Financing Telecommunications Infrastructure in Latin America: Sources of Financing Broaden as the Sector Evolves

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Increasingly, liberalised regulatory frameworks allow new companies to enter and challenge the ex-state monopolies. This combination of private ownership and the emergence of competitive providers has changed the face of financing for the sector. New sources of capital and new financing instruments are increasing the speed at which development can take place while enabling a larger group of companies to participate.

As Latin America's telecommunications and media sectors have evolved over the last few years, the sources of financing for infrastructure development have broadened. In 1990 the telecommunications sector was owned almost entirely by governments with no hope of being able to finance the massive build-out and upgrade requirements faced by their state-owned telecommunication monopolies.

In 1997 the sector is characterised by private sector ownership in most countries, and by increasingly liberalised regulatory frameworks, which allow new companies to enter and challenge the ex-state monopolies. This combination of private ownership and the emergence of competitive providers has changed the face of financing for the sector.

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The Menu of Financing Alternatives

The options for obtaining capital to build infrastructure today are numerous. Latin telecommunications and media companies can choose from private market (M&A) equity from strategic as well as financial investors, and public equity. Large pools of bank financing and/or public market debt are also increasingly available.

The M&A market continues to be an important source of equity funds, with foreign operators taking stakes in several Latin operators over the last two years. With CANTY's October 1996 Initial Public Offering (IPO) of shares, all of the major privatised telecommunication companies (telcos) are now listed on the New York Stock Exchange. In addition, several other telecommunications and media companies with no state background have raised equity internationally.

On the debt front, the privatised telcos are major issuers of public debt. But recently several upstarts have also tapped the international markets for cash to finance their build-outs.

M&A as a Source of Capital

Strategic investors

A key development in Latin American telecommunication has been the emergence of new companies looking to challenge the ex-state monopolies. Either around the edges with services such as cellular and Very Small Aperture Terminal (VSAT) in countries where the ex-state telco has exclusivity in local and long distance, or directly in Chile and Mexico where long distance is open to competition.

Challenging the incumbent requires substantial capital and know-how, which is often best obtained by issuing new shares to a strategic partner. Mexico's Grupo Iusacell recognised this, and garnered US$520 million in new equity in 1994 when Bell Atlantic invested US$520 million for a 21% stake. Grupo Iusacell's shareholders also benefited when Bell Atlantic subsequently raised its stake to 42% by purchasing secondary shares.

Facing a tough competitive environment and a strong incumbent in CTC, several Chilean operators have also sought capital and technical backing from international players: SBC Communications took a 40% stake in VTR S.A. in 1995 and pumped US$237 million into the company, while STET acquired 17% of Entel in 1996 and fortified Entel's balance sheet with $273 million. Both companies have used these investments to bulk up their infrastructure. VTR went from being a minor player in cable television at the time of the SBC investment to the country's largest CATV provider today. Entel is using some of the STET capital to build out local exchanges and possibly Personal Communication Systems.

Two recent investments by major international operators have shown the continuing appeal of the Latin telecommunications sector. Telefonica's December 1996 acquisition of 34% of the voting shares of the Brazilian regional telco CRT stunned observers and set a new benchmark for valuation, since Telefonica's bid was approximately $5,000 per line.

Further reinforcing the new valuation benchmark was the fact that the cover bid from STET was within 1 % of Telefonica's bid. Also in December 1996, BellSouth invested US$100 million to take a 54% stake in Tele2000, Telefonica del Peru's main competitor in cellular and cable TV. The fact that BellSouth closed its deal just days after the beginning of Peru's hostage crisis shows that the sector remains attractive to foreign buyers.

An important advantage afforded by raising capital in the M&A market is that strong "sponsorship" from a well-known foreign partner opens the door to the international capital markets. Grupo Iusacell demonstrated this when it raised US$254 million in an international IPO seven months after the Bell Atlantic investment. The same sort of sponsorship was crucial to the success of the July 1996 high yield offering by Net Sat Servicos, which recently rolled out Direct-To-Home satellite TV service in Brazil. Net Sat's 60% ownership by Brazil's TV powerhouse Globo was bolstered by News Corp.'s 40% stake and strong DTH-operating experience in Asia and the UK.

Financial investors

Private equity investment in the region has also grown dramatically in the last several years, with numerous well capitalised financial investors taking major stakes in telecommunication and media operations, typically along with US operators. Notable examples include Texas Pacific Group's investment in MTel's pan-Latin American paging operations; Warburg Pincus's investment in TV Filme, the leading pay TV operator in Brasilia, and its co-investment in paging in Brazil alongside PageNet; and Hellman & Friedman's investments in cable TV in Mexico along with Falcon Cable and in SMR operator Radio Movil Digital Americas.

The US cellular engineering company LCC has been an active investor in the region, and sold its interest in the largest SMR operator in Brazil to McCaw International for US$186 million in January 1997.

Public Market Financing

Ever since CTC became the first SEC-registered Latin American corporation, the big ex-state telcos have been able to tap the international markets for equity and debt financing. With their strong cash flow profiles and ability to self-finance a high percentage of their infrastructure investments, these companies have not needed to issue additional equity. They have issued debt primarily in the Euromarkets and the bonds have been marketed to emerging markets buyers, often as near proxies for sovereign risk.

High Yield Debt: A long way from Brady Bonds

The new wrinkle that holds great promise for the financing of Latin infrastructure is the tapping of non-traditional investor bases via the public markets. These include US institutional investors in the high yield market who focus on industries rather than on emerging markets. As the telecommunications and media sectors have -grown to comprise nearly half of all US high yield issuance, sector investors have become increasingly receptive to high-growth "story" credits outside the US. Additionally, as securities tailored towards cashflow-negative growth companies (such as debt/equity units and zero-coupon notes) have become commonplace in the US market, emerging markets telecommunication companies have been able to raise capital via similar structures.

The ground was broken in 1994 with Celcaribe's issuance of combined debt-and-equity units to finance the start-up of its cellular business in Colombia. By combining zero-coupon notes with equity in the first-ever Latin American "units" deal, Morgan Stanley was able to raise US$109 million for a company with no cash flow and effectively no assets other than a license. This was the first time a Latin telecommunications company raised true "project finance" in the public markets. Strong sponsorship (but no recourse) from controlling shareholder Millicom International Cellular was a key factor in the success of the deal.

The issuance of high yield by Latin telecom and media companies in 1996 was impressive. Investors showed their hunger for paper from well-established credits in Grupo Televisa's blowout multi-tranche deal, which was increased in size from US$500 million to US$750 million to meet the strong demand. Upstarts were also well received: Brazilian DTH provider Net Sat raised US$200 million before its DTH service even began operations, using a pre-funded structure that enabled it to make interest payments until it began producing cash from operations. Argentine VSAT provider Impsat raised US$125 million of coupon notes to fund its continuing expansion despite relatively low current cash flow.

The pattern is continuing in 1997, with McCaw International's highly successful March issuance of US $500 million in debt-with-warrants units to finance the development of its cellular-like Enhanced Specialised Mobile Radio (ESMR) service in Argentina, Brazil and Mexico. The equity component of the deal was equal to a mere 1% of the company and the projected blended returns to investors were in the 14-15% range.

The deal was doubled in size due to exceptionally strong demand. Considering the uncertainties that until recently surrounded McCaw parent Nextel's ability to turn plain old trunking into a true cellular-like phone service in the US together with the regulatory uncertainties surrounding the company's ability to use its SMR frequencies in Brazil to provide interconnected mobile telephony, and the non-investment grade rating of McCaw's parent Nextel,.the fact that the company was able to raise such a large amount for start-up operations in emerging markets shows the enthusiasm of investors for credible growth stories.

Riding on the heels of McCaw's success, a number of consortia bidding on the upcoming B-band cellular licenses in Brazil are expected to tap the high yield markets for non-recourse financing to support their system build-outs. With a minimum price tag of US $3.6 billion for the total of the 10 licenses to be issued, the financing needs are formidable. However, the best-structured deals with solid sponsorship and compelling business cases should find favour with eager investors.

Public Equity: Disconnecting from the Bolsa indexes

The other noteworthy development for the future of Latin America's telecommunication and media infrastructure is the availability of public equity for new entrants. The ex-state telcos generally track the bolsa indexes in each of the major Latin countries and in fact make up a large part of those indexes. New entrants may offer a more specific company growth story rather than a country play. Grupo Iusacell and Telex-Chile both tapped the international markets in 1994 for funds to use in challenging the incumbents.

The difficult experiences of both companies since their debuts will reinforce equity investors' focus on company fundamentals as well as regulatory and competitive risks prior to investing in other up-and-coming telcos. Nonetheless, the appetite is there for the right opportunity.

Conclusion

In the media sector, relatively young Brazilian pay TV companies both large (Multicanal Participacoes) and small (TV Filme) completed international IPOs in 1996. Brazil's Algar Group is expected to take its telecommunications operating group Lightel public via an ADR offering in 1997, hoping to ride on the success of the CRT privatisation.