ETPrime

AIFs due for closure struggle to sell holdings in startup firms

Illustration: Rahul Awasthi

Synopsis

Some ask Sebi to extend the liquidation period by two years till private market funding improves

Alternative Investment Funds (AIFs) that are scheduled to wind up in the next few months have been struggling to sell their holdings in unlisted ventures and startups, as investors stay clear of risky investments due to tightening liquidity.

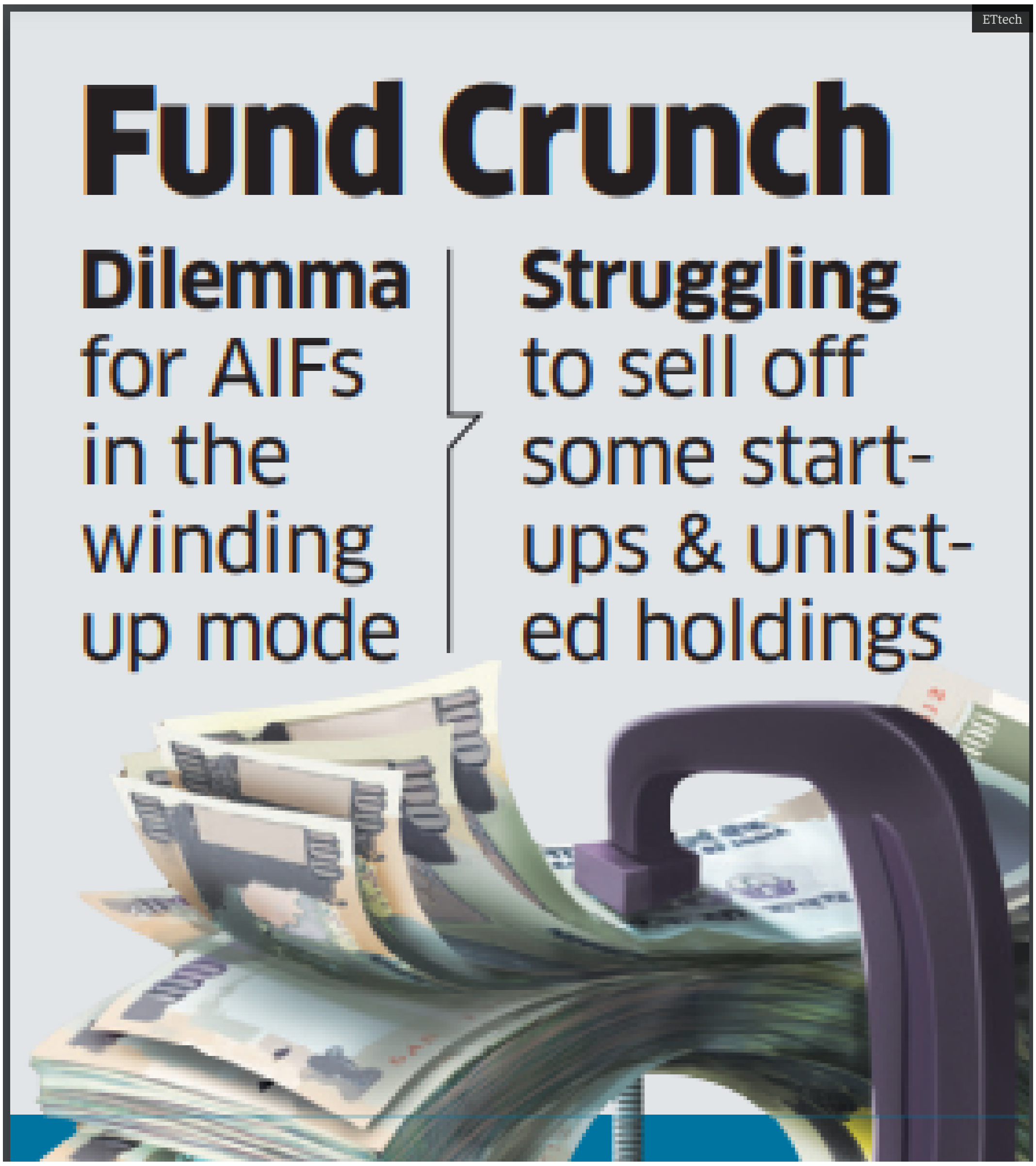
Typically, the Category I and Category II AIFs are registered with India's capital markets regulator, the **Securities and Exchange Board of India** (**Sebi**).

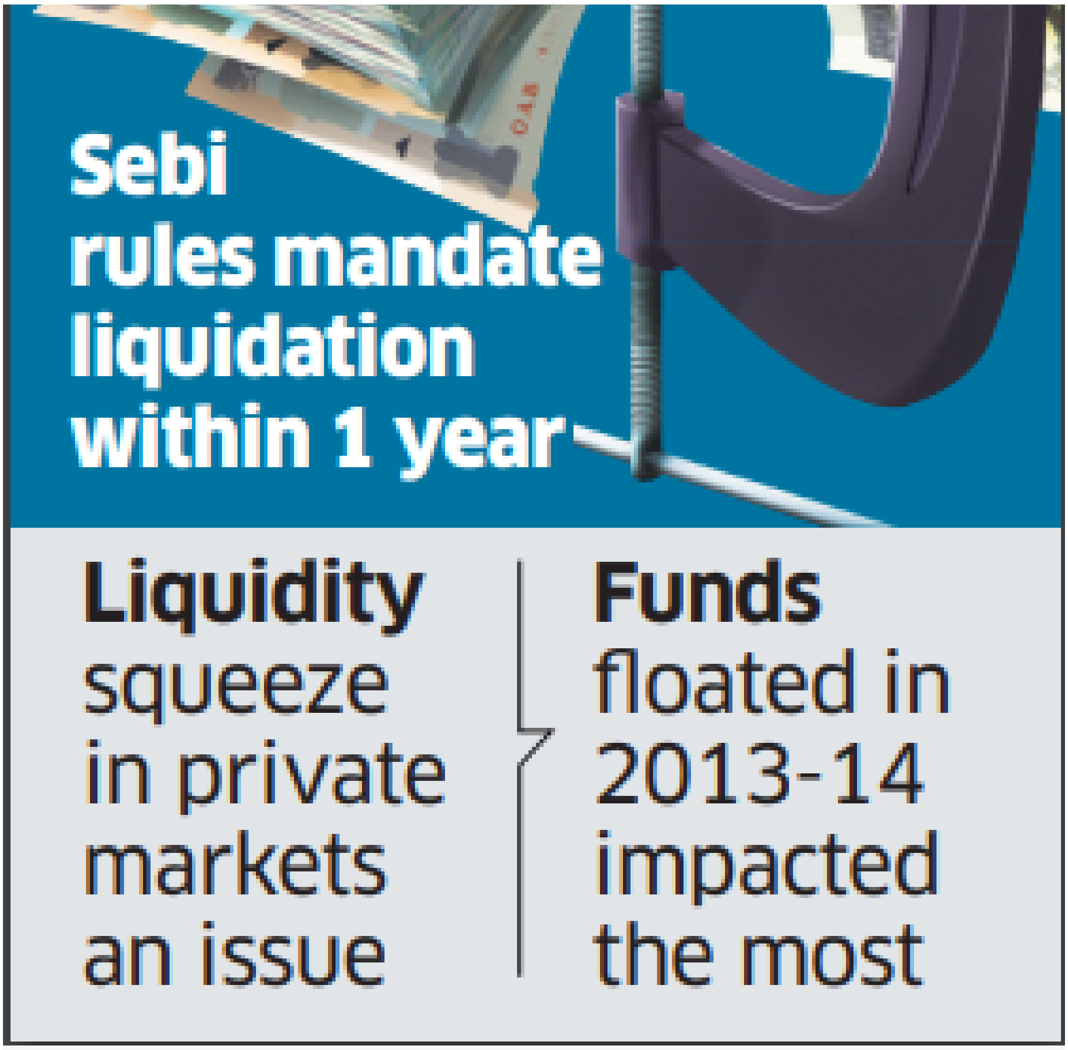
Once a close-ended **AIF**'s life cycle is complete, the fund manager is required to liquidate its holdings within 12 months and distribute the proceeds to investors.

Most of these AIFs are, however, either not keen to sell their holdings or have been unable to find buyers at the desired valuations because of liquidity-related challenges.

As central banks across the world trim their balance sheets, fund flows into unlisted companies, especially **tech-driven startups**, have been adversely affected.

Some of the AIFs have now requested Sebi to extend the liquidation period by a further two years till the private market funding scenario improves, people with direct knowledge of the matter said.





Investors look to book profit

These are funds that mostly hit the market in 2013-14 and whose life cycle is about to end.

Sebi did not respond to ET's emails seeking comment.

While applying to Sebi for an AIF licence, a Category I or a Category II AIF is required to declare the fund's life cycle.

According to the rules, the minimum life cycle of a fund is three years, while the maximum is 10 years.

However, in special situations, the fund can avail a further two years extension to wind up, but that would need investor approval.

"The risk appetite is not encouraging right now; investors are looking to book profits and hence getting approval for an extension becomes tricky," said a person representing several such funds.

The only other option is to transfer the existing securities to the accounts of investors, but they are not keen to manage the portfolio by themselves, the person added.

"The one-year liquidation period, along with no more than two years of extension to the fund tenure, is posing operational difficulties for many AIFs from the 2013-14 vintage that have started preparing for winding up," said Nandini Pathak, leader-fund formation, **Nishith Desai Associates**.

She said the "in-specie" distribution provision was turning out to be "more theoretical than practical." Sebi should provide a framework to extend the tenure further, Pathak added.

In-specie transfer refers to a transaction by which a fund house transfers the securities in the portfolio of a fund being wound up, to a new fund.

Legal experts said the in-specie transfer of securities would lead to a scenario wherein investors would end up paying capital gains tax twice, once during the transfer of securities to the new fund and the second time when the actual liquidation of the fund takes place.

Over the last few months, several startups have seen a decline in their valuations due to reduced appetite among venture capital and private equity firms.

"Sebi regulations require an AIF to liquidate its assets within one year of intimation to the regulator regarding the circumstances leading up to the wind-up of the AIF," said Moin Ladha, partner, Khaitan & Co. "Since the valuation of underlying assets depends on and is impacted by external factors, it could be the key reason why an exemption is being sought."

Category I and Category II AIFs usually invest in unlisted equities and in the debt market.

Market participants estimate that around 70% of their total investments is in unlisted equities, while the rest is in debt and hybrid instruments.