

Financing Opportunities and Challenges Facing Submarine Cable Projects

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Abstract: The submarine cable industry has greatly changed over the past few years. Following a multi-year construction drought, new systems are being announced in many regions of the world. This is largely driven by the need to bring large amounts of content closer to the user. Silicon Valley Internet companies and other online content providers have become anchor tenants in multiple systems. More than any other single factor, financing impacts the timing and success of a submarine cable project. This paper describes the possible financing structure options available and the tasks that a sponsor should complete to successfully fund a new submarine cable build. Successfully securing the funding for a submarine cable project will take a significant amount of preparation. To succeed, sponsors will need to identify a market opportunity and prepare a credible business plan. The first ingredient is equity. After some years on the sidelines, private equity funds, venture capitalists and other institutional investors appear to be slowly returning to the submarine cable industry. In addition to securing capacity sales to large Internet companies or content providers, cable sponsors should look at these institutional investors as the most likely source of outside equity for new projects. These equity investors are extremely selective on the projects they back and sponsors need to have realistic assumptions in their business plans. Moreover, virtually no privately-sponsored project can be completed without debt. Commercial banks and multilateral organizations (e.g., IFC, OPIC, regional development banks) continue to be the obvious candidates to provide the debt component for a new system. While interest rates remain at all-time lows, lenders heavily scrutinize business plans and loan conditions tend to be more stringent than before the Great Recession. Performance history, reputation, and effective accountability are prime factors that will differentiate which deals lenders choose to finance. The structuring and negotiation of financing documentation is a delicate balancing act. This paper identifies steps for structuring projects to improve funding options and ways to successfully negotiate financing with multiple funding sources.

1. INTRODUCTION

Constructing, maintaining and upgrading submarine cable networks requires significant amounts of capital. Financing considerations significantly influence the timing and the ultimate success of submarine cable projects. In recent years, securing financing for cable projects has been a significant obstacle because of substantial upfront capital expenditures,

falling margins, increasing operating expenses, and stricter financial scrutiny following the economic downturn of the last decade. But following a lengthy construction drought, worldwide demand for Internet connectivity and bandwidth has revived the submarine cable industry, particularly as content moves away from the U.S. More content is now located on servers in South America, Africa, Asia, and Europe, providing opportunities to

expand existing worldwide submarine cable connectivity to underserved markets. The ability to obtain funding for a new system requires both identification of a strategically-located project and hinges on the sponsors' ability to accommodate the requirements generally imposed by prospective investors and lenders.

Several billion dollars will be spent on submarine cables in the coming years. For example, most recently, it was announced that Partners Group, a global private markets investment manager will be providing all of the equity financing for the Seabras-1 cable, a 40 Tbps, four fiber pair system extending 10,400 km between São Paulo, Brazil and New York, which has a total project cost of approximately US\$ 500 million. However, new cable systems as well as expansions and upgrades of existing systems will not come to fruition unless adequate funding is available. This article provides an overview of possible sources of financing and describes steps necessary to successfully negotiate funding with various funding sources.

2. Submarine Cable System Structure

The organizational structure of a submarine cable system affects the available financing options. Consortium systems or "carrier clubs" are systems where telecommunications providers of one or more countries join forces to build and operate the network. Usually one carrier leads the group and is responsible for overall administration of the network. The funds for construction and operation of these networks are usually provided by cable participants. Traditionally, participants have been carriers, but content providers are now investing directly in new submarine networks (*e.g.*, Google, Facebook, Microsoft). Generally, there is no need for outside equity financing. Carrier-led consortium projects account for

the bulk of total investment in submarine cables.

Conversely, private systems are generally started by a sponsor who raises funds from capital markets and/or commercial banks for construction and operation of the network. These systems use the "carrier's carrier" model to provide bulk capacity to competitive telecommunications providers, content providers and large corporate users by leasing circuits or entering into sales of capacity mainly in the form of Indefeasible Rights of Use ("IRUs"). Private systems are becoming more prevalent even though many private systems were sold or restructured during the telecom downturn. For private systems, funding can be a challenging endeavor and, increasingly, submarine systems are turning to hybrid models to mitigate risk and improve financing opportunities.

3. Identifying Market Opportunities

The first goal for structuring a cable system project is to identify a market opportunity. New systems will likely be local and regional systems rather than worldwide systems. South Asia, Africa, Latin America, and the Caribbean are the most likely areas where new systems will be built. IP-enabled communications have the potential to drive the demand for undersea cables and additional capacity.

4. Business Plan Development

After identifying the market opportunity, sponsors need to consider several items to prepare a successful business plan. Sponsors should: (a) be realistic with respect to assumptions and valuation including traffic demand, existing network bandwidth availability, other planned infrastructure, and bandwidth policies and trends; (b) consider the likely requirements from equity financiers; (c) identify sources of debt financing, including vendor

financing; (d) address regulatory and environmental issues early (*e.g.*, licensing and permitting); (e) maximize tax efficiencies; and (f) assemble a top-notch management team. Corporate structure often takes a back-seat because, as described below, it is usually informed or dictated by financial sponsors, especially lenders.

As noted, a key aspect of preparing a successful business plan is identifying and securing financing for a system. Securing financing involves many moving pieces. Assembling the jigsaw puzzle may be done all at once, but it generally needs to be done in parts. Sponsors and their backers should seriously explore obtaining part of the financing from the network supplier or equipment vendors. In addition, securing a technology provider and obtaining a commitment from the vendor is often a precondition to financing.

5. Potential Funding Sources - Private Equity and Venture Capital

Potential funding sources for cable systems include private equity (“PE”) funds, venture capitalists (“VCs”) and other institutional investors. PE funds are extremely selective with respect to the opportunities they pursue. Thus, VC funding may be the answer for early stage developers given that VCs are generally willing to take on higher risk for higher reward. In comparison, true PE requires more mature companies as a general rule. PE may be an option for: (1) developers building subsequent systems; (2) funding network updates; (3) funding systems that otherwise have significant customer commitments with predictable cash flows; or (4) providing an exit strategy for venture funded systems.

VC and PE differ in a number of ways, but they also share a number of common

objectives. Among issues generally considered by equity sponsors in deciding whether to fund a project are: (i) expected high returns (including free cash flow); (ii) the need for a “fully funded” network (*i.e.*, having significant number of pre-sales); (iii) a preference over other equity providers and sponsors; (iv) anti-dilution protections; (v) sophisticated corporate governance provisions; and (vi) a clear exit strategy.

With respect to financial projections, venture funds generally expect assurances of greater than 30% returns on equity capital while PE expects somewhat less. Further, sponsors would likely be required to contribute some money of their own and may be required to contribute hard assets, such as contracts, licenses or permits in addition to “sweat equity.” At the outset, sponsors should have significant pre-sales or commitments for network capacity.

The most common structure used by the venture community is convertible preferred stock. Other equity securities or combinations of debt and equity (*i.e.*, subordinated notes and warrants) can be structured to mirror the economics of convertible preferred but may be unnecessarily complex and may raise problems with subsequent debt offerings.

6. Commercial Lending

Funding any submarine system without debt is virtually impossible. In most cases, debt will be around 50% of the total cost to build, leaving the remainder to equity. Depending on the size and complexity of the project, developers may require multiple sources of debt, including vendors, a commercial bank syndicate, hedge fund or subordinated loan provider, multilateral agency, local bank financing, and additional commitments (*i.e.*, loans) by

equity sponsors. Other newer finance techniques may also involve a sale-lease-back or lease-to-own solutions.

Interest rates remain low despite being raised in December 2015 for the first time in nearly a decade. Commercial financial institutions appear somewhat willing to fund private submarine cable developers, though business plans are likely to be scrutinized more closely, conditions on loans are likely to become more stringent, and fees for submarine projects are likely to be higher than in pre-recession years. Moreover, lenders seek deals with reputable operators and sponsors who have solid track records to mitigate risk.

Hedge funds or other alternative lenders may also be relevant in this sector. We are increasingly seeing them play an active role in previously untapped sectors such as real estate, financial services, technology, consumer goods and infrastructure. The higher regulation to which traditional commercial banks are now subject may open the door for such asymmetric players to begin funding submarine systems.

Many private submarine systems were financed using a pure “project finance” structure (*i.e.*, senior secured, non-recourse or limited recourse debt payable solely from the cash flows of the project). The “project finance” model is likely to remain for new systems. Now more than ever, syndication is very important for the financial community as lenders like to “spread the risk.”

In addition to long-term debt, the business plan would likely require short-term financing, including revolving facilities and letters of credit. This type of financing was usually provided together with “project finance,” but in current markets may need to be obtained elsewhere. If debt

is not a “package,” intercreditor provisions will be required. For example, debt in different facilities may want to be “*pari passu*,” sharing collateral and coordinating “required lender” provisions.

7. Multilateral Organizations and Development Banks

An alternative, and perhaps additional, source to commercial finance may be the availability of funding from multilateral organizations. Depending on the location of a project, sponsors should inquire with regional organizations (*e.g.*, Asia Development Bank, Inter-American Development Bank, Overseas Private Investment Corporation (“OPIC”), International Finance Corporation (“IFC”), *etc.*). Developers may also seek out local or domestic development banks, infrastructure funds, sovereign wealth funds, broadband development plans or other “stimulus” sources from national or local organizations, which are referred to herein as multilateral organizations.

Multilateral organizations generally provide better terms than commercial banks, although funds usually come with more rigid conditions, including restrictive provisions not typically found in commercial lending transactions (*e.g.*, covenants related to child labor, collective bargaining, pornographic content, more stringent environmental standards, *etc.*).

In addition, multilaterals lend and/or insure projects in emerging markets, which are often more expensive on the transaction side (*i.e.*, legal, accounting, engineering and consulting fees). Typically, legal and regulatory structures are underdeveloped in emerging markets, so there is greater legal and regulatory risk. In particular, permits licenses and other governmental approvals may take long periods to be obtained,

although having a multilateral organization on the capital structure may facilitate local permitting.

The principal role of multilaterals as primary debt providers generally occurs in the form of “A Loans” project financing. Although not typical, multilateral agencies may also act as equity sponsors. For example, the IFC has an equity program for telecommunications companies.

Development agencies can also act as: (1) secondary debt arrangers/providers (typically through “B Loans” where the development agency acts as administrative agent and syndicates loans to other commercial banks), (2) guarantors (generally partial guaranties of bonds or loans), (3) political risk and currency risk insurers and (4) providers of technical cooperation and grants for feasibility studies.

8. Financing Negotiations

The negotiation of financing terms and the resulting agreements is a delicate balancing act. Numerous pieces need to come together at the same time, and patience is the greatest virtue of entrepreneurs and management.

One of the most heavily negotiated issues in any project is corporate governance. Investors typically insist on “calling the shots” through control of the board and/or negative blocking rights. However, in our experience, sponsors need to be flexible. It is advisable to have a corporate governance structure that meets the Sarbanes-Oxley requirements at the outset even if no U.S. landing point is planned.

Another negotiated issue is the exit strategy. Institutional investors generally expect profitability in 3-5 years, and the next question, once that occurs, is “how do

we monetize our investment?” Since an Initial Public Offering may not be an option, alternative strategies must be considered such as: (1) identifying potential buyers and merger candidates; (2) a possible combination of the system with other regional networks; and (3) evaluating the availability of private equity or strategic buyers for more mature systems.

9. Other Considerations

Other financing terms should be considered. Financial covenants, including debt-to-equity and debt coverage ratios and cash reserves are likely to remain on every banker’s top priority list. Debt sources may also look for additional equity backup to cover cost overruns, project delays, etc. It is also likely that “lock box” structures and cash sweeps will be utilized more often. In addition, dividends and other distributions are likely to be significantly limited during the term of the credit facility, since lenders want to see prudent cash reserves to cover foreseeable and unforeseeable events. Free cash flow should be sufficient to ensure payment of principal and interest and funding reserves, while at the same time guaranteeing return on equity. As in any other significant secured financing, lenders will likely expect a full collateral package, including hard assets, contracts and stock.

When speaking with financing sources, sponsors should be prepared to address issues not directly associated with the business plan, but present in most cross-border transactions. These issues include currency risks from devaluation and convertibility, political risk, expropriation risk, and changes in law and regulatory risks. Depending on the location of the project, the cost of insuring against these risks may be significant. Political risk

insurance will likely be a requirement in many emerging market transactions.

Regulatory and environmental issues are also key considerations. The ability to timely secure landing licenses and easements is vital for lenders. Issues become more complex with each different jurisdiction touched by the cable. Local law plays a very important role in matters surrounding perfection of collateral. Lawyers from many countries are usually required, increasing the overall cost of the project.

10. Conclusion

The continued rapid growth of the broadband market presents sound opportunities for investment in new submarine cable systems, particularly in underserved markets. However, there is no “one size fits all” solution to financing new networks, and multilateral organizations will likely continue to play a significant role in new networks. Success will hinge on identification of local and regional needs for capacity, strategic partnerships and development of a realistic and focused business plan.