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Pension Investments in Infrastructure – India Case Study

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Promoting Infrastructure Investment through PPP: Pension Investments in Infrastructure – India Case Study

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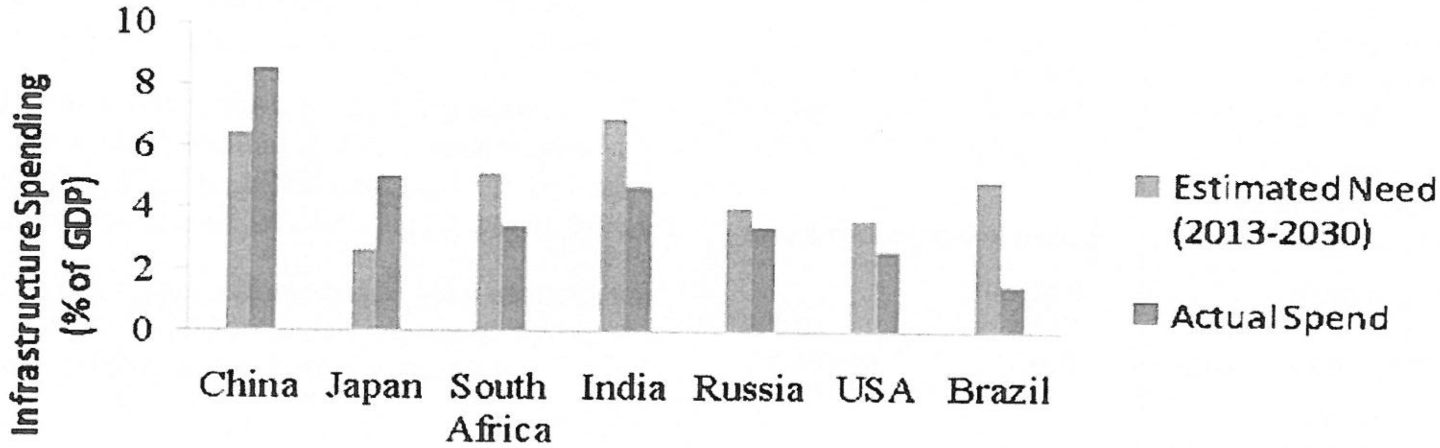
Overview of Infrastructure Need - India & Asia



Significant Gap in Infrastructure Need vs. Spend

- **$8Trn = required Asia spending** (gap between need vs. spend) for infrastructure investment between 2010 – 2020
- **Asia infrastructure market expected to grow 7 - 8% a year** over the next decade approaching $5.36 trillion annually by 2025 with significant growth required in India (ranks 85 out of 148 economies in infrastructure)
- **Infrastructure gap is having a material economic impact**. Growth in Asia is restrained by 3 to 4 % of GDP as a result of lacking infrastructure in electricity/energy, ground transport, water, rail, housing, communications.
- **Chinese Government** open up pension regulations to allow corporate pension fund investors to invest in Infrastructure debt
- **India's new government** has a key mandate to develop infrastructure in order to support economic growth and create jobs. Focus will be on communications, ports and airports, freight industrial corridors, railways, energy.
- **India government supporting infrastructure investments via innovative products such as IDF** (Infrastructure Debt Fund) focusing on investor needs while boosting local infrastructure. India's largest pension funds EPFO is now allowed in invest into IDFs beyond the current 100% fixed income portfolio.

Source: PWC Infrastructure Study, 2014. Mckinsey 2011 Infrastructure Challenges Report

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Global Pension Funds Activities in Asia

Overview

- With Asia-Pacific being the world's fastest growing region (projected to account for 50% of global GDP by 2050), pension funds are increasingly looking to boost their Asia exposures by:
  - Establishing regional offices: as pensions evaluate opportunities in Asia, it's becoming more and more critical to have a local presence due to the relationship nature of business in the region
    - Smaller pensions work around this by leveraging strong relationships with local banking for market access and knowledge transfer
  - Exploring new investment opportunities: in addition to traditional asset classes, key regional growth areas include:
    - **Real estate**: both commercial and residential opportunities abound given India's extensive absorption office space and China's urbanization plan, respectively
    - **Infrastructure**: according to a recent WB report, South Asia is facing a $2.5tn infra gap over the next 10 years; renewed focus by governments and multilaterals is paving the way for innovative funding solutions
- Given the long-term investment nature of pension funds, Asian governments have been relaxing their regulatory procedures to further attract foreign pension investors

Pensions Establishing Offices in Asia

Name	Location	Est.	Detail
APG (Netherlands)	• Hong Kong, China	• 2007	• On-the-ground presence provides new opportunities and dedicated Asia team • China accounts for 15% (€0.7bn) of total Asia allocation (€4.67bn)
CPPIB	• Hong Kong, China	• 2008	• First international office, reflecting commitment to LT growth in Asia • As of Dec 2013, Asian investments of C$23.4bn (11.6% of total portfolio)
	• Mumbai	• Exp 2014	• Setting up later this year; targeting $5bn+ over next five years
Lockheed Martin	• Hong Kong, China	• 2009	• First US corporate pension to establish office in Asia
AustralianSuper	• Beijing	• 2012	• First overseas office; dedicated board advisers for Asia
OTTP	• Hong Kong, China	• 2013	• Aiming to boost Asia assets from C$11bn to C$20bn in three years

Infrastructure Investment Approach – Australia vs. Canada

Public and Private institutional investors are increasing investing in infrastructure through a variety of means *(example:* CPPIB investing in India through direct investments, JV real estate finance companies and listed equity investments)

Two Different Approaches to Infrastructure Investments

	Australia	Canada - CPPIB
Project Finance	• Project bond market is rather undeveloped	• One of the most developed project bond markets (typically IG)
Privatizations	• Extensive history, especially with large transport items	• Very few public infrastructure assets privatized
PPP Policy	• Early adopter due to large-scale privatizations in 90s • Reform process underway to identify weaknesses / 'retune'	• In the past, lagged behind peers, but there has been a recent pick-up in healthcare, road and prison sectors
Locations of Assets	• Both of economy and abroad (former due to privatizations)	• Primarily overseas
Investment Vehicles	• Old model: listed infrastructure (both companies and funds) • New model: shift towards unlisted open-ended funds	• Direct / co-investment as well as unlisted closed-end funds
Infra Allocations	• Approximately 5% to 6%	• Nearly 5%
Returns	• Long term: ~10%; 3-5 year horizon: ~7%	• Long term: ~10%; 3-5 year horizon: ~5%
Benchmarks	• Use absolute, ie CPI + 3%/4% or nominal target of eg 10%	• Variety: absolute (nominal/CPI) and relative (mix of equity/bond indices)

Source: (1): OECD 2013 Pension Survey (sample of 56 funds); (2): OECD Comparison of Australian & Canadian Pension Fund Infrastructure Investment

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A Closer Look at Infrastructure Investments in India

The need for large-scale infrastructure investment is increasing, and governments will need to find alternative ways to finance infrastructure in a world where balance sheets are over-levered and bank credit is scarce.

Why infrastructure is an attractive asset class

- Long-term nature: matches long duration of pension liabilities
- Stable cash flows: continuous income over life of investment
- Attractive yields: compared to sovereign / corporate debt
- Hedge: inflation-linked payoff can help offset long-term liabilities
- Diversification: typically uncorrelated with other asset classes
- Valuation: not marked to market, so pricing is more stable than FI

Investment Vehicles

Investors are participating in infrastructure investments through a variety of investment vehicles

Debt / Equity	Investment Mechanism	
Debt	Project Lending	← Economy regional banks with balance sheets more debt heavy investments
↕	Balance Sheet heavy or balance sheet light lead arranger	
	Advisory (with or without equity)	← Foreign companies are usu. more equity heavy investments
Equity	Equity fund management	
Integrated	Debt led integrated model; Equity led integrated model	

India Infrastructure Debt Funds (IDF) – an innovative Infrastructure investment vehicle

- **Government and Private sector partnership** – India IDF funds are co-sponsored by commercial banks and non bank financial companies
- The creation of IDF was a key decision by the government & RBI to improve flow of capital to infrastructure projects
- **Global and domestic institutional investors** can invest through units and bonds into the IDF
- **IDF acts as a refinancing vehicle for existing infrastructure** company debt and meets two key purposes:
  - Facilitates investment into infrastructure projects
  - Frees up headroom for new lending by banks
- **Investors' Risk mitigation -** IDF regulated by RBI, SEBI. Government offers credit enhancement for IDF issuing bonds, allowing some level of sovereign guarantee
- Especially focused on insurance and pensions sector to allow government to tap into previously inaccessible sources of funding for infrastructure

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India Case Study

Pensions Investing in India

- Economic & political landscape: Given the long-term growth prospects and the game-changing election in May, India will be well positioned to attract foreign investment with Modi's policies being viewed as pro-business / development
  - As of Dec 2013, sovereign wealth and pension funds held $35bn (16%) out of $216bn in Indian equities
- Investment activity: Over the past several months, there has been significant activity among pensions increasing their India exposure:

CPPIB
- Commercial real estate: acquire stabilized office buildings (Shapoorji Pallonji)
- Residential real estate: provide rupee debt financing (Piramal)
- Infrastructure (L&T)

PSP Investments
- Infrastructure: purchase two hydel power plants; partnered with:
  - IDFC PE
  - Abu Dhabi National Energy Co (Taqa)

APG
- Commercial real estate: purchase tenanted office space
  - Partnering with Xander

- Regulatory environment: In Jan 2014, SEBI established the FPI Regulations, replacing the FII / QFI frameworks and thus simplifying the regulatory process in order to further encourage foreign investment

Foreign Portfolio Investors (FPIs)

Eligibility	Categories of FPI	Investment Conditions	Offshore Derivatives (ODIs)
• Not a resident in India or a non-resident Indian • Resident of economy with formal relations with India (IOSCO MOU, BIS, FATF) • Legally permitted to invest in securities outside economy of incorporation / place of business	• **I**: government and govt-related investors (CBs, agencies, SWFs, multilaterals) • **II**: mutual funds, investment trusts, insurance/reinsurance cos – AMCs, portfolio /invest mngers, university / pension funds • **III**: all others not included in **I** or **II**	• Instruments available broadly in line with previous FII regime • Total investment by FPI restricted to 10% of co's issued equity capital • If same ultimate owners invest via multiple entities, will be treated as part of same group (ie single FPI) – 50% threshold of direct/indirect common ownership for purpose of clubbing investment limits	• FPIs can issue/deal in ODIs directly/indirectly, only if issued to persons regulated by foreign regulatory authority (and KYC) • Unregulated broad based funds (cat II) cannot deal in ODIs • Category III FPIs cannot deal in ODIs

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Key Challenges for Investors

Inherent Challenges

- **Long Investment horizon** required in Infrastructure in Asia (as well as globally, in general) and must account for capital locked up for extended periods of time
- **Tax considerations** – Asia governments still need to refine tax considerations and create an efficient tax structure that also meets the needs of investors. The various infrastructure investment vehicles have diverse tax considerations which need to be clearly understood.
- **Legal** agreements often need re-drafting and deep review due to a lack of skills/ experience in government departments.
- **Uncertainty, whether political, legal, and regulatory** with respect to foreign ownership restrictions, capital controls, and partnership terms continue to exist and arise. **Bureaucratic delays** in project progress. *Example*: Bandra-Worli Sea Link in India, required >20 years before approval was finally given.
- **Currency fluctuations** as Asian economies continue to grow is a significant concern for investors.
- **Depth of capital markets** is still lacking in Asia causing an impact on availability of instruments for risk mitigation – *Example: hedging currency exposure with FX, derivatives.*

Some Important Solutions

- **Offshore products/structures** domiciled in financial centers like Singapore and HK could be a solution when local currencies are illiquid
- **Holding company in tax-friendly jurisdiction** rather than have the investment in the underlying infrastructure special-purpose vehicle (SPV), which is an asset of economy.
- **Innovative solutions such as IDF in India** to allow institutional clients access to Infrastructure investments while hedging political risk
- **Partnerships** between foreign players and a dominant local institution can help
- **Selecting the right investment vehicle** and mechanism from various available options is key, in addition to mitigating investment risks.
- **Financial institutions with a well-rounded product offerings are adopting integrated models for infrastructure investment**. *Example, besides funding the construction of an airport, an integrated player might also offer transaction banking services and insurance to the airport operator, delivering significant value and a sustainable models.*

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Citi works with its clients in greenhouse gas intensive industries to evaluate emerging risks from climate change and, where appropriate, to mitigate those risks.

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