# Alternative Investment Leaders Program

AIP

Cohort 2

**Session by Mr. Ravi Vukkadala** (CEO, Northern Arc Investment Manager)

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# Prior to AIFs: Mutual funds dominance within asset management segment

***Source**:*
*AMFI 'History of Mutual Funds' in India*

**1st Phase: 1964 to 1987**
Units under UTI, AUM stood at Rs. 6,700 crs at the end of 1988.

**2nd Phase: 1987 to 1993**
Entry of Public sector funds, AUM reached Rs. 47,000 crs at the end of 1993.

**3rd Phase: 1993 to 2003**
Entry of Private sector funds, AUM reached Rs. 1.21 lakh crs at the end of 2003.

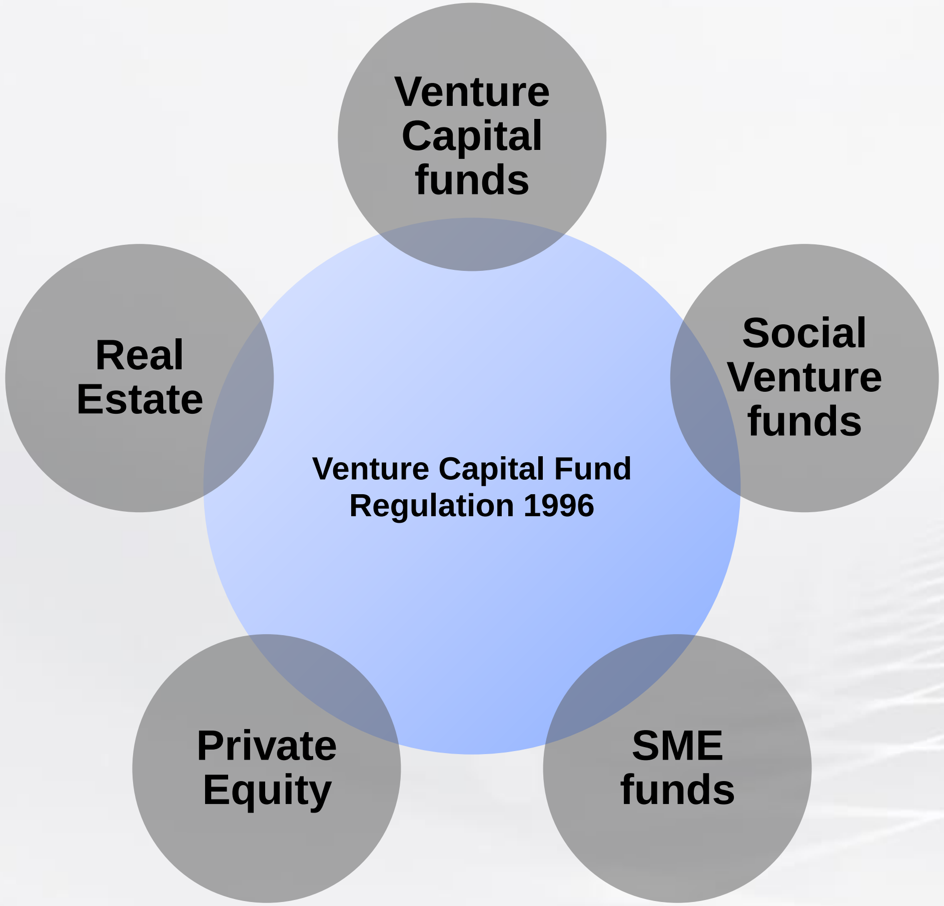
**4th Phase: 2003 to 2014**
Industry impacted by after effects of GFC, AUM growth remained sluggish between till 2013.

**5th Phase (Current): Since 2014**
Steady growth & inflows, AUM at milestone figure of~40 lakh crs at October 2022

- ❑ Mutual fund industry has grown rapidly over the last few years, with a growth rate of almost 40% per year. In 2022, it is expected that this rate will remain at around 30%.
- ❑ Investments in mutual funds has seen steep growth as it is perceived more flexible compared to traditional investment options like bank deposits and fixed deposits.
- ❑ The growth in the size of the industry has been possible due to the twin effects of the regulatory measures taken by SEBI in re-energizing the MF Industry in September 2012 and the support from mutual fund distributors in expanding the retail base.
- ❑ MF distributors have also had a major role in popularizing Systematic Investment Plans (SIP) over the years. In April 2016, the no. of SIP accounts has ***crossed 1 crore mark*** and as on 31st October 2022 the total no. of SIP Accounts are 5.93 crore.
- ❑ In the past decade, the Indian mutual fund industry has increased its assets under management from $24 billion to more than $1 trillion. This growth has been driven by a combination of factors, including changes in demographics, macroeconomic conditions, and investor behavior.

The main drawback of mutual funds, is that the structure does not make it easy to offer more differentiated and higher risk-return strategies. This does limit the return potential of mutual fund investments, which is where a number of HNI's seek to invest in PMS or AIF strategies.

# Prior to AIFs: Venture Capital Fund Regulations 1996




### *History of Venture Capital in India*

1. The venture capital industry in India evolved in the late 1980s with the Government of India legalized venture capital operations in 1988 and has been garnering attention ever since.

2. Technology Development and Information Company of India Ltd. (TDICI), an equal joint venture of ICICI and UTI, was the first organization to begin its venture capital operations in India. TDICI was the investment manager.

3. Thereafter in 1996 the regulatory environment of the industry was defined by the SEBI (Venture Capital Fund) Regulations, 1996 followed by the SEBI (Foreign Venture Capital Investor) Regulations, 2000 on the recommendation of Chandrasekhar committee fostering growth in the industry.

### *Drawbacks of VC Regulation 1996, paving way for AIF Regulation 2012.*

- Loose regulation in place for pooling vehicles.
- Venture Capital funds were being used as an omnibus investment fund vehicle for all pooling vehicles.
- No compulsory registration in place, many unregistered funds in the market.
- Need to create a distinct private pooled vehicle that would regulate different kinds of investment vehicles under one roof.

A couple of watchouts may continue to affect the ecosystem for a while: stricter IPO norms are expected from SEBI affecting exit strategies for VC funds, regulatory uncertainty for a few sectors is likely to continue (e.g., online gaming and fintech *(**Source**: Bain Capital Indian VC Report 2022)*

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# Prior to AIFs: Portfolio Management Services, PMS

***What is Portfolio Management Services?***

According to SEBI "A portfolio manager is a body corporate who, pursuant to a contract or arrangement with a client, advises or directs or undertakes on behalf of the client (whether as a discretionary portfolio manager or otherwise), the management or administration of a portfolio of securities or the funds of the client.

***History of Portfolio Management Services in India***

1. The Securities Exchange Board of India (hereafter SEBI) issued the Securities and Exchange Board of India **(Portfolio Manager) Regulations, 1933** from where legalization of the Portfolio Management Services started. Before this PMS was a totally unregulated activity and was no control, legal compliance, over the Government. The issuance of these guidelines within a year establishment of SEBI reflects the potential growth in the service in the capital sector.

2. Parag Parikh Financial Advisory Services Ltd. (PPFAS) launched the PMS named the Cognito in October 1996. In 2000, ICICI Prudential was the first institutional participant to provide PMS services.

**Portfolio Management Services**

**Discretionary**

Managers have the full authority to buy and sell any type of securities. there is no obligation on the service provider to consult the investor before taking any decision.

**Non-Discretionary**

The investor has right in most of the portfolio activities. He/she can provide suggestions and ideas, the portfolio Manager despite of the appropriate knowledge and attitude has to consult the investor before trading any call.

AUM under PMS rose nearly 17% to ~26 lakh crs at the end of October 2022. (***Source:*** SEBI Monthy PMS Report October 2022*)*
The increase in AUM of the PMS industry is in line with the recovery in broad markets and heightened interest from HNIs & family offices.

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# What are Alternative Investment Funds?

**Alternative Investment Fund or AIF** means any fund established or incorporated in India which is a privately pooled investment vehicle which collects funds from sophisticated investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors.

## Category I

- **Venture Capital funds including Angel funds.**
- **SME funds**
- **Social Venture funds**
- **Infrastructure funds**

AIFs that invests in start-up or early stage venture or social venture or SMEs which the government or regulators consider socially or economically desirable

## Category II

- **Real Estate funds**
- **Private Equity funds**
- **Funds for distressed assets**

AIFs which do not fall in category I or category III and which do not undertake borrowing or leverage apart from to meet day-to-day operational requirements

## Category III

- **Hedge Funds**
- **PIPE funds**

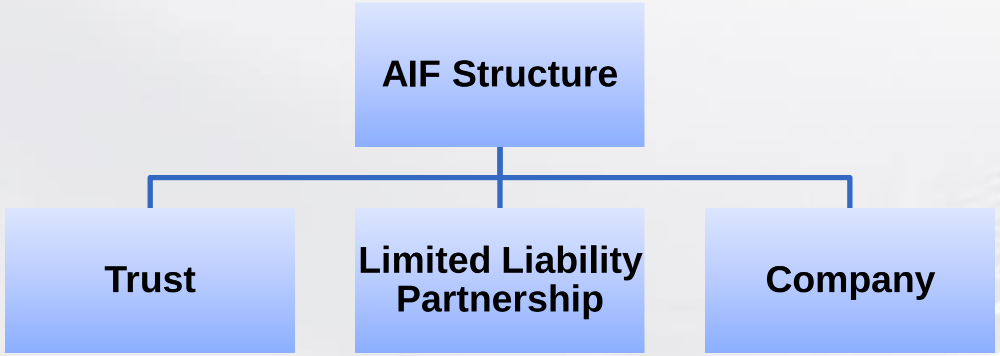
AIFs which employ diverse or complex trading strategies and may employ leverage including investment in listed and unlisted derivatives

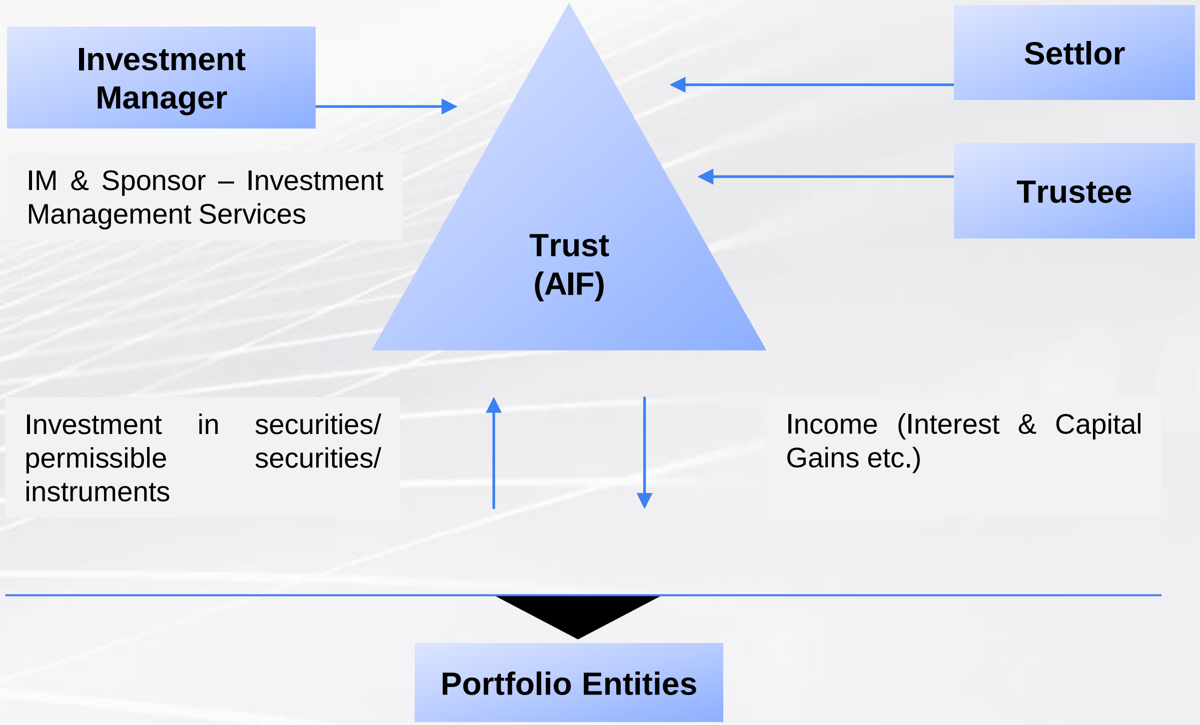
**Debt fund** is an AIF which invests primarily in debt or debt securities of listed or unlisted investee companies according to the stated objectives of the fund. These funds are **registered under Category II**

AIF Regulations were announced by SEBI in May 2012 in line with the global trend of carving out a new set of regulations for alternative assets and to bring all investment funds under the regulatory ambit of SEBI

## Structure of an AIF fund

AIF maybe set up in the form of a trust, company or limited liability partnership and is a privately pooled investment vehicle, not covered under the SEBI's Mutual Funds (MFs) Regulations or Collective Investment Schemes (CIS) Regulations but excluding ESOPS, Family Trusts, employee gratuity trusts, fund managed by securitization companies, holding companies, Special Purpose Vehicles not managed by fund managers.

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# Key terms of an AIF

| | |
|---|---|
| **Minimum Investment** | 1 crore |
| **Sponsor Contribution** | 2.5% of fund size or 5 crores whichever is lesser |
| **Minimum Fund Corpus** | Minimum fund corpus for launching an AIF is INR 20 crs |
| **Listing** | While investments by CAT I AIFs are required to be atleast 75% unlisted, CAT II AIFs invest in primarily unlisted securities. |
| **Tenure** | While CAT I & CAT II AIFs are close ended with a minimum tenure of three years, CAT III AIFs may be open ended or close ended. Two-year extension permissible as well. |
| **Leverage** | CAT I & CAT II AIFs can leverage only for meeting temporary funding requirements for not more than thirty days and not more than 4 occasions in a year and not more than 10% of the corpus. CAT III AIFs however can leverage based on the consent of the investors. |
| **Registration** | On submission of the PPM together with the application form and fees registration takes anywhere between 1 to 3 months. |
| **Single Party Exposure** | SEBI provides that maximum single party exposure should be limited to 25% |
| **Super Majority Approval** | Incase of any material change 75% investor approval is required at all times. |

# Robust platform for fund set-up

**Less stringent regulatory environment as compared to mutual funds but sufficient oversight to act on loosely pooled investment vehicles**

- **Co-Investment**
- **Conflict of Interests Mitigation**
- **Obligation of Manager**
- **Transparency**
- **Prescribed Valuation**

***Co-investment* -** 2.5% of the fund corpus or Rs 5 crore whichever is less.

***Strong regulatory oversight*** through strict guidelines on:

- **Conflict of interest** – All such situations must be avoided and in case unavoidable, adequate disclosures must be made for the same
- **Obligation of Manager** – Manager will act in a fiduciary responsibility to clients and is required to display prudence in the discharge of his responsibilities
- **Valuation** – Detailed guidelines on valuation for accessing true asset values

***Taxation*** – Cat I and II AIFs are tax pass through vehicles. The AIFs do not pay any tax and also do not suffer any Tax Deducted at Source (TDS) for interest payments. CAT III AIFs deduct tax at the fund level itself.

- 10% withholding is done while making distributions
- For offshore investors, the rate of withholding to be determined based on DTAA

***Strong Reporting* –** AIF regulations require extensive reporting to be made to investors on a periodic basis

***Foreign Investments*** - AIFs have been permitted by both SEBI and RBI for accepting foreign investments

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# Placement Memorandum includes all material information of the fund including underwriting criteria

## Assessment of Shareholding Structure

- Suitable disclosures
- Extent of Encumbrance
- Transfer pricing Consideration

## Assessment of Management

- Experience of Management
- Involvement in day to day operations
- Ability to identify business risks and Mitigating procedures
- Organisational and reporting structure, accountability and succession planning
- Track record of Financial management

## Assessment of Industry

- Growth Phase of Industry
- Competition
- Regulatory Framework

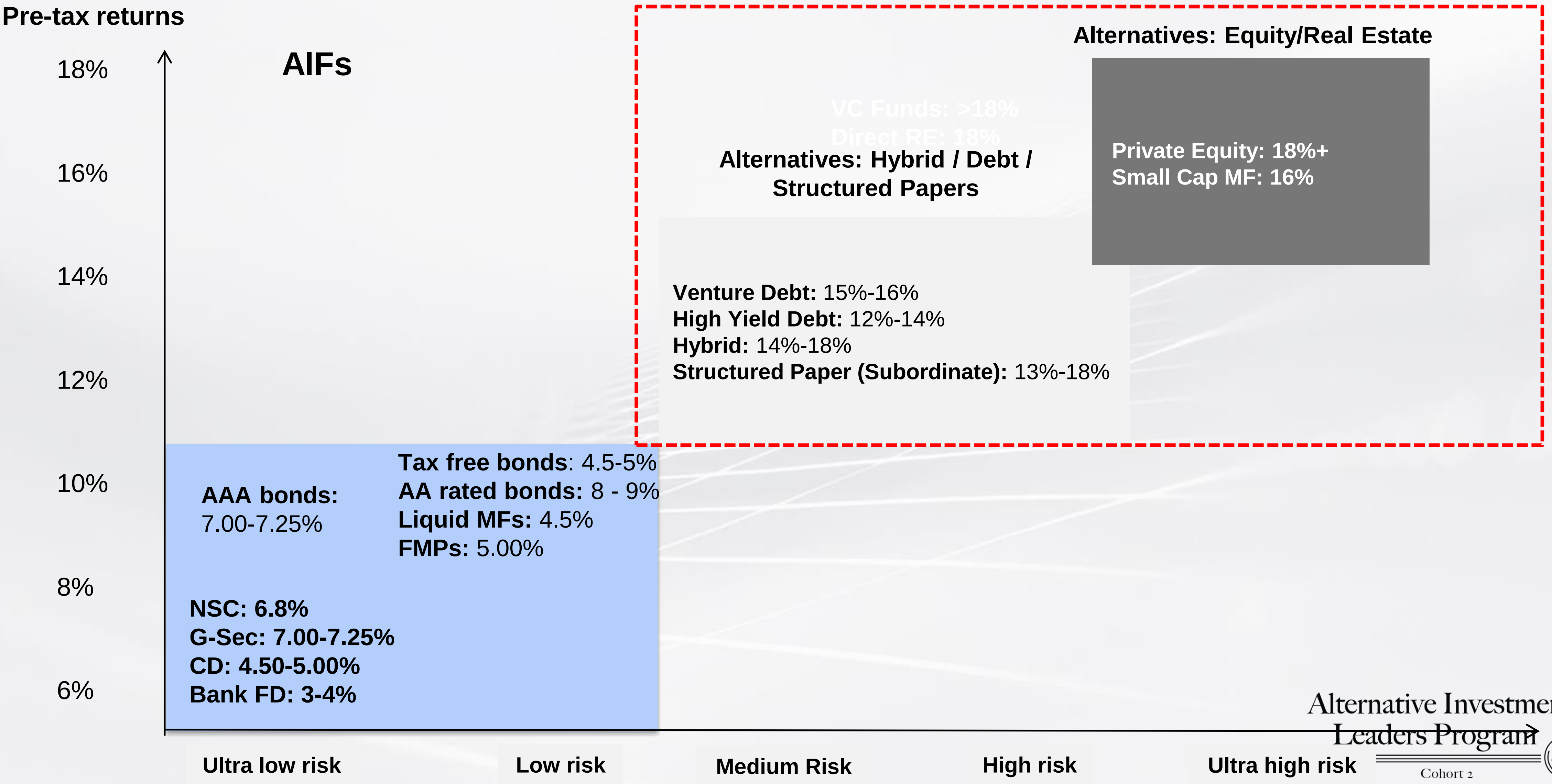
## Assessment of Business

- Nature of Business
- Competition
- Operating Efficiency
- Diversification
- Risk Management

## Assessment of Financials

- Accounting Policy
- Financials Analysis
- Cash Flow and Liquidity Analysis
- Ratio Analysis

# AIF: Risk – Return Continuum



# Comparison of Mutual Fund vs PMS vs AIF

## Mutual Funds

### *Pros*

Very Small Minimum Investment

Highly Tax-Efficient

Ease of Operations

Systematic Investment / Transfer / Withdrawal Possible

Typically, Low-risk Diversified Portfolios

### *Cons*

Lower risk leads to lower returns

Low Differentiation

Risk of Fund Manager Changes
Targeted at Retail Customers

## PMS

### *Pros*

Differentiated strategies

Wider range of risk-reward options

Customised portfolios possible

Direct ownership of stocks

Fund Manager stability (owner-managed PMS)

### *Cons*

50 lakh Min Investment

Tax disadvantage (as pass through unlike MF)

Large number of lower-quality schemes

Leverage & shorting not allowed

## AIF

### *Pros*

Highly complex strategies possible.

Wider range of risk-reward options.

Fund Manager stability (owner-managed AIF's)

### *Cons*

1 cr Min Investment

Tax Disadvantage

May be Difficult to Understand True Risk-Reward

# AIF Industry: Rise in capital Commitments

**Commitments raised by all classes of AIFs (in INR Crs.)**

| | | | | |
|---|---|---|---|---|
| **80,792** | **117,503** | **87,840** | **81,228** | **190,143** |
| *(FY18)* | *(FY19)* | *(FY20)* | *(FY21)* | *(FY22)* |

***Source:*** *SEBI figures on AIF commitments*

**June 2022**

**Cum. Commitments: Rs. 6,94,520 crs**

**March 2022**

Cum. Commitments: Rs. 6,41,359 crs

**Dec-2021**

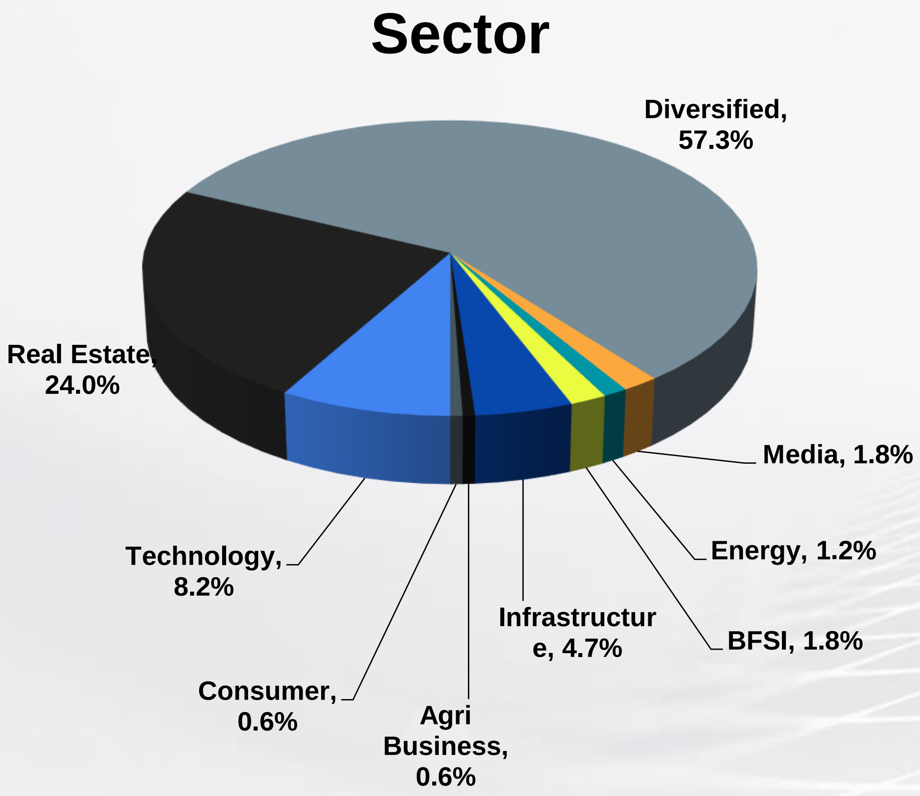
Cum. Commitments: Rs. 6,09,091 crs

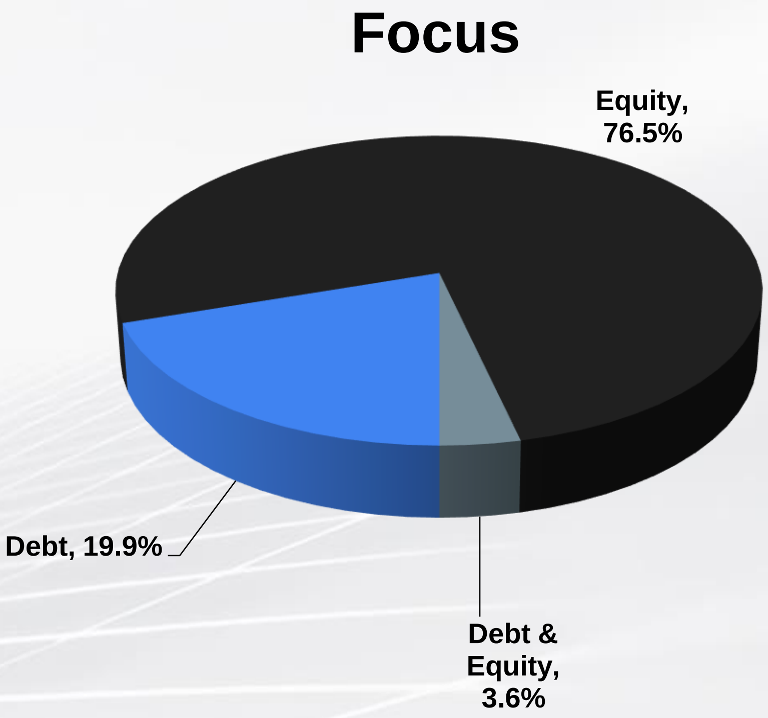
**Sept-2021**

Cum. Commitments: Rs. 5,35,007 crs

1. The biggest chunk of commitments were for **Category 2 AIFs**, garnering ₹1.62 trillion worth of commitments **(~85%)**, followed by category 3 and 1 receiving commitments worth ₹18,766 crore and ₹8,815 crore, respectively.
2. Globally, alternatives is roughly 15% of the total AUM (assets under management), of which more than half is private equity. However, in India, alternatives are still fairly new to investors and for product providers

# AIF Industry: Overview




1. **Most funds have a diversified focus .**
2. **Real estate emerges is a prominent industry for AIFs which have single-sector investment strategy**

1. **Most funds are equity funds.**
2. **Among the debt funds, a large part of the AIFs are real-estate focused.**

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***Note:*** *based on a sample of 171 AIFs for which data was available in public sources ; Percentages based on number of AIFs*

# Investor Landscape & Considerations

**Retail**

- Minimum ticket size – INR 1 crore
- AIFs have seen participation from HNIs/ UHNIs / Single & Multi Family offices
- Investors have found this attractive from a diversification standpoint
- Taxation – less attractive than Mutual Funds due to indexation benefit (for debt funds)
- Liquidity, cash-flow considerations,
- Effectively captures the 'missing middle' segment

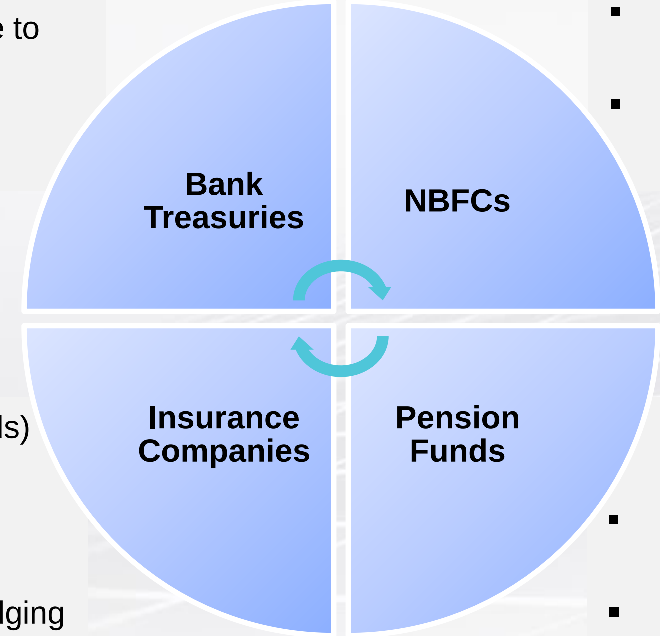
**International**

- Minimum ticket size – INR 1 crore
- Foreign investors (non-FPIs) permitted to participate in all categories of AIFs. FPIs can invest in CAT III AIFs only
- Applicability of DTAA benefits makes AIFs attractive for offshore investors
- Rather than have a feeder vehicle offshore which increases costs, regulation permits direct investments by non-residents in India-based AIFs
- Concern among non-resident investors could be to apply for a PAN in India and come under the purview of Indian IT Act

# Investor Landscape & Considerations

- Medium to long term duration with no liquidity is a concern
- Risk weight could be penal
- Modification of policy
- Taxation – less attractive than Mutual Funds due to indexation benefit
- Core part of large treasuries take exposure in alternatives for yield kicker and diversification.

- In sluggish loan growth environment, attractive addition to grow investment book
- Managed product, so no-hassle investment without diligence and monitoring
- Building underwriting expertise on sectors through managed products before direct exposure
- Better risk weight than banks




- 3% of the fund size (traditional + shareholder funds) can be investment in AIFs
- In low interest rate environment, alternative investments gain attractiveness to buck up yield
- Medium to long term duration of AIFs helps in bridging asset-liability duration gap
- Diversification away from  portfolio heavily tilted towards ultra-safe assets.

Private sector NPS permitted to invest in AIFs of up to 5%

- Given long term nature of AIFs, fits into long term investment philosophy of pension funds
- Offers diversification away from ultra-safe long-term assets.

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# The way forward for AIFs

## Changes we foresee

- Broadening the definition of social venture
- Listed & Unlisted investments
- The definition of AIF as a security
- Investment restrictions IRDAI & PFRDA
- Risk weights for banks
- Tax rate for FPIs
- Pass through status for CAT III AIFs

- Aligning fund management safe harbor provisions to promote offshore fund managers in India.
- Increased Capital Flow from Pension Funds, Insurance Companies in CAT II.
- Liberalization of FPI Shareholding – while computing foreign shareholding.
- Centralized body for presenting consolidated AIF Industry metrics.
- Investor Advisory Company to be set up by AIFs.

# Thank you

For more details, please get in touch

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