

## AIG Indian Sectoral Equity Fund (AISEF)

### Innovation Report

#### I. The Context

- (1) Infrastructure Leasing & Financial Services Limited ("IL&FS") and the American International Group, Inc. ("AIG") had jointly set up the AIG Indian Sectoral Equity Fund (the "Fund") with the intent to mobilize private sector funds from both Indian and international sources and direct these towards the key development sectors earmarked by the Fund
- (2) The Fund focus was on making direct investments through equity and quasi-equity-related instruments in Infrastructure Projects, New Technology, and growth sector opportunities in India
- (3) The Fund was conceptualized in 1995, set up in 1996 and commenced investment operations in 1997, following the receipt of the requisite regulatory approvals. The objective of the Fund was to address India's expanding infrastructure requirements, growing new technology base and increasingly active consumer appetites
- (4) Innovative Features: The Fund had the following innovative characteristics:
  - (a) First infrastructure private equity fund in India
  - (b) One of the first private equity funds to have international contribution
- (5) Period Characteristics: The Fund was set up at a time characterized by the following:
  - (a) Absence of regulations and regulatory authority
  - (b) Limited experience / expertise in Fund structures
  - (c) Absence of peer competition for Fund management
- (6) Key Driver: The Indian reform process had commenced in the early 1990s and there was a need to append development of focused funds to private capital for fueling the national development and growth process

#### II. Implementation of Innovation

- (1) Team Creation: With a view to effectively manage the Fund and its investments, a Service Unit (SU) was created. Members of the SU were handpicked from the pool of investment personnel within IL&FS. In addition, a team comprising of personnel with legal background and accounting knowledge was created to provide the back-end function for the Fund
- (2) Team Role: The SU as a whole performed the function of an integrated organization within an organization. The key roles performed by the SU are as follows:

- (a) Fund Marketing
- (b) Deal Identification
- (c) Deal Evaluation
- (d) Business Due Diligence
- (e) Transaction Documentation
- (f) Investor Relations and Servicing

(3) Key Difficulties Faced: The Fund was formed with a life of 10 years, including an Investment Period of 5 years. In the initial years, the Fund faced significant difficulties in sourcing potential transactions on account of the following:

- (a) New nature of business for most Indian entrepreneurs – who were hitherto used to funding from banks
- (b) Infrastructure projects required funding greater than that provided by the Fund.

These difficulties were overcome using innovative investment structures and creating investor consortia for the requisite funding amounts

### **III. Impact Assessment**

(1) Fund Investments: The Fund was raised with a mandate to invest a minimum of 65% of its corpus in infrastructure projects and related industries. The Fund's contribution in promoting private sector interests in the infrastructure sector are indicated below:

- (a) Telecom Sector: At the time AISEF was created, India had witnessed substantial interest in the cellular telecom sector from the local industrialists, international telecom companies and the foreign investor fraternity. The Fund's investments in the telecom sector were hence a natural extension of the appetite displayed by various entities in this sector. However, it is relevant to note that the changes in the telecom regulatory structure, primarily responsible for the transformation of cellular operators from a loss position to that of profitability, were undertaken largely at the behest of the institutional investor group. Hence, in the telecom sector, the Fund's contribution towards private sector participation in the telecom sector has been one of increasing the bargaining power of the private sector
- (b) Surface Transport Sector: The Fund has two investments in the surface transport sector viz. Noida Toll Bridge Company Limited (NTBCL) and Gujarat Toll Road Investment Company Limited (GICL) the project companies formed for implementing the Delhi Noida bridge project and the toll road projects in Gujarat respectively. The Delhi-Noida Bridge project, developed and implemented by IL&FS, was one of the first toll based bridge project completed in India. This project, from a private sector participation perspective has achieved a landmark status owing to the following:

- (i) First surface transport project to achieve financial close based on project recourse funding from lenders
- (ii) First surface transport sector project to tap the retail capital market for convertible and non-convertible debt
- (iii) Participation from both national and international private equity funds

Subsequent to the financial close of the DNB project, several road sector projects have achieved financial close with project recourse funding of debt and equity participation from private sector players

- (c) Oil & Gas Sector : The Fund has made one investment in the Oil & Gas sector through its participation in the equity of Indraprastha Gas Limited (IGL). IGL was incorporated as a Joint Venture between Gas Authority of India Limited (GAIL) – a public sector monopoly for gas distribution, and Bharat Petroleum Company Limited (BPCL), a public sector oil major. The Sponsors, along with the Government of Delhi hold 50% of the equity, with the remaining 50% of the equity being held by Financial Investors viz. Unit Trust of India, Infrastructure Development Finance Company Limited and the Fund. As indicated earlier, IGL has significantly contributed to the lowering of vehicular pollution in New Delhi. IGL is now a listed company and is traded on the Stock Exchange, Mumbai and National Stock Exchange

- (2) Given the above, the Fund has made an exemplary contribution towards the improvement of private sector participation in the infrastructure sector through the improvement of the regulatory framework as well as active commercialisation of projects
- (3) The Fund has essentially been the anchor for private equity investors in each of the above investments and has helped attract additional private equity investments to the companies. Additionally, the Fund has achieved exits from the above investments through sale of its holdings in the companies on stock exchanges either through an IPO or post listing and forsee exits from its remainder investments in the same manner. Thus, the Fund has created a positive framework enabling its investee companies to tap the capital markets as well as create a market appetite for such projects
- (4) Social Impact: The Fund investments have an excellent record with respect to social protection. The Fund has two investments in the Surface Transport Sector. Both the projects required substantial degrees of Rehabilitation and Resettlement (R&R). The projects have strictly adhered to guidelines of multi-lateral agencies on R&R. Additionally, the R&R work for these projects has been lauded by the local governments, the project affected persons, social institutions and eminent citizens from the project area

The Fund's investments in the Telecom sector have aided key telecom companies to emerge as market leaders within their respective operating environment. The growth in the telecom sector has resulted in the creation of an apt regulatory framework accompanied by a boom in employment in this sector

Additionally, the changes in the regulatory framework have effected in improved revenue flows to the Government in the form of license fees, service taxes and income tax

The Fund has also invested in the equity of Indraprastha Gas Limited (IGL), a natural gas infrastructure and distribution company, operating in New Delhi. Given the alarming level of vehicular pollution in New Delhi, the Supreme Court of India directed the Gas Authority of India Ltd (GAIL) to distribute Compressed Natural Gas, a clean fuel, to all commercial passenger vehicles in New Delhi. Consequently, GAIL and Bharat Petroleum Company Ltd co-Sponsored IGL for implementing the Supreme Court directive. IGL, through its activities, has made a significant contribution towards lowering of pollution levels in New Delhi and thereby improving living standards of the New Delhi populace

Overall, the Fund has been responsible for creating an employment generating environment through its investment programme. The funded companies have made positive contributions to the social sector through the creation of trained manpower, positive social rehabilitation and increased revenues to the Government

- (5) Corporate Governance: The Fund has adopted international best practices for Corporate Governance. The Corporate Governance Code has been in practice since the inception of the Fund. AIG ISEF has developed a Standard Operating Manual based on best practices in the field of Private Equity Investing. Given the Fund's Corporate Governance Framework, the Fund has been instrumental in influencing its portfolio companies to adopt similar practices for their governance
- (6) Operating Environment: The AIG ISEF was amongst the first private equity funds in India and the first fund with a focus on the infrastructure sector. At the time when the Fund was set up, the private equity sector was at a very early stage, void of a clear policy and regulatory framework. Over the years, based on representations made by IL&FS, AIG ISEF as well as other entities, with the relevant ministries in the Government of India a number of changes in the regulatory structure were implemented. The key changes are as follows:
  - (a) Tax Benefits for the Infrastructure Sector: In 1996, a new Section 10(23G) was introduced in the Income Tax Act. This Section provides fiscal incentives for equity investments in the infrastructure sector by 'Infrastructure Funds' and 'Infrastructure Capital Companies'. Given that benefits from infrastructure projects are essentially back ended, the tax incentives for infrastructure projects have resulted in evincing strong private sector participation in the sector
  - (b) Fiscal Benefits for Funds: The Securities and Exchange Board of India has recognised funds with a clear focus on the infrastructure sector as 'Venture Capital Funds' (VCF) and have permitted registration of such funds. Whilst the AIG ISEF could not be registered as a VCF due to the significant time that had elapsed between the time the Fund was set up and when the regulations permitted such registration

The registration of private equity funds as VCFs enables the funds to avail of significant fiscal benefits and also provides an automatic route for operations into India, neutralising the need for approvals from the Reserve Bank of India and the Foreign Investment Promotion Board

- (7) Summary: In summation, the AIG ISEF has been a significant contributor to the development of the PE/VC sector in India. Given the need for private sector participation in key developmental sectors, the AIG ISEF has been instrumental in ushering in the policy framework for PE fund structures. Additionally, the Fund has also been partially responsible for global PE/VC firms and investors evincing interest in the Indian infrastructure space as well as other sectors. With the changing perception of private equity, assisted by flows of retirement money to PE/VC firms, the Indian PE industry is well poised to attain the next level of maturity over the medium term