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FINANCINGS OF SUBMARINE FIBER OPTIC NETWORKS

THE BUILDING BOOM AND THE NEED FOR FINANCING

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The importance -- and fragility -- of the subsea cable network was recently highlighted by damage to four undersea Internet cables last month -- two in the Mediterranean Sea and two in the Persian Gulf. For days, Internet service in large portions of the Middle East was disrupted, cutting 70% of Egypt's connectivity, and leaving India's large outsourcing industry at only half capacity.

This disaster comes at a time when the subsea industry is well into another building cycle, following several painful years of underinvestment and disinvestment. Unlike the fiber cable boom of the late 1990s when most investment was speculative, the recent surge in cable development is a result of actual demand for greater capacity – driven in part by the mainstream use of bandwidth-intensive Web sites like YouTube and Google Earth. Still, the effects of the last fiber boom linger in the form of skepticism and caution. For example, business plans must be linked directly to end-user revenues, replacing speculative systems of the last fiber boom. Demand for connectivity has become less U.S.-centric, with the result that new cable systems are connecting areas – such as within the Asia-Pacific region as well as the Caribbean, the Indian Ocean, the Middle East, Africa and Latin America -- where revenue forecasts are not predicated on solid historical data and thus benefit from higher confidence levels.

This building boom in the subsea cable industry and expansions and upgrades of existing cable systems will, however, not come to fruition unless adequate funding is available. Given that much of the activity is centered in the developing world – where many operators and sponsors do not have the financial resources to sustain the massive investments necessary – industry growth will in large part rely on the availability of debt or equity financing from outside the industry.

The Role of Debt Providers

This article focuses on capital raising in the form of debt, specifically from commercial banks. Even before the current "credit crunch" emerged, neither traditional equity markets, nor the debt capital markets, provided an easily accessible option. Once the credit markets more available, commercial banks, with their large credit staffs and, in some cases, significant experience in the sector, will be in the best position to evaluate submarine cable projects. Commercial banks are often willing to accept the construction risks associated with these projects and have the ability to provide funds for the short to medium term (typically up to ten years), by which time a project could become profitable and capable of refinancing or repaying its debt.

Several factors add to the risk profile as viewed by commercial banks, including the sheer size of the debt, uncertain revenue forecasts, alternative capacity through satellites and competing cable systems, and, of course, the continued march of technological progress that could render submarine cable systems obsolete sooner than expected. Finally, overall project risk on any particular installation is still not insignificant, given the complex and increasingly stringent environmental, permitting and other regulatory requirements, as well as capacity constraints currently affecting cable-laying ships.

Offsetting these impediments are a number of developing trends. While commercial banks offer the best source of financing in the near term, the equity and debt markets remain in the wings. Moreover, private equity investors have begun to recognize that the submarine cable industry has the potential for significant returns. Acquisitions by private equity can spur consolidation and greater network investment, as newly acquired companies expand their business under new management, and other operators react to a now well-capitalized competitor.

Structural Options for Financing

Obviously, the financing needs of submarine cable operators will vary, and their position in the market will dictate different approaches. It is likely that the financing of submarine fiber optic networks will continue to rely heavily on project finance techniques in large part because the project finance structure affords an excellent mechanism for addressing the risks and difficulties present in start-ups and new installation projects. It should be noted, however, that owners of submarine systems that are "investment grade" will always have the option for financing network expansions on their own balance sheets.

A key advantage of the project finance route is the ability to leverage the financing to a higher degree than might be possible or desirable on an owner/sponsor's balance sheet. The non-recourse nature of project finance debt, in which the shareholder/sponsor is not liable for the debt incurred by the operating entity, means that the debt does not burden the sponsor's balance sheet.

The participants in a project financing often include equipment vendors, because they are in an excellent position to supply the "early money." They have the sophistication and industry expertise to evaluate project risk, and no other financing source will be as knowledgeable at the pre-revenue stages of a project. Multilateral institutions (such as the World Bank and its affiliates) and export credit agencies or "ECAs" are also increasingly willing to promote communications infrastructure (as evident in their current support of Project EASSy in Africa). Those institutions are often willing to lend in high risk circumstances where commercial banks will not, their interest rates will usually be lower than commercial financings, and they typically have a more lenient approach to waivers and default scenarios. However, social policy and development goals of those institutions often impose additional reporting and compliance costs.

Project finance also has unique costs that should be evaluated. Project financings are highly structured and have substantial transaction costs. Costs and risks are shared across and among sponsors, vendors, lenders and investors and the significant amount of debt that must be raised for large projects entails a higher amount of risk, which is often apportioned among several tranches of debt. The complexities involved contribute to longer lead times to complete the financing and to begin construction. Financing is further complicated by the problematic nature of the collateral security interests since there is no single facility that can be mortgaged; the real value is inherent in the network itself. This is exacerbated by the fact that cables that lie in international waters are not subject to any collateral scheme, landing rights are governed by local law, which may prohibit assignment, and contractual rights are difficult to collateralize and collect on, especially if a company has declared bankruptcy.

Invariably, a creditor's response to the challenges of obtaining (and potentially enforcing) a lien on a submarine cable company's assets is to seek a pledge of its shares of capital stock where possible. Clearly, this will be inappropriate in the case of a public company and difficult where minority shareholders are involved. Moreover, by its very nature, a pledge of shares is effectively subordinate to creditors at the operating level, since the shares can reflect only the net worth of the company. Still, a pledge is simpler to create and affords ease of foreclosure since it carries with it not only the varied assets but also licenses, permits, contract rights and other intangible property on which it might be difficult to obtain a lien.

Another set of issues grows out of the corporate structure of the borrower. Historically, there have been two types of submarine cable owners: traditional consortia of telecom operators who use the system for their own traffic and speculative models that rely on sales to third parties. In the latter model, the sponsor generally seeks to minimize taxes by establishing the principal cable owner in Bermuda or another tax haven, with separate entities, in their own jurisdictions, owning cable assets or furnishing services. The sheer number of corporate entities presents the same challenges as in any financing, as lenders need to track cashflows and dividend streams through the corporate labyrinth and seek stock

pledges of multiple companies in many countries. The traditional model, generally structured as a consortium of telecom companies, obviously diversifies risk and affords a range of expertise but lenders may have to be reassured that there is a meaningful way to hold each sponsor accountable for its obligations.

Requirements for Financing in Today's Debt Markets

Whatever the form of the financing, submarine fiber optic network projects will need to be structured to meet today's realities. Business plans will need to be "fully-funded" and lenders should be expected to scrutinize both the creditworthiness of any customers that account for a significant percentage of the business plan. Commercial banks and capital market investors will typically discount a project's revenue projections by 10% or more, to be conservative, and want to verify that even in a reasonable worst-case scenario, revenues will be sufficient to repay the debt.

Lenders may also require covenants for debt service coverage ratios and leverage ratios, restrictions on new business activities or investments beyond what is specifically contemplated in the current business plan, and limits on the payment of dividends; and they will typically insist on a debt service reserve account, which would be funded with at least six months' (sometimes a year's) worth of projected debt service payments. Lenders will expect strong sponsor support of the projects. Sponsors will likely need to demonstrate a debt-equity ratio in the 50-50 or perhaps 60-40 range, with the equity funded up-front.

These restrictions, the multiple layers of financing, and the significant amount of debt required, result in an effective prohibition on incurring further debt. A strong "fully-funded" business plan that will generate sufficient revenue to repay the debt financing is thus critical.

Conclusion

There is good news and bad news in the current picture for financing in the submarine cable industry. There is significant demand for capacity and the industry is confident that its worst days are behind it. Even with new supply, growth in demand will at a minimum stabilize bandwidth prices and in all probability cause prices to increase. Still, the creation, operation and maintenance of subsea cables presents a range of complex business risks. No one financing source or model is available to absorb these risks and meet the extraordinary capital requirement of the industry as it returns to an expansion mode. Rather, multi-sourced solutions to financing, with several debt providers over the life cycle of a project will be increasingly seen. By combining financing and equity ownership models in new ways, and tailoring financing precisely to particular risks and problems, the industry will be able to meet its financing needs. While the increased complexity and current "credit crunch" (hopefully of limited duration and intensity) will pose unique challenges for all project participants, the situation may have a silver lining. The complexity of financing and the current caution of lenders could help temper a repeat of the boom-bust cycle of the late 1990s and help create an environment for stable growth.

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