and is active in management, took Hughes Communications public in 2006.

"We invested in Hughes because we always like the underlying business and growth opportunities," says Andrew D. Africk, a board member of Hughes Communications and a senior partner with Apollo. "Our existing satellite will provide us with plenty of capacity for the next several years," he says. "But we have a new, next-generation satellite on order that will provide us with a great deal of capacity beyond 2012."

Since Hughes went public in 2006, its revenue has grown at a compound annual rate of 6.9%, rising from \$858 million in 2006 to more than \$1 billion in 2009. And its adjusted earnings before interest, taxes and depreciation and amortization, or Ebitda—a common measure of profitability in a growing business like the satellite industry—has advanced, on average, 10.3% a year during the same span.

The company is believed to have lost \$2.40 a share in 2009 (including a one-time charge of about \$2.10), versus a profit of 44 cents a share a year earlier. But its booming business of supplying VSATs to homes and small businesses is expected to push it back into the black this year.

Earnings are expected to hit 91 cents a share in 2010 and \$2.26 in 2011, according to analyst James Ratcliffe of Barclays Capital in New York. "We expect Hughes to drive margin expansion, due to a combination of lower satellite costs and a larger share of revenue from higher-margin services," he says.

Hughes basically has just one peer—ViaSat (VSAT). Ratcliffe notes that Hughes recently was trading at 28 times his 2010 earnings estimate and 11 times his 2011 forecast. The valuations put Hughes at a 40% premium to ViaSat (but with faster growth), based on next year's expected profits—but at a 33% discount based on 2011's.

"For an individual investor, it is basically priced to buy, and trading at a good entry point," Ratcliffe asserts.

One big potential plus: In 2012, Hughes plans to launch a satellite—called Jupiter—that will have three times the capacity of its current service.

The new satellite will pump out 100 gigabits of data per second—10 times the current Spaceway 3 satellite's 10 gigabits. That should be more than enough to keep the long-term growth story moving and to ensure that Hughes Communications keeps flying high. ■