Reaching happy compromise on AIF exit timelines

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India's growth story can be linked to the massive fund mobilisation through alternative investment funds (AIFs). These privately pooled investment vehicles raised INR6.95 trillion (USD86.81 billion) from Indian and overseas investors up to mid-2022 since the launch of the first few funds in 2013.

Promising high double-digit returns, AIFs include hedge funds, private equity, venture capital and angel investors. To address the unorganised pooling of investments, the Securities and Exchange Board of India (SEBI) introduced a regulatory framework called the Alternative Investment Fund Regulations in 2012.

Long-only AIFs massively outperformed long-short funds in 2021-22, by almost three times. While the former averaged returns of 30.6%, the latter returned 13.6% on average, according to research platform PMS Bazaar.

As investors continue seeking high double-digit returns to combat rising inflation, demand for these funds is expected to grow exponentially.

However, the greater the returns, the higher the risk. It's little surprise that some of these AIFs have found themselves cornered by poor market conditions, litigation, non-performance of portfolio companies, reduced property prices, and delays in IPOs by investee companies, especially startups, laments a Mumbai-based fund manager who wishes to remain anonymous.

With no one ready to buy unlisted securities of companies in distress, or stressed assets, it becomes difficult to liquidate investments in AIFs, says Venkatesh Prabhu, a co-founder of trustee company MITCON Credentia based in Mumbai.

Industries across the board have been impacted, from infrastructure and real estate to startups, he says, with many real estate funds badly hit by the property slump. There are also instances of AIFs extending tenure of the funds in expectation of a higher price later, post expiry of the fund, says Prabhu, citing probability of a fresh round of funding.

The delayed IPO of India's largest stock exchange, for instance, due to ongoing investigations of former National Stock Exchange (NSE) officials, could affect some AIFs' ability to exit the stock.

Although the price of the NSE's unlisted shares has doubled from INR1,700 in 2021 to INR3,400 today, most fund managers would prefer not to exit the stock yet, considering market expectations that open offer price could be in the INR7,000-7,500 range, bringing fund managers windfall gains.

"Considering the limited size of the public offering, the shares could touch upwards of INR10,000 on listing," says the fund manager.

Fund managers claim fiduciary responsibility to look for better offerings for their investors, and have therefore deferred exits and kept funds alive.

This has invited the wrath of the capital market watchdog, following many complaints from investors unable to exit their investments in AIFs. With fund managers extending tenures, investors with a five-year plan are forced to remain invested even into a ninth year, with no exit options.

SEBI gets miffed

The SEBI has sent out notices to several AIFs for failing to honour the timeline of funds specified in their offer documents. The fate of at least 67 AIF schemes hangs in abeyance. Some 24 AIFs valued at INR30.37 billion will expire by the end of the next financial year (2023-24), and another 43 valued INR134.5 billion will expire the following year (2024-25).

The question now being asked is whether extension of tenures should be allowed if it is beneficial, and more importantly for whom – the investor whose investment mindset was around seven years, or the fund manager who continues to reap hefty commissions off the corpus of the fund?

While some degree of flexibility is needed, as markets are cyclical and valuations fluctuate, investor interest equally needs to be taken into account, says Akil Hirani, managing partner and head of transactions at Majmudar & Partners in Mumbai.

In the current market scenario, both sides have valid concerns, he says. Investors typically park their funds for around seven years, and AIFs are generally structured on that basis, although some could have longer tenure. The SEBI is concerned about another set of investors losing their money through AIFs, Hirani tells Indian Business Law Journal.

Many fund managers are, meanwhile, in a fix on how best to dispose of the illiquid portfolio of securities without impacting investor interest. “We are aware of several fund managers having approached the SEBI to seek some flexibility around the extension of the tenure of these funds,” says Gaurav Desai, a New Delhi-based partner at Touchstone Partners.

The SEBI is hesitating to allow extensions beyond tenure to protect investor interest, he says, but given market conditions, the fund may not have realised the full potential value of the investment.

Hirani agrees. “Although AIFs should not end up as open-ended schemes where the tenure gets extended easily, forcing AIFs to undertake fire sales in a down market may also not be prudent.”

Extension: Boon or bane?

AIFs may get a breather as the SEBI recently proposed they could carry forward unliquidated investments to a new plan, post closure of the existing scheme, provided 75% of investors consent.

The stop-gap arrangement is welcome, says Prabhu, as it will help secure investment funds for the short term by allowing the transfer of underlying investments into a new plan.

Desai agrees that the proposal is a welcome step as the tenure of some funds set up early in the AIF regime are either on the verge of expiry or expiring in the next 12-18 months.

The SEBI notes in its consultation paper that a “full closure of the scheme, recognition of the true asset value, and reopening of a fresh fund at that value would satisfy both objectives of providing additional flexibility to investors/funds while ensuring disclosure and tracking of true asset value and fund performance”.

The capital market watchdog's proposal is not aimed at granting unlimited extensions. Currently, the tenure can be extended only once, by up to two years, with consent of the prescribed majority of investors. This is supposed to protect investor interest, the basic principle of SEBI decisions.

Greater flexibility

By requiring 75% of investors to consent, the SEBI's proposed rollover attempts to maintain a balance between investor interest and timely liquidation of funds, while enabling dissenting investors to exit at a valuation from two independent valuers.

This will enable AIFs to carry forward investments under a new scheme. "Instead of funds being forced to liquidate investments within a timebound manner – for which the market may or may not be suitable – this will give greater flexibility to roll over funds for a particular amount of time, and liquidate when market conditions are suitable, which in turn will be in investors' interest," says Desai.

Under the proposed regulation changes, the SEBI may only allow short tenures of new plans where existing unliquidated investments have been transferred, says Prabhu. "While the idea is to discourage funds from going bad, fund managers would need to give some specified timeline for the fund, considering it is already more than 10 years old."

Desai and Hirani suggest that, similar to insolvency cases, AIF assets could be transferred to investors on a pro-rata basis should fund managers be incapable of delivering or returning the capital within a stipulated period.

"Investors could then decide when and how to liquidate their investment," says Desai.

The fund manager, however, dismisses the option of individual investors taking charge of the investment on a pro-rata basis, saying it is "impractical" for most investors.

Sophisticated investors like pension funds and sovereign wealth funds are likely to be neutral over the SEBI proposal, now open for consultation, thanks to their adequate contractual protection and veto rights over such decision-making, says Desai. "Typically, they hold more than a 25% stake. Given the requirement for 75% approval, they could veto a rollover."

Hirani believes fund managers should equally share the burden, suggesting that the SEBI could ask them to "plough back their fees, which can be as high as 2% per annum and 20% of profits".

With 900 AIFs registered with the SEBI, the fate of 67 might be just a drop in the ocean today, but the SEBI's ultimate decision could be the saving grace for other AIFs in future.

The Briefing is written by Freny Patel.