The Sunday Brief: To What End - Sprint and Softbank?
14 October 2012

Greetings from Dallas, home of the COMPTEL association fall convention. It was great seeing many of you there and catching up. It looks like they met their goal of 2,000 paid attendees, and there was an enthusiastic buzz in the air.

Occasionally, we use this column to answer Sunday Brief readers' emails on particular topics. This week, we have several dozen questions on the Sprint/ Softbank acquisition as well as the effect of the upcoming elections on the telecommunications landscape. We'll try to answer those and a few more over the next two issues.

The most pressing question on everyone's mind is "What's the end result of a Softbank acquisition of Sprint?" It is an intriguing transaction. While no details have been released on the form of the investment (we'll discuss that later), let's consider two sobering pieces of information, beginning with a chat about currency:

Source: Index Mundi. Click here for charts of different time periods.

This is the 10-yr exchange rate chart for Yen/ Dollar. Over the past decade, the yen has appreciated nearly 40% (37.15% to be precise). And, since the summer of 2007, the decline in the dollar's value has been about the same as it has been over the past 10 years. We should not be surprised that companies holding Yen would begin to look at US companies in a different light. In fact, if it were not for the fact that the Yen/ Euro exchange rate has fallen even more, we would be hearing more about Japanese acquisition.

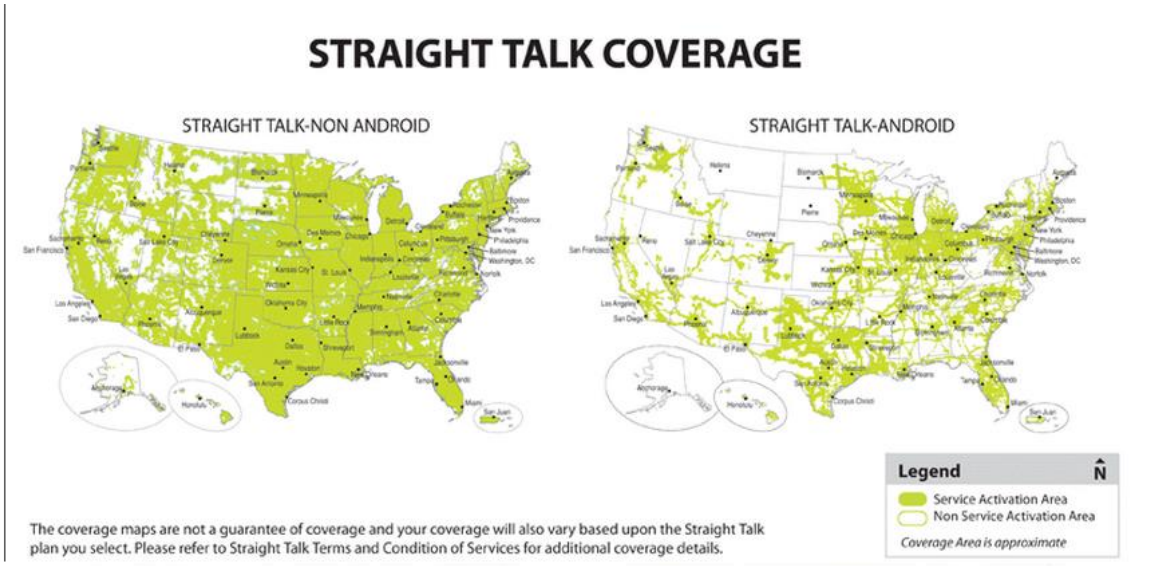
Sad to say, the second point is even worse and shown by the following chart:

Sprint's stock is down 47% over the past 10 years, and Clearwire is down nearly 90% since their public debut at $20/ share in early 2007. While Sprint's stock has had great gains this year, Sprint shareholders saw higher stock price levels as recently May 2011 ($5.91). While many are focused on Sprint's YTD and one year stock performance (re: last October investors were bailing on Sprint's stock due to an abysmal analyst day that resulted in a public apology from Sprint's chairman, Jim Hance), a dollar invested two years ago - October 12, 2010 - would be worth $1.52 today (with dividends) if invested in Verizon, $1.40 (including dividends) in AT&T and just $1.25 invested in Sprint.

Meanwhile, Sprint and Clearwire now carry just over $25 billion in debt, with about $7 billion of this combined figure refinanced over the past year. This results in an annualized interest expense for Sprint and Clearwire of just over $1.7 billion. To put into context, $1.7 billion equals about one quarter of Verizon Wireless total 2012 capital expenditures.

While this has not been a good run for anyone who has held Sprint shares for more than a year, it's definitely a good time for Softbank to move on Sprint and Clearwire. The combination of a weak dollar, depressed S and CLWR equities, and improving cash flow provide a trifecta of sorts for Softbank.

Sprint's near-term issue is LTE coverage. Here is the chart from our friends at Straight Talk (Wal-Mart's MVNO) outlining the coverage differences between Sprint (right - Android) and one of their largest competitors:



In the past, Sprint could deploy a similar postpaid experience across a roaming partner's network – they could use the (other-than-Sprint) network on the left to enhance the (Sprint) network on the right. In a Voice over LTE (VoLTE) world, their roaming strategy becomes a lot more expensive.

The price tag to create a 4G network that looks more like the left hand side of the page is steep. Sprint will need a lot of scale. But if Sprint can build an LTE footprint that completely overlaps their 1XRTT network (the right hand side), additional operating efficiencies could be gained (AT&T is doing something similar with their 2G network decommissioning we discussed in last week's Sunday Brief). With the issuance of new equity (see scenarios below), Sprint could erase some or all of the gap between the two pictures.

Sprint also needs a third party to affect a change in the Sprint/ Clearwire relationship (the drama over last December's delayed bond payment to Sprint is quickly forgotten but has been one of the sources of Sprint's cash flow growth in recent quarters. It also was one of the factors depressing Sprint's stock as we entered 2012). What started with the best of intentions in 2008 turned into repeated management conflicts and frayed relationships: retail vs. wholesale investments, unlimited vs. per gigabyte inter-company pricing, microwave vs. fiber-based backhaul, and WiMax vs. LTE technology selection are just a few of the many wedge issues that created the current tensions. With recent news reports clearly indicating that Softbank has a great interest in Clearwire's spectrum, the opportunity to take their 2.5GHz band coverage and pair it with Sprint's current tower portfolio is enormous. All that's needed is several billion in additional investment.

Given the need to be more competitive with LTE, and to do so with Clearwire's rich spectrum holdings, how will a Softbank investment be structured? That's the question analysts should be asking in October as the details unfold.

The most likely scenario is a straight issuance of some or all of the existing 3.5 billion shares that have already been authorized (see Sprint's current liabilities and equity statement below – left hand column is as of June 30, 2012, while right hand column is as of Dec 31, 2011. Full 10-Q can be found here). This would generate up to $20-22 billion in immediate cash for Sprint and give Softbank voting control. Current shareholders would be diluted – significantly, but the certainty of a long-term growth rate rises.

Bondholders will cheer, and coupon rates on future debt will fall. It's a straightforward solution if the transaction can be structured to keep Softbank as a long-term shareholder. It's also the best option for the shareholder who wants to see a double digit share price in the next five years.

LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 3,387	$ 2,495
Accrued expenses and other current liabilities	3,669	3,996
Current portion of long-term debt, financing and capital lease obligations	307	8
Total current liabilities	7,363	6,499
Long-term debt, financing and capital lease obligations	20,957	20,266
Deferred tax liabilities	7,038	6,986
Other liabilities	4,439	4,205
Total liabilities	39,797	37,956
Commitments and contingencies		
Shareholders' equity:		
Common shares, voting, par value $2.00 per share, 6.5 billion shares authorized, 2.999 and 2.996 billion shares issued	5,999	5,992
Paid-in capital	46,735	46,716
Accumulated deficit	(42,726)	(40,489)
Accumulated other comprehensive loss	(781)	(792)
Total shareholders' equity	9,227	11,427
Total liabilities and shareholders' equity	$ 49,024	$ 49,383

Another less likely scenario is a convertible bond offering that buys out some or all of the existing debt holders but keeps the current shareholders intact. This bond would carry a lower coupon (and lower the interest paid), favorable debt payment terms (which will help 2013/2014 earnings per share), and a higher equity conversion price (perhaps as high as $6.50 or $7). Depending on Sprint's operating performance, this solution may or may not dilute the current shareholders, and also may not tie Softbank's hands as much as the first scenario. Sprint gets less cash today, but consolidates the bondholders and defers equity dilution until a higher share price can be attained by the company. As a few industry analysts have stated, this scenario creates additional liquidity, but results in minimal synergy opportunities.

A third scenario is to have Softbank buy out the current shareholders through a Sprint and Clearwire tender offer. That locks in the gains of the current Sprint equity owners (who saw higher share prices than the current level as recently as May 2011), but does little to build a stronger Sprint. Sprint would continue to pay the same coupon rate on their debt, and it's unclear how Softbank would be able to create/ leverage a global platform to lower Sprint's operating expenses.

Sprint is clearly on the rebound without Softbank, but a well-structured equity investment would lay to rest any concerns about Sprint's ability to compete against Verizon and AT&T. The investment vehicle is the critical element – it's what results in Sprint singing "Happy Days Are Here Again" as opposed to opposed to "I Think I'm Turning Japanese."

Next week, we'll probe the effect of a Romney administration on the telecom landscape. As always, welcome your comments and questions. If you have friends who would like to be added to this email blog, please have them drop a quick note to sundaybrief@gmail.com and we'll add them to the following week's issue. Have a terrific week!

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