Need for Enabling Domestic LP Capital

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The coronavirus pandemic has taken a heavy toll on both the health of our citizens as well as the economy. Despite a 7.3% contraction in the country's GDP as of FYE March 31, 2021, the Indian Venture Capital and Private Equity ("VC/PE") industry has continued to repose its faith in the 'India story', with total investment value hitting a record high of US$ 62.2 Bn in 2020 (in aggregate including infrastructure, real estate, PIPE and credit investments).

India ranks third globally in the number of unicorns generated (start-ups with a valuation exceeding US$ 1 Bn), behind US and China. India's top 25 start-ups have created more than a million jobs (including both payroll and contractual). The Indian start-up ecosystem has seen an estimated US$ 90 Bn in value creation by unicorns. Currently there is a strong pipeline of potential unicorns across sectors, as 250+ Indian Start-Ups have reached valuations above US$ 100 Mn.

India requires at least 2.5% of GDP (US$ 125 Bn / Rs. 8.75L Cr) to come in the form of PE/VC investment in order to achieve the target of becoming a US$ 5 Tn economy by 2024. In parallel, the country also needs to create 1-1.5 crore (10-15 million) jobs per year during the next decade to provide gainful employment to its young literate population. Accelerating innovation driven entrepreneurship and business creation through start-ups is crucial for large-scale employment generation.

While domestic capital has not historically participated in this opportunity with as much zeal as its global counterparts, a significant part of private equity and venture capital inflows have now started to come via SEBI registered Alternative Investment Funds ("AIFs"). Domestic capital can serve as an important and resilient source of capital appreciation for domestic investors, while simultaneously acting as an effective national policy tool. VC/PE investing can also be used in tandem to channelize funds for diversification, providing capital with access to a safe and well governed route to generate returns.

Overseas investors' appetite for India has proven to fluctuate over time, undermining the stability of fund flow into the VC/PE ecosystem. In order to reduce the risk of dependence on foreign capital, India needs to be *Atma Nirbhar*, and tap into domestic long-term capital. Domestic capital is an important asset class for funding and growing Indian enterprises. Recently, the government has taken several key initiatives on opening domestic pools of capital. Namely, the Insurance Regulatory and Development Authority ("IRDA") allowed insurance companies to invest into Fund of Funds, similar to making a direct investment into an AIF. The Pension Fund Regulatory and Development Authority ("PFRDA") and Employees Provident Fund Organization ("EPFO") allowed domestic private provident funds to invest in Alternative Investment Funds ("AIFs") subject to certain conditions.

The following steps could provide a significant impetus towards ensuring that we channelize domestic capital into VC & PE as an asset class:

- While there are large pools of domestic capital available with pension funds, provident funds, and charitable organizations, they are not being used as sources of investment in the country. These funds should be allowed to invest in private equity and venture capital by setting up a Fund of Funds ecosystem via a partnership model (as has proven successful in the case of NIIF & SIDBI's FOFs).
- <u>The government can catalyse the emergence of this FoF eco-system by allocating capital to FoFs in the following manner.</u>
  1. The government may allocate a total sum of Rs. 10,000 Cr. to at least 10 FoF managers, entrusting each with Rs.1,000 Cr.
  2. This government contribution may be accompanied by a target of raising 4x of the corpus allocated to the FoFs, which would create a total capital pool of Rs.50,000 Cr. among the FoF managers.
  3. The FoF managers will in turn invest their corpus in Indian AIF managers with criteria to raise 4x of the corpus assigned. This would ultimately create a total capital pool of Rs. 150,000 - 2,50,000 Cr. of VC & PE ready capital in the economy, generated from an initial Rs. 10,000 Cr capital allocation by the government.

- <u>There can be various checks and balances to guarantee the efficient use of the proposed capital pool:</u>
  1. The entire program should be targeted only towards SEBI registered AIFs.
  2. The FoF managers may be selected from amongst the large domestic Mutual Fund houses that already have ongoing relationships with institutional and retail investors. This would ensure both institutional and retail contribution to the funds.
  3. These fund houses have ongoing relationships with most of the big institutional investors and

may even be existing managers of PFRDA, NPS, EPFO, Banks, Insurance companies, HNIs and other investors.

The availability of a large capital pool would in turn start a virtuous cycle in the economy, by augmenting the FoFs' capability to attract and retain talent and global expertise, including expats, given the appeal of the opportunity to work in India with a sizeable corpus. NIIF is a prime example of the success rate of such a setup in attracting talent, given its positioning in the private sector while at the same time leveraging the initial equity provided by the government of India.

FoFs significantly reduce risk for institutional investors, as compared to investing in Funds, by providing a higher level of diversification and considerably reducing the risk of permanent impairment of capital . Indian institutions have limited experience of investing in the VC & PE asset class. FoF investing significantly reduces the need for prior expertise and sophistication for first time participants in this asset class. Over a period of time, many of these institutions will gain experience and successfully transition towards direct investing in Funds, leading to a self-reliant and thriving VC & PE ecosystem in India

In addition to these steps, the industry has been working in collaboration with the government to ensure tax parity with public market investors and offshore managers. Developing a robust, local FoF ecosystem also brings the additional benefit of helping onshore the predominantly offshore Indian PE industry. On the eve of a de-globalizing world, injecting stability in the economy by balancing any potential volatility in international capital flows with a steady stream of domestic capital flows, has become an urgent task for India.