Investment Funds: Monthly Digest

August 31, 2020

CURRENCY EXCHANGE RISKS AND AIFS: A PRIMER - AUGUST 2020

Alternative Investment Fund/s ("**AIF**" or "**fund**") are registered with the Securities and Exchange Board of India ("**SEBI**") under the SEBI (Alternative Investment Funds) Regulations, 2012 (the "**AIF Regulations**"). AIFs with participation from overseas investors may offer returns in non-Indian Rupee ("**INR**") terms.

Indian AIFs provide for a wide range of opportunities for foreign LPs (or 'fund investors'); however, such AIF structures also create the need to recognise, measure and control exchange rate risk.[1] Currency volatility happens to be a sincere concern for LPs while allocating towards international investments, especially given the long-term nature of investments (generally ranging across years and passing through the unpredictable 'highs and lows of currency swings')[2].

In this edition of the monthly digest, we have discussed certain structural issues associated with AIFs offering returns in non-INR terms.

WHAT'S THE CONCERN?

Market factors such as inflation, interest rates, current account deficits, trade terms, political and economic performance lead to a frequent change in the value of currency often in an unfathomable manner. Currency risk or exchange rate risk as it is otherwise known, signifies that exchange rate movements can potentially impact negatively an investment's total return.[3]

Currency risk depends on the investor's base currency and is generally considered from this perspective. A United States Dollar ("**USD**") based investor, for example, might not obtain the same outcome from a domestic investment as an INR-based investor due to the impact of the USD/INR currency exchange. A USD– based investor would have experienced a negative impact on its offshore investments in the last decade, while the same may not be true for INR – based investors investing offshore, given the falling strength of INR against USD. Such impacts on the performance of foreign assets for the offshore investors are attributed to the currency movements, which are undoubtedly significant and shouldn't be undermined in the investment decisions, irrespective of the nature of the underlying asset.

Although, such currency fluctuations do not necessarily impact investments at all times, they have the ability to downturn the events in a given period. Private equity investments are no stranger to this, especially when funds generally have a tenure of 10-12 years and continue investments over a range of years with different economic conditions prevailing at different times. As far as such risks are concerned with an investment in India by an offshore investor, four distinct periods are generally recognized:

- **Corpus** – The total corpus of a closed-end fund is expected to be certain by the final closing date of the fund. However, in case of commitments expressed in different currencies in the fund, the corpus may become a moving number and impact the inter-se drawdown ratio between different investors (in a blind-pool fund) for each drawdown notice.

- **Commitment period** – The commitment period, being the period during which the GPs (or 'fund managers') may drawdown from LP's capital commitment for *inter-alia* fresh investments.

  Since commitments are made in the investment currency (for example, INR) and the LP (including private investors or fund of funds) has a different base currency (for example, USD), this can result in a higher base currency investment when the investment currency depreciates. Such factors can lead to either an excess or a shortfall in the commitment (as expressed in the investment currency).

  Generally, the GPs provide for a mechanism to adjust such excess. However, it becomes difficult to make adjustments for a shortfall in the commitment (as expressed in the investment currency).

- **Investment and distribution period**

  The difference in the currency exchange value between the date of investment by a non-INR LP into the AIF, and the date of distribution by the AIF to such LP becomes critical to be commercially agreed and adjusted for – especially given the calculation of returns on the basis of internal rate of return ("**IRR**").

  Let us consider a hypothetical example, wherein an offshore investor invests in an Indian company through an AIF. Six months post investment by the fund, there is an increase in the value of the investment by 20%, but the investment currency i.e. INR has decreased by 20% as compared to the USD. In other words, on an investment of

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INR 600 crores in a company (which, say, translated to USD 100 million), the fund may generate a return of 20% with an overall distribution amount of INR 720 crores. However, the currency exchange fluctuation has lead down to the weakening of INR against USD, which at the time of distribution of income is pegged at INR 72/USD. Under such circumstances, the USD investor will only be entitled to its capital, as the total distribution amount now translates to USD 100 million.

Certainly, it can work the other way as well. Let us say, in the above situation, at the time of distribution, the INR happened to increase by 20% relative to the dollar, pegged at INR 48/USD from INR 60/USD. In this instance, the offshore investor will be entitled to a much greater return than that generated at the fund level i.e. more than 20%.

- **Exits** - The rupee depreciation not only kicks in during the commitment period or the distributions but also at the time of exits from the investments. The returns on exits for private equity firms are hit negatively. If we consider a scenario wherein an exit which was supposed to happen in December, 2017 got postponed and is happening now, the rupee having seen a depreciation of close to 15 percent in past three years, the returns on the exit for the private equity firm in USD terms will be reduced by that 15%. Let's say the IRR (internal rate of return) on such investments has been 15%, it means the fund would have to now generate an additional 15% to just break even. Such a depreciation ultimately affects the private equity investors. Such an effect becomes more prominent for someone who has invested in 2009 and was seeking to exit by the year of 2020 with an IRR of 15%. The INR has, in the meanwhile, depreciated by more than 60% (the rupee has weakened from around INR 45/USD in 2009 to INR 73/USD now) leading to severe headwinds for the LPs.

WHAT IS THE LEGAL FRAMEWORK?

Notably, chapter IV of the AIF Regulations provides for specific disclosure obligations on the AIF to the investors including conflict of interest, information on fund investments, fees, various risks etc. However, such provisions are limited in nature and do not discuss currency exchange risks in detail. Regulation 22 (g) only mandates AIFs to provide information on foreign exchange risk at fund level, in their reports to investors, at least on an annual basis, within 180 days from the year end.

SEBI recently released a Circular on Disclosure Standards for AIFs[4] ("**Circular**") as a part of its efforts to streamline the disclosure standards in the growing AIF space. While providing for a template PPM, SEBI therein mandated the disclosure of information relating to the currency in which the returns are being calculated, and also currency fluctuations arising from foreign investments into the AIF.

Besides mandating divulgence of minimum level of information, the template PPM also specifically referred to disclosure of choice of currency for the target corpus of the fund (currency equivalent to INR as applicable), functional currency of the fund, currency for redemptions, currency for making contributions and currency for making commitments. Such disclosures being provided for in the PPM indicates the growing significance of the currency exchange risks on the GPs and LPs.

SEBI, vide the Circular, also provided for the development of an industry benchmark comparing the performance of AIFs against other (including global) investment opportunities for investors. Further, SEBI mandated the AIFs to provide such performance versus benchmark reports not only in the PPMs but also in any marketing or promotional or other material, where past performance of the AIF has been mentioned.

It would be instrumental for the benchmarking agencies to also take into account management of multiple currencies by an AIF, so that such AIFs are able to demonstrate their track record for this purpose against the benchmark so created.

HOW ARE ADJUSTMENTS MADE?

Generally, LPs with no liquidity constraints in the commitment period i.e. liabilities can be processed with ease, may opt to hedge in the investment/distribution period as their focus will be on the impact of currency fluctuations on performance. The same may not be true for LPs with liquidity constraints, as they will prefer to hedge in both the periods in order to limit the impact of currency fluctuation on excess and shortfall in commitments (as expressed in the investment currency). However, there is an increasing divergence of opinion on who should undertake the hedging strategies – the LPs or the GPs. Majority of the LPs indicate a preference for both GP and the LPs to control hedging decisions or solely the GP to manage the costs of hedging the risks, including by building it into the distribution waterfall.

Taking our earlier example of when the fund generates a 20% higher return on its investment of INR 600 crore with a distribution amount of INR 720 crore, whether the offshore investor receives USD 100 million or INR 600 crore under step (1) (on return of capital) of the waterfall would, as one example, determine who (among the GP and LP) is taking up the impact of the currency volatility.

Currency exchange risks also tend to impact the amount of capital commitments thereby skewing the ratio of commitments between the domestic investors and offshore investors. The GPs depending on the commercial expectations engage a variety of strategies to deal with the exchange rate fluctuations.

Generally, the exchange rate ratio is either fixed from the date of the first closing itself or may be closed at the time of final closing, as no further commitments will be expected after the final closing. However, there may be situations where due to currency exchange risks certain commitments of one set of currency remain unfunded while the other currency's unfunded capital commitments is reduced to nil, then GP and LPs may agree to either continue investing through the available class (with necessary disclosures), or suspend any investment making among other options.

CONCLUSION

With most of the LPs and GPs neither constructing their portfolios with currency risk as an explicit objective nor hedging the currency risk of their commitments, the industry trends seem to tide against the sentiments, thus compelling the GPs and LPs to incorporate risk mitigation practices now more than ever before.

From a legal perspective, the provisions determining the corpus, drawdown ratios for different types of drawdowns, rules for calculation of the internal rate of return, and method of distribution waterfall should be drafted, expressly taking into account the commercially agreed position with respect to the changing values of different currencies.

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You can direct your queries or comments to the authors

[1] Currency Management: An Introduction, 2020 Curriculum, Portfolio Management and Wealth Planning, available at https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/2020/currency-management-introduction.

[2] Arleen Jacobius, Currency swings grab attention of limited partners, May 16, 2016 available at https://www.pionline.com/article/20160516/PRINT/305169984/currency-swings-grab-attention-of-limited-partners.

[3] David Dierking, Currency Fluctuations and Their Impact on International Funds, October 17, 2017, available at https://mutualfunds.com/international-and-global-stock-funds/currency-fluctuations-impact-on-international-funds/.

[4] https://www.sebi.gov.in/legal/circulars/feb-2020/disclosure-standards-for-alternative-investment-funds-aifs-_45919.html.