RAISING CAPITAL FOR SUBSEA SYSTEMS IN TROUBLED FINANCIAL WATERS

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Abstract: The development and financing of a submarine cable system has always presented difficulties due to the multijurisdictional nature of projects, complex permitting and operational risks and uncertain revenue streams. Current circumstances have introduced two new factors that add hurdles to overcome: first, commercial bank and other lending institutions, as a result of capital constraints and increased scrutiny of new loans, view any infrastructure projects with a heightened degree of skepticism; and second, as projects increasingly move into the less developed world, novel risks and greater uncertainty are injected into the financing equation.

1. UPHEAVALS IN THE FINANCIAL WORLD

At the SubOptic 2007 conference, industry participants were commenting hopefully that they thought "the worst was over" and demand for increased submarine cable capacity would resume its upward trend after the disaster of the dot-com and telecoms collapse of a few years before. Three years later, the subsea industry is now clearly on the rebound – and this time it is the bankers who are wondering if the financial services sector has weathered the worst storm since the Great Depression. Commercial bank lending plunged to record lows in late 2008 and most of 2009, the high-yield debt market and IPO markets essentially collapsed during that period, and even development banks and multilateral institutions – normally bastions of financial security in volatile markets – were forced to reduce private sector lending as governmental liquidity crises took first claim on available resources. Those institutions and markets were key funding sources for the submarine cable industry during its periods of growth. Their unprecedented contraction spells greater challenges, if not difficulty, for system sponsors and operators who are seeking funds for network expansion and upgrades.

New builds as well as capacity upgrades for existing systems are capital intensive, with project costs easily in the tens and typically hundreds of millions of dollars. While many "tier one" carriers might be able to afford such amounts out of operating cash flow, they would generally prefer to leverage their capital expenditures and perhaps seek to keep the debt off their balance sheet through limited recourse financings where possible. Lesser telecom operators who do not enjoy such cash flow, and of course virtually all sponsors of investor-owned (as opposed to operator-owned) systems, would clearly need to obtain external debt or equity funding. With equity costly and scarce, debt has of course been the traditional solution to funding large capital expenditures in the cable sector. So the collapse of the debt

markets is an important issue for the sector.

2. JUST WHEN THE CABLE SECTOR HAS RESUMED GROWTH.

It's ironic that the collapse in commercial bank lending comes precisely at a time when the submarine cable industry is hungrier than ever for new money to support capital expenditures. With 16 new cables placed into service this past year throughout the world – a record – the industry is on pace to spend over $3 billion over the next three years.

While the rest of the economy stumbles out of a recession, cable system owners, telecom operators and some service providers such as Google are intent on meeting the exploding demands for international data (and to a lesser extent, voice) transmission. The demand is of course engendered primarily by the explosion of web-based video, voice and data and multimedia-centric websites. Innovations like Facebook, Twitter and Flickr and blogs on every topic – all just a few years old – have garnered a worldwide audience and placed a high premium on instant accessibility to photos, music and video, as a new generation of "I-reporters" documents its surroundings, personal interactions, current events and even daily lives through these mechanisms, and through 12 megapixel cameras. All of those applications and photographs, combined with the inexorable increase in web traffic, have generated astonishing demand for intercontinental data connectivity. As the Internet becomes less US-centric, there is a corresponding increase in demand for connectivity throughout the rest of the world. This is a function not only of webpages being hosted all around the globe but also increased broadband penetration in the developing countries such as China and India. Moreover, the roll-out of 3G wireless service in densely populated countries in Asia and elsewhere, not to mention the advent of 4G, all ignite further demand for capacity.

The result, of course, is that we are entering a boom cycle in the development of new cables. The recent completion of the SEACOM cable and the anticipated installation of the EASSy and Main One and Glo-1 cables in Africa are all testimony to the fact that the action has in part shifted to Africa and other countries with low Internet penetration. Thus, there are several new cables planned for the Caribbean, the Middle East and intraregional routes, as well as long-haul routes such as the proposed Arctic Link cable.

3. CONFLUENCE OF FACTORS CREATE NEW RISKS AND CHALLENGES FOR FINANCING

The development and financing of a submarine cable system has always presented difficulties that included not only the ones traditionally found in any infrastructure development generally, but also a separate set of obstacles unique to subsea projects. Today's environment has, however, introduced two new factors that add an entirely new level of hurdles to overcome: first, commercial bank and other lending institutions, as a result of capital constraints and increased scrutiny of new loans, view any infrastructure projects with a heightened degree of skepticism; and second, as projects increasingly move into the less developed world, novel risks and greater uncertainty are injected into the financing equation. The confluence of both traditional challenges plus the new rigor of lenders and difficulties in these newer markets thus present extra complications in what is already a formidable task.

4. THE TRADITIONAL CHALLENGES OF SUBMARINE CABLE PROJECT FINANCING

Turning first to the traditional challenges of financing subsea cables, the most obvious difference from ordinary infrastructure development is the fact that the geographic scope of a subsea system inevitably entails dealing with multiple jurisdictions. Sponsors and lenders must be aware of the myriad of legal schemes (some of which may be conflicting) regarding the acquisition of permits and landing rights, the taxing of revenues and environmental regulatory schemes. The overlapping of legal jurisdictions applicable to the cable system is coupled with the high degree of technical specificity and expertise required to build a proper system, starting with the demand surveys and desktop routings to the actual deep-sea cable laying. Furthermore, sponsors must be cognizant of the management of the cable system (including damage due to earthquakes, ships' anchors or inquisitive sharks), the establishment of a network operations center, negotiation of backhaul and interconnection rights, as well as agreeing upon the proper channels for marketing and selling of capacity.

Given all these complexities, any successful sponsor must be capable of providing (or at least arranging for) disparate inputs (technical, operational, marine, environmental and cross-jurisdictional legal expertise). An obvious solution to this challenge is to introduce a greater number of parties to spread the risk and to bring their respective proficiencies to the table. However, the need for multiple players inevitably leads to increased costs and complexity.

One of the fascinating aspects of the subsea cable industry is that there is no one blueprint for how to structure a project. Each system is unique and is structured differently. Exactly how the sponsor will arrange, structure and carry through the project to completion and eventual provision of the service to the end-user is a function of many factors that need to be assessed in each specific transaction. Equally, financing can be a variegated mix of public and private equity, debt from commercial banks and developmental financial institutions and so on. Billions have already been spent on many subsea systems and yet, surprisingly, there is still a constant evolution of approaches.

For decades, the standard response to some of these challenges was the consortium model, in which each participating carrier (historically, a government-owned monopoly operator) would invest an equity share, as co-owner, in exchange for a proportional allocation of bandwidth capacity on the new cable. (Even so, no two consortia were structured in exactly the same manner.) These equity contributions paid for the construction costs, and the consortium members committed to the future operating and maintenance costs. With few exceptions, a telecom operator would have insufficient traffic to warrant construction of its own submarine cable, and by partnering with others, risks and costs could be shared among a number of operators and access could be accorded to a range of expertise. Today, in most instances, any consortium model will likely be dominated by non-governmental sponsors. Such consortium members can sell capacity to third-party buyers or use it for their member networks.

In general, consortium projects are not financed at the project level partly because the operator/sponsors are able to finance the costs out of cash flow or they finance the contributions on their own balance sheet, and partly because financing what is in effect a partnership is a messy business for a lender who ultimately has to look to many sponsors for their share of the debt in the event of problems with the loan.

Tax planning inserts another layer of complexity into the picture, since sponsors will naturally try to minimize taxes whenever possible, customarily by having the principal cable owner sited in a tax haven. Many developing nations insist, however, that cable landing rights and other relevant licenses be granted to only domiciliaries of that nation – and consequently the requirements for local participants and owners lead to a complicated web of multiple corporate entities. Many sponsors will have the different aspects of the submarine cable system (marketing, contracts, maintenance) conducted by separate subsidiaries in distinct locales.

From the lender's viewpoint, these structural complexities put an additional burden on its credit analysis. Sponsors should anticipate this and structure with a eye toward creating transparency for lenders so that they may monitor cashflows and dividend streams, and ultimately access such monies by placing liens on them.

5. ADDITIONAL CHALLENGES ARISING IN TODAY'S ENVIRONMENT.

The credit committees that are charged with approving new loans at almost every major financial institution around the globe are applying much tougher standards today than at the height of the "easy money" boom of two years ago. This translates into a number of requirements for a new cable system, some of the more salient of which are:

- the demand forecast, revenue projections and the entire business case must withstand stricter scrutiny;
- permitting, construction, operation and management risk will be borne solely by the sponsors, not the financiers, and will be greatly minimized;
- the sponsors will be expected to contribute a significant equity component and be responsible (and creditworthy) for covering cash shortfalls (whether due to construction cost overruns or revenue shortfalls); and
- documentation for the transaction will be tighter, with less operational freedom for the borrower and an increased importance placed on collateral security.

The first requirement is of course the trickiest. It's usually not that difficult to predict project costs with some reasonable degree of certainty for an undersea cable projects (or at least have a clear understanding of what the cost variables might be). Having a solid handle on revenue projections, however, is far more problematic. Both sponsors and lenders have to take into account demand forecasts that are assessing novel situations (Internet take-up rates in developing countries, the effect of 3G and 4G technologies, and so on), against a backdrop of dramatically falling prices for capacity and the uncertainty produced by the amount of unlit fiber on some routes, potentially competing new cable systems and the availability of alternate capacity through satellites. Also, lenders have to anticipate the effect of consolidation among telecom operators in the many markets where there are perceived to be too many players – consolidation could increase purchasing power of major operators and drive capacity prices down further.

Permitting and environmental risk has always been part of the picture for subsea cable development. But as attention shifts to the developing world, sponsors and lenders much expend more time and effort in order to understand unfamiliar, and often nascent and incomplete, legal and regulatory schemes. Lenders will insist on clear communications about licensing and permitting requirements, build in

milestones or other "conditions precedent" in loan documentation before disbursements will be made, and ultimately demand that sponsors be available to cover costs and problems arising from compliance with those requirements. From a lender's perspective, the problem is exacerbated when there are multiple sponsors/owners involved. Lenders will be concerned with how they will hold each sponsor liable (jointly and severally liable for the full amount or merely severally liable for each's share of the debt), as well as how to deal with variations in the creditworthiness among the sponsors in the consortium.

Lenders are scrutinizing the expertise and capabilities of owners of a new cable project, whether they be simply financial investors or operators in a consortium. With the prevalence of smaller regional projects in the emerging markets with a multitude of parties who may not have the large staff and expertise of a tier one carrier, a turn-key construction contract is often the solution. Moreover, while the major fiber-optic system vendors are reputable and proficient at their tasks, this approach puts a premium on the sponsor/owner being responsible for overseeing the vendor. Often, sponsors will engage separate consultants to undertake this supervising role, and lenders to such a project will invariably engage their own engineers and other advisors to vet everything from the marketing studies to the projected "ready for service" date.

The shift to developing countries also has an associated impact on drafting the governing contract. Along with the problems that accompany any contract (including which law shall govern and remedies in the case of breach), sponsors must pay particular attention to dispute resolution procedures and query whether it is realistic to achieve the judicial or arbitral relief they require in the jurisdiction selected. In short, developing cable systems in the Third World means dealing with inchoate legal systems and judicial and licensing systems that, to put it charitably, may not always be predictable. Prudent sponsors will often seek to balance nationalistic desires against the need for governing law and dispute resolution procedures that are familiar and established.

Finally, commercial banks have learned a lesson the hard way in some recent financial distress situations in other industries, in which their collateral was inadequate or unenforceable. The analysis for a subsea project starts of course with a decision about which entity the lender will lend to – directly to the sponsors to fund their respective equity contributions, or to some newly created joint venture of sponsors whose creditworthiness reflects the sponsors' combined strengths. Ideally, from the lenders' viewpoint, the loan could be made directly to the project company. This approach has the benefit of lending to where the assets and cashflow are located and the ability to obtain liens on or pledges of the assets.

Sponsors will typically also be asked to give a pledge of all of their shares in the project company in these instances to ensure appropriate security and remedies to the lenders. Indeed, lenders are generally approaching collateral with greater rigor, now insisting on share pledges of an entire chain of subsidiaries or affiliates (whereas before they might have settled for merely the corporate parent entity), a lien on all bank accounts and key contracts. In particular, sponsors should anticipate that lenders will insist on more detailed contractual acknowledgments from key vendors and perhaps even key customers, in which the counterparties acknowledge the assignment of the contract to the lender for purposes of collateral security. The form and scope of these acknowledgments is often fought over by the borrower's and lender's lawyers.

6. CONCLUSION: DESPITE GREATER CHALLENGES, THE UNDERLYING FUNDAMENTAL NEED FOR INCREASED SUBSEA CAPACITY WILL STILL PERMIT PROJECTS TO BE FINANCED

The tougher requirements of lenders today and the more difficult markets in which subsea projects are increasingly being planned do not mean that financing is not available. (Those requirements probably now have the salutary effect of cutting short some weaker projects at an earlier stage.) On the other hand, the same broadband capacity demand forecasts that propel investors and owners to undertake new systems and upgrades present an equally compelling story to lenders, so it should be possible for properly structured and documented projects to obtain financing even in the current restricted credit market.