Industry Insider

An interview with Dr. Christian Diller, Montana Capital Partners

Welcome to the first of our Industry Insider series, during which we will be speaking to a number of key private capital industry participants from across the globe and across asset classes, including fund sponsors and investors, investment professionals and operational experts, established managers and first-timers; each providing an unrivalled insight into the industry.

In this edition **Ted Craig**, Head of Private Funds UK at Dentons, and **Dr. Christian Diller**, Co-Founder and Managing Partner at Montana Capital Partners, explore the current pressures and challenges facing general partners (GPs) and limited partners (LPs), and some practical solutions. Looking ahead, they consider post COVID-19 opportunities as well as their ESG predictions for the industry.

Ted Craig
Head of Private Funds UK
Dentons

Dr. Christian Diller
Managing Partner and Co-founder
Montana Capital Partners

Introduction to Montana Capital Partners

Ted: Montana Capital Partners (MCP) is an established secondaries fund manager and therefore has an excellent market overview as, on the one hand, it is a GP, investing on behalf of your LPs and, on the other, a LP invested in private capital funds. You are therefore well placed to comment on the current pressures and challenges faced at all levels of private equity investing, as well as the approaches taken to address them.

Christian: We are a secondaries fund manager with a focus on the smaller and more complex end of the market. We source most of our deals directly from LPs and GPs and, therefore, have an extensive and global network in the private equity industry. Our investors range from sovereign wealth funds to insurance companies, pension funds, foundations and family offices globally, and we invest with more than 150 GPs. Over the past weeks, we have been in contact with more than 75% (in terms of value) of our GPs to better understand the impact of COVID-19.

1. Challenges

Ted: What are your thoughts on the key challenges facing the portfolio companies, GPs and LPs that you currently observe in the market?

Christian: First, let's start with the key challenges for portfolio companies which are affected, both operationally and financially. Due to the lockdown in almost all countries, revenues decreased significantly from one day to the next, resulting in lower EBITDA numbers as their cost has not been easy to adjust. In particular, companies in the consumer, travel, restaurant and entertainment sectors have been hit hard, while healthcare and online businesses, and software and technology companies have been less affected or, in some cases, have even benefited from the crisis. Furthermore, the interruption and delay in supply chains of manufacturing and industry companies caused additional issues. All of these challenges potentially resulted in liquidity shortages or even covenant breaches of loans.

Ted: When turning the focus one level up, what do you see as the key challenge which GPs face during the COVID-19 crisis?

Christian: As a priority, GPs have had to handle the operational and financial issues of the underlying portfolio companies. In cases of capital requirement and supply chain issues, GPs have been able to support the management teams, synchronise their help over many portfolio companies as well as organise financial support through their in-house capital market teams. GPs also made sure that companies used every available source of finance e.g. that they used the revolving loans which had already been in place from banks or applied for government programmes. In addition, potential exits of companies might be delayed in the short term due to lower M&A activity, which is expected to pick up again after the summer. On the other hand, they also had to monitor a potential default on a capital call from their LP base or face the challenge of a slowdown in fundraising activity for new funds. However, some investors see the current COVID-19 crisis as an attractive investment opportunity.

Ted: You just talked about LPs. How do they generally cope with the current situation and what are their challenges?

Christian: Generally, LPs face the challenge of a mismatch between upcoming distributions and future capital calls. While distributions start to be delayed due to lower exit activity, capital calls have increased due to liquidity needs and financial issues in underlying portfolio companies, new investment opportunities that have been closed recently or which have already been financed through the funds' capital call lines. Some banks asked funds with larger outstanding balances on their capital call facilities to draw capital from LPs. In addition to the cash flow environment, the key challenge for LPs was to assess the impact of the COVID-19 situation on their overall portfolio and its valuations. It is currently more difficult to value the underlying private equity fund investments and the lack of reporting might create a denominator effect and increase the private equity allocation in relation to public markets.

2. Solutions

Ted: In the context of the challenges we have discussed above, can you provide some insight on some of the solutions that have been developed and put into practice – are these different to those utilised post-global financial crisis (GFC)?

Christian: The current crisis is different to the GFC with a much larger impact on the operational functionality of businesses in a much shorter time frame. In cases where companies have needed liquidity for covering their costs or for acquiring add-ons to their businesses at attractive prices, GPs have had various options: (a) to draw capital from their investors, (b) to provide co-investment possibilities to their LPs who acquired a portion of the portfolio company directly, and (c) to seek a preferred equity solution provided by secondary funds. Preferred equity solutions will be added on top of the fund structure and will provide capital for the GP who can use it to support the underlying companies or to benefit from the current attractive markets. It is an advantage for GPs to have capital readily available with an easy and transparent structure. MCP is currently active and offers co-investment capital and preferred equity solutions for GPs.

Ted: You just mentioned transactions with GPs. In the past year, before COVID-19, the market was driven by many GP-led deals which covered around 1/3 of the entire secondary volume. What is your expectation for them in the short, mid and long term?

Christian: This is a very good question. Currently, many of these deals are not actively promoted in the market as investors would first like to get more clarity on the status of the underlying portfolio companies. However, preferred equity solutions are currently put in place, while other deals are being prepared for the second half of this year and for 2021. As we expect a short-term delay in exits and companies needing more time to recover from the COVID-19 situation, we anticipate a wave of GP-led transactions in 2021 which will be very attractive opportunities for many LPs and secondary buyers in the mid and long term.

Ted: What are the solutions for LPs and how can they handle the mismatch in distributions and capital calls?

Christian: Depending on their financial and liquidity situation, LPs can liquidate some of their more liquid assets in the portfolio, try to get a financing solution on the private equity portfolio from a bank, or sell stakes on the secondary market. Here, we have already performed some transactions with LPs which urgently needed liquidity and acquired their funds in a straight sale. However, we also offer more complex solutions, such as deferred payments, earn-out structures or strip sales of their fund portfolio in which only a portion of each fund is bought. In such a solution, the seller still keeps the relationship with the GP and benefits from the further development, while receiving liquidity from the partial sale. Each situation is different and we at MCP are happy to customise the solution to the needs of the sellers.

3. Opportunities

Ted: Where do you see the opportunities for private equity/private capital post COVID-19?

Christian: Due to its flexibility, governance structure and the possibility to react quickly to the current situation, private equity will benefit from the current crisis. There are many opportunities on the investment side for attractive prices, with companies needing support. Private capital can provide solutions for them.

Ted: And what about MCP specifically? Where do you see the opportunities for your business?

Christian: We are currently seeing very attractive market opportunities for secondaries. With our focus on the smaller and more complex end of the market, we are well positioned to offer innovative solutions to GPs, supporting their further growth strategies through add-ons, or for companies and to LPs with liquidity or strategic restructuring needs. We provide various transaction structures as a one-stop solution to the market participants and create win-win situations. We expect to see many opportunities over the coming years and are actively investing right now.

4. ESG predictions

Ted: One of the key trends prior to COVID-19 has seen ESG moving up the agenda for everyone in the PE industry, with an increase in pace over the past 12 to 24 months. Will this continue post crisis, or will this momentum stall as attention moves elsewhere?

Christian: As you say, ESG has already been a very important topic in private equity over the past few years and will also remain so for the future. Investors are putting greater emphasis on environmental, social and corporate governance topics during their due diligence when investing in funds. Many buy-out fund managers have implemented dedicated ESG policies and have kept a close eye on the ESG performance of their underlying companies. This is a very good development – I believe it will stay and might even increase in importance. We at MCP have implemented these measures as a standard in our investment process and also at management company level, and received the highest rating in UN Principles for Responsible Investment (UNPRI).

5. The reality of working from home

Ted: Finally, COVID-19 changed the way in which we work together in the financial industry as it keeps us at home. What is the best thing about working from home? And the worst?

Christian: COVID-19 has forced us all to adapt very quickly to a new reality. This new reality shortened our long-distance air travel to a short walk into our home office and moved our physical meeting into the virtual video conference room. The positive element is that many people adopted the new technologies very quickly, so that meetings with business partners on the other side of the globe have become much more efficient, and travel time and pollution have, and will continue to be, reduced as many people alter their mindsets. At the same time, one drawback to video conferences is that there is less of the personal touch and social interaction, making it harder for people to laugh at your jokes.

Ted Craig
Head of Private Funds UK
Dentons
D +44 20 7246 7144
ted.craig@dentons.com

Dr. Christian Diller
Managing Partner and Co-founder
Montana Capital Partners
D +41 41 511 79 50
Christian.Diller@mcp.eu