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Executive Interview: An Interview with Dan Champeau and Chad Lewis

Daniel A. Rascher
University of San Francisco, RASCHER@USFCA.EDU

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Conducted by Daniel Rascher

Dan Champeau is a Managing Director in Fitch's Global Project Finance and Public Finance groups and leads Fitch's sports finance practice company-wide and is also head of the Municipal Public Finance Group's New York Office. Fitch currently has about 1,600 employees in 50 offices.

In November 2003, at 33 years old, Dan was named as a recipient of the *SportsBusiness Journal*'s "40 Under Forty" award; which recognizes the 40 Top and most innovative sports industry executives under the age of 40. Dan has also won the "Smith's Research and Rating Review Annual Analytical Award" in Revenue Bonds twice in the past few years for his work as an analyst in the sports finance field.

Since joining Fitch Investors Service, L.P. in 1994, Dan has been involved in transactions involving all four of the US major league sports, including league-wide deals, sports franchise transactions, and public and private placement sports facility transactions in the US, Europe, Asia, Australia, and other locations throughout the world.

Fitch has opined on roughly $17 billion in sports finance debt over the last decade. Fitch has rated more than 65 sports related debt transactions and reviewed about 120. Fitch-rated clients have included Major League Baseball; the NFL; the NBA; Boston Celtics; Phoenix Suns; Washington Redskins; The Staples Center in Los Angeles, CA; The Pepsi Center in Denver, CO; The American Airlines Arena in Miami, FL; and the refinancing of the America West Arena in Phoenix, AZ; as well as major league facilities in Boston, Tampa Bay, Detroit, and San Francisco.

Dan also manages all Tax-Exempt Revenue Bond Sectors nation-wide including Health Care, Housing, Public Power Utilities, Higher Education, and Transportation. Through his various management responsibilities, Dan oversees about 60 employees. Dan is also a member of the Public Finance Executive Committee and Credit Criteria Policy Board.

He has been an authority on sports finance having spoken as an industry expert at approximately 35 industry events over the past few years. In addition, he has appeared on CNNFn, ABC News, Forbes.com's SportsMoney, and other media outlets as an expert to discuss sports finance, has been quoted regarding sports finance in the *SportsBusiness Journal*, the *Wall Street Journal*, *Barron*'s, *Investment Dealers Digest*, *Investors Business Daily*, *The Bond Buyer*, and numerous other publications. Dan lectures annually at Columbia University, NYU, and Florida Atlantic University on the bond markets and the sports business in particular.

Prior to joining Fitch Investors Service, L.P., Dan was at AMBAC Inc., working in the corporate finance department on strategic financial planning, budgeting, competitive analysis, and cash flow modeling.

Dan received his BA from the University of Maryland at College Park, attended Fordham University Graduate School of Business, and received an MBA from San Francisco State University.

Chad Lewis is an Analyst in Fitch's Global Project Finance focusing on both sports-related transactions and other revenue-backed infrastructure transactions. Since joining Fitch Ratings in 2002, he has been involved in transactions involving all four of the US major league sports, including league-wide deals, sports franchises, colleges and universities, and public/private placement sports facilities in the US and Europe.

Chad primarily focuses on stadium and arena transactions as well as the league-wide credit facilities for the NFL, NBA, and MLB. He has played a lead role in transactions including Citizens Bank Ballpark in Philadelphia; Dolphin Stadium in Miami; the Verizon Center (formerly MCI Center) in Washington, DC; PETCO Ballpark in San Diego, and the Los Angeles Dodgers. Additionally, Chad is responsible for monitoring ratings in Fitch's sports portfolio on an annual basis.

Chad has been a guest speaker at Columbia University, NYU, and Florida Atlantic University on the bond markets and the sports business in particular. Prior to joining Fitch, Chad worked at the Dormitory Authority of the State of New York, which issues tax-exempt bonds for colleges, universities, hospitals, and other non-profit organizations. Chad received his BA in political science and economics from the University of Rhode Island and was a member of the men's ice hockey team.

Role and Trends

Q: What are the essential skills needed for your job?

A: Essential skills for the job include a solid core understanding of sports franchises and the league economics and the relationships between the two. Additionally, a strong financial background including the ability to analyze financial statements, financial modeling and forecasting, legal aspects of bond transactions, and understanding of demographic elements in an area that could impact a transaction, both positively and negatively, are necessary.

Q: What are the recent trends or changes in rating debt in sports?

A: Overall, sports in the US are in a very unique position. All four of the major leagues currently have Collective Bargaining Agreements (CBA) that extend until at least 2011 (certain provisions in the NFL that allow for an early termination) and all are arguably in a good position from a television broadcast standpoint, excluding the NHL. However, Fitch believes the new CBA should allow for a sizeable national television contract given the elements in the new CBA, underlying leagues economics, and strong fan base. Fitch has also seen strong growth in attendance numbers across all of the leagues, strong renewal rates of suites, key sponsorships, and advertising contracts, and no immediate signs of negative trends. Essentially, the recent trends are that the underlying economics of the leagues have strengthened.

Q: Are there fundamental differences in debt rating in Europe, Asia, or Australia? If so, what are they?

A: Fitch approaches ratings in similar sectors the same throughout the world. Standard financial measures, including debt service coverage ratios, acceptable leverage amounts, debt maturity length, legal packages and covenants, and construction packages are all viewed the same. The key differences are in the structure of the leagues. Clearly the Premiership League has a structure which differs greatly from any league in the US, in that, the top 10 clubs greatly benefit from the television contract revenues and the bottom 10 clubs receive a significantly smaller portion. Given this structure, revenue certainty based on the television contracts is significantly less; however, there are certain structural features that mitigate some of the concerns.

Q: Why was/is Wall Street biased against sports debt?

A: Historically, there has been a negative bias towards sports as a business from the debt side. People not involved in the industry have viewed sports as not being a real business, and not having meaningful, bankable, real revenue streams that could support ongoing amounts of debt, but rather as an entertainment venue where they go to have a beer and hot dog. This has changed as investors on the buy-side and investment banks have gained comfort with the economic models of the leagues, and as league and team officials have put forth the effort to help the market understand their business from a financial wherewithal perspective. Over time, there have been fairly sizable long-term revenue contracts that have been relied upon for long-term debt issuances in the billions of dollars. Any analyst will have a healthy sense of skepticism when reviewing a new industry for them, but once they see the excellent track record of debt in the industry, the Wall Street bias has gone away. This industry has performed exceptionally well. There are very few problems that one can point a finger at. In fact, there has been no debt that Fitch has rated in sports that has even come close to defaulting.

Example

Q: Please take us inside of a project, such as your work involving Dolphins Stadium. What were the key elements?

A: In 2006, Fitch rated a transaction for the South Florida Stadium Corp. (Dolphins Stadium, formerly Pro Player Stadium and prior to that Joe Robbie Stadium). Fitch has had a long rating-relationship with the stadium dating back to the early 1990s. The Stadium Corp. issued approximately $100 million in revenue bonds supported by certain stadium revenues. This transaction is unique because the stadium, which was constructed in 1985, continues to be a marquee stadium, which in addition to attracting such events as Super Bowls and BCS National Championship games, plays host to the NFL's Miami Dolphins and MLB's Florida Marlins. The key elements of the transaction looked at the Dolphins' renewal rates of key contracts, including advertising and sponsorships, suites and club seats, all pledged to the bonds and attendance levels for both the Dolphins and Marlins, respective lease agreements and risks associated with those, and other events at the stadium. Fitch ultimately downgraded the bonds to 'BBB' from 'BBB+', which is still very strong for a sports stadium rating, but given higher leverage and lower forecasted debt service coverage levels, Fitch appropriately lowered the rating by one notch.

Details

Q: What are the methodologies and criteria applicable to the sports sector and which of these are fairly unique to sports?

A: Some factors that help determine league credit ratings and ratings for related team and sports facility debt transactions include the following:

- Player salary restraints
- National television contracts
- Revenue sharing among member clubs
- Role of league in team financial matters
- Other financial policies, including debt limits
- Relationship with players' union

Fitch views sports ratings from a top-down perspective for team-related ratings as well as project finance stadium and arena financings. From this perspective, team and sports facility ratings are analyzed within the operating and regulatory environment of their parent league, which provides analysis of that league's core function, economic model, financial policies and legal structure. Consequently, it is in some ways analogous to the "sovereign ceiling" concept of the international bond markets when rating the debt instruments of nations and their sub-sovereigns or applicable corporate entities, such as provinces, states, or corporates that are part of and operate within that respective nation's laws and financial regulations. For sports facilities, the rating ceiling could be somewhat different, though this scenario is unlikely, as stadiums and arenas may have strong economic characteristics stemming from multiple anchor tenants and the ability to host many other revenue-producing events.

The economic model of professional sports began to change when the crush of sports-facility building began in the early 1990s that introduced teams to additional revenue that was never before realized. This added revenue provided teams with financial strength to be utilized in signing marquee players that could be lured away during free agency with higher salaries and also helped to increase the value of sports franchises. National media contracts between the leagues and television networks also skyrocketed, along with player salaries and player endorsement contracts, creating a big business out of sports with an ever-increasing focus on financial success.

An understanding of league policy and procedures, as well as its underlying economic model, is a prerequisite for considering franchise fundamentals. It is the competitive nature and long-term stability of these associations that foster and preserve fan interest, which, in turn, attracts advertisers and broadcasters. Macro- and micro-influences, such as demographics, stadium and arena issues, and management ultimately differentiate the financial profiles at the team level. These influences help serve as key credit support measurements.

Because most debt at the team level is secured by a direct lien on the franchise, team debt can be considered a hybrid transaction incorporating elements of both a traditional cash flow obligation, as well as elements of an asset-based transaction. As a result, Fitch's approach gives appropriate consideration to both of these measures in establishing a senior secured rating. A more favorable rating will be considered where the team is the legal obligor (team-level debt), as opposed to a holding company or partnership (HoldCo. or partnership) debt. The position of the borrower addresses such issues as structural subordination and being closer to the economic assets of the transaction. Debt at the HoldCo. level is structurally subordinate to debt at the team level, similar to the concept of a holding company in traditional corporate finance.

Timeliness of Repayment and Collateral Coverage Ratings

Establishing a senior secured rating is a two-step process. The first step involves establishing a timeliness of repayment rating or implied senior unsecured rating. The second step involves notching from the implied senior unsecured rating based on the collateral coverage provided by the value of the franchise.

Implied Senior Unsecured Rating in Senior Secured Ratings

The implied senior unsecured rating effectively serves as the starting point for the secured rating. Key considerations for establishing an implied senior unsecured rating consider the overall quality of the team's key revenue components. More specifically, Fitch differentiates contractual revenue streams from non-contractual revenue streams. Contractually obligated revenues (COR) primarily include national and local media contracts, local sponsorship agreements, and luxury suite rentals. Sometimes revenues are referred to as "highly probable." These revenues are not explicitly contractual but have a contractual component that may be represented as highly probable. Highly probable revenues are analyzed and reviewed to determine the likelihood that they will be realized. Fitch considers highly probable revenue streams as revenues that are not necessarily contractual but, through historical evidence, suggest a high probability of realization. Season ticket sales, which have demonstrated consistent renewals over a long period of time, may be considered highly probable. The greater portion of revenues deemed contractual and/or highly probable, the higher "quality" assigned to these revenue streams.

Another key analytical factor is a team's COR as a percentage of player payroll. Because player payroll constitutes the largest cost component for a team, the extent to which player cost can be matched against contractual revenue streams helps to assess a team's reliance on less certain revenue streams to support player payroll, operating expenses, and debt service. COR representing greater than 70% of total player expenditures will, on average, result in a higher implied senior unsecured rating. Conversely, teams with COR substantially less than 70% of player cost will likely receive lower implied senior unsecured ratings. Teams operating in leagues with weak restraints on player costs and loose debt limitations, as well as those in which the COR is less than 70%, would most likely have the lowest implied senior unsecured rating. To date, Fitch's implied senior unsecured ratings have ranged from 'B–' to 'BBB–'.

Traditional cash flow-based credit metrics, such as total debt/EBITDA and EBITDA/interest expense, have limitations when evaluating team-level debt obligations. The primary limitation is using GAAP EBITDA, which does not take into account items such as cash bonuses, deferred compensation and other cash items that are not reflected on the income statement. As a result, EBITDA may not be the most accurate proxy for a team's cash flow. Allowing for certain cash adjustments to EBITDA is required. With this in mind, Fitch uses slightly altered credit measures in rating team debt.

Leverage: The ratio of debt (at the team level) to a team's annual COR should not exceed 2.0 times (x) for investment-grade consideration.

Debt Service Coverage: As a general guideline, Fitch has targeted a minimum ratio of operating income (total revenues less total operating expenses and cash bonuses) to annual debt service to be 1.5x for investment-grade consideration.

As mentioned previously, the relative strength of a league's economic model is also considered in establishing an implied senior unsecured rating. The NFL's economic model is the strongest of all the major professional sports leagues and helps to create a favorable credit environment for the league's individual franchises. The NFL's robust TV contracts roughly match a team's largest expenditure—player payroll. The NFL has a hard salary cap, which establishes a maximum for player payroll and adjusts player payroll according to the escalating nature of annual national broadcast rights fees. Essentially, player payroll and a team's share of the national media contracts are adjusted in tandem. This is viewed as a credit positive. Debt service is reasonably protected given the league's conservative debt limitations, broad revenue sharing arrangements, and solid industry fundamentals. Due to the NFL's sound economic policies, the ratings disparity for teams in the league will be small relative to teams operating in leagues with weaker economic structures.

For leagues in which revenues are not as equitably distributed, the effect is illustrated via a performance gap. Small-market franchises find it increasingly more difficult to compete with large-market teams, as they do not have comparable economic resources to procure top player talent. From a ratings perspective, a lower shared percentage requires greater scrutiny on a franchise's local revenues. These include gate receipts, local broadcasting rights, and stadium-related revenue. These revenues are more closely tied to market demographics and team performance.

Collateral Coverage in Senior Secured Ratings

The second step in rating franchise debt assesses the overall collateral coverage provided by a pledge of the franchise. Recent transaction prices serve as the most relevant valuation measure. From an asset coverage standpoint, most teams experience significant asset coverage over committed secured debt amounts. Additionally, leagues with actively enforced debt policies that limit an owner's ability to leverage a team help to ensure sufficient overcollateralization. Fitch will notch above the implied senior unsecured rating by as many as three notches (see Fitch's criteria report, "Rating Methodology for U.S. Senior Secured Bank Loans," dated Sept. 28, 2000) where ultimate recovery of principal is certain. In general, to receive a three-notch enhancement on loan to values (LTV) should be 50% or less. The 50% LTV guideline is a general rule and should be matched against the overall credit quality of the team.

Anatomy of a Sports Franchise Transaction

The biggest credit risks in a sports franchise transaction involve renewal of the national media contracts (and local media contracts and other COR where appropriate), the possibility of a work stoppage, and a deterioration in franchise values. Fitch views favorably debt obligations that contain structural features which help to offset these risks.

National Media Contracts

Fitch considers renewal risk of national media contracts to be among the most important factors in assessing the creditworthiness of sports franchises. Because broadcasting rights fees provide a substantial portion of a team's revenues, any adverse change in these contracts would likely have a material effect on a team's overall credit profile. Ideally, the tenor of the debt obligation should expire prior to the expiration of the national media contracts so as to avoid renewal risk. When the maturity of the rated debt obligation goes beyond the expiration of the national media contracts, Fitch considers the historical trends in renewals for sports programming and for the respective league. In cases where creditors are exposed to broadcast contract renewal risks, covenants that set minimum thresholds for national broadcasting renewals are helpful in providing remedies in the event league-wide broadcasting contracts are lower than anticipated. Possible remedies may include mandatory debt reductions, capital calls, and debt acceleration. Fitch views positively structural features which allow creditors to readjust credit risk in light of lower than anticipated league-wide broadcasting renewals.

Labor Environment

Fitch views positively structural provisions that address potential work stoppages. This applies to instances where the CBA expires prior to the maturity of the rated debt obligation. While contractual terms of the national media contracts may provide for the continued receipt of broadcasting fees during a work stoppage, teams will not receive any game-related income (ticket sales) and may have to remit refunds to ticket holders and sponsors. A labor contingency reserve helps to offset this risk by protecting debt service in the event of a work stoppage. Typically, labor contingency reserves will fund one-year's worth of debt service. Similar structural protections are required for investment-grade sports facility ratings.

Collateral Coverage

Similar to an asset-based transaction, collateral valuations are a key measure of credit support. Fitch views favorably covenant triggers that set minimum team valuations. Periodic appraisals and/or recent purchase transactions may serve as the mechanisms for collateral monitoring. Fitch examines the rights of creditors to readjust credit risk if asset valuations decline. Mandatory debt repayments to reduce LTVs and asset coverage to prevailing rates are viewed most favorably as an offset to potentially declining franchise values.

Support Agreements/Guarantees

In some cases, a team's underlying credit profile may be extremely weak and rated low on a stand-alone basis. In these instances, a credit may require some type of thirdparty support. This support usually takes the form of an "operating support" arrangement in which the owner or supporting entity agrees to fund operating losses unconditionally or up to a specified, agreed upon amount. Fitch's implied senior unsecured rating factors in both the team's creditworthiness on a stand-alone basis and the level of support provided by the outside party. In considering the level of support, a review of the outside party's financial ability to cover operating losses and debt repayment are considered. The financial strength of the support provider, as well as the level of support required by creditors, helps determine the level of enhancement given to the implied senior unsecured rating.

Lock Box Mechanisms/Accounts

Certain lock-box or debt service account (DSA) structures may be established to provide debt service through contractual revenue streams. Franchise debt transactions may attempt to somewhat mitigate team financial risk by creating a lock-box structure that directs national broadcasting rights fees into a lock-box account. The lock-box account deducts amounts required for debt service and remits the remaining portion to the team. Additionally, the transaction may require additional funds be held in the DSA as added debt service protection. The DSA and lock-box arrangement somewhat insulates creditors from team-related risk. It should be noted that this structure only serves as a method of payment and does not necessarily protect creditors' claims should the team file for bankruptcy. The automatic-stay provision within the bankruptcy code could freeze interest and principal payments owed to creditors.

League Standstill Agreements

One of the key considerations in rating a team's debt obligation is the ability/willingness of the governing league to provide relief in a distressed scenario. Some leagues, such as the NFL, have taken an active role in helping financially troubled teams. In fact, the NFL, on a few occasions, has stepped in to provide financial relief and has helped facilitate the sale of a troubled franchise. As a result, Fitch views the NFL's demonstrated support of its member clubs as a key source of support for NFL franchise ratings. The NBA takes a similar position and MLB has historically played an active role in supporting some of its weaker franchises. Since 1975, two bankruptcies have occurred in professional sports. Both times, the bankruptcies were declared by the same team, the Pittsburgh Penguins of the NHL. While the NHL was actively involved with the Buffalo Sabres as the team sought new ownership, in Fitch's view, the NHL has yet to demonstrate consistent financial support for its member teams relative to, for example, the NFL.

Q: What are the different types of risk that you incorporate in your sports ratings and how are those quantified?

A: For a financing that is pre-construction, construction risk is the biggest concern when assigning a rating. While most stadium/arena financings have guaranteed maximum price (GMP) contracts, other factors could impact construction and ultimately delay the opening, negatively impacting revenue. This can be mitigated by longer periods of capitalized interest and strict liquidated damages packages with the contractor. For a financing that is in operation, work stoppages, and associated potential long-term fan alienation, and renewals of key contracts are the two primary credit concerns. Work stoppages in the short-term are usually covered by sufficient reserve levels. Renewal risks are viewed as long-term contracts, and it has been Fitch's experience that these contracts are relatively stable and a downward trend is more of a long-term event.

Q: Over the past decade, some sport finance experts thought that the use of asset backed securitization (ABS) would become popular for the financing of U.S. sports facilities, especially after the Pepsi Center and Staples Center deals. This has not occurred. Why do you think that ABS never took off here in North America?

A: There have been a few sports transactions that have been structured with securitization techniques (which is what asset-backed means). Staples Center in LA and Pepsi Center in Denver, which were issued a number of years ago, are both rated in the A category and used ABS. The only other major transaction in sports that is structured as ABS, and it's an important one, is MLB's league-wide credit facility. It's a securitization of national TV revenue that the league has with broadcast and cable partners, and other key revenue streams. There is a lock box structure such that bankruptcy risk is a lot less than other typical monetization techniques where you don't have a separately segregated bankruptcy remote entity like in this case. Having only three transactions using ABS is very limited. There are a number of reasons for this. One is that in asset-backed transactions it is necessary to carve out very high quality long-term significant revenue contracts from the overall business of the team, stadium, or arena. That concept of stripping those particular revenue streams out of the business is troublesome to those in industry who would rather have full control of all of these types of revenue contracts. They would rather use a more broad-based, full basket of revenues instead of isolating and selling off certain contracts into a special trust. This is similar to what was done in the Dolphins case described above.

Another reason for the limited use of ABS in sports is that the ABS market grew up around transactions that don't have a lot of operating risk as a credit factor. Examples include highly liquid home equity loans, student loan receivables, and credit card receivables, where one can structure, through various modeling techniques, a transaction that has very little operating company exposure. Essentially, these ABS structures set up a pool of receivables and do the transactions around them. It is different from an operationally-based securitization where you have the performance of teams, leagues, and sports facilities as key linchpins that help drive the debt rating process. Those operating risks make it much less of a clean transaction relative to other traditional uses of ABS. Los Angeles and Denver are both large markets with a history of viable revenue streams and MLB's television revenues are large and low risk.

Q: How does each league's Collective Bargaining Agreement impact your work?

A: The leagues' CBAs, when incorporated into a stadium/arena deal, are stressed as referenced below. When we look at the league ratings we certainly use the CBAs as a key underlying credit factor. When a CBA is up to expire/renew, we would usually expect key provisions to remain the same. For example, we would not expect the NFL to move away from the core revenue sharing functions and hard salary cap. Smaller, more detailed items, such as changes in the rookie salary "floors and ceilings" would be less of a concern.

Q: What are some specific financial techniques that you use in your job?

A: Fitch spends a good amount of time developing various stress scenarios for both stadium and arena financing. For example, stressing various downside scenarios associated with lower renewal rates with key revenue contracts pledged to the bonds such as suites, club seats, and advertising and sponsorships and how those lower revenues impact debt service coverage ratios. By stressing, we mean that we run scenarios with different levels of renewal rates and then look at the likelihood of those different renewal rates occurring.

Future

Q: Where do you see the largest potential in revenue growth for either sport facilities or sport franchises/leagues globally?

A: Given the growth in new facilities in the US in all four major sports over the last 15 years, Fitch feels that the best growth potential is in college/university stadium finance and European football stadium finance, both due to the aging infrastructure and growing fan base.

Q: What are some of the big unanswered questions in sports debt financing or rating that you wish you had answers to?

A: One area that is interesting is the tax benefits or advantages from joint ownership of teams and facilities. There are potentially related-party transactions between the two that affect the underlying economic value of both businesses. A broad and in-depth academic study (or even book) using actual financial data would be very much appreciated by analysts like us. Additionally, the estimates of franchise value created by *Forbes* magazine each year are very popular, yet this is a tough business in which to assign accurate valuations. An academic study that examines, in detail, the specific drivers of the valuation for each team would also be very useful. Finally, team and facility financing in the US and Europe is well known by us, but we have less information on how things are done in Asia or Latin America, for instance. What mechanisms are used to finance teams and facilities in these areas? Do the financial markets in these parts of the world get involved?