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Six Considerations for LPs Navigating Private Market Uncertainty

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When it comes to finding clarity in an environment mired in uncertainty, an open dialogue between LPs and GPs is as critical as ever.

The effects of COVID-19 are being felt across nearly every sector and industry. While some companies are certainly feeling the effects more acutely than others, shelter-in-place orders across the globe have weighed heavily on businesses, causing revenues in many industries to slow significantly—and in some cases, all but come to a halt. These are unprecedented and extremely difficult conditions and they must be navigated carefully. For limited partners (LPs) trying to understand the potential impact of the pandemic on their respective private market portfolios, an open dialogue with their general partners (GPs) is key. Below, we outline six topics in particular that we think are worth addressing.

One

PRIORITIZATION OF MULTIPLE COMPETING INTERESTS

GPs are facing a number of critical decisions in today's challenging environment, and it is important for LPs to understand how those decisions are being made—or more specifically, how managers are allocating resources to support their portfolio companies. Time, attention and capital are in high demand, but a manager has to prioritize, as a capital injection for one company may mean a shortage for another. When considering how to allocate capital, there are numerous questions to consider. At the same time, capital decisions are being made when the depth and duration of the current economic disruption is difficult to predict. The same is true for GP deal partners' time and energy. There simply are not enough hours in a day to appropriately triage each and every company to react to real-time, evolving situations. An hour spent with one portfolio company CEO or board is an hour not spent with another portfolio company that is experiencing the same unprecedented level of business disruption. Deciding what, ultimately, will have the highest economic value is far from cut-and-dry. But for LPs, it's a worthwhile process to try and understand.

Two

BALANCING PORTFOLIO MANAGEMENT WITH NEW OPPORTUNITIES

Another consideration in this environment is how GPs are striking the balance between supporting their existing portfolio versus committing time and capital to new investments. Even with the challenges introduced by coronavirus that many businesses are facing today, there will be opportunities emerging to put new capital to work, often at very attractive prices. However, it can be challenging for GPs to allocate the time and resources to new investments, especially if they are working through issues in their established portfolios. In this respect, emerging managers may have somewhat of an advantage—without large legacy portfolios, they tend to have a greater ability to shift focus readily, and look for new opportunities to deploy capital at lower valuations. Understanding how GPs are striking this balance—and ensuring that there is a reasonable amount of time and attention being dedicated to making new commitments—may provide LPs with valuable insight into what to expect going forward.

Three

HOW & WHEN VALUATIONS WILL REFLECT DISRUPTION

Private equity valuations lag, typically by one to two quarters. While year-end valuations should start to trickle in over the coming weeks, they will not reflect the current declining market environment. Certainly, some managers will offer additional guidance to their year-end data in order to give LPs a better perspective on the true value of the portfolio. But the full economic impact of the pandemic thus far is unlikely to show up in portfolio valuations for several months—possibly until September or October. With smoothed valuations, private portfolios will seem much larger on a relative basis than if the companies in them were truly marked to market. This may seem obvious, but it's worth pointing out as it creates a unique problem for investors, in that they knowingly hold onto illiquid positions where public market comparables have experienced material deterioration in value, and therefore will very likely be marked down at a later date. It is also worth noting that FASB guidelines for fair market value may be interpreted by some GPs and auditors to treat COVID-19 impacts on revenue and earnings as one-time events, which may lead to net asset value (NAV) add-backs. And this again speaks to the importance of a continued dialogue between GPs and LPs, as any additional information or guidance that GPs can offer in the interim—until valuations catch up with the current environment—can provide a better view of how companies are truly performing.

Four

UNDERSTANDING LP CREDIT QUALITY

The importance of credit quality can't be understated, particularly in challenging times like these. With that in mind, we think it is worthwhile for LPs to question GPs about the credit quality of their broader LP base, and to try to understand the remediation steps within the limited partnership agreement. There may very well be LPs facing liquidity challenges, and it's critical to understand the risk this imposes. As an example, if 10% of a manager's investor base has liquidity issues, and the manager makes a capital call, the manager may not be able to transact on the deal as a result. While getting full insight into the credit quality of a fellow LP may be slightly unrealistic, it does make sense, in our view, to ask a GP if they've done a credit analysis to ensure that all participating LPs in the vehicle are liquid and have the means to fulfill any capital calls. Additionally, to the extent that the LP is able to provide liquidity, having that conversation could create an opportunity to purchase a defaulting LP's existing interest in the event that an investment opportunity arises.

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Five

MONITORING PROCESS—& WHAT NEEDS TO BE ADJUSTED

Many LPs spend a significant amount of time with their GPs during the diligence phase—but over time, ongoing monitoring may become less of a focus outside of annual meetings and a cursory review of annual reports. The COVID-19 fallout has underscored the importance of a real-time understanding of portfolio holdings. It's critical, for instance, to be able to quantify and assess risk exposures to industries, sectors or even commodity price changes. Certainly, some LPs are better positioned going into this environment than others, with monitoring processes across the space varying in robustness. But one of the lasting lessons of this crisis for LPs may be a recognition of the importance of being able to constantly track and monitor companies—as opposed to relying fully on managers for information.

Six

ADDITIONAL SCRUTINY REQUIRED WITH CO-INVESTMENTS

The approach to co-investments is fundamentally different from primary fund investments in that co-investors have direct exposure to portfolio companies. For this reason, operating-level scrutiny is paramount, though that can often be hampered by limited access to these companies' management teams as minority investors. To that end, LPs can benefit from asking their GPs to shed light on the nuanced conversations they're having with portfolio companies as they're underwriting investments. Specifically, we see value in understanding the following characteristics of each portfolio company:

- **Leverage:** It is important to understand total leverage levels, with a focus on key terms, covenants and amortization schedules—or more specifically, when debt is due.
- **Cash and Working Capital:** LPs can gauge whether cash is accessible by understanding cash and working capital requirements. One way to do this is by looking at weekly cash forecasts three months out—which most managers should be able to provide.
- **Sensitivity Analysis:** It's worthwhile to ask GPs for scenario and contingency plans for varying levels of crisis severity and length. For instance, if a manager is taking into account 20% unemployment, what does that mean for the economy, and by extension, for portfolio companies? Or, what would happen if we see a second COVID-19 spike later this year? The question, ultimately, is whether these GPs have enough capital to support their businesses and manage default risk.
- **Prioritization of Interests:** Ask questions to gain a better understanding of how GPs and management teams are prioritizing competing interests across stakeholders given the unique circumstances surrounding COVID-19. How does this translate across dealings with suppliers, lenders, customers, shareholders and employees, for instance, particularly within the context of evolving government and regulatory frameworks?
- **Identification of a "Critical Team":** Another important question to ask is whether portfolio companies have a "critical team" in place to help make pressing decisions on a daily basis—particularly given today's rapidly evolving and extremely uncertain environment. When managing through crises, companies often pull together an agile group of leaders who understand key aspects of the business including operations, customers and personnel. The "critical team" typically includes members of the organization who can process information quickly, react to unfolding events and make informed decisions. This team may differ from the normal leadership team and can greatly benefit, in our view, from diversity of both background and thought.

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As is often the case in a downturn, the COVID-19 pandemic may very well be an opportune time to invest—based on both lower valuations overall, and liquidity-related rescue opportunities. GPs who smartly navigate the crisis and its related fallout will distinguish themselves as potential long-term partners. But the choices GPs are faced with—including where to invest their own time and resources—are not always straightforward. As such, we believe now is the time for LPs to be particularly proactive and push for greater communication and transparency with their GPs in an effort to ensure mutual long-term success.

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