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MARCH 2007



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Perspectives on Global Infrastructure

Capital Pursuit: India Takes Initiative to Attract Foreign Investment in Infrastructure

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NEW DELHI – With a growth rate of more than 9%, India needs massive amounts of capital to finance, build and maintain the infrastructure to support one of the world's fastest-growing economies.¹ But its public spending on infrastructure has been constrained by the country's substantial budget deficit, equal to about 10% of GDP,² and its infrastructure spending has fallen short of what is required to maintain its current growth rate. India has been seeking private capital to help meet the shortfall, and foreign investment in India's infrastructure has been increasing, helped by government initiatives to attract investment. These initiatives include the government's deregulation of highways, power and certain other sectors, its establishing a national highway toll system (including provisions for toll increases), its streamlining of processes for awarding contracts for infrastructure development, and its providing model concession agreements for investment in some sectors.

The government has been particularly successful in attracting foreign investment in India's ports and highways and it is trying to interest investors in other sectors. For example, in the power sector, it has started a program to attract investment in generation projects of 4,000 megawatts (MW) – christened “Ultra Mega Power Projects” – and in large transmission projects with individual project costs of around US\$1 billion each. For this purpose it has streamlined the bidding process and is also pre-arranging consents and clearances for these projects. In fact, the first two Ultra Mega Power Projects of 4,000 MW each were awarded to developers in December 2006.

In the railroad sector, traditionally a government monopoly, the government has also started a program to attract foreign investment, and in the past year it has awarded licenses to a few foreign companies for handling long-haul container traffic. The government also plans a US\$5 billion development of a dedicated rail line from Delhi

to Mumbai and Delhi to Kolkata, which it intends to finance mainly with private investment. It also is planning to invite foreign investment in building rail coach and rail engine factories in India. However, investment in infrastructure in India generally has been hampered by the lack of a national master plan for development of infrastructure across all sectors. Each sector is managed by a separate ministry, and in the opinion of some observers, communication among ministries is fragmented leading to piece-meal development of the Indian infrastructure.

Investors

Foreign investors in India's infrastructure market are mainly private equity funds and other investors from the US and European Union, whereas the market's developers and contractors are mainly from Asia, Australia and the EU. Foreign investors typically invest in infrastructure through partnerships with local developers and investors. These partnerships, in turn, enter into public pri-

1 India Overheats, *The Economist*, 1 February 2007. http://economist.com/opinion/displaystory.cfm?story_ID=E1_RGNJVDP

2 Infrastructure Finance in India: Shares & Shovels, Equity Investors Pitch in to Help Solve India's Transport Needs, *The Economist*, 3 August 2006. http://economist.com/finance/displaystory.cfm?story_ID=E1_SNPVTRP

vate partnerships (PPPs) with government agencies to finance, build and operate infrastructure projects. Additionally, a large number of private equity investors are investing in infrastructure portfolio companies which own existing operational infrastructure assets as well as under construction infrastructure assets. Based on our experience, foreign investors are most interested in investing in the highway and port sectors, and with the government's plans for the railroad sector, opportunities may open up in that sector over the next year or so. By contrast, investors have been cautious about investing in sectors that are heavily regulated by state or local governments, or that do not have strong track records of previous foreign investment. Prominent among such sectors is the water sector.

In most sectors, government approval is not required for foreign direct investments of up to 100%. Depending on the risk, most infrastructure projects deliver equity internal rates of return of around 14% to 20%. In

some sectors such as airports, the government proposes to put a cap on returns by applying a cost plus methodology to determine tariffs; in other areas returns are not limited. Debt financing is readily available from a number of providers, typically at debt-to-equity ratios of 70:30 (70% debt to 30% equity) which go up to 80:20 in certain cases. The emergence in India of more sophisticated financial vehicles such as mezzanine debt and derivatives for investing in infrastructure have given investors more flexibility in structuring the financing of infrastructure projects and leveraging their investments. The government does not provide foreign investors with protection against foreign exchange swings, but investors are generally allowed to repatriate up to 100% of their profits from investments in India.

Outlook

India's continuing need for private capital to help finance its growing infrastructure needs will open up more opportunities for foreign

investment. A fair and transparent process for the award of projects has been established in most sectors, and a sound contractual system is in place to protect investor interests. In general, the most attractive sectors are those where the government has been the most aggressive about promoting privatization. These include ports, highways, special economic zones and parts of the power and airport sectors. Opportunities could also open up in the rail sector over the next year or so.

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EYG DF0017