

SUCCESSFUL FINANCING STRATEGIES FOR A PRIVATE (NON-CONSORTIUM) SUBMARINE CABLE

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Abstract: The submarine cable industry has experienced rapid expansion over the past few years and there appear to be opportunities for private (*i.e.*, non-consortium) sponsored cables. More than any other single factor, financing impacts the timing and success of a submarine cable project. Successfully securing the funding for a submarine cable project will take a significant amount of preparation. To succeed, entrepreneurs will need to identify a market opportunity and prepare a credible business plan.

In addition to securing capacity sales to large Internet companies or content providers, cable sponsors should look at institutional investors, such as venture capital and private equity funds 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.

Virtually no privately-sponsored project can be completed without debt. Commercial banks, multilateral organizations and system vendors providing vendor financing are the obvious candidates to provide the debt component for a new system. But lenders thoroughly scrutinize business plans and only well-crafted plans will ultimately get funded.

The structuring and negotiation of financing documentation is a delicate balancing act. This paper attempts to identify steps for structuring projects to improve funding options and ways to successfully negotiate financing with multiple funding sources.

1. INTRODUCTION

Over the past few years, a boom of the submarine cable industry has been stimulated by IT giants such as Google, Facebook, Amazon and Microsoft. These over-the-top (OTT) service providers are building their own global submarine networks to process the ever-increasing traffic of their services. But bandwidth demands, particularly in emerging markets, have sparked not only transcontinental systems funded by OTT providers, but also new, targeted, regional cable projects led by private entrepreneurs. There are now more than 30 new cables planned to be built by 2022 and the combined submarine cable industry value is expected to

increase from approximately US \$12 billion in 2018 to approximately US \$21 billion by 2023.

Constructing, maintaining and upgrading a private (*i.e.*, non-consortium) submarine cable network requires significant amounts of capital. Without an adequate financing scheme, private subsea cable projects will never succeed despite the expanding business opportunities in the market. Given that the subsea cable industry is unique, arranging the capital structure for submarine cable projects requires a deep understanding of the industry as well as legal and financial knowledge. This article highlights some important

strategies to consider in seeking financing for a private submarine cable project.

2. DEVELOPING A REALISTIC BUSINESS PLAN

The first step to structuring a successful private cable system project is identifying a market opportunity. New cable routes have been chosen recently due to several reasons, including providing redundancy or diversity of existing networks, or meeting rapid Internet bandwidth demands in emerging markets. Recent trends move toward local and regional systems because content providers and cloud service providers are trying to establish local and regional content delivery networks (CDNs) to meet rapid demand in developing countries where Internet penetration has been increasing. Moreover, many new cables are moving away from traditional interconnection and content aggregation points, such as the United States or Western Europe, and are now bypassing legacy hubs. South Asia, Africa, Latin America, the Caribbean and the Middle East continue to be areas where opportunities still abound.

Once a market opportunity is identified, the business model appears fairly straightforward, a private sponsor leads the construction of a network and raises funding from equity and debt sources with the goal of providing bulk capacity to OTTs, competitive telecommunications providers and large corporate users. Developers act as “carriers’ carriers” because they generally do not have their own traffic to transport, but aim at filling the requirements of others by leasing circuits or entering into sales of capacity mainly in the form of Indefeasible Rights of Use (IRUs).

In developing their business plan, entrepreneurs need to pay particular attention to the following factors: (a) a realistic prediction of future traffic demands, including existing network capacity, other planned infrastructure, and bandwidth trends; (b) the likely requirements from equity financiers; (c) possible sources of debt financing, including vendor financing; (d) regulatory and environmental issues such as licensing and permitting from relevant governments or regulatory bodies; (e) maximization of tax efficiencies; and (f) having a top-notch management team with a proven track record of success.

Sponsors should be prepared for the fact that even with a credible and comprehensive business plan, potential investors will incorporate a significant discount on projected revenues as they assess the proposal.

3. SECURING PRE-SALES

In virtually all circumstances, the business plan must demonstrate that the network will be “fully funded” when construction begins. This means that the more pre-sales or firm capacity commitments that the sponsors can obtain at the outset, the more chances of securing sufficient outside equity and other sources of funding. Selling IRUs or even entire fiber pairs to OTTs appears to be the obvious path for entrepreneurs to get an “anchor tenant” for a new system. However, developers should cast their nets widely and look for more initial customers, such as financial institutions or other corporate customers who may have particular needs for capacity on a specific route.

4. RAISING EQUITY

When raising equity from third party sources, depending on whether the project is in its

early stages or in more advanced stages of development, the answer may be in either venture capital (VC) or private equity (PE). For new systems, the answer would most likely lie on VCs. This is because VCs are generally willing to invest in early stage projects while PE funds are more selective and they rarely invest in immature companies. In contrast, PE funds would likely be potential financing sources in cases of (1) building subsequent systems; (2) upgrading an existing network; (3) funding for systems that otherwise have significant customer commitments with predictable cash flows; or (4) providing an exit strategy for VC-funded systems.

There are many differences between VCs and PE funds, but they also share a number of common objectives. The following factors would be generally considered by both VCs and PE funds when they make investment decisions: (i) whether high returns, including free cash flow, can be expected --VCs in particular will expect profitability in three to five years; (ii) whether they can obtain preferences over other common stockholders and sponsors; (iii) whether they can obtain anti-dilution protections; (iv) whether the company has strong corporate governance provisions; and (v) whether there is a clear exit strategy to monetize their investment.

5. DON'T FORGET THE DEBT

Behind pre-sales and early capacity commitments, debt financing is arguably the most important ingredient in making a submarine cable project a success. In most cases, debt generally accounts for approximately 50% of the total cost to build, leaving the remainder to equity. The larger and more complex the project, the more likely developers will need a diverse portfolio of debt, including from technology

vendors, a commercial bank syndicate, local bank financing and/or additional commitments (*i.e.*, loans) by equity sponsors.

Over the past few years, financial institutions have cautiously become more willing to fund private submarine cable systems. Moreover, interest rates remain low when compared to historical standards. However, lenders still heavily scrutinize business plans and loan conditions tend to be more stringent. Performance history, reputation and effective accountability are prime factors that will differentiate which deals lenders choose to finance.

In many cases of newly implemented private networks, one of the important financial techniques is the "project finance" structure, which combines senior secured, nonrecourse or limited-recourse debts payable solely from the cash flows of the project. As if late, system suppliers and equipment vendors have also actively participated in the financing of new networks by providing vendor financing packages on preferential terms.

In addition to traditional banks and equipment vendors, another financing source for new systems may be multilateral organizations, such as Asia Development Bank, Inter-American Development Bank, Overseas Private Investment Corporation and International Finance Corporation (IFC). In many cases, multilateral organizations provide primary debt in the form of "A Loans" project financing, while in other cases they may also provide funds for the project as equity sponsors. For instance, the IFC provides telecommunications carriers with an equity financing program. In addition, multilateral organizations may also act as (1) secondary debt arrangers through "B Loans" where they syndicate loans to other

commercial banks rather than on their own accounts, (2) guarantors (generally partial guaranties of bonds or loans), (3) political risk and currency risk insurers and (4) providers of technical cooperation and feasibility studies. While multilateral organizations generally provide long-term loans below prevailing market rates, they usually require a borrower to follow more rigid conditions, including public interest provisions such as covenants related to child labor, collective bargaining, pornographic content, and stringent environmental standards.

Finally, hedge funds or other alternative lenders may also play important roles as financial sources in this sector. We are increasingly seeing them play an active role in previously untapped sectors such as real estate, technology and infrastructure. The higher regulation to which traditional commercial banks are now subject may open the door for these new players to provide funding for submarine systems.

6. IDENTIFYING AND NEGOTIATING KEY ISSUES

Once all financial sources have been found and an outline of the capital structure has been drawn, sponsors will need to sit down and negotiate with all stakeholders the key issues of the structure. The financial jigsaw puzzle is best completed in steps. Patience is crucial.

When negotiating with equity sponsors, the most common structure preferred by VC and PE investors is convertible preferred stock, which guarantees that these investors will be paid dividends before payments to common shareholders, as well as being granted an option to convert their shares to common stock at any time. Other equity securities or

combinations of debt and equity such as subordinated notes and warrants can be used but may be unnecessarily complex and may cause problems with subsequent debt offerings.

One of the most heavily negotiated issues by equity sponsors is their exit strategy. Institutional investors generally expect the network to generate a profit in 3-5 years and, once that occurs, they will seek to monetize their investment by exiting from the project. As Initial Public Offerings (IPOs) are often not an option, other options must be considered, such as identifying potential strategic buyers and merger candidates, combining with other regional networks and securing new PE or institutional investors that prefer mature systems.

Another important issue are the corporate governance provisions, which enable investors to participate in the important decision-making process through control of the board and/or negative blocking rights. Based on our experience, it is advisable that sponsors implement world-class corporate governance structures, even if the company is only in its infancy. Having strong corporate governance provisions would provide investors with confidence that the business will be run in a professional manner.

With respect to debt, there may need to be heavy negotiations with lenders over financial covenants, including debt-to-equity and debt coverage ratios. Lenders generally request that a borrower secure enough cash reserves or additional equity backup to cover unexpected costs. In addition, financial institutions may request more stringent conditions under which dividends and other distributions will be significantly limited during the term of the credit facility. Debt sources would invariably seek a full

collateral package, including liens over hard assets, contracts and stock. Finally, inter-creditor arrangements will need to be in place to secure each lender's place in the capital structure.

Deep knowledge of regulatory and environmental issues is also indispensable. Sponsors should be ready to address diverse laws and cross-border, environmental and regulatory risks. The timely securing of landing licenses and permits will also be crucial to lenders and equity sponsors. Having expert advisors and counsel early on in these negotiations is vital.

7. CONCLUSION

The submarine cable industry appears to have entered a new phase. Expansion of the industry is expected to continue over the next few years and opportunities may be plentiful for private submarine entrepreneurs. However, there is no "one size fits all" solution to every project. The foundation for success in securing funding lies in a well-constructed and realistic business plan and precisely identified market opportunity. Following through in the multiple negotiations necessary to bring a project to fruition also requires significant patience and skill.