India set for wave of new-look municipal bonds

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By Krishna Merchant

SINGAPORE, June 19 (IFR) - A wave of Indian municipal bond issues could mark the coming of age of a market which has struggled to take off because of a lack of investor appetite.

Pune Municipal Corporation and New Delhi Municipal Council have both mandated SBI Capital Markets as lead arranger for municipal bond offerings.

PMC plans to raise 2 billion rupees ($31 million) from 10-year bonds this month, chief accounts and finance officer Ulka Kalaskar said. NDMC is planning to raise a similar amount, but is yet to finalise the tenor and timeline.

Greater Hyderabad Municipal Corporation is also in the pipeline, according to DCM bankers.

Earlier this year, the Securities and Exchange Board of India eased rules governing the issuance of municipal bonds in an effort to kick-start the market. Sebi allowed municipalities with budgetary surpluses in the preceding three financial years to issue public debt securities. Under earlier rules, municipalities could not issue bonds if they had negative net worth for the three years preceding the offering.

Municipal corporations, known as urban local bodies (ULBs), are testing the waters with small bond issues.

The offerings come at a time when India is shifting the burden for funding urban infrastructure onto local governments and the private sector.

Grants have been made conditional on ULBs raising their own funding.

"The ones which have good financials and surpluses would perforce have to come to the bond market," said Madan Sabnavis, chief economist at Care Ratings.

Unsurprisingly, cash-rich and financially sound municipal corporations are tapping the market first. Of the 94 cities that have been assigned credit ratings so far, only six are rated AA and above. Pune, New Delhi and Navi Mumbai's urban local bodies are rated AA+ and that of Greater Hyderabad is rated AA.

PMC plans to raise 22.64 billion rupees in total from municipal bonds over the next five years to help fund a 32 billion rupees water supply project. NMDC is most likely to use the funds for general obligations. Both ULBs have sustained revenue surpluses, according to Care.

GOVERNMENT PUSH

Behind the push to encourage municipal bond issuance is Prime Minister Narendra Modi's two-year-old Smart Cities Mission to modernise 100 cities by 2020, providing them with clean and uninterrupted power and water supplies and efficient public transport systems.

The government is looking for ULBs to raise 75 billion rupees from municipal bonds in FY17 alone, compared with the 13.5 billion rupees mobilised since 1997, according to Crisil Data.

Credit ratings, pricing and the performance of initial offerings will have a crucial impact on demand for the bonds. Investors will want a spread of at least 80-100 basis points over AA+ rated 10-year corporate bonds, currently trading at 7.67 percent, according to the fixed income head of a domestic mutual fund.

The Ministry of Urban Development will give a 2 percent interest subsidy to municipal corporations issuing bonds.

Pune plans to create a separate escrow account and transfer money on a monthly basis for coupon payments, Kalaskar said, which will provide some comfort to investors.

Additionally, since municipal bodies do not have a state-government guarantee, state-owned banks are likely to be the main participants in the first few issues, said Akhil Mittal, senior fixed income fund manager at Tata Asset Management.

There is still no clarity on whether provident funds can invest in ULB bonds because current guidelines only allow them to invest in debt securities issued by corporate bodies, including banks and public financial institutions.

Most mutual funds and insurance companies are waiting to see how the first few issues are priced before subscribing to muni bonds, even though there is plenty of liquidity and mutual funds are not restricted to buying only bonds with a AA rating or better.

"Municipal bonds are not tax-free bonds and may not find too much retail interest, and the absence of a secondary market will be a deterrent," said Sabnavis of Care Ratings.

Although many investment bankers have bid for ULB bonds, there is some disappointment among arrangers that the investment banking arm of state-owned State Bank of India won both early mandates.

"If there were more arrangers, they would be talking to more investors that could be educated about a new product," said a DCM banker.

Additionally, small and mid-sized ULBs will face difficulty in raising capital through bonds for two reasons, "their issuances are typically small, owing to low debt requirement and their knowledge of financial market is limited. These ULBs could consider structures such as pool financing to access the markets," said Anuj Sethi, senior director from Crisil Ratings. (Reporting by Krishna Merchant; Editing by Vincent Baby and Daniel Stanton)