RADIO FINANCING:

A Guide For Lenders And Investors

DB08528365

By
Robin B. Martin
and
Erwin G. Krasnow

NAB™
BROADCASTERS

RADIO FINANCING:

A GUIDE FOR LENDERS AND INVESTORS

By

Robin B. Martin
The Deer River Group

and

Erwin G. Krasnow
Verner, Liipfert, Bernhard, McPherson and Hand

Copyright 1990. National Association of Broadcasters
All rights reserved
ISBN 0-89324-090-7

National Association of Broadcasters
1771 N Street, N.W.
Washington, DC 20036-2891
(202) 429-5300

TABLE OF CONTENTS

Page

LIST OF EXHIBITS v

ACKNOWLEDGEMENTS vii

I. EXECUTIVE SUMMARY 1

II. THE RADIO INDUSTRY—AN OVERVIEW 3

1. A Medium Positioned for the Future 3
2. "Narrowcasting" for Advertisers 3
3. Competitive for the Media Dollar 5
4. A Local Advertising Medium 5
5. A Service Business with High Operating Leverage 6
6. An Active Trading Market 6

III. OPERATING RADIO STATIONS 9

1. Basic Characteristics 9
   - A. FCC Regulation 9
   - B. Sources of Revenue 10
   - C. Programming 11
   - D. Transmission of Programming 12
   - E. AM vs. FM 13
   - F. Radio Groups 13
2. Organization of a Radio Station 13
   - A. The Programming Department 14
   - B. The Sales Department 15
   - C. The Technical Department 15
   - D. General and Administrative Department 15
   - E. People—The Key to Success 15
   - F. Managing a Competitive Radio Station 15

IV. VALUING RADIO STATIONS ... 19

1. The Market for Stations ... 19

2. Valuation Considerations ... 19
   - A. General Factors ... 19
   - B. Market Characteristics ... 20
   - C. Station Assets ... 21
   - D. Quantitative Factors ... 21
   - E. Seller Terms ... 21

3. Models for Valuation ... 21
   - A. Using Financial Statements ... 21
   - B. Cash Flow Multiples ... 22
   - C. Discounted Cash Flow ... 23
   - D. Comparable Sales ... 23

V. SPECIAL ASPECTS OF RADIO FINANCING ... 25

1. Cash Flow Lending ... 25
   - A. Lack of Hard Assets ... 25
   - B. Radio's Key Assets are Intangible ... 25
   - C. Securing the License ... 26
   - D. The Concept of Cash Flow ... 26
   - E. One Operator's Cash Flow is Another's Expense ... 27
   - F. Air Time Has No Traditional Fixed Cost ... 28

2. Uses of Financing ... 28
   - A. Acquisition Financing ... 28
   - B. Financing Construction Permits for New Stations ... 28
   - C. Financing Upgrades ... 29
   - D. Refinancing ... 29

3. Debt Financing—Typical Instruments ... 30
   - A. Senior Debt ... 30
   - B. Subordinated Debt ... 30
   - C. Equipment Financing and Leasing ... 31

4. Elements of Credit Analysis and Negotiation ... 31
   - A. Character ... 31
   - B. The Value of Security ... 32
   - C. Covenants and Restrictions, Subordination Agreements, and Credit and Yield Enhancements ... 32
   - D. Competitive Pricing ... 33
   - E. The Ideal Borrower Presentation ... 34

5. Relationship with the Operator: Understanding the Radio Station Following Closing ... 34
   - A. Communication with the Borrower ... 34
   - B. The Operator's Expectations of the Lender ... 35
   - C. Qualities Lenders Should Look for in an Operator ... 35

VI. RADIO AS AN EQUITY INVESTMENT ... 37

1. Investment Opportunities ... 37

2. The Investor's Role ... 37
   - A. Guidelines for All Investors ... 38
   - B. Passive Investments ... 38
   - C. Joint Ventures and Other Active Investments ... 39

3. Investment Strategy and Goals . . . 40
A. Maximizing Operating Strengths . . . 40
B. Types of Opportunities—Weighing the Risks . . . 40
C. Investment Goals . . . 41
D. Financing Strategy . . . 41

4. Matching the Investment and Operator—A Checklist . . . 42
A. Matching Goals, Objectives, Philosophy and Style . . . 42
B. Learning About the Operator . . . 42
C. Initiating the Deal . . . 43
D. Investor or Operator—Who Controls the Deal? . . . 43
E. The Operator's Expectations of the Investor . . . 44

5. Structuring the Deal . . . 44
A. Common Investments for Equity Money . . . 44
B. Pricing the Investment . . . 46

VII CONCLUSION . . . 47

VIII ABOUT THE AUTHORS . . . 49

IX APPENDIX: RADIO PUBLICATIONS AND OTHER PRODUCTS AVAILABLE FROM THE NAB . . . 51

LIST OF EXHIBITS

Page

I. U.S. Radio Station Advertiser Spending 4

II. Outlook for Advertising Spending on Radio Stations 4

III. Radio Advertising Revenues: 1980–1989 5

IV. National and Local Advertising Spending on Radio 6

V. Distribution of National and Local Radio Advertising 6

VI. Appreciation (Depreciation) in Station Values 7

VII. Top 10 Local Radio Advertisers 10

VIII. AM and FM Formats 1989 11

IX. Share of Day Radio Listening, AM vs. FM 13

X. Trend Analysis by Station Type: 1986–1988 14

XI. Average Station Income Statements by Market Size 16

XII. Radio Stations Sold and Dollar Volume: 1954–1989 20

XIII. Cash Flow Margin by Market Size 27

ACKNOWLEDGEMENTS

A number of our professional colleagues who contributed to this book deserve special credit for providing their expert advice and counsel: Jay Williams, Jr., Broadcasting Unlimited, Inc.; Bill Kennard, Dorothea Summerell and Michael Beller of Verner, Liipfert, Bernhard, McPherson & Hand; Richard L. Geismar; Kevin L. Reymond, Price Waterhouse; Jim Duncan, Duncan's American Radio, Inc.; Geoffrey B. Baker, Esq; J. Jeffrey Krumpelman, Central Trust Co., NA; Scott Fitzpatrick, Radio Business Report; Jim Taszarek, Phoenix Broadcasting, Inc.; Kathleen Meyher, Society Bank of Cleveland; Ray Suarez, Broadcast Capital Fund; and Bruce Bishop Cheen, Paul Kagan Associates, Inc.

Some sections of this book have appeared in the following publications:

- Robin B. Martin, *Broadcast Lending* (Washington, D.C., National Association of Broadcasters, 1984)
- Erwin G. Krasnow, J. Geoffrey Bentley and Robin B. Martin, *Buying or Building a Broadcast Station,* Second Edition (Washington, D.C., National Association of Broadcasters, 1988)

Cindy Chung of Verner, Liipfert, Bernhard, McPherson & Hand, provided invaluable support during the writing and editing of this book.

We would also like to express our sincere thanks to Teri Lepovitz, Senior Vice President, NAB Services, National Association of Broadcasters, who worked enthusiastically with us from the conception of the idea for this book right through to the final edit. Her colleagues at the NAB, John Abel, Mark Fratrik and Rick Ducey, gave much assistance during the editing phase and we appreciate their support.

I. EXECUTIVE SUMMARY

This book addresses two primary audiences: lenders and investors. However, lenders, investors and even broadcasters who read the various sections of this book should gain a better understanding of each other, how each approaches radio station opportunities and the perspective each brings to financing. This book is no substitute for a due diligence report, or for the loan or investment documentation lenders and investors require. Rather, it provides a background on the industry to lenders and investors and illuminates the perspectives that different players bring to a deal. It should prompt further questions and investigation. This book should also give broadcasters a better idea of how to work more effectively with financiers.

The beginning sections of this book will interest both lenders and investors. Section II discusses the overall radio industry, putting into perspective radio's distinctive features as compared to other advertising and entertainment media. Radio's unique selling points are described in some depth. In addition, a financial picture of the industry is presented to illustrate radio's historical growth of revenues and profits and its potential prospects for the future.

The workings of the radio station are examined in Section III, which describes both the operations and the economics of the typical station. Topics include: the hiring of staff, the positioning and marketing of a station, how the air product is produced and sold, and a discussion of expense categories.

The principles of radio station evaluation are covered in Section IV which also includes the concepts of selling a radio station and marketplace liquidity. Key elements include appraising both the tangible and intangible assets and understanding the concept of "stick value." (The bare value or "stick value," as it is sometimes called, of the license refers to the market value attributable just to the Federal Communications Commission (FCC) license.) For most potential buyers, the value of a station is determined by the perception of the operator's ability to improve operating performance; therefore, the "value" of the same station for different operators may be quite different. Projecting future results is discussed as an important step in evaluating a property.

Sections V and VI are specifically designed for the lender and for the investor, respectively. Most loans to radio stations are based on cash flow lending, which is discussed in detail. A look at the use broadcasters make of borrowed funds and typical ways lenders structure loans is coupled with a brief discourse on credit analysis and negotiation. The lender's relationship with the radio operator completes Section V.

Equity investment opportunities are the focus of Section VI. The topics covered range from the investor's role in a radio deal and investment strategy to the possible structures of deals. Finding the right investment and the right operator is a matter for keen attention by the investor and is discussed in detail.

The Appendix contains a listing of resources available from the National Association of Broadcasters covering a variety of general radio-oriented topics.

II. THE RADIO INDUSTRY: AN OVERVIEW

1. A Medium Positioned for the Future

Radio is the only medium, electronic or otherwise, that is truly flexible. It requires only the ear's attention to be fully appreciated. The technology can be contained in a small environment and transported virtually anywhere—in a car, in a headset, or near a swimming pool.

Radio is everywhere. With over 500 million radios and over 99 percent of homes equipped with an average of 5.6 radios per home, radio is virtually omnipresent in the United States. Over 95 percent of all automobiles have radios. Each week over 95 percent of all Americans listen to the radio. Americans, on average, devote more than three hours to radio listening every day. During the average day, radio reaches 86 percent of all teenagers and adults and 83 percent of adults at work. Over 57 percent of radio listening occurs away from home.

Historically, the radio industry has shown a unique ability to respond and adapt to market changes, competition and new technology. Changes in technology have improved the prospects for radio. New audio improvements (such as advances in digital processing, which reduces noise) have enhanced the quality of sound broadcast by radio stations. Over 90 percent of radio stations have at least one satellite receiving dish for receiving network and syndicated services, enabling stations to improve the quality and diversity of their programs. The market position of radio is further enhanced as CD recordings become an increasing part of a station's playlist.

The National Telecommunications and Information Administration, in a report on telecommunications in the year 2000, was bullish on the long-term prospects for radio: Radio cannot be eclipsed entirely by other audio services because of its portability and convenience. Although cassettes and compact discs are becoming common in automobiles, the high use of broadcast radio in cars, in walk-along sets, and as a means of waking up in the morning make most industry observers believe that radio is here to stay.[1]

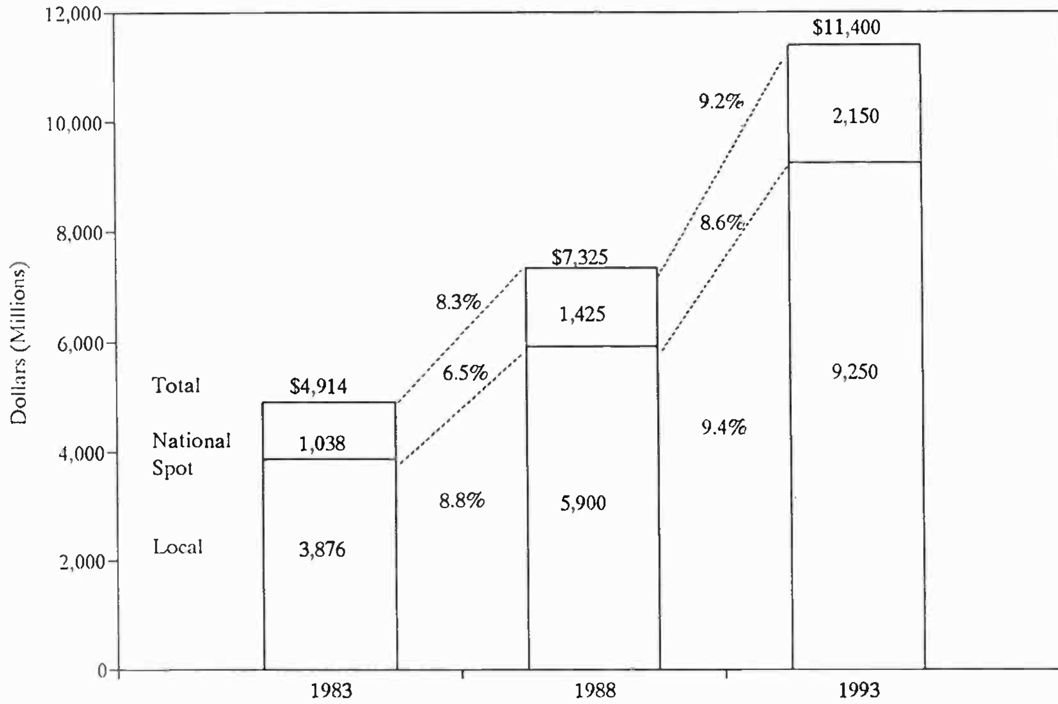
2. "Narrowcasting" for Advertisers

Radio is a distinctively "user-friendly" medium which gives advertisers the speed, flexibility and immediacy needed to compete in a media-saturated marketplace. As the most effective medium for reaching consumers while they are away from home or are involved in other activities, radio holds a special position as an advertising medium. Radio's attractiveness to advertisers comes from its ability to target programming to specific segments of the population and its low cost relative to other media. Through this "narrowcasting," advertisers are able to target hard-to-reach demographic and psychographic niches in a cost-effective manner.

Advertising media have been expanding at growth rates generally exceeding that of the general economy, as measured by the Gross National Product (GNP). Advertising's share of the American economy has increased from 2.36 percent of GNP (nearly $12 billion) in 1960 to 2.45 percent ($109 billion) in 1987.[2] During the 1980s, advertising grew at an average annual rate of 11.4 percent.[3] See Exhibit 1.

In an increasingly competitive economy, producers of goods and services need to educate potential customers about the existence and value of their products and services. The competition of similar retail products forces each producer to create a market niche for its product. Only advertising can create the awareness and the level of understanding needed for a consumer to make a buying decision. Studies show that advertising facilitates the entry of new products, informs consumers and results in lower retail prices. As a result, radio is relatively recession-resistant—it performs well both during soft economic cycles and high inflation.

Exhibit I
U.S. Radio Station Advertiser Spending



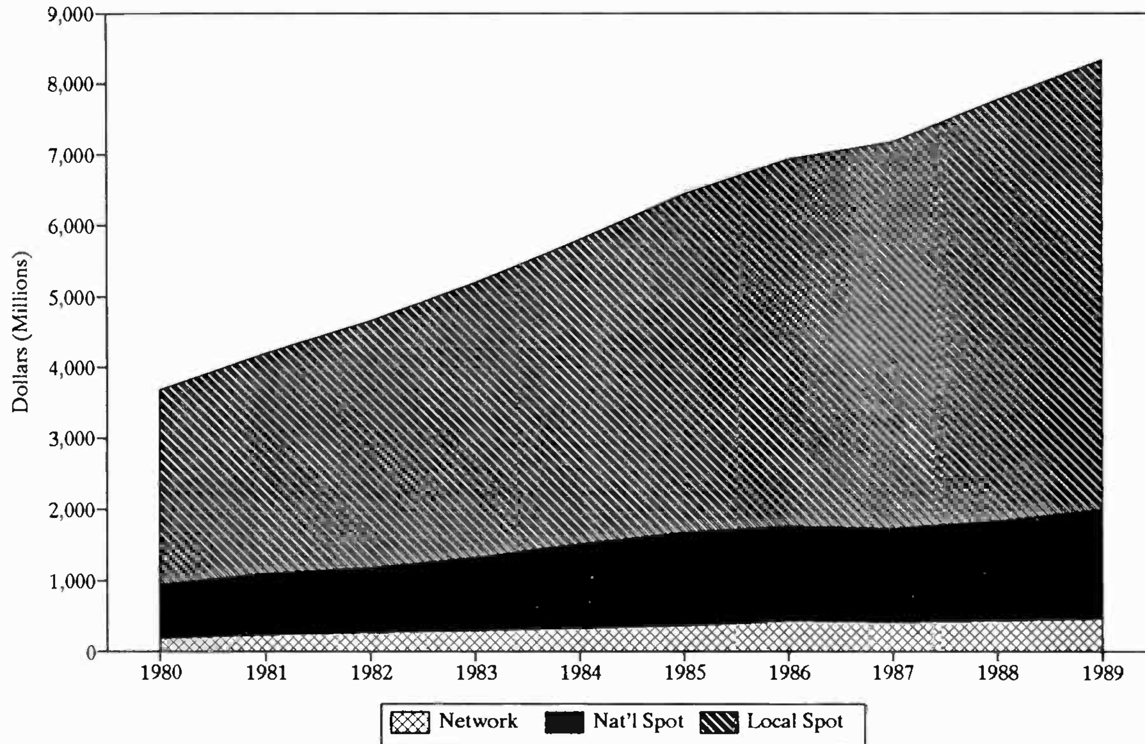
Source: Veronis, Suhler & Associates; Wilkofsky, Gruen Associates, Communication Industry Forecast.
Reprinted with permission.

Exhibit II
Outlook for Advertising Spending on Radio Stations ($ Millions)

Year	Local	National Spot	Total Station
1988	$5,900	$1,425	$7,325
1989	$6,380	$1,520	$7,900
1990	$6,950	$1,650	$8,600
1991	$7,600	$1,800	$9,400
1992	$8,450	$1,970	$10,400
1993	$9,250	$2,150	$11,400

Source: Veronis, Suhler & Associates. Wilkofsky Gruen Associates, Communications Industry Forecast. Reprinted with permission.

Exhibit III
Radio Advertising Revenues
1980 - 1989



Source: Bob Coen, McCann-Erickson. Used with permission.

3. Competitive for the Media Dollar

Despite the proliferation of advertising in television and other media, radio's share of measured media advertising has remained steady. Radio advertising in 1988 accounted for 10.5 percent of total measured media (newspapers, television, radio, cable) advertising, the same share as in 1987 and approximately the same as the average share over the last five years.[4] In 1988, advertisers spent $7.7 billion on radio, with $7.3 billion going to a total of 10,244 radio stations and $420 million going to the radio networks.[5] According to a report issued in 1989 by the investment banking firm of Veronis, Suhler & Associates, all measured-media advertising is expected tc increase at an average annual rate of 8.8 percent during the next five years, while radio station advertising is projected to grow at a slightly greater annual rate, 9.2 percent.[6] See Exhibits II and III. Some economists, however, are projecting a lower rate of growth based on current economic trends.

4. A Local Advertising Medium

Radio is primarily a local business. As of the beginning of 1990, there were 10,647 radio stations operating in the United States—of these, 4,971 were commercial AMs, 4,257 were commercial FMs, and 1,429 were noncommercial FMs. To be effective, radio broadcasters must meet local audience preferences. They must have strong ties to the local community. They must also develop support from among local advertisers.

Local sales are the backbone of radio's revenues and profits. Radio stations do not earn significant revenues from their network affiliates, unlike television stations. In 1988, local advertising accounted for 77.9 percent of radio station revenue.[7] See Exhibits IV and V.

As a result of the emphasis on local advertising, radio stations are sensitive to the strengths and weaknesses of local economies. Thus, radio stations in certain sections of the Northwest which enjoyed a vibrant economy in the late 1980s

Exhibit IV
National and Local Advertising Spending on Radio (**$ Millions**)

Year	National* Radio	Local Radio	Total Radio
1983	$1,334	$3,876	$5,210
1984	$1,517	$4,300	$5,817
1985	$1,700	$4,790	$6,490
1986	$1,771	$5,178	$6,949
1987	$1,743	$5,463	$7,206
1988	$1,845	$5,900	$7,745

Source: Veronis, Suhler & Associates. McCann-Erickson. Wilkofsky Gruen Associates, Communications Industry Forecast. Reprinted with permission.

*Network and national spot.

Exhibit V
Distribution of National and Local Radio Advertising (**Share**)

Year	National* Radio	Local Radio
1983	25.6%	74.4%
1984	26.1%	73.9%
1985	26.2%	73.8%
1986	25.5%	74.5%
1987	24.2%	75.8%
1988	23.8%	76.2%

Source: Veronis, Suhler & Associates. McCann-Erickson. Wilkofsky Gruen Associates, Communications Industry Forecast. Reprinted with permission.

*Network and national spot.

fared better than stations located in states such as Texas and Louisiana which suffered depressed economies in the same period.

5. A Service Business with High Operating Leverage

Radio is a service business. Virtually no inventories or materials are required to create the programming service provided. Companies that own radio stations normally have few tangible assets beyond those required to broadcast their signals and many companies lease some or all of their tangible assets. The intangible assets are comprised of the use of the license (which is granted to the licensee by the Federal Communications Commission and not owned by the licensee) and the goodwill of the station. (Unless a station has been sold, goodwill does not appear as an intangible asset on the financial statements.) Goodwill has a number of different forms. It includes the base of advertiser and listener support in the community and also the value of an ongoing operating staff of the station, as enhanced by the competence and longevity of individual staff members.

Radio is a service business marked by a relatively high level of fixed costs compared to variable costs. The fixed costs represent those for general overhead and administrative expenses, including the approximately 50 percent of a typical radio station's expenses earmarked for salaries. Salaries are in part a function of the format of the station—all-news and talk stations and those with music formats which rely on air personalities have relatively high salary expense compared to automated or satellite-fed stations which have a lower percentage of fixed costs devoted to salaries. The variable costs are primarily agency commissions (normally 15 percent of revenues) and music licensing fees (about 2 percent of revenues). Other significant variable costs include advertising and promotion, bad debt expense, travel and entertainment, and sales commissions to in-house sales staff. The relatively low level of variable costs creates a business with a very high degree of operating leverage when the station has become profitable. Once a station has reached the breakeven point, profitability increases dramatically. Thus, for every incremental sales dollar a high proportion falls to the bottom line.

6. An Active Trading Market

The increased growth of radio advertising coupled with the relatively fixed supply of radio stations has resulted in the appreciation in value of stations, especially FM stations in larger markets. The attractiveness of radio stations as an investment has been aided during the mid-1980s by the liberalization by the Federal Communications Commission of ownership restrictions—currently 12 AMs and 12 FMs

Exhibit VI
Appreciation (Depreciation) in Station Values

	Station Types			
	AM-Only	FM-Only	AM/FM	All Stations
Resold at Higher Price (#)	122	135	202	459
Resold at Lower Price (#)	154	28	43	225
Resold at the Same Price (#)	10	2	7	19
Average Ownership Period	4.8 yrs	4.3 yrs	4.8 yrs	4.7 yrs
Average Annual (Compound) Change	-4%	+20%	+18%	+10%
Median Annual (Compound) Change	-2%	+17%	+11%	+7%

Source: David E. Schutz, Radio Station Transfers. Reprinted with permission.

(14 AMs and 14 FMs if at least two are controlled by minorities), by the elimination of restrictions on the minimum period of time an owner had to operate a radio station before it could be sold, and by relatively low interest rates. As pointed out earlier, radio stations are able to generate high operating cash flows capable of supporting a significant amount of debt service.

There is a continual turnover of stations each year. A review of 703 radio station sales in 1985, 1986 and 1987 showed generally increasing prices for radio stations. See Exhibit VI. Compiled by David Schutz, now managing director of Hoffman Schutz Media Capital, Inc., a New York-based investment banking firm, the study showed that 65.3 percent of the stations were sold at a profit, 32 percent sold at a loss and 2.7 percent sold at their previous price.[8] FM stand-alones led the list with price increases, representing an average annual (compounded) growth of 20 percent. AM-FM combinations showed an average 18 percent increase in value (also compounded).

NOTES:

1. National Telecommunications and Information Administration, *Telecom 2000, Charting the Course for a New Century,* (Washington, D.C.: U.S. Department of Commerce, October, 1989), p. 530.
2. National Association of Broadcasters, *RadiOutlook: Forces Shaping the Radio Industry* (Washington, D.C.: National Association of Broadcasters, 1988), p. 128.
3. *Ibid.*
4. Veronis, Suhler & Associates, *Communications Industry Forecast* (New York, N.Y.: Veronis, Suhler & Associates, 1989), p. 48.
5. *Ibid.*
6. *Ibid.* at p. 53.
7. *1989 NAB/BFM Radio Financial Report* (Washington, D.C.: National Association of Broadcasters, 1989), p. vii.
8. David E. Schutz, *Radio Station Transfers—1988* (New York, N.Y.: Hoffman Schutz Media Capital, Inc., 1989).

III. OPERATING RADIO STATIONS

1. Basic Characteristics

With over 9,000 commercial radio stations licensed to communities of all sizes, there is no typical radio station. The diversity in the size of radio stations ranges from the small town station operation with five or six employees (often referred to as "mom and pop" stations) to major market facilities with over 100 employees. However, each radio station shares the following characteristics:

- Radio stations are licensed by the FCC to serve the public interest, convenience and necessity; licenses are renewed for a period of seven years.
- The license for a radio station cannot be transferred to a new owner without first receiving the prior approval of the FCC.
- The market for a radio station is defined by the city of license, frequency, power, tower height and tower location specified by the FCC.
- Although individual owners may legally own or control more than one station, every radio station is licensed separately to serve a specific community.

A. FCC Regulation

In the early 1920s, AM radio stations began transmitting in various cities around the United States. They were under virtually no regulation at that time. As more and more stations took to the airwaves, technical interference problems became severe. In separate Congressional Acts signed into law in 1927 and 1934, the federal government passed the Radio Act and then the Communications Act. The Communications Act of 1934 and its amendments are the basis for today's broadcasting regulations. Congress created the FCC to oversee the regulatory structure. The FCC is an independent federal agency controlled by five commissioners who are appointed by the President and confirmed by the Senate for five year terms. One commissioner is appointed chairman to serve at the pleasure of the President.

Much of the original philosophy of broadcasting regulation is based on the following premises that underlie an entire body of regulatory and court decisions:

- Stations must be licensed so as to ensure interference-free operation at the highest reasonable technical standard;
- Broadcasters use the airwaves as trustees for the public, and federal regulation is proper, constitutional and supersedes any claims of the states;
- Licensees operate as public trustees and therefore must be chosen in consideration of their qualifications and character;
- Stations may not be owned by aliens, representatives of aliens or corporations organized under the laws of any foreign government;
- Station licenses must be granted so as to ensure the most equitable distribution of radio services among diverse population and geographic areas of the country.

From a practical viewpoint, FCC regulations affect the individual station in two basic areas—ownership and operation. In ownership, the FCC limits the number of radio stations a single person or entity can own to 12 AM and 12 FM (14 AM and 14 FM for minorities); the Commission places certain restrictions on the amount of foreign ownership permitted and broadly defines the character qualifications needed to own a property; and the FCC requires all sellers and buyers of stations to complete a transfer application which is then available for public comment and requires Commission approval. This last requirement forces a delay in the transfer process that is of operational concern to buyers and sellers. Until the closing takes place following FCC approval, the buyer may not exercise any control over the

Exhibit VII
Top 10 Local Radio Advertisers

Rank	Type of Business	% of Total Advertising
1	Auto Dealers	10.7
2	Dept. Stores	8.4
3	Banks	8.0
4	Clothing Stores	7.7
5	Restaurants	7.0
6	Supermarkets	6.7
7	Furniture Stores	6.4
8	Bottlers	5.9
9	Appliance Stores	4.9
10	Savings & Loans	4.2

Source: Radio Advertising Bureau, Radio Facts, New York, NY, 1989. Reprinted with permission.

station's operation. Therefore, if a transfer is delayed three months after the sale is announced, the station employees may be understandably confused and concerned about the future of their jobs.

From an operational standpoint, the FCC has adopted detailed rules governing engineering standards and procedures stations must follow. These pertain to the operating parameters of the transmitter, the location of the tower, tower height, frequency, power, and so forth. The FCC also monitors the station's compliance with equal employment opportunity (EEO) regulations, political broadcasting requirements, and the general responsiveness of the licensee to community needs and problems. The Commission maintains a field staff that spot-checks the technical and paperwork compliance of stations on a random basis.

B. Sources of Revenue

Media aimed at a mass audience derive their operational revenues from relatively few sources. For the electronic broadcast media, almost all revenues come from advertising, which may be broken down into local, regional, and national advertising. Mass print publications receive significant revenue from circulation income not available to radio or TV, in addition to a large share of advertising revenues. Cable television derives most of its revenues from subscription charges, with an increasing but still moderate amount coming from advertising.

The bulk of local radio advertising comes from local retail businesses, such as auto dealers, banks, restaurants, and department and specialty stores. See Exhibit VII. National or regional advertising revenues are mainly derived from either retail chain stores (such as fast-food restaurants), discount department stores, regional specialty shops, or manufacturers or providers of goods and services such as cosmetics, soft drinks, airlines, cars, and brand-name foods.

Each advertiser develops a marketing and advertising strategy which is then implemented either by an employee of the concern buying the advertising (this is the case with most small local businesses) or by an advertising agency acting on behalf of the business. All national, most regional, and some local businesses use agencies. Agencies charge a fee usually based on an hourly consulting charge or approximately 15 percent of the total advertising expenditure for its services. The 15 percent commission is normally added by the station to the basic ad cost or deducted from a rate specially constructed for agency buyers.

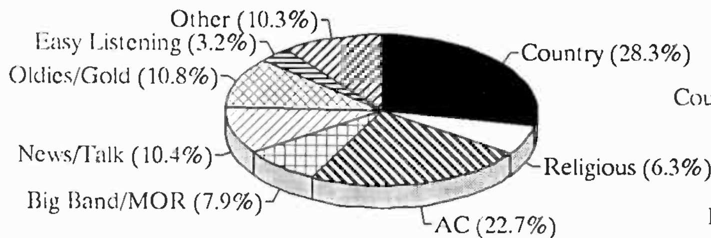
Most stations sell discrete units of advertising, such as 10-second, 30-second, or 60-second "spots." Some stations offer longer units, such as five minutes, while others offer to sell entire half-hour or longer programs sponsored by the advertiser. An advertiser may buy "run of schedule" (ROS) advertising, which consists of spots placed in a variety of time periods during the broadcast day. The advertiser may buy particular dayparts, or even fixed-position spots that run at particular times. Or the advertiser may buy sponsorships of special features, such as news, weather, or sports events. Generally, the more specific the time period requested and the fewer the spots an advertiser commits to in a schedule, the higher the per spot price.

One source of advertising revenue available both nationally and locally is "co-op." Under a co-op plan, a manufacturer will pay for part or all of a local distributor's media costs in placing advertising. The local distributor is reimbursed by the manufacturer after the manufacturer has received confirmation that the spots were broadcast and were paid for by the local distributor. Many retailers, however, are unaware of the availability of co-op dollars or are unwilling to process the paperwork to satisfy the manufacturers.

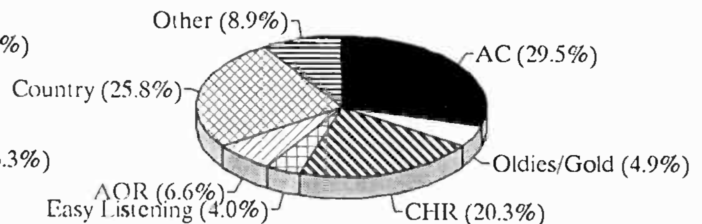
The differences between radio's appeal to the listener and the appeal of other media are reflected in the particular mix of advertiser categories on radio. Radio projects an audio image which is a powerful tool in creating innovative mental images to sell a product. However, some local advertisers still believe that hard-copy print or moving-image television is the only way to "show" a product or service. Most local

Exhibit VIII

AM Formats - 1989



FM Formats - 1989



Source: 1990 NAB Radio Programming Report.

and regional supermarket chains and many clothing outlets maintain art departments for pasting up newspaper ads. The radio industry and individual stations must continue to educate retailers about radio's effectiveness in increasing traffic for their stores. Each year, more and more advertisers include radio in their mix and find that it produces results. Fewer and fewer advertisers decline to use radio at all.

Other sources of revenue, in addition to the standard radio advertising, are being developed all the time. For example, some stations sell blocks of time to religious organizations. Some FM stations sell the use of their subcarrier channel to background music services. Other stations program channels with advertiser support on the local cable television system. Many broadcasters use their facilities to co-promote local concerts and other for-profit events. Also, AM and FM towers have rental value to nonbroadcast users, such as paging services and microwave communications companies.

A number of stations also barter or "trade" commercial time in return for merchandise or services of advertisers, rather than for cash. This use of advertising time (commonly referred to as "trade deals") should be watched carefully, for it can lead to abuse if not controlled and can diminish the cash value of the advertising time. Bartering is most useful for acquiring assets, services or merchandise from a business that will not otherwise buy time on a cash basis.

C. Programming

Although the majority of radio stations employ music formats, there is great variation among the 9,000 plus commercial stations on the air. Some stations broaden their appeal by daypart programming—the use of format variations, each suited to a different part of the day. For example, these stations may schedule all-news programming during drive times, shifting to middle-of-the-road music at other times.

Music formats on radio are increasingly diverse and specifically targeted to individual markets. In many instances, the selection of a music format is based upon audience research. Some broad format groups include adult contemporary (AC), contemporary hit radio (CHR), album-oriented rock (AOR), top 40, soft rock, classic rock, heavy metal, and "oldies." Of these, adult contemporary is probably the most common format for successful stations in the top 100 markets. The adult contemporary format has several variations, such as oldies-based AC and hip-AC. Country, another popular radio format, draws particularly high ratings in the South and the West. Easy listening, a format combining instrumental music and soft vocals, appeals to older demographics and is represented in most radio markets. Other popular music formats include big band or nostalgia, urban contemporary, New Age, gospel, religious and classical music. See Exhibit VIII.

Radio stations use information programming, as a stand-alone format, within music formats, or combined with talk. Representing only about 2 percent of all fulltime radio formats, all-talk stations typically combine drive-time news programming with daytime and late-night in-studio and telephone interviews using telephone conversations with listeners. AM and FM stations do not normally target the same audiences—thus, many AM stations favor non-musical formats to reach an older audience that tends to prefer AM radio.

Certain radio formats normally attract more advertising revenue than other formats for the same size audience reached. The active nature of such formats in engaging the listener is a major factor in this phenomenon. The "power

ratio," or market revenue share divided by audience share, of a station reflects the strength of its format to produce revenues.

D. Transmission of Programming

The geographic listening area of a radio station is defined in terms of "coverage contours," i.e., imaginary signal "boundaries" within which the signal strength from a station will equal or exceed a given value. The strength of a radio signal is expressed most commonly in millivolts per meter (1/1000 of a volt or 0.001 volts per meter). Signal strength for FM stations also may be referred to in terms of decibel units above one microvolt or "dBu." The method of expressing the value is not significant; the higher the number, the stronger—and hence better—the signal. The coverage of an FM station is determined by the station's effective radiated power (ERP), the height of its antenna, expressed as the height above average terrain (HAAT), as well as by the antenna's "directional" nature. For FM stations, the higher the ERP and the HAAT the better, because increases in either improve a station's coverage. For AM stations, it is desirable to locate the transmitter in a low, watery area which provides good ground conductivity for the signal.

There are two basic types of radio broadcast transmission services. The radio service originally known as the standard broadcast service is AM (amplitude modulation) and operates on frequencies between 540 and 1600 kiloHertz, each separated by 10 kiloHertz. In 1990, the AM band will be extended to 1705 kiloHertz. The second principal type of radio broadcasting is FM (frequency modulation) and operates between 88.1 and 107.9 megaHertz with 100 channels of 200 kiloHertz width each. FM channels can be designated by frequency (e.g., 88.1 megaHertz) or by channel number (e.g., Channel 201 is 88.1 megaHertz), but the AM band is designated only by frequency and does not use channel designations.

The paths of AM and FM signals differ from one another. Ground waves (radio waves which travel in the earth) create AM's primary service area. Other waves project upward into the sky from the transmitter (referred to as sky waves) and have a significant effect on the coverage capabilities of AM stations during nighttime hours. At night, the skywave portion of signals in the AM frequencies is reflected back to the earth by electrical particles located in the ionospheric portion of the atmosphere. The bouncing of sky waves, often over thousands of miles, permits AM signals to skip over long distances. While this skipping effect increases the number of stations available for listening in evening hours, it also increases the opportunity for "interference" of the signals caused where two or more stations operating at or near the same frequency (i.e., dial position) can be picked up by a radio receiver. As a result of the skywave phenomenon, some AM stations must cease operation near sunset (stations commonly referred to as "daytimers") while other AM stations must reduce power and/or utilize a directional antenna to prevent interference.

Another factor affecting coverage is a station's frequency or dial position, a factor of particular importance to AM stations. As a general rule, the lower the frequency of an AM station, the further its signal will tend to travel at the same transmitter power level. Also, since more space is devoted on some AM receivers toward the lower end of the dial (e.g., near 550 kHz, etc.), listeners often find it easier to tune the signal of AM stations on the lower frequencies.

The FCC, in order to assure the most efficient use of the broadcast spectrum, has established a classification system for both AM and FM stations. AM stations are grouped into four classes of frequencies according to their coverage characteristics. Class I stations operate on "clear" channels (they share the channel with only one or two other stations). Class I stations operate with power up to 50 kw; these stations cover large regions of the United States. Class II stations, which are assigned power ranging from a minimum of 250 watts and a maximum of 50 kw, operate on clear channels and must protect Class I stations. Class III stations (located on regional channels) commonly operate with a maximum power of 5 kw and are intended to serve the city or town and adjacent areas within 35 miles of their city of license. Class IV stations operate on "local" channels with a maximum power of 1 kw and cover about a 20-mile radius.

The FCC has established three basic classes of frequencies for commercial FM stations. Class A stations, the least powerful of FM stations, operate with maximum power of 3 to 6 kw ERP and are restricted to an antenna height of 328 feet above average terrain. Class A stations have a coverage radius of about 15 to 18 miles and are located in all parts of the United States. Class B stations are licensed to Southern California and the Northeastern quadrant of the United States and may operate with power of up to 50 kw ERP with a maximum antenna height of 492 feet. The coverage radius of Class B stations is about 33 miles. Class C stations, the most powerful FM outlets, are licensed to markets in the rest of the nation and may operate with power of up to 100 kw ERP and a maximum antenna height of 2,000 feet. Class C radio waves carry on the average 40 miles from their point of transmission. In the 1980s, the FCC introduced four new subclasses of FM stations in an attempt to provide additional radio service: Class C1 stations, which are authorized to transmit up to 100 kw ERP with antennas not exceeding 984 feet; Class C2 stations, with power of up to 50 kw ERP and antennas not in excess of 492 feet; Class C3 stations, with power of up to 25 kw ERP and antennas up to 328 feet; and Class Bl stations, with power of up to 25 kw ERP and antennas up to 328 feet. In 1989, the FCC authorized Class A stations to increase power from the previously authorized

Exhibit IX
Share of Day Radio Listening, AM vs. FM

Year	Share of Listening on AM Stations	Share of Listening on FM Stations
1983	33.7%	66.3%
1984	30.6%	69.4%
1985	28.2%	71.8%
1986	27.8%	72.2%
1987	25.5%	74.5%
1988	24.3%	75.7%

Source: Veronis, Suhler & Associates, RADAR, Wilkofsky Gruen Associates, Communications Industry Forecast. Reprinted with permission.

3 kw to 6 kw ERP so long as they meet certain mileage separation requirements. Also in 1989, the FCC allowed FM stations to use directional antennas, thereby enabling some stations to relocate their antennas without causing interference to other stations.

E. AM vs. FM

One of the most significant trends in radio during the 1980s was FM's increase in audience, share and revenue and AM's decrease in these categories. See Exhibits IX and X. One of the main reasons for the growth of FM is its superior sound. The sound quality of the AM service is generally inferior to FM for several reasons. First, the AM band is more vulnerable to atmospheric interference and noise. Interference from stations on the same and adjacent frequencies is a problem with nighttime AM broadcasting, but not with FM. Second, most electronic products, from hair dryers to personal computers, emit radio waves which interfere with AM broadcast stations. An FM signal is generally free of AM's annoying static and has excellent obstruction penetration capability. Third, AM stations have been allocated more liberally than FM stations, with stations packed more tightly in the AM broadcast band. Therefore, AM stations have not been able to transmit signals with equal fidelity to FM. Music listeners especially appreciate the greater sound fidelity of FM receivers because FM music quality is roughly comparable to that of cassette tapes or records. However, new standards have been developed to improve AM broadcast and reception quality by reducing station-to-station interference problems. By order of the FCC, all AM stations should have implemented National Radio Systems Committee (known as NRSC) standards by mid-1990. Additionally, the NRSC has developed a set of guidelines for improved AM radio receiver design. It is expected that many new AM radios will incorporate these improvements.

Radio listening trends have moved sharply in favor of FM stations. In 1988, FM constituted 75.7 percent of total radio listening. FM radio has become the dominant service for music listening because of its superior reception quality. Shifts in listenership have also corresponded to the increase in the number of FM stations. Most new radio stations in the 1980s were FM stations.

F. Radio Groups

There are significant efficiencies in the joint operation of AM and FM stations in the same community. Typical AM/FM combinations can result in savings in equipment of as high as 30 percent and salary savings of 35 percent over what separate operations would cost (in 1989, only 43.5 percent of AM stations were stand-alone operations). Even more significant economies result when AM and FM stations simulcasted their programming; in 1989, about 37 percent of AM/FM "combos" simulcast their entire program schedule.

The owners of multi-station groups of radio stations also enjoy savings on equipment and supplies as a result of their group purchasing power and are often able to attract as employees individuals whom the owner of a single station could not afford. Group ownership allows the owners to spread the costs in such areas as accounting (e.g., centralized payables and cash management), programming, and senior management, and increased bargaining leverage with national sales representative firms, program suppliers, other vendors and some advertisers. Employee benefits programs are usually lower in cost, as they cover a larger employee group. Similarly, the cost of insurance may be lower because premiums can be negotiated on a group basis. In addition to the benefit of diversification of risk resulting from the ownership of many stations, a group owner often has greater financial flexibility to withstand or initiate program format attacks in a particular market.

2. Organization of Radio Station

As noted earlier, there is no typical radio station which conforms to a standard organizational chart. Yet all radio stations need to perform four basic functions: 1) programming, 2) sales, 3) technical and 4) general and administrative. These functions are performed by departments which are discussed below.

Exhibit X
Trend Analysis by Station Type: 1986-1988

	1986 Average	1987 Average	1988 Average	Average Annual Change
Daytime AM Stations				
Network Compensation	$6,759	$6,594	$2,748	-36.2%
Nat'l/Reg'l Advertising	$45,210	$32,976	$35,986	-10.8%
Local Advertising	$224,466	$172,886	$215,974	-1.9%
Total Time Sales	$276,434	$212,456	$254,707	-4.0%
Total Net Revenue	$261,294	$203,049	$243,686	-3.4%
Total Expenses	$268,921	$195,079	$228,405	-7.8%
Pre-Tax Profit	($7,627)	$7,969	$15,282	N/A
Cash Flow	$31,683	$35,842	$54,189	30.8%
Fulltime AM Stations				
Network Compensation	$25,873	$27,998	$21,876	-8.0%
Nat'l/Reg'l Advertising	$252,085	$236,451	$201,854	-10.5%
Local Advertising	$887,299	$888,516	$740,497	-8.6%
Total Time Sales	$1,165,257	$1,152,965	$964,228	-9.0%
Total Net Revenue	$1,038,048	$1,020,025	$873,637	-8.3%
Total Expenses	$982,035	$966,086	$788,167	-10.4%
Pre-Tax Profit	$56,013	$53,939	$85,471	23.5%
Cash Flow	$153,161	$171,907	$173,834	6.5%
AM/FM Stations				
Network Compensation	$17,839	$18,023	$20,143	6.3%
Nat'l/Reg'l Advertising	$313,104	$280,664	$271,769	-6.8%
Local Advertising	$1,071,712	$1,058,822	$1,058,264	-0.6%
Total Time Sales	$1,402,655	$1,357,509	$1,350,175	-1.9%
Total Net Revenue	$1,253,985	$1,224,037	$1,222,213	-1.3%
Total Expenses	$1,189,409	$1,203,254	$1,157,406	-1.4%
Pre-Tax Profit	$64,575	$20,784	$64,807	0.2%
Cash Flow	$256,440	$242,823	$290,286	6.4%
FM Stations				
Network Compensation	$17,437	$19,312	$23,683	16.5%
Nat'l/Reg'l Advertising	$291,442	$299,620	$314,851	3.9%
Local Advertising	$1,103,457	$1,193,459	$1,160,608	2.6%
Total Time Sales	$1,412,336	$1,512,392	$1,499,142	3.0%
Total Net Revenue	$1,245,267	$1,330,277	$1,333,123	3.5%
Total Expenses	$1,162,270	$1,250,231	$1,225,949	2.7%
Pre-Tax Profit	$82,997	$80,045	$107,174	13.6%
Cash Flow	$252,234	$291,156	$321,468	12.9%

Source: 1989 NAB/BFM Radio Financial Report.

A. The Programming Department

The programming department is the heart of the station. It provides the on-air product that attracts listeners and sells advertisers. Usually a program director or operations manager heads the department, which may also include other functions such as news, sports, and promotion. (Some medium and large market stations have separate news, sports or promotion departments.) This department is responsible for implementing the programming strategy and philosophy

developed by the general manager and program director. Programs may originate live from a local studio, play over a tape automation system, or be rebroadcast from a distant satellite source.

Elements that comprise a local station's broadcast day often include music, weather, local and national news, features such as talk shows, public service broadcasts, sports broadcasts, and a host of other special programs created or acquired for a local station. The purpose of the programming department is to develop a format of information and entertainment that fits a need of the community, that is saleable to advertisers, and within a budget set by the station's management. Even including those stations using automated or satellite-delivered long-form (hours at a time) programming, every station's sound is unique. No two have the same character, no two are localized the same way, and no two have the same attractiveness to listeners and advertisers.

B. The Sales Department

The sales department consists of a sales manager, a sales force of local "account executives" and a regional/national representative firm. This sales team packages the station by developing rates for commercials and features to sell. Individual salespeople are costly to train and very valuable assets of a radio station. Many training courses and consultants are available to assist local management in sales development, but the key to increasing sales is hiring the right people and managing them well. A station with a sales team that has worked together for an extended period of time and is well managed and motivated is usually successful. See Exhibit XI.

The smaller the market, the more critical are the relationships which salespeople develop with their accounts. With each additional sales call on the same account, the station's account executive has a better understanding of the client's business, personal desires and needs. That improved understanding, in turn, allows the salesperson to create advertising plans for the client that meet their expectations and fulfill their business objectives. Many stations use the "consultant sell" approach. This method projects the salesperson into the role of an advertising consultant to the client, advising the client on the broad picture of advertising opportunities for the business and in the community, while at the same time selling the virtues of radio and the station.

C. The Technical Department

The technical or engineering department is now fairly streamlined since the requirements for technical maintenance, which had been subject to strict FCC regulation, have been relaxed during the 1980s. Those stations with complex systems employ full-time chief engineers. Others with less complicated equipment may hire the services of outside contract engineers who live in the area. Local engineers, whether contract or employed, perform the routine logging requirements of the station and maintenance on all equipment, help design new studios, buy new equipment, and install simple additions to the existing plant. Consulting engineering firms offer their services to stations for the major engineering tasks, such as applying to the FCC for new facilities, changes in tower height or antenna location, increase in power, and so on. For most stations, though, the bulk of the work to be done on a technical basis is studio and transmitter-related maintenance.

D. General and Administrative Department

The general and administrative area is the one that includes the functional areas that make up the "back office"—accounting and administration. A station may designate the general manager (GM) as the chief administrator, although the GM is often considered in the sales department to emphasize his or her critical role as the lead salesperson. Many stations employ a full-time full-charge bookkeeper or office manager who is responsible for billing, managing accounts receivable and cash disbursements, maintaining the general ledgers, and preparing financial statements. An outside accounting service is sometimes employed to produce the financial statements and prepare the payroll, thus reducing internal personnel needs. This department is the catch-all for duties and functions not related to any other department, such as liaison with rental property owners, taxing authorities, utilities services, legal and accounting firms, and so on. As computer hardware and software becomes less expensive, more stations are automating their traffic (the scheduling of programming and commercials), billing, and general ledger functions.

E. People—The Key to Success

In every department the key ingredient for success is good people. These are people who not only have skills and intelligence but who also have a commitment to the radio station and the community. It is those people who spend inordinate amounts of time working at the station because they love it and they want to succeed. Department heads are the most important people at the station, for they create the atmosphere and work environment for the rest of the staff. A radio station thrives on high morale. The more excited everyone at the station is about the on-air product and the ability of the station to be successful, the better its chances of winning. A radio station sells excitement and entertainment that can only be created by motivated and competent people.

F. Managing a Competitive Radio Station

In each one of these four departments, the management team must have a clear strategy and a plan for its execution.

Exhibit XI
Station Income Statement by Market Size - 1988
($ Thousands)

	Large	%	Medium	%	Small	%	Very Small	%
Revenue (a)								
Network	$154	1.9%	$29	1.5%	$6	0.9%	$3	1.2%
National	$1,878	23.3%	$416	21.5%	$113	16.1%	$23	9.4%
Local	$6,017	74.8%	$1,486	77.0%	$582	83.0%	$219	89.4%
Total Time Sales	$8,049		$1,931		$701		$245	
LESS Comm.	$1,257	15.6%	$250	12.9%	$42	6.0%	$6	2.4%
PLUS Other	$125		$46		$19		$5	
Net Revenues (b)	$6,917	85.9%	$1,727	89.4%	$678	96.7%	$244	99.6%
Operating Expense (c)								
Engineering	$244	4.6%	$73	4.2%	$32	4.7%	$12	5.1%
Program	$1,245	23.4%	$329	19.0%	$147	21.6%	$52	22.1%
News	$248	4.7%	$54	3.1%	$25	3.7%	$10	4.3%
Sales	$1,065	20.0%	$337	19.5%	$140	20.6%	$41	17.4%
Promotion	$881	16.6%	$150	8.7%	$35	5.2%	$4	1.7%
Gen. & Adm.	$1,633	30.7%	$787	45.5%	$300	44.2%	$116	49.4%
Tot. Oper. Expenses	$5,316		$1,730		$679		$235	
Pre-Tax Income (d)	$1,601	23.1%	($3)	-0.2%	($1)	-0.1%	$9	3.7%
LESS								
Deprec.& Amortiz.	$363		$222		$74		$27	
Interest	$246		$158		$45		$14	
Pre-Tax Cash Flow (e)	$2,210	32.0%	$377	21.8%	$118	17.4%	$50	20.5%

(a) Revenue percentages are shares of Total Time Sales. (b) Net Revenue after agency commission expenses and addition of "other" revenues. Percentages are shares of Total Time Sales. (c) Department expense percentages are shares of Total Oper. Expenses. (d) Pre-Tax Income percentages are shares of Net Revenues. (e) Cash Flow is Pre-Tax Income plus Depreciation & Amortization plus Interest. The percentages are shares of Net Revenues.
Source: NAB/BFM 1989 Radio Financial Report.

The programming department must have a good picture of the competition—its strengths and weaknesses—and the desired audience that each station is targeting in the market. Armed with that information and a sense of its own station's strengths and weaknesses, the team can develop a programming plan that addresses the desired audience. The implementation plan should include such elements as the requirements for personnel; live or automated entertainment

fare; sports and other features; and wire, network, and local news services. If the station is in a market surveyed by Arbitron or Birch (currently the only two national radio rating firms), the programming department must also plan for additional promotional activity to position the station for success during critical rating periods.

In the sales department, finding the right people, managing them and keeping them are the keys to long-term consistent performance. If there is high turnover in salespeople, the advertising community will not be able to develop relationships with the station conducive to increasing sales volume. The sales manager (or general manager if acting in that capacity) must be a solid individual, have a close knowledge of the community, know how to identify, hire, and train new salespeople, and be keenly aware of the internal relationships between the sales, programming, engineering and accounting departments that are critical to the station's success.

Both the engineering and general and administrative departments are service departments that provide support for the sales and programming departments. The equipment at the station must function properly and provide the best possible sound for the listener at all times. A station cannot expect peak listenership or strong programming performance if the production or transmitting equipment is poorly maintained or not state-of-the-art. Listeners do not know what state-of-the-art equipment looks like, but they do know which station in town sounds the most pleasing and the most professional. The back office must give the sales staff the best information possible with respect to the current status of receivables for the station's clients, spot availabilities, and each salesperson's performance. Management and ownership reports are critical to the operation of any small business, and owners must have direct control of such reports as monthly profit and loss statements, balance sheets, payroll summaries, and aged accounts receivable and payable lists. The business manager also needs to monitor the filing requirements of all governmental agencies, prepare the year-end financial statements and help prepare federal, state and local tax returns. The business manager and the general manager must also coordinate the financial audit and tax return review with the station's independent accounting firm.

IV. VALUING RADIO STATIONS

1. The Market for Stations

Many radio stations in smaller markets, or ones that sell for low prices, are sold directly by the sellers to buyers. Brokerage firms are available to assure the seller that potential buyers are screened before they see the financial data or physical plant of the station. Most sellers are legitimately concerned about maintaining the confidentiality of the sale because information leaks can damage a station's image. If the station's employees become aware of the sale without being told by management, their respect for the owners' honesty can be compromised. Some employees fear for their jobs during a sale and begin looking for new positions immediately. Competing radio stations use such information to advise advertising clients not to buy time on the station being sold, implying that there may be major changes at the station.

There is an active market for the sale and purchase of radio stations. See Exhibit XII. About 10 percent, or 800–1,000, of all radio stations change hands each year. The bulk of stations that are up for sale are sold within six to nine months after the initial offering, but there are wide variations on sale times as certain categories of stations are studied. For instance, daytime AM stations in competitive markets take a longer time to sell, while highly profitable full-power FM stations in growth markets sell quickly. The pricing and flexibility of the terms of the sale as set by the seller also determine the speed of a sale.

Stations are bought because buyers want to purchase an existing stream of revenue or because they feel they can do a better job of increasing sales and cash flow (and therefore future value) than the seller was able to do. (Because this book focuses on the financing of station transactions, we may refer generally to the "buyer" but the phrase encompasses the buying entity, the investor and the lender.) The prices paid for most properties indicate the extent to which buyers foresee substantial improvements in performance. It stands to reason, then, that the value of a property depends greatly on the plans and expectations of each buyer. One buyer may see little growth in a station and be willing to pay a certain price for it; another buyer with a different perspective may see an opportunity with the resources available to build the station dramatically and therefore may offer a much higher price for the same station. Who is right? Both are using their best judgments about the future of the station. Each proposed acquisition must therefore be judged on the credibility of the past record and performance of the buyer. If the buyer has judged situations correctly in the past, has a record of strong operating experience, and has the resources to implement the business plan, then that buyer's plan is just as likely to succeed as that of someone with lower expectations.

There are appraisers who specialize in making independent valuations of radio stations. If an appraisal is used to value a property, remember that the appraiser will use yardsticks and methods of determining value that may not incorporate the wisdom and planning skills of an individual buyer. This may tend to undervalue a property if the buyer is astute, or it may overvalue a property if the buyer is not experienced. A good appraisal will contain detailed assumptions about future performance. Most radio station appraisers are experts in the field and their estimates of value can be relied on as true indicators of market price. As in any industry, however, the consistency of appraisal figures may vary depending on the qualifications and experience of the particular appraisers.

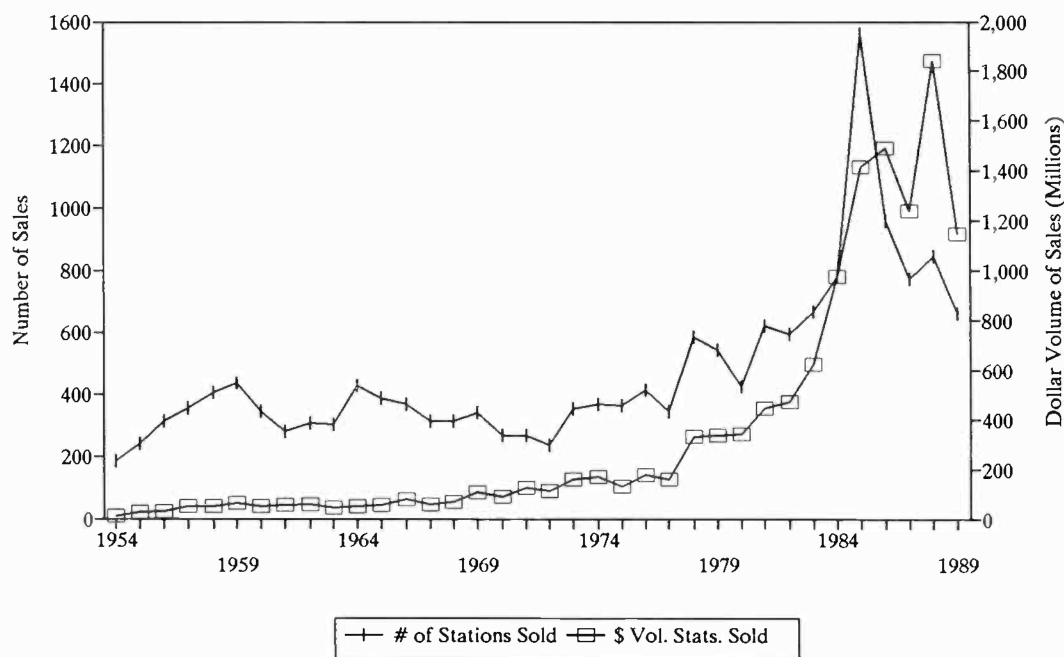
2. Valuation Considerations

A. General Factors

A major consideration in any valuation of a broadcast property is the supply of comparable stations and the

Exhibit XII
Radio Stations Sold and Dollar Volume

1954-1989



Source: Broadcasting, February 5, 1990, p.41. Reprinted with permission.

demand for that type of property. The supply and demand picture encompasses both the national and the local market in which the property resides and interacts. The marketplace conditions affect the prices agreed to by buyers and sellers of similar stations and ultimately influence the price of the station in question.

An important factor that affects prices is the general health of the local economy (and the national economy, if national advertising is significant for the station). During a recession or economic downturn, some retailers cut back on the amount of advertising and generally resist paying premium rates. This tends to lessen the growth of station revenue and cash flow and to lower station multiples. In good times, stations may sell out their spot inventories relatively easily, allowing higher rates to be charged and increasing revenues and cash flow. As a consequence, station values will go up. Another factor which directly affects the availability of financing (and hence prices) is prevailing interest rates.

B. Market Characteristics

Information on the financial condition of the area served by the station is critical to the station value. A review of the station's financial statements and sales reports will reveal strengths or weaknesses of the sales staff. It is possible that the analysis will show categories of business which can be targeted and reached for future sales. The interaction and match between the audience being reached and the potential audience, and the present and potential advertisers, is an important exercise in evaluating the station's position in the market. The buyer must consider overall economic trends in the area for factors such as retail sales, commercial relocations, disposable income, dependence on government spending or one or more major employers, median income trends, median age levels, and the number of families relocating to the area. All of this information will result in a useful financial profile of the market.

The key factor to estimate is the overall dollar value of advertising in the area to be served and the portion of those expenditures which can be garnered by the station. In making projections of revenues, evaluation of audience research studies for the station is particularly important in view of the direct relationship between audience positioning and advertising business potential. An analysis of audience research for the station's market can reveal whom the station is reaching, whom it can reach and, as naturally follows, the audience advertisers will reach by buying spots on the station. Many knowledgeable buyers say that they do not buy a station, they buy a market. For these reasons, it is essential potential buyers learn about the present makeup and potential for growth of the market in which the station is located.

C. Station Assets

Regardless of the formula used to determine the value of a station, other factors must be considered. These include the value of the physical plant and any real property and other assets included in the sale, the extent of long-term contractual obligations that might have to be assumed, and results of the due diligence process. With regard to the real estate valuation, it should be noted that broadcast stations often have several acres of real property for their transmitter and tower site and additional space and structures for studios. While extensive holdings might be involved, the property may be unavailable for development under local zoning laws. (The fact that a station is federally licensed does not affect the authority of local zoning bodies.) In some instances the station may be leasing its transmitter site; if so, the seller should have a favorable and assignable long-term lease. If there is only a short-term lease, it may be extremely difficult, if not impossible, to find another site should the station need to move. This is especially true for AM stations with directional antennas involving multiple towers and many acres of land, with only a limited geographic area possible for a site.

Because the acquisition of broadcast properties involves the purchase of technical equipment, a buyer should make arrangements to have a broadcast engineering consultant inspect the premises and evaluate the equipment before making a binding offer.

D. Quantitative Factors

In addition to the qualitative analyses which affect station prices, the final estimate of market value must necessarily reflect quantitative analyses of a number of factors. The single most important factor is station revenue—past, present and potential. Past revenues show trends in the station's, and sometimes in the market's, development. A buyer may be able to determine if station growth has peaked, is growing, or has slowed. Estimates of potential revenues determine how much a buyer can afford to pay for a station and still make a reasonable return on investment. A useful working assumption is that station revenues should be roughly equivalent to total radio revenues in a given market multiplied by that station's percentage share of the total audience. Within this rough approximation, there will be wide variations based on station format and performance.

A seller normally will give a potential buyer information on the property's revenues but a buyer may want to make an independent investigation to verify market and competition revenue estimates. In these situations, it is naturally more difficult to get a complete picture of a station's revenues, but there are ways of making an informed guess. Very useful information is contained in *Investing in Radio*, published annually by Broadcast Investment Analysts, Inc., Washington, D.C., *Duncan's American Radio* and *Duncan's Radio Market Guide*, published by Duncan's American Radio, Inc., Indianapolis, Indiana, and *Broadcast Stats*, published by Paul Kagan Associates, Carmel, California. These publications provide relatively detailed estimates about market and station revenues and station ratings in ranked markets.

E. Seller Terms

The terms buyers negotiate to purchase the property affect station prices. Under a deferred payment purchase, the buyer completes payment for the property over a period of time. If the seller offers the buyer a "terms purchase," current and projected future interest rates must be considered. If interest rates are forecast to increase in the future, then the present value of the station to the seller is reduced if the interest charged the buyer is below the market rate. On the other hand, the buyer may plan for the contingency of making higher interest payments over the period of the promissory note if the debt owed the seller carries a floating interest rate.

Therefore, the question to be answered is: what is the station worth to the buyer at various interest rates? The buyer will adjust the total price of the station he or she is willing to pay to reflect the various interest rates considered under the deferred payment purchase plan—the higher the interest rate, the lower the price.

If a portion of the purchase price is deferred, that portion of the purchase price is worth less to the seller than the same amount of cash received today. Also, the longer the payment of the full price is deferred, the less it is worth to the seller. Thus, if a seller offers to defer payment of a portion of the purchase price over a number of years at below market interest rates, it can be safely assumed that in setting the asking price the seller has taken into account the lesser present value of the deferred portion and the favorable interest rate.

Sellers sometimes agree to accept payment without interest carrying charges in the form of consulting agreements or agreements not to compete over a period of time, which reduce the present value of the purchase price for both buyer and seller.

3. Models for Valuation

A. Using Financial Statements

Before beginning serious negotiations, the buyer must obtain complete financial records on the station. This is essential in order for the buyer to develop a financial profile of the station. These financial records usually take the form of a balance sheet, an income statement and statements of cash flow for the last three to five years. Preferably, the

financial statements will be accompanied by a report from the station's outside independent accountants. Such reports of independent accountants come with three different degrees of assurance. "Compiled" financial statements simply reflect information provided by the station to its accountant. This means, from the accountant's standpoint, that all figures are unverified; transactions have simply been compiled and categorized in accordance with generally accepted accounting principles. The term "reviewed," when applied to financial statements, means that the accountant has applied analytical procedures to the company's financial statements, made inquiries of management, and has formed a general conclusion that no material modification must be made in order for the financial statements to be in conformity with generally accepted accounting principles.

The greatest level of assurance is provided by "audited" financial statements. In preparing an audit, accountants test original records of entry and independently verify the existence of assets, obligations, income and expense as well as management disclosures presented in the financial statements. Unfortunately for buyers, few companies that own radio stations undertake the expense of preparing audited financial statements, except publicly traded companies or where audited financial reports are required by lenders. In addition, stations that are part of a group rarely have audited statements on a stand-alone basis.

With all financial statements, whether compiled, reviewed or audited, the explanatory paragraphs contained in the accountant's report should be studied carefully to ascertain the accountant's comments about the statements and the limitations of the report.

Most banks, when reviewing a loan application, require financial statements audited by an independent accountant. When a buyer intends to use the private capital markets for financing, e.g., for a limited partnership offering, audited financial statements are usually required. When the acquisition is to be made through the purchase of stock rather than simply the sale of assets, the availability of audited financial statements takes on added importance.

The buyer should insist on the opportunity to make what accountants refer to as a "businessman's review" of the financial statements and operations and should seek to make the satisfactory completion of such a review a condition of the buyer's obligation to complete the purchase. This type of review is an important part of the acquisition process because these investigations often expose matters that may either have an effect on the purchase price and/or terms or influence the decision on whether to proceed with the acquisition.

B. Cash Flow Multiples

The buyer of a radio station, like buyers of most other businesses, is concerned primarily with the internal rate of return to be earned over the life of the investment. This can best be estimated from an analysis of future cash flow. As noted earlier and discussed in further detail in Section V, broadcast cash flow normally refers to operating profit before depreciation, amortization, interest and taxes. In addition, certain items may be of an extraneous or nonrecurring nature and should be appropriately added to or subtracted from cash flow. For example, there may be above average salaries or benefits taken by absentee owners or officers not involved in the daily operation of the station. There may also be personal expenses of the owner paid by the station such as life insurance, travel and entertainment, country club dues, etc. These are items which should be added back to calculate the true cash flow. On the other hand, if there are services provided by the seller which are not paid for by the station, the value of these services should be subtracted from the stated cash flow.

Because cash flow is needed to amortize debt, multiples of cash flow are sometimes used to determine purchase price. By focusing on projected cash flow, the buyer can determine how many years it will take to recover the investment, assuming a certain interest rate. When used in this fashion, future cash flow will determine the current return, i.e., the rate of return that will be earned and that is required by the buyer to justify the investment.

The higher the risk associated with a particular investment, the higher the current return that will be required by the buyer. Thus, the greater the risk, the lower the multiple for which a property will sell. The buyer will be unwilling to pay a higher multiple when the return is not as sure. A buyer who assesses a station as an "8" times rather than "10" times cash flow property is making a judgment about the relative degree of risk. However, even with a risky deal, if the potential rewards are sufficiently high, the risk may be acceptable.

Sellers and buyers typically assign cash flow multiples for a particular property from different perspectives. Sellers want a buyer to pay a multiple based on the projected cash flow that a buyer should be able to generate with improvements and future development. On the other hand, buyers may feel that they should only pay for what they are getting now rather than what they might get through their own developmental efforts. Usually, the purchase price will reflect a compromise of these points of view.

Cash flow multiples vary from time to time depending on circumstances and they reflect the cost of attracting money to a particular investment. The price described as a multiple will also be affected by the quality of the station's licensed technical facilities, including power, tower location and frequency. Stations in the larger markets command the upper range of multiples and those in the smaller markets in the lower range. The range of multiples for moderately mature stations is currently five to eight times cash flow for

AM stations and seven to 12 times cash flow for FM stations.

Stations fall in the low end of the range when they have poor prospects of future earnings, inferior facilities or are located in weak markets. Some stations, such as those with no record of earnings and those requiring substantial improvement, are impossible to value meaningfully using cash flow multiples.

For some acquisitions, even stations with a solid track record of earnings and sound technical facilities, an apparently reasonable sales price based on normal cash flow multiples may be impossible to achieve. This is particularly likely in the case of AM stations. Many lending institutions are unlikely to consider an AM station, no matter how profitable, to be sufficient collateral for a loan unless coupled with a companion FM station or guaranteed with other assets. The relative unavailability of bank financing for such properties obviously depresses prices. Thus, a lower cash flow multiple paid for a station may reflect the buyer's inability to finance a higher purchase price without bank debt. Conversely, a higher multiple may reflect the owner's willingness to provide favorable long-term bank or seller financing.

Cash flow multiples also tend to decline in the case of stations that have reached a dominant position in the market. If a station is pre-eminent in the market and is relatively efficiently managed, it is more difficult for the buyer to achieve the increase in cash flow necessary to service debt required to pay a premium price. Indeed, such a stations performance may be vulnerable to new competition. In this situation, unless growth of advertising revenues in the market is exceptionally strong, both the cautious buyer and the cautious lender must consider whether the station's performance can go up at all. The highest cash flow multiple is likely to apply to an established but underperforming sound technical facility in a growing market.

Use of cash flow multiples requires thoughtfully prepared cash flow projections which take into account market revenue growth characteristics, demographics, quality of facilities, media competition, and the station's projected share of audience and revenues in relation to its present share of audience and revenues. Any thorough analysis of financing needs will also include state and federal income taxes, working capital requirements, equipment replacement schedules, pension and other employee benefit funding requirements, and debt service (principal and interest) payments, all of which reflect the actual use of cash.

C. Discounted Cash Flow

A second way to determine value is to use the investment analysis technique known as "discounted cash flow." The basic premise underlying discounted cash flow analysis is that a given amount of money to be received at any time in the future is less valuable than the same amount of money currently in hand today. Using the cash flow projections that have been developed, the method implies that a station's value today is equal to a cumulative total of all future yearly cash flows (including any cash proceeds from a future resale of the station) discounted back to the present at an assumed annual rate of interest.

In performing a discounted cash flow analysis, the buyer should consider the current and projected interest rates reflecting not simply the interest to be paid to lenders and the seller but also the rate of return that would be available from other investments over the same period of time, the amount of deferred money owed the seller and the length of time that it is deferred. For these reasons, discounted cash flow analysis should always be done with varying assumptions of rates of interest (for example, from 10 to 16 percent), and for varying periods of time (for example, five to 10 years). It should be noted that cash flows to be received far into the future, say eight years, add little to the value of the station today.

D. Comparable Sales

A third method of valuing a broadcast property is by a comparable sales study. This is a difficult analysis which attempts to relate the value of one station to the value of another which was sold in a comparably-sized market, with similar revenues and cash flow and approximately the same market rank or position. For a number of stations, recent sales may be a useful basis for comparison. But all too frequently there is no well-founded basis for a comparison of the station being valued and few "comparable" stations. Every station in every market will have many characteristics which uniquely affect its value. These characteristics will skew any comparable sales study and an attempt to relate the value of the target station to the station or stations which are being compared. Therefore, the best use of this type of analysis is as an additional check on the values reached through other analytical methods.

Now that the reader has a better understanding of the radio industry, the following sections cover the more specific aspects of radio financing.

V. SPECIAL ASPECTS OF RADIO FINANCING

1. Cash Flow Lending

A. Lack of Hard Assets

The main purpose of this publication is to inform financiers at banks and other institutions, as well as entrepreneurs and investors not familiar with broadcasting, about the basic elements of the industry and its financing needs. Banks and other lenders have experience with traditional industries in which they have developed knowledge and relationships. A lender that has decided to develop a specialization in a particular industry might set up a separate division or department to oversee that lending activity and then hire bankers or business experts with experience and skills in that industry to manage the direction of the department.

Most banks have real estate departments, staffed with experts in such areas as appraisals, leasing, tax matters, zoning, and the like. Many banks have departments devoted solely to other industries or groups of industries, such as computers, high technology, transportation, international trade, or heavy industry. The most common thread among these and other industries is the existence of a significant level of tangible assets. The tangible assets in these industries comprise a high value, whether measured as a percentage of total assets, book value, market value, or total loan funding. The tangible assets may be in the form of machinery, land, buildings, tools, work-in-progress, or raw materials. In most cases, the tangible assets form the basis of a product. The product's worth may be measured by the number of unit assets times the value of each unit, the cost to make each unit asset, or the replacement cost of each asset.

A radio station is different. As mentioned earlier, tangible assets usually consist of studio and transmitting equipment, one or more towers, furniture and fixtures, and some computer equipment. Some stations have a considerable inventory of tangible assets while others are quite limited. Some radio stations own no assets outright, but lease all equipment from a third party. Is a radio station worth more or less because of its tangible equipment inventory? Only when the equipment of a station is either too minimal for adequate performance or too extensive to be of practical use to the operator do the hard assets affect the value of the radio station.

B. Radio's Key Assets are Intangible

The product of a radio station is programming and air time. Air time is perishable, somewhat like airline seats, in the sense that if unused the advertising time (the seat) is lost and has no salvage value. Similarly, there is no work-in-progress. And other than taped recordings of the station, the product vanishes after it has been aired.

As noted earlier, the main assets of a radio station are intangible. The primary asset is one to which the "owner" of a radio station has no direct ownership claim. It is the broadcasting license from the FCC. The license is issued to an operator for a term of seven years, and can be renewed upon application if the licensee has operated the station in a manner consistent with FCC rules and regulations. Control of the license can be transferred to a new operator upon prior approval of the FCC.

An operator can safely predict that the license will be renewed for as long as the operator wishes to maintain the license unless the licensee violates either the spirit or the letter of FCC rules and policies. There have been few cases of revocation or denial of renewal of broadcast licenses by the FCC. Most of the instances of loss of license were accompanied by egregious acts of dishonesty or bad faith by the licensee. The operator's FCC legal counsel can assist in protecting the license and should be an integral member of the resource team assembled by ownership. In addition, license retention

materials available from the NAB provide helpful guidelines for broadcasters.

The value of the license lies in the right it gives to the operator to broadcast to a specific city of license at a certain frequency, power, and tower height and location. The station's signal creates the opportunity to generate an income stream from advertising clients. Profitable radio stations control their expenses and derive a "broadcast cash flow," or operating profit from the station. Lenders seek consistency in this cash flow stream to allow payback of their loans. This form of cash flow lending has become synonymous with broadcast financing and indicates the recognized strength of radio stations to produce cash flows.

C. Securing the License

There are some restrictions on the ability of an operator to use the license as security for a loan. As a senior or subordinated lender, an institution may require the attachment of a security position against the license. Since the license is not owned by the licensee but merely reflects the operator's temporary right to use the radio frequency, the radio station owner may only offer certain types of liens against the right to broadcast.

A secured lender must have the ability not only to repossess the equipment and other hard assets through conventional mortgage security, but also be able to take over the operation of the radio station following default. The tangible assets alone are worth less in the resale market compared with their value to an operating station. Moreover, the value of the license and goodwill of the station will rapidly decline if the station is not on the air. In other words, the value of the radio station as an operating business is worth significantly more than the sum of each of the elements if not operated as a going business.

The key to protection for a lender is to be able to take control of the operation of the station in its entirety following default. However, under FCC rules, no license may be controlled by a party not approved in advance by the FCC through its formal process. How does a lender secure such approval?

The legal structure of the licensee will determine how lenders gain control of a station in accordance with FCC rules. If the owner is a corporation, a lender will typically get a pledge of stock from all shareholders. This pledge would be exercisable only in the event that notice of default and possibly a cure period have been given to the owner. It can be enforced only subject to prior approval of the FCC. The pledge agreement might contractually obligate the shareholders to cooperate in the application for transfer of the license to the lender following notice of default. If the owner is a partnership, the lender might typically have a power of attorney by contract over the partners' interests in the partnership, again subject to the conditions stated above, including prior approval of the FCC.

On the other hand, if a licensee seeks protection under bankruptcy laws, the bankruptcy judge will seek permission from the FCC to have a designated third-party operator oversee the operation of the station until the debtor/operator is reorganized or the station sold. This subsequent sale must be approved by both the bankruptcy court and the FCC. A transfer of control under any of these procedures must be approved by the FCC before anyone other than the existing licensee can make decisions relating to the operation of the station.

D. The Concept of Cash Flow

Actual or projected cash flow is the basis of value of most radio stations. The much-advertised reports of escalating prices for radio stations in the last decade have been predicated on actual sale prices of stations as reported in filings with the FCC. The transfer applications do not indicate, however, how prices were determined and do not indicate performance levels of the stations.

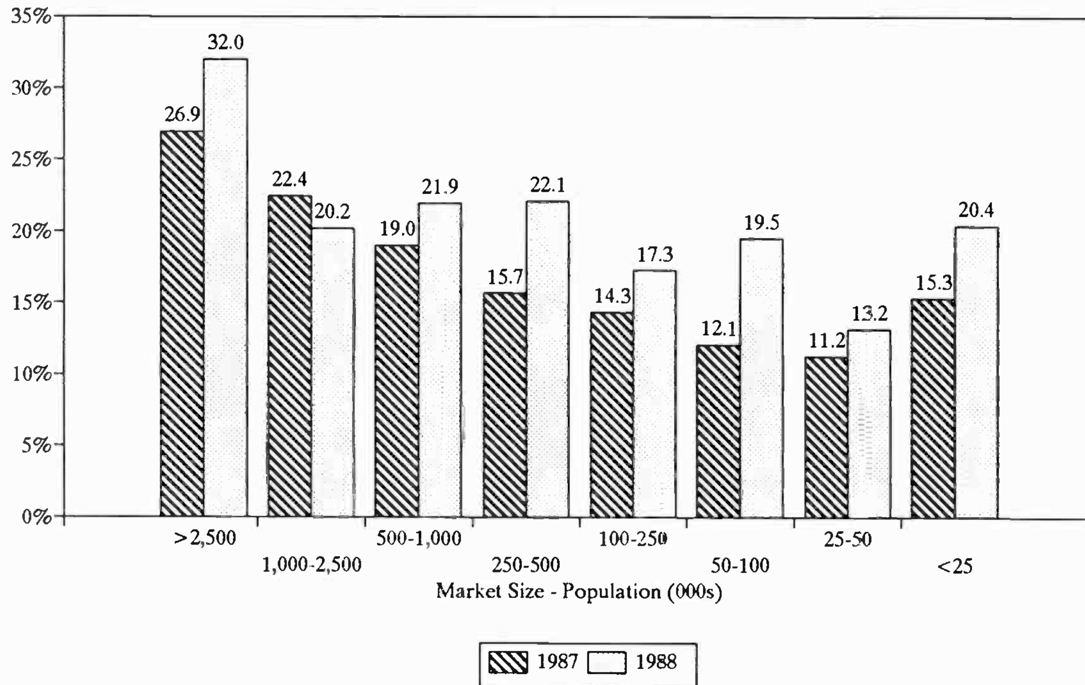
Sellers, buyers and brokers agree that some of the increase in prices has been due to buyers' willingness to pay a higher multiple of cash flow than in past times. This multiple inflation may reflect the current low rate of inflation, the stability of interest rates, or an increased interest in the acquisition of radio properties. Most observers of radio transactions concur that increased prices for properties (mainly FM stations) have resulted from an improvement in cash flow generation. Revenues and profits, as measured by broadcast cash flow, have increased significantly in the last ten years, making radio stations more valuable to their owners. Exhibit XIII illustrates recent cash flow margins for radio stations in various market sizes.

What is broadcast cash flow? As discussed earlier, it is the net profit of the licensee entity, with income taxes, depreciation, interest, and amortization added back. It could also be called the operating profit of the station, that is, revenues less direct operating expenses. Cash flow is also labeled the money available to pay income taxes, service debt, and make capital improvements.

What cash flow is not also helps define the concept as well. It is not the actual, physical cash available for discretionary spending. Since many licensees are corporations or limited partnerships, most operate on the accrual basis of accounting. In these cases, cash flow relates to an accounting definition which does not reflect the difference between collected revenues and paid expenses. Thus, the actual cash in the bank as a result of the year's operation may have little correlation to broadcast cash flow.

The reason for defining broadcast cash flow in this manner is fairly simple. Each licensee has a different financing

Exhibit XIII
Cash Flow Margin by Market Size



Source: NAB, Fair Market Value of Radio Stations: A Buyers Guide, Second Edition.

structure, a slightly different accounting method, and different experience and practices relating to receivables, payables, and capital expenditures. The definition of cash flow described here makes the differences among the accounting practices of individual stations irrelevant. It provides a numerical measure of performance that can be compared with stations having similar or differing market sizes, revenues, locations, power, formats, and so forth.

E. One Operator's Cash Flow Is Another's Expense

Not everyone agrees on the more intricate issues of adjustments to cash flow. Many sellers and brokers make additional add-backs to the cash flow number to reflect unusual or one-time expenses they believe should not reduce cash flow. For instance, if the owner doubles as the general manager and takes a higher than average salary for a competent general manager in the market, the owner might claim the excess payments should be added back to the cash flow. Other items typically added back include repairs and maintenance that should have been capitalized or were one-time; excess expenses or salaries for shareholders, directors, or relatives; legal, accounting or engineering consultant services above normal yearly levels; and many other legitimate as well as some more creative categories.

Disputes over cash flow calculation sometimes obscure the importance of the buyer's attention to formulating new pro-forma projections of revenues and expenses. Each potential owner of a property projects different operating assumptions based on his or her own past experience, knowledge of the market, staff plans, format and rate strategy, personal view of economic growth, and many other factors. For the same station, one prospective owner may project cutting promotional expenses in favor of adding salespeople, while another might wish to increase advertising expenses and the sales staff simultaneously. Each, from a different perspective, will derive a cash flow projection, and they will not produce the same numbers.

Lenders and investors must rely on the operator's projections of cash flow and feel comfortable that: 1) all assumptions are clearly stated; 2) they are understood by the operator and the financier; and 3) they are agreed upon as reasonable. Due to the relatively high cash flow margins (cash flow as a percentage of gross revenues) typically found in many radio stations, small changes in either revenue or expense growth assumptions can translate into dramatic

changes in cash flow. Therefore, financiers should be comfortable that the deal has sufficent headroom to allow for negative changes in some of the assumptions, such as total revenues or interest rates.

F. Air Time Has No Traditional Fixed Cost

A difficult concept for non-broadcasters to understand is that there is no easily identifiable cost of a minute of air time. One can postulate that direct and indirect monthly costs of the operation, including salaries, electricity and rent, can be apportioned among the total number of hours that the station is on the air during the month. However, there are no raw materials consumed, no tangible assets lost. There is a practical limit to the amount of inventory—the number of minutes in the month. The station will continue to produce the product whether or not there are any customers. And the product will continue to perish with no regard to the use made of it.

Advertisers may make the same point when negotiating the price of radio time: "The station would be on the air anyway even if we don't buy your time. It is worthless unless we buy it. Why don't you sell it for a bargain price?" Experienced broadcasters know well how to position and sell air time through fairly easily understood marketing concepts that join the ideas of value and service with the advertising power of the medium. These are concepts financiers of radio stations should know and understand.

2. Uses of Financing

A. Acquisition Financing

The most common use of funds provided by lenders and investors to radio companies is for the acquisition of radio properties. Many radio stations are acquired in much the same format typical of the now fairly common leveraged buyout. The station assets acquired are used as security for new debt used to finance most of the acquisition. The projected cash flow of the station is available to service the acquisition debt. Equity and subordinated debt are used to complete the financing package, providing the remainder of the funds needed to close the transaction and for working capital.

The market for buying and selling stations is quite active and, depending on the location and size of the property, its performance, and whether it is AM or FM, a station can be sold in a relatively orderly fashion at a reasonably predictable price. This market liquidity allows operators a choice of ownership strategies. Some decide to acquire properties and keep them for a long period of time, allowing development of community involvement, interaction and service, and long-term growth of revenues and cash flow. Other owners choose to buy and sell properties after shorter periods of ownership. They believe certain properties may be improved sufficiently over a brief time period to yield an acceptable return on investment. Operating strategies and decisions that might accomplish this type of turn-around include a format change, expense reduction, better direction of the sales staff, rate increases, or a focus of the station on a different market within the signal area.

As lenders and investors establish relationships with broadcasters, they need to understand the owners' acquisition strategies. Some financiers look for owners to continue buying properties so the financing needed will grow and the initial investment can be hedged with different stations in a number of diverse markets. Others wish only to invest in a limited number of stations, for such reasons as limitations on the amount of funding available or a policy that restricts investments outside certain geographic territory. Other financiers new to the radio industry may be uncomfortable enlarging a relationship until they have experience with several different deals. In any case, the operator and lender or investor should discuss upfront the goals and strategies of each before they enter into a business transaction. Neither party wants to be disappointed or to have its expectations raised on false assumptions.

B. Financing Construction Permits for New Stations

In response to its own rulemakings, petitions by prospective broadcasters, and through hearing decisions by FCC administrative law judges, the FCC grants construction permits (CPs) for new stations. These CPs have a time limit for completion of construction and contain details of the facilities authorized by the FCC. Once the new station is built, the operator submits an application for a license for the new station. This final procedure is routine and usually occurs while the station is on the air under "program test authority."

FCC regulations require that applicants for CPs show evidence of the ability to finance the new station's construction and the first three months of operation. Applicants must document their ability to raise money from their own and their partners' resources and the willingness of a financial institution to lend to the station. Therefore, one opportunity for a bank or other lender to begin the development of a relationship with a broadcaster is to provide a commitment letter. The commitment can be highly contingent on a number of different reasonable points and still be of use to the broadcaster. For each contingency, the applicant may or may not need to submit evidence to the FCC that the contingency can be met reasonably.

If the operator wins a construction permit, the station is ready to be built. Financing construction of a station involves a wide range of elements, including acquisition and construction of the tower, transmitter building, related broadcast

equipment, and the studios and offices; including related furniture and fixtures. In addition, working capital and reserves will be needed to hire staff, operate the station without income for a period of time, advertise and promote the station, reimburse the applicant for legal, engineering and other costs for prosecuting the application, and carry the debt until the cash flow break-even point. If the operator has won a CP with a good location, power and frequency, the station will be worth more than the total invested capital and loans the minute it is on the air. The station then has earning power and yet carries no large debt load due to the acquisition of goodwill from a prior owner.

New station start-ups of this nature are sound borrowers if the same tests are applied as to any other radio investment—the need for a good operator, market and competitive technical facility. Operators who have managed start-ups in the past have experience with which to tackle new and similar challenges. They have a realistic understanding of the lead time to develop staff and an advertiser base. Introducing a new station into a market can look easy when done correctly, but can be painfully costly if mismanaged. Planning and strategizing the right programming niche and marketing approach are the keys to success.

C. Financing Upgrades

Upgrading a radio station can take several forms. The most common results from a change in the station's license that improves some of the following elements: tower height, tower location, authorized power, directionality of the station or frequency. Any one of these changes in operating parameters requires a technical upgrade of the transmitting facility. The transmitting facility includes such elements as the studio-transmitter-link (STL), main and standby transmitters, transmitter site and building, audio processing equipment at the transmitter site, phase-adjusting equipment, generators, tower, ground system, and antenna.

Another type of upgrade involves improvement of the studio and office complex and its equipment. Improvements might include a full move of the studio and office site to a new location, expansion of the site, reconfiguration and redecorating of the interior space, replacement and upgrade of studio and processing equipment, installation of new satellite receiving equipment, major additions to the music library, and so forth.

A non-technical, but very important, type of upgrade is termed a "repositioning" of the station. Some station owners and financiers might consider this sort of expenditure merely a temporary increase in operating expenses or absorption of losses for a limited period of time, but for the purposes of this discussion, it will be considered a discrete and planned upgrade.

Sometimes operators may decide, following research and other more informal information-gathering, that the station must change its programming format. There are wide variations in such formatic adjustments, ranging from an evolution in which the music shifts slightly and slowly within a general format like contemporary hit radio, to a major switch, in which the station changes format dramatically, for instance from country music to all news. Each one of these changes, some to a greater degree than others, requires a fairly definable investment of funds. Money is typically spent on such items as market research, acquiring a new music library, changing staff members and levels, expenses related to a call letter change, advertising and promotional expenses, and the possible loss of advertising revenues due to a change in the advertiser base.

Any of these upgrades—transmitting, studio or programming—can be accomplished separately, but often two or all three are combined at one time. They may underlie the rationale for acquiring a station and become the driving force of the strategic plan for the station's growth. Or they may simply be a part of the station's improvement during a longer period of ownership. In the case of transmitting facility upgrades, the station must obtain the approval of the FCC, Federal Aviation Administration, local zoning authorities, or other governmental bodies and may need to rely on the availability of land in order to achieve its upgrade ambitions. The other upgrades, namely, changes in equipment and format, can be initiated at any time.

D. Refinancing

Radio stations have many occasions to desire or require refinancing, thereby creating opportunities for lenders. In addition to replacing exisiting debt, refinancing a radio station could involve changes in the financial structure, acquisition of certain owners' interests, an upgrade of the station, or a combination of these elements.

Why might a radio station owner wish to refinance? Usually, the borrowing in place has one or more of the following unfavorable characteristics the owner wants to remove: high interest rates, floating interest rates, equity kickers, repayment schedules unsuited to the company, personal guarantees, cross collateralization, overly burdensome covenants or restrictions, and so forth. In many cases the borrower requests an increase in total borrowing in addition to a removal or change in the other terms and conditions.

Lenders and borrowers at times understand that relationships do not equally benefit both parties. For the station and its lender to be satisfied with the lending arrangement each side must achieve its principle goals. The station must have sufficient financing to operate in a manner reasonably consistent with its business plan; it must have the flexibility to react to a changing marketplace; and it must have a repayment schedule for both interest and principal that reflects

realistic cash flow availability. The lender must be comfortable with the business relationship with the borrower in terms of its integrity and character; it must have adequate protection for repayment of its loan from cash flow, asset sales, sale of the station, or other guarantees; and it should realize a rate of return on its loan consistent with the risk.

Radio operators sometimes take the opportunity of a refinancing to alter the entire capital structure of the company. Depending on the needs and the borrowing ability of the company and the strategic direction of ownership, the station might replace subordinated debt with senior debt, buy out several partners' or shareholders' interests in the company, add new layers of mezzanine financing, buy out venture capitalists, or inject new working capital from existing or new equity participants.

Refinancing loans are often attractive ways for lenders new to the industry to learn about radio. Since the borrower has ownership experience with the station, the risk of acquiring a new and unknown venture is eliminated. The track record of the station can be fully attributed to the current owner and performance can be projected into the future with more certainty. A refinancing could allow a lender to establish a relationship with a new borrower with lower risk than would be present during an acquisition.

3. Debt Financing—Typical Instruments

A. Senior Debt

Senior debt is the most common form of bank lending to radio stations. As in lending to any other industry, senior lending to radio properties means that the lender has the first priority on the secured assets. The assets subject to first security interests usually include all owned tangible assets and real estate, accounts receivable (i.e., advertising revenues), and often a first pledge on the stock of the company or a power of attorney over the partnership interests. Should a liquidation be required for the lender to be repaid, the assets legally secured by the lender would be sold, with the proceeds first applied to the outstanding loan obligations, including costs, fees, penalties, interest and principal. Any remaining proceeds would be applied to secured interests junior to the senior debt, then to unsecured debtholders and creditors, and then to the shareholders or partners.

In a previous section of this chapter, the concept and desirability of selling a station as an ongoing concern was discussed. In all but a few instances, the value of a radio station as an operating entity is considerably higher than the sum of the salvage value of its equipment and the bare value or "stick value" of the license. Therefore, most lenders believe the security interest in the tangible assets provides leverage with the borrower, not the primary means of raising cash through asset sales.

It is not unusual for a lender with the senior position to have a second or other junior position on some or all of the tangible assets. For instance, if the operator leased all of the broadcast equipment, the senior lender's position would be junior to that of the leasing company or other equipment owner. The tower site, office and studio building and other real estate might be rented or leased from other parties. The senior lender might obtain an assignment of the leasehold interest as the best security obtainable on the sites.

The lack of tangible or real property assets should not deter lenders from looking favorably on a senior loan. The main asset of the radio station, the asset that gives it marketable value, is the license. If the lender is comfortable with its ability to force the sale of the radio station as an operating entity with the equipment, property and other contracts as part of the package, then full ownership of the tangible assets is less important. If lessors or other lenders senior to the traditional senior lender experience a direct default by the borrower or are forced into default by the senior lender, they too will benefit from a sale of the station as an operating entity as well. It is quite conceivable that the resale value of the equipment could be less than the indebtedness it secures.

Who lends senior debt to radio stations? Many money center banks and some large regional banks have departments devoted to communications or media lending. For instance, some specialize in lending to media (newspapers, magazines, radio, television, cable television, outdoor), communications (satellite, telephone, cellular, specialized mobile radio), or entertainment (movies), or a combination of these industries. Banks without specialized lenders versed in radio tend to prefer deals with either a preexisting relationship or which have some local or regional interest to the lender. In addition, some venture capital companies, insurance companies, pension funds, and other non-bank financial institutions lend senior money to radio stations. At times, the seller of a radio station may become the senior lender, accepting a down payment from a buyer and the remainder in a note over time.

B. Subordinated Debt

One step below senior debt is senior subordinated debt or mezzanine debt. This debt is usually much smaller in amount than the senior debt and provides a strip or layer of additional borrowing between the senior debt and the equity in a deal. As a subordinated instrument, its security position is junior to that of the senior level debt. If the senior debt has a first mortgage on the real estate and a first lien position on the broadcast equipment, the mezzanine strip could receive second mortgage and second lien interests as security.

The risk to a lender is usually greater on subordinated debt

because the assets, both tangible and intangible, that help protect lenders from loss are pledged to a senior lender ahead of the mezzanine lender. Also, the existence of subordinated debt usually indicates higher total leverage than if there were only senior debt. More indebted stations require more cash flow to service debt. Therefore, a station with subordinated debt usually has a lower cash flow coverage of total interest and principal than a station with only senior debt, creating more risk to all lenders.

In a capital structure with debt provided by different sources, the lenders require that all lenders and the borrower agree to a subordination or intercreditor agreement. This agreement primarily sets the procedural and legal terms and conditions defining the relationships among the various lenders. This type of understanding is necessary to avoid disagreements among lenders over security interests, priority of claims, default notices, conflicting covenants and restrictions, and so forth. The radio station owner usually plays only a minor role as these agreements are struck.

Subordinated lenders tend to be, but are not always, different institutions than senior lenders. The most common subordinated lenders are sellers of stations. In order to complete a sale at a sufficient price, the seller may decide to accept a portion of the purchase price in the form of a subordinated note. Sellers usually are the most comfortable lenders of this type of money, because of all lenders they are in the best position to judge the new owner's risks—they are taking back as security a station they owned for a period of time. They also are the most willing to accept the risk of taking back and operating the station or of reselling it following a default.

Some senior lenders, including banks and other institutional lenders, are writing loans that include both senior and subordinated elements. Banks might desire to play this multiple role for several reasons. They may believe in the operator, the deal, and the loan and wish to participate as much as possible; they may want to increase the overall yield from their loan portfolio by adding higher-priced subordinated loans; or they may wish to avoid dealing with a second lender and negotiating a subordination agreement. Entire transactions have collapsed because the lenders could not agree on an intercreditor agreement among themselves. Eliminating one lender can prevent such a problem.

C. Equipment Financing and Leasing

A number of specialized lenders, financial institutions and manufacturers offer equipment financing for radio stations. In this simple form of financing, the lender collects a down payment for the equipment to be acquired, pays the vendor of the equipment the full cash price, and delivers the equipment to the station. The station signs a promissory note, backed by the security of the equipment just acquired, for the interest and balance of the principal due the lender. Title to the equipment is in the name of the station. The transaction mechanics are similar to personal car financing. The rates for equipment financing are similar to higher-rate personal loans and reflect the limited security held by the lender and the fast depreciation of broadcast equipment on the open market.

The leasing of broadcast equipment is similar to business car or computer leasing. The major difference between broadcast equipment leasing and financing as described above is that the leasing company, not the station, holds title to the equipment. The radio station usually has full responsibility for the maintenance and upkeep of the equipment. There is often a negotiated formula for the buyout of the equipment at the end of the lease.

Some radio broadcasters form separate entities, with similar shareholders as the station, to own the equipment and the real estate used by the station. This second company then leases its assets to the station through an arms-length lease at market rates. There may be tax reasons for pursuing this course, but often it is used to attract different sources of funding only available for real estate or equipment financing.

4. Elements of Credit Analysis and Negotiation

A. Character

The old saw about three things bankers look for in borrowers is still true today. They are character, character and character. While of course character is not literally the only quality a banker looks for in a borrower, it represents a key indicator of the type of relationship the lender can expect.

Character refers to many elements of individual and corporate behavior. The honesty and integrity of the prospective owner are obviously paramount. How can a lender without a prior relationship, either business or professional, learn relatively quickly and accurately about a borrower's integrity? The business presentation on the future of the station to be bought is an indicator of the borrower's ability to synthesize information about the station's history, analyze the current and future competition, define the strengths and weaknesses of the station's staff and signal, and project into the future. The business plan reveals the station operator's perspectives on the future and abilities. It is not a window to his view of ethics.

The history of an operator will give a borrower the most information about character. How does someone get a clear understanding about an operator in the radio business? As in most industries, people in radio share two traits—they do not like to talk to people they do not know well and they belong to a well-developed network of radio professionals. Many seasoned broadcast lenders have developed a group of radio operators and people associated with the industry

upon whom they call for identification and verification of information about operators. What sort of information is useful in judging operators and who will give it to a lender? Reference checking in the radio business is no different than in any other business. The best checks come from past employers, co-workers, competitors, previous lenders, investors and suppliers. As a borrower talks to more and more people in radio, there become clear connections among groups of people and their contacts. The information received can be checked and cross-checked against known sources and judged for its credibility. Good character should represent a basic underlying trait without which the remainder of the business plan is irrelevant.

B. The Value of Security

Both senior and subordinated secured lenders place much importance on the strength of the security backing the promissory notes signed by the radio operator. Earlier, the basic assets available for security were outlined. They include the tangible assets: equipment and real estate, and the intangible assets, including the license and goodwill of the radio station. The goodwill is a developed by-product of the license value and includes such elements as: the recognition of the call letters and dial position nurtured through years of advertising, promotion and existence in the marketplace; the loyalty of an audience base, both to the content of the programming and the personalities associated with the station in on-air and management or sales capacities; the advertiser base of the station, directly represented by a customer list; and the community involvement of the station. The tangible assets of the station are normally valued by independent radio appraisers or engineering firms. Real estate values are usually supplied by local real estate appraisers or brokers.

The goodwill of the station comprises a significant if not dominant portion of the total value of the typical operating radio station. Therefore, a lender will realize a greater recovery in a default situation if it controls the entire radio station as an operating entity, not just the tangible assets. In analyzing the value of various pieces of the asset inventory, it is important to look first at the value of the station as an ongoing concern. This should be done for the station under two conditions—its current operating condition and a "worse case" operating scenario. The worse case will reflect a collaborative judgment by the lender and operator, and in some cases will be "stick value," as defined earlier.

There are a number of qualified appraisers of radio station values, ranging from public accounting firms, brokers and acquisition consultants, to investment bankers and firms specializing only in radio and television appraisals. Each firm has its own subspecialty or niche, so care should be exercised in choosing the appropriate appraisal firm.

Section IV of this book describes in detail the valuation process. In addition, there are a number of publications devoted entirely to the subject of radio station valuation. See, for instance, NAB's *Fair Market Value of Radio Stations: A Buyer's Guide—Second Edition.*

C. Covenants and Restrictions, Subordination Agreements, and Credit and Yield Enhancements

Lenders that view credit to a broadcast station as a business transaction and not a personal loan to the owner regard the performance of the station as a key indicator of the health of the loan. One of the most common ways to gauge operating results is through the use of operating reports, ratios and other tests of financial health.

Yet, in requesting these reports, the lender must be careful not to overstep its position as a creditor in the eyes of the FCC. Therefore, loan documents (if in full compliance with FCC regulations) will not include restrictions on the operation of the station. The FCC strictly prohibits any party other than the licensee from controlling the station. The licensee may not delegate such authority without prior FCC approval and transfer. Even under default conditions, until the license has been transferred under FCC approval, the secured lender may not make any decisions affecting the operation of the station, such as those affecting management, staffing, hours of operation, programming, and the like.

In a typical loan document, a senior lender can require, in compliance with FCC regulations, the following information:

- Monthly financial reports in a form acceptable to the bank, usually unaudited, including a complete statement of profit and loss and a balance sheet.
- Quarterly financial reports, usually unaudited, but certified as accurate by an officer or partner.
- A statement or certification by an officer or partner of covenant and restriction compliance on a quarterly basis. Typical covenants include minimum cash availability, minimum cash flow, meeting of ratio tests such, as senior debt to cash flow, senior debt coverage, total debt coverage, and current assets to current liabilities, maximum capital expenditures, payment of taxes and insurance, among others. Restrictions could include limits on the use of cash flow for non-broadcast purposes, use of loan proceeds, payment of dividends, interest or principal to shareholders, payment of directors' fees, or changes in management or ownership.
- Annual audited statements with a "no default" letter from the station's independent accountant, which might include some or all of the certifications required on a quarterly basis from station management. A "no default" letter states that during the course of the audit the independent accountant did not find information that the station was in default of specified sections of the loan agreements.

A subordinated lender sometimes has less restrictive provisions in its loan agreements. Once the senior lender and borrower agree on the business arrangement, the subordinated lender usually has a weaker bargaining position than the senior lender because its provisions cannot conflict with those of the senior lender. In most cases subordinated lenders must execute an intercreditor agreement with the senior lender, which details the procedures for defaulting the borrower.

For example, if a default occurs on a subordinated loan but not on the senior loan, the intercreditor agreement might require the subordinated lender to notify the borrower and the senior lender simultaneously of the default. If the senior lender chooses not to default the borrower as a result of the notice, the subordinated lender may need to overcome additional hurdles or tests before initiating legal proceedings. Some subordination agreements provide for a period of time to pass before junior lenders may take legal steps to protect their position; others require defaults be only of a certain nature or size before action can be taken.

A senior lender is in a strong position to control the negotiation of a subordination agreement. The senior lender does not want control of the first position to be dictated by a junior lender, which may have far less money at risk and also may have a greater potential rate of return upon payoff. The senior lender's goal is to reduce the risk of loss and protect its margin and its negotiated interest rate. Coordinating these conflicting perspectives is the function of the subordination agreement, but the station owner must be aware of the potential for disagreement during the life of the loans.

In some instances an institutional lender may be uncomfortable funding a particular radio deal. For example, the lender may hesitate because it is new to the industry, has no prior relationship or good knowledge of the borrower, or because the target station is a turn-around situation or the loan is large in relation to cash flow coverage or current station value. Under these circumstances, the lender may request credit or yield enhancements to compensate for the difficulties with the loan. These devices either lower the risk or raise the return for the lender.

Credit enhancements may include personal guarantees of repayment of the loan by the owners or other persons or companies. A guarantee provides an additional source of security independent of the radio station that can be called upon either for current payment coverage or for repayment of the principal, or both. Another form of credit enhancement is the pledging of collateral not associated with the radio station assets.

Yield enhancements might include higher rates for a certain portion of the loan, equity participation kickers, high compensating balances, or high fees for providing the loan. Yield enhancements are limited only by the creativity of the lender, the receptivity of the borrower and any state or federal laws that might restrict the lender.

D. Competitive Pricing

How do different lenders price their products? Since senior and subordinated lenders, for example, have quite different risks associated with their loans, the pricing of the loans is tailored to the type of debt. Many factors influence a lender's perceptions of risk and reward in transactions, including the following:

- The track record of the operator. A more experienced operator with a history of success in similar markets or strategic challenges will be regarded as a lower risk.
- The security available to the lender. If the security is clean and there are substantial tangible assets, the risk is lower. The addition of credit enhancements is a further plus. And obviously, the higher the position of the lender with regard to lien status, the lower the risk.
- The leverage of the deal. The higher the debt as a percentage of total capitalization, the greater the perceived risk.
- Complexity of strategic decisions and competition. The more difficult the resolution of strategic direction in terms of format, marketing, and sales approach, or the more aggressive and numerous the competitors, the more the perceived risk.

Senior lenders may offer either floating or fixed rate loans, depending on the size of the transaction. Floating rate loans are pegged to a number of percentage points over a base or prime rate used by banks. Some banks offer an operator the opportunity to lower the rate premium over prime as operating cash flow or other performance improves. For example, when the senior debt to cash flow ratio is over 6.0, the loan rate might be prime plus 2 percent. When the ratio falls below 6.0, the rate might drop to prime plus 1½ percent. This reflects the perceived reduction in risk as cash flow coverage of debt service increases. Fixed rates are tied to a premium over the bank's average cost of funds. The size of the premium reflects the bank's analysis of risk inherent in the loan.

Junior lenders price their loans in a similar fashion, but with a presumed higher attendant risk they raise their return expectations considerably and charge more for the funding.

In the past few years, more large and medium-size banks and other financial institutions have begun to lend to radio stations. The larger banks will usually seek out and fund deals in all regions of the country that, in addition to the normal deal criteria, meet their minimum size requirements. Smaller banks tend to fund only deals in regions centered around the bank's existing operations. However, such banks may look at smaller radio deals in other areas if they meet their normal funding criteria. Broadcasters do have a choice of lenders in all but the smallest of transactions. For smaller loans, local community banks with probably little experience

in the radio business may be the only ones willing to consider loans below $500,000–$1,000,000. And these loans may need to be supported fully by real and tangible assets and personal guarantees of the borrower.

E. The Ideal Borrower Presentation

Many radio financing presentations cover two basic elements: 1) an overview of the radio industry and its future, and 2) deal-specific information pertaining to the transaction under consideration. Numbers of recently published books, pamphlets, videotapes, computer programs, trade magazines, and reference materials are available to the lender that provide a good understanding of the industry as a whole. In addition, acquisition consultants and broadcasting seminars and conventions provide educational services to lenders to raise their general understanding of the industry.

Therefore, lenders primarily should seek information in a presentation of specific applicability to the transaction at hand. At the least, this information should include the following:

- An overview of the transaction. Who is buying or building what, when, where, and for how much? What are the expected results?
- A detailed description of the ownership and management of the proposed enterprise. This section should have resumes which include in-depth information on how the principals' experiences match the expertise needed in the current deal. In addition, a management plan should discuss the authority and responsibilities of the key management personnel.
- A market overview, with emphasis on the trends in the market relating to major industries and businesses, population, retail sales, and household income. A detailed picture of radio and other media competition is a must. Estimates of radio revenues and growth should include all relevant assumptions so they can be judged for accuracy.
- A discussion of the plan for the radio station. Its operating and financial history should be included. The operating strategy should be clear, since this comprises the heart of the business plan. Financial projections with a full explanation of the assumptions should complete this section. Some operators include best, worst and most probable case scenarios with explanations.
- A plan for the acquisition structure. This section would include the price and terms of the deal, proposed capital structure, and loan request. It would detail the rationale for the price and financing structure, with a projection of coverage ratios based on meeting the operating plan.
- Appendices. Included here might be any miscellaneous information too bulky to appear in the body of the plan, such as complete historical financial statements on the seller's company for the most recent three years (audited if possible and with all internal control memoranda issued by the independent accountant), ratings information, and a copy of the letter of intent to acquire the station.

Lenders should not be surprised if the financial statements provided by the seller are not audited or even reviewed. Many sellers, albeit mostly of smaller stations, operate their stations with very little overhead and have neither the desire, the need, nor the money to have their statements audited. It is the duty of buyers through a due diligence review to satisfy themselves, the lenders and investors that the statements accurately reflect financial performance. In addition, the purchase and sale agreement should contain representations and warranties pertaining to the accuracy of the statements and their fair presentation of the financial picture of the station. If a lender is uncomfortable with the level of sophistication of the presentation, it may wish to employ an acquisition consultant (or suggest the buyer hire an acquisition consultant) to provide a review of the deal or assist in scrutinizing the presentation, or hire an independent accounting firm to perform a due diligence review.

5. Relationship with the Operator: Understanding the Radio Station Following Closing

A. Communication with the Borrower

Some radio stations are owned by a group of "radio people," representing different but complementary skills. For instance, in one station, the three principals had backgrounds in sales and management, programming, and finance. Other stations have larger or smaller teams, but most have two to five key people with varied skills. It is more unusual today to find single-person owners of stations (those remaining are in very small markets) because the radio business is becoming increasingly specialized. Few individuals alone have the breadth and depth of skills or experience to operate a competitive station, even in a medium-size market. Although it is possible to hire people with the needed skills, most owners recognize the long-term benefits of incorporating the best talent into ownership. Therefore, the lender may work with more than one person at many stations.

Lines of communication between lender and borrower normally run between the chief financial officer at the station (or the untitled person who acts in that capacity) and the loan officer of the lender. If this link is open and communication is frequent and responsive, the lender will receive all the information needed to track the loan and the station's progress relative to plan.

Good communication does not end with the required reports and statements. A conscientious borrower wants the lender to understand the radio station, thereby encouraging a long-term relationship of trust with the lender. The lender should foster any and all communications with the

station, especially those initiated by the station itself. Some borrowers are ill at ease talking with their lenders. It is incumbent upon both parties to develop a good working relationship to avoid a surprise to either.

Besides the normal financial reports, lenders typically add the following to their list of tracking requirements:

- Infrequent but periodic visits to the station to meet the owners and key staff, tour the market and understand the competition.
- More frequent meetings with the key contact of the borrower at industry conventions, at the bank, or at the station.
- Telephone contact with the financial contact as well as the key operating personnel at the station.
- Additional information from the station such as ratings, significant market changes in employment, unemployment, growth, retail sales, competition, and so forth.

B. The Operator's Expectations of the Lender

Most operators are primarily entrepreneurs and want one thing from their lender during the course of a relationship—simple and open communication. Loan documents tend to be verbose, although many are now written in plain English and are understandable in good measure by the average businessperson. Stressing a need for ease of understanding by the borrower is a must when lenders charge their lawyers with the task of drafting the papers.

Most loan agreements consist of a number of documents, schedules, exhibits, notes, mortgages, attachments, and the like. Reporting requirements are not always organized in a simple fashion for either the loan officer or the operator to review. Both parties benefit from a clear summary of the essential reporting requirements, covenants and restrictions, either in a separate schedule or as part of the loan documentation.

The operator expects the lender to have not only a basic understanding of the radio industry, its language, and current trends, but also to take the time to understand and appreciate the unique aspects of the market and the station. When and if problems occur, the borrower needs the lender to be ready to react. It is obviously the borrower's obligation to keep the lender informed, but the lender must take the time and effort to digest materials sent by the station.

One of the frustrations for an operator is to have developed a good rapport with a loan officer, who understands the complexities of the deal, only to find that the loan officer has been reassigned to a new position. The process of education of the lender and a new loan officer must begin anew at that point. This turnover usually does not occur as frequently with banks that have communications departments; it is more prevalent in institutions where the loan falls into the general corporate lending department.

The station owner hopes that the lender understands the seasonal fluctuations and the seeming volatility that can beset radio stations from time to time. A good operator seldom gets caught by surprise by the competition or the economy. However, changes in the market can happen faster than predicted, usually when new or changed competition stirs up the market with little advance warning of its programming or sales strategy. Finally, the operator hopes that the lender believes in the station sufficiently to realize that occassionally missing sales or cash flow targets does not foretell the end of the universe.

C. Qualities Lenders Should Look for in an Operator

Lenders primarily loan money to people—radio station operators. The track record and successful experience of the station owner in managing properties similar to the target station are vital in predicting another successful venture. The goal of the lender is to have confidence in the operator to assemble the best team appropriate for the task at hand. That comfort will allow operators to concentrate their efforts on running the station, not convincing the lender that the people in place are the right ones. The lender can gain comfort from broadening its knowledge base about the operator from discussions with people who know and have worked with him or her.

Neither the lender nor the borrower wishes to be surprised. A borrower who understands that goal and treats it with respect can develop a more meaningful relationship with the lender. This elevated level of mutual respect contributes to a working partnership in which each side makes allowances for problems or missed targets that otherwise might portend serious consequences.

How do lenders find out about operators and the stations they have managed? The radio industry is small. Many people can recall from memory characteristics of stations ranging from call letters, frequencies, and tower heights to programing formats and managers. These miscellaneous data are not important to most people, but to a lender, being able to call three or four broadcasters in a region to get an honest reading on a manager, market or a station is useful.

What specific traits are important in judging an operator? The following are some quite universal qualities that could be applied to leaders in many businesses and they are certainly valid in radio:

- Personal integrity and respect for others
- Leadership qualities
- Spirit and pride
- Competence and knowledge
- Motivation to win

There is no ideal owner or operator. Many operators have some but not all of the above characteristics. The lender must

decide when and if the balance is acceptable and appropriate for the proposed deal.

The lender must also realize that the skills required for each station are different than those required for other properties. (The general personal qualities listed above are basic characteristics of any manager.) For instance, some station situations require management that can build a staff from scratch, while others require motivation of a mature staff. Some stations need full development of a programming strategy and others need changes in engineering to improve the signal or audio.

These skills must be matched—the operator's skills and the station's requirements should be complementary. During the life of a deal, the skill needs will change as well, necessitating changes in staff to keep the station running at its best.

VI. RADIO AS AN EQUITY INVESTMENT

1. Investment Opportunities

The radio industry has two features that continue to attract equity investment—the potential for generous returns on investment and a thriving atmosphere for entrepreneurs. Although difficult to verify with data due to a lack of information on private deals, some equity investors in radio deals in the last decade have enjoyed pre-tax compounded internal rates of return in excess of 25–30 percent, with some in the 30–35 percent range or higher. These returns are possible, but not always achievable, and should not be viewed as probable. Each deal is structured differently, providing a varying range of possible returns, many much lower and some much higher than those indicated here.

High equity returns are possible for a variety of reasons. First, companies acquiring stations can be leveraged significantly, thereby reducing the equity required to support the deal. Second, there are a number of situations in which the operating performance of a station can be improved dramatically in a relatively short period of time, increasing the value quickly. Finally, as noted earlier, since the fixed expenses of a station are relatively high when compared to the variable portion, once break-even is achieved, operating cash flow margins increase dramatically.

This potential for high returns does not imply that radio is without risk. Radio is management-intensive and requires hands-on attention 100 percent of the time. Poor marketing research or strategy, mismanagement or mishiring of staff, or lack of attention to community involvement and sensitivities can contribute to less than successful performance. The more the investor understands the underlying business of a radio station, the better prepared he or she will be to ask good questions, talk to the right people and perform the appropriate due diligence before making an investment.

Radio is a good vehicle for investments of all dollar sizes and this positive environment should not change in the future. A characteristic of radio that fosters involvement by all forms and sizes of investment is government regulation of ownership. As discussed earlier, the FCC, with the support of Congress, limits the number of licenses any one owner may possess. The ownership limits mean that there will never be industry consolidation into a powerful group of owners who amass hundreds of stations and crowd out smaller players. Most owners today pick market size, geographic areas, or programming niches and acquire stations that fit these targets. Owners may trade up as they reach ownership limits, but to keep within the limitations they may have to sell others as they add new stations. Even with the relatively low current limits on ownership, less than a handfull of operators are within one or two stations of the maximum. Because of these restrictions, it stands to reason that large corporations will concentrate on large markets to reap higher potential dollar returns. This common strategy all but eliminates the possibility of these corporations competing with small owners.

Two other characteristics that prevent large companies from dominating small and medium size markets are the localized community involvement so important to radio and the management intensity of running a successful radio station. Larger companies generally are not well suited to running small profit centers where economies of scale cannot be realized or to micromanage fairly small, independent and unique local stations. This is the role of smaller, more entrepreneurial companies.

2. The Investor's Role

Two avenues of investment are available to individuals or corporate entities. One is to invest on a private basis with an individual station owner or a group operator. This option gives investors the chance to shape and mold the role they

would prefer to play, thereby potentially tailoring the investment to their needs. The other method is to invest in public company stock or as a limited partner in a large radio venture, such as a master limited partnership. While these types of investments are more liquid, they do not permit the investor to have any meaningful involvement in the business nor do they have the flexibility to be fitted exactly to the investor's financial or tax requirements. Many securities firms follow public companies specializing in radio and other electronic media and provide good research and background on those stocks or partnerships. Therefore, this section will concentrate on private investments.

Individual investors can assume a number of different roles in a radio company. The choice of opportunities depends on: 1) the willingness of the operator to accept different positions an investor might request, 2) the total number of investors in the deal, 3) the ability to carve out a particular role for any individual, and 4) the legal, tax, and strategic goals of both the operator and investor.

A. Guidelines for All Investors

How should the average investor, who may be unfamiliar with radio, protect himself or herself prior to and during the investment cycle? Several steps are important and they include the following:

- Get the best education possible on the industry. Read books, publications, and trade magazines. Be familiar with the terminology and the names of major players. Understand the key concepts behind the business of radio. Visit several stations in different sized markets and talk to owners and managers.
- Understand how radio stations are valued. A number of publications report information on the sales of radio stations. Little data are available on the financial performance of the stations transferred, but the market, facility (power, tower height and location, and frequency), and sale price are all in the public record in addition to the names of the buyer, seller and broker, if any. Investors may also wish to discuss the radio marketplace with an acquisition consultant, broker or appraiser to get a more in-depth understanding of the process of valuation and the liquidity of the marketplace.
- Request a full presentation by the operator on the proposed transaction. The content and format should be similar to the borrower presentation described earlier in Section V-4(E) for use by lenders. The investor presentation will contain additional information about the equity structure and relationship between the operator and the investors.
- Understand the concepts and strategy behind the proposed investment. Challenge the assumptions in the context of well-accepted radio benchmarks. The projections provided by the operator should not only include the pro-forma results of operations, but should provide a set of possible sale or refinancing scenarios based on varying assumptions. For instance, a sale of the station could be assumed in three years and five years; the multiples of cash flow used to calculate the selling price could vary according to interest rate assumptions, but should decrease as the station's performance matures; and so forth. The investor should choose the set of assumptions with which he or she finds comfort. If none in the presentation meets the investor's test, then the operator might need to make new assumptions and recalculate the sale projections.

  A central element of the operator's presentation to the potential investor is the rate of return calculation. It combines all of the assumptions previously made, including purchase price, financing structure, interest rates, projected results of operations and estimated sale price, to arrive at a compounded pre-tax internal rate of return on the investor's cash in the deal. This will result in a single number, expressed in percentage terms, for each complete set of assumptions. If one variable or assumption changes, the calculation of internal rate of return must be redone and a new number will result.
- Remain active in the negotiation of the agreement between the investor and the operator. The investor's passive role in the operation of the station should not limit the investor from forging an agreement among the parties protecting the investor and creating a deal suited to both operator and investor. The shareholders' or partnership agreement detailing the relationship among the parties should contain not only particulars about the financial structure of the company and how the various interests in the deal will be apportioned. It should also contain the reporting requirements, investment exit provisions, buy-sell agreements among shareholders or partners, contingency plans for additional capital, and potential guarantee requirements, for example.

B. Passive Investments

The materials covered in this section generally apply to private equity raises as well as ones performed in the public market. Each financing has a different set of laws under which it operates. Investors should always obtain legal advice concerning securities laws, the regulations governing the private or public solicitation of funds, and their rights and obligations as investors before investing.

Many broadcasters acquiring stations invest their own cash in the deal and assemble a close-knit investor network composed of relatives, lawyers, accountants and other professionals, business colleagues, and friends. Sometimes this circle is enlarged because of the size of the deal or the need

to include certain people for non-financial reasons. Operators solicit "bite-size" equity contributions from these people in return for a stake in the venture. The operator promises to run the station, report periodically to the shareholders, pay dividends if possible, prepare and distribute tax returns, and sell the station at the right time. The investors usually make no commitment to fund additional capital requirements or to contribute their time or expertise on a formal basis.

The operator normally takes considerable risk and expends a great amount of time developing the investment before it is presented to the investors. Depending on the operator's employment status while preparing for an acquisition (working at a station or another business venture, or spending fulltime looking for properties, for example), he or she may be taking time away from their main business or spending considerable time after regular hours to pull together the acquisition project. Time is spent working with brokers, analyzing and inspecting stations, cultivating banking relationships, and preparing pro-forma projections and the presentations necessary for funding. When an attractive opportunity is identified, the operator may need to secure a letter of intent to acquire the station by committing a good faith deposit of $25,000 or more. The expended time, travel expenses and legal, accounting, engineering and acquisition consulting fees can all be lost if a deal collapses.

In return for the effort to find and prepare the acquisition for funding and for the ongoing responsibility of overseeing the management of the property, operators often request and are entitled to receive a portion of the acquiring company at a greatly reduced cost. Even if the operator becomes a fulltime employee, gets a salary and is entitled to bonuses or other benefits, that person has earned a "sweat equity" share through the sheer ability to put the deal together. Within the reasonable limits of propriety, passive investors should judge a deal by how they believe it will perform for their own account, not by how much the operator will receive. Creating appropriate incentives for the operator means ensuring that the operator makes a lot of money only if the investors do also. Some incentive agreements stipulate that some or all of the operator's equity be earned over a period of time to ensure a lasting commitment to the deal.

With most passive investments in radio the operator finds a station to buy before having a private placement memorandum prepared or before making a formal presentation to potential investors. The investment offering is then deal-specific, which allows the investor not only to judge the operator, but also an active deal. The operator may approach the equity investor in another way. In a two-step approach, some operators prepare a skeletal presentation containing all of the elements pertaining to the management, philosophy, and overall strategic goals of the company, but without identifying a specific acquisition target. One use for this sort of presentation is merely to familiarize potential investors with the operator and his or her goals. The operator may request no action by the investor other than a general indication of interest in the concept. Following the identification and analysis and during the negotiation of an acquisition, the operator would complete a full presentation, incorporating elements from the skeletoal presentation and adding pertinent information on the actual station under consideration.

Another variation of the two-step process is to ask investors to make, with varying degrees of commitment, a more firm expression of interest to fund the company prior to the selection of a deal. For instance, as in the previous case, investors could merely indicate a general willingness to look at a deal at the appropriate time, or they could commit to invest a specific sum of money following acceptance of a final business plan. Investors also might sign a subscription agreement and transmit funds to the company, either to be held in escrow until a deal was approved by the investors and closed, or to become part of a blind pool to fund acquisitions not requiring the investors' approval.

C. Joint Ventures and Other Active Investments

Investors with expertise in some aspect of radio or with a desire to be more active in the day-to-day business activity of the company may wish to structure a role allowing and encouraging participation. This type of partnership might allow the operator to make use of experience not otherwise available without considerable expense. For instance, in the case of an application for a new station, the majority owner and general manager may form an ownership team with a consulting radio engineer and a sales expert, all of whom would invest cash in the deal.

As mentioned earlier, forming a management team to lead an acquisition is becoming a common trend. The radio industry is becoming increasingly complex, due to growing competition, year-round ratings, fast-changing engineering and technical developments, new and sophisticated research, marketing and promotional techniques, higher station values and prices that demand more intricate financing plans, and the difficulty of finding and training good people. In the past, one single owner could perform all the key functions at the average station. The owner could find the property, arrange financing, manage the station, plan programming and sales strategies, and hire a good staff. With the exception of some smaller stations, the business has changed to make the traditional one-person show obsolete.

The gradations of involvement by investors in a radio station are virtually infinite. Passive investors should take care to insure that the assembled team is qualified to manage the station. Investors who take a more active role should be comfortable with the other members of management and

ownership. A deal whose key participants have not worked together in the past may experience difficult times as they adjust to each other's styles. Undoing an acquisition because of internal conflicts among either ownership or management can be quite costly and sometimes leads to protracted litigation. Contingencies for an orderly dissolution of the team may provide a smoother transition in case of a problem.

3. Investment Strategy and Goals

A. Maximizing Operating Strengths

The makeup and skills of the ownership and management team, to a large extent, will determine the type of station most suited for acquisition. For instance, if the operator has been responsible for the successful turn-around of three medium market FM stations, a new potential medium market FM turn-around acquisition would take advantage of that person's track record. If, on other hand, the same operator wanted to acquire a large market, mature AM standalone, those skills might not be as appropriate and the success of the venture might be less assured.

Successful experiences and skills that are generally transferable from one station to another (usually only in similar sized markets) include the following:

- Turn-around situations
- Start-ups and new construction
- Stations with identical or specialized formats
- Experiences in a particular market or region
- Move-in stations from outlying locales to larger markets.

Of course the basic skills of sales, programming, administration, engineering, and development of people are essential for all radio stations. Larger and more complex stations may have more people and billing, but the underlying skills needed are the same as for the smallest of stations in rural America.

The investor must look at the operator and the proposed station and assess whether the operator's team is up to the management requirements of the deal. If not, the deal may need to be restructured to bring in new staff or hire consultants with the missing experience or it may make more sense not to invest in a situation with such a mismatch between the operator and the acquisition.

B. Types of Opportunities—Weighing the Risks

In the first meeting between a radio station broker and a new buyer (once the broker has financially qualified the buyer), the broker will ask what type of property the buyer is seeking. The answer to this question from a variety of buyers would reveal the myriad types of properties and ways of describing them. The job of the investor is to match his or her appetite for risk with the skills of the operator and to agree with the operator on target categories of stations. What follows in this section are examples of types of investments available to buyers and a brief discussion of the potential returns and risks inherent with each. This is not an exhaustive or a fixed list. The categories of stations may shift in nature and number as the industry changes. The order of the listings is roughly from higher risk/higher reward to lower risk/lower reward.

- **Start-ups.** The FCC allows new stations to be allocated in both the AM and FM bands, with somewhat different procedures for each. Once an allocation is made or a frequency is applied for, the public is invited to file competing applications. Settlements among the parties prior to a final administrative decision by the FCC are permitted; alternatively, the FCC holds hearings to determine the applicant most qualified to hold the license. Among the most important criteria for passing FCC muster in a comparative hearing are the integration of ownership and management (owners proposing to work at the station fulltime are given credit) and diversity of media ownership (the applicant who owns fewer media outlets is better). Minority and female ownership is awarded a preference on a secondary level. The application process is simple and the costs are modest. If an investor funds an applicant through a full hearing, however, the legal and other costs can be significant, and the ultimate result can be a decision against the applicant. Many applicants attempt to settle without taking the risk of losing everything. No one, however, can predict if a settlement is possible in a given case.

  Investors wishing to participate in start-ups take the risk of spending several years prosecuting an application with a real possibility of not getting the construction permit. Settlements are laborious and one holdout among a large number of applicants could delay or frustrate the chances of a settlement, forcing a costly hearing. However, if the applicant is well-positioned and has the funding to last through a tough hearing, obtaining a construction permit through an application for a new station is a viable investment. The value of the station immediately after it is built is usually much higher than the sunk costs. Financing commitments should be sought from lenders months prior to the anticipated date of the CP grant, for many banks need additional time to understand the economics of a new station with no operating history.

  Sometimes holders of construction permits wish to sell them prior to building the station. The FCC permits the seller only to recover only the actual costs of pursuing the application, so this type of acquisition offers the investor and operator a chance to buy a start-up CP with no risk of losing the license in a hearing at a cost equal to that of the original applicant.

The next two types of radio properties, turn-around and mature stations, represent extremes. Most properties fall in between the two and exhibit qualities, problems, and opportunities of each.

- **Turn-arounds.** A turn-around is defined as a station that is performing below expectations. Many reasons can contribute to this underachievement, including a substandard technical signal not covering the market, poor program positioning, lack of good management, for example. An operator who sees an opportunity to improve ratings, sales or cash flow can justify paying a premium price for the station based on its current performance. Many turn-arounds have lost money on an operating basis, but some just have earned less than they could. In both cases the broker and seller will set a price for the property not based upon a normal multiple of cash flow. It is set higher to reflect the perceived improvement possible with a new owner.

  If the seller sees this potential, why doesn't he or she make the changes and reap the benefits? Many factors influence a seller to dispose of the property, rather than attempt to improve it, including lack of interest, poor health, inadequate funding, desire to acquire other properties, and a genuine inability to understand how to compete successfully.

  Turn-arounds can provide lucrative returns, with station values potentially tripling, quadrupling, or more. The downside risk to the owners depends on the initial entry price and the amount of additional funding needed. If the "stick value" of a station in the market continues to exceed the total money invested, the risk is minimal. Yet, it is possible to over-invest, not to succeed as projected, and to lose money on a resale. Turn-arounds are difficult to plan and manage, require much time, money and luck to succeed, but are well worth the effort if successful.

  Many operators would prefer to acquire turn-arounds, because they envision the greatest profits of any investment situation. Investors should be aware of the risks and be comfortable that the talents of the operator are the appropriate ones to accomplish the turn-around.

- **Mature stations.** These are properties that have long histories of consistent or improving performance in their markets. They are well-known and respected by the audience and advertisers. Cash flow margins are at the industry standard for the size market and format. The opportunity in these stations is to continue to maintain and improve performance at least incrementally. The highly predictable cash flow will allow for high leverage, therefore reducing equity requirements. With a low equity base, a small improvement in performance, either through market expansion or operating abilities, translates into a higher market value and a solid return for the investors.

  The risk in mature properties is that the station may be operating on borrowed time. The program format or general marketing approach to the market may be outdated, other stations may be starting to attack the station, or the number of new stations coming on the air may make the format too broad to continue to succeed. For these reasons, investors and operators should understand the vulnerabilities of the station and plan not just to be defensive but to wage an offensive battle for improved positioning in the market. High leverage also means that a slight drop in performance resulting in a loss of market value could significantly reduce the value of the station's equity. It also puts intense pressure on cash flow available for debt service.

C. Investment Goals

Some investors view all investments as financial transactions, regard the station as a commodity with more or less risk, and do not care to know much about the internal workings of the station. Few investors with significant positions take that radical an approach to investing in radio. Part of the attraction of the industry is its glamour, its visibility, and the opportunity to make millions because the investment was just right. Critical for investors, though, is a good idea of their own financial goals and personal aspirations in radio. Examples of substantive reasons investors buy radio stations are the following:

- Projections of high rates of return
- Loyalty to a trusted colleague who is buying a station
- Need for long-term investment
- Desire to learn about the electronic media
- Desire to invest in a particular market or region
- Goal of buying and selling properties rapidly to increase equity stake
- As a hedge with other investments
- Desire to increase personal stature in community or to complement another local business.

The particular station or group of stations under review may meet some of these goals but not others. Each operator can contribute useful strengths to stations that meet some of the particular goals listed above, but very few station situations can satisfy more than two or three categories.

D. Financing Strategy

As with the choice of types of stations to acquire, the investor and operator can choose the financing strategy that fits their individual styles and the needs of the station and the lenders. Flexibility in structuring the financing is dependent on the ability of the station to support different levels of debt. A station with higher and more consistent cash flow can support a higher amount of overall debt and can enable the

company to inject levels of subordinated debt as well.

Aside from the financial capability of the station to take on debt, the investors and the operator need to be comfortable with the debt load they will accept. From an operating standpoint, higher debt and therefore higher interest and principal payments may narrow the options for a station to make bold changes in operating strategy. Instead of switching formats to reposition the station better for future profitability, the operator of a highly leveraged property may choose to stick with the existing format, thereby jeopardizing the long-term prospects for the station. The short-term cash needs to support a strong marketing push with a format change may be too costly for the cash-tight station.

Some forms of financing do not consume cash during the normal life of the investment. Bullet or zero-coupon notes, rising interest rate notes, or equity kickers given to sellers, debt holders, or other providers of station financing serve to reduce payments of principal and interest in the short term, but carry a higher cost at the time of sale or refinancing. To accommodate the cash needs of the operator, financiers will negotiate the form, timing and payback method of the investment. If a lender is asked to forego any payments until the time of sale, the overall cost to the operator and the rate of return to the lender will rise. This higher return compensates the lender for loss of use and time value of the interest not received as well as the increased risk incurred by waiting for payment. In return for an easier payment schedule during the operating life of the deal, thus allowing the station to raise less equity and giving it more operating flexibility, some operators agree to pay a higher rate of return for funds and to give up more of the back-end profit.

A higher infusion of equity capital, coupled with less debt, reduces significantly the pressure on a station to meet interest and principal payments to the lenders, and allows profitable stations to pay out dividends or distributions to its holders. However, this strategy may not be a wise use of a limited equity source if the investors wish to acquire additional properties. And if the appreciation of the station is not significant, the rate of return at sale time on a large equity base will be low.

The following simplified cases illustrate the relationship between levels of debt and equity and rates of return:

	Profitable sale
Acquisition funding	$5,000,000
Sale proceeds after three year hold	5,715,000
Case One—High Leverage	
Equity invested	750,000
Debt upon acquisition	4,250,000
Debt payable upon sale	4,250,000
Return to equity holders	1,465,000
Compounded internal rate of return	25%
Case Two—Moderate Leverage	
Equity invested	$1,500,000
Debt upon acquisition	3,500,000
Debt payable upon sale	3,500,000
Return to equity holders	2,215,000
Compounded internal rate of return	14%

4. Matching the Investment and Operator—A Checklist

Successful business transactions combine the precision of science and the creativity of art in such diverse qualities as analysis and intuition, planning and pragmatism. This section will begin to address the dichotomies and inconsistencies in assessing operators, in searching for the perfect deal, in knowing when to say "go" and when to say "no."

A. Matching Goals, Objectives, Philosophy and Style

In general, investors and operators are different types of people. Operators can be good businesspeople who understand the bottom line, appreciate the need for profitability, and reap and enjoy the same rewards as investors, but their outlook on life is usually from a different perspective than that of investors. The investor's goal should be to find an ideal operator to invest with, not one who simply has an identical personality type but whose personality complements the investor's. Their overall business goals and objectives should be similar and certainly compatible.

If the operator forms a team of management people and the investors comprise a group, the leaders of each must represent the entire set of people when negotiating on their behalf. Each individual, however, must be heard as the deal is being put together. Each person in management will play an important role in some aspect of running the station and will have an impact on its operation. As the deal is finalized, the tone of the operation will be established and, subject to changes throughout the deal, the initial responsibilities and authority of the parties will be formalized. The time to voice concerns is before the deal closes. Too often an investor will suppress discomfort or decline to raise questions before the deal is closed for fear of upsetting the transaction, which may result in more difficult resolutions of problems later on.

B. Learning About the Operator

Ideally, investors and operators would find each other long before an attractive transaction becomes available. Both parties benefit from a longer relationship than one begun in the midst of the pressure of completing a deal. Building a relationship requires much planning and a major commitment of time and effort, but will assure that the parties have

a better basis for understanding each other when the final deal is negotiated.

In reality, some constraints prevent most opportunities for operator and investor to work together before a deal is on the table. The investor usually has little time to perform due diligence on each and every potential operator. The investor does not know at the time of a first introduction, prior to a deal presentation, whether or not the operator will find a good deal or if the operator will be a good fit in a deal. The investor risks interviewing dozens of operators with a small chance that any one of them will find an acceptable station. (Likewise, the operator does not want to spend many hours meeting with prospective investors most of whom may never commit to fund a deal.) Also, when presented a transaction for review, the investor has the opportunity to judge the operator's ability and desire to find and analyze a deal on his or her own, without the comfort of knowing the financing is in place.

C. Initiating the Deal

Operators and investors are both excellent initiators of transactions. Does the investor gain any advantage by finding a property and then searching for an operator, or is it preferable to let operators with deals find him or her? Here are some points to consider:

- Operators working on their own, without at least a core group of identified potential financial backers or some cash of their own, will have a hard time establishing credibility with brokers and sellers. If such an operator finds a deal and is able to lock it up with a letter of intent, there will be a limited time to find funding for the deal before a sizeable escrow deposit is due upon contract signing. Therefore, most operators secure some financing through their own resources and those of close associates prior to looking for stations. Once the deal is tentatively agreed upon, the operator has a less pressured environment within which to work because less additional funding is needed and his or her own commitment of equity in the deal is a positive draw for investors.
- Investors shown deals by operators usually have limited time to decide whether or not to invest. It is incumbent on the operator to prepare a complete presentation for the investor's review as soon as possible. Investors must ask questions and request information about the deal quickly. While this factfinding is progressing, the investors and the operator are learning about each other and attempting to determine if they can work well together.
- Investors do find stations on their own through personal contacts in the industry, directly from sellers, or through brokers. Investors have several choices for filling management needs once a deal is tentatively accepted. The first job of investors is to assess the quality of the existing management team and its compatibility with their own goals and style. If the target station has good people in place and everyone believes management should remain at the station, a deal can be struck. On the other hand, the seller may be the general manager and desire to leave once the closing has taken place. There may be department heads or a station manager who could be elevated to the top position. If not, or if the investor wants a new management team, the investor needs to find management from outside the station. As with any job search there are a number of sources for candidates available to the investor, ranging from competitors in the market, contacts in the radio industry and the personal network of people the investor develops, to executive search firms.

When investors decide to hire an outside general manager or a management team, they may choose to hire the persons on a salaried basis, including bonuses, incentives, and the like. In addition, they may choose to supplement the package with a stock or partnership interest. This interest in the company can be designed in many ways. It can be in the form of the right to acquire stock at a fixed price or a price based on a formula, the issuance of stock options or warrants, or an earn-in where the stock or options are earned or the right to acquire them is earned following a vesting period or the achievement of performance goals.

D. Investor or Operator—Who Controls the Deal?

Unless the investor has radio experience and plans to contribute time and effort to the running of the radio station, the operator usually will be regarded as the chief operating officer of the company, responsible for the day-to-day activities of the station. The investor might be the chief executive of the entity, controlling only overall corporate affairs. Such sharing of responsibilities may typify a deal in which the investor and operator have equal or comparable stakes in the company or when the operator controls a majority interest. With this split in duties, the parties should have a shareholders' (or partnership) agreement that covers not only the normal governance issues such as election of officers and directors, tax status election, selection of accountants, buy-sell provisions among shareholders, issuance of new shares, borrowing of money and provisions for additional capital. It should also cover the management duties of the operator. Provisions pertaining to management might include, for example, delegation of certain duties to the general manager, reporting requirements, procedures for setting performance goals and budgets, and delineation of decisions requiring the investor's prior notification.

An investor may become the chief executive of the station as well, controlling the management of the station and the affairs of the company. The operator would probably own a minority position in this situation. Here, the parties

need to detail their understanding in an agreement similar to the one described above, but with more elements typically found in an employment agreement. The operator may request protection in areas such as the sharing of a decision to sell the station, the adequacy of funding for future operating and capital expense items, and the sufficiency of authority to manage the station appropriately.

Some investors and operators believe that a full written delineation of the understandings between them is unnecessary and a waste of time and legal fees. However, even if the people involved have worked together for years, every deal is different and has its own nuances. The parties always share some common directions upon which they will agree. There will also be issues upon which, by the nature of their roles, they are natural adversaries. Litigation can be avoided by addressing fully all reasonable concerns and eventualities in a legal document. There should be no surprises.

E. The Operator's Expectations of the Investor

Operators who do not deal frequently with financiers can have trepidations about such relationships. Both sides usually sense the differences in perspective each brings to a deal. Viewed objectively, this divergence of positions is healthy and brings new and fresh ideas to a radio deal and to its financing. Subjectively, many partners in properties see the possible friction as a cause for concern about the well-being of their relationships.

In roughly equal partnerships, the investor and operator each feels somewhat at the mercy of the other—the investor for the expertise of the operator and the operator for the funding of the investor. It is relatively simple to detail the investor's expectations from the operator in an agreement between the parties. However, the operator views the investor not only as a source of funds whose checkbook might disappear the day after the closing, but as an integral player in the long-term strategy of the company.

What role does the operator want the investor to play? Many investors can bring solid banking or other financing sources to the table. Through past dealings with lenders, the investor may have relationships that enable the bank to offer the station a better set of terms than the operator alone would have received. This assistance can place the investor in the role of an overall financial advisor to the company. Along the same lines, the investor usually has a better understanding of creative financing and structuring than the operator and can be of great help. Other strengths that some investors bring to a deal might include legal and accounting expertise, personal business experience and contacts, and management skills. These strengths can be utilized if the investor and operator have a mutual respect for each other. Although operators may be nervous and reluctant at times to seek help, they usually would welcome the opportunity to accept assistance if proffered in a nonthreatening way.

The main hope of an operator is to have investors who are knowledgable about the industry, or are willing to take the time to educate themselves. It is frustrating for operators who inform their investors about financial and operating progress at the station to find that the investor does not understand the information or care to learn. When a crisis hits the station and the investors' input is needed on a timely basis, the operator is in no position to spend precious time teaching basic radio to the investors. On the other hand, it is incumbent on the operator to fully educate the investors about the deal in the initial presentation for funding and during the deal in periodic meetings and reports.

5. Structuring the Deal

Two basic investment points explain the perspective that equity participants hold when investing in radio stations. First, equity is the last money in the deal, the money that closes the gap and makes the deal possible. Therefore, it is the money at the most risk and the money that comes out last. Only after all other holders of debt and other instruments are paid do the equity investors get their principal returned plus any profits. Second, risk and reward have a positive correlation to each other. That is, when the perceived risk of an equity position rises, the reward must be higher to compensate for the risk. Conversely, when the risk decreases, the equity holder deserves a smaller potential return.

Remember, the risk mentioned above is specific to the equity holder, which is not the same as risk to others in the deal. All layers of debt and the other financing elements have their own perceived risk, thereby necessitating different rates of return. For instance, a small layer of senior debt on a particular station might carry very little risk in the eyes of the lender. And the same station may have a large mezzanine debt layer that to the mezzanine lender looks more like equity than debt in terms of risk and reward.

Through an analysis of a number of deals, it is apparent that virtually no equity players give up the right to an unlimited upside potential—there is no cap on their rate of return other than the economic realities of the deal. However, there are structuring techniques used by equity holders to limit the downside exposure.

A. Common Investments for Equity Money

There are many types of legal structures and methods of investing most common to equity participants in radio station transactions. Corporations and partnerships are two viable legal entities used for radio station acquisitions when there is more than one owner. Even with a single individual owner, few persons choose to use sole propietorships as the ownership vehicle. Corporations have the advantage of the

general shield against personal liability for the shareholder. The directors and officers have a limited but real exposure to personal lawsuits, but only under reasonably avoidable situations. Corporations can be taxed on a regular basis or, if they meet certain tests, under Subchapter S of the IRS Code. "Sub S" corporations are not taxed at the corporate level—all tax consequences are passed through to the shareholders, similar to the effects of partnership accounting. This reduces the amount of taxes paid.

Partnerships can be either "general" or "limited" in legal terms. In either type of partnership, the general partners are legally liable for all normal exposure of the partnership, including taxation and financial and legal liabilities. General partners under certain circumstances may be corporations or other partnerships. Limited partners in a partnership receive a shield against liability similar to shareholders in a corporation. Any legal entity, including an individual or another partnership, can be a limited partner in a limited partnership. Partnerships are not taxed at the partnership level. Any taxes are paid by the partners.

A partnership agreement can be written to incorporate the simplest or the most complex understandings and is merely dependent on the creativity of the partners for its ability to meet the needs of the parties. For instance, a partnership formula to determine distributions upon the sale of the radio station can change when certain targets are met. The language might read:

> ". . . of the first $1 million in proceeds, 100 percent of the funds are paid to the limited partners (investors) as a return of their capital contribution; of the next $1 million in proceeds, 60 percent of the funds are paid to the limited partners and the remainder to the general partner (operator); of any proceeds over $2 million, 85 percent of the funds are paid to the general partner and the remainder to the limited partners."

The investor's legal and tax counsel should give advice on the most advantageous structure for the company acquiring the station. The structure that accomplishes the business and tax goals of the investor can probably meet the operator's needs. The element of critical importance to the operator is the sufficiency of funding provided by the investor.

The following is a brief list of typical investment vehicles used in broadcast properties. For simplicity, the terms apply specifically to a corporate entity, which is less flexible in its structure, due to its legal nature, than a partnership. Partnership agreements can accomplish the same goals but must be worded differently.

- **Common stock.** The most frequently used form of ownership is the issuance of common stock to both the investor and the operator. The price each pays for stock might be different to reflect the "sweat equity" earned by the operator. If there are no other classes of stock in the company, the dividends, distribution of sale proceeds and personal tax consequences (if any) flow to the individual shareholders according to their percentage ownership of common stock.
- **Preferred stock.** Only regular, and *not* Sub S, corporations can have more than one class of stock. Preferred stock is a class of stock issued as a secondary form of ownership after common stock. Preferred shares usually have a coupon or rate of return that is paid as a dividend prior to the distribution of any proceeds to the holders of common stock. Preferred stock is used to differentiate rights among the various classes of stock and commonly gives the holders a lower risk investment because of its prior rights to distributions. It is not unusual that preferred shares lose some other rights, such as voting. In some cases preferred shares are convertible into common shares at a predetermined price. Many preferred issues must be converted prior to a complete liquidation of the corporation in order to calculate the proceeds due the preferred shareholders.
- **Options and Warrants.** An investor might decide to invest in a broadcast company by buying both common stock and an option to buy additional common stock. The option would convey to the holder the right to acquire a certain number of shares or percentage of the company at a prenegotiated price or at a price determined by formula. Care must be taken while designing the option so that the tax ramifications are completely understood. If the option price is less than the fair market value of the shares at the date of issuance, the investor may be liable for a personal tax on the difference. The value of an option to the investor lies in the opportunity to acquire stock at a future date at a fixed price presumably lower than its future worth. Usually the investor pays a modest sum for the option; the operator views the issuance of the stock option and the future cost of the dilution as a necessary cost to entice the investor to the deal.

  A warrant to acquire stock is usually attached to a debt instrument. If and until the warrant is exercised, the debt pays interest and principal according to a repayment schedule. Upon the warrant's exercise, the debt associated with it is eliminated in exchange for a certain number of shares or percentage of the company. A warrant is attractive for an investor because he or she has the choice of maintaining the investment as debt or converting it into stock at a time when the relative values of the alternatives are well established.
- **Other investment vehicles.** In addition to equity-type investments, many operators offer investors the chance to acquire pure debt. Some investors prefer to lower the risk and potential return with a balanced investment of

part debt, part stock. If there is no other senior debt, investors can acquire debt in a senior position in addition to some form of equity participation to achieve a balanced risk/reward ratio and receive current income in the form of interest payments. Few investors, however, decide to become the only source of funding for a deal. From the investor's standpoint, the more money the operator commits to the deal, the better. Any other lenders or investors who stand near the investor in risk help to manage the financial structure of the company should there be difficulty.

Some investors prefer to take a non-equity role and reduce their risk substantially. One way of participating in the upside of a radio deal while keeping the body of the investment secured is by funding subordinated debt. As described in an earlier section, subordinated debt usually commands a higher rate of return than senior debt and is often enhanced through the use of equity kickers, options, warrants, or other profit participation vehicles. The principal of the debt would normally be secured by a second position on the assets and the stock of the licensee, thus somewhat protecting the creditor. The upside potential resides in the yield enhancements that depend on increased value or performance of the station.

Leasing land and buildings or equipment from a separate corporate entity to the broadcast company is yet another way for an investor to derive income from radio. It also can create tax advantages for both the station and the investors if used correctly. This financing method is normally used to attract institutional financing rather than private investors, for the risk and returns are both relatively low.

B. Pricing the Investment

A number of factors influence the rate of return investors need to induce them to invest in a particular deal. Other factors influence the rate of return an operator will give up to receive financing. The following are examples of forces that impact upon typical investors as they decide to invest in a radio deal:

- Risk/reward balance. Is the risk of losing money balanced by the potential for high returns? Can the return be high enough to justify the downside risk?
- Alternative investments. For the same risk, can the investor find an investment with a better potential return? For the same return, can the investor find an investment with a lower risk?
- Control. Is the level of control the investor keeps or concedes appropriate for the competence level of the operator? Is the management team fully capable of running the enterprise?
- Personal risk. Is the dollar amount of the investment prudent relative to the net worth of the investor? Can the investor afford to lose the entire investment, or should the risk be lowered through the use of debt-like instruments to help alleviate this concern?
- Time pressure of the deal. If the funds need to be committed quickly, has the investor spent sufficient time getting comfortable with the deal and the operator?
- Deal effort. Who drove the deal? Did the investor or the operator find, analyze and structure the deal? Who will commit time to the management and oversight of the station once the transfer is completed?
- Operator's financial and personal commitment. Does the operator have personal financial risk in the deal? Has the operator committed all the funds reasonably available for investment and backed the deal with a personal guarantee? Will the operator focus solely on the investor's venture?
- Knowledge of the deal. Does the investor know the station, the seller, the market, and the proposed operator? Does this working knowledge allow the investor to be more comfortable with the investment?
- Economic trends. Does the general tenor of the national or regional marketplace tend to support investments like radio stations? Are economic growth, employment, and interest rates rising or falling?

There is no formula that integrates these and the many other factors that enable the investor to decide upon a reasonable rate of return. Some investors are naturally more conservative and others more aggressive in their approach to risk. While individual investors make their own analyses, there are benchmark rates of return that are typical in the radio business. The actual rates of return common at any time reflect current interest rates. The investor should check with knowledgable sources for the appropriate range of returns before investing.

VII. CONCLUSION

There is an old adage that owning a radio station is like owning a license to print money. Anyone familiar with the radio industry knows that the radio business is intensely competitive, and for many station owners, profitability is an elusive goal. But with a few rare exceptions, the difference between success and failure in radio station ownership is not a matter of chance. Successful radio station ownership is the reward for a thorough understanding of the economics and management of radio, intelligent financing, meticulous due diligence, and development of a candid, constructive relationship between the broadcaster and his or her lenders and investors. This book is intended as a starting point toward achieving that understanding.

VIII. ABOUT THE AUTHORS

ROBIN B. MARTIN

Robin B. Martin is the founder and Chief Executive Officer of The Deer River Group, a Washington-based investment banking firm specializing in communications consulting and a group owner of radio, television, and cable television properties. The firm specializes in assisting buyers, investors and lenders interested in broadcast properties in several areas: structuring and financing of acquisitions, education in the electronic media, determination of investment strategy, and the finding and analysis of potential acquisitions. In addition, the firm advises on the development of strategic and operational plans.

Mr. Martin acquired his first radio station in 1968 and since then has owned a total of 21 broadcast stations. He received an undergraduate degree, *cum laude,* in Electrical Engineering and a Master's degree in Communications, both from Rensselaer Polytechnic Institute. He served in the White House under President Ford and then as Assistant to the Chairman of the National Transportation Safety Board. Mr. Martin has spoken at many industry conventions on the acquisition of properties and has assisted over 200 consulting clients in their purchase and financing of radio and television stations and cable television systems.

Mr. Martin is the author of *Broadcast Lending* and a co-author of *Buying or Building a Broadcast Station,* Second Edition, both published by the National Association of Broadcasters.

ERWIN G. KRASNOW

Erwin G. Krasnow, a partner in the Washington, D.C. law firm of Verner, Liipfert, Bernhard, McPherson and Hand, Chartered, was formerly Senior Vice President and General Counsel of the National Association of Broadcasters. He is a *summa cum laude* graduate of Boston University, and received a Doctor of Jurisprudence degree from Harvard Law School and a Masters of Law Degree from the Georgetown University Law Center.

Mr. Krasnow is the coauthor of several books, including *The Politics of Broadcast Regulation, Buying or Building a Broadcast Station,* and *101 Ways to Cut Legal Fees and Manage Your Lawyer.* He is a founding Director and Treasurer of the Broadcast Capital Fund and serves as Washington Counsel to the Broadcast Financial Management Association.

In April 1984, COMM/ENT Law Journal, Hastings College of Law, selected Mr. Krasnow as the recipient of the Roscoe Barrow Award for "outstanding achievement in the field of communications." The Broadcast Education Association named him as the 1987 recipient of the Distinguished Education Service Award, an annual award given to a person who has made "a significant and lasting contribution to the American system of broadcasting."

Mr. Krasnow serves as General Counsel of the Deer River Group, an investment banking firm specializing in communications consulting. A member of the FCC's Advisory Committee on Minority Ownership in Telecommunications, he is an expert on minority tax certificates. During the past five years, Mr. Krasnow and other members of his law firm have represented clients in media transactions totalling over one billion dollars.

IX. APPENDIX:

RADIO PUBLICATIONS AND OTHER PRODUCTS AVAILABLE FROM THE NAB

MANAGEMENT

- *Radio In Search of Excellence: Lessons from America's Best Run Radio Stations,* 1985
- *The Radio Station*—Second Edition, 1986
- *Developing an Effective Business Plan: A Working Guide for Radio Stations,* 1987

FINANCE AND INVESTMENT

- *NAB/BFM Radio Financial Report,* Annually in Fall
- *Fair Market Value of Radio Stations: A Buyer's Guide,* 1990
- *Radio Acquisition Videotape: "How to Value, Locate and Finance a Radio Station,"* 1988
- *Buying or Building a Broadcast Station,* Second Edition, 1988

RESEARCH

- *RadiOutlook: Forces Shaping the Radio Industry,* 1988
- *Broadcasting Bibliography,* 1989

LEGAL

- *NAB Legal Guide to Broadcast Law & Regulation,* 1988

ADVERTISING AND MARKETING

- *Radio Advertising: The Authoritative Handbook,* 1988
- *Developing an Effective Marketing Plan: A Working Guide for Radio Broadcasters,* 1989

PROMOTION AND PROGRAMMING

- *Radio Programing: Consultancy and Formatics,* 1987
- *Programming Radio to Win in the New America*

For information on the resources listed above, or to obtain a free copy of NAB's Member Services Catalog, call NAB Services toll free at 1-800-368-5644 (in the Washington, DC area, 1-202-429-5376) between 9 am and 5 pm ET.