Commercial Sensitive

14 September 2009

RBA Licence Renewal Payments: Modelling of Options

Purpose

This report outlines the results of a recent analysis undertaken by Deloitte on the financial position of the two major radio broadcasters and their ability to meet payment terms for the purchase of radio spectrum renewal licences. Your direction is now sought concerning the next steps.

Action Sought

	Action Sought	Deadline
Minister for Communications and Information Technology	**Agree** to the recommendations.	28 September 2009
Minister of Broadcasting	**Note** the contents of the report.	28 September 2009

Ministry Contacts

Name	Position and Unit	Telephone: Work	Telephone: After Hours	1ST Contact
Brian Miller	Manager, Radio Spectrum Policy & Planning	04 462 4221	021 569 981	✓
	Analyst, Radio Spectrum Policy & Planning			

23

Ministry of Economic Development

Manatū Ōhanga

14 September 2009

Minister for Communications and Information
Technology
Minister of Broadcasting

RBA Licence Renewal Payments: Modelling of Options

Executive Summary

The Radio Broadcasters Association (RBA) has written to you and other Ministers to propose alternative contractual arrangements under which payment would be made by a series of instalments, rather than a lump sum.

The licences held by radio broadcasters expire in April 2011 and offers for further licences were accepted in 2008. The aggregate of all offers totals approximately $96 million, payable by October 2010.

Modelling by Deloitte (utilising updated data) of the financial position of the two major radio broadcasters and their ability to meet the currently contracted terms has shown that the payments will affect their profitability (with alternative payment options marginally improving affordability), but their operations should remain viable in the long term.

The major issue facing MediaWorks and TRN is the capital structure imposed by their parent companies. For instance, Deloitte advises that it is unlikely MediaWorks would have been able to fund its $42 million liability through two years of positive cash-flow even if the advertising market had not suffered a downturn.

As per our earlier report to you dated 8 May 2009, the Ministry still does not see a strong case for the Government to accede to the RBA's request, a move which would place the Government in a credit financing role in lieu of the existing market mechanisms and potentially also create an expectation of financial relief for other licence holders.

Risks

There is a risk that some RBA members will default on the October 2010 payments. This risk is mitigated by the ability to review the situation prior to settlement. The cost of this eventuality depends on what prices may be obtained at auction and the market perception of the ongoing viability of radio broadcasting as a profitable enterprise.

Recommended Action

We recommend you:

a **Note** the information in this report.

b **Note** that Ministry officials recommend the drafting a reply letter to the RBA that:

i Rejects its proposal on the basis that the information provided to date does not indicate that alternative avenues for raising funds have been adequately tested and documented; and

ii Notes that any further consideration by Government would only occur closer to settlement and after the affected broadcasters provide suitable evidence that all alternative avenues had been adequately explored.

c **Agree to** forward a copy of this report to the Prime Minister, Minister of Finance, and the Minister for Economic Development and discuss with them and the Minister of Broadcasting as necessary.

forwarded 16/9 00 Yes / No

d **Agree to** indicate which of the following two options you would prefer:

i The Ministry drafts a letter from yourself to the RBA rejecting its proposal as above; or

Yes / No

ii The Ministry continues to work on the development of a deferred payment plan option and associated reply to the RBA.

Discuss with Minister first Yes / No

Brian Miller
Manager, Radio Spectrum Policy & Planning
Energy and Communications Branch

Steven Joyce
Minister for Communications and Information Technology

Hon Dr Jonathan Coleman
Minister of Broadcasting

RBA Licence Renewal Payments: Modelling of Options

Purpose of Report

1 This report outlines the results of a recent analysis undertaken by Deloitte on the financial position of the two major radio broadcasters and their ability to meet payment terms for the purchase of radio spectrum renewal licences. Your direction is now sought concerning the next steps.

Background

2 In April 2009, the RBA requested alternative contractual arrangements under which payment would be made by a series of annual payments, rather than a lump sum, citing a deterioration of trading conditions.

3 The licences used by radio broadcasters expire in April 2011 and offers of further licences with a term of 20 years were made in 2008. The new licences for commercial broadcasters were priced using a formula based on the values obtained in earlier market-based allocations, but scaled down to an aggregate price of $96 million, payable six months before expiry, in October 2010.

4 The licence offers included an option to place any licence in an auction, but all offers were accepted at the offered price. The two major broadcasters, MediaWorks and The Radio Network (TRN) are each liable for approximately $42 million with Radio Rhema and other smaller broadcasters being liable for the balance.

Previous Analysis

5 In May 2009, Deloitte updated its original 2005 modelling to both incorporate the final contract pricing and the recent economic downturn. The revisited base case modelling suggested that the licence purchases (at the prices originally contracted) should be affordable without compromising the long term financial viability of the major broadcasters (albeit at reduced profit levels), with interest cover being tight against the assumed capital structure in some scenarios.

6 The original RBA proposal was analysed by the Ministry in a briefing dated 8 May and a letter was sent from your office to the RBA rejecting the proposal on 18 May. Deloitte recommended that the Ministry review the position closer to the time of payment. This remains a useful safeguard against further deterioration in trading conditions.

7 Following further correspondence from the RBA to yourself and other Ministers, the Ministry provided subsequent briefings (dated 27 July and 14 August) analysing the implications of potential options for altering the contracted payment terms. These options were explored with the RBA in subsequent discussions but no commitments were made.

8 Following your direction, the Ministry sought additional and updated information concerning the financial position of the two major broadcasters affected, MediaWorks and TRN. Deloitte was contracted to update its previous modelling

to incorporate the new information, the current economic situation, and potential alternative repayment options covered in the two previous briefings, including annual payments and a two-step plan over four to six years.

Analysis

The Broadcasters' Claims

9 The RBA advises that pressure on the radio broadcasting industry is faced on a number of fronts, with advertising revenue being generally down by about 14% and agencies' advertising revenues (one of their sales income streams) being down by about 25%. The industry claims it is facing strong competition from television broadcasting in a severely declining market.

10 The radio broadcasters are seeking to mitigate the effect that the licence renewal payments could have on the commercial radio business on the basis that restricted access to capital and reduced profitability has made it difficult to raise the cash required. The RBA initially sought to change the October 2010 lump sum arrangement to a series of annual payments over 20 years. In subsequent discussions with MED officials on 17 July, the RBA suggested that deferred payments over six years may be achievable.

11 Details of an interim restructure arrangement for MediaWorks by its parent company Ironbridge have been provided to the Ministry. According to Ironbridge, one of the conditions of this arrangement is the banks' requirement that licence payments be spread over a five to six year period. Ironbridge states that MediaWorks cannot fund the payment over a shorter timeframe. MediaWorks is seeking a decision on the spreading of licence renewal payments before 31 October this year, as this is the date by which MediaWorks is required to present its longer term financial restructuring plan.

Most Recent Financial Modelling

12 Deloitte has updated its analysis of the two major radio broadcasters and their ability to pay for the licences under three alternative payment options:

a. Status quo – lump sum payments due October 2010;

b. Two-step payment plan – with an initial deposit in Year 0 for the first *N* years, and the remainder to be paid in Year *N*, where *N* is in the range of four to six years

c. *N* equal annual payments where *N* is in the range four to six years.

13 The modelling used a base case which reflected current reported advertising downturns in 2008, 2009, and 2010, and with real growth returning in 2011 (incorporating the positive projected impact of the Rugby World Cup). Three other scenarios incorporate increasingly pessimistic assumptions concerning declining nominal and real growth in revenues.

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14 Deloitte has assumed a recovery to earlier levels in 2014 based on projections by economic analysts. The current global economic conditions make forecasting difficult, however, and it is possible that further deterioration in advertising revenues could occur.

Year	2009	2010	2011	2012	2013	2014	2015	2016
Revenue								
EBITDA								
NPAT								
EBIT % Revenue								
Debt/Debt + Equity								

9(2)(b)(ii)

Table 1: MediaWorks' Key Metrics (base case)

Year	2009	2010	2011	2012	2013	2014	2015	2016
Revenue								
EBITDA								
NPAT								
EBIT % Revenue								
Debt/Debt + Equity								

9(2)(b)(ii)

Table 2: TRN's Key Metrics (base case)

15 Both companies have suffered a reduction in advertising revenues, reduced profitability, and are currently behind budget for the 2009 financial year. The tables show that each company faces different profitability initially (with negative net profit for TRN reflecting an assumed capital structure). Even with rising revenue in 2010 and 2011, earnings are constrained for both parties because of the debt required to service the licence renewal payment.

16 However, the base case modelling suggests that, in the absence of any further deterioration in financial performance, the licence purchases at the prices contracted with the Ministry should be affordable without compromising the longer term financial viability of the companies.

17 This conclusion does not change, even for the worst-case scenario modelled. Each entity remains profitable (albeit at reduced levels) with interest cover nevertheless being tight against the assumed capital structure. The scenario analysis suggests that as revenues decline, the companies' profitability and ability to meet lending covenants will fall further. This is likely to further restrict access to credit and create difficulties with licence renewal affordability next year.

18 If this situation persisted, the companies would need to consider refinancing and potentially increasing the level of equity funding in order to remain viable. MediaWorks may require this regardless of whether relief is provided in relation to the payments.

19 The alternative payment options would improve affordability. Both companies would still need access to credit and, in the case of MediaWorks, current financing difficulties may affect its ability to fund the first payment regardless of the extent to which subsequent payments are delayed, as the interim restructure

discussed above in paragraph 11 suggest. Deloitte notes however that, after 2010, the projected EBIT to interest ratios should recover to levels likely to be acceptable to lenders under each of the deferred payment options and profitability is maintained.

Debt Position

20 The capital structure assumptions are a critical determinant of the affordability of the proposed licence renewal payments for each company. The MediaWorks radio operation and TRN have no external debt with both companies being 100 percent equity funded through parent companies. All external debt is therefore held at the parent company level.

21 If TRN is assumed to be leveraged to the same level as MediaWorks, the enterprise would have difficulty funding the payments. We have not analysed the potential for additional debt or equity and purchase of the renewals is assumed to be funded through an overdraft facility. Further, Deloitte has assumed continued dividend payments to both parents and there may be some capacity to forego or reduce these in order to fund the purchase.

22 Against this background, Deloitte recommends that the situation be reviewed again nearer to the expected payment date, with a consideration of restructuring the payments at that time.

Ministry Comment

23 The Ministry notes that the payment liability has been known to the broadcast industry for some years now, and broadcasters have been able to build the payment into their cash-flow forecasts since late 2006 when Cabinet agreed the aggregate sum of $96 million for payment in 2010. The matter was well known when Ironbridge purchased the MediaWorks business. We understand that the Ironbridge purchase of MediaWorks was followed by changes to the capital structure of the company.

24 For these reasons, and the conclusion by Deloitte that there will be longer term profitability in the radio broadcasting industry, the Ministry still does not see a strong case for the Government to accede to the RBA's request. Such a re-litigation of the licence renewal process agreed in 2008 would place the Government in a credit financing role in lieu of the existing market mechanisms and potentially create an expectation of financial relief for other licence holders and other businesses in the broader economy that face similar constraints.

25 There is little evidence that the viability of the underlying radio broadcasting business has changed significantly compared with other sectors of the economy, and the RBA does not seek to renegotiate the contracted amounts for the licence renewals. The major issue facing MediaWorks and TRN is the capital structure imposed by parent companies. For instance, Deloitte advises that it is unlikely MediaWorks would have been able to fund its $42 million liability through two years of positive cash-flow even if the advertising market had not suffered a downturn.

26 There are a number of options available to TRN and MediaWorks for funding the payment liabilities before next year. Options include selling assets, cutting operating costs, or injecting capital – either existing equity directly from the parent companies, or by raising equity or debt from the market (for instance via a bond issue or through existing banking arrangements). The Ministry considers that evidence that these options have been adequately tested and explored should be presented before a deferment of payments is considered by the Crown.

27 Considering the above, the Ministry still does not see a strong case for the Government to accede to the RBA's request, a move which would place the Government in a credit financing role in lieu of the existing market mechanisms. It is recommended that no further consideration will be given unless suitable evidence was provided by the affected broadcasters that all alternative avenues had been adequately explored.

28 The Ministry now seeks your direction as to whether you wish to reject the RBA's proposal or further consider the deferred payment options. If you wish to alter the current payment terms, any extension of the payment arrangements would be contrary to the existing Cabinet authority for the present contracts and would require a Cabinet paper (EDC Min (05) 16/14 of 22 June 2005 refers).

Risks

29 There is a risk that some RBA members will default on the payments. This risk is mitigated by the ability to review the situation next year, although relatively quick decisions may be necessary closer to the renewal date. The cost of this eventuality depends on what prices may be obtained at auction and the market perception of the ongoing viability of radio broadcasting as a profitable enterprise.

30 Any decision regarding the payment terms therefore carries a financial risk to the Crown. The extent of this risk has been considered in the comparison of potential alternative payment options to ensure fiscal neutrality over the period, developed in consultation with the Treasury.

Consultation

31 The Ministry has kept the Treasury informed throughout the process of analysing various options. Whilst not offering any specific policy advice on relaxing the RBA renewal payment terms, generic Treasury advice and the Minister of Finance's position regarding the role of the Crown in assisting firms seriously affected by the recession has been to let commercial processes run and that intervention is only justified for firms with important strategic or significant economic impacts. Treasury advises that Ministers should be concerned that acceding to particular firms' requests for relief risks setting a precedent.

Communications

32 Subject to your agreement, the Ministry will prepare a response to the RBA for your consideration.

33 It is recommended that a copy of this report be forwarded to and discussed with the other Ministers that have already been engaged on this issue, specifically the Prime Minister, the Minister of Finance, the Minister for Economic Development, and the Minister of Broadcasting for their information.