European Telecoms Deal of the Year 2001-Hutchison 3G UK

01/02/2002

If project finance requires clear and predictable cashflows to work, then 3G operators face the most serious barriers to financing a sponsor can encounter. In the light of this, the fact that 2001's largest start-up telecoms financing came from the 3G sector is a remarkable achievement. The Hutchison 3G UK deal was also the first off the blocks in the limited recourse market.

Hutchison prefers to call its award of a 3G licence a ?re-entry? into the UK market. It was initially the main shareholder in the Orange mobile venture (which now claims to be the country's largest), before Orange passed into Mannesmann's then Vodaphone's and finally France Telecom's hands. It was not immediately apparent that Hutchison was a winning bidder, since the auction rules for the sale of UK 3G spectrum would have disqualified it.

A Canadian operator, Telesystems International Wireless (TIW), initially fronted the bidding for the licence. TIW holds a number of franchises (especially in emerging markets such as Asia, Latin America and Central and Eastern Europe) but was not seen as a credible contender. Nevertheless, market observers were stunned as TIW kept in the bidding and managed to secure the fifth new entrant's licence.

The £4.4 billion price tag was replicated for the other licences and the UK gained the dubious honour of the most expensive 3G market per capita in the world. With hindsight this (and the auction in Germany) were the highpoint of telecoms fever and few other countries have been able to realise such substantial sums from spectrum auctions. Speculation swiftly turned to how network build-out could be financed on top of sizeable license costs.

Hutchison's emergence from the shadows behind TIW pointed to one solution ? deep-pocketed shareholders. Whilst other sponsors embarked on a furious round of asset disposals, Hutchison Whampoa (65% sponsor, along with NTT DoCoMo of Japan, with 20%, and KPN Mobile, with 15%) could draw upon large cash reserves. Hutchison 3G UK, together with Germany's Mobilcom, prepared to pitch themselves into a telecoms market reeling from the debt demands of 2G and alternative fixed-line operators.

Hutchison's chief difficulty was that it was the only one of the 3G winners to require a new network from scratch. The four incumbents could hitch new equipment to existing infrastructure. Hutchison has therefore come to an agreement with MM02, the demerged BT mobile arm, to use some of its masts and infrastructure. Nevertheless, build-out required a great deal of support from vendors.

The final package was put to lenders after a 13-strong beauty contest. Joint co-ordinators and bookrunners are HSBC, JP Morgan Chase and WestLB, while the mandated lead arranger group is rounded out by ABN Amro, Merrill Lynch, Royal Bank of Scotland and Citibank. In order to give lenders meaningful control over the build-out of the network, the license cost comes from the pockets of shareholders. The bank loan, however, is without recourse to the shareholders. It takes the form of a $2.475 billion revolving credit facility.

Vendor finance, from Nokia and Siemens-NEC, amounted to £777 million and is pari passu with the senior bank facilities. Hutchison was again fortunate that it was able to be at the front of the queue in asking for finance from the equipment suppliers ? all of which were desperate to take the lead in installing their kit and had not yet started to fill up on 3G credits. Indeed the success in raising vendor finance (at an undisclosed but almost certainly very competitive rate) facilitated a reduction in the size of the bank piece.

The bank loan was structured in a way familiar to most telecoms finance practitioners. It is a four-year deal (or to be more precise a three-year deal with one year term out subject to full funding) that is non-amortizing. Lenders have been forced to accept refinancing risk because 3G operators are unlikely to have sufficient free cashflow to repay principal until several years down the line. In this respect the loans resemble a miniperm to be refinanced down the line and ? once operational ? with a longer deal, as several 2G operators already have done.

Lenders benefit from a drawdown conditional upon several milestones in build-out and financial ratios and the vendors assume technology risk. The deal is priced at 175bp over libor for the first year, 200bp in years two and three, and 225bp for the optional fourth year ? subject to a 10bp extension fee. An additional subordinated loan of £375 million comes from Hutchison Whampoa. Participant banks came largely from the main sponsor's relationship group and included Agricultural Bank of China, China Construction Bank, IntesaBci, Standard Chartered as arrangers, Credit Agricole Indosuez, Goldman Sachs and Mizuho as co-arrangers and CITIC Ka Wah Bank and Sumitomo Bank as managers.

Sell-down was achieved in an atmosphere of intense distrust of telecoms credits. Exposure limits amongst previously active players were one problem but the feeling towards 3G potential cooled markedly in the same period. The additional revenue to be derived from data revenue has few precedents and little on which to base a model. Take-up of so-called 2.5G WAP services has been sluggish.

H3G UK will not comment yet on the exact suite of products to be put before consumers, believing that first movers will need to keep their cards close to their chest to snare the early adopters. And it is lucky that it does not have an existing 2G customer base to cannibalise and is therefore free from the lower-margin users that have been a recent drag in revenue.

It is for this and other reasons that replication of the deal is fairly difficult. Few other mobile operators have the low debt burden of Hutchison. Moreover, few licences have required the level of equity contribution that Hutchison Whampoa, NTT DoCoMo and KPN mobile have had to inject. Nevertheless, this interim financing provides useful pointers to the level of liquidity in the market for 3G ? others tempted to dip a toe in the market should take heed.