Financing Infrastructure – Role of Private Equity

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The development of infrastructure has been a key driver of growth since liberalization. Especially in the late 1990s and the early part of this decade important initiatives were taken in all key infrastructure sectors. The Golden Quadrilateral, the new telecom policy, the initiatives to spur investment in the power sector, toll roads and the private ports policy were some examples. Interest rates were low, public expenditure in these sectors was increased and a framework to encourage private sector involvement was created. Private investment in infrastructure has increased from about Rs. 61,500 crores in FY07 to Rs. 216,500 crores in FY11 before declining sharply to Rs. 180,900 in FY12.

This trend will need to reverse if India is to get back on track to achieve over 8% GDP growth. Infrastructure spending does not just create massive jobs at the lowest and mid levels but also creates assets vital to ease the bottlenecks such as lack of power and transportation, clogged roads and ports, inadequate warehousing and cold storage, currently hampering growth.

Eleventh Plan Review

In the eleventh plan, a total investment of Rs. 27 lakh crores (2011/12 prices) was made towards infrastructure development. This investment at 7.22 percent of GDP (average) represents a significant shift from 5.02 percent of GDP (average) invested during tenth plan. This sharp increase in total infrastructure investment was largely due to the rapid rise in investment by the private sector especially in energy and telecommunications, which accounted for ~70% of the private sector investment.

While the government achieved 95% of the projected outlay in the eleventh plan (actual investment of Rs. 19.44 lakh crores against projection of Rs. 20.56 lakh crores – 2006/07 prices), there were significant deficits in the creation of physical infrastructure. In the 11th Five-Year Plan, only 17,571 km of roads was constructed against a target of 48,479 km; 14,572 km of railway lines were added against the targeted 21,500 km; 55,000 MW of power generating capacity was added against a target of 78,700 MW.

Twelfth Plan Targets

The Government realizes the importance of accelerating investments in infrastructure, especially physical infrastructure to boost the country’s slowing economy. Therefore, it has set a massive target for doubling investment in infrastructure from Rs. 27 lakh crores (eleventh plan – 2011/12 prices) to Rs. 51 lakh crores during the twelfth plan period, i.e., 2012–2017. The share of infrastructure investment as a percentage of GDP is planned to be increased to more than 10% by the end of the twelfth plan. While the share of public investment is projected to decrease from 62% to a level of 53%, the share of private investment is projected to increase from 38% in eleventh plan to 47% in the twelfth plan.

On a rough assumption that most projects will be funded on a 70:30 debt:equity ratio, this estimates an equity investment of about Rs. 15 lakh crores over five years of which about half, Rs. 7.5 lakh crores, has to come from the private sector. This will need to come from promoters, portfolio investors, DFIs and private equity investors.

Sources of Equity Funds for Infrastructure Projects

Capital Markets

Buoyant capital markets have allowed promoters to raise equity for unfinished projects at premiums in the past. Reliance Power, JSW Energy, KSK Power and JaiPrakash are some examples. However this avenue has been shut for the last few years partly due to lack of investor appetite and partly due to additional regulatory requirements for such IPOs.

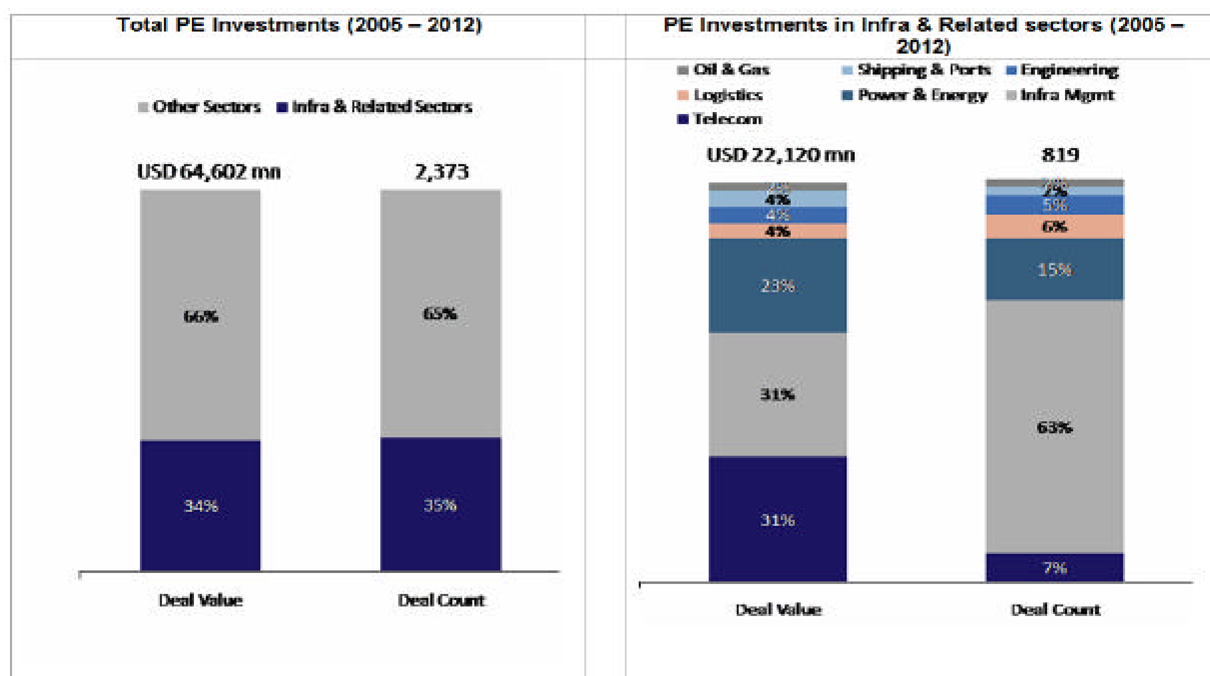
Strategic Investments/FDI

The current regulations allow 100% FDI in most of the infrastructure sectors, allowing easy entry of foreign players into India. Several large global infrastructure players like China Light and Power, SNC Lavalin and Hochtief have already established their operations in India. However, foreign interest in Indian infrastructure has been declining of late due to various bottlenecks faced by Indian infrastructure which have been discussed in sections below.

Private Equity

Private Equity (PE) is bound to play a significant role in funding infrastructure projects and companies, especially given the constraints other sources of financing infrastructure projects face. There are funds with different focuses investing in infrastructure and related sectors in India: (i) India focused infrastructure funds investing in infrastructure assets like IDFC project equity and Actis,; (ii) India focused PE funds investing only in infrastructure and related sectors like UTI Capital, AMP, Kotak, IDFC PE; (iii) Global infrastructure funds like Morgan Stanley and 3i, and (iv) General PE funds investing a portion of their fund in infra companies like Sequoia, Bessemer, Everstone, Ascent.

Nearly one third of the total PE investments between 2005 and 2012 both in value terms and in terms of deal count have gone into infrastructure and related sectors.



Source: Grant Thornton Deal Tracker

A total of USD 22 billion was invested in infrastructure and related sectors between 2005 and 2012. This is a significant pool of capital contributing to infrastructure development but has shown a declining trend as discussed below.

Challenges for PE in Infrastructure

In recent times, the infrastructure sector has been facing certain challenges due to which infrastructure investing has seen a decline over the last few years. As per Grant Thornton reports, investments in Power, Energy and Infrastructure Management have fallen from USD 1.9 bn in calendar year 2010 to USD 686 mn in calendar year 2012. This slowdown has mainly been on account of (i) macroeconomic issues leading to project level challenges; (ii) high valuations, tepid capital markets and lack of exits; and (iii) regulatory challenges.

Project Level Challenges

The key reason for declining PE flow into infrastructure is the project level challenges faced by the developers, apart from macroeconomic issues like high inflation and increasing fiscal deficit which have resulted in high interest rates and have been partly responsible for rupee volatility. This has substantially increased the cost of both domestic and foreign credit for Indian companies. As debt forms a significant portion of project cost, escalation in borrowing cost pulls down the equity returns drastically and in some situations makes the projects unviable.

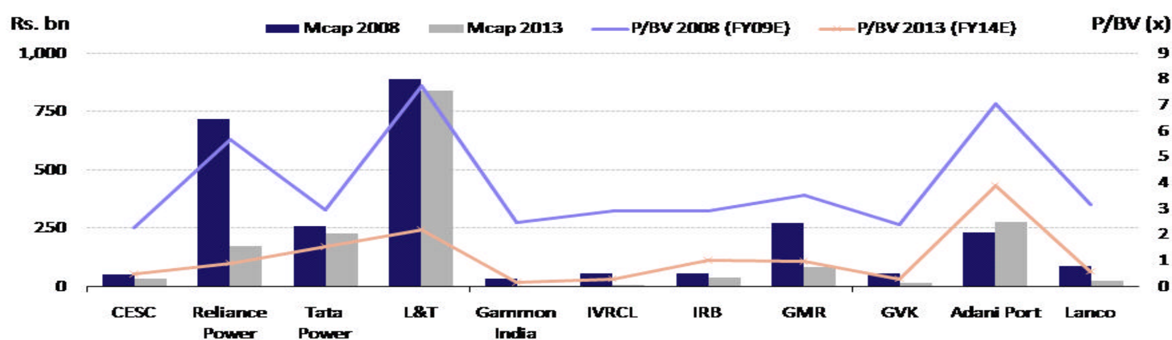
Other major reasons for most of the delayed or stalled projects have been land acquisition by the States and environment clearance from the Ministry of Environment and Forests. Further, each infrastructure sub-sector has its own specific challenges like issues relating to fuel supply agreements like coal linkages and gas allotments, power purchase agreements for thermal power projects; longer than estimated gestation period due

to unanticipated geological surprises and local litigation for hydel power projects; extension of concession period due to lower than estimated traffic for roads and cost and time over runs. In total, there are 341 projects worth Rs 10.5 lakh crore that are held up in red tape across India.

The government has identified 215 projects, each with a project size of Rs. 250 crores or more, worth Rs 7 lakh crore, which have been stalled at various stages of implementation due to reasons like administrative delays and want of environment clearances. Out of these 215 projects, 106 are in power sector, 79 in roads, 20 in iron and steel, and 5 each in cement and port sectors. About Rs 53,000 crore of bank funds are stuck in these projects. Another 126 projects worth Rs 3.5 lakh crore are yet to take off. Delay in project completion increases the overall project cost due to increasing interest during construction which is capitalized. This pulls down the equity returns of these projects and in many cases making them unviable as the capitalized interest escalates. Promoters are often unable to bring in equity to complete the project.

High Valuations, Tepid Capital Markets and Lack of Exits

There have been long delays in exits from investments made due to tepid capital markets and significant fall in valuations. This had made investors wary of having their money stuck in these projects for much longer than anticipated. This is especially difficult for investors who are not infra funds and have shorter fund lives. Valuations have also seen a decline due to various reasons like aggressive bidding for projects leaving little margin for the developer, high leverage and interest cost burden, delay in project commissioning due to execution issues and tight liquidity.



Source: Stock prices as on March 31, 2008 and March 28, 2013; research estimates

It can be observed in the chart above that while the market capitalization has declined on an average by 49%, the price to book multiple has fallen by an average of 75% from 2008 to 2013. This has meant that investors have to mark down investments significantly thereby causing hurt to their limited partners. Infrastructure funds globally are considered to be low risk, stable return investments, which has not been the case in India. Due to this, Indian infrastructure investments are not being looked upon favorably by limited partners, which has resulted in very little money being raised for infrastructure. Potential new funds such as Ashmore PTC and Nomura have abandoned their plans and large fund like 3i have decided to exit India, while Actis has decided to focus only on power sector in India.

Regulatory Challenges

Uncertain regulatory environment: Changes in the regulatory landscape in various infrastructure sectors like telecom, mining, and satellite have created an unstable environment for investment in these sectors. Further, the government has not been able to implement various economic and financial reforms announced by it such as The Land Acquisition, Rehabilitation and Resettlement Bill. There also needs to be clarity on taxation issues like retroactive taxation and provisions related to tax indirect investments.

Restricting exit options: There is a ban on forward trades in securities, which is extended to shareholder agreements with call/put or right of first refusal. These are commercial non-speculative agreements and not permitting such structures takes away some basic protection that PE investors seek from promoters of a company.

Restricting due diligence: A due diligence by a PE player in a listed entity and a subsequent investment may be considered as insider trading. However, due diligence is critical for taking a commercial call on investment. This restriction has made PE investors shy away from such companies

Restrictive investment structures: Subscription to partially convertible or non-convertible instruments by any foreign investor is treated as external commercial borrowings under the Foreign Exchange Management Act 1999, subjecting these instruments to the ECB guidelines, which have end use and cost ceiling restrictions. This makes such instruments unviable for PE funds as they look for atleast high teen returns for their investments.

Resolution of Challenges for PE

Project Level Challenges

In order to boost the investment environment in the country and to support infrastructure development and financing, a number of enabling steps have been taken by the government and policy makers since 2010. Some of the measures taken by the Government include like finalizing Model Concession Agreements for all sectors – road, port, railways and airports, implementation of viability gap funding scheme, approval of a uniform definition of "infrastructure", elimination of the cascading effect of Dividend Distribution Tax, benefiting infrastructure companies that operate out of a SPV model.

The Government has set up Cabinet Committee on Investments (CCI) to review the status of stalled projects and clear the hurdles for project completion. It has already cleared projects worth Rs 74,000 crore mainly in oil and gas exploration sectors and is expected to consider other projects shortly. It has also brought some procedural simplifications in sectors like roads and highways. To further speed up clearances for stalled projects, the government has set up a panel led by an officer in the cabinet secretariat that will examine every stalled project.

While the government has taken various steps to attract investments to the infrastructure sector, the real test would lie in implementation of the announced reforms. The financial targets of the proposed 12th Five Year Plan can to be achieved if timely implementation of reforms is done and certain other steps are taken like a single window clearance approach for approval of infrastructure projects, speeding up environmental and other regulatory clearances, creating favorable taxation policies for infrastructure projects, including for foreign investment, increasing transparency and accountability in the tendering and administration of projects and speedy dispute settlement.

New Sources of Funds and Avenues of Exit

Business Trust: Business trusts are business enterprises structured as trusts which can be listed and operates and runs a business enterprise. However, business trusts are distinctively different from companies in a few ways. First, unlike a company, a business trust is not a separate legal entity as the trustee-manager has legal ownership of the trust assets and manages the assets for the benefit of the beneficiaries of the trust. Second, business trusts are able to pay distributions to their investors from their surplus operating cash flows. Hence, their distribution per unit can be in excess of its earnings per unit, making it attractive to investors seeking stable returns, especially those in countries with low interest rates. Religare Health Trust, comprising of healthcare assets, is an Indian business trust listed in Singapore.

Business Trusts allow investors to have a direct exposure to cashflow-generating assets, such as utilities, shipping or other infrastructure assets. The structure unitizes big ticket assets into liquid and affordable units which are traded on an exchange, giving investors a new alternative to existing yield plays. Of late, several Indian players in renewable energy space have been looking to explore this route to raise funds, mainly on the Singapore exchange.

Listing on Alternate Investment Market, London Stock Exchange: Indian companies have been attracted to AIM for its key features like no minimum admission criteria, no minimum fund raising requirement, unless the company is an investing and no requirement to have an office in the United Kingdom.

The leading industry sectors for Indian AIM listed companies by market capitalization are (1) energy, exploration and production, (2) business support services and (3) infrastructure, real estate holding & development. Some of the Indian infrastructure companies listed at AIM include Greenko Plc, OPG Power Ventures Plc, KSK Power Ventures Plc, etc. AIM provides an avenue to raise funds for development of assets as there is no specific requirement of having operating assets for a company, making it an attractive destination of Indian infrastructure companies.

Regulatory challenges

The AIF Guidelines issued by SEBI have addressed some of the challenges faced by the PE industry like ability to make secondary purchases in listed securities, investment in NBFCs, etc. The regulators should also consider giving some flexibility on deal structuring, in terms exit options, by allowing put/call in PE deals and permitting different investment instruments like convertible instruments to the PE investors. Allowing the PE funds to conduct robust due diligence mitigates their risk and would attract more investment. There is a need for sound, stable and consistent regulation. Any change in regulations governing either the PE funds or the sectors where

the funds invest in, especially retroactive ones, is a cause of concern as funds are raised for 7-10 years and if rules are changed mid-way, it affects investor confidence.

Conclusion

Kuwait Investment Authority (KIA), one of the largest investors in infrastructure globally, recently celebrated 60th year of Kuwait Investment Office in London, where KIA managing director Bader al-Saad said, referring to the UK, that "Any infrastructure investor would rather be in a regulatory environment that is stable, time-tested and transparent." Most of the large infrastructure investors share the same philosophy in selecting their target markets. Infrastructure sector provides stable cashflows which is best suited for long term institutional investors looking for stable returns like sovereign wealth funds, pension funds, insurance companies and endowment funds. Private investment in Indian infrastructure has a limited history which makes it difficult to offer a time tested environment in India. However, by implementing some of the suggestions given above to provide a stable and transparent investment and regulatory landscape, the Government can go a long way in attracting large sums of investible funds to Indian infrastructure.