THE FOLLOWING ARTICLE APPEARED IN THE OPASTCO ROUNDTABLE MAGAZINE IN THE FALL OF 1994. MANY OF THE ISSUES IMPACTING VALUES OF MINORITY INTERESTS IN CELLULAR PARTNERSHIP ARE STILL RELEVANT TODAY

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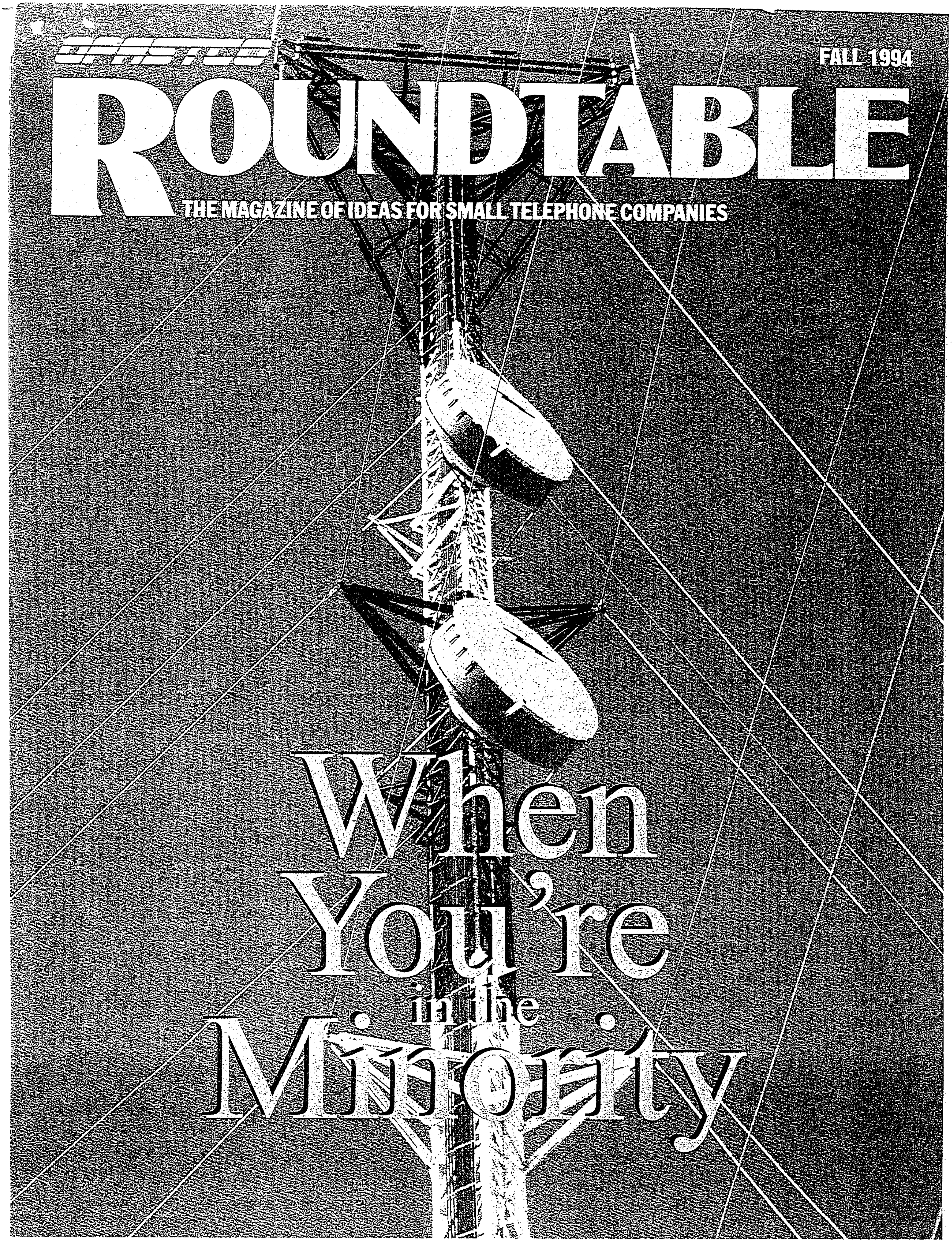

When You're in the Minority

A minority interest in a cellular property has certain limitations, but it may be worth more than you think.

by Michael Mazer

Minority interests in cellular markets are commonplace in the telephone industry, particularly for small independent telephone companies. Despite the fact that minority owners often have less-than-favorable experiences, minority cellular interests frequently have significant value. There are, however, a variety of factors that determine just what that value is.

BECOMING MINORITY PARTNERS

Independent telephone companies were in a quandary at the inception of the cellular industry. They recognized the potential value in cellular but were uncertain how to participate in the new industry. Filing individually for the lottery and risking being shut out of cellular entirely was not appealing. Assuming a lottery win, high construction and marketing costs, lack of cellular operating experience, and uncertainty over how quickly cellular might develop all loomed as further concerns.

Accordingly, many independents elected to hedge these risks by foregoing the lottery and entering into settlement agreements which provided a minority position in a market through partnerships formed with other independents and major telecommunications providers. Lacking the expertise and resources to operate a cellular system, many independents executed partnership agreements that gave the major telecommunications provider the right to manage the system; the independents received certain more limited rights.

Many independents now find themselves with little input into the financial and operational management of their cellular markets. Requests to majority partners for more information, better financial disclosures, and so on meet with varying success. Considerable frustration often exists because independents realize their cellular ownership is a valuable asset over which they have little or no control. Frustration rises further when they reflect that while capital calls were large and frequent during market construction, cash distributions are atypical now that operations are, or should be, generating cash.

This situation often leads independents to consider selling their cellular interests, but they soon discover that purchasers of cellular properties typically only are interested in buying markets which they can manage and effectively control. Consequently, locating a purchaser outside the existing partnership often is quite difficult. Nevertheless, because minority interests invariably sell at a discount, the notion of buying part of a cellular property at an attractive price is appealing to purchasers.

A critical exercise in valuing minority interests is to determine the appropriate discount from full majority value. But there are no magic formulas to determine an appropriate discount. Discounts range from a low of 0 to 20 percent if the minority piece gives the purchaser a controlling or veto-proof stake in the partnership (but such a scenario is rare), to more than 50 percent for an interest in a system where control already resides with the market's primary owner. Passive, non-controlling minority interests always will sell at a substantial discount to full majority value. However, minority interests with attractive partnership rights can be far more valuable.

PARTNERSHIP/MANAGEMENT AGREEMENTS

Partnership and management agreements determine how much control a minority owner has over its investment, thus, a careful review of these documents provides a better idea of the value of a minority interest.

The most critical issue is to determine whether the controlling partner has the right to perpetually manage the market. Can a minority owner, either alone or in conjunction with others, replace the system manager? Do the minority owners have the right to renegotiate the management agreement after it expires? Do the minority owners have the ability to review and change the market's operational budget? Do the minority owners have input into the amount and nature of capital spending and corporate allocations? A "yes" to any or several of these questions clearly enhances the value of a cellular minority interest.

Conversely, a minority interest is effectively devalued when partnership and management agreements allow the system manager carte blanche system operation or when the agreements give minority owners few rights to either replace the manager or influence the manager's performance. In such situations, cash distributions, which can add a positive dimension to a minority interest, often are very modest or even non-existent. This can further erode the value of a minority interest.

THE ISSUE OF CONTROL

Minority interest holders should take careful note of the control provisions within the partnership. There are times when a managing partner can gain control of a market by buying out some, but not all, of the minority partners. While rights of first refusal may mitigate this problem, they do not eliminate it. Minority owners should attempt to present a united front whenever one partner elects to sell, as this can help prevent a "divide and conquer" strategy that could give effective control to the majority partner.

Typically, if several minority owners sell in tandem, they have enhanced negotiating leverage which can lead to a substantially higher sale price. Working together, however, is difficult because the majority partner may make it financially attractive for any one minority partner to break ranks. Once effective control resides with the majority partner, the remaining minority partners immediately have a devalued asset.

RIGHTS OF FIRST REFUSAL

Most partnerships do have rights of first refusal. These rights, often conceived to protect minority owners, actually can depress prices. Because the majority owner knows it will see all offers, often it is content to "wait out" the minority partner until 1) an offer comes from an outside party that the majority partner might match, 2) the minority interest holder, unable to generate any offers, comes back to the majority partner and settles for a low price, or 3) the minority partner does not sell and the majority partner continues to manage the cellular market to its advantage.

But while rights of first refusal can make it difficult to receive bids for minority cellular interests, it is possible to obtain offers for the asset. Rights of first refusal may not apply when the sale of the parent company owning the minority interest is involved. Such a situation eliminates most of the negatives usually encountered with rights of first refusal.

A technique which may entice potential purchasers to the table is to offer a "break-up" fee in the event the purchaser's offer is matched under a partnership's right of first refusal provisions. This fee ensures the potential purchaser will receive at least some return on the time and effort it puts into making an offer on the minority interest if its offer is accepted but then matched by the majority owner.

But regardless of the rights of first refusal, if the minority interest is in a market that is profitable, well-managed, and has some element of control, the market generally will be attractive to at least some potential purchasers and offers will be made.

TAG ALONG/DRAG ALONG RIGHTS

The presence of tag along or drag along rights in partnership agreements can add considerable investment value to a minority interest. Tag along rights generally provide that no partner, including the majority owner, can sell its interest unless all partners are offered the opportunity to sell at the same price and upon the same terms. Accordingly, a third party can never buy control of the market without offering the control premium price to all owners. Such a provision effectively insulates minority owners from the abuses of multi-step takeover offers.

Drag along rights also can offer some measure of protection and value to minority owners. These arrangements typically allow a majority owner to compel a minority owner to sell upon the same terms and conditions accepted by the majority owner. Designed to allow a purchaser to eliminate minority owners, such agreements often help minority holders by increasing their ability to receive the control premium price for their interest. Furthermore, if execution of drag along rights is based upon a majority vote of the number of owners instead of a majority of percentage of ownership, this effectively can eliminate minority discounts and enhance liquidity for minority owners by giving minority owners a greater role in the decision to sell their interests at the control premium price.

THE FUTURE OUTLOOK

While independent telephone company owners of minority cellular interests frequently are frustrated that their holdings are valued at a discount to the market's overall worth, a bit of perspective is helpful. First, these assets originally were acquired at nominal cost. Second, while discounts from full majority value exist and probably always will, the value of a minority interest can be very substantial. But if a minority interest is well structured, the discounts involved are often quite modest.

As cellular continues to grow, cash distributions to minority owners will become both larger and more common. As distributions become more prevalent and significant, the incentive for majority partners to buy out minority partners at reasonable levels will likely increase. And finally, a minority owner can enhance the value of its investment and increase its ownership options by understanding and using its minority rights, working closely with other minority partners, and attempting to exert influence on the majority owner. ©