COVID-19: Deliberations of a Private Fund LP

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Note: The views expressed in this article are the views of the author alone and not the official views of his employer, CDC Group plc.

Introduction

In this article, I summarize how CDC Group plc, (CDC), the UK's development finance institution (DFI), is responding to the impact of COVID-19 on its private funds investment program (Portfolio) given the commercial and strategic challenges faced by the managers (GPs) of many of its investee private credit and equity funds (Funds).

I focus on our engagement with GPs and suggest ways private fund investors (LPs) might help GPs to safeguard portfolio companies (Portfolio Companies), which are likely to experience severe liquidity issues in the coming months. But some context first…

Background

CDC has been committing capital to funds for the past twenty-five years. We are currently invested in 225 funds managed by 129 GPs and indirectly invested in 1,228 portfolio companies. We provide equity and debt to companies and projects directly too. Our portfolio companies operate businesses across Africa; from Egypt, Morocco and Tunisia in the north to Mozambique and South Africa in the south; and Asia; from Pakistan in the west to Bangladesh, Myanmar and Vietnam in the east.

We are beginning to understand the impact of the pandemic in our priority countries through our GPs and African and Asian offices, which is increasingly significant in some countries; limited or, yet unseen in others.

Priorities

As a long-term investor, our primary priorities are preserving the value of our portfolio and helping our GPs, borrowers, and direct portfolio companies to weather the pandemic.

When we are considering how best to preserve the value and long-term impact of our portfolio, we think defensively. However, we do want to respond actively to the economic and health challenges of the pandemic. Thus, we are reviewing potential investments in and loans to companies, projects, and partnerships that can directly mitigate the consequences of the pandemic.

Finally, we shall want to re-enter countries quickly once the worst effects of the pandemic have passed to help rebuild businesses and economies and mobilize capital from others.

I now turn to a key priority; supporting partners through the crisis.

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Initiatives

We have produced various guidance notes to help GPs support their portfolio companies. These notes cover, amongst other things, business integrity, customer protection, employer responsibilities, gender considerations, job protection, and the management of risks in the construction sector risks. All are accessible here and more are on the way: www.cdcgroup.com/en.

We have also launched two technical assistance facilities. The first, the COVID-19 Business Response Facility, will provide grants (of up to GBP165,000) to help portfolio companies adapt/scale up as part of their response to the pandemic. The second, the COVID-19 Emergency Technical Assistance Facility, will provide expertise, advisory, and capital building (up to GBP25,000) to support our GPs' portfolio companies as they navigate the pandemic (e.g. crisis planning, HR and financial planning support, ESG support, etc.).

Other DFIs and multilateral finance institutions (MFIs) have launched facilities of their own. All are accessible via their websites. The DFIs of 16 OECD countries, grouped under the DFI Alliance, have issued a joint statement to announce they will work together to respond to the pandemic. These DFIs are working to bring liquidity to the market, support companies impacted by the pandemic, and promote new investment in global health, safety, and economic sustainability. Announcements to follow.

Liquidity

We have also been considering how to address liquidity issues at funds and portfolio companies. When, for example, might it be appropriate to "vary" or "flex" the terms of a fund to increase a GP's liquidity options, paying close attention to portfolio companies facing specific COVID-19 related issues, particularly tight liquidity and/or significant revenue reductions?

CDC and like-minded LPs are reviewing the financial and legal tools at their disposal, which include varying the terms of funds to permit greater flexibility in the use of uncalled capital commitments and fund-level leverage, providing new capital to funds via equity "top ups" or direct lending to portfolio companies.

Any variation or flex of an existing contractual arrangement will, of course, require an amended limited partnership, shareholder and/or side letter agreement (collectively, Agreements), which typically require supermajority LP approval. Liquidity solutions require persuasion and are unlikely to be achieved overnight.

Deeper Dive

I now look more closely at the legal tools mentioned above, noting that it can take a long time for GPs and LPs to negotiate the terms of emerging/frontier market private funds. Given their ubiquity in the market and custodianship responsibilities, DFI and MFI LPs tend to look longer and harder at terms than many LPs. Historically, they have generally been unwilling to revisit terms after close. However, due to the pandemic, we foresee a greater willingness to do this, selectively, than in the past.

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If a fund has uncalled capital commitments, then LPs might consider loosening restrictions on how those commitments are used to provide greater liquidity. If, by way of contrast, a fund is fully drawn and thus "dry", it might be appropriate for the fund to obtain debt capital from its LPs or third-party lenders or, alternatively, for LPs (or a sub-set of LPs) to provide new equity capital. Another alternative might be LPs providing a direct loan to a portfolio company.

LPs could consider varying other terms. Examples might include less stringent reinvestment restrictions, which would allow a GP to recycle a greater percentage of capital otherwise available for distribution to LPs; enhanced follow-on investment rights; less stringent diversification restrictions; the use of capital for broader purposes, especially in the case of follow-on investments (e.g. the provision of short term liquidity facilities to Investees); an enhanced ability to borrow at fund level or below, etc.

LPs might also be open to permitting a GP to use (more) leverage if the fund has no uncalled capital commitments depending on their assessment of the GP's credit skills, ability to manage leverage, and proposed use of leverage. The agreements for many funds, particularly those managed by first time GPs, limit/prohibit the use of leverage, so they would need to be amended.

A further option might be the provision of a debt facility to the fund on terms to be agreed in relation to tenor, pricing, ranking (senior or pari passu with the equity LPs and any other leverage providers?), collateral, and waterfall impact.

Equity "top ups" might be feasible if a fund has no uncalled capital commitments. LPs will consider the choice of investment structure (existing fund, annex fund, or co-invest fund), whether the "top up" is temporary or permanent, whether the fund is still operating in its commitment period (and if not, the implications of that), likely LP participation (and the treatment of non- participating LPs), the proposed use of the new capital (for some or all portfolio companies?), the terms on which the new capital is provided, and how conflicts are managed.

Finally, LPs might consider lending directly to portfolio companies in exceptional circumstances. A practical issue, however, is the inability of LPs to undertake full due diligence on a prospective borrower, with whom they have an indirect relationship, due to COVID-19-related travel restrictions.

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There is, however, a willingness in the DFI/MFI LP community to support GPs, who evidence genuine business needs.

LP Expectations

LPs will consider GP requests on a case-by-case basis. Liquidity issues differ from fund to fund so GPs should engage with their LPs early, communicating their (and their portfolio companies’) concerns and needs clearly, fully, and honestly. They (and their lawyers) should review the relevant agreements prior to a discussion on how a proposed course of action might address a liquidity issue.

Business Integrity

I now move to another topic: the importance of good governance during times of crisis. We firmly believe that pandemics increase business integrity risks, which, if not managed carefully, can significantly impact a GP’s reputation as well as portfolio value. A crisis mentality might lead GPs and the management of portfolio companies to take greater risks, shortcutting procedural safeguards, and circumventing controls.

We strongly recommend that GPs continue to: (a) allocate appropriate resources to business risk assessment and management; (b) monitor changing regulatory requirements; (c) comply with existing policies; (d) develop new policies and procedures for expedited decision-making if urgent decisions are required on short notice; (e) keep reporting to LPs; and (f) continue messaging expectations of high integrity standards to the management of portfolio companies.

Conclusion

LPs recognize that this is a difficult time for many GPs. DFI LPs are open to discussions that will support their GPs and preserve the value of their portfolios. Honest communication and openness are essential during times like these. We are in this together; we shall get out of this together.

About the Author

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