Infrastructure investment in India: Setting up the second wave

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The first wave of infrastructure investment in India emphasised development of infrastructure projects through PPP.

This process has got into a lot of trouble.

Problems within the field of infrastructure: Clarification of the role of government.

Problems in the institutional environment: courts, land, bankruptcy code, government procurement process, etc.

A very large amount of investment is stuck at various stages in the pipeline.
A problem of first order importance

- Few things in India are as important as this question.
- Vast pools of capital are stuck in these projects.
- The investment/GDP ratio depends on getting infrastructure investment back on track.
- The economy badly requires infrastructure.
- $1 trillion of infrastructure investment in 5 or 10 years is a big number when compared with the overall economy.
In parallel, a financing bottleneck

- Various people estimate $1 trillion of required infrastructure investment.
- Actually there is no hard and fast number – this depends on the user charge and the traffic.
- If the user charges were sufficiently low, much more infrastructure is viable.
In parallel, a financing bottleneck

- Various people estimate $1 trillion of required infrastructure investment.
- Actually there is no hard and fast number – this depends on the user charge and the traffic.
- If the user charges were sufficiently low, much more infrastructure is viable.
- The financing methods used in the first wave – banks and quasi-banks – are not going to deliver the numbers that we require.
- E.g. if you believe $1 trillion over 10 years then this is $100 billion per year.
- A new approach is required.
Shift private participation to operating assets

Increasing sense that the right place for the private sector is to own and operate working infrastructure assets.


The development process is too messy and it just does not fit the private sector.

The private sector should buy operating assets, and toll them.
Key insight on the size of construction/development firms vs. operating assets

- If India has $1 trillion of infrastructure investment, will the balance sheet size of L&T and HCC and so on go to $1 trillion?
- This makes no sense
- L&T and HCC and so on are just the pipeline through which operating assets come out the front door.
- The pool of operating assets will become bigger and bigger and will eventually have a balance sheet of $1 trillion.
Examples of some recent transactions

<table>
<thead>
<tr>
<th>Seller</th>
<th>Buyer</th>
<th>Name</th>
<th>Consideration (Rs. crore)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GMR</td>
<td>SBI Macquarie</td>
<td>GMR Ladcherla</td>
<td>204</td>
</tr>
<tr>
<td>Shapoorji Pallonji - IJM</td>
<td>SBI Macquarie</td>
<td>Trichy Tollway</td>
<td>275</td>
</tr>
<tr>
<td>HCC</td>
<td>IDFC India Infra Fund</td>
<td>Nirmal BOT</td>
<td>64</td>
</tr>
<tr>
<td>GMR</td>
<td>IDFC India Infra Fund</td>
<td>GMR Ulunderpeth</td>
<td>220</td>
</tr>
<tr>
<td>IJM</td>
<td>ISQ Asia Infrastructure</td>
<td>Jaipur Mahua</td>
<td>525</td>
</tr>
<tr>
<td>Madhucon / SREI</td>
<td>Tata Realty</td>
<td>Agra Jaipur</td>
<td>250</td>
</tr>
</tbody>
</table>
Operating assets : How to finance

- Envision an asset that has worked for 1 full year
- Construction risk is over
- Hard data for toll income for one year is in hand
- Now all that remains is traffic risk and O&M skills
- This is a risk the private sector can take
- Now these assets can be bundled together in large listed companies
- Access the public equity and the public bond market
- A company with a balance sheet of $20 billion with bonds of $10 billion will have excellent liquidity of its securities, and global investor interest.
- Note: The bond issued by an infrastructure company is just a corporate bond.
The importance of foreign investment

- Public equity is already a globally accepted asset class with near-complete capital account convertibility.
- Quasi-infinite debt investment is available, as long as we fix our mistakes on the Bond-Currency-Derivatives Nexus.
- Rupee denominated debt must emerge as a second Indian asset class that is globally welcome.
- Currency risk is placed on the investor.

The only way to get to $1 trillion of investment is to tap into these vast pools of capital.
Not much can be done to change the cost of steel and cement that goes into a project.

The main raw material for an operating assets company is: Capital

If the cost of capital comes down, the user charge goes down.

How to get a lower cost of capital? Reduce the risk.

*Make operating infrastructure boring*

“Utilities” – low beta, low risk, low action.
How to reduce the risk of equity and debt of utilities

- Sound independent regulator which the private sector will trust
- Bond-Currency-Derivatives Market development so as to get to 30 year corporate bond issuance.
- Trust in the rupee – credible inflation targeting.
- Capital account convertibility – remove the risk of future capital controls.
- Get up to the orthodoxy:
  - Remove financial repression
  - Floating exchange rate
  - Inflation targeting
  - Modern financial regulation
  - No capital controls
  - Get comfortable with larger current account deficits
State: VC, Owner, Developer

EPC to private firms

Build
EPC to private firms

State: VC, Owner, Developer

State: Operator, Regulator

Build

Prove

EPC to private firms
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State: VC, Owner, Developer

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Operating infrastructure companies

Build

Prove

Operate
EPC to private firms
State: Regulator
State: VC, Owner, Developer
State: Operator, Regulator
Operating infrastructure companies
Public market
Equity
Debt
Domestic
Foreign
Build
Prove
Operate
How to solve the logjam

- Let us assume the operating assets side starts working well
- The public market will bid up the value of operating assets
- That creates visible exit opportunities for projects under development
- Entrepreneurs and government agencies will see opportunities in solving the last x% of the barriers, finishing a project, and selling it off.
The financing question

- If government is to be the VC for incubating projects until they work, does this call for a great surge of fiscal deficits?
- No, all we have to do is sell existing operating infrastructure assets in the hand of government.
- Vast portfolio of power plants, highways, trains, planes, etc. which can be sold.
- Government as VC will score a 2x return over 5 years.
- In a few years, the money coming in from exits will keep the process going.
Reorientation of government

- Public policy should be classified as Planning, Contracting and Regulating.
- E.g. NHAI did planning and contracting.
- There is value in pulling together related kinds of infrastructure e.g. ports and railway lines. An agency structure:

<table>
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<tr>
<th>Energy Ministry</th>
<th>Transportation Ministry</th>
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<tr>
<td>(Corporate Governance)</td>
<td>(Corporate Governance)</td>
</tr>
<tr>
<td>National Energy Agency</td>
<td>National Transportation Agency</td>
</tr>
<tr>
<td>(Planning and contracting)</td>
<td>(Planning and contracting)</td>
</tr>
<tr>
<td>Energy Regulator</td>
<td>Transportation Regulator</td>
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</table>

- This requires an FSLRC-style law to setup the regulators and ensure they work properly.
Work required in parallel

- The rest of the environment has to improve!
- Bankruptcy code, Land acquisition, Judiciary, etc.
- We should push on all those fronts.
- As and when this progress comes about, government as VC and Developer will reap the benefits.
Let’s get the foundations right

- If the underlying incentives are not correct, we have to go solve these
- Let us not inject steroids in the corpse:
  - Development financial institutions
  - Forcing banks to buy infrastructure assets
  - Surge in fiscal deficit
  - Specialised “infrastructure debt funds”
  - Tax exemption.
- None of these are big enough to shake the needle: $1 trillion is a scary big number.
- The only way to get to $1 trillion is to get the incentives right, and tap the vast global financial system.
- Let’s privatise / close down IDFC, IIFCL, REC, PFC, “IDF” framework; let’s remove tax exemptions; etc.
Thank you.