High-yield funding for telecom markets

Telecommunications analyst Pam Friedman of Dresdner Kleinwort Benson explains why telecom companies like Energis plc are issuing high-yield bonds.

UK based Energis Plc, an alternative telecommunications company, is one of a long list of UK and European companies that have raised long-term funding in the high-yield market.

Telecom sector dynamics have driven many telecommunications operators like Energis to the high-yield bond market. The structure of the bonds provides telecom companies with long-term funding that involves fewer restrictions than other types of financing.

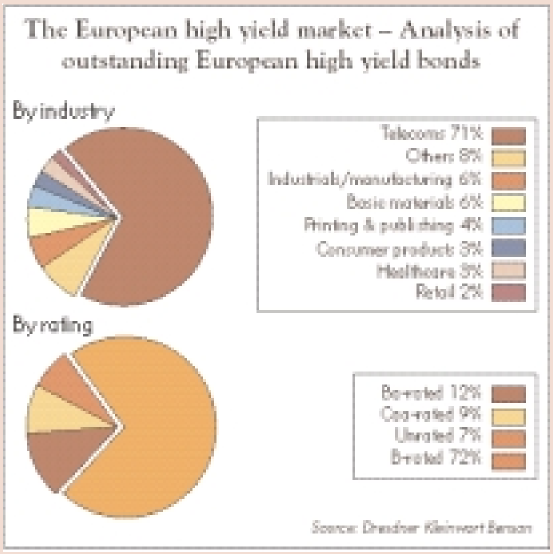
Emerging telecommunication companies represent over 70% of the e35bn European high-yield market. (see *Figure 1*). Other rapidly expanding high-yield issuers in the sector include COLT, Global Telesystems, Jazztel, Tele1 Europe, and KPNQwest.

The need for funding

The need for long-term, flexible funding from the high-yield market is clear. Emerging operators face long lead times for costly network construction. More established alternative players like Energis require financing for the continued development of their business, both organically and through acquisitions. The telecom market environment is itself relatively unpredictable, shaped by constantly changing technologies and regulations. Recent merger and acquisition activity means there will be a rapidly changing competitive landscape. But there is no doubt that these new telecom companies have long-term merit. The exploding demand for the internet and other advanced, bandwidth-hungry services is expected to drive future revenues and profitability.

High-yield investors have been willing to provide the long-term liquidity these companies need. The Energis transaction was increased from an initial £200m to £300m due to overwhelming interest in alternative telecommunications and rising demand for high-yield bonds.

FIGURE 1



What are high-yield bonds?

High-yield bonds are bonds rated as 'below investment grade' – bonds rated below BBB or Baa3 by Standard & Poor's and Moody's Investor Services, respectively. These bonds offer long-term, bullet maturities and flexible structures.

Why use high-yield bonds?

Energis used high-yield in order to achieve two important objectives. First, long-term flexibility as it moves into new markets on the continent, and second, maintenance of its target debt to equity ratio.

Last autumn, for example, Energis used the proceeds of a bridge loan to acquire EnerTel, a telecommunications network backbone operator located in the Netherlands. The company repaid the majority of the bridge via an equity offering shortly thereafter. The high-yield offering took place two months later. Proceeds were used in part to repay the small amount remaining outstanding under the bridge loan, to fund the development of the company's operations on the continent (including the development of EnerTel), and to further its network in the UK.

Energis could have continued to borrow under its £500m senior loan facility but chose instead to raise funds in the high-yield bond market. High-yield bonds offered long term funding and fewer constraints. This financial flexibility is required given the highly dynamic nature of the sector and the company's development plan. Flexibility is furthered by keeping the loan available for future opportunities.

> High-yield bonds offer longer term funding and fewer covenants. This flexibility is required given the highly dynamic nature of the sector

How are high-yield bonds structured to be more flexible?

High-yield bonds are routinely structured as long-term bullets with principal paid at the end of the term. Typically high-yield bonds have a ten-year maturity but can be structured for less. Call features permit the company (issuer) to refinance halfway through the bonds's life at par plus half the coupon. In contrast, senior lenders favour amortisation (repayment) over the last few years of the loan. Most loans can be voluntarily repaid without call premiums.

High-yield covenants are more flexible when compared to bank debt. They are generally limited to 'incurrence' covenants, principally tested when the company wants to incur additional indebtedness or sell assets. Senior loan facilities from banks require 'maintenance' covenants – covenants that are tested monthly, quarterly or semi-annually. Maintenance covenants require financial predictability, a condition that few emerging telecommunications companies can meet. The security packages required by bank lending covenants further hampers the ability of companies to grow opportunistically in this dynamic market environment. This restrictiveness does matter – missing a covenant sends a bank facility into technical default and impacts the company's future ability to raise funds, equity or debt, in the capital markets.

The trade-off for flexibility is cost (see *Figure 2*). Like other emerging telecom companies, Energis has been willing to pay the higher spread on its bonds today for the long-term liquidity needed to address its markets. The coupon for the recently issued £300m bonds was 9⅛%.

Energis is further along the line in its development than other high-yield bond issuers in the telecom sector and its UK operations generate sufficient cash to cover interest payments. In contrast, most emerging telcos are only at the start up phase. High-yield investors have been willing to fund these early stage companies, but in the absence of strong support from established telcos, the cost is high.

For example, last February Jazztel issued $200m of bonds with a coupon of 14% and warrants for 10% of the company. Jazztel's equity funding at the time was a mere $70m. As an early stage company, Jazztel was not expected to generate cash sufficient to cover its interest payments for three years. To provide assurance to investors, Jazztel put $72m of the $200m of proceeds in escrow to cover the first six semi-annual interest payments. Atlantic Telecom, Tele1 Europe and Carrier1 have also used this structure to attract investors.

How will a credit rating impact future financing decisions?

The public debt markets routinely demand that issuers are rated by the two primary rating agencies (Moody's and Standard and Poor's). Once a company issues public debt and is rated by the agencies, the percentage of total debt borrowed under bank credit facilities must be managed.

> There is no doubt that these new telecoms have long-term merit. The exploding demand for the internet and other advanced, bandwidth-hungry services is expected to drive future revenues

Secured senior lenders routinely obtain what is called 'structural subordination' of the high-yield relative to the loan (see *Figure 3*). This provides comfort that the banks will be first in line for repayment if there is a default or liquidation. High-yield bond investors have been willing to accept this condition so long as the company maintains a prudent level of borrowing under its bank loan. If borrowing goes beyond a desired level (relative to business risk) investors will view such borrowing as 'cramming down' their interests. Investors are liable to then sell their bonds, causing bond prices to fall (and spread to widen). This in turn will impact both the companies ability to issue bonds, and the cost of issuing them in the future.

Energis has been committed to improving its credit quality. The company maintains an appropriate balance between bond and bank borrowing in addition to an appropriate balance between equity and debt. At the time of the most recent offering, its overall financial and business risk had improved sufficiently to warrant a Standard & Poor's rating upgrade from single B to single B+, despite the increased business risk of moving into continental Europe. Given Energis' track record, the agencies were increasingly confident that management could take the UK business model into Europe and that they would continue to manage funding and growth to improve risk. The higher credit rating increased the pool of potential investors and was a factor in boosting demand for the issue.

Who are high-yield bond investors and what are they looking for?

Investors in the European high-yield market include commercial banks, insurance and pension funds, and retail funds. Simply put, investors are looking for additional yield. Equity investors may buy high-yield bonds to participate in the growth of these companies while taking less risk than buyng equity – especially as share prices continue to rise.

Like equity investors, high-yield bond investors in telecommunications buy 'the story' and rely on the expertise of management and sponsors to drive the business forward. For Energis, investors believe that management will be able to take the expertise it developed in providing telecommunications services in the UK to successfully launch services on the Continent.

How do investors measure relative value and credit improvement?

Market capitalisation is one measure investors may use to assess relative value. Energis' market capitalisation at the time of the offering on 7 February this year was over £11bn.

Pro forma net debt represented less than 4% of the company's total

FIGURE 2

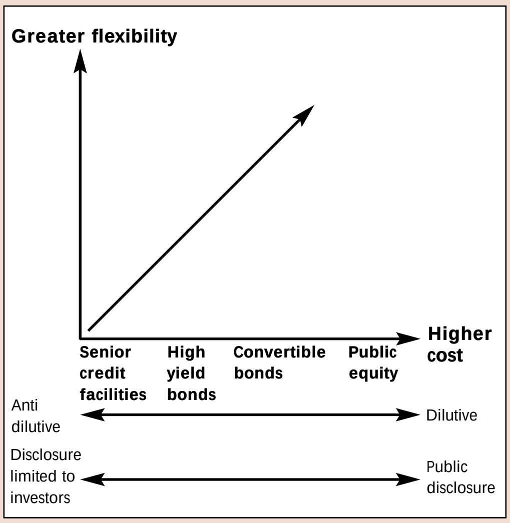
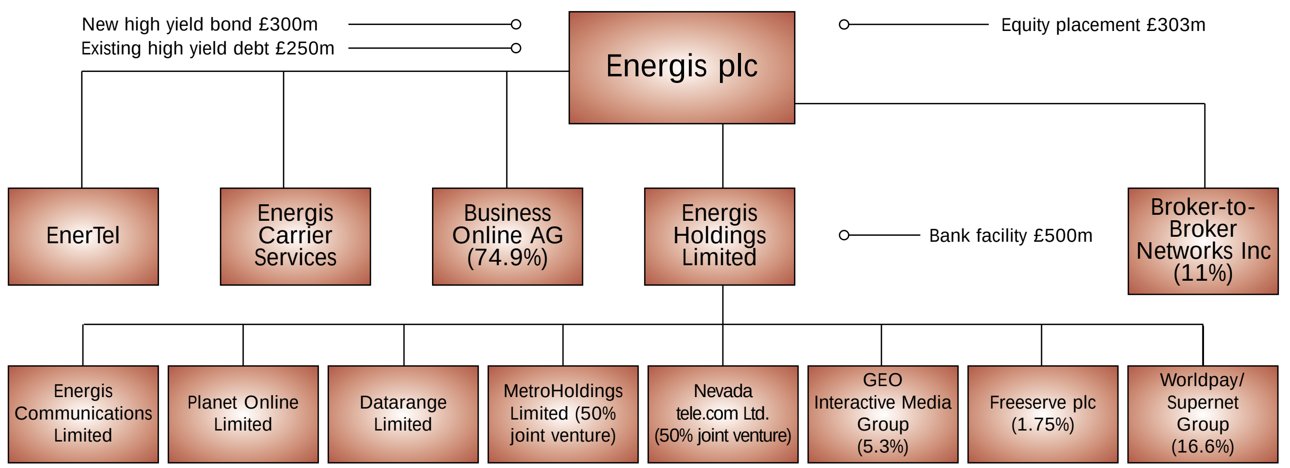


FIGURE 3

Structural subordination



Corporate structure at time of bond offering.

enterprise value (market capitalisation plus gross debt, less cash not held in escrow for interest payment or otherwise), meaning that bond investors had a 96% equity cushion to rely on. Given the magnitude of the company's market capitalisation, even if the share price were halved investors would still have a 93% cushion.

To measure credit improvement, high-yield bond investors monitor an issuer's coverage ratios over time – such as the degree that earnings before interest, taxes, depreciation, and amortisation (EBITDA) covers interest expense. However most emerging telecommunications companies have negative EBITDA, and coverage is meaningless.

Instead, high-yield telecom investors use relative liquidity. Investors feel that liquidity mitigates default risk. Well funded business plans have lower default probability and higher relative value because they are better prepared to cope with changing business and market conditions.

Unlike other telecom issuers, Energis has EBITDA that can cover its interest. How much coverage improves, and when, depends on the progress of its new ventures and its ability to address sector dynamics. These uncertainties drove the need for long termfunding without many restrictive covenants and thus a desire to use the high-yield bond market.

Who should use the high-yield market?

Because of their long-term structure, high-yield bonds are most attractive where recurring revenues and cash flows are present – or anticipated, as is the case for emerging telcos. High-yield funding tends to fail where revenues are deemed to be variable or may weaken over the longer term. Size is also important. $100m is the minimum amount for investors to view the bond as liquid and tradable. To assess whether high-yield bonds should be part of funding, potential issuers need to plan for the degree of leverage, financial flexibility and credit rating desired at every stage of development. ■

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FIGURE 4 Recent high-yield telecoms funding

As on 23 March 2000	Coupon	Maturity	Rating	Size(m)	Launch	YTW
Energis	9.5%	6/15/2009	B1/B+	£125	Jun-99	9.2%
	9.8%	6/15/2009	B1/B+	$200	Jun-99	9.4%
	9.1%	3/15/2010	B1/B+	£300	Feb-00	9.1%
Colt Telecom	7.6%	12/15/2009	B1/B	1320	Dec-99	8.4%
	7.6%	7/31/2008	B1/B	DM600	July-98	8.5%
Global Telesystems Europe BV	10.5%	12/1/2006	B3/B	1225	Nov-99	11.6%
	11.0%	12/1/2009	B3/B	1275	Nov-99	12.0%
Jazztel	13.25%	12/15/2009	Caa1/CCC+	1400	Dec-99	12.9%
	14.0%	4/1/2009	Caa1/CCC+	$100	Apr-99	13.3%
KPNQwest	7.1%	6/1/2009	Ba1/BB	1 340	May-99	7.5%
	8.1%	6/1/2009	Ba1/BB	$450	May-99	8.0%
Tele1 Europe	11.9%	12/1/2009	B3/B-	1150	Dec-99	11.4%
Viatel INC	11.2%	4/15/2008	B3/B-	DEM 178	Apr-98	12.0%
	11.5%	3/15/2009	B3/B-	1150	Mar-99	12.0%
	11.5%	3/15/2009	B3/B-	$200	Mar-99	12.8%

Source: Dresdner Kleinwort Benson