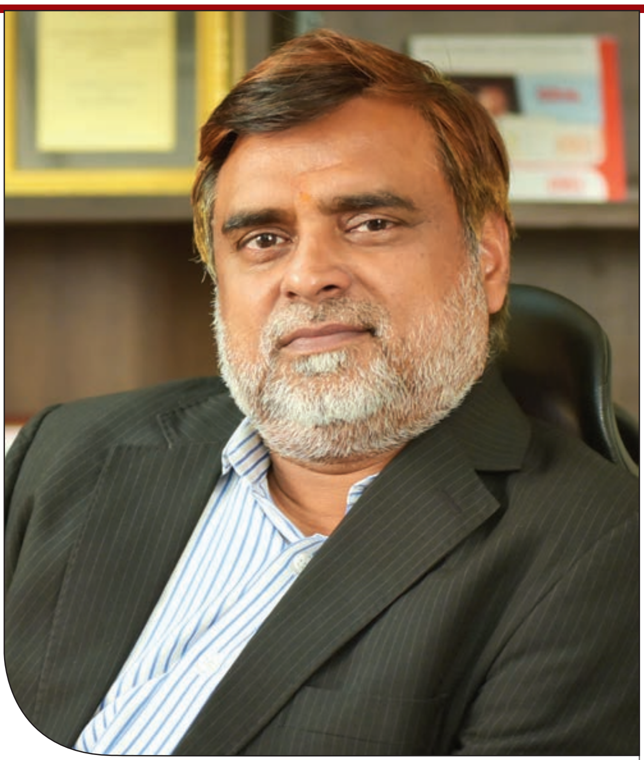
Infrastructure Financing Woes



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Indian Infrastructure market today finds itself at critical crossroads. While the economy has been progressing rapidly to claim its rightful position of the fifth largest global economy, the widening infrastructure finance deficit is constantly threatening India's growth and prosperity. As one of the most vital cogs in the wheel of development, infrastructure sector must always adopt a prudent financing strategy that appropriately covers the cash flow uncertainties over the asset life cycle. The structuring and delivery of modern infrastructure had always been complex and requires in-depth understanding of the risks associated with the projects over their entire life cycle.

Against this backdrop, the recent flustering in the infrastructure financing sector should be carefully analyzed before making preposterous assumptions on the future of the sector. According to the industry estimates, the country needs about USD 4.5 trillion worth of infrastructure investments till 2040 to commensurate with the growing aspirations of an emerging economy. Such a humungous investment requirement could never be met only with Government funding and hence it is imperative to facilitate private funding for infrastructure creation.

While the sector is battling negative sentiments triggered by NBFC crisis, the absence of a quick strategy by policymakers could translate into a larger solvency issue leading to aggravated domestic credit crisis inflicting irreparable damage to overall infrastructure sector in the long run. The present situation may not be the lowest ebb for the sector but could potentially turn into one of the worst nightmares unless core pain-points on financing are diagnosed and addressed proactively.

Quest for Golden Hammer

Infrastructure projects typically involve various stakeholders across the project life cycle with different roles, responsibilities, risk-management capabilities and risk-bearing capacities, and often conflicting interests. The complexity of these projects demands systematic approach and solution which would vary depending on the project type and execution mechanism. However, we have so far seen an obsession for finding quick fix solutions to every problem. The quest for Golden Hammer or one-size-fits-all approach had landed us in deep trouble in past and may continue to do so in near future as well. We must note that what may work for Power sector, may not necessarily be suitable for Aviation, or something that may sail through the Ports may not be on track for Highways sector. The uniqueness of each sector demands an in-depth understanding of the sectoral complexities.

The Stress of Revised Framework for Resolution of Stressed Assets

As mounting non-performing assets (NPAs) constantly threatens the Indian banking and financial services sector slipping into a jeopardy, RBI quite expectedly sprang into action and in February this year it announced a revised framework for resolution of Stressed assets. The framework aims at installing a stringent credit discipline and considerably improves the asset quality of banks. The framework puts an end to all the previous means and ways for restructuring loans.

Without raising any doubts over the efficacy of the framework, it must also be acknowledged that the circular might end up creating more problems while attempting to solve some. Though it may help weed out a sizeable portion of bad loans from the banking system, it might not work well for sizeable number of road BOT assets which were bided during the initial stages of PPP. Unlike other infrastructure classes, most of the existing road BOT assets are most likely to have asset liability mismatch due to the past bidding behaviors and the funding mechanism at that time.

Financing BOT Assets: Decoding the Asset Liability Mismatch

The nature of Highway infrastructure demands debt financing with longer tenor and lower costs. Looking at a typical BOT-Toll project structure which was a dominant mode of highway development in past, it was quite apparent that there would be a likely scenario of a serious asset-liability mismatch in the structuring of the project which can even affect its commercial viability. With almost negligible sources of long term funding available for highway assets, financing was solely dependent on public sector banks with a limited tenor of 10-15 years and this used to trigger the mismatch between the tenure of the debt taken and the Concession Period of the project, with the former being much shorter than the latter almost by 40-50%. This was not only depriving the sponsors/ stake holders from the harvesting returns on their investment during the loan period but was also putting stress over the cash flows of the Project as almost the entire cash accruals from the project was getting appropriated towards the servicing of the project debt.

Typically, the Concession Period for a BOT-Toll road project is 20-25 years. Although road BOT assets typically carry the risk of income fluctuations, they provide assured cash flows over the life of the assets coinciding with the concession period. With funding coming from PSU bank(s) with a door to door tenure of maximum 15 years and also considering the Construction Period of 2.5 to 3 years for any Project, the repayment of the entire debt was required to be made within remaining 12 -12.5 years, leaving ahead a long tail period of 10 years . Therefore, considering the challenges in the sector and volatility in the debt market (due to high interest regime), the cash flows are under stress and the developer can hardy expect any return from the project during the initial 15 years period. The return to the developers has always been rear ended coming in during the last 10 years of the Concession.

Thus, the private investors were required to take a calculative call before investing in road projects considering the long gestation period. Therefore, unless there is a super normal traffic growth on the project road post their commercial operation, the possibility of cash flow returns to the investors is bleak during the loan period. Furthermore, the project delays emanating out of land acquisitions issues, delay in environment and forest clearances, the cost overrun in the project aggravates liquidity crunch for the infra creation.

Against this backdrop, the industry called for resolution for funding woes and to address the asset liability mismatch either by facilitating Long term funding in line with the concession agreement or by considering refinancing to avoid the prevalent asset liability mismatch.

RBI Circular on Refinancing – A setback to the industry

The RBI circular on refinancing under 5/25 scheme was indeed one of the best things to happen for the industry. It was aimed at resolving the asset liability mismatch and brought in fresh lease of life to the projects which were struggling purely due to cash flow mismatch. However, the recent RBI circular on refinancing has indeed taken a lot of sheen out of the sector and needs to be reviewed for its efficacy in the system. While the circular may aim to check the spiraling NPAs in banking sector, in spirit it may actually fail miserably in doing so, atleast, for the Roads and Highways sector.

Contrary to other asset classes and industry practices, road projects under earlier BOT model typically have a fixed life of assets with assured cash flow. It would be therefore always more prudent to extend the financing for the projects upto the concession period rather than loading the entire debt obligations for the initial period of the assets. Though RBI may claim that the recent circular is aimed at instilling credit discipline, it failed to take cognizance to the fact that temporary default in meeting debt obligation due to cash flow mismatch doesn't necessarily reflect the true nature of the asset quality. The circular should have taken into consideration the debt servicing capability over the life of the assets and facilitated the refinancing opportunity rather than pressing the alarm bell upfront and push a relatively good asset into vicious cycle of default and put a question mark over the fortune of those assets.

When infrastructure needs long term financing, and more affable regulatory regime favoring facilitation, it is now been seen as one inching towards confrontation. The spirit of Public Private Partnership demands congenial environment for partnership among all the stakeholders and requires more flexibility in approach than rigidity of regulations.

As one of India's leading Highway Concession companies operating in asset ownership model in PPP space, we do hope that policymakers would take cognizance to the aspirations of the private players committed to contribute towards country's infrastructure creation. EPC World

(Views are personal)