

# PROMOTING PRIVATE EQUITY IN NEPAL

BINDING CONSTRAINTS AND  
POLICY RECOMMENDATIONS

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## FOREWARD

The Government of Nepal has stated its intention of graduating the country from its current status of least developed nation to a developing nation by 2022. To achieve this goal, Nepal needs to embark on a higher trajectory of economic growth—and sustain it: something that has eluded the country because of its inability to institutionalize the democratic gains, the ten-year insurgency, and the recent natural disasters. With the new constitution finally promulgated, there is hope for a renewed focus of the government on attaining its stated vision. But this requires significant investments in overcoming Nepal's extant infrastructure deficit and in promoting an ecosystem for the private sector, especially the small-and-medium enterprises (SME), to flourish and contribute their share in development.

The experiences from successful countries, including those from the Asian Miracle, indicate that the effective mobilization of capital investments in infrastructure, both hard and soft, and on a functioning market systems that is globally integrated is instrumental in achieving high and sustained growth. The Government has taken some initiative in this regards, exemplified by the establishment of the Investment Board of Nepal to promote foreign investments in large-scale infrastructure projects in the country. Despite some initial promises, the ability to fulfill its current undertakings is yet to be seen. On the other hand, adequate mechanisms to attract investments towards building robust enterprises is still lacking.

Against this backdrop, private equity funds is one investment instrument that is increasingly providing for the financing needs, for infrastructure and enterprises, in many developing countries. The benefits from these funds to entrepreneurs can be multi-fold: they offer an alternative financing route for companies that are yet to be sufficiently established or those that are already burdened with debt; private equity, by its very nature, is willing to take more risks on entrepreneurial innovation; and as equity investors, have a larger interest, and investment, in the wellbeing of the company (particularly in relation to interest-based investments of banks) because their returns are tied to the economic performance of the company. In many cases, private equities, especially foreign-based, have also been known to help better integrate local economies into the global market, introduce technological innovation, and promote better corporate governance among local businesses.

Several policy constraints, however, hinder the growth and facilitation of private equity funds in Nepal. Unlike legislation in neighboring South Asian countries, Nepal is yet to develop a single dedicated legal framework to govern and facilitate different means of alternative financing such as private equity. These funds remain governed under the same framework that governs traditional notions of investments and doing business. Several issues including, but not limited to, entry and exit, lock-in period, lack of partnership options, currency reparations, and lengthy approval periods inhibit the growth potential of private equity funds in Nepal.

This report on Promoting Private Equity in Nepal: Binding Constraints and Policy Recommendations adds to the debate on promoting an investment-friendly climate for economic growth in developing countries. If a frontier market like Nepal, where the economy is less developed than other emerging markets, but are still investible due to their economic growth potential, is to develop then proper regulations and policy frameworks that foster alternative investments such as PE have to be formulated.

# SECTION 1: INTRODUCTION

Nepal is yet to formulate any regulatory provision for the formation of onshore-regulated institutional funds that can invest in private companies. Private equity (PE), as an organized institutional investment vehicle, is not recognized under the legal framework of Nepal. Investments are made by resident or non-resident individuals/institutions of Nepalese origin or foreign origin at a private level. While there is no official definition of the role and function of the PE Industry in Nepal, for the purpose of this study, it is defined as a formal investments vehicle that participates in risk capital formation in the form of equity investments or its derivatives in any new, growing, or struggling businesses and is recognized and guided by well-defined regulations. The PE market, depending on the choice of entrance in business or ownership can take the form of venture capital investments, private equity investments or Foreign Direct Investments (FDI).

Moreover, offshore PE investment is included under the large bracket of FDI and is administered and regulated by the Foreign Investment and Technology Transfer Act (FITTA) 1992, and the Industrial Enterprise Act (IEA). The Department of Industries (DOI) monitors both onshore and offshore investments of all kinds across all sectors and is the sole agency for administration and implementation of FITTA in Nepal. FITTA defines Foreign Investment as an investment made by foreign investors in any industry in these following forms:

- Investment in shares (equity)
- Re-investment of the earnings derived from equity
- Investment made in the form of loans or loan facilities
- Investment in kinds, for example, machineries and equipment

Industrial development in Nepal can be defined within two broad time frames: pre 1985 and post 1985. Prior to 1985 the government's attitude to the country's economic development was characteristic of inward-looking strategies. A protectionist stance towards domestic industries was common and the government was extremely vigilant of all aspects of the economy. The liberalization of the economy began in 1987 when Nepal became part of the World Bank and International Monetary Fund (IMF) initiated reform programs under the Structural Adjustment Facility (SAF) and Structural Adjustment Program (SAP) in order to break the supply-side bottlenecks and improve Balance of Payment (BOP) deficits. Structural changes were pursued in order to modernize the economy and make it more investment friendly to both domestic and foreign investors. Nepal opened up avenues for foreign investments after the enactment of the Foreign Investment Transfer Act (FITA) 1981; however, the concept of investment flourished only after the introduction of the Industrial Enterprise Act in 1992.

The Industrial Policy of 1992 recognized the need to promote industrial investment in order to increase the level of production and meet the growing demands of domestic and foreign consumers, while generating employment and improving the balance of payments. In an attempt to encourage investments, the policy introduced the Industrial Enterprises Act (IEA); the Foreign Investment and Technology Transfer Act (FITTA), and the One-Window Policy.

Active private participation became prominent in the economy after the enactment of the IEA in 1992, as the government began to review its interventionist stance towards the economy. The replacement of FITA 1981, with the FITTA 1992, accelerated the number and scale of foreign investments in the Nepali economy. The central objectives of these Acts and policies were the promotion of market-driven business strategies and operations and the involvement of domestic and foreign private enterprises. As a result, in the last decade, a total of 2545 projects with foreign investments have been recorded which amounts to projects costs of US\$ 2583.96 million, with foreign investment worth US\$ 1608.24 million.

Private Equity as a formal investment vehicle, is relatively a new concept in the Nepali financial sector, as a result of which, comprehensive laws governing PE investments are non-existence. Multiple laws and institutions govern the scope of PE investment and operations in Nepal. Though changes and reforms have been made in laws and policies that govern industrial and investment sector to encourage the flow of investment, overall, laws and the regulatory environment remains traditional (protectionist), vague and cumbersome. The section below discusses the key policies and institutions that govern and regulate the financial market in Nepal.

# SECTION 2: ACTS AND GOVERNING BODIES RELATED TO INVESTMENT IN THE CURRENT LEGAL AND ADMINISTRATIVE FRAMEWORK OF NEPAL

Several Acts and regulations govern investments in Nepal, which are executed by various governing bodies. Some of the important ones that regulate investments are:

## 2.1 ACTS

### COMPANY ACT, 2006

The Company Act introduced by the Parliament in 2006 regulates the operations of companies and outlines the legal limits within which companies can conduct their business. This Act consolidates the laws relating to companies with the aim to promote investment in industry, trade and other business sectors through economic liberalization. It also presents guidelines that support the operations and administration of companies by making them easier, simpler and more transparent.

### BANKING AND FINANCIAL INSTITUTION ACT (BAFIA)

This Act was passed by the Parliament in 2006 to create a governing standard for the financial services and to improve the level of trust of the general public in the overall banking and financial system of the country. By protecting and promoting the rights and interests of the depositors, the Act aimed to improve the quality and reliability of banking and financial intermediary services through healthy competition between banks and financial institutions. The Act was introduced to minimize the risks related to the banking and financial sector, boost and consolidate the economy through liberalization and outline necessary legal provisions related to the establishment, operation, management and regulation of banks and financial institutions.

### SECURITIES ACT

The Securities Act was passed by the Parliament in 2006 and covers laws which regulate and manage the activities of the Securities market and individuals. It was aimed at

regulating the issuance, purchase, sale and exchange of Securities for the purpose of protecting the interests of investors and developing the capital market to mobilize necessary capital for the economic development of the country.

### SECURITY REGISTRATION AND ISSUES REGULATIONS, 2008

According to section 116 of the Securities Act 2007, the Securities Board of Nepal postulated certain rules and guidelines that regulate the registration, issue, operation and exit of Securities in the Nepalese financial market.

### THE TAX ACT

The Tax Act was passed by the Parliament pursuant to Sub-articles (1) of Article 83 of the Interim Constitution of Nepal 2006. This Act dictates guidelines regarding some of the charges, taxes, duties, excises, fees, and includes amendments to existing laws relating to revenue administration.

### THE FOREIGN TECHNOLOGY AND TECHNICAL TRANSFER ACT, 1992

The Foreign Investment Technology and Technical Transfer Act (FITTA) was enacted by the Parliament to expedite the promotion of foreign investment and technology transfer necessary to making the economy dynamic and competitive through the mobilization of limited capital, human and natural resources.

## **THE INDUSTRIAL ENTERPRISE ACT, 1992**

The Industrial Act was intended to create an enabling environment for industrial enterprises in order for them to foster in a competitive manner through increased productivity and increased investments.

## **2.2 GOVERNING BODIES**

### **THE DEPARTMENT OF INDUSTRIES**

The Department of Industries (DoI) falls under the Ministry of Industry. It was created in order to expedite and implement policies, rules and regulations that would be more favorable to industrialization. The objective of the department is to facilitate and encourage the establishment of industries in different parts of the country. Among the various functions of DoI, the following are the most important:

- To formulate and implement rules, regulations and policies related to medium and large scale industries
- To perform promotional activities for industrial investment and disseminate knowledge and information to that respect
- To issue licenses to prescribed industries and to register all medium and large scale industries
- To approve industrial projects with foreign investment and provide them with consultancy services in the form of data, information and general response to any queries

### **THE SECURITIES BOARD OF NEPAL**

The GoN established the Securities Board of Nepal (SEBON) in 1993 as an apex regulator of the Securities market in Nepal. It has been regulating the market within the framework of the Securities Act 2006. It operates strictly in the context of equity investments and its main functions are as followed:

- To grant permission to operate collective investment schemes and investment fund programs and to supervise and monitor them
- To register the Securities of corporate bodies established with the authority and to make a public issue of their Securities.
- To issue licenses, subject to the Security Act, or to the rules and the by-rules framed under the Act, to companies or institutions that desire to conduct business in the Securities market.

### **THE NEPAL RASTRA BANK**

The Nepal Rastra Bank (NRB) is the central bank of Nepal and is responsible for regulating and monitoring the activities of banks and financial institutions. It is also the sole institution responsible for repatriation of foreign currency.

### **THE MINISTRY OF FINANCE**

The Ministry of Finance (MoF) is the central agency that drives the key financial policies and Acts of Nepal. The MoF monitors SEBON, NRB and other organizations and also designs tax structures and any other policies that directly or indirectly impact investments.



## SECTION 3: REGULATORY ISSUES RELATED TO PE INVESTMENT IN NEPAL

Over the years, on-shore investments have managed to steadily foster amidst the arduous policy environment through loosely organized private equity funds. However, despite prioritization by the government, offshore PEs still remain hesitant to enter Nepal in absence of clear and conducive investment environment. The following section analyses issues related to foreign investors, domestic investors and entrepreneurs with regard PE investment in Nepal.

### 3.1 ISSUES RELATED TO FOREIGN INVESTORS

Issues	Present Situation	Suggestions	Potential Outcome
<b>ENTRY</b>			
Automatic Approval Route	Absence of Blanket Approval Route or an Automatic Approval Route for foreign investments.	Automatic approval of FDI in certain sectors (Reference: India).	Mitigating the uncertainty of deal flow due to the time lag and possibility of change in the company's performance.
Protectionism by increasing MCR	Restricts foreign capital and expertise to reach the lower strata of the economy.	Lower MCR on FDIs.	Low MCR would help SMEs to grow with foreign capital and technical expertise.
Debt Financing	Permitted in the positive sectors with prior permission from NRB; only in the case of unavailability of domestic debt; at an interest rate no greater than LIBOR +5.5%.	Dilution of such clauses	This would facilitate deal flow and bring in huge amount of investments from abroad.
Valuation	No standard method of valuation in the financial system.	Assignment of internationally acceptable valuation methodologies to facilitate fair deal flow.	Brings about transparency in the transactions. Feasible for both investors and investee to negotiate deals.
Hybrid Instruments	No legal restrictions on the use of hybrid instruments; however, lack of guidelines related to the use of hybrid instruments restrains the use of such financial instruments.	Introduction of Hybrid Instruments in the market.	Foreign Investors prefer to use variety of hybrid instruments that suit their interests. This would encourage inflow of FDI.
<b>OPERATIONS</b>			
Tedious Approval Process	Foreign PE funds are required to seek permission for every investment they undertake.	Provision to allow investments in all the permitted sectors without prior approval but with a clause of transparent documentation.	This would shorten the time-lag and make the investment procedures smoother.

Issues	Present Situation	Suggestions	Potential Outcome
<b>EXIT</b>			
Lock-In Period	Lock-in Period for private equity investors is 3 years post IPO.	Foreign Equity Investors can be exempted from this obligation in order to increase the number of undertaken projects.	With Private Equity investment being closed-end, investors would be encouraged to invest in Nepal.
Repatriation	Repatriation is legally free and applies no income or dividend caps; however, the procedure is unclear and time-consuming.	Free flow of repatriable income with clear bureaucratic guidelines.	Motivate investors to undertake larger projects.

### 3.2 ISSUES RELATED TO DOMESTIC INVESTORS

Issues	Present Context	Suggestions	Potential Outcome
<b>STRUCTURING</b>			
Parallel Development of FDI and non-FDI investments	In the recent years, FDIs and investments from NRN are being prioritized over domestic investments.	Provide financial as well as motivational incentives to domestic investors.	Domestic savings are capable of pooling huge investment-ready capital that can be injected into sustainable sectors.
Tax Incentives	Totalitarian Taxation System (in terms of geography)	Tax distribution should be based on the geographical realm.	Encourage domestic investors to undertake projects in rural areas and help to attain balanced growth.
	Sectoral Taxation System (in terms of sectors)	All sectors should be given equal priority	
	No provision of tax holidays to new industries (except Hydroelectric Projects).		Tax holidays for new industries and firms can be encouraging to domestic entrepreneurs and investors.
	Companies are subject to dividend tax on the profits scraped for the purpose of reinvestment in any other company apart from their existing companies.	Dividend tax should be exempted if the fund is directed towards reinvestment of any form	
<b>OPERATIONS</b>			
Blacklisting Norms	As per NRB's approach to blacklisting, if an investee company with 15% of its stakes controlled by PE investor, defaults from any commercial loan, the PE investor is subject to blacklisting and is forced to withdraw all the existing investments.	The norms should be relaxed for the domestic investors.	Investors would be encouraged to invest in risky yet profitable ventures. Seed investments and Venture capitals would be active in the domestic economy.

### 3.3 ISSUES COMMON TO ALL INVESTORS

Issues	Present Situation	Suggestions	Potential Outcome
<b>STRUCTURING</b>			
Alternative Investment Fund	Alternative asset classes offer a wide range of possibilities, from commodities, futures contracts to vintage cars. However, Nepalese capital market is yet to introduce AIFs under its umbrella.	Alternative investment class should be added to the existing traditional mixed-asset portfolio.	AIFs are of great importance to portfolio investors as they are a major determinant of investment performance and are critical to the investment process.
Lack of Clarity in Existing Laws	Laws related to investment and disinvestments lack clarity. Few Acts governing investment procedures contradict with each other.	All the Acts, policies and directives should be revised to bring about clarity.	This would create momentum in investments, minimize operational costs and save time.
<b>ENTRY</b>			
Recognition of PE Funds	PE funds are not recognized as an independent financial strategy. Equity investments are governed either by FIP or the Companies Act.	Recognize PE funds as an individual financial tool capable of performing specific financial transactions. Space for SPVs and Investment Firms should be created along with the regulations necessary to guide them.	Identifying PE funds would organize investments in Nepal under a legal decorum.
Valuation	No specified method of valuation	Guidelines to evaluate different sectors with unique approach should be introduced.	Terms of transaction would be fair and both parties would benefit mutually.
Share Pricing	Face value of shares is fixed at Rs.100 par. Companies can collect shares capital at par value only.  Only after complying with the preconditions as stipulated under clause 29 of the Company Act	In pursuance of the proposed amendment draft of SEBON, premium share price can be fixed up to 2.5 times the net worth. Such limits should not be imposed and it should be left to the market to decide.  A speedy approval of the amendment is essential.	Premium share pricing at the value equivalent to the company's net worth provides little stimuli for new investments. Premium pricing greater than net worth would have a multiplier effect on the economy.
Multi-sectoral Approval	There is a need to seek investment permission from individual authorities. This requires extensive documentation and is often time consuming.	A committee, which acts as a single window approval for all the sub-sectors would be ideal.	Easy approval procedures would accelerate investments of all scales in all sectors.

Issues	Present Situation	Suggestions	Potential Outcome
<b>OPERATIONS</b>			
Personal Guarantors	Equity Investors are required to be the personal guarantor for ventures undertaken.	Recognize the unique nature of equity fund.  Legal acceptance of equity as financial asset by the commercial banks.	PE firms would be more experimental and would be able to undertake many small to big risky ventures.
Director's Liability and Penalty Driven Filings	A director is liable to several penalties (sometimes imprisonment) in the event of bankruptcy, and other intentional and unintentional mishaps.  Various authorities demand repetitive and sometimes unnecessary filings. Failure to comply by the deadlines lead to penalties and fines.	Provision to relax some clauses in the Companies Act to protect the interest of PE investors who chair the seat of directors.	Motivation for investors without the fear of unnecessary sanctions.
Exit Policies	<b>Lock-in Period</b> Company should show dividend distribution for consecutive 3 years in order to qualify for exit through IPO at premium price.  <b>IPO</b> A company can only float its shares at market price after 3 years from the date of the IPO.  The public issuance can be made only if promoters own at least fifty one percent of the shares.	The lock-in period should be relaxed, as the ultimate goal of PE investors is to exit the market by selling off their stakes at higher value.  Public can be categorized into financial literate and general. Thus the shareholdings of promoters can be brought down which can be covered by the shareholdings of financial literate public.	Free exits and entry is essential in the private equity market.  Easy exits are an incentive for equity investors.

### 3.4 ISSUES RELATED TO ENTREPRENEURS

Issues	Present Situation	Suggestions	Potential Outcome
<b>STRUCTURAL</b>			
Investors' Goals	<p><b>Short-term Investments</b> Domestic investors are more inclined in making short-term investments.</p> <p><b>Risk In-take Capacity</b> Domestic Investors have low risk intake capacity, which is a drawback for PE investments.</p> <p><b>Traditional Assets</b> Due to limited asset class in the economy, investors feel more secure investing in traditional assets over new ventures.</p>	<p>Insurance for private equity undertakings</p> <p>Introduction of AIF in the economy to promote venture and equity investments.</p>	Promote entrepreneurship and start-ups.
Investment Advisory Firm	There is no recognized investment advisory body to negotiate and facilitate a fair deal between investor/s and entrepreneur/s.	Regulations to bring such firms into existence	Facilitate private equity deal flows. Protects the interest of investees and investors through win-win scenario.
<b>ENTRY</b>			
Valuation	<p><b>Share Pricing</b> Clash between share pricing guidelines by the DoI and the OCR.</p> <p>Absence of <b>Market Mechanism</b> to determine the price of shares</p> <p><b>New Companies</b> There is no mechanism to evaluate potential financial worth of a new industry.</p>	<p>Provision to have Market-based Accounting system</p> <p>Valuation guidelines by various departments</p>	Help negotiate a symbiotic deal between investors and entrepreneurs.
<b>OPERATION</b>			
Sweat Equity	<p>There are no legal guidelines to regulate the issue of sweat equity. <i>Note: Sweat equity is the ownership interest, or increase in value, that is created as a direct result of hard work by the owner(s)</i></p> <p>Double Taxation applicable on entrepreneurs.</p>	Guidelines monitoring and supervising the tax issues of sweat equity.	Protect the interest of entrepreneurs especially in the service sector.

Issues	Present Situation	Suggestions	Potential Outcome
<b>EXIT</b>			
Valuation	<b>IPO</b> Dividend distribution record of minimum three out of five years; a difficult condition for start-ups.	Shorten the time frame	Allows new firms with potential growth to generate capital for further expansion
Repatriation	Repatriation though legal, has many operational hurdles.	Guidelines for repatriation to stimulate process of repatriation.	Incentivizes foreign investments resulting in increased number and amount of investments.

### 3.5 SUGGESTIONS TO REGULATORS

Issues	Present Situation	Suggestions	Potential Outcome
<b>STRUCTURING</b>			
Collective Investment Scheme	Existence of provision for using CIS under Security Act of Nepal; however, regulations governing VCFs is absent.	Introduction of Alternative Investment Fund Regulation	This, like Mutual Fund Regulation, would facilitate venture financing in a structured manner.
Classification of Shares	There is no system of rating shares based on their liability.	Classification of shares on the basis of their liability	Would facilitate investors in making rational decision based on their interests.
IPO Rating	The current securities regulations require risk ratings of IPOs. There is no system to measure the different instruments issued by the private companies based on their risk-return credibility.	A provision to rate IPOs based on their potential risk and return.	This would bring about clarity for the investors, providing them with an array of rational options to choose from.
Limited Liability Partnership	There is no concept of LLP in Nepal.	Introduce the concept of LLP in the legal books of the Nepalese financial system.	This would prove as an incentive to the investors in regards to limited liability
Company Act	Recognizes all companies as the same	Investment funds should be excluded from the umbrella of Companies	Investment Fund is altogether a different form of company/trust that requires special recognition.

Issues	Present Situation	Suggestions	Potential Outcome
<b>OPERATIONS</b>			
Company Act	Section 9 of the Company Act prohibits any private company to have more than 50 shareholders.	Upon recognition, Investment Fund can be exempted from this clause.	Investment Funds are able to generate more funds if the ceiling of permitted number of shareholders is raised.
	Section 176 of the Act restricts any company to invest beyond 60% of its paid up capital or 100% of its free reserve; whichever is higher. This clause is not applicable to financial institutions and some other institutions.	Investment Fund should be exempted from the Clauses of Section 176.	This would increase the amount of funds to be invested for any investment company.
BAFIA	Section 47 restricts all the domestic organizations apart from banks and financial institution to make loan investments.	Investment Fund should be clubbed with banks and other financial institution, which are exempted from this clause.	This would facilitate investments through a combination of debt and equity in companies that have high-risk association along with higher degree of scalability.
	Banks are restricted from making any Private Equity Investments.	Provision for banks to invest in the PE up to a prescribed limit.	This would allow domestic enterprises to flourish through additional injection of funds in the economy.
Blacklisting Norm	Equity Investors are subject to risk of being blacklisted if they are members of BoD in a defaulting company.	This norm should be amended so that the entire portfolio of a PE firm does not get adversely and unnecessarily affected due to the problem in one company within its portfolio.	This provision allows investors to undertake several risky yet potentially profitable ventures.
Forfeiting Share	Forfeiting of shares is often time consuming.	Quick and easy process allowing forfeiture of shares in case of default by investor/s.	This would curtail operational lags of the investee companies.
Reorganization Process	No existing provision that facilitates reorganization of an underperforming firm.	Liberal conditional banking norms.	This would allow the distressed company to adopt structural changes.

# SECTION 4: SUMMARY OF FINDINGS AND RECOMMENDATIONS TO PROMOTE PE IN NEPAL

Private equity in Nepal needs fundamental structuring through legal amendments. These reforms in the financial system would bring about positive shifts in the mindset of investors and entrepreneurs. The following chapter brings into highlight findings and recommendations of various actors involved in PE

## 4.1 SUMMARY OF FINDINGS ON OFF-SHORE PE

### ISSUES IN ENTRY

#### ABSENCE OF SINGLE BLANKET NORMS

The absence of an automatic and blanket approval route for foreign investments has constricted the free flow of foreign investments in Nepal. Automatic Investment Route enables foreign investments to enter the economy without prior permission. For every investment to be made, foreign investors are required to seek permission from at least two counseling bodies: the Investment Board or the Industrial Promotion Board/Department of Industries and the Nepal Rastra Bank (Central Bank of Nepal, NRB). These authorities have their own list of procedures and documentation required for the approval of the proposals. Such a provision is a major hurdle for offshore PE funds who have a mandate to invest in multiple companies/projects.

#### LIMITED POSITIVE SECTORS

Only limited sectors with sectoral caps are open to foreign investments. Adding to these limitations are the guidelines from FITTA and IEA, which restrict foreign investment only to the industries recognized as positive sectors by the various Acts.

#### MINIMUM CAPITALIZATION REQUIREMENT

There is no written legal prescription for minimum volume of investment required for on-shore investments. In the absence of such guidelines, it can be inferred that domestic investments can be of any amount.

On the other hand, MCR to foreign investors for all the sectors is USD 50,000. The newly proposed FIP draft proposes raising the MCR by four times. This could stunt the growth of foreign investments in SMEs and limit them to large and concentrated sectors.

#### TREATMENT OF FOREIGN LOANS

An onshore investment is eligible to receive loans from foreign financial institution only if:

- The company cannot avail loans from domestic banks and financial institutions, and
- The rate of interest on foreign loan is lesser than the domestic rate of interest.

The rules are even more rigid for procuring loans from a foreign investor. A company can avail loans from a foreign investor only if the company is unable to procure loans from-

- At least two domestic banks, and
- At least one foreign financial institution

NRB's norms are rigid even in the case of repayment of foreign debt. A debtor is required to fulfill the above mentioned criterion in order to undertake foreign loans. The debtor should not have any debt payable to local banks and financial institutions, and is not blacklisted as a defaulter.

The promotion of offshore PE funds can only be possible if these norms are relaxed. Criterion pertaining to debt financing from foreign investors need to be relaxed along with the eligibility criterion of the debtor.



## LIMITED INVESTMENT INSTRUMENTS

Currently, foreign equity investments can be made only through FDI. Offshore PE funds are restricted from using any type of debt instruments. Moreover, hybrid instruments are not used in the financial market of Nepal. Since most of the foreign investors prefer the use of hybrid instruments like convertible debentures and preference shares, investment inflow is stunted.

## ISSUES IN OPERATIONS

### ONE WINDOW POLICY

The Single Window Policy was introduced as part of the Industrial Enterprise Act 1992, to eradicate bureaucratic roadblocks for industrialists and expedite the process of industrialization. However, this policy has had a very limited impact. Currently, the function of the One Window Policy is managed by the DoI/Bol and is limited to providing necessary facilities and concessions to industries by making recommendations for time-bound provisions

of infrastructure for the industries and providing initial approval to foreign investments in Nepal.

Permissions need to be sought repetitively from various departments upon each investment from the fund. This often turns out to be time consuming leading to delays in the investment process.

One Window Policy needs to be simplified whereby a One Window Clearance System is introduced to allow the investors to get all of their documentation completed from one office.

## ISSUES IN EXIT

### LOCK-IN PERIOD

One of the crucial demands of all the PE funds is sufficient liquidity. The firm can only be open to investments when the lock-in period is short and the exit is hassle-free.

## 4.2 SUMMARY OF FINDINGS ON ON-SHORE PE

## ISSUES IN ENTRY

### IDENTIFICATION OF PE

Domestic PE Investments have not been identified until now. Shareholders' investment and debt investment are the only popular categories of domestic investments. PE Funds can grow only if laws and regulations cover PE investments as an independent investment tool.

### LIMITED INVESTMENT INSTRUMENTS

According to Section 47 of the BAFIA, only licensed banks and financial institutions can perform banking transactions. This section regards lending as a banking transaction, which limits the scope of lending only to banks and registered financial institutions. Onshore PE funds and investment firms are restricted from using any type of debt investments.

## 4.3 SUMMARY OF FINDINGS ON COMMON ISSUES

### ISSUES IN STRUCTURING

#### POLICY FRAMEWORK

In Nepal, policies related to equity investments lack clarity. The laws governing foreign investments are not clear either. Unlike India, there is no legal definition that differentiates FDI from FII, thus there is no law enunciating distinct sets of guidelines for the entry and exits of FDI and FII. The protocols for foreign investments are obscured right from their entry to their exit.

Policies should be framed in an effort to make them transparent and comprehensible. By simply distinguishing investments based on their investment strategy and sectoral focus, PE funds can efficiently combine the different investment regimes to make investments in Nepal.

It is essential to have visionary and holistic policies in order to cut down bureaucratic 'red-tapism', improve investment climate and give confidence to the investors. Simplified clearance procedures for offshore PE funds and lenient norms for the existing investment firms can act as a catalyst to increase both demand and supply of PE funds. Political stability and rigid enforcement and implementation of rules and guidelines can change the environment of investment in Nepal.

### ISSUES IN ENTRY

#### VALUATION

Valuation methods are not defined in any of the regulations. Any company preparing for an exit is required to submit its valuation to the NRB. However, there are no specific valuation methods and guidelines to be followed. Ambiguity in the choices of valuation methods often result

in exit delays. This is a serious issue for foreign investors as smooth and quick repatriation procedure is a mandatory requisite.

There is a need for prescribed methods of valuation for investments and repatriating disinvestment, dividends, and sales proceeds.

### ISSUES IN OPERATIONS

#### PENALTIES

The operations side of companies are burdened by numerous filing requirements. Companies registered in Nepal are required to file corporate documents before the Office of the Company Registrar (OCR). Some of the documents demanded by OCR are irrelevant and unnecessary like the annual filing of share-capital structures (even when there has been no change in capital structure for a period) or the requirement to notify the appointment of an auditor.

Failure to comply with filing and reporting of the prescribed documents within the designated time can lead to penalties and fines imposed on the companies and in some cases the nominee directors.

#### DIRECTOR'S LIABILITY

In many cases, failure to file documents in the specified time frame can result in fines imposed on the directors.

## 4.4 RECOMMENDATIONS FOR STRUCTURING INVESTMENT FUND WITH NEW REGULATION

A new regulation has the ability to change the scale of PE investments in Nepal. In addition, guidelines can be introduced and regulations can be amended to address the pertinent problems that exist in the current environment in order to pave the way for smoother investment ventures. The following table recommends few strategies that can be adopted if a regulating body for PE was introduced in Nepal.

Issues	Regulations	Expected Impact
<b>STRUCTURING</b>		
Regulation	New Regulation under Chapter 6, CIS of Security Act	Formation of regulation to regulate financial activities involving VCFs and PEFs.
<b>ENTRY</b>		
Clarification of Fund Objectives, Targeted Investors, Proposed Corpus, Investment Strategies, Tenure of Fund, etc., at the time of investment	Registration at SEBON	Monitor operations of fund
Individual Investment	Guidelines by SEBON	Hedge against risk by assigning minimum investment bar for individual investors
Corpus Amount	Guidelines by SEBON	Hedge against risk by assigning minimum level of Corpus Amount to be generated
Issue of Investment Defaults	Penalty guidelines by SEBON	Hedge against risk
<b>EXIT</b>		
Lock-in Period	As per the guidelines by SEBON (generally 5 to 7 years) that is to be followed strictly in all normal cases	Hedge against investors' risk
Closure	Guidelines by SEBON	Limited life of Funds

## 4.5 RECOMMENDATIONS FOR STRUCTURING INVESTMENT FUNDS FOLLOWING AMENDMENTS OF EXISTING LAWS

Existence and operation of PE funds can be facilitated through amendments in the existing laws in Nepal. Certain changes in the laws covering taxation, registration and operation of investment companies can be reformed to expand the growth rate of private equity investments that are operating in the absence of specific guidelines.

Issues	Regulations/ Acts	Expected Impact
<b>STRUCTURING</b>		
Recognition of PE Fund	The Company Act	Identifies the uniqueness of PE Fund as common in international markets
Introduction Pass-through Tax System	The Tax Law	Provision to exempt PE fund from Double taxation
Parallel Development of FDI and Non-FDI Investments	The MoF and the DoI	Holistic growth; sectoral and geographical.
<b>ENTRY</b>		
Minimum Investment Bar for individual investors	The Company Act	Hedge against risk
Minimum level of Corpus Amount to be generated	The Company Act	Hedge against risk
Number of Shareholders	Sub-section (1) of section 9, Company Act	Facilitates pooling of huge funds from small to big investors
Personal Guarantor	The Company Act	Investments in risky yet scalable businesses
<b>OPERATIONS</b>		
Formation of SPVs	The Company Act	Precision in investment related decision-making
Blacklisting	Sub Section 10 of Section 57, BAFIA	Facilitates fund operations
Debt Investments	Section 47, BAFIA	Diversify investment strategies
Risk Supervision	IPO Rating, SEBON	Facilitates fair decision making for investors based on their risk-return expectations
Issue of Investment Defaults	Penalty guidelines by SEBON	
<b>EXIT</b>		
Lock-in Period	The Company Act, The Securities Regulations	Protects Investor interests

Investment undertakings by investment firms can be better organized by the bringing about changes in the existing laws or through new regulations altogether.

## 4.6 RECOMMENDATIONS FOR ORGANIZING INVESTMENTS UNDER NEW REGULATIONS

A new regulation has the ability to change the magnanimity of PE investments in Nepal. A set of guidelines can be introduced to address pertinent problem that exist in the current situation and pave way for smoother investment ventures at different stages.

Issues	Regulations	Expected Impact
<b>STRUCTURING</b>		
Identity	New Regulation	Recognition of Private Equity Investment as a unique investment strategy
<b>ENTRY</b>		
Clarification of Investment Objectives, Proposed Investment Corpus, Investment Strategies, Tenure of Equity Investment, etc. at the time of investment	Guidelines from SEBON	Legal decorum for investments
Investment level	Guidelines by SEBON	Hedge investment related risks by putting a ceiling on investment amount.

## 4.7 RECOMMENDATIONS FOR ORGANIZING INVESTMENTS FOLLOWING AMENDMENTS OF EXISTING LAWS

In the absence of PE regulations, investment undertakings can have easy structuring, entry, operation and exit through changes in the existing laws. These changes would cater to the regulatory hurdles that have made equity investments difficult in Nepal.

Issues	Regulations	Expected Impact
<b>STRUCTURING</b>		
Identity	The Company Act, BAFIA, SEBON	Recognition of Private Equity Investment as a unique investment strategy
Tax- incentives	The Tax Law	Compensation for liquidity risk/ Motivation to Investors
<b>ENTRY</b>		
Investment Advisory Firms	Guidelines by SEBON	Helps to cut a symbiotic deal between the two parties
Clarification of Investment Objectives, Proposed Investment Corpus, Investment Strategies, Tenure of Equity Investment, etc. at the time of investment	Registration at DoI Notification to SEBON	Approval of investments while protecting the interest of investors
Maximum volume of funds that can be invested in one equity undertaking	Guidelines by SEBON	Protection of Investor's Interest
Automatic Approval Mechanism	Guidelines by DoI	Mitigates time-lag

Issues	Regulations	Expected Impact
<b>OPERATION</b>		
Forfeiture of Shares	Sub-Section (3) of Section 53, the Company Act	Smooth operation by protecting the interests of investee companies
Director's Penalties and Liabilities	Section 81, 160,161,162, the Company Act	Protects investment manager
Sweat Equity	The Company Act	Addresses the issues related to sweat equity
Classification of Shares	The Company Act	Determines rights of investors
<b>EXIT</b>		
Lock-in period	Shareholders' lock-in Sub Regulation (1) of Regulation 10, SRI Regulations, SEBON	Faster exits
Share Pricing	Market-Driven Share Pricing SEBON	Fair deal flow
IPO Exit	Promoter's Share Sub-Regulation (4) of Regulation 7, SRI Regulations, SEBON  Divestment Inclusion of provision to divest through IPO  Dividend Record Sub-Regulation (3) of Regulation 10, SRI Regulations, SEBON	Facilitate faster exits
Valuation	Market Price Method, The Company Act and SEBON	Easier deal flow and Fair valuation of equities
Buy Back of Shares	Section 61, the Company Act	Easier exit

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