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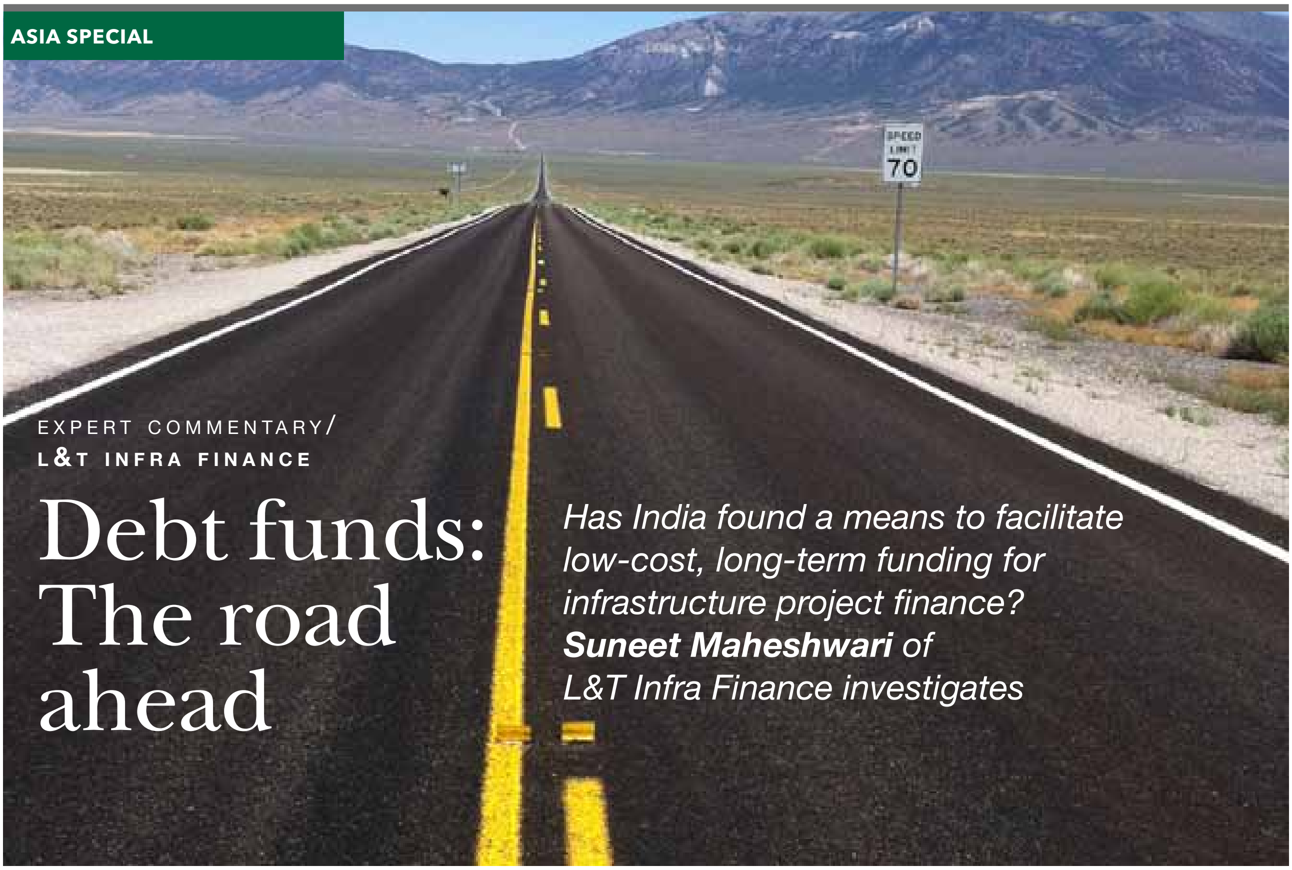

EXPERT COMMENTARY/
L&T INFRA FINANCE

Debt funds: The road ahead

*Has India found a means to facilitate low-cost, long-term funding for infrastructure project finance? **Suneet Maheshwari** of L&T Infra Finance investigates*

There is no doubt that one of the most critical means to jump-start the Indian economy is infrastructure spending. Given the fact that India is deficient in infrastructure, large investment in the sector is the need of the day. The government may not be able to contribute more than 50 to 60 percent of this requirement. Therefore, the need for financing from the private sector, both equity and debt, is a given. In recent times, there have been several private equity players who have already entered the fray.

Infrastructure lending, by its nature, has a long gestation period. In the early stages of the life of an infrastructure project, where completion risk is high, Indian banks have been more active than foreign banks, primarily because Indian banks are better at monitoring and managing completion risks.

The bulk of domestic private sector funding comes from scheduled commercial banks (for 2011 to 2012, 42 percent of total loans were from banks and financial institutions and 26.4 percent from finance companies). In the last ten years, with several infrastructure projects cropping up in the private space, Indian banks have started to develop a substantial exposure to the sector. It is well known that infrastructure loans are longer in tenure, whereas bank liabilities are shorter term, thus posing an asset-liability mismatch.

SLUGGISH ECONOMY

The 12th Five-Year Plan (2012 to 2017) envisages $1 trillion spending for infrastructure; 47 percent ($470 billion) of which is to come from the private sector, either directly or via public-private partnerships (PPPs). However, the current sluggish economic environment may result in lesser spend than this. Whatever ends up being the government component of infrastructure spending, requirement for private sector investment will remain. This will increase the exposure of banks' balance sheets to infrastructure sectors, thereby aggravating the problem of asset-liability management (ALM) and also exposing their balance sheets to a larger than advisable exposure to infrastructure.

Given the constraints on the banking system, it is time to develop other reliable sources of funds at different stages of the project cycle. For instance, a lot of operating projects are coming on-stream where the completion phase has nearly ended or actually ended. In several of our interactions, it has become evident that international investment in infrastructure debt is more likely in operating projects. Further, even domestic investment in fixed income from pension funds, insurance, and high-net-worth individuals is more likely in operating projects.

A lot of initiatives in the area of take-out financing have been tried, but have not been successful, partly due to the double-counting of asset risk in the primary financier and take-out financier's books. »

» CONSISTENT SUPPORT

The infrastructure debt fund (IDF) was therefore conceived to provide additional international and domestic financing in operating infrastructure projects, thereby reducing banks' ALM problem and allowing them to focus more on new projects as they are better at managing completion risks. IDFs are one of the key initiatives that the government has taken up and consistently supported. In the Union Budget 2013-2014, the Finance Minister reiterated the importance of IDFs as a vehicle to tap into long-term low-cost funds for infrastructure.

With a view to giving this idea active support, the government, Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI), have created a framework with fiscal and policy benefits to support the development of IDFs:

- The income of the IDF-NBFCs is exempt from income tax.
- Withholding tax for foreign investors on interest income from bond investments in IDF-NBFCs has been reduced to 5 percent compared with 20 percent for other bond investments. This will significantly improve the post-tax return of foreign investors.
- Regulations allow a lower risk weight for the purpose of capital adequacy (50 percent instead of 100 percent for other NBFCs).

Several players in the Indian market are at different stages of setting up their IDF platforms. An IDF could be set up either as a trust or as a company. A trust-based IDF would be a mutual fund (MF) that would issue rupee units, while a company-based IDF would be a non-banking financial company (NBFC) that would issue rupee and foreign currency bonds.

The investors in an IDF are largely domestic and foreign institutional investors, especially insurance and pension funds that have long-term resources. Banks and financial institutions would only be allowed to invest as sponsors of an IDF.

> ***"IDFs will tap into hitherto untapped sources of savings like insurance and pension funds"***

CREDIT ENHANCEMENT

For an IDF-NBFC that issues bonds, credit enhancement that is inherent in public-private partnership (PPP) projects would be available. This element of a sovereign guarantee makes this route attractive. They can refinance PPP projects after construction is completed and they have successfully operated for at least one year.

Such projects in sectors such as roads, ports, airports, urban infrastructure, etc. would involve a lower level of risk and, as a result, a higher credit rating. In the case of IDF-MFs that issue units, investors will bear a higher risk with the possibility of higher returns and funds from this vehicle can be invested in all infrastructure sectors.

In addition, given that the domestic market generally has an appetite for debt up to 15 years and also has floating interest rates, IDF offers an opportunity to offer fixed rates for longer tenures, which could result in breaking this "glass wall" of 15 years for long-term debt. This could also facilitate longer concession periods, thereby making infrastructure projects more affordable to the common man, thus reducing a common project risk, where consumers may be unwilling to pay higher toll rates, etc.

Also, as discussed before, the project completion risk is done and there is some stability/visibility on cash flows, making IDFs more attractive. For instance, in the case of the roads sector, with construction completed and one year of successful operation, it eliminates completion risks and risks arising from base traffic assumptions. With considerably lesser risk, it would be easier to borrow funds at a cheaper rate.

The IDF is thus clearly a way to increase financing to the infrastructure sector through the bond market, from domestic and foreign investors, such as insurance companies, mutual funds, other institutional investors, and high-net-worth individuals (HNIs).

IDFs will tap into hitherto untapped sources of savings like insurance and pension funds. By refinancing bank loans of operational projects, the IDFs are expected to take over a fairly large volume of the existing bank debt that will, in turn, release an equivalent volume for fresh lending to infrastructure projects. The IDFs will also contribute to developing a secondary market for bonds. Thus, IDFs would help tap alternate sources to bridge the likely debt gap.

IDFs provide renewed hope and may just be what it takes to tap into the much-needed low-cost long-term funds for infrastructure project finance in the country. How effective it will be as a viable alternative remains to be seen. ■

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