Pushing the funding boundaries

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Indian construction and engineering major Larsen & Toubro pulled off the first external borrowing for an Indian roads BOT concession in September. The deal also broke tenor and debt-to-equity ratio records for an Indian project – 16.5 years and 9.09 respectively.

The financing is symptomatic of both the growing standing of the sponsor in the international debt market and a highly structured approach to long-term financing for infrastructure projects.

Lead arranged by Citigroup, the deal comprises a US dollar equivalent Rp500 crore 50/50 mix of domestic FCNR (foreign currency loans) and external commercial borrowing for L&T Interstate Road Corridor, an SPV floated by Larsen & Toubro (L&T) for the 76km Palanpur-Swaroopganj road project.

The debt priced at around 150bp over Libor and banks that joined the deal were India Infrastructure Finance Company Limited, Bank of Baroda and Abu Dhabi Commercial Bank. Citigroup also acted as the escrow agent.
L&T has an option to convert the FCNR portion of the loan into a rupee loan after three years when it would be benchmarked against three-year government securities. L&T corporate treasury is putting up forward cover on the forex borrowing.

The template is likely to be repeated given L&T's expansion plans. The company is performing strongly – shares have risen 55.8% this year, outperforming the Mumbai market's 42.6% rise, and L&T expects to double its annual revenue by 2010. This year alone L&T will be raising finances for its various SPVs to the tune of Rp7000 crore ($1.55 billion).

Growing sponsor role

L&T started sponsoring projects in 1997 – although it has been an EPC contractor for 60-plus years. The company has 37 projects at various stages of development – financial closure, construction, operation and some close to end of their concessions. Of that portfolio 11 concessions are in roads & bridges, 17 in urban infrastructure (IT parks, residential and commercial space), 3 in ports and berths, 3 power projects, 1 in water supply and 1 in airports (India's first public-private-partnership (PPP) greenfield airport financing – Bangalore International) with equity stakes ranging from 10% to 100%.

L&T has plans for significant expansion into infrastructure and given its dual role of EPC contractor, it has a competitive advantage over banks and investment funds. The company looks for a 20% return of contracting net worth on its EPC deals and 16-18% IRR on equity investments, with investment and EPC decisions made by separate committees.

Yeshwant Deosthalee, CFO at Larsen & Toubro, is also a fan of private participation in Indian infrastructure: "It is well established and policy reforms and regulatory frameworks are continuing to evolve enabling developers to conceive viable BOT projects that are bankable. Project financing is also well established with banks comfortable with non-recourse structures."

Funding options

But despite the growing maturity of the Indian infrastructure market there are problems with diversity of funding. "At present the main source of funding is commercial banks. Earlier there were large development finance institutions such as IDBI and ICICI which have since converted into banks. This puts severe limitations on both the quantum of long-term funds and tenors due to asset liability mismatch in commercial banks. Furthermore, the group/single company exposure norms may limit bank funding of large infrastructure projects," adds Deosthalee.

Given the capital markets are not ready for Indian project bonds, or even bond refinancings, the options appear limited – hence L&T's ECB template. "We may have to look at further ECB as funding needs increase," concedes Deosthalee.

But ECB has its drawbacks. "ECB is a feasible funding source but international lenders have not exhibited large appetite for funding infrastructure projects and, due to long tenors, the currency hedge is either costly or unavailable and most infrastructure projects have no natural hedge through Forex denominated revenue. In addition, ECB is not permitted by the regulator (Reserve Bank of India) for refinancing. Were such deals allowed they would carry lower risk and it would be easier to attract international lenders.

"In the immediate future there is no threat but if the rate of growth of investments in infrastructure continues at current pace and accelerates further this may become an issue. The situation may become more difficult as the project sizes become much larger – the Ultra Mega Power project for which the first bids have just been opened is a case in point.

"As far as project financing is concerned we have a large portfolio and we go for the best deal in the market – there are no favourites. Each case is different and appetite of banks is also different. All the top 10 banks have participated in funding our various projects and many of them have acted as Lead Bank (SBI – Vadodara Bharuch Toll Road, Dhamra Port – IDBI Bank, Bangalore Airport – ICICI Bank)," explains Deosthalee.

Despite the hurdles, Deosthalee is still bullish about funding development: "Project financing is maturing in India – despite all the limitations. Earlier there was a simple equity and senior debt structure. Lenders have evolved this into equity plus senior debt plus subordinated debt. So our financing options are expanding. There are also a few cases of take-out financing structures as well as refinancing through securitization of future revenue receipts. Besides instrument structures, project financing has also looked at floating versus fixed rates, foreign exchange denominated rates, resets without commitment charges and so on.

"We have innovated further than this and introduced mezzanine capital (to be contributed by investors/promoters) which helps to enhance equity returns and also provides for a conduit for cash up-streaming (under certain terms and conditions acceptable to lenders). We have also introduced certain innovations in the transaction structures for both project SPVs and Sector Holding Company level as illustrated by the L&T Interstate project (see box)."

The growing trade between the Gulf and India is a further potential funding source – but Deostahlee says it is early days. "There is a growing demand for construction exports to many gulf countries and we have a large presence there. However the flow of project financing for projects in India has just begun and the initial interest is in property and real estate – though some Gulf banks came into our L&T Interstate road financing."

EPC growth and risk

According to Deosthalee the EPC side of the business is growing as fast as the concessions side. And with EPC demand outstripping supply in markets like the Gulf, L&T is in a strong negotiating position. But at a time when most EPCs are demanding contracts and pricing that are heavily in their favour, Deosthalee remains open-minded about how much and what type of EPC risk L&T will take.

"We take these decisions on a case-to-case basis. We have taken different positions at different times taking full price/time risk (fixed lump-sum price/time) on one end and cost-plus arrangements at the other end. This partly depends also on the customer's unique requirements.

"Can projects sustain growing EPC costs and margins? There are two different issues here – the first is a general escalation of costs due to inflation, escalation of raw material, wages, etc. This is easily addressed by passing on the costs to the extent possible to end user of the infrastructure facility. The second issue is related to demand-supply gap in availability of construction services, especially for large and complex projects. This is certainly an important concern for most developers. For us that is a competitive advantage due to our tremendous strengths in turnkey construction capability.

"Some of our large customers are also developers but they do rely on L&T's construction capability to execute their BOT projects. Consequently we treat these two (BOT and Construction) as different businesses," says Deosthalee.

L&T is also looking for significant growth from the power sector: US Congress has just passed a nuclear cooperation bill with India which aims to grow nuclear capacity from its current 3,500MW output to 30,000MW over the next 20 years.

"The demand – supply gap is considerable, the regulatory direction is clear and without power the country cannot achieve its growth targets," says Deosthalee. "Therefore power projects have to happen. We are keen to develop power projects. We already have considerable strength in EPC and now have also tied up with Mitsubishi for joint development of boilers."

L&T, in partnership with Everest Bank, is currently bidding for three major hydropower projects in Nepal – the 300MW Upper Karnali in the north, the 402MW Arun III in the mid-west and the 600MW Budi Gandaki – and is also one of 11 bidders for the Ultra Mega Power projects for Sasan and Mundra in India (10 requests for proposals have been submitted for the Sasan project and six for the Mundra project with L&T going for both).

L&T Interstate