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Private Equity Leveraged Buyouts in European Telecoms: The Case of Eircom

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Abstract

Highly leveraged buyouts (LBOs) of former state owned telecoms operators by private equity groups have occurred in a number of countries in recent years. This paper examines the case of Eircom in Ireland which has experienced five changes in ownership since full privatisation in 1999, two of which were LBOs. Enormous increases in Eircom's debt levels as a result of the LBOs resulted in the company's bankruptcy in 2012. This paper argues that this outcome was largely attributable to the short-termist strategies adopted by the private equity groups that assumed ownership of the enterprise. These strategies included high leverage, cash extraction and underinvestment in the fixed-line network which contributed to the demise of the enterprise and had wider economic and social effects. The Eircom case demonstrates the risks attendant to ownership of important network infrastructure by private equity groups and the need for regulatory safeguards to protect the public interest.

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1. Introduction

In May 2012, Ireland's former state-owned national telecommunications operator Eircom went into bankruptcy.[1] This was the biggest case of corporate bankruptcy in the history of the Irish State to date and represented the culmination of a series of events that followed full privatisation in 1999. These included five changes of ownership, two of which were highly leveraged buyouts by private equity firms in 2001 and 2006. These buyouts resulted in the build-up of an unsustainable level of debt which severely undermined the company's financial performance but also limited its scope for investment in telecommunications infrastructure to the detriment of Ireland's export-led economy.

This article examines events at Eircom following privatisation. It focuses on the issue of highly leveraged buyouts and questions their suitability in the case of strategically important network industries such as telecommunications. It argues that the case of Eircom serves salutary lessons for other economies faced with decisions in relation to the privatisation of network infrastructure operators.

2. Background: The Privatisation of Eircom

The experience of Ireland in relation to developments in the telecommunications sector was very much in line with that of Western Europe up until 2001. Prior to 1983, Ireland's telecommunications service was run by the civil service. Following the recommendations of a review group, the operation of the telecommunications service was corporatised and transferred to a commercial state-owned enterprise, Telecom Éireann, in 1984. In 1996, 20 per cent of Telecom Éireann was sold to the Comsource consortium – consisting of Sweden's national operator, Telia, and the Netherland's national operator, PTT Telecom (later KPN) – as part of a strategic alliance. Comsource also acquired an option that entitled it to increase its shareholding to 35 per cent in the future. The establishment of the strategic alliance paved the way for full privatisation which was completed in July 1999. The final sale consisted of the allocation of a 14.9 per cent block shareholding to employees and

[1] In more precise terms, Eircom was placed in examinership in May 2012. Examinership is a formal process in Ireland that facilitates the restructuring and survival of an insolvent company while under the protection of the High Court.

the flotation of the company (and the government's remaining 50.1 per cent stake) on the stock market under the new name Eircom.

Privatisation was followed by a number of key events which further altered the structure and ownership of the former state-owned utility[2]. The principal events were:

- the demerger and sale of Eircom's mobile phone subsidiary, Eircell, to Vodafone in May 2001;
- the highly leveraged buyout of the remaining fixed-line business in December 2001;
- the re-flotation of the company in 2004;
- the second highly leveraged buyout of the company in 2006;
- the sale of the company to the state-owned Singapore Technologies Telemedia in 2010;
- the takeover of Eircom by creditors in 2012 after going into examinership.

Of the changes, the takeovers in the form of highly leveraged buyouts (LBOs) by private equity groups (PEGs) had the biggest impact on the financial and economic performance of Eircom after privatisation. The LBOs by Valentia in 2001 and Babcock and Brown in 2006 resulted in enormous change to Eircom's capital structure and the strategies pursued by the company. Moreover, as Eircom remained the dominant incumbent fixed-line operator in the Irish telecommunications sector the LBOs had wider effects on a sector which is of key strategic importance to the Irish economy.

We argue that the short term strategies adopted by private equity investors are at odds with the long term imperatives required in strategically important network industries such as the fixed-line telecoms sector. To develop this argument the paper is structured as follows: the next section describes the typical LBO model before outlining the increased incidence of leveraged buyouts by private equity groups over the last 30 years and its impact on target companies. We then examine the case of the telecoms sector in Europe where there have been examples of LBOs by PEGs in Denmark, Bulgaria and Ireland. The

[2] For a full description of post-privatisation results see Palcic and Reeves (2011).

paper proceeds to focus on the case of Eircom in Ireland where the impacts of two LBOs over a five-year period culminated in the former SOE's bankruptcy in 2012. We conclude with a discussion of the implications of the Eircom experience for governments and regulators faced with future decisions in relation to the ownership of network industries.

3. Typical private equity LBO model

The objectives and strategies commonly adopted by PEGs executing LBOs create risks that can have serious implications for the long term future of the target company. In general, the principal objective of such new owners is to maximise short-term profits rather than invest in the long-term growth of the target firm. Such private equity LBOs usually involve a small group of investors that provide approximately 20 per cent of the equity required to purchase the target firm, with the remaining funds made up of debt financing secured on the assets of the target firm. The new owners then generally recoup their equity investment by restructuring the target firm, extracting cash from the business and reselling the firm, typically within 3-5 years.

After the LBO, the target firm is in a position where its debt ratio has increased significantly. It also faces considerable cash requirements to pay interest on its new debt and pay out high returns to its new investors, absorbing most of the internally generated funds that might otherwise have been allocated to long-term investment. Where private equity groups take complete control, the target firm is de-listed from stock exchanges and therefore avoids securities and public accountability regulations thereby dramatically reducing public transparency and accountability. Financial and operating policies that would not have been acceptable or appropriate when listed on the stock market can then be pursued by the new owners. This information advantage for the new owners allows them to raise debt financing levels to the point where the corporation tax deductibility of the interest expenses reduces taxes to a minimum, reduce the levels of operational expenses, and reduce capital investment levels to the minimum level required for continued operation, all of which allow for the maximising of short-term cash flow for payouts to investors. The change in the target firm's planning horizon to a short-term focus on debt management and short-term cash

generation has significant implications for the long-term growth of the firm (Appelbaum and Batt, 2012; Melody, 2008).

4. Extent of private equity LBO activity

The popularity of the private equity leveraged buyout investment model has gone through multiple phases in the past three decades. Kaplan and Strömberg (2009) show how the value and number of leveraged buyouts (LBOs) peaked in the late 1980s, fell during the early 1990s, rose and peaked in the late 1990s, fell in the early 2000s and then experienced explosive growth from 2004 onwards. A significant proportion of private equity buyout activity took place after 2000, particularly in the period between 2005 and mid-2007 just prior to the global financial crisis. Indeed, Kaplan and Strömberg (2009: 127) estimate that in the two and a half year period between January 2005 and June 2007, the number of transactions and the total real value of transactions that took place accounted for 30 and 43 per cent respectively of all transactions between 1984 and 2007. While the majority of LBO activity by PEGs took place in North America in the 1980s and 1990s, buyouts spread rapidly to Western Europe by the turn of the century. Between 2000 and 2004, 48.9 per cent of global LBO transaction value ($1.055 trillion) took place in Western Europe, with the region also accounting for 45 per cent of the $1.56 trillion total transaction value generated between 2005 and mid-2007 (Kaplan and Strömberg, 2009: 127-8).

Worldwide, the private equity industry is estimated to have approximately $2.4 trillion under management[3], while in the US alone the Private Equity Growth Capital Council estimates that there are 2,600 private equity firms headquartered in the country with investments in 15,300 companies that employ 8.1 million workers.[4] Private equity investment in firms has long been controversial, particularly when it involves leveraged buyouts or financial engineering strategies. Proponents generally claim that private equity takeovers create value and jobs and improve the efficiency of target firms, while critics claim the opposite and that buyouts only result in financially distressed firms that often end up bankrupt. The LBO wave of the 1980s has received considerable attention in the

[3] http://knowledge.wharton.upenn.edu/article.cfm?articleid=2939

[4] "Private Equity by the Numbers", Private Equity Growth Capital Council, available at: http://www.pegcc.org/education/pe-by-the-numbers/

empirical literature, with many studies (mainly examining management buyouts) finding that LBOs at the time created value and led to significant improvements in operating performance.[5] The wave of LBO activity that ended in 2007 has only recently begun to receive attention with a number of studies examining the impact of LBOs on industry performance (for example, Guo et al., 2011 and Davis et al., 2009), employment (for example, Amess and Wright, 2007; Davis et al., 2008) and investment (for example, Harford and Kolasinski, 2012).

Guo et al. (2011) study a sample of 192 LBOs carried out in the US between 1990 and 2006 and examine whether the transactions created value. They found that the returns to capital invested on average were large and positive, however, improvements in operating performance were similar to those observed for benchmark firms. Davis et al. (2009) use a sample of approximately 4,500 firms that experienced an LBO in the US between 1980 and 2005 to test whether private equity takeovers led to an improvement in productivity as measured by real value added per employee. They found that target LBO firms experienced productivity growth gains after two years that were approximately 2 per cent higher than benchmark firms. The authors attribute this to restructuring and reallocation effects within target firms, as well as more establishment entry and exit, with target firms much more likely to close underperforming businesses than benchmark firms.

Amess and Wright (2007) examine the impact of 1,350 LBOs on wages and employment in the UK. They found that, on aggregate, LBOs had an insignificant effect on employment growth but experienced significantly lower wage growth than non-LBO firms. Davis et al. (2008) assess the impact of LBOs on employment growth in approximately 5,000 LBOs between 1980 and 2005 in the US. The authors found that employment shrinks more rapidly in LBO firms than in control firms in the aftermath of a takeover and that this was largely the result of greater job destruction at LBO firms in the retail trade, services and finance, insurance and real estate sectors. However, the authors found that job destruction was partly mitigated by more greenfield job creation at LBO firms. Harford and Kolasinski (2012) examine whether LBOs damage the long-term value of target firms and the efficiency of

[5] See for example, Kaplan (1989), Lichtenberg and Siegel (1990) and Smith (1990).

company investment policies using a sample of 788 large US private equity buyouts between 1993 and 2001. They found no significant difference between the investment levels of private equity portfolio companies and a matched sample of comparable public firms.

Whereas these studies provide important insights into the impact of LBOs by PEGs they do not distinguish between different industries and, given the focus of this paper, it is important to note that they do not pay particular attention to infrastructure industries (e.g. transport, energy and environmental infrastructure) where there has been significantly increased activity by PEGs since the early 2000s. LBOs by PEGs represent one of a number of forms of PEG involvement in infrastructure firms. Another form is the supply of private equity to individual projects by firms that hold a 'strategic' interest in the relevant project (e.g. construction, engineering or architectural firms). This type of private sector participation in infrastructure industries has risen in popularity in the context of long term infrastructure contracts such as design, build, finance, operate (DBFO) and concessions. Other forms of PEG involvement in infrastructure that have emerged in recent years include private equity infrastructure funds (PEIFs) consisting of financial investors such as investment banks, pension funds and insurance companies that provide equity for infrastructure projects focusing primarily on the financial returns their investments yield (Page et al., 2008).

Greater private equity involvement in the provision of public infrastructure raises important questions in public policy terms. These include concerns about how private equity involvement in the form of LBOs impacts on the objectives and practices of firms operating in strategically important infrastructure industries, whether they are owned wholly or partly by private investors. The following section examines private equity involvement in the European telecoms sector where these issues have arisen after former state owned operators in a number of countries have been the subject of LBOs by PEGs.

5. Private equity LBOs in European telecoms

Three European former incumbent telecoms operators have been the subject of private equity LBOs by private equity funds in the last decade, namely Eircom in Ireland, TDC in Denmark and BTC in Bulgaria. Our focus in this paper is on the impact of the two separate LBOs of Eircom in Ireland, however, the Danish and Bulgarian experiences display many similar characteristics. Melody (2008) argues that in both cases, private equity ownership led to companies being forced to take on high levels of debt that imposed strict constraints in terms of making long-term investment in network development. This problem was amplified by strategies focused on generating short-term cash gains which could then be extracted in the form of dividend payments and the eventual re-sale of the operators. Moreover, managers of the utilities were given incentives that were inimical to taking long-term perspectives since personal rewards were high if management facilitated the takeovers.

In the case of TDC, a private equity consortium – which included Providence Equity, Blackstone, Apax, Permira and Kohlberg Kravis Roberts – purchased the Danish telecoms operator in February 2006 in a highly leveraged buyout financed by just over 80 per cent debt. As a result of the takeover, TDC's net debt increased from DKK16.5 billion in 2005 to DKK55.2 billion by the end of 2006 (TDC Annual Report 2006). Just two months later, the new owners paid themselves a special dividend totalling DKK43.5 billion, worth almost 47 per cent of TDC's total assets in 2005.[6] In order to pay down TDC's significant debt, TDC's private equity owners have since gone on to sell all of TDC's non-Nordic businesses and entered into sale and leaseback agreements for a significant amount of its property assets.[7] The private equity owners have begun to exit their investment – reducing their stake to almost 60 per cent by selling shares worth approximately $2 billion in December 2010 and a further sale of almost $1 billion of shares in February 2012, which reduced their stake to approximately 43 per cent.[8]

[6] Authors' calculation from TDC Annual Report 2006.
[7] Source: TDC Annual Reports 2006-2010.
[8] Thomas, D & Schaefer, D. (2012) 'TDC owners reduce their holding, *Financial Times*, 14 February. Available at: http://www.ft.com/intl/cms/s/0/2be42706-5738-11e1-869b-00144feabdc0.html

In the case of BTC (now Vivacom), the company has gone through a number of changes in ownership since its privatisation in 2004 when 65 per cent of the company was sold to a subsidiary of private equity firm Advent International. The 65 per cent stake was bought some months later by Icelandic billionaire Thor Bjorgolfsson who increased his stake to 90 per cent before selling it to AIG Investments, the private equity arm of AIG, in 2007 in a highly leveraged buyout.[9] In the aftermath of the global financial crisis, BTC was taken over by a subsidiary of the Hong Kong private equity firm Pacific Century Group when they acquired AIG Investments in March 2010.[10] Bank creditors took control of BTC in June 2010 after debt covenants were breached and the company is currently in the middle of a debt restructuring deal which will see creditors take over ownership after a number of bids for the business were rejected.[11]

The Danish and Bulgarian experience with private equity leveraged buyouts of their incumbent telecoms operators is broadly similar to that of Eircom. All three cases illustrate the pitfalls associated with the build-up of unsustainable debts especially where debt is not used to finance productive investment in companies that require a long-term investment focus. The LBOs of all three companies have not only had negative consequences in terms of financial sustainability but have also had serious implications for the fixed-line telecommunications sectors in each country as the companies were national incumbents and owners of the national fixed-line network. The next section outlines the various changes in the ownership of Eircom post-privatisation, focusing in particular on the impact of the two LBOs on Eircom's financial structure.

6. Eircom ownership changes

The first major change in the structure and direction of Eircom after privatisation was the de-merger and sale to Vodafone of its mobile communications subsidiary, Eircell. Originally established in 1985, Eircell was the most profitable and fastest growing division of Eircom

[9] Parker, A. (2007) 'AIG to buy 65% BTC stake from Novator', *Financial* Times, 4 May, available at: http://www.ft.com/intl/cms/s/0/62610a6a-f9dc-11db-9b6b-000b5df10621.html

[10] 'Vivacom in restructuring talks', *Financial Times*, 11 June 2010, available at: http://www.ft.com/intl/cms/s/0/60ee9d46-753a-11df-a7e2-00144feabdc0.html

[11] 'Creditors to Put Bulgaria's Vivacom for Sale Again in 1-2 Years – Report', *Sofia News Agency*, 2 May 2012, available at: http://www.novinite.com/view_news.php?id=138965

accounting for approximately 70 per cent of Eircom's market value with over 1.3 million subscribers at the time of the de-merger.[12] From April 2000 onwards, Eircom's share price had suffered a sharp decline as a result of the downturn in the global telecommunications market and the Vodafone bid for Eircell thus provided an opportunity to placate shareholders nursing significant losses. The all share deal for Eircell, with a value of approximately €3.3 billion, was finalised in May 2001 and included a clause that prevented Eircom from re-entering the mobile market for a three-year period.

6.1 First leveraged buyout

While negotiations on the sale of Eircell were ongoing, a number of groups expressed an interest in acquiring the remaining Eircom fixed-line business. Although there were a number of contenders, two different consortia emerged as the most likely buyers: the *Valentia* consortium, headed by Irish investor Anthony O'Reilly, and the *eIsland* consortium, headed by another Irish businessman, Denis O'Brien. The Eircom ESOP Trustee held significant power throughout the bidding process, since any takeover would require the support of more than 80 per cent of shareholders. Although the final *eIsland* offer was marginally higher than that of Valentia, the board of Eircom controversially accepted the Valentia offer on the basis of some debatable calculations concerning warrants offered by both consortia.[13]

The final deal resulted in the ESOP taking a 29.9 per cent stake in Eircom, along with two of the 11 seats on the board of directors. The Valentia consortium was made up of two US-based private equity groups (Providence Equity Partners and Soros Private Equity Partners), US bank Goldman Sachs and Irish investor Anthony O'Reilly. It formally completed the takeover of Eircom on 10 December 2001 for €2.8 billion through a highly leveraged buyout. The €2.8 billion purchase price was made up of approximately €2.2 billion in debt and €600 million in equity, of which €202 million was provided by the ESOP to purchase its 29.9 per cent ordinary share stake. In addition, the ESOP also subscribed for €247 million in preference shares (Eircom ESOP Trustee, 2001).

[12] McManus, J. (2000) "Short-term outlook prompts Eircom's U-turn on Eircell", *Irish Times*, 13 October, p. A5.
[13] McManus, J. (2001) 'Fuzzy maths relies heavily on cash and warrant considerations', *Irish Times*, 12 June, p. 16.

The takeover resulted in Eircom's net debt increasing from -€124 million in March 2002 (total debt was €195 million) to €1,791 million in March 2003 (total debt was €2,231 million). As a result, Eircom's net debt/EBITDA ratio increased from -0.24 to 3.25 over the same period, one of the highest leverage ratios of any former incumbent European telecoms operator at the time.[14] Eircom's financial structure deteriorated further some 20 months after the takeover, when the new owners implemented a significant restructuring and refinancing of the company's debt. Valentia took out a new bank loan of €1.4 billion and issued bonds worth €1.05 billion to the European and US financial markets. Part of the funds raised were used to repay existing debt and the company then paid a special dividend of €446 million to shareholders along with the redemption of €66 million in preference shares held by the Eircom ESOP (Eircom ESOP Trustee, 2003).

The payout of such a large special dividend (equivalent to approximately 15 per cent of total assets) represented the extraction of a high level of company value at a time when the company was already loss-making.[15] Moreover, Eircom's total debt increased slightly from €2,125 million to €2,253 million and shareholder funds were significantly reduced, from €757 million to €279 million, meaning that the ratio of debt to debt plus equity increased from 75 per cent to 89 per cent after the refinancing. In addition, the €1.05 billion in new bonds issued were high yield junk bonds that were given sub-investment grade ratings by both Standard & Poor's and Moody's and resulted in a higher cost of servicing debt (Eircom ESOP Trustee, 2003). The refinancing of Eircom's debt increased the levels of leverage and financial risk that the company was exposed to and reflected the short-term profit maximising goals of Valentia and the ESOP Trustee, which directly conflicted with the long-term sustainability of Eircom's business. Having already realised sizeable gains from its acquisition of Eircom, the Valentia consortium exited its investment in March 2004 when

[14] Source: Eircom Annual Report 2002 and 2004 and authors' calculations. EBITDA = earnings before interest, taxes, depreciation and amortisation. Net debt/EBITDA is a common measurement of a company's leverage and shows how many years it would take for a company to pay back its debt if net debt and EBITDA were to remain constant. Most European telecoms operators operate financial policies that keep their net debt/EBITDA ratio between 2 and 2.5 (see figure 1).

[15] Eircom incurred a net loss of €62 million for the financial year ending in March 2003 and recorded a net loss of €531 million for the financial year ending in March 2004 as a result of the special dividend paid out (Eircom Annual Report 2004).

Eircom was re-floated on the stock exchange generating capital gains of over 20 per cent for Valentia and the ESOP.[16]

6.2 Second leveraged buyout

In the aftermath of the re-flotation the company became the subject of persistent takeover speculation. An attempt by the Swiss national telecoms operator, Swisscom, to purchase Eircom in 2005 was aborted following the intervention of the Swiss Government to block the takeover. It was followed by a bid from the private equity arm of Australian investment firm, Babcock and Brown Capital (BCM), in early 2006 after it had built up a sizeable shareholding in Eircom. The takeover bid, jointly agreed with the Eircom ESOP Trustee who negotiated an increased shareholding of 35 per cent, was completed in September 2006. As in the case of the Valentia takeover, the buyout was highly leveraged with the total transaction value, including Eircom's existing net debt and transaction costs, approximately €4.8 billion, of which 80 per cent was funded through debt finance and the balance through equity finance (Eircom ESOP Trustee, 2006). The takeover resulted in an enormous increase in the level of Eircom's total borrowings, from €2.467 billion in March 2006, to €4.268 billion by March 2007[17] and further increases in the cost of servicing its debt. Over the same timeframe Eircom's net debt/EBITDA ratio increased from 3.51 to 6.31, a level widely seen as unsustainable and triple that of most other former incumbent European telecoms operators in 2007 (see figure 1).

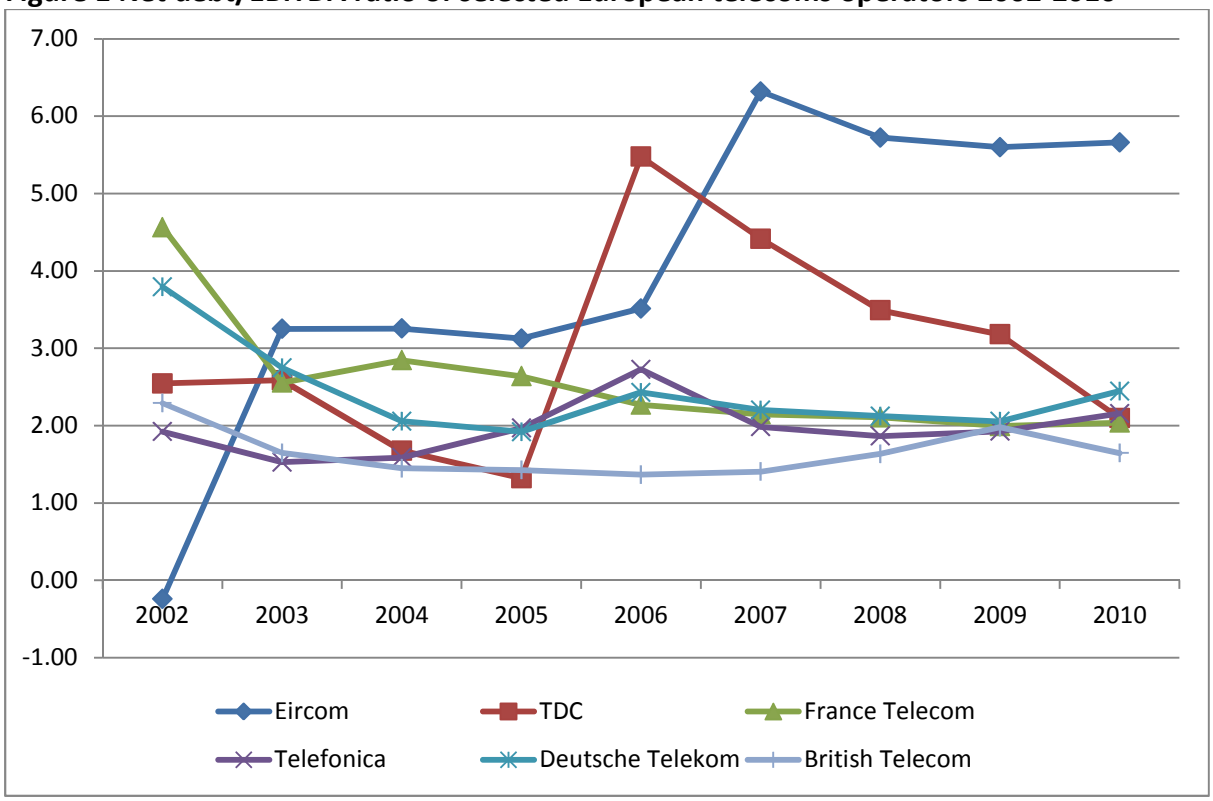
As with the Valentia takeover, the ESOP Trustee explicitly recognised the risk associated with further increasing Eircom's leverage but stated that it had been advised that it was in line with some recent transactions such as the acquisition of Denmark's incumbent telecoms operator, TDC (Eircom ESOP Trustee, 2006). It is interesting to note that TDC was the example used by the ESOP Trustee to defend its support for the BCM takeover. TDC was acquired in a highly leveraged buyout by a private equity consortium which included

[16] This approximate value is based on an initial equity investment of €676 million and proceeds to equity investors of approximately €872 million (McManus, J. (2004) 'Eircom comes to market… again', *Irish Times*, 5 March, p. A3). The estimated proceeds in the article were based on an expected flotation share price of €1.62. Since Eircom was eventually floated at a share price of €1.55, the estimated proceeds were adjusted downwards and totalled approximately €834 million.

[17] Source: BCM Ireland Finance Ltd (Eircom), Quarterly and pro forma 12-months results announcement, June 2007.

Providence Equity Partners, one of the main investors involved in the Valentia consortium that acquired Eircom in 2001. The takeover significantly increased TDC's leverage (see figure 1) and the company's new owners pursued a strategy of value extraction similar to that pursued in Eircom. The LBO by BCM led to further pressure on Eircom to generate enough cash to pay off its growing interest payments and its new owners resorted to cash generation activities such as sale and leaseback agreements to facilitate this.[18]

Figure 1 Net debt/EBITDA ratio of selected European telecoms operators 2002-2010



Source: Authors' calculations from company annual reports and financial statements. Note: For Telefonica and France Telecom, OIBDA (operating income before depreciation and amortisation) was used instead of EBITDA since no EBITDA figures were reported. In all other companies, the leverage ratio was calculated as: (adjusted) EBITDA/net financial debt.

6.3 STT takeover and bankruptcy

Financial difficulties at BCM Ireland's parent company in the aftermath of the global financial crisis prompted its withdrawal from Eircom in 2009. Singapore Technologies Telemedia (STT) which is owned by the Singapore state investment company, Temasek,

[18] For example, Eircom sold its headquarters in Dublin for €190 million in December 2006, as well as another office building for €40 million, as part of sale and leaseback agreements (*Irish Times*, 'Citywest sale and leaseback deal to net Eircom €40m', 20 June 2007, p. B1).

launched a bid for Eircom in June 2009. Due to Eircom's substantial net debt burden of approximately €4 billion, STT paid just €140 million in January 2010 for its controlling stake in the company. As a result of heavy losses in 2009 and 2010, the company had to implement large scale cost saving plans and also entered into a number of sale and leaseback deals for some of its exchange buildings in order to raise cash.[19] In September 2010 it signalled that it may breach debt covenants within 12-18 months and in early 2011, the company and its bondholders appointed advisers to work out a debt restructuring agreement for the firm.

After protracted debt restructuring negotiations over the course of 2011, STT announced it was withdrawing its proposals for the company and Eircom formally applied for examinership in March 2012. A debt restructuring deal agreed in May 2012 with senior lenders, which included Blackstone, Deutsche Bank and various hedge funds, saw them take full control over Eircom. As part of the deal, first lien lenders accepted a haircut of 15 per cent on their €2.7 billion of debt, second lien lenders accepted a haircut of approximately 90 per cent, while the lowest tiers of unsecured bondholders were wiped out. As a result of the deal, Eircom's total debt burden has been reduced by approximately 40 per cent from €4 billion to €2.35 billion and a five-year survival plan involving investment in high-speed broadband infrastructure and approximately 1,000 redundancies is being put in place.[20]

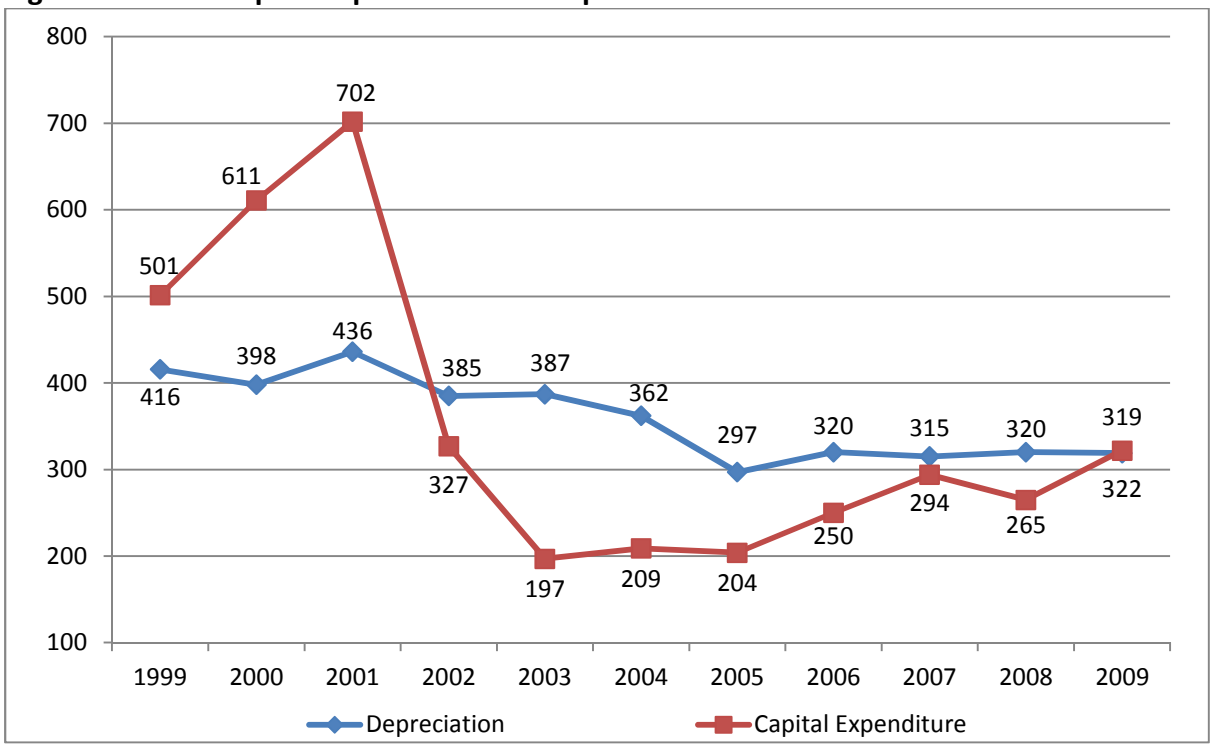
7. The Wider Effects of LBOs: Focusing on the fixed-line telecoms sector

The highly leveraged buyouts of Eircom that followed privatisation have had significant economic and social effects in addition to the damage caused to the financial structure and performance of the company. As a regional economy that places the attraction of foreign direct enterprise at the heart of industrial policy, Ireland faces ongoing challenges in terms of providing high quality physical infrastructure that enhances competitiveness. Telecoms infrastructure is critical in this regard, with the creation of a modern knowledge economy relying heavily on a competitive and innovative sector that delivers high quality infrastructure and services to consumers.

[19] Hancock, C. (2011) 'Sale and leasebacks on cards for Eircom', *Irish Times*, 18 February.
[20] Thomas, D. (2012) 'Senior lenders take control of Eircom', *Financial Times*, 11 June. Available at: http://www.ft.com/intl/cms/s/0/8c25780a-b3e9-11e1-a3db-00144feabdc0.html

The Irish government viewed the privatisation of Eircom in 1999 as a key part of plans to develop a competitive telecommunications market in Ireland. The benefits anticipated at the time of privatisation have, however, failed to materialise as Eircom continued to dominate the fixed-line market, stymied competition and underinvested in modern technologies, such as high-speed broadband, that are vital in terms of the interests of the Irish economy and society. The LBOs of Eircom in 2001 and 2006 were particularly inimical to the development of the competitive and innovative telecommunications sector envisaged at the time of privatisation. Both LBOs resulted in enormous increases in the company's level of debt, imposing binding constraints on the scope for investment in telecommunications infrastructure.

Figure 2: Eircom capital expenditure and depreciation allowances 1999-2009



Source: Eircom annual reports and quarterly financial statements. Note: the capital expenditure and depreciation figures for Eircom post-2006 include capital expenditure and depreciation charges on mobile communications infrastructure after the company bought the mobile operator Meteor in 2006.

After spending €1.8 billion in acquiring tangible fixed assets in the three years between 1999 and 2001, Eircom only spent €1.18 billion in capital investment in the five years between 2002 and 2006. The reduction in investment post-2001 is largely a result of the strategies

pursued by Eircom's private equity investors who implemented substantial cuts in capital expenditure and a significant amount of labour shedding during its years in ownership. Figure 2 shows that capital expenditure since 2001 has been consistently below depreciation allowances in each year. Whereas Eircom had invested almost €480 million more than its depreciation allowances between 2000 and 2001, capital investment was just over €400 million less than depreciation allowances between 2002 and 2004.

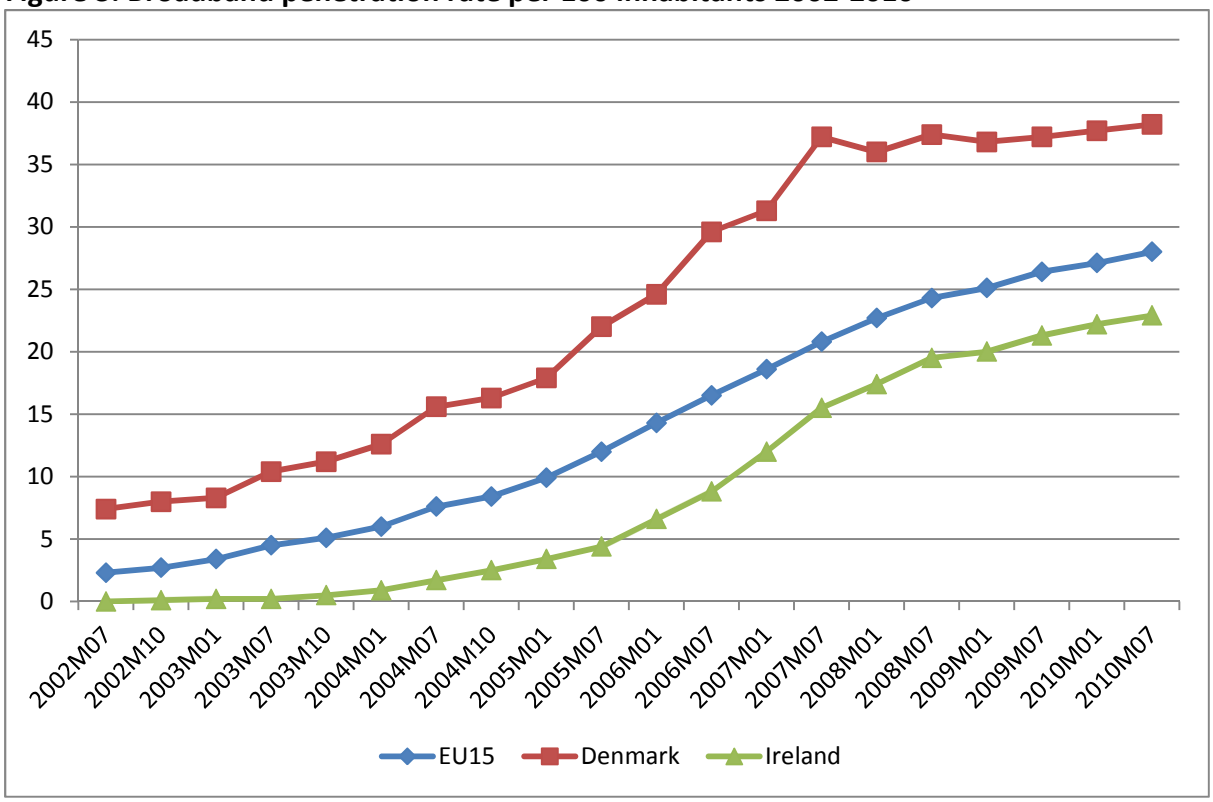
In addition to a lack of investment in the network, Eircom used its dominance of the fixed-line market to ensure that the pace of increased competition in this market was tortuously slow in the post-2001 period. Eircom retained an approximate 80 per cent market share from 2001 until 2005, and still maintained a market share of almost 70 per cent by the end of 2009. Eircom's ability to stifle competition in the fixed-line market owed much to its extreme sluggishness in allowing other firms access its local loop infrastructure as well as increasing the cost to other operators of renting fully unbundled or shared access lines to the highest in Europe up until 2010.[21] Over the years, the Irish communications regulator, ComReg, consistently criticised 'the lack of robust and efficient LLU processes from Eircom' which continued 'to hamper investment in what has in other markets been a key driver of innovation and broadband take-up' (ComReg, 2007: 19). However, despite repeated ComReg pressure to speed up Eircom's implementation of local loop unbundling (LLU), by September 2009 the number of unbundled lines as a percentage of total DSL lines in Ireland was the lowest in the EU15, amounting to just 3.4 per cent compared to an average of almost 34 per cent for the EU15 (ECTA, 2009).

The low levels of capital investment by Eircom, along with its stifling of competition in the fixed line market had particularly grave consequences for the rollout of broadband services, with Ireland consistently ranked among the worst performers in the EU across most broadband development indicators up until recently (see figure 3). While most other European countries had launched full-scale broadband services in 2001, Ireland was a full 18-24 months behind with its launch. National DSL coverage by population in Ireland has

[21] In October 2008 Eircom's monthly rental price was €16.43 for fully unbundled lines (EU average was €9.28) and €8.41 for shared access lines (EU average was €2.62) (EC, 2009).

consistently been among the lowest of the EU15, with this largely explained by low levels of coverage in rural areas. While DSL coverage in urban and suburban areas in Ireland has effectively been at 99 per cent since the end of 2005, the expansion of DSL coverage in rural areas in Ireland was extremely slow in comparison to other European countries, with Ireland perennially ranked next to last in the EU15 in terms of rural DSL coverage up until 2011.[22] This is of considerable concern given that Ireland has one of the highest rural populations in the EU, with almost 40 per cent of the population living in rural areas. As a result of Ireland's poor broadband performance, the Irish government had to invest directly in rural broadband infrastructure itself in order to tackle the market failure that emerged.[23]

Figure 3: Broadband penetration rate per 100 inhabitants 2002-2010



Source: Eurostat

[22] Source: IDATE (2006-2011) and DG AGRI (2006-2011).

[23] The State has invested in rural broadband infrastructure through the County and Group Broadband Scheme (CGBS) in 2004, which was replaced by the National Broadband Scheme (NBS) in 2007. The NBS, which rolled out wireless broadband services to remote rural areas, was completed in October 2010. The Government also invested significant sums of money through the Metropolitan Area Networks (MANs) programmes. The MANs programme involved the rollout of over 1,000 km of fibre optic cable in approximately 90 towns across Ireland and was completed in two phases between 2004 and 2009 (see Palcic and Reeves (2011) for more detail).

Eircom's dominance of the fixed-line market and its low levels of capital investment over the years have also had negative consequences for the quality of services available to consumers. The broadband speeds available in Ireland have consistently been among the lowest in Europe since broadband services were launched. As of January 2011, Ireland was next to last in the EU15 in terms of the number of fixed broadband lines with download speeds greater than 10Mbps, with less than 15 per cent of fixed lines achieving such speeds compared to a EU27 average of 40 per cent (EC, 2011). This can be partly explained by the fact that almost 36 per cent of all broadband subscriptions in Ireland at the end of 2011 were mobile broadband with download speeds of less than 10Mbps (ComReg, 2012).[24] Moreover, the cost of DSL residential broadband services has also consistently been among the highest in Europe, which is largely the result of the high cost of line rental from Eircom.[25]

It is instructive to briefly compare the Irish experience with that of Denmark and Bulgaria. Whereas the strategies pursued In Denmark by TDC's private equity owners were broadly similar to those pursued in Eircom by Valentia and BCM, the impacts on their respective national fixed-line telecoms markets has been markedly different. This can largely be explained by the fact that when TDC was taken over in 2006, Denmark ranked first in Europe in terms of broadband penetration per capita (see figure 3). In contrast, when Eircom was taken over by Valentia in 2001, Eircom had yet to launch any broadband services. In Bulgaria, the continued dominance of BTC post-privatisation in 2004, and the lack of network access provided to other operators, resulted in hundreds of small operators bypassing BTC's network and deploying their own fibre broadband infrastructure to provide services to consumers. In 2010, there were approximately 670 registered ISPs providing broadband access using LAN/FTTB technology throughout Bulgaria (Rood, 2010).

8. Lessons from the Eircom Experience

[24] Mobile broadband subscriptions recorded explosive growth in Ireland 2007 until 2010, with much of this growth due to the lack of fixed-line broadband services available, as well as the high cost of residential DSL broadband.

[25] Since 2002, the monthly PSTN rental charge for residential customers charged by Eircom has been the highest in the EU27. As of September 2010, Eircom's charge of €25.36 per month was 65 per cent higher than the EU27 average rental charge of €15.36 (Teligen, 2010).

Larouche (2008) argues that EC liberalisation policy is at a crossroads, with public policymakers in EU member states shifting their policy focus from increasing efficiency towards stimulating infrastructure investment in a liberalised environment. The difficulty in stimulating investment in fixed-line telecoms infrastructure is most evident from the considerable divergence in the speed at which high-speed broadband infrastructure has been rolled out across EU member states. In the case of Ireland, the history of the telecommunications sector since 2001 has been characterised by significant failure in terms of investment and provision of quality services. The analysis presented in this paper demonstrates how these problems can be plausibly attributed to a succession of highly leveraged buyouts by a number of PEGs. From a public policy perspective therefore it is necessary to consider lessons from the Eircom experience and to ask how the outcomes observed might be avoided.

An overarching lesson from the Eircom experience is that governments must consider the risks attendant to the privatisation of important telecommunications networks and adopt suitable measures to protect strategic interests as well as wider social welfare. The Eircom experience demonstrates the risks associated with the ownership of former public utilities by PEGs whose interests are incompatible with the public interest role served by public utilities, which generally involves the provision of essential public services and, in some cases, carrying out important public service responsibilities (for example, universal service obligations).

The experience with ownership by PEGs in the case of Eircom prompts important questions about possible measures that can be adopted to avoid the outcomes discussed in this paper. One measure that requires careful consideration by governments is the maintenance of some degree of control by retaining a significant shareholding in the privatised utility. The Eircom case exemplifies the negative consequences that can occur when governments relinquish full control of former state owned monopolies. A unique aspect of the privatisation of Ireland's national operator was the decision by the government to sell its entire shareholding in one-go. In every other EU15 country a partial stake was either floated on the stock market or placed with institutional investors, followed by the subsequent sales

of partial stakes and a gradual reduction in state ownership. In countries where the government's shareholding was eventually reduced to a minority stake, or even reduced to zero, governments generally retained a 'golden share' granting them certain veto rights over future changes in ownership. The decision not to retain a minority share large enough to thwart undesirable bids is all the more remarkable in light of the findings by Bortolotti and Faccio (2008), who reported that governments maintain control of two thirds of privatised firms in the EU by a variety of means including partial sell-offs, golden shares and certain regulatory and contractual requirements. The Irish government's decision to sell its entire government shareholding proved to be a costly mistake, leaving it powerless to influence the takeovers that took place from 2001 onwards.

In terms of the impact of PEG ownership on the development of the fixed-line telecoms sector in Ireland, two main factors have shaped events since privatisation. First, the two leveraged buyouts resulted in the build-up of unsustainable levels of debt and consequent underinvestment in broadband infrastructure. Second, Eircom's continued dominance of the fixed-line sector where it resisted pressure to unbundle its local loop and raised the cost of doing so to the highest levels in Europe, hindered the development of broadband services in Ireland. We recognise that the latter factor is not necessarily attributable to ownership by PEGs but it does point to the weakness of regulation. There is a significant literature covering questions of regulation and investment in the European telecoms sector (see for example, Cambini and Jiang, 2009 and Cambini and Rondi, 2011) but these issues go beyond the scope of this paper. Our focus on ownership by PEGs raises specific regulatory challenges which are highlighted by the Eircom case. For example, the issues that arise in the context of LBOs point to a potential role for the regulator with respect to financial practices. This point is made by Melody (2008) who suggests the strengthening of regulatory powers in EU states to enable effective governance over utilities. In particular, he advocates extending regulatory powers and bringing matters relating to financing, ownership and management under the remit of regulators:

> …regulators will need to be empowered to prevent financial practices and transactions that are contrary to the public interest in long term infrastructure and services

> development […] Most utility regulatory agencies in the US and Canada have strong regulatory powers over the financial practices of public utilities precisely because they are "businesses affected with a public interest".
>
> (Melody, 2008: 282)

Such powers might include the establishment of leverage limits that could be structured on the basis of norms currently observed in the telecoms sector. Most European telecoms operators have financial policies that commit them to maintaining a net debt/EBIDTA ratio of between 2 and 2.5 (see Figure 1). Setting a regulated ceiling of 3-3.5 would appear to be a reasonable limit to permissible leverage ratios and would reduce the risks of over-indebtedness and bankruptcy. Such limits could be linked to a system of resolution powers or step-in rights. For example, where a firm exceeds prescribed leverage limits or fails to meet the investment targets covered by its license, the regulator could step in and take over the operations of the firm run the firm and dispose of the assets. Such arrangements have precedence in the banking sector and similar provisions are included in the special administration process that seeks to protect network assets of regulated utilities in the United Kingdom (see for example, Gorecki et al. 2011).

9. Conclusion

It is now over ten years since Ireland's former state-owned telecommunications company was the target of the first of two highly leveraged buy-outs by private equity groups. Both takeovers resulted in unsustainable increases in debt which ultimately led to the bankruptcy of the firm in 2012. The short term strategies that focused on generating sufficient cash to service debt adopted by both owners were largely consistent with expectations given the 'typical' behaviour of PEGs that can be discerned from the relevant literature. However, there are no examples in the Western European telecoms sector where the impact of such behaviour has been so dramatically negative. The bankruptcy of the company, which was almost debt-free when privatised in 1999, in addition to a lack of capital investment has had serious economic and wider social effects as Ireland lags far behind its peers in terms of the quality and extent of broadband coverage.

The problem of high debt levels in privatised utilities is not confined to the telecommunications sector. Helm and Tindall (2009: 429) found that in the UK, almost all of the utility companies that had been privatised in the 1980s-1990s "ended up with much more highly geared, and in some cases, exhausted balance sheets". The substantial increase in debt at most utilities was not always directed towards capital investment but towards generating returns for shareholders instead, and investment in key utility infrastructure in the UK has consequently suffered. The authors argue that the financial engineering that occurred has resulted in a debt overhang which has severely inhibited the ability of privatised utilities to finance investment and that without regulatory reform, a return to nationalisation or the mutual model of ownership cannot be ruled out. The case of Eircom indicates that the potential for such problems is significantly increased where utilities come under the ownership of PEGs. The possibility of ownership by PEGs therefore presents another layer of complexity to the already challenging task of designing appropriate privatisation and regulation policies.

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