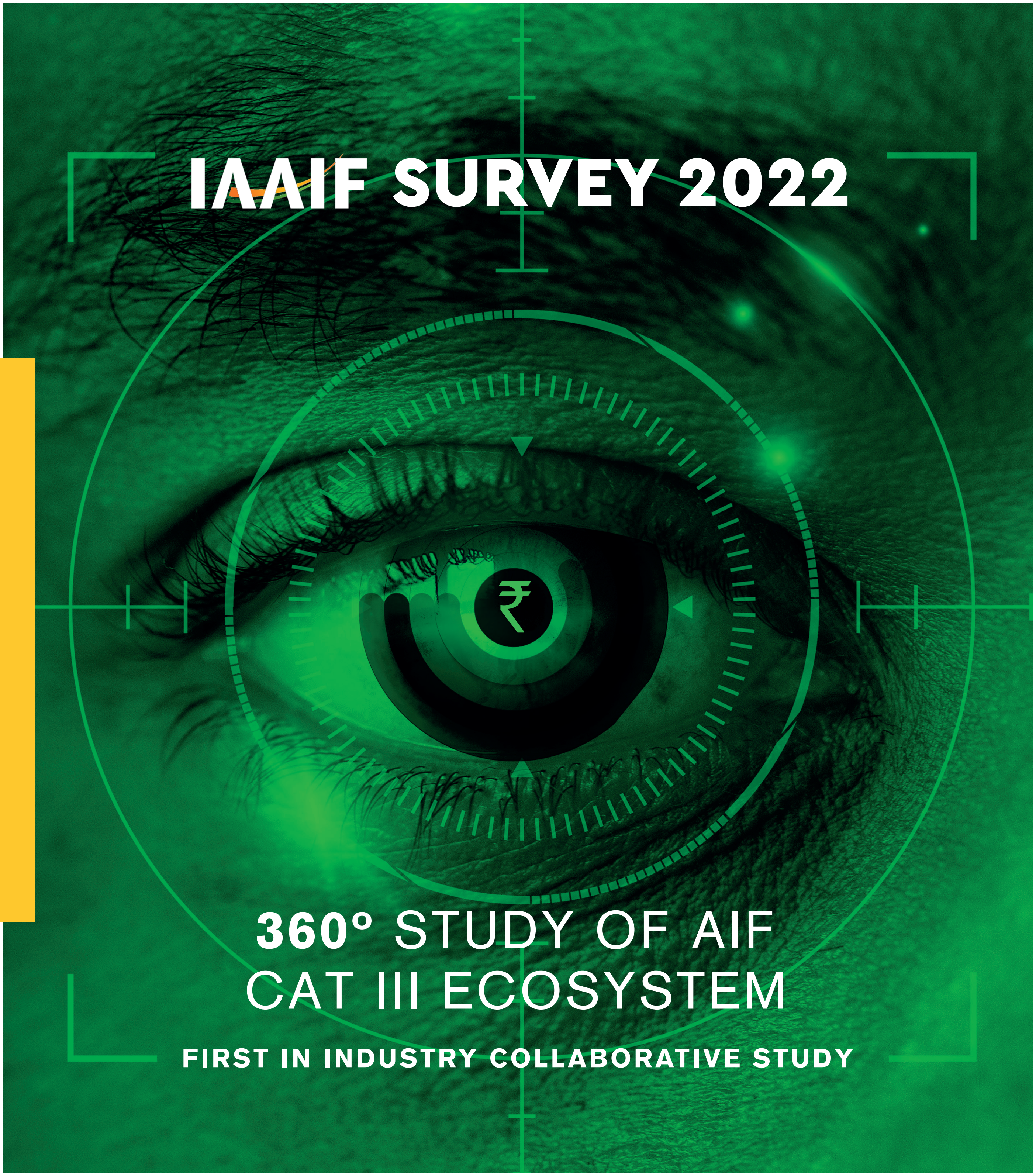
equaliFi

#aifresearch2022



IAAIF SURVEY 2022

360° STUDY OF AIF CAT III ECOSYSTEM

FIRST IN INDUSTRY COLLABORATIVE STUDY

IN ASSOCIATION WITH:

BNP PARIBAS | DOLAT CAPITAL | IC UNIVERSAL LEGAL Advocates & Solicitors | ASCENT

CONSULTING & EXECUTION PARTNER: The Stack Co.

Aditya Gadge
FOUNDER, EQUALIFI (ERSTWHILE AIWMI)

FOUNDER & PRINCIPAL ADVISOR, INDIAN ASSOCIATION OF ALTERNATIVE INVESTMENT FUNDS (IAAIF)

Equalifi (erstwhile AIWMI) is a global membership network of financial services leaders, professionals and aspirants. The Indian Association of Alternative Investment Funds (IAAIF) has been established as a non-profit organization, with the objective of promoting and protecting the interests of the Alternative Investments industry in India. The IAAIF has been set up by Equalifi (erstwhile AIWMI)

FOREWORD

Planting seeds is easy. However, watering them and nurturing them such that they eventually grow into trees that cast large shadows can be challenging. Which is why, for any ecosystem to thrive, there is a need for a central platform that can bring together all stakeholders, ensure that their voice is heard, and thereafter orchestrate positive change. The AIF industry in India is nascent but has already showed its metal over the last few years. More importantly, it now lies at the cusp of exponential growth, one that will be enabled by all the stakeholders in the AIF ecosystem. This report is an effort in that direction. At Equalifi we believe in creating collaborative ecosystems that provide an opportunity to network, share knowledge, educate, and envisage tangible solutions that can firepower ecosystem growth. In this report, we have done an in-depth study of the prevailing AIF ecosystem and ensured that the voices of key stakeholders are heard.

This is a key step towards our contribution to the AIF ecosystem and we hope that insights gleaned through this report can potentially add value to all stakeholders.

TABLE OF CONTENTS

THOUGHTS BY KNOWLEDGE PARTNER

Amit Saxena

Director & Head Alternative Investment Funds, Dolat Capital Market Private Ltd.

Dolat Capital Market Pvt. Ltd. is a multi strategy trading firm, dedicated to producing superior returns adhering to mathematical and statistical techniques.

The investment landscape in India is rich both in terms of product proposition and access. However, it is important to take note of the fact that investor needs are constantly evolving and becoming even more nuanced. Just like in several other aspects of their life, in investing as well, individuals are demanding a certain level of customisation and differentiation. Traditional investment products like mutual funds and even PMS are not able to holistically meet these evolving portfolio requirements. This is where AIFs can play an integral role.

As an investment vehicle, AIFs have the ability to be flexible and offer unique investment solutions across asset classes, themes, and strategies. This is especially true for CAT-III AIFs that have the additional advantage of employing leverage and deploying strategies that can potentially add value to investor portfolios across market cycles. Further, there are several other features of AIFs that help them score a notch over traditional investment solutions.

Within the AIF ecosystem, Wealth Managers are the Key Stakeholders as they can optimally align investor needs with the products available. They are the first point of contact for the investors and hence have a better understanding of their requirements. However, at the same time, a lot more needs to be done to deepen the AIF industry further and to ensure that the benefits of this investment vehicle can accrue to a wider segment of eligible (accredited) investors. Prevailing challenges such as taxation of CAT-III AIFs, transparency, and benchmarking need to be proactively addressed by stakeholders in order to ensure that the true potential of AIFs as an investment vehicle can be realised by all players in the ecosystem.

A thriving investment landscape that offers multiple investment solutions and vehicles across the risk-return spectrum is positive for investors, institutions, and the economy as a whole.

DOLAT CAPITAL

THOUGHTS BY KNOWLEDGE PARTNER

Akshay Thakurdesai

Head – BNP Paribas Securities Services India

BNP Paribas Securities Services is a multi-asset servicing specialist with local expertise in 35 markets around the world and a global reach covering 90+ markets. This extensive network enables them to provide the institutional investor clients with the connectivity and local knowledge they need to navigate change in a fast-moving world. BNP Paribas Securities Services provides integrated banking solutions ranging from custody to clearing and settlement, global banking, forex, trade execution, research, listed derivatives and clearing under one roof for AIFs and FPIs in India. As of 30 September 2021, BNP Paribas Securities Services had USD 14.22 trillion in assets under custody, USD 2.84 trillion in assets under administration and 9,284 funds administered.

India's Alternative Investment Fund (AIF) industry has grown significantly over the past few years and has outstripped the fast growing traditional assets sector.

Over the past few months, there have been wide-ranging regulatory concessions and incentives provided to foreign investors to encourage the setup of AIFs in Gujarat International Finance Tec-City (GIFT City). These recent developments have created a structure on a par with the structures offered in many preferred overseas jurisdictions for Foreign Portfolio Investors (FPIs) like Mauritius and Singapore. International fund managers will benefit from a reduction in fund management costs and efficiencies in their fund management activities. The fact that more than 30 AIFs are at the registration stage in GIFT City is testament to the appetite for these new structures.

BNP PARIBAS

THOUGHTS BY KNOWLEDGE PARTNER

Tejesh Chitlangi

Senior Partner
Head- Financial Services & Regulatory Practice, IC Universal Legal Advocates & Solicitors

IC Universal Legal, Advocates and Solicitors has been providing service across Banking & Finance, Capital markets, Corporate advisory, Family law, Intellectual Property since 2017.

At IC Universal Legal, it has always been our endeavour to support industry initiatives such as IAAIF survey 2022, 360 Degree Study of AIF CAT-III Ecosystem. Release of this report marks a decade of the regulatory regime of Alternatives in India and hence the timing is special. Looking back, when the Securities & Exchange Board of India (SEBI) introduced the Alternative Investment Funds (AIFs) regulatory regime in May 2012, the Alternatives have come a long way since then. I am particularly proud of ICUL for being a frontrunner and leader in providing legal-regulatory services to the investment managers across asset classes since the inception of the regulatory regime. And thrilled with the year-on-year growth the Alternatives industry has witnessed in the past decade, particularly in the last couple of years despite the pandemic hitting us. These are indicators of being resilient and affirm that the industry is set for exponential growth in the coming years. Category III AIFs despite not having a conducive tax regime and whilst facing relatively higher degree of regulatory supervision from SEBI compared to other categories, has still achieved significant success and witnessed some path-breaking structures and funds. Per the SEBI official data available as on September 30, 2021, the commitments raised under Category III AIFs have reached ₹57,953 Crore. The sheer size of the segment today is impressive since this segment does not have the tax pass through status unlike the other categories of AIFs. The Category III in its various avatars as close-ended and open-ended funds with a variety of underlying strategies like the long-short funds, hedge funds, long only funds etc. has the potential to grow by leaps and bounds and this survey captures the essence quite well.

As a contributor to the report, we are excited to see the promise this asset class has showcased and the potential for Alternatives to continue to rise and become the mainstream investment route in times to follow.

IC UL
IC UNIVERSAL
LEGAL
Advocates & Solicitors

THOUGHTS BY KNOWLEDGE PARTNER

Jayesh Khaitan

Head of Sales – India, The Ascent Group

*ASCENT Group is an Independent Global Fund Administrator dedicated to providing customised One-Stop Solutions for our clients. This includes Fund Solutions, Corporate Solutions and Fintech Solutions. ASCENT provides a technology platform that integrates all processes and procedures for streamline valuations, 24*7 web portal, proprietary E-KYC, automated transaction monitoring to manage high-volume transactions.*

This report marks the tenth year of the Indian Alternative Investment Fund Industry. SEBI AIF regulation came into effect in 2012 and it's completing a decade. Today the size of AIF Industry is INR 5 trillion. Driven by a high-performing market and low interest rates globally, Indian AIF industry is continuously evolving, and we will continue to see a significant growth in terms of capital inflows.

As AIF industry matures, greater transparency and flexibility is essential to attract high net worth (HNW), Ultra high net worth (UHNW) and institutional investors.

The objective of the study is to understand expectation and interest from various stakeholders UHNW and HNW Investors, Family Offices, Manufactures and Wealth Managers / distributors and to show that technology and connectivity continue to play an essential role. Through technology and connectivity, processes are further streamlined which in turn help Fund Managers focus on their core competencies thus generating more Alpha. ASCENT Group understands the pace of advancement of technology in AIF industry and recognizes how essential it is for asset managers and the investors. We continue to stay focused to anticipate changes, adapt to them and implement strategies to achieve excellence. This way, we are best positioned to keep up with the dynamic nature of the alternative investment industry.

DEPTH OF RESEARCH: METHODOLOGY

This research has been conducted as a First in Industry collaborative initiative that covers the perspective of all the key stakeholders - Industry Association, Wealth Managers, Manufacturers, Legal, Fund Accounting & Tax players and Investors (HNIs, Family Offices).

This report aims to bring across the underlying needs, sentiments and comprehensive outlook of the stakeholders.

RESEARCH OBJECTIVES

Understand **end consumer (investor) perception, preferences and needs** for AIFs through in-depth research

Understand **perspective of industry participants** - wealth management firms, service providers (Tax, Legal, Fund Accounting) , manufacturers on future potential of AIF industry (primarily limited to category III AIFs)

Identify **opportunities and list recommendation** for AIF industry in India in collaboration with the industry stakeholders

RESEARCH METHODOLOGY

Online survey with leading Manufacturers, Distributors and Investors to gather data and identify trend indicators

1:1 Interviews with senior leaders **(CXOs, Product/Investment heads, Leading Family Offices, HNI/UHNI, Senior Wealth Managers)** to gather actionable insights

The report covers the key takeaways from the Manufacturer lens, Distributor lens and the Investor lens. The manufacturers surveyed contribute **~75% to the industry AUM.** Of the total surveys done,

34% MANUFACTURERS	**46%** DISTRIBUTORS	**20%** INVESTORS

indicating fair representation by key industry stakeholders.

45% of the manufacturer surveys were conducted through 1:1 interviews while **55%** were through an online survey.

90% of the distributor surveys were conducted through 1:1 interviews while **10%** were through an online survey.

8% of the investor surveys were conducted through 1:1 interviews while **92%** were through an online survey.

In-depth secondary research was conducted by leveraging reliable publicly available information. Extensive data was collected and then analysed to arrive at meaningful insights.

The research has been conducted by The Stack Co.

The Stack Co. is a new age consulting and project management firm that is working with businesses across sectors like BFSI, Pharma, Food Service, CSR to drive superior results through quality research, business strategy, digital transformation and project management by following an integrated approach towards planning and implementation. The Stack Co. has a compact team of researchers, industry experts, practitioners that have an experience in delivering large scale projects for global and domestic clients.

Thorough research, Transparent project management and 100% Quality delivery are the core values of The Stack Co. (Stac Consulting LLP)

www.thestackco.in | info@thestackco.in

EXECUTIVE SUMMARY: A DECADE OF AIFS AND REARING TO GO

The world is currently undergoing a kaleidoscope of transformation that is revealing gaps in prevailing ecosystems and engendering great opportunity. In the backdrop of such a landscape, it is imperative that we don't miss the forest for the trees. At the surface, we know that we are currently in a low interest rate regime and persistently low bond yields, stretched valuations in traditional markets, and an era of limited correlation benefits between fixed income and equity investments. These are the trees, obvious to most. But take a step back and you will be able to see the forest, i.e., megatrends like Environmental, Social and Governance (ESG) considerations, technological adoption, and diverse investment opportunities as offered by Alternative Investment Funds (AIFs).

POTENTIAL FOR 3X GROWTH IN NEXT 5 YEARS

Currently, there are two evolving trends that augur well for the AIF industry. One, an increasing number of people are joining the ranks of the wealthy with a corresponding increase in absolute wealth. Two, the financialisation of savings is gaining momentum as wealth finds its way into financial assets. Both these factors combined are set to give a sharp fillip to growth in the AIF industry.

IMPROVED REPORTING AND TRANSPARENCY CAN ACT AS TAILWINDS FOR GROWTH

Wealth can be optimally managed and allocated to the right investment avenues only if there is a level playing field that enables all stakeholders to access the right set of information in a fair and unbiased manner. Thus, there is a need to create appropriate benchmarks and bring in transparency in terms of disclosure with respect to return calculation and portfolio composition.

ESG CONSIDERATIONS MOVING UPWARD AND CENTRAL

Globally, ESG considerations are taking centre stage as investors look to allocate capital in investments that have positive outcomes not just from the perspective of returns but also through the lens of environmental, social, and governance impact. Currently, approximately USD 30 trillion of assets are being managed under some form of ESG mandate or other by asset managers around the world. This represents a world of opportunities for AIF manufacturers to offer ESG focused investment solutions.

TAXATION OPACITY BIGGEST HURDLE TO GROWTH

CAT-I, CAT-II and Mutual fund investments have all been accorded a pass through status. This means that returns generated through these investment vehicles are taxed at the investor level and not at the fund level. However, in the case of CAT-III, investors are not accorded this pass through status, thereby putting them at a disadvantage to other investors. This needs to be corrected.

NEED FOR INSTITUTIONAL CAPITAL TO DEEPEN AIF INDUSTRY

The depth and stability of an industry increases when there are multiple sources of capital in the ecosystem. Today, the Indian AIF space is dominated by retail capital. However, institutional capital is visible primarily due to its missing representation. Regulatory changes need to be made to allow institutional capital like money from pension funds to participate in the AIF industry. For example, in April 2015, the world's largest pension fund, the USD 1.1Tn Government Pension Investment Fund (GPIF) of Japan introduced a new mandate that allowed for a 5% allocation to alternatives in a bid to achieve higher returns and address the needs of an ageing population. This engendered a significant opportunity for alternative firms.

TECHNOLOGY SOLUTIONS DRIVING EFFICIENCY AND DIFFERENTIATION

Inevitably, success in the future is firmly tethered to an industry's ability to optimally leverage technology solutions. Stakeholders in the AIF industry can leverage technology in myriad ways ranging from improving distribution and enabling transparency through standardisation created by technology to implementing the right technology solutions in operations and accounting.

ENABLING REGULATION TO EMPOWER ALL STAKEHOLDERS

For any industry to thrive, regulation needs to be empowering while ensuring that the rights of all stakeholders in the ecosystem are safeguarded. The recent introduction of Accredited Investors (AI), relaxation of diversification norms, removal of certain investment restrictions on Venture Capital Funds (VCFs) are all steps in the right direction.

COLLABORATION TO CREATE A FECUND ENVIRONMENT FOR IDEA GENERATION AND GROWTH

An ecosystem only thrives when all the stakeholders in the ecosystem can converse with each other and seamlessly exchange ideas. To enable this, there is the need for a dedicated body that can bring together all ecosystem stakeholders on a common platform and create opportunities for value accretive interactions. This body should be 'by the stakeholders and for the stakeholders' and comprise representatives from each segment of the AIF industry.

TRAINING AND EDUCATION PROGRAMS CRITICAL TO ELEVATE KNOWLEDGE AND ENSURE INFORMED DECISION MAKING

Today, everyone knows that 'Mutual Funds Sahi Hai'. Inarguably, holistic marketing had a strong role to play in spreading this message. However, at the same time, efforts were made by industry players to educate all the important members in the ecosystem. Similar efforts need to be undertaken in the AIF industry as well with training and certification programs that ensure that the people selling the product are well-acquainted with its nuances.

INNOVATIVE PRODUCT SUITE TO HOLISTICALLY MEET INVESTOR NEEDS

The reason why most people turn to AIFs is because they tend to offer something that other investment products do not. This could range from an ability to invest in a preferred theme or unique strategy to simply being convinced about the fund's alpha generation capabilities. However, as the investment landscape gets commoditised, investors are increasingly looking for unique themes and ideas that resonate with them and can potentially enhance the risk-adjusted returns of their portfolio. For manufacturers, this means examining the current offerings and thinking out-of-the-box to offer unique investment opportunities.

Within the broader AIF space, offerings by boutique fund managers are likely to attract more capital as they can create specialised structures for the right type of investors. It depends on the fund manager's competency and epertise as well to create niche offerings rather than following a mainstream retail approach.

AASHISH P SOMMAIYAA
Executive Director & CEO,
WhiteOak Capital Asset Management Ltd.

Stakeholder Speak

HERE IS WHAT INDUSTRY STAKEHOLDERS HAD TO SAY

Amrita Farmahan

MD & CEO, Ambit Wealth Management

Getting access to the appropriate audience is not the challenge for the AIF industry. What is important is that the particular AIF's investment objective is understood and then appropriately placed, keeping risk profile and goals of the investor top of mind. Scalability is the real challenge in the industry. Institutional players with well trained wealth managers and quality standards for product fitment can offer a better service to the investors.

Arvind Bansal

Head of Products & Advisory, Avendus Wealth Management

AIFs, where investment team is the GP (entrepreneurial set ups) are likely to flourish going forward as they can bring better performing, more innovative and customised products to the industry. This trend is evident globally as well. Further, from the perspective of knowledge transfer, training is a big challenge. Key things that need to be considered to enhance knowledge transfer include availability of the relevant skills, capability, intent, and duration. Unless these are in place, people may not get trained at the pace at which industry needs.

Rohit Sarin

Founder Partner, Client Associates

There is sufficient investor appetite for CAT - III funds, within which long-short could potentially be a huge opportunity. The investment industry has reached a scale where the large investor is fatigued for choices and is looking for non-commoditised ideas. Further, due to the prevailing interest rate structure, there is a need to sustain the yield of the portfolio on the protection side and find an optimal replacement. In the backdrop of such a landscape, long/short funds under CAT - III could be a huge opportunity.

Shiv Gupta

Founder and CEO, Sanctum Wealth

Collective and individual efforts need to be undertaken in order to enhance transparency and reduce information asymmetries in the industry. All stakeholders must leverage digital dissemination of information while there should be more forums for interaction.

Sundeep Sikka

ED & CEO, Nippon Life India Asset Managment Ltd

AIFs offer a natural progression for HNIs/UHNIs due to the diversity of the offerings and an opportunity to go beyond the limited asset classes available (e.g. long short, structured debt, unlisted stocks). With the growth opportunity that India offers, especially the action in the entrepreneurial space, AIFs are well poised for a growth trajectory.

Sunil Singhania

Founder, Abakkus Asset Manager LLP

Traditional investment pools are increasingly getting fragmented, and facing challenges in product innovations, differentiation and alpha generation owing to size and other factors. As the number of wealthy people and the affluence increase, investors have become increasingly demanding and need innovative offering which has differentiated and boutique style of managing risk and reward.

Umang Papneja

Executive Director, IIFL Wealth

Education and training is important. We ensure that at the time of a product launch, there are multiple interactions between our product team, our RMs, and the AIF fund manager. The idea is to facilitate the exchange of information and enable clients to make the most optimal invesmtent decisions.

*All names have been mentioned in alphabetical order

Chapter 1: Evolution Of AIFs & Current Landscape

AIFs offer a good opportunity for thematic play as well as the benefit of leveraging the fund manager pedigree e.g long short strategies are available in AIFs. The disadvantage however lies across liquidity (e.g. money can be invested any time but opportunity for redemption is at a limited frequency), transparency (e.g. no standardisation with respect to the information on charges levied) as well as taxation drawback (e.g. no pass through status for CAT-III).

ANKUSH CHANDGOTHIA
Head -Family Office,
Survam Partners LLP

The origins of alternative investment funds (AIFs) can be found in SEBI (Venture Capital Funds) Regulations ("VCF Regulations"), which were framed in 1996 to encourage funding in early-stage companies in India. However, over time, private equity (PE) funds, real estate funds, etc. also started using this route which was not conducive given their unique investment objectives. Hence, there was a need to address and regulate various structures of pooling vehicles based on the distinct asset classes or investment strategies they catered to and act as a meaningful source of funding for diverse range of investee entities based on their life cycle from start-up, venture capital, early stage or growth stage, and to enable targeted concessions and incentives.

How regulation in the space has evolved

SEBI published a regulatory framework for AIFs on August 1, 2011, through the concept paper and proposed to regulate all funds established in India which are private pooled investment vehicles raising funds from Indian or foreign investors.

The SEBI (Alternative Investment Funds) Regulations, 2012 ('AIF Regulations') was introduced to the Indian market on May 21, 2012. An AIF was defined as any fund established or incorporated in India in the form of a trust or a company or a limited liability partnership or a body corporate which is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors. The AIF Regulations do not cover the SEBI (Mutual Funds) Regulations, 1996, SEBI (Collective Investment Schemes) Regulations, 1999 or any other regulations of SEBI to regulate fund management activities. However, ESOP trusts, family trusts, holding companies, securitization trusts, other special purpose vehicles not established by fund managers, etc and any such pool of funds which is directly regulated by any other regulator in India have been excluded from the purview of the AIF Regulations.

Over the years, many noteworthy changes have been introduced to the AIF regulations to make it robust and keep its standards upto the international market.

The Finance Act, 2015, extended tax pass through status to AIFs that are registered with SEBI as Category I AIFs or Category II AIFs. SEBI registered AIFs and VCFs were permitted to invest overseas, subject to an overall limit of USD 750 million which has now been enhanced to USD 1,500 million.

Recent amendments...2021

In the recent amendments to the AIF Regulations on May 5, 2021, all AIFs were permitted to make investments in other AIFs, subject to certain conditions like AIFs receiving investments from other AIFs cannot further make fund-of-fund investments. Further, the definition of venture capital undertaking (VCU) has

been expanded to mean any company which is not listed on a stock exchange at the time of making the investment and permits investments by Category I AIFs in non-banking financial companies (NBFCs). The amendments effectively removes the negative list from the definition of VCUs. Also, the key management personnel of the AIF and the manager must compulsorily follow the Code of Conduct as specified in the Fourth Schedule of the AIF Regulations. Recent regulatory update also includes the formal introduction of Accredited Investors into the securities market. SEBI vide circular dated August 26, 2021, notified modalities for implementation of the framework for Accredited Investors ("SEBI Circular") and this comes with a host of benefits to the AIF where the Accredited Investor has the flexibility to participate in AIF with an investment amount lesser than the mandated minimum amount. Further, AIF having accredited investors where each such investor is making a minimum investment of ₹70 crore, may avail relaxation from regulatory requirements like portfolio diversification norms, conditions for launch of schemes and extension of tenure of the AIF in addition to certain other relaxations available to such AIFs. As per the definition "Accredited investor" means any person who is granted a certificate of accreditation by an accreditation agency upon qualifying the requisite criteria for accreditation. It is to be noted that the Central Government and the State Governments, developmental agencies set up under the aegis of the Central Government or the State Governments, funds set up by the Central Government or the State Governments, Qualified Institutional Buyers, Category I FPI investors, Sovereign Wealth Funds, and other multilateral agencies are deemed to be accredited investors and are not required to obtain certification from accredited agencies.
SEBI vide circular dated October 21, 2021, also introduced the modalities for the role of the merchant bankers in the AIF space, where independent due diligence regarding the disclosures of the AIF in the PPM needs to be made and the merchant banker is required to provide a due diligence certificate on the same. The new framework has come into effect from November 11, 2021. Also, the opportunity to co-invest alongside the fund has been extended to investors of Category I & II AIFs only and will now require the investment manager of an AIF to obtain a portfolio management services (PMS) license to enable such co-investment.

AIFs and GIFT City

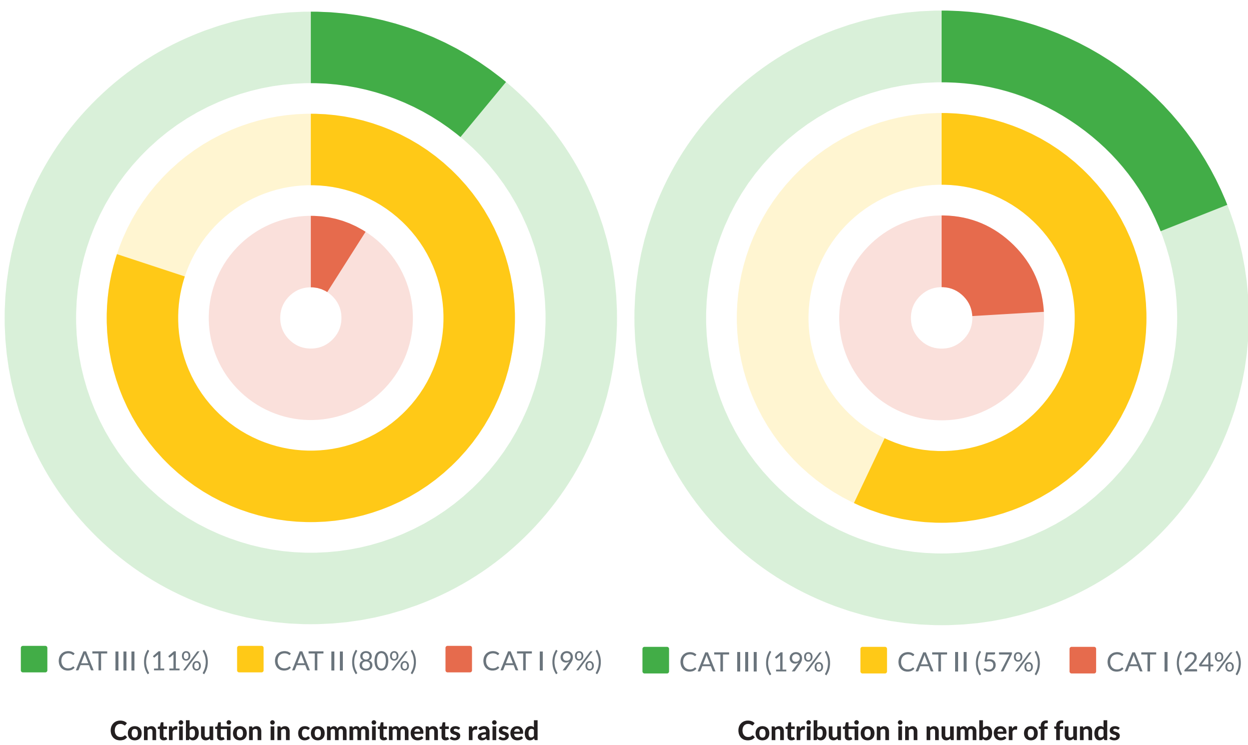
Progress has also been made on the International Finance Services Centre (IFSC) front where AIFs can now be set up in Gujarat International Finance Tec-City (GIFT City), which is aimed to make India a competent offshore jurisdiction comparable to the likes of Singapore and Mauritius.

The Central Board of Direct Taxes exempted all non-residents and foreign companies from the mandatory requirement for obtaining a permanent account number (PAN) with respect to the AIF investments under certain conditions. AIFs situated within IFSC can borrow funds or engage in leveraging activities within the set parameters. AIFs situated in IFSC are exempted from investment diversification norms for investing in any single entity. There are also considerable tax benefits applicable to the AIF structures set up in IFSC.

THE CURRENT AIF LANDSCAPE IN PICTURES

Maximum commitments raised by CAT-II funds

Exhibit 1.1:Category-wise Composition of AIFs



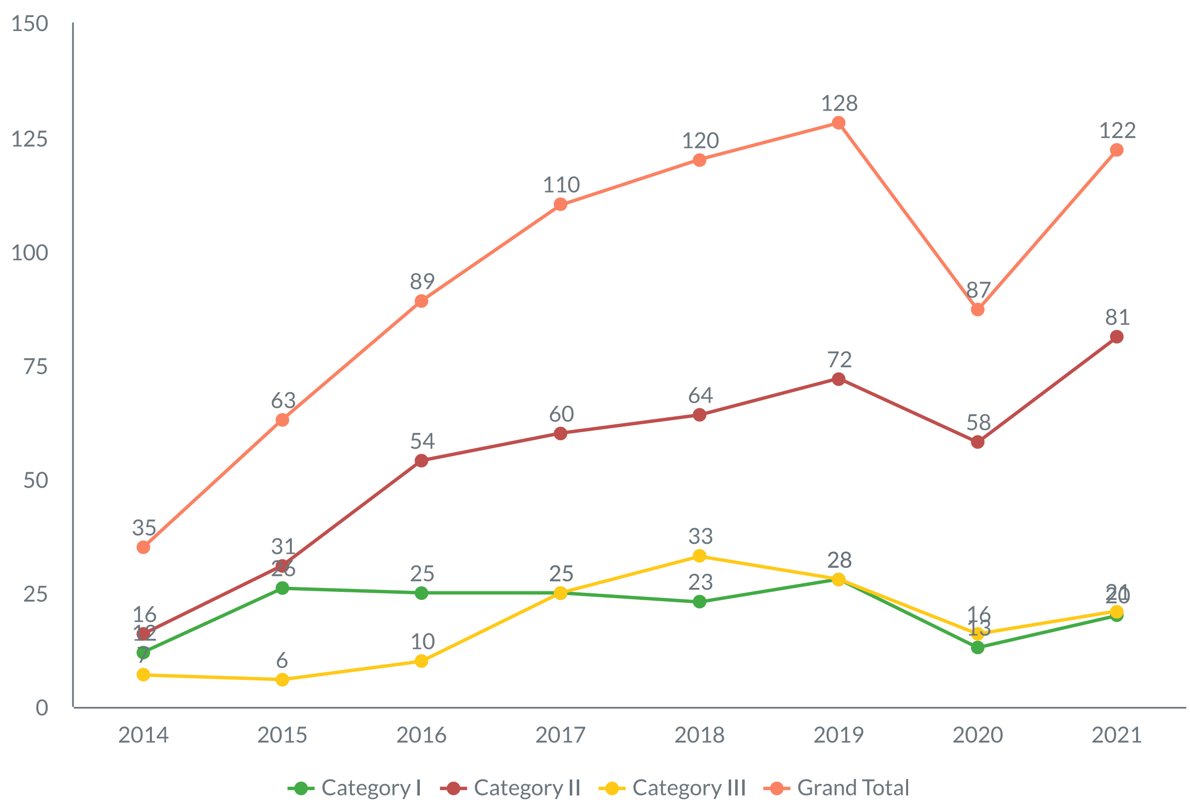
Source : SEBI
Contribution data as on Sep 30, 2021
Number of AIFs as on Jan 20, 2022

Category II AIFs contribute 80% to the AIF Industry (in terms of commitments raised). In last 5 years, the contribution of Category II AIFs has increased almost **1.3X** whereas Category III contribution remained unchanged; Category I in fact has **dropped** from 27% to 9% .

Out of the total 831 funds, 475 are in Category II followed by 196 in Category I and 160 in Category III.

Promising growth in number of AIFs launched

Exhibit 1.2: Growth in the No. of AIFs launched across categories



Source : SEBI
Number of AIFs as on Jan 20, 2022

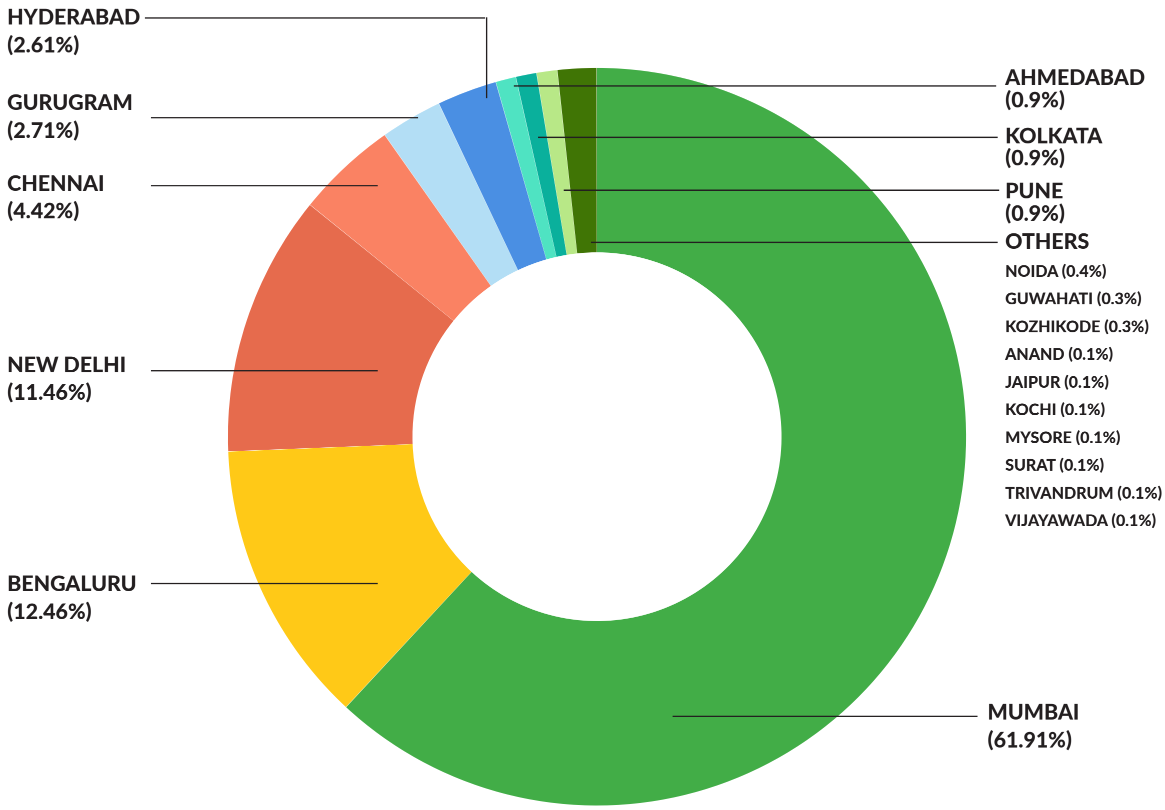
The number of funds launched has **doubled** in **Category III** and **Category II** AIFs in the past 5 years.

2019 saw the highest number of AIFs launched over the years.

AIFs offer a fair playing ground where performance matters the most. The largest of the fund houses like Motilal Oswal, ASK, White Oak etc. have started with boutique offerings under PMS/AIF and evolved into larger fund houses.

AIFs not limited to top cities. Offer level playground.

Exhibit 1.3: Geographical Spread Of AIFs In India (% Count)



Source : SEBI | Number of AIFs as on Jan 20, 2022

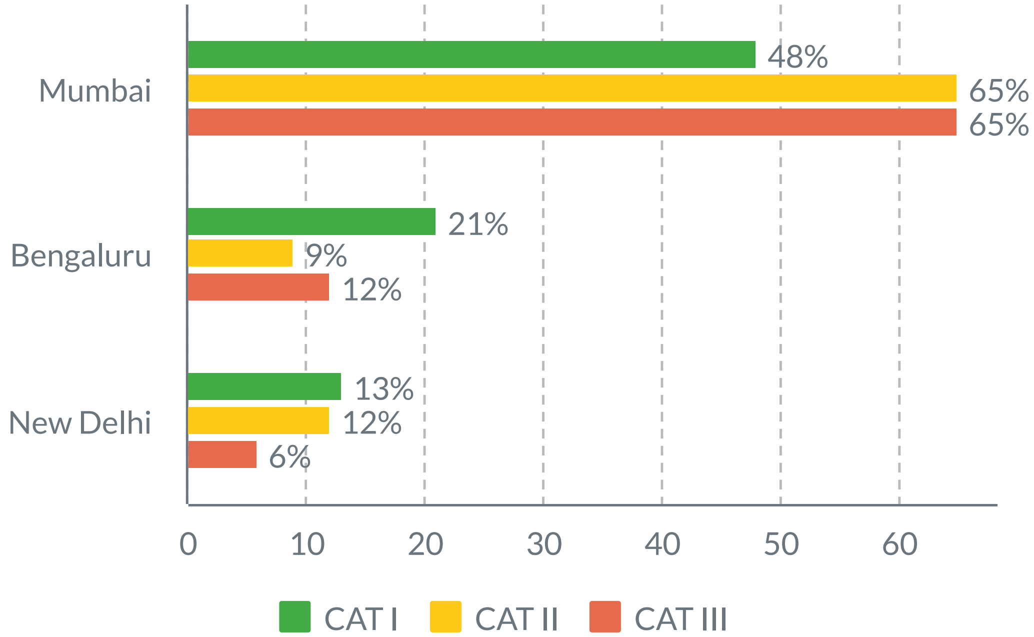
Top 2 cities - Mumbai and Bengaluru contribute ~ 75% in terms of number of AIFs (Mumbai contributing ~2/3rd). Ease of business vs Mutual funds or PMS reflects in the geographical spread of AIFs beyond Mumbai, Bengaluru, New Delhi. Over the last 5 years, contribution of Mumbai has gone down from 79% to 75% with the addition of new cities like Kozhikode, Guwahati, Surat etc.

Mumbai based funds are more concentrated towards CAT-II & CAT-III whereas Bengaluru and New Delhi host more CAT-I funds.

While diversification is one part of building robust portfolios, clients usually focus on optimisation of returns. AIF as a vehicle can ensure that clients' more nuanced needs are optimally met. Further, there is a lot of opportunity to enhance the offerings under CAT-III.

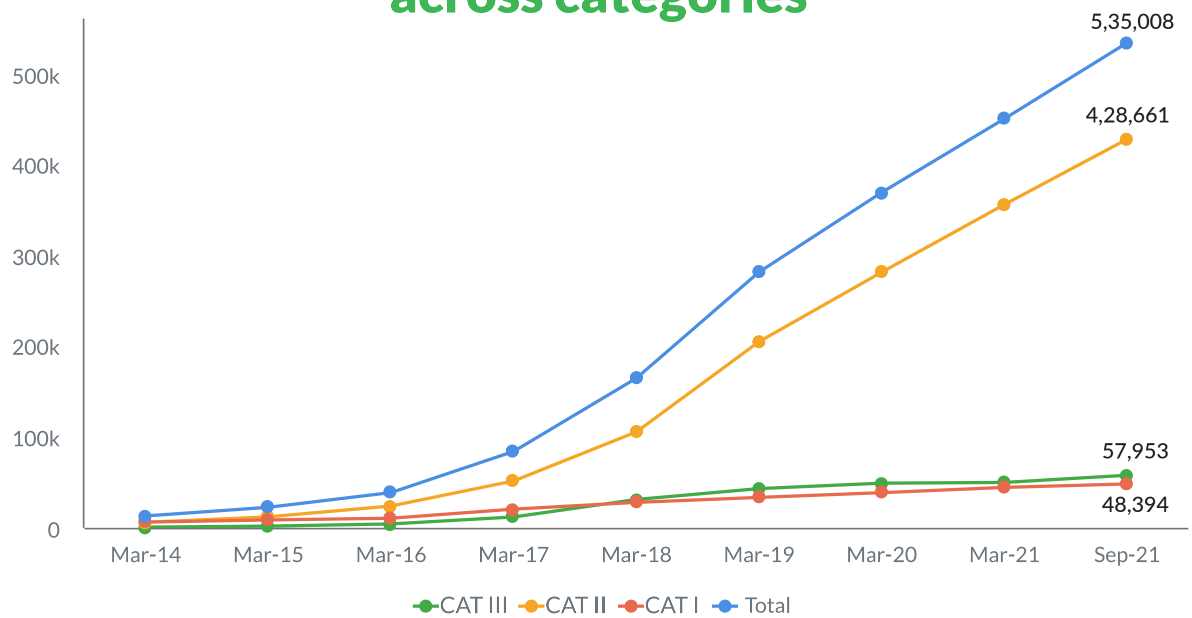
AMIT BIVALKAR
Managing Director and CEO,
Sapient Wealth Advisors & Brokers Pvt. Ltd.

Exhibit 1.4: Contribution of top 3 cities in respective category of AIFs



Source : SEBI | Number of AIFs as on Jan 20, 2022

Exhibit 1.5: Growth in commitments raised across categories



CAGR : (Mar14-Mar21 | All figures in Rs. Crores)
Cumulative net figures as at the end of period | Source : SEBI

Category III AIFs showcased the highest growth rate over the years with 83% CAGR since inception, followed by Category II with 79% CAGR

Best of all worlds; AIFs offer an ease of setting and scaling the business

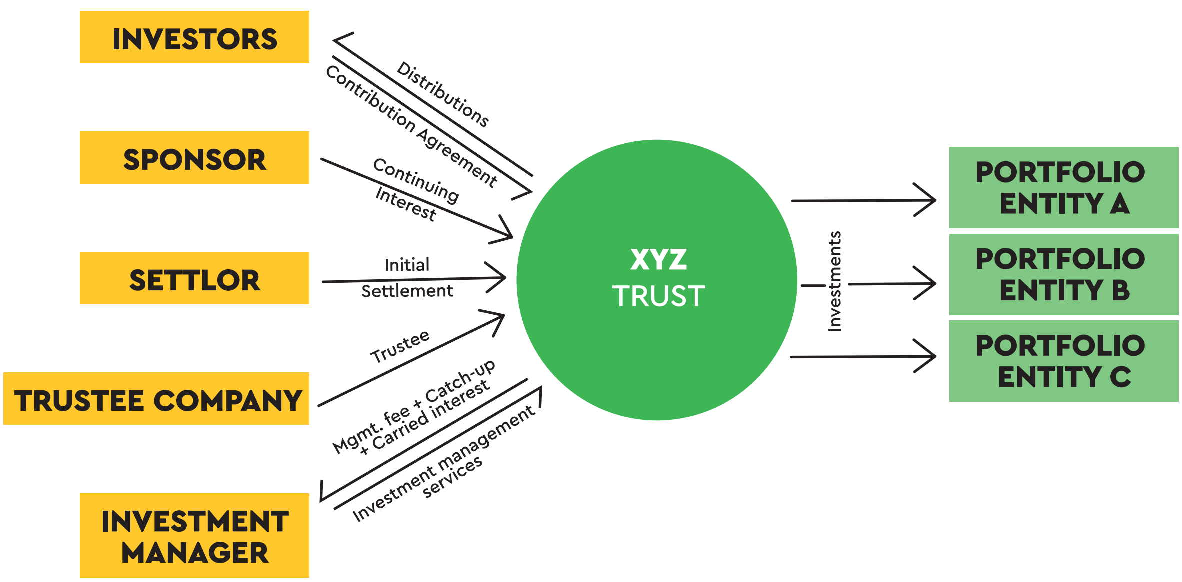
Legal & Regulatory considerations for categories of AIFs

CRITERIA	CATEGORY I AIF	CATEGORY II AIF	CATEGORY III AIF
Registration Fees	₹5 lakh	₹10 lakh	₹15 lakh
Minimum continuing interest of the manager/ Sponsor in the fund	Lower of 2.5% of the corpus, or ₹5 crores		Lower of 5% of the corpus, or ₹10 crores
Ability to invest in listed securities	Limited; different norms across sub-categories	Investments must be 'primarily' (i.e., more than 50%) in unlisted securities reckoned at the time of making the investments	Up to 100%
Overall restrictions/ compliances	Moderate	Low	High
Status as Qualified Institutional Buyer under securities regulations	Yes (and no lock-in for securities held by such funds for at least 6 months prior to the IPO)		No
Leverage Investment by Development Finance	No		Yes (up to 2x leverage or 100% additional exposure permitted)
Institutions, Insurance companies, Banks	Yes, subject to compliance with prescribed norms		No
Diversification	Not more than 25% of the investable funds can be invested in a single portfolio entity, directly or through investment in other AIFs		Not more than 10% of the net asset value in listed equity of an investee company and not more than 10% of the investable funds in securities other than listed equity of an investee company, directly or through investment in other AIFs
Tenure	Close-ended; minimum 3 years		Open-ended; or Close-ended (with a minimum of 3 years)

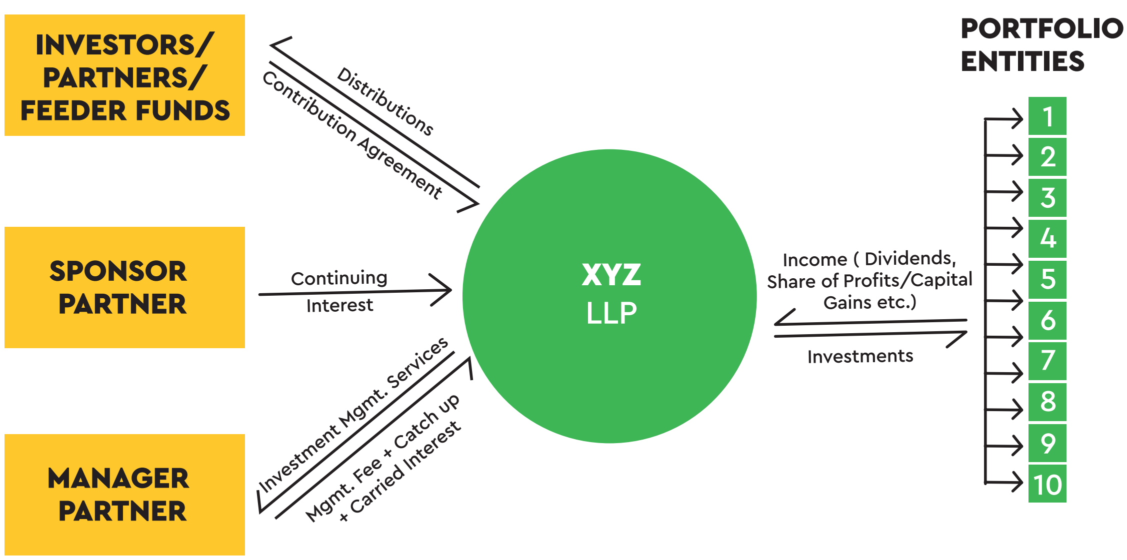
Fund structures

Under the AIF Regulations, AIFs may be set up in India in the form of a trust or a company or a limited liability partnership ("LLP") or a body corporate. However, almost all funds formed in India use a trust structure, with the LLP structure forming a growing minority.

A TYPICAL TRUST STRUCTURE FOR AN AIF



A TYPICAL LLP STRUCTURE FOR AN AIF



TRUST OR LLP?

In general, the choice between Trust and LLP structures depends on the following considerations:

- Compliance requirements for a trust are considered low, compared to LLPs, which have a moderate level of registration and ongoing compliance requirements in relation to the Ministry of Corporate Affairs and the Registrar of Companies.

- Client confidentiality is considered easier to maintain with a trust structure, as compared to an LLP which is required to make public filings of, inter alia, its constitutive documents, partnership interest holders and financials as part of regulatory compliance.
  Trust structures are easier and quicker to set up, involving only registration of the trust deed upon execution and transfer of the initial settlement amount; whereas LLPs involve a lengthier process of approvals and filings with the Registrar of Companies to be set up.

- Non-banking financial companies are permitted to invest in trust structures, but not LLPs.

- Multiple schemes can be launched under a single trust deed with a single, umbrella AIF registration, which is not possible for an LLP.

- On the other hand, LLP structures may be preferred with regard to tax considerations for the management fee earned by the manager, applicable tax rates if assessed at the AIF level (and not the investor level) and for placing employees for AIF activity directly with the AIF, rather than with the manager.

Fund-of-Fund and Master-feeder Structures

The AIF Regulations permit AIFs to invest in portfolio entities through investment in units of another AIF, provided inter alia that such an AIF offering its units to another AIF shall not make further investments in a third AIF. Such structures may be used by managers not only to gain more diverse exposure, but also with regard to maximising benefits amongst the different structures which may be adopted at each level. For example, a trust AIF may be used to pool investor capital with a greater assurance of confidentiality and simpler compliance requirements; the trust AIF would then invest in LLP AIFs, at which level tax benefits may be availed by the manager; and the LLP AIFs would invest directly in the portfolio entities.

Feeder funds established outside India are also used to pool investor capital in an offshore jurisdiction, where compliance and regulatory requirements are lower compared to Indian regulation of foreign investment and pooling vehicles, and which may be more tax efficient for offshore investors. Such feeder funds act as pass-through vehicles for investment in a master fund (AIF) in India. Typically, the commercial terms on which the contributions, fees and expenses, investments and distributions are made are set forth at the master fund level, and the feeder fund issues share classes to investors with rights and obligations mirroring the units issued by the AIF to the feeder fund.

> **In the case of AIF products, engagement and awareness with investors needs to be at a more enhanced level. Case in point being that while there are 45 MFs currently, there are almost 300 players in the PMS + AIF space. With 3X more players, there needs to be more interactions and higher level of transparency.**
>
> **Susmit Misra**
> Country Director, Prudent Private Wealth

Chapter 2: CAT – III: The Unicorn among the Thoroughbreds

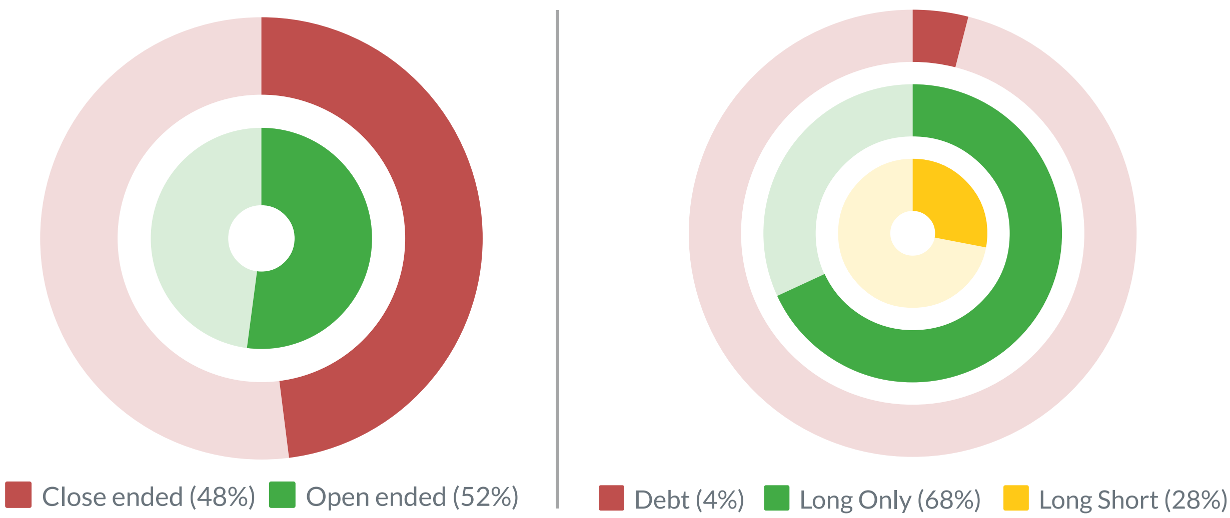
Often, innovative ideas cannot be offered on traditional platforms. AIFs can be an excellent vehicle for launching innovative investment ideas and themes.

UMANG PAPNEJA
Executive Director,
IIFL Wealth

CAT-III FUNDS TO PROVIDE LEGS FOR THE NEXT LEVEL GROWTH

Long Only Funds dominate CAT-III offerings

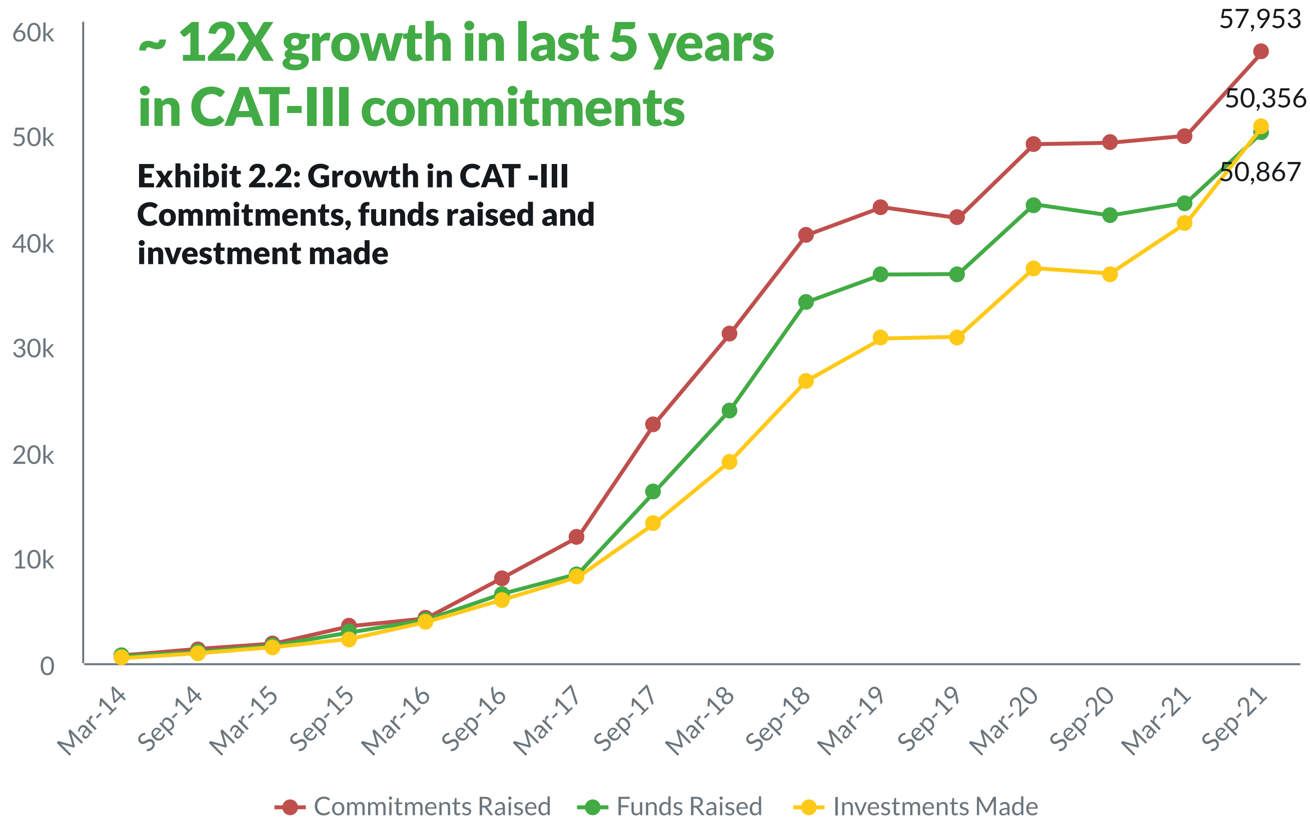
Exhibit 2.1: Composition of of Category III AIFs



(Source: PMS Bazaar)

~ 12X growth in last 5 years in CAT-III commitments

Exhibit 2.2: Growth in CAT -III Commitments, funds raised and investment made



Cumulative net figures as at the end of September 30, 2021 - CAT -III AIFs (All figures in Rs. Crores)

Similar split between boutique and institution-driven AIFs

Exhibit 2.3: Number of AIFs based on type of manufacturer

TYPE OF AIF	% AIFS
Boutique firms	55.00%
Other financial Institutions-backed	25.00%
AMC-backed	15.00%
Bank-backed	5.00%

**AMC-backed includes AIFs which predominantly have Mutual Funds among the group companies. Examples - Nippon India Mutual Fund, Franklin Templeton, etc.*

**Bank-backed includes AIFs which predominantly have a Bank among the group companies . Examples - Kotak Mahindra Bank, ICICI Bank, SBI, etc.*

**Other Institution-backed includes AIFs which predominantly have an institution other than Banks & Mutual Funds among the group companies. Examples - Anand Rathi, Karvy, Unifi, etc.*

**Boutique firms include AIFs which are AIFs predominantly run with a boutique Fund Manager approach*

Exhibit 2.4: Number of AIFs based on Manufacturer product offerings

Product Offerings	% AIFS
AIF Only	56.25%
AIF + PMS	23.75%
AIF + PMS + MF	20.00%

**Categories are exclusive and unique. AIF + PMS + MF numbers are not reflected in AIF + PMS, and so on.*

The above mentioned data is based on our understanding of the AIFs available in the industry.

(Source : SEBI)

Within the AIF umbrella, CAT-II offers the opportunity for maximum innovation. Inevitably, it has attracted significant investor interest and witnessed sharp growth over the last decade. At 80%, it has the largest share of investor capital under the AIF umbrella. However, the future lies in CAT-III. Within this category, offerings can be divided into long-only and long-short, with the former attracting higher capital.

Long-only funds: Currently in India, a majority of the funds registered under CAT-III are long-only equities. This tilt stems from the fact that AIFs give **entrepreneurial fund managers an opportunity to create their own custom investment offerings,** which allow them far more flexibility than mutual funds in terms of diversity of themes and strategies and portfolio composition. Prominent names include Old Bridge Capital, White Oak Capital, Abakkus Asset Managers, etc.

68% of the CAT-III funds follow a long-only strategy, while 4% follow a long-short strategy. Only 4% of the total CAT-III funds follow a debt-strategy. While this indicates a great potential for value investing in Indian equities, it also indicates the absence of structured, leveraged and innovative debt products, which can be tapped by these funds for superior returns.

Another factor that has contributed to the popularity of long-only funds is the regulatory constraints of mutual funds. For example, launch only one fund per category. Consequently, the sponsors of around 15 mutual funds have leveraged CAT-III as a platform to offer thematic and close-ended funds.

Long-short funds: Within this sub-category, offerings are primarily of two types, i.e., equity long-short funds and debt risk long-short funds. While the former holds cash equities and uses derivatives to maintain net exposure ranging from 50% to 100%, the latter primarily holds debt papers with a net exposure of 5% to 25% and competes with an arbitrage fund or a short-term debt fund.

The freedom to use leverage is one of the biggest factors attracting manufacturers to CAT-III. This enables them to effectively participate in the futures market and generate alpha.

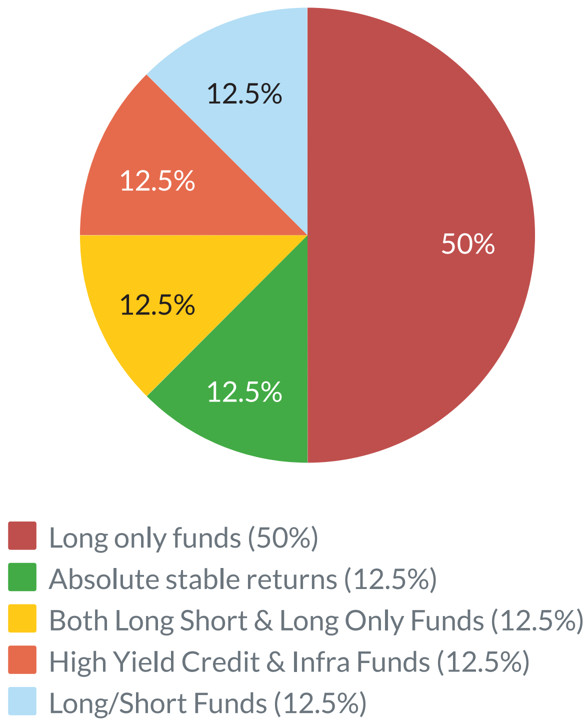
“AIFs have become a very generic term. You may have an AIF with the objective of being at-par or slightly better than a liquid fund vs an aggressive AIF dealing with distressed assets. Unfortunately both are classified as AIFs. To the end investor this may be challenging to decipher. First and foremost, industry leaders should start talking about classification of AIFs based on risk and asset class. It will help in bringing more investor confidence and aid the wealth managers as well.”

APOORVA VORA

Founder & CEO, Finolutions LLP

In CAT-III 50% investors attracted to long only offerings, making it the preferred choice

Exhibit 2.5: Investor interest within CAT-III offerings - Manufacturer view



Q:Which product offering are you seeing the maximum interest?

Within CAT-III, approximately 50% of the manufacturers surveyed said that they were seeing maximum investor interest in **long-only funds.** Correspondingly, we have also observed that a large number of recent offerings are in this segment.

Factors that appeal to CAT - III Investors

You get the benefits of long-only investing with the added advantage of concentrated exposure	55%
Unlike Category I and II AIFs, which are close ended, these can be both open and close ended	36%
You get the opportunity to invest in long / short funds	36%
They don't have the same regulatory constraints as Mutual Funds which are restricted in terms of the number of funds they can launch per category - this limits diversification	27%

Q:What makes CAT-III AIFs a compelling investment choice?

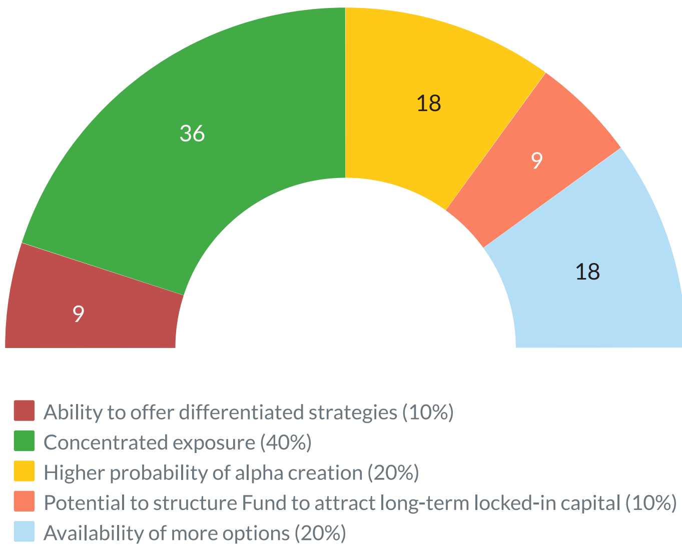
The investor survey (HNIs/UHNIs/ Family offices) revealed a preference for long-only AIFs due to the **concentrated exposure that they offer.**

The ability to take concentrated exposure to select themes and ideas holds maximum appeal for Long-only AIF investors

Exhibit 2.6: The je ne sais quoi of long-only AIFs - Manufacturer view

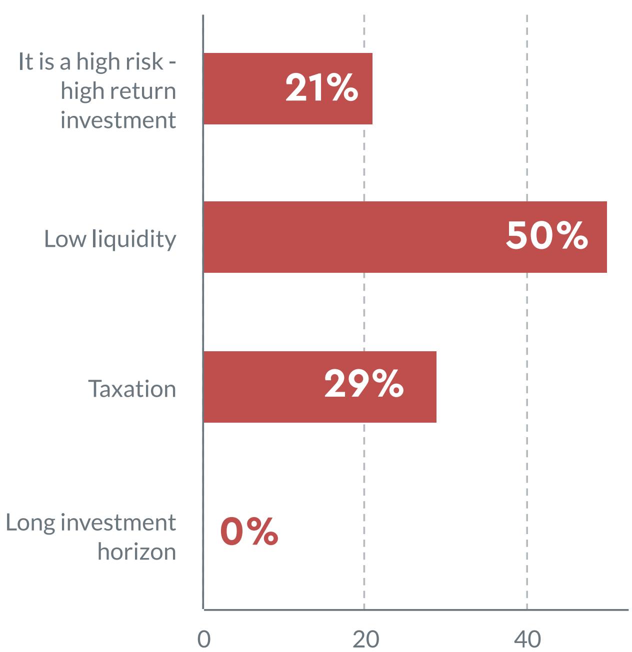
Q: What makes long only AIFs a better investment option than traditional mutual funds?

Primary factors that make long-only AIFs attractive for manufacturers:
Concentrated exposure to select themes and securities.
The concentrated exposure increases the risk but also improves **the probability of creating alpha** over the long-term.
Manufacturers have **the flexibility to launch innovative themes and ideas** which in turn ensures that investors have a wide suite of products to choose from.



Low liquidity and taxation opacity acting as major deterrents to investing in CAT-III AIFs

Exhibit 2.7: What is keeping investors away from CAT - III investments -Investor view



Q: What is the biggest deterrent to investing in Category - III AIFs for you?

Interestingly, a majority of investors surveyed expressed **low liquidity and taxation** opacity as the major deterrents to investing in CAT - III AIFs.

Multi-strategy offerings are a clear winner

Strategies preferred while investing in hedge funds - Investor view

Q: Which approach do you prefer while investing in hedge funds?

We asked the respondents to rank the key strategies in their order of preference. These are the key takeaways:

1 — **83%** respondents ranked **multi-strategy offerings** at No. 1

2 — **50%** respondents ranked **direct hedge funds** at No. 2

3 — **33%** respondents ranked **Single strategy/style** specific as No. 3

4 — **33%** respondents ranked **Fund of Funds strategy** as No.4

> **If you look at the fund management industry, when the ability to create alpha gets matured then you need to constantly innovate to generate alpha. Typically, in a commoditised fund management structure, alpha creation can be challenging. There is a lot of white space in India in that area right now and this is where AIFs can add immense value - they have the ability to invest in a lot of fund management infrastructure, and in ideas that are more innovative, and can potentially consistently generate alpha.**
>
> **UJJWAL JAIN**
> Founder, WealthDesk

Opportunities for the next level of growth

Products

AS IS SCENARIO

Two main products: long-only funds and long-short funds that use leverage

OPPORTUNITY

Funds focused on commodities, for example, a gold or silver based AIF.

Option based strategies.

High conviction and high leverage based strategies.

Longer tenure AIFs, for example, GSec focused strategy.

Products specifically for institutional investors like insurance companies.

Distribution

AS IS SCENARIO

Split amongst IFAs, Pvt Banks, Public Banks, Global Banks, Individual driven funds, Institutional funds (that have MFs, PMS etc.)

OPPORTUNITY

Only just begun to scratch the surface in terms of growing business through IFAs. This can be enabled by regular interactions between manufacturers and IFAs and through focused education and support programs.

Operations

AS IS SCENARIO

Currently being managed by large service providers who manage other investment vehicles, predominantly mutual funds. Resources allocated to AIFs within these firms are minimal which creates challenges in issue resolution among several other operational challenges.

OPPORTUNITY

Opportunities to invite new custodian, global players, and legal and taxation specialists. Further, opportunities to outsource operations can also be explored.

Chapter 3: Through the stakeholder lens

> **Investment in Mutual fund industry increased to INR 37.34 Trillion in November 2021 as compared to INR 10 Trillion in May 2014. This pattern of financialization of savings in India denotes the increasing need for different financial products. Alternative Investment Fund which provides access to diverse variety of products such as Private Equity, Pre IPO Funds, Funds with hedging capabilities, etc. will see an increasing acceptance in coming years. Also with introduction of the concept of Accredited Investor by SEBI, AIF can witness flows as this new class of investors will have the flexibility to participate with investment amount less the minimum amount required as per AIF regulation.**

TWINKLE JAIN
Head of Product – Alternatives,
Edelweiss Asset Management Limited

The AIF Ecosystem

An ecosystem needs all the pieces to be integrated in such a way that each piece can thrive independently while enabling growth for the other pieces. Within the AIF ecosystem there are present 7 key players that assume an important role in the smooth functioning of the industry.

THE AIF ECOSYSTEM

DISTRIBUTORS

act as a conduit between manufacturers and investors enabling two-way communication - **the most important cog**

LEGAL

Regulatory and other compliance by manufacturers, implementation of regulatory policies, helping with funds structures, etc.- **Making complex problems simpler with efficient processes**

MANUFACTURERS

Build alternative investment solutions - **rise of boutique players deepening the ecosystem**

FUND ACCOUNTING

Operational support in terms of portfolio valuation, scheme and fund related accounting - **New entrants joining the industry**

INVESTORS

Invest in alternative investments for portfolio diversification and growth - **Growth in disposable income, more wealth creation, long-term alpha generation, need more awareness**

TAXATION

Managing money matters behind the scenes - **Taxation and accounting critical to the scalability of operations**

CUSTODIAN

safekeepers of investments bought by manufacturers on behalf of investors - **Rise of Global players**

"AIFs offer a great platform for both boutique managers as well as institutionalised managers to flourish. It allows investors to participate across asset classes and avail the services of best in class managers. It is the only platform to bring non benchmark investment management skills to the fore. To the audience for AIFs, investment performance is critical. Managers delivering consistently superior performance have ample opportunity to grow.

Globally the largest investors in Alternative Investments are institutions. Approximately 90% of the money into the Indian Alternative Industry is from such overseas institutional investors. Domestic institutional capital from pension & retirement funds, sovereign funds, insurance funds, etc., which is as yet negligible, can further propel the growth of the industry.

SHAHZAD MADON
Head, Nippon India Alternative Investments"

DISTRIBUTOR LENS

Sellers need to be more aware than buyers

BRIDGING THE INVESTOR AND INVESTMENT GAPS

Distributors, i.e., wealth managers and private banking desks are perhaps the most important cog in the AIF ecosystem. They act as a conduit between manufacturers and investors and play two important roles:

- Ensure that the client is aware of the relevant AIF products such that optimal investment decisions can be made.
- Keep the manufacturers updated with respect to prevailing and emerging client requirements such that relevant products can be launched.

Key Challenges

An added layer of due diligence

Inarguably, offerings under the AIF umbrella are unique and can serve multiple investor requirements. **This is both a boon and a bane.** While the differentiated strategies and themes ensure that there is a strong potential to enhance portfolio risk-adjusted returns, it also means that the level of **due-diligence required with these products is much higher.** **75%** of the distributors surveyed said that they perform a much higher degree of due diligence while evaluating AIF offerings.

Distributors believe that the study needs to be deeper since the commitment being made is more long-term in nature while the transparency is relatively lower compared to mutual funds or a PMS.

> "Asset class might be the same, for example, debt, but how one approaches it is different. Thus, there are added elements like lifespan of the fund manager, mistakes made in the past, hits, etc. These assume greater importance vs the listed space."

Q: How do Wealth Managers select the alternative funds for clients?

From an evaluation perspective, a majority of the distributors surveyed **(~55%)** said that uniqueness of idea / theme, tax implications, pedigree of the fund manager, consistency in returns, and liquidity are the five most important factors for selection of funds.

Benchmarking and comparative analysis

60% of the distributors surveyed felt that benchmarking, while challenging due to the uniqueness of different product offerings, is a **necessary yardstick.** However, while creating benchmarks, it is equally important to ensure that the contours of the benchmark are similar to the offerings. In the absence of this, investment solutions end up getting compared to irrelevant benchmarks which could mar the investment decision making process. For example, within CAT - III there could be two long-short funds. One that is extensively using leverage to create derivatives positions and another that is mostly long-only with limited derivatives exposure. While both are long/short, their investment approach and strategy are completely different. Hence, a standard benchmark might not be a viable option to assess the performance of these funds. **Further, due to product differentiation on multiple factors, product positioning becomes challenging.**

Open criteria > **confusing investor & sellers as well**

The right set of benchmarks and comparison metrics will enable clear product positioning and differentiation, thereby empowering wealth managers to make the right investment recommendations.

The conundrum between transparency and disclosures

Just like beauty lies in the eyes of the beholder, it seems that transparency **can also mean different things to different stakeholders.** Responses to this factor were highly mixed. While 50% of the survey participants felt that more needs to be done to enhance transparency and disclosures, the balance believed that there is sufficient transparency in the ecosystem. This issue gets further amplified when compared to mutual funds that have clear disclosure norms. In the AIF ecosystem, and especially from the perspective of distributors, transparency is primarily related to the following factors:

Availability of relevant information

like fund composition, performance, AUM, etc. This is a fairly big challenge as there are some funds that don't even reveal their AUM simply because it is not mandated.

Information analysis:

Information on its own is of little value. There need to be relevant platforms and benchmarks that can help distributors optimally leverage this information through in-depth comparative analysis.

Information asymmetries:

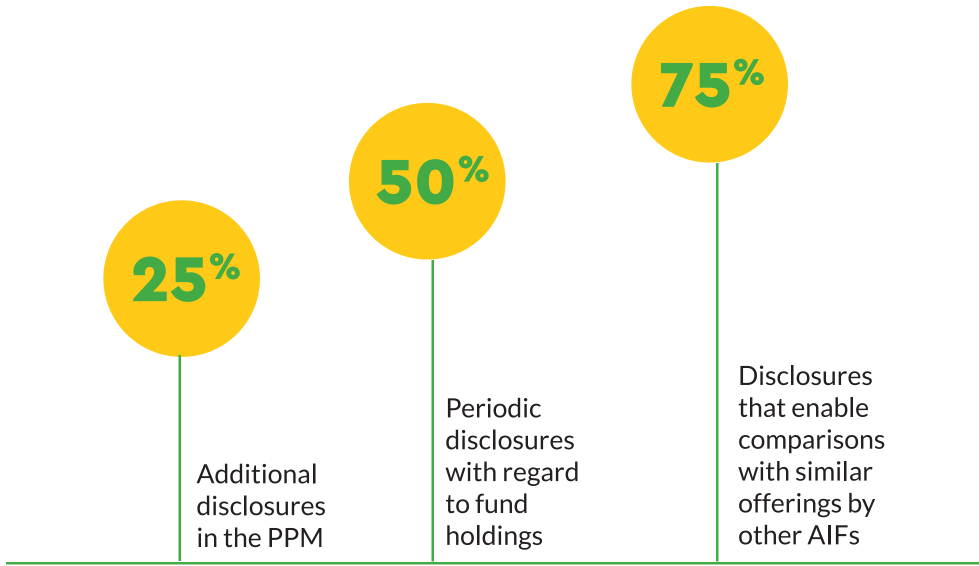
Every stakeholder should receive the same level and depth of information and there should be no bias in information exchange. This means that investors and distributors of different sizes should get access to the same information.

> "The absence of portfolio disclosure or NAVs brings about a subjectivity in the evaluation process which is not desirable."

Comparison with similar offerings can build more confidence

Exhibit 3.1: Improving transparency from a distributor lens

Q: How can the AIF industry improve transparency?



Lack of awareness and training

The AIF industry, unlike the mutual fund industry, is still relatively nascent. Correspondingly, the offerings under the AIF umbrella are far more sophisticated than those offered by Mutual Funds and even PMS. Thus, engagement and awareness with investors needs to be created at two levels.

- Awareness about AIFs: Currently, there are 45MFs but PMS + AIFs is almost 300 players. **Even though the number of players is almost 3X, awareness is limited.**
- Products are more nuanced requiring specialised skills: **There are no standardised training and certification programs** that can ensure the upskilling of RMs and product specialists.

Biggest challenge: AIF has become a generic term. However, offerings under the AIF umbrella can be very unique. For example, while one AIF may have an objective to be at par or slightly better than liquid fund there might be another AIF dealing with distressed assets. Each offering is distinct, however, as long as media and other publications address both in similar manner, it will end up creating information asymmetries.

Differential tax treatment souring the investment experience

100% of survey respondents have ranked taxation as the biggest hindrance to the growth of CAT-III AIFs followed by liquidity & information asymmetry.

CAT - I and CAT - II AIFs are accorded a pass-through status, which means that income earned by AIF is only taxable when it is passed on to the investors, and not when held by the AIFs. The business income is tax exempt in the hands of investors and can be taxed at maximum marginal rate when held by the AIF. However, Category III AIF investors are not accorded this pass through status. Therefore, all the income accumulated by Category III AIFs is taxed at the fund level itself, depending on the legal form of the company. Taxation is in line with the MMR or maximum marginal rate of tax, which indicates the rate of tax applicable in accordance with the highest slab of income for the individual.

For business income, an MMR of 42.74% is levied, while short term capital gains attract an MMR of 19.94% and long term capital gains are taxed at 11.96%. Dividend income arising from Category III AIFs are taxed at an MMR of 42.74%. Further, such AIFs are pressed to segregate investments into capital gains and business income and must maintain separate account books for each sub-division. The high taxation of Category III AIFs makes them less attractive to investors and industry bodies are prompting the authorities to let go of this demarcation.

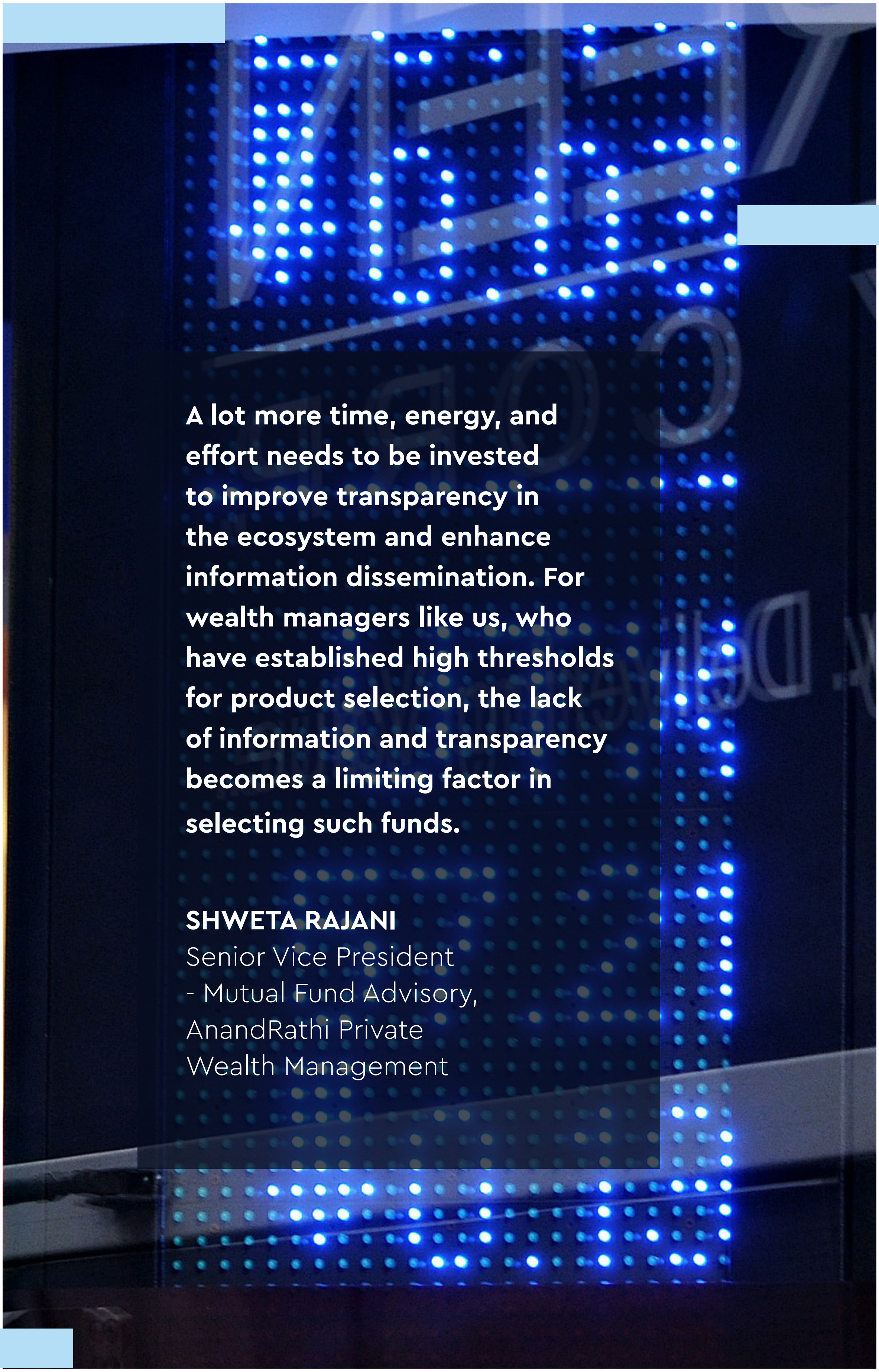
A potentially wider product suite

Concept of AIFs is to create significant alpha but that is not necessarily happening. A large number of FMs are adopting a **conservative approach** which is limiting alpha creation.

Innovation is key to AIFs and thus there is a need for new ideas, innovative themes, new structures, and also pure mandate fund managers. For example, the appeal of long-short funds is in the leverage **they take to deploy sophisticated derivatives strategies.** However, in reality, many long-short funds are simply long-only funds that use very little leverage to **exploit opportunities in the derivatives market.**

MANUFACTURER LENS

Scratching the innovation surface



A lot more time, energy, and effort needs to be invested to improve transparency in the ecosystem and enhance information dissemination. For wealth managers like us, who have established high thresholds for product selection, the lack of information and transparency becomes a limiting factor in selecting such funds.

SHWETA RAJANI
Senior Vice President
- Mutual Fund Advisory,
AnandRathi Private
Wealth Management

AIFs: Packaged solutions to meet multiple needs

There are several factors that make AIFs a compelling vehicle for launching new investment solutions or creating new funds offerings. Some of these include:

Vehicle of innovation:

Traditional platforms can be limiting in terms of idea and theme innovation. AIFs as a vehicle offer a great deal of flexibility to the manufacturers in terms of how they want to shape the contours of their core offerings. While other investment vehicles are well-suited for certain segments of investors, they have their own limitations. For example, mutual funds are increasingly getting more restricted in terms of the types of schemes they can launch and cannot be agile due to their size. On the other hand, PMS is restricted to the listed universe.

Lower entry barriers:

Further, the entry barriers for AIFs are fairly low, making it easier for boutique firms and investment managers to package their investment offering under the AIF umbrella. AIF is fragmented and has a wide suite of products in terms of asset class exposure and strategies. From a manufacturer's perspective, AIFs are easier to manage at a pool level. From an investor's perspective, AIFs can offer concentrated exposure, more investment options, and a higher probability of alpha creation.

In short, AIFs offer the best of both the worlds in terms of management fees, upfront costs, pool level management, leverage, and ease of doing business.

Largest profit pie:

From an earnings perspective, manufacturers are likely to find AIFs highly value accretive as they can charge upfront fees, performance fees, and management fees. As a result, AIFs or fund managers that are able to deliver results have the potential to grow substantially over a period of time. It is important to note that while the same investment managers can potentially generate similar performance through other vehicles, their earnings will not be commensurate.

Enabling ecosystem:

Brand matters the least in AIFs vs MF/PMS. Thus, boutique players who deliver well have an advantage and ease of business & setup is immensely favourable. To that extent, it is not necessary to have an institutional backing to attract capital. Boutique firms have an equally fair chance at success.

Ambitious fund raising target indicative of future growth potential

Exhibit 3.2: Fund raising targets for the next 2 years

Increasing investor interest coupled with the ability to seamlessly offer innovative investment ideas have created optimism amongst manufacturers. Approximately **60%** of the manufacturers surveyed have set a 2 year fund raising target of upto INR 1000 cr.

With the rise in interest from global as well as local investors, AIFs have seen a steady rise in assets under management with many having met their fund raising targets. **What is your target to raise in next 1 to 2 years?**

Upto 500 CR	30%
Upto 1000 CR	30%
Upto 2000 CR	10%
Upto 5000 CR	20%
More than 5000 CR	10%

Drivers for launching new funds

Manufacturers take into consideration several factors before launching a new fund under the AIF umbrella. Broadly, these variables can be bifurcated into investor requirements, external landscape and internal infrastructure and expertise

INVESTOR REQUIREMENTS

- Client Demand
- Investor interest
- Target investor profiles
- Target market size
- Distributor feedback

EXTERNAL LANDSCAPE

- Market Scenario
- Favourable Risk Return Proposition
- Industry demand

INTERNAL INFRA & EXPERTISE

- Strong research
- Good client base
- Breakeven AUM
- Internal capability to manage the funds
- Unique Product
- Scalability

Key Challenges

Product - investor alignment:
Client suitability often gets compromised as frequently the wrong investor is sold the right product. Product is always right - the investor needs to be right. Further, onboarding long-only investors can be challenging.

Taxation: Differential treatment of CAT-III acts as a hindrance to the growth of the category. Similarly, investors compare MF taxation with AIF taxation, which is not feasible.

Skin in the game: High upfront cost plus high running cost can make it unviable in the short-term.

Information asymmetries: It is difficult to promote standardisation in this industry since each offering is unique. There needs to be some level of information symmetry. Due to asymmetries it is challenging to create the right benchmark. Limited information is available in public domain and that too in a uniform manner. A platform that enables standard dissemination and analysis of information (e.g. Value research in Mutual Funds) can address the challenge.

Training and education: Train wealth managers and update them about offerings. This should ideally be a continuous and ongoing process

Manufacturers also prefer a staggered investment: Should not be easy come and easy go - ticket size of investors is important

Building credibility with investors

Q. How would you rate the factors in the order of fund governance requirements for AIFs as a need of the hour for building more credibility with investors?

KEY TAKEAWAYS:

1. Transparency and timely disclosure of events / material information to the Investor before and after investing
2. Training and specialisation of partner/channel distribution network
3. Strengthening risk management towards investment capabilities
4. More fiduciary accountability towards Trustees and Investment Managers

67% of the respondents ranked the factor 'transparency and timely disclosure of events' as the No. 1 factor that can help the industry build credibility with investors.

This was supplemented by the statements from manufacturers about making investors understand about the risks and other limiting factors associated with AIFs along with benefits to get the onboard the right set of investors.

Correspondingly, **~ 80%** of the respondents also ranked the factors, 'training and specialisation of partner / channel distribution' as top two factors.

50% of the responded ranked 'more fiduciary accountability towards trustees and investment managers' at No. 2.

Manufacturer view on taxation

83% of the manufacturers surveyed felt that a better taxation regime in CAT - III AIFs will make it a more compelling investment choice

Disruptive compliance requirements

Q. From being a macro managed fund structure to being closely monitored fund structure. Please rate the most disruptive compliance requirements. [1 being the highest priority; 4 being the least priority].

42%

respondents ranked "Single issuer limit from 10% on investable funds to NAV for listed equities (For CAT-III fund)" as No.1

50%

respondents ranked "PPM audit" as No. 2

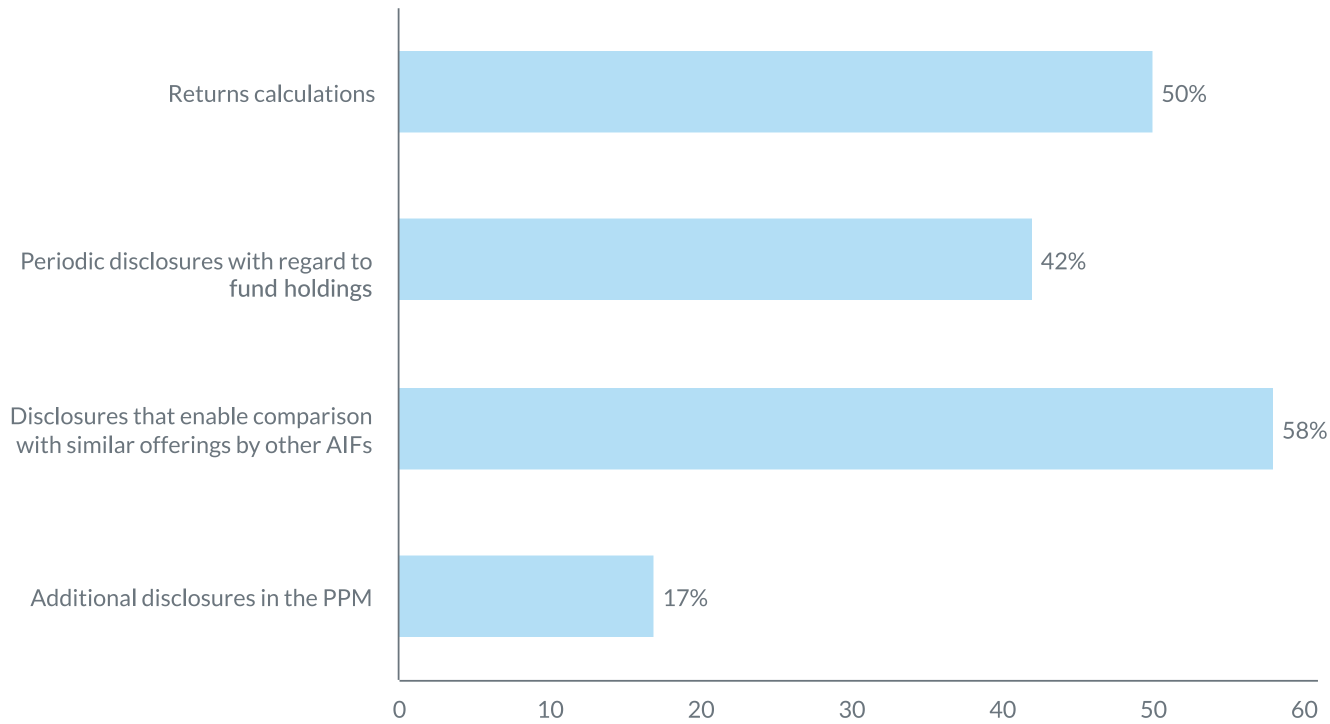
42%

respondents ranked "Enhancement in reporting requirements " as No. 3

Exhibit 3.3: Roadmap for increasing transparency

Q. How can the AIF industry improve transparency?

Disclosures that enable comparison with similar offerings and publishing return calculations were rated as the top 2 factors



Manufacturer lens on other stakeholders

Custodian bank

Manufacturers indicated a preference for a custodian with global presence and an assurance on speed of execution and efficiencies in the system.

Fund administrator

AIFs offer a limited scope for standardisation and hence the scalability of operations becomes a challenge. The uniqueness of the category does come with added complications. Most of the service providers are offshoots of existing RTAs and hence, the capacity to offer dedicated support to AIFs causes operational hassles. This gets escalated with limited team stability. The need to understand NAV and impact on performance is an ask from the manufacturers as well.

Tax

AIFs, due to their differentiated strategies, require custom service and solutions. Unlike MFs where one change can be applied to all, there is no one-size-fits-all approach in AIFs. Since it is privately placed, the queries are not standard. Although the umbrella structures are uniform including the SEBI compliances, deviation arises due to the multiple facets of filing for every fund. Apart from BFSI regulators, other regulators also come to play in AIFs, for example, GIFT city regulations, ROCE for trust registration etc.

Wealth managers

The biggest ask that manufacturers have from wealth managers is a dedicated effort towards product understanding. The understanding of risks associated with the products and conveying all factors to the investors is of utmost importance.

INVESTOR LENS

Dipping their toes and keen to wade in

AIFs: Elevating the portfolio structure

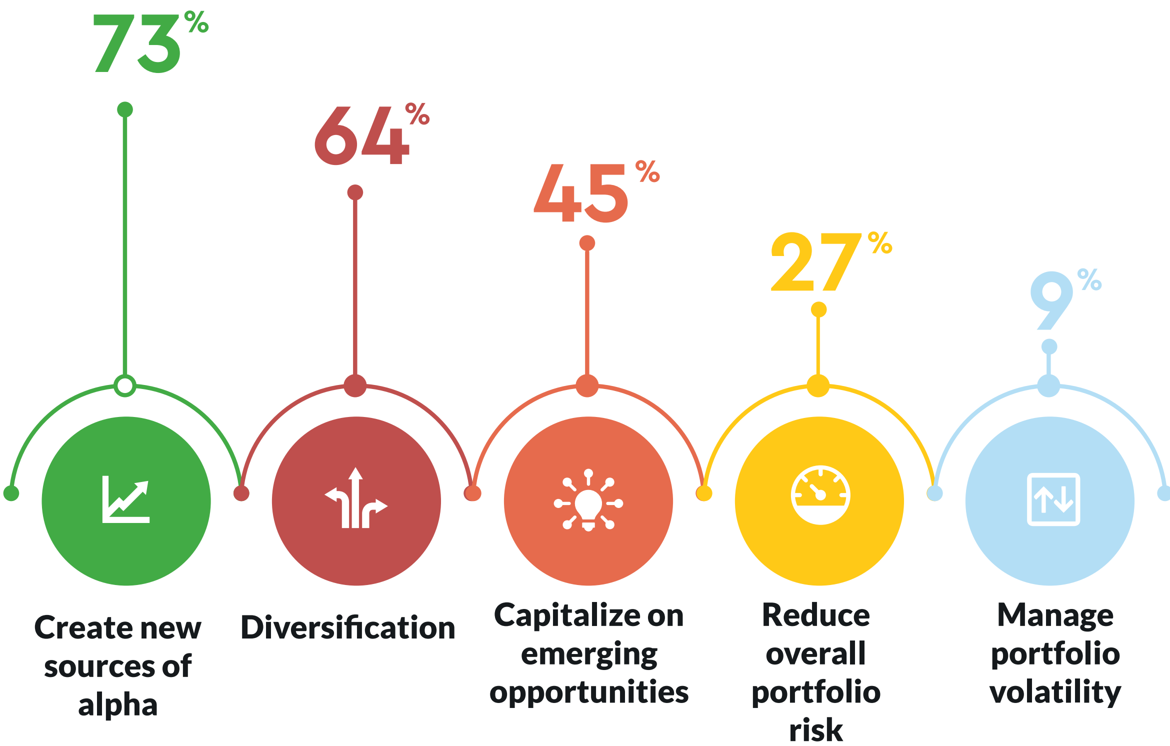
HNIs and Family Offices structure their investment portfolio with two main goals. One is **wealth preservation** and two is to **grow their wealth.** To achieve these two goals they explore a host of investment opportunities along the risk-return spectrum. Inevitably, their myriad requirements cannot be optimally met through a single investment option or vehicle. From that perspective, a calculated allocation to AIFs can be ideal. AIFs provide a great opportunity to access **thematic and curated products** that might not be available in the mutual fund space. Through AIF investments, investors can potentially add diverse investment products to their portfolio, thereby enhancing risk-adjusted returns.

Exhibit 3.4: The value add of AIFs in investor portfolios

Q. Why do you add alternative investments to your portfolio?

The top 3 reasons for investing in AIFs include:

- Create new sources of alpha.
- Portfolio diversification
- Capitalising on emerging opportunities

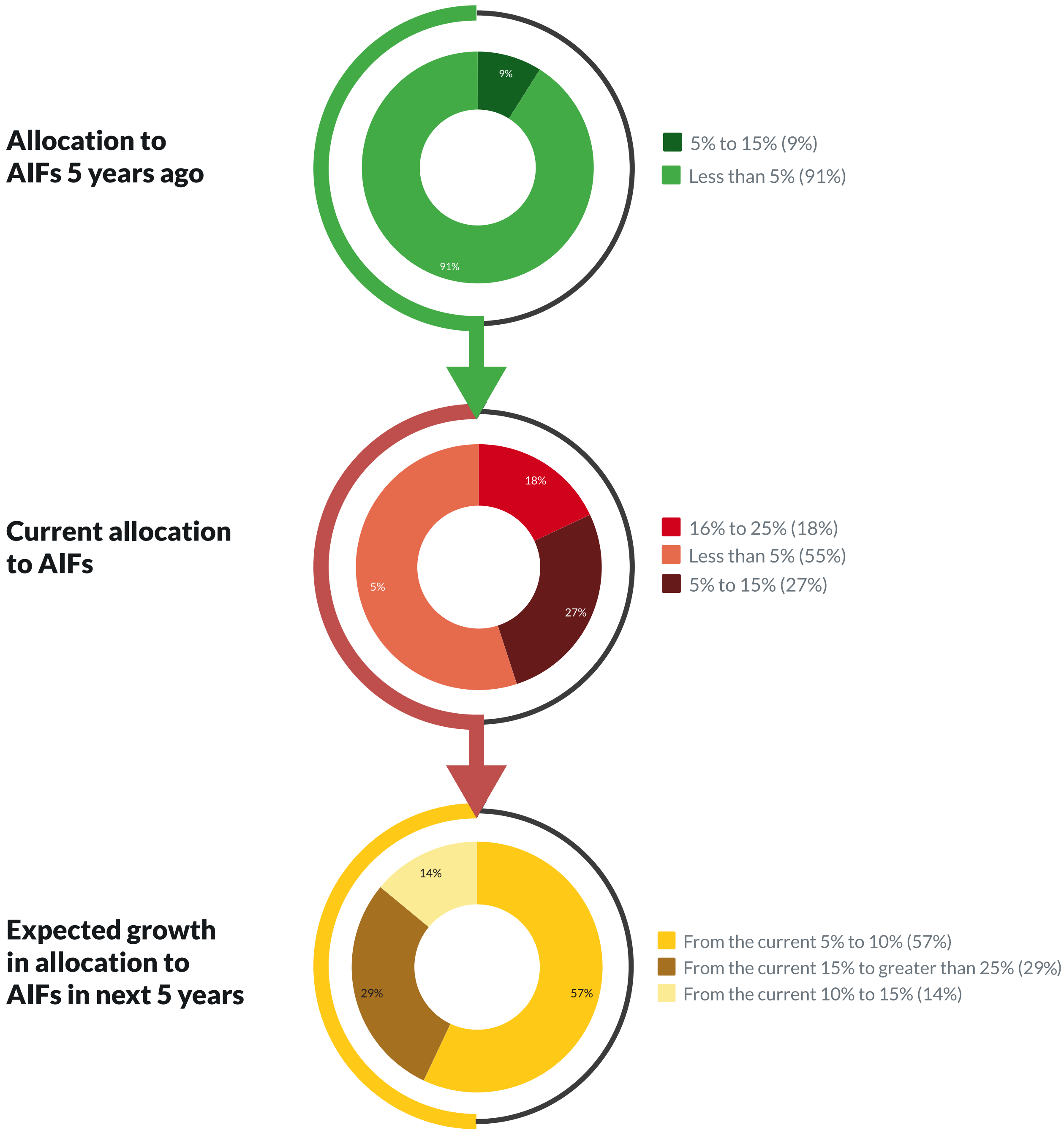


> The AIF industry has a potential to become as large as the MF industry in a decade. Earlier AIFs were primarily an extension of MFs or PMS. Now more boutique fund managers are coming into the CAT-II & CAT-III space with more innovation and diverse product offerings to cater to sophisticated Ultra HNI Investors & single family offices.
>
> **SUMEGH BHATIA**
> CEO & Managing Director, Lighthouse Canton

~65% of the respondents expect their allocations to alternative investments to grow in the next 5 years

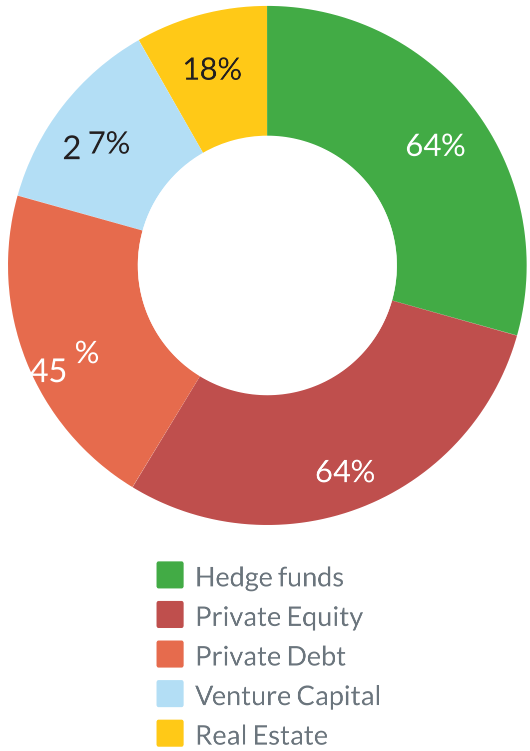
Exhibit 3.5: Trend of increasing allocations to alternative investments

5 years back, approximately 91% of respondents had less than 5% allocation to alternative investments. However, allocations are expected to accelerate over the next 5 years with 57% of the respondents saying that they are likely to increase their alternative investment allocations from the current 5% to 10%.



Hedge Funds and Private Equity to see maximum increase in investor allocations

Exhibit 3.6: Offerings that are expected to witness larger capital flows



Q. Going forward, where do you expect to increase allocations?

64% of the respondents expressed an intent to increase allocation to private equity and hedge funds, exemplifying the potential of these two investment options. This was followed by 45% of the respondents expressing an intent to increase allocations to private debt.

PMS vs AIF - The preferred investment vehicle

Q. What is preferred between PMS and AIF?

60% of the investors surveyed expressed their preference for AIF offerings versus PMS, whilst citing the following reasons for their choice:

- NAV fund level structure like MF
- Less cumbersome in term of managing demat
- No historical bias of stock holding, thereby allowing access to a new investment portfolio which is aligned with the prevailing market conditions

	AIFs	PMS	MF
Approach	Investor money is pooled and then invested as per the investment scheme mandate	No pooling of investor funds. A separate portfolio is maintained for every client	Investor money is pooled and then invested as per the investment scheme mandate
Leverage	Only in CAT-III	With investor permission	Allowed in certain categories
Fee Structure	Management fee + performance fee	Management fee + profit sharing Operational expenses fee capped at 0.50% per annum of client AUM	Expense ratio between 1.50% to 2.50% depending on scheme
Cost of Compliance	Low	High	Medium
Regulatory framework	Regulated by Securities Exchange Board of India (SEBI) (Alternative Investment Funds) Regulations 2012	Regulated by Securities Exchange Board of India (SEBI) (Portfolio Managers) Regulations 1993	Regulated by the Security Exchange Board of India (SEBI) Regulations 1996
Capability to customize	High	Medium	None
Sharing with intermediaries	AIFs can choose to share the fee with intermediaries	No upfront commission to distributors, only trail commission	No upfront commission for distributors. Only trail can be offered
Skin in the game	**High:** In the case of Category I and II of AIFs, managers should hold at least 2.5% of the corpus, or, ₹5 crores, whichever is lower. For Category III AIFs, a manager should hold at least 5% of the corpus, or, ₹10 crores, whichever is lower.	**Low:** No specific requirements on fund manager contribution.	**Medium:** Key employees of the AMC to mandatorily invest a minimum of 20% of the salary/ perks/ bonus/ non-cash compensation (gross annual CTC) net of income tax and any statutory contributions, i.e., PF and NPS, in the units of Mutual Fund schemes in which they have a role/ oversight.

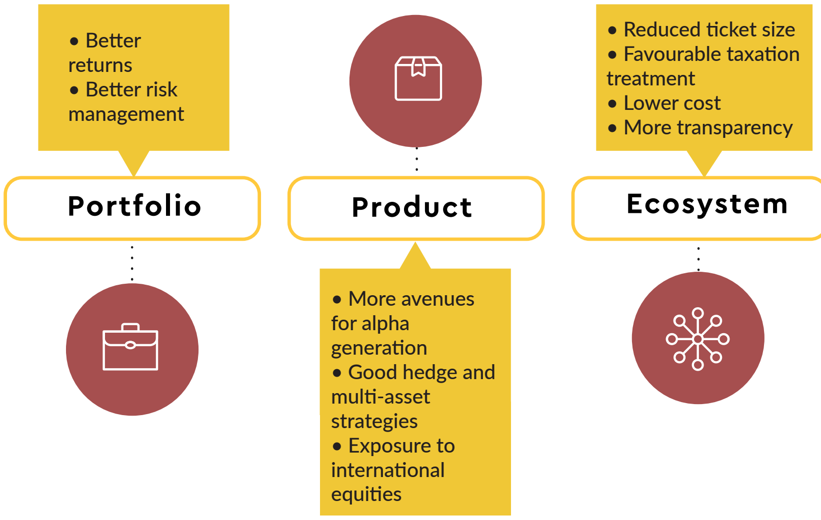
“The AIF ecosystem is still in its early days and there is enough opportuntiy for the entire pie to expand. Existing tax ambiguity and the cap on gross exposures make it a challenging scenario for the long / short Category-III AIFs. However, as the market matures and also sees more institutional investor participation, the regulations may also become more light touch and allow the industry to grow meaningfully.

DEBASHISH BOSE

Managing Director, OAKS Asset Management
(Formerly Alpha Capital)”

How can AIFs become more attractive?

In order to attract more investor capital, the AIF ecosystem can evolve along the following three tracks, i.e., meet the investor's portfolio requirements, meet the investor's product requirements, and create a more enabling ecosystem.



Fund manager expertise is the highest rated followed by pedigree of investment team managing the hedge fund

Exhibit 3.7: Factors driving investment in alternative offerings

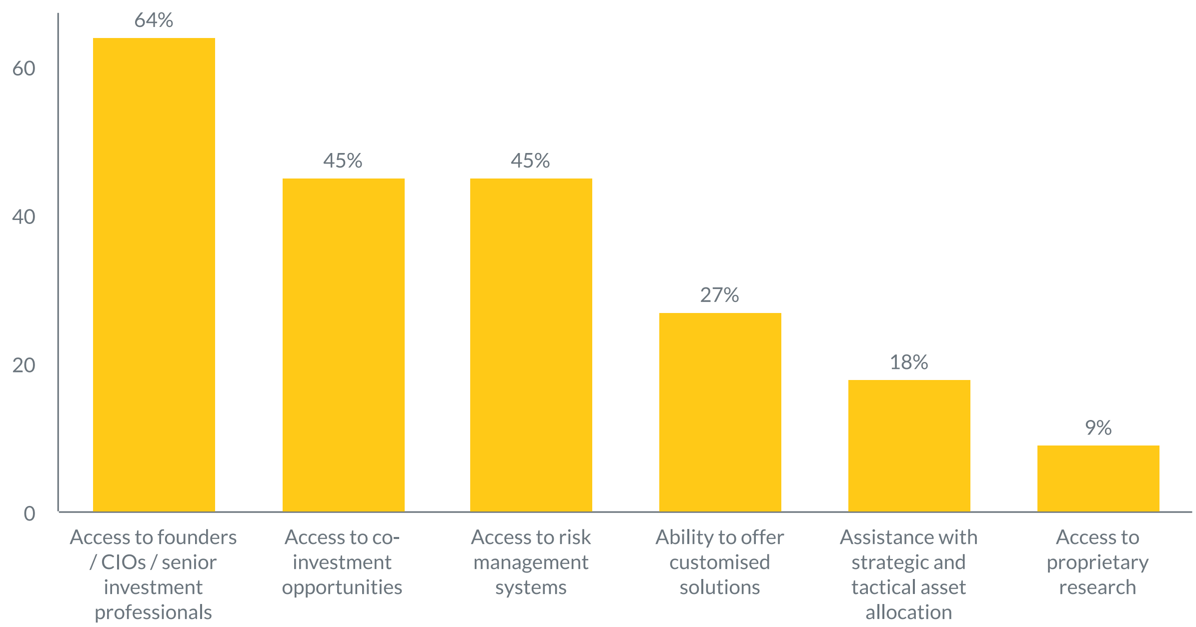
Q. Rank the factors that drive your decision to invest in alternative investments.

Exhibit 3.8: What do investors look for in manufacturers

Q. When deciding on whether or not to partner with an alternative investment fund manager, which of the key factors below may influence your decision apart from performance?

Key factors:

- Good historical track record
- Risk management
- Market share
- Responsive & expertise
- Ability to clearly put across investment theme
- Domain experience

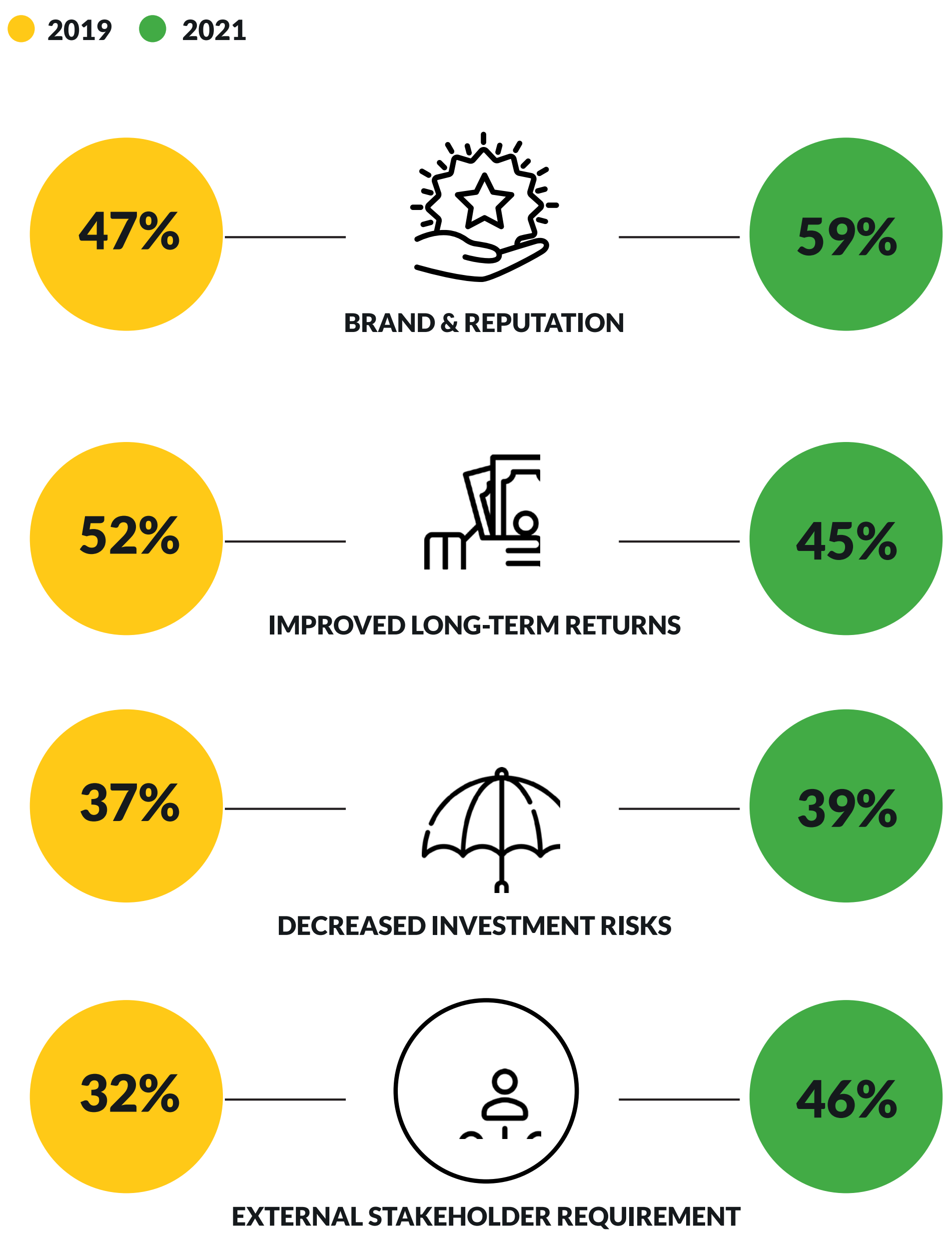


The ESG Global Survey 2021 by BNP Paribas Securities Services.

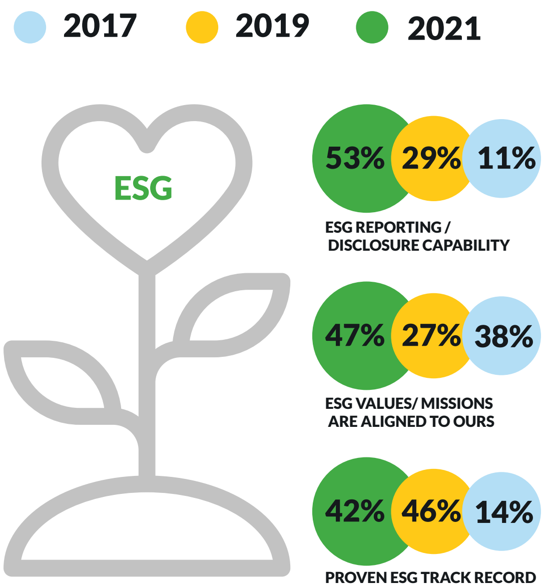
The Path to ESG. No Turning Back for Asset Owners and Managers.

Now in its third edition, The Global ESG Survey 2021 shows the incorporation of ESG among institutional investors has matured and is accelerating, but with key challenges and room for growth. For the 2021 report, 356 institutional investors were surveyed across Europe, North America & the Asia Pacific, representing more than EUR 11 Trillion assets under management. Building on the 2019 and 2017 surveys, here are just two of the many findings from the latest research.

Takeaway 1: Brand and reputation has overtaken investment returns as the main ESG driver. Stakeholder expectations have become more important.



Takeaway 2: Shared values are becoming more important to asset owners when selecting an asset manager for an ESG mandate.



In addition to the recent regulatory changes implemented, the Indian government is increasingly focusing on sustainability commitments and this is a challenge with far reaching potential impact on India's asset management industry.On 01 February 2022, the Finance Minister presented India's Union Budget 2022-23. As expected India's commitment to addressing climate change was reinforced, with various initiatives aimed at achieving net zero by 2070.

Whilst Environmental, Social, and Governance (ESG) investing is in its nascent stages in India, with limited ESG thematic funds available today and demand growing slowly, a slew of ESG-focused funds have been launched recently, with many more lined up. Those who seize this growing market opportunity will reap the rewards.

The findings from the latest BNP Paribas ESG Global Survey 2021 showed that commitment to ESG is growing across the world. More asset owners and fund managers say ESG plays a central, integral or necessary role today than in the same survey two years ago. However, barriers to further adoption remain with respondents citing inconsistent data quality across asset classes as one of the top five hindrances. However, brand and reputation were strong drivers for investors to incorporate ESG in investment decisions.Through its commitments to be a sustainable bank, BNP Paribas is supporting its clients on their ESG journey.

Source : The Global ESG Survey 2021, third edition. BNP Paribas Securities Services. Download the full report at https://securities.cib.bnpparibas/esg-global-survey-download-form/ or send an email to sundeep.kumar@asia.bnpparibas.com

View on management fee

Respondents were evenly split in terms of the status accorded to management fees when choosing an alternative investment fund.

Bottom line: Management fee is an important factor for investors with an overwhelming 90.1% respondents attributing it an important to very important status.

Average management fees that investors are willing to pay

Q. What is the average management fee you are willing to pay for your alternative investments?

On an average, more than **80%** respondents are willing to pay more than 1% management fees

---

Average performance fees that investors are willing to pay

Q. What is the average performance fee you are willing to pay for your alternative investments?

On an average, **~ 55%** of the respondents are willing to pay a performance fee of less than 10% to 12.5%.
Interestingly, approximately **19%** of the respondents were also willing to pay performance fee in excess of 15%, **exemplifying that investors are willing to pay for value accretive offerings.**

> **For family offices, generally wealth preservation takes priority over growth. Hence, there is a need for products which are consistent with predictable returns (upto a certain extent) , i.e., have low standard deviation . Offerings under CAT-III potentially meet this requirement as they usually have low standard deviation and can potentially generate 5-6% returns tax-free.**
>
> **GANESH JHA**
> CEO & Co-Founder, FinoFii

Key Challenges

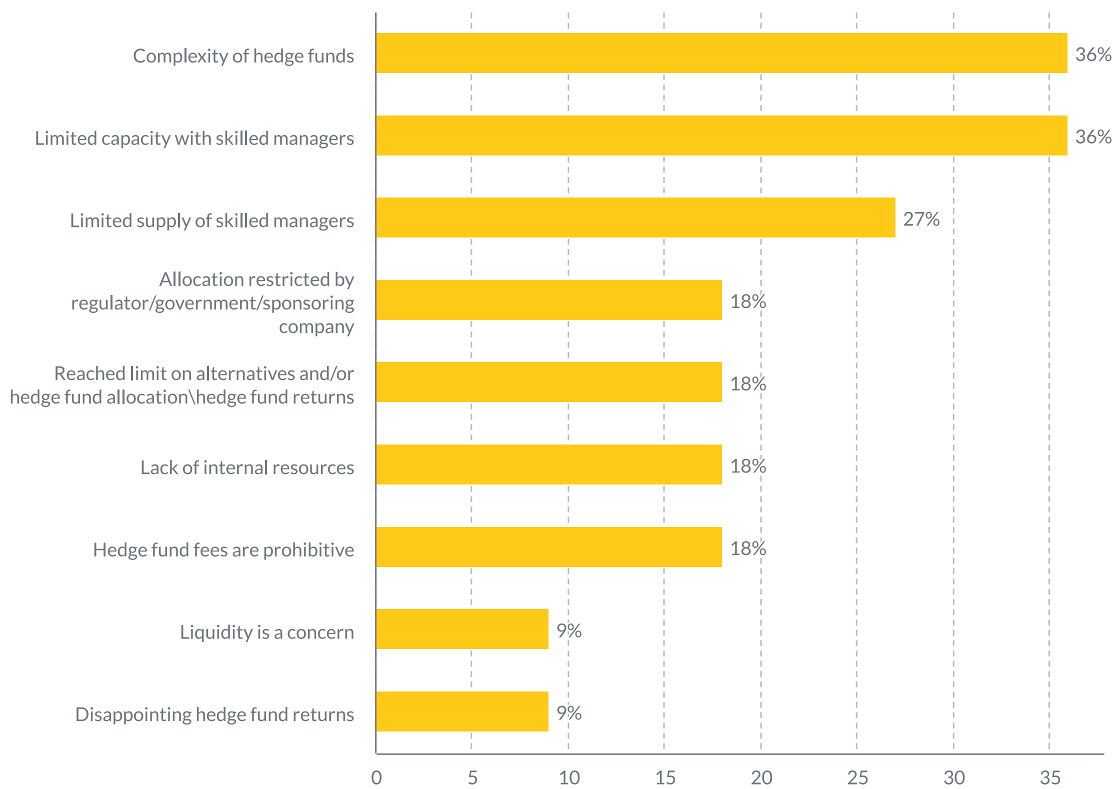
Key challenges faced by investors in the AIF ecosystem

Exhibit 3.9: Factors impeding an increase in allocations to alternative investments

Q. What is your biggest hindrance in increasing your overall exposure to alternative investments?

The top 3 factors that act as a hindrance to increasing alternative investment exposure include:

- Complexity of hedge funds
- Limited capacity with skilled managers
- Limited supply of skilled managers



Information asymmetry and lack of transparency

Q. Do you think that the AIF industry lacks transparency?

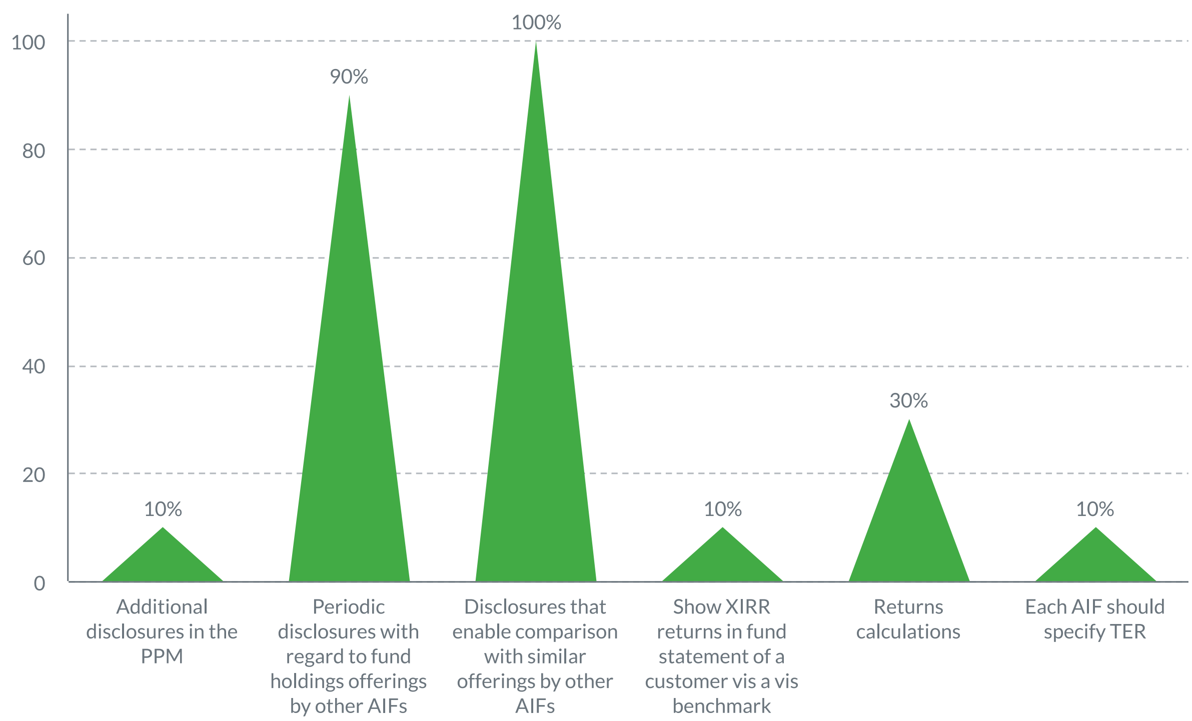
55% investors showed a tilt towards information asymmetry and lack of transparency.

Further, insights gleaned from our 1:1 interactions revealed that investors lament the absence of transparency as one of the factors that limit their understanding about the industry and the availability of unique investment products.

Exhibit 3.10: Steps to improve transparency

Q. How can the AIF industry improve transparency?

100% of the respondents would like to see disclosures that enable comparison with similar offerings. It is important to understand that investor capital is limited and thus, needs to be optimally allocated across different investment solutions. However, optimal allocations can happen only if there are standardised benchmarks and information sources that can enable comparison not just in terms of returns but also in terms of strategies, fund manager pedigree, investment time-horizon, risk, etc.



Liquidity

AIFs can take money every week but withdrawal is allowed once every quarter. As a result, investors cannot time the market easily.

Further, funds in CAT-III usually come with a long-term lock-in period which can impact overall portfolio liquidity.

33% of the investors surveyed ranked liquidity terms at No. 1 while 41.7% ranked it at No. 3 as a challenge for increasing allocations to Category III AIFs.

Exhibit 3.11 : Taxation a sore point amongst investors

Q. What changes would you like to see in the taxation of Category III AIFs?

In MFs you can buy/sell without tax implication; in AIFs, every trade has a tax implication. Post tax, limited AIFs can beat MFs.

An overwhelming 87.5% investors would like to see taxation in AIFs align with the taxation of mutual fund investment returns.

18% CLARITY ON INCOME CATEGORISATION

45% PASS THROUGH STATUS

73% TAXATION SIMILAR TO MUTUAL FUNDS

> **"NAV disclosures should be mandated. There is a need to ensure that there is minimal subjectivity while valuing investments. Also, taxation is an aspect that can be optimised for CAT-III AIFs."**
>
> **PRASHANT BISHT**
> Vice President – Investments, True Beacon

> **"Disclosures in the form of NAVs could facilitate better decision making. Mechanisms need to be established to ensure minimal subjectivity while valuing investments. Also, taxation is an aspect which acts as a hindrance for CAT-III AIFs."**
>
> **PRATEEK PANT**
> Chief Business Officer, White Oak Capital Management

Limited Standardisation

Sharing of information with a INR 1 Cr investor is very different from sharing information with an INR 50 cr investor. This requires a certain degree of standardisation that can enable comparison and robust analysis. However, currently there is hardly any degree of standardisation of data with no clarity on charges, TER, carry, management expenses, set up fees, etc. There is also an absence of nuanced categorisation in terms of market capitalisation, themes, etc.

View on performance benchmarks

70% of the survey respondents felt the need for common performance benchmarks, especially for CAT-III AIFs.

"**Multi-asset strategy because of its unique nature of risk and reward, fits into the HNI/UHNI portfolio aptly. It offers liquidity as well as stability along with the opportunity to participate in the upside of equity with much lower draw-downs. As an HNI/ UHNI at least 10% of the portfolio should be in Multi-asset category.**

SIDDHARTH VORA
Fund Manager and Head Quant Investment Strategies – PMS, Prabhudas Lilladher Pvt. Ltd."

In India, both the size and number of HNIs is growing as a result of which the savings pool is expanding. Given the ability of AIFs to meet the nuanced needs of investors, a sizeable portion of this increase in savings and investments will find its way into the AIF industry.

VIKRAM KOTAK
Co-founder & Managing Partner,
Ace Lansdowne Investments Services LLP

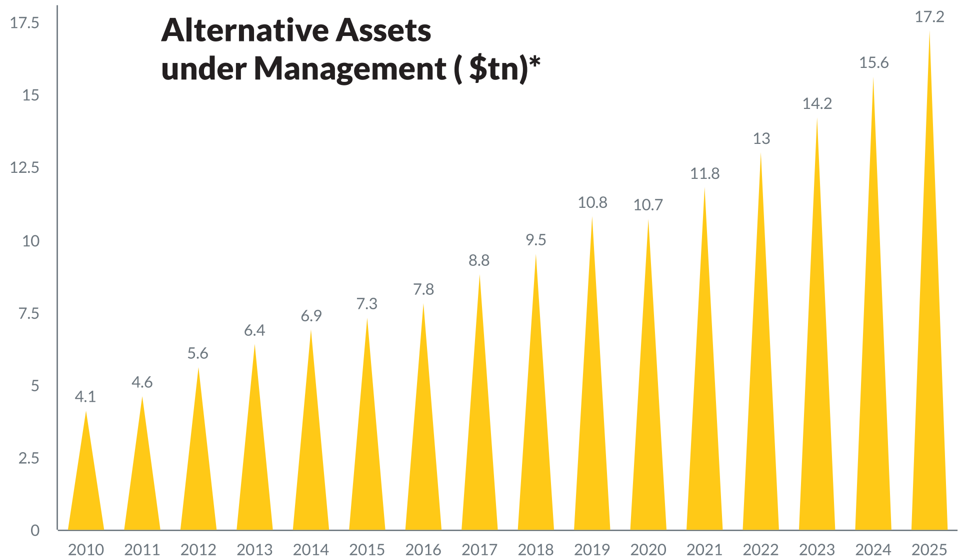
Chapter 4: Global Landscape

Rapid socio-economic developments on a global landscape have propelled alternative asset managers to the forefront of change. With the role that they play in terms of channelising private capital from areas of excess to areas of opportunity, their relevance in global economic development should be underscored.

Further, investors today are increasingly demanding customisations, diversification, and sustainable long-term alpha. Alternative firms, with their focus on outcome rather than products and tilt towards specialisation while eschewing commoditisation prove to be a viable investment option.
Due to these two very compelling factors, alternatives are set to occupy a prominent allocation in both developed as well as emerging economies.

Exhibit 4.1: Global AIF set to experience exponential growth

The alternative AUM grew from USD 4.1 tn in 2010 to approximately 10.7 tn in 2020, more than doubling in size in under a decade. As per research by Preqin, the alternative industry is expected to hold USD 17.17 tn by the end of 2025.



*2020 figure is annualised based on data to October. 2021 - 25 are Preqin's forecasted figures.

Exhibit 4.2: Growth within each asset class

The largest asset class within the alternative AUM is private equity at USD 4.42 tn. Private equity is expected to double over the next five years. Private debt is also likely to achieve double-digit CAGR in AUM. Growth in the other asset classes is expected to be modest.

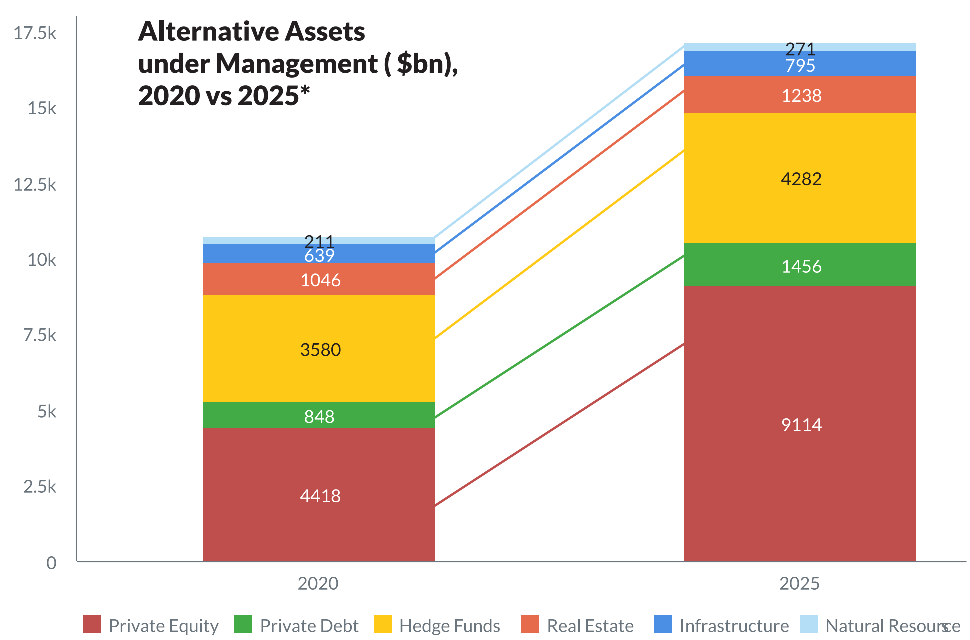


Exhibit 4.3:
Alternatives to become truly global

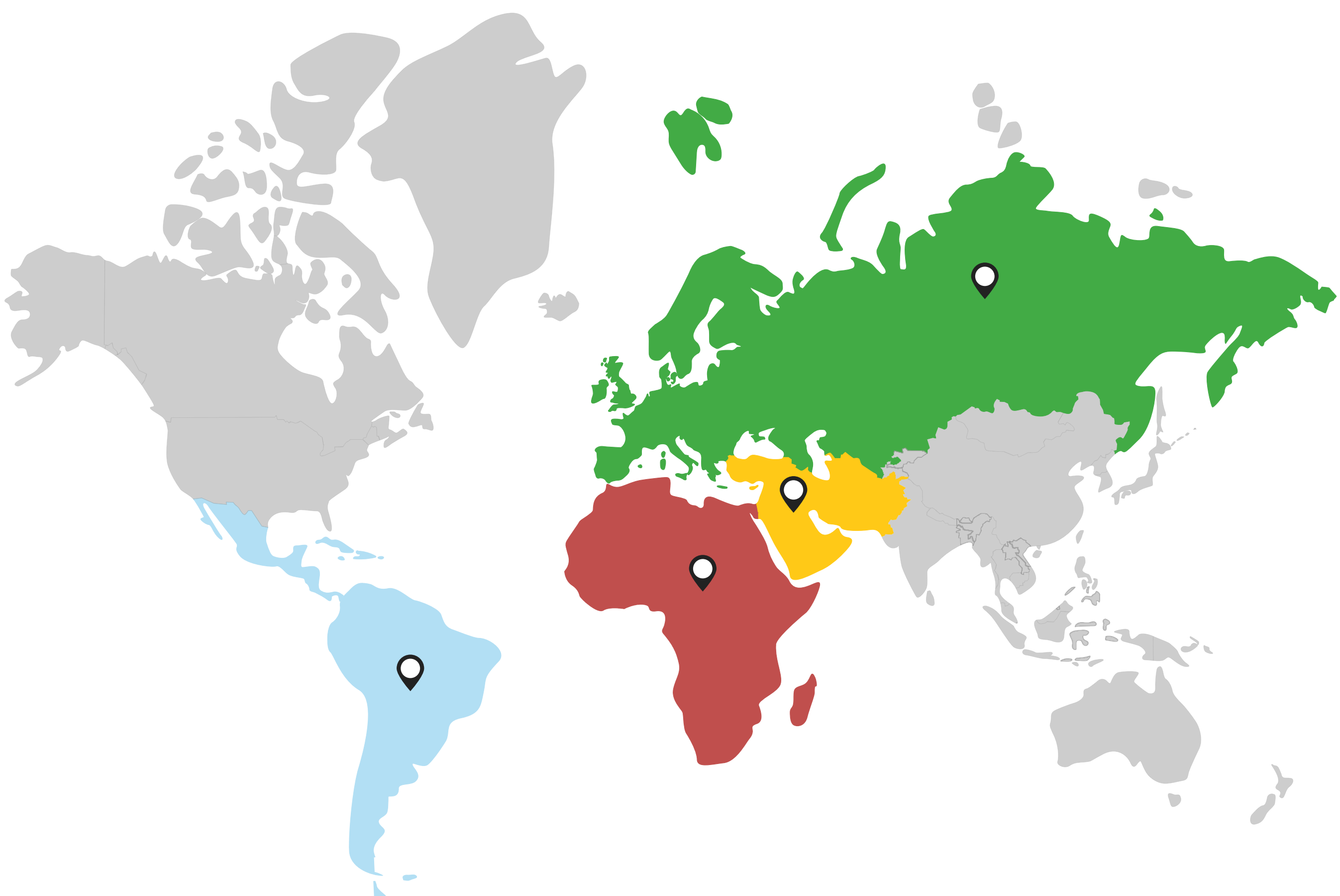
North America: Currently the world's largest alternative market but slowly reaching maturity as investor commitment to alternatives are near allocation ceilings.

South America: Facing serious underfunding issues, pension funds are increasing allocations to international alternatives funds to make up the shortfall.

Europe: AUM forecast to rise from USD 2.21Tn in 2019 to USD 2.83Tn in 2025.

Middle East: Declining oil revenues set to rechannelise private investments.

AUM growth in Asia and emerging economies outpaces North America and Europe.



Chapter 5: Call to Action

> **“Inarguably, the suite of products offered under the AIF umbrella are quite unique. However, in order to enable comparison and astute decision making there is a need to have accurate benchmarks that can act as suitable yardsticks for performance.”**

AMIT RAWAL
AVP, Emkay Global Financial Services Ltd

Targeted measures needed to attract institutional capital

It is well-known that institutional participation adds depth to an industry and brings a degree of innovation and stability due to its long-term nature. However, in India, institutional participation in the AIF industry is low. For example, there is little to no participation by endowments, pension funds, sovereign funds, etc. Thus, there is a need to create an enabling environment, primarily from a regulatory perspective, that can attract and retain institutional capital.

1

Right platforms and benchmarks needed to enable transparency and comparison

When it comes to greater transparency it is not just from the manufacturers' perspective. Rather, it is from the perspective of the ecosystem as a whole.
For example, in the mutual fund industry, platforms like value research brought transparency to the entire ecosystem. Similarly, PMS Bazaar, PMS AIF world, etc., made information sharing seamless and enabled comparison between PMS offerings and to some extent AIFs as well. However, with respect to AIFs, all the stakeholders including the regulator need to make additional effort to identify and define the factors that will help categorise AIFs to a greater extent for the benefit of the wealth managers as well as the investors. That said, every industry has its own evolution life cycle and it is just the beginning for the AIF industry's growth trajectory.

2

More focus on product innovation, clear differentiation and positioning

Investor needs are changing and becoming more nuanced. Thus, investors require unique products that fit well on their risk-return spectrum. To meet evolving investor needs, manufacturers must focus on product side innovation and the regulator should enable the same. For example, while the regulator has opened the investment avenue for commodities trading, there are several avenues like precious commodities (gold/silver), stressed loans, bitcoin & crypto, etc., that should be further considered.

3

Need for a unified body/forum for training and certification

Multiple initiatives can be taken on this front. First, a separate industry body can be created to design a dedicated certification program for distributors to not only understand AIF offerings but also carve a niche for themselves. Second, trainings can be organised by manufacturers or third party establishments with a focus on the AIF industry. And, third, there needs to be a systematic way of providing client level and business level training.

4

Differing tax treatment to be addressed

One of the biggest asks from all stakeholders, i.e., distributors, manufacturers, and investors was to bring the taxation of CAT - III AIFs on par with the other category AIFs and in line with mutual fund taxation. This is an issue which needs to be addressed with urgency.

5

Technology interventions needed for bringing efficiency

Over the years, investing in mutual funds has become easy, especially due to the ways technology has been leveraged by both AMCs as well as distributors. Technology also helps to enable transparency and reduce information asymmetries. The AIF industry should explore how various stakeholders can leverage technology to interact with the end consumer and also enable information and knowledge transfer amongst stakeholders.

6

Drive awareness about the industry and it's offerings

Today, the AIF industry is where the mutual fund industry was 20 years back. At that time people were not aware about mutual funds and many doubted whether MF sahi hai or not. However, that has now completely changed. The AIF industry needs to make a concerted effort to share structured information and maybe even envisage campaigns like 'Mutual Funds Sahi Hai'. Further, there is need for forums that allow for interactions amongst industry stakeholders so that collaborative action can be taken to drive awareness.

7

Authors

Upasana Koul

Co-founder, TheStackCo.

Upasana has more than a decade of experience in management consulting. She was heading strategy for large corporates like Nippon Life Asset Management prior to starting her venture. She is a director with a leading financial education company FinX as well.

Deepika Asthana

Deepika has an experience of over 15 years in the Indian financial markets, across a variety of verticals including equity sales, derivatives sales, derivatives research, and macro research. She has worked in leadership roles at some of India's leading financial institutions, while her last corporate employer was D.E. Shaw India.

Partners & Acknowledgements

Our heartfelt gratitude to all the contributors to this report. We appreciate the insights that various distributors, manufacturers, and investors shared with us and would like to thank each and everyone of you for helping us present a nuanced and holistic view of the Indian AIF industry.

Amit Saxena
Director & Head Alternative Investment Funds,
Dolat Capital Market Private Ltd.

Jyotii B Rai
Senior Industry Professional

Jayesh Khaitan
Head of Sales – India
The Ascent Group

Sundeep Kumar
Vice President- Institutional Sales
BNP Paribas Securities Services- India

Vikram Bohra
Partner
Price Waterhouse & Co LLP

Please note that the data has been leveraged to the best of our knowledge.

The Stack Co. equaliFi

This report is an exclusive property of Equalifi and TheStackCo.
For further information or permission to reprint please contact
Info@IAAIF.com or Info@thestackco.in