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PE investments in infrastructure

IT IS now widely acknowledged that India's physical infrastructure may need over \$1 trillion of fresh investments over the next 8-10 years for it to achieve a steady state GDP growth of 8-9% per annum. Considering the need for fiscal consolidation and the government's enhanced focus on social sector spending, a bulk of the fresh investment in infrastructure may need to be brought in by the private sector either directly or under the PPP route. The private sector has already made deep inroads into the power, roads and seaports sectors where a large part of new investments are being funded through private capital and, if the government plays its cards well, airports, railways and urban transportation could be the next big investment catalysts.

Having emerged relatively unscathed from the financial crisis, a host of private infrastructure developers in India are now looking to significantly grow their presence in existing sectors and diversify into new ones. A few global infrastructure development companies have also stepped into the country and are now bidding for greenfield projects in partnership with domestic developers. This trend is likely to be accelerated further and FDI in infrastructure may assume more meaningful proportions in the coming years. That said the country would still need a significant quantum of additional private capital, not all of which may possibly be met by public capital markets.

Private equity has the golden opportunity to bridge a part of this resource gap and provide growth capital to private infrastructure developers for expanding their business and become more valuable from a public capital market perspective over the next 3-5 years.

India's perception amongst international investors in private equity funds has significantly improved over the past few months. Recently announced big-ticket deals like the investment of \$425 million by a group of global and domestic private equity investors in Asian Genco and Rs 930 crore by Temasek in GMR Energy, apart from several other deals currently being negotiated, are clear

GUEST COLUMN

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- India's physical infrastructure may need over \$1 trillion over the next 8-10 years to post a GDP growth of 8-9% per annum
- The perception among global investors of Indian PE market has significantly improved over the past few months
- We could well do with more pure-play specialist infrastructure funds with long-term investment horizon

sign that investor confidence in the Indian infrastructure market has revived.

Another key development in the Indian PE market is the rising presence of sell-side intermediaries in deal closures. Although most funds would still like to cut bilateral deals, the promoters are now increasingly seeking intermediation from investment banks to run a process and have funds compete for participation. Even from the funds' perspective, intermediation by investment banks opens up opportunities which may otherwise be difficult to bilaterally access considering the small teams most funds operate with. **Valuation mismatch:** High return expectations of funds, however, remains a key obstacle with most funds still looking for returns well north of 20% per annum—at least 300-400 basis points higher than levels seen in 2007, before the financial crisis hit the world.

On a cash-in, cash-out basis, most infrastructure projects, either due to regulatory

limits on returns or competitive pressures, are unlikely to generate such high equity returns even if the investments are made at par. An exit through listing in favourable market conditions during which the market uses much lower discount rates to price the issue is perhaps the only way in which investors can hope to make such returns. Given the significant valuation mismatch between investors and issuers, most of the deals are currently being structured as convertible instruments with conversion ahead of the IPO. **What India needs:** India could well do with more pure-play specialist infrastructure funds with long-term investment horizon and reasonable return expectations (in the mid-to-late teens). This may attract infrastructure developers who would otherwise consider listing themselves, most of them somewhat prematurely, and raise capital even at the cost of higher dilution.

SPV-level investors in greenfield projects: Most PE as well as infrastructure funds are currently focused on entity-level deals with a mix of operational, under implementation and under development projects with clear visibility of an IPO in the next 3-4 years which provides them an exit opportunity. While a couple of SPV-level investors are currently operating in the country, there is room for more such players. Internationally these funds list themselves to provide an exit opportunity to their investors without the fund having to exit the underlying investment through an IPO or otherwise.

Yield investors: These investors typically look to invest in operational projects with stable cash flows and expect yields in the mid-teens, enabling sponsors to take out capital from mature assets and use it as growth capital to develop more Greenfield projects and create value. Some offshore investors are already eyeing this segment in India and more investors will likely step in once the universe of commissioned projects reaches a critical mass over the next 2-3 years.

(The author is executive director & head of infrastructure group, Kotak Investment Banking. Views are personal.)