



# **Session 3: Regional Bond Market for Infrastructure – Prospects and Opportunities for Asia-Pacific: *India – Emerging Bond Market: Experience and Lessons Learned***

**Strengthening Private Sector Participation and Investment in Physical Infrastructure, ADBI**

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## Characteristics of Indian Bond Markets

- > In terms of outstanding issued amount, Indian debt market ranks as the third largest in Asia, next only to that of Japan and South Korea.
- > According to the estimates of the Bank for International Settlement (BIS), the size of the India's corporate bond market was a mere 0.3 % of the nominal GDP in December 2003 – well below those of Malaysia (43.3%) or South Korea ( 27.7%).
- > Government accounts for more than 75% of total debt issuance in the Indian bond market
- > Private placements dominate public issues
  - Banks, Financial Institutions and Public Sector Undertakings are major issuers
- > Private sector accounts for only about 20% of debt raised
- > Low retail participation



## Characteristics of Indian Bond Markets

- > Limited secondary market activity
  - Only 3% of trading is in corporate debt while the bulk of the activity is concentrated in gilts
- > Over a ten year period ending FY05, municipal bond issuances were just eleven and garnered some INR 8.5 bn only
- > Hardly any appetite for lower rated instruments
  - Over 90% of issues are rated AA or above while less than 2% of the issues are rated in the BBB category
- > Banks, who form the majority of the class of institutional investors by amount in corporate debt paper, adopt an asymmetric credit evaluation methodology when they are willing to provide loan to a client but unwilling to invest in the debt paper issued by the same borrower if the debt paper is not rated very highly by the rating agencies.



## Historical Perspective – Key Observations

- > Over the years, a very limited number of entities have accessed domestic bond markets for infrastructure financing
  - These have been predominantly by way of private placement of bonds to select institutional investors (mainly Banks and Provident Funds); partly driven by regulatory investment allocation criteria
  - Public offerings have been even more limited in number
- > Issuers predominantly state-owned corporations
  - Some of these suffer from the weak credit quality of the state governments that are either a counter-party or guarantee the debt service or both



## Historical Perspective – Key Observations

- > Aggregate amounts raised (Fitch estimates this to be less than INR 500 bn) is a miniscule percentage of the total funds invested in infrastructure
- > Several of the issuances have been credit enhanced – mainly by government guarantees and structured payment mechanisms
- > Classical project finance issuances very negligible
- > Tenors have generally not exceeded 10 years
  - In many cases, maturities have been 5-7 years and /or put & call options exercisable at the end of say, 3, 5 or 7 years
- > Not much secondary market trading activity in these bonds – liquidity a concern



## Categories of Issuers

- > Electricity Boards
- > Irrigation Corporations
- > Finance Companies – some raising resources for on-lending to infrastructure projects; others for many other types of lending as well such as corporate loans
- > Urban Local Bodies and parastatals
- > Industrial promotion boards
- > Private sector developers / operators (very few in number)



## Private Sector Bond Issue – Case Study

- > **Viramgam Mahesana Project Ltd.** (“VMPL”) is an SPV set up to implement the conversion of c. 82 km railway track between Viramgam and Mahesana stations in Gujarat from meter gauge (“MG”) to broad gauge (“BG”) for Western Railway (“WR”) on a BOT basis
- > Project Sponsors - a consortium of DS Construction Ltd (“DSCL”), Tantia Construction Company Ltd (“TCCL”) and Vogue Construction and Consultancy Ltd (“VCCL”)
- > Indian Railways (IR), as part of its efforts to involve the private sector, bid out this project through WR; the lowest quote of fixed semi-annual access charges was the key bidding parameter



## Private Sector Bond Issue – Case Study

- > Original cost of the project, INR899 million, was financed with a debt/equity mix of 2.33:1, the overrun of INR100m being funded by capital account creditors
- > 13.5 year concession including 18 months for design, engineering, finance, and construction of the project
- > The concession entitles VMPL to receive fixed semi-annual payments of INR79.6m each in advance towards access charge for a period of 12 years from the COD
- > O&M responsibility with the IR, but concession provides for a 120-day defect liability period from the COD, and a maintenance liability period of 12 months thereafter, during which time VMPL is responsible for costs due to defective material and poor workmanship



## Private Sector Bond Issue – Case Study

### Key Project Milestones

Sl	Activities	Date
1	Letter of Acceptance	27 Dec 2002
2	Award of EPC Contract to DSCL	7 Mar 2003
3	Signing of the Concession Agreement	23 May 2003
4	Scheduled Date of Completion	27 Jun 2004
5	Actual Date of Completion (PVC)	25 Oct 2004
6	COD/CRS Inspection- Actual	2 Dec 2004
7	Defect-Liability Period/Performance Certificate	31 Oct 2005
8	Maintenance Liability Period/ Completion Certificate – Revised	31 Oct 2006
9	Scheduled Payment of First Annuity	30 Jun 2004
10	Actual Payment of First Annuity	31 Dec 2004
11	Annuity Payments Received	3

Source: Company



## Private Sector Bond Issue – Case Study

- > VMPL planning a INR 950 mn bond issuance for:
  - refinancing the existing debt of INR630m
  - with the balance being used for investments in other infrastructure entities of the DS Construction group
- > Key credit strengths
  - Fully mitigated construction risk
  - Fixed semi-annual revenue stream from the Indian Railways, Government of India
  - Completion of defect liability period
  - Crystallisation of liabilities relating to delay in project implementation
- > Key take-away:
  - Bond market presenting a good option for refinancing once the construction risks were fully mitigated after the initial funding was obtained through bank loans



## Emergence of Innovative Financing Structures

- > Use of escrow funds and structured payment mechanisms for ensuring timely debt service
- > Lower default risk by pooling municipal loans
  - Reduce dependence on state guarantees
- > Independent bond trustees with an important transaction oversight role to protect bondholders' interests
- > Various types of public-public and public-private partnerships can be used to attract private capital for infrastructure projects



## **Case Study # 1: How to Make a Debt Guarantee Credible Maharashtra Patbandhare Vittiya Company (“MPVC”) Limited**

- > Many examples throughout Asia of state-created and -owned agencies or corporations that issue debt which is guaranteed by a parent government.
- > However, rating distinctions between straight government debt and government-guaranteed debt can arise due to differences in a local government’s public accountability, budgetary process, administrative controls, and statutory or contractual debt arrangements
- > In the case of MPVC’s (rated by Fitch at BBB(ind)(SO)) bonds, the guarantee from the government of Maharashtra is further supported by a tripartite agreement between the government, the trustees and MPVC, in which the government has a contractual obligation to provide annual budgetary provision for all the debt service payments of MPVC.
- > MPVC itself is a SPV with no operational role other than raising funds and equitably distributing them to various entities executing irrigation projects throughout the state.
- > This avoids the risk that funds provided for debt service could be diverted to another end-use. It also eliminates commingling risk, which was a problem for some earlier irrigation company bond issues, resulting in delays in payments to bondholders.
- > The existing arrangements are contractual and a stronger security could be made with statutory authorization.



## **Case Study # 2: Securing Debt for a State Corporation With Operational Responsibility Maharashtra Jeevan Pradhikaran (“MJP”)**

- > Like MPVC, MJP has a tripartite agreement.
- > Its initial series of debt was rated (BBB(ind)(SO)) one notch below the debt of MPVC, owing to MJP’s operational role, which created a slightly higher risk that funds meant for debt service payments could be diverted.
- > MJP is responsible for conceiving, preparing and implementing water supply and sewerage schemes in urban and rural areas throughout the State of Maharashtra, with the exception of Greater Mumbai.
- > As a statutory body of the government of Maharashtra (“GoM”), it also acts as advisor to the state and to local urban entities on water and sewerage planning, operations and training matters. MJP receives budgetary support from GoM, which it leverages in the form of bond issues to accelerate the construction of local government water and sewerage projects.



## **Case Study # 2: Securing Debt for a State Corporation With Operational Responsibility Maharashtra Jeevan Pradhikaran (“MJP”)**

- > In January 2005, MJP further tightened the structure for its upcoming Series XII bonds, opening a designated escrow account for the new series with a bank mutually agreed upon by both MJP and the trustee.
- > This structural enhancement did not affect previously outstanding debt series. In terms of the cash flow management for the full and timely payment of debt service, a contractual process has been established whereby MJP notifies the appropriate state government departments of an upcoming payment requirement three months in advance of the actual payment date. MJP credits payments received from GoM to the designated escrow account.
- > This series was rated BBB+(ind)(SO)



## **Case Study # 3: Using Trustee Relationships to Maximize Full and Timely Payment Karnataka State Financial Corporation (“KSFC”)**

- > Established under the State Financial Corporation Act of 1951
  - manages loans to small and medium enterprises (“SMEs”) in the State of Karnataka.
- > KSFC is an arm of the government of Karnataka (“GoK”) and its board, mostly comprising GoK officials, has approved the bond issue, which has been guaranteed by GoK under a government order.
- > KSFC established a designated, trustee-held account for the repayment of its debt service under the terms of its financing agreement.
  - The trustee is required to monitor the balance in the designated account and notify KSFC of any shortfall in funds at least 15 days prior to a debt service payment date.
  - KSFC must ensure that the designated account contains the scheduled debt service amount at least seven days prior to the payment date. The agent bank confirms the adequacy of funds in this account by sending notice to the trustee.
  - In the event of a continuing shortfall seven days prior to the payment date, the trustee notifies the finance department of the State of Karnataka to transfer the required funds into the designated account.
  - The state is required to make this transfer at least five days prior to the payment date. The trustee confirms receipt of this payment and makes debt service payments to the investors three days prior to the payment date.



## **Case Study # 3 (Contd.): Using Trustee Relationships to Maximize Full and Timely Payment Karnataka State Financial Corporation (“KSFC”)**

### **> Special Note on Bond Trustees**

- The trustee’s role is of great importance as it oversees:
  - > adherence to the segregation of accounts,
  - > the flow of receipts into these accounts,
  - > the actual debt service repayment and notification mechanisms, and
  - > the procedures for investor remedies in the event of default.
- Trustees in India have by and large evolved into effective organizations in the past few years and a few of them have become specialists in this field.
  - > However, Fitch has come across instances where trustees have not necessarily measured upto the standards expected of them
- Typically, a large financial institution/bank sets up a trustee arm that caters to the demand for trustee services, although in some cases the banks themselves may provide such a service.



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