

IL&FS Infrastructure Debt Fund – Series 2: Schemes 2-A, 2-B and 2-C

Full Rating Report

Ratings

Scheme Series 2	Size (INRbn)	Tenor (years)	Rating
2-A	5	5	IND AAAidf-mf
2-B	5	8	IND AAAidf-mf
2-C	5	12	IND AAAidf-mf

Rating Summary

India Ratings & Research (Ind-Ra) assigned IL&FS Infrastructure Debt Fund's (IDF or the fund) three mutual fund schemes of Series 2 an 'IND AAAidf-mf' rating in February 2014. The rating is an opinion regarding the strength of the credit protection factors embedded in the fund's investment policies, expertise and experience of its sponsors and investment managers and its vulnerability to losses and prospects of ultimate recovery in case of defaults. The rating, however, does not measure the expectation of default risk for the scheme itself, as a fund/scheme generally cannot default.

Key Rating Drivers

Sponsor Strength and Experience: The rating benefits considerably from the presence of a strong and experienced sponsor, IL&FS Financial Services Ltd (IFIN, 'IND AAA'/Stable), a 100% subsidiary of Infrastructure Leasing & Financial Services Ltd. (IL&FS, 'IND AAA'/Stable). The IL&FS Group is an established lender, equity investor and financial advisor in the infrastructure sector. In recent years, it has emerged as a major infrastructure developer – often playing a pioneering role - with considerable experience in all phases of a project's lifecycle including conceptualisation, development, financing, construction, maintenance and operation and exits.

The IL&FS group, particularly IFIN, has a strong track record of financing infrastructure projects. Its capital adequacy ratio of 21.60% (30 September 2013) is particularly noteworthy.

Strong Expertise in Financial Advisory, Asset Management: The group's expertise in the financial advisory and asset management space is likely to be an important success factor in the IDF being able to achieve its objectives. IL&FS' strong working relationship with banks and financial institutions, international and domestic investors, infrastructure developers as well as with the central and state governments gives it easy access to infrastructure business opportunities; it is often one of the first ports of call for the policy makers to discuss new projects. The group has strategic relationships with some 22 states and is often invited to work with various state governments on creating policy frameworks for the development of infrastructure.

Sponsor's Commitment: Ind-Ra believes that the sponsor's INR2bn investment commitment in all the schemes demonstrates its confidence in IDF's prospects. The state-owned Life Insurance Corporation's (LIC) might make a matching commitment, in its capacity as a co-sponsor/strategic investor, subject to regulatory approvals. Also, five public sector general insurance companies have also entered into an MOU to invest in the schemes along with purchasing a stake in the asset manager of IDF.

Sound Asset Manager Credentials: IL&FS Infra Asset Management Company Ltd (IIAML), as the asset management company (AMC) or investment manager, has impeccable credentials that would reflect in its management of IDF. IIAML has senior professionals seconded from the sponsor group including nominations to the board. Also, AMC has enlisted senior professionals with considerable experience in the infrastructure sector and the financial services business.

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The group's private equity arm, IL&FS Investment Managers Ltd. (IIML), has managed over 50 exits, securing an average internal rate of return of around 25%. This indicates AMC's timely, orderly and smooth exits from its investments.

Ind-Ra also considers the group's past asset management experience - prior to its sale in 2004, the group had around INR25bn of assets under management (AUM), spread over 10 mutual fund schemes.

Structural Strength: The agency deems IDF's investment management policies, risk management systems including control through the internal audit function robust and conducive to the achievement of objectives. Board sub-committees have oversight over key functions of AMC. Securities and Exchange Board of India (SEBI)-approved trustee, custodian and registrar and transfer agent have already been appointed and should contribute to the protection of the interests of investors in the schemes.

Portfolio Characteristics: Within the overall ambit of the investment guidelines prescribed by SEBI, Ind-Ra expects the fund, pursuant to its investment criteria, to create a balanced and diversified portfolio that ensures adequate credit quality, not below 70% of the corpus invested in companies/instruments rated at least in the 'IND BBB' category or equivalent. The fund also avoids concentration to any particular sector and/or entity/group. Exposure to a single entity is not likely to exceed 15%. IDF is likely to benefit enormously from its sponsor's vast experience and wide reach in sourcing, screening, evaluating, structuring and exiting investments in a profitable manner.

Securing Favourable Transaction Structures: IDF, with an average exposure of INR1.5bn–INR2bn per project / company, will co-invest with a limited number of other investors. This will provide it with the opportunity to secure favourable transaction structures and play an active role, where necessary, in ensuring that investors perform according to expectations. Should one or more of the portfolio investments come under stress, IDF would exercise creditor rights to harness the long-term economic value, characteristic of several projects in the infrastructure sector despite short-term volatility in performance/cash flows.

Data on the ultimate recovery in infrastructure projects is limited and India's insolvency regime also has limitations, characterised by the lack of robust liquidation laws. However, Ind-Ra believes that the fund is adequately equipped to take timely steps to initiate the recovery process even if certain investments default; this is an important rating consideration.

Rating Sensitivities

Portfolio composition and characteristics not conforming to Ind-Ra's initial expectations is a negative trigger. Furthermore, any sharp deterioration in the credit quality of investments that could permanently impair the prospects of a full recovery within the tenor of the schemes could also result in a rating downgrade.

Transaction Structure

IFIN has set up an IDF under the mutual fund route which will be governed by SEBI's mutual fund regulations. IDF (Series 2) initially aims to raise a corpus of INR15bn from both domestic and international investors on a private placement basis. The minimum target amount is INR500m. The targeted amount is sought to be equally divided in three close ended schemes with tenors of five, eight and 12 years. Once fully paid-up, the units will be listed. The schemes will offer its investors both dividend and growth options.

IFIN proposes to invest minimum INR0.75bn in IDF (Series 2). LIC along with the five general insurance companies will also invest in Series 2, subject to regulatory approvals. IIML has been appointed by IL&FS AMC Trustee Ltd (IATL or the trustees) as the investment manager and HDFC Bank Ltd is the custodian. Computer Age Management Services Pvt. Ltd. is the

Applicable Criteria

[Rating Criteria for Infrastructure and Project Finance \(September 2012\)](#)

[Rating Mutual Fund Schemes of Infrastructure Debt Funds \(April 2013\)](#)

[Bond Fund Rating Criteria \(September 2012\)](#)

registrar and transfer agent.

IDF's investment objective is to generate income and capital appreciation by investing at least 90% of the corpus in a portfolio of predominantly infrastructure debt.

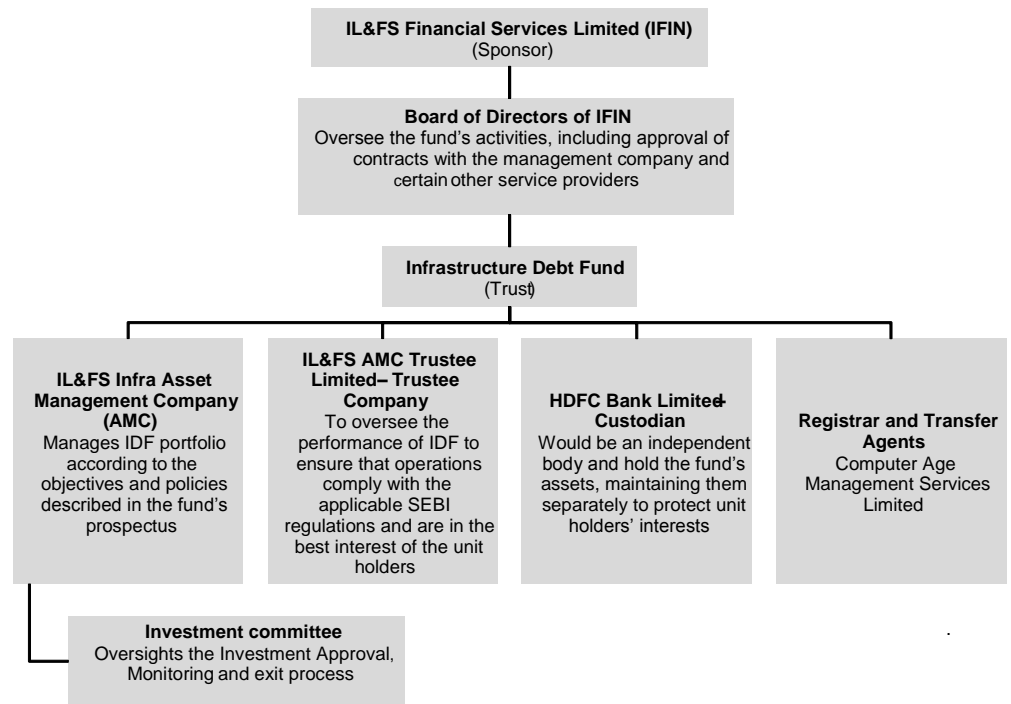
The structure of the fund is depicted below:

Fund Structure

50% of AMC's board will comprise independent directors. Likewise, two-thirds of the directors of the trustee company would be independent.

Figure 1

Fund Structure



Source: Company

Sponsor Assessment

IL&FS group's financial strength and over two-decade-long track record are likely to benefit IDF in the following ways:

- Sourcing deals through early identification of attractive investment opportunities
- Weeding out unviable and risky investment proposals where lack of sponsor discipline might have led to aggressive bids resulting in potential stress
- Conducting rigorous appraisal and evaluation of credit risk
- Structuring investments
- Monitoring performance including spotting early warning signals in respect of investments under stress
- Managing an orderly and profitable exit

Established in 1988, IL&FS has evolved into a full-fledged player in the infrastructure sector with well-rounded capabilities in the following segments:

- Project development
- Asset and project finance
- Asset management
- Financial advisory including mobilisation of resources

Playing these multiple roles has allowed IL&FS to acquire a unique position in the Indian infrastructure sector. It has the skills to identify bankable projects, extend/raise the requisite financing, identify and manage various risks both at the project level as well as systemic risks such as political and legal and optimise returns for different stakeholders.

Through the following group companies, IL&FS has demonstrated that it can successfully function in India's extremely challenging infrastructure sector:

IFIN: It is an investment banking firm with a focus on asset and structured finance, project debt syndication and corporate advisory services. It targets mainly at firms in the infrastructure and related sectors.

IIML: With AUM of around USD3.2bn, IIML manages private equity funds for domestic and international investors with a focus on the infrastructure and real estate sectors.

IL&FS Infrastructure Development Co. Ltd. (IIDC): It is engaged in project development in partnership with the central and state governments. It undertakes technical studies and develops implementation frameworks particularly in the public private partnership model.

IL&FS Transportation Network Ltd. (ITNL): A listed company, ITNL focuses on the group's investments in the surface transportation sector particularly road projects including construction and operations and maintenance on a build-operate-transfer model.

IL&FS Energy Development Co. Ltd.: It develops power projects in the thermal, wind and biomass sectors.

IL&FS Urban Infrastructure Managers Limited: It assists and partners with urban local bodies to render advisory services, project development and implementation.

IL&FS Environmental Infrastructure and Services Ltd.: Its objective is to advise, develop and implement environmental and social projects in a sustainable institutional framework.

IL&FS' Track Record in Infrastructure Sector

Financing – Debt and/or Equity

The IL&FS group, particularly IFIN, has a strong track record of financing infrastructure projects. IFIN's total lending portfolio size was INR97bn as of 30 September 2013 with a capital adequacy ratio of 21.60% (30 September 2013). Total assets as on 30 September 2013 amounted to INR140bn.

IFIN has an asset and structured finance vertical which offers lending solutions to projects. The lending portfolio includes direct infrastructure loans, promoter financing, capital market financing and corporate loans. IFIN has a broad-based sectoral exposure in the infrastructure sector which includes power projects, project development, telecom, maritime infrastructure, environmental solutions and surface transformation.

Intermediation – Financial Advisory/Syndication

IFIN has over the years set up a strong project debt syndication desk that has arranged debt/mezzanine debt for a diverse set of projects with different complexity levels. Since FY08, it has syndicated project loans of around INR700bn in the infrastructure sector, comprising entities operating in various fields such as roads, power, ports and telecom among others. The group's experience and domain knowledge have enabled it to pioneer several innovative financing structures both for its own projects as well as for third-party clients.

Project Development, Construction and Maintenance

The group has a nearly three-decade-long track record in conceptualising and developing infrastructure projects. IL&FS has a strong project portfolio with exposure to diverse sectors including area development, cluster development, power, ports, transportation, water, waste water and urban infrastructure. Its pool of mature assets and pipeline of projects under

development aggregate to over INR250bn and INR1,000bn, respectively.

Some of the complex transactions structured by the group include the effluent treatment project in Ambur and Vaniambadi, incorporation of an SPV - New Tirupur Area Development Corporation Limited – to implement Tirupur Area Development Programme, gas-based power project in Tripura, Indo-Nepal transmission line project and some waste-to-energy projects. Many of the projects are operational. The group’s experience in implementing projects in geographically challenging terrains and politically sensitive regions has helped it acquire skills to assess the technological and political risks involved.

Policy Advisory

The group is often invited to work with various state governments to create policy frameworks for infrastructure development. This has initiated several pioneering structures in the public private partnership format. Besides state government-granted highway concessions, the group has active partnerships with the governments of Rajasthan, Jharkhand and Chhattisgarh to develop some stretches of their road infrastructure. The group has strategic relationships with 22 state governments and also with the various departments of the central government. It has successfully completed the first phase of road projects (Ridcor- Phase I) in Rajasthan and has been awarded the second phase.

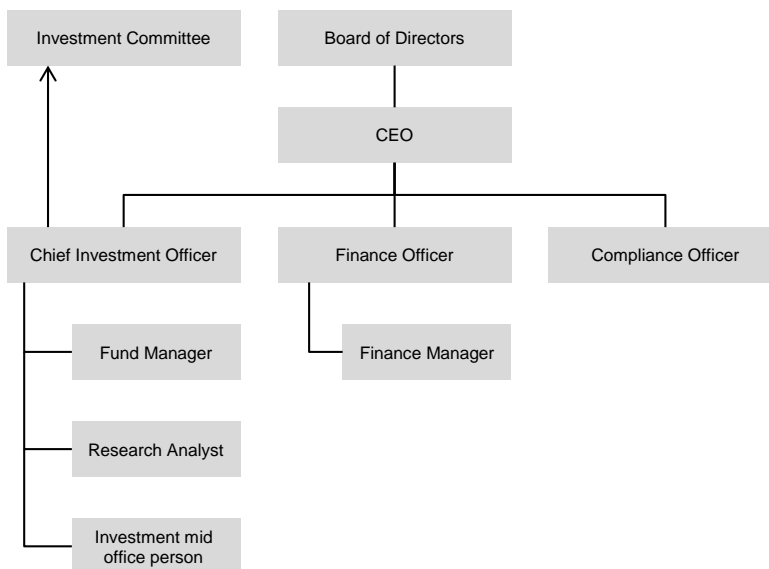
Asset Manager Evaluation

Asset Management Structure

IIAML, a direct subsidiary of IFIN, is the asset manager for IDF. 50% of the AMC’s board comprises independent directors, mainly retired, senior bankers. Two-thirds of the directors of IATL, the trustees, are also independent.

Figure 2

Asset Management Structure



Source: Company

AMC has senior and experienced professionals with strong skill sets in the infrastructure sector and investment management. Also, project finance, risk management and financial advisory professionals are being seconded from different group companies of IL&FS.

Experience and Track Record in Portfolio Management

Ind-Ra has assessed that IIAML has excellent credentials to capably discharge its obligations to IDF. It has been capitalised at INR183m, with IFIN holding a 91.80% stake while LIC holding the remaining stake.

Ind-Ra views the IL&FS group's rich experience in fund management as being immensely beneficial to IDF in establishing and managing its investments. The group undertakes asset management activities through both IFIN and IIML. IFIN manages debt funds focussed on investments in long-term infrastructure projects.

Figure 3

Different Funds Managed by IL&FS Group

Fund	Vintage	Size (INRm)	Status	Gross returns per annum (%)
IIML				
AIG India Sectoral Equity Fund	1997	4,550	Divested	27
India Project Development Fund	2000	800	Divested	23
Leverage India Fund	2004	7,650	Divesting	
Pan Asia Project Development Fund	2006	2,250	Divesting	
Tara India Fund III	2007	11,250	Monitoring	
SCI Asia Fund	2008	32,900	Investing	
IFIN				
Structured Mezzanine Credit Facility	2007	26,500	Financing	14

Source: Company

IIML is one of the first movers in India's infrastructure private equity market. So far, it has invested USD545m, spread over 37 investments in the infrastructure space.

Figure 4

IIML's Notable Investments

Year	Sector	Investment company
1998	Telecom	Hutchison Max Telecom (Vodafone)
2000	City gas	Indraprastha Gas
2000	Roads	Noida Toll Bridge Co Ltd
2001	Water	Vizag Water Supply Co Ltd
2004	Railways	Pipavav Railway Corporation
2009	Waste management	Ramky Enviro Engineers
2011	Agricultural warehousing	JICS Logistics

Source: Company

IDF's objective is to maximise returns by investing in subordinated, mezzanine and unsecured debt instruments. Ind-Ra draws comfort from IFIN's experience in operating and managing the structured mezzanine credit facility (SMCF) formed by IL&FS. SMCF was formed with a corpus of INR26.5bn in partnership with 14 banks and financial institutions to offer financing for organic growth in infrastructure, industrial and service sectors and inorganic growth through mergers and acquisitions. IFIN is the facility manager for SMCF and has experience in the identification of projects, credit appraisal and monitoring. Instruments under SMCF include optionally convertible debentures, subordinated debt, guarantees, risk participation agreements, collateralised debt obligations, viability gap instruments and leveraged leases.

Moreover, prior to its sale in 2004, the IL&FS group had around INR25bn of AUM, spread over 10 mutual fund schemes. The agency believes that AMC's organisation and operations are structured in compliance with the duties specified under SEBI guidelines.

Quality and Stability of Credit Selection and Monitoring Process

The credit selection process is governed by an investment committee formed by AMC's board, which has designed the investment policy adopted by the company for managing IDF's investments.

The AMC, leveraging the existing IL&FS' relationships, would identify and source potential investment opportunities. These would be screened from techno-legal-commercial and environmental angles to establish *prima-facie* feasibility of making an investment. Critical issues will also be identified and addressed through an appropriate transaction structure.

Every such proposal is passed through a well-documented, detailed credit evaluation process. AMC may use a proprietary credit rating model to estimate the risk levels to appropriately price

and incorporate suitable mitigating factors.

After finalising the transaction structure, contractual obligations are captured in legally enforceable documents.

The proposal would then be presented to the investment committee, whose approvals are based on a two-thirds majority of members present and voting. The committee would also periodically consider the fund's investment policy, track portfolio composition and review performance. The fund's performance will be monitored against its peer group and presented and reviewed at every meeting of the committee.

To better monitor its investment portfolio, AMC would appoint, where possible, its nominee on the board of investee companies. Periodic performance reports would be sought from the investees and presented to the committee.

Ind-Ra believes that the experience and track record of the investment teams and management, gained by managing funds at the sponsor (IFIN), will benefit the credit selection and monitoring process at IDF.

Extent and Quality of Internal Controls, Operating Policies, Systems and Risk Management Guidelines

The rating benefits from IDF's strong internal control mechanisms, robust risk management practices and operational policies.

As required under the relevant SEBI guidelines, the following committees have been constituted:

Figure 5

Committees Constituted

Committee description	Composition	Quorum	Frequency of meeting
Audit committee	Three directors including two independent members	Two members or two-thirds of the members of the audit committee, whichever is greater	Quarterly and as often as required
Risk management committee	<ul style="list-style-type: none"> One independent and one non-independent director Chief executive officer Chief risk officer – IL&FS group Chief investment officer Compliance officer Chief financial officer 	Two members or two-thirds of the members of the audit committee, whichever is greater	Quarterly and as often as required
Investment committee	<ul style="list-style-type: none"> Two non-independent directors plus Chief executive officer Chief risk officer Chief investment officer 	Two members or two-thirds of the members of the audit committee, whichever is greater	Quarterly and as often as required
Valuation committee	<ul style="list-style-type: none"> One non-independent director plus Chief executive officer Chief investment officer Chief financial officer Compliance officer 	Two members or two-thirds of the members of the audit committee, whichever is greater	Quarterly and as often as required
Investor grievance redressal committee	<ul style="list-style-type: none"> One independent director Chief executive officer Chief investment officer Compliance officer Chief financial officer 	Two members or two-thirds of the members of the audit committee, whichever is greater	Quarterly and as often as required

Source: Ind-Ra

The audit, risk management, investment, valuation and investor grievance redressal committees are headed by AMC's board members or experienced and senior managerial personnel. The risk management team is housed outside the fund management to maintain independence and avoid conflict of interest in the credit oversight function. The chief

investment officer appraises proposed investments after a holistic evaluation and recommends them to the investment committee. The chief risk officer independently takes a final view of the risks associated with credits and recommends them to the investment committee.

Infrastructure

In Ind-Ra's view, AMC is equipped with technological infrastructure commensurate with the fund's size and operations including the need to secure effective segregation of various functions (e.g., investment management and risk management) and operations (dealing and back office).

Portfolio Credit Quality

Target Portfolio Composition

Figure 6 shows IDF's asset allocation strategy and the likely risk profile, according to its investment policy:

Figure 6

Asset Allocation Strategy

Instrument	Indicative allocation	Risk profile
Debt instruments (including fixed/floating rate debt instruments and securitised debt) of infrastructure companies or infrastructure capital companies or projects or SPVs which are created to facilitate or promote investment in infrastructure and other permissible assets in accordance with SEBI regulations or bank loans in respect of projects - both completed and under construction	90% to 100%	Medium to high
Money market instruments	0% to 10%	Low to medium

Source: Private placement memorandum

Figure 7 shows IDF's target investments, portfolio allocation and target yield range to achieve the investment objective.

Figure 7

Target Investments

Target investment	% of portfolio range	Rating range
Refinance operational infrastructure projects	20-100	'IND AAA' to 'IND BBB-'
Funding to infrastructure companies or infrastructure capital companies investing in operational infrastructure projects subject to adequate existing cash flows	0-40	'IND AAA' to 'IND BBB-'
Bonds of public financial institutions or infrastructure finance companies	0-100	'IND AAA' to 'IND AA'
Money market/liquid securities	0-10	'IND AAA' to 'IND AA'

Source: Private placement memorandum

AMC has identified two projects which are operational and/or in advanced stages of construction completion for an aggregate investment of around INR3.5bn-INR4bn.

The fund would target to invest at least 70% of the corpus in instruments rated 'IND BBB-' (or equivalent) and above. The maturity of the investments will be prior to the maturity of the scheme, or later only when a guaranteed take-out is available from an investment grade rated entity. For any deviations in the credit ratings from the floor, the fund manager shall endeavour to rebalance within 180 days from the deviation, subject to market conditions.

The fund's strategy to invest around 20% of the portfolio in operational projects with an established track record and credible sponsors should help lower risk levels in the portfolio.

According to the fund's investment strategy, 15% of the portfolio could be invested in projects which are under construction or construction is fairly advanced. However, these projects should

be backed by experienced and financially strong sponsors who will finance cost overruns.

In Ind-Ra's experience with projects facing construction delays, none of the sponsors have defaulted on their obligations relating to cost overruns, especially in highway concessions. Credible and disciplined sponsors are also known to provide additional (non-contractual) support to the project during the critical revenue ramp-up phase. The provision of such ad-hoc support from sponsors is a common feature in Ind-Ra's rated universe of infrastructure projects. For example, in 2012, on an average, out of the total debt service requirement of under-performing projects, around 30% was brought in by sponsors.

Take-out financing of bank loans (25% of the portfolio would be invested in bank loans) with respect to completed projects would allow AMC the benefit of abundant information to take well-informed investment decisions. In addition to the risk appraisal of projects that would most likely have already been conducted by banks, insights about the sponsor's relationship with the banks and comparison of actual performance with initial projections would help AMC make a more rigorous risk assessment.

The IL&FS group's investment experience from SMCF will strongly help IDF in selecting, structuring and monitoring investments in subordinated debt facilities including funding to sponsor vehicles and investments in mezzanine debt instruments. The experience will also help in credit appraisal. The group has concluded sizeable investments through SMCF.

Figure 8

Some Projects Funded by SCMF

Sector	Tenor (years)
Water	10
Thermal power	16
Wind energy	12
Port	12
Roads	14
Port	13
Telecom Infra	10

Source: IIAML

According to the investment policy, the internal auditor has to alert the board when the portfolio falls short of regulatory stipulations and/or prudential internal guidelines. This is considered as positive by Ind-Ra as the portfolio is being constantly monitored.

The agency expects the fund managers to leverage the IL&FS group's track record in implementing and financing infrastructure projects to have IDF's investments appropriately financially engineered. Where revenue/cash flow volatility is likely, credit enhancing structures and protective covenants could be built in, mitigating overall credit risk. The fund expects to seek and play an active role in its investee entities. By structuring investments that bestow on IDF's share pledges and step-in/substitution rights, AMC can play a pro-active role, particularly during periods of prolonged asset stress. The options to participate in day-to-management, effect ownership changes or induction of new and stronger sponsors/operators (including one of the group entities) become valuable tools to minimise losses on investments and ensure that residual recovery value in stressed projects is realised to the fullest possible extent.

Ind-Ra believes that the IL&FS group's experience will be valuable in AMC effecting timely, orderly and smooth exits from its investments. IIML has successfully managed, in its various private equity funds, over 50 exits at an average multiple of 2.0x, securing an average internal rate of return of around 25%.

IDF could be investing, subject to regulatory limitations, in entities/projects belonging to the sponsor group. Ind-Ra expects such transactions to be conducted at arm's length in a transparent and fair manner.

Drawing on its expertise and leveraging the sponsor group's experience, Ind-Ra expects the fund managers to construct a well-diversified (in terms of geography and sector) portfolio. This will enable IDF to achieve its investment objective, while managing the overall risk levels. Individual investments are likely to include structural enhancements and strong contractual provisions that will allow the fund to maximise recoveries over the life of the schemes even if there are payment defaults.

Appendix 1

Figure 9

IL&FS Infrastructure Group Verticals

Sector	Company	Presence
Surface transportation	ITNL	ITNL is IL&FS' group company handling the road infrastructure vertical. It has a market capitalisation of INR35bn as on date. It has 32 road projects in its portfolio, of which 11 are operating. The rest are under various stages of construction. ITNL is rated 'IND A'/Stable by Ind-Ra.
Energy	IL&FS Energy Development Corporation Ltd	It commenced operations in 2008. Besides the development and operation of power projects, the company performs advisory services in project development and implementation for state governments, large public sector companies and private sector clients. The company has 1,000MW of capacity under operation and around 13,000MW under construction/implementation.
Maritime	IL&FS Maritime Company Ltd	The company has mandates for project development, implementation and advisory services for a size of around USD3bn. The company was a co-developer of Dighi port and Pipavav shipyard. The company also undertakes project development activities in the marine sector and is actively working on around five mandates. It also performs advisory services for ports including Gangavaram port, Krishnapatnam port, Cochin port and Vizhinjam port
Water	IL&FS Water Ltd	This company handles the water and waste water sector for the group. The mandate is to develop, implement and manage water projects on a build-operate-transfer model. Tamil Nadu Water Investment Company, New Tirupur Area Development Company Ltd and IL&FS Paradip Refinery Water Ltd are some project companies under IL&FS' water portfolio.
Waste management and environmental services	IL&FS Waste Management and Urban Services Ltd	This company develops waste management models for urban local bodies, including innovative disposal methods such as waste to energy, composting and landfill. The company manages around 17 different projects and has been involved in advisory functions for local bodies and at state government level.
Project development	IIDC	IIDC is the project advisory arm of IL&FS. It has over 10 years of experience in project advisory consisting project management consultancy, project development, bid process management, policy advisory and evaluation. IIDC also actively works with government authorities and has been involved in developing policy framework for the central and state governments.
Education	IL&FS Education and Technology Services Ltd	It has around 30 branches and a tie-up with around 5,000 schools and 150 institutions. The company targets public-private partnership in the areas of education services, skill development, cluster development, health and e-governance initiatives. It is rated 'IND A+'/Stable by Ind-Ra.

Source: IIAML, Ind-Ra

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