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THE WAVE OF ALTERNATIVE INVESTMENT FUNDS IN INDIA

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ABSTRACT

In India, alternative investment funds (AIFs) were introduced in 2012 by the Securities and Exchange Board of India (SEBI). This study aims at examining the structure of AIFs in India and their growth since inception. The variables considered for the categories and their subcategories are commitments raised, funds raised and investments made. These variables are analysed using graphical and inferential analysis. The study reveals that AIFs as an investment avenue have grown by leaps and bounds. This is mainly due to the benefits and the wide array of options it offers to the investors, and the experimentation it allows to the fund managers. However, in the coming years, there is immense scope for this relatively new investment option to experience an unprecedented progress in Indian as well as global market. And, this progression would mainly depend upon the decisions taken by SEBI for the AIF industry.

KEYWORDS: *High Networth Individuals, Alternative Investment Funds, SEBI Regulations, India*

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INTRODUCTION

According to the WorldWealth Report2020, by Knight Frank,the global Ultra-high-net-worth individual (UHNWI) numbers will grow by 27 % over the next five years. Of the top twenty fastest growing countries measured by them, six are located in Asia,which is led by India expecting to witness a 73 % growth. In line with this, another World Wealth Report2020, by Capgemini,India is ranked amongst the top five countries in the Asia Pacific region in terms of number of High Networth Individuals (HNWIs).The report also explains the growth in HNWI population in India vis-à-vis the Asia-Pacific region, where its states that with the exception of a couple of years, the HNWI population in India is growing exponentially.

Until 2012, the investment management regulations of Securities and Exchange Board of India (SEBI) were confined only to Mutual Funds, Collective Investment Schemes and Venture Capital Funds (VCF). Amongst these, the VCF route was widely adapted for investments. This was primarily because there were no dedicated regulations for private pools of capital and investment vehicles. Also, the benefits and concessions generally available to VCFs, could not be extended to the other funds.However, this obtructed VCF from achieving its sole objective of promoting early-stage firms. Consequently, SEBI felt the need to recognize such other funds as adistinct asset class and introduced the AlternativeInvestmentFund (AIF) regime in August 2012 to ease capital flows into alternative asset classes.

The Following Asset Classes Summarize the Various Investment Vehicles Observed in India

- Mutual Funds and Exchange Traded Funds
- Collective Investment Schemes
- Alternative Investment Funds (AIFs)

  Category I AIF

  Category II AIF

  Category III AIF
- Foreign Portfolio Investors
- Real Estate Investment Trusts and Infrastructure Investment Trusts

AIF can be explained as a privately pooled investment vehicle that collects funds from investors, both, domestic and foreign. Based on a defined investment policy, these funds are then invested by AIF for the benefit of its investors.

AIFs float various schemes in accordance tothe risk appetite of its investors.Investors interested in alternative funds are in general referred to as Limited Partners (LPs).An individual or team that establishes an AIF is known as a Sponsor and an individual or a team,responsible for the fund is termed as a Manager. In order to run an AIF, a Manager mustholdappropriateproficiency, as defined by SEBI. And,subject to this relevant expertise, a Sponsor may also serve as a Manager.

AIFs are more often than not held by institutional investors or accredited, HNWIs. This is mainly because of their complex nature, limited regulations and lack of liquidity as compared to other investment options.Walker, (2019)too states that many large institutional funds such as pensions and private endowments have begun to allocate a portion of their portfolios to alternative investments.According to him, the chief reason for this is thatthe returns from AIFs have a low correlation with those of standard asset classes.

Therefore, given the growinginclusion of AIFs in the portfolios of institutional investors and HNWIs, it is important to study the trend of this new asset class in India.

CONCEPTUAL FRAMEWORK

Meaning and Definition of AIF

In India, AIFs have been described and classified in detail under Regulation 2 (1) (b) of SEBI (Alternative Investment Funds) Regulation, 2012 (last amended on May 10, 2019) 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 pooledinvestmentvehicle collecting funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors; and
- Is not covered under the Securities and Exchange Board of India (Mutual Funds) Regulations,1996,Securities and Exchange Board of India (Collective Investment Schemes) Regulations, 1999 or any other regulations of the Board to regulate fund management activities.

Categories of AIF

Across India, alternative investments may be registered under three categories as depicted below-

Category I

Funds that invest in start-ups, small and medium enterprises (SMEs) and new businesses which have high growth potential form a part of this category. These projects are considered socially and economically viable,as they have a multiplier effect on the economy in terms of growth and job creation. Hence, the government encourages investment in such projectsby providing incentives.This category comprises of the following sub-categories:

- **Venture Capital Fund**

These funds make an early-stage investment in start-ups which have high growth potential but face investment crunch in the initial or expansion phase.

- **Infrastructure Fund**

These funds invest for the development of public assets and infrastructure. Investors who are bullish on the infra-development can invest in the fund.

- **Angel Fund**

Established VCFs typically do not invest in firms that carry growth uncertainty. Hence, managers of angel fund, pool money from angel investors and invest in start-ups.

- **Social Venture Fund**

Socially responsible investing has led to the emergence of this fund that typically invests in companies that have a strong social conscience and aim to bring a change in the society.

Category II

Funds that invest in various equity and debt securities fall under this category. All those funds that are not covered under category I and III by SEBI, fall under category II. The government does not provide any incentive or concession on investment in these funds. This category comprises of the followingsub-categories:

- **Private Equity Fund**

Unlisted private companies cannot tap capital through the issuance of equity or debt instrument, hence, they look out for PE funds that invest in such companies and take a share of their ownership.

- **Debt Fund**

Companies with high growth potential, good corporate practices but facing capital crunch are a good investment option under these funds.

- **Fund of Funds**

As the name suggests, this fund is a combination of various AIFs. The investment strategy of the fund is to invest in a portfolio of other AIFs rather than making its own portfolio.

Category III

Funds that aim at generating short-term returns are a part of this category. They employ various complex and diverse trading strategies in order to achieve their goal of short-term capital appreciation. This category comprises of the following sub-categories:

- **Hedge Fund**

This fund invests the capital pooled from institutional and accredited investors, into domestic as well as international markets. They are highly levered and follow an aggressive style of managing the investment portfolio in order to generate high returns.

- **Private Investment in Public Equity Fund**

Under this fund, shares of publicly traded stocks are purchased at a discounted price. While enabling the investor to purchase a stake in the company, this provides capital infusion to the company that is selling its stake.

Registration Process for AIFs

For AIFs to work under one of the three categories explained above, it is essential to obtain a certificate of registration from SEBI.In order to set up an AIF, an investor must apply to SEBI through an application form and submit a bank draft of ₹1,00,000. SEBI, then, reviews the application form and notifies the investor of its success within 21 days. In the event that the investor receives an intimation of acceptance from SEBI, the investor must pay therequisite registration fee for operating as an AIF in India.

The AIF may approach the exchanges for listing only after SEBI issues the certificate of registration. An AIF cannot change its category once it has been registered, except with the approval of SEBI. And, the AIF can do so only until it has not raised any funds from the investors. No registration fees will be charged for a change of category, however, a new application form has to be submitted.

Key Eligibility Features and Reporting Requirements of AIFs in India

As per SEBI regulations, the minimum eligible corpus amount is ₹200million. Angel Fund, which is a subcategory of Category I AIFs, is the only exception to this rule since they have lower qualifying requirements in terms of fund corpus, at ₹100million. Some additional key features of the three categories are captured here-

AIF Category I

These close-ended funds charges a registration fees of₹5,00,000, with a minimum investment amount of ₹10 million. This category has a lock-in period of three years and allows a maximum of 1,000 investors. The investible fund limitcannot be more than 25 percent of the investible fund in one investee company.And, the continuing interest of the fund managerhas to be lower of 2.5 percent of the initial corpus or ₹5 crore.

AIF Category II

These close-ended funds charges a registration fees of ₹10,00,000, with a minimum investment amount of ₹10 million. Similar to category I, this category has a lock-in period of three years and allows a maximum of 1,000 investors. The investible fund limit cannot be more than 25 percent of the investible fund in one investee company. And, the continuing interest of the fund manager has to be lower of 2.5 percent of the initial corpus or ₹5 crore.

AIF Category III

Unlike categories I and II, this category allows open-ended as well as close-ended funds. These funds charges a registration fees of ₹15,00,000, with a minimum investment amount of ₹10 million. No lock-in period is applicable to this category, however, the maximum number of investors can be 1,000 only. The investible fund limit cannot be more than 10 percent of the investible fund in one investee company. And, the continuing interest of the fund manager has to be lower of 5 percent of the initial corpus or ₹10 crore.

The reporting norms for AIFs in India have been updated by SEBI in April 2021. The new reporting regulationswhich will be effective from the quarter ending on Decemeber 31, 2021,requiresthe funds under all the categories to report their activities on a quarterly basis. This report has to be provided within ten days from the end of a quarter. Along with this, category III funds, also have to provide the details on the leverage undertaken by them. This is decided exclusively for category III funds, mainly because they aim at generating short-term returns and include hedge funds. Prior to this amendment, all funds that did not use leverage, had to submit their reports on a quaterly basis. However, category III funds that employed leverage had to report on a monthly basis.

Factors Conducive for Growth of AIFs in India

According to the surveys carried out by the Emerging Markets Private Equity Association, India has gained attractiveness as an investment destination among emerging markets. India has been one of the top three emerging markets for LPs to invest capital in the last few years. This is the prime reason why India is experiencing increased capital flows. Supporting these surveys, Soni, (2019)perceives that long-term sustainable growth is one of the key factors attracting private capital to the country. As for alternative investments, he believes that they are growing in popularity and are finding their way into the portfolios of HNIs, as they do not correlate with the stock market. This attribute of alternative investments definitely increases the diversification of a portfolio and helps in mitigating itsvolatility.

On the regulatory front too, the AIF regime has proved to be more efficient for investors and hence more fund managers are opting to deploy capital through this route (Dhanjal, 2019). Kelly, (2019) brings out that in an effort to bring the AIF industry onshore from places like Mauritius and Singapore,in 2018, SEBI took a decision to allow AIFs to operate from International Finance Services Centre (IFSC), Gift City. Thenew AIF-platform by IFSC enables private equity investors to launch funds at a marginal cost. And, since the launch of AIFs from IFSC is dollar-based, it is now relatively easy to raise foreign capital across various strategies.

On the tax regime front, treaty benefits are available for foreign investors coupled with the fact that Category I and II AIFs have a tax pass through (Chitlangi, 2019). In addition, foreign capital coming into the country through an AIF does not face Foreign Direct Investments (FDI)restrictions such as sectoral caps, limited choice of instruments etc. as long as the ownership and control of the manager and sponsor of AIF vests with resident Indian citizens.

On the investment regime front, the Ministry of Finance permitted private Provident Funds to invest their funds in categories I and II of AIFs with certain restrictions. This notification which was issued in March 2021 will definitely lead to a prominent change in the Indian AIFs. The funds will now experience an ehanced investor-base and this will help them to achieve further significance.

Research Design

The research for this study is based on secondary data from published sources. The principal sources used to gather secondary data were reports published by SEBI.Category-wise data for commitments raised, funds raised and investments made has been collected for a period of 32 quarters i.e. from third quarter of FY 2013 to second quarter of FY 2021.This study uses graphical analysisand inferential analysis for studying the changes in the commitments raised, funds raised and investments made over the quarters.

Some Important Terms Used With Regards to AIF Regulations as Given by SEBI Are Explained Here-

- As per regulationRegulation 2(1)(h),'Corpus or Commitments Received refers to the total amount of funds committed by investors to the AIFby way of written contract or any such document as on a particular date'.
- Funds Raised refers to the actual amount that is deposited by the investors towards the AIF.
- As per Regulation2(1)(p).'Investible Funds or Investment made refers to the corpus of the AIF net of estimated expenditure for administration and management of the fund'. In other words, it is the real amount that has been spent from the AIF after being raised.

As the AIF industry has seen steady growth in India over the years, CRISIL has developed an AIF benchamrk. The benchmark measures the category-wise performance of the AIFs on an aggregrate level. The private pension funds that are now allowed to invest in AIFs, can invest in only those AIFs that carry a rating of AA or above. CRISIL also computes three types of ratios for arriving at its benchamrk. These are distributions to paid-in capital (DPI), residual value to paid-in capital (RVPI) and total value to paid-in capital (TVPI). The DPI is the ratio of the total distributions made to the paid-in capital. The RVPI is the ratio of the residual value of all investments remaining in the fund after distributions to paid-incapital. The TVPI is the ratio of the sum of total distributions and residual value, to the total paid-in capital. It is also known as the investment multiple.Subsumed in the new requirements introduced by SEBI for AIFs, categories I and II have to provide DPI, RVPI and TVPI as a part of its disclosures.

DATA ANALYSIS AND FINDINGS

As compared to the traditional methods of investment, AIF is a relatively new concept in India. However, although the regulations for AIFs were formulated by SEBI just over eight years ago, it is evident from exihibit II that they have gained immense popularity amongst India's HNIs. According to the data from SEBI, over 520 AIFs are already registered in India.

Figure 1 shows As witnessed in Figure 1 above, the total commitments raised have increased from ₹200 billion ($3.16 billion) in 2014 to over ₹4,419billion ($60.79 billion) in December 2020. Of this, approximately ₹3,500billion are attributable to Category II AIFs as of December 2020.To emphasise further on this aspect, Table 1 below reflects the commitments received, funds raised and investments made from theearly years of AIF in India until December 2020.

It can be observed here that across categories, 42 percent of commitments raised and 87 percent of funds raised have been invested, keeping a dry powder of ₹284.54 billion. Dry powder can be explained as cash reserves kept in hand by the fund managers to purchase assets, cover future obligations or make acquisitions. Though the commitments raised are maximum from category II, the dry powder is least in case of category III. Investments made as a percentage of commitments raised and funds raised is the highest for Category III at 82 percent and 90 percent, respectively. This can be attributed to the fact that prior to Category III AIFs being set up in India, leverage and complex trading strategy implementation was not possible. Therfore, it works as a blessing for investors, allowing them to hedge with positions despite the markets being atsuch inordinate valuations.

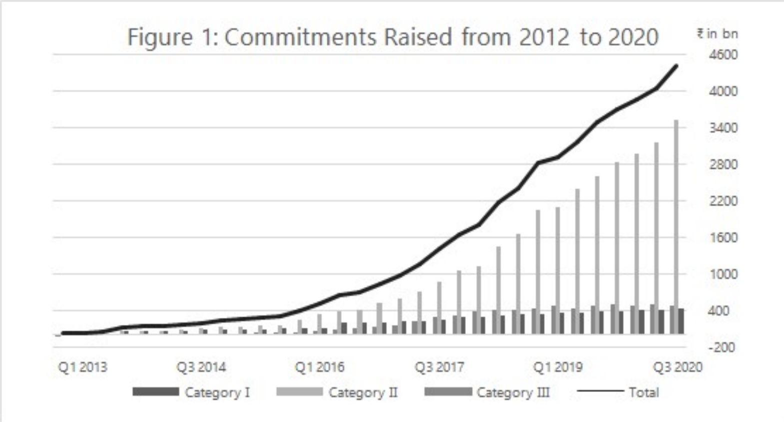
According to the data published by CRISIL on 156 schemes, the average 3-year annualised rolling returns for category III was 11.58 percent from June 30, 2016 to September 30, 2020 with a quarterly shift.However, the return as on September 30, 2020 was at 4.52 percent. The category had achieved two-digit returns from June 30, 2020 until June 30, 2018, after which it has been seeing a consistent drop.The low returnsmaybe attributed to the tax regime applicableto Category III AIF, where no tax pass-through has been granted.

A study of category-wise commitments, funds raised and investments made (₹ in billion) since FY 2012-13 until FY 2019-20 reveal that the investment ratio for category I has improved considerably over the years.And it has remained quite stable and acceptable since the early years for categories II and III indicating that the dry powder has been low. Investment ratio indicates the amount of investments made out of the total funds raised. The average ratio for categories I, II and III over FY '13 to FY '20 has been 0.69, 0.81 and 0.85 respectively.

Upon observing the correlation between commitments raised, funds raised and investments made for each of the categories as well as on a wholistic basis,it supports the earlier findings where category I displays a huge amount of unallocated capital and hence there's ample scope for increasing the funds raised in this category. The correlation of funds raised and investments made with commitments made is only 0.13 and 0.026 respectively for category I. Whereas, it is 0.78 and 0.66 for category II and 0.91 and 0.85 for category III. The correlation between funds raised and investments made is high at 0.95, 0.90 and 0.95 for categories I, II and III respectively.

Based on the values published by CRISIL as on September 30, 2020, the DPI, was 0.00 and 0.17, the RVPI was 0.92 and 0.87 and the TVPI was 0.92 and 1.04 for categories I and II respectively. We can observe here that no exits were made under category I as the DPI is zero and approximately 17 percent was cash returns realized by the investors under category II. On the other hand, we can observe a high RVPI under both the categories, indicating the unrealized value. The RVPI ratio would continue to remain high as the funds are at the initial phase. As discussed earlier, TVPI is the sum of RVPI and DPI and as a ratio it represents the total amount of capital to paid-in capital. For categories I and II,the investment multiplesare0.92 and 1.04 timesindicating the amount of investment made out of the total capital called-in by the funds. These results by CRISIL support the investment ratio computations and findings stated above.

The composition of category I has experienced some drastic changes over the years. Unlike the other sub-categories of Category I (Infrastructure Fund, Social Venture Fund and Venture Capital Fund) which were introduced in 2012, SME Funds were introduced in 2014. Since conception and until FY '16, the commitments raised under Category I were dictated by Infrastucture Fund. However, this composition changed over FY '17 and Venture Capital Fund surpassed Infrastuture Fund. Until recently too, we can see that the commitments raised under Venture Capital Fund are the highest in Category I. The composition of category I as of March 2016 was as follows- Infrastructure Fund 64 percent; Venture Capital Fund 27 percent; Social Venture Fund 7 percent and SME Fund 2 percent. However, the composition of category I as of March 2020 changed as follows- Infrastructure Fund 29 percent; Venture Capital Fund 65 percent; Social Venture Fund 5 percent and SME Fund 1 percent.



Source: Data from SEBI website

Figure 1: Commitments Raised from 2012 to 2020.

Table 1: Commitments Raised, Funds Raised and Investments Made under the AIF Categories Since Inception Till December 2020 (₹ in Billion)

	Commitments Raised			Funds Raised		Investments Made		
Category	**Amount**	**Weightage Within Category**	**Overall Weightage**	**Amount**	**Percentage of Commitments Raised**	**Amount**	**Percentage of Funds Raised**	**Percentage of Commitments Raised**
Category I								
Infrastructure Fund	118.03	27.87 %	2.67 %	87.31	73.97 %	77.11	88.32 %	65.33 %
Social Venture Fund	32.16	7.59 %	0.73 %	20.13	62.60 %	11.63	57.74 %	36.15 %
Venture Capital Fund	267.92	63.26 %	6.06 %	117.13	43.72 %	89.90	76.76 %	33.56 %
SME Fund	5.42	1.28 %	0.12 %	0.75	13.87 %	0.65	86.08 %	11.94 %
Category I Total	**423.53**		**9.58 %**	**225.32**	**53.20 %**	**179.29**	**79.57 %**	**42.33 %**
Category II	**3528.17**		**79.82 %**	**1,480.99**	**41.98 %**	**1,283.69**	**86.68 %**	**36.38 %**
Category III	**468.25**		**10.59 %**	**423.48**	**90.44 %**	**382.28**	**90.27 %**	**81.64 %**
Grand Total	**4419.95**			**2,129.79**	**48.19 %**	**1,845.25**	**86.64 %**	**41.75 %**

Source: Data from SEBI website

CONCLUSIONS

The study shows that the AIF industry in India has grown at a rapid pace ever since its regulations were introduced by SEBI in 2012. Investors always had access to various investment avenue including real estate and complex infra projects.However, the AIF structure has simplified these complex investment processes. AIFs have attracted volumedue to their pooling structure and the options they provide through various categories and subcategoreis. AIFs also offer a high risk-return combination that the ultra-high net worth investors are always looking for. Not only the investors, but also the fund managers are drawn towards AIFs since the scope for experimentation is higher as compared to the traditional investment oppurtunities.

Hence, over the years, the commitments raised for AIFs have increased and for FY ’20 it is over 31 percent of what fund managers have raised in all the previous years. However, the industry experts believe the quantum of capital waiting to be deployed in India is significantly higher (Dhanjal, 2019). India being best-placed on growth, among the emerging markets, is now at a crossroad where both proactive regulatory reforms and further capital infusion are much-needed. Though it is still too early to judge the returns from the funds already in the market, as of this moment the future of the AIF industry looks very promising.

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