



Capital League

PRIVATE WEALTH MANAGEMENT

ALTERNATIVE INVESTMENT FUNDS



Investing for Higher Yields

—— **Knowledge Series** ——

Introduction

Over the past few years, Alternative Investment Funds (AIFs) have gained popularity as a unique and dynamic investment vehicle offering specialized opportunities and potential for higher yields. This paper delves into the intricacies of AIFs, exploring their types, benefits, risks, taxation, and the rationale for considering them as part of your investment portfolio.

An Alternative Investment Fund, regulated by the Securities and Exchange Board of India (SEBI), is a privately pooled investment vehicle that targets alternative asset classes such as private equity, venture capital, hedge funds, real estate, commodities, and derivatives. These funds primarily attract High Net Worth Individuals (HNIs) and institutions due to their substantial investment requirements.

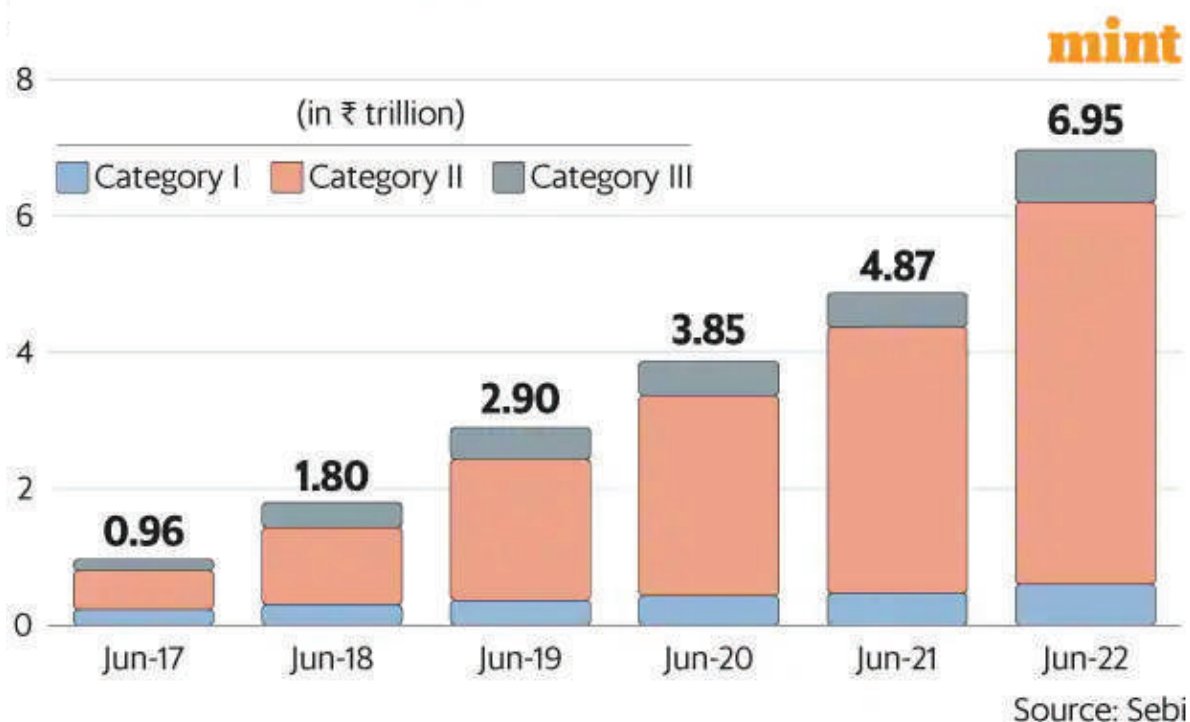
Evolution and Growth

In recent years, AIFs have witnessed remarkable growth, evolving into a preferred investment vehicle. Regulatory developments and evolving norms have made AIFs more investor-friendly, resulting in a tremendous flow of funds in the AIF category in India over the past several years. AIFs experienced an annual growth rate of 30% in FY23. According to the Indian Association of Alternative Investment Funds (IAAIF), assets under administration have surged to USD 84.3 Billion as of FY23. Despite a Rs.1 crore minimum investment requirement, sophisticated investors seeking tailored investment strategies have fuelled this growth. Domestic investors now provide 80 -90% of the funds raised, viz. a decade ago when foreign investors represented a majority of investments.

Current trends suggest that AIFs could potentially rival India's ₹46 trillion mutual fund industry, marking a substantial milestone in the financial ecosystem.

Growth of AIFs in India

Commitments raised from investors has grown more than 7 fold in last 5 years.



Driving Factors and Trends

One of the key drivers of the AIF industry's growth is the expanding pool of domestic capital, extending its reach into Tier II and Tier III cities. The participation of these investors in the start-up ecosystem has been instrumental, leading to considerable wealth creation.

AIF Categories and Themes

Category I AIF

Cat I AIFs invest in socially or economically beneficial sectors, supporting start-ups, early-stage ventures, SMEs, and government-identified sectors.

- **Venture Capital Funds (VCF):**
Invests specifically in start-ups or early-stage ventures with high growth potential, providing crucial financial support during their initial stages.
- **SME Funds:**
Focuses on small and medium enterprises with a proven track record of profitability and growth, aiding them in overcoming challenges in capital raising.
- **Social Venture Funds:**
Invests in companies aiming to make a positive impact on society or the environment, such as sustainability and clean energy, combining philanthropy with potential returns.
- **Infrastructure Funds:**
Invests in critical infrastructure projects like railways, bridges, and airports, contributing to the development of essential infrastructure.

Category II AIF

This category encompasses funds that do not fall under Categories I and III, including private equity funds, debt funds, and fund of funds.

- **Private Equity Funds:**
Makes equity investments in unlisted private companies, assisting them in raising capital through equity.
- **Debt Funds:**
Invests in debt securities of unlisted companies through instruments like bonds and debentures, focusing on companies with good corporate governance and growth potential.
- **Fund of Funds:**
Invests in multiple AIFs, offering diversification through exposure to various investment funds rather than directly in stocks or bonds.

Category III AIF

Funds in this category engage in complex trading strategies, using leverage for investments in listed or unlisted derivatives.

- **Private Investment in Public Equity Fund (PIPE):**
Invests in the equity of publicly traded companies, acquiring bulk quantity of shares at a discounted price.
- **Hedge Funds:**
Utilizes various investment strategies like short selling, arbitrage, futures, derivatives, and margin trading, mostly adopting aggressive investment strategies for maximizing returns.

Cumulative Net Figures	March 31, 2023 (Figures in crore)			March 31, 2022 (Figures in crore)		
Category of AIF	Commitments Raised	Funds Raised	Investments Made	Commitments Raised	Funds Raised	Investments Made
Category I						
Infrastructure Fund	15,581	5,466	4,743	11,852	7,912	6,821
Social Venture Fund	1,473	565	331	2,897	2,101	578
Venture Capital Fund	41,726	22,191	18,886	37,445	18,789	16,234
SME Fund	149	62	52	1,181	199	165
Category I Total	58,929	28,283	24,013	53,374	29,000	23,798
Category II	6,93,945	2,66,296	2,42,915	5,19,189	2,23,457	1,99,452
Category III	80,900	71,030	71,055	68,796	61,406	60,809
Grand Total	8,33,774	3,65,609	3,37,983	6,41,359	3,13,863	2,84,059

Note: The above report is compiled on the basis of quarterly/monthly information submitted to SEBI by registered AIFs

Investor Eligibility and Minimum Requirements

Eligibility criteria for investing in AIFs include Indian residents, Non-Resident Indians (NRIs), and foreign nationals. Joint investors, such as spouses, parents, or children, are also eligible. The minimum investment amount for investors is ₹1 crore, while for directors, employees, and fund managers, the limit is ₹25 lakh. Most AIFs come with a minimum lock-in period of three years, and the maximum number of investors in every scheme is capped at 1,000, except for angel funds where the cap is 49.

AIF Taxation

Taxation of AIFs depends on their category

- **Category I and Category II:**
 - Enjoy pass-through status. The income generated is taxed in the hands of the investor and the fund does not have to pay tax. Without this, investors would be subject to double taxation.
 - Gains are taxable in the hands of investors as if they made the investments personally.
- **Category III:**
 - Does not have pass-through status.
 - Income earned is taxable at the fund level at the highest rate, with investors exempt from paying taxes on gains.



Benefits of Investing in AIFs

- **Potential for Higher Returns:**

AIFs may offer higher returns compared to traditional investments due to exposure to a broader range of assets and investment strategies. However, this potential for higher returns is accompanied by higher risk.

- **Portfolio Diversification:**

AIFs provide access to alternative asset classes, including hedge funds, real estate, and private equity, aiding in diversifying portfolios.

- **Access to Exclusive Investing Techniques:**

AIFs provide investors with the opportunity to access exclusive investing techniques and strategies that may not be readily available through traditional investment avenues. This can include sophisticated approaches employed by hedge funds, private equity, and other alternative asset classes, allowing investors to add potentially high-yielding strategies as an add-on to their portfolio.

Risks Associated with Investing in AIF

- **Aggressive Risk Profile:**

AIFs often involve higher risks compared to traditional investments like mutual funds and bonds, as they may include exposure to non-traditional assets like private equity and hedge funds.

- **Market Volatility:**

The performance of AIFs can be influenced by market volatility, economic downturns, or changes in industry-specific dynamics, impacting returns.

- **Lack of Liquidity:**

AIF investments may have limited liquidity, making it challenging for investors to quickly sell their positions in certain market conditions.

- **Complexity and Sophistication:**

AIFs employ complex investment strategies and instruments, requiring a higher level of sophistication from investors to understand and assess associated risks.

- **Regulatory Changes:**

Changes in regulatory frameworks or tax policies can affect the functioning and returns of AIFs, adding a layer of uncertainty.

Suitability for Investors

- **Mature Investors with Higher Risk Tolerance:**

AIFs are suitable for mature investors who are willing to take higher risks for the potential of greater returns.

- **High Net Worth Individuals (HNIs):**

Due to the substantial investment amounts required, AIFs are often more suitable for High Net Worth Individuals (HNIs) who can allocate a significant corpus.

- **Diversification Seekers:**

Investors seeking diversification beyond traditional asset classes may find AIFs attractive for accessing alternative investments like private equity and hedge funds.

- **Long-Term Investors:**

AIFs often have longer investment horizons, making them suitable for investors with a long-term perspective and the ability to withstand market fluctuations.



Conclusion

AIFs represent a unique investment channel beyond traditional instruments like fixed deposits, equity, mutual funds, and stocks. Appropriate for mature investors willing to take higher risks for potentially higher returns. AIFs have shown an overall growth of 30% in FY 2022-23, according to recent SEBI data. As of March 2022, the total commitment raised was ₹6.41 lakh crore, increasing to ₹8.34 lakh crore in March 2023.

Despite the potential for greater returns, investing in AIFs requires careful consideration. Thorough research, understanding of risks, and alignment with individual financial goals are crucial before venturing into the realm of Alternative Investment Funds.

Given the complexity of AIFs, investors are advised to seek guidance from financial advisors who can provide insights into the suitability of AIFs based on individual risk tolerance and financial goals.