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Indian InvIT IPOs build foundations for an asset class

By Jackie Horne | 14 February 2017

Falling interest rates should be good news for India's prospective new asset class — infrastructure investment trusts — as long as issuers price the first few deals to perform.

A first wave of Indian infrastructure developers have begun spinning off their completed projects into initial public offerings, freeing up much needed capital for the country's infrastructure drive.

Rating agency ICRA recently estimated that infrastructure investment trusts, known as InvIT's, could raise about $3 billion from the IPO market over the coming year-and-a-half. However, this estimate may prove to be an undershoot given the first four deals alone hope to raise just shy of $2 billion between them.

All four are at various stages of marketing their offerings, with IRB Infrastructure InvIT likely to launch first since it filed its red herring last September and has already completed pre-deal investor education.

It is currently waiting for Securities and Exchange Board of India (SEBI) comments. The company has said it is confident of completing the IPO before its financial year-end in March.

With an estimated IPO size around the $815 million mark, IRB Infrastructure InvIT is also shaping up to be the largest flotation of the four. According to local experts, it will encompass an Rp43 billion ($644 million) new share issue and an Rp11.4 billion ($170 million) offer-for-sale of existing shares.

Shortly behind are: India Grid Trust (IndiGrid), which has filed for a Rp26.5 billion ($397 million) primary share offering and is midway through pre-deal investor education, plus Reliance Infrastructure InvIT, which began pre-marketing a $400 million to $450 million offering last week. Subject to SEBI approval, both deals may come in late March or April.

The final issuer of the quartet, ILF&S, has opted to go down the private placement route according to local bankers so will not need to file a red herring. It is talking to investors about raising Rp18 billion ($270 million).

Boosting infrastructure spending

Monetising their equity investments and using IPO proceeds to pay down debt at the parent level should create a virtuous circle for developers. In particular, it will enable them invest in new or existing projects, which can later be injected into the listed vehicle.

As such, the new asset class should help India get closer to China's 11% infrastructure-spending-to-GDP ratio. It is a level many people despaired India was capable of achieving after decades spent bumping along decrepit rural roads, or inching through gridlocked city traffic.

However in 2016, India built a record 6,029 kilometres of new highways and the recent Union budget prioritised increasing the country's ratio of infrastructure spending to GDP from 8% to 10%.

Declining interest rate cycle

Bankers and investors agree that Indian InvIT's are coming at a fortuitous time for Indian equity markets. Unlike China and the US, India is still on a declining interest rate cycle making yield products an attractive proposition.

This is one of the main reasons why Jon Thorn Founder of India Capital Fund is so bullish about InvIT's.

"We're very excited about these products for two reasons," he told *FinanceAsia*. "Firstly India is in a disinflationary environment, which is good for yield assets. The liberalisation of the economy is freeing up supply and reducing the country's historically high inflation.

"Secondly it's very hard to find yield assets in the Indian equity markets," he continued. "Capital constraints mean companies hold onto cash and even banks typically yield less than 1%."

India's risk free rate – 10-year government bonds – currently stands at 6.8%. Given that global real estate investment trusts (Reits) and infrastructure trusts typically yield about 250bp to 300bp over risk free rates, this would suggest that Indian InvIT's need to offer a dividend yield around the 10% mark after accounting for an IPO discount.

One US benchmark – New York-listed InfraReit – is currently yielding 5.4% or 297bp over US Treasuries. Analysts say it is valued around 11.58 times forward EV/Ebitda.

Bankers say a majority of investors are pushing for low double-digit yields, while issuers are hoping to price closer to mid single digit levels. However, they believe it is critical for Indian issuers accept the need to price the first couple of deals to sell in order to set the market off on a firm footing.

"The regulations governing these deals have been thoroughly thought through and they should go well," one banker commented. "But we're dealing with a new asset class, which is never straightforward.

"We've already had quite a few investors tell us they're finding them quite complex to understand," the banker added. "They're contemplating sitting on the sidelines and seeing how the first few deals perform."

One factor, which may help push yields slightly closer to where issuers would like them to be, is the potential for dividend growth. Similar to Reits, Indian InvIT's offer the prospect for organic growth in tandem with India's GDP as well as through asset injections.

Issuers are also well aware that many investors have long wanted to play India's infrastructure development, but have been wary of all the associated greenfield risks dealing with a country where construction timelines are elastic, capital is constrained and politics often hinders projects from reaching completion.

As one banker put it: "There's huge pent up demand for completed assets where the cash flows are transparent and it's easy to measure the upside and downside risk."

Sound structure

Bankers and investors also conclude that SEBI has put in place all the technical requirements for the deals to succeed. After issuing its first guidelines in September 2014, it revised them this November boosting the product's appeal by exempting them from dividend distribution tax.

Companies must distribute at least 90% of net distributable cash flows as dividends, which can be fully passed through.

All three public deals are being structured more for institutional than retail investors. Local bankers say there is likely to be a 75%/25% allocation split between the two rather than the standard 50/50 split.

The minimum retail lot size of Rp1 million is higher than standard IPOs but those investors who do participate benefit from a dividend tax exemption.

Bankers also argue that India has learned from US mistakes where YieldCo's were very popular until investors realised the demarcation between sponsor and listco was not clear enough, assets were being overvalued and vehicles overloaded with debt.

One Mumbai-based banker who helped draft the regulations said that any future asset injections in India will require unit holder approval, lessening the risk of overvaluation. Leverage has also been capped at 49%.

Each red herring also includes an independent valuation of portfolio assets.

IRB Infrastructure InvIT

Its red herring carries an enterprise value (EV) of Rp80 billion, although analysts say they now expect the assets to be injected at Rp76 billion.

The company has estimated 2018 Ebitda at Rp9.5 billion equating to a pre-marketing EV/Ebitda valuation of 7.98 times based on the lower EV estimate.

The equity value has been calculated at Rp30 billion.

The IPO vehicle has six operational projects covering 3,635km, with an average residual life of 11 years and projected 7% compound annual growth rate (CAGR) for traffic volume during the residual concession period.

The figure for the 2014 to 2016 period stood at 9.4%.

Global co-ordinators are Credit Suisse and IDFC with ICICI Securities, IIFL and Karvy as lead managers.

Reliance Infrastructure InvIT

According to the company's red herring the sponsor is offering 10 road assets with an EV of Rp83.4 billion and equity valuation of Rp13.3 billion.

This equates to a 2018 EV/Ebitda valuation of 10.06 times based on projected 2018 Ebitda of Rp8.29 billion.

The company is forecasting 8% traffic growth in 2018 and 9% in 2019. The 10 toll roads are geographically diverse spanning six states and covering 770km.

The residual concessional life spans nine to 21 years.

Global co-ordinators are Axis Capital, Bank of America Merrill Lynch and UBS, with SBI Capital and YES Securities as lead managers.

India Grid Trust

IndiGrid differs from Reliance and IRB as it is offering transmission assets rather than road projects. Its annuity-based model and highly regulated asset base means its cash flows should be the most predictable of the three.

This is likely to the biggest plus point for defensive investors and the biggest negative for investors looking for greater equity upside potential. Non-syndicate bankers say IndiGrid is likely to offer the lowest dividend yield of the three because of its defensive characteristics.

According to the red herring, fair value EV stands at Rp41.39 billion and equity value at Rp13.1 billion. Based on projected 2018 Ebitda of Rp4.55 billion, this equates to an EV/Ebitda valuation of 9.07 times.

The parent owns a total of 10 inter-state power transmission projects and two have been injected into the IPO vehicle: the Bhopal Dhule Transmission Company (BDTCL) and Jabalpur Transmission Company (JTCL). BDTCL operates six power transmission lines of 944 ckms, while JTCL has two of 992 ckms.

The concessions have a 35-year life from their commission date and 50-year useful life after taking maintenance into account.

Global co-ordinators are Morgan Stanley, Citi, Edelweiss and Karvy.

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