AXON Partners Market Assessment

The Covid-19 Crisis – What are The Implications for LPs?

AXON PARTNERS IN A NUTSHELL

Focus: limited number of mandates to assure quality service

Primary Placements: exclusive mandates, top-up mandates, co-investment placement

Secondary Transactions: broad auctions, complex restructurings

Experience: capital raised for > 35 funds and > €4bn secondary transactions executed

Relationship: Longstanding and comprehensive investor coverage

Understanding: investor-driven approach

Independence: partner-owned, no conflicting mandates

Success: Each mandate is a key reference

INTRODUCTION

AXON's partners have been active in European private equity for three decades. In our time we have been direct investors and fund investors. Having lived through previous crises we thought it appropriate to share some thoughts on the implications of Covid-19 for LPs.

VALUATION UNCERTAINTY FOR NEXT 3-6 MONTHS

31 March 2020 valuations will start to arrive mid-May. Estimates of declines from various sources are currently in the range 10-25%. March valuations are expected to reflect sharply lower market multiples in the main. When June valuations are received in late summer the impact of reduced EBITDA on an LTM basis will be more apparent. One valuation aspect that has not received much attention is the impact of higher debt. Many businesses have required emergency loans which when deducted from the enterprise value will further reduce equity value.

REPORTING LAG IN VALUATIONS

Private equity valuations typically lag the reporting date by up to two months whereas public market valuations adjust in real time. Where private equity allocations are set as a percentage of an overall portfolio e.g. insurance companies and pension funds the so-called denominator effect highlights an overweighting of private equity exposure when there is a sharp correction in the stock market. In some cases this triggers remedial action such as secondary sales. Elsewhere a freeze on commitments or a limitation to selected re-ups only may be the outcome.

DECREASING CAPITAL CALLS

On the one hand a dearth of new deals will lead to a reduction in capital calls. However, those deals that do proceed are likely to require a higher equity contribution (a) due to a lack of debt capacity and (b) the need for a substantial safety buffer. Elsewhere capital calls can be anticipated to repay subscription lines and for equity cures. Subscription lines which are now omni-present in the market have created much comment.

THREAT OF LP DEFAULTS

There is a school of thought that GPs will look to repay subscription lines early to counteract the threat of LP defaults whereas cash-strapped LPs will favour these being outstanding for as long as possible. A further factor is that GPs will not wish to delay repayment in situations where the underlying asset has to be written down. LPs with long memories will remember Candover's investment in Technogym during the GFC: by the time Candover called capital Technogym had been written down to 0.5x thus a Euro contributed was immediately worth only 50 cents. Recently raised funds and tail end funds are likely to be at greatest risk of LP defaults.

DISTRIBUTIONS ON HOLD

If the GFC is any guide outright exits are likely to be off the agenda for some time as buyers and sellers come to terms with the new reality. Cynically one might say that GPs whose next fundraising is likely to be delayed will be inclined to hold on to assets in order to preserve fee income. Dividend recaps are likely to be non-existent as debt providers prioritise rescue situations. Those LPs with a leveraged over-commitment strategy are particularly exposed to a distribution freeze as they may be unable to satisfy loan to value covenants. This in turn could lead to distressed secondary sales.

INVESTMENT PERIOD EXTENSIONS

With new deal activity grinding to a halt it is inevitable that LPs will be faced with numerous requests for investment period extensions. As LPAs rarely deal with such eventualities it is to be hoped that GPs act reasonably and offer to step down management fees on the expiry of the original investment period. Funds of funds may also require investment period extensions.

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FUND LIFE EXTENSIONS

It is a racing certainty that investment period extensions result in fund life extensions! Lengthy holding periods are also a factor here. Again it is the case that LPAs often do not cater for such eventualities. LPACs have an important role to play in determining fund economics in an extension scenario. Fund life extensions are also a consideration for funds of funds.

RECENTLY RAISED FUNDS

While it is true that new funds have a better buying opportunity ahead of them, they are potentially susceptible to defaults. In addition, drawing fees during a prolonged period of inactivity will not win any friends. The longer this situation persists, the greater the likelihood of LP demands for fee rebates and fund size reductions.

FUNDS FULLY INVESTED PRE-CRISIS

Longer holding periods and fund life extensions are highly likely outcomes. GPs will require to investigate different transaction structures in order to provide support to portfolio companies. These are likely to include fund re-openings, annex funds, cross fund investments, portfolio strip sales and NAV facilities with preferred returns. Needless to say, each of these solutions has the potential for conflicts to arise but for discerning LPs interesting investment opportunities should not be overlooked.

FUNDS PARTIALLY INVESTED PRE-CRISIS

Investment period extensions can be anticipated. GPs will need to weigh up the merits of using undrawn capital for new deals versus equity cures. Debt availability is likely to be a consideration.

HUNG SYNDICATIONS

GPs who underwrote deals pre crisis with a view to syndicating these to their LPs may now be unable to do so. This has several ramifications: disproportionate exposure to certain companies thus limiting the ability to support them further without breaching diversification thresholds as well as limiting capital to be deployed elsewhere either in equity cures or new deals.

Equally, banks which underwrote LBO debt in the expectation of selling it down to other banks and debt funds may be stuck with such exposure which in turn will limit capacity for new lending.

SEASONED PRIMARIES LESS ATTRACTIVE

Until recently having initial investments in a fund was seen to be advantageous versus persuading LPs to commit to a blind pool. This is no longer the case. Indeed the more exposure that a fund in the market has to pre-crisis deals, the greater the likelihood of failing to raise further capital.

WHERE TO INVEST?

In the first instance LPs may look to the secondaries market and distressed debt/special situations/turnaround funds.

In recent years LPs have increasingly bypassed secondaries funds and ‘done their own thing’ in acquiring LP stakes in the secondary market. It will be interesting to observe if this behaviour continues or if outsourcing to genuine secondary specialists and securing co-investment rights increases in popularity.

In theory the distressed space is attractive but in Europe at least the opportunity set may be rather limited as many turnaround funds are small and country specific in nature.

GET IN TOUCH!

AXON Partners would welcome the opportunity of having a conversation with you on these topics. Please do not hesitate to contact us with any feedback and questions that you may have.

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