PEI Alternative Insight

INFRASTRUCTURE INVESTOR

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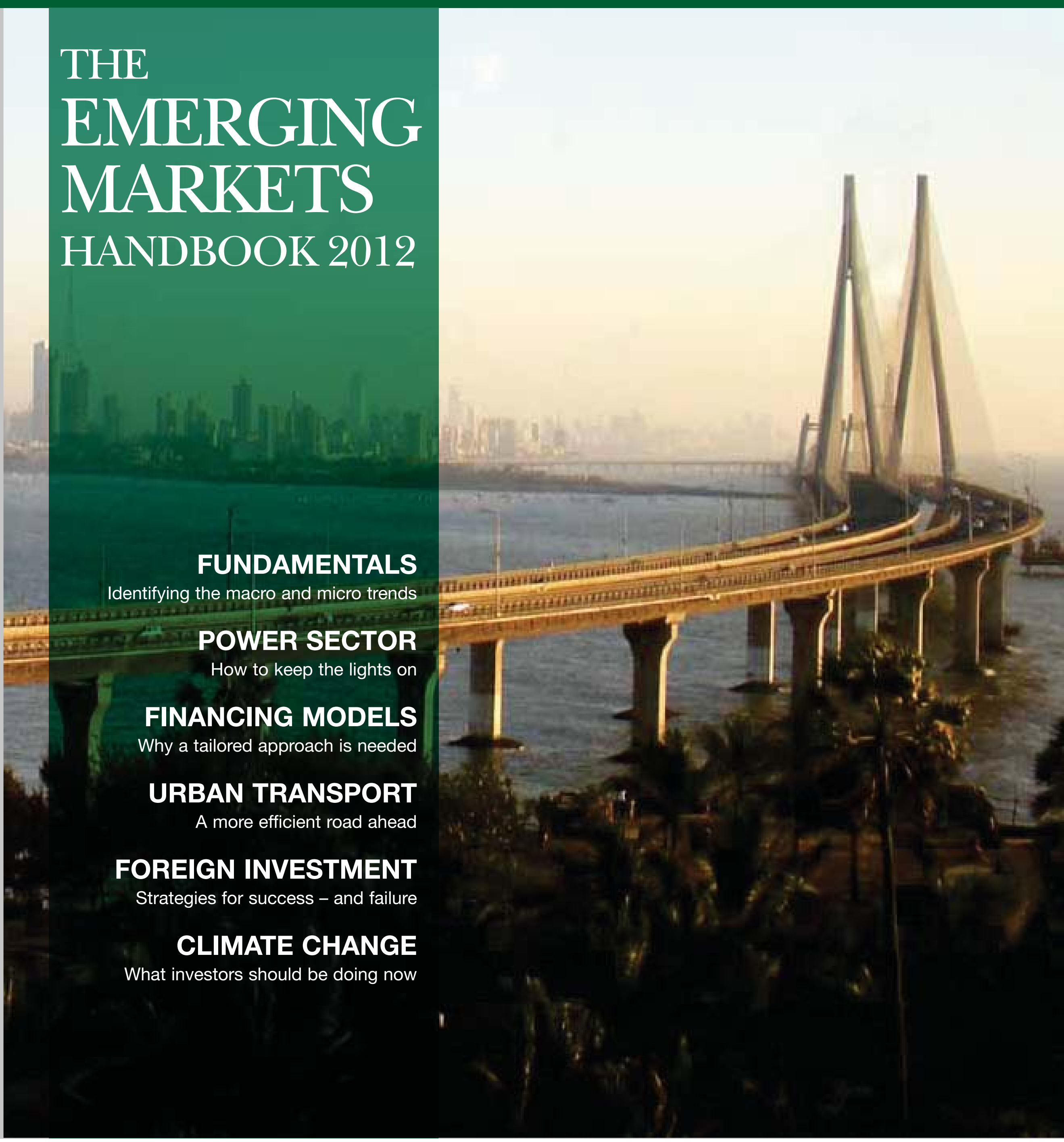
FOR THE WORLD'S INFRASTRUCTURE MARKETS



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THE QUEEN'S AWARDS
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INTERVIEW

SUNEET MAHESHWARI, L&T INFRASTRUCTURE FINANCE COMPANY LIMITED

Opportunity with a sense of discipline

Indian infrastructure offers great opportunities but both investors and government need to show more discipline in order to avoid pitfalls. Suneet Maheshwari of L&T Infrastructure Finance Co. casts an eye over the Indian infrastructure landscape

L&T Group is one of the largest engineering, construction and infrastructure companies in India, employing over 56,000 employees across the globe, easily comparable to global giants such as GE and Bechtel. With a revenue base of $11.5 billion and market capitalisation of $22.2 billion (at May 31 2011), L&T's expertise spans the infrastructure sector encompassing energy, transportation, water and urban development. Another way of measuring it is to take a look at L&T's website, where you will discover that the firm lists no fewer than 119 subsidiaries and 23 associate companies.

More recently, L&T Group, through its establishment of its subsidiary L&T Infrastructure Finance Company (L&T Infra), has emerged as a leading player in the field of infrastructure finance, led by managing director and chief executive Suneet Maheshwari. Launched in 2006, it was one of the pioneering non-banking finance companies introduced by the Reserve Bank of India to spur private investment in Indian infrastructure.

Most recently, in June 2011, L&T Infra achieved the status of a 'public financial institution' in recognition of its contribution to the infrastructure financing space over the last few years. And L&T Infra has taken up the challenge of helping to fund Indian infrastructure – Maheshwari says the firm will ultimately have more than $2 billion in financial assets.

Maheshwari: *sees potential in the energy sector for 15 years*

In an interview in central London, Maheshwari is asked to reflect on where the opportunities and challenges lie in Indian infrastructure today.

PRIVATE PARTICIPATION

Energy is one of the most talked-about sectors in India, and it's where Maheshwari starts. He says L&T Infra saw thermal coal power projects go through a difficult phase due to fuel linkage issues and consequently developed other renewable energy sectors such as solar, hydro power and wind, given the burgeoning demand for power. He adds: "Energy will be a long-term sector for infrastructure investors. We see growth in energy for the next 15 years in India. While power generation continues to be a focus, there are other sectors like transmission and distribution where we see potential for private sector participation."

He also sees "a lot of scope" in transport, especially in roads where former roads minister Kamal Nath made his famous pledge to oversee the building of 20 kilometres of new roads per day. Moreover, Maheshwari says: "We are seeing more activity in ports and airports as well as rail. Transport as a whole will be a fairly big opportunity. It may take three to five years for private participation in rail to come to fruition."

Interestingly, Nath made the switch from roads to the urban development ministry in January 2011, and, in his new post, has called for public-private partnerships to become mainstream in the country's water and waste management sectors. In a recent speech in New Delhi, he said that total investment in these sectors over the last 20 years had been a mere one-tenth of that required. Maheshwari quips that a lot more action will be witnessed in the water and sanitation sector over a three-year horizon.

Social infrastructure, such as education and healthcare, is another area where Maheshwari believes there is a lot of potential. "It could be an area to look at. There are already private hospitals which are operational and there is scope for more," he says. "We think social infrastructure is an essential component of Indian growth and will become even more critical as incomes increase."

CALIBRATED GROWTH

But while opportunity abounds in India – and is much publicised – Maheshwari is a realist and admits that to paint a picture of seamless progress in Indian infrastructure investment would be less than accurate. So, for example, when it comes to the telecommunications sector, he says: "In telecom there will be competition which could affect a few companies. We would be cautious about picking up the right assets. As opposed to services, we still see huge potential in broadband networks and telecom towers."

He also believes there are some factors which could hinder infrastructure investment in India, regardless of how attractive the opportunities are in given sectors. For example, he thinks demand for capital could soon outstrip supply. "Indian banks will, with time, become overweight in the energy and roads sectors," says Maheshwari.

But what about that much-discussed

> *The land acquisition process needs to be fully streamlined. One part is to have proper laws and regulation. Implementation is another thing, however*

topic in the infrastructure investment universe – the enticement of institutional investors? "At present, equity is an area where there is interest by the institutional investors. In the debt market for long-term instruments, we have not seen the same depth. However, with the announcements about debt funds we are optimistic. This would provide a greater fillip if the market for long-term infrastructure bonds is also developed. "

Maheshwari also believes the government needs to create a more predictable environment for investing. "While infrastructure reforms will proceed at their own pace, it is important to provide predictability over the long term considering that infrastructure projects have a long gestation period."

He adds: "Infrastructure investors are long term 10- to 15-year investors and investments can happen better in an environment of certainty. Multiplicity of institutions and an overlap of different departments within the three-tier political system makes the environment challenging. Thus it is required for the government to work in close cooperation with the private sector."

He believes that telecommunications sector regulation has matured. National-level regulatory systems mature faster than their counterparts in the states. He adds: "On average, India can be rated 6 out of 10 in terms of regulatory frameworks vis-a-vis other developed countries. The maturity of the telecom sector contributes to a great degree to this level of rating."

COMPLEXITY CONTINUES

He also refers to the complex issue of land acquisition, which is likely to see the introduction of new regulations. Legislation, however, may not solve all the problems. "The land acquisition process needs to be fully streamlined," says Maheshwari. "One part is to have proper laws and regulation. Implementation is another thing, however. I suspect that land acquisition could remain a complex issue for a long time."

Also complex is India itself – and this is why Maheshwari believes that, for foreign investors interested in the country, teaming up with a local partner would be a wise move. "India is like the European Union," he suggests. "You can't expect the outside world to understand a complex country where the language changes every 500 kilometres. India is difficult even for Indians to understand and more so for international investors – hence the need for a local partner."

As someone with 22 years of experience of infrastructure in India, Maheshwari arguably understands the nuances of the sector well. And, despite the challenges that exist, he insists that his view of the future is an optimistic one. "I'm willing to commit [to this career] for another 10 or 15 years," he says. "And if I give my lifetime to this, that's the biggest vote of confidence I can provide!" ■

EXPERT COMMENTARY

L&T INFRASTRUCTURE FINANCE COMPANY

The transformation of Indian infrastructure

As infrastructure investment in India matures, the opportunity for the private sector continues to grow. However, the attractiveness of a sector depends to a large extent on whether it is subject to federal, state or concurrent jurisdiction. Suneet Maheshwari *of L&T Infra explores the nuances*

Infrastructure spending in India has transformed over time. From being largely dominated by government budgetary provisions, it is now creating massive opportunities for the private sector. Today, India envisages a five times increase in infrastructure investment compared with the last 10 years – leading to a substantial $1 trillion planned spending over the next five years (2012 to 2017). Given the large infrastructure deficit and continued need for economic growth, this accounts for nearly 10 percent of GDP.

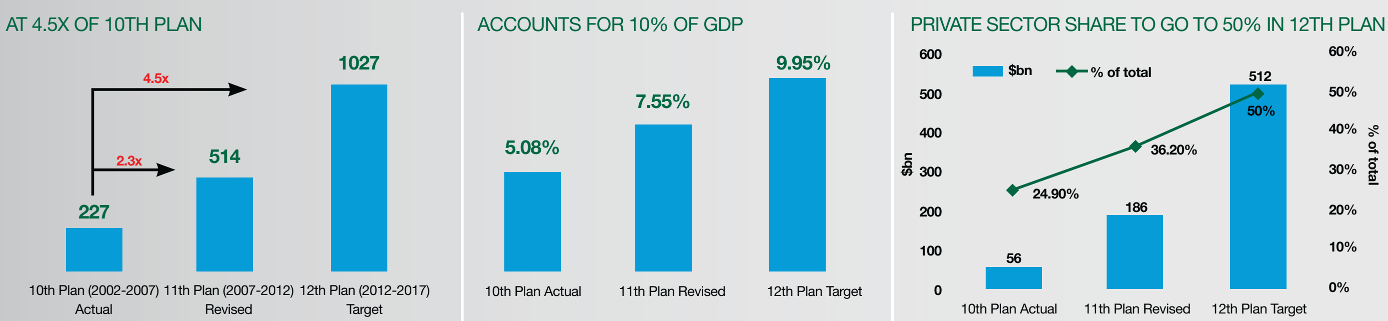
Since India's economy opened up in July 1991, greater benefits of liberalisation have been shared – in turn, better contributions have been made by the private sector and there is a greater acceptance of a framework for Public-Private Partnerships (PPPs). But one of the most significant developments is that there is now a greater political consensus evolving on infrastructure development which has contributed significantly to the stability of PPPs. With this momentum in PPPs, it is projected that the share of private sector investment is likely to have doubled to 50 percent over the last 10 years (see table 1). However, the flow of private investment evenly across infrastructure sectors continues to be a challenge given the different degrees of policies and regulatory maturity across various sectors.

Quite often, international investors forget that India, though a single country, is as complex in terms of ethnic diversity, language, governance and decision making as the European Union, if not more. Its three-tier governance structure of federal, state and union territories (totalling 35) is further sub-divided into municipal and local authorities – a quasi-federal structure which is an amalgamation of English Parliament and US Federal structures and based on the design principles of constitutions of various countries. The Indian constitution has exclusive federal, state or concurrent (joint) jurisdiction over various subjects – a fact that makes approvals and regulatory oversight more complex and thereby increasing the risk perception of infrastructure projects across sectors. It may seem reasonable for international investors to partner with Indian sponsors, since they have a better reading of its dynamics, than to follow a solo strategy.

The country is characterised by highly capable, strong administrative machinery at the federal level. With gradual liberalisation, this federal administration has made a concerted effort to take progressive decisions across verticals such as power, aviation and telecom. Further, all administrative and executive action can be challenged by an independent judiciary which has the power to review decisions that do not conform to the Indian constitutional framework. While varying degrees of political direction at federal level may recalibrate development in a few sectors, the states have begun to emerge as hubs for PPPs which bring about effective mitigation to any lull in federal action.

This has been further strengthened by

TABLE 1 – **TARGET INFRASTRUCTURE SPENDING DURING 12TH 5 YEAR PLAN**



Source: Planning Commission

the 73rd and 74th constitutional amendments which empower and provide more teeth to local self governments. The full effect of devolution to local bodies is yet to take effect because of inadequate capacity at that level, but once this transition takes place effectively, it could unleash huge latent infrastructure potential in the country.

Given the dynamic environment and complex governance structure prevalent in India, the infrastructure sectors (across federal, state and concurrent jurisdiction) vary in their phase of development in terms of the effectiveness of policy interventions, availability of financing, commitment to project development and capacity for development efforts.

> *The country is characterised by highly capable, strong administrative machinery at the federal level*

FEDERAL SUBJECTS: "GOING STRONG, GOING STEADY"

Infrastructure sectors with strong federal oversight exhibit a relatively higher degree of maturity and private sector involvement, which is a reflection of consistent policy and institutional framework, established financing structures and a sizeable flow of bankable projects. A good example is the development of national highways in India through the $60 billion National Highways Development Programme (NHDP) – one of the largest road development programmes to be undertaken by a single authority in the world[1].

Concerted policy interventions to attract the private sector in the form of dedicated funding schemes (viability gap funding, India Infrastructure Project Development Fund, India Infrastructure Debt Fund), standardisation of bid documents and processes, quick statutory approvals/ clearances, dedicated SPV for funding (IIFCL, etc) have been made. Given the stability of the sector, investors are keenly exploring diverse financing options such as subordinate debt, take-out financing, IPOs, qualified institutional placements (QIP), private equity etc.

The focus on the sector is also highlighted in the recent Union Budget 2012-13 where it was announced that a length of 8,800km has been targeted under the NHDP thus creating ample investment opportunities. A concrete validation of these efforts is the fact that where, traditionally, development of highways was primarily government budget-dependent, today more than 60 percent of the estimated investment requirement is expected to be privately financed.

In fact, increased competition and the entry of quality mid-market contractors have crowded the market, leading to aggressive bidding. A similar trend is noticed in other federal regulated sectors such as telecom as well where the presence of an independent regulator further provides support for private sector involvement.

STATE SUBJECTS: "SLOWLY STABILISING"

In comparison, sectors which are managed by state governments are gradually evolving but have been historically replete with problems of a less predictable policy structure, complex institutional frameworks, weak finances, inadequate project development efforts and capacity constraints. Urban infrastructure, a state subject, is beginning to evolve today with a fundamental shift in the mechanisms of service delivery. Services such as water supply, sanitation, solid waste management and affordable housing are gradually improving in most Indian cities and with the 74th constitutional amendment empowering Urban Local Bodies (ULBs) as "institutions of self-government", they will soon be able to tackle such challenges.

Achievement of inclusive growth and larger private participation requires a shift in focus of policy from creating physical infrastructure to delivering services, strengthening local self-governments, institutional reform and a comprehensive capacity-building programme. Given the urgency, states have initiated necessary action by introducing PPP cells, launching BOT laws, forming dedicated agencies for project development (such as PDCOR – Rajasthan, PIDB – Punjab, iDeCK – Karnataka) and creating dedicating infrastructure funds (such as in Gujarat, Tamil Nadu) etc. These efforts have spurred competition among states which, in combination with federal support through reform-linked subsidies programmes (such as JNNURM, UIDSSMT), will encourage investments in these sectors as we move towards the next phase of India's development.

CONCURRENT SUBJECTS: "MIXED BAG"

Under the constitution of India, electricity is a "concurrent" subject where both the centre as well as state governments have authority to enact legislation. The central government generally provides the policy framework and the state governments focus on specific issues. The Electricity Act, 2003 is the overarching federal statute that governs the power sector in the country and introduced the much-needed power reforms mandating all State Electricity Boards to unbundle their operations into separate functional entities. Until the enactment of this act, various acts governed the power sector such as the Indian Electricity Act of 1910, the Electricity (Supply) Act of 1948 and the Electricity Regulatory Commissions Act of 1998.

EXPERT COMMENTARY

The first phase of reforms in the power sector focused on opening it up to private sector investment by amending the Electricity (Supply) Act, 1948. This led to the initial rush of private sector investment in power generation which slowed down by the mid-1990s due to the perceived requirement for a strong and independent regulatory set-up. This led to the formation of regulatory commissions at the state and federal level. Under the Electricity Regulatory Commissions Act 1998, the Federal government constituted an independent electricity regulator at the federal level (Central Electricity Regulatory Commission) to regulate on matters related to centre and inter-state issues.

Taking their cue from this, a number of states created their own state regulatory commissions by either enabling the provisions of the federal act or respective state acts. At the same time, the centre continues to command substantial influence on the power sector across generation, transmission, and financing through agencies/ PSUs like Coal India Limited (fuel linkages), NTPC (generation), Power Grid Corporation of India Limited (Transmission) and Power Finance Corporation/ Rural Electrification Corporation (financing).

> *The distribution of power continues to be in the hands of the state and pricing continues to be the weak link in the chain*

However, the distribution of power continues to be in the hands of the state and pricing continues to be the weak link in the chain. The operating and financial position of each state differs (partly also due to location or resource availability) and, while some states have prospered, other states continue to face challenges arising from inadequate tariff hikes as compared with the cost of supply, rising subsidy dependence and high operational inefficiencies.

Out of the overall financial losses (without accounting for subsidy) of Rs80,000 crore for distribution companies (discoms) in India, about 70 percent are expected to be concentrated in six states: Rajasthan, Tamil Nadu, Uttar Pradesh, Haryana, Punjab and Madhya Pradesh, which together consume 40 percent of power in the country[2]. With increasing concern about the credit quality of discoms, there is an increase in off-take risk and the availability of financing for such losses has been adversely affected, resulting in stretched liquidity situations and limited investor interest.

CONCLUSION

The relative stage of development for each infrastructure sector differs – which itself is an indication of the abundant investment opportunities for the private sector. The relatively mature sectors such as roads, power, telecom etc, which have the backing of a better policy environment and larger shelf of bankable projects, would be the "sectors to scout". However, with the global economic slowdown and other structural problems, these sectors will be astutely watched by investors for investment opportunities. At the same time, emerging sectors in the urban space would require greater policy attention and institutional strengthening to focus on their need for continued development and increased financing.

While democracy slows the process of decision-making in the long run, it proves itself as a far more robust base than that which a totalitarian regime can offer. With rising incomes and increased willingness to pay, an average Indian today expects growth and development and is willing to exercise a vote in its favour – as witnessed by the pro-development elections in the states of Bihar and Gujarat. It is this focus on development which can bring about a structural transformation of the Indian economy while sustaining high rates of economic growth. ■

Suneet Maheshwari is managing director and chief executive of L&T Infrastructure Finance Company, based in Mumbai

1. The National Highways are under the jurisdiction of the centre; however state roads and district roads come under the state domain.

2. Source: "*State Owned Electricity Distribution Companies: Some Positives, though several concerns remain*", ICRA Rating Feature, March 2012. The report is an assessment of key trends in the operating/regulatory environment and the financial position for discoms in eleven key states, which approximately contribute to about 82% of the overall power consumption in the country. These states are Gujarat, Maharashtra, Andhra Pradesh, Karnataka, Punjab, Haryana, Rajasthan, Uttar Pradesh, Madhya Pradesh, Tamil Nadu and West Bengal.