

Can Short-Term Cash Flow “Investor value” Incentives Satisfy Long-Term Diversified Public Policy Objectives?¹

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Introduction

As private equity funds are investing in firms of varying size in an increasing variety of industries, it is difficult to develop a general analysis about their impact upon industry development and the efficient allocation of resources in the economy. There is a general concern about the implications for investors in this new financial market where individuals, pension funds and others invest in the funds. This raises traditional financial market governance issues in a new setting, including the nature of the principal-agent relation between investors and Fund super-managers, market transparency on Fund activities and performance, investor understanding of the risks they are assuming, and the implications for taxation. Equally important is the impact of the Funds upon the firms and industries in which they invest.

The Funds force attention to maximizing short-term “investor value” by selling and restructuring assets and operations, and then selling on the residual firm. Their returns, and the returns to their shareholders, must come from the increases in the investor cash value they create during a short-term window of opportunity. By this standard, the Funds claim the high returns they have earned justify their activities as both profitable and efficient for the economy.

However, this is an insufficient standard because it does not address the source of the increased investor value, or even consider the efficiency of the reallocation of resources that the Funds create by their interventions, let alone the implementation of industry specific public policy objectives. There is a big difference between takeovers of Hertz or Chrysler, firms that operate in highly competitive markets where failure will have no demonstrable impact on competition, diversity of consumer choice, the external economy or the implementation of public policy objectives, and dominant network infrastructure providers in telecom, media and other sectors where they will.

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In these sectors, cashing out a firm's assets may simply be trading off long-term profitable growth for short-term cash, increasing short-term investor value at the expense of long-term investor value. Running a firm's debt up to an unsustainable level for long-term investment is simply acquiring short-term cash at the expense of long-term development and increased financial risk and costs. As Funds typically do not invest for the long-term, but rather plan to have sold off the target firms within 3-5 years, there is clearly a strongly biased incentive to maximize short-term investor value at the expense of long-term value. The high returns being realized may simply be a reflection of the differential between short-term and long-term investor value.

The standard method of financing Fund investments in target firms is the leverage buyout (LBO) where the Fund acquires large amounts of debt capital, secured by the assets of the target firm, which is used to purchase the stock from public shareholders. A common arrangement is about 80% debt and 20% equity supplied by the Fund and its investors. After the takeover, the capital structure of the target firm is increased dramatically, usually higher than 80%. This LBO financing raises establishes a conflict between short-term and long-term investor value and risk. For many target firms, a debt ratio of 80% or higher may create maximum investor value in the short-term, especially if interest rates are low. But this is unsustainable in the long-term as the firm must remain preoccupied with managing its cash flow to meet its debt requirements, is subject to very high financial risk, and is incapable of attracting or investing long-term capital.

Thus, in sectors of the economy that require long-term investments, there are strong reasons to suggest that the returns to Fund takeovers of firms, especially if financed by LBOs, will be, at least in part if not in whole, simply trading off long-term value for short-term value, with negative consequences for industry development and efficient resource allocation. Recently the Funds have entered some traditional public utility industries that provide basic infrastructure services for the economy, including telecom and media. Press reports indicate infrastructure operators in energy, water, pipelines and other sectors also will be high priority targets over the next few years.

Distinctive characteristics of public utilities³

My presentation today focuses on telecom infrastructure as a case study with application the PU industries. The public utility industries provide the basic infrastructure for the economy and a variety of social services, and traditionally include airports, ports, telecom, electricity, gas, water and forms of public transport. They differ from general industry in several important ways:

- ?? the largest "incumbent" firms in the public utility sectors in any country typically have significant monopoly power in their respective sectors over the provision of essential infrastructure facilities and public services;
- ?? they carry important public service responsibilities (e.g., universal access and service obligations);

³ Melody, W. ed. 1997 Telecom reform: principles, policies and regulatory practices, Chapter 2.

- ?? they are very capital-intensive requiring significant and continuing long-term investments in physical infrastructure assets, their maintenance and expansion;
- ?? they make extensive use of public rights-of-way and other public resources that require special grants from the state. In most cases these have been granted at minimal or no cost, not sold or leased at market value;
- ?? they are subject to special government oversight with respect to their delivery of public services, often by industry-specific regulatory authorities.

Historically in many countries these public utility operations have been owned by governments and provided as public services. During the last 10-15 years many have been privatized in part or in whole with a view to stimulating a degree of competition. Under private ownership, industry specific regulation has been established to ensure the monopoly power is not exploited and public service objectives and standards are maintained.

The Funds' attraction to public utilities

The distinctive characteristics of public utility operators that the Funds must find particularly attractive are the following,

- ?? large, stable cash flows from a customer base that considers the service a necessity and has few, and sometimes no alternatives;
- ?? a significant degree of monopoly power in the primary market(s);
- ?? public utilities do not maximize short-run profit because primary consideration in decision making is given to long-term investment needs, stable financial structures and public service responsibilities;
- ?? financial structures and policies are geared to risk optimization for long-term investments in capital intensive fixed assets; the large cash flows provide internally generated capital necessary to meet significant ongoing long-term investment requirements in infrastructure facilities;
- ?? public utilities own significant public resources and special rights (e.g., land, rights-of-way, eminent domain, radio spectrum, etc.) that are undervalued, or even unvalued assets;
- ?? public utilities are typically characterized by conservative management (often bureaucratic and inefficient), and management policies and practices often untested by significant competition;
- ?? public stockholders who are attracted to public utility providers have been investors looking for a stable long-term return with regular dividends and reduced market risk. Stock prices will reflect this.
- ?? industry specific governance/regulation has focused typically on certain service performance objectives in basic services, with less attention to ownership and financial policies.

The attractiveness of each of these individual characteristics of public utilities will vary depending on individual circumstances, but collectively they demonstrate that public utility operators are likely to become more significant targets in the future as the scrutiny of infrastructure operators by the Funds deepens. For the Funds, the market risks of public utility operator takeovers are relatively small and the possibilities for enormous

financial gains are great. Most utility managers are likely to be receptive to bids given their custodial management style, the diversity and relative passivity of the public stock ownership, and the possibilities for large personal gains for the management. A more serious risk is whether the Funds are likely to provoke political responses to their plans from concerns about the implications for the long-term development of public utility services.

Conflict between long-term and short-term investor value

The effects of Fund buyouts and restructuring of public utility operators are magnified because of these unique characteristics of infrastructure provision. The most significant impact is on the capability for efficiently long term investment programs. After the acquisition, the new owners are not likely to be providing any new equity or debt capital, and they have a powerful incentive to pay to themselves the major portion of the large internally generated cash flow that would have been reinvested in infrastructure expansion.

As the utilities inherit the large debt borrowed by the Funds to buy them, This dramatically increases the firm's debt/equity ratio and its annual interest expense obligations. It suffers a major decline in its credit ratings to junk status and a corresponding significant increase in the interest rates it must pay. Thus, internally generated capital for reinvestment is dramatically reduced, as is the firm's capability to borrow investment funds, even at higher interest costs. The utilities are no longer well positioned for making efficient long-term investments. This must require significant reductions in both operating expenses and investment programs and/or increases in prices for consumers of their monopoly services.

Other areas where this conflict between the short-term priorities of the Funds and the long term development priorities of the utilities include,

- ?? research and development, a long term priority where utilities traditionally have maintained activities, and the Funds typically have had little interest;
- ?? quality of service where the utilities traditionally have targeted a higher quality reflecting public interest considerations and the Funds interest in reducing quality to a level consistent with maximizing short-term profits;
- ?? fulfillment of public service responsibilities, such as universal service, where the Funds are likely to maximize their discretion to minimize expenditure;
- ?? staffing and training where the short-term requirements of the Funds require significantly fewer resources than traditional utility operators long-term staff development programs;
- ?? services pricing strategy, where there will be a reduced incentive to compete on price.

Recognizing that infrastructure provision in public utilities could benefit from improvements in managerial and operational efficiency, as they still operate in markets where the degree of competition they face is relatively weak, one might expect that Fund takeovers could provide some unambiguous efficiency improvements. However, these same utilities need increased long-term investment to improve their infrastructure facility

networks. The distinctive characteristics and circumstances of public utilities suggest that the overall effects of Fund takeovers are likely to be highly negative with respect to both infrastructure development and the longstanding public policy objectives for public utilities. Short-term investor value maximization will prevent efficient long-term sector development.

Broader economic and social implications

One can expect investments in long-term infrastructure development to be significantly reduced not only during the period of Fund ownership, but also for a significant period afterward because of the debt mountain created, and the highly restricted possibilities for and costs of renewing long term investment programs. This in turn can be expected to have significant negative multiplier effects on the efficiency and growth of utility industries, and eventually on economic growth for the economies dependent on the continued development of public utility services.

Case studies: telecom In Europe

Financial stability in the telecom sector in Europe

Issues of the financial stability of Europe's largest telecom operators have arisen in recent years, affecting their capabilities to invest in long term network development. In 1999, at the height of the dotcom stock market boom, British Telecom, France Telecom, Deutsch Telecom, KPN Netherlands and others all bid extraordinary sums in buying up smaller companies and bidding very high prices for a limited supply of national third generation (3G) mobile spectrum licenses. This raised their debt ratios and interest obligations to such a high level that financial analysts, and then even the managements called debt mountains. Debt ratios increased to 65-70% and net debt/EBITDA ratios went above four. This was viewed as unsustainable for L_T survival, let alone investment. All the CEOs were replaced. The French government released France Telecom from some of its financial obligations. The advice from the financial community was that net debt/EBITDA ratios had to get below 2.5 before L-T sustainability would be achieved.

These incumbent operators then had to sell off many for their recent purchases, scale back their investment programs in 3G network development in major ways, slowing economic growth in both the telecom services and equipment manufacturing sectors significantly, and delaying the introduction of new 3G mobile services for several years, until these major European incumbent telecom operators were able to reduce their debt mountains to levels that would support sustained long term development. During this period Europe lost its global leadership in mobile telecom development to Asia, where operator investment plans were not constrained by debt mountains.

There are two countries in Europe where the former incumbent telecom operator has been taken over by PE funds using LBO, one of the worst, Ireland, and one of the best, Denmark

*eircom in Ireland*⁴

eircom is the former national operator in Ireland. It is the principal provider of fixed-line telecom services in Ireland with approximately 2.2 million fixed-lines, and is the designated universal service provider. When eircom was privatized by the government in 1998, it was relatively inefficient in terms of comparison to incumbent operators in leading countries in Europe, and in need of significant investment. The shares were purchased by a wide cross-section of Irish citizens.

In late 2001, The Valentia private equity consortium acquired eircom with mostly debt financing. After the acquisition eircom repaid Valentia debt by issuing bonds which increased debt from about 25% to 70% of its capital structure.

Under Fund ownership eircom capital expenditures declined from E 700m per annum in 2001 to 300m in 2002 and 200m in 2003 and 2004. In 2001, before the takeover, eircom invested its internally generated capital from depreciation allowances plus another E275m from retained earnings. Between 2002 and 2004, the Fund reduced eircom's infrastructure investment was more than E 450m less than its internally generated capital from depreciation allowances alone. This enabled payment of a special E 400m cash dividend to Valentia. A second public stock offering was successfully floated in 2004 at a significant profit.

During the following 2004-06 period of publicly held stock ownership, the 70% debt ratio was maintained. Capital expenditure stayed low at E 200m pa. Consumer prices remained high because of the strict financial constraints.

In 2006 Private Equity firm Babcock and Brown from Australia purchased eircom, again through debt finance. Through a complex holding company structure, ultimate ownership is traced to the Cayman Islands. After this takeover, eircom debt has risen to E 3.8 billion supported by assets of E3.1 billion, providing a debt/assets ratio of 117%. Although the new owners have announced their intention to invest in upgrading the eircom network to European broadband standards, eircom's capacity to invest significant amounts seems virtually straight-jacketed. The new owners have requested the government to provide funds to support universal service investments in rural areas, and have announced price increases for basic services.

According to recent statistics on Broadband Penetration per Capita in EU countries, Ireland ranks 17th, between Slovenia and Lithuania.⁵ Thus, Ireland remains a contradiction in information society development. It is the "Information Technology Celtic Tiger" for its leadership on the computing side of information/communication convergence. But it is having enormous difficulty establishing the telecom infrastructure needed to realize the benefits throughout Irish society. Under the present ownership and financing structure, it is difficult to see how the situation is likely to improve significantly for either eircom or Ireland in the foreseeable future.

⁴ See Leavy, D. 2006, and eircom, Annual Reports.

⁵ Source: ECTA Scorecard 2006.

*TDC in Denmark*⁶

TDC is the former national operator in Denmark. TDC was partly privatised in 1994 and fully privatised in 1998. In contrast to Ireland, Denmark always has been a European leader in the provision of efficient telecom services over a technologically up-to-date network with universal service coverage. It has the largest per capita broadband penetration in Europe. TDC's corporate vision was "to be the best provider of communication solutions in Europe" Prior to the Fund takeover. As well as continuing dominance of the Danish market, where it owns both the major telecom and cable TV transmission and distribution networks, the company has expanded its portfolio to include significant holdings in nine other European countries, as well as Oman. In 2005 TDC purchased additional operations in Hungary, Sweden and Switzerland. In addition, it is co-owner of several international partnerships covering services in other countries. International operations contributed nearly half TDC revenues. Capital expenditures were about E 800m.

TDC stock was widely held by institutions and retail investors in Denmark, Europe and North America. It has paid a regular quarterly dividend since privatization. In recent years TDC has been able to fund its growth and new acquisitions primarily with internally generated cash as well as steadily reduce its debt. Since 2001 its net interest-bearing debt has been cut in half, declining from 38% to 18% of total assets, and from 50% to 27% of debt plus equity. In this era of historically low interest rates, one cannot but speculate whether TDC was preparing itself for a PE Group takeover.

The Fund was offer made on 2 December, 2005, supported by the TDC Board on the same day, completed on 1 Feb. 2006. TDC was taken over by a group of five international private equity firm specialists in the largest takeover in Europe to that date for just under E 12bn. (Apax, Blackstone, KKR, Permira & Providence). It was financed by slightly more than 80% debt. A new elaborate holding company structure was created for the purchase of TDC by the Nordic Telephone Company (NTC).

The acquisition increases TDC's net debt to total assets ratio from 18% to more than 90% at junk bond interest rates substantially higher than those for the previously established debt. The new owners have been deliberately vague about why they have taken over TDC and what their plans are, stating only that they expect to own TDC for about five years.

On 5 April 2006, two months after the takeover, TDC declared a special dividend of DK 43.481m (E 5.9b), more than 57% of the share price paid by the new owners, about 47% of TDC total assets, and about twice the equity investment of the takeover partners. It was funded by TDC sales of some of its investments in other countries, additional debt, and the cash reserve TDC had built up in prior years, presumably in anticipation of making long-term investments.

⁶ See Melody 2007 and Annual Reports of TDC and NTCH.

Annual Investment declined only slightly in 2006 from 2005, but was less than depreciation allowances and about 60% of investment a few years ago. Net debt is now 94% of total capitalization and four times EBITDA, levels that are unsustainable according to the industry standards of a few years ago. About 70 % of the net debt falls due in 2014-15, as a bullet as they describe it. The PE group expects to have exited before then.

The TDC management and board have seen significant personal returns on their holdings in the company while TDC has seen debt, interest rates and risk exposure rocket and investment capacity crumble. The CEO was made Board Chairman and the Chief Financial Officer was retained. Both received special bonuses far in excess of their normal pay levels. The new CEO of TDC has announced his assessment that he does not see synergies in TDC international holdings and expects to be selling most of them and focusing on the Danish and Scandinavian markets, and staff reductions of 7% for the next several years have been announced and begun. R&D has been virtually abandoned. Buildings are being sold and leased back to generate cash needed for payouts to the PE Group.

The evidence to date suggests that the TDC takeover has very little to do with improving the efficiency of TDC. The new owners have no expertise in telecom and are relying heavily on the previous management. The immediate cash payout of almost half DTC's assets suggests a pretty clear case of asset-stripping. It appears to be short-term disinvestment, not long-term investment.

Conclusions from the case studies

The evidence of the telecom infrastructure case studies of Ireland and Denmark is not encouraging. This suggests that a new governance structure is needed for PE takeovers of infrastructure operators that can capture the benefits of PE ownership and constrain the abuses of short-term cash valuations. This must involve much greater transparency, preventing the running up of debt mountains that are unsustainable in the long run, ensuring that long-term investment and universal access targets are met, and long term human resources and R&D programs are maintained. This will change the nature of PEG takeovers in this sector, but it need not foreclose it.