Inside the investment rush in operational infrastructure projects

Source: BloomberQuint

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India's infrastructure sector has witnessed a steady increase in investor interest over the recent past, especially in operational renewables and road projects. To put things into perspective, 35 percent of all private equity and venture capital investments in the first eight months of 2019—which has already surpassed the all-time high recorded in 2018—is focused on large infrastructure projects. Road deals worth an estimated Rs 13,000 crore or $1.8 billion have been announced in the first six months of the present fiscal year.

Several factors have contributed to heightened investor appetite. From an investors' perspective, such projects are free of construction and pre-development risks and offer a low-risk moderate-return profile, while developers (both government and private sector) can monetise existing assets, potentially to pare debt or raise fresh capital. It is interesting to note that a significant portion of investor interest is presently focused on road sector projects. As an example, Canadian pension fund manager CPPIB-backed infrastructure investment trust IndInfravit Trust announced in July 2019 that it is acquiring nine operational road assets from Sadbhav Infrastructure Project Ltd. for Rs 6,610 crore, IRB Infrastructure Developers Ltd. announced that GIC is investing R 4,400 crore in its road platform and Edelweiss too acquired two roads this year for around Rs 1,000 crore.

The catalysts:

While the government's decision a few years back allowing highway developers to divest up to 100 percent stake in projects has been instrumental in breathing fresh life into this sector, the enhanced investor activity is driven by several factors, such as:

- Predictable cash flows over a significant duration, which is critical in driving pension fund interest, who typically prefer longer-term cash yields over short term capital gains,
- Large portfolio of projects enabling the bigger institutional investors to invest at scale,
- The relatively mature profile of the road sector when compared with infra peers such as airports and renewables, for example, etc.

The relatively lower risk of revenue being impacted through adverse government action—as happens in renewables and power projects—and a progressive revenue structure of road projects, where returns are enhanced over the concession life, are equally important considerations.

NHAI's HAM and TOT success:

The widespread adoption of the 'Hybrid Annuity' and 'Toll Operate Transfer' models by the National Highways Authority of India have also contributed immensely to the development of road sector projects in the country.

HAM, introduced by the Ministry of Road Transport and Highways in 2016, has triggered additional inflows of investment in highway projects by providing for government funding during the construction phase and reducing the equity burden on, and financing risks of, the concessionaire. Although the private party continues to bear the risks associated with construction and maintenance, the financing risk is partly borne by the government, which ensures higher liquidity during the project.

To date, over 100 road projects covering more than 6,600 kilometres have been awarded on HAM, with around 70 percent projects achieving financial closure.

Similarly, NHAI's TOT model has been a catalyst in monetising the operational public-funded national highway projects. Under the TOT model, highway projects are put up for bidding and toll collection rights are assigned for 30 years to the successful bidder or developers against upfront single payment to NHAI of a lump sum amount. Operation and maintenance obligations for the projects are assigned to the private developer during, and till the completion of, the concession period.

The TOT model not only ensures efficient toll collection by involving the private sector and reducing post-construction involvement of NHAI in road projects but also promotes investment by institutions who are interested in making long term investments but do not wish to undertake construction risks.

Till date, NHAI has successfully auctioned two rounds of road monetisation programs to two prominent international investors – Macquarie Group of Australia and Cube Highways of Singapore (which is backed by IFC and I Squared Capital), with the resultant investment amounting to one of the largest FDI in public infrastructure in India.

Given its success, the Cabinet Committee on Economic Affairs recently approved an amendment to the TOT model which allows for the monetisation of public-funded highways one year after they are operational, reducing the earlier operationalisation period of two years to further encourage increased participation of institutional investors in national highways projects.

Additionally, NHAI now has the authority to determine the concession period of projects—between 15 and 30 years—as opposed to the earlier fixed concession period of 30 years.

A reduced concession period allows investors to assess sectoral challenges, including risks and returns, and will help attract institutional investors who have traditionally had a low exposure to infrastructure projects in India. Around 75 operational projects, in 10 separate bids, have been identified for potential monetisation.

IBC-led investments:

India's Insolvency and Bankruptcy Code has also been a significant driver by instilling a sense of urgency among all stakeholders to resolve bad loans. The availability of projects for investment has indeed been positively impacted by the developments pertaining to the IBC, which have opened up a bouquet of investment opportunities in stressed road assets. While IBC can generate competitively valued inorganic growth opportunities for investors, companies bidding for distress assets will have to ensure that valuations are ring-fenced and liabilities are a bare minimum. Similarly, actions by certain state governments to renegotiate PPAs and large infrastructure and renewables projects – as was discussed in the last article in this column – will help in investors looking even more favourably at the roads sector.

Looking ahead, this sector is expected to demonstrate continuing transaction activity. While domestic market sentiment, tight liquidity, and other economic factors will impact investment in new projects, seasoned investors – especially buyout, sovereign, and pension funds – are likely to continue to invest in yield-generating assets either directly or through alternate structures such as InvITs.