Overview of Infrastructure Finance

Infrastructure Leasing & Financial Services Limited

Pune

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Section I: Infrastructure and Development

The Objective of Development

"The basic purpose of development is to enlarge people's choices. In principle, these choices can be infinite and can change over time. People often value achievements that do not show up at all, or not immediately, in income or growth figures: greater access to knowledge, better nutrition and health services, more secure livelihoods, security against crime and physical violence, satisfying leisure hours, political and cultural freedoms and sense of participation in community activities. The objective of development is to create an enabling environment for people to enjoy long, healthy and creative lives.“

- Development is about much more than just the rise or fall of national incomes
- Development is about creating an environment that build human capabilities:
  - To lead long and healthy lives
  - To be knowledgeable
  - To have access to the resources needed for a decent standard of living
  - To be able to participate in the life of the community

"Wealth is evidently not the good we are seeking, for it is merely useful for the sake of something else" - Aristotle

Infrastructure and Economic Development

- Infrastructure contributes to economic growth, both through supply and demand channels by:
  - Reducing costs of production
  - Contributing to the diversification of the economy
  - Providing access to the application of modern technology, raising the economic returns to labour (by reducing workers' time in non-productive activities or improving health)
- Infrastructure contributes to raising the quality of life by:
  - Creating amenities
  - Providing consumption goods (transport and communication services)
  - Contributing to macroeconomic stability
- Infrastructure does not create economic potential by itself; it only develops it where appropriate conditions (i.e. other inputs such as labour and private capital) exist

Section II: Characteristics of Infrastructure Projects

Characteristics of Infrastructure Projects

- Monopolistic
  - Economies of scale and scope favour supply through a single provider
  - Large capital investments, low operating costs
  - Long gestation; Cost recovery periods
  - Relative certainty of revenue streams
- Lack/absence of asset backed security
  - Sunk costs
  - Physical assets created cannot be moved or utilized elsewhere
- Complex, multiple linkages, the need to exercise sovereign authority
  - High dependence on other sections of political economy

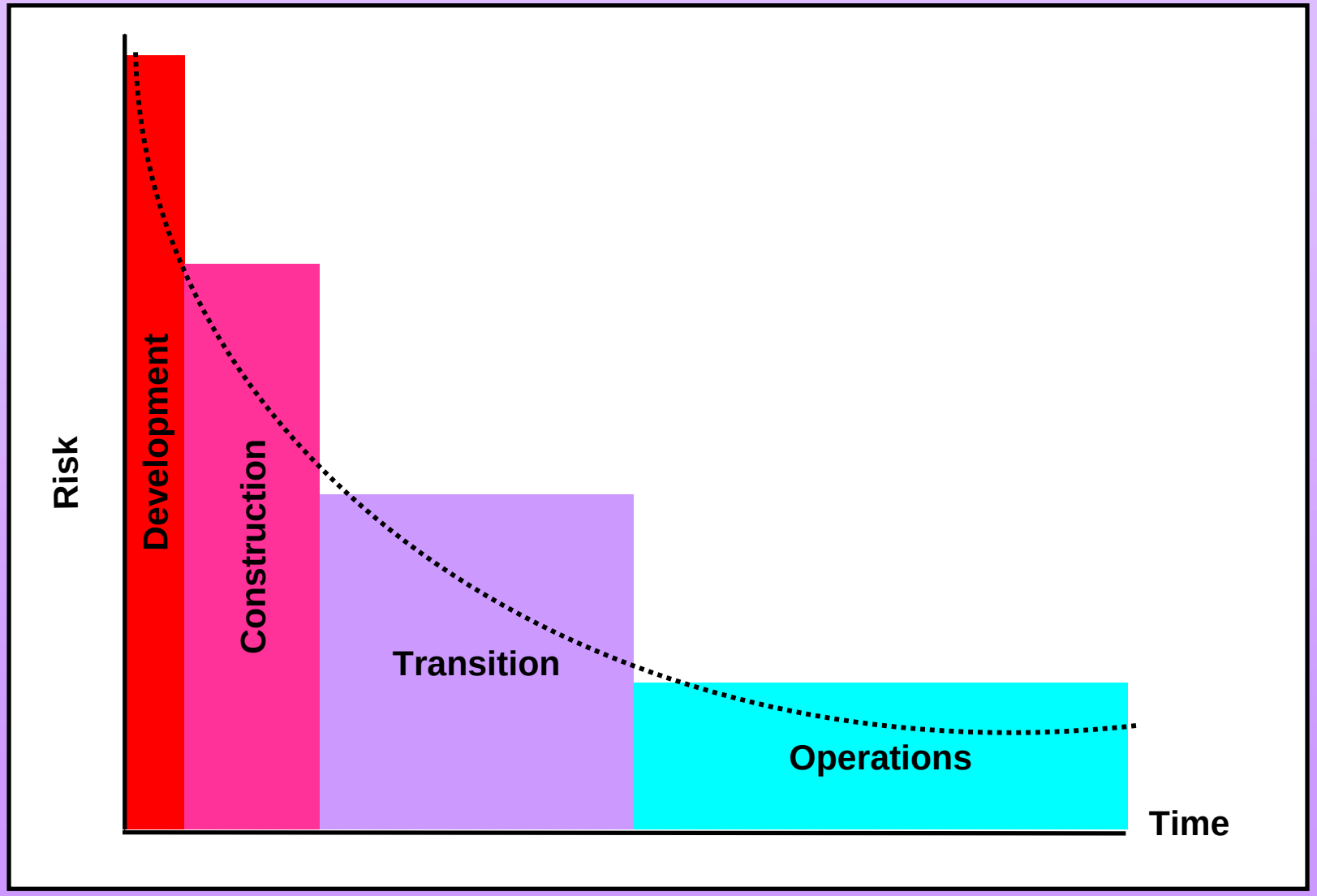
Financing Considerations

- Traditionally all infrastructure investments, and therefore risks have been undertaken/absorbed by the government
- Financing and implementation of infrastructure projects has shifted to the Private domain of late
- However, long return horizons need long term players – both lenders and investors
- The Resource Mobilization has to meet the project expenditure profile
- Debt servicing has to match the cash flow profile
- Infrastructure Projects require special assessment skills and framework for risk management

Risk Profile

- The Risk profile of infrastructure projects vary with the stage of the project cycle. These Risks include:
  - Political risk
  - Technological risk
  - Environment and social risk
  - Construction risk
  - Financing risk
  - Commercial risk
  - Other non-commercial risks (force majeure, forex)
- Development of institutional and financing strategies are closely linked to each phase of the project cycle

Risk Expectancy



Section III: Need for Commercial Financing of Infrastructure

WHY Commercial Financing?

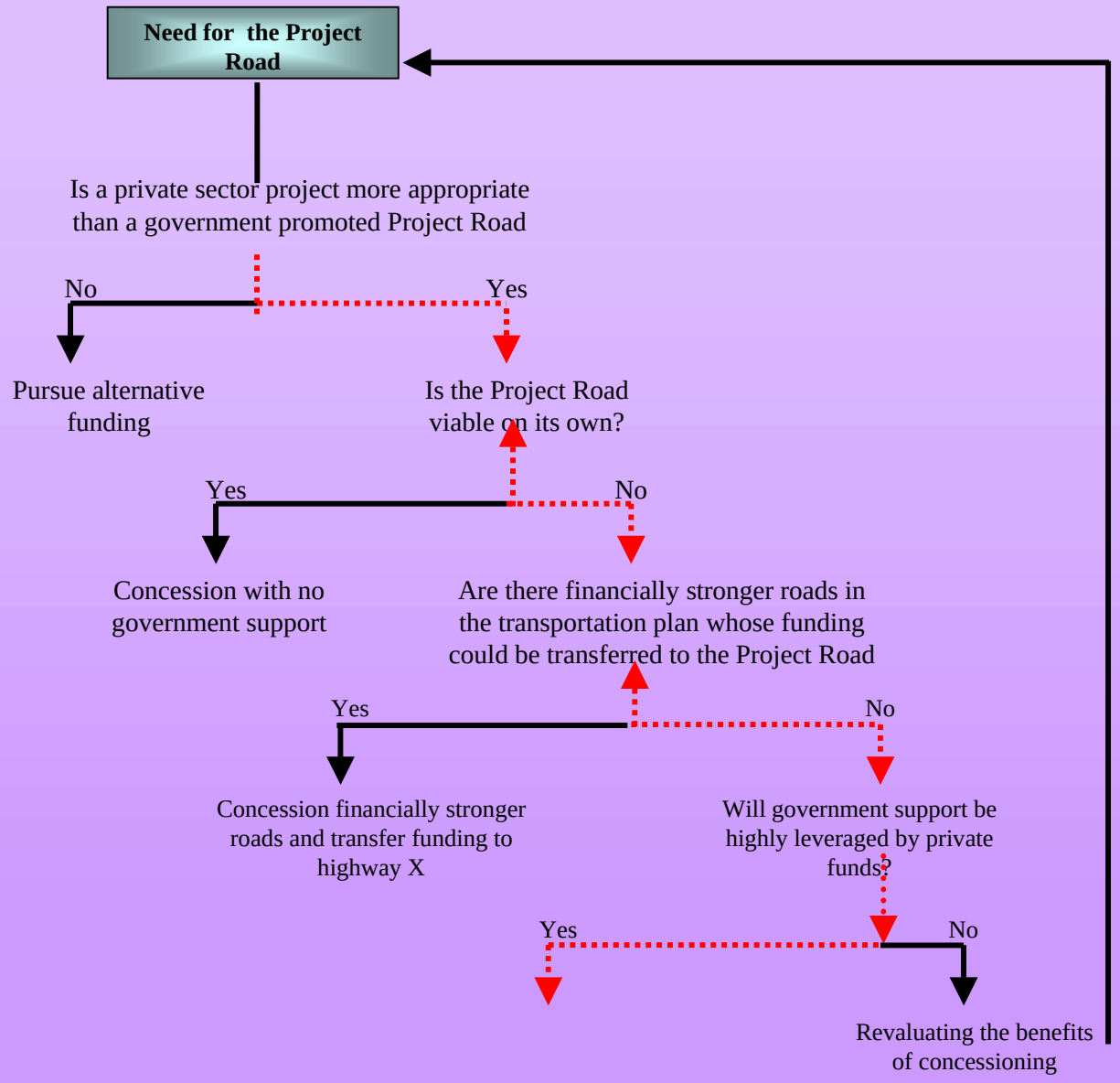
Because There isn't Enough Money!!!

“The belief that private financing is more expensive to the government is untrue. A large number of infrastructure projects languish through years of sub optimal implementation due to lack of funds. This leads to enormous cost overruns and escalation on account of sub optimal and inefficient implementation, growing overheads and inflation. It is essential to remember the opportunity cost of this situation is prohibitive.”

Why Invite Private Sector Partnerships?

- Transfer Construction Risk
- *Transfer Design/Solution Risk*
- Transfer Operations Risk
- Transfer Market Risk
- Transfer Financing Risk
- *Make Subsidies more efficient*

Privatisation Decision Tree

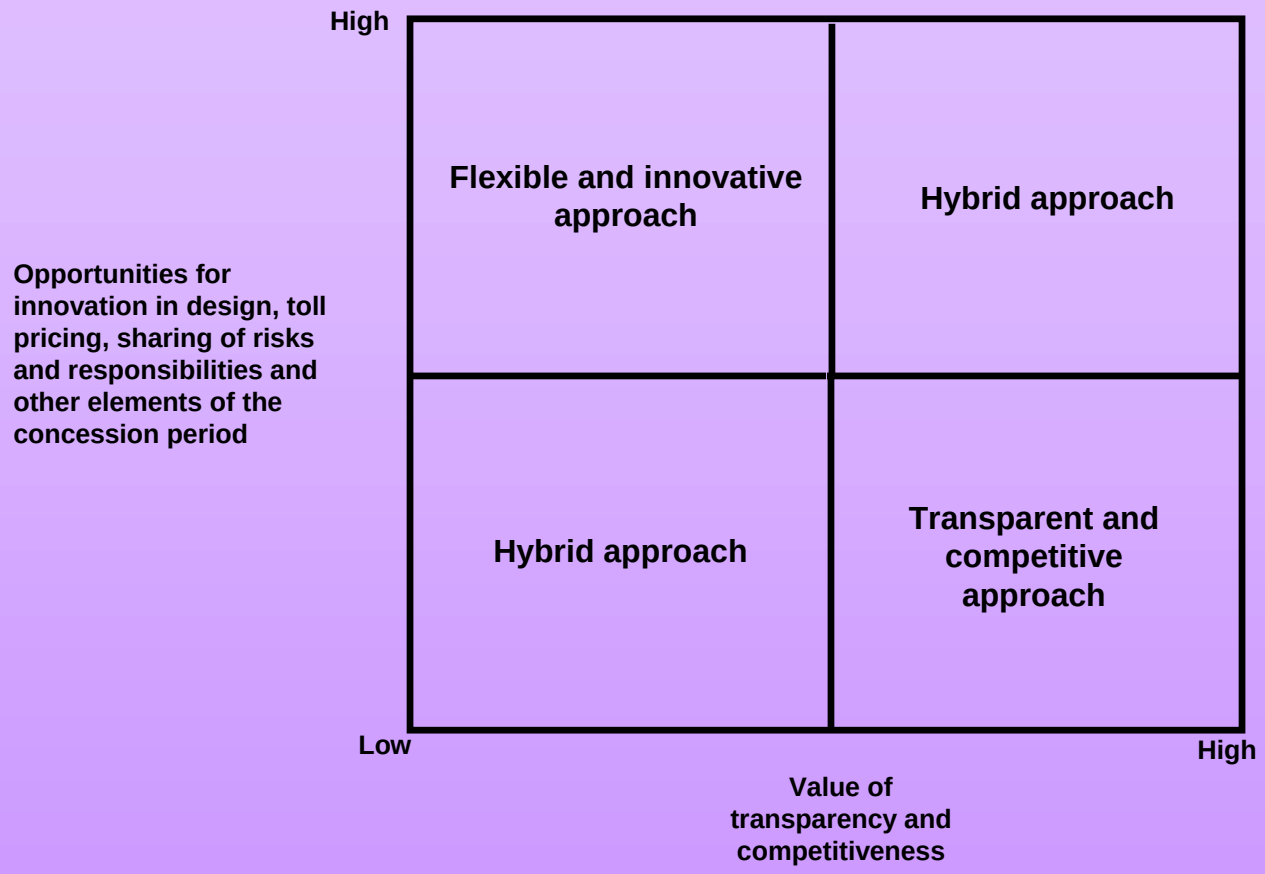


User Fee

Concession

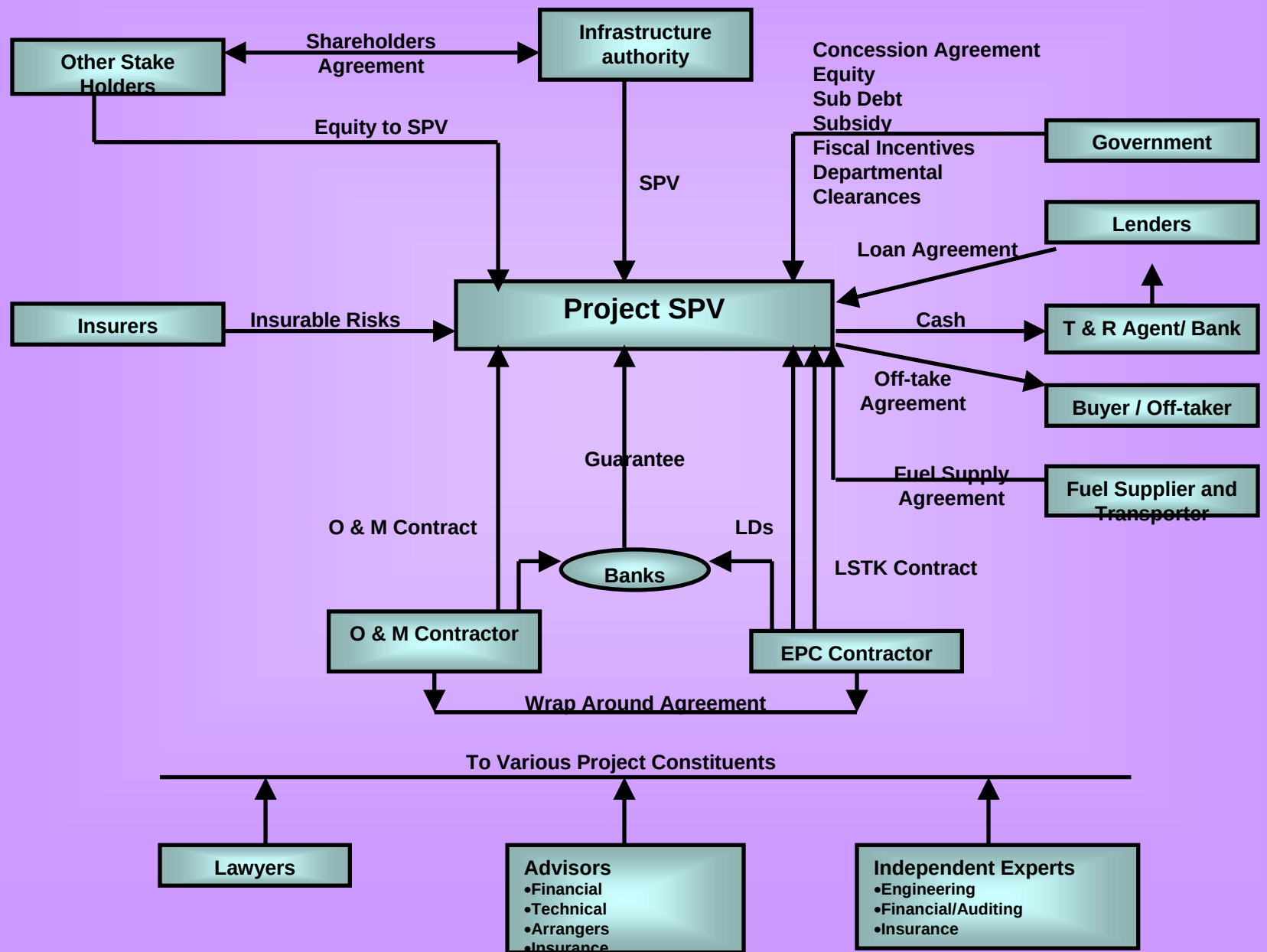
“Concession in the Absence of Regulation!”

Approach to Concession



Project Finance to Limit Liability of Private Sector Participants

A Typical Project Structure



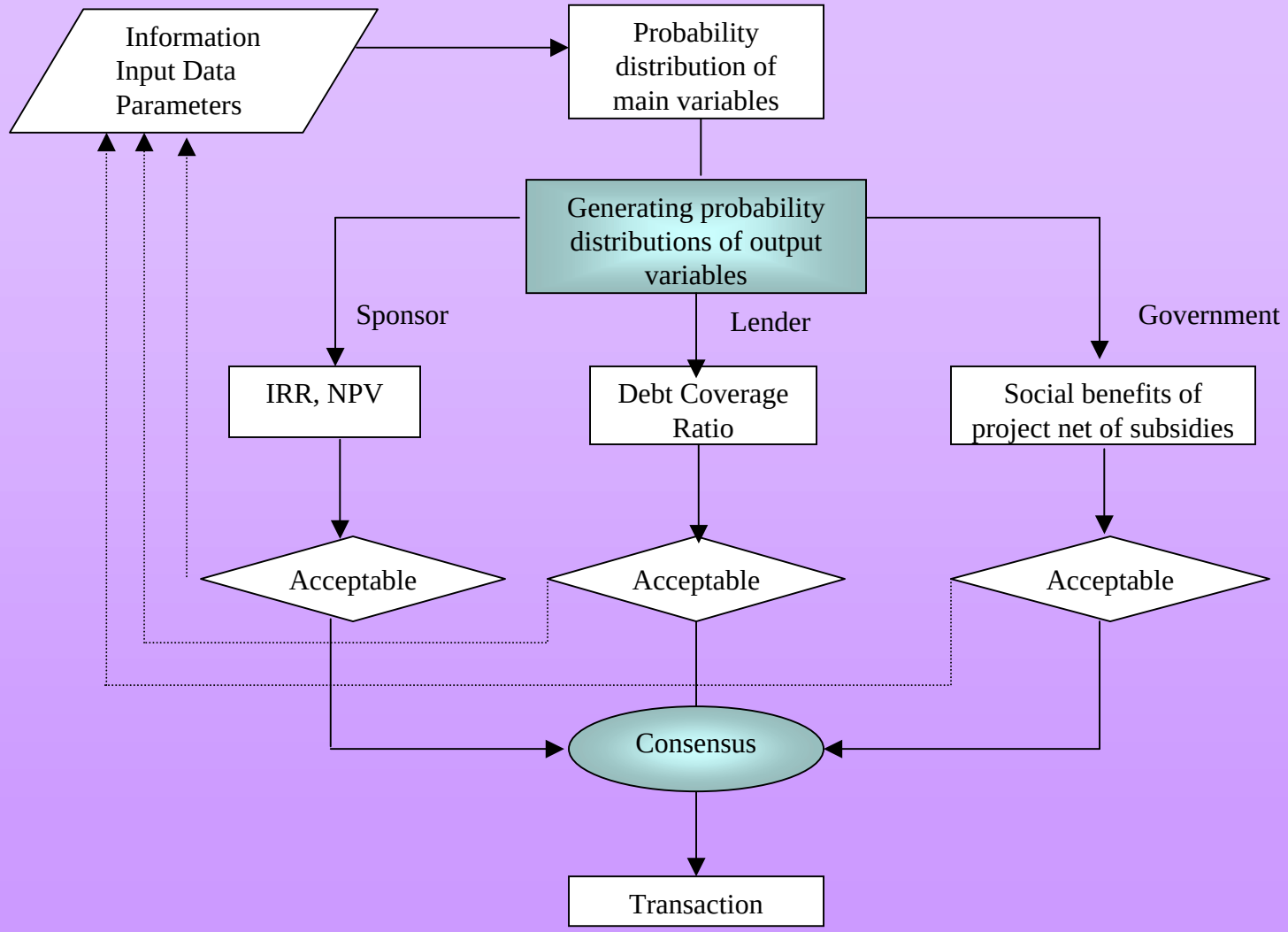
Section IV: Project Financing

“Project Financing is an option granted by the financier-exercisable when an entity demonstrates that it can generate cash flows in accordance with long term forecasts. Upon exercise of the option, the entity’s parent(s) or sponsors company(s) balance sheet is no longer available for debt service. The assets, rights and interests of the development are usually structured into a special – purpose vehicle (SPV) and are legally secured to the financiers as collateral”

Stake Holders

- Sponsors
- Lenders
- Government

Building a Consensus



Types of Capital Available

- Equity
  - Ordinary
    - Sponsors
    - Contractors
    - Equity Funds
  - Preference
- Debentures / Bonds
- Convertible Debentures / Loan Stocks
- Bank Loans
- Subordinated Debt
- Government Export Credits
- Trade Credit
- Leases

At what Cost?

Equity

Capital Market Opportunities

- The Indian Capital Markets have as yet not been exposed to Companies, which are a pure infrastructure play
- Companies with pedigreed parentage and strong antecedents would pave the way for investors to share in the expected upside
- A Public Issue of securities while diversifying the shareholding would bring a sense of ownership among the users
  - The success of any project clearly hinges on the support from the local community and the major users
  - The IPO should be intensively marketed in the service area of the project
  - This would entail a wide retail shareholding and ensuing liquidity for the stock

Institutional Investor Interest

- The SPV may be structured in a format to leverage its value created
  - As its corporate objective establish additional infrastructure in the area either by itself or through affiliates / subsidiaries
- A business model on these lines would position the SPV as a holding Company with a diverse basket of projects within its fold.
- Valuations would be on the basis of the
  - Individual valuations of the businesses
  - The respective share of the businesses in the holding company
- There has been an acceptance of the holding company concept amongst large institutional equity investors
  - Larger values emanating from significant chunks of a diversified business model rather than individual chunks in those businesses.
- This would attract institutional shareholders at the time of the IPO and post listing

Regulatory Issues

- As per the extant SEBI Guidelines, infrastructure companies are not restricted on the extent of dilution or the mode of Issuance
  - Can dilute upto a minimum of 10 %
  - Can use the Book Built or Fixed Price mode of Issuance
- Infrastructure Company is defined as
  - whose project has been appraised by a Public Financial Institution or Infrastructure Development Finance Corporation (IDFC) or Infrastructure Leasing and Financing Services Ltd. (IL&FS) and
  - not less than 5% of the project cost is financed by any of the institutions referred above, jointly or severally, irrespective of whether they appraise the project or not, by way of loan or subscription to equity or a combination of both.

Debt Funding

Term Lending

- Term Lending would typically be on commercial Terms and a Project Recourse basis
- The following is a security package normally required by lenders
  - Debt Service Reserve Account
    - Equivalent to six months debt servicing
  - Concession rights assigned to lenders
    - Lenders can step-in to cure event of default within a period of 90 days
    - After 90 days lenders can appoint substitute entity as concessionaire
  - Pari-passu first charge on all fixed assets and revenues
  - Comprehensive insurance package to cover all risks during construction period,.third party liability and business interruption. Lenders will be designated as 'Loss payees'
  - Appointment of Security Trustees to safeguard Lenders security interest
  - Appointment of Trust and Retention Agent to monitor cash inflows and outflows of the Project

Debt Market Instruments

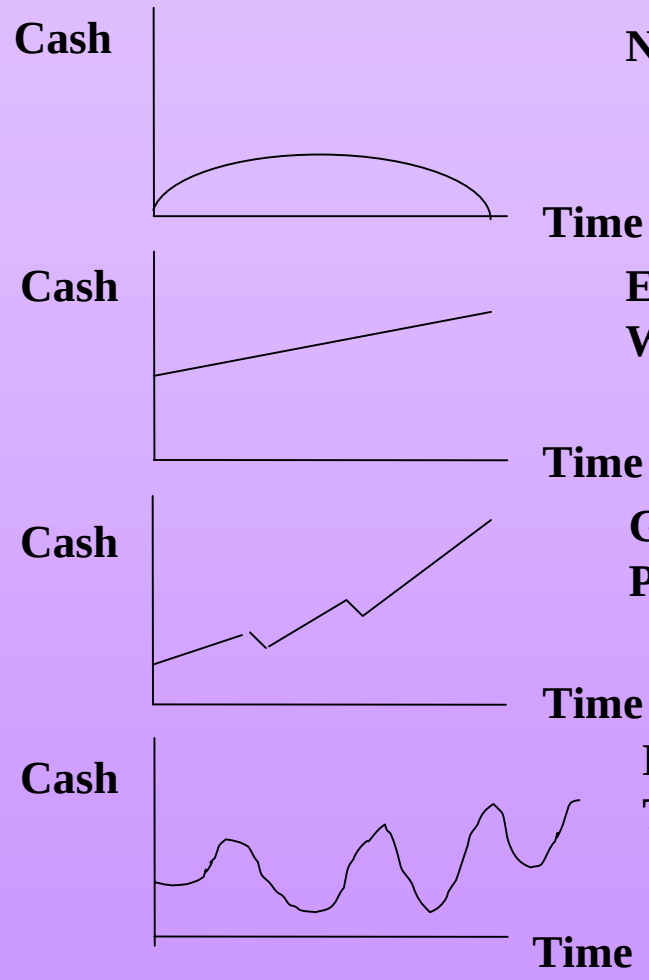
- Long tenor debt instruments Issued either through a Private Placement or Public Issue route
- Debentures / Bonds / Preference shares may be issued which are
  - Partly / Fully / Optionally Convertible or Non Convertible
- Extant SEBI Guidelines for Public Issue of Debt stipulate the following
  - Requirement of credit rating
  - Requirement in respect of Debenture Trustee
  - Creation of Debenture Redemption Reserves(DRR)
  - Distribution of Dividends with approval of the trustees
  - Redemption as per Terms defined in the offer document.
  - (Disclosure and) Creation of Charge
  - Filing of letter of option (for Convertibles)
  - Additional Disclosures as may be specified

Multilateral Funding

- World Bank provides Financing for both Public and Private Sector projects with a guarantee of the host government
  - Direct Loans or Guarantees to Lenders
  - Through International Bank for Reconstruction and Development (IBRD) to middle income countries at market lending rates
  - Through International Development Association (IDA) at concessional rates and long maturities to poorer countries
- International Finance Corporation (IFC) provides and syndicates loans and makes equity / Quasi equity investments
  - No Government Guarantee required
- The Multilateral Investment Guarantee Agency (**MIGA**) provides political risk insurance
  - under contracts of guarantee for foreign equity and related debt investments

Credit Rating / Enhancement

Project Cash Flow Profiles



New Oil Exploration

Existing Regulated Utility (Eg. Water)

Greenfield Manufacturing Project

Existing Cyclical Commodity Type Product Producer

Project Related Loans Key Risks for the Lenders

COMPLETION
- Will it Work
- Within Budget
- On Time

CASH FLOW
- Product Price
- Market Conditions (Demand)
- Operating Case
- Disruption

POLITICAL
- Expropriation
- Fiscal
- Government Interference in Operations

Risk Assessment Chronology / Issues

- Assessment of key risks: what are key risks; are they acceptable
- Who are the participants; what are their objectives and are they compatible?
- What are the key operating assumptions
- Sensitising the key operating assumptions: is the project viable under any likely set of operating conditions
- How is the project to be financed
  - Debt: Cash flow coverage; which banks; priority amongst lenders
  - Equity: IRR - comparison with cost of capital
- Legal structuring
  - Detailed provisions of financing
  - Project contracts
  - Financing and operating agreements
  - Financial / operating covenants
  - Monitoring arrangements
  - Inter creditor agreements
  - Shareholder documentation
  - Security structure

Credit Rating Methodology

- Common Parameters considered in a rating exercise of Infrastructure Projects
  - Economic base of the service area
  - Regulatory Framework
    - Evaluation of Project Documents
  - Management Evaluation
  - Demand Analysis
  - Credit Assessment of Purchaser of services
  - Project Implementation Risk
  - Operating Risk
  - Financial Structure
  - Credit Enhancements

The Rating Agency analyses each of the above factors and their linkages to arrive at the overall assessment of credit quality

Credit Enhancement Techniques

- Credit enhancement measures can have a beneficial impact on the project's stand alone credit quality
- It adds strength to the debt servicing ability
- Such provisions may take various forms
  - guarantees
  - standby facilities
  - limited recourse to the Promoter / Issuer's assets
  - escrowing of receivables (either from the project or other businesses) to be used for the specific purpose debt servicing
- These measures have the ability to reduce credit risk of the Promoter / Issuer and improve its stand alone rating

Risk Minimising Techniques

- New Technology
  - Increased Equity and / or Guarantees from Sponsors
- Political Risk
  - Insurance (limited)
  - Composition of Project Consortium (Deterrent)
  - Composition of Financing Group (Deterrent)
- Before Completion
  - Insurance (Limited)
  - Performance Bonds
  - Completion Guarantees (Small Companies?)
  - Fixed Price Construction Contracts

- After Completion
  - Sales Contracts (if available)
  - Loss of Income Insurance (Limited)
  - Non-payment Insurance
- Project Complexity
  - Increased Equity and/or Guarantees from Sponsors
- Management
  - Increased Equity
- Financial Management
  - Currency + Interest Rate Hedging
  - Derivatives

Third Party Credit Support

- Comfort Letter
- Guarantees
- Indemnities
- Insurance Policies
- Contract Bonds
- Offtake Agreements
- Put Options
- Repurchase Arrangements
- Subordination Agreements
- Cost Overrun Agreements
- Partly Paid Share Capital
- Margin Arrangements

Securitisation

Conventional Lending

Borrower

CREDIT EVALUATION

- Rating of the Borrower
- Unencumbered assets
- Debt/Equity Ratio, DSCR,
- Asset Cover, Interest cover
- Balance Sheet/ P&L strength

Loan

TERMS FOR LENDING

- Interest Rate commensurate with Rating of Borrower
- Loan secured by land, building, plant/ equipment,current assets
- Standardised repayment terms

Lender

Agglomeration of project and operating risk - participation of a multiple lenders

Raising Resources through Securitisation

Borrower/Originator of Cash Flows

CREDIT EVALUATION

- Assured cash flows arising out of unencumbered or superior assets

Tradeable Security

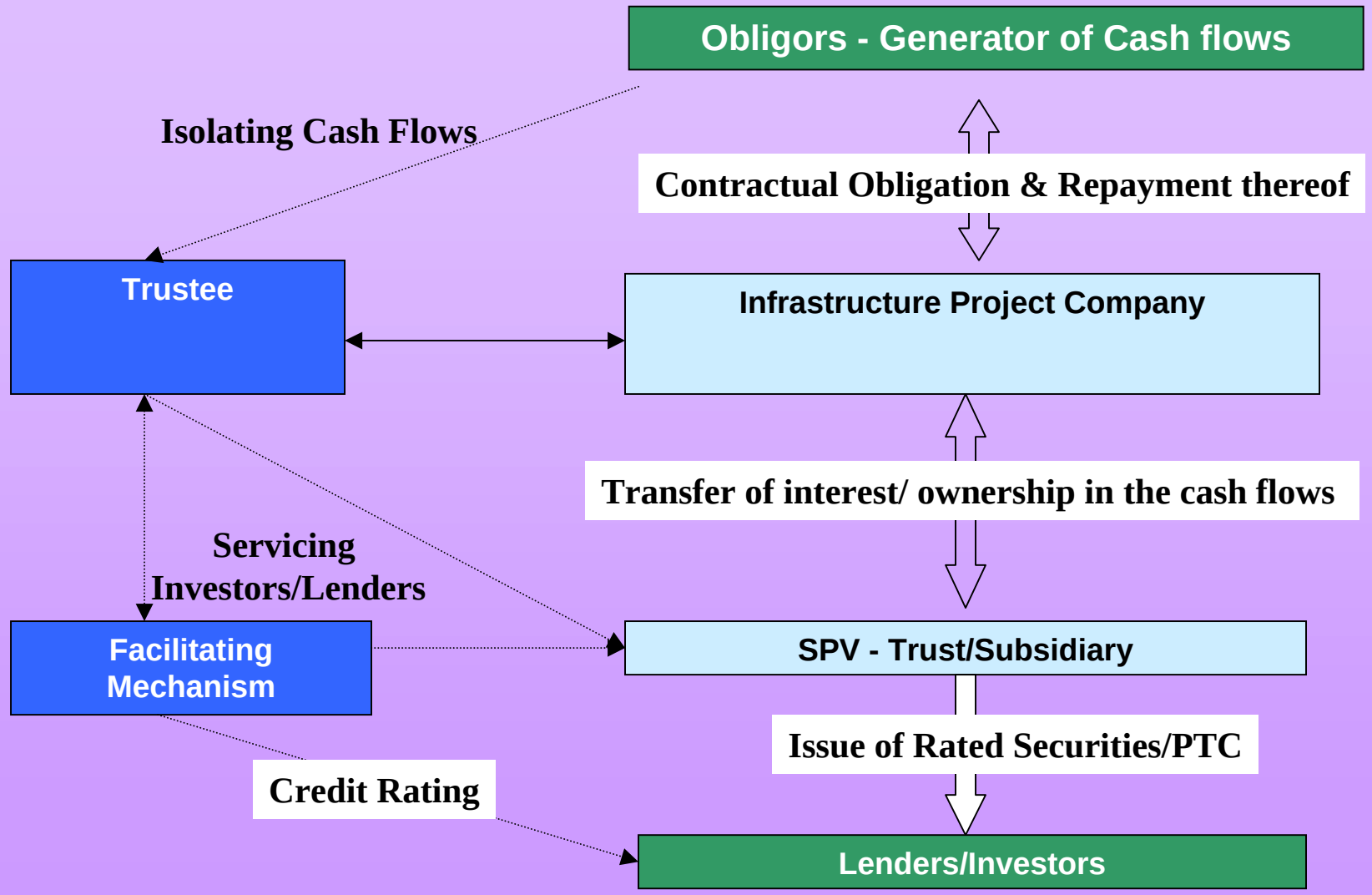
TERMS FOR LENDING

- Lower costs - enhanced rating through assured cash flows
- Repayment mechanism

Lender/Investors -Right to Cash flows

Securitisation works on the principle of unbundling cash flows - Customising risk and Evolving Superior credit structure

Conventional Securitisation Structure



What can Securitisation achieve for Infrastructure Financing?

- Conventional financing pattern
  - Driven by credit extended in the form of non-tradeable loans
  - Project risk compensated by high cost of debt
  - Sponsor comfort and “right” to project cash flows - Key driver
- Securitisation - Benefits/Advantages
  - Disseminate risk by identifying risk parameters
    - *Allocate cash flows to lenders/investors*
    - *Leverage on structure of infrastructure projects - Quasi Government risk*
  - Lending driven by Credit Rating of Structure rather than overall project risk
  - Participation of a large number of investors
    - *Tradeability of loans - Participation /Pass thru Certificates*
  - Resultant reduction in cost of capital for infrastructure projects

Facilitate resource raising through tradeable instruments - Municipal bonds/PTCs widely used in International markets

Thank you