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A PARADIGM SHIFT IN THE PATTERN OF FINANCING THE INFRASTRUCTURE SECTOR OF INDIA- RISE OF PRIVATE EQUITY INVESTMENTS

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ABSTRACT

A robust physical infrastructure is a pre-requisite to achieve a sustained growth rate and creation of such infrastructure requires mobilization of funds for financing such projects. Emphasis on private sector participation to attract private capital in emerging economies like India cannot be undermined in contributing towards the availability of finances for the huge infrastructure investments along with budgetary and government funding. There are credible reasons to believe that the private equity market as a component of private capital would make an important contribution in this endeavor. The paper is an attempt in the direction to analyze the paradigm shift in pattern of financing of the infrastructure projects in India. The main objectives of the paper include analyzing the trends of private equity investments in the infrastructure sector of India from 2001-2010. Besides, it also examines the push and pull factors attracting private equity investments in the infrastructure sector during the period of study. The researchers trust that the findings of the paper would provide ample background for helping the policy makers identify practical solutions to concerns holding back investments in the infrastructure sector. The study is primarily based on secondary data collected from specific databases such as Venture Intelligence and EMIS. The collected data will be analyzed with the help of appropriate statistical tool as per the requirement of the study.

Keywords: Infrastructure, Paradigm Shift, Private Capital, Private Equity

I INTRODUCTION

Infrastructure is a cornerstone of a stable and productive society.The manner in which our country responds to meeting the Infrastructure Financing needs is likely to define the growth path for its GDP growth as well as its relative growth in the region and in world economy.

As India opened up infrastructure sector for private sector participation in its Eleventh Plan, there has been a paradigm shift in the trend of financing with a large pool of private investment coming in over and above the government allocation. Several of the Indian infrastructure companies participated in the development bid of the

Government which resulted in increasing investment from private players and attracted global investors and private equity funds to form India infrastructure focused funds to reap the benefit of the India growth story.

However, the domestic Infrastructure funding and financing is in a period of flux. The lack of depth in the financing market, lack of innovation in financial instruments, slow development of alternate sources of finance as well as project quality have continued to remain the top Industry challenges over the last decade. Private equity has emerged as an important class of investment within the financial system in India, yet it is nowhere close to the developed country average exposure.

II OBJECTIVES OF THE STUDY

Investments in the infrastructure sector being crucial for claiming the country's future growth and with rise in private equity investments in India and companies forming partnerships with private equity firms on a large scale, the present study has been undertaken with the following clear objectives:

1. To analyze the shift in investment trend that has happened over the years in infrastructure spending in India
2. To understand the projected level of investments that Government has envisaged in the next five year plan
3. To evaluate the funding gap arising from the present level of commitments from the private sector and the Government exchequer
4. To assess how Private Equity and other means of alternate finance could be tapped to fund this gap by examining the past trends in PE investments in the sector and to identify the sub-sectors which have been successful in playing a dominant role in attracting PE investments, and
5. Recommend the road ahead

III REVIEW OF LITERATURE

The alternate investment asset class has attracted the attention of many researchers after the 1980s. Some major studies which have been undertaken in this area nationally and internationally has been quoted here. A large literature investigating the economic effects of buyouts, mainly focused on the U.S. in the 80's and 90's, have generally demonstrated a positive impact of this new form of corporate organization, measured by increased profitability and productivity of the investee company. [**Kaplan[1] (1989); Lichtenberg and Siegel[2](1990); Muscarella and Vetsuypens[3] (1990); Palepu[4] (1990); Smith[5] (1990); Wright et al [6](1992)**]

[1]Kaplan (1989) The effects of management buyouts on operating performance and value. Journal of Financial Economics
[2] Lichtenberg, F. Siegel (1990) The effects of leveraged buyouts on productivity and related aspects of firm behavior. Journal of Financial Economics
[3]Muscarella, C. and Vetsuypens, M. (1990) Efficiency and Organizational Structure: A study of Reverse LBOs. Journal of Finance
[4]Palepu, K.G., 1990. Consequences of leveraged buyouts. Journal of Financial Economics
[5] Smith, A.J., (1990) Corporate ownership structure and performance: the case of management buyouts. Journal of Financial Economics
[6] Wright, M., Thompson, S., Robbie, K. 1992. Venture Capital and Management led Leveraged Buyouts: European evidence. Journal of Business Venturing

A central hypothesis since **Jensen**[7] **(1989)** has been that private equity has the ability to improve the operations of firms. By closely monitoring managers, restricting free cash flow through the use of leverage and incentivizing managers with equity, it is argued, private equity-backed firms are able to improve operations in the firms they back. In this study, Jensen suggested that these leveraged buyouts (LBOs) may not only affect the bought-out firm itself but may also increase competitive pressure and force competitors to improve their own operations. The claim that private equity-backed firms have improved operations has been supported by a number of empirical studies, which focus on the effects on the individual private equity-backed companies. **Kaplan (1989)** examined changes in accounting performance for 76 large management buyouts of public companies between 1980 and 1986. He showed that in the three years after the transaction operating income, cash flow and market value increases. He argued that these increases reflect the impact of improved incentives rather than layoffs.

Impact of Private equity and Venture Capital on Indian Economy[8] **(2007)** revealed that private equity-backed companies grew at a significantly higher rate compared to non-private equity backed companies as well as to market indices like the Nifty and CNX Midcap in terms of key economic parameters like Sales, Profitability, Exports, Wages and Research & Development in the business process outsourcing, pharmaceuticals and telecom sectors of India for the period 2000 to 2005. **A study conducted by KPMG in India**[9] **(2008)**, found out that India was one of the emerging markets for private equity investment in Asia-Pacific and the reasons for its attractiveness were: (a) entrepreneurial status (b) ease and benefits of English speaking culture (c) an investment base that truly understands the multiple opportunities for private equity and lastly (d) a developing infrastructure with strong underlying economic growth. The survey revealed that there was a growing acceptance of private equity as an alternative source of capital by owners of businesses although large business houses and groups have yet to embrace this source of capital.

The Indian market for private equity remains very positive with Infrastructure, Retail and Consumer related Media and Financial Services being sectors of focus going forward. Portfolio companies' expectations of private equity have increased and they expect private equity to help facilitate growth and improve corporate governance. Private equity houses would need to consider setting up operations teams, in addition to deal teams to add more value to their portfolio companies. Portfolio companies currently perceive that private equity houses need to add more value post-investment. A survey was jointly conducted by **KPMG and Stanford University's Shorenstein Asia Pacific Research Centre**[10] **(2009)** to study the impact the global financial crisis on private equity in India and their findings were presented in the report titled **'Private Equity Reshaping for Future Success'.** According to this report India offers immense opportunities for private equity investments and India will likely be at the forefront of a global private equity recovery. The coming months should be viewed as an opportunity to build value in portfolio firms, and show that private equity is an integral part of India's future. The private equity environment in India has fundamentally changed post the credit crunch. Gone are the days of

[7] Jensen, M., (1986) Agency cost of free cash flow, corporate finance and takeovers. American Economic Review
[8] Venture Intelligence, (2007) report on Private Equity Impact- Impact of Private Equity and Venture Capital on Indian Economy
[9] KPMG, Private Equity Investing in India (2008)- A Survey of Private Equity investor and their Portfolio Companies
[10] KPMG and Stanford University (2009) report, Private Equity Reshaping for Future Success

making money by investing in pre initial public offer (IPO) and private investment in public equity (PIPE) transactions and riding out on increasing valuations on the Indian stock market. To achieve the desired returns of 25 percent or more, private equity firms are going to need to work closely with their portfolio companies. According to a study by **KPMG and Confederation of Indian Industries[11] (2010)**, few companies that have received private equity investment were shortlisted and interviews were conducted both for the company as well as the private equity firms to get their inputs on the value addition provided by the private equity firms and the manner in which private equity has impacted their business besides just providing capital. Findings indicated the broad range of areas where the private equity firms influence their portfolio companies and bring resultant benefits include advice on business strategy, enhancing corporate governance, helping in brand building, scaling companies domestically and internationally, funding new and innovative business models and helping professionalizing the organization.

A study conducted by Deloitte and ASSOCHAM in India[12] (2013) discusses the paradigm shift in the pattern of financing in the infrastructure financing in India and analyses some innovatice financing options to meet the huge investment demand.

IV RESEARCH METHODOLOGY

The present study is exploratory in nature and is primarily based on secondary data collected from public sources of information, specific database such as EMIS and Venture Intelligence, as the data related to private equity is not freely available in public domains. Besides, the secondary data has also been collected from other sources like business journals, research papers, consulting companies' publications and thought leadership papers for the purpose of the data analysis.

The study will examine the private equity inflow in India from 2001-2010 and compare the private equity investments in seven sub sectors of Energy and Infrastructure namely:

i. Power & Allied (Power)
ii. Oil & Gas (O&G)
iii. Heavy Construction (HC),
iv. Transportation and Logistics (Logistics),
v. Water and Waste Treatment (W&W),
vi. Cement, and
vii. Telecommunication & Wires (Telecom)

The data has been collected for the period from 2001-2010 on two major aspects of private equity which are volume and value of deals in the sub sectors of Energy and Infrastructure sector of India. This period has been deliberately been chosen as it includes an upward and downward cycle in the economy and maximizes the number of companies taken for comparison. The collected data has been analyzed with the help of tables, bar diagrams, and graphs.

[11] KPMG and Confederation of Indian Industries (2010) report, Enabling Growth in Promising Indian Companies- The Positive Power of Private Equity

[12] Deloitte and ASSOCHAM (2013) report, Funding the Infrastructure Investment Gap

V PARADIGM SHIFT IN INFRASTRUCTURE FINANCING

The Government of India has set a massive target for doubling investment in infrastructure from Rs.27 lakh crores (eleventh plan – 2011/12 prices) to Rs 51 lakh crores during the twelfth plan period, i.e., 2012–2017 to boost the country's slowing economy.The share of infrastructure investment in GDP is planned to be increased to more than 10%by the end of the twelfth plan. This investment, if it materializes, can propel India's economic growth to a higher trajectory. It was not so long ago that infrastructure investment in India was financed almost entirely by the public sector— from government budgetary allocations and internal resources of public sector infrastructure companies.

However lately, the private sector has emerged as a significant player in bringing in investment and building and operating infrastructure assets from roads to ports and airports and to network industries such as telecom and power. Private investment now constitutes almost 40% per cent of infrastructure investment. In these times of tight fiscal environment, private sector will need to play a greater role without which infrastructure development will not meet the growing demand and could fall far behind the requirements.

In eleventh plan, a total investment of Rs. 27 lakh crores (eleventh plan – 2011/12 prices) was made towards infrastructure development. This investment at 7.22 % of GDP (average) represents a significant shift from 5.02 % of GDP (average) invested during tenth plan. This sharp increase in total infrastructure investment was largely due to the rapid rise in investment by the private sector especially in power and telecommunications. (70% of the private sector investment was made in power and telecommunications.)

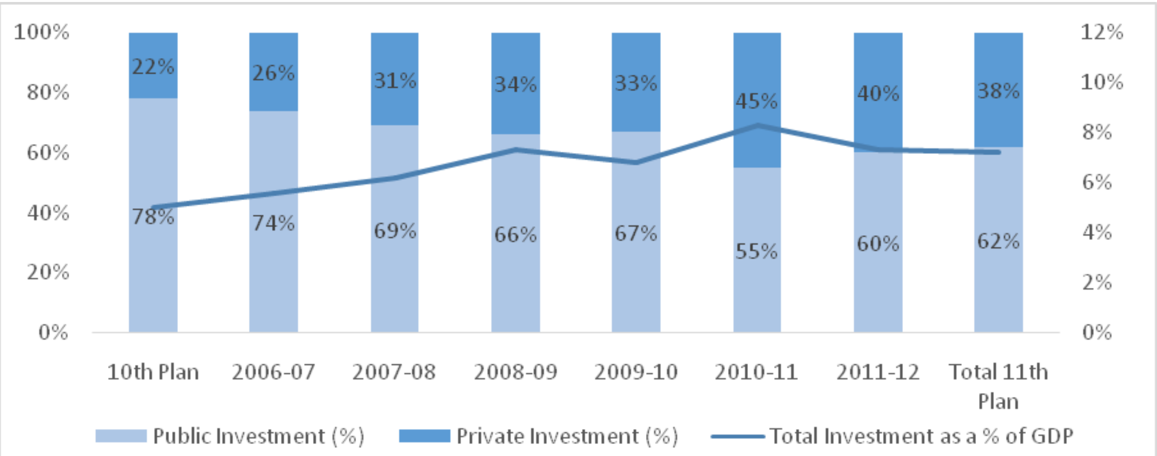
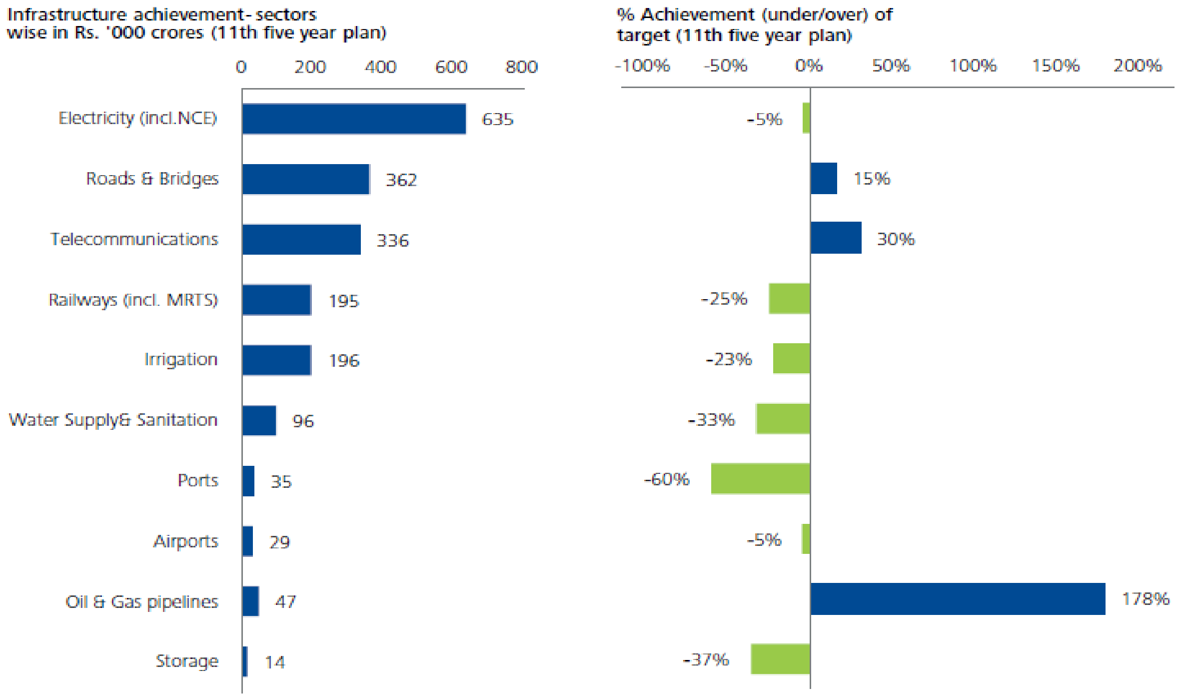


Figure 1: Total Infrastructure investment breakup into public and private investment - 11th Five Year Plan (Source: Interim Report of High Level Committee, Planning Commission – Aug 2012)

During eleventh plan, substantial private investment in telecom helped this sector over-achieve whereas agood mix of private and government funding gave oil & gas sector a massive push resulting in significant overachievement against targets. Power sector also saw a significant investment from private sector.Ports, railways, storage and water supply sectors lagged behind in development and didn't meet their investmenttargets.



Source - Interim report of the High Level Committee (Planning Commission) - Aug 2012

Figure 2: Total Infrastructure investment achieved across sectors for 11th year plan

Sources of Funding in 11th Plan: In first 3 years of eleventh plan, budgetary support constituted ~45 per cent of the total infrastructurespending. The debt from Commercial banks, NBFCs, Insurance Companies and the external sourcesconstituted ~41 per cent of the funding while the balance 14 per cent was funded through Equity and FDI.

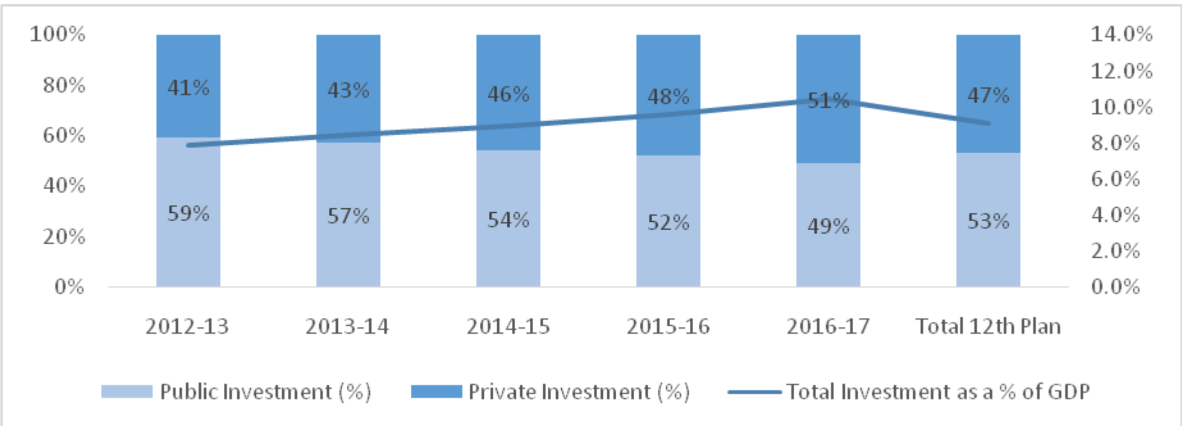


Figure 3: Total Infrastructure investment breakup into public and private investment - 12th Five Year Plan Projected (Source: Interim Report of High Level Committee, Planning Commission – Aug 2012)

12th Plan Investment Projections: The Government of India is targeting an investment of 51 lakh crores over the duration of the twelfth five yearplan which is almost double the amount proposed under the eleventh plan. While the share of publicinvestment is projected to decrease from 62% to a level of 53% in the twelfth plan, the share of privateinvestment is projected to increase from 38% (eleventh plan) to 47% (twelfth plan) of the total investment.The Governmentis expecting private sector to play a key role in twelfth plan with an overall investment growth of 131%. Private investment is projected to grow in all the infrastructure sectors with Railways,Water Supply, Storage and Ports projected to grow at greater than 200% whereas investment in other sectors is projectedto grow at greater than 100%. Overall private sector investment will be a key to success of infrastructure development under12th five year plan.

VI FUNDING GAP

In twelfth five year plan, planning commission is projecting an investment of Rs.51 lakh crores. About 53% of this is expected to be funded through budgetary support and rest will need to come from private sector funding.Based on estimated funding flows from various sources and the incremental investment required, twelfthplan will have a huge funding gap and will need to channelize an additional private sector investment ofabout Rs.6.08 lakh crores over the duration of the plan.This is assuming that budgetary support remains same. In the given macro-economic environment, this will be huge challenge and won't be possible without the radical reforms.

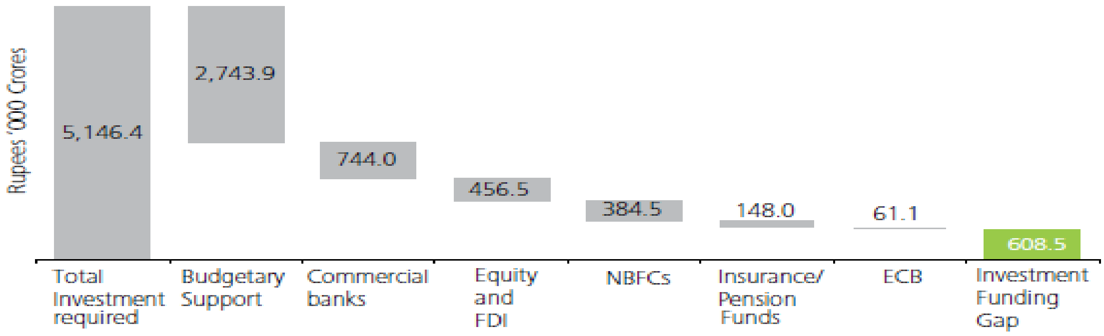


Figure 4: Estimated Funding Gap (Rs '000 Crores); Source: RBI, Interim Report of High Level Committee, Planning Commission – Aug 2012

With this perspective, it becomes critical to examine how alternative investments like private equity can contribute towards reducing the funding gap as estimated above. It is worthwhile therefore to study and learn from the experiences how PE funding has contributed to the growth of the Infrastructure in India in the past and the subsectors which have benefitted the most. The following section makes an effort to study the several forms of alternative investment classes available for funding of private capital and analyses the trend in the PE investments in the India's infrastructure sector.

VII PRIVATE EQUITY

Alternative investment asset classes have become important pools of capital in the global financial system. An alternative investment asset class is a type of asset that was traditionally considered as a part of an investment portfolio. Private Equity (PE) is a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. PE is a financial transaction. If a company's management chooses to accept PE, this is because it determines that the company needs long-term risk capital. Often, PE is chosen because long-term risk capital is not accessible elsewhere, due to underdeveloped equity markets. Sometimes, PE may be taken as an alternate for long-term debt because public and private borrowing channels may be underdeveloped or unavailable.Categories of Private Equity investment include leveraged buyout, venture capital, growth capital, angel investing, mezzanine capital and others.

Private Equity in India (2001-2010)

The Indian economy has been enjoying a period of sustained growth at around 8 per cent in the recent years. This attracted the attention of private equity houses who have been participating in an unprecedented number of investment deals. In sharp contrast to the time private equity funds invested in India from a base overseas (for example Singapore), many private equity firms have now established a presence in the country, spurred on by a bullish market and some spectacular and well documented exits. This reflects the importance of understanding local markets and working closely with promoters (families or controlling shareholders), as well as the benefits of local decision making. The following figure provides an overview of the volume of private equity investments in India for last few years.

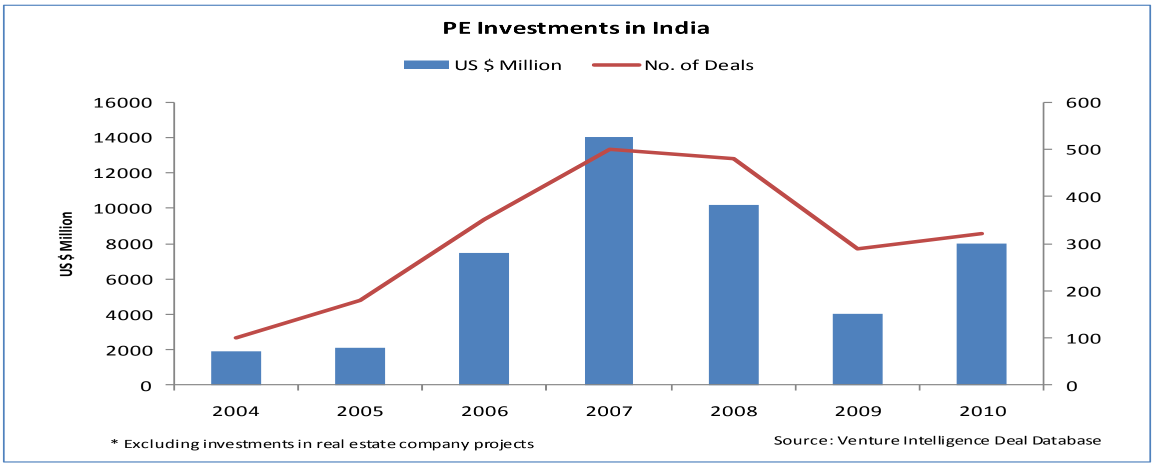


Figure 5: Trends in Private Equity in India

The Indian private equity market was at a nascent stage in the year 2004-2005 before picking up in the year 2006 and finally reaching its peak in 2007. The recession then led to the decline in the private equity investments in India but soon the year 2010 witnessed the investments picking up again.

The Indian private equity market is different from that of Europe or the United States in that small family-owned and family-managed businesses account for a high proportion of the market and therefore investment opportunities. The average deal size in India is significantly lower than in China or South Korea, for instance, but 8,000 companies are listed on Indian exchanges, a huge number by any standard, and the rising performance of the stock market since 2004 has resulted in substantial wealth creation for families with majority stakes in listed companies.

With an expanding domestic market and additional opportunities brought by globalization, the impact of private equity on Indian business is likely to increase further in the coming years. For the period 2008-2010 **infrastructure** attracted significant private equity investments, accounting for 28 per cent of total private equity deal value in second quarter of the year 2010. Furthermore, private equity houses are also likely to pursue investment opportunities in the domestic demand-driven sectors including education, healthcare retail and consumer products. Sector-wise allocation of private equity has been shown in the following table.

Table I: Top Private Equity Sectors in India 2010

SECTOR	VOLUME	VALUE	VALUE %
Power and Energy	24	1537.1	25%
Real Estate and Infrastructure Management	33	944.7	15%
Banking and Financial Services	33	594.1	10%
Telecom	6	515.4	8%
IT &ITes	41	398.1	6%
Pharma, Healthcare and Biotech	23	320.4	5%
FMCG, Food and Beverage	6	221.3	4%
Education	20	174.6	3%
Manufacturing	6	163.9	3%
Cement	1	159.6	3%
Shipping and Ports	2	157.6	3%

(Source: Grant Thornton Dealtracker 2010)

Table II: Private Equity Investments in India in the year 2009-2010

Deal Board			Top 5 Sectors	
Rank(2010)	**Last Year**	**Move**	**PE Sectors (Volume – Top Deal)**	**Value in US $ Bn**
1	2	↑	Power & Energy (24deals-Moserbaer Power US $300 mn)	1.5
2	1	↓	Real Estate (33 deals – Amit Housing US $111 mn)	0.9
3	3	↔	Banking (33 deals – Star Health US $100 mn)	0.6
4	9	↑	Telecom	0.5

			(6deals – Tower Vision US $300 mn)	
5	6		IT & ITES (41 deals – Tikona US $106 mn)	0.4

Source: Grant Thornton Dealtracker 2010)

It is evident from Table 1 and 2 that 'power & energy' sector attracts the maximum private equity investments in India both in terms of volume with almost 24 deals and value close to US $1.5 billion. The past few years has seen turmoil in the markets, resulting in a fundamental reformation of the financial landscape. As the extent of the turmoil and its consequences has become clear, it's about time to closely examine the role of financial intermediaries. These have not only included traditional financial institutions such as banks and insurance companies, but also alternative investment asset classes such as private equity, which in many nations have remained largely outside the purview of regulators. Thus, in an era when financial regulation is rapidly evolving, understanding the role and consequences of private equity has become very important.

The following table shows the value of private equity investments in the 7 sub sectors of the infrastructure sector of India.

Table III: Value of Deals in Sub Sectors of Infrastructure 2001-2010

Sub-sectors	**Deal Value (USD Mn)**	**Percentage (%)**
Cement	5331.01	4.20%
Heavy Construction	170.15	0.13%
Oil & Gas	24521.12	19.31%
Power & Allied	20112.49	15.84%
Telecom	71145.21	56.03%
Logistics	5515.95	4.34%
W & W	170.29	0.13%
Total	126966.22	100.00%

(Source: Deal Analysis)

During the period of study, private equity inflows have taken place in energy and infrastructure sector but all the sub-sectors have not witnessed the same growth of PE investments. No doubt some sub sectors have been lagging behind while others have performed exceedingly well for example cement; logistics and heavy construction have witnessed low growth whereas the infrastructure sectors – Telecom, Power and Oil & Gas have been consistently amongst the top sectors to attract PE investment as can be seen from the table below. This clearly depicts that Telecom, Power and O&G are the three sub-sectors which dominated the Infrastructure space in terms of attracting private investments during the last decade.

Infrastructure has continued to attract significant private equity investments, accounting for approximately 28 per cent of total private equity deal value in the year 2010. The increasing need for telecom infrastructure, oil& gas, primary and tertiary healthcare and power sector ensured both growth and consolidation related transactions within these sectors. The table below outlines the investments that took place in these three sub-sectors in the evaluation period.

Table IV: Top 3 Infrastructure Sub-Sector Deal Values 2001-2010 (USD Mn)

Subsector	2001-04	2005	2006	2007	2008	2009	2010	Average
O&G	521	11	4,207	1,929	3,017	3,036	11,801	3,503
Power & Allied	55	61	195	1,492	738	8,453	9,119	2,873
Telecom	787	5,096	1,962	16,350	19,155	5,364	22,430	10,164

(Source: EMIS Deal Watch)

VIII ROAD AHEAD AND RECOMMENDATIONS

Infrastructure development will continue to remain in focus for the government.To catalyse investments, the Government has to therefore introduce various proposals some of which will require significant infusion of funding through private sector, including various forms of private capital.

A multi-pronged reform process and a holistic approach towards improving and enabling doing business in India needs to be initiated to mobilize this private capital. Also, an integrated planning needs to be put together to attract and sustain large inflows of foreign capital, both debt and equity. Along with an improved enabling environment, focused systemic changes and interventions will be required to be implemented.

We believe that the following key interventions will help improve in attracting private equity funding for new and existing infrastructure development projects.

8.1 Policy and regulatory

Unlike Indian Energy (Power and Oil & Gas) sector, the Indian Telecom sector started with the reforms process earlier way back in 1990s and with the introduction of NTP 1994, it opened the doors to the private sector entry without any restriction in the number of operators. Along with de-licensing the trade, what the Telecom sector could manage was to provide an ambient environment for the private investors to participate and stay invested for a longer time. Despite having investor friendly policies in the Indian Power sector, there was lack in participation from private investors due to the deficiency in support from Government in acquiring the various clearances required for the project, for the private party.

It is therefore necessary for the Government to take a note that policy alone is not the most important factor for boosting private investment and welcoming private capital, but the public administration also needs to tie up the loose ends and provide a completely stress free environment for the business to operate.

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Also, there is a high level of positive correlation of growth and investments between Indian Power Sector and Oil & Gas sector. Hence, policymakers should have a view of the overall energy security of the country while developing policies and regulations governing each of these sectors. For e.g. availability of Natural Gas and Natural Gas Distribution policy would have a direct impact on the power generation potential of the country, thereby, linking it to sale of power to Power Distribution utilities from the gas based generation plants and tariff charged to the consumers of electricity. Therefore, any such policy affecting one end of the value chain has an impact on the entire value chain of investments and therefore, has to be carefully developed.

8.2 Credit enhancement

Credit enhancement mechanisms provide adequate security comfort to lenders for extending debt to infrastructure projects. The need for credit enhancement arises in developing countries due to a variety of risks associated with infrastructure sector projects. A credit enhancement scheme would provide partial risk guarantee to enhance the rating of the infrastructure project. For e.g. credit enhancement product aims to enhance the quality of long-term bonds issued by infrastructure firms, thereby, making them attractive for investment and enabling them to raise more funds at reasonable price. Multilateral Banks including ADB along with other agencies extend credit enhancements to bond issues of infrastructure firms to improve their credit worthiness.

8.3 Developing long term bonds market

This has been talked about for quite some time now in various forums and advisory panels, but there has been very little interventions taken towards achieving this. The creation of a deep and robust debt capital market is a key to making available long term debt instruments for infrastructure. The domestic bond market continues to be dominated by public borrowing and does not address the needs of the corporate sector as in the case of other emerging markets.

This intervention could provide a great opportunity inthe near future as interest yields in developed countrieshave been very poor and asset managers are looking for higher returns in overseas markets.

8.4 Developing currency and derivatives market

Availability of foreign exchange hedging instruments need to be strengthened as foreign debt investors are wary of betting on the currency of a developing economy for long tenure. There is a need to deepen the interest rate futures market. Market based lending will attract issuers and investors to hedge in the futures market. This will however require transfer and pricing of risk, regulatory safeguards to be put in place considering the experience of the recent financial crisis.

IX CONCLUSION

In this tight fiscal environment, private capital infusion is seen as a means to bridge the funding gap. This is currently hampered by the significant challenges and risks faced by private sector.The government should therefore play a pivotal complementary role of a facilitator, enabler and regulator to allay down the apprehensions of the private sector. It should introduce innovative financial instruments for risk mitigation and should more closely align the nature of infrastructure development with funding sources. This will encourage private sector investment in infrastructure.

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