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Should the FCC allow Mortgaging of FCC Licenses?

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For decades the Federal Communications Commission (FCC) has refused, as a matter of policy, to allow lenders and equity investors to take security interests in the FCC licenses that permit spectrum users – broadcasters, wireless operators, and all the rest – to use the spectrum. While this may not seem like a big deal to some, many lenders disagree: they claim that the FCC's policy significantly impedes the flow of communications-related investment funding. While debates over the wisdom of the FCC's policy have flared up periodically over the years, the FCC has not budged and its policy has remained unchanged.

But the current credit crunch has brought this issue into focus for renewed reevaluation. With the availability of capital drying up for small- and medium-size broadcasters and telecommunications companies, it is important to examine any kinks in the financial pipeline that might unnecessarily slow, or block, the flow of capital.

To understand how the "securability" of FCC licenses affects lending practices, it is helpful to understand how lenders evaluate whether to make broadcast loans. As a general rule, of course, lenders like to have some assurance that they will be able to get their money back. If a borrower's business is successful, repayments are made from cash flow. But if the business stumbles or fails, the lender may not be able to rely on cash flow. With that in mind, lenders normally require borrowers to provide, in addition to a promise to re-pay, a commitment of other assets as security for the loan. If the borrower's business fails, the lender gets its money back by laying claim to the secured assets.

In deciding whether (and if so, how much) money to lend to a prospective borrower, a lender generally reviews the borrower's assets to be sure that there will be enough to secure the loan. Some businesses are asset-intense. A car dealership, for example, or a jewelry store will have inventory the dollar value of which can be easily calculated.

Determining how much an inventory-based business is good for can be reasonably simple.

The trouble with broadcasting is that it is *not* an inventory-based business. There is no warehouse full of appliances or parking lot full of automobiles that a lender can look to as collateral for a loan. In fact, there is rarely even any owned real estate. The broadcaster's only real assets (other than the microphones, antenna and transmitter) are its FCC license and the airtime that the broadcaster can program and sell as a result of that license.

Another measure of the credit-worthiness of a business is its cash flow. However, many new or growing broadcasters have little cash flow. This is especially true if the prospective borrower plans to change the programming on the radio or TV station being acquired. In that instance the borrower's business is more like a start-up with no cash flow at the outset. As a result, in many broadcast-related deals, cash flow valuation is not available as a practical matter. Instead, lenders are forced back to asset-based security. But again, with broadcasting, there is no inventory in which to take a security interest.

And therein lays the dilemma. Almost invariably, the broadcaster's most valuable asset is its FCC license. But that is precisely the one asset that the FCC will *not* permit lenders to take as collateral. So with no established and reliable cash flow and insufficient assets, many small- and medium-sized companies looking to enter the broadcasting business or expand their existing holdings are having trouble finding funding. That raises the obvious question: if an FCC license could be used for security, wouldn't that encourage lenders to provide funding which is not now available? If so, doesn't that mean that the FCC's "no securitization" policy is impeding the flow of capital into broadcast markets.

Because of the FCC's policy, lenders – many of whom are known for the "belts and suspenders" approach to doing any kind of business – are often hesitant to lend to broadcasters, particularly new entrants to the field. Consequently, the pool of senior lenders familiar with broadcast and telecom valuations is relatively small, and the pool of those willing to finance transactions below \$10 million is even smaller. The source of senior debt financing for broadcasters is generally limited to a small group of national lending and financial institutions that possess more sophisticated media lending groups. These lenders frequently will attempt to mitigate their risk by requiring the borrower to set up separate "license subsidiaries," which are entities that are created for the sole purpose of holding the FCC license (all other assets of the company are held by an operating or tangible asset subsidiary). The lender can then take a security interest in the equity of the license subsidiary as a means of getting as close as possible to obtaining something akin to a lien on the FCC license. While such gambits may be attractive (or at least acceptable) to a relatively small universe of lenders, it is clear that the burdens these extra hurdles impose tend to shrink the pool of available capital sources and force the borrower to incur additional costs for the loan (by, *e.g.*, forcing the creation of a multi-subsidary structure).

As a result, many smaller local and regional banking institutions are reluctant to make broadcast loans. Such bankers are already constrained by leverage and loan-to-value

ratio limitations. Add to that the fact that the balance sheet compositions and income statements of media companies tend to be (a) different from those of traditional companies and, therefore, (b) unfamiliar to local and regional banks. What the banks end up seeing is a heavily regulated business where the ability to secure the loan is limited. Moreover, they see an enterprise that is difficult to appraise on anything but an asset basis. For this reason, they usually will not loan beyond the value of any tangible collateral the broadcasters may have – such as real estate that may be owned at a tower or studio site – or beyond any SBA guaranty, where such a guaranties is available.

This is ironic because in most other businesses and industries, local and regional banking institutions are the greatest sources of small- and medium-sized business loans. It is especially ironic because regional banks frequently have a longstanding relationship with the community and the businesses that operate in their regions, just as local broadcasters do. However, broadcasters (and other FCC-regulated companies) are often unable to take advantage of these financing sources because those banks are unfamiliar with the methods of valuing broadcast properties and the loan structures and leverage granted in such loans. The unfortunate bottomline: local banks are not actively participating in a sector where they are needed the most.

Because local and regional financing options tend to be few and far between, broadcasters are forced to rely on an ever-dwindling group of large national media lenders – but those lenders are usually subject to floors that will not allow them to finance transactions below the \$15-20 million level. Aggravating the increasing shortage of willing and knowledgeable lenders is the fact that significant consolidation in the banking industry has reduced both the number of players with media expertise and the number of players actively participating in syndicated financing. As a result, there are fewer players in general and specifically fewer players making loans below the \$10 million and \$15 million threshold.

This problem could possibly be addressed through a concerted effort to familiarize smaller regional banks with mechanisms to effectively secure of broadcast loans. For example, through a series of programs or seminars local banks could be introduced to industry valuation methods and exit multiples. A similar approach could be taken with state and Federal banking regulators, to demonstrate to them the sometimes subtle distinctions between, on the one hand, most broadcast and communications loans and, on the other, highly-leveraged transactions based solely on the asset value of the collateral. Confusion between those two types of transaction can lead to mischaracterization of broadcast loans as undesirable or worse. Such educational programs could be presented by, or in cooperation with, state and regional banking associations, as well as through national organizations.

The second, far more controversial, method of addressing the problem involves re-evaluating the FCC's ban on security interests in FCC licenses. The FCC's justification for the policy has been that FCC licenses are not property than can be pledged. Instead, a license is, in the FCC's view, merely a permissive entitlement that allows the broadcaster or wireless company to use the public's airwaves for limited periods, subject to renewal.

Broadcasters themselves have often embraced this rule because it provides them with protection against unscrupulous predatory lenders looking to snatch away FCC licenses.

These are all valid points. However, they do not diminish the fact that, in the eyes of many, the FCC's ban on license liens acts as a significant impediment to the flow of capital into the market. Over and above the problems mentioned above, the security interest ban adds additional risk for foreign banks (a potentially significant source of capital for broadcasters) that are already disincentivized by strict, Federally-imposed limits on foreign ownership or control of FCC broadcast licenses. Moreover, the ban on security interests prevents lenders from being able to bundle broadcast or telecom loans for sale on the secondary market as is done with mortgage-backed securities in the housing market.

Many lenders legitimately note that no one would expect to obtain a home loan without first providing the protection of a mortgage to the lender. Moreover, the theoretical basis of the FCC's concerns runs counter to the practice of other regulatory agencies, which routinely permit liens on licenses (such as liquor and casino licenses). At the Federal level, the Federal Energy Regulatory Commission has permitted liens on certain types of authorizations for energy generation and distribution. The ability to create such liens facilitates the project financing of these business endeavors.

Notwithstanding the cloud that has recently been cast over the lending industry in the wake of the subprime mortgage melt-down, mortgage-backed securities, and the ability to sell them on the secondary market to institutional buyers such as Fannie Mae and Freddie Mac, have been a major engine behind the U.S. housing market and the ability of many to obtain loans to purchase homes. A change in the FCC's policy would free up not only capital at the national level but also, most importantly, capital from local and regional lending sources which are intimidated from making loans to broadcasters and other telecom companies.

This is not a new debate. In the 1990's a consortium of lenders filed a petition with the FCC requesting a relaxation of the security interest policy in order to free up the credit crunch that preceded the 1996 Telecommunication Act. However, the petition lay largely ignored by the FCC. Thereafter, following a series of court cases addressing the issue, the FCC began to allow security interests in the "proceeds" of FCC licenses, but would not go farther than that. More recently, in 2004, the FCC's Federal Advisory Committee for Diversity in the Digital Age – formed by former FCC Chairman Powell to investigate ways to free up capital and create business opportunities for minority-owned media and telecom companies – made a number of formal recommendations. Specifically, the Committee urged: (i) a policy change to allow private lenders to take security interests in FCC licenses; and (ii) the creation of a Freddie Mac-like entity to purchase bundled broadcast and telecom loans on the secondary market.

Although such an FCC policy change (along with rule changes that would relax the foreign ownership limits by institutional lenders seeking to make domestic broadcast and wireless loans) could assist in freeing up the flow of capital, it would be a mistake to

think that these FCC prohibitions are the sole cause of the mid-market gap referenced above or the credit crunch suffered by small- and medium-sized broadcast businesses. The rapidly changing media and telecom landscape is equally at fault, as are the ever-growing competition faced by traditional broadcasters from podcasts, satellite radio, internet video, and internet streaming, and generally falling valuations. Still, the credit problems have naturally been exacerbated by the country's current financial downturn and corresponding mortgage and credit crises that have infected most financial institutions. So serious has the situation become that in July, 2008, the FCC hosted an *En Banc* Hearing on Barriers to Communication Financing in New York to probe the causes and possible solutions to the credit crunch in the telecom and media markets. Again, it would be a mistake that a single silver bullet – be it educational programs for local or regional banks or a loosening of the FCC's regulatory choke chain – exists that will magically free up needed capital to the broadcasting or telecom sectors. However, in order to address the problem, the FCC must probe and understand the methods used by banks and lending institutions to evaluate prospective financings and work with those institutions to address the problems faced. While many possible solutions are beyond the control of the FCC, the limits on the ability of lenders to secure broadcast loans is one that should be studied and evaluated.