Corpsec Hotline

April 19, 2020

ENVISIONING DEAL ENVIRONMENT POST COVID19 – DEALMAKING FOR INDIA FOCUSED FUND MANAGERS

There is time during the Corona crisis and there will be a time after the Corona crisis. As a firm focused on private equity and predictive legal study thereof, we analyse a few themes from a deal making perspective that may evolve and emerge in the next few months as economies gear up to gradually relaxing the lock down.

Over the course of next few weeks, we will try to discuss themes set out below with a series of articles, research papers and webinars sharing our insights from a commercial, legal and tax perspective. Please click **here** to register to receive all such videos, podcasts and written materials.

As part of our client continuing education program (cCep), we will discuss the following in the course of next week

- **April 23rd at 3pm**: Interactive session with *Shishir Kumar of Edelweiss* on challenges for private debt fund managers on invoking pledge during COVID-19 crisis with focus on recent .
- **April 27th at 3pm**: Interactive session with *S. Srinivasan of Kotak and Dev Santani* of Brookfield on Special Situations Opportunities and Fundraising during and post COVID19.
- **April 28th at 12 noon**: Interactive session on Opportunities in LP / GP Secondaries and Portfolio Buyouts.
- **April 29th at 3pm**: Interactive session on InvITs with *Hardik Shah of KKR* in collaboration with PWC and APREA on monetising infra assets through unlisted InvITs.
- **April 30th at 3pm**: Interactive session with *Arpan Sheth of Bain and Company* on Fundraising and Investments: Bain Research Analysis analysing each of the themes below.

1. **Lockdown Relaxation.** Whilst enough antivirals, antibodies, cell / RNA based therapies and vaccines are concluding human clinical trials, consensus seems to be that a vaccine is at least a while away. As businesses move to the brink of financial collapse, millions lose jobs, resources tend to be wiped out, political leaders globally are gearing up to relax the lockdown gradually. Trump's tweet 'we cannot let the cure be worse than the disease' has clearly suggested that the damage to the economy might outstrip the damage to public health. Hence, cure or no cure, flattening of the curve or not, lockdown may reluctantly need to be relaxed sooner than later. Denmark has already announced opening up of schools and countries like Austria and Norway are likely to open up soon.
2. **Recession v Depression; Structural Changes.** While recessions may seem to be cyclical (usually resulting in contracting of GDP for two quarters), Covid19 implications will be much deeper. There are likely to be structural changes in the way businesses are run and economies managed. There will be a need to relook at - supply chain management (India may get a big pie as business look to diversify beyond China), stabilising capital markets to mitigate impact from external factors, significant focus on public health, logistics etc. India's informal economy which aided our rescue in 2008 is likely to be the first to collapse in the pandemic as trade overall has come to a grinding halt. India's GDP is expected to severely contract and grow in the region of 2% to an ambitious 4.8% as per D&B against prior estimates of 5% in FY 21.
3. **LP – GP Perspective; 'Denominator Effect'.** LPs often have specified allocations to private credit / equity strategies and public markets to diversify between illiquid and liquid investments. As public markets decline, illiquid investments look larger in the portfolio (referred to as the 'denominator effect'), which galvanises LPs to hold back on illiquid private investments, or sell such LP interests in secondary trades to rebalance allocations between illiquid private investments and liquid public market exposure. Funds may also find it difficult to access offshore leverage for making investments in India. While LPs are not defaulting, they have requested GPs not to make capital calls raising the likelihood of 'pulled deals'. Managed accounts may soon hit deadlocks as LPs become increasingly hesitant in approving projects.
4. **Secondary Funds.** Secondary funds are likely to find great deal of LP interests in well performing GPs at substantially discounted prices. LP interests aside, secondary funds are likely to find a great market in portfolio buy-outs as LPs persuade their GPs to 'strengthen their strengths' and focus on their core strengths and strategies resulting in sale of non-core investment portfolios and strategies. With portfolio values falling, certain GP entities (generally valued at 2 – 5% of portfolio value) may also be available at substantial discounts.
5. **Security Enforcement**. As markets plunge to all-time lows, security cover on pledged shares are being breached causing lenders to make 'margin calls'. Courts seem to be sympathising with the borrowers. In a recent case (*Future Retail case*), Bombay HC temporarily restrained lenders from selling certain pledged shares. Supreme court refused to intervene. This sets a very dangerous trend, deviates from global and prior domestic jurisprudence and defeats the very fundamental premise of '*secured lending*'. LP – GP disputes cannot be ruled

Research Papers

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out as GPs walk the thin rope between managing relationships with the LPs (requiring immediate enforcement of security interests on breach of loan covenants) and relationships with the investee companies (requiring deferral of enforcement until the crisis settles). Credit funds may need to redesign a revised SOP for such eventualities. Credit fund managers may use default triggers to renegotiate credit documentation to give them added protection should insolvency proceedings be initiated against the borrower. For instance, in consideration of not triggering the default, they may require the debt to be moved to be moved to an asset rich SPV where the lender is the only / major lender giving him much better handle on IBC proceedings as and when they happen. Or, require enhanced guarantees / top ups, ring-fence the cash flows using strong escrow mechanisms etc.

6. **Special Situations and Credit Secondaries**. Secondary trade of credit at substantial discount will likely dominate the market. Our offshore fund clients have shown tremendous interest in these opportunities, which seem to have come in vogue after we did one of the largest loan portfolio sale to an offshore fund before they turned NPA. As private and public lenders face defaults, flight of deposits and liquidity crunch, sale of credit portfolios may be on the rise. Offshore funds may look to acquire such loan portfolios through a standard asset securitisation trust, or through an asset reconstruction trust, if the loans have become NPA, or through their NBFC in India by way of ‘direct assignment’. Today the global debt burden is at an all-time high, making businesses more vulnerable than ever. Early victims of the debt burden are likely to be ‘zombie companies’, those that are functioning at unsustainable levels of debt and reliant on refinancing, which may be difficult in current times.
7. **EBITDA adjustments**. Earnouts usually include a component that is to be paid on deferred basis the adjusted valuation over a course of 12 – 24 months, and such adjustments are based on a multiples of the EBITDA. The EBITDA calculations are usually defined to exclude one-time gains (non-recurring in nature) and similarly require losses from one-time events to be written back. Whether Covid19 will be an event that requires losses to be written back will be a matter of litigation in most cases.
8. **Infrastructure Investments**. Infra sector has been most affected as traffic on roads, airports, freight etc. has come to a grinding halt. Lack of clarity on government compensation to such projects and looming interest burden (owing to the high leverage ratios in such projects) is likely to offer such projects at cheap valuations. Complete tax exemptions given to InvITs and sovereign funds are likely to drive infrastructure growth, including sovereign participation in infra credit growth. Liquidity crunch may drive sponsors to monetise their assets (yield generating and under construction) at cheaper valuations. Resistance from domestic lenders may further gravitate infra developers towards a partnership with or sale to, private equity players.
9. **Banks and NBFCs**. Whilst NPA norms are being relaxed and bailout packages announced, banks and NBFCs are indeed looking at enhanced defaults and a much larger NPA book. Post Yes Bank crisis, flight of deposits to large state owned banks may be seen; in fact, state governments are already seen moving their deposits to safer state owned banks. Hence, the crippled operating environment for banks may see further contraction on the back of mounting defaults, falling deposits (CASA and otherwise), debt servicing obligations and weak economic indicators, which has already prompted banks and NBFCs to initiate ‘business continuity plans’. Hope of retail investors for EMI waivers may also cause adverse behavioural changes. Hence, investments in banks will be available at cheaper valuations and since most of the large banks and NBFCs are listed, one may see substantial public market trades.
10. **Real Estate.** Blackstone’s recent example of giving a complete rent holiday for 3 months in the US sets an example for other tenants to make similar demands, though legally tenants may find it difficult to avoid paying rentals claiming force majeure. Ecommerce is likely to prevail over retail traffic further depressing rentals by about 20%. Residential real estate sales will probably be the worst hit amidst approval delays, expensive cost of capital and subdued sales. With close to about 30% urban unemployment rate as of April 11 (based on CMIE data), all asset classes – office, retail, residential, warehouses, hotels may suffer a contraction proportionate to the contraction in the GDP.
11. **ESG**. ESG is likely to be a substantial driver for LPs, seemingly way more than what it was. That humane and sensitive angle is soon assuming primordial importance in LP checklists. Interestingly, GPs are engaging in what is being interestingly referred to ‘greenwashing’, ‘social washing’, ‘rainbow washing’, ‘pink washing’ and so on, essentially misrepresenting their compliance levels with environment best practices, HR best practices, complicity with UNDP sustainability principles and LGBT amenability, respectively. Blackstone, for instance, was recently criticised for being ‘insensitive’ when it refused to cede to tenants’ request to waive rentals in one of their UK assets; it later had to agree to a complete waive for 3 months. On the other end of the spectrum, there are examples like Partners Group whose top executives contributed 6 months of their salary to setup a fund for employees of their portfolio companies affected by Covid19.

– Ruchir Sinha & Nishith M. Desai
You can direct your queries or comments to the authors

April 01, 2025

Vaibhav Parikh, Partner, Nishith Desai Associate on Tech, M&A, and Ease of Doing Business

March 19, 2025

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February 18, 2025