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Survey of the Nepal Private Equity and Venture Capital Environment

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Abstract

This paper discusses the landscape for private equity and venture capital financing in Nepal. It provides an overview of the nascent private equity and venture capital market in the country, describing key players, including funds, fund managers, investors, and public sector entities. The paper provides an analysis of key market drivers and impediments, as well as legal/regulatory/taxation drivers and impediments that affect Nepal's private equity and venture capital industry.

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[1] This report was completed in 2018 by a team led by Shanthi Divakaran (Senior Financial Sector Specialist), and comprising Gianni Lorenzato (Industry Consultant, World Bank FCI Practice); Pioneer Law Associates, Nepal (team comprising Anup Upreti, Managing Partner; Pratikshya Dahal, Associate); and Trilegal, India (team comprising Ganesh Rao and Aditya Jha (Partners); Yash Bansal, Counsel).

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DISCLAIMER:
The originals of Acts of Parliament and Rules and Regulations made by the regulator are in the Nepalese language. No official English version of these laws is available. It is understood that only the original Nepalese versions are binding. References to Nepalese laws in this Report are to English versions of the documents obtained from either the website of SEBON or translations arranged for by the World Bank/IFC offices in Kathmandu.

I. Overview of the Nepalese PE/VC Industry

A. Background

While still a novelty, PE/VC investors have shown interest in Nepal. Investor interest is driven by three factors. First, the economy has stabilized after the April 2015 earthquake and, later that year, major trade blockades resulting from disputes with India (Nepal's largest trade counterpart). Second, Nepal suffers from chronic underinvestment and weak FDI inflows, due to political instability, protectionism and capital controls; capital is needed to fulfill the country's development potential and DFIs and impact investors are stepping in to help fill this vacuum. Third, as is common in many developing markets, Nepalese commercial banks do not lend on a cash flow basis, requiring collateral instead; this is an obstacle for growing SMEs that are still asset-poor. Bond issuance is limited to the sovereign and a few large corporates.

Nepal is home to a nascent PE/VC ecosystem. Four investment firms have formalized their operations in PE-like structures: Dolma, BO2, True North Associates and One to Watch. They managed a collective $48 million as of March 2017. Dolma and BO2 are the industry leaders with $26m and $14m of committed capital, respectively. Dolma is a Mauritius-registered fund, 95% funded by development finance institutions (DFIs), and invests in hydropower projects and the broader SME sector. BO2 is incorporated as a Nepalese company with governance attempting to mirror the operations of a PE/VC fund (different share classes for general and limited partners); it is entirely DFI-funded with the IFC as largest investor, and is focused on SME investments with a generalist sector approach. In addition, several consortia of local businessmen pursue PE/VC strategies through informal investment clubs –these are outside the scope of the study. Preliminary findings suggest that larger regional funds have not yet targeted the country, perhaps due to small market size and/or perceived difficult investment environment. With the exception of one investment exited by One to Watch, as of March 2017 funds had yet to harvest their portfolios. Table 1 provides summary information on the funds interviewed by the task team. Detailed information can be found in Annex 1.

Table 1: Main PEVC/PEVC-type funds in Nepal [2]

Fund manager	Fund	Inception	AuM (US$m)	Fund strategy	Target sectors
WLC Ventures Pvt. Ltd.	Business Oxygen Pvt. Ltd. (BO2)	2015	14.0	SMEs, growth capital	Generalist, including agriculture, hospitality, manufacturing, ICT
Dolma Fund Management	Dolma Impact Fund	2014	25.7	SMEs, growth capital	Generalist with focus on renewable energy, healthcare, agriculture, education, tourism, technology
One to Watch	One to Watch	2010	3.0	Impact investor and accelerator	Generalist with focus on agriculture, food, renewable

[2] For simplicity, in the rest of the document the fund managers and their respective funds will be referred to as: BO2, Dolma, One to Watch and True North.

					energy, IT, building materials
True North Associates	T.N.A. Invest Pvt. Ltd.	2016	5.0[3]	SMEs, growth capital	Generalist with focus on e-commerce, education, marketing, IT services, energy

B. Main features of PE/VC firms in Nepal

Based on investor surveys and extensive interviews, the team has analyzed the key features of the funds investing in Nepal. The detailed discussion is followed by Table 2, which provides a summary of these features.

Investment strategy

The prevailing investment strategy is minority, growth-equity investments in SMEs and midcaps. This is instrumental to servicing the capital needs of a growing economy, in infrastructure as well as the corporate sector. Average ticket size across funds ranges from less than \$300k to \$2m – although bigger investments were made in the hydropower sector (by Dolma in particular). Funds usually acquire a stake ranging from 20% to 49% and, despite not having equity control, try to have a proactive role in company management. Majority deals are extremely unlikely, due to a culture of long-term ownership and control that is typical of Nepalese entrepreneurs, and indeed most SMEs across developing countries.

While all funds expressly claim to focus on SMEs, only one provides clear parameters in terms of portfolio company size. BO2 defines as SME any company that meets at least two of the following three criteria: fewer than 50 employees, less than \$3 million turnover, less than \$3 million assets. This definition seems consistent with the typical profile of a portfolio company for the other funds interviewed. Hydropower investments, as indicated by Dolma, can be substantially bigger.

Funds invest exclusively in equity and equity-like instruments, as is most common in the PE/VC industry and also reflecting Nepalese-specific constraints. First, due to draconian blacklisting rules applied to shareholders and directors of companies in default (see detailed discussion in Section II), funds err on the side of caution and prefer to minimize or avoid leverage at the portfolio company level. Second, leveraged finance is not yet offered by Nepalese banks, which prefer to lend on an asset rather than cash flow basis.[4] Last, the NRB restricts PE/VC funds established in Nepal (like BO2) from providing capital in the form of debt, given these funds are not licensed under the Banks and Financial Institutions Act (BAFIA); in addition, the Central Bank has set strict limits to lending by foreign institutions, which is allowed only where domestic debt is unavailable, and is subject to an interest rate cap of LIBOR+5.5% (see detailed discussion in Section III).

While the exit track record is still very limited, funds lean towards buy-back by controlling shareholder and strategic sale as the main exit strategies. Due to the young age of the industry,

[3] US\$-equivalent (fund is denominated in Nepalese rupees).

[4] Leveraged finance loans or HY bonds are usually unsecured, especially when portfolio companies are in sectors that are not capital intensive. In that case, loan/bond repayment is made from the cash flows generated by the portfolio company. Sometimes loans are also secured on a company's collateral (e.g. real estate), but not always.

only one investment has been harvested so far – One to Watch exited a portfolio company through buy-back by the company's promoter. Since all funds invest in minority stakes, this exit strategy is likely to be widely adopted, followed by sale to other industry buyers.

Given an environment where mergers and acquisitions (M&A) are limited, IPOs could also potentially be an attractive exit option for investors. However, the IPO exit route is not very effective, mostly due to regulatory constraints. As discussed in detail in Section II, IPO pricing in Nepal is subject to NRB's valuation guidelines if the shares issued are priced at a premium over book value. The Securities Registration and Issuance Regulation 2016 (2073) allows shareholders of unlisted shares to exit through an offer document and with approval from SEBON. However, this provision has not yet been tested, and presents a risk to promoters seeking to offload unlisted shares. In addition, most of the stocks listed on the Nepal Stock Exchange are financial institutions, followed by hydropower companies – stock market investors have had limited exposure to sectors other than these two and more effort may be required during the IPO marketing phase to bring them up to speed.

Fund size and fund-raising plans

Funds operating in Nepal are small compared to other emerging and developing economies, reflecting the early stage of development of the PE/VC industry and investor composition. The two industry leaders, Dolma ($26 million capital) and BO2 ($14 million), benefited from large capital injections by DFIs keen to demonstrate the viability of a PE/VC industry in Nepal. For instance, the IFC alone represents half of the $14 million capital committed to BO2, with the remainder provided by DFID and the Pilot Program for Climate Resilience, among others. Dutch and other European high net worth individuals are the main investors in One to Watch, and Nepalese high net worth individuals (including the fund's founders) are the main investors in True North – these high net worth individuals on average made smaller individual investments than DFIs.

As of 2017, all funds were still actively investing and only one was currently contemplating a new fund-raising. BO2 has the largest "dry powder" ($12 million out of $14 million capital committed to the fund). Dolma, running the largest fund ($26 million total capital), has slightly less dry powder ($10 million), having made fairly sizable investments in hydropower already. True North has started operations recently. Only One to Watch, which started in 2010, has almost entirely depleted its original capital of $3 million, and is now looking to raise additional capital, the size and timing of which are unclear.

Legal structure and domiciliation

The players in this nascent ecosystem reflect a variety of choices in PE/VC legal structures, which are discussed in more detail in the section analyzing legal/regulatory drivers and impediments. Dolma is technically a limited liability company registered in Mauritius. The other firms operate through company structures, with by-laws and shareholders agreements that attempt to simulate fund operations (voting power and board representation for limited and general partners). BO2[5] and True North Associates are incorporated under Nepalese company law, One to Watch under Dutch law. Sections II and III include a detailed discussion of fund legal structures, the existing

[5] BO2 issued ordinary shares for both the fund manager and IFC; and the relationship between the Fund Manager and IFC is primarily dealt with under the Shareholders Agreement. There have been a few local funds (for example Himalayan Infrastructure Fund) structuring the GP/LP structure as Class A and Class B shares with different voting rights.

impediments to fund set-up and operations in the Nepalese legal and regulatory system, and proposed policy amendments.

The choice of Nepalese or onshore domicile is critical when determining whether a fund is subject to FDI controls. Offshore funds such as Dolma are subject to FDI controls under Foreign Investment and Technology Transfer Act (FITTA). Nepal-domiciled funds with an exclusively Nepalese investor base are considered as domestic investors under FITTA, and are not subject to FDI controls. Nepal-domiciled funds with foreign investors (such as BO2) are considered as foreign investment under FITTA, and require prior approval of the DOI on a deal-by-deal basis; their investment will also be restricted in the negative list as provided by FITTA. See Section III for detailed discussion.

Fund investors

The largest source of PE/VC capital unsurprisingly comes from DFIs, as is typical in other developing countries. BO2 is entirely DFI-funded – the IFC is the largest investor with half of the fund's committed capital, followed by DFID and the Pilot Program for Climate Resilience (PPCR), a $1.2 billion funding program of the Climate Investment Funds focused on climate adaptation investments to which BO2 obtained access due to the climate-related nature of some of its investments. Dolma is funded 95% by DFIs, including FMO, Finnfund and an Austrian DFI, and 5% by two high net worth individuals from the UK and Singapore. The two smaller funds, One to Watch and True North, representing 17% of total capital commitments in the industry, are funded by high net worth individuals – Europeans in the case of One to Watch and Nepalese in the case of True North. The Nepalese founders of True North also committed half of the fund's capital.

Nepalese institutional investors have not allocated to PE/VC and lack sufficient knowledge about the asset class. The 2014 Investment Policy issued by the Insurance Board (the insurance regulator) imposes restriction on insurance companies from investing in funds, favoring government bonds and bank certificates of deposit. Restrictions apply to pension funds, which are all public entities established with *ad hoc* laws that also discipline their investments. Neither insurance companies nor pension funds can invest offshore.

Geographic and sector focus

All funds interviewed invest exclusively in Nepal. Larger regional funds have not yet targeted the country, perhaps due to small market size and/or perceived difficult investment environment.

All funds are sector generalists, although there is increased interest in hydropower. Hydropower offers the biggest opportunities, in number and size, given Nepal's vast potential in this area (due to vast water resources in the Himalayas) coupled with the country's electricity shortage. Other sectors targeted by PE/VC include tourism and hospitality, agribusiness, education, health care, IT, cement and manufacturing.

Several sectors are closed to foreign investment, due to legal restrictions to FDI. Foreign investment is permitted largely depending on the following two conditions: (i) the proposed business activity should be classified as an "Industry" under Industrial Enterprise Act, 2016 (2073) (IEA 2016); and (ii) the proposed business activity should not fall under FITTA's negative list. Foreign investment is therefore permitted only in industrial activities; the trading and retail sectors are closed to foreign investment. However, investment in retail (although listed under the Negative List of FITTA) is permitted if being conducted in more than two countries as an international chain. Industries listed under FITTA's "negative list" (such as internal courier service, poultary farming, bee-keeping) are also closed to foreign investment. See Section III for a detailed discussion of FITTA.

Returns

With the exception of One to Watch, all funds target north of 20% local currency returns. One to Watch has an impact mandate, for which it is willing to realize sub-market financial returns – it indicated a target of 15% IRR at deal level, or 10% at fund level net of fees. Note that while Dolma also brands itself an impact fund, it aims to achieve commercial returns.

However, the ability to realize returns in the ecosystem remains to be seen. Given their short history, most funds have not yet exited any investment. One to Watch is the only fund to have realized an exit, with a return in the 10% range (pre-fees).

Fee structure

The funds charge fees broadly in line with international PE/VC practices. These include a management fee levied on the total assets of the fund (2-3% p.a.), and an incentive fee of 20% applied to the capital gains realized on an investment. The incentive fee is subject to achieving a minimum return ("hurdle rate") that varies fund by fund. However, certain funds receive access to technical assistance, which essentially subsidizes management costs.[6]

Use of concessional tools

With the exception of True North, all funds offer some form of technical assistance. BO2 is the beneficiary of a $600,000 interest-free technical assistance facility provided by the IFC. One to Watch operates an in-house business acceleration program, known as Rockstart, in which all portfolio companies participate for a 3-month period; the accelerator is funded by donors including DOEN and Triodos Bank. Dolma uses DFI assistance in the implementation of ESG standards at portfolio level.

ESG standards

Three out of four funds apply ESG standards, both to fulfill their development agenda and to attract DFI capital. Both BO2 (as IFC investee company) and Dolma apply the IFC's ESG performance standards. True North Associates, having raised money only from Nepalese high net worth individuals, does not currently apply ESG standards.

[6] For more on this, please refer to WB Policy Research Working Paper WPS6827 on the role of technical assistance in private equity/venture capital funds investing in SMEs in developing countries.

Table 2: Summary of prevailing PE/VC fund features in Nepal

Feature	Description
Investment strategy	• Growth equity, via significant minority stakes in SMEs and midcaps • Only equity or equity-like investments. Very limited or no use of leverage • Exit expected mainly through buy-back by controlling shareholder or strategic sale • IPO exits deemed by funds as difficult, for regulatory reasons
Geographic and sector focus	• Funds focus exclusively on Nepal (not the broader region) • Funds are sector-generalists • Dolma is particularly focused on hydropower due to large market potential and the fund's larger size allowing for hydropower investments
Fund size and fund-raising plans	• Fund size ranges from $3 million to $26 million – small by international standards • All funds are still actively investing • Only one fund (One to Watch) has almost depleted capital and is looking to raise more
Fund legal structure and domiciliation	• Funds have adopted a variety of legal structures and domiciliation • Two funds (Dolma and One to Watch) are domiciled offshore (Mauritius and Netherlands, respectively) • The Nepal-domiciled funds, in the absence of a fund legislation, were set up as companies with governance replicating the operations of a typical PEVC fund
Fund investors	• The largest funds (>80% of the industry) are predominantly DFI-funded • The smallest funds are predominantly funded by high net worth individuals (Nepalese and foreign) • Nepalese institutional investors (insurance, pension) not allowed by regulation to invest in PE/VC, and lack knowledge/capacity
Returns (target and realized)	• With the exception of One to Watch, all funds target north of 20% local currency returns • One to Watch has an explicit impact mandate and accepts lower returns • Very limited evidence of realized returns due to short industry track-record (only one exit by One to Watch)
Fees	• Generally in line with international PE/VC standards (2-3% management fee, 20% incentive fee)
Use of concessional tools	• Most funds provide some form of technical assistance – from help on ESG compliance to a full business-acceleration program • Technical assistance, while led by the funds themselves, is donor-funded

II. Existing Legal and Regulatory Environment for Domestic Funds

The analysis of the legal and regulatory framework for PE/VC funds operating in Nepal is structured around the different phases of the life horizon of a fund. These include fund set-up, the fund's investments in portfolio companies (investment entry), the structuring and execution of such investments, and the sale of the fund's interest in its portfolio companies (investment exit). A discussion of each bottleneck follows below.

A. Fund set-up

<u>AIF regulation</u>

The existing regulatory framework for securities allows SEBON to regulate collective investment schemes (CIS). However, specific provisions are currently provided for only one form of CIS, namely, mutual funds; there is no specific regulation to discipline onshore PEVC funds or their managers. The Securities Act, 2063 (2007) ("Securities Act") established the Securities and Exchange Board of Nepal (SEBON) to regulate the "securities business." This broad mandate allows SEBON to regulate collective investment schemes,[7] which is elaborated in Chapter 6 of the Securities Act, and which can include private equity and venture capital funds set up as companies, trusts or other vehicles as specified by SEBON. However, the framework currently focuses on mutual funds -- that is, open-ended funds that invest in listed securities and are sold also to retail investors -- which require more stringent regulations than closed-ended PEVC funds invested in illiquid securites and offered exclusively to accredited or sophisticated investors. Chapter 6 of the Securities Act and specific regulation dealing with mutual funds-Mutual Fund Regulations 2010 govern mutual funds, with provisions concerning fund registration, fund manager licensing and portfolio composition. Chapter 6 of the Securities Act does not provide a specific exemption for closed-ended funds; however, given the definition of mutual funds requires that the shares of the mutual fund should be listed on the stock market, PEVC or closed ended funds which would not list on the stock exchange are not subject to Mutual Fund regulations. (Chapter 6, Article 71). *See Box 1 below on increasing oversight of private equity and venture capital funds since the global financial crisis.*

Box 1: Increased global regulatory oversight of PE/VC

Since the 2007-08 global financial crisis, there has been a trend in increasing oversight of previously unregulated entities such as private equity funds and hedge funds. The G20's November 2008 summit was a defining point, leading to the decision that all significant financial market participants must be regulated to preserve financial stability and to protect investors. In line with this decision, the EU adopted the Alternative Investment Fund Managers Directive (AIFMD) or Directive 2011/61/EU[8] to regulate and supervise alternative investment fund managers (AIFMs) who manage alternative investment funds (AIFs), including PE funds, VC funds, hedge funds etc. operating in the EU. Similarly, the US Dodd-Frank Act, enacted in 2010, gave the US SEC greater purview over private funds.

[7] The Securities Act defines Collective investment schemes as "an investment fund, unit trust or similar other participatory fund management program as specified by the Board, from time to time as may be operated by a scheme manager in accordance with this Act in order to distribute returns to, the participants of the concerned program proportionately, accrued from the efficient investment service on saving investment amount which has been undertaken in custody of the manager and so mobilized that various persons or bodies that have participation in it."

[8] DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

Increased regulatory oversight of the asset class also engenders investor confidence. Institutional investors, particularly in markets where PE/VC is nascent, are less comfortable investing in an asset class which is unregulated. Thus, more oversight can increase the flow of capital into the asset class from such investors.

Similarly, Nepalese legislation on partnerships does not cater to the specific needs of private equity fund structures which seek to differentiate between Limited Partners (LPs) and General Partners (GPs). Nepal adopted a Partnership Act in 1964 but this caters essentially to professional partnerships such as accounting firms and other service providers. Such partnerships are considered as corporate entities for tax purposes and would be taxed at the corporate rate. The present partnership framework does not provide for limited liability of a class of partners or for a pass-through tax structure. Nepal adopted legislation concerning trusts, but this is meant mostly for charitable trusts set up for religious purposes. However, the new Civil Code,[9] which came into effect August 2018, provides specific provisions related to trusts which will allow trusts to be used to establish investment funds, thus providing an alternative vehicle to companies under the Companies Act *(see discussion below)*.

<u>Substitute corporate structure</u>

In the absence of a specific legal and regulatory framework for PE/VC, Nepalese fund managers have adopted corporate structures (under the Nepal Companies Act) to replicate the operations of a PE/VC fund. The main example is BO2, set up by a local team with an initial capital injection and close cooperation from the IFC (True North also adopted a corporate structure, but only manages the founders' money as of now). When BO2 was set up, the IFC was the only external investor. To replicate a typical PEVC fund structure, the following structure was adopted: The IFC acquired 80% of the paid-up capital of the company for a nominal amount, and provided an additional $6.7 million loan representing the vast majority of its investment. The fund manager acquired 20% of the paid-up capital – allowing the manager to collect 20% of future investment income generated by the company via dividend distributions. The company is subject to standard Nepalese corporate income tax. The shares owned by the fund manager carry special voting and distribution rights, to allow independence of investment decisions and priority payment of carry, respectively.

The first pitfall of this substitute corporate structure is its legal complexity, and the potential for legal challenges. Significant legal work and negotiations are involved in structuring different classes of shares, waiving voting rights for shares allocated to LPs, delegating sole power over investment decisions to GP-shareholders, and prioritizing income distributions to GP-shareholders to mirror the standard "2 and 20" private equity fees. The Companies Act broadly requires investment decisions to be made by the Board itself, and cannot be delegated.[10] In a typical PE/VC structure, where the company's Board has to delegate its authority to make investment decisions to the fund manager or an investment committee, the Board may provide a broad investment mandate outlining the maximum investment amount, sectors of investment, etc., and is ultimately still responsible under company law for investment decisions. The company structure can also be problematic because it does not provide certainty that the investor / limited partner advisory committee of the fund does not owe fiduciary obligations or acts as 'shadow

[9] The Civil Code is a compilation of laws related to civil matters. Currently, there is a General Code comprising laws related to civil matters and criminal matters, which will be replaced by two separate codes for each of the matters.
[10] The law specifically lists a number of powers of the board that cannot be delegated and can be exercised only by passing resolutions at a board meeting. Decisions related to investment are one such non-delegatable power of the Board.

directors.' This is important as such a committee is a common feature for PE/VC funds intrnationally and is an important governance body for LPs. In jurisdictions where a company is commonly used as a fund vehicle, such as Mauritius and Singapore, the local company law permits flexibility to structure arrangements to closely mimic a traditional limited partnership structure. Local counsel interviewed by the task team expressed concern that the structure is not yet tested and could be challenged in court, because the nature and extent of what the board can delegate to the investment committee has not yet been interpreted by the courts of Nepal.

The second pitfall of the structure is its highly unusual nature, which is likely to alienate institutional investors (foreign in particular) who are used to more conventional fund structures. BO2 was able to embark on the lengthy and complicated legal path required to set up the structure because of the proactive involvement of the IFC, keen to demonstrate the feasibility of a domestic PE/VC vehicle. Specific governance arrangements, including delegation of authority, differentiation of shareholder rights, and management agreements had to be put in place to reflect the different roles and economics of the GP and LP. Other foreign/ commercial institutional investors in PE/VC are unlikely to commit the time and resources needed to understand and negotiate all relevant terms, especially when the alternative is to invest in a conventional fund set up in a familiar offshore domiciliation such as Mauritius, and considering the small size of the Nepalese PE/VC investment opportunity. In addition, the company structure is not subject to any regulatory supervision other than under the general Companies Act framework for companies. The legal uncertainties and the absence of statutory safeguards for investors in the company will not be conducive to the development of PE/VC in Nepal, unless SEBON introduces specific regulation on PE/VC as collective investment schemes.

The third pitfall of the structure is its tax inefficiency, specifically the fact that the structure is not pass-through from a tax standpoint. In other jurisdictions, alternative investment funds are structured so that the fund itself does not pay tax on any investment income; only the fund's investors are subject to taxation on any investment income distributed to them by the fund, based on the tax rules in force in their countries of domiciliation or the domicile of the fund (but subject to tax treaty benefits or credits). Even where the fund must withhold tax, a tax credit regime is typically available to investors. Some jurisdictions do not impose any tax (in that jurisdiction) on the income received by the fund or distributions from the fund to its investors (thereby effectively making it tax transparent). The substitute corporate structure adopted by BO2 is for all intents and purposes a company under Nepalese law and, as such, it is subject to normal corporate tax rules and pays tax at the rate of 25%. In addition, any distributions by the company to its investors-shareholders can only occur via dividends, which are subject to a 5% withholding tax.[11]

While the efforts of BO2 and the IFC to devise a domestic fund-like structure are commendable, in light of the pitfalls described above, this structure remains inadequate to spearhead the development of a domestic PE/VC industry. At the same time, as described in Section III, conventional PE/VC funds domiciled offshore suffer from other bottlenecks in their investment activities in Nepal, primarily linked to FDI and capital controls. As a result, the introduction of a Nepalese AIF legal and regulatory framework (including in relation to tax) is important to increase the penetration and availability of PE/VC capital in the country provided that existing provisions applicable to foreign investment (currently the primary source of PEVC capital in Nepal) are also specifically amended for PE/VC.

[11] The dividends distributed by the company to its shareholders are subject to 5% tax withholding. The company as a withholding agent must file the statement of tax withheld within 25 days from the end of each month. The company should also pay such tax withheld within 25 days from the end of each month.

Restrictions on Nepalese institutional investors

The pool of institutional capital available to invest in PE/VC funds is very limited, because of legal and regulatory restrictions. In addition, neither insurance companies nor public pension funds currently have sufficient knowledge and capacity to invest in PE/VC funds or fund-like vehicles. In more mature markets, it is typical that banks, pension funds and insurance funds / companies form a part of the domestic LP base in the industry, albeit their fund investments are subject to capital market exposure or prudential norms. Two types of institutional investors are present in Nepal: insurance companies and public pension funds. 35 insurance companies operate in Nepal (17 life, 17 non-life and 1 reinsurance). They are regulated by sector regulator Beema Samiti. Total assets under management in the sector amount to Rs 13,480.08 million (approximately $130mn). The two main pension funds operating in Nepal are the Citizen Investment Trust ("Citizen") and the Employees Provident Fund ("EPF"). Both are government-controlled and were established with *ad hoc* acts of parliament. Citizen manages the savings of 575,000 civil servants, teachers, military and police personnel, for a total of US$900mn AuM. EPF manages the social security contributions paid monthly by employees and employers in both the public and private sectors; total AuM amount to approximately US$2.25 billion.

The 2014 Investment Policy issued by the Insurance Board allows insurance companies to invest in investment companies (life insurance companies) and in collective investment schemes (both life and non-life insurance companies). However, the regulation provides no definition of "investment company"; and it is unclear if collective investment schemes would include PEVC funds. The 2014 Investment Policy clearly states the investment criteria for insurance companies and favors liquid investments in government bonds, bank deposits or collective investment schemes – these three combined must represent at least 70% of AuM of life insurance companies and 65% of AUM of non-life insurance companies. The policy permits life and non-life insurance companies to invest up to 10% of investment capital in public limited companies; up to 5% in manufacturing or national priority projects,[12] and to provide investment seed capital to collective investment schemes with prior approval of the Insurance Board. In addition, the policy allows only life insurance companies to invest up to 2% of AuM in investment companies, although these are not defined in the policy. These provisions cannot exceed 15% of total investable capital for both life and non-life insurance companies. B02-like strctures may possibly qualify as an investment company, but the guidelines published by the Insurance Board are not sufficiently clear -- there is no reference to investment companies, and no reference to a total of 15% investment allowed in public limited companies, national priority projects, and seed funding for collective investment schemes.

Of the pension funds, investments by Citizen are disciplined by the establishing Act of parliament, while EPF operates as a self-regulating entity. Neither is currently allowed to invest in PE/VC funds or vehicles. At the time of the mission, 57% of EPF's portfolio was in loans to its members (mortgages in particular); 25% in certificates of deposit; 8-10% in government bonds; and the remainder in loans to hydropower projects, aircraft financing for the government-owned airline and a small portion in listed stocks. Approximately two-thirds of Citizen's portfolio was in bank deposits; 15% in loans to members (mortgages); 10% in project loans; 7% in listed stocks and less than 5% in government bonds.

[12] E.g., hydropower, health, education, tourism and agriculture.

B. Investment entry

FDI approvals

Domestic PE/VC funds[13] that receive any amount of capital from foreign investors are treated as foreign investors themselves. As a result, they are subject to cumbersome FDI approvals on every single investment they make in Nepal. FITTA disciplines foreign direct investment in Nepal. It defines a foreign investor very broadly as any entity in which a foreign entity owns at least one share. Although FITTA has not prescribed a minimum amount required for foreign investment in Nepal, in practice the Department of Industries (DOI) will not grant FDI approval for foreign investment less than 5 million Nepalese rupees (US$50,000)**.** Foreign investors are subject to cumbersome and lengthy FDI approvals, on a deal-by-deal basis. A detailed discussion of FITTA can be found in Section III. For domestic funds, it is important to note that domiciliation in Nepal does not necessarily exempt them from FDI approvals. For instance, BO2 is subject to FDI approvals as a result of the investment made by IFC in the company. As comparison, in India, no approval is required for foreign investment in onshore funds. However, if either the manager or the sponsor of the onshore fund is not owned and controlled by Indian resident citizens, investments by such onshore funds are treated effectively at par with foreign investment (i.e. as indirect foreign investment). The quantum of foreign capital in the onshore fund is not relevant.

In fact, recent regulatory changes prevent domestic PEVC investment companies from attracting foreign capital. For foreign investment to be permissible in any business activity in Nepal, the business activity should not fall within the “negative list” of FITTA and should be classified as an “industry” under the Industrial Enterprises Act, 2016 (EIA, 2016). Previously, the Industrial Enterprises Act, 1992 (2049) had classified “investment company” under the list of industries. However, “investment company” is not included as a classified industry in the new IEA, 2016, thus preventing foreign investment in investment companies established in Nepal.

Sector-specific approvals

The Nepalese economy is heavily regulated and investments in several sectors are subject to government approval, regardless of the domiciliation (domestic or offshore) of the investor. These approvals add time and complexity to the execution of a PE/VC deal. To operate a business in Nepal, the sponsor needs to (a) to establish an entity and (b) take sectoral approval from the concerned government institution per the sector-specific law. Regulated sectors include a) generation of electricity (governed by the Ministry of Energy and Department of Electricity Development); b) insurance (governed by the regulator Beema Samiti); c) telecommunications (governed by the Nepal Telecommunications Authority); and d) banking (governed by Nepal Rastra Bank). Operators need a license to conduct activities in the following sectors: industries producing arms and explosives, security printing, bank notes and mint industries, cigarettes and tobacco, and alcohol. In sectors where no license is required, operators need to be registered with the government department concerned.

Pricing of shares

Prior restrictions on private companies and non-listed public companies issuing shares at a premium have been relaxed since the Companies Act was amended in 2017, allowing investee companies to obtain a more favorable valuation from PEVC investors. Previously, according to

[13] Structured as corporate entities as previously described.

Section 29 of the Companies Act 2006 (2063 BS), companies had to fulfill three conditions to issue shares at a premium: (i) the company had to have made profits and distributed dividends for three consecutive years; (ii) the company's net worth had to exceed its total liabilities; and (iii) issuance had to be authorized by a general meeting. In 2017, the first amendment of the Companies Act 2006[14] eliminated the first two criteria -- (i) and (ii). Thus private companies and non-listed public companies can now issue shares at a premium,[15] provided that the company does not have negative net worth and the issuance is authorized by a general meeting. This may in turn have encouraged more companies to consider PEVC as a source of capital, especially in industries such as technology where the absence of profits does not necessarily reflect an absence of value. As comparison, in India there are no restrictions on issuance of shares at a premium by private companies and non-listed public companies.

C. Investment structuring and execution

<u>Blacklisting</u>

The Nepalese central bank (NRB) has put in place draconian "blacklisting" rules for individuals and corporates that fail to meet debt obligations, leading to the inability to access new loans and other severe consequences. The risk of blacklisting is a major deterrent for PE/VC investors to use leverage at the portfolio company level. NRB Directive 12/067 ("Blacklisting Directive") states that when a borrower defaults on a loan, the lender can recommend to the Credit Information Bureau to include the borrower in the blacklist, and within 15 days the Bureau would include the name in the blacklist.[16] In essence, the blacklisting decision lies with the lender, and cannot be appealed. Blacklisting involves very severe consequences, including: it prohibits the borrower (company or individual) from assuming new or additional debts or renewing existing loan facilities; prohibits them from operating a bank account; and confiscates the borrower's passport (if the lender so recommends to the government). The directive also includes a broad definition of defaulter, which extends to borrowers who are unwilling to sell mortgaged property to repay the loan; borrowers "operating more than one business or industries but not utilizing the earnings from such business and other own assets to repay the loan"; and borrowers who have not furnished additional collateral or personal guarantee as demanded by the bank if the loan is overdue. These provisions imply that a PE/VC fund may not be able to segregate the solvent portion of the fund's portfolio from any insolvent portfolio company.

What is worse, a wide range of parties related to a defaulting borrower can be blacklisted, including directors, shareholders and other companies participated by the shareholders. As a result, blacklisting related to one portfolio investment gone sour could result in the freezing of the operations of an entire PE/VC fund. The directive lists a number of parties to be included in the blacklist, including: the actual borrower (company or individual); guarantors; other partners in a partnership; directors of public or private companies; shareholders holding at least 15% of a public or private company (or less than 15% "if such shareholders have financial interest in the company

[14] Companies (First Amendment) Act, 2017 (2074 B.S.) was passed by the Parliament of Nepal, and certified by the President. The Amendment came into force on May 2, 2017 (2074/01/19).
[15] They do not need SEBON approval for pricing in this case.
[16] The circumstances leading to blacklisting are very broadly defined and include: non-payment of principal or interest overdue by 12 months; misuse of loan proceeds; misuse of goods pledged as collateral; borrower declared bankrupt according to existing laws; lender's filing of a lawsuit against borrower; forging of loan documents; proof that borrower has been "involved in offences relating to financial matters;" seizing of collateral by a licensed financial institution in the event of overdue loans; loan write-off; and issuance of a cheque not backed by sufficient balance.

through any means"); and persons or companies having the right to nominate the director of a public or private company. In addition, if the blacklisted individual or organization owns more than 15% of the shares in any other company, the Director and CEO of this company are also blacklisted.[17]

A recent amendment on blacklisting issued by NRB has, however, exempted Offshore PEVC Funds. Specifically, clause 18 (9) of NRB's Credit Information and Blacklisting Directive, 2017, exempts (a) foreign investors investing in equity, (b) Foreign Diplomatic Mission, (c) Donor Agency and (d) Development Partners from blacklisting. The immunity of blacklisting does not exempt Onshore Funds.

<u>Restrictions on financial instruments</u>
Domestic PEVC funds cannot undertake lending activities since lending is permitted only for licensed financial institutions per the Banks and Financial Institutions Act 2016. The study team understands that in the past NRB has placed specific restrictions on domestic entities such as BO2 from providing loan facilities. In India, while there are restrictions on the type of entities that can provide loans (and PEVC funds cannot provide loans to their portfolio companies), the Indian AIF regulations permit certain types of PE/VC funds to invest in debt instruments, such as debentures of a portfolio company.

<u>Corporate tax considerations</u>

The Income Tax Act ("ITA"), 2002 (2058) does not impose any specific punitive or cumbersome tax provision for Portfolio Companies. As per Section 2(1) of Schedule 1 of ITA, the applicable Corporate Tax is generally 25% for all Business Entities including Portfolio Companies. In India, corporate tax is on a differential slab basis, with lower tax rates being applied to small and medium sized enterprises and tax breaks being provided to priority sectors.

However, at the level of the investee, both onshore and offshore PEVC funds may be incentivized to invest in the manufacturing sector in Nepal, since the tax rate for manufacturing firms is lower at 20% (vs 25% general income tax rate). The general tax rate is 25%, but taxes are lower for the manufacturing sector at 20%, and higher for banks, financial institutions and tobacco sectors at 30%.

D. Investment exit

<u>IPO restrictions</u>

Given exit options are restricted in an environment where M&A is limited, put options and IPOs are the practical exit options available for investors. However, IPOs on NEPSE, regulated by SEBON, suffer from two pitfalls that make them unattractive for PE/VC exits: (i) IPO pricing is not market-driven and is subject to significant restrictions from SEBON *(see discussion below)*; (ii) the promoter of a newly-listed company is subject to a 3-year lock-up period on its stake.[18] In most advanced economies existing shareholders can sell some of their stake at IPO, in addition to the issuance of new shares by the company. Such distortions to demand/supply dynamics, while

[17] "If the blacklisted individual or organization owns individually or institutionally 15% or more shares in any other firm/company/corporate body, the Director and Chief Executive of such firm, company, corporate body" can be blacklisted.
[18] By comparison, in India, the lock-in period is 1 year.

aimed at protecting IPO subscribers, can deter promoters from choosing the IPO route and, ultimately, have adverse effects on IPO supply and the development of the local stock market.[19] Box 2 contains a brief discussion of the spillover effects of over-regulation in the Chinese IPO market, as an interesting reference. A third pitfall which was corrected by regulation in 2016 was that previously existing shareholders in a company could not sell their shares through an IPO – thus IPOs were not a viable exit opportunity for PEVC funds to divest their investment. Section 24 of Security Registration and Issue Regulation, 2016 (2073) now allows shareholders that have at least 1% of promoter shares in a listed company, or promoter shares in an unlisted company, to issue shares to the public with SEBON's approval through a public sale with an offer document approved from SEBON.

With regards to IPO pricing, shares for a listed public company can be issued at a premium, subject to the price being approved by SEBON. As a general rule, IPOs are done at face value, which is NPR 100 per share. If shares are to be issued at a premium over face value, the pricing of the shares is subject to guidelines issued by SEBON in Securities Issuance and Allocation Directives 2016 (2074). These guidelines provide that the premium price should be the lower of (a) four times the networth or (b) average price calculated on the basis of capitalized earning, discounted cash flow and any one other valuation methodology based on international practice. Nepalese rules are tailored to IPOs of newly-established financial institutions, but are very restrictive for IPOs at a later stage of maturity. As comparison, in India IPOs are priced either through a fixed price process or a book building process. With a fixed price issue, the issuer determines the price of the securities in consultation with the lead manager(s). In the case of a book-built issue, there is no fixed share price; instead, the issuer provides a price band. Investors are free to bid for the desired quantity of shares with the price that they are willing to pay (but within the price band). The share price is then determined based on the bids, but within the band.

With regards to the lock-up period, the key issues are that (i) promoters are subject to a 3-year restriction on the sale of their stake in non-financial institutions; (ii) "promoters" are broadly defined under regulation issued under the Securities Act as any investor (regardless of shareholding) pre-IPO, which could include minority stakeholders such as PEVC funds.[20] In more developed capital markets, the lock-up period is usually a commercial decision of the promoter and the brokers underwriting the offering. In most cases, the lock-up is shorter (e.g. one year), allowing promoters more flexibility to monetize their stake. In India, where businesses tend to be promoter driven, only a certain percentage of post-IPO capital held by promoters[21] is locked in, albeit for a period of 3 years,[22] and any excess is locked in only for a period of 1 year. Also, while the general principle is that the pre-IPO capital of non-promoters is locked in for 1 year, there is no lock-up period applicable on securities held by certain categories of PE/VC funds if such capital is held for at least a year prior to the IPO. In Nepal, after the expiry of the 3-year lock-up,

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[19] The mix of primary and secondary issuance is purely driven by demand and supply considerations: an existing shareholder that tries to liquidate the vast majority of its investment signals lack of confidence in the prospects of the business, which adversely impact demand for shares at IPO and, as a result, pricing.

[20] The lock-in requirement is set out in the Securitites Registration and Issue Regulation 2017. Rule 38 of the regulation requires "Other Category of Securities" to be locked in for three years, which is further defined as securities (a) which are held by promoters and other category of shareholder, and (b) which do not fall within the securities issued in IPO. Therefore, although PEVC funds (who have made investment in the target before IPO) do not fall within the typical definition of "promoters" as per the Companies Act, the Securitites law considers them eligible for lock-in alongside the promoters.

[21] Under relevant Indian law, a promoter is defined as a person (a) named as such in the draft offer document or offer document or is identified as the promoter in the annual return filed by the company with the corporate ministry; or (b) who has control over the affairs of the company in accordance with shareholders' arrangements, voting arrangements or in any other manner; or (c) in accordance with whose advice, directions or instructions, the board of directors of the company usually acts.

[22] From the date of allotment in the IPO or commencement of commercial production, whichever is later.

promoters of banks and insurance companies can sell down their stake subject to regulation issued by NRB and the insurance regulator, respectively; promoters of companies in any other sector are free to sell down their stake without additional approvals. Non-promoters who received shares at IPO are free to trade at any point in time.

Box 2: The pitfalls of Chinese IPOs

The China Securities Regulatory Commission (CSRC) approves the IPO price for new listings in the stock exchanges of Shanghai and Shenzhen. While not formally capping the IPO price, CSRC issues a "special risk notice" if companies issue shares at a price/earnings ratio higher than the average for sector peers. In practice, this gives CSRC the ability to block listings when it deems the price as too high – regardless of actual investor demand.

The objective is to protect investors from purchasing overvalued shares and suffering future losses. The approval system, however, has severe side effects.

Since newly-listed shares are generally undervalued as a result of this regulatory action, IPOs are routinely oversubscribed by tens or hundreds of times. Prices increase dramatically as soon as shares start trading. To take advantage of this arbitrage opportunity, *ad hoc* funds are set up specifically to participate in IPOs. Short-term interest rates increase prior to a large IPO because investors borrow to subscribe to the offer. After the initial large increase in share price, it is not unusual to witness a sudden drop when IPO subscribers decide to cash in.

Importantly, since shares are undervalued at issuance as a result of regulatory action, company promoters who sell some of their shares or issue new shares at IPO are penalized to the advantage of the new shareholders, who purchase a stake in the company at an unduly low price. The lengthy approval process has also created a backlog of companies waiting to be listed – the Financial Times estimated that 629 companies were queuing for approval in January 2017.

Experts have proposed various solutions to the Chinese government. In particular, they argue for a reduced role of CSRC, limited to ensuring proper disclosure of information prior to the offer, rather than a detailed assessment of the company's business and valuation. As of now, the timing and extent of any reform are unclear.

In addition to the regulatory limits previously described, other factors make NEPSE an unattractive venue for PE/VC IPOs. Specifically, the Nepal Stock Exchange (NEPSE) is characterized by (i) small size, (ii) limited liquidity and (iii) over-representation of banks and financial institutions. 196 companies are listed on NEPSE, a large number for a small economy like Nepal, but most of them have negligible market value. NEPSE's total market cap as of mid-September 2018 is approximately $15 billion, with an average daily traded volume of $3 million. Trading is dominated by domestic retail investors; Nepalese mutual funds (currently 13) and insurance companies also trade stocks. 67% of listed companies are banks and financial institutions, due to a legal requirement for financial services companies to list within 2 years from establishment. This requirement has generated a wave of IPOs for financial institutions that aim to raise the bulk of their initial capital during the IPO itself. The remaining 33% of listed companies are in the hydropower, manufacturing, hospitality, trading and telecom sectors. As a result of this skew towards financial companies, investors on NEPSE have limited experience of other sectors and greater investor education would be needed during the marketing phase of IPOs of companies belonging to other sectors.

<u>Capital gain tax considerations</u>

Nepal does not have a specific capital gains tax to incentivize long-term investors such as PEVC funds; nor does it confer tax pass-through status for PEVC funds (except in the case of mutual funds). Instead, at the level of the fund vehicle, the onshore fund incurs corporate tax at the rate of 25% for any "income" it receives from the sale of an investee company. The fund vehicle also incurs 5% final dividend tax for dividend distributions it receives from the investee. When the investee company distributes dividends to the fund vehicle, which owns shares in the investee, the fund is taxed 5% (final tax), and distributions to onshore and offshore investors thereafter are not taxed. Since onshore funds are not allowed to lend,[23] tax on interest income received from the investee company is not applicable. When the fund vehicle sells an investee company, it incurs income tax of 25%. The Income Tax Act recognizes their profit earned on investments as income earned from business. Further distribution by the onshore fund to the investor is treated as dividend and thus is taxed at the rate of 5%.

In India, by comparison, long-term capital gains are taxed at a lower rate than short-term capital gains; and PEVC funds are generally tax transparent. Dividend tax is only paid at the investee level. In India, short-term capital gains[24] tax for Indian investors ranges from 15.60% to 17.47%, and for non-resident investors from 15.60% to 16.38%. Long-term capital gains[25] tax for resident investors generally ranges from 10.40% to 11.64%, and for non-resident investors is between 10.40% and 10.92%. While a PE/VC fund is generally tax transparent, PE/VC funds are generally required to withhold tax, where the rate depends on the tax residency of the investor. This tax is generally subject to credit or refund, if applicable. Dividend tax, in contrast, is paid by the portfolio company but is thereafter exempt from tax.

Nepal's tax policy provides stronger incentives for domestic HNWs to invest in PEVC vs. a corporate or institutional entity. This may discourage both onshore corporate investors and offshore investors from investing in a domestic PEVC fund. The tax policy further incentivizes HNWs to invest in listed companies (5% tax for divestment) vs. unlisted companies (10% tax for divesting) such as a PEVC fund. When a resident natural person (such as a HNW) disposes shares of a non listed company, such as when they divest their shares from an onshore PEVC fund, they incur a tax rate of 10% on their income from gains. In contrast when an onshore institutional investor (resident entity) or offshore investor divest their shares in an onshore PEVC fund, they incur a tax rate of 25% on their income from gains. This incentivizes domestic HNWs to invest in PEVC funds, rather than corporate or institutional entities, whether foreign or domestic. Dividends received from investee through the onshore fund are not taxed further when the onshore fund distributes dividends to its investees. In addition, resident natural persons only have to pay 5% tax when they divest from a public company, thus incentivizing their investment in mutual funds over PEVC funds. In India, the capital gains tax rate is broadly similar for individuals and institutions/corporates.

[23] Lending is permitted only for licensed financial institutions per the Banks and Financial Institutions Act 2016.

[24] Short-term capital gains is charged if the (a) listed securities are held for 12 months or less; (b) unlisted shares are held for 24 months or less; and (c) unlisted securities (other than shares) are held for 36 months or less.

[25] Long-term capital gains is charged if the (a) listed securities are held for more than 12 months; (b) unlisted shares are held for more than 24 months; and (c) unlisted securities (other than shares) are held for more than 36 months.

III. Existing Legal and Regulatory Environment for Offshore Funds

The treatment of offshore PE/VC funds is affected by different factors that are a by-product of Nepal's broader policy stance towards foreign investment. Nepal has a comprehensive framework of controls and limitations on FDI, aimed at protecting domestic industries. Nepal also exercises rigid controls over currency flows in and out of the country reflecting, among other factors, its decision to peg its currency to the Indian rupee. A discussion of each bottleneck follows below.

Three issues affect offshore PE/VC funds: (i) FDI controls, (ii) capital controls and (iii) limitations to foreign lending. FDI controls exercised by DOI, NRB and the Investment Board of Nepal (IBN) require a laborious and time-consuming process; they are particularly cumbersome for funds, which are required to obtain approval on a deal-by-deal basis. NRB capital controls are also deemed by industry participant as cumbersome and time-consuming; while approval is speedy once all documentation is in place, funds deem compiling such documentation and successive exchanges with NRB funds tedious. NRB has also imposed certain restrictions – an interest rate ceiling of LIBOR +5.5; and loan applicants must demonstrate that financing is not available from Nepalese banks) -- on foreign lending which also limits the ability of offshore funds to provide credit to portfolio companies, in addition to equity.

A. Fund (and fund manager) set-up

An Offshore PEVC Fund, established in a jurisdiction outside Nepal, can currently invest directly in Nepalese companies (but not in onshore PEVC funds) and is subject only to Nepal's FDI regime, not to a regulatory regime for funds in Nepal. IEA 2016 does not permit offshore investment in an onshore PEVC fund. FITTA only permits foreign investment in sectors which are classified as an "industry" under IEA 2016. Therefore, in addition, foreign investment in Nepal is also subject to IEA 2016. Thus even if a business is not restricted from foreign investment by FITTA, if the business is not classified as an "industry" in the IEA 2016, the business will be unqualified for foreign investment. Prior to the enactment of IEA 2016, offshore funds were permitted to invest in a Nepalese PE/VC Fund, as investment activity was classified as an "industry." However, IEA 2016 discontinued this industry classification. PE/VC Funds established offshore can therefore currently invest only in Nepalese portfolio companies, and are not allowed to set up a subsidiary company in Nepal with the business objective of investing in other entities.[26] Effectively, this means that a fund like BO2 (which constitutes offshore investment into an onshore fund) cannot be established in Nepal today.[27] Each investment of an offshore fund is subject to prior approval of the DOI/IBN/IIPB and NRB, as described below. In India,on the other hand, offshore investors/PEVC funds can invest directly into portfolio companies as well as in onshore funds. *(See further discussion below on India's regulatory regime for FDI.)*

[26] Even before the advent of IEA 2016, it was unclear if an offshore fund was required to have a branch office in Nepal. Section 154 of the Companies Act requires a foreign company carrying on any business or transaction in Nepal to have a branch office registered with the CRO. In line with this, FITTA allows an offshore fund to set up in Nepal a private limited company or a public limited company incorporated with the Company Registrar's Office (CRO). However, for the purposes of Section 154, making an investment in shares of a Nepalese company or participating in the operation or management of such a company is not considered as carrying on of a business or transaction.

[27] As of the writing of this report, there are efforts to amend this IEA 2016 restriction, which may then be published in the official gazette.

Restrictions on Nepalese institutional investors

In addition to the restrictions described in the previous section, Nepalese insurance companies and pension funds are prevented by regulation or the establishing acts, respectively, from investing outside of Nepal. As a result, Nepalese institutional investors are unable to invest in PE/VC registered offshore. As comparison, under Indian law, Indian investors are not free to invest in offshore funds, but could do so with regulatory approvals (subject to limits).

Fund Manager

To provide fund management services in Nepal, foreign fund managers must have a commercial presence in Nepal. PEVC fund managers are primarily private limited companies incorporated which provide consultancy services. Per the Companies Act 2006, foreign entities cannot conduct business in Nepal for a period over 30 days without registering a branch office. Thus, foreign fund managers must have a commercial presence in Nepal to provide fund management services in Nepal. However, there is currently no effective mechanism for foreign fund managers to have commercial presence in Nepal by registering a branch office. They cannot set up a branch office because FITTA permits foreign entities to hold only up to 51% shares in a local entity which provides management and consultancy services. Offshore funds can instead seek management service from local companies. Therefore, Dolma Advisers, which is a 100% locally owned company, provides fund management services to Dolma Impact Fund, which as an offshore fund does not require a license. In India, foreign investors can generally invest up to 100% in investment managers or sponsors of AIFs in India without approval. Foreign investors can also invest, without approval, in onshore Indian funds. It is therefore possible to establish a purely offshore fund and management structure to invest in India, with no mandatory requirement to establish a presence in India; however, it is common (and there is a mechanism) to establish an Indian investment advisory entity. Foreign investors may invest upto 100% in regulated Indian advisors, without government approval. For various reasons that are outside the scope of this study, while it is regulatorily permissible for offshore funds to be managed by an Indian fund management entity, this is not common.

B. Investment entry

FDI approvals

Foreign direct investments are subject to tight controls in Nepal. The Foreign Investment and Technology Transfer Act (FITTA) and Foreign Exchange Regulation Act 1962 (FERA) regulates foreign direct investment in Nepal. The Foreign Investment and Technology Transfer Act 1992 (FITTA) defines “Foreign Investment" as investment made by a foreign investor in any industry - which can include investments in shares, reinvestment of the earnings derived from a share investment, and investments made in the form of loan or loan facilities. FERA also uses a similar definition for foreign investment.

Three aspects of FITTA are particularly cumbersome to foreign investors, including offshore PE/VC funds. These are: (i) a “negative list” of sectors in which foreign investors cannot invest and the requirement that investment can only be businesses identified as “industries” in IEA 2016

(ii) cumbersome, multi-layered FDI approval procedures and (iii) the absence of a "blanket" approval, as opposed to deal-by-deal approval, for fund investors.

FITTA's negative list forbids foreign investments in a wide range of industries, including large ones such as retail;[28] while IEA 2016 prevents foreign investment in activities not classified as an "industry." The IEA 2016 classifies business activities by its nature under various industries such as services and manufacturing. If a proposed business activity is not classified as an industry, foreign investment in the sector is not permitted.

A bill (the "Draft Bill") was recently drafted by the Ministry of Industries which seeks to amend and consolidate laws related to foreign investment and technology transfer and to replace FITTA; this Draft Bill also introduces a new definition for Venture Capital Funds, which would need to be reconciled with any definition which may be subsequently be issued by SEBON. The Draft Bill broadens the scope of foreign investment by permitting foreign investments in industries as well as companies incorporated in Nepal. The definition of foreign investment is also broadened to include investment in areas including Venture Capital Funds.[29] That is, the Draft Bill permits a foreign corporate entity to create and invest in a Venture Capital Fund with the intent to making equity investments in other industries. Per the Draft Bill, the Venture Capital Fund would need to obtain SEBON's approval to be incorporated; and is permitted to issue shares in Nepal's stock market. The Bill, however, still imposes a 51% ownership ceiling for foreign investment in companies focused on consultancy and management services – thus, for example, PEVC funds will be restricted from investing more than 51% in fund management companies. The Draft Bill will have to be re-submitted to the Parliament; although it is unclear if the it will be re-visited by the Ministry of Industries.

Second, FDI approval is a time-consuming, documentation-heavy process that often requires navigating multiple government agencies. Anecdotal evidence from the funds interview indicates that the process can easily take months. The agencies that must be involved depend on project size. Any investment in industry[30] with fixed assets[31] size lower than US$20 million requires approval only by the Department of Industry (DOI), a unit of the Ministry of Industry. Interview with DOI indicates that, once the documentation is complete, approval takes as little as 2-3 weeks. However, this does not consider the time required to compile all necessary project documentation and the preliminary consultations with DOI. Moreover, the list of documents required to apply for DOI approval is lengthy.[32] If the investment is in an industry with fixed assets of more than US$20

[28] The list includes: cottage industries; personal service businesses (businesses such as hair cutting, beauty parlor, tailoring, driving training, etc.); arms and ammunition; gunpowder and explosives; industries related to radio-active materials; real estate (excluding construction industries); film industry (national languages and other recognized languages of Nepal); security printing; bank notes and coins; retail business (excluding international chain retail business with its business in more than two countries); bidi (excluding more than 90% exportable); internal courier service; atomic energy; poultry; fisheries; bee keeping; consultancy services such as management; accounting and engineering; legal services (maximum 51% foreign investment is allowed); beauty parlor; processing of food grains on rent; local catering services and rural tourism.

[29] Venture Capital Fund has been defined by the Draft Bill as a company established pursuant to prevailing laws by any institutional foreign investor for making equity investment in any industry upon receiving approval from SEBON. Other areas as defined for foreign investment include lease finance to provide tools, machines or instruments; investment in listed securities in the secondary share market; investments made to purchase assets or shares of a company; investment made in branch/liaison office; foreign currency earned through foreign listing of shares.

[30] This refers to a business classified as "industry" by IEA 2016.

[31] Investment in land, building, machineries, etc.

[32] It includes a project report outlining project background, market aspect, technical aspect, financial aspect, etc. In addition, a financial credibility certificate issued by any bank of the country of the registration of the investor, corporate documents and decisions of the investor, transaction documents.

million, the DOI routes the application to the Industry and Investment Promotion Board ("IIPB"), a more senior body established under the IEA 2016. The IIPB, which does not have a fixed schedule of meetings and is generally called on ad hoc basis, may take longer to process the application. Investments exceeding US$100 million in certain sectors, or investments in strategic sectors such as hydropower (project size exceeding 500 MW) and infrastructure,[33] go through an entirely different process. The approving entity in this case is the Investment Board of Nepal, which reports directly to the Prime Minister's office and is made up entirely of political appointees. The Investment Board of Nepal meets much less frequently and may take longer time to provide its approval. The documents required by the Investment Board of Nepal are similar to those required by the DOI. Offshore PEVC funds also have to obtain DOI's approval prior to embarking on a technology transfer agreement with a Nepalese company.

Third, FITTA approval is strictly on a project-by-project basis. There is no "blanket approval" for professional investors such as PE/VC funds. This significantly slows down the operations of an offshore PE/VC fund in Nepal. The Draft Bill referred to above does not change the requirement by a Venture Capital Fund set up by a foreign corporate entity to seek foreign investment approvals from both DOI and NRB for each investment.

As regional comparison, the Indian government has significantly eased foreign exchange and capital account controls following economic liberalisation starting in early 1990s; thus foreign investment in onshore funds typically requires no government approval.[34] At the time of writing this report most sectors in India are open for foreign investment, with only a short list of sectors where foreign investment is prohibited. In a vast majority of sectors foreign investment is permited up to 100% without the requirement of any governmental approval. In some other sectors that are open to foreign investment, foreign investment is permitted either (i) under automatic route (i.e. without governmental approval) up to a certain percentage of equity ownership (generally 100%),[35] but may be subject to certain sector specific conditions or (ii) under the approval route (i.e. with government approval). In addition, to the limited extent any approvals are required, the Government of India has set-up a Foreign Investment Facilitation Portal ("FIFP") which is an online single point interface for investors to facilitate FDI. FIFP has been created to reduce timelines and streamline the process for FDI approvals required in India.[36]

<u>NRB capital controls – at entry</u>

NRB imposes strict limitations on the amount of foreign investment into Nepal. Approval procedures are lengthy and cumbersome, and additional to all other FDI and sector-specific approvals a certain investment is subject to. Offshore PEVC Funds investing in Nepalese companies have to first obtain clearance from DOI/IBN/IIPB before applying to the Central Bank

[33] E.g., roads, if designated by the Government of Nepal.
[34] India's first foreign exchange regulation was passed in 1973 – the Foreign Exchange Regulation Act, 1973 ("FERA 1973") -- which imposed stringent regulations on certain kinds of payments, dealings in foreign exchange and securities, transactions which had an indirect impact on foreign exchange, and the import and export of currency and foreign investment. FERA 1973 was repealed in 1998 and was replaced by the Foreign Exchange Management Act, 2000 ("FEMA"). FEMA liberalized foreign exchange controls and restrictions on foreign investment. Initially, foreign investment in most sectors under FEMA required government approval, which was rendered by the Foreign Investment Promotion Board ("FIPB"). Approvals from FIPB required multiple layers of information from the proposed investor and were a time-consuming process. However, with time, the foreign investment restrictions set out under FEMA have been relaxed.
[35] Even where restricted to a specified equity percentage, this percentage is generally permitted to be increased to 100% with government approval.
[36] Processing is per a prescribed 'Standard Operating Procedure', which is available to the public.

for transfer of funds, amounting to a fairly lengthy process to bring in investment funds into Nepal.[37] The documents required to be submitted to NRB include the source and time schedule of investment; Credit Information Bureau report indicating that the investee company is not blacklisted; and all documents that were submitted to DOI/IBN/IIPB for FDI approval. The application is processed by the FOREX Management Department of NRB. Approval should ordinarily be granted since DOI/IBN/IIPB have cleared the investment, although NRB has the right to refuse approval. Generally, NRB may take 30 to 45 days to issue the approval. While NRB indicated that, once all documentation is properly submitted, approval only requires a few weeks, anecdotal evidence from the funds interview indicates that the process to compile the documentation, including preliminary feedback from NRB, can easily take months. In addition, when applying for approval from NRB for its initial investment the Offshore Fund will have to undertake not to repatriate the funds within a year.

Sector-specific approvals

Investments in several sectors are subject to government approval. These approvals add time and complexity to the execution of a PE/VC deal, especially for an offshore investor that is also subject to FDI approvals and NRB capital controls. See Section II for a more detailed discussion of such sector-specific approvals.

C. Investment structuring

Blacklisting

The Blacklisting Directive exempts offshore funds and their directors from blacklisting. However, the Blacklisting Directives does not provide such exemption to on-shore funds which may have been set up with foreign investment, such as BO2.

Restrictions on financial instruments

NRB regulation imposes strict limitations on lending by foreign institutions, and grants approval for each loan extended by a foreign entity. As a result, it would be extremely difficult for an offshore PE/VC fund to lend to portfolio companies. The objective of these rules is to protect domestic lenders from foreign competition.[38] According to the Unified Circular on Foreign Exchange 2017 issued by NRB's Foreign Exchange Management Department, a Nepalese company must prove that equivalent loans are not available from domestic lenders, and provide a lengthy series of documents, before borrowing in foreign currency.[39] After reviewing these documents, NRB may grant approval and impose mandatory terms and conditions to the foreign loan. In addition, should the loan be approved, the regulation caps interest rate to 5.5 over LIBOR (12 months).

In India, subject to certain limits, offshore PEVC funds can invest in debt instruments if they are registered with the Indian securities markets regulator, the Securities and Exchange Board of India

[37] One of the documents required while applying for the NRB approval is the approval for FDI received from DOI/IBN/IIPB.
[38] According to the Foreign Exchange Management Department officials met by the task team.

[39] These include approval letter by the company's competent regulatory body, business registration certificate, bank account number, record of tax clearance, documents "relating to the articles of association", proof that the company has not been blacklisted, documents to show "the assurance of repayment of the loan", proof of use of proceeds, "potential risk of investment and documents to show that it can be managed."

("SEBI"). Onshore companies in India can typically raise debt from foreign lenders through a separate route, referred to as External Commercial Borrowings ("ECB"). The ECB route permits permits borrowings from certain types of foreign lenders such as overseas banks, financial institutions and other lenders (subject to conditions). The ECB guidelines also lay down rules for lenders and borrowers of ECBs, such as eligible lenders, eligible borrowers, minimum average maturity, permitted end-use of ECB proceeds and other restrictions. Importantly, offshore PEVC funds, outside of the ECB framework, are permitted to invest in debt instruments (such as non-convertible debentures) if they are registered with the Indian securities regulator (albeit subject to certain limits, such as investment limits and country-wide aggregate corporate bond limits).

D. Investment exit

IPO restrictions

The IPO regulation does not envisage any difference in treatment between domestic and offshore promoters.

Stock trading restrictions

Active stock trading is forbidden to foreign investors. Foreign investors are allowed to buy or sell large blocks of shares through private placements (subject to FDI approvals required for any foreign investment in Nepal), but are not allowed to trade stocks actively. In practice, this is unlikely to represent a major issue for PE/VC funds, since they are usually not involved in daily trading of the shares they own in listed companies. A broader side-effect, however, is that the Nepalese stock exchange does not benefit from the additional liquidity generated by foreign investors (especially foreign institutional investors).

Tax considerations

The tax treatment of foreign investors – whether foreign investor in a local PEVC fund; or an offshore PEVC fund investing in Nepal -- differs depending on the existence of a Double Taxation Avoidance Agreement (DTAA) between Nepal and the foreign investor's country of residence. If a DTAA exists, the provisions of the each DTAA discipline the tax treatment of investors from the corresponding foreign country. Nepal currently has DTAAs with the following countries: Norway, Thailand, Sri Lanka, Mauritius, Austria, Pakistan, China, the Republic of Korea, Qatar and India. Nepal is also a party to the SAARC Limited Multilateral Agreement on Avoidance of Double Taxation and Mutual Administrative Assistance in Tax Matters with Bangladesh; Bhutan; India; Maldives; Pakistan; and Sri Lanka. Some DTAAs establish that foreign investors are taxed exclusively in their country of residence – a significant advantage for offshore investors whose tax residence does not tax capital gains. Other DTAAs provide for foreign investors to be also taxed at source (in the country where income is generated), but at preferential rates compared to local investors. *(See Box 3 below on DTA between Mauritius and Nepal.)*

If no DTAA exists, both foreign investors in a local PEVC fund and offshore PEVC funds investing in Nepal are subject to a tax rate of 25% on gains arising from the sale of investments in Nepal. Thus offshore natural person investors investing in a local fund are subject to higher tax (25%) on gains from sale of investment than domestic natural person investors. Tax from gains on the sale of investment is collected generally as (i) 15% on a withholding basis and (ii) the remaining 10% to be deposited by the non-resident investors with the relevant tax office.

Dividend distribution is subject to the same rate of 5% for both domestic and off-shore investors, and irrespective of whether natural or corporate investors. Applicable tax rate on dividend distribution is 5% and is also collected on a withholding basis. In the event of liquidation, the capital return (in excess of investment amount) is treated as both dividend and capital return in equal proportion – that is, 50% is treated as dividend and taxed at 5%; while 50% is treated as gain on capital and taxed at 25%. The ITA imposes 25% income tax rate on non-resident individuals,[40] equivalent to the corporate tax rate on resident entities -- thus, the taxation of non-resident investor and resident entity investors is the same. In contrast, domestic investors who are natural persons are subject to effective capital gains tax of only 5% (for sale of listed entity) and 10% (for sale of unlisted entities).[41] This is considered a final tax and thus, natural resident persons are not further subject to tax on such capital gains.

Box 3: DTA betweent Mauritius and Nepal

The DTA in place between Nepal and Mauritius is particularly important since the latter is the tax residence of many offshore funds operating in South Asia.

The Double Taxation Avoidance Treaty ("**DTA**") entered between Nepal and Mauritius (the "**Nepal-Mauritius DTA**"), aims to prevent both double taxation and fiscal evasion on applicable taxes on income.

Per the Nepal- Mauritius DTA, a person is a resident of a country for taxation purpose based on criteria including residence, domicile, and place of management. In a situation where a person is a resident of both Mauritius and Nepal, or of neither per the criteria above, the resident status is determined based on the individual's personal and economic relations, habitual abode, nationality or place of effective management.

Permanent Establishment ("PE")
As per the Nepal-Mauritius DTA, Permanent Establishment ("PE") – or a place of business which gives rise to a tax liability in a particular jurisdiction -- is formed if the services or activities are carried out in a particular jurisdiction for more than 183 days in a period of 12 months.

When the Nepalese entity is a PE of a Mauritius entity, the business profit of the Mauritian entity is taxed in Nepal to the extent it is attributable to (a) PE in Nepal; (b) sales in Nepal of goods or merchandise of the same or similar kind as those sold through the PE in Nepal; or (c) other business activities carried on in Nepal of the same or similar kind as those effected through the PE in Nepal.

Dividends
Dividends earned by any entity in Nepal is taxable in Nepal at the maximum rate of:

- 5% if the Mauritian entity directly holds at least 15% of the capital of the Nepalese entity;
- 10% if the Mauritian entity directly holds at least 10% of the capital of the Nepalese entity;
- 15% in cases other than (i) and (ii).

Gains from divestment
The DTAs (including entered with Mauritius but excluding with India) do not specifically cover gains arising out of the sale of shares. Gains from the sale of immoveable property, however, is taxed in the country where the seller is a resident. Thus, the Capital Gains from alienation of shares / capital stock of the Nepalese entity held by the Mauritian entity is taxable only in Mauritius. However, there has been an instance where the Inland Revenue Department ruled that gains made on disposal of shares of a

[40] Thus, the tax rate for nonresidents on capital gains is 25%.
[41] The resident person is required to file the tax return within three months from the end of each fiscal year. Nepal does not have a system of tax refund.

Nepalese entity held by a non-resident shall be subject to tax in Nepal. The litigation is currently pending before the Supreme Court.

Therefore, the issue of tax treatment on disposal of shares under the DTAs (except for the DTA with India, for which there is a specific provision to be taxed in source country) is still subject to legal interpretation.

Several aspects of Nepal's DTAs with other countries are open to interpretation, including how offshore funds are taxed on the sale of shares in a Nepalese investee company, which can deter PEVC investors. Thus offshore funds hoping to benefit from lower capital gains tax in their jurisdiction of domicile may not be able to do so. Double taxation agreements are designed to avoid investors having to pay two levels of tax – at the country in which they are resident, and the country in which the fund operates. However, investors could be discouraged by several aspects that lack clarity or are open for interpretation. First, it is unclear if restrictive provisions included in the Income Tax Act 2002 pertaining to DTAs is applicable to DTAs signed prior to 2002. To discourage forum shopping, Nepal tax law of 2002 requires that to enjoy DTA, the tax payer has to either be a resident of another state, or if a corporate entity, must be at least 50% beneficially owned by resident of the other state. However, it is unclear if these provisions apply to DTAs signed before 2002. Second, while it is clear that Nepal has the right to collect 5% dividend tax from offshore funds (from the dividend distributed to the offshore fund by its investee in Nepal), DTAs do not specifically cover capital gains on disposal of shares, so it is unclear if offshore funds are taxed on capital gains in Nepal (at 25%) or in their jurisdiction of domicile (where capital gains could be lower). Nepal's Revenue Authority including Inland Revenue Department and Revenue Tribunal have decided a case requiring the non resident seller to pay the capital gains tax in Nepal for the disposal of shares of Nepalese entity. However, the case is under review in the Supreme Court. The only DTA that is currently clarified is a new DTA with India (2011), where Nepal has indeed been given the right to collect capital gains of 25% for offshore funds based in India that dispose off their shares in a Nepalese investee company. Third, the Treaty Act, 1990 of Nepal provides that if there is a conflict between treaty to which Nepal is party and domestic law, the provisions of the treaty must apply. However, the decisions of the Nepalese courts in this matter are not uniform. *(See Box 4 below on India's DTAs with Mauritius and Singapore.)*

Box 4: India's DTAs with Mauritius and Singapore, and Combating Tax Evasion

India receives foreign investment from two key jurisdictions, namely Mauritius and Singapore. India has executed DTAs with both these countries, which have been amended recently to provide for source-based taxation of capital gains. Further, the tax rate for interest income (relevant for investment in debt securities) for Mauritius is 7.5% and for Singapore investors is 15%.

India has also notified General Anti-Avoidance Rules ("GAAR") to combat tax evasion, which can be invoked by the Indian tax athorities if the main purpose of an arrangement is found to be to obtain a tax benefit and which also satisfies at least one of the four following tests:

1. the arrangement creates rights or obligations which are ordinarily not created between parties dealing at arm's length;
2. results in direct/ indirect misuse or abuse of the income tax legislation;
3. lacks commercial substance or is deemed to lack commercial substance in whole or in part; or
4. entered into or carried out in a manner that is not normally employed for bona fide business purposes.

However, in order to promote predictability and investor confidence, tax authorities must follow procedural safeguards put in place for invoking GAAR.

NRB capital controls – at exit

In addition to the lengthy NRB procedures previously described, repatriation of capital offshore can only occur for amounts approved by NRB under its valuation rules (for private companies and unlisted public companies), and not before one year from the date of the original investment. The approved amount of repatriable capital may differ from the portfolio company divestment proceeds of a PE/VC fund, adding significant uncertainty in terms of capital return to fund investors. According to FITTA, which guarantees an investor's repatriation rights, an offshore investor is allowed to repatriate the amount received from sale of shares; dividend or profit; payment of principal and interest on a loan; and the amount under agreement for technology transfer. However, NRB's Unified Circular on Foreign Exchange provides specific rules for repatriation. If an offshore investor sells its shares listed on the Nepal Stock Exchange, the investor can repatriate proceeds up to the full market value. However, for companies not listed with Nepal Securities Exchange (i.e. private limited companies and unlisted companies), repatriation can be up to the share price as calculated per NRB's valuation methodology under the *Nepal Financial Reporting Standard 3: Business Consideration*, which is based on the fair value amount of the company's assets and liabilities. In contrast, while Indian law requires compliance with valuation guidelines on exit by a foreign investor in certain cases (which operates as a cap), it does not provide any caps for repatriating capital offshore.

IV. Other Legal and Regulatory Considerations

A. Corporate governance rules

Despite provisions in the Companies Act 2006 that focus on good governance, PEVC funds and their professional service providers are challenged by the absence of transparency, lack of a compliance culture as well as inadequate corporate governance rules amongst target investee companies. The Companies Act went through substantial reform process in 2006 to focus on good corporate governance. Section 108 of the Companies Act has various provisions to require companies to maintain accounts that "clearly reflect the actual affairs of the company." Per Section 109, the company's Board of Directors is required to prepare financial statements that give a true and fair view of the state of affairs of the company, and are made available to shareholders. Section 110 requires companies to appoint an auditor. However, many potential portfolio companies are family-owned and may have a poor record on compliance and disclosure. Some of these companies may prefer traditional bank loans to finance their business rather than PE investors who require more disclosure, transparency and better governance. In evaluating investment options the PE/VC Fund may find that it cannot always rely on available books and records. However, the situation should improve with the engagement of more professional investors in the Nepalese corporate sector, such as institutional investors and PE/VC funds (particularly where the DFI LP base is significant) as they will seek to apply global standards and best practices in terms of transparency and reporting.

As comparison, India's Companies Act, 2013 has, amongst other things, introduced enhanced corporate governance standards particularly in relation to independent directors, audit, corporate social responsibility, mandatory valuation, private placement of securities, cross-border mergers (including merger of Indian companies into foreign companies) and class action suits. Further, corporate governance and accounting standards in India, particularly for listed companies, have gained increased attention in recent years and have become more stringent with respect to disclosures, segmental reporting and consolidation of financial statements. For example, SEBI requires listed companies to pass ordinary resolution for all all material related party transactions. The rules also require entities to give prior intimation about fund-raising events such as preferential issue, rights issue and debt issue (including the method for determination of issue price), as well as file an annual information memorandum.

B. Minority protection for AIF in portfolio companies

Various provisions of Nepal's Companies Act seek to protect minority shareholders. Some of the key provisions related to protection of minority rights include:

a. Per Section 138, any shareholder may petition the Court to prevent a director or officer of the company from acting *ultra vires* (beyond his/her powers).
b. The Companies Registry Office ("CRO") may also petition the Court if, based on investigation, the CRO finds that the business of a company is being conducted, or or at risk of being conducted, in a manner that is not in the best interest of any of its shareholders. Similarly, a shareholder can petition the Court, providing necessary evidence, if an act is considered not in the best interest of any shareholder.
c. The Court may make an order to prevent the act complained of, requiring the company to institute civil proceedings as directed by the Court, requiring the buy-back of the shares of any shareholder by reducing the capital of the company, and to return the amount of such shares. Where any shareholder has incurred any loss and damage as a result of any discrimination against him, the Court may order the company or the person making responsible for such discrimination to pay compensation to the shareholder. The court may order the liquidation of the company.
d. Per Section 140, if a Company fails to take legal action against any director, officer or shareholders, a shareholder holding 2.5% or more of the paid-up capital of the company may start such legal action on behalf of the company.[42]

In comparison, under India's Companies Act, 2013, members of a company[43] can file an application to the National Company Law Tribunal ("NCLT") in case of oppression and mismanagement. Additionally, if the members[44] of a company are of the opinion that the management or conduct of the affairs of the company are being conducted in a manner prejudicial to the interests of the

[42] The shareholder may choose to take such action separately or jointly with two or more shareholders holding 5 percent shares. If the shareholder wins the case, expenses and legal costs incurred by him/ her in connection with the legal proceedings must be reimbursed by the company.
[43] In case of a company having share capital, not less than 100 members of the company or not less than 1/10th of the total number of its members, whichever is less, or any member or members holding not less than 1/10th of the issued share capital of the company and in case of a company not having share capital, not less than 1/5th of the total number of its members.
[44] In case of a company having share capital, not less than 100 members of the company or not less than 1/10th of the total number of its members, whichever is less, or any member or members holding not less than 1/10th of the issued share capital of the company and in case of a company not having share capital, not less than 1/5th of the total number of its members.

company or its members or depositors, such members can file an application before the NCLT as a class action suit on behalf of the members or depositors and for the benefit of all of them.

C. Contract enforcement

In practice, delay in the court system is a challenge for shareholder rights protection in Nepal because Nepal does not have specialized commercial courts. Only some commercial disputes – such as under the Companies Act or Insolvency Act -- are submitted to the commercial bench in the High Court. Disputes related to contract law enforcement are referred to the District Courts (court of first instance) which has not yet established a commercial bench. The courts in Nepal would benefit from capacity-building to deal with commercial cases more expeditiously. As regional comparison, India's fast track courts were established in 2000 to handle long pending cases. Currently, the Indian government is considering adopting revised arbitration guidelines for fast track settlement of commercial disputes. Further, dispute resolution with the Indian government for commercial contracts is generally at par with any other commercial dispute (which is of importance particularly in sectors such as infrastructure, where concessions are provided by the government).

Nepal has adopted an Arbitration Act which is largely based on the UNCITRAL model. Nepal is also a party to New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, but only for commercial transactions and on the basis of reciprocity. Nepal has sufficient provisions under the Aribtration Act to enforce foreign arbitral awards. Globally, including in India, parties to a dispute are generally permitted to resolve disputes through arbitration in a seat of their choice, using rules of arbitration that they agree upon, and using governing law of choice (subject to certain exceptions). In India, enforcement of arbitration awards is limited only in certain limited circumstances, such as where the enforcement would be contrary to public policy.

D. Insolvency regime

The Companies Act and Insolvency Act makes provisions to govern the liquidation of companies; but the Insolvency Act is as yet largely untested. Chapter 10 of the Companies Act provides for the voluntary liquidation of a company. A company which is not deemed insolvent under Nepalese law can appoint a liquidator who can exercise the powers conferred under Section 131 of the Act. The Insolvency Act 2006 is a relatively new law providing a modern approach to dealing with corporate insolvency. It requires a mandatory evaluation to consider restructuring before ordering the liquidation of insolvent entities. It also prioritizes claims for creditors. However, in practice, the Insolvency Act has not been tested, except for liquidation related to a few banks, so it is as yet unclear how effective the regime will be in dealing with possible insolvency of PEVC fund investees. India has recently enacted a new insolvency regime, the Insolvency and Bankruptcy Code, 2016 ("Insolvency Code"), which provides for time-bound insolvency resolution and has gained traction in the market. The corporate insolvency resolution process is required to be completed within 180 days, and can be extended by 90 days upon request. It also provides for a fast track corporate insolvency resolution process which is required to be completed within 90 days.

E. Intellectual property rights

To promote private equity funds in the country, Nepal should modernize its Patent, Design and Trademark Act 1965 to incorporate WTO trade-related intellectual property rights (IPR). Nepal's legal framework for IPR is found in the Patent, Design, and Trademark Act 1965 and the Copyright Act 2002. However, the law does not meet modern standards for trade-related intellectual property rights. International trademark holders have complained that that they are unable to protect trademarks which are well-known in international markets, despite Nepal being party to several IPR related conventions: i) Paris Convention for the Protection of Industrial Property (June 22, 2001); ii) Convention Establishing the World Intellectual Property Organization (February 4, 1997); and iii) World Trade Organization (WTO) - Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement) (1994) (April 23, 2004). Nepal also adopted The Competition Promotion and Market Protection Act in 2007 which governs anti-competitive practices, monopolies, fair competition, and mergers and acquisitions However, this Act has not been effectively implemented or enforced in practice.

V. Business-Enabling Environment

In addition to the legal and regulatory environment, the task team has analyzed several other factors that affect PE/VC investment in Nepal. These factors impact a fund's ability to operate during different phases of its lifetime, including fund-raising, investment entry, management of portfolio companies and investment exit. Table 3 provides a summary of the task team's findings.

In general, there is substantial room for improvement in business environment in Nepal, which currently ranks as number 107 (out of 190) in the World Bank Doing Business ranking. While this is better than the rankings for India (130) and all other south Asian countries except Bhutan, on a broader international basis it is an unsatisfactory result. Nepal's position also deteriorated from 2016 to 2017. Five components of the Doing Business survey are particularly relevant for PE/VC: enforcing contracts, resolving insolvency, paying taxes, protecting minority investors and getting credit. In contract enforcement Nepal scores very poorly (rank 152), due to the long timing, high cost and poor quality of its judicial process. Tax payments are equally time and process-intensive, resulting a low rank of 142. Getting credit (rank 139) is negatively affected by the lack of credit information and a credit bureau. Nepal scores better in minority investor protection (rank 63) and resolving insolvency (rank 89).

Table 3: Business-Enabling Factors

Factor	Investment Drivers	Bottlenecks in Nepal
Political stability	• Stable political situation is key to investor confidence	• Investor concerns remain • Nepal held local level and national elections in 2017 and a new government is being formed. Local level elections were held in three phases -- on 14 May, 28 June and 18 September, 2017. National elections were held in two phases on November 26 and December 7, 2017. •

Novelty and acceptance of PE/VC	• Entrepreneurs' familiarity with private equity investors and their *modus operandi* increases the likelihood and success of PE/VC investments	• Nepalese entrepreneurs are new to PE/VC and its investment process • Culturally, entrepreneurs are long-term owners and reluctant to accept co-investors • Technical assistance by PE/VC investor is perceived as real value added and helps mitigate fund perception
Lending environment	• Most private equity deals are funded with a mix of equity and debt • The latter is usually provided by banks on the back of the cash flow generation capacity of the portfolio company • An established bond market allows for the issuance of bonds to fund investments (in addition to loans)	• Lending is predominantly asset-based, no leveraged finance • Sudden contraction in loan growth at the beginning of 2017, after years of very sustained growth, due to banks' undercapitalization and new requirements to increase regulatory capital • Bond market limited to sovereign and large corporates
Government initiatives to promote FDI	• A country that poses few limitations to foreign investments is more likely to attract capital from offshore funds	• Government goal to attract FDI has not yet materialized in concrete reforms
Quality of human resources	• Both for deal-making and subsequent management of portfolio companies, PE/VC funds rely on the services of a wide range of professionals including lawyers, accountants and strategy consultants • The availability and quality of these local professionals are an important enabling factor for PE/VC funds	• Migration is a drain on skilled human capital • High employee turnover at portfolio company level • Restrictions on visas for foreigners limit human capital inflows in areas such as PE/VC and related support services (legal, accounting)
Corporate governance and transparency	• Clear and properly enforced accounting standards, and clear corporate governance rules facilitate PE/VC investment in local portfolio companies	• Corporate accounting and disclosure generally sub-par • Funds use technical assistance to bring portfolio companies up to speed

A. Political situation

Political stability is crucial to foster investor confidence in a country. While the end of the civil conflict is a significant positive, concerns remain over the timing and outcome of the elections. Some industry participants interviewed by the task team believe that the ethnic tensions in the country have the potential to escalate, unless differences are resolved quickly. Per the recent national elections, the left alliance party -- CPN-UML and CPN-Maoist (Central) -- received the majority of votes. These parties are in the process of unification. Considering the majority of vote and election agenda of the left alliance party, Nepal is expecting a stable government conducive to focusing on economic development of the country.

B. Novelty and acceptance of PE/VC

PE/VC is a novel concept in Nepal and local business owners have limited knowledge and understanding of it. In an economy in which banks are still the dominant provider of capital, entrepreneurs are cautious when approached by investors keen to enter the shareholder base of their companies. PE/VC deals entail at least partial sharing of control of a company, through governance arrangements (e.g. on voting rights, board representation and veto power) sanctioned by contractual arrangements more complicated than a typical bank loan agreement. In addition, the Nepalese business community does not have a culture of selling businesses, which are instead owned for the long term and passed on to the next generation.

However, technical assistance is perceived by entrepreneurs as a valuable contribution that PE/VC investors can offer. Help in areas such as governance, budgeting, accounting and strategy helps the perception of a PE/VC as a partner rather than a solely return-minded investor. A conversation with a PE/VC portfolio company in Kathmandu confirmed this finding.

C. Lending environment

The lending environment in Nepal is volatile, with years of significant credit growth coming to a sudden halt in the first quarter of 2017. Nepal has seen a proliferation of banks and other financial institutions, as witnessed by the large number of entities listed on NEPSE. Over the past few years, credit growth has been very sustained, especially in the SME segment (loans smaller than $1 million). Most sectors of the economy benefited, including retail, trading, manufacturing, hydropower, car loans, mortgages and personal loans. As previously noted, most lending is on a collateral basis – in other words lending growth has not necessarily benefited fast-growing, asset-poor companies that are targeted by PE/VC funds operating in Nepal. Many banks stretched their balance sheets beyond sustainable capital ratios, a phenomenon that came to a halt in the first part of 2017. The ensuing liquidity crunch resulted in a significant spike in deposit and lending rates. A bank interviewed by the task team, for instance, indicated that its corporate loan rates increased from 5.5% on average during the boom period to 14-15% during the crunch.

As in many emerging markets, bank lending in Nepal is still on an asset rather than cash flow basis. This, in addition to blacklisting rules (discussed above), is an obstacle to the use of leverage in PE/VC deal financing.

Bond issuance in Nepal is effectively limited to the sovereign and a few banks. Bonds markets are not an effective venue for corporates to raise capital. Corporates, therefore, continue to rely on banks for the vast majority of their funding needs.

D. Government initiatives to promote FDI

Despite headline initiatives such as the Nepal Investment Summit held in March 2017, foreign investors continue to have a negative view on Nepal's openness to FDI. In the view of industry participants, the government's intentions to ameliorate the environment for FDI have not yet translated into actual reforms. Industry participants consistently lament the constraints imposed by FITTA and NRB rules on investment and capital movements in and out of the country. Some perceive the government to be unfriendly towards foreign investors.

E. Quality of human resources and support services

Investor views on the quality of human resources for PE/VC in Nepal are mixed. Some funds are currently satisfied, but note the limited size of the talent pool for the investment industry and are concerned about lack of resources should the industry expand further. One fund noted the difficulty of retaining skilled employees in portfolio companies. Migration contributes to high employee turnover – one interviewee observed that migration is the primary career option in the eyes of the most skilled, young Nepalese. Local employment laws may be reviewed to provide for norms on working environment, employee protection as well as provide certainty on enforcement of provisions on non-compete and non-solicitation (particularly for senior-level employees). Employment law is an important component of building a vibrant PE/VC industry, particularly in the brick & mortar portfolio side, including infrastructure.

As with other developing countries, the quality of all support services may not be on par with international standards. Restrictions on visas for foreigners limit human capital inflows, which compounds the problems generated by the migration of skilled Nepalese workers.

F. Corporate governance and transparency

Accounting and tax compliance by Nepalese companies is poor. Any investment by a PE/VC fund requires a thorough financial due diligence. As previously highlighted, funds have technical assistance programs in place to upgrade portfolio company budgeting process, accounting and disclosure to more investor-friendly standards. In order to promote a vibrant eco-system for reporting and transparency, global service providers should be incentivized to establish a meaningful presence in Nepal. Accordingly, local laws may be reviewed to allow for 100% ownership of management consultancy service providers or even joint ventures with local partners, per the Singapore model.

VI. Conclusion

Nepal is home to a nascent private equity and venture capital (PEVC) ecosystem. While still a novelty, four investment firms have formalized their operations in PE-like structures in Nepal: Dolma, BO2, True North Associates and One to Watch.[45] Funds operating in Nepal are small compared to those in other emerging and developing economies, reflecting the early stage of development of the PE/VC industry and investor composition. The prevailing investment strategy is minority, growth-equity investments in SMEs and midcaps. All funds are sector generalists, although there is increased interest in hydropower. Funds invest exclusively in equity and equity-like instruments, as is most common in the PEVC industry and also reflecting Nepalese-specific constraints. The largest source of PEVC capital unsurprisingly comes from DFIs, as is typical in other developing countries. Nepalese institutional investors have not allocated to PEVC and lack sufficient knowledge about the asset class.

[45] Since the completion of the market analysis of this diagnostic, in May 2018, One to Watch and True North Associates announced they have formed a partnership to invest in Nepal. See: https://finnpartnership.fi/wp-content/uploads/2018/05/PRESS-RELEASE-One-to-Watch.pdf.

However, several market impediments deter the nascent industry. PEVC is a novel concept in Nepal and local business owners have limited knowledge and understanding of it. In an economy in which banks are still the dominant provider of capital, entrepreneurs are cautious when approached by investors keen to enter the shareholder base of their companies. Despite headline initiatives such as the Nepal Investment Summit held in March 2017, foreign investors continue to have a negative view on Nepal's openness to FDI. In the view of industry participants, the government's intentions to ameliorate the environment for FDI have not yet translated into actual reforms. Industry participants consistently lament the constraints imposed by the Foreign Investment and Technology Transfer Act (FITTA) and Nepal Rastra Bank (NRB) rules on investment and capital movements in and out of the country (details provided below, and in the broader report). The talent pool for the investment fund industry is limited. And as with other developing countries, the quality of all support services may not be on par with international standards. In addition, accounting and tax compliance by Nepalese companies is poor.

While the Securities and Exchange Board of Nepal (SEBON) has recently initiated the development of an Alternative Investment Fund regulation, currently no regulatory framework for PEVC funds exists. There is no specific regulation to discipline onshore PEVC funds or their managers. The existing regulatory framework for securities allows SEBON to regulate collective investment schemes (CIS). However, specific provisions are currently provided for only one form of collective investment scheme, namely, mutual funds. In the absence of such a framework for PEVC funds, the existing legal/regulatory/ taxation framework applicable to PEVC funds set up domestically presents a few bottlenecks:

a. *Legal structures available for PEVC are inefficient.* Nepalese legislation on partnerships does not cater to the specific needs of private equity fund structures which seek to differentiate between Limited Partners (LPs) and General Partners (GPs). In the absence of a specific legal and regulatory framework for PE/VC, Nepalese fund managers have adopted corporate structures (under the Nepal Companies Act) to replicate the operations of a PE/VC fund. However, this substitute corporate structure is susceptible to legal challenges and is not tax efficient for investors.
b. *Limited domestic institutional capital for PEVC.* The pool of domestic institutional capital available to invest in PE/VC funds is limited, because of regulatory restrictions on eligible investments. In addition, neither insurance companies nor public pension funds currently have sufficient knowledge and capacity to invest in PE/VC funds or fund-like vehicles. The 2014 Investment Policy issued by the Insurance Board allows insurance companies to invest in investment companies (life insurance companies) and in CIS (both life and non-life insurance companies). However, the regulation provides no definition of "investment company"; and it is unclear if CIS would include PEVC funds.
c. *Onshore PEVC funds now cannot receive offshore capital.* Previously domestic PE/VC funds[46] that received any amount of capital from foreign investors are treated as foreign investors themselves. As a result, they are subject to cumbersome FDI approvals on every single investment they make in Nepal. Recent regulatory changes prevent domestic PEVC investment companies from attracting foreign capital. The Industrial Enterprises Act (IEA), 1992 (2049) had classified "investment company" under the list of industries.

[46] Structured as corporate entities as previously described.

However, “investment company” is not included as a classified industry in the new IEA, 2016, thus preventing foreign investment in investment companies established in Nepal.

d. *Sector specific approvals lengthen time/ complexity of PEVC transactions.* The Nepalese economy is heavily regulated and investments in several sectors are subject to government approval, regardless of the domiciliation (domestic or offshore) of the investor. These approvals add time and complexity to the execution of a PE/VC deal.

e. *Central Bank’s blacklisting rules could potentially freeze PEVC fund operations.* The Nepalese central bank (NRB) has put in place draconian “blacklisting” rules for individuals and corporates that fail to meet debt obligations, leading to the inability to access new loans and other severe consequences. The risk of blacklisting is a major deterrent for PE/VC investors to use leverage at the portfolio company level. A wide range of parties related to a defaulting borrower can be blacklisted, including directors, shareholders and other companies participated by the shareholders. As a result, blacklisting related to one portfolio investment gone sour could result in the freezing of the operations of an entire PE/VC fund. It is important to note, however, that a relatively recent amendment on blacklisting issued by NRB exempts offshore PEVC funds from this rule.

f. *No flexibility of financing instruments.* Domestic PEVC funds cannot undertake lending activities since lending is permitted only for licensed financial institutions per the Banks and Financial Institutions Act 2016.

g. *Restrictions on IPO exit and a long lock-in period.* In terms of PEVC fund exits through an IPO, shares can be issued at a premium only if the price is approved by SEBON. Promoters (which include minority shareholders such as PEVC funds) are generally subject to a 3-year lock-in period before they can sell their stake.

h. *No capital gains tax regime, no tax pass-through status, and other tax issues.* Nepal does not have a specific capital gains tax to incentivize long-term investors such as PEVC funds; nor does it confer tax pass-through status for PEVC funds (only available for mutual funds). Nepal’s tax policy provides stronger incentives for domestic HNWs to invest in PEVC vs. a corporate or institutional entity. This may discourage both onshore corporate investors and offshore investors from investing in a domestic PEVC fund. The tax policy further incentivizes HNWs to invest in listed companies (5% tax for divestment) vs. unlisted companies (10% tax for divesting) such as a PEVC fund.

Most PEVC investment in Nepal is through offshore capital; however, offshore capital is subjected to tight controls in Nepal. An offshore PEVC fund, established in a jurisdiction outside Nepal, can currently invest directly in Nepalese companies (but not in onshore PEVC funds) and is subject only to Nepal’s FDI regime, not to a regulatory regime for funds in Nepal. The treatment of offshore PEVC funds is therefore affected by different factors that are a by-product of Nepal’s broader policy stance towards foreign investment.

i. *Foreign direct investments are subject to tight controls in Nepal.* FITTA’s negative list forbids foreign investments in a wide range of industries, including large ones such as retail; and IEA 2016 prevents foreign investment in activities not classified as an “industry.” Second, FDI approval is a time-consuming, documentation-heavy process that often requires navigating multiple government agencies. Anecdotal evidence from the funds interviewed indicates that the process can easily take months. Third, FITTA approval is strictly on a project-by-project basis. There is no “blanket approval” for professional investors such as PEVC funds. This significantly slows down the operations of an offshore PEVC fund in Nepal. In addition, NRB imposes strict limitations on the amount of foreign investment into Nepal. Approval procedures are lengthy and cumbersome, and additional to all other FDI and sector-specific approvals a certain investment is subject to.

j. *Limited domestic institutional capital.* In addition to the restrictions described anove, Nepalese insurance companies and pension funds are prevented by regulation or the establishing acts, respectively, from investing outside Nepal.

k. *No mechanism for foreign fund managers to establish a branch office in Nepal.* To provide fund management services in Nepal, foreign fund managers must have a commercial presence in Nepal. However, there is currently no effective mechanism for foreign fund managers to have a commercial presence in Nepal by registering a branch office. They cannot set up a branch office because FITTA permits foreign entities to hold only up to 51% shares in a local entity which provides management and consultancy services. Offshore funds must instead seek management service from local companies.

l. *Limited flexibility on instruments.* NRB regulation imposes strict limitations on lending by foreign institutions, and grants approval for each loan extended by a foreign entity. As a result, it would be extremely difficult for an offshore PEVC fund to lend to portfolio companies.

m. *Double Taxation Agreements are open to interpretation.* Several aspects of Nepal's Double Taxation Agreements (DTAs) with other countries, including how offshore funds are taxed on the sale of shares in a Nepalese investee company, are open to interpretation, which can deter PEVC investors. Thus, offshore funds hoping to benefit from lower capital gains tax in their jurisdiction of domicile may not be able to do so.

n. *Restrictions on repatriation of capital/gains.* Repatriation of capital offshore can only occur for amounts approved by NRB under its valuation rules (for private companies and unlisted public companies), and not before one year from the date of the original investment. The approved amount of repatriable capital may differ from the portfolio company divestment proceeds of a PEVC fund, adding significant uncertainty in terms of capital return to fund investors.

Annex 1: List of Interviewees

Interviewees are listed in alphabetical order:

Funds

BO2	Siddhant Raj Pandey (Chairman/CEO)
Dolma	Tim Gocher (CEO) Shabda Gyawali (Investment Manager) Bidhyabaridhi Sigdel (Investment Director)
Everest Equity	Krishna Raj Parajuli (Managing Director)
One to Watch	Willem Grimminck (Director)
True North Associates	Suman Joshi (Founder and Managing Partner) Arpan Khanal (Investment Manager)

Government and regulators

Department of Industry	Pradip Kumar Koirala (Director General) Khagendra Basnet
Investment Board of Nepal	Maha Prasad Adhikari (CEO) Madhu PD Bhetuwal (Joint Secretary)
Insurance Board	Chiranjibi Chapagain (Chairman)
Ministry of Finance	Ananda Raj Dhakal (Joint Secretary)
NEPSE	Niranjan Phuyal (Acting Deputy Manager)
NRB	Bhisma Raj Dhungana (Executive Director) Narayan Prasad Paudel (Executive Director and Spokesperson) Sunil Udash (Director)
SEBON	Niraj Giri (Executive Director) Rewat Bahadur Karki (Chairman)

Banks

Himalayan Bank	Ashoke SJB Rana (CEO)
Nabil Bank	Krishna D. Bhattarai (Chief Financial Officer) Sashin Joshi (CEO)

Pension funds

Citizen Investment Trust	Ram Krishna Pokharel (Executive Director)

Employees Provident Fund	Krishna Prasad Acharya (CEO)

Insurance companies

Nepal Life	Vivek Jha (CEO) Agam Mukhia (Assistant General Manager)
Shikhar Insurance	Dip Prakash Panday (CEO) Suraj Rajbahak (Manager)

Legal and financial advisors

EOS Advisors	Suman Rayamajhi (Founder)
Kriti Capital	Sandeep Karki (Manager) Deepesh K. Vaidya (Managing Director and Founder)
Pioneer Law Associates	Anup Raj Upreti

DFIs

DFID	Rabi Rayamajhi (Private Sector Development Adviser) Gareth Weir (Team Leader, Economic Development Team)

Portfolio companies

Dalle Restaurants	Subash Gauchan (Founder)