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Analysis

SEBI is slowly re-defining InvITs: What's at risk for the product and its institutional audience?

Key Takeaways

- Strong minority unitholder protections introduced – for both public and private InvITs
- Private InvITs originally designed to attract large institutional capital – light touch regulations allowed flexibility to parties to manage their arrangements
- New changes include nominee director rights, stewardship principles and enhanced governance norms
- Changes good for retail investors, but appear misplaced in more sophisticated private setups
- Distinction between public and private InvITs seems to be fast fading – potentially risking the confidence of institutional investors in private InvITs

Introduction

Nominee directors, stewardship principles, governance requirements and more – the most recent round of governance-focussed amendments to the InvIT regime clearly demonstrate SEBI's keenness to continue "developing" one of its most successful products: infrastructure investment trusts (***InvITs***). However, each amendment takes us back to the same important question: should SEBI adopt a broad-brush approach and introduce common changes for both public and private InvITs? Or, should there be a conscious decision to distinguish between private InvITs which house institutional investors and public InvITs which house retail investors? In this piece, we look at how InvITs were originally rolled out, SEBI's most recent changes and what it means for the industry, and the future of private InvITs.

InvITs as yield vehicles (public) vs growth vehicles (private)

When the InvIT regime was rolled out in 2014, it adopted two clear strategies to boost a fragile infrastructure sector. One, provide retail and institutional investors access to top-quality revenue-generating infrastructure assets through public InvITs. Two, provide institutional investors a risk-mitigated stable regime to invest large amounts of capital into under-construction assets through private InvITs, while also benefitting from the growth of these assets.

SEBI's 'horses-for-courses' game plan was clear from the very beginning. It was simply not wise to throw both strategies into the same ring. Under-construction infrastructure projects were expensive, uncertain and historically unreliable, especially after the 2008 crisis. This naturally merited a unique breed of capital willing to take on construction risk. SEBI was well-aware of this and its solution, the private InvIT, was carefully designed with this in mind: minimal diversification, larger ticket sizes, only institutional investor participation, fair-degree of regulatory oversight, and more. The messaging was clear: this was a sophisticated product for a sophisticated audience.

Public InvITs on the other hand were marketed as a retail product – i.e. the general public could now opt to invest in stable yielding infrastructure assets. The retail participation naturally necessitated a greater degree of scrutiny and protection, and SEBI has done an excellent job at this.

Conflating public and private InvITs

The initial years of InvITs met with a lukewarm response from the market, with just two public InvITs being rolled out in a span of 5 years ('14-'18). The last 5 years however have been more dramatic – with private InvITs attracting billions of dollars from foreign investors. In fact, it may not even be a stretch to say that the success story of InvITs has been scripted by private listed InvITs and the now discontinued unlisted private InvITs.

Undoubtedly, SEBI played a constructive role in ensuring that investors are comfortable

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with InvITs. But, as with most regulators, SEBI seems to be losing sight of the original intent with which two different kinds of InvITs were conceptualized. So much so that other than the nature of assets housed by a private InvIT, there is hardly any difference between a publicly listed InvIT which typically has thousands of retail unitholders and a privately listed InvIT which has 5-10 highly sophisticated large institutional unitholders. The two regimes have unfortunately been conflated, leading private InvIT sponsors and investors to think just of one question – will we be forced to shed our private avatar gradually and become a public InvIT in due course?

What has SEBI changed now, and how do we see it?

Most recently, SEBI introduced 3 key changes which are applicable to private InvITs as well: (a) all unitholders having >10% stake in the InvIT can nominate a director on the board of the investment manager (***IM***), and (b) unitholders nominating directors are bound by a stewardship code, including the obligation to vote in the best interests of the InvIT, and (c) IMs are now required to follow a whole host of governance provisions which are applicable to public listed companies.

Is this good for private InvITs? Possibly not. The changes seem to be better suited for a product which has large-scale, retail participation – which is practically absent in private InvITs today. Stakeholder committee norms, stewardship principles, and detailed policy requirements are more justified in retail contexts since retail investors do not benefit from the same amount of visibility and discretion which institutions have.

The typical investors in private InvITs (PEs, pension funds and sovereign wealth funds) carry significant commercial insight, benefit from historical precedence, enter into extensive governance arrangements at the IM level and can exercise influence where required. For them, it makes sense to have the ability to contractually determine their board composition and governance policies, similar to how private companies or even public companies for that matter, operate.

The way forward for private InvITs

It‘s natural for any regulator to start plugging loopholes and develop a safe regime as investments scale up. However, in the context of private InvITs, hardcoding retail-focussed governance protections into law takes away institutional investors’ ability to effectively plan and manage their investments. SEBI is more likely to see private InvITs flourish by retaining the regime as-is – and not disturbing the foundational principles for 3-5 years.

To be fair, SEBI’s justification to regulate private InvITs in the same manner as public InvITs is premised on the fact that retail participants can potentially acquire stakes even in private InvITs through secondary trades. But instances of this taking place in the market are limited today and importantly, market participants would be comfortable if SEBI enacts a new stipulation restricting retail investors from purchasing units of a private InvIT.

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It is worth remembering that the success of InvITs is largely attributable to swathes of institutional capital which drew comfort in the flexibility offered by a de-regulated regime. However, the constant changes in regulation and increasing governance measures may eventually become counterproductive and compromise investor confidence in the product overall. At the risk of being undiplomatic, if SEBI's only calling card in marketing private InvITs is the attendant tax benefit, it's only a matter of time before the vehicle loses sheen since this benefit will eventually fall away. The rather simple solution is written in SEBI's own words (2013 InvIT consultation paper): distinguish between products based on the nature of capital required and the very purpose of that capital, and prescribe regulation accordingly.

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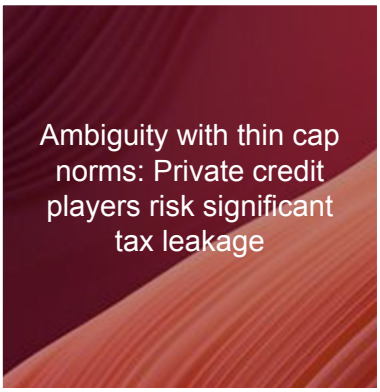
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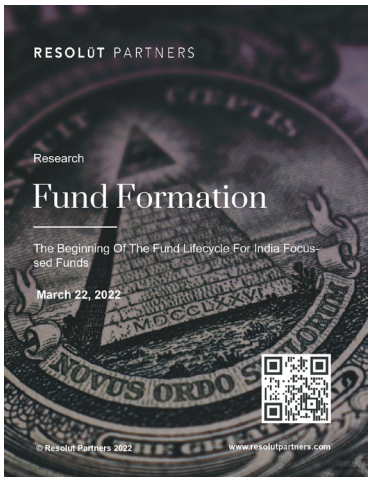
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