Treatment of Non-Recourse Debt

Indian Construction Sector

Special Report

Summary

Non-Recourse Debt (NRD): A debt is considered non-recourse if no entity other than its borrower has any legal obligation to make up for any deficiencies in debt-servicing. Typically, non-recourse debt-holders have access only to the borrower's cash flow and in case of default, have only the borrower's assets as collateral. A non-recourse debt is not backed by a corporate guarantee or cross-collateral of the parent, and the borrower's cash flow is ring-fenced using various covenants.

Trend of PPP Projects: The use of NRD is prominent in the construction and infrastructure sector in India. The central and various state governments opt for the development of infrastructure such as highways, ports, airports, power, waste management and water projects under different schemes of public–private partnership (PPP). Concessions are usually made under the build–operate–transfer (BOT)/build–own–operate–transfer (BOOT) models.

Execution Through SPVs: Those companies that are awarded such projects (sponsors), execute them through project-specific special-purpose vehicles (SPV). Such SPVs are then funded with equity from sponsors and debt from banks/financial institutions, generally on a non-recourse basis to the sponsor.

Sponsor's Perspective: From the sponsor's perspective, this model is suitable for such projects, as it provides for higher gearing (debt to equity sometimes goes up to 80:20). It also allows the sponsor to have different policies for servicing SPV debt and parent debt and ring-fences the parent from difficulties at the SPV level. Raising equity also becomes easier, as the investors may be interested in specific projects and it may involve only a sale of SPV shares.

Debt Investor's Perspective: Debt investors also find it suitable, as this model allows for the identification and trapping of cash flow for debt-servicing and isolates the project from debt-servicing problems at parent or other group entities. This also allows for specialisation, as lenders can lend to specific types of projects of a sponsor.

Specific Treatment: This report describes India Ratings' specific approach to the treatment of such non-recourse debt issued by SPVs, which appropriately captures its effect on the parent's cash flow and correctly matches the debt to be serviced with the specific cash flow available to service them.

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Treatment of NRD

India Ratings uses the following approach for the treatment of non-recourse debt of ring-fenced SPVs:

1. Equity required to be invested in the SPVs is included as an outflow in the cash flow projections of the sponsor.
2. The following stresses are also included in the base case:
   - Cost overruns in SPV projects, at the levels indicated later in the document are factored into the sponsor's cash flow as these have to be funded by the sponsor.
   - The revenue of the SPVs after completion is examined to determine whether temporary debt service support would be required. It is assumed that sponsors would provide such support, even though legally not obliged to do so, if it is temporary as it protects their investment.
   - Any gaps in the cash flow of the sponsor after the stresses as above are assumed to be funded through debt on the books of the sponsor.

If the sponsor uses a subsidiary as an intermediate-level holding company for its SPVs:

1. The analytical treatment as described above is applied at the intermediate company level, considering the intermediate company as the sponsor.
2. All cash flow of the intermediate company is then consolidated with the parent and its debt is considered debt of the parent company.
3. Raising equity in such a company is a positive rating factor, as it reduces the pressure on the sponsor's cash flow.

Any debt that has corporate guarantees/cross-default clauses or other recourse to the parent or sponsor is not treated as non-recourse debt and is consolidated with the debt of the parent.

Any restructuring of the SPV's debt may lead to a reduction in the temporary support required from the sponsor. A rating review of the parent is then undertaken to examine if the revised cash flow indicates any rating action. We note that the rating action can also be positive.

Stress Levels Used

In the base case, India Ratings considers cost overrun of around 15% of the original project cost estimate (includes the effect of time overrun) and revenue underperformance of around 25% of the variable portion of the revenue. These are used for projects in the preliminary stage of construction, at which point actual data is not available.

For projects in the advanced stage of construction, the analyst makes appropriate adjustments to cost overrun assumptions based on actual data derived from the latest independent engineer's report. Actual data on revenue performance is used in case of operational projects.

The analyst may also make adjustments for the sponsor's historical record, contractual terms with various third parties and other factors, which the analyst may deem important. For example, in case of hydropower projects in the difficult terrain, the overrun assumption may be adjusted to higher levels, around 30%-50%.

Impact of the Approach

In most cases, the cash flow impact of the approach on the sponsor is likely to be the same as if the project was housed in the sponsor company itself. Therefore, the approach assumes the unstated intent of the management to support projects, despite the non-recourse nature of the SPV debt. It is assumed that the strategic importance of the project (including reputation risk posed by a default by the SPV and the need to preserve investment) is high enough for the sponsor to support the SPV as explained above. However, when the sponsor has a past track-record of not supporting any debt obligations of SPVs there would be a significant reduction in the extent of support factored for new projects.

Applicable Criteria

Corporate Rating Methodology (September 2012)

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