Debt Funding in India Series

November 11, 2020

OFFSHORE FUNDING ROUTES: FOREIGN VENTURE CAPITAL INVESTOR

SEBI by way of introduction of SEBI (Foreign venture Capital Investor) Regulations, 2000 ("**SEBI FVCI Regulations**"), introduced a new regime for encouraging investments in venture capital undertakings and the start-up ecosystems. The investors registered with SEBI as foreign venture capital investors ("**FVCI**") are provided certain special incentives for making investments such as exemption from the pricing norms, relaxations from lock-in requirements when the investee company goes public, investment into optionally convertible securities etc.

We have listed down a few FAQs which will help understand the debt investments by FVCIs into India better.

1. ***What are the instruments and the entities in which FVCIs can invest in?***

   An FVCI can invest in equity instruments, equity-linked instruments (instruments optionally or mandatorily convertible into equity share) or debt instruments. These instruments must be issued by (i) companies engaged in the specified sectors and whose securities are not listed at the time of issuance of securities to an FVCI; or (ii) 'start-ups', irrespective of the sector in which the start-up is engaged in. In addition, FVCIs are also permitted to invest in units of a Category I Alternative Investment Fund (Cat-I AIF) or units of a scheme or of a fund set up by a VCF or by a Cat-I AIF.

2. ***What are the specified or permitted sectors in which an FVCI can invest as mentioned in FAQ 1?***

   FVCIs can invest only in specific sectors. These are (1) Biotechnology; (2) IT related to hardware and software development; (3) Nanotechnology; (4) Seed research and development; (5) Research and development of new chemical entities and pharmaceutical sector; (6) Dairy industry; (7) Poultry industry; (8) Production of bio-fuels; (9) Hotel-cum-convention centers with seating capacity of more than three thousand; and (10) Infrastructure sector[1].

   As mentioned above, in case of a start-up, the sector is irrelevant for the purpose of investment by an FVCI, as long as the investee companies satisfies the conditions to qualify as a 'start-up'.

3. ***What is a start-up, and the conditions referred to in FAQ 1 and 2 above?***

   In a bid to push investment in start-ups, the government of India has introduced a slew of sops for start-ups. The policy defines start-up as any entity which satisfies the following conditions, and the same has been referred to in case of investments by FVCI in start-ups as well.

   - Up to a period of ten years from the date of incorporation/ registration, if it is incorporated as a private limited company (as defined in the Companies Act, 2013) or registered as a partnership firm (registered under section 59 of the Partnership Act, 1932) or a limited liability partnership (under the Limited Liability Partnership Act, 2008) in India.
   - Turnover of the entity for any of the financial years since incorporation/ registration has not exceeded one hundred crore rupees.
   - Entity is working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.

   If any entity is formed by splitting up / restructuring of existing entities, it will not qualify as a start-up.

4. ***What are the different class of debt instruments in which an FVCI can invest in?***

   An FVCI can invest into the broadest category of instruments as a non-resident investor:

   - Compulsorily convertible debt instruments (such as compulsorily convertible debentures); and
   - Optionally convertible debt instruments (such as optionally convertible debentures);
   - Non-convertible debt instruments such as non-convertible debentures / bonds etc. (subject to the FVCI holding any equity or equity linked instruments in the investee company).

5. ***What are the main pros and cons for investment through the FVCI route?***

   Investment, through FVCIs, have certain benefits over the other forms of investment routes:

   - The FVCI is permitted to invest in the widest possible basket of debt instruments, as explained in FAQ 4 above.
   - Investments into compulsorily convertible debentures ("**CCD**") by non-resident investors under the foreign direct investment route ("**FDI Route**") are subject to pricing norms, as per which the investment by any non-resident into any compulsorily convertible debt instruments cannot be at a price lower than the then prevailing fair

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market value (determined as per any internationally accepted pricing norms). On the other hand, at the time of exit by way of a buy-back / sale, the exit must be at a valuation not exceeding the then prevailing fair market value (determined as per any internationally accepted pricing norms). This limits the returns at the time of exit for a non-resident investor under the FDI Route. However, investments through the FVCI route are not subject to any such pricing norms, making the investment and exit easier to structure.

- Under the securities regulations applicable in India, shares held by investors (including non-resident investors) are subject to lock-in requirements post listing. Any shares held by non-promoters are subject to a lock-in of 1 year post listing. The same is not applicable to any shares held by FVCIs, provided the FVCI shall not be permitted to transfer shares unless they have held the same for a period of 1 year. Accordingly, the pre-listing holding period of FVCIs are also considered when computing the 1 year lock-in period, which is not the case with other investors.
- Considering that only CCDs are permitted under the FDI Route, only NCDs are permitted under FPI route[2] and any investment into optionally convertible debentures ("**OCDs**") would be deemed external commercial borrowings[3], the FVCI route provides massive fillip to investors to be able to invest in all such instruments through the same route.
- As opposed to any other form on non-resident investment, any debt investment under the FVCI route is not subject to any lock-in requirements.

On the other hand, some of the drawbacks of the FVCI route are as follows:

- Any investment by an FVCI into NCDs can be made only in investee companies in which the FVCI holds either equity shares or equity linked instruments (compulsorily or optionally convertible instruments). This poses challenges at times for a pure NCD investment.
- The FVCI route is available as an option only for investors looking to invest into the sectors specified above. For investments into any other sector, the FVCI route may not be used. Accordingly, sector agnostic investors look at this route with skepticism.
- The FVCI is subject to certain diversification norms. The FVCI may invest only up to 33% of its investible funds (defined as fund committed net of expenditure for administration and management of the fund) into debt instruments.

6. ***Considering that FVCIs are permitted to invest in companies that do not have their securities listed, how are the securities law exemptions provided in FAQ 5 relevant?***

While FVCIs are permitted to invest only in unlisted securities, they are permitted to hold on to the shares upon the listing of any investee company. In case of investment into OCDs, investors prefer to hold on to their securities (post conversion) and sell the securities on the floor of the stock exchange, getting a higher return and benefitting from lower tax rates as well. Alternatively, the investors can seek an exit by asking the investee company to redeem the instruments at any time as well.

7. ***Considering the diversification norms mentioned in FAQ 5 above, is this route suitable for debt investments?***

While the diversification norms require not more than 33% of the investible funds to be invested in debt securities, convertible debt instruments (whether optionally convertible or compulsorily convertible) are not computed in the 33% limit, and hence provide the investors adequate investment opportunities.

8. ***Considering the pros and cons we have seen above, where does FVCI investments become useful?***

FVCI is a critical tool for certain investors. The FVCI route is used extensively in some cases.

- Infrastructure sector: A strategically important sector requiring extensive capital, infrastructure sector has seen extensive investment under the FVCI route. The option to invest by way of a mix of equity and debt has attracted substantial foreign interest. A large number of investors have used this route to invest nominal equity and majority investment by way of debt.
- Bridge financing: Investors have also looked at the FVCI route as a route for bridge financing, to meet cash flow mismatches or unexpected cash requirements. As opposed to any other route, which are administratively more cumbersome and expensive, and is subject to minimum lock-in requirements, the FVCI route provides a good alternative to investors for short term, freely repatriable investments.
- Composite investment vehicle: While the investors may be registered as an FVCI, the same entity may also invest in India under the FDI Route. This provides investors the ability to benefit from the arbitrage of both routes through a single entity. Accordingly, for sectors where FVCI investment is permitted, the FVCI route is used, and for others, the investment is made by the same entity under the FDI Route.
- Social impact funds / sovereign funds: Considering the areas that social impact / ESG funds focus on (concentrated around infrastructure and related areas), FVCI offers them a good alternative. Additionally, a large chunk of investment by sovereign funds is focused on infrastructure, making FVCIs a preferred mode of investment by them due to the reasons mentioned above.

For the reasons mentioned above FVCI route has been a popular mode of funding for certain sectors and class of investors.

Debt Funding Team

[1] 'Infrastructure Sector' has the same meaning as given in the Harmonised Master List of Infrastructure sub-sectors approved by Government of India vide Notification F. No. 13/06/2009-INF dated March 27, 2012 as amended/ updated

[2] See our paper Offshore Funding Routes: Foreign Portfolio Investors for details of the FPI route **here**.

[3] See our paper Offshore Funding Routes: External Commercial Borrowings for details of the ECB route **here**.

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