Infrastructure Debt Funds in Incipient Stages

Inherent Features Create Conundrum between Investors and Existing Lenders

Special Report

Scope

Infrastructure debt funds (IDFs) will moderate banks' over-exposure to the infrastructure sector (33.29% of overall funding at FYE14) and reduce their burden to pave way for newer investments, believes India Ratings & Research (Ind-Ra). IDFs are investment vehicles to channelise long-term and low-cost funds into infrastructure assets. The government considers IDF to be a panacea for the ailing sector and its introduction as an inflection point.

IDFs can be set up both as mutual funds (MFs) and non-banking financial companies (NBFCs). Although IDFs are gradually gaining momentum in refinancing the existing loans, certain elements restrain the smooth takeover of such loans. Existing lenders prefer IDF MF while investors prefer to invest in IDF NBFC. Nevertheless, certain structural adjustments, improved investor's risk appetite and the availability of active secondary market could nurture IDF activity.

Why do Existing Lenders Prefer IDF MF?

Interest to Retain Operational Projects: Substituting the existing compressed amortisation loan with a longer-term IDF loan (15 to 20 years) could aid projects (majorly those under construction and delayed) facing debt servicing pressures. Existing lenders may prefer to retain operational projects (generate cash flow to meet debt service) rather than those under construction. Since IDF NBFC can take over only operational projects, existing lenders prefer IDF MF which can take over any project. Whereas, project companies favour IDF NBFC for their generally low lending rates.

Inclination to Hold Senior Termination Rights: On entry, IDF NBFC demands super seniority rights on the termination payments. Lenders may not be willing to relinquish the seniority rights on termination payments after having endured the construction risks and delay risks. These risks are generally high in a project life cycle. The existing lenders might be willing to give up on their super seniority rights in circumstances wherein IDF NBFC's benefits outstrip abnegation.

Why do Investors Prefer IDF NBFC?

Low-risk Investments: IDF NBFC regulation stipulates fund capitalisation. Consequently, a few projects' debt service default may not significantly impair investment returns. Investments were restricted to operational projects, resulting in a low portfolio risk. Whereas, IDF MF investments in under construction/diverse projects heighten the default risk and any risk is pass through. Thus, Ind-Ra believes domestic and foreign pension funds would embrace IDF NBFC for the low-risk.

Termination Payments Protects Default Risk: Given IDF NBFC's exposure ceilings (85% of the project debt) on investments, any concessionaire default would be fully protected by the termination payments.

What Could Accelerate IDF Activity?

Active Secondary Market

The Indian infrastructure space is in dire need of long-term funds at an affordable cost in conjunction with an effective secondary bond market. Although IDF aims to build a primary market, the long-term prospects of IDF are bleak in the absence of a secondary market.

Related Research

Rating Mutual Fund Schemes of Infrastructure Debt Funds (13 May 2013)

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Existing Lenders Would Prefer IDF MF Over IDF NBFC

Willingness to Preserve Cash Flow Generating Projects

Projects facing completion delays could benefit from the relatively longer-tenor loans from IDFs. This is because the existing bank loans already have a compressed amortisation schedule and the protracted delays in completion could further pressurise debt servicing or call for sponsors to inject additional equity.

Existing lenders might want to release relatively risker projects from their portfolios, especially those under construction, to IDF rather than replacing operational projects that generate cash flow adequate to service debt. Also, lenders require operational revenue to bolster their financial strength. Since IDF NBFC can invest only in operational projects (minimum one year of operations), we believe existing lenders would strongly prefer IDF MF to diversify their risk profile.

On the other hand, sponsors and project companies would crowd in to secure funds from IDF NBFC for refinancing their project loans (public-private partnership (PPP)) due to the supposed interest rate advantage that the NBFC would offer. The limited universe of investments for IDF NBFCs is reinforced by the regulatory exception for investing in the non-PPP projects and construction stage projects. Also, given IDF NBFC's non-risky investment profile, fundamentally weak projects, which otherwise qualify for investments would not be preferred. This also gives way to some naturally mutually exclusive merits for IDF MF in the choice of investments.

Termination Payments Priority Rights Pivotal

Given the exclusive lifecycle risks associated with infrastructure assets, the existing lenders' rights on the security features of project assets are crucial and IDF NBFC's demand for super seniority over the termination payments may act as a deterrent for investments by IDF NBFCs. Having borne the higher risks during the under-construction stages, the existing lenders may not forego the right to termination payments unless the benefits of the abnegation substantially overweigh the associated risks.

The agency views the introduction of IDF's investment in projects as a positive, considering the debt is long term in nature and the amortisation profile is adequately comfortable to accommodate the project cash flow, thereby increasing the debt-viability of the project.

Buyout Guarantee Clause could Elongate Refinancing Process

IDF NBFC stipulates compulsory buyout from the project authority to reduce the default risk.

The imposition of super seniority (on the termination payments) vitiates the existing senior lenders' footing, who are impelled to partake risks higher than those contemplated originally. Therefore, the existing senior lenders substitute the risk of IDF NBFC and hence, can add a risk premium to the interest rate. The ultimate benefit of IDF NBFC's intervention into the project will be weighed including this additional premium, if any charged by the existing consortium. Ind-Ra believes this 'risk-substitution' process could dis-incentivise the existing senior lenders from including IDF NBFCs into the consortium. The absence of such provisions in IDF MF is conducive for the existing lenders to allow the MF structure into the consortium.

Investors Prefer IDF NBFC

Low Risk

Since IDF NBFC are generally well-capitalised, default on one or an insignificant few of its investments may not materially alter the return on investments, due to the portfolio effect. Also, the portfolio has low risk due to investments in operational and cash flow generating projects. IDF NBFC is adequately capitalised; the presence of compulsory reserves acts as a natural liquidity reserve. Therefore, the investors are sufficiently protected. At the same time, equity, as a first loss piece protects the debt investors' interests by preventing equity distributions. Although the portfolio effect could benefit IDF MF investments, the potentially inherent risky characteristics of its investments would carry a higher default rate than IDF NBFC.

Investors Fully Covered by Termination Payments

Given the exposure ceilings on investments by IDF NBFCs, it is likely that their exposure would be fully covered by the termination payments, even under a concessionaire event of default. Therefore, investors are completely covered by termination payments. However, this may not automatically translate to a higher rating, since a premature termination is generally triggered under a default event.

Tax Incentives

Domestic and foreign pension funds and insurers aim to invest in long-term securities (15 to 25 years) that yields lucrative returns with a low tax burden. We expect the government's initiative to reduce the withholding tax to 5% from 20% to kindle investors' interest in IDF bonds.

Missing Essential Components

'Transfer-of-Risks' Function Essential

Unless the functions of availability of longer-term funds at lower costs and the effective transfer of risks take place simultaneously, the mission of IDFs would not be met. While other risks relating to default (in case of non-termination) are common between IDF NBFC and other senior lenders, the termination risks are not. In case of IDF NBFC, the effective transfer of risks is inhibited by creating super seniority in favour of IDF NBFC. Also, an active secondary bond is necessary to perform the 'transfer-of-risks' function effectively. While the regulations give fillip to the creation of an effective primary market for bonds by regulating direct lending by IDFs, the absence of a secondary market may act as an impediment in the longer term.

Investor Appetite for Various Risk Buckets Necessary

Based on the current market trends, the agency's experience shows that the bond investors' (for infrastructure assets) preference is vastly skewed towards highly rated instruments ('AA' and above on the national scale). In Ind-Ra's view, the mission of forming IDFs will be achieved only if an appetite is created for various risk categories across the sector. This is necessary to create a secondary-debt market for infrastructure assets.

Indian Infrastructure Financing Landscape

The 12th Five Year Plan estimated an investment of USD1trn in the infrastructure with a substantial portion (47%) to be funded by the private sector. The absence of a longer maturity (20 to 25 years) debt market exposed the incompatible banking system to infrastructure financing risks; the banks had neither the specialisation required to finance infrastructure nor the long-term sources of funds. Institutions with interest in longer maturities - pension funds and life insurance corporations - have not yet taken an active part in funding infrastructure.

Banks' increasing exposure (CAGR over FY07-FY14: 26.46%) to the long-gestation infrastructure assets created a serious mismatch in its asset-liability maturity profile. While globally pension funds and insurance companies are active players in financing infrastructure, they have nearly remained dormant in India.

The increasing burden of non-performing infrastructure assets in the banking system, the sluggish equity markets including private equity and the absence of an effective bond market have forced the government to seek an alternative vehicle for infrastructure financing, leading to the genesis of IDFs. The experiences of developed economies indicate that pension funds and insurance monies have helped build infrastructure debt market. The Reserve Bank of India's (RBI) recent measure to permit banks to raise long-term resources for infrastructure financing is also aimed at addressing these issues.

IDF Ideal Source for Refinance

Infrastructure Development Role

Should IDF provide a fixed interest rate below bank interest rate for a longer tenor, it would propel the infrastructure development, given its incipient stage. IDF's refinancing option increases the viability of the project which otherwise does not exists. Such long-term financing equips the project to combat cyclical slowdowns effectively. Simultaneously, it offers fixed rates for a longer duration given the floating rates from banks.

Avenue for Bond Market Development

Banks' lending needs are higher than their funding abilities. Allowing IDFs to issue bonds is likely to bring in changes in the amortisation schedules against the traditional structures. Also, this is possible only if an effective investor appetite is created for various risk categories of assets.

Fresh Lending Headroom for Banks

Many PPP projects are derailed due to multitude of reasons including the requirement of funds at fixed interest rates. Additionally, banks' limited headroom to absorb volatility and shocks of these assets, including credit quality deterioration, inhibited further asset creation in the sector. Therefore, IDFs can refinance the existing debt of the banks to create space for fresh investment in the upcoming infrastructure projects.

Merits and Demerits in IDF NBFC and IDF MF

Flexibility in MF Method's Allowable Investments

Only PPP projects' debt with minimum one year of commercial operation qualifies for IDF NBFC takeover whereas IDF MF can take over any infrastructure projects. IDF NBFC must enter into a tripartite agreement with the project authority and concessionaire. The agreement must stipulate compulsory buyout in the event of default by the concessionaire. Whereas, IDF MF must invest a minimum 90% of scheme assets in debt securities of infrastructure companies or special purpose vehicles (SPVs) and thereby offers investment flexibility.

Exposure Limitation

IDF MF will restrict its investments to 30% of the net assets in any single infrastructure company or an SPV (rated below investment grade or unrated) which may be extended to 50% of the net assets with an approval from the trustees. Whereas, IDF NBFC limits its investments to 85% of the debt assessed by the project authority provided it is not over 60% of its total capital funds.

High Credit Risk in MF Mode

Based on the model of 'high risk high reward', both the inherent risks of the project and its related rewards will be passed on to the investor in IDF MF. However, risk averse investors (domestic and foreign) would be inclined to bank on the IDF NBFC mode as the IDF would bear the risk on the project. In IDF NBFC, the first loss piece would be the equity. Additionally, investors would be eager to invest in projects generating cash flow although banks may be unwilling to share them.

Equity Enables Gearing in NBFC

IDF NBFC has to maintain minimum capital adequacy norms (capital to risk weighted assets of 15%) and is allowed to issue debt instrument, thereby opening vista for gearing. That said, IDF MF issues units obliterating the concept of gearing.

Equity Participation in NBFC

The sponsors of IDF NBFC can hold a maximum of 49% and a minimum of 30% in equity of IDF NBFC; the balance could extend an opportunity for domestic or foreign investors. Additionally, investors can buy the debt instrument issued by IDF NBFC or the units of IDF MF. Overall, foreign and domestic investors can participate in two forms – sponsor or investor – in IDF NBFCs and in one form in IDF MFs. Lower withholding tax on the interest for non-resident investors under IDF NBFCs gives an edge over other highly rated debt instrument. Withholding tax in IDF NBFC is reduced to 5% in comparison to others at 20%.

Illustrative IDF Qualifying Project Matrix

Figure 1

Salient Features of IDF Takeover Project

	Project		Stage				
IDF Route	**Non-PPP Model**	**PPP Model**	**Construction**	**Operation**	**Credit Rating**	**Debt Exposure**	**Remarks**
Mutual Fund	✓	✓	✓	✓	Investment grade	No stipulation. However, not over 30% of the net assets in any project.	Although generally under-construction projects may not fit into an investment grade, few projects with a strong credit profile could yield an investment grade rating. Nevertheless, until now IDFs majorly invested only in operating projects. Additionally, bankable power projects and other infrastructure projects could be the potential choice for refinance under MF mode. The RBI's data indicates banks' exposure to the power sector is maximum (19.36%), followed by roads (6.24%) in the infrastructure sector at end March 2014. According to the National Highways Authority of India (NHAI), of all the 239 PPP projects awarded until May 2014, nearly 27% are under construction.
NBFC	✗	✓	✗	✓	Preferably investment grade	Maximum 85% of debt approved by the project authority.	Low-risk PPP projects would be the choice of investment with investment grade and above. Generally, a power project does not qualify under the PPP mode. The regulation does not stipulate investment grade rating for investment. However, operating projects with reasonably sound metrics will be generally in investment grade.

Source: Ind-Ra

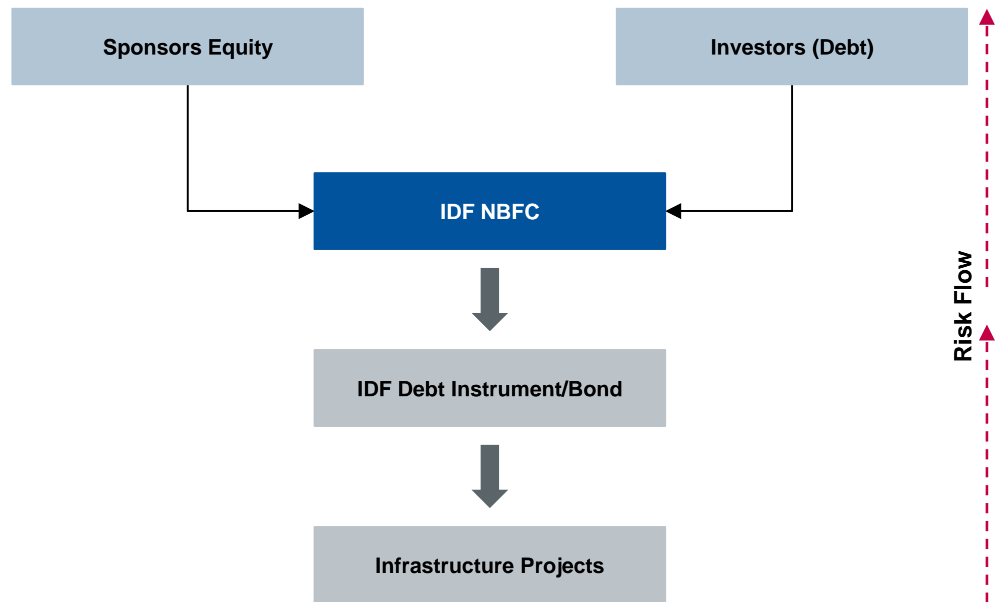
Structure of IDF

IDF NBFC

All NBFC infrastructure finance companies (IFC) and banks are permitted to start IDF NBFC after an approval from the RBI. IDF can raise funds through rupee or dollar denominated bonds with a minimum five-year tenor. IDF will bear all the credit risks related to the underlying projects and if there is insufficient cash flow, debt service would be met before equity or subordinate debt.

- The sponsor would inject a maximum of 49% or a minimum 30% of the equity of IDF NBFC
- Post investment in IDF NBFC, the sponsor NBFC must maintain minimum capital to risk weighted assets and net owned funds prescribed for IFCs

Figure 2
Sample IDF NBFC Structure

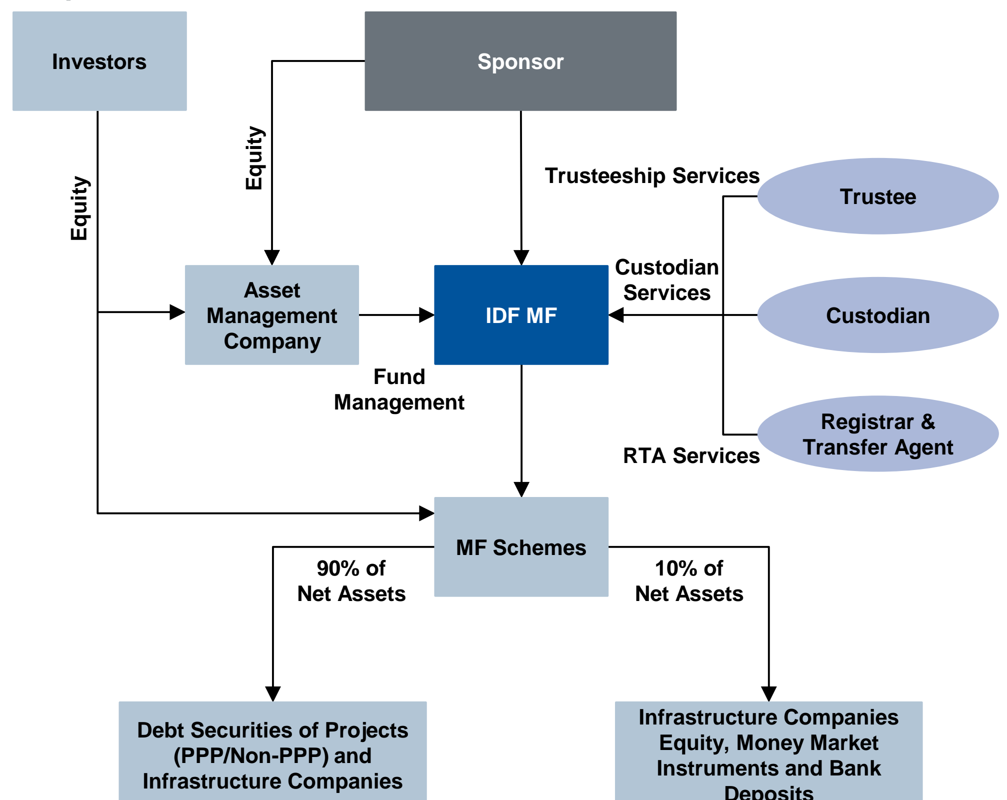


Source: Ind-Ra

IDF MF

An NBFC, IFC or bank can sponsor IDF MF with the RBI's approval, subject to SEBI regulations. IDF MF will raise funds in rupee denominated units with a minimum five years of maturity. IDF MF will pass on all the credit risks and the return on assets less management fee.

Figure 3
Sample IDF MF Structure



Source: Ind-Ra

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