Growing Preference for Corporate Debt Markets

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As India aspires to be one of the fastest growing major economies in the world, achieving sustainable growth over the medium term is critical. High quality infrastructure development has an unmatched ability to boost economic growth and create employment. A significant portion of the infrastructure investments are expected to be funded through budget allocations; however, the facilitation of a favourable ecosystem which integrates public and private sector funding will be also be required – and that is where the Capital Markets will step in.

Infrastructure: Paving the road for a USD 5 trillion economy

In India, infrastructure financing has witnessed its fair share of challenges, including lack of long-term funding, high funding costs and limited number of lenders willing to fund larger projects. Banks, the predominant source of infrastructure debt have found it challenging to increase proportion of funding as they grapple with asset quality challenges and managing ALM mismatches. CRISIL's recent report estimated that the infrastructure sector would witness Rs.5.5-7.5 trillion of bond issuances over the next five years and expects another Rs.7-10 trillion of bond issuances using innovative instruments.[1] Therefore, cultivating alternative sources of finance is critical to the meaningful achievement of NIP targets.

> **"Debt Capital Markets can play a pivotal role by attracting long-term investors and enable issuers to diversify their funding sources."**

GoI has enhanced its focus in some segments like roads, renewables and power transmission which have seen record levels of project execution. Facilitating agencies in these segments (NHAI, SECI, PGCIL) have been actively working towards developing structural safeguards to make these projects bankable. This segment has also emerged as a preferred investment destination for bond investors looking for low risk, long-term returns. GoI has taken steps for rejuvenating the sector by setting up a statutory DFI -NABFID[2]. Institutions like NIIF and its associate Aseem Infrastructure Limited have a vital role to augment the financing ecosystem to raise private capital through bond markets. This combination of mobilizing government supported and private capital with structured safeguards has the potential to transform the financing landscape and can be done by focusing on two key pillars of *Structural Interventions and Product Innovation*.

Structural interventions needed to incentivize capital market investors

Key structural shifts are needed in the capital markets in order to create an alternate funding avenue for infrastructure projects. These interventions will incentivize investors to use the bond market route to fund infrastructure projects.

Refinancing of operational projects through bond markets will free up bank capital

A structural shift is needed from investors in order to match the project life-cycle risks with the risk appetite of investors. This can be done if under construction projects are financed by banks/project lenders who understand and have the risk appetite for the associated project risks. Post completion, a number of project-related risks fall off and hence attractive for capital market investors seeking relatively stable returns over longer tenures. This risk-based lending approach will allow refinancing of project exposures allowing banks/NBFCs to free up capital for lending to new projects.

Reforms in investment guidelines for Insurance and retirement funds

There is a dire need to encourage Indian insurance and pension companies to invest in infrastructure assets. Total AUM of these institutional investors is estimated to be ~Rs.69 trillion[3]. Investments in corporate bonds by retirement funds like EPFO have seen a steady growth with total bond investments achieving ~10% CAGR[4] in the last 5 years. While IRDAI has allowed insurance companies to invest in debt issued by InvITs, retirement funds are not permitted to do so though they can subscribe to the units of InvITs. This dichotomy in the regulations needs to be eradicated to incentivize these investors to increase their investments in the sector. Additionally, global retirement funds like CPPIB, CPDQ have been active investors in the funds raised by Indian InvITs and enabling regulation will allow a level playing field for these institutional investors.

> **"The long-tenure, stable cash flows of completed infrastructure projects offer attractive returns for investors like insurance & retirement funds seeking low-risk long term assets."**

PF and insurance companies can look at investing directly into infrastructure companies as well as specialized infrastructure finance companies (like NIIF, PFS[5] etc.).

Apart from relaxing investment restrictions, there is a need to institutionalize an investment mechanism as there is aversion to investing in structured issuances (partially guaranteed instruments, securitization of assets) despite being highly-rated. A more nuanced approach of risk-based investing can allow infrastructure projects to gain access to long-term funding to match the asset life.

Product innovation in bond markets can bridge the funding gap

An often repeated concern by investors is the lack of well-structured projects having a balanced risk-reward framework. For bond markets to capitalize on these opportunities, these issuances need to be structured to meet the requirements of risk-averse bond investors who mostly invest in highly-rated credits. Some of the key product innovations that could accelerate bond market activity in infrastructure and need to be supported by the stakeholders are:

- InvITs
- Co-obligor structures/ Covered bonds
- Hybrid Annuity Model
- Sustainability linked bonds

InvITs -an efficient platform for asset monetization

The global success of InvIT as an efficient asset monetization platform for long-term assets has been replicated in India with almost 8 InvITs being floated over the last five years. InvITs have become a preferred vehicle allowing equity investors to hold operating assets and developers to monetize their assets as well as attract debt investors into the highly–rated issuances of the InvIT. The portfolio of assets with infrastructure PSUs in addition to passive infrastructure assets to be completed over the next two fiscals totaling upto ~Rs. 30-35 trillion offer a significant potential for asset monetization. Furthermore, Hybrid Annuity Model (HAM) projects and renewable energy projects have an inherent low-risk cash-flow structure and can be easily monetized by transferring to an InvIT platform. The launch of PGCIL's InvIT and the proposed InvIT by NHAI reflect the renewed confidence of the investors in the platform.

> **"InvITs have the potential to create a vibrant ecosystem for infrastructure development especially for passive infrastructure segments like roads, renewables, and transmission."**

Co-obligor structures and Covered bonds

Investors are wary of concentration risks in infrastructure assets due to the geography or counterparty. Co-obligor structure or securitization of pool of infrastructure assets helps in diversifying these risks to a large extent. A restricted co-obligor structure allows cash flows from completed projects to be ring-fenced from other under-construction projects, thereby providing a robust cash flow profile. Roads and renewables have already witnessed such structured issuances in the capital markets tailor-made to suit the investors' risk appetite. Covered bonds (which have a dual recourse on the issuer as well as the identified pool of high quality loans) issued by NBFCs have seen good traction with investors and the same structure can be replicated using infrastructure loans. The above structures have the potential to attract investors with their structural safeguards and diversified revenue profile.

Hybrid Annuity Model provides structural safeguards for bond investors

Hybrid Annuity Model (HAM), launched in 2016, continues to be the favoured route for implementing projects for developers and lenders. These projects have a pass-through structure for expenses while having a stable annuity flow. Operational HAM projects have a low-risk, long-term cash flow, and ideal for refinancing through bondmarkets especially for investors like insurance and retirement funds. Additionally, HAM projects are well-designed for being transferred to InvITs allowing investors with safeguards of HAM with the benefits of InvIT.

> **"Increasing integration of ESG processes in infrastructure will unlock a large pool of long-term global capital into the sector."**

Sustainability linked bonds

As climate change becomes a key talking point for stakeholders around the world, the need for sustainable infrastructure has become more pronounced. A growing proportion of global capital is being invested in ESG-compliant assets. While global markets have already recognized the need of dedicated, low-cost funds for infrastructure, India is catching up as well with ~ USD 8 billion[6] of green bond issuance in the last 3 years. SEBI's efforts towards increasing non-financial disclosures and extending the applicability of BRSR[7] will enhance global investor confidence in Indian bond markets.

Conclusion

India is poised to transition into a period of high economic growth as business activity picks up. India's infrastructure sector is a key driver for economic prosperity, playing a critical role in bolstering overall development of the nation.While government has enhanced its focus on implementation and facilitation of finance, bond markets have a vital role to play in mobilizing funding for the sector. Refinancing operational projects allows freeing up of capital lent by banks and innovative structures like InvITs, HAM, sustainability-linked and covered bonds can significantly enhance volumes of debt mobilized from the capital markets. Additionally, enabling regulations can unlock a large untapped pool of capital with insurance companies and retirement funds. It is an opportune time for boosting the infrastructure development in the country through a vibrant capital market if we want to achieve the dream of making India a USD 5 trillion economy.

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1 Source: CRISIL Yearbook on the Indian Debt Market-2021
2 National Bank for Financial Infrastructure and Development
3 Source: IRDAI, TRUST estimates
4 Source: CRISIL
5 PTC India Financial Services
6 Source: Climate Bonds Initiative
7 Business Responsibility and Sustainability Reporting