

All change for MSS distribution?

In November 2006 we commented (in response to speculation that Inmarsat might ultimately decide to roll-up its distributors) that vertical integration made far less sense than horizontal integration between Stratos and Telenor/FTMSC. However, earlier this week it was announced that Inmarsat has agreed to acquire an option to purchase Stratos after April 2009, when the existing Commercial Framework Agreement (CFA), which currently prohibits such consolidation, expires. The proposal is that Communications Investment Partners (CIP), a private investment firm, will purchase all of Stratos's equity for \$250M, using a loan from Inmarsat (which will be made at below market rates), but Stratos will continue to operate independently until at least April 2009. Inmarsat then has an option to purchase Stratos any time between April 2009 and December 2010 (at a price essentially equal to the value of the loan, subject to assumption of Stratos's net debt of \$327M).

Inmarsat has highlighted that it is not a forgone conclusion that it will purchase Stratos, but it has the option to reshape its distribution strategy in 2009, "maintain[ing] effective, efficient, competitive and profitable distribution channels, maintain[ing] diversity of choice for customers and ensur[ing] a sustainable future for distribution partners". On the analyst call to discuss the deal, Inmarsat also asserted that potential horizontal consolidation (i.e. between Stratos and Telenor/FTMSC) was "anti-competitive" whereas they believed vertical consolidation (i.e. between Stratos and Inmarsat) would be viewed positively by regulators as providing efficiency gains. Nevertheless it is our understanding that Inmarsat maintains it could later roll-up Stratos and Telenor/FTMSC, even though it believes a counter-bid by Apax (owner of Telenor/FTMSC) for Stratos would be unacceptable to regulators.

So what has changed since November 2006, when Inmarsat management claimed vertical integration "was not part of its strategy"¹? Our view at that time was that the traditional LESO businesses are likely to suffer substantial long term pressure on margins, as Inmarsat captures more of the value chain (by operating the Earth stations for I4), and the LESOs are forced to spread the costs of their own Earth stations over a declining number of customers using Inmarsat's traditional services. In addition, competition from non-facilities-based distributors will become more intense, because it is more difficult to provide a differentiated service when Inmarsat operates the Earth stations for I4

¹ Q&A response on Inmarsat 2006Q3 results call

services, and Inmarsat has announced its intentions to continue to appoint new distributors for BGAN. As a result, we concluded that (from a financial point of view) purchasing the LESO businesses made relatively little sense for Inmarsat, because Inmarsat holds many of the cards in renegotiation of the CFA, and these LESO businesses may well become less valuable in the future.

However, what this did not account for is what appears to be (despite its attempts to project a positive aura), Inmarsat's rising concerns about whether its existing distributors will sell BGAN as actively as it desires, especially while the CFA remains in place, and restricts Inmarsat's freedom of action². In our view, one of the most interesting comments on their analyst call was Inmarsat management's assertion that the option "creates stability for new services" and would encourage distributors to "sell both existing and new services" providing "choice for customers". Our sense is that Stratos has not been terribly enthusiastic about BGAN's potential, even compared to Telenor, and in fact Telenor/FTMSC had probably activated around 3000 terminals in total at the end of 2006, compared to 2049 for Stratos (despite our belief that Stratos has a higher share of Inmarsat's overall land mobile revenues than Telenor/FTMSC). Once BGAN is extended into the maritime sector, it will substitute much more directly for existing Fleet services, which deliver a much higher share of end user revenues to the distributors (by our estimate ~50% of revenues compared to ~30% for BGAN) and therefore those distributors with a substantial maritime installed base may not wish to force the pace of migration to BGAN and may even encourage migration to other services such as VSAT, where these distributors can potentially retain higher margins (and more service differentiation).

While Inmarsat clearly has no direct control over Stratos, it is not hard to see why Stratos would have an incentive to favor Inmarsat services (and ultimately accept Inmarsat's terms for replacement of the CFA), since if Inmarsat does not exercise its option, the interest rate on Inmarsat's loan to CIP increases substantially (from 5.75% to 11.5%) and (as noted above) Stratos's MSS business may become less rather than more valuable over time, as its margins decline. We also note that the financial upside of the acquisition for CIP appears to lie primarily in any cashflows it can extract from the Stratos business over the period prior to Inmarsat's exercise of its purchase option (since Inmarsat's purchase price is essentially fixed). As a result, any investment to promote alternative

² This concern is also apparent in Inmarsat's January 22, 2007 opposition to the Telenor/FTMSC consolidation, where Inmarsat asked the FCC to "examine whether Telenor and France Telecom, after the merger, would lack appropriate incentives to sell new BGAN offerings...because sales of BGAN service would come at the expense of their sale of traditional Inmarsat services"

(Inmarsat replacement) services would potentially harm CIP's financial return, even if it would promote long term value for Stratos³.

A second consideration may be what appears to be Inmarsat's increasingly difficult relationship with Apax, as that company seeks to consolidate the ownership of Telenor and FTMSC, and as renegotiation of the CFA becomes imminent. Inmarsat filed with the FCC and European regulators to oppose this merger, which Inceptum (Apax's merger vehicle) characterized in its response as using the "transfer of control review processes to obtain leverage in a commercial dispute". One example of this difficult relationship has been that Telenor and FTMSC (as well as Stratos) opposed Inmarsat's appointment of Thrane & Thrane as an Inmarsat distributor, and though their position was upheld by the arbitrator, Inmarsat was able to proceed with appointment of a Thrane & Thrane affiliate in its place. It seems likely that the most obvious exit strategy for Apax would be to sell out to Inmarsat, and a key determinant of who would have the advantage in striking such a deal will be the outcome of negotiations for replacement of the CFA. However, if Inmarsat has sufficient leverage with Stratos for that company to accept Inmarsat's conditions for replacement of the CFA, then Inmarsat would also have additional leverage in any negotiations with Apax. As such Apax may consider it needs to move now to tie up with Stratos, if it is to maintain a strong position in the CFA negotiations, even though the sale price of Stratos is somewhat higher than it paid for Telenor.

It is also worthwhile to consider what the attitude of regulators is likely to be to the proposed transaction (and indeed any potential consolidation between Stratos and Telenor/FTMSC, whether proposed as an alternative transaction or later as a roll-up of its distributors by Inmarsat). While Inmarsat has argued that vertical consolidation would be viewed positively by regulators, this omits the counter-argument, likely to be made by Iridium, that Inmarsat would then exercise control over distribution of competitor products. As noted above, Inmarsat's leverage in this regard, while indirect, could also be argued to apply even before their option could be exercised. In addition, of Stratos's \$108.1M of MSS revenues in 4Q2006, \$88.8M was from Inmarsat services and \$19.3M was from equipment (including Inmarsat) and other MSS services (particularly Iridium). As such we estimate Stratos could account for up to \$20M of Iridium's annual wholesale commercial service revenues of roughly \$120M (excluding its DoD contract) and is most probably Iridium's single

³ Of course the same calculation might apply to investment in new Inmarsat products, but this would presumably increase the likelihood of Inmarsat deciding to exercise its option

biggest commercial distributor. As such, Iridium will almost certainly make the argument that any control of Stratos by Inmarsat would be anti-competitive, especially given Inmarsat's clear intentions (as expressed in its opposition to the Telenor/FTMSC merger) to encourage its distributors to sell BGAN products more actively than they might otherwise do (and presumably in place of competitors' products⁴).

In terms of an alternative transaction between Stratos and Telenor/FTMSC (not including Inmarsat), our view is that the concerns about such a deal being anti-competitive could potentially be mitigated somewhat by relieving Inmarsat of the restrictions (embedded in the CFA) on its ability to authorize additional distributors for both traditional and new services (although significant regulatory risks will still remain). On the other hand, if Inmarsat were to proceed with the Stratos transaction and later seek to roll-up Telenor/FTMSC (after April 2009), then it has created numerous hostages to fortune by its statements that horizontal integration would be *a priori* anti-competitive and by its opposition to the Telenor/FTMSC merger, which other MSS operators could use to oppose such a deal. Indeed, since we understand FTMSC is Thuraya's biggest single distributor, we would expect both Iridium and Thuraya to contest such a transaction aggressively.

In summary, it is clear that maneuverings over Inmarsat's future distribution arrangements have now begun in earnest, but we suspect that the full implications have yet to emerge. In particular, it would be logical to expect a more contested regulatory approval process for the Stratos transaction than Inmarsat has suggested, as well as the emergence of a possible counter-bid from Apax. The next six months are likely to be very interesting for all participants in the MSS market.

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⁴ Importantly Iridium will soon launch a broadband data product for the maritime market, which is expected to compete directly with Inmarsat's Fleet and later Fleet Broadband (BGAN) services