# Infrastructure Financing Through Capital Markets


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**Infrastructure development in India**

The development of infrastructure services in a country is imperative for its economic growth as well as strengthening its social fabric. In order to sustain the targeted growth rate, it is estimated that India has to pull its infrastructure investments to around 8-9% of GDP, as against the current level which is at around 4-5%.

The Indian infrastructure development requires a huge capital injection and it is currently drawing maximum attention of investors worldwide. The 11th five year plan of the Government of India has envisaged an investment to the tune of USD 500 billion in the country's infrastructure development program. Considering the projected requirement in infrastructure in India, it is estimated that the shortfall in financing these projects by government funds would be in the range of USD 150-190 billion. Of the various options available with the government for infrastructure financing, such as the public financing, transferring assets to the private sector space, or a hybrid approach – Public-private partnerships (PPP), it is expected that the shortfall is to be met through the Public-Private Partnership (PPP) model. This presents a huge opportunity for investors both domestic and foreign as the government is doing away with most of the barriers and encouraging private investment. There is a growing consensus among policy makers that public-private partnership model is key to development of infrastructure in the country.

| | | | | In USD billion |
|---|---|---|---|---|
| **Projections of Investments** | | | | |
| | **Private** | **PSU** | **Govt.** | **Total** |
| Equity | 33 | 56 | 142 | 231 |
| Debt | 70 | 88 | 39 | 197 |
| | | | **Total (a)** | **428** |
| **Estimated availability of Funds** | | | | |
| Government of India | | | | 191 |
| Equity from Private Sector | | | | 22 |
| Debt from Banks & FIs | | | | 70 |
| | | | **Total (b)** | **283** |
| **Expected Shortfall** | | | **(a-b)** | **145** |

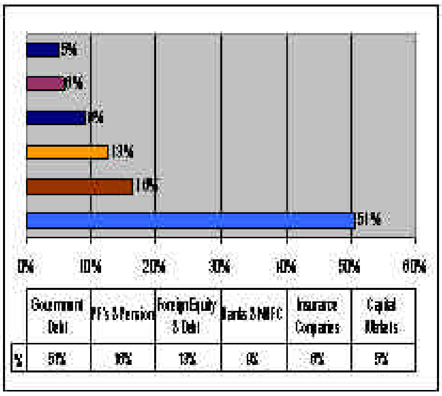



*Exhibit-1: Investment projections in infrastructure projects 11th five year plan and Projected sources of funds (Source – McKinsey & Company Analysis)*

Globally, investors see PPP model as an exciting business opportunity and have welcomed Indian government's commitment towards this method for national asset creation. The successful implementation of number of such projects has made the corresponding risks clearer. On the other hand, with the current difficult global macroeconomic background, funding growth through public spending programs would be seriously constrained with the rise in fiscal deficit of the Government. India can take advantage of the heightened interest of investors in the infrastructure projects.

In India, the structural barriers in the financial system and the recent global liquidity crisis are affecting capital flows to the infrastructure projects. The exposure limits for lending, asset-liabilities mismatch, high pre-emption of funds from the banking system, investment restrictions on insurance pension or provident funds, the shallowness of bond market and constrained supply of External Commercial Borrowings (ECB) are the impediments faced for funding infrastructure projects. All these factors have resulted in a shortfall in debt as well as equity capital available for infrastructure projects.

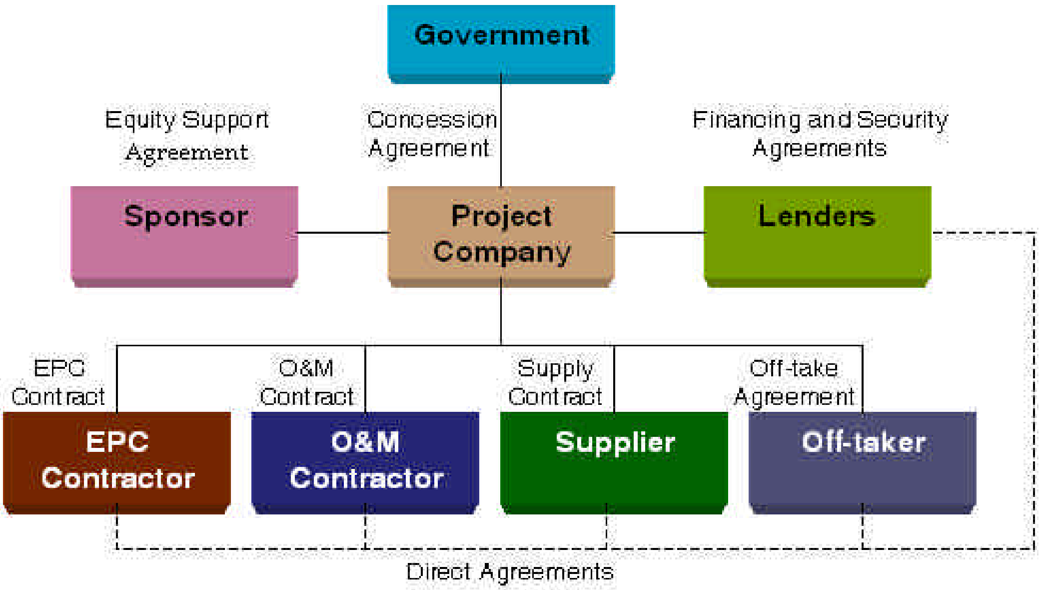
Financial intermediaries play an instrumental role in providing solutions for financing infrastructure projects. Globally, sophisticated products such as securitization, carbon credit financing, wrapped bonds, revenue bonds, partial credit guarantees, quasi-equity, income participating loans, international swaps for providing long term loans in local currency and ECBs have enhanced the bankability of such projects. Regulatory challenges have limited the usage of similar financial products in India to a certain extent.

**Financing Infrastructure Projects**

Infrastructure projects are complex, capital intensive and carry several risks. The key issues which make financing of infrastructure projects complex are as under.

- Combination of high capital costs and low operating costs means that the initial financing costs are a large proportion of the total costs.
- Huge upfront costs, longer gestation period and reliance on future cash flows to meet financial obligations and provide reasonable returns.
- The returns to the investors are spread over a long-term of 10-15 years.
- The project involves a number of interrelated contractual agreements between multiple parties like the lenders, sponsors, contractors, suppliers, etc.
- The pressure on pricing to protect public interest and the uncertainties associated with execution of projects in developing countries hamper the ratings of these projects.
- Other risks involved such as breach of contract, changing political landscape and increased expenses due to delays in execution.

A typical debt equity deal structure for an infrastructure project is as under:




*Exibit-2: Deal structure of traditional debt-equity financed project (Source - SBI Capital Markets Limited)*

The hurdles encountered in tying up the debt for the infrastructure projects are as under.

- Exposure limits set by the banks put a ceiling on the lending capacity to infrastructure projects which have a high debt requirement.
- Banks are needed to allocate 40% of the lending to priority sectors such as agriculture and small scale industries. The regulatory requirement for banks to place funds with RBI close to 29% of its liabilities further reduces the funds available for lending.
- The current regulations restrict the banks from raising long-term bonds of ECBs. Presently, only around a third of the banks deposits come from long term resources. Thus, banks have restricted the long term loans between 10 to 15 percent of the total deposits.
- The endowment funds are restricted from investing in privately held or unlisted companies, sub-investment grade bonds or a company which do not have dividend payment track record.
- Shallow bond markets have resulted in competition between the project companies for availing debt finance from banks. Thus the cost of debt is on a higher side as compared to global benchmarks.

- Traditionally, interest rate caps set by RBI on ECBs put a constraint in utilization of foreign currency loans. However, RBI has recently liberalized its ECB policy on account of the economic scenario and dispensed with the interest cap till 31st December 2009. The quantum cap on ECB has also been raised from $100 million to $500 million.

Arranging the equity finance is a challenging aspect of infrastructure financing as the level of operational, financial and market risk for equity investors is the high. Funding from the private equity players has also suffered due to the global liquidity crunch. Mezzanine financing, employed to bridge the gap in equity tie-up of the project and reduce the cost of capital, is limited in India as the pool of infrastructure funds is not sufficiently large to participate in this type of financing structure.

**Role of Capital Markets**

The high cost of term loan financing in traditional debt-equity financed projects, particularly in developing countries where the risk premiums add to the cost of capital and in most cases render it economically non-feasible. The Government can look at an option to make increased use of these markets to fund such projects. The institutional investors may also look for new ways to balance their portfolios and at this juncture the capital markets issues can become an interesting option.

Presently, the infrastructure developing companies are relying more on loan finance for their projects. However, the cost advantage that will be offered by the capital markets issues to infrastructure projects in turn will enhance the project fundamentals, and can pave the way for future streams of lower-cost financing.

The banks might not see a competitive threat for their project lending from capital markets at this point of time as the quantum of lending will be huge as compared to the issuance in capital markets. However, the potential for attractive terms and lower cost of project capital provided by capital markets issues for developing countries, when covered by risk mitigating instruments, could develop this competition in future. Most of such products would tread into the category of structured finance, bond issuances and in the mezzanine funding space. Currently, India’s domestic appetite for bonds is restricted to Government and PSU bonds. The key obstacles for the growth of this market are the time-consuming disclosure requirements for bond offerings and the restriction on investments by banks and insurance companies in unrated bonds. However, in the recent case of an IIFCL tax-free bond issuance structure, many institutional investors have participated indirectly into the infrastructure financing space. IIFCL will be utilizing the funds mobilized through such a structure to invest into infrastructure projects. Thus, in India, this structure does indicate the extent of governmental support essential for the success of such fund raising programs.

**The Challenges Ahead**

Specific challenges that India faces in terms of structuring and financing its infrastructure projects include the effective implementation and success of the PPP model, capital raising with effective risk pricing built in, exploring the various avenues of financing, development of the financial/capital market ecosystem favoring fund raising for infrastructure projects.

A) Public-private partnerships

PPPs have seen their fair bit of success across the globe and India too has implemented this strategy and is committed to PPPs for infrastructure development. However, it continues to face new challenges with the number of projects under PPP growing steadily, such as

- The need to combine the profit motive of private players and the public service motive of public sector;
- The distribution of risk that is sustainable and fair to all the stakeholders;
- Public-Private Partnerships to the extent of 20-30 years in a dynamic environment;
- Develop capacities in financial institutions so that they are able to participate in long tenor projects;

The Government measures to like stable policy and legal frameworks, efficient dispute resolution procedures, liberal financial systems and effective coordination across political and administrative machineries (across various levels – central, state and local) shall be essential in establishing the success of this model.

B) Risk pricing and foreign investments

Typically, infrastructure sector is associated with higher risks as compared to alternative avenues of investment having shorter gestation period. For emerging markets, country risk also gets added on from a foreign investment perspective. In this context, effectively pricing the risk for investing into such projects is a critical challenge for the foreign investors as well as lenders.

Keeping in perspective the long gestation periods of such infrastructure projects, providing risk capital should be encouraged by liberalization of regulatory norms to assure liquidity for long tenor capital and also provide immunity for the domestic loan markets. Opening avenues for refinancing existing loans (rupee denominated) with foreign currency loans might be helpful to the industry.

C) Development of financial markets

Indian corporate bond markets do not enjoy the depth of distribution and capital raising efficiency as the developed nations' markets have. In the recent past, many steps have been taken towards deepening of the bond markets. SEBI has streamlined the regulations and disclosure norms for bonds and debentures, and the Government has allowed higher limits for FII inflows into the bond markets, but still a lot is expected. Increasing the efficiency of the private placement market would be high on the priority of the policy makers. Enabling qualified institutional investors to participate in these transactions would require changes in regulations, disclosure norms, structured options (credit wraps/ monoline insurance), and operational processes (such as TDS exemption, stamp duty regulations etc). Introducing credit derivatives and enabling provisions for the banks (credit versus treasury) and insurance companies (long-term liabilities) to directly participate into infrastructure bonds would also help the case of infrastructure financing in the bond markets. Also, to bring in the retail participation into these markets either through mutual fund schemes or direct participation would be the key consideration and an ultimate challenge.

**Conclusion**

In order to sustain the India growth story and improve upon the GDP growth rate, India would need significant amount of infrastructure investments and thus highlighting the challenges faced from the perspective of the availability of financial resources. With many steps initiated recently, the indications for positive and wide spanning reforms are visible. Facilitating equity flows into infrastructure, through domestic or foreign capital providers would be the most critical. PPP projects transmit the capital raising plans to the promoters and they can access the primary as well as secondary market instruments for their capital augmentation plans. The domestic bond markets need a strong fillip and would be crucial to the overall development of infrastructure financing. Regulatory overhauls would be necessary for ironing out various aspects such as dividend distribution tax, exit options, and refinancing of projects amongst other things.

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The paper aims at discussing the various aspects of infrastructure financing, the capital markets route, challenges being faced and author's views on improvising the current situation.