

FINANCIAL DIRECTOR BRIEFING business model

VIRGIN MOBILE IPO AND BRANSON 'RISK'

The Virgin Mobile listing particulars shed light on the operation of a 'virtual' network operator and its relationship with the parent Virgin Group, which owns 75% of the phone operator following its flotation on the London Stock Exchange.

Virgin launched its mobile phone service in November 1999 and has since acquired 4.0 million subscribers out of a total market of 53.9 million. The published subscriber and market share data of the network operators is:

T-Mobile	13.8m	25.5%*
Orange	13.7m	25.5%
O2	13.2m	24.6%
Vodafone	12.8m	23.7%
3	0.4m	0.7%

* Includes Virgin Mobile, 4.0 million, 7%.

*Virgin Mobile = Virgin Mobile Holdings (UK) plc, which floated on the LSE, 26 July 2004.
VMTL = Virgin Mobile Telecoms Ltd – the operating subsidiary.*

Relationship with T-Mobile

Virgin Mobile is a mobile virtual network operator (MVNO), which uses the facilities of T-Mobile, a mobile network operator (MNO). It also competes directly with T-Mobile, just as it does with BT Mobile, another MVNO.

There were various legal disputes between Virgin companies and T-Mobile companies concerning a shareholders' agreement and a telecoms supply agreement, which were resolved in January 2004 with (a) T-Mobile paying £16m to VMTL; (b) Virgin Group acquiring T-Mobile's shareholding in Virgin Mobile; (c) a new telecoms supply agreement;

and (d) a £50m payment by a Virgin Group company to T-Mobile following the listing of Virgin Mobile.

As a virtual network operator, Virgin Mobile is reliant on T-Mobile providing it with customer and usage data. Until January, Virgin had only limited rights of audit in respect of the information provided by T-Mobile. The new agreement between them allows for greater audit rights, though Virgin Mobile has not exercised these rights. "As a result, there can be no assurance that the data we receive are accurate."

Financials

Virgin has no network infrastructure of its own as it operates a telecoms supply agreement with T-Mobile. Hence, its capital expenditure is low and its return on capital employed was 80% in 2003.

For the year to 31 March 2004, Virgin Mobile reported turnover of £487.6m, EDITDA of £91.3m and operating profits of £75.8m (15.5% of turnover).

As of the date of publication of the listing particulars, the subsidiary operating company, VMTL, had negative distributable reserves of about £80m and was applying to the courts to eliminate this shortfall by reducing the share premium account. Without such a reconstruction, the subsidiary will not be able to pass dividends up to the parent, which will then not be able to pay anything to shareholders. But assuming the court gives its approval, the group intends to adopt a distribution policy that reflects the cash flow generation of the business, split 67:33 between the final and the interim dividend.

The Branson factor

The listing particulars claim that Virgin is the fifth most admired brand in the UK. Virgin Mobile has a 30-year licensing arrangement that entitles the group to use the Virgin brand, subject to various conditions. VMTL pays 0.25% of annual revenue for the licence to use the Virgin brand.

If for any reason the group lost the right to use the Virgin brand, it would also lose the right to use T-Mobile's network and would trigger a default under a credit facility – amounting to £330m at the time of listing plus a further £20m not drawn down – which could result in a cessation of business.

At the same time, the group is also under an obligation to use the Virgin brand, restricting the group's ability to operate other than under the Virgin brand.

The listing particulars state that the company believes its market position has been enhanced through the affiliation with the Virgin brand and with Sir Richard Branson, who will be the company's president from the date of listing. (This position is honorary and not a director position; Virgin Mobile will receive 10 days' service from Branson per year to assist with business strategy issues, mentoring and promotional activities. Virgin Mobile will pay £100,000 a year plus VAT plus expenses to either the Virgin group or a charity of Branson's choice.)

But the document also recognises that if any other part of the Virgin group, or even Branson himself, were to suffer from negative publicity, that could have a material adverse effect on the business, operations and brand of Virgin Mobile.

The group has contractual arrangements for the promotion of Virgin Mobile in Virgin Retail's shops. These outlets make up 17% of new connections.

IT system

In September 2003, the management information system used for extracting individual customer usage information "reached capacity", says the listing particulars in the chapter headed Risk Factors. Since then, the company has had to make various assumptions in calculating its total and active customer data.

An enhanced MIS is being developed but is not expected to become operational until January 2005. While this does not affect the calculation of Virgin's turnover, the perception that its operational data is unreliable could result in investors changing their estimation of the value of the business, the document says.

E-money

There is a possibility that Virgin Mobile may be regarded as an issuer of 'e-money' and, as a result, become subject to regulation by the Financial Services Authority. While it is currently a grey area, it may be that the use of prepay phones to buy goods and services constitutes the use of e-money. If it becomes subject to FSA regulation as an "electronic money institution", the company will have to meet certain capital adequacy requirements and impose regulatory requirements on the company's management.

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Useful links

- The listing particulars are available to UK readers only at www.virginmobile.com