

**Report and Recommendations of the Committee on
'Launch of Dedicated Infrastructure Funds (DIF's) by
Mutual Funds'**

(Mumbai, July 23, 2007)

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Executive Summary

1. The basic infrastructure a country develops is the backbone for its long-term economic growth and employment generation. It is not possible to achieve inclusive and sustainable growth without the creation of enabling infrastructure in an economy. To sustain its current economic growth trajectory, India will need to develop and augment infrastructure in all the key sectors like Power, Roads, Urban-Infrastructure, Rail, Ports, Airports etc.
2. A sustainable and long-term shift to 9-10% GDP growth rate is only possible if the country is able to channel large investments in infrastructure creation. Various government bodies & Committees, international agencies and research houses point to the investment requirement for the infrastructure sector, during the next five years, to be in the range of US\$280bn-US\$475bn. Considering the magnitude of investments required during the next five years, it is imperative to tap all available sources of the capital and a significant role needs to be played by the private sector. Emerging funding patterns include Toll structures, Build-Operate-Transfer (BOT), Public Private Partnership (PPP) etc. Traditional investors into infrastructure have been the Government, Banks & Financial Institutions and lately foreign investors through the FDI route.
3. In the 2007 Budget speech for the Financial Year 2007-08, the Hon'ble Finance Minister mentioned the need to promote the flow of investment to the Infrastructure sector by permitting domestic mutual funds to launch and operate dedicated Infrastructure funds. With a view to suggest a detailed action/plan for 'operationalising' this, the Securities & Exchange Board of India (SEBI) had set up the Committee to suggest the broad guidelines for launch and operations of Dedicated Infrastructure Funds (DIFs).
4. India is a country of savers. The household savings rate to GDP hovers around the 30% mark. Household savings have traditionally been channelised into Bank Deposits, Small Savings Schemes of the Government, Insurance etc. With the advent of mutual funds, it has been observed that these have increasingly become a significant channel for focused investment into the listed equity and debt

markets. Similarly, DIFs, can potentially become an important source of capital for various infrastructure projects that are important for the country's economic development. Such funds can act as channeling agents of capital from Indian retail investors, pension funds, insurance companies as well as overseas institutional investors. DIFs, if they are successful in attracting large retail-investor participation, can also reduce dependence upon foreign capital for investments in infrastructure assets. From an investor perspective, DIFs can also provide an alternative investment opportunity to retail investors and ensure broader public participation in the infrastructure creation in the country.

5. The proposed DIF's will need to be structured differently from the current Mutual Fund Schemes, as these will largely invest in unlisted companies, with longer gestation periods. Venture Capital Funds have the ability to invest in such unlisted and longer tenure projects, but have high minimum contribution requirements, thus leaving out the retail investors. DIFs can be structured to fill this gap and can be uniquely positioned to benefit both the ongoing infrastructure initiatives as well as the potential retail investors.
6. **Structure:** The Committee believes that DIFs should operate as close-ended schemes with a maturity period of seven years and a possibility of one or two extensions, subject to adequate disclosures in the offer documents and approval of trustees.
7. **Liquidity:** The proposed DIF's should get listed within 24 months of the launch of the scheme and be allowed to buy-back the units, from the market within certain limits to safeguard the interests of investors.
8. **Types of investments permitted:** In terms of Investments, it is suggested that the DIF's may be allowed to invest up to 100% of its funds into unlisted securities including both equity and debt instruments. Exposure to listed companies, however, should be limited to 10% of the NAV at the time of making the investments. Further, the DIF's may be allowed to take control of the asset, if they so desire, and own up to 100% of the paid up capital of a company. The

Committee has suggested safeguards to protect the interest of investors. However AMCs can adopt different approaches to achieve the objective.

9. **Exit:** The DIF's can look to exit the investments through strategic sale, IPO's, buyback agreements, etc.

10. **Fees and Expenses:** In light of the unique nature of DIFs like dedicated teams for the management of such schemes, requirement of in-depth research because of companies being unlisted and information not being available, higher level of monitoring of investments, the fee structure of such funds will have to be different from the existing Mutual Fund schemes, in line with global practices. The Committee therefore suggests that maximum overall permissible expense ratio for DIFs including investment management fees be additional 1% over and above that specified in the Mutual Fund Regulations. Additionally, the DIFs should also be allowed to charge a performance fee after providing a certain minimum return to the unitholders, as per global practice.

11. **Valuation Norms and Disclosures:** The DIF's should report the fund NAV at the time of each asset valuation and also at quarterly intervals. About valuations, the Committee believes that current SEBI guidelines to value unlisted equity shares will need to be suitably amended for the proposed asset class. The proposed DIFs should engage an approved consultant to value the assets semi-annually. Such an approved list can be drawn up by the SEBI registered rating agencies. Approved consultants for respective DIFs, however may be replaced every three years as a matter of good corporate governance.

12. **Eligible Sponsors:** The Committee proposes that the DIFs can be launched by all SEBI registered AMCs, but should have a dedicated team for managing the funds and their trustees should be satisfied in this respect.

13. **Investor Profile:** The Committee suggests that all the individual/ companies/ corporates/ institutions and FI's should be eligible for making investment in such mutual funds. The profile of DIFs in terms of tenure, risks and returns are also complimentary to liability side of insurance companies and pension funds.

Therefore, Govt./concerned Regulators may also consider modifying the investment guidelines for Insurance/pension funds and provident funds so that they could invest directly in such type of mutual funds, as it will serve the twin purpose of meeting sectors' capital needs as also in managing risk-return requirements of Insurance Companies and Pension Funds.

14. **Disclosure of risk factors and reporting of compliance:** Risk factors relevant for such schemes may be disclosed in the offer documents and advertisements for the launch of such schemes so that the investors may take well informed investment decisions. In addition to disclosure of the NAV's and annual accounts of the scheme, the DIFs may also report financial review of each investee company and the status of implementation of various projects, on quarterly basis. The valuation methodologies may be approved by the trustees and may also be disclosed to investors. The trustees shall review the performance and compliance of regulations in case of DIFs in their periodical meetings and shall report it to SEBI in their reports submitted to SEBI in accordance with regulations.

15. **Tax Benefits:** Considering the long-term and close-ended nature of the proposed DIFs, the Committee believes that it will be extremely important to provide some tax incentives to retail investors to motivate them to invest in DIFs and therefore help in and benefit from the infrastructure creation in the country. The Committee also believes that without the tax incentives no retail investor would be motivated to invest in a DIF. Tax benefits may be provided by (i) enhancement of limit under Section 80C from Rs.1,00,000 to Rs.2,00,000 with the incremental limit exclusively set apart for investment in designated infrastructure funds and (ii) Capital gains arising on account of transfer of long term capital assets may be exempted from tax if the capital gains amount is invested in DIF units for a period of 7 years. However, such tax benefits should be available only to the original investors.

Background

In the 2007 Budget speech for the Financial Year 2007-08, the Hon'ble Finance Minister while announcing the various measures for strengthening the capital market made the announcement of the need to promote the flow of investment to the Infrastructure sector by permitting domestic mutual funds to launch and operate dedicated Infrastructure funds. With a view to suggest a detailed action/plan for 'operationalising' this, the Securities & Exchange Board of India (SEBI) set up a Committee, through its letter on "Formation of a Group regarding launch of dedicated Infrastructure Funds by Mutual Funds" dated 26th March, 2007 (Annexure 1), headed by Mr. UK Sinha, Chairman and Managing Director, UTI Asset Management Company Pvt. Ltd. The other members of this Committee are:

1. Mr. Milind Barve, Managing Director, HDFC AMC Limited
2. Mr. S Naganath, President and CIO, DSP Merrill Lynch Fund Managers
3. Mr. PK Nagpal, ED-SEBI as the Member Secretary

The Committee was advised to submit its report within three months. The term was extended by a month at the Committee's request. The Committee had its first meeting on 2nd April 2007 followed by four other meetings and also had informal interactions over the phones and through e-mails. The Committee also had extensive discussions with experts in India and abroad, which included asset management companies, private equity and venture capital funds, infrastructure companies and developers and banks.

This report presents the recommendations of the Committee, along with the background on India's infrastructure investment needs and the current status on the available routes of funding. It has examined what needs to be done to operationally permit Mutual Funds to launch dedicated infrastructure funds.

Methodology

In formation of the report and the recommendations for the launch of DIFs the Committee has followed a consultative and analytic approach. The Committee solicited views of more than 20 experts in the Infrastructure and Financial Services

industry from India and abroad. During the whole process the Committee met leading industry experts and also examined presentations on wide-ranging issues like sector specific needs, regulatory policies and regulations, international best practices, regulations and tax regimes in other markets, investor interest for investing in such funds, economic viability of proposed DIFs etc. International experience in global markets, specifically Australia, Singapore and South Korea which have successful operating models for Infrastructure funds were also evaluated by the Committee (Annexure 2). Various aspects for the successful launch and operation of DIFs were researched using experts' help, research reports, regulations and other publicly available data.

Acknowledgments

At the outset the Committee wishes to acknowledge the contributions made by the following, through sharing their experience, views and knowledge on the subject:

Mr. Deepak Parekh, Chairman, HDFC Ltd. & Chairman, Committee on 'Infrastructure Financing'

Mr. S.S. Kohli, Chairman & MD, IIFCL

Mr. Tantra Narayan Thakur, Chairman & MD. PTC India

Ms. Renuka Ramnath, MD & CEO, ICICI Venture

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Mr. K.E.C. Rajakumar, MD & CEO, UTI Venture Funds

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Mr. Syed Shahabuddin, MD & CEO, SBI Funds Management Pvt Ltd.

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Mr. S. Vaidya Nathan, Head-Product & Risk Management, Sundaram BNP Paribas AMC

The Committee also looked closely at global practices in this area and for this purpose is grateful to Mr. Nick van Gelder, ED, Infrastructure & Specialized Funds, Macquarie Bank for his views and Mr. Stuart Smythe, Division Director, Head of Equity Asia, Macquarie Bank for his help in answering various queries and the

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SECTION A. India's Infrastructure Investment Needs

1. Investment requirements with respect to XI plan growth target

The Planning Commission's "Approach Paper to the 11th Five Year Plan" (2007-2012) stresses the need for infrastructure development in India. It states that it is possible to increase the base-line growth rate of the economy (viz. the growth that is likely to be achieved without significant new policy initiatives) from around 7% to 7.5 % per annum to close to 9% with acceleration through the Plan period to end with a rate of around 10%. This will require enormous capital infusion in developing the infrastructure in all core sectors like Power, Roads, Ports, Airports, Rail and Urban Infrastructure.

Various government bodies & Committees, international agencies and research houses point to the investment requirement for the infrastructure sector, during the next five years, to be in the range of US\$280bn-US\$350bn. The Deepak Parekh Committee on 'Infrastructure Financing' estimates that the investment requirements now has gone up to US\$475bn at current prices.

Some of the sector-wise investment requirements and opportunities are²:

Power	Total investment opportunity of about US\$ 200 billion over a seven year horizon.
Roads	Over US\$50–60 billion investment is required over the next five years to improve road infrastructure.
Rail	The dedicated freight corridors in the Western and Eastern high-density routes will require investments in about US\$ 5 billion.
Ports	Investment need of \$13.5 billion in the major ports under National Maritime Development Program (NMDP) to boost infrastructure at these ports in the next 7 years. Additionally, investment need of US\$4.5 billion for improving the minor ports.
Airports	Estimated investment of about US\$ 9 billion for airport development over the next 5 years
Telecom	Investment opportunity of \$22 billion across many areas.

¹ Towards faster and more inclusive growth- An approach paper to the 11th Five Year Plan, Planning Commission. http://planningcommission.nic.in/plans/planrel/app11_16jan.pdf

² <http://infrastructure.gov.in/publications.htm>

Considering the magnitude of investments required during the next five years, it is imperative to tap all sources of the capital to achieve the targets. According to some estimates, out of about US\$300 billion investment requirement, about 50% will have to be funded through the private sector. This includes PPP's at various levels and also various investor classes like developers, FDI, Banks and domestic retail investors.

As per the approach paper, to fund the investments and to increase the growth rate from 7% to 10% will require the average investment rate to go up from 29.1% of the GDP currently to 35.1%. Additionally, an enabling policy and economic environment will have to be created to direct savings and investments into the infrastructure sector.

2. Progress and likely sources of funding:

Looking at the current scenario, the Committee noted that a good amount of progress has been made on several fronts, especially in roads, telecom, ports and airports sectors. However, significantly more investments are needed to achieve the 9-10% growth target.

The funding requirement for infrastructure creation is very large compared to India's past experience. Foreign capital is a likely source, but it needs to be balanced due to the resultant impact on the currency and inflation. In this context, it becomes even more important to access more avenues of domestic capital-both retail and institutional.

An overview of the different sources of funding is shown below. There are three broad sources of equity capital for funding Infrastructure creation:

1. Public Sector

- Government Budgetary Support
- Multi-lateral Grants
- Internal accruals and borrowings of the PSE's (Public Sector Enterprises)

2. Private Developers

3. Investors

- Strategic Investors
- Investments in listed companies
- Investments (through infrastructure funds) in unlisted companies

To develop a world class infrastructure, within the shortest possible time frame, the country will need to target all sources of funding. The focus of this report is on dedicated infrastructure funds (targeting retail and institutional investors) investing in unlisted infrastructure projects and companies.

Section B: Current Status on Regulations and Investments in the Infrastructure Sector

Currently, in India, financial investors can invest in infrastructure through the following two routes:

1. Through Mutual Funds
2. Through other routes (Private Equity / Venture Capital)

1. Investments through Mutual Fund Route

Mutual Funds can invest through the listed equity route in infrastructure companies. At this point, there are around ten Infrastructure focused mutual fund schemes launched by certain Mutual Fund houses. These schemes mainly invest in listed companies that either

- own or operate infrastructure assets or
- provide services to companies operating infrastructure assets or
- are involved in the value chain in the creation of infrastructure assets.

This route of investments in infrastructure has done well in terms of garnering assets (the total assets under management as on 30 Mar 2007 in all such funds was Rs8,522 crores, the details are mentioned in Annexure-3. However, looking closely, these funds direct investments mainly to listed companies. The investment restrictions on such funds are listed out in Annexure-4. According to these restrictions, open ended and close ended mutual fund schemes can only take limited exposure to unlisted securities (5% & 10% respectively). To sum up, these funds can not direct investments to core infrastructure projects or companies that are unlikely to be listed and have a short operating history.

2. Investments through Other Routes (Venture-Capital/ Private Equity Investments) in Infrastructure Sector

Currently domestic investors can invest in Infrastructure assets through the Venture Capital Route. This involves setting up a fund company or a trust and registering the same with SEBI under the SEBI Venture Capital Funds Regulations 1996. This Fund company or Trust can then in turn raise monies from any investor whether Indian, Foreign or Non Resident Indian by way of issue of units. However the Venture Capital Route also faces the following issues:

- **Liquidity:** No venture capital fund can get its units listed on a recognized stock exchange until the expiry of three years from the date of the issuance of units by the venture capital fund.
- **Promotion and Reach:** No Venture Capital Fund can advertise in any public domain for the subscription or purchase of any of its units.
- **Investment Size:** Minimum investment size for an investor is Rs. 500,000. Therefore retail investors are not in a position to invest through this route.
- **Investment Restrictions:** All investment made by the venture capital fund shall be subject to the following conditions:
 - It should disclose the investment strategy at the time of application for registration
 - It should invest at least 75% of the investible funds in unlisted equity shares or equity linked instruments.

Therefore it would not be possible under the existing regulatory (SEBI VCF Regulations) to allow wider retail investor participation in the Infrastructure Sector by directly owning infrastructure assets through the venture capital route. Retail investments would require a lower minimum investment size as well as an ability to reach out to investors through public channels.

With effect from April, 2007, the pass through benefits will be available to VCFs only in relation to investments in domestic unlisted companies engaged in the business of:

- (A) Nano technology,
- (B) information technology relating to software and hardware development
- (C) seed research and development,
- (D) biotechnology,
- (E) research and development of new chemical entities in the pharmaceutical sector,
- (F) production of bio-fuels
- (G) building and operating composite hotel-cum-convention center with a capacity of more than three thousand;
- (H) developing or operating and maintaining or developing, operating and maintaining any infrastructure facility as defined in the Explanation to Clause (i) of sub-section (4) of Section 80-IA;

(I) dairy or poultry industry;

“Venture Capital Undertakings (VCUs) means such domestic company whose shares are not registered in recognized stock exchange in India and which is engaged in the business as mentioned above.”

Section C- Definition of Infrastructure

The Committee noted that there are separate definitions of infrastructure under the various Rules/Regulations (such as those relating to banks and insurance) and Acts (such as Income Tax Act). There is a need to harmonise the definition of infrastructure to bring together the interests of various bodies involved in the creation (investors of various types) of and regulation (RBI, SEBI, IT Department, IRDA etc.) of the sector.

The Deepak Parekh Committee on Infrastructure Financing suggests (in its interim report) that “the RBI’s definition provided in Annexure I of the circular dated October 10, 2006 be adopted as the definition under IRDA (Registration of Indian Insurance Companies, 2000) as well as under Income Tax Act, with the only exception that the definition should explicitly include pipelines”.

However, for the success of the proposed Dedicated Infrastructure Funds (hereafter referred to as DIF’s) it is important to preserve the tax benefits provided under the IT Act. This will enable the investee projects and companies of the DIFs to have a tax efficient structure.

In the interest of timely launch of the DIF’s, the Committee suggests that the definition provided under Section 80IA of the Income Tax Act may be considered as the definition of Infrastructure for the purpose of regulation of DIF’s.

The applicable definition, however, may be amended if so required, if and when the definition under the IT Act is amended to comply with the RBI definition. The business of “Infrastructure under sub-section (4) of Section 80IA of the Income tax Act provided in Annexure-5 is attached to this report which can be adopted for this purpose.

Section D: Structure, Regulations and Operations of the proposed DIFs: Issues and Suggestions

This section discusses the proposed suggestions (along with the rationale of the same) to make the DIF's a successful source of capital for infrastructure creation in the country. It also discusses various structural and operational issues the proposed DIF's are likely to face and proposes ways to address the same. The suggestions are organised along the following heads.

Structure of DIF's

- i.) Maturity Period**
- ii) Liquidity**
- iii) Draw Downs**
- iv) Types of Investments Permitted**
- v) Exit**
- vi) Fees and Expenses**
- vii) Valuation Norms and Disclosures**
- viii) Eligible Sponsors**
- ix) Investor Profile**
- x) Nomenclature**
- xi) Disclosure of Risk Factors & Reporting of Compliance**
- xii) Tax Benefits**

Structure of DIF's

The existing regulations regarding launching of mutual fund schemes can be made applicable to the proposed DIFs. This would essentially require the formation of a separate scheme under the mutual fund (Trust) with a specific investment mandate. However, certain key characteristics of the proposed DIF's will need to be fundamentally different from the Mutual Fund Schemes currently in existence, as the proposed investment by DIFs will largely be in unlisted projects and companies, with gestation periods of up to 7 years. The main differences resulting from this will be related to the aspect of Product Structure, Liquidity, Valuation, NAV Reporting, Fees and the maturity period of these schemes.

Keeping in mind the nature of investments, it is suggested the proposed DIFs should operate as close-ended schemes with some flexibility provided in the maturity period. We discuss the relevant issues in the following sections.

i.) Maturity Period

Committee's recommendation:

- **The Committee believes a maturity period of seven years with a possibility of one or two extensions, at the behest of unit-holders, could be optimal. However, it may be desirable to give the flexibility of deciding the term of the product to the concerned mutual fund subject to adequate disclosures in the offer documents and approval of trustees.**
- **At a later point, the option of multiple extensions to DIF's to allow them to operate to perpetuity (thereby recycling the capital across projects) could be considered.**

Recommendation Rationale:

- Infrastructure projects generally have a long gestation period involving a construction period followed by a break-even period. A typical project may take 1-2 years in conception and pre-planning stage, 2-5 years in construction and 5-15 years to give acceptable returns to equity holders. A seven-year initial maturity period provides the developers and fund managers an opportunity to unlock value through optimizing the performance and capital structure of the asset.
- The investment evaluation process would be lengthy and it is envisaged that the proposed DIF's could take 12-24 months to deploy the funds in to projects.
- Globally most unlisted long gestation funds have similar 7-9 year terms, generally extendable by 1-2 years. It may be difficult to exit all investments at a certain point in time. In some cases, at the end of the seven year period, the underlying project may be close to attaining a milestone that could help in enhancing the value. Also obtaining the best prices may be a function of market conditions in some sectors. Hence an option of a 1-2 year extension would give flexibility to the DIF to negotiate / get the best price for the investments. However, DIFs should make adequate disclosures with respect to extension options in the offer document for the launch of such schemes.

ii.) Liquidity

Listing and timing of listing

Committee's recommendation:

- **The proposed DIF's should be listed on at least one of the recognized stock exchanges, thereby providing liquidity to investors. Such funds can be traded on exchanges just like other close-ended, listed mutual fund schemes.**
- **However, while close ended schemes get listed on the exchanges after a short time, early listing of DIFs may not be desirable as the underlying investments would happen in a staggered fashion. It is therefore suggested that the DIF, should get listed within 24 months of the launch of the fund. This will provide some medium term liquidity to the investors and also give the DIF's a window to deploy the funds.**
- **The proposed DIFs may be allowed to buy-back the units, from the market, from investors up to a maximum of 20% of the initial unit capital, during the life of the fund.**
- **However there are other pre-requisites to and associated risks with the listing of proposed DIF's, that should also be given due consideration.**

Recommendation Rationale:

- **The proposed DIFs will target the retail investor, who might be averse to investing in a close-ended fund with no liquidity options during the term of the scheme. Listing at an appropriate time can allay such reservations.**
- **The Committee believes that a 24 months listing option for the DIFs is optimal as it addresses liquidity need of investors while trying to avoid negative fallout of units trading at a discount during the investment phase of the fund. For the success of proposed DIF's, its important to meet the liquidity but also avoid the negative perceptions if units trade at the discount to the initial investment price. This can happen in the initial period for the following reasons:**
 1. **The proposed DIF will have a two year period where it will be in the investment mode, and would have fully deployed the funds only after this period.**
 2. **The nature of infrastructure projects, discussed above, will include a gestation period where the project could be loss making. Thus, the NAV performance of**

the DIFs may suffer during the initial periods. This could have a negative impact on the listed price and generate adverse reactions from investors who exit early. Hence providing a listing window of 24 months will help the DIF to deploy a substantial portion of the funds as well as some investments might move beyond the initial construction / build-out period.

- Listed infrastructure funds are quite prevalent in Australia. Additionally Singapore, South Korea and Europe have such funds. Retail participation has been around 30%-35% in the Australian markets, which have a longer history of dedicated infrastructure funds. The funds have also become extremely popular with Pension Funds and Insurance Companies in Australia. However the initial retail investor participation in South Korea has been lower.
- **Buyback from the market-** Providing the proposed DIFs the flexibility of buy-back will be in the investors interest as:
 - If a DIF has not been able to fully deploy the funds in a given time-frame, repurchasing and extinguishing units can narrow discounts of the unit price in the market (if any, compared to NAV) and provide better valuations to existing investors.

iii.) Draw-downs

Committee's recommendation:

- **The Committee proposes that the DIF should be raised in a single tranche.**
- **While the money raised would be invested over the next 12-24 months, in the interim the funds may be allowed to invest the proceeds in money market instruments.**

Recommendation Rationale:

- Despite the large need for infrastructure investments in India, the assets available for investment at any point in time could be limited. The DIF's would need to build a pipeline of investments, and the Committee did look at the possibility of such DIF's raising capital in 2-3 tranches as investment opportunities are identified. However, looking at the operational issues and involvement of large

number of retail and lay investors would make the process complex. Hence it was proposed that the DIF's should raise money in a single tranche.

- Globally, in some cases, few of the infrastructure assets are first acquired by the sponsoring AMC/Company and are warehoused. These assets are then transferred to the fund at the time of the launch.

iv.) Investments Permitted (Asset classes permitted)

Committee's recommendation:

- **It is suggested that DIF's be allowed to invest up to 100% of its funds into unlisted securities**
- **It is suggested that the DIF's should be eligible for investing in both equity and debt to balance the needs of the sector**

Recommendation Rationale:

- As discussed in the earlier section, investments in listed securities can be carried out by existing mutual funds. However, a large part of infrastructure financing happens into unlisted companies / projects / Special Purpose Vehicles (SPVs). To, be able to participate in this segment, it is therefore necessary to direct investments through the proposed DIF's into such unlisted companies.
- Most infrastructure projects have a long gestation period but fairly predictable revenue and cash flow streams. The nature of such projects, thus make them suitable for high gearing, thereby offering superior IRR's to project developers and equity investors. Hence the opportunities for debt investments in the infrastructure sector will be available and could generate returns for fixed income investors.
- Further, the size of several infrastructure projects is also very large, which can only be funded through highly geared and complex capital structures. It is important, therefore, to offer the flexibility to the proposed DIF's to invest in most of the instruments, which are convertible into equity at a later date, floated by infrastructure projects and companies.
- It was also felt that the flexibility to create a mix of debt and equity instruments could also provide retail investors with differentiated DIFs to choose from, based on their risk appetite.

- Additionally, investing in securitised papers and equity linked (convertible) products can enable the DIF's to manage the risks a lot better. Some of the equity linked (convertible) instruments offer a mix of capital protection as well as upside (akin to equity investments), making them an ideal investment vehicle for retail-targeted funds.

Investments Permitted (Limits):

Committee's recommendation:

- **It is suggested that the DIF's may be allowed to take control of the asset, if they so desire, and own up to 100% of the paid up capital**
- **Exposure to listed companies should be limited to 10% of the NAV at the time of making the investments.**
- **To reduce risks and to enable proper diversification of the funds, DIF's shall not invest more than 20% of their NAV in the equity/debt/hybrid-instruments of a single issuer.**
- **It is suggested that DIF's may be allowed to invest up to 50% of their NAV in un-rated debt papers against the 25% limit currently applicable (SEBI Mutual Funds Regulations, 1996, Seventh Schedule 1A). In all cases, the existing requirement of the approval from the Trustees would be applicable.**
- **AMC should exercise due diligence while investing in Infrastructure companies to mitigate the associated risks.**

Recommendation Rationale:

- The Committee felt that there should be no restrictions to the maximum ownership/ voting rights in a particular company. The proposed DIF's should be allowed to own up to 100% of the paid capital of any company as against the 10% limit applicable currently (SEBI Mutual Funds Regulations, 1996, Seventh Schedule 1A).

It is envisaged that specialized and dedicated teams would manage the proposed DIF's. The teams will be making investments in a limited number of companies. The monitoring of each investment thus will be much more rigorous compared to the current Mutual Fund investments in listed companies. The proposed DIF's will be making substantial investments in one single company for a long period. The

voting rights and a possible control over the asset/company will enable the DIFs to better manage the asset and protect their interest.

- In future, there could be opportunities for the proposed DIF's in listed infrastructure companies. The Committee felt that having a 10% limit on such investments would allow the DIF to invest in such opportunities. However, it was also felt that given the objectives of such DIF's and to restrict any use of the proposed DIF scheme as a normal Mutual Fund Scheme—a 10% limit would be appropriate.
- The focus of DIF's must be to source long-term funds with tenures of at least 5-10 years. Hence the restrictions on investment in unrated papers will need to be relaxed.
- It is suggested that there should not be any restrictions on sectoral limits (within the broader infrastructure sector) for the proposed DIF's to invest in. As an extension, the proposed DIF's could be allowed to launch sector focussed DIF schemes (e.g. a Power sector DIF)
- There are a number of risk factors associated with launch of infrastructure projects like construction risk, operating risk, market risk, interest-rate risk and other regulatory & political risks. The Asset Management Companies (AMCs) must ensure that the investee company has taken adequate steps to mitigate these risks. DIFs should follow prudential investment norms and may consider certain factors while investing in securities of infrastructure companies.
 - AMCs should undertake due diligence on the viability of such projects to ensure that revenues stream from the project is sufficient to take care of the debt servicing obligations. They must develop their own internal appraisal mechanisms to evaluate such projects. They must undertake proper credit appraisal and invest only in those projects that are intrinsically viable. Ideally, investments should be made after financial closure of such projects. The mutual fund may also consider whether there are guarantees from the Government pertaining to events over which it has full control like various approvals from the Government, non-interruption of projects and performance of specific Government obligations.
 - Bonds are the preferred way for infrastructure companies to raise long-term finance. Banks and insurance companies lend to infrastructure projects and

various international agencies also participate in such projects. Therefore, it may be considered that the DIFs invest in those projects in which other banks, domestic and international financial institutions also participate by way of equity or debt. Thus the project would be appraised and monitored by other institutions also. The AMCs may also consider having first / pari passu charge on assets of the infrastructure company against the debt instruments subscribed by them.

- DIF may also consider investing 50% of its funding in any infrastructure company by way of debt and the remaining may be by way of equity. This would mitigate the risk and enable the scheme to get constant stream of returns and also help it in meeting various expenses of the scheme. However, its practicability would have to be examined considering various factors like the type of project, its likely revenue streams and investment objective of the DIF.

The committee felt that the asset management companies may consider the above approaches or may develop alternative approaches to mitigate the aforesaid risks and safeguard the interests of investors and achieve the objectives of the DIF scheme, which may be recorded and approved by the trustees.

v.) Exit from the investments

Committee's recommendation:

- **The DIF's can look to exit the investments in one or a combination of the following options:**
 - **Strategic Sale-** The stake in a particular project can be sold to a strategic investor interested in a particular asset.
 - **Sale to Financial Investors-** The stakes in a particular project can be sold to an interested financial investor looking for steady cash flows. The investor could be in the form of and FI, FII, bank or a fund.
 - **IPO's-** Another exit opportunity could be an IPO of the asset/investee company in the domestic or an overseas market.

- **Buyback Agreements with promoters and partners-** The DIFs can also seek buyback options with the asset operators and their financial partners co-investing with them.
- **Concession Expiry –** Since many of the infrastructure projects are based upon a fixed concession (fixed lease) term, expiry of a concession (lease) will give them an automatic exit, presumably after providing the investors with expected returns on the investment.

vi) Fees/ Expense ratio

Committee's recommendation:

- The Committee feels that a fee structure for the proposed DIF's will have to be different from the existing norms (SEBI Mutual Funds Regulations, 1996, Regulation 52) and should be aligned to globally accepted best practices.
- The Committee's recommendations on each of the following (1) an Overall Expense ratio (2) a Management Fee and (3) a Performance Fee:
 - The Committee suggests that maximum permissible expense ratio for DIFs be additional 1% over and above as specified in the SEBI MF Regulations
 - The Committee suggests that the proposed DIF may be allowed to charge up to 1% above that prescribed under SEBI Mutual Fund Guidelines as indicative investment management and advisory fees (as a part of overall expense ratio, as suggested above).
 - Additionally, the Committee suggests that the DIFs be allowed to charge 20% performance fee above the hurdle rate. This performance fee will not be a part of the expense ratio, as stated above. The Committee suggests a hurdle rate of at least 10%. A hurdle rate is the minimum required return, per annum, that the fund must achieve, before the sponsors receive a performance fee. The performance fees will become payable at the closure of the fund.

Recommendation Rationale:

- The proposed Dedicated Infrastructure Funds will largely invest in unlisted infrastructure projects and/or companies. The level of expertise, resources and commitment required to manage these investments will be significantly higher than as well as different from that used for existing Mutual Funds. Some of the factors, which will increase the cost of managing and operating proposed DIFs compared to current Mutual Funds are:

1. **Higher Investment Costs-** Listed instruments are fairly liquid and provide managers an option of easy entry and exit. However, in the unlisted space, the process of both entry and exit can be quite lengthy and complex. For every single investment a DIF makes, it will have to evaluate multiple investment options (the Committee's discussions revealed that the ratio of investment options selected could be one out of ten selected for detailed analysis). The costs associated with the evaluation of the projects, in which the DIFs do not invest, will therefore be significantly higher compared to other mutual funds. These will include expenses related to legal fees, due-diligence costs, travel costs, advisory fees etc, apart from higher managerial time and effort spent on each investment idea.
2. **Expenses related to periodic valuations-** The NAV calculation for current Mutual Fund schemes is based upon the market prices of the securities. However for investments in Unlisted space DIF's will have to engage external parties (discussed later in this report) to periodically value the investments, thereby increasing the costs.
3. Listed securities are well researched by in-house research teams as well as several sell-side brokers, making the cost of researching companies lower. Most of the companies have a fairly long history and a lot of information is publicly available. However, in the unlisted space, information flow is restricted and there is practically no third-party research available. DIF's will need to do all the basic research to be able to meaningfully evaluate investment proposals.
4. **Investment monitoring Costs-** The DIFs will have to continuously monitor the performance of investee projects. The level of involvement of a DIF, with

each investment, will be extremely deep. As per prevailing international practices, DIFs may need to invest time to provide inputs to strategic decision making, board level decisions (probably with a seat on the board of the investee companies) and even day-to-day functioning of the investee companies. All this will result in higher commitment and efforts on the part of senior team members of the Mutual Funds.

5. **Requirement of a dedicated Team:** Unlike existing Mutual Funds where the same team may manage multiple schemes, the proposed DIF's will need to be managed by dedicated teams. As per international best practices, a fully dedicated team manages such funds. Both the investment evaluation and monitoring processes will be time-consuming. Additionally, the team managing the funds shall ideally stay with the investments through the full cycle (7-9 years) and internationally is thus compensated for their longer commitment.
6. **International Best practices-** A study of the global best practice shows a dual fee structure to be prevalent. This comprises a management fee and a performance fee. The Committee's recommendations are on the lines of these practices.
 - **Management Fees-** This is the fee charged on the AUM and generally varies between 1.5%-2.5%.
 - **Performance Fee/ Carried Interest/ Incentive-Fee -** These terms are generally used interchangeably. This is the fee paid to the manager once the DIF has delivered the hurdle or base rate of return agreed upon to investors. The incentive fee is generally expressed as a percentage of the total profits of the fund. The industry practice globally is 20%. Thus, the investment manager will receive 20% of the profits generated by the fund over and above a certain rate known as hurdle rate. This fee helps align the interest of the investment manager with those of the investor.
 - **Hurdle Rate-** The hurdle rate as stated above the minimum rate of return agreed upon and that the DIF will seek to deliver to its investors. It can either be flat figure or linked to a certain benchmark. However, the Committee felt it is better to keep the hurdle rate as fixed percentage to

avoid confusion with investors and to provide clarity of the possible returns to both investors and the managers.

vii) Valuation Norms and Disclosures

Committee's recommendation:

- Overall, keeping in mind the international best practices the Committee recommends the following valuation practices:
 1. **Frequency of valuation of investments:** Individual assets should be valued at each half-yearly anniversary of the investment.
 2. **Report the fund NAV at the time of each asset valuation / revaluation:** While calculation and reporting of NAV on daily / weekly basis is not practical in such schemes, the Committee felt the proposed DIF's should report the NAV to the investors at the time of every valuation of each asset and also at each quarter end so that the investors know the performance of the company more frequently.
 3. **Third-party valuations:** The DIF's should engage an approved consultant to value the assets semi-annually . Such an approved list can be drawn up by the SEBI registered rating agencies and could comprise Institute of Chartered Accountants of India (ICAI) members.
- The Committee envisions involvement of different parties in the valuation exercise for the investments
 - i. **Rating Agencies-** The SEBI registered rating agencies can draw a list of approved consultants to value underlying investments (companies or projects). The rating agencies themselves can also act as the valuation consultant.
 - ii. **Consultants-** Consultants will value each investment (in the company or projects, as the case may be) of the DIF periodically.
 - iii. **Valuers-** The consultants can in turn appoint valuers for valuation of specific underlying assets of the investee companies, if appropriate. The list of such valuers will also have to be approved by the rating agencies.

- The Committee also suggests that the approved consultants for respective DIFs, be replaced every three years, to ensure stronger governance and transparency.

4. Valuation Methodologies:

The Committee believes that current SEBI guidelines to value unlisted equity shares will need to be suitably amended for the proposed asset class. Instead of the current guidelines, the valuations of the equity shares (assets) should be left upon the discretion of the third party valuers, while following the below mentioned specifications

- Each new acquisition should be reported at cost adjusted for transaction costs.
- Broad parameters of valuations, assumptions and methodology should be clearly defined for each asset at the time of acquisition by respective DIFs and with the approval of trustees.
- Revisions to valuations should be done at the half yearly anniversary of each asset acquisition. This should be based upon any change in original assumptions and sufficient rationale for the change should be provided.
- Assumptions and therefore valuations could change with reference to:
 - Changes to the discounting rate for future cash flows, based on macro parameters like interest rates, inflation, GDP growth estimates, forex rates etc.
 - Reassessment of earnings and cash flows on the project based on the assets' actual performance like construction schedule, achievement of originally stated targets, changes in regulatory environment.
 - Market related factors like recent acquisition in the sector, liquidity etc.
- The Committee suggests that, for valuations methodology application and best practices, the valuers could refer to the International Private Equity and Venture Capital Valuation Guidelines as a reference. These guidelines have been set by various European, Asian, African

and South American Private Equity and Venture Capital associations³.

5. **Disclosures**- In addition to preparation, disclosure and reporting of the NAV's, as mentioned above, and annual accounts of the scheme (as per SEBI Mutual Funds Regulations, 1996, Chapter VIII, General Obligations), the DIFs shall also report financial review of each Investee Company and the status of implementation of various projects, on quarterly basis. The valuation methodologies should also be disclosed to investors.

Recommendation Rationale:

- The valuation norms and NAV calculation methodologies are the most important factors for the success of proposed DIF's as well as to safeguard investor interest. The valuation process will be different from and more complex than that used for current mutual fund schemes. As most of the investments will be in unlisted space, there would not be readily available valuation comparison for these investments.
- Globally, most funds calculate the NAV internally and report it to investors. The frequency of reporting is generally half-yearly. However, in some cases (where the fund is listed and actively covered by the brokers in their research reports) the funds do not declare their NAV's but provide detailed financial statements of the investee companies and leave the price discovery totally to the market forces. However, in the Indian context the Committee suggests that proposed DIF's should get their investments valued thorough a third party and independent approved valuers.
- The current SEBI guidelines to value unlisted equity may be restrictive for the proposed DIF's. The current guidelines (provided in Annexure 6) mandate valuations, at an average of Networth and PE-multiple-based valuations after applying significant 'discounts'. However, high discounts will likely underestimate the valuation of the assets in DIF's and make actual investment in such alternatives practically improbable. Additionally, many of the assets in the initial years might not report accounting profits, making PE based valuations not

³ <http://www.privateequityvaluation.com/>

relevant. Further, some of the assets, to reflect their true value, might need to be valued using methodologies different (e.g. DCF) from Book Value and PE multiples, as stated in the guidelines.

- Instead of the generally followed practice of reporting NAVs at the Fiscal half year-ends, the Committee feels its better to announce NAVs at the half-year anniversary of each investment. In other words, while effectively each asset will be valued only twice a year, NAV would be declared at the time of each such valuation and also at the end of each quarter. This will help smoothen the NAV changes and investors would also know the performance of the scheme more frequently.

viii) Eligible Sponsors

Committee's recommendation:

- **The Committee suggests that all SEBI registered Mutual Funds should be eligible to operate such DIFs. The trustees should ensure that the team managing such DIFs has sufficient, relevant and demonstrable experience to manage DIFs. The team should demonstrate capabilities, in terms of prior experience and team profile, to manage such funds to the trustees.**

Recommendation Rationale:

- While promoting this new investment class, it becomes important to strike a balance between the growth of the asset class and protection of the investor. However, the Committee felt the criteria should be sufficiently broad to motivate all capable and experienced sponsors to launch such funds. Hence all SEBI registered Mutual Funds should be eligible to manage DIF's.

ix) Investor Profile

Committee's recommendation:

- **The Committee suggests that the following measures shall be taken to attract capital to DIF's and to broaden the investment options for the investing public/institutions at large:**

- **All the individual/ companies/ corporates/ institutions and FI's should be eligible for making investment in such mutual funds**
- **Govt./concerned Regulators may consider modifying the investment guidelines for Insurance/pension funds and provident funds so that they could invest directly in such type of mutual funds.**

Recommendation Rationale:

- To make the proposed DIF's a success and to meet the demand for the capital in the infrastructure sector, the proposed DIFs should be able to target a wider range of investors.
- Besides retail investors, the proposed DIF's should also attract investments from FIIs, FIs, banks and Insurance and Pension Funds.

- **Suitability of investments by Pension funds and Insurance companies in proposed DIFs-**

Infrastructure assets and the proposed DIFs as its extension, are a very good match for the liability side of the insurance companies' and pension funds' balance-sheets for the following reasons:

1. The very long-term nature of infrastructure assets makes them particularly attractive to pension and insurance funds. Investments in infrastructure assets provide a closer match between the duration of assets and the liabilities of pension funds.
2. In addition, cash flows are usually stable and relatively protected against inflation and market volatility. Some infrastructure assets have monopoly characteristics with predictable and stable cash flow streams.
3. **Benefits of diversification-** Infrastructure Funds globally have had a low correlation with most of the other asset classes, making them suitable for diversification and risk management in a portfolio.
4. **Global Experience-** Pension funds and Insurance companies are the biggest investors in infrastructure funds in developed markets.

A good example is Australia, where both the infrastructure fund asset class and pension markets are significantly developed, large and sophisticated. The pension assets are about US\$400bn in Australia, one of the biggest in

the world. Mandatory contribution of 9% of employees' salary to superannuating contribution scheme by all employers has led to the explosive growth of pension funds in Australia. Considering the close match of infrastructure asset profiles with their liabilities, pension funds and insurance companies have made significant investments into infrastructure funds in the last few years. In fact, about 30-35% of total investment value of infrastructure funds can be directly attributed to pension funds and insurance companies. Investments in infrastructure funds, as percentage of total pension fund's AUM generally ranges between 2-10%.

Even in Korea pension funds have been large investors in infrastructure funds. Pension funds and insurance companies in fact have been the early investors in infrastructure funds. Retail investors have followed pension funds with some time gap.

Pension Funds in India

In India the total progressive contribution (AUM), as of 31 March 2006, to EPFO (the Employees Provident Fund Organisation) schemes is Rs. 2,16,110 crore⁴ (US\$52.7 bn)⁵. Even if a part of the contribution is invested in the proposed DIFs, it will significantly help in promoting this new investment vehicle. In fact, early participation by pension funds and insurance companies can ensure a successful take off for DIFs and will also help in attracting other retail and institutional investment.

Even an initial 1% allocation by pension funds, or an incremental 10% (of yearly contributions), at about Rs. 2,000 crore, to proposed DIFs can play a crucial role in making DIFs a significant source of capital for infrastructure creation in the country.

Indian Pension funds and Insurance companies investing in Infrastructure funds will also increase the comfort level of overseas pension funds for investing in

⁴ Source: http://epfindia.nic.in/operational_stat.htm

⁵ 1 US\$= Rs.41

DIFs. In fact, given the right policy environment, pension funds from OECD countries, which manage assets in excess of US\$18 trillion, can become a long-term source of capital for the infrastructure sector in India.

x) Nomenclature

Committee's recommendation:

- **DIF's across fund houses should be permitted to use appropriate names in line with the objectives of the fund with a tag of 'Dedicated Infrastructure Fund' below the name to signify the specific nature**

xi) Disclosure of Risk Factors & Reporting of Compliance

Committee's recommendation:

- **Risk factors relevant for such schemes may be disclosed in the offer documents as well as in the advertisements so that the investors may take well informed investment decisions.**
- **Reporting of compliance of regulations- Apart from the role of trustees specified earlier, they shall review the performance and compliance of regulations in case of DIFs in their periodical meetings and shall report it to SEBI in their reports submitted to SEBI in accordance with regulations.**

xii) Tax Benefits

Committee's recommendation:

Considering the long-term, high-risk and illiquid nature of proposed DIFs, the Committee believes that it is extremely important to provide some tax incentives to retail investors to motivate them to invest in DIFs and therefore help in and benefit from the infrastructure creation in the country. The Committee also believes that without such tax incentives it will be very difficult for DIFs to make any significant contribution to the larger goal of infrastructure creation in the country.

- **The following tax benefits may be provided to investors at the investment stage:**
 - **Section 80C- Up-front tax incentives in the form of an enhancement of limit under Section 80C from Rs.1,00,000 to Rs.2,00,000 with the incremental limit exclusively set apart for investment in designated infrastructure funds.**
 - **Capital gains arising on account of transfer of long term capital assets may be exempted from tax if the capital gains amount is invested in DIF units for a period of 7 years (on the lines of earlier Section 54EB of IT Act.)**
 - **Income earned by the fund and distributed to investors must be exempt from taxes subject to a minimum holding period of three to five years and dividend distribution, if any, is done only after the third year.**
 - **The tax treatment given to the capital gains/dividend income received from such DIF units may be kept at par with other equity mutual fund schemes.**
 - **Such tax benefits should be available only to the original investors, and not to the investors who buy the units from the market once the DIF gets listed.**

Recommendation Rationale:

- To successfully develop the required infrastructure, India will need to tap all sources of capital and channel it efficiently, in a time bound manner. The Government has created a conducive environment for sophisticated investors to invest in the sector. However the ways to tap the domestic investor and retail participants are limited.
- The proposed DIF's will create an attractive option for the retail investors as well as Institutions to invest directly into the infrastructure creation in the country. However due to the nature of such investments, the returns and liquidity in the initial years might be lower than other available investment options.
- To create an environment suitable for retail participation and to encourage broader participation in the sector, it is suggested that investors be provided with some tax incentives in the initial years of the scheme. Without the tax incentives no retail

investor would be motivated in a DIF which is a long-term investment and that too in unlisted securities and with a lock-in requirement. The success of the DIF hinges primarily on the tax incentives that the Government can provide, guided by the policy to provide a push to the infrastructure sector. In the past, in order to meet its policy objectives, Government has provided tax concessions for the growth of various sectors of the economy. Globally, also such concessions are permitted.

Shri Milind Barve
Member

Shri S. Naganath
Member

Shri. P.K. Nagpal
Member Secretary

Shri U.K. Sinha
Chairman

Annexure 1- SEBI letter: Formation of the Committee



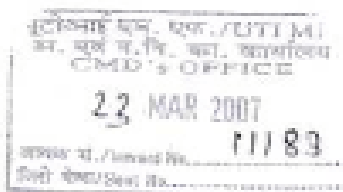
T C NAIR
WHOLE TIME MEMBER

भारतीय प्रतिभूति
और विनियम बोर्ड

*Securities and Exchange
Board of India*

Ref No: IMD/PM/89599/2007

March 23, 2007



Dear Shri *Sinha*,

Sub : Formation of a Group regarding launch of dedicated Infrastructure Funds by Mutual Funds.

Finance Minister Shri P. Chidambaram in his budget speech for the financial year 2007-08 has inter-alia announced that to promote the flow of investment to the infrastructure sector, Mutual Funds would be permitted to launch and operate dedicated infrastructure funds.

In order to suggest a detailed action plan to operationalise the budget announcement, it has been decided by SEBI to set up a Committee.

Chairman, SEBI is pleased to inform you that you will be heading the Committee and your team will comprise:

- | | | | |
|---|--------------------|--|------------------|
| 1 | Shri Milind Barve, | MD, HDFC AMC | Member |
| 2 | Shri S. Naganath | President, DSP Merrill Lynch Fund Managers Ltd | Member |
| 3 | Shri P. K. Nagpal | CGM, SEBI | Member Secretary |

The Committee will be free to co-opt any person who, in the view of the Committee, would be useful for the committee's work.

The Committee should submit its report within a period of three months.

A line in reply conveying your acceptance of the above will be much appreciated.

Warm
With regards

Yours sincerely,

T C Nair
T. C. NAIR

Shri U K Sinha
CMD, UTI AMC
UTI Tower, 'GN Block',
Bandra Kuria Complex
Bandra (E), Mumbai 400 051

Annexure 2- The International Experience

Globally, Infrastructure Funds can be divided into three broad categories

1. Listed Funds investing in listed Equity
2. Unlisted Funds largely investing in unlisted infrastructure companies/projects- These are generally Private Equity Funds investing in unlisted companies.
3. **Listed Funds investing in unlisted Infrastructure companies- These funds are similar to DIF's and are popular in Australia, South Korea and Singapore.**

A brief overview of different markets

- **Australia-** Australian corporates have been pioneers in operating listed infrastructure funds. There are more than 20 listed infrastructure funds on Australian Stock Exchange (ASX) and about 35 Investment Companies that invest in unlisted infrastructure companies.
- **Singapore-Business Trust (Business Trust Act):** It is a new asset class in Singapore, wherein the first Business Trust was registered in 2006. Business Trusts offer investors a new way to invest in cash-generating assets. Business Trusts are business enterprises set up as trusts, instead of companies. They are hybrid structures with elements of both companies and trusts. Like a company, a business trust operates and runs a business enterprise. But unlike a company, a business trust is not a separate legal entity. It is created by a trust deed under which the trustee has legal ownership of the trust assets and manages the assets for the benefit of the beneficiaries of the trust. Purchasers of units in the business trusts, being beneficiaries of the trust, hold beneficial interest in assets of the Business Trust.

Listed infrastructure funds are formed as Business trusts instead of companies. In Singapore companies are restricted to paying dividends out of accounting profits, however there are no such restrictions on trusts. Business trusts can therefore pay distributions to investors out of operating cash flows. This suits businesses involving high initial capital expenditures with stable operating cash flows.

Tax Incentives may be provided:

- To investors, on the interest income they derive from bonds issued to finance qualifying infrastructure projects (i.e. directly and not through an infrastructure fund)
 - For Infrastructure funds or other entities listed on the SGX, on interest received from overseas, provided that the entity is engaged in offshore infrastructure projects.
 - On income received by entities providing advisory services or underwriting and distributing project bonds to qualifying infrastructure projects may be taxed at a favorable concessionary tax rate.
- **South Korea-** Infrastructure Funds in Korea are regulated as investment companies (close-end type).

Such Funds can be established under the PPI (Private Participation in Infrastructure) Act and will be regulated as an investment company (close end type or non-redeemable type) under IIAMBA (Indirect Investment Asset Management Business Act) unless otherwise stipulated to be regulated under the PPI Act. Macquarie Korea Infrastructure Fund (MKIF), a fund operating within PPI Act got listed on Korea and London Stock Exchanges in March 2006.

Retail domestic investors are taxed at concessionary rates compared to normal financial income tax rates on distributions received from listed infrastructure funds.

Growth of Infrastructure Funds

Infrastructure Funds, as an asset class have seen significant growth in various markets in the last decade. The growth generally, across countries, has been aided by:

- **Fiscal Constraints-** Large budget deficits and significant infrastructure requirements in various countries, have motivated respective governments to look for private sector participation in the sector
- **Political Support-** Strong support in early years in the form of tax incentives and revenue guarantees have fuelled the growth of private sector participation
- **Limited early participation by financial institutions** and need for significant investor education has made infrastructure funds an important alternative source of capital.

- **Successful delivery of early projects-** Government supported bonds and revenue guarantees provided the support to the funds in early years.
- **Investor Education-** The characteristics of infrastructure returns particularly suit pension funds and life insurance companies with long dated liabilities. Institutional investors provide credibility to infrastructure as an ‘accepted’ and popular investment class. Retail investment in infrastructure generally lag those of institutional investors
- Strong fund management expertise.
- Availability of deal flow and investment opportunities

Operations and Features of Listed Infrastructure Funds

Operations-Most of the funds operate on 2/20 principal, charging 1.5%-2% as Management fees and 20% performance fees above the hurdle rate. Hurdle rate generally is either the benchmark (an index with listed infrastructure stocks as its constituents) or 8%-9%. These funds actively churn their portfolio by seeking new opportunities and divesting mature assets out of the portfolio.

Features

- **Open- Ended**
- **Flexible capital management**, including buybacks
- **Additional investments typically funded from capital raisings**
- **Trading of securities through stock exchange**
- **Strong appeal for retail investors due to liquidity**
- **Legal Structure-** Infrastructure funds have been formed using structures that include companies, trusts and partnerships. There is no standard structure for an infrastructure fund, with the legal and taxation structure of each fund determined with consideration of:
 - Existing legal and regulatory requirements of the fund’s domicile jurisdiction
 - The nature of the investments (structure and location) of the fund.
- **Taxation-** Most funds have been structured as a **tax flow through entity**, such that no tax is payable at the fund level. For example, this is achieved:

- In Australia, through Structuring the fund by way of unit trusts, which are tax flow through entities; and/or Franking credits / dividend imputation received for funds structured by way of a company or discretionary trust.
- In Korea, through Deductions allowed against taxable income of the fund for dividends declared (and paid) to fund investors
- **Liquidity- Focus of liquidity is on ability of fund investors to trade or transfer their securities.** Timing of listing is typically after a fund is fully invested and is dependent on market conditions
- **Valuation**
 - **Generally done internally-** Normal practice is for valuations of assets to be performed internally, with a third party brought in to ‘validate’ the valuations, usually the fund auditor.
 - **Discount to NAV-** Market price of listed securities do not always match NAV and might trade at either a discount or premium to NAV.
- **Fees**
 - **Base Fee** – Its generally 1.5%-2.5% of the AUM or Market Value (if listed)
 - **Performance Fees-** Its generally 20% over the hurdle rate.
 - **Hurdle Rate** generally is 8%

A practical Issue- Cash Traps

- Infrastructure assets require large up front capital investments. The accounting and taxation treatment of infrastructure assets (i.e. at the project company level) typically allow depreciation and/or amortization of these up front capital costs.
 - Consequently, infrastructure projects typically report accounting losses for many years due to the amortization of significant capital cost
 - Beneficial from a tax structuring perspective, through the deferral of tax payments from accrued tax losses at the asset level
 - However, the resulting effect on accounting profit (that is, accounting losses and/or negative retained earnings), may restrict the payment of distributions from the asset to the fund
- Most infrastructure projects are usually cash flow positive notwithstanding the reporting of accounting losses

- ‘Cash traps’ may therefore occur notwithstanding that the asset may be performing strongly from an operational and cash flow perspective
- It is therefore important to understand that investors will seek structuring that will enable distribution (dividends) of all distributable cash irrespective of accounting treatment

Performance- During the last seven years infrastructure funds have consistently outperformed global equity markets. ASX listed Infrastructure funds on an average have given returns of 15.22% and 26.18% per annum for the last one year and three year period (Year to March) respectively. These funds have a Market Capitalization of more than USD39bn. AUMs are likely higher than the market cap as the funds generally trade at a discount to their NAV.

Exhibit 1: Performance of Infrastructure Funds (using Macquarie Bank’s funds as a case study) compared to Equity markets

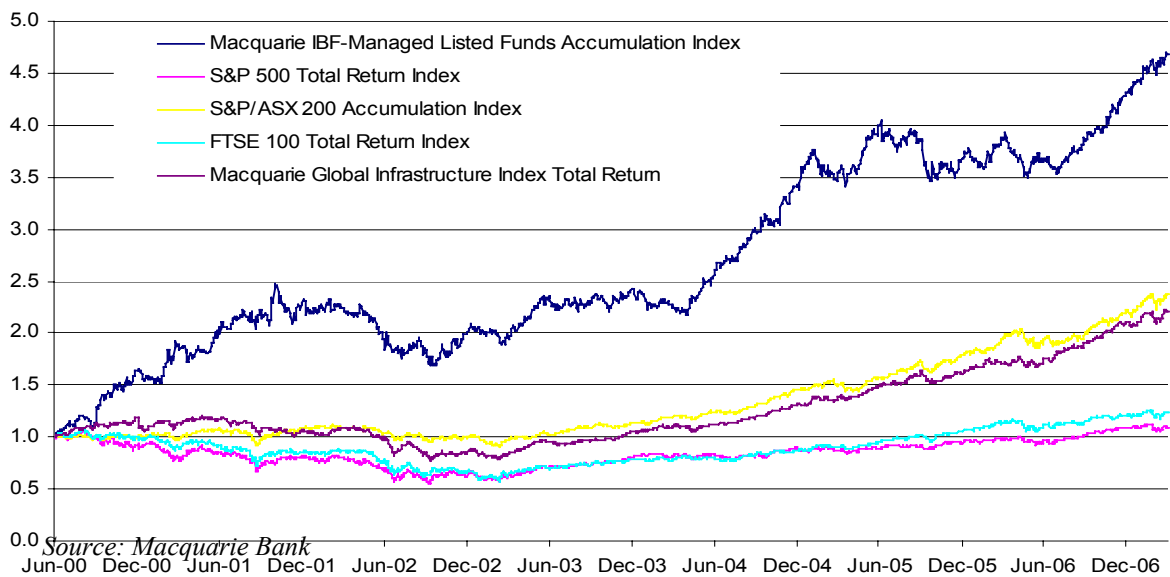


Exhibit 2: Details of some of the listed Infrastructure Funds

	<i>Macquarie Infrastructure Group (MIG)</i>	<i>Macquarie International Infrastructure Fund (MIIF)</i>	<i>City Spring Infrastructure Trust (CSIT)</i>	<i>Macquarie Korea Infrastructure Fund (MKIF)</i>
Listing:	<ul style="list-style-type: none"> ♦ Australia Stock Exchange (ASX) ♦ November 1996 	<ul style="list-style-type: none"> ♦ Singapore Stock Exchange (SGX) ♦ June 2005 	<ul style="list-style-type: none"> ♦ Singapore Stock Exchange (SGX) ♦ January 2007 	<ul style="list-style-type: none"> ♦ Korea Stock Exchange (KRX) and London (PSM) ♦ March 2006
Market Cap:	~ \$ 8,030 mn	~ \$ 1,030 mn	~ \$ 450 mn	~ \$ 2,560 mn
Retail Participation:	♦ Permitted	♦ Permitted	♦ Permitted	♦ Permitted
Minimum Commitment:	♦ AUD 2,000	♦ S\$ 1000	♦ S\$ 890	♦ None
NAV Reporting:	♦ Annually	♦ Quarterly	♦ Annually	♦ Quarterly
Permitted Investments:	♦ Globally in both unlisted and publicly listed securities with or without controlling interest	♦ Globally in both unlisted and publicly listed securities with or without controlling interest	♦ Globally in both unlisted and publicly listed securities with or without controlling interest	♦ Korean concession companies that operate infrastructure assets
Fees:	<ul style="list-style-type: none"> ♦ Base Fee: 1.25% p.a. ♦ Performance Fee: 15% of returns > Benchmark 	<ul style="list-style-type: none"> ♦ Base Fee: 1.50% p.a. ♦ Performance Fee: 20% of returns > Benchmark 	<ul style="list-style-type: none"> ♦ Base Fee: 1.00% p.a. ♦ Performance Fee: 20% of returns > Benchmark 	<ul style="list-style-type: none"> ♦ Base Fee: 1.25% p.a. ♦ Performance Fee: 20% of returns > Benchmark
Structure:	♦ Triple stapled structure with 2 Australian Trusts and 1 Bermudan Mutual Fund Company.	♦ Bermudan Mutual Fund Company	♦ Business Trust registered with the Monetary Authority of Singapore	♦ Registered as an Investment Fund under the IIAMB Act and as an Infrastructure Fund under the PPI Act

Annexure-3 Listed 'Infrastructure' Funds in India

Table 1. Performance of Indian Infrastructure Funds as on March 30th 2007					
Scheme Name	Launch Date	AUM (in Rs. Crs)	Returns (%)		
			1 Month	6 Months	1 Year
UTI Thematic Infrastructure Fund - Growth	07-Apr-04	916.42	9.70	12.87	12.22
Birla SunLife Basic Industries - Growth	15-Jan-00	150.32	8.64	5.12	3.85
CanInfrastructure Fund - Growth	11-Sep-05	72.01	9.01	7.18	1.73
DSP ML India Tiger Fund - Growth	25-May-04	1562.10	8.19	14.01	17.12
ICICI Prudential Infrastructure Fund - Growth	16-Aug-05	1711.81	8.73	12.88	18.64
ICICI Prudential Power - Growth	24-Aug-94	1450.51	7.76	9.48	12.69
Reliance Diversified Power Fund - Growth	15-Apr-04	932.49	10.19	19.26	24.37
Sundaram BNP Paribas CAPEX Opportunities Fund - Growth	05-Sep-05	211.35	8.72	6.53	5.19
Tata Infrastructure Fund - Growth	22-Dec-04	1318.60	8.04	8.14	9.37
Tata Service Industries Fund - Growth	10-Mar-05	197.06	6.39	18.98	15.92
Indices					
BSE Sensex				-2.39	6.51
BSE100				-2.51	6.11

Annexure-4: Restrictions under Regulations

Currently Indian Mutual Funds investing in the infrastructure sector are bound by the SEBI MF Regulations, 1996. The regulations limit the extent to which the mutual funds schemes can invest in unlisted companies and also impose other restrictions which would make it difficult for DIFs to operate under existing norms. Some of such restrictions are: listed below:

- The Fund can invest in unlisted securities only up to 5% and 10% of its Net Asset Value in case of open ended and close ended scheme, respectively.
- The Mutual Fund as a whole cannot hold more than 10% of the Paid up Capital of a Company carrying voting rights.
- The expense ratio allowed for equity funds including investment management fees is capped at 2.5% and decreases with an increase in the size of the Fund.
- The total annual recurring expenses of a fund including the investment management fees are subject to the following limits:
 - On the first Rs.100 crores of the average daily net assets - 2.50%
 - On the next Rs.300 crores of the average daily net assets - 2.25%
 - On the next Rs.300 crores of the average daily net assets - 2.00%
 - On the balance of the assets - 1.75%

However, such recurring expenses are required to be lesser by at least 0.25% in respect of a scheme investing in bonds :

- The Investment management fees (within the above mentioned expenses) cannot exceed the limits specified under clause 2 of regulation 52 of SEBI (MF) Regulations, 1996 namely:
 - 1.25% of the daily average net assets outstanding in each accounting year for the scheme as long as the net assets do not exceed Rs.100 crores, and
 - One percent of the excess amount over Rs.100 crores, where net assets so calculated exceed Rs. 100 crores.
- The valuation of assets have to be done as per the guidelines laid down in SEBI MF Regulations, 1996.

Annexure-5: Infrastructure Definition as per IT Act

(Excerpts from the Act)

Section 80 IA applies to-

(i) any enterprise carrying on the business any infrastructure facility which fulfils all the following conditions, namely:-

- (a) it is owned by a company registered in India or by a consortium of such companies;
- (b) it has entered into an agreement with the Central Government or a State Government or a local authority or any other statutory body for (i) developing or (ii) operating and maintaining or (iii) developing, operating and maintaining a new infrastructure facility;
- (c) it has started or starts operating and maintaining the infrastructure facility on or after the 1st day of April, 1995:

Provided that where an infrastructure facility is transferred on or after the 1st day of April, 1999 by an enterprise which developed such infrastructure facility (hereafter referred to in this section as the transferor enterprise) to another enterprise (hereafter in this section referred to as the transferee enterprise) for the purpose of operating and maintaining the infrastructure facility on its behalf in accordance with the agreement with the Central Government, State Government, local authority or statutory body, the provisions of this section shall apply to the transferee enterprise as if it were the enterprise to which this clause applies and the deduction from profits and gains would be available to such transferee enterprise for the unexpired period during which the transferor enterprise would have been entitled to the deduction, if the transfer had not taken place.

Explanation.-For the purposes of this clause, "infrastructure facility" means,-

- (a) road including toll road, a bridge or a rail system;
 - (b) a highway project including housing or other activities being an integral part of the highway project; and
 - (c) a water supply project, water treatment system, irrigation project, sanitation and sewerage system or solid waste management system;
 - (d) a port, airport, inland waterway or inland port;
- (ii) any undertaking which has started or starts providing telecommunication services whether basic or cellular, including radio paging, domestic satellite

- service, network of trunking, broadband network and internet services on or after the 1st day of April, 1995, but on or before the 31st day of March, 2003;
- (iii) any undertaking which develops, develops and operates or maintains and operates an industrial park or special economic zone notified by the Central Government in accordance with the scheme framed and notified by that Government for the period beginning on the 1st day of April, 1997 and ending on the 31st day of March, 2006:

Provided that in a case where an undertaking develops an industrial park on or after the 1st day of April, 1999 and transfers the operation and maintenance of such industrial park to another undertaking (hereafter in this section referred to as the transferee undertaking) the deduction under sub-section (1), shall be allowed to such transferee undertaking for the remaining period in the ten consecutive assessment years in a manner as if the operation and maintenance were not so transferred to the transferee undertaking;

- (iv) an undertaking which,-
- (a) is set up in any part of India for the generation or generation and distribution of power if it begins to generate power at any time during the period beginning on the 1st day of April, 1993 and ending on the 31st day of March, 2006;
- (b) starts transmission or distribution by laying a network of new transmission or distribution lines at any time during the period beginning on the 1st day of April, 1999 and ending on the 31st day of March, 2006:

Provided that the deduction under this section to an undertaking under sub-clause (b) shall be allowed only in relation to the profits derived from laying of such network of new lines for transmission or distribution.

Annexure- 6: SEBI Guidelines: Valuations of Unlisted Equity Shares

A. Investment in Unlisted Equity Shares

With a view to bringing about uniformity in calculation of NAVs of mutual funds schemes, the following guidelines are being issued for valuation of unlisted equity shares in consultation with Association of Mutual Funds in India (AMFI). The guidelines also prescribe exercise of due diligence while making such investments and review of their performance so as to protect the interests of investors.

Methodology for Valuation

Unlisted equity shares of a company shall be valued "in good faith" on the basis of the valuation principles laid down below:

- a. Based on the latest available audited balance sheet, net worth shall be calculated as lower of (i) and (ii) below:
 - i. Net worth per share = [share capital plus free reserves (excluding revaluation reserves) minus Miscellaneous expenditure not written off or deferred revenue expenditure, intangible assets and accumulated losses] divided by Number of Paid up Shares.
 - ii. After taking into account the outstanding warrants and options, Net worth per share shall again be calculated and shall be = [share capital plus consideration on exercise of Option/Warrants received/receivable by the Company plus free reserves(excluding revaluation reserves) minus Miscellaneous expenditure not written off or deferred revenue expenditure, intangible assets and accumulated losses] divided by {Number of Paid up Shares plus Number of Shares that would be obtained on conversion/exercise of Outstanding Warrants and Options}

The lower of (i) and (ii) above shall be used for calculation of net worth per share and for further calculation in (c) below.

(b) Average capitalisation rate (P/E ratio) for the industry based upon either BSE or NSE data (which should be followed consistently and changes, if any, noted with proper justification thereof) shall be taken and discounted by 75% i.e. only 25% of the Industry average P/E shall be taken as capitalisation rate

(P/E ratio). Earnings per share of the latest audited annual accounts will be considered for this purpose.

(c) The value as per the net worth value per share and the capital earning value calculated as above shall be averaged and further discounted by 15% for illiquidity so as to arrive at the fair value per share.

The above methodology for valuation shall be subject to the following conditions:

- i. All calculations as aforesaid shall be based on audited accounts.
- ii. In case where the latest balance sheet of the company is not available within nine months from the close of the year, unless the accounting year is changed, the shares of such companies shall be valued at zero.
- iii. If the net worth of the company is negative, the share would be marked down to zero.
- iv. In case the EPS is negative, EPS value for that year shall be taken as zero for arriving at capitalised earning.
- v. In case an individual security accounts for more than 5% of the total assets of the scheme, an independent valuer shall be appointed for the valuation of the said security. To determine if a security accounts for more than 5% of the total assets of the scheme, it should be valued in accordance with the procedure as mentioned above on the date of valuation.

At the discretion of the AMC and with the approval of the trustees, an unlisted equity share may be valued at a price lower than the value derived using the aforesaid methodology.

Due Diligence

The mutual funds shall not make investment in unlisted equity shares at a price higher than the price obtained by using the aforesaid methodology. However, it is clarified that this will not be applicable for investment made in the initial public offers of the companies (IPOs) or firm allotment in public issues where all the regulatory requirements and formalities pertaining to public issues have been complied with by the companies and where the mutual funds are required to pay just before the date of public issue.

The boards of AMCs and trustees of mutual funds shall lay down the parameters for investing in unlisted equity shares. They shall pay specific attention that due diligence was exercised while making such investments and shall review their performance in their periodical meetings as advised in SEBI Circular no. MFD/CIR/6/73/2000 dated July 27, 2000.

Reporting of Compliance

The AMCs and trustees shall offer their comments on the compliance of these guidelines in their quarterly and half-yearly reports filed with SEBI.

These guidelines effective immediately are being issued in accordance with the provisions of Regulation 77 of SEBI (Mutual Funds) Regulations, 1996.