

All signs point to an increase in subsea cable M&A activity



Guest comment by **Costa Smith**, **Stuart Blythe** and **Jonathan Gordon**

Three professionals from Baker Botts explain what's driving this increase in activity and what investors should do to navigate it successfully

The rapid pace of funding and building of ambitious submarine cable infrastructure shows no signs of abating despite a changed economic cycle. The pace of growth in the subsea cable sector, and the secular market forces driving such growth – including increasing demands for data and low latency capacity – are likely to fuel increased M&A activity in the space.

The unique characteristics of the submarine cable infrastructure require similarly unique ownership and financing models and, therefore, differentiate M&A in the subsea sector.

Ownership structures

Traditionally, subsea projects have been developed along either a consortium or joint-build model, with each party bringing a degree of specific expertise to the project. In the consortium model, partners will typically collaborate either by entering into a multilateral consortium agreement or through an incorporated joint venture vehicle, in which each consortium member owns an equity stake. While the entry into the subsea sector of certain hyperscalers is noteworthy (with hyperscalers more

likely to act alone as a sole owner of a system), the consortium model continues to be the most prevalent in the sector. The continued importance of the consortium model means that it is often stakes in consortia that are subject to subsea M&A.

Purchasing a stake in an existing subsea consortium means that future risks, costs and benefits can be shared among consortium members. Participation in a consortium can provide comfort regarding anticipated and unanticipated risk, particularly where the consortium is composed of participants with strong balance sheets and covenant strength.

However, if one or more participants are ultimately unable to cover their share of the consortium liability, other members may be required to assume those liabilities. While some risk of counterparty default can be managed through the use of contribution agreements between consortium members, due diligence on fellow consortium members is a key element to entering into such projects.

As with all jointly owned assets, a material issue in subsea systems is operational decision-making. Depending on the build-stage of the acquisition,

subsea route selections may have already been determined, but potential members must consider how decisions will be made on issues such as system upgrades, future financing requirements and whether any party holds a negative blocking right or veto on a



given matter. These day-to-day concerns are crucial for effective operation and maintenance post-completion.

When evaluating a consortium transaction, a potential member also needs to consider how a change of control will be governed, how the consortium will be governed during its life, how new members can join the consortium in the future and which exit rights will be available.

Consortium agreements often prohibit sales to competitors, who may be the most interested purchasers, and therefore realistic exit planning and detailed due diligence of the existing consortium agreement is critical. One of the perceived inhibitors to past M&A activity in the space has been the lack of track record for exits into the market, provoking transactional uncertainty.

Financing

A key feature of the subsea asset class is the nature of contractual revenue profiles in the sector, in which capex spend and revenue receipts are “front loaded”. Traditionally, submarine cable

projects have been financed on the basis of one or more large capacity sales, which provide a lump sum revenue payment upon system completion.

This model works well for both asset owners and customers: for owners, early revenue receipts compensate for capex spend during the cost-intensive build phase and provide an ability to refinance debt accumulated during build; for customers, fibre capacity or access is reserved, with phased, or in some cases, no payments due until the given system is live. These front-loaded costs and revenues are then typically followed, for the remainder of the system’s operative lifetime, by more modest, regular operation and maintenance receipts.

In light of front-loaded costs, and the likely incurrence of third-party senior debt to support capex, senior debt prepayments (or locked cash reserves) are often required prior to making shareholder distributions. Owners can then seek refinancing once the system is operational and less risky, thereby improving the refinancing terms which may be available.

Potential investors or lenders must diligence the system’s position in the revenue cycle. Whether a subsea system is pre- or post-completion will be a material consideration from both a risk management perspective, and the perspective of investment return and cost of capital (with a knock-on impact on pricing). While an investment in or acquisition of a post-completion system will minimise an acquirer’s build risk, allowing for technical due diligence of a completed route and live contracts, future revenue generation may be limited to operation and maintenance receipts.

There does appear, however, to be a trend away from the reliance on fixed, long-term commitments, with operators and customers alike beginning to switch to shorter-term capacity contracts, particularly in the super-fast low latency capacity segment.

For example, this has even developed to such an extent that a metered dark fibre TM product, constructed on a pay-as-you-go model, has been offered by CrossLake Fibre on its high-fibre count non-repeated system. As well as maximising usage of the asset, and reducing unused capacity, short-term contracting can allow parties to more accurately track market pricing over time, as well as ensuring a smoother revenue profile for the asset owners.

Such shorter-term contracts, combined with traditional longer term “anchor” arrangements, may provide the best of both worlds for an acquirer: financing certainty during the capex-intensive build phase, with an ongoing refreshing of shorter-term contracts for capacity.

This approach may also increase the attractiveness to investors and lenders of post-completion systems, with an increased opportunity of ongoing revenue generation throughout the life of the asset and could provide existing asset owners with increased exit opportunities. ■

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