



ICRA RESEARCH SERVICES

Infrastructure Finance Companies Update for FY2014-15

Performance Review of Infrastructure Finance Companies and Industry Outlook

Financial Sector Ratings

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1. Executive Summary

Infrastructure Finance Companies (IFCs) remain an important source of funding for the development of infrastructure in the country. The IFCs have funded Rs.6.6 trillion of infrastructure loans as on Mar 31, 2015 and are expected to contribute another Rs. 2.0 trillion over the remaining period of 12th plan ending FY17 (FY16-17). However, challenges in the operating environment have partly reduced the risk appetite of such NBFCs. While limited availability of long term funds was always a challenge for IFCs (barring IFC-PSUs), large level of vulnerable accounts and the heavily indebted nature of the large infrastructure companies pose additional challenges. Power sector continues to face challenges arising out of high fuel supply risks given the large quantum of affected coal based capacity post cancellation of coal blocks by Supreme Court, aggressive bidding in the recently conducted auctions as well as due to uncertainty over the improvement in domestic gas availability. With some moderation in interest rates and implementation of stalled projects, there could be revival of demand albeit at a slower pace. Multiple steps announced by the Government to improve the availability of funds to the infrastructure sector in the Union Budget 2015-16, policy initiatives including efforts to revive stalled projects, liberalization of FDI investment in sectors like rail infrastructure, defense and construction, positive steps taken to improve fuel supply, scheme for pooling of gas prices, de-regulation of diesel prices along with implementation of mechanism to fix prices of natural gas, introduction of broad guidelines for greater government participation in 'hybrid annuity' models for the road projects, re-schedulement of premium payouts for road projects and relaxation of environmental clearances have partially alleviated some sector-specific concerns.

The current ICRA note highlights some of these challenges and an update on the performance of IFCs in FY15.

1.1 Pace of Growth and Outlook

According to ICRA's estimate, the total infrastructure credit in India (Banks and NBFCs) stood at Rs. 16 trillion as on Mar 31, 2015. Of this, banks accounted for 58%, followed by the public sector IFCs (IFC-PSU) at 35%, and private sector IFCs (IFC-PVT) with 6%. The rest (<1%) was accounted for by other NBFCs (other than IFCs). At this industry size, India's infrastructure credit penetration to GDP stood at around 12.7% (of which IFCs' credit penetration was 5.3% of GDP) as on Mar 31, 2015 (marginally higher than Mar 31, 2014). The total credit to the infrastructure sector witnessed a growth of 12% during FY15; with IFCs recording higher growth of 14% as compared to 10% for banks. Banks credit growth was impacted by their focus on recoveries amid weak asset quality profile and weak capitalisation levels as well as subdued addition of new projects. With the current environment in infrastructure sector remaining marked by weak demand for credit and a reduction in lenders' risk appetite, ICRA analysis indicates that the growth in FY15 was largely led by disbursements to earlier sanctioned under-implementation projects while fresh investment in infrastructure sector remains subdued.

The 14% growth rate of IFCs in FY15 was significantly lower than the 20% CAGR reported over the last five years (FY10-FY15). ICRA expects IFCs' growth to remain subdued at similar levels as FY15 over the short term, however, medium-long term growth potential would be linked to the extent and speed of resolution of structural issues in infrastructure and the extent of private sector participation.

With the infrastructure as a key priority, the Government in the Union Budget 2015-16 has proposed multiple steps to ease availability of funds for infrastructure sector, improve private sector participation, as well as allocated higher funds towards public sector infrastructure projects. In total, investment in infrastructure is proposed to increase by Rs. 700 billion in FY16 over FY15. In addition conversion of excise on petrol/diesel into Road Cess will enable higher public spending towards these infrastructure projects. The stated aim of the Government to revitalise projects being implemented on the PPP mode by assumption of greater responsibility by the sovereign for sharing risks, re-introduction of tax free bonds by FIs for funding in infrastructure projects as well as announcement of a National Investment Infrastructure Fund with initial fund infusion of Rs. 200 billion so as to enable infrastructure finance companies to increase their fund raising ability are positives as these measures are expected to encourage investments in infrastructure in the long run. Within infrastructure, disbursements could witness an increase in the telecom sector with sizeable spectrum payouts expected for the March

2015 spectrum auctions. In the road sector, GOI's intention to award projects only after acquiring land and requisite approvals (plug and play projects) will significantly reduce execution delays and thereby attract higher private sector participation.

In the long term if the structural issues are resolved, the balance sheet growth of IFCs could witness higher momentum than seen in the past provided they are able to mobilize resources at competitive rates to fund growth.

1.2 Asset Quality

Notwithstanding the risks in lending to infrastructure segments, the reported Gross NPA% of IFCs remain at moderate levels partly aided by a sharp growth in the portfolio over the last few years. The Gross NPA % of IFCs stood at 1.6% in FY15 (1.7% in FY14) as compared to the banking average of Gross NPAs at 4.4% as in FY15 (3.9% as on Mar-14). As for solvency, Net NPA as % of networth as on Mar-15 for IFCs is low at 6.1% (similar to 6.2% as on Mar-14). On excluding IFCI Limited, the overall Gross NPA% increased from 1.1% as on Mar-14 to 1.2% as on Mar-15 while the Net NPA/ Net Worth increased to 4.5% over 4.0% as on Mar-14. Nonetheless, the reported asset quality indicators of IFCs may not be reflective of the underlying stress. There has been an increase in the restructured advances from ~2% as on Mar-14 to ~5%¹ as on Mar-15. Higher slippages from restructured portfolio combined with withdrawal of regulatory forbearance could lead to an increase in fresh NPA generation. The NPAs for IFCs could be further impacted by RBI's revised guidelines for NBFCs, proposing tightening of the NPA recognition and provisioning norms so as to bring them on par with those applicable for banks. RBI's norm for flexible structuring of existing long-term project loans to infrastructure may restrict the formation of NPAs to an extent, resolution of structural issues and deleveraging of these corporate hold the key for actual reduction in stress on credit profile of such issuers.

Within IFCs', the power sector accounts for 70% of total credit, which continues to face challenges arising out of high fuel supply risks given the large quantum of affected coal based capacity post cancellation of coal blocks by Supreme Court as well as due to uncertainty over the improvement in domestic gas availability, counter party risk arising from weak financial health of state power utilities and uncompetitive off take arrangement in the case of some of the power projects. Nonetheless, ICRA takes note of the improving trend in domestic coal production by Coal India Ltd (CIL), with production having gone up by 7% in FY 2014-15, and measures being planned by CIL to further improve the coal output. RBI's notification allowing refinancing of existing loans for operational infrastructure projects is a positive step for power sector as it is expected to benefit cash flow position of such projects by way of amortization of principal over a relatively longer repayment period (i.e. up to 20-21 years instead of 12 year period earlier, post CoD) aligning with life of the project cash flows. The scheme could provide a cash flow relief in the initial period for the projects which have structurally weak & unviable PPAs however, viability of such projects remains an area of concern unless tariff compensation is implemented. While the companies have been evaluating credits more cautiously and cherry picking new assets, the exposures taken during the 11th plan will remain an overhang for the lenders. ICRA believes that there could be a steady buildup in the delinquent exposures and the IFCs could witness asset quality pressures over the medium term.

1.3 Borrowing Profile

The borrowing profile of IFCs had a greater reliance on bonds and debentures which form the bulk of the resource mix at 72%, followed by loans from banks and financial institutions at 14% as on Mar 31, 2015. With the softening of interest rates in the bond markets, there has been a rise in the share of debentures in the overall funding mix from 70% as on Mar 31, 2014. As for the break-up, as on Mar 31, 2015, the proportion of bonds and debentures in the borrowing profile of IFC-PVT stood at 46%, followed by 39% loans from banks and financial institutions.

¹ PFC also classifies exposures where there has been a change in the DCCO as restructured, the same has been excluded in our calculation.

For FY15, the cost of funds for IFCs has declined with the increase in mobilization through debt market instruments given the softening of interest rates. As a sizeable proportion of borrowings of IFCs are fixed rate, the impact of the interest rate softening on the existing balance sheet of IFCs is lower. Further, the Government had not allowed any entity to raise Tax free bonds in FY15 which could have exerted pressure on the overall cost of funds. However, Government has allowed few entities to issue tax free bonds to boost development. For the near term, if bank base rates were to be revised downwards, the spread of base rates with higher-rated corporate bonds can still be expected to remain substantial. Underpinned by this belief, along with the availability of funds at finer rates in commercial paper and bond markets and an increasing risk appetite amongst investors in debt capital markets, ICRA expects incremental fund-raising to largely be conducted through bond market issuances.

1.4 Profitability

In FY15, on an overall basis, IFCs have witnessed increasing Net Interest Margin with the improvement in NIMs of IFC-PSU. IFC-PSU reported higher NIMs in FY15, with increase in yield on advances and decline in cost of funds supported by the ability to borrow funds at competitive rates. The non interest income remained stable in FY15 at 25 bps/ATA, similar to FY14 levels. The operating expenses of IFCs were higher in FY15 at 34bps/ATA vis-a-vis 30bps/ATA during FY14. On the back of improvement in NIMs, IFCs witnessed an increase in the operating profits to 3.9% in FY15 (3.8% in FY14). The operating profits increased across most of the entities in IFC-PSU space (5 of the 6 in the public sector space). For IFC-PVT, the NIMs fell with the decline in yields being higher than the decrease in cost of funds. Consequently, operating profits for IFC-PVT were lower in FY15.

The increase in operating profitability of IFCs on an aggregate basis was offset by a 15-16 bps increase in provisioning expense resulting into lower Net Profitability of IFCs with Net Profits/ Average Total Assets at 2.3% in FY15, vis-a-vis 2.5% in FY14. Similarly, the return on Net Worth of IFCs stood at 15.8% in FY15, a decline of 80 bps compared to FY14 levels, while gearing remained at similar levels of 5.5x-5.6 x during the period.

Provisioning levels for IFCs was partly impacted by the increased provisioning requirement on restructured assets as per guidelines issued by RBI in January 2014.²

In light of the possibility of a further increase in credit provisions with continued stress in the infrastructure sector, increased provisioning for restructured assets and the new RBI regulations requiring NBFCs to migrate to a tighter minimum NPA recognition norm, ICRA expects IFCs' ROE to reduce from FY15 levels, however it may still remain in double digits. The long term prospects on profitability will be linked to the resolution of structural issues in infrastructure.

1.5 Liquidity and Capitalization

Both public as well as private sector entities on a broad basis have maintained adequate levels of un-utilized banking lines commensurate to the scale of operations to plug any short term liquidity mismatches. However, overall IFCs' liquidity profile will be dependent on their ability to tap the bonds market for raising long term resources to a fair extent. As the investor appetite in the bond market for non-PSU IFCs is limited, mobilization of long term finances is likely to remain a challenge for IFCs. Take-out financing scheme by IIFCL and development of IDFs may help NBFCs-IFCs to improve the liquidity of the assets and offload part of them to free up capital. Availability of funds for infrastructure finance companies may further improve with the setting up of the National Investment and Infrastructure Fund (NIIF) with annual flow of Rs 200 billion which can further raise debt and invest as equity in infrastructure finance companies.

The gearing levels (total debt/net worth) of most ICRA-rated IFCs have remained in the 4.50-5.50x band, with regulatory capital adequacy at 18-22% (against the requirement of a minimum 15%) and with sufficient room to raise Tier-II debt. As for solvency, Net NPA as a % of networth for most IFCs is low, with the aggregate Net NPA/ Net worth at 6.1%

² In January 2014, the RBI has issued guidelines on Restructuring of Advances applicable to Non Banking Finance Companies. As per the guidelines, a provision is required on standard accounts restructured prior to January 24, 2014 at 2.75% from March 31, 2014, and would further increase to 3.50% from March 31, 2015, 4.25% from March 31, 2016 and 5.00% from March 31, 2017. Restructuring of standard accounts subsequent to January 23, 2014 would attract a provision at 5.00%.

(similar to 6.2% as on Mar-14). Despite lower reported restructured advances, the vulnerability of the underlying assets remains the same and the possibility of pressures on asset quality cannot be ruled out, capitalization and solvency profile of IFCs would be dependent on the performance of stressed accounts.

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- Summary of Infrastructure Verticals – Power, Road and Telecom form > 75% of Overall Financing of IFCs
- Analysis of ICRA Rated IFCs
- Financial Indicators: IFCs
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