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Can Commercial Banks Return to the Submarine Cable Market?

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Even a quick flip through the pages of *Submarine Telecoms Forum* or other industry publications makes clear that the subsea cable industry is in the midst of a rebound. The source of that rebound is equally apparent: the explosive growth of the Internet and the desire to replicate that growth in the heavily populated countries of the Third World. Surprisingly, those very factors are now creating difficulties in planning and financing for new submarine cable systems.

As the industry increasingly moves into Africa and focuses on regional systems elsewhere connecting, for example, Caribbean islands or countries in Southeast Asia, two consequences ensue that spell difficulty. First, obviously enough, building cables in the Third World is more likely to present construction challenges, permitting and licensing obstacles and cost overruns. Second, and potentially more worrisome, is the fact that revenue traffic projections are inherently uncertain in these markets with little history of broadband connectivity, or indeed any significant telecoms penetration. This uncertainty affects planning for all sorts of subsea projects – from the consortia model to the investor owned cable system. Predicting demand is always tricky in any scenario, but the problem is compounded where there is so little data from which to extrapolate and make revenue projections. For instance, a commercial lender looking to back a new trans-Atlantic cable can assess a borrower's "base case" by comparing it to traffic on other existing cables or derive estimates with some degree of confidence from telecom/Internet usage and connection rates in what are clearly more developed markets. Obviously, that's not possible when the cable in question is running along the African coast. Moreover, the intrinsic difficulties of construction in the more problematic corners of the globe exacerbate the uncertainties in the revenue projections, since delays may be more common and thus push back "ready for commercial service" dates of submarine cable systems. Finally, the enticing prospects of robust growth in these underdeveloped markets mean that many sponsors and operators are planning – if not racing to complete – cable projects that will inevitably compete with one another, further confounding revenue projections for any system.

Ironically, the growth in the subsea cable sector comes at a time when commercial banks are slowly staggering out of a recession and are greatly curtailing lending to anything other than highly creditworthy borrowers. Needless to say, submarine cable projects – with memories of the industry's collapse several years ago not quite erased, and with new projects subject to the revenue uncertainties noted above – will not fall into that highly creditworthy category!

Capital expenditures continue apace in the industry and commercial banks will somehow have to play a role in funding those expenditures. The cable industry is on track by some estimates to spend over $3 billion over the next three years with a record 16 new cables placed into service this past year throughout the world. Cable system owners, telecom operators and some other service providers are intent on meeting demands for international data and voice transmission (engendered primarily by the explosion of web-based video, voice and date and multimedia-centric websites). The recent completion of the SEACOM cable and the anticipated installation of the EASSy, Main One, and Glo-1 cables in Africa are testimony to the fact that the development (and lending) "action" has in part shifted to Africa and other countries with low internet penetration. In fact, 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 cables.

Commercial banks have been noticeably absent from the funding picture for some of the recent African cable systems and regional projects, leaving the field to multilateral development institutions or simply to equity investors. The multilaterals are a useful addition to financing options but they have special requirements and can sometimes not move as fast as commercial lenders. The massive

amounts of capital required by the subsea industry can ultimately be met efficiently only through the active participation of the commercial banking sector.

So how do wary lenders react to this burgeoning demand for capital in an uncertain seascape? Generally, the response has been with heightened attention to detail and assurance of returns to satisfy the credit committees to whom these lenders are ultimately responsible. The credit committees that are charged with approving new loans at almost every major financial institution around the world are consistently applying tougher standards (whether in the form of operational and financial covenants, due diligence or improving upon typical tax and yield maintenance provisions) than at the height of the "easy money" boom of a few years ago. These tougher standards are applied first and foremost to the project's revenue projections, and will be discussed in detail later. In addition, those standards generate some notable requirements for cable systems, including: (i) the shift of permitting, construction, operation and management risk to sponsors instead of the financiers; (ii) the expectation that sponsors will contribute a substantial equity component to the project and be responsible for (and capable of) covering cash shortfalls of the project, whether due to construction cost overruns or revenue shortfalls; (iii) credit documentation for the transaction becoming much more tightly negotiated and limiting the borrower's operational freedom while ensuring that complete collateral security remains paramount; and (iv) increased skepticism of using developing countries' laws for any aspect of a subsea project (in the form of increased importance of governing law provisions, dispute resolution procedures and available judicial/arbitral relief).

These requirements translate into a "flight to quality:" Lenders will seek to do deals with reputable operators and sponsors who have solid track records, eschewing untested management teams or financial investors with little experience in successful subsea projects. Those operators and sponsors can in turn shoulder the responsibility for further equity support as well as other risks noted above that lenders will not accept for their own account. Lenders are manifestly insisting these days on tighter credit agreement provisions (*e.g.*, lenders will demand more stringent financial ratio compliance). As for collateral security, commercial lenders are demanding liens on both all assets as well as a pledge of shares of the operating company (where feasible). Of course, in practice this can sometimes prove difficult because of the multijurisdictional nature of a subsea system and the most valuable assets, the licenses, often being unpledgeable. Given these difficulties in obtaining "perfect" collateral packages, commercial lenders often utilize collateral as a means not to ensure repayment through actual enforcement, but as a means of control and to establish that no other creditor will have leverage in a financial distress situation. But that doesn't mean operators and sponsors shouldn't be prepared for robust negotiations over collateral with commercial banks. One battleground is a lender's demand for express acknowledgements for contractual assignments from the borrower's/operator's key customers and other important counterparties.

Assuming the requirements outlined above can be satisfied, lenders are still left to grapple with uncertain revenue streams, which obviously are critical to ensure repayment of the loan. Commercial lenders are wisely concerned with the current declining bandwidth cost per unit, as the rate of long-term declines in bandwidth pricing is impossible to predict with any certainty. This uncertainty is exacerbated by the fact that in many markets there are simply too many telecom operators. For example, in India, the telecom industry is being further pushed towards consolidation and infrastructure sharing and thus operators (and their lenders) are forced to consider how this will affect pricing. Even precisely which direction market consolidation will push bandwidth prices is unclear. Will a decrease in ruthless competition allow pricing to "firm-up" in

a given market, or will the increased purchasing power of major operators (in say, a duopoly) drive capacity prices down further?

Competitive threats figure highly in any lender's analysis of a project's base case. In some cases, when faced with the prospect of investing in second or third projects in a developing market, commercial lenders have to account for the possibility that it may be relatively simple and cost-effective to upgrade a competing cable system and this would negatively affect the profit return to the project they have under consideration. In other situations, lenders may need to account for the fact that there might be a great amount of unlit fiber on some routes. Finally, alternative technologies such as satellites can shift traffic and revenues away from subsea cables.

Uncertainty in revenue forecasting only gets worse as the industry increasingly shifts to the less-developed world. Extrapolating from demand patterns in the US and western Europe may be useless. In many of the developing markets fixed line telecom and cable TV penetration is very low, so the population is adopting wireless technologies directly, and users are leapfrogging to 4G, WiMAX and LTE. In these new and untapped markets, there is no accepted model to predict revenues, further vexing lenders.

Sustaining the current boom in the subsea sector will require that commercial banks turn on the spigot to a greater degree. While to some extent that will depend on macro-economic and bank regulatory issues, at least in the subsea cable industry, borrowers should recognize that they will be asked by banks to assure adequate equity, stand behind project costs, make available full collateral security, engage competent local counsel to familiarize lenders with emerging market risk and legal requirements and to resolve licensing and permitting issues before drawing down a loan. Even more importantly, commercial banks and borrowers must analyze the base financial case and demand forecast with an eye for the uncertainties noted above. Inevitably that will mean that sponsors and operators must be prepared for lenders to discount, possibly significantly, their revenue projections. If so prepared, with a robust business case, borrowers should be able to find that middle ground with their bank lenders that enables successful deals to be launched.

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