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Pick-Up In Municipal Bond Market Hinges On Government Support.

Two years after the Securities and Exchange Board of India (SEBI) cleared a new set of rules for issuing municipal bonds, India may finally see some activity in this segment with a couple of cities now ready to hit the market. Don't expect a booming municipal bond market yet, though, as the pick-up in municipal bonds is still linked to government support.

Both Pune and Ahmedabad are ready to go to market, Varsha Purandare, managing director and chief executive officer of SBI Capital Markets, told BloombergQuint, while adding that some regulatory clarifications are awaited. The cities have approached SEBI, asking the regulator to allow them to file their prospectus based on financials that have been audited by an external statutory auditor rather than wait for audited financials from the Comptroller and Auditor General (CAG).

While Pune and Ahmedabad are at an advanced stage of preparedness, a number of other municipal corporations are also hoping to raise money through bond issues as a way to fund their smart city projects.

In the past, most municipal corporations have depended on state or central government grants for infrastructure development. However, there is now a perceptible feeling that the government wants municipal corporations to have ownership of projects being undertaken. In particular, for smart city projects, municipal corporations have to bring in 40-50 percent of investment upfront.

Varsha Purandare, MD & CEO, SBI Capital Markets

To be able to meet this funding requirement, a number of municipal corporations will need to try and tap the markets, Purandare added.

The first step to this is to get rated. A total of 94 municipal corporations have been rated so far, Subodh Rai, senior director at rating agency Crisil, told BloombergQuint in a phone conversation. The rating profile, however, differs widely.

According to data provided by Crisil, of these 94 rated municipal corporations, only 10 are rated AA or above. About 14 are rated in the A category, while the rest are rated BBB or below.

The AA rated firms can access the market directly but the A and BBB rated firms may need some structured mechanism, said Rai. He added that A rated firms can look at securitising future cash flows or a structure where property taxes are put in an escrow account which is set aside for interest payments.

For municipal corporations rated BBB or below, accessing the market would be tougher and some sort of pooling mechanism or partial guarantee may be required, said Rai.

Subsidised Borrowing Cost

Given the rating profile of municipal corporations, the true market borrowing cost for most of them (in the BBB category) would be close to 10 percent, said Purandare of SBI Caps. However, borrowing at that interest rate may not be a viable way to fund infrastructure development, she added.

That's where government support will need to come in.

While the government has rejected a demand for tax-free status for these bonds, the urban development ministry has set aside Rs 400 crore to provide interest subsidy for these bonds, the Economic Times reported on May 15.

Both Rai and Purandare said that such a subsidy would make it more viable to fund city infrastructure development through bonds. The difference between tax-free and taxed bonds is almost 2 percentage points, Rai pointed out, while adding that the interest subsidy may help in bridging that gap. The subsidy will help bring down the cost of funds to near 7 percent, which is affordable, said Purandare.

Is There Investor Appetite?

The story of municipal bonds in India has been one of numerous stops and starts. The earliest such bond dates back to 1998 when Ahmedabad raised Rs 100 crore. Others like Hyderabad, Nasik and Visakhapatnam have also tested the market with small issues.

Municipal corporations coming to the market now will also likely start with smaller issues in the 5-7 year tenure bucket, said Purandare, adding that once the market becomes more comfortable with the product, demand may pick up leading to a decline in interest rates. This would allow for larger-sized issues to come to market.

According to Rai, the key issue for investors remains the quality of financials reported by the municipal corporations. Delayed reporting of financials and lack of transparency may concern investors, he said. At present, municipal corporations do not report quarterly or half yearly financials. The issues that come to market in fiscal 2018 will be based on fiscal 2016 financials.

On the flip side, volatility in municipal finances is typically low and expected loss would be low for this category of issuers which may attract investors, said Rai.

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