

Money matters

Which factors are affecting the types of financing techniques employed by satellite operators in the Asia-Pacific region? What are the pros and cons of each financing option? Richard Gray, a Partner in US-based international corporate law firm Milbank, Tweed, Hadley & McCloy, provides some answers.

Satellite operators in the Asia-Pacific region are beginning to access the public equity markets as a source of finance. AsiaSat, Pasifik Satelit Nusantara (PSN) and APT Satellite raised a total of over US\$500 million in those markets in 1996, and others, including Satelindo, Laostar, Optus and Binariang, are expected to go public in 1997.

But a word of caution. Although the issues by AsiaSat and PSN were oversubscribed, APT's issue was not regarded as a resounding success. The share prices of all three issuers soon fell below their initial offer price, which some felt was due to a market perception of oversupply of transponders in the region.

Nevertheless, the ability of a satellite operator to issue shares publicly, or indeed to obtain financing through private equity investments or various forms of debt, reflects its business having achieved a certain stage of development. The changing risk profiles associated with successive stages of development will open up financing opportunities that were not previously available to it. At the same time, increasing competition in the Asia-Pacific region, driven by deregulation and other factors, may affect the types of financing techniques used by satellite operators in the region generally.

Risks at various stages of development

A distinguishing feature of satellite projects is that they have substantial financing needs at a time when risks are relatively high and difficult to mitigate for

third-party investors. There are three distinct periods in the development of a satellite project for which these risks can be identified: the pre-launch period, the launch and commissioning period, and the operational period.

After the earliest stages of the pre-launch period, when the most basic strategic questions have been addressed, funds will be required to begin construction. During this period, many risks will become apparent.

The most obvious risk, of course, is the risk of completion - whether a working satellite will be delivered on time, on budget and in accordance with specifications. In many cases, this risk can be mitigated with manufacturers' warranties and agreements to pay liquidated damages, or with completion guarantees from project sponsors.

Other risks during this period arise from the unanswered questions that potential investors will have in order to assess the likely success of the satellite project. These questions pertain to, among other matters, the identities of strategic partners and key management personnel and the factors of a comprehensive business plan. In addition, at the time construction commences, necessary governmental approvals for the operation of the satellite may not have been obtained.

As the launch date approaches, the ability of a project sponsor to obtain third-party financing based upon a successful project will depend upon the degree to which these questions have been answered satisfactorily and these approvals have been obtained. If the success of the satellite project relies upon transponder leases, lenders will expect the

lease agreements to be in place prior to launch.

Some have argued that lenders should place greater reliance on the asset value of the satellite and therefore be more willing to release shareholder support upon construction of the satellite, even if other elements of a successful project are not present. However, the extent to which lenders are now willing to accept re-marketing risk is not clear.

The launch and commissioning period is typically much shorter than the pre-launch period. The risks associated with a failed launch, or the satellite failing to meet specifications, are typically covered by launch insurance and manufacturers' warranties.

Even after a satellite has been launched and in-orbit commissioning has occurred, risks remain in the operational period. The most significant potential risk is technological - will the satellite work? Lenders tend to be conservative on issues of technology. If they are relying on the cash flows from the satellite, they normally will have assured themselves much earlier in the pre-launch period, through technical consultants and historical experience, that any technological risk is low. In the Asia-Pacific region, satellites have mostly been of the more conventional types and therefore are not subject to the technological risks associated with the new LEO or MEO systems.

A remaining risk in the operational period relates to how stable the market is. Although lenders will have sought to mitigate this risk through careful review of business plans and market research, historical experience and other due diligence, the impact of technological change and

regulatory and political actions can significantly affect a competitive position. The rate of digitalisation of transmissions, deregulation, the construction of new land lines, privatisation and new licenses for free-to-air terrestrial broadcasting are all examples of developments that will affect the success of a satellite project. This is particularly true in cases where a satellite operator is seeking to move beyond providing only a space platform (as PSN, PanAmSat and Satelindo have sought to do). Lenders will find it increasingly difficult to rely exclusively upon long term transponder lease agreements as a guaranteed source of revenues.

Financing options

The sources of financing for satellite operations, like those for any business, are varied. Those considered here include private equity, bank debt, vendor finance, high yield bonds, IPOs and leasing. Each carries its own advantages and disadvantages for a satellite operator and may be more appropriate at particular times in a project's development.

Private equity

Equity contributions from founding shareholder(s) are the normal source of funds for start-up operations. The principal issue for a foreign operator will be whether, and at what stage, to enter into a joint venture with a local investor. It is usually advantageous to do so, since a local investor is likely to have superior knowledge of the local markets and may be better equipped to negotiate local business and legal hurdles. In any event, a local partner is usually legally required. Even after implementation of the agreement earlier this year at the World Trade Organisation talks, most countries in the region will maintain a requirement of some degree of local ownership.

Shortly after the initial start-up has begun in the pre-launch period, substantial progress payments will need to be made for construction, often with bank finance. In the early stages of construction, when the risk is highest, banks will likely require full guarantees or other recourse to shareholders. Thereafter, financing may be structured on a corporate basis with continued recourse to shareholders, at a lower cost and with greater flexibility, or on a project finance basis, at a higher cost and with less flexi-

bility. In a typical project finance structure, banks will be willing to release shareholder support as the satellite passes certain project milestones and becomes operational. APT Satellite employed a project finance structure, using long term transponder leases with creditworthy lessees as a guaranteed income stream and as security for its financing.

Bank debt

Bank debt will naturally be more restrictive than equity and may impose a more conservative structure on the satellite project than the equity sponsors might have otherwise chosen. Indeed, bank debt is likely to be more restrictive than other, longer term debt such as high yield bonds. However, bank debt will be less expensive than longer term debt, and it can generally be prepaid without penalty. In addition, the right banks can be expected to bring to bear a high level of industry and project expertise, and it will generally be easier to modify or restructure a bank credit facility to respond to unanticipated difficulties or to meet new needs or opportunities.

The bank finance for AsiaSat provides a good example of the flexibility that this option can offer. The bank financings for AsiaSat 1, AsiaSat 2 and AsiaSat 3 which were secured, contained typical restrictive covenants and were guaranteed by the shareholders. In contemplation of the pending IPO, AsiaSat was able to restructure this debt in order to provide additional financing for a fourth satellite if certain benchmarks were met, to finance a replacement satellite if AsiaSat 3 or AsiaSat 4 suffered launch failure, to eliminate recourse to shareholders, to permit dividends sufficient to attract public investors and to loosen covenants and extend maturities so as to enable AsiaSat to pursue additional business opportunities. ACeS, now at an earlier stage of its development, recently announced having obtained a \$250 million credit facility from a syndicate of local Indonesian banks.

Vendor finance

The availability of vendor finance has grown in the Asia-Pacific region, as it has in the rest of the world. Manufacturers of satellites and ground facilities, responding to competition, are making this form of finance available in increasingly creative ways, including through the use of options, equity investments and commitments to use transponders. In addition,

Arianespace has announced a vendor finance programme for its launch services.

High yield bonds

High yield bonds are a potential source of finance beginning at a somewhat advanced point in the pre-launch period, when management, a comprehensive business plan and material regulatory approvals are in place. More expensive than bank debt, high yield bonds are likely to have less restrictive covenants (although, as discussed above, they may be more difficult to modify after closing than restrictions contained in bank financings). They have not been a significant source of finance for satellites in the Asia-Pacific region.

IPOs

IPOs have become a popular form of finance for satellite operators as they have the advantage of establishing an objective market price for the shares in the satellite company. They should also increase liquidity of those shares, although lock-up periods for founding shareholders after the IPO and the endemic illiquidity of public satellite shares will tend to reduce this advantage. This funding source used to be available only to companies that had commenced operations, but it has become more available in the pre-launch stage.

Leasing

A final form of finance to be considered is leasing. The primary advantages are a substantial reduction in financing costs and, depending on local accounting rules, favourable balance sheet treatment. The primary disadvantages are the limited flexibility imposed by financing restrictions and often complex structures. Also, this financing technique may be available only for high quality corporate (not project) risk and post-launch operations, and may be subject to the identity of the client, the origin of the satellite and the timing of the project.

Possible trends in financing techniques

The wave of deregulation across the Asia-Pacific region in telecommunications has been a catalyst for increased competition in all segments of the industry. Several countries now permit the entry of new satellite operators into local markets. As a

result, operators have begun to deploy large satellites (such as JCSat 3) for commercial activities outside of their native markets, and this trend is expected to continue with Thaicom 3, Mabuhay 1, JCSat 4 and Superbird C.

Similarly, some operators will lose the benefits of artificially high fees resulting from exclusive local uplink or downlink rights when the exclusivity disappears. Optus loses exclusivity in 1997, Shinawatra in 1998, and Japan has recently granted downlink rights for the first time to non-Japanese operators, PanAmSat and AsiaSat.

Operators are also subject to increased pressure from licenses granted to terrestrial-based broadcasting or telecommunications systems offering competing services. By way of example, in 1995 and 1996 alone, new free-to-air licenses were granted in Taiwan, Thailand, Indonesia and Malaysia and new subscription television operators started in Malaysia, Australia, New Zealand, India and Vietnam. Finally,

the elimination or loosening of foreign ownership restrictions on telecommunications firms, agreed to in February of this year at the World Trade Organisation talks, opens up the prospect of competing directly or indirectly with foreign telecommunications giants.

One might expect certain results from this increased competition. First, some believe that transponder leasing has become commodity-like and that new operators are unlikely to be engaged solely in the space segment of the business. If this is true, one might expect to see fewer (if any) project financing structures like APT Satellite's, based upon long term transponder lease agreements as the guaranteed source of payout.

As noted above, many operators are seeking to provide services to end users, where off-take agreements will not exist.

Second, one might expect to see consolidation in the industry. Bigger companies, with bigger balance sheets and greater efficiencies, will be better able to compete.

This likelihood is further increased by the loosening of ownership restrictions, which will permit the entry of large foreign competitors. The survivors may be better positioned to take advantage of leasing and other taxed-based financings that are best suited to mature, investment grade companies. In addition, consolidation itself may present opportunities for more traditional forms of corporate finance to facilitate merger and acquisition activity.

Third, the increased competition may be an incentive to minimise financing costs. Shareholders with strong balance sheets might be relatively less likely in some transactions to pursue non-recourse financings at higher expense. Finally, the trend towards creative forms of vendor finance will continue. Vendors, subject to competition of their own, are likely to offer incentives to attract the satellite operators, and the larger operators in turn are likely to be in a stronger position to request concessions. ☎