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New Financial Instruments – A New Rule for Transformation

By M. Gibbens

Whether carriers operate in mature telecommunications markets or are blazing new trails in emerging economies, it is becoming increasingly important to find new and creative ways to fund new infrastructure development initiatives. In this global context, all service providers are caught between competing trends:

- Investor pressure to control costs and increase profitability
- Market demands for a new generation of services and multimedia offerings
- Increasing capital market pressure

Business and financial leaders are, therefore, looking for new and innovative ways to re-structure capital and operating frameworks to address market demand and fund emerging market growth opportunities.

In the past, increases in networking capabilities involved making large initial capital outlays for new equipment and infrastructure. These investments have typically been associated with significant operational expenses for maintenance and operation of these capital assets to support traditional subscription-based business models. The market risks associated with traditional infrastructure investments for both capital expenditures (CAPEX) and operational expenses (OPEX) have been borne almost exclusively by service providers and their shareholders. At a minimum, it has resulted in a large balance sheet item. To maintain a competitive edge and meet the rising demands of end users for richer, higher quality services, service providers must be capable of rapidly expanding new network-based services, even as they scale back uncompetitive or unprofitable services.

Outsourcing, hosting, managed services and other business-process innovations have softened the risk of investing in new network resources. Nevertheless, all of these activities still show up as additional obligations on balance sheets that constrain funding for new corporate priorities. In particular, these obligations can serve as a disincentive to making the necessary investments in the profitable infrastructures of the near future.

New Investment Models Emerging

The good news is that there is a consensus in the investment community that the communications industry will be extremely profitable, global and sustainable, thereby alleviating some of the pressure that new infrastructure investments can place on corporate balance sheets. There is growing interest from large institutional investors in identifying opportunities to ride the wave of growth and profits that are expected to flow from this future trend. Analysts at Deloitte LLP point out that “even as their core business continues to erode, opportunities abound for telecommunications (telecom) companies in 2008 – if they can turn their installed networks into money makers by offering new consumer products and services to leverage their pipes in the ground.”[1]

Consequently, investors who have previously played a minor or indirect role in funding the communications industry are emerging as major players in how new infrastructures are financed and deployed. Across the globe, there is an emerging pool of institutional investment funds interested in

1 ©2008, 2008 Industry Outlook: A look around the corner - Telecom, Deloitte Development LLC.

directly owning key communications infrastructures. It is therefore important for service providers to understand the new impact investors can have on the industry as they:

- Identify existing service providers that appear to be making the commitments necessary to succeed in the new communications economy and share their financial investments and rewards;
- Underwrite start-ups or new entrants with compelling business plans to wrestle market share away from incumbent providers; and/or
- Directly invest in the underlying infrastructures upon which traditional service providers and new entrants will build value-added service offerings.

This last option is creating brand-new investment instruments that will affect the entire service provider community. It is creating what many are calling New Financial Investment (NFI) opportunities. NFI is a concept that is gaining increasing appeal in the communications industry because it provides a way to make direct investments in specific infrastructure initiatives – as opposed to investing in the companies that are involved in the development and deployment process.

Here is how this NFI instrument can work. Instead of having service providers buy or lease new technology elements from infrastructure partners – transactions which show up on balance sheets as obligations against shareholder equity – service providers can reach an agreement with investor groups who see a business case for introducing new capacity in a particular service area. As investors allocate their capital to fund the infrastructure development project, service providers can form agreements in which they can benefit from the new infrastructure capabilities without having the line items impact their balance sheets.

These types of agreements basically consist of a commitment from investors to fund and own the infrastructure build- out so that new services that generate new revenues can be created. The service provider, in return, commits to marketing new services that use the new network infrastructure. The ensuing revenues generated by the new services are then shared by all participating parties.

Many service providers are also exploring opportunities associated with "sale-and-lease-back" arrangements whereby service providers sell networking assets to another service provider to free-up capital resources and then pay a monthly fee to, in essence, "rent" network capacity that they once owned. The main benefit of this approach is that it gives service providers the capital resources needed to fund next-generation infrastructures that will support new business models and revenue streams.

Another potential NFI model that is capturing the interest of the telecom-munications industry revolves around leveraging current business models to create new financial instruments. For example, service providers can work with investment bankers and other institutional investors to issue bonds that are backed by revenues from contractual agreements generating recurring annuity revenues, such as aggregate calling plans and MVNO (mobile virtual network operator) agreements.

In these NFI models, service providers can benefit from third parties who underwrite the development and deployment of modern infrastructures – or segments of infrastructures – within their service footprints, with minimal impact on their balance sheets. For this reason, these infrastructure investment models have the potential to significantly accelerate the global rollout of new enabling technologies.

- In developed economies, this model could be used by service providers that have a heavy legacy asset load that is still in the process of being depreciated – or by organizations that have been involved in strategic mergers and acquisitions and have taken on new obligations. These situations can be very attractive to investors who believe a market territory that is being well-served with traditional telecom services may have unmet demands for next-generation services – like IPTV, mobile video/TV, m-commerce and others.

- In high-growth economies, service providers may simply lack the access to financial resources to introduce voice and data wireless services in under-served markets. In this scenario, investors may find a long-term opportunity to not only roll out technology, but also stimulate the economic development of the region by connecting people and businesses to digital society.

In both scenarios, financial resources remain available to ensure unencumbered support of existing revenue streams. In the case for funding infrastructure projects that generate new revenue streams, the risk of new capital investment in network resources is shared among the financial institution, the network-services provider and any other third party that brings value to the relationship.

NFI offers a way for service providers, institutional investors and venture capitalists to increase revenue and market share while actually reducing their exposure to risk.

- For service providers, NFI offers a way to build out network infrastructures while strategically managing the impact that this has on an organization's financial picture.
- For large institutional investors, a properly managed telecom infrastructure investment model, in partnership with service providers and infrastructure providers, can generate handsome returns on investment.

Conclusion

These new investment models require service providers to reexamine not only what they consider to be their core assets, but also their strategy on how these assets can be best managed in a rapidly changing marketplace. In some cases, service providers who want to realize NFI benefits must be prepared to release their direct ownership and perhaps management of network assets to third-party partners. In other cases, they will have to explore new financial arrangements that may require them to reassess how they manage financial risks. There will always be a group of service providers who will see these new financial models as simply too radical because they view their core value as stemming from the network itself. As a result, they will be very reluctant to relinquish control of operations to investors and, at the same time, miss the opportunity to unleash the value they hold in their tangible and intangible assets.

Nonetheless, many will look to mitigate these concerns by developing and managing robust service-level agreements that also address corporate control. For these players, the NFI arrangements described in this article have the real potential to strategically shift capital and operational expenditures in a way that will allow them to invest more aggressively – and more strategically – in new and emerging business models.

As the need to roll out new services becomes more acute, Alcatel-Lucent is exploring ways that different types of service providers can work with the institutional investment community to identify opportunities that will expand funding resources in the most promising communications markets around the world.

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