Weathering the Storm: What Indian PE Fund Managers Should Consider

By Pallabi Ghosal and Kashish Bhatia, Partners at AZB & Partners

Introduction

The Sanskrit phrase *"Vasudhaiva Kutumbakam"* (the world is one family) has never been as relevant as it is today and the Indian economy with its close linkages to the global economy is already staring at a big challenge ahead of itself.

Fund managers on their part are readying themselves to take harsh steps and face harsher consequences. Irrespective of the stage of a fund cycle that a fund manager finds itself in, it is time to chalk out a "COVID-19 roadmap," both at the fund and the portfolio company level, that will help fund managers and their investors navigate the path ahead.

Fund Level Steps

1. **Fund Raise or Offering Period:** Given the delays in the offering process and with many investors potentially reconsidering their commitment/ commitment amounts, fund managers may want to consider extending the offering periods for their fund. It can be at the fund managers' discretion or coupled with investor advisory committee approval.
2. **Investment or Commitment Period:** Fund managers nearing the end of their investment period need to reconsider the time they will need to deploy capital given the lockdown in India. Active steps in engaging with investors and seeking extensions in a judicious manner would be key. Further, fund managers may need to consider the valuation and terms of investments that are in process and work with portfolio companies to preserve the value of potential investments of the fund.
3. **Term:** As per the regulations regulating alternative investment funds in India (AIF Regulations), a fund is permitted only two extensions of one year each with the consent of 66.67 percent of investors by value of their investment, once the fund term as stated in the placement document (Fund Term) comes to an end. Thereafter, the AIF Regulations require the fund to wind down its operations within 12 months. While there is sufficient latitude given under the AIF Regulations for funds to extend their Fund Term on account of this pandemic, this still might not be enough. If a fund is in the sunset phase, fund managers will need to assess the impact of the lockdown on the exit horizon of portfolio companies. Given the Indian securities market regulators' (SEBI) general reluctance to allow fund managers to amend their Fund Term, it is critical that fund managers of funds in the sunset phase engage with investors and SEBI over extending the fund term. Other options such as undertaking a secondary transaction may also be considered.

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4. **Investment Objective and Strategy:** For fund managers who have a narrow investment objective and strategy (such as specific sectors and/or instruments), it is critical to revisit this and expand the scope if required. The AIF Regulations require consent of 66.67 percent of investors by value of their investment to alter the investment objective and strategy. For fund managers considering this option, it is important to consider ancillary sectors along with the primary focus sectors and take a well-thought-through and implementable plan to investors.

5. **Re-investment and Follow-on Investment:** Ailing portfolio companies may need more infusion of capital or debt. Fund managers may be required to bridge the funding gap by providing interim financing or making follow-on investments and re-investments. Given that, typically, there are limits (both time and quantum) on the capital that can be deployed for re-investments and follow-on investments; this is the time when those limits need to be revisited. In doing so, fund managers will need to keep in mind the concentration norm prescribed by SEBI, which is that no more than 25 percent of the investible funds (defined to mean the total binding commitment received from investors net of estimated expenses) can be invested in a single portfolio company.

6. **Leverage at the Fund Level:** Alternative investment funds in India are severely challenged with regards to their ability to seek leverage. AIF Regulations do not permit funds to borrow directly or indirectly or engage in any leverage except for meeting temporary funding requirements for not more than 30 days, on not more than 4 occasions in a year and not more than 10 percent of the investible funds. In light of this limitation, the option of seeking loans from investors directly at the portfolio level will need to be explored.

7. **Reporting to SEBI and Investors:** Per the AIF Regulations, funds are inter alia required to provide quarterly reports to SEBI and annual report to investors within 180 days from the financial year end in relation to the fund, including financial information of portfolio companies. In light of the COVID-19 pandemic, SEBI has extended the reporting timelines for regulatory filings for the periods ending March 31, 2020 and April 30, 2020 by two months. In addition, should fund managers be unable to provide reports/information that is typical for investors to seek under the fund documents, fund managers should nonetheless make reasonable efforts to provide those and keep investors informed of situations where they are unable to do so and the reasons for the same. Fund managers should be seen as being proactive and communicative during these times.

Portfolio-Level Considerations:

1. **Lockdown Compliances:** Given the national lockdown and various state-level-lockdowns, care must be taken that the portfolio-level entities are properly advised and aware of their obligations under various central- and state-level directives and advisories. The violation of such directives and advisories could expose the company (as well as their directors) to legal consequences.

2. **Labor and Employment Law Compliances:** Most businesses are facing cash flow concerns with the extended lockdown and seeking ways to reduce their outflow. Employee and labor costs are a substantial expense. It must be borne in mind that there are national- and state-level directives as well as advisories in place on employee/labor related issues. Further, any steps in relation to lay-offs, unpaid leave, and wage deferment could in the current atmosphere create a negative reputational risk. It is important that portfolio companies are guided to ensure that their approach is not only humane and tempered, but also in accordance with applicable laws (as any breaches could entail liabilities for the company and/or its directors).

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3. **Contractual Obligations:** Businesses have a plethora of payment and other obligations under lease agreements, customer agreements, supply agreements, and distribution agreements. In the current atmosphere of lockdowns and business uncertainty, it is important for businesses to review all such obligations and, where required, take steps to follow any force majeure procedures, if applicable, and where no such exemptions exist or apply, consider options for ensuring that they are not staring at a liability for breach of contract.

4. **Regulatory and Statutory Compliances:** Various ministries and regulators are providing exemptions and extensions in relation to compliance requirements. It is important that the portfolio companies be nudged to keep track of the compliance calendar and, where necessary, take active steps to take advantage of any such exemptions. Where no exemptions/extensions are available, portfolio companies should actively reach out to the concerned

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authorities and regulators and highlight the challenges faced and seek leeways.

5. **Work from Home Models:** With there being very few exceptions to the lockdown, most businesses have either suspended operations or are continuing to operate under the work from home model, where possible. These changes impact various contractual as well regulatory obligations of the company. For instance, specific compliance requirements apply to companies with an OSP license if they are implementing a work from home model, and such models also raise concerns on confidentiality and delivery constraints under contractual obligations. Therefore, any work from home models must be carefully designed to address any such concerns.
6. **Business Continuity Plans:** It is important for investors to have portfolio companies consider all of the above issues and any other sector/ geographically specific concerns and put in place appropriate business continuity plans, to ride through the crisis and evaluate how value may be preserved through this period and beyond.

Fund managers and investors, with the benefit of specialized advice and experience across various businesses, sectors, and geographies, can play an important role in guiding portfolio companies on the appropriate approach for each of the above issues. That will allow such companies to focus on immediate day-to-day ground-level concerns.

Conclusion

The aspects highlighted above are by no stretch exhaustive and more often than not, difficult to implement. With fund managers facing a host of challenges, including dealing with a team that is facing both professional and personal challenges of a lockdown in India, it is imperative that, at the fund level, the investors work together with fund managers and, at the portfolio level, the fund managers work with their portfolio companies in navigating through these challenging times. It is time for fund managers to be steadfast, tenacious, and innovative.

No one could have foreseen the scale of this crisis and therefore, we cannot go back and make a new beginning. However, one can start today and make a new ending. As investors keep close watch, fund managers who are able to calmly tackle the current challenges and not seek opportunistic leeway, will be poised to benefit in the long run.

About the Authors

Pallabi Ghosal is Partner at AZB & Partners.

Kashish Bhatia is Partner at AZB & Partners.