Policy for investment in equity of power projects

1. Background

a) Rationale

Since PFC has attained remarkable experience in power sector debt financing during its over 20 years of operations, the stage seems to be now set for PFC to make a mark in the area of equity investment. PFC can leverage its immense financial strength, large debt providing capability and domain expertise in power sector to invest in instruments other than debt like equity, mezzanine products etc. in attractive power projects. The profits from a skillfully built equity portfolio are expected to go a long way in maximizing the shareholders' wealth.

b) Instruments for investment in Equity

The exposure in equity can directly/indirectly be taken mainly through the following instruments :

- Equity shares
- Preference shares
- Sub-ordinated Debt with equity conversion option
- Bonds with warrants/equity conversion option
- Convertible Debentures

2. Overall exposure limits

The exposure norms as defined in PFC's Prudential Norms and the investment limits as stipulated in DPE guidelines would serve as overall ceiling limits for any kind of equity investment.

3. Classification of investee companies

The companies have been divided into following four broad groups for the purpose of equity investment.

a) Central Public Sector utilities(CPSU) or a SPV in which a CPSU has minimum of 51% equity stake (Group1)

b) State Public Sector utilities(SPSU) or a SPV in which a SPSU has minimum of 51% equity stake (Group 2

c) Companies u/s 619-B of Companies Act, 1956 i.e. companies where at least 51% stake is held jointly by any combination of Central Govt./State Govt./one or more Government Company(Group 3)

d) Private Companies (Group 4)

The broad risk profile of equity investment not only varies across above categories but also within a single category, the perceived risk profile undergoes change depending on the institutional and financial strength of the companies.

4. Policy guidelines for investment in equity

The various aspects of equity financing related to the above categories of companies are described below:

<table>
<tr><th></th><th>Group 1</th><th>Group 2</th><th>Group 3 (619 B Cos)</th><th>Group 4 (Pvt)</th></tr>
<tr><td rowspan="3">Maximum Exposure

(Lower of the two)</td><td colspan="4">As a % of PFC’s networth</td></tr>
<tr><td>Navratna/ Miniratna CPSUs in any sector or CPSUs in power sector - 5%

Other CPSUs – 2.5%</td><td>A+ : 3%
A : 2%
B : 0.5%</td><td>Companies operating in power sector or companies in which power sector CPSUs have a minimum equity stake of 26% - 5%

Other 619B companies - 2%</td><td>Grade IR1, IR2: 2%

Grade IR3, IR4: 1%</td></tr>
<tr><td colspan="4">As a % of equity capital of the Project company : 26%
(If the equity exposure proposed to be taken is more than 11%, then such cases shall be considered only when PFC has taken debt exposure)</td></tr>
<tr><td></td><td colspan="4">• The grade for private sector shall be based on composite rating model of PFC.
• The total equity commitment (sanction) in a financial year shall be limited to 10% of the networth of PFC.
• Power sector CPSUs shall include the main plant equipment manufacturers for power sector like BHEL etc.
• Consequent to PFC’s investment, the regulatory identity of the investee company should not undergo a change.</td></tr>
<tr><td>Investment decision</td><td colspan="4">The various aspects to be examined and assessed are:
• Techno-economic viability of the project as per criteria laid down in OPS.
• Tie-up of various project inputs and outputs.
• Bankability of project structure and contractual arrangements.
• Experience, financial strength and rating of the promoters in acceptable grade (as mentioned in para ‘Exposure’ above) .
• The entity in which the equity exposure is proposed should fall within Investment Grade as per PFC’s categorization.
• A minimum targeted return would be required as decided by PFC.</td></tr>
<tr><td>Exit Strategy</td><td colspan="4">Normally, PFC shall not exit a project till it is commissioned. After commissioning, the decision to hold/sell shall be taken depending on market conditions, performance of the plant, dividend pay out, expansion plans of the project company etc. Also, at times, the exit is governed by the shareholders’ agreement which may stipulate conditions like necessary lock-in for a certain period, first right of refusal to promoters etc. The various methods for exit from equity investments are as follows:
• Trade sale (Trade Sale implies sale of the equity shares of a company to another company)
• IPO
• Buyback arrangement with promoters and/or company with a minimum guaranteed return
• In case of holding co.–SPV structure, conversion of shares at SPV level into shares</td></tr>
</table>

	of holding company and selling shares of holding company through stock exchanges(secondary market)/trade sale/IPO • Any other acceptable route. In private projects, where PFC enters at the Greenfield stage with equity commitment, it would normally insist on promoters and project company undertaking to provide an exit through trade sale or an IPO with a minimum post-tax IRR as decided by PFC. In case exit through above routes with the desired return could not be accomplished, the promoters and/or company would normally be required to buyback shares providing the pre-stipulated minimum post-tax IRR to PFC. However, in cases where PFC enters at an advanced stage of project implementation, the exit options would be negotiated on a case to case basis. Further, in Government projects, exit may generally be possible through a Trade Sale or an IPO with no minimum IRR provision. Exit route / Conversion of equity shares of SPV into shares of the holding company shall be decided upfront.
	In all cases of equity investments, exit should necessarily be available to PFC either through trade sale or buyback arrangement. Additionally, exit through IPO may also be available. In case of buyback arrangement, PFC shall also have the right to sell the equity holding to third party in the unlikely event of project promoters/company not being able to execute buyback due to any reason. PFC shall negotiate one or more exit options with the promoters depending on the merits of the case.
Draw down of Equity	There could be two ways of putting in equity by strategic financial investors like PFC - (i) Last Mile (LM), (ii) Pro-rata with other shareholders without participating in upfront equity (PWU) ***Last mile*** equity shall be the last installment(s) of equity payable for the project as per the latest cost estimate and cash flow statement approved by the lenders. LM is the most favored mode by strategic investors like PFC while promoters would push for PWU. However, the issue is generally negotiable. Hence, PFC may prefer to follow a pragmatic approach while negotiating various issues related to equity financing with the core promoters on a case to case basis. The minimum LM limit for different kinds of companies is presented below:

Group 1	Group 2	Group 3	Group 4
• Navratna/ Miniratna CPSUs in any sector or CPSUs in power sector – 50% • Other CPSUs- 75%	• A+ & A : 75% • B : 100%	• Companies operating in power sector or companies in which power sector CPSUs have a minimum equity stake of 26%: 75% • Other 619B companies- 100%	• Grade IR1& IR2: 50% • Grade IR3& IR4: 75%

	• The PWU option would normally be applicable for any borrower only if PFC is also a lender to the project, otherwise the entire equity shall be invested by PFC as Last Mile equity. • In case of projects involving long gestation period (with construction period more than four years), PFC shall insist on subscribing to last mile equity irrespective of the grading of the project.
Board	PFC shall insist on securing a right to appoint nominee director on the board in all

<table>
<tr><td rowspan="2">Nomination</td><td colspan="2">cases of equity financing. However, the right shall be a pre-requisite in following cases:</td></tr>
<tr><td><u>Group 1,2 & 3,</u> where

PFC's equity stake is 15% or more</td><td><u>Group 4,</u> where

PFC's equity stake is 7.5% or more</td></tr>
<tr><td>Shareholder's Agreement (SA)</td><td colspan="2">Shareholder's agreement (SA) defines issues like Board composition, management control, ratio of shareholding, transfer of shares, terms of exit, arbitration, issue of further shares in instances like cost-overrun, expansion projects etc. Moreover, SA in case of private projects generally has certain provisions in favor of PE/strategic investors. These include drag along rights, tag-along rights, buyback arrangement with minimum guaranteed return, promoter-lock-in, price protection, put/call options etc. SA would be negotiated on a case to case basis depending on strength of the promoters as also the prevailing market practice.</td></tr>
<tr><td>Valuation</td><td colspan="2">The equity, in case of green field projects, would normally be taken at par value.
In case of extension/ commissioned projects or green field projects nearing completion, equity may be considered to be taken at a premium. In such cases, services of an Independent Firm shall be used to obtain an independent view regarding valuation of the Project Company.</td></tr>
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5. Structuring on a case to case basis

PFC could take direct equity stake or invest in other equity related instruments like Preference shares, sub-ordinate debt with equity conversion option, bonds with warrants convertible debentures etc. The equity deal could be structured on case to case basis on merits and prevailing market practice so as to balance risk-reward matrix.

In special cases, where it is more advisable w.r.t exit option, risk reward position, higher flexibility etc., PFC may explore the possibility of investing in a holding company which owns one or more power projects. In such cases, all the operational projects & under-construction projects as well as future plans of the company would be analysed. Generally, views of an Independent Firm regarding valuation would be considered while taking equity at the holding level.

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