

WHERE ARE THE FUNDING SOURCES FOR SUBMARINE CABLE PROJECTS?

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Abstract: Identifying funding sources and securing financing drives the ultimate success of submarine cable projects for new cable systems and upgrades and expansion of existing systems. This paper offers suggestions for equity and debt funding sources and new approaches to obtaining financing following a multi-year construction drought. Private equity funds, venture capitalists and other institutional investors, for example, are returning to the industry following the Great Recession. Commercial banks and other financial institutions appear to be returning to provide debt financing for submarine systems. Multilateral organizations may also provide an alternative, and perhaps additional, source to commercial finance. This paper identifies steps for structuring projects to improve funding options and ways to successfully negotiate financing with multiple funding sources.

1 INTRODUCTION

More than any other factor, financing issues influence timing and the ultimate success of submarine cable projects. In recent years, securing financing for cable projects has been a significant obstacle because of falling margins, increasing operating expenses, and regulator demands for stricter financial scrutiny following the market collapses of the last decade. But, following a multi-year 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 sub-Saharan Africa, Asia, and Europe.

According to industry reports, over \$3 billion will be spent on submarine cables over the next few years. New cable systems as well as expansions and upgrades of existing systems will not come to fruition unless adequate funding is available. This paper identifies multiple sources of financing and describes steps to

successfully negotiate funding with various funding sources.

2 CONSORTIUM VS. PRIVATE SYSTEMS

The organizational structure of a submarine cable system affects 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). Generally, there is no need for outside equity financing.

Conversely, private systems are generally started by a sponsor who raises funds for construction and operation of the network. These systems use the “carrier’s carrier” model to provide bulk capacity to

competitive telecommunications providers and large corporate users. Private systems are becoming more predominant even though many private systems were sold or restructured during the telecom downturn. For private systems, funding is most challenging component with sponsors raising funding from capital markets and/or commercial banks.

3 PROJECT STRUCTURING

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. The Middle East, South Asia, Africa, Latin America, and the Caribbean are the most likely areas where new systems will be built. Also, IP-enabled communications have the potential to drive the demand for undersea cables and additional capacity.

After identifying the market opportunity, sponsors need to consider several items to prepare a successful Business Plan. These include: (a) be realistic on assumptions and valuation including traffic demand, incumbent network bandwidth availability, other planned infrastructure, and bandwidth policies and trends; (b) consider the likely requirements from equity financiers such as *pro forma* financial statements; (c) identify sources of debt financing, including vendor financing which may be coming back; (d) address regulatory and environmental issues early (e.g., permitting); (e) maximize tax efficiencies; and (f) assemble 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 the same time, 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 vendor. In addition, securing a technology vendor and obtaining a commitment from the vendor is often a precondition to financing.

4 ROLE OF PRIVATE EQUITY/ VENTURE CAPITAL

Potential funding sources for cable systems include private equity (“PE”) funds, venture capitalists (“VCs”) and other institutional investors, which are returning slowly to the telecommunications industry after a few years on the sidelines due to the recession. PE funds are extremely selective with respect to the opportunities they pursue. Thus, VC may be the answer for early stage developers. VC is 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) as an exit strategy for venture funded systems.

VC and PE differ in a number of ways, but also share a number of common interests. Among issues generally considered by equity sponsors in deciding whether to fund a project are: (1) expected high returns (including free cash flow); (2) the need for a “fully funded” network (*i.e.*, having significant number of pre-sales); (3) a preference over other equity providers and sponsors; (4) anti-dilution protections; (5) sophisticated corporate governance provisions; and (6) a clear exit strategy.

With respect to financial projections, venture funds generally expect financial projections to ensure 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.

In addition, 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.

It should be noted that the negotiation of documentation 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. Also, it is recommended 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 available, 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) the

availability of private equity or strategic buyers for more mature systems.

5 DEBT FINANCING

Funding any submarine system without debt is virtually impossible. In most cases, debt will be between 50-75% of total cost to build, leaving the remainder to equity. Commercial banks are slowly recovering from the Great Recession, interest rates are at an all-time low, and financial institutions appear to be returning to fund private submarine cable developers. However, nowadays 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. Moreover, lenders seek deals with reputable operators and sponsors who have solid track records.

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.” Underwriters will likely require strong “market flex” language with regards to syndication. “Market flex” allows lenders to change pricing and fees based on market feedback after the deal is announced and the legal documents are drafted and closed. In our opinion, true “underwritten” deals will be unusual in the space and even “best efforts” may be more qualified than usual.

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. 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 for 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 to 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 sources of financing, 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 project, the cost of insuring against these risks may be significant. Political risk insurance will likely be a requirement in many emerging market transactions. Also, regulatory and environmental issues are key issues. 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.

In addition to equity, depending on the size and complexity, developers may need multiple sources of debt, including: vendors, a commercial bank syndicate, multilateral agency, local bank financing, and additional commitments (*i.e.*, loans) by equity sponsors. Further, in addition to long term debt, the business plan would likely require short term financing, including revolving facilities and letters of credit. This 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*,” share collateral and have coordinated “Required Lender” provisions.

6 ROLE OF MULTILATERAL ORGANIZATIONS

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 look to regional organizations (*e.g.*, Asia Development Bank, Inter-American Development Bank, Overseas Private Investment Corporation (“OPIC”), International Finance Corporation (“IFC”), etc.). Developers may also look for local or domestic development banks, infrastructure funds, sovereign wealth funds, broadband development plans or other “stimulus” sources from national or local organizations, which are being 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, higher environmental standards, etc.).

Also, 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 so there is greater legal and regulatory risk. In particular, consents, 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 provider generally occurs in the form of “A Loans” project financing. Although not typical, Development Agencies may also act as equity sponsors. For example, the IFC has an equity program for telecommunications companies. Other agencies, such as OPIC, leverage emerging market funds investing in this space. These funds typically have target geographical regions and sectors.

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) providing technical cooperation and grants for feasibility studies.

7 CONCLUSIONS

The future looks brighter than a couple years ago. However, the environment is still not optimal. 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. The key is to identify local and regional needs for capacity and developing a realistic and focused business plan.