

## Funds Hotline

July 11, 2013

### A BREATHING FOR ROAD DEVELOPERS: GOVERNMENT EASES EXIT NORMS, ALLOWS EXIT AT ANY TIME AFTER SECURING THE BID

In a path breaking move aimed at reviving the private sector's interest in national highway projects, the Government of India has allowed developers to partially or fully divest their equity in a project at any time after securing the bid, provided they can effect a substitution of the members of the consortium with the approval from the project's lenders and consent from National Highway Authority of India ("NHA").

#### BACKGROUND

The Public Private Partnership ("PPP") model was adopted in the infrastructure sector to facilitate the investment and development of capital intensive infrastructure. NHA, the nodal agency for national highways in India adopted the PPP model wherein it would award national highway projects to private sector entities (the "Concessionaire") under a concession agreement on a Build, Operate & Transfer or the BOT model. The Concessionaire was required to achieve financial closure, build, operate and then transfer the project to the NHA. Further, the existing policy and NHA's Model Concession Agreement ("Model Concession Agreement") required that pre-2009 Concessionaires could exit only 74 per cent. of their stake in any project after the second anniversary of the commercial operation date.

#### CURRENT STATE OF THE PPP IN NATIONAL HIGHWAYS

Initially the BOT model was popular and found several takers, including among the NHA's former contractors who had previously executed contracts financed by the NHA on an engineering, procurement and construction ("EPC") model. However over the last year the response to PPP projects has been extremely poor. Several projects did not find any takers despite repeated bids and a large number of the projects awarded during 2011-2012 are yet to achieve financial closure.

The reduced interest could be a result of a combination of factors such as:

1. general economic slowdown;
2. changes in policy guidelines relating to environment and forest clearance required for constructing national highways which has made implementation difficult; and
3. developer's failure to achieve financial closure on the existing PPP projects.

While on the one hand lack of financial closure of existing projects and cost overruns has led to the developers (already engaged in the PPP projects) facing severe shortage of capital as they are neither able to attract additional equity nor raise debt from the market, on the other hand investment companies with sufficient access to resources have expressed their interest to acquire national highway projects but are either unable or unwilling to take on construction risks. Hence there was a need for an enabling policy change that would allow the developer and investment companies to work together, share risks and revitalise the sector.

#### REVISED POLICY

In a policy revision on 21 June 2013, the government has allowed existing Concessionaire(s) in on-going and completed national highway projects awarded under the PPP model to divest their equity stake in the project at any time after securing the bid. The revised policy applies both to existing and future projects. This is a significant departure from the earlier policy and the terms of Model Concession Agreement.

#### PROCESS FOR SECURING THE FULL OR PARTIAL EXIT FROM THE PROJECT

The revised policy characterizes the Concessionaire's exit from the project as a substitution ("Substitution") and requires that the leading substituting entity must hold at least 51 per cent. equity in the project special purpose vehicle ("SPV") and prescribes the following procedure to be adopted by the Concessionaire seeking to exit the SPV:

1. the Concessionaire shall make a written representation to the lender's representative (the "Representative") with a copy to NHA requesting the Representative to seek NHA's approval;
2. the Representative shall assess the request and upon being satisfied that such Substitution is in the interest of the project shall make a representation to NHA;
3. the NHA shall review the representation and credentials of the entity proposed to substitute the Concessionaire (the "Nominated Entity") and give its decision along with reasons in writing;
4. if NHA approves of the Nominated Entity then the Representative in consultation with the Concessionaire would invite, negotiate and procure offers either by private negotiations or public auction or tenders, for the takeover and transfer of the project highway including the concession to the Nominated Entity upon the Nominated Entity's assumption of the complete liabilities and obligations of the Concessionaire towards NHA under the concession

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5. the final decision to permit the Substitution will be taken by the Concessionaire's lenders based on their assessment of the credit worthiness of the Nominated Entity.

## ANALYSIS OF THE REVISED POLICY

### Recognition of relative strengths and risk appetite

The revised policy aims to revitalise the sector by facilitating the sharing of risks between industry participants based on their core strengths and relative risk appetite. A majority of the highway developers in India are former contractors who had previously executed projects for NHAI on an EPC model and whose strengths lie in engineering, procurement and construction (i.e. in the build phase of a BOT project) rather than in raising capital and financing the project or operating, managing and collecting toll over a 20-30 year concession period. These contractors partnered with financial investors like infrastructure focused private equity funds that were seeking opportunities to employ capital and secure a return on their capital rather than stay invested for the entire duration of the concession period. The industry participants with expertise in the operations and management of toll roads are interested in the revenue stream from the project roads but are unable to take on the financial and construction risk associated with such projects but have the ability to manage operational assets. Thus allowing the developers and financial investors to exit the project upon completion and not locking them until two years after the commercial operation date recognizes the relative strengths and risk bearing capacity of these distinct industry participants.

### Exercise of the discretion and the process of substitution under the policy

A bare reading of the revised policy indicates that while the Concessionaire's proposal for Substitution gets assessed first by the Representative who is required to assess the proposal and be satisfied that the proposed Substitution is in the interest of the project and in the second instance by NHAI which has to be satisfied about credentials of the Nominated Entity, the decision to finalise the substitution is to be made by the project's lenders collectively.

While the policy requires the Representative to assess the request for Substitution by determining whether such Substitution would be in the interest of the project, it does not set out the criteria on which the NHAI shall assess the credentials of the Nominated Entity, although it does require the NHAI to give written reasons for its decision. This level of wide discretion becomes important as under the revised policy the Concessionaire(s) can exit the project at any point after having secured the project and in the absence such wide discretion NHAI may lose control over the process of Substitution.

Further the policy states that following the Representative's approval and NHAI's consent the Representative is required to invite, negotiate and procure offers either by private negotiations or public auction or tenders, for the takeover and transfer of the project highway including the concession to the Nominated Entity. This additional step of the process is likely to delay the process of divestment by the Concessionaire(s) and could perhaps be avoided as any approval of the Substitution by the Representative would have been secured in consultation with the lenders.

## CONCLUSION

The revised policy is a welcome change as it gives the Concessionaire(s) the option to exit at any time after being awarded the project and not wait until financial closure, completion or commercial operation of the asset. While it is likely to increase the liquidity for the project developers, it remains to be seen whether:

1. this increased liquidity will be of the extent that would allow the exiting Concessionaires to take on additional PPP projects based on the BOT model; and
2. financial investors such as private equity funds and industry participants with expertise in operating toll roads would be interested in uncompleted assets that would expose them to construction related risks or whether they would prefer completed projects where they acquire operational assets from the developer.

In any event, we can expect the revised policy to help attract investors to existing and future projects due to the increased flexibility of exit and hence provide developers a wider range of potential partners and investors in the project.

– Pratibha Jain & Shinoj Koshy

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