Determining financial capability

Tim O'Keefe explains how the ABT determines whether a licensee is financially capable

When deciding whether to grant, renew, suspend, revoke, or transfer a licence or approve a share transaction, the Australian Broadcasting Tribunal is required to have regard to the financial capability of an applicant for a licence, a licensee or a transferee. This is done before deciding whether it is advisable in the public interest to grant, renew, suspend, revoke, or transfer a licence or approve a share transaction.

In making any of the above decisions, except whether or not to approve a share transaction, the Tribunal is to have regard to the need for the commercial viability of existing services.

The decision of the Tribunal has to be made in the public interest and can therefore be made even though financial capability is not proven or commercial viability of an existing service may be jeopardised. However, in practical terms, this is unlikely.

The terms 'commercial viability' and 'financial capability' are often mistaken as synonymous. In essence the two terms can be distinguished as follows: commercial viability is service area based while financial capability is licensee based.

Commercial viability deals with the net economic resources available to broadcasters in a service area over a period of time. These economic resources are required to support broadcasters operating in accordance with their licence obligation to provide adequate and comprehensive services to the area specified in the licence. In ensuring commercial viability, the Tribunal is not required to guarantee that all the services are profitable or generating an acceptable rate of return on assets.

Financial capability

Financial capability, on the other hand, does not refer to the market but refers to the individual resources possessed by each licensee.

Where commercial viability is considered in relation to the economics of broadcasting in the service area, financial capability takes into account the support structure around the service – being the licensee company, related companies, the holding company, shareholders, bankers, creditors, contracts and agreements. If the licensee company is also involved in another non-broadcasting business, this is taken into account when assessing financial capability.

If there was a slump in advertising revenues and all services in a market were operating at a loss with a negative cash flow, this would obviously raise doubts about the commercial viability of the market. However, the licensees could still remain financially capable of providing an adequate service if it is supported by other sources of funds than advertising.

The opposite is not necessarily true. Even though a service area could support several broadcasters, a financially weak licensee, brought about by poor management or an inappropriate capital structure, may not be able to discharge its responsibilities under the *Broadcasting Act*. In this situation the response in the public interest may not be a reduction in the number of operating services, but to replace the financially weak operator with someone who can comply with the conditions of the licence.

Assessment of financial capability

The Tribunal considers that financial capability involves having the necessary financial resources or access to such resources to broadcast programs that meet the standard imposed by the *Broadcasting Act* for the duration of the licence period. This means that the licensee must be solvent.

In considering a licensee's solvency, the Tribunal needs to be satisfied that the licensee:

- has adequate cash resources or sustainable credit lines to meet its immediate requirements, without resorting to additional borrowings; and
- will have a cash flow surplus at all times over the licence period after allowing for operating, financial and capital outflows as well as allowing for any outflows or inflows of cash from any form of investment account.

In the event that either criterion is not established to the Tribunal's complete satisfaction, then the Tribunal may still conclude that the licensee is solvent if it has the ability to raise by itself either debt or equity from sources to cover any identified cash shortfalls.

Put simply, the Tribunal assesses financial capability by investigating:

- the nature of the financial resources available;
- the availability of those financial resources; and
- the degree of control over the financial resources.

Nature of financial resources

Equity, debt and positive cash flow are the three constituent elements of financial resources.

Equity and debt are structural and fairly static, whereas cash flow is a dynamic factor. An inappropriate capital structure may be saved by good management which achieves a strong positive cash flow. However, this will almost always be an unstable structure subject to the overall health of the economy and the retention of independent successful management.

The prudent course is to have in place a sound capital structure. Clearly the safest structure is 100 per cent equity. The Tribunal, however, recognises that there are sound commercial reasons why licensees would incur some debt but how much debt is acceptable? This is up to the industry to determine, not the Tribunal. Remember the level of debt is only one aspect in determining financial capability and in an industry where intangibles constitute such a large component of the book value of assets, gearing of itself is a relatively crude measure, the type of assets underpinning the debt and the basis of their valuation is more important.

Cash flow includes both inflows and outflows of a trading nature and of a capital nature. Surplus trading cash flow either remains with the company in the books as retained earnings or is distributed as dividends to the shareholders. Surplus trading cash flow which is not distributed as dividends can be converted into non cash assets provided the process can be reversed on the same terms.

In its February report into the renewal of the Sydney and Melbourne commercial television licences, the Tribunal pointed out that surplus cash flow which is directed into speculative investments such as factoring or real estate development no longer remains a financial resource suitable to establish financial capability because of realisation difficulties.

Availability of resources is particularly important in assessing the value of credit facilities. Term facilities, whose availability for a fixed term are guaranteed (subject to normal conditions for default), are far superior to at call facilities. However, the Tribunal recognises that the decision to go long or short may depend on the available rates at the time the loan funds are required. However, the Tribunal would prefer to see the licensee working towards a longer term fixed rate facility. The reason is that it allows the Tribunal to eliminate the interest rate variable in its financial capability assessment.

The Tribunal also considers access to additional loan funds to be relevant in determining financial capability. The licensee may be well within the debt levels with which its lenders feel comfortable. Profits may cover interest and assets may cover liabilities in excess of current loan conditions. How close the licensee is travelling to these limits is also of concern to the Tribunal.

The ability of the licensee to raise additional equity may depend upon the current share trading price exceeding the par value of the shares. With many media stocks currently trading below par, equity funds have made a limited contribution to increasing the financial capability of licensees over the past two years. However, with the restructuring of the Nine network, increased equity funding to repay debt was not only attractive to the Tribunal but also to the investing community.

Central treasuries

It is not much comfort to the Tribunal if the financial structure of the licensee relies heavily on the ability of the licensee to generate operating cash flow if the licensee loses control of that cash flow as soon as it is earned.

The central treasury issue was discussed at length in the Sydney/Melbourne television inquiry. The licensee, which is just one subsidiary in a group of companies, feeds excess cashflow into the central treasury by way of loan accounts shown as assets in the licensee's accounts. There may be doubt that these funds would flow back to the licensee in difficult trading times. This would depend on the success of the other businesses contributing to and withdrawing from the central treasury.

So the Tribunal has to consider the nature of the related business in assessing the availability of the cash if needed. The control over the cash once it is placed in the central treasury system is out of the hands of the licensee. In most cases there are no formal arrangements for access to funds, the licensee joins the queue with other companies in the group.

This is not to say that the Tribunal considers central treasuries an evil. It acknowledges them as a fact of commercial life, with groups pooling funds to gain maximum benefit from available cash resources. Central treasuries can also stabilise cash flow with investments in counter cyclical industries. The concern of the Tribunal is that the licensee may be sending its cash surplus up a 'one-way street'.

Another difficulty for the Tribunal in assessing financial capability is where the licensee's assets are used as security for debts of other companies within the group. This places the disposal of these assets outside the control of the licensee.

Although the *Broadcasting Act* refers only to licensees or applicants having to possess the requisite financial capability, it is not possible to adequately assess solvency and consequently financial capability without taking into account the financial position of the group as a whole.

Tribunal options

In the event that the Tribunal reaches an adverse view regarding the financial capability, the Tribunal still has to take into account the public interest before acting either in a licence grant, licence transfer, licence renewal or a share transaction.

The Tribunal has the most flexibility to act in a licence grant as it is required to make a decision prior to the service going to air. The Tribunal can decide not to grant a licence due to the applicant's lack of financial capability without taking a service away from the public. However, the Tribunal may consider that to withhold a service from the public while new applications are called may not be in the public interest and decide to grant a new licence despite the fact that the applicant does not have the necessary financial capability. The circumstances for this later decision could relate to the lack of available services within the market and the strengths in other areas of the application. The Tribunal could place conditions on the licence granted to ensure financial capability over the period of the licence.

The Tribunal is in a similar position with licence transfers, where it has prior approval powers. The Tribunal may not approve the transfer of the licence if the applicant does not have adequate financial capability. However, it may be in the public interest for the transfer to be approved if the service is more likely to continue under the applicant's control than the current licensee's control. Under those circumstances the Tribunal would investigate all other possible options available to the licensee to sell the licence before approving a transfer to a financially weak applicant. The Tribunal is not empowered to place conditions on a licence transfer.

In a licence renewal the Tribunal has somewhat less flexibility if the applicant has not met the financial capability criteria. There are a number of options open to the Tribunal which fall short of not renewing the licence. The Tribunal might renew the licence for a shortened period only and may impose conditions aimed at allowing it to closely monitor the financial position of the licensee. Alternatively it may issue directions. A more drastic option open to the Tribunal could be to renew the licence for a limited period and to call upon the Minister to call for applications, open to the incumbent, for a new licence in the service area. This last option has never been taken by the Tribunal, but it does leave the decision with the Minister.

In a share transaction the Tribunal has the least flexibility. The Tribunal is asked to consider a transaction that has already taken place and may be very difficult to reverse. For example, the previous owner of the licensee company has already been paid and the new owner has installed its own management into the licensee company. However, the new owner of the licensee company could be put on notice that the licensee's financial capability needs to be improved before the next renewal of the licence. The Tribunal cannot give a conditional approval to a share transaction but it can immediately open a separate inquiry to place conditions on the licence.

Even though the Tribunal has less flexibility in dealing with licence renewals and share transactions it has the ultimate power to not renew and to disapprove share transactions in the public interest. It may be in the public interest to simply not renew the licence because the financial repercussions of an insolvent licensee upon the industry and community outweigh the short term loss of the service.

This is an edited version of a paper presented to an ABT seminar on 19 August 1991. Tim O'Keefe is a member of the Tribunal.