Alternative Investment scenario in India

Leveraging privately pooled Funds for risky investments and generate returns on such risk capital.

Nomura Research Institute Consulting and Solutions India Pvt. Ltd.

Global Knowledge Centre

Written By: Suramya Shome

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Session View

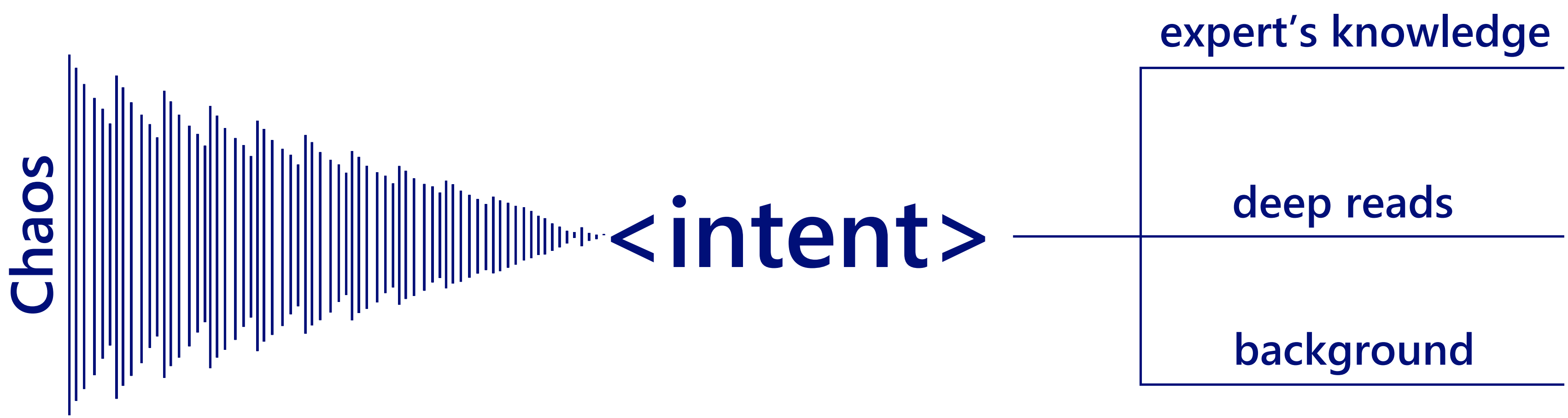
1. Intent

The goal is to understand how the concept of Alternative Investment Fund (AIF) evolved in India through this paper

~ The document is made with an understanding to persuade potential reader on Alternative Investments in India.

~ It combines expert's knowledge and research that discusses over policies taken up by the Government of India, the overall investments arrived in India after recommendations from experts.

~ The paper allows the reader to understand the background of AIFs in India. The information provided are data-centric, text-heavy and are for deep reads and tend to have a formal tone.



SEBI in-short refers to a privately pooled investment vehicle as Alternative Investment Fund or AIF

~ Alternative Investment Funds (AIFs) deeply influence the global financial system and economy with investment decisions affecting the capital markets, companies and individuals. According to Securities and Exchange Board of India (SEBI) under Regulation 2(1)(b) of the Regulation Act, 2012, Alternative Investment Fund or AIF means any fund established or incorporated in India which is a privately pooled investment vehicle which collects funds from sophisticated investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors.

~ AIF does not include funds covered under the SEBI (Mutual Funds) Regulations, 1996, SEBI (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities. Further, certain exemptions from registration are provided under the AIF Regulations to family trusts set up for the benefit of 'relatives' as defined under Companies Act, 1956, employee welfare trusts or gratuity trusts set up for the benefit of employees, 'holding companies' within the meaning of Section 4 of the Companies Act, 1956 etc.

~ AIFs has 3 major concepts for raising and investing capital:

~ Commitments received refers to Corpus which is the total amount of funds committed by investors to the AIF by way of a written contract or any such document as on a particular date. [Ref. Regulation 2(1)(h)]

~ Funds raised refers to the actual amount been deposited by the investor to the AIF of its Commitment

Investment made refers to the real amount that has been spent from the AIF after being raised.

Source: SEBI website

Before July 2011, India did not have any regulation that defines or regulates the Alternative Investment Funds

Before 2011:

~ SEBI (Venture Capital Funds) Regulations ("VCF Regulations") were framed in 1996 to encourage funding by entrepreneurs' early-stage companies in India. However, over the years, the Venture Capital Funds (VCF) route was being used by several other funds including Private Equity (PE) funds, Real Estate funds, etc.

~ This made it difficult to target concessions and incentives specific to VCFs without enabling other funds to avail of such incentives or concessions.

~ Further, the investment restrictions placed on VCFs were not suitable for such funds. Hence, on one hand, there was a set of funds like VCF which required incentives and concessions and were comfortable with consequent restrictions attached and on the other hand, there was another set of funds like PE funds that did not require incentives and concessions but required investment flexibility.

~ Further, since registration of VCF was not mandatory under VCF Regulations, all players in the alternative funds' industry were not registered with SEBI. Hence, there was a regulatory gap that needed to be addressed.

Source: SEBI website

On July 28, 2011, a regulatory framework for private pools of capital and a mechanism to monitor and assess systemic risks were formalized

After 2011:

~ The SEBI Board, in its meeting held on July 28, 2011, while considering the agenda on "Plan of Actions for Compliance to Eight New International Organization of Securities Commissions (IOSCO) Objectives and Principles of Securities Regulation", approved the proposal for a clear regulatory framework for private pools of capital which may, inter-alia, provide for a mechanism to monitor and assess systemic risks and risks to financial market stability posed by the activities of such funds.

~ Taking into consideration the above, SEBI proposed a Regulatory framework for Alternative Investment Funds on August 1, 2011 through the concept paper placed on SEBI website along with the draft AIF Regulations which was kept open for public comments till August 30, 2011. Through this concept paper, SEBI proposed to regulate all funds established in India which are private pooled investment vehicles raising funds from Indian or foreign investors, excluding Mutual Funds and Collective Investment Schemes registered with SEBI. Further, any such pool of funds which is regulated by any other regulator in India like banks, pension funds, etc. was also proposed to be excluded from the purview of the proposed Regulations.

~ Based on the public comments, the revised Regulations were submitted for the approval of the SEBI Board in its meeting held on 2nd April 2012. The final Regulations were issued on 21 May 2012.

~ The AIF Regulations is an attempt to extend the perimeter of regulation to hitherto unregulated funds, so as to ensure systemic stability, increase market efficiency, encourage formation of new capital and provide investor protection.

Source: SEBI website

To have a distinctive capital asset class, that reforms macroeconomic drivers and financially stressed industry

Role:

~ AIFs generate new investment opportunities and services to increase the source of the capital. It also helps to reform the macroeconomic drivers, post-crisis financial industry regulation and two critical industry trends.

Objective

~ To provide:
  a. Flexible options to take long and short positions for investment returns
  b. Specific, measurable, achievable, relevant and time-bound opportunities for investors
  c. New business models for alternative investment firms and individuals
  d. Less volatile investment environment
  e. Benefits of diversification

~ To develop strategies for safe and steady growth in income.

~ To recognize Alternative Investment Funds (AIF) such as PE or VC etc., as a distinct asset class apart from promoter holdings, creditors and public investors.

Source: SEBI website and NRI analysis

As per SEBI's Regulation 3(4), there are 3 different category of AIFs in India, namely Category 1 AIFs, Category 2 AIFs and Category 3 AIFs

According to the Securities and Exchange Board of India, AIFs are classified into three broad Categories along with subsequent categories: [Ref. Regulation 3(4)]

Category 1 AIFs	Category 2 AIFs	Category 3 AIFs
Venture capital funds (Including Angel Funds)	Private Equity (PE) Fund	Hedge Fund
Small and Medium Enterprises (SME) Funds	Debt Fund	Private Investment in Public Equity Fund (PIPE)
Social Venture Funds	Fund of Funds	
Infrastructure funds		

~ Total investments made by all categories of AIFs put together has increased from INR 351 billion in March 2017 to INR 614 billion in March 2018 to INR 1098 billion in March 2019. The surge in assets is a function of simplified regulatory framework, options for customization, investment flexibility and robust returns.

Source: SEBI website

Category 1 AIFs mainly invests in start-ups or early stage ventures or social ventures or SMEs or infrastructure or other social sectors

▶ **Category 1 AIFs**:

~ AIFs with positive spillover effects on the economy, for which certain incentives or concessions might be considered by SEBI or Government of India;

~ Such funds generally invests in start-ups or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable.

~ They cannot engage in any leverage except for meeting temporary funding requirements for not more than thirty (30) days, on not more than four (4) occasions in a year and not more than ten (10) percent of the corpus .eg. Venture Capital Funds, SME Funds, Social Venture Funds, and Infrastructure Funds. Giving effect to the announcement by Union Finance Minister on angel investor pools in the Union Budget 2013-14, SEBI in June 2013 has approved a framework for registration and regulation of angel pools under a sub- category called 'Angel Funds' under Category I- Venture Capital Funds. [Ref. Regulation 3(4)(a)].

Category 1 comprises the following funds:

- Venture capital funds [Including Angel Funds (HNI)]

~ Venture Capital Funds invests in Startups which have high growth potential but facing investment crunch in the initial phase and need funding to establish or expand their business. Since it is difficult for new businesses and entrepreneurs to raise funding through the capital markets Venture Capital Funds become the most sought after solution for their financing needs.

Source: SEBI website

High Net Worth Investors (HNIs) who seek high risk-high return investment options prefer to invest in AIFs

~ VCFs pool in money from investors who want to make equity investments in ventures. They invest in multiple startups, depending on their business profiles, assets' size, and phase of product development. Unlike mutual funds or hedge funds, venture capital funds focus on early-stage investment. Each investor gets a share of the business the VCF has invested in proportional to their respective investment.

~ High Net Worth Investors (HNIs) who seek high risk-high return investment options prefer to invest in VCFs. After the inclusion of VCFs in AIFs, HNIs from abroad are also able to invest in VCFs and contribute to the growth of the economy.

- Angel Fund

~ This fund is a type of Venture Capital fund where fund managers pool money from numerous "angel" investors and invest in budding startups for their development. As and when the new businesses become lucrative, investors get the dividends.

~ In the case of Angel Funds, units are issued to the angel investors. An "angel investor" refers to an individual who wants to invest in an angel fund and brings in business management experience, thus guiding the startup in the right direction. These investors typically invest in firms which are generally not funded by established venture capital funds because of their growth uncertainty.

- SME Funds

~ An Alternative Investment Fund which invests primarily in unlisted securities of investee companies which are Small and Medium Enterprises (SMEs) or securities of those SMEs which are listed or proposed to be listed on an SME exchange or SME segment of an exchange.

Source: SEBI website

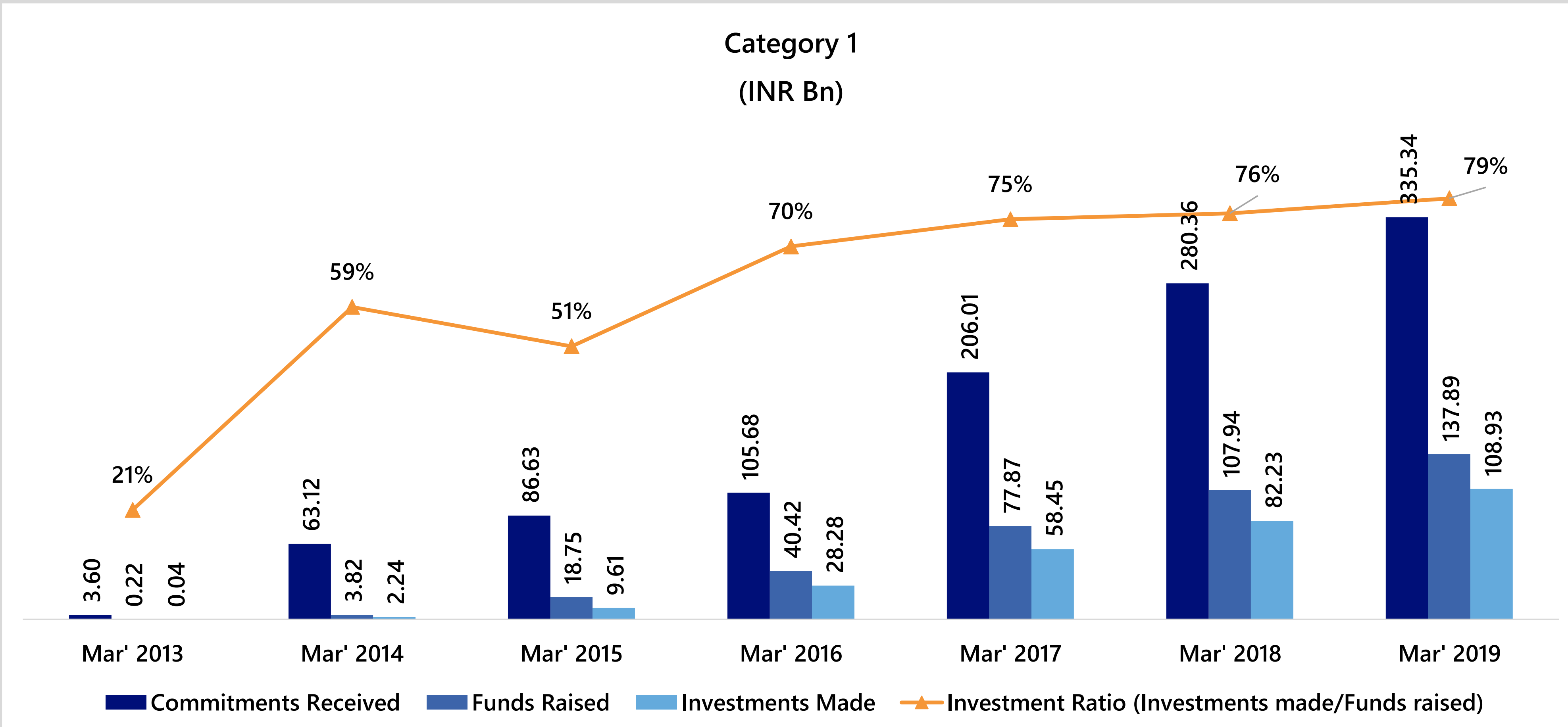
Social Venture Fund and Infrastructure fund makes it a win-win deal for all stakeholders including investors, enterprises and society

- Social Venture Fund
  - ~ Socially responsible investing has led to the emergence of the Social Venture Fund (SVF) that typically invests in companies that have a strong social conscience and aim to bring a real change in the society.
  - ~ These companies focus on making profits and solve environmental as well as social issues simultaneously. Even though it is a kind of philanthropic investment, one can still expect returns because the firms would still make profits.
  - ~ Social Venture Fund generally invests in projects based out of developing countries as they have great potential for growth as well as social change. Such investments also bring the best managerial practices, technology and vast experience on the table which makes it a win-win deal for all stakeholders including investors, enterprises and society.
- Infrastructure Fund
  - ~ The fund invests for the development of public assets such as road and rail infrastructure, airports, communication assets etc. Investors who are bullish on the infra development in the coming times can invest in the fund since the infrastructure sector has high barriers to entry and relatively low competition.
  - ~ Returns from investing in Infrastructure Fund can be a combination of capital growth and dividend income. When an Infrastructure Fund invests in socially desirable/viable projects, the government may also extend tax benefits on such investments.

Source: SEBI website

Category 1 AIF, till March'19, Funds raised INR 137.89 billion, 79% equivalent to INR 108.93 billion has been invested, keeping a dry powder of INR 28.96 billion

! Investment Trend in Category 1 Alternative Investment Funds:



#Dry powder is referred to cash reserves kept on hand by the fund managers to cover future obligations, purchase assets or make acquisitions.

Source: SEBI website & NRI representation

Category 2 AIF, comprises of debt funds, private equity funds (PE funds), funds for distressed assets and fund of funds

- **Category 2 AIFs**:

  - ~ Category 2 AIFs do not undertake leverage or borrowing other than to meet the permitted day to day operational requirements, as is specified for Category 1 AIFs. e.g. Private Equity or debt fund. [Ref. Regulation 3(4)(b)].

  - ~ Various types of funds such as real estate funds, private equity funds (PE funds), funds for distressed assets, etc. are registered as Category II AIFs.

Category 2 comprises the following funds:

- Private Equity (PE) Fund

  - ~ PE funds basically invest in unlisted private companies and take a share of their ownership. Since unlisted private companies cannot tap capital through the issuance of equity or debt instrument, they look out for PE funds.

  - ~ Further, these companies present their investors a diversified portfolio of equities which essentially, lowers the risk to the investor. A PE fund typically has a fixed investment horizon ranging from 4 to 7 years. After 7 years, the firm expects that it would be able to exit the investment with a good amount of profit.

Source: SEBI website

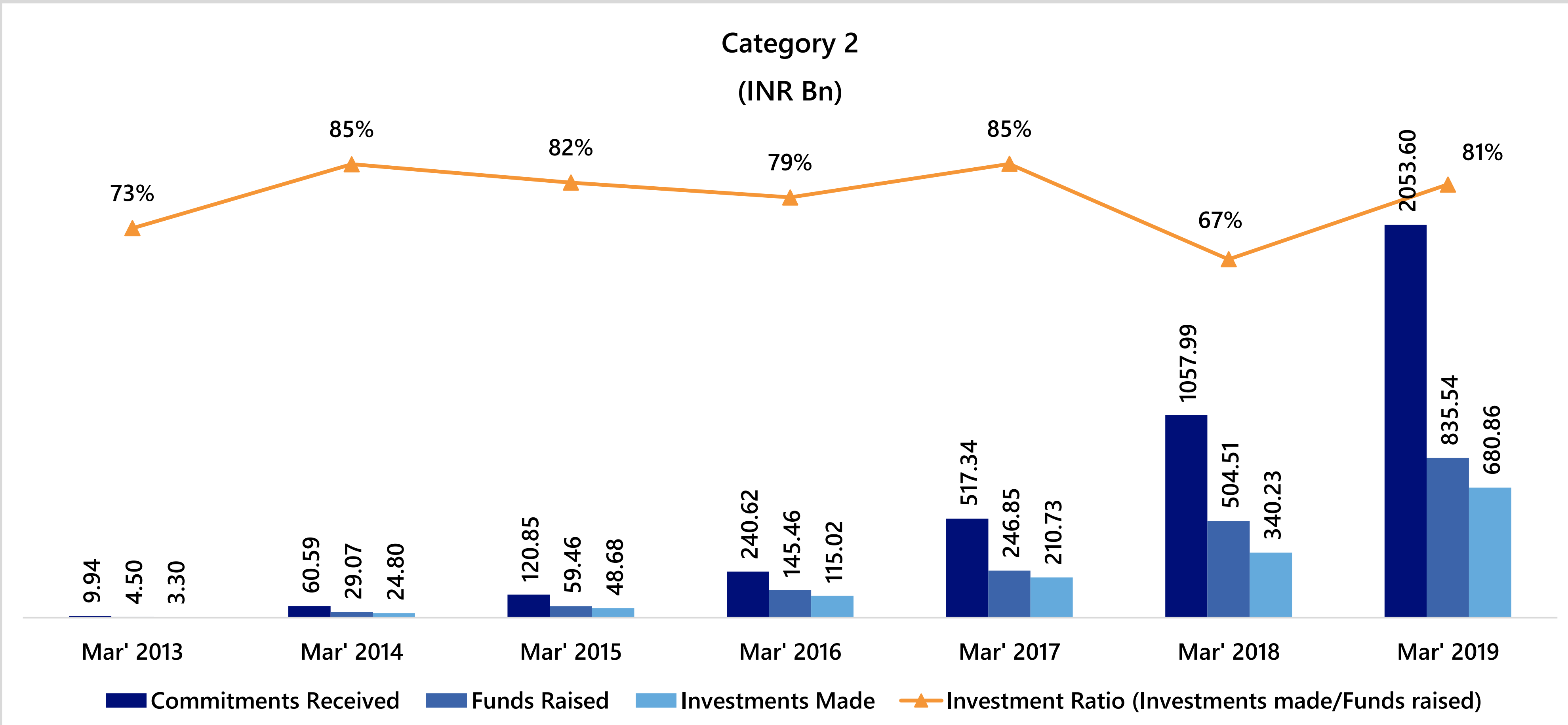
SEBI regulation prohibits the amount invested in Debt Fund to be utilized for the purpose of giving loans

- Debt Fund
  - ~ This fund primarily invests in debt instruments of listed as well as unlisted companies. Companies that have low credit score generally release high yield debt securities accompanies with high risk. So companies with high growth potential, good corporate practices but facing capital crunch can be a good investment option for debt fund investors.
  - ~ As per the SEBI regulations, the amount invested in Debt Fund cannot be utilized for the purpose of giving loans, as Alternative Investment Fund is a privately pooled investment vehicle.
- Fund of Funds
  - ~ As the name suggests, this fund is a combination of various Alternative Investment Funds. The investment strategy of the fund is to invest in a portfolio of other AIFs rather than making its own portfolio or deciding what specific sector to invest in. However, it should be kept in mind that Fund of Funds under AIFs cannot issue units of funds publicly, unlike Fund of Funds under Mutual Funds.

Source: SEBI website

Category 2 AIF, till March'19, Funds raised INR 835.54 billion, 81% equivalent to INR 680.86 billion has been invested keeping a dry powder of INR 154.68 billion

! Investment Trend in Category 2 Alternative Investment Funds:



#Dry powder is referred to cash reserves kept on hand by the fund managers to cover future obligations, purchase assets or make acquisitions.

Source: SEBI website & NRI representation

Category 3 AIFs are considered to have some potential negative externalities in certain situations and are used for hedging purposes

- **Category 3 AIFs**:
  - ~ Funds that are considered to have some potential negative externalities in certain situations and which undertake leverage to a great extent; These funds trade with a view to make short term returns. These funds are allowed to invest in Category 1 and 2 AIFs also. They receive no specific incentives or concessions from the government or any other Regulator.eg. Hedge Funds (which employs diverse or complex trading strategies and invests and trades in securities having diverse risks or complex products including listed and unlisted derivatives). [Ref. Regulation 3(4)(c)].

Category 3 comprises the following funds:

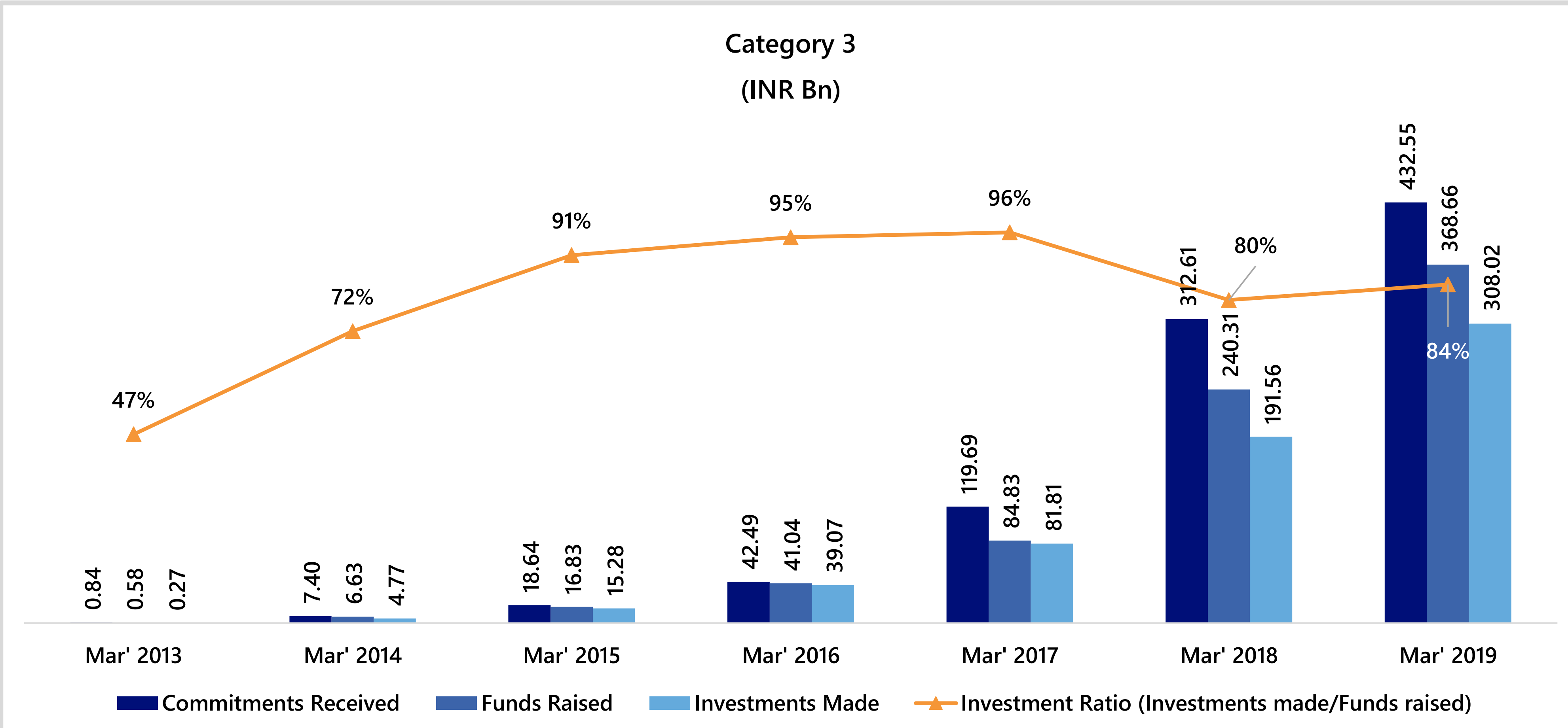
- Hedge Fund
  - ~ A hedge fund pools capital from institutional and accredited investors and invests in domestic as well as international markets to generate high returns. They take up leverage to a great extent and have aggressive management of their investment portfolio. Hedge funds are relatively less regulated as compared to their counterparts such as mutual funds and other investment vehicles. However, they are expensive relative to other financial investment instruments. Hedge Funds generally charge 2% as the asset management fee and take up 20% of the profits earned as a fee.

- Private Investment in Public Equity Fund (PIPE)
  - ~ It is a privately managed pool of privately sourced funds earmarked for public equity investments. Private investment in public equity refers to buying shares of publicly traded stock at a discounted price. This enables the investor to purchase a stake in the company, while the company selling the stake receives capital infusion to grow its business.

Source: SEBI website

Category 3 AIF, till March'19, Funds raised INR 368.66 billion, 84% equivalent to INR 308.02 billion has been invested keeping a dry powder of INR 60.64 billion

! Investment Trend in Category 3 Alternative Investment Funds:



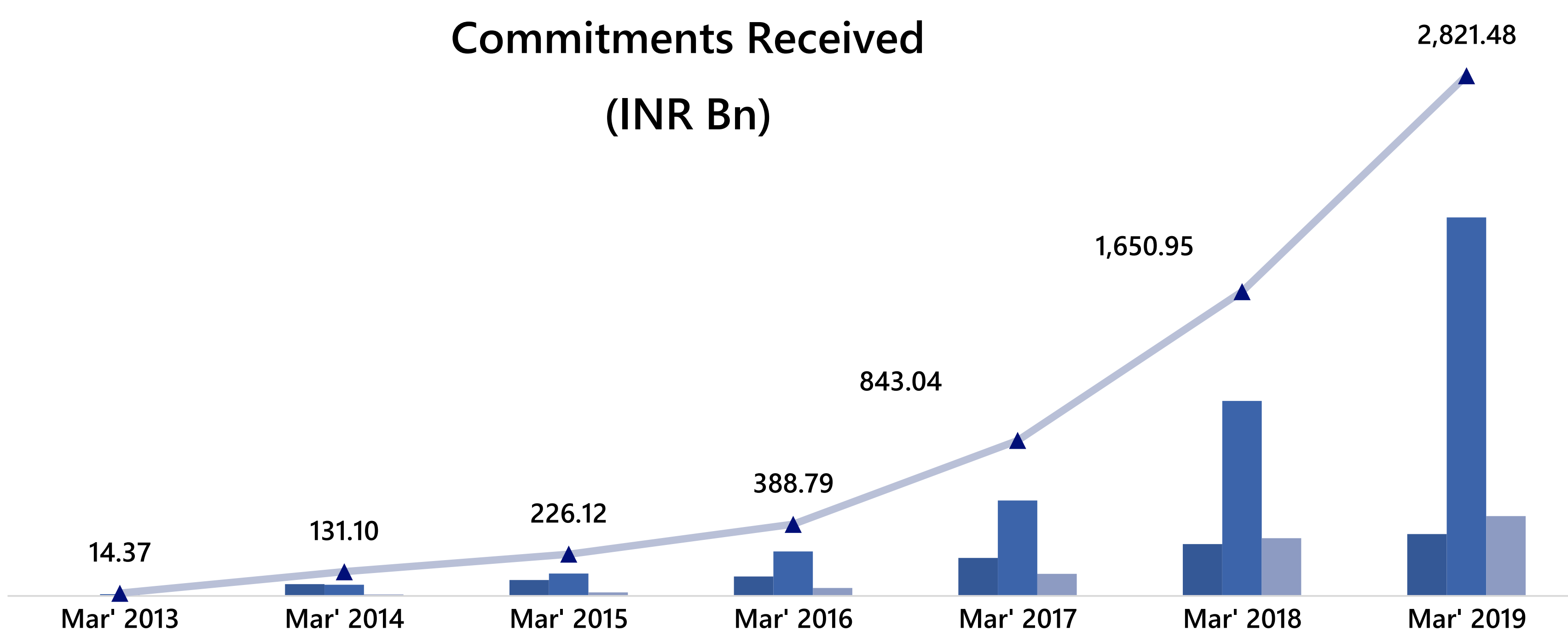
#Dry powder is referred to cash reserves kept on hand by the fund managers to cover future obligations, purchase assets or make acquisitions.

Source: SEBI website & NRI representation

6. Opportunity-wise Trend of Alternative Investment Funds (1/3)

Till March’19, Commitments to the tune of INR 2821.48 billion was received across all the categories of AIFs

! Total Commitments Received across the Alternative Investment Funds:



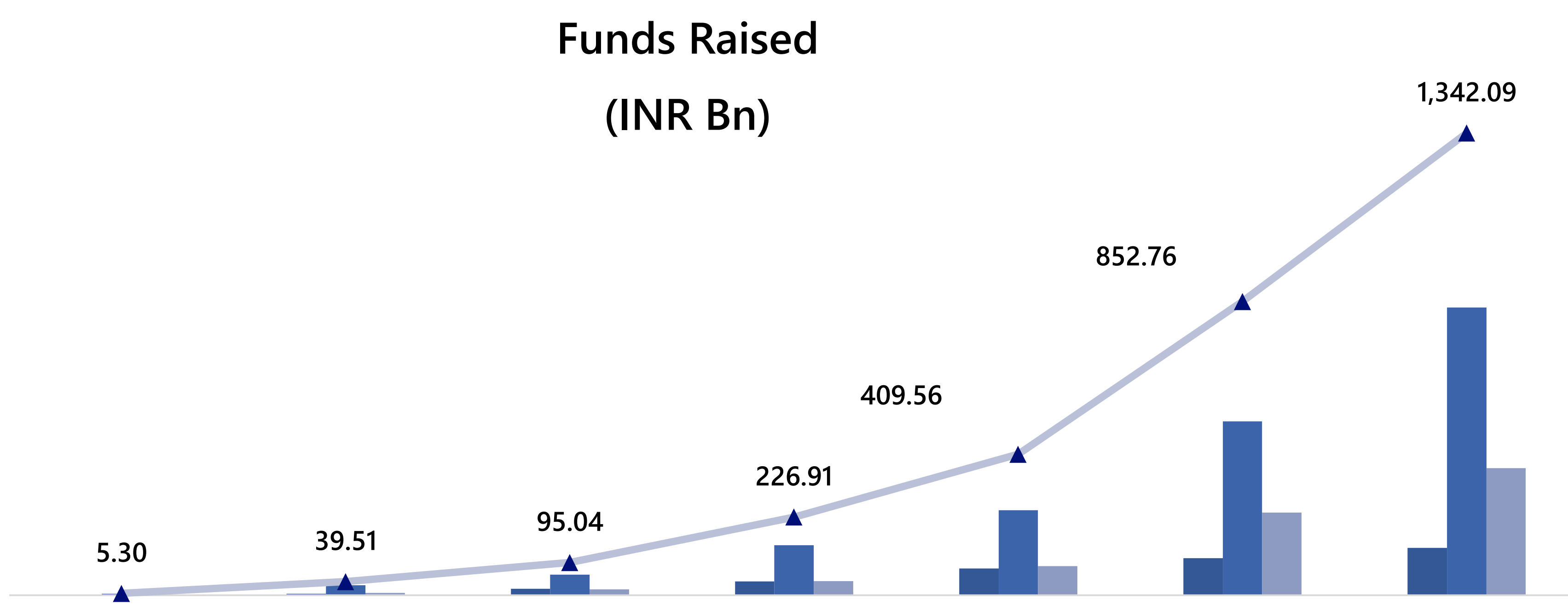
	Mar' 2013	Mar' 2014	Mar' 2015	Mar' 2016	Mar' 2017	Mar' 2018	Mar' 2019
Category 1	3.60	63.12	86.63	105.68	206.01	280.36	335.34
Category 2	9.94	60.59	120.85	240.62	517.34	1,057.99	2,053.60
Category 3	0.84	7.40	18.64	42.49	119.69	312.61	432.55
Grand Total	14.37	131.10	226.12	388.79	843.04	1,650.95	2,821.48

Source: SEBI website and NRI analysis

6. Opportunity-wise Trend of Alternative Investment Funds (2/3)

Till March'19, Funds to the tune of INR 1342.09 billion was raised across all the categories of AIFs

! Total Funds Raised across the Alternative Investment Funds:



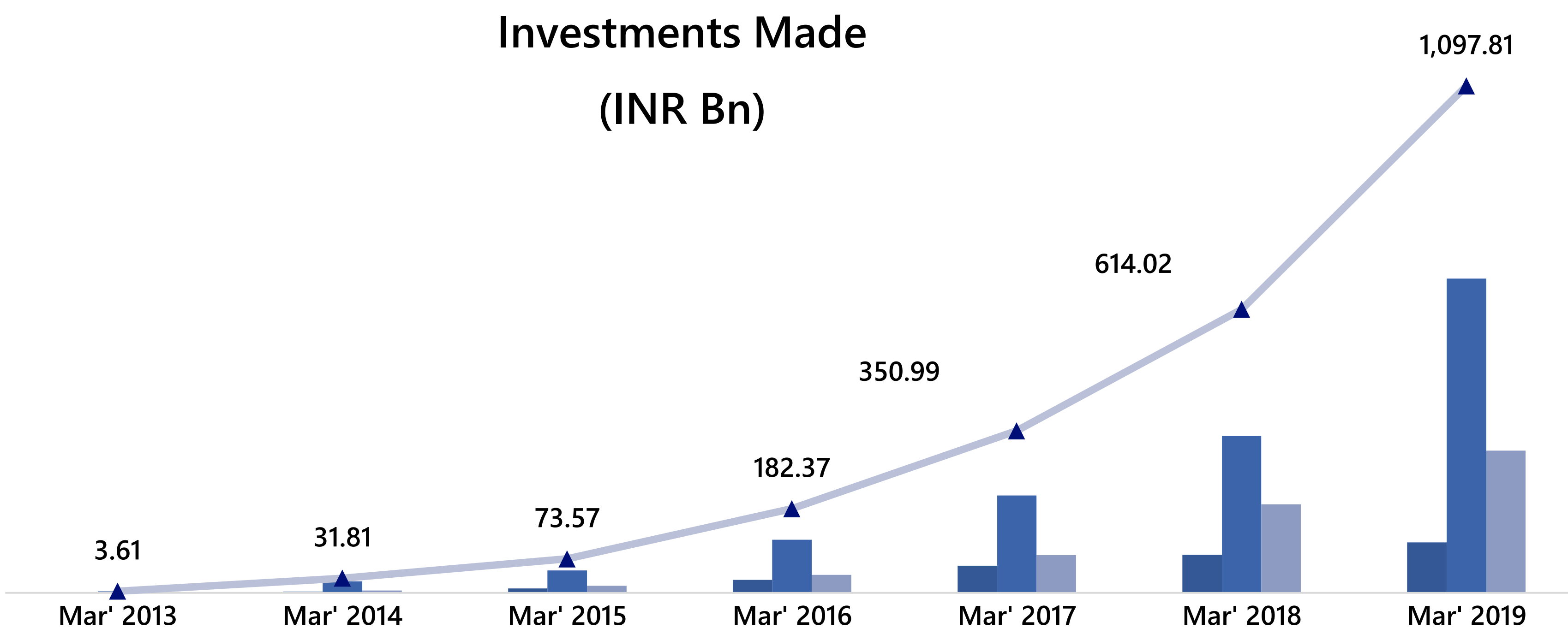
	Mar' 2013	Mar' 2014	Mar' 2015	Mar' 2016	Mar' 2017	Mar' 2018	Mar' 2019
Category 1	0.22	3.82	18.75	40.42	77.87	107.94	137.89
Category 2	4.50	29.07	59.46	145.46	246.85	504.51	835.54
Category 3	0.58	6.63	16.83	41.04	84.83	240.31	368.66
Grand Total	5.30	39.51	95.04	226.91	409.56	852.76	1,342.09

Source: SEBI website and NRI analysis

6. Opportunity-wise Trend of Alternative Investment Funds (3/3)

Till March'19, Investments to the tune of INR 1097.81 billion was made across all the categories of AIFs

! Total Investments Made across the Alternative Investment Funds:



	Mar' 2013	Mar' 2014	Mar' 2015	Mar' 2016	Mar' 2017	Mar' 2018	Mar' 2019
Category 1	0.04	2.24	9.61	28.28	58.45	82.23	108.93
Category 2	3.30	24.80	48.68	115.02	210.73	340.23	680.86
Category 3	0.27	4.77	15.28	39.07	81.81	191.56	308.02
Grand Total	3.61	31.81	73.57	182.37	350.99	614.02	1,097.81

Source: SEBI website and NRI analysis

SEBI proposes 'Introduction of Performance Benchmarking' and 'Standardization of Private Placement Memorandum (PPM) for AIFs

~ SEBI data shows that 82% of funds has been invested by the AIFs while the remaining 18% is yet to be invested.

~ Category 2 AIFs got the maximum attention in India with a long term approach in the debt fund.

~ Category 3 AIFs have utilized 73% of their commitments raised amount.

~ Levels of dry powder across the funds are generating maximum traction in the market.

~ India based fund managers have raised more than USD 6 billion since 2015.

~ Several notifications in recent years such as removal of initial public offering (IPO) lock up for AIF investors, banks being allowed to invest in AIF 1 and 2 domestically, and clarification on the characterization of tax for AIF, among others, have reinstated confidence in the Indian market.

~ With a recent initiative SEBI with an objective to create a conducive environment for a sound Alternative Investment Fund asset class in India is to enhance disclosure standards in this space. In this context the following two initiatives are proposed:

a. introduction of minimum benchmarks for disclosure of performance history of AIFs.
b. standardization of Private Placement Memorandum

~ SEBI has sought public comments on 'Introduction of Performance Benchmarking' and 'Standardization of Private Placement Memorandum for AIFs'. Considering inputs from public consultation and deliberations in Alternative Investment Policy Advisory Committee (AIPAC), it has been decided to introduce template(s) for PPM, subject to certain exemptions, and mandatory performance benchmarking for AIFs with provisions for additional customized performance reporting.

Source: SEBI website & NRI analysis

Pooled Capital has helped around 1,600 stalled housing projects, where conventional investment products were failing

- Private Placement:
  - ~ AIFs units can be placed only through the private offering and not through a public offering.

- Number of Investors:
  - ~ The maximum number for any AIF scheme cannot exceed more than 1,000 investors (provisioned under the Companies Act, 1956).
  - ~ The maximum number of Angel Investors cannot exceed more than 49 investors.

- Taxation:
  - ~ Category 1 and 2 are tax pass-through vehicles. TDS will not be deducted.
  - ~ 10% withholding is done while making distributions
  - ~ The rate of withholding for offshore investors will be determined based on Double Taxation Avoidance Agreements (DTAA)

- Foreign Investments:
  - ~ SEBI has permitted AIFs for foreign investments. Upon the discretion of the Finance Ministry and the Fiscal policy, the range of investment could alter. Majorly in india these pooling in capital are used in infrastructure projects which has helped to complete over 1,600 stalled housing projects., where conventional investment products were failing.

- Manager/Sponsor Continuing Interest:
  - ~ Continuing Interest could be above 2.5% of fund size or INR 50 million (whichever is less).

Source: NRI analysis

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