

Unlocking 15x Growth: Muni-Bonds as Catalysts for Urban Infra Financing

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Synopsis

In this report, CareEdge Ratings provides an in-depth analysis of the increasing importance of municipal corporations in India for financing urban infrastructure development, the potential of municipal bonds, and the key reforms needed to unlock this potential.

- Urban infrastructure capital expenditure is projected at Rs. 3.5 lakh crore for the period FY21-FY26 under the National Infrastructure Pipeline. Historically, government grants and the revenue sources of municipal corporations have been the primary methods of financing.
- CareEdge Ratings has analyzed finances of 36 key municipal corporations (representing metros, tier I and tier II cities) with aggregate annual revenue receipt of ~Rs.1.3 lakh crore. It is observed that own revenue- in form of property tax, fees and user charges constituted ~50% of total revenue receipts while property tax revenue share formed ~60% of own revenue.
- Tax revenue had grown at modest Cumulative Annual Growth Rate (CAGR) of 5% for the period ended FY18-FY23 necessitating implementation of reforms for augmenting property tax base in India.
- As per the study undertaken, the aggregate outstanding borrowings of 36 municipal corporations in the country was estimated at ~Rs.12,000 crore as on March 31, 2023, with the share of bonds in the overall borrowing composition- a meagre 18%.
- Cumulative Debt raised in the form of Muni bonds stood at just ~Rs.2380 crore for the period FY18 to 9MFY24. As per CareEdge Ratings estimates, municipal corporations reporting adequate surplus possess superior financial flexibility to raise incremental debt of ~ Rs.25,000 crore. This also underscores the potential of muni bond market to grow by 15x over the next 5 to 8 year period.

Burgeoning urban infrastructure requirements

- Urban population in India significantly rose from ~28% of the total population in 2000 to ~35% in 2022. By 2036 this is expected to further inch up to 40%. With increasing urbanization, and industrialisation along with the higher contribution of cities in state GDP, the need for augmenting existing urban infrastructure becomes imperative. Urban local bodies (ULBs), by their constitution, are entrusted with the responsibility of providing and augmenting basic municipal services. Thus, they play a pivotal role in overall capital outlay towards urban infrastructure growth viz. improving roads, water supply, and sewage treatment infrastructure besides incorporating green energy and climate change solutions. Revisiting the master plan of the cities every 2-3 years, effective engagement of all stakeholders for the development of cities and creating resilient infrastructure thereby minimising operations and maintenance requirements would be crucial for requisite urban infrastructure development.

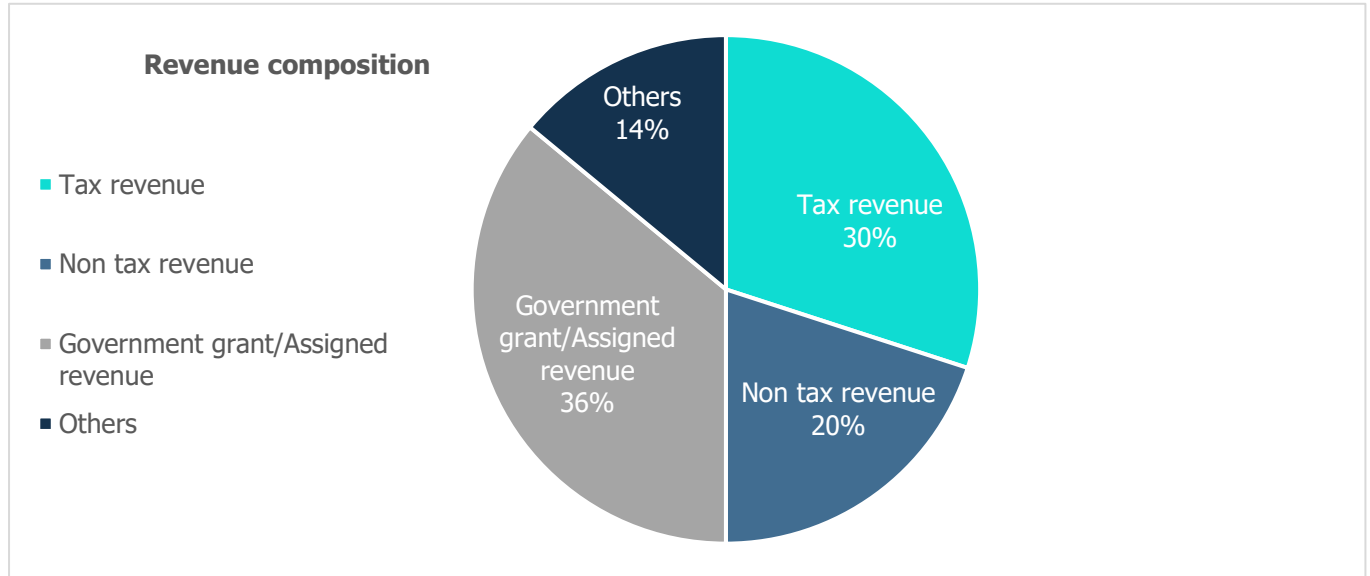
Urban Infrastructure Capex and Muni Bond Financing

Government grants and own revenue of municipal corporations are the prominent sources of funding for the urban infrastructure capex estimated at Rs.3.5 lakh crore for FY21-FY26 under the schemes of Atal Mission for Rejuvenation and Urban Transformation (AMRUT) and Smart City mission- as part of the National Infrastructure Pipeline. Dependence on State grants continues to be high for the ULBs and therefore in order to increase self-

reliance, there is a strong need to evaluate alternate funding sources. Municipal bonds are one such alternative which can bridge the financing gap.

Revenue Profile of Municipal Corporations

On examining the revenue profile of the municipal corporations, the various components are enumerated as below-

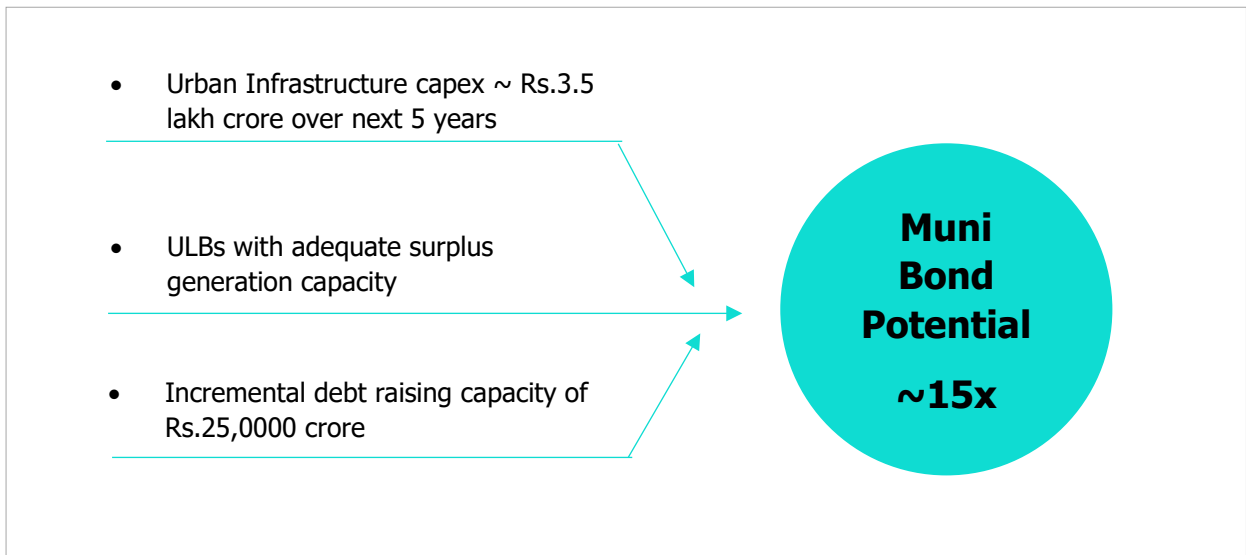


Source: CareEdge Ratings and Munify

- The revenues comprising tax and non-tax revenue receipts (forming almost 50% of overall revenue profile) signifies the revenue generating capacity of the Corporation on its own and is thus critical for its financial health. Property tax revenue, on an average, comprises nearly 60% of the own revenue source and it is estimated to have grown at a moderate CAGR of 5% for the period ended FY18-FY23. This thereby necessitates implementation of reforms for augmenting property tax base in India. CareEdge Ratings has also observed that all the municipal bond issuances typically stipulate escrowing of property tax with coverage of 1.5-2x thus underscoring the importance of own revenues.
- While various reforms have been undertaken by the municipal corporations, the latter's inability to increase the tax rates for nearly a decade has subdued the potential property tax revenue growth. Also, under recovery of user charges has restricted the revenue-generating potential of the Municipal Corporations. CareEdge Ratings opines those reforms in user charges with effective cost recovery, linking of property tax assessment to capital value and increase in revenue collection efficiency are crucial for augmenting own revenue for municipal corporations. Therefore, successful implementation of reforms in enhancing own revenue can also increase the penetration of municipal bonds.
- Receipts from the State Government (~36%) along with other income (~14%) comprise the balance 50% of revenue for the Municipal Corporations. It thus becomes even more important to devise ways to improve its own revenue share to reduce dependence on the State and evaluate alternative financing mechanisms.

Potential for the muni-bond market

- The Indian Muni bond market is still at a nascent stage of development with an aggregate issuance of Rs.3260 crore (~USD40 million) of bonds raised during the past two and half decades ended December 2023 as against ~USD 292 billion by USA Municipal bodies in calendar year 2022 alone.
- Based on a study undertaken by CareEdge Ratings, the aggregate outstanding borrowings of sample 36 municipal corporations in the country was estimated at ~Rs.12,000 crore as on March 31, 2023, with a share of bonds in the overall borrowing composition a meagre 18%. These entities have healthy profitability (revenue surplus/revenue receipts) in the range of 20-25% and have ample liquidity mainly in the form of unencumbered fixed deposits. These corporations are expected to have financial flexibility in the form of raising incremental debt of around Rs.25,000 crore. This also signifies muni- bond market potential to grow by 15x. Needless to mention, the liquidity available with the ULBs in form of cash and cash equivalents provide additional financing support for urban infra capex requirements.



Challenges and Way forward

- The ULBs are quasi-government bodies with functions and operations not comparable to the Corporates. However, from bond investors and credit perspective, both are alike and thus warrant strengthening of disclosure norms, compliance with regulatory requirements, management information system, etc for tapping bond market.
- Adopting socialistic approach and reluctance to increase charges (in fear of public protest) also explain the modest growth in property tax in India over the years. The centralization of property tax rules across India, improving service deliverables and digitalization can also pave way for growth in property tax revenue and in turn boost muni bond issuances. Implementation of geographical information system and linking it to tax collection; smart metering for water connection etc are also crucial for enhancing tax collection efficiency and user charges recovery.
- The Investors especially the Insurance and pension funds have investment restrictions basis underlying credit rating thus leaning towards only high rated bonds, which are very few. Thus, encouraging the existing issuers to re-issue bonds, exploring retail participation and introducing credit enhancement structures for the bond issuances shall provide an enabling environment for deepening the muni bond market.

CareEdge view

The Interim Union Budget for 2024-25 has placed a strong emphasis on maintaining a robust pace of infrastructure development, allocating an overall capital expenditure (capex) outlay equivalent to 3.4% of GDP. The capex planned for Urban Infrastructure stands at approximately Rs. 3.5 lakh crore, with additional investments necessary to meet the demands of a burgeoning urban population. Consequently, Municipal Corporations must enhance their financial autonomy to effectively finance the capex requirements associated with this demographic growth.

"Tax revenues represent a significant portion, nearly 60%, of municipal corporations' own revenue sources. It has been observed that the Compounded Annual Growth Rate (CAGR) of tax revenue was modest, at 5%, for major municipal corporations over the period FY18-FY23. This underscores the urgent need for implementing reforms to expand the property tax base. CareEdge Ratings suggests that reforms in user charges to ensure effective cost recovery, linking property tax assessments to capital value and improving revenue collection efficiency are essential steps for increasing the own revenue of municipal corporations. Regular revisions of city master plan every 2-3 years, effective stakeholder engagement in city development, and the construction of resilient infrastructure are also pivotal for the advancement of urban infrastructure development," says Rajashree Murkute, Senior Director at CareEdge Ratings.

Puja Jalan, Associate Director, further comments on the potential and future direction of municipal bonds. "CareEdge Ratings believes that strong municipal corporations with sufficient surplus have the financial flexibility to raise additional debt of approximately Rs. 25,000 crore, alongside leveraging their substantial cash reserves for urban infrastructure funding. This indicates the municipal bond market's potential to expand by 15 times. However, from the perspective of investors and credit rating agencies, it is imperative to strengthen disclosure norms, internal controls, compliance with regulatory standards, and the robustness of management information systems to access the bond market effectively. The standardization of property tax regulations across India, enhancements in service delivery, and digitalization efforts can further contribute to the growth of property tax revenue, thereby stimulating the municipal bond market. Moreover, focusing on credit enhancement mechanisms for bond issuances shall be a useful strategy for deepening the municipal bond market's penetration in India."

Contact

Rajashree Murkute	Senior Director	rajashree.murkute@careedge.in	+91 - 22- 6837 4474
Maulesh Desai	Director	maulesh.desai@careedge.in	+91 - 79- 4026 5605
Puja Jalan	Associate Director	puja.jalan@careedge.in	+91 - 40 - 4010 2030
Tej kiran G.	Assistant Director	tej.kiran@careedge.in	+91 - 40 - 4010 2030
Mradul Mishra	Media Relations	mradul.mishra@careedge.in	+91 - 22 - 6754 3596

CARE Ratings Limited

Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Phone : +91 - 22 - 6754 3456 | CIN: L67190MH1993PLC071691

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