Inmarsat and Skyterra: what does the proposed merger mean for MSS and ATC?

On July 25, 2008, Harbinger and Skyterra announced an agreement to provide $500M of additional debt financing to enable MSV to continue with the construction and launch of its next generation satellites, together with a framework for a possible combination of Skyterra and Inmarsat if regulatory approval for a merger can be secured from the FCC, DoJ and international regulators. While most attention has focused on the potential merger between Skyterra and Inmarsat, the additional financing which ensures MSV is funded through the third quarter of 2010 (including the construction and launch of MSV-1 and the construction of MSV-2) is just as important in ensuring MSV's spectrum remains a viable option for potential ATC partners. However, it appears that MSV will not actively pursue the existing partnership arrangement with Inmarsat to clear the L-band spectrum for ATC unless and until such a partner is secured, since this would require an upfront cash payment of $250M to Inmarsat and would therefore significantly reduce MSV's available funds (to a level which would probably not support launch of MSV-1).

Instead, MSV and Harbinger appear to be digging in for a fairly long wait before any ATC deployment takes place, since if Inmarsat did not begin to clear the spectrum until after completion of a takeover in late 2009, this would take between 18 and 24 months (according to the timetable set out in the Inmarsat-MSV agreement). Thus, even if a terrestrial partner was identified relatively soon, any ATC network would be unlikely to be launched commercially before the end of 2011 or more likely 2012. This timetable is not particularly surprising, given that most wireless operators are likely to be pre-occupied with deployment in the AWS and 700MHz frequency bands over the next several years, and fits with the timescales on which the success or otherwise of the Sprint-Clearwire joint venture will become clear. We believe that Clearwire will need to achieve success in the wireless broadband market as an essential pre-requisite for major wireless operators to consider acquiring ATC spectrum. This is because their success would be largely based on the advantage derived from Sprint and Clearwire's massive spectrum holdings (of 100+MHz) in the 2.5GHz band and the ability this would give them to offer subscribers economical access to data services (such as unicast streaming video) which would consume too much capacity on existing 3G networks. If other operators see that added spectrum (over and above what they have already acquired) is critical to their future competitiveness, then they will be much more willing to consider "non-traditional" bands such as ATC. Given that the success or failure of Clearwire will mostly likely not become clear until late

2010, we expect that wireless operators' re-consideration of ATC spectrum would also not take place until that point.

In the interim, the only potential new entrants to the wireless market (excluding the cable operators many of whom are already partnering with Clearwire) appear to be the satellite TV operators, DISH and DirecTV, whose enthusiasm for wireless broadband investments appeared to have waned after their failed bid for AWS spectrum in 2006, with DISH focusing on mobile TV and DirecTV concentrating on expanding its High Definition TV offering. Nonetheless, in a Wall Street Journal article[1] after its recent poor results, DISH indicated its renewed interest in merging with DirecTV, and highlighted that the ability of the combined company to offer broadband would be a critical component of their argument for the merger to be permitted. This gives a strong hint that DISH is again looking closely at a two-way wireless broadband deployment, most likely using ATC spectrum, as it did in the 2005 to 2006 period. However, the position of DirecTV appears more equivocal, since it is still achieving considerable success with its HD offerings and has also been able to reduce churn, which was one of the key drivers for moving to develop a broadband offering. As a result, even if it does decided to move into wireless broadband, DISH could be forced to go it alone, with the most obvious vehicle for such an project being TerreStar, which Echostar Communications (SATS)[2] has already invested in. On the other hand, Skyterra and Inmarsat have access to much more spectrum, and would therefore potentially be the preferred choice for a larger scale partnership of DISH and DirecTV if that could be realized.

Despite the emerging possibility that DISH could move towards a wireless broadband deployment in the near term, in our view it is probable that Harbinger will need to take additional actions of their own to ensure that ATC's credibility is maintained. Given their willingness to invest a total of more than $5B in Inmarsat, Skyterra and TerreStar (assuming the proposed takeover of Inmarsat is completed) it is hard to believe that Harbinger would not invest $2B or $3B in a wireless operator to ensure that they proceed with an ATC deployment, and the most obvious candidate for such an investment (given Harbinger's existing substantial equity stake) would be Leap Wireless. Indeed a joint investment with DISH into Leap might even be a possibility, given Harbinger's earlier collaboration with Echostar to invest in TerreStar. We therefore expect that the next step beyond an

[1] See "Dish Network Again Casts Its Deal Gaze at DirecTV", August 5, 2008 at http://online.wsj.com/article/SB121784781012209687.html

[2] SATS was spun off from DISH at the end of 2007, but both companies are controlled by Charlie Ergen

acquisition of Inmarsat would be for Harbinger to make such an investment in Leap, probably in the second half of 2009, after the price for an Inmarsat takeover is agreed and at the right time for the approval process for an ATC deployment to commence, unless Harbinger is prompted to move more quickly by a potential partner such as DISH. This is somewhat of a change from our previous assessment that partners might never be found to support an ATC deployment, primarily because it now seems clear that Harbinger will be willing to invest as much as is necessary to ensure that such a deployment actually happens.

All of this assumes that regulatory approval for a Skyterra-Inmarsat merger can be obtained, and that the FCC proves willing to interpret its ATC rules in a manner which do not impose prohibitive difficulties on any ATC deployment by a terrestrial operator. In our view the omens for both of these regulatory outcomes are fairly positive: in the wake of the XM-Sirius merger the competitive impact of an MSV-Inmarsat seems relatively minimal (given MSV's current revenues of around $35M per year and Inmarsat's relatively modest domestic US presence), and it is unlikely that substantial opposition would emerge from other MSS competitors, since both ICO/TerreStar and Iridium/Globalstar could wish to seek consent for mergers of their own in the near future. With the FCC apparently now willing to write rules for an AWS-3 auction that are designed to promote the emergence of another national broadband wireless provider, it also seems likely that they would do the same for a prospective large scale ATC deployment, despite what would presumably be intense opposition from existing wireless operators[3]. The timing of approval is somewhat uncertain: given the upcoming presidential election, it is probable that no decisions would be reached on an MSV-Inmarsat merger before mid-2009 and it could take until the latter part in 2009. The main risk is whether limitations might be placed on a merged company with regard to its total allocation of L-band spectrum in the US, since MSV has previously had limitations placed on its access to L-band spectrum under its US license (which is why it needs two satellites, one licensed by the US and one by Canada) and clearly this could potentially be a major problem if it restricted the amount of L-band spectrum available for ATC. However, without any other entrant seeking access to this spectrum, it is unlikely the FCC would allow spectrum to lie fallow: presumably at worst it would require that any future new entrant should be able to share the L-band MSS spectrum.

[3] AT&T's recent roaming agreement with TerreStar could also be viewed from this perspective, since mobile operators argued during the original debate on ATC, that if MSS operators can strike terrestrial roaming agreements then there is no need to deploy ATC. MSS operators countered that they did not have the leverage to obtain advantageous roaming agreements, but as we noted in our February 2006 report on ATC, mobile operators might eventually decide to enter into such agreements to avoid "becoming the target of a regulatory backlash"

Harbinger has expressed the hope that Inmarsat will not "brief against the idea of our involvement"[4] and we suspect that Inmarsat will not actively oppose potential consolidation in the MSS industry when Skyterra and Harbinger seek approval from the FCC. However, given that the indicative price point for a bid used in the Harbinger-Skyterra agreement is only 535p, which is below some analysts' estimates of the value of Inmarsat's core business even ignoring ATC, we expect Inmarsat to instead focus on opportunities to demonstrate/enhance the value of its core MSS business. Inmarsat indicated on its 2008Q2 results call that it would submit a bid for the S-band license in Europe, which will require signed contracts for both a satellite and launcher before the bid submission deadline in October 2008 (although Inmarsat does not expect to make more than "single digit millions" of capex expenditure unless a partner is found, and we believe that any European mobile TV partnerships are likely to prove elusive). It may even involve other acquisitions by Inmarsat and we speculate that perhaps the most likely option here would be of a company in the maritime VSAT market, given the growth seen in these services in recent years and the opportunity to complement Inmarsat's existing maritime strength.

Finally, it is worth considering some of the financing issues which underlie a potential acquisition, since it is clear that MSV's debt load will pose a substantial burden for a combined company, one this (currently pay-in-kind) debt requires cash payments beginning in late 2010. Harbinger plans to invest $2.4B in Skyterra stock to fund the equity component of any bid for Inmarsat (as well as contributing its existing 28.8% stake to Skyterra), but even at a price of only 535p this would mean a further $1.3B would be required to fund the purchase of Inmarsat's shares and convertible debt. This might be provided in Skyterra equity (though with Skyterra's stock price trading well below the $10 price used to value Harbinger's investments this seems unlikely) but it may also involve Skyterra raising further debt, bringing the total net debt of the combined company (including Stratos) up to around $4B (based on $1.2B of net debt at Inmarsat and $1.4B of debt at MSV including the recent $500M notes offering), compared to a combined 2008 EBITDA of around $500M. This would be a relatively high debt level (~7 times 2009 EBITDA), exacerbated by the high interest rates (14%-16.5%) payable on Skyterra's debt, which will require cash payments of over $200M in 2011. It will certainly place a significant strain on the resources of the combined company at a time when Inmarsat is likely to have major capital expenditure commitments associated with construction of both Alphasat and a European S-band satellite, which could require combined capex of up to $200M per year through the

[4] See http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article4289635.ece

2010-2012 period, in addition to the currently unfunded launch of MSV-2. As a result, we believe it will be essential for Skyterra to find an ATC deal to alleviate concerns over the outlook for the combined company before the cash payments begin on Skyterra's debt. As noted above, most wireless operators are unlikely to turn their attention to ATC before late 2010, lending support to our hypothesis that Harbinger will ultimately make a substantial investment in Leap (or perhaps another wireless carrier) to secure an ATC rollout agreement sometime in 2009.

In conclusion therefore, we now believe that a Skyterra-Inmarsat merger will happen in 2009 and that an ATC deployment is likely to take place in the US thereafter, albeit with many billions of dollars of investment required from Harbinger to fund this rollout. After such a long wait and so many doubts about the future of ATC in the last 18 months, it appears that we may finally be approaching the point at which ATC can realize its promised transformation of the MSS industry. However, we will have to wait for several years to find out if ATC will prove as lucrative for Harbinger as its enormously successful investments in other industries. If ATC ends up simply being used to provide a low cost source of additional spectrum for terrestrial operators, then it seems unlikely to justify the huge investments being made in new satellite systems. On the other hand, if integrated satellite access proves to be a significant differentiator in attracting potential subscribers from the consumer market, then both the MSS operators and their terrestrial partners could achieve much greater success. MSV is working hard to substantiate the benefits of integrated satellite access, as highlighted on its most recent results call, but it remains far from clear that consumers truly understand both the benefits *and* the significant limitations of satellite coverage. Iridium's commercial launch ten years ago this fall provides a salutary reminder of what can happen when there is a mismatch between the expectations in the marketplace and the product that is actually delivered.