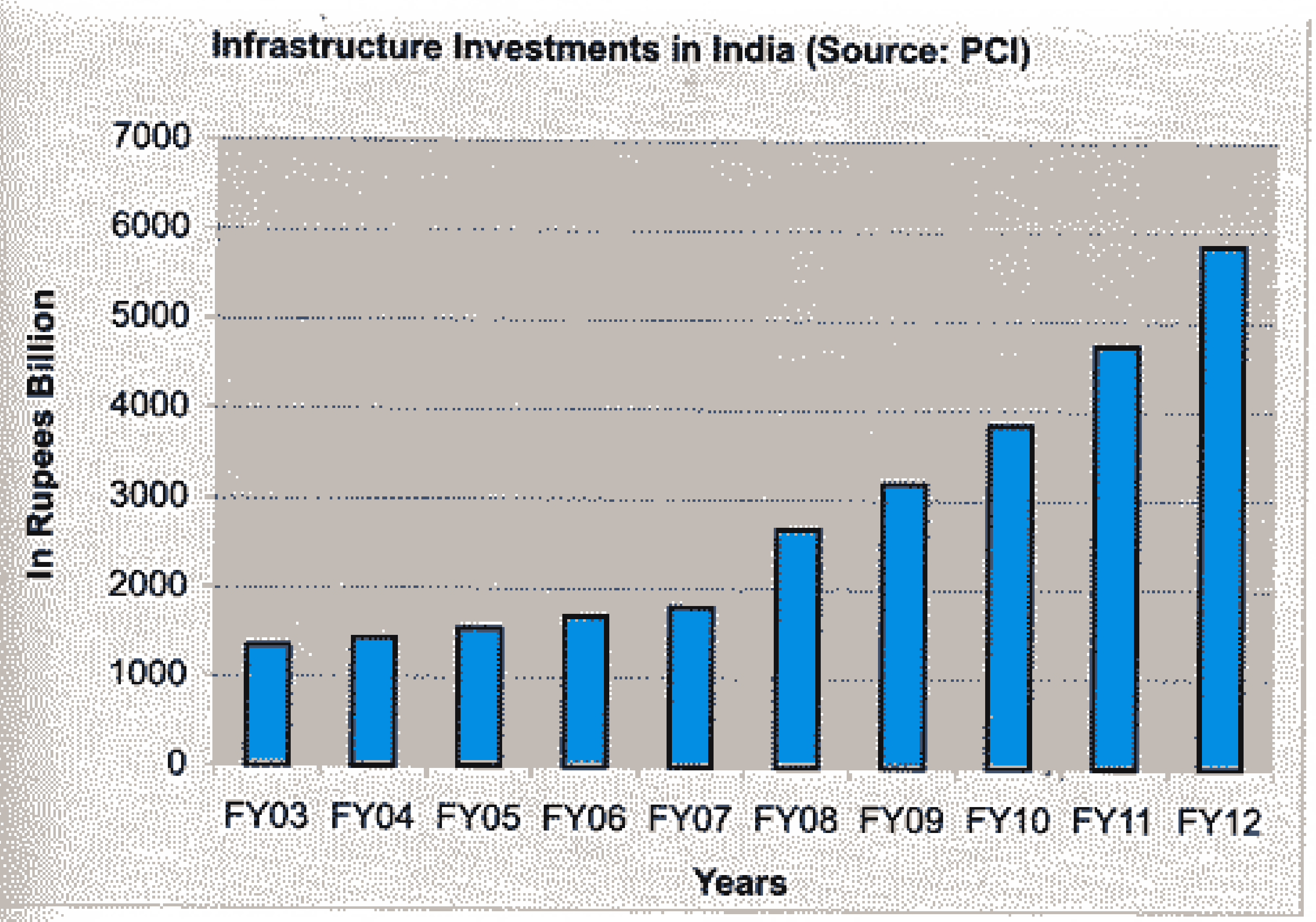
How deep is your pocket?

The private sector in infrastructure has been clamouring for innovative solutions for the existing and impending funding deficit in the industry. SUNIL TANDON explains the routes ahead and recommends we look outward, and look harder.

The 11th Five Year Plan of the Government of India has set extensive targets for the development of the nation's infrastructure. With an estimated investment requirement of over $502 billion in the sector, the Government hopes to increase the Gross Capital Formation in Infrastructure (GFCI) to 9 per cent of the GDP by 2012 (GFC has been hovering at 5 per cent). Nearly 30 per cent of this requirement is earmarked as private sector investment.



With most infrastructure projects requiring long-term funds, the onus of financing them has often been on the government, multilateral credit institutions and PSUs. But faced with severe budgetary constraints, the Government of India has placed significant importance on the availability of foreign and private sector investment in order to achieve any milestones.

FIRE FIGHTING

As the word "recession" still breathes down the economy's neck, most infrastructure companies have braved most of 2009 without the aid of adequate or cheap capital. Backed into a corner, the Government of India has undertaken fire fighting measures such as increasing the ECB limit, allowing its financing SPVs to issue bonds to foreign institutions and lowering interest rates. But these remain stop gap measures.

The government needs to work on a large scale communications programme with the following objectives: dispel myths about the dearth in infrastructure financing, educate the corporates about the benefits of existing schemes such as viability gap funding, tax holidays and incentives on return of capital.

BREAKING THE CEILING: ECB

With a view to increasing alternative funding sources, the government allowed the infrastructure sector to avail of external commercial borrowings (ECB) through the Automatic Route. The annual ceiling for such ECBs has been raised to $500 million per year. The rule that funds not in use should be kept abroad has been lifted as well. The silver lining for the infrastructure sector is that the minimum average maturity period of seven years has been removed for loans of over $100 million. There is an ongoing debate in the industry that while the changes are progressive, it will be the larger companies with higher ratings and proven track records that will really benefit.

Bickering is rife too, in the non financial banking companies(NBFC) sector, as foreign lending agencies are obligated to maintain a 3:1 ratio of their total lending to the infrastructure sector in India to their NBFC lending. This ratio poses a problem for smaller overseas institutions that are unable to lend directly to infrastructure projects, and thus are not able to maintain the required ratio. Such restrictions limit the sourcing options available to NBFCs that wish to expand the list of eligible overseas lenders to include bilateral FIs and banks. Moreover, due to the stringent rules that NBFCs need to follow in terms of ECBs, the availability of funds for smaller players in the infrastructure arena is limited.

In spite of these roadblocks, ECBs could emerge a viable option of financing for infrastructure developers.

ELEVENTH PLAN SECTOR-WISE INVESTMENTS

(INR billion)	Expenditure Xth plan	Investments planned XIth plan (initial estimates)	Investments targets (after 15% cut)	Inflection over Xth plan	PPP opportunity	% Private share
Power	2,919	7,253	6,165	2	1,625	26
Roads	1,449	3,668	3,118	2	1,125	36
Telecom	1,234	3,141	2,670	2	1,777	67
Railways	1,197	3,035	2,580	2	505	20
Irrigation	1,115	2,625	2,231	2		0
Water Supply and Sanitation	648	2,343	1,991	3	54	3
Ports	41	870	739	18	545	74
Airports	68	409	347	5	212	61
Storage	48	263	224	5	112	50
Gas	87	241	205	2	65	32
Total Investment	8,805	23,849	20,271	2	6,020	30

Source: The Planning Commission of India

VIABILITY GAP FUNDING

The Government has created a facility for availing viability gap funding (VGF) for infrastructure projects undertaken via the PPP route. The basic criteria for eligibility are that the PPP project must be an entity with at least 51 per cent private equity, and that the total VGF shall not exceed 20 per cent of the total debt. The agency that implements the project would be selected through a competitive bidding process. The usual form of disbursement is a capital grant availed at the construction stage.

IIFCL: LONG TERM COMMITMENT

In order to meet the long-term financing requirements of infrastructure projects, the government has also started special purpose vehicles (SPVs) that can borrow money against government guarantees, and ease the asset-liability mismatches of the banks, and lower the cost of long-term debt in general.

With this view in mind, the India **Infrastructure Finance Company Ltd (IIFCL)** was set up in 2006. Apart from raising money from the markets against Government bonds, IIFCL also borrows money from international agencies such as the **World Bank** and **Asian Development Bank,** as well as the international debt market. While IIFCL continues to lend money through a scheme called scheme for financing viable infrastructure projects (SIFTI) to both public and private ventures, preference is given to PPP and public sector projects. Loans are capped at 20 per cent of the project costs and usually are in the form of direct loans or refinanced through Financial Institutions. Within a short span of three years, IIFCL has sanctioned upwards of Rupees 18,760 Crores for 107 projects in the infrastructure space. In 2008-'09 alone, IIFCL disbursed close to Rupees 3197 Crores as opposed to Rupees 1541 Crores in the previous year. In fact, IIFC was authorized to raise Rupees 30000 Crores to refinance bank lending of longer maturity, this could result in leveraging bank financing to PPPs of about Rupees 100,000 Crores over the a period of a year and a half. The current budget announced that IIFCL would evolve a 'take out financing' scheme to address asset liability mismatches of commercial banks. IIFCL is also expected to refinance up to 60 per cent of commercial bank loans for PPP projects in critical areas over the year and a half.

SECTOR WISE DETAILS OF PROPOSALS SANCTIONED AS ON 21-OCT-2009

Rs. In crore

Sector	No. of Projects	Project Cost	Loan Sanctioned
Road	63	54,009	8,275
Port	6	4,985	820
Airport	2	14,716	2,150
Power	23	94,246.00	9,629
Urban Infrastructure	1	70	14
Total	95	168,026.00	20,888

Besides above, the Company has sanctioned Rs. 88 Crore in 26 cases under the Pooled Municipal Debt Obligation (PMDO) facility. Source: IIFCL

WHAT IS REQUIRED:

According to **Dr SD Nanda, AVP, IIFCL**, in order to successfully finance an infrastructure project through debt, the sponsors need to be aware of certain criteria that they need to meet, viz, a) the financial strength to meet the cost overruns without recourse to lenders, and b) the ability to arrange the committed equity on time. Issues such as environment concerns and rehabilitation and procurement matters should be addressed. The banks are required to monitor the implementation of the projects according to the milestone as defined in the Concession Agreements, and ensure that asset-liability mismatches are managed through refinancing and internal generations or deposits.

A SLICE OF THE FOREX PIE

Two other significant largely untapped sources of infrastructure funding could be the countries that are sitting on huge trade surpluses and India's burgeoning foreign exchange reserves. In March 2009, the RBI released the first tranche of USD 250 million to IIFC Plc, the UK subsidiary of IIFCL. With this event, the highly debated and controversial issue of whether or not to use the nation's burgeoning foreign exchange reserves to plug gaps in infrastructure financing has been laid to rest. The new fund would be used to part-finance import of capital goods. IIFC Plc plans to lend the money to Indian companies at more affordable rates than those prevailing overseas.

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BANKING ON INSTITUTIONS

Most infrastructure projects are financed through high debt-equity ratios, making the availability of debt crucial to the private sector. According to the **Planning Commission of India,** 84 per cent of the debt requirement can be met through domestic bank credit, NBFCs, pension and insurance companies and ECBs.

While the banks' exposure to infrastructure lending has grown from 6 per cent in March 2005 to 9.25 per cent of bank credit now, in recent times, banks have been slow in disbursing funds. A number of projects have remain unfunded due to asset-liability mismatches, increasing cost of funds, cost overruns, lower than budgeted revenue flows, questionable viability of the projects subjected to high interest rates, and group ceilings that are prescribed by the RBI. Banks have been adhering to stringent norms for meeting the conditions precedent to infrastructure-related disbursement. Another major concern facing the banks last year was the scarcity of private equity investments, and the infrastructure promoters' inability to source private equity played further tightened the banks' purse strings. Depreciation of the Indian rupee has also affected projects dependent on imported equipment. Volatile currency markets have also forced banks to ask for additional Forex cover in infrastructure projects.

CATCHING THE PE WAVE

The immense potential in the Indian infrastructure sector has also caught the fancy of private equity (PE) players, and the number of funds dedicated to the sector is on the rise. According to a recent global report released by **Perqin**, India is raising Rs 6,800 crore dedicated for infrastructure funds. A large proportion of these funds seek to back Greenfield projects.

Transactions in the private equity space were few and far between last year, with PE funds engaging in secondary transactions and QIPs. This was also prompted by promoters' reluctance to dilute equity stakes at low valuations. The PE space is now gaining momentum once again. With project pipelines building up, many PE funds believe that the time is now ripe for investing in Indian infrastructure projects.

UNDERSTANDING RISK

With banks and institutional investors paying due importance to well-structured risk management programmes, it becomes imperative for the infrastructure developers to understand risk from the lenders' perspective. Banks generally view the risk assessment of infrastructure projects differently than they would the risk assessment of corporate borrowers. These risks in infrastructure projects would necessarily include liquidity crunches, interest rate and credit risks, cost and time overruns, delay in project implementation, poor cash flows, higher input costs, asset-liability mismatches. Structured products, detailed risk allocation matrices and hybrid investment plans could be carefully used to mitigate the risks. While strict regulations prove to be a challenge in the sector, PE funds are on the lookout for well-planned bankable projects backed by promoters with a proven track record and stellar managerial capabilities.

PATH FORWARD

The Government of India has already laid the basic foundation for attracting investment into the infrastructure sector; however, it needs to buttress it with sustained efforts towards developing a long-term debt market, relaxation of regulations for financial institutions such as insurance companies with respect to their borrowing and investing norms, and boosting private investor confidence.

To address the need for a deeper debt market, the Government of India needs to ensure that its reforms programme is carried on and strengthened, if we wish to achieve low cost, affordable and longer tenor financing.

Further, the government should concentrate on tackling with existing asset-liability mismatches, primarily in Indian Financial Institutions and banks, and the resultant paucity of long term loans (15 years). While take-out financing could also bridge the gap, it is at too premature a stage and not deep enough to make a positive impact. Further reforms related to the opening up of insurance and pension funds' capital towards achieving long term financing are the paramount needs for infrastructure projects to be adequately and speedily financed. IT

The author, a former IAS officer, has been the Secretary to the Union Minister of State for Finance; advisor to GoI and three state governments; has headed large infra companies; and now heads Ariston Advisors' (www.ariscap.com) investment banking venture.