KHAITAN &CO ADVOCATES SINCE 1911

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VENTURE CAPITAL VOIR

How to keep pace in a changing venture capital environment

Foreword

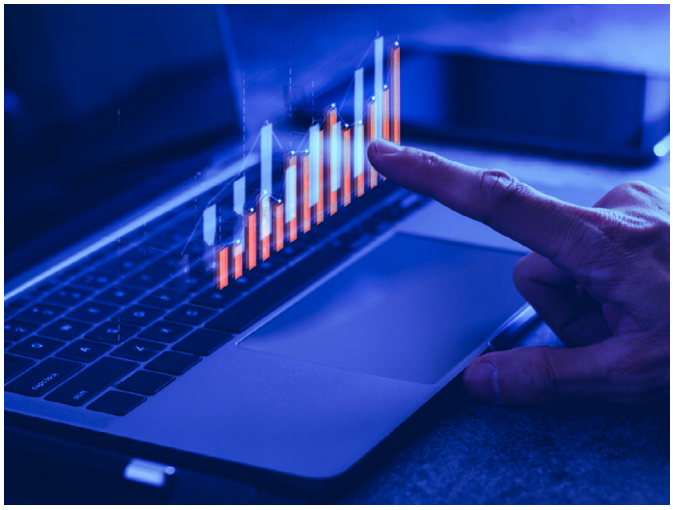
Dear Reader,

As the world recovers from an unprecedented global pandemic, the Indian economy is set to emerge as a strong global player in 2023 having shown constant growth and resilience to the several operational hurdles observed over the last two years. Venture capital (VC) investment in India has seen a massive growth over the past decade, with an increase from US$3.1 billion in 2012 to US$38.5 billion in 2021[1]. Since then, VC investments have declined and continued to remain muted in the first two quarters of 2023 because of rising interest rates in the west, geopolitical tensions, and rising inflation.

While global market conditions will continue to impact the Indian economy and the paradigm of VC investments in India, market trends indicate a steady and resilient growth in the remaining months of 2023. We expect investments to be bolstered by few underlying factors such as emerging investment opportunities, regulatory developments, a growing digital population, and government's unprecedented push towards 'Digital Public Infrastructure' backed growth.

An expected consequence of several operational hurdles observed in 2022 has been the emergence of new investment trends. India's startup industry has also been affected by a change in investor inclinations but at the same time, has been growing consistently in certain fintech and new emerging technologies, artificial intelligence (AI), clean and alternate energy, Software as a Services (SaaS) and allied activities, and e-mobility.

VC investments have also increased in pockets of traditional sectors such as real estate and infrastructure. The technology boom in India due to a surge in remote working during the pandemic, rising internet population, financial inclusion, increased smartphone usage, and cheap data penetration in sub-urban and rural areas in India, has been pushing for increased data storage and processing requirements.

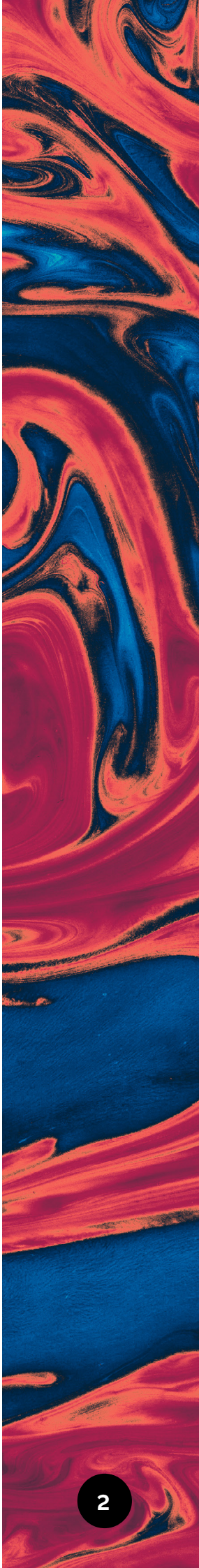


[1]Source: India Venture Capital Report, IVCA and Bain & Company, 2023
https://www.bain.com/insights/india-venture-capital-report-2023/#:~:text=Despite%20the%20drop%20in%20Indian,seed%20to%20series%20B%20deals.

The Indian government aims to make India a 'Global Data Centre' hub and has conferred an 'Infrastructure' status to the industry to make investments in the data centre industry more lucrative to potential investors. Consequently, a sharp rise has been observed in private equity (PE) and VC investments in the data centre industry. This will also be bolstered by the Digital Personal Data Protection Act, 2023 which has been passed by the Parliament and affirmed by the President of India.

Institutional investors are also adopting a cautious approach and ramping up their diligence efforts. In new-age sectors, where the laws are nascent and developing, investors seek to ensure that they are on the right side of the policy spectrum. Recent instances of financial irregularities and malpractices coming to the forefront has not helped the matters either. Institutional investors have in the recent past also considered undertaking a preliminary diligence of the target business in many instances before issuing a term sheet, which was hitherto usually pushed to an action item between term sheet and documentation.

Our newsletter series is aimed at presenting an overview of the market trends, expert insights and regulatory developments impacting the VC ecosystem in India.



Funding Winter

After a year of record investments in 2021-22, the Indian PE-VC ecosystem has witnessed a downtrend in the months that followed. Driven by several global and domestic factors, the Indian startup environment has seen investors tightening their purse strings, accompanied by steep corrections in valuations. Given this, it has become commonplace to witness anti-dilution or valuation protection mechanisms being triggered pursuant to fund raises at reduced valuations[2]. While parties may choose various methods to give effect to a right of anti-dilution based on their commercial understanding, typically, in cases where an affected shareholder holds convertible shares, anti-dilution is given effect to by adjusting the conversion ratio of the affected class of shares. The adjustment in conversion ratio consequently results in an increase in the affected shareholder's shareholding on an as if converted basis.

Alternatively, in the case of preference or equity shares, a bonus issuance may also be considered.

However, the legal permissibility of a selective bonus issuance, i.e., a bonus issuance made only to investors holding a specific class of shares is yet to be tested in Indian courts.

We have also seen companies agreeing to issue shares or promoters agreeing to transfer their shares to the affected investors (or their nominee) at the lowest permissible price under the applicable law. The issuance of shares may also be in the form of a right to subscribe to shares at a future date (or an exit event) but at a pre-determined valuation. Other methods include buyback, where shares held by the promoters or other shareholders (excluding the affected investor) may be bought back by the company. A buyback results in a consequent increase in the value of shares held by the affected shareholder.

It is worthwhile to note that in cases involving issuance or transfer of additional shares to foreign investors, exchange control laws may prescribe additional conditions. For instance, pricing guidelines prohibit the issuance or transfer of securities of Indian companies to foreign investors at a price which is lower than the fair market value of such securities. Furthermore, each of these methods require an independent scrutiny from an Indian taxation laws standpoint, which may differ on a case-to-case basis.

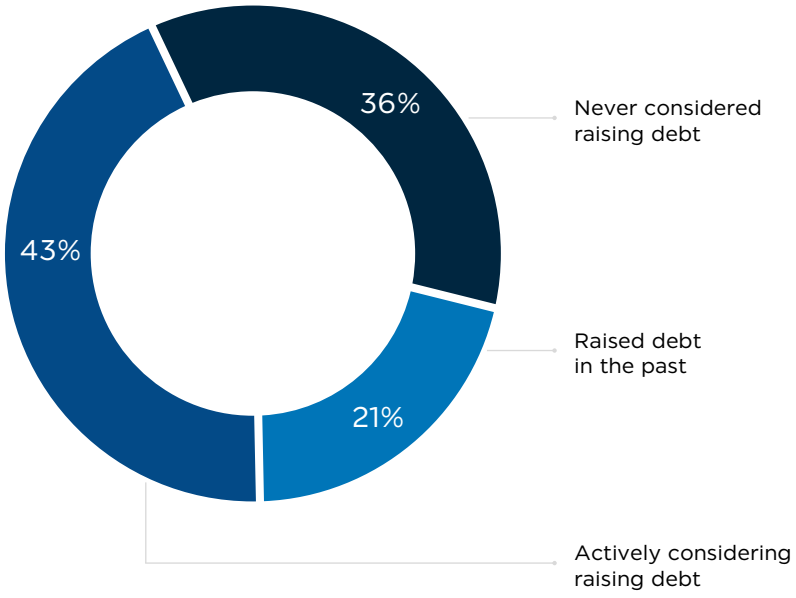
[2]Source: What's Market Report, Khaitan & Co, 2023

Venture Debt

Given the dearth in funding, Indian companies are also increasingly resorting to venture debt. Apart from coupon rates, these typically also carry an option to participate in the future equity fund raises of the company.

We are also witnessing a trend where investors make a nominal equity investment along with venture debt. This allows the investor to test waters and participate in the portfolio's uptrend. Based on performance of the portfolio company, such investors may write larger cheques in future rounds.





Source: Venture Debt: The rising tide of credit in the new economy, BCG-Trifecta Capital, 2022

Developments in India's gaming sector

The past year has seen significant statutory developments in the online gaming landscape.

Imposition of GST on online gaming platforms

In July, the GST Council of India (federal constitutional body for making policy recommendations on imposition of GST) in its 50th meeting has recommended levy of GST at 28% on full face value of the monies staked in online gaming platforms by players/users without distinguishing between 'games of skill' and 'games of chance'.

The following specific recommendations were made by the GST Council in this meeting:

- Online gaming to be included in the same category as lottery, horse racing, betting and gambling, which are excluded from the "NO-GST" dispensation for supply of actionable claim
- All three, namely casino, horse racing and online gaming to be taxed at the uniform GST rate of 28%
- 28% GST will be applicable on:
  - face value of chips purchased in the case of casinos
  - on full value of bets placed with bookmaker/ totalisator in case of horse racing
  - on full value of bets placed in case of online gaming



However, on account of representations from various gaming associations and contrary views of few states, the GST Council, in it's 51st meeting, recommended that GST would be levied only on the amounts initially deposited with the gaming platform/ supplier by/on behalf of players and that 'winnings' redeployed for gameplays by players will not attract GST.

To implement these recommendations, necessary amendments in the Central, State and Union Territory GST statutes were required to be made. In this regard, the Central Goods and Service Tax Act, 2017 (CGST Act) and Integrated Goods and Services tax Act, 2017 (IGST Act) were amended on August 18, 2023, to insert relevant definitions of "online gaming," "online money gaming" and "specified actionable claim" and other necessary amendments.

Subsequently, the valuation rules under the Central Goods and Services Tax Rules, 2017 (CGST Rules) were also amended on September 6, 2023 to prescribe the taxable base for imposition of GST at 28% as the total amount deposited with the supplier/ gaming platform for playing the game and to clarify that redeployment of winnings to play the games without withdrawing the same from the platform is not leviable to GST.

Interestingly, while the Ministry of Finance attempted to make these changes effective pan India from October 1, 2023 both at the Central and State level, in an unprecedented situation many states have not amended their respective State GST statutes unlike the amendments in Central GST statutes. This has created a constitutional anomaly and a disparity in taxation with effect from October 1, 2023 in so far as the online gaming industry is concerned. For example – Karnataka has issued an ordinance to amend its State GST law but Rajasthan has not. Operators with registration in Rajasthan will technically not be liable to SGST but will be liable to CGST for deposits from customers located in Rajasthan. However, IGST will be applicable for all deposits from customers located outside Rajasthan. Whereas operators in Karnataka will have to charge full 28% GST for all customer deposits irrespective of whether customer is within or outside Karnataka. This defeats the very purpose of implementation of GST in India having been brought in as a "One Nation One Tax" measure.

Illustrative example

EXISTING	RECOMMENDED
Pool/Pot value – 100	Pool/Pot Value – 100 (irrelevant)
Platform Fee – 10	Platform Fee – 10 (irrelevant)
GST = 18% of 10 = 1.8	Cash deposit by a Player = 50
	GST = 28% of 50 = 14

Further, the Hon'ble Supreme Court has also stayed the judgment of the Karnataka High Court in the case of Gameskraft Technologies v. Union of India (W.P. No. 19570 of 2022) where in a detailed 325-page judgment, the Karnataka High Court reiterated the established legal position that "games of skill" played offline or online, with monetary stakes or without, cannot be equated with or taxed in the same manner as "Betting and Gambling" and struck down the Rs 21,000 Crore GST demand (1000 times of the revenue earned by the Company). This may result in enhanced actions against the online gaming companies who were seeking refuge under the judgment of the Karnataka High Court including issuance of show cause notices demanding GST.

The above development assumes importance even for overseas players (companies located outside India but having operations in India) in the online gaming industry, as the Finance Minister during the press briefing has clearly indicated that the recommended changes would not benefit the gaming entities being run from overseas. The amendment to the IGST Act has also brought companies located outside India under the purview of GST and seeks to make them liable to pay GST in India even when they do not have a presence in India. Strong enforcement actions including blocking of such websites in India who do not comply with GST provisions in India are being put in place so as to mitigate tax avoidance.

Since there will be substantial impact of the increased GST rate (18% to 28%) and the widened taxable base on the profit margins/ unit economics of online gaming companies, it is likely that only a few large entities would survive in this space. In the short to medium term, the foregoing developments may result in significant consolidation in this sector.

We are noticing developments regularly in this space on all three pillars of governance - the legislative front, the executive, and the judiciary - being kept active. We will continue to watch out the developments by the day.

Online Gaming (Regulation) Bill, 2022

The Online Gaming (Regulation) Bill, 2022 was introduced in the Lok Sabha on 1 April 2022 as a private members bill. Key features include setting up of an 'Online Gaming Commission' to oversee the online gaming industry, and introduction of a licensing regime. Currently, the bill is pending approval.

Income tax on transfer of virtual digital assets

As part of the FY 2022 budget, an income tax at the rate of 30% was introduced on transfer of virtual digital assets with effect from 1 April 2022. Inter-se set off of loss arising from the transfer of virtual digital assets against any income from such transfer is not permissible.

ASCI guidelines on advertisements for online betting and gambling platforms

In June 2022, the Advertising Standards Council of India (ASCI) prohibited print media, private satellite television channels, and digital media from advertising online betting and gambling platforms in India. Advertisements of online games of skill and fantasy sports are not covered within the ambit of the advisory.

Amendments to the Information Technology Intermediary Guidelines to include the online gaming industry

The Ministry of Electronics and Information Technology (MeitY) notified amendments to the Information Technology (Intermediary Guidelines and Digital Media Ethics Code) Rules 2021, to include the online gaming industry within its ambit. The amendments include the introduction of a self-regulatory structure for the online gaming industry and inclusion of definition of 'online games', 'online real money games', 'permissible online games', and 'permissible online real money games.'

Tamil Nadu's ban on online gambling and playing of any online games of chance

On 10 April 2023, The Tamil Nadu government published the Tamil Nadu Prohibition of Online Gambling and Regulation of Online Games Act 2022. The new law prohibits online gambling and playing of any online games of chance with money or other stakes, including rummy and poker, in the state of Tamil Nadu. The ban was challenged before the Madras High Court, however, on 27 April 2023 the Court refused to grant any interim orders in the case.



Regulatory developments in the fintech ecosystem

The Indian fintech ecosystem witnessed various regulatory developments in the past year. The Reserve Bank of India (RBI) issued its guidelines on digital lending, microfinance regulations and default loss guarantees. The fintech ecosystem also raised around USD 1.2 billion in the first quarter of 2023 alone[3].

In the payments space, RBI officially rolled out the central bank digital currency (CBDC) in wholesale segment, known as the Digital Rupee-Wholesale (e₹-W) on November 1, 2022, with its use case being limited to the settlement of secondary market transactions in government securities. The RBI also rolled out CBDC for retail users on a pilot basis in Bengaluru, Bhubaneshwar, Mumbai and New Delhi on 1 December 2022.

The National Payments Corporation of India (NPCI) through its circular dated 1 April 2023 allowed levying of certain charges on specified merchant transactions initiated using Prepaid Payment Instruments (PPIs) on Unified Payments Interface (UPI) rails. The said circular introduced an interchange fee of 1.1% on the transactions applicable to all online merchants, large merchants, and small offline merchants with transaction values greater than INR 2,000.

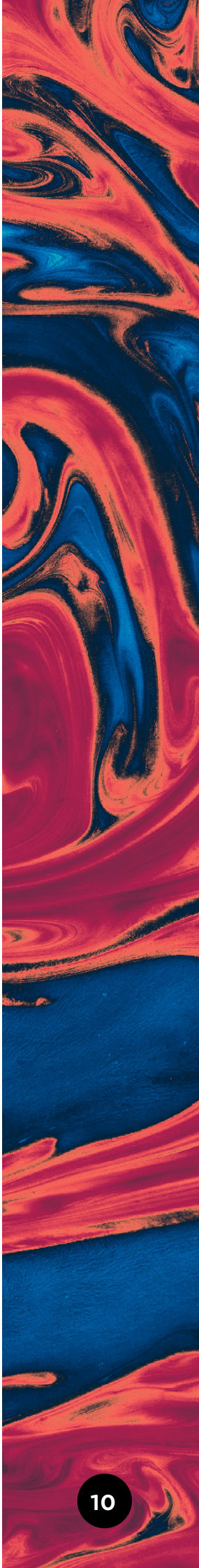
The RBI issued its guidelines on digital lending on 2 September 2022 (Digital Lending Guidelines) which mandate various compliances on Regulated Entities (REs) involved in digital lending. The Digital Lending Guidelines also recognised entities in the form of Lending Service Providers (LSPs) which are involved in digital lending functions such as customer acquisition, underwriting support, portfolio monitoring and loan recovery. Further, they also recognised interfaces involved in facilitating digital lending as Digital Lending Apps. Furthermore, they provide several other customer protection and conduct requirements which include aspects related to charging of fees by the REs only, disclosures related to fees, grievance redressal, due diligence, technology and data management requirements.

The RBI issued the Guidelines on Default Loss Guarantee (DLG Guidelines) granting legitimacy to First Loss Default Guarantee (FLDG) arrangements in India. The DLG Guidelines allow for default loss guarantee (DLG) arrangements between REs and LSPs or between two REs. It prescribes that the total amount of DLG cover on any outstanding portfolio specified upfront should not exceed 5% of the amount of such loan portfolio.

[3]Source: Tracxn Geo Quarterly India Report - Q1 2023

The RBI also revised its existing framework relating to its Know Your Customer Master Directions (KYC Master Directions) which caused significant impact on the fintech industry. The KYC Master Directions prescribe enhanced due diligence requirements for customers onboarded in a non-face-to-face manner. Such requirements include customers onboarded through non-face-to-face mode to be categorised as high-risk customers.

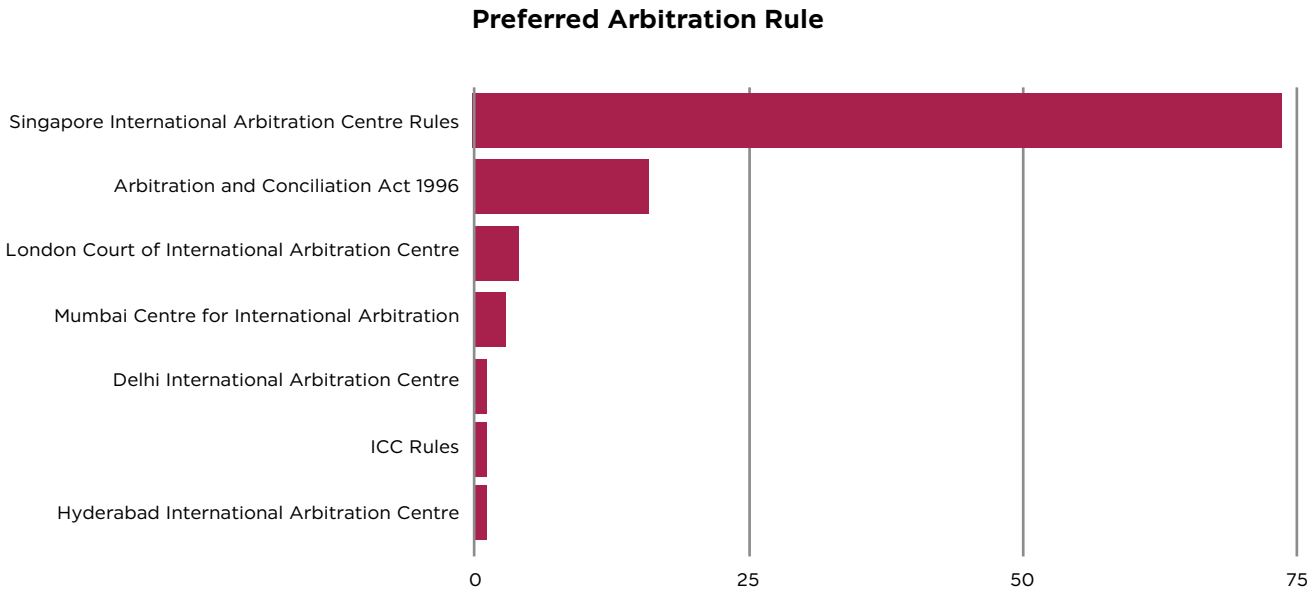
Accounts of such customers should be subject to enhanced monitoring until the identity of the customer is verified in a physical manner or by conducting Video Customer Identification Procedure (V-CIP). REs are now required to verify the current address of its customer through positive confirmation before allowing operation in such customer's account. The recent amendments align the KYC Master Directions with the changes brought in the Prevention of Money Laundering Rules, 2005 and Financial Action Task Force (FATF) recommendations.



Disputes update on Singapore seated arbitrations

This was a case before the Singapore Court of Appeal's (SGCA). The matter dealt with differences between an investor and a promoter of an Indian company over the intention to exit from the Indian company. The shareholders' agreement (SHA) executed by the investor and the promoter, among other parties, was governed by Indian law and stipulated that disputes were to be resolved by Singapore-seated arbitration. The SHA did not expressly specify which law is applicable to the arbitration agreement.

The SGCA in this matter concluded that the Singapore law would apply to the arbitration agreement based on facts of the case. The promoter initially sought to resist arbitration by asserting that the dispute was an issue of oppression and mismanagement (O&M) under Indian company law which is not arbitrable under Indian law. The SGCA rejected this contention and allowed the arbitration to proceed on the reasoning that (i) O&M disputes are arbitrable under Singapore law;



and (ii) the question of whether an issue is arbitrable or not had to be determined by reference to the law of the seat and the law applicable to the arbitration, both of which were Singapore law in this case.

SHA with respect to Indian companies typically provide for arbitration as a dispute resolution mechanism. However, recalcitrant parties often try to resist arbitration (and in turn, expeditious resolution of the dispute) by presenting the dispute as an issue of oppression & mismanagement which cannot be settled through arbitration under Indian law. This matter throws light on the need to ensure that SHAs with respect to Indian companies specifically call out that (i) the arbitration will be a Singapore 'seated' arbitration (i.e., an arbitration that is governed by the arbitration law of Singapore); and (ii) Singapore law will be the law as applicable to the arbitration agreement (i.e., the law that would govern the validity of the arbitration agreements)[3].

Subsequently, in September 2023, the Bombay High Court (BHC) and the National Company Law Tribunal (NCLT) issued injunctions that effectively restrain the arbitration between the parties. In doing so, neither the BHC nor the NCLT have expressed views (one way or the other) on the SGCA's findings as to what law will govern arbitrability. These injunctions issued by the BHC and NCLT diminish the pro-arbitration approach of the SGCA and its implication for Indian parties seeking to arbitrate shareholder disputes in Singapore. Nevertheless, it is likely that the BHC and NCLT orders will be appealed, and therefore, these decisions may not be final word on Indian parties arbitrating shareholder disputes in Singapore.



[3]Source: What's Market Report, Khaitan & Co, 2023

Foreign Trade Policy Updates

The foreign trade policy (FTP) of India impacts businesses that are dependent on imports and exports. This includes start-ups and emerging businesses especially in the e-commerce space – a subset in which VC funds have a fair amount of exposure in India. In order to encourage investments, the FTP 2023 has introduced significant measures for promotion of exports with a special emphasis on the e-commerce sector, for the first time.

Some of the key measures introduced this year are as under:

- Export linked benefits under the FTP have been specifically enabled and extended for e-commerce exports as well. Also, the cap on imports through courier has also been revised from INR 5 lakh to INR 10 lakh with scope of further revisions as may be necessary.

- Export hubs specific to the e-commerce industry (such as bonded warehouses) will be set up to facilitate the aggregators. Such hubs would primarily be used for stocking of goods, clearance, labelling, testing, repackaging and others.

- Measures for greater outreach to various parts of India and promotion of export culture even at a district level have been envisaged. This is to be implemented by nodal Directorate General of Foreign Trade (DGFT) Regional Authorities.

- Formation of Dak Ghar Niryat Kendras, which will work in collaboration with Foreign Post Offices to facilitate cross border e-commerce and enable artisans, weavers, craftsmen, micro, small and medium enterprises (MSMEs) in the hinterland and land-locked regions to reach international markets.

Another favourable announcement for VC funds that came out as a part of 2023 Union Budget grants autonomy to International Financial Services Centres (IFSCs) with respect to governance under the Special Economic Zones Act, 2005 (SEZ Act), thereby enabling IFSCs to emerge as a single platform for all SEZ Act related compliances and resolution of any disputes. This is likely to provide a degree of comfort to VC funds exploring to increase their footprint in India.

Looking forward to

(a) Implementation of Data Protection Bill

(b) Digital India Act

(c) Open Credit Enablement Network (OCEN)

In conversation with Siddharth Pai, Founding Partner, 3one4 Capital



Siddharth Pai
Founding Partner
3one4 Capital

1. **What in your view is the single greatest challenge before the Indian VC landscape today?**

   The global shift from a low interest rate environment to a high interest rate has fundamentally altered the VC playbook of the last decade. The paradigm of "move fast and break things" has been replaced with "repair and rebuild." The flight of capital to safer, high yield assets has flushed liquidity out of the system and dislocated the assurance of further funding if a company demonstrates high growth. VCs who fail to adapt to this new normal will see massive value destruction as old playbooks need to be rewritten for this new macro environment.

2. **What will be the major investment themes in the next couple of years?**

- **Generative AI applications**

  Generative AI is powering the next generation of computing platforms. Thanks to deep learning, AI systems can see, hear, understand, and reproduce natural language at near human level accuracy.

  Taking this horizontal technology into mainstream sectors like finance, education, healthcare, and more will be a large area of innovation in India.

- Electric Mobility

  Despite short term variability due to macro and policy events, electric vehicle (EV) sales are expected to grow significantly during the next five years. EV sales growth could be lumpy as factories are built to scale but should be robust over time as EV adoption gains traction.

  India will be a large market for commercial EVs specifically. Building the entire stack - from motors to fast charging networks - will be an important area of investment.

3. What are your thoughts on the exits landscape? Do you think secondary transactions will remain the flavour of the season?

The exit landscape has shrunk as companies seek to conserve cash and optimise for high primary infusions as opposed to secondary sales. Even for initial public offerings (IPOs), a high offer for sale (OFS) component is looked upon with suspicion by the market. Only companies with free operating cashflows and strong balance sheets can generate exits for their investors as interest in such assets remains strong. Each secondary transaction is a benchmark of the valuation of the company, with discounts being deeper than what was seen in the past.

4. Which regulatory development do you feel will provide necessary impetus for the next phase of growth for Indian startups?

Indian startups need to go global very early on in order to remain competitive. Indian startups looking to go global prefer domiciling in Singapore or the US as opposed to India. A key reason for this is the operational friction in global billing from India faced by startups. Allowing Indian startups to maintain foreign currency accounts that can integrate with payment gateways will provide a level playing field for them as they compete globally.

Another component is to allow Indian financial institutions the ability to invest in Indian startups and funds. The US VC ecosystem accelerated when pension funds and insurance companies were allowed to invest in such funds. Regulations still prevent this from being an option in India.

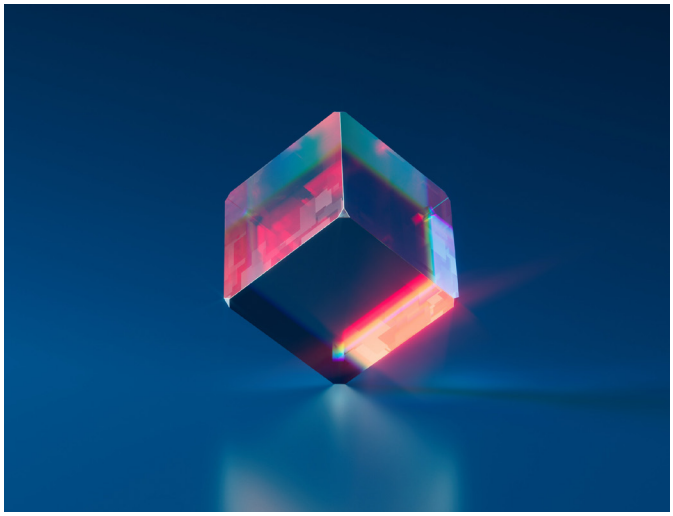
Angel Tax

The income-tax law provides for minimum pricing norms, or tax fair market value (Tax FMV), for the issuance of shares by a closely held company – popularly known as the 'Angel Tax' provision. It provides that in case where shares are issued at premium (i.e., above face value) and the consideration received for issuance of shares is higher than the Tax FMV, then the difference between the consideration and Tax FMV shall be treated as ordinary income for issuing company. An exemption is provided from the Angel Tax provision for cases where shares are issued to a 'VC company' or 'VC fund' by a 'VC undertaking', meeting certain prescribed conditions. Previously, the Angel Tax provision was restricted to cases of shares issued to an Indian tax resident. This has now (i.e., for FY 2023-24 and onwards), been extended to shares issued to non-resident shareholders as well. Further, the valuation rules for computing Tax FMV have also been amended recently (vide Notification No. 81 / 2023 dated 25 September 2023) whereby, inter alia (i) flexibility has been provided in terms of more options of valuation methods and the relevant date for obtaining valuation report, (ii) a safe harbour or a tolerance band of 10% differential has been allowed in certain scenarios.

Angel Tax was initially introduced in 2012 to 'prevent generation and circulation of unaccounted money through share premium'. But the wider tax net cast through extension of Angel Tax to non-resident investments can be attributed to increasing pressures on Indian government to increase its revenue from direct taxes.

Angel Tax has been long seen as an irritant by startups and investors. Several efforts have been made to rationalise it. While certain relaxations were given to startups registered under the Startup India programme, those exemptions were not seen to have adequately addressed the concerns.

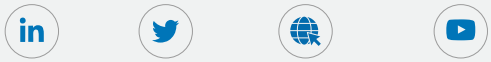
Indian companies have in the past received notices from Indian tax authorities seeking to review and reopen valuations basis which investments were previously accepted. This allowed tax authorities to challenge and open gates to tax Indian companies on investments which were otherwise kosher. Indian companies should henceforth put more onus on their valuation exercise and ensure that it is defendable.



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Our PE-VC practice is designed around our clients, enabling them to achieve a competitive edge, position themselves to make the highest quality investment decisions and enable them to realise maximum value. We understand that our clients in this deal space face daily pressures of origination, valuations, execution, performance, exit strategies, fund-raising and regulation and we partner with you through this journey. Our award-winning, top-ranked team works with clients across asset classes, offering full-service support, covering all aspects of the life cycle of a business.



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