FinanceAsia

InvITs could help plug India’s gaping infrastructure hole

By Danny Leung | 15 August 2017

By attracting private sources of funding, the first wave of infrastructure investment trusts in India could help unblock the logjam holding back the country's infrastructure push.

The construction of an 80 kilometre-long railway line between Nangal Dam and Talwara in northern India first won government approval in 1974. More than four decades later it is still only halfway done.

Like other big-ticket projects across India, the Punjabi rail link is unfinished and way behind schedule, mirroring the many challenges that developers face when it comes to trying to build and update the country's patchy infrastructure, to the detriment of the Indian economy.

When the result, among other things, is more than 700,000 villages without a road connection, 83% of Indians without internet access, and 47% of homes with no piped drinking water and sanitation, it isn't hard to imagine how infrastructure failings could limit the country's economic ambitions.

From insufficient planning to red tape and poor execution, there are multiple reasons behind India’s infrastructure woe. But among them, funding is widely seen as one of the biggest hurdles.

New infrastructure investment trusts, commonly known as InvITs in India, could help break the impasse by securitising infrastructure revenue streams and attracting new sources of funding.

The InvIT market started to take shape this year with two public listings already completed, while at least three companies are in the process of setting up InvITs.

“We see the launch of InvITs as a very promising development and is game-changing for the Indian infrastructure sector,” Pratik Agarwal, chief executive officer of India’s largest private power transmission company, Sterlite Power Grid Ventures, told *FinanceAsia* in an interview.

Funding challenge

Finance minister Arun Jaitley has said India needs over $1.5 trillion of investment to help plug its infrastructure gap over the next 10 years. That's a chunky number, equivalent to 5.5 times India’s government spending last fiscal year.

Both public and private capital will be needed to fund the construction of roads, highways, railways, airports, power plants, and more. But India’s ability to deploy public capital is undermined by its bad debt problems. Some 17.7% of the country’s public sector bank assets as of the end of 2015 were classed as “stressed assets” compared with 11% three years earlier, according to State Bank of India.

The Indian public sector’s fiscal distress means increased debt financing, which currently accounts for about 80% of the country’s infrastructure spending, would hardly be sustainable. As such, private sector investment is becoming more important for the country’s infrastructure push.

However, the private sector faces its own obstacles. For one, the scale of private infrastructure funding is generally much smaller than government financing, meaning that private investment alone can hardly support large and capital-intensive infrastructure projects.

What's more, private companies are more concerned about investment returns, profitability and cash flows. As a result, they are more inclined to avoid projects that have long development phases or carry significant operational risks.

InvIT push

In view of these obstacles, the government explored new ways to raise capital for infrastructure investment in recent years, echoing Prime Minister Narendra Modi's call to step up infrastructure investment and speed up execution.

An important step was made in September 2014 when the Securities Exchange Board of India (Sebi) introduced regulations for establishing infrastructure investment trusts, or InvITs, paving the way for the country's first securitisation of infrastructure assets.

It's been a long time coming, as with other things in India, but close to three years later the country's first infrastructure investment trust, IRB InvIT Fund, finally made its way to the public market after completing a $724 million initial public offering in May. IRB InvIT Fund is an investment trust containing the toll road assets of IRB Infrastructure Developers.

Two weeks later Sterlite Power Grid Ventures completed the securitisation of its inter-state power transmission assets through the listing of India Grid Trust, marking the floatation of the country's second infrastructure investment trust.

CEO Agarwal said the development of a sound InvIT market is crucial to India's infrastructure push because it creates recurring cash flows for developers and operators.

"Listing of India Grid trust is core part of our overall strategy to execute more power transmission projects and offer them to financial investors post completion, with stable and sustainable long-term returns."

Monetise completed projects

Srinivasan Subramanian, head of institutional equities at Axis Capital, said InvITs help to untie a knot in the infrastructure cycle – the lack of an incentive to invest in projects at the early stage of development.

"Compared to some other Asian countries, investors are less likely to invest in Indian infrastructure because of all the problems associated with it," Subramanian told *FinanceAsia* in an interview. "When less capital is deployed in these projects, developers will run into funding difficulties and project delays, and that would result in less investment."

InvITs do not directly channel funding into early-stage projects. Instead, they form an important way for developers to free up capital locked in completed projects and re-deploy capital into early-stage ones.

By spinning off the assets as a standalone entity developers could also obtain additional borrowings for new projects.

In addition, they could help to relieve funding stress within the banking sector.

"When developers raised capital through InvITs they can repay their borrowings to banks. And then banks lend the money to other infrastructure developers," Subramanian told *FinanceAsia*. "This creates a healthy cycle."

Such credit relief for banks, albeit small in scale for the moment, could be crucial now that they have to prepare for the implementation of IFRS 9 next year. The new accounting standard will put downward pressure on regulatory capital for banks, potentially resulting in less capital deployed for infrastructure financing.

Enhance pricing transparency

InvITs help resolve one of the key issues surrounding infrastructure investment in India – the lack of pricing transparency and the mispricing of assets.

In the absence of a public market, infrastructure investment has been confined to private enterprises, banks, and government-linked entities. The lack of transparency has resulted in common asset-liability mismatches, posing difficulties for banks seeking to pin down fair value in order to provide financing for these projects.

Pratik Agarwal, Sterlite Power CEO

Sterlite Power's Agarwal said InvITs offer a direct solution to the pricing mismatch problem commonly associated with infrastructure projects.

“The infrastructure trust is a more efficient market-determined method for raising funds from public market investors,” Agarwal told *FinanceAsia*.

“It results in better matching of investor and developer needs, better price discovery, and lays a path forward for good corporate governance.”

A market-determined valuation provides a clear guidance of how much debt financing an InvIT can raise. Currently, Sebi regulations allow InvIT to raise up to 49% of its asset value.

At the same time most InvITs will be rated by credit agencies before they list on the stock market, thereby defining the cost of their borrowing.

Public participation

From an industry perspective, InvITs are crucial to expanding the sources of funding for India's infrastructure developments. For now, it is the only way for public investors to directly invest in India's infrastructure projects, most of which provide stable and generous returns.

For instance, IRB InvIT Fund and India Grid Trust offered investors a yield of 12% and 10.95% on a forward basis, making them an extremely attractive investment in a country where interest rates have fallen continuously since 2012.

More InvITs are now in the pipeline.

Reliance Infrastructure received regulatory approval in May for the listing of an InvIT that houses some of its toll road assets, while MEP Infrastructure and GMR Infrastructure have both expressed interest in setting up InvITs in the near future.

Investment Information and Credit Rating Agency (ICRA) has estimated the size of the InvIT market will grow to Rp200 billion ($3 billion) by mid-2018.

“Recently, IRB Infrastructure came out with India's first InvIT and received good response from investors," said Shubham Jain, vice president of ICRA. “This will pave the way for other infrastructure developers to unlock capital through this route.”

Jon Thorn, founder of asset manager India Capital Fund, told *FinanceAsia* the new asset class is set to attract capital in the long term if there is a wide variety of businesses to choose from.

"For now, critical mass is a factor. There is just is not enough of them yet," Thorn said, referring to the fact that there are only two publicly-listed InvITs. "It is not a function of how the InvITs are trading in the aftermarket, but the fact that people can only take what is offered to them instead of investing in assets that they want, be it roads, ports or power plants."

There is still a long way to go for India's ambitious infrastructure push. Complicated and lengthy government approvals, drawn-out land acquisition processes, and contract breaches remain major hurdles that could require a thorough reform of the legal system and the regulatory process.

But the establishment of the InvIT market is a good first step. India's infrastructure market is now getting more attention from the public and for stock market investors, India is now a new destination for income investment.

“As more companies raise capital through the InvIT route, it has the potential to become a very large asset class in Indian capital markets,” Sterlite Power's Agarwal said. *This article has been updated to correct the full name of ICRA*