Investment Funds: Monthly Digest

March 31, 2020

INDIA FOCUSED INVESTMENT FUNDS: MARCH, 2020 ONWARD

The world is collectively and individually grappling with an unprecedented event of a pandemic in modern times. The first case of COVID-19 was reported in India in late-January, and as of date there are (reportedly) about 1251 patients suffering through this pandemic in the country.

As a precautionary measure, the Government of India announced a 21-day lockdown across the country starting from March 25, 2020. During this time, most of the private firms and organisations (for whom it is practicable to do so) are implementing a working from home model for their respective employees.

Physical movement of persons, whether interstate or internationally, is restricted due to the nationwide lockdown.

The securities market regulator of India, the Securities and Exchange Board of India ("**SEBI**") has clarified that all capital market intermediaries (stock exchanges, depositaries, clearing corporations, mutual funds, asset management companies, alternative investment funds, etc.) will continue to operate.

At the same time, SEBI has (in line with other securities market regulators round the globe), restricted any type of financial transactions which could result in traders making a financial advantage due to a downward trend in the value of securities (restrictions on short sales).

Just yesterday, SEBI issued a circular, relaxing compliance obligations pertaining to *inter-alia* Alternative Investment Funds (AIFs), Foreign Portfolio Investors (FPIs) and Venture Capital Funds (VCFs). However, there was no mention by SEBI of relaxation in compliance with its February, 2020 circular on standardisation of PPMs and benchmarking.

In light of these circumstances, we are dedicating this issue of the monthly digest to a practitioners' projection of the impact of COVID-19 on fund raising and fund life-cycle of India focused investment funds.

IMPACT ON FUND RAISING

In the past couple of months, there was an increase in fund raising efforts. In February, 2020 alone, there were at least 12-13 new filings for registration as Alternative Investment Funds, as posted by SEBI on its website. This, in comparison, is more than what was happening over the past few months on an average.

The onset of COVID-19 as a pandemic in India beginning March, 2020, however, has put GPs on a backfoot. Fund raisings and closings are likely to get tougher, despite technological advancements. Road shows and LP due diligences may not entirely be replaceable with virtual 'Namaste'. First time GPs who are on the road may face more difficulties.

Further, depending on investment strategies, different funds may get impacted differently. Global funds may not get as impacted as domestic only funds.[1] LPs are likely to seek more diversification and flexibility while assessing allocation to funds.

In the past few years there has been an increase in institutional investors' participation in private equity as compared to earlier. Indian and foreign sovereign wealth funds, pension funds, insurers etc. have been allocating to India. From an LP perspective, the pandemic could lead to a 'denominator effect', and lead to a higher allocation towards illiquid assets (as value of illiquid stocks would go up due to value of liquid portfolio falling). LPs are likely to revisit their allocation strategies for the coming quarter, especially due to the impending recession in the United States.

Regulators are also operating on a lower bandwidth due to the pandemic. While SEBI has introduced an online portal for all filings, SEBI officers continue to prefer reviewing physical submissions and make requests for the same from time to time. Accordingly, GPs working on a reverse timeline should make relevant adjustments.

For funds which have undergone a closing, raising further capital could still be a bit difficult and accordingly, the raising period itself in fund documents may need to be increased (as opposed to tapping the extension opportunity that is built into the fund documents). GPs may need to segregate closings instead of aggregating them for once or twice a year, and hold them on an as needed or rolling basis. This could, however, lead to a more complex accounting for closing adjustments.

This pandemic may require innovative ways for GPs to increase fund allocations, perhaps by offering better co-investment opportunities to existing investors or recalibrating the fund size among other options.

IMPACT ON LIFE-CYCLE OF FUNDS

Investment allocation among different sectors and securities may need to be revisited by existing funds depending on the actual outcome of the pandemic in its full form, as and when India gets into recovery mode.

For most funds, this pandemic is a 'risk factor' coming into effect, which could lead to certain fund key fund terms getting impacted. For example, GPs may now wish to take an exposure on certain untapped portfolio or take a larger

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exposure on existing portfolio and accordingly, request the LPs for an extension of their commitment / investment period. Management fees for such increased commitment period is expected to become an interesting dialogue between LP-GPs due to the events leading to such extension.

Decisions are being taken from wherever the decision makers have been halted due to the lockdown. Given this, it should be considered whether GPs who are currently in India and not in their country of tax residence engaging in such decision making could result into adverse tax consequences in India for their respective offshore funds from a permanent establishment or place of effective management perspective.

From a hedge fund or liquid funds perspective, for long-short funds or for funds which hedge in futures and options are facing restrictions on short-selling or any strategies which provide a financial advantage due to diminishing value of certain securities. This could be a significant break on their investment strategies.

IMPACT ON EXITS

There are funds from the 2008-09 vintage who have already taken extensions to their fund tenures (much before the outbreak of COVID-19). Further, there are funds from the 2011-12, 2012-13 vintages who are in the 7th, 8th, 9th year of their respective lifecycles, who would now be looking at their fund documents to rethink the fund tenure, given the pandemic. In this regard, the SEBI (Alternative Investment Funds) Regulations, 2012 require that AIFs have to undergo liquidation within 1 year of their termination. This imposes an additional challenge on funds who are nearing their termination.

Due to the performance of Indian Rupee against the US Dollar, most foreign investors who expect returns referenced to the US Dollar are likely to be disappointed. Given these circumstances, GPs are expected to consider several different exit mechanisms and secondary sale structures.

The traditional option and expectation is to be able to exit from the investments, even though at a lower valuation. GPs could also consider facilitating LP to LP secondaries and extend the fund’s tenure. Another option is to consider a portfolio sale to another GP, as opposed to a piecemeal sale of the investments. There could also be an option to create a successor fund by the same GP as a continuation fund, where such continuation fund could purchase the portfolio from the existing (terminating) fund whether with the same set of or new LPs. In this option, concerns on balancing the fiduciaries of the GP to previous LPs and new LPs should be handled upfront and transparently.

WHAT NEXT?

The true and full impact of COVID-19 is yet to be seen. The views shared in this piece are to this extent, preliminary.

Different regulators are taking different measures and coming out with new announcements every day. Even the tax authorities are working continuously on appropriate fiscal measures and making interim announcements.

The LP-GP dialogue for live and operational funds may not have begun as of today regarding status quo and next steps due to COVID-19. Such dialogues are likely to provide more details on LPs’ perspective on India funds, and how are different GPs looking to tackle the situation.

– Nandini Pathak, Parul Jain & Richie Sancheti
You can direct your queries or comments to the authors

[1] T&I Asia Fund Raising Summary for March 30th, 2020

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