Research survey

The Impact of COVID-19 on Black Private Equity Funds

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27four Investment Managers

Black Business Growth Fund®

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We surveyed a number of black private equity managers whose combined strategies include targeted sectors such as healthcare, education, mid-market infrastructure, financial services, and ICT (amongst others), to understand the impact of COVID-19 on their firms, portfolios and pipelines.

The summarised survey results are presented in this report and have been anonymised.

Contributors

The survey participants are listed in no particular order. We would like to express our gratitude to all the survey participants for their input and valuable insight

ETHOS MID MARKET

INFRA IMPACT INVESTMENT MANAGERS

KHUMOVEST

KLEOSS CAPITAL THE VALUE OF VALOUR

PAPEfunds

RH Managers Investing in Healthcare

SANARI CAPITAL

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1 Outline how your investment thesis has been affected as a result of COVID-19 and changes to strategies to address this to ensure the fund is able to deliver its expected targeted returns and associated impact outcomes?

While the impact of COVID-19 on portfolio companies has been mixed, core investment strategies across the Manager group surveyed are not expected to change. In fact, investment strategies have generally proven to be resilient, broadly owing to the defensive nature of the sectors targeted. Impact on businesses has been markedly different across sectors, for example the healthcare sector has seen some challenges particularly where specific hospitals rely on elective surgeries, which paused during the initial stages of lockdown. Conversely, companies directly and indirectly exposed to telecommunications have seen strong growth due to shifts in working and consumer patterns.

A number of managers recognise the opportunity that has been highlighted by COVID-19 for the private equity sector to contribute to the re-building of the economy, and continue to see investing in sectors such as healthcare, education and infrastructure as both commercially attractive and aligned with the needs of the country.

The incorporation of more risk mitigation strategies appears to have a greater degree of focus in the current environment. Fund managers are looking to put more protection in place by shifting their deal selection towards more cash generative businesses, and where possible looking at more regulated sectors for additional protection. Managers are also looking to structure more downside protection, and are applying greater scrutiny to both maintainable earnings and impact metrics.

2 Have your investment case and growth plans for portfolio companies and pipeline opportunities changed as a result of COVID-19?

The majority of the manager group surveyed anticipate a deferral of the initial investment case by between 1 and 2 years.

While there have been pockets of growth during the year, businesses that have been negatively impacted have been forced to taper down growth expectations and have focussed on operational optimisation and capital restructuring to ensure that a stable base can be re-built from. As a result, higher yielding investments will likely be sought for the final investments in each Fund to ensure that initially anticipated outcomes are achieved.

3 What new strategies have been implemented with respect to the way pipeline opportunities are assessed and executed on, including (but not limited to) origination, due diligence processes, approvals, pricing and contracting?

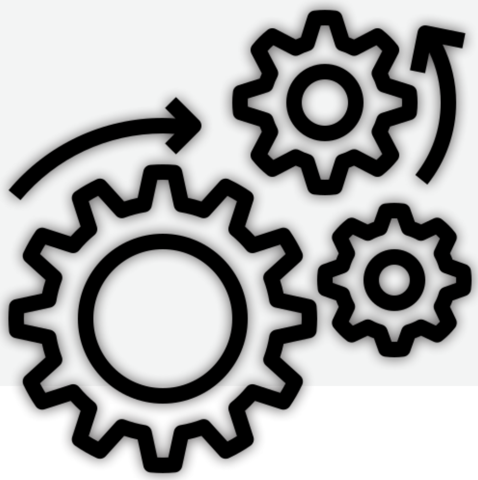
Origination:
There appears to be greater leverage on personal networks and sourcing proprietary opportunities, rather than traditional carve-outs and competitively run processes. The rate of new pipeline opportunities has also been noted as having slowed, primarily due to the negative short term impact and uncertain timing of recovery to pre-COVID growth expectations.

Due diligence processes:
As with much of the professional services world, there has been an increased use of technology enabling platforms (such MS Teams and Zoom) to engage with service providers and vendors. In-person meetings have seemingly reduced to only those which are crucial, with the necessary safety precautions being taken. The use of Google Earth and strategic networks across the country have also been used to facilitate site inspections where necessary.

Pricing and approvals:
There were mixed responses in respect of pricing, with some managers noting a stubbornness in pricing declines which may only normalise to lower levels in the next 6 to 12 months, and has resulted in delayed or rejected opportunities. Other managers have noted the attractiveness of current entry prices or have noted that previously unavailable opportunities have become possibilities.

There is a large consensus across the managers surveyed that the impact of COVID-19 on existing operating models, growth strategies, and valuations is a key area of focus and analysis.

Contracting:
There appears to be increased preference for the use of tranched deal structures linked to earn-outs or other management KPIs to cater for the gap between actual and projected earnings, and the sharing of risk in agreeing deal pricing.



4 Have there been any changes to your investment guidelines/ processes and/or investment policies aimed at maintaining deployment within the contracted commitment period of the fund?

The majority of survey respondents have indicated no change to investment guidelines and/or policies. Changes that have been listed include:

- An extension to the commitment period of the fund;
- Lowering the minimum EBITDA criteria, and the knock-on impact on the lower limit of deal size ranges; and
- A necessitated increase in focus on follow-on investments and recycling provisions without fundamentally changing exit timeframes to enhance returns.

5 What has Covid-19's impact been on the profitability/ sustainability of existing portfolio companies and pipeline opportunities being assessed during Covid-19?

The impact appears to be mixed, with profitability growth seen by some essential services providers. Whether the impact has been positive or negative, respondents are quick to highlight the temporary nature and recovery path that has already been treaded by those with negative impacts. Many portfolio companies have, in Q3-2020 reached close to pre-COVID trading levels and are beginning to trade out of the liquidity challenges faced during the stringent lockdown periods. The sustainability of the recovery is however uncertain with the possibility of a "second wave" and the return to strict lockdown levels.

6 How has COVID-19 affected the growth potential of existing portfolio companies/pipeline opportunities, and what impact has this had on job creation. What specific strategies have been implemented to mitigate the negative impacts thereon?

The weak macro-economic outlook compounded by many portfolio companies which have been negatively impacted by the pandemic has resulted in investment cases and timeframes being pushed out by at least a year.

Minimal job losses were experienced across portfolio companies, with the predominant focus being on operational optimisation, and job preservation rather than job creation. Managers have challenged portfolio companies to use retrenchments as a last resort, rather being in favour of short time and salary sacrifices.

Interestingly, the acceleration of digitisation across sectors may see an alternative skill set being preferred as businesses acclimatise to operate and grow in a post COVID environment.
Portfolio and pipeline companies which do not have defensive business cases have seen reduced growth expectations and value creation potential.

Our views

The negative financial and social impact of the COVID-19 pandemic has escaped only a few.

While private equity backed companies have not been spared, the resilience of investment strategies has lessened these impacts. The road to recovery is likely to be a long one with ramifications that include delayed exit timeframes and slower job creation. The themes emerging across the responses to our questions demonstrate the commitment of managers to overcome the challenges posed by the pandemic through robust levels of engagement with existing portfolio company management teams.

A heightened level of rigour in screening pipeline opportunities for defensibility in the current environment and assessing the adequacy of risk mitigation factors has become the order of the day.

We are optimistic that the industry will play a key role in re-building the economy, bolstering investment on the ground and catalyzing sustainable job creation.

About us

The Accelerated Black Business Growth Funding project is a partnership between 27four and the Jobs Fund, which sees the Jobs fund contribute R200 million in concessional funding to the 27four Black Business Growth Fund (the "Fund"). 27four has in-turn committed to raising R1 billion in matched funding to be invested alongside the Jobs Fund capital. The Fund's mandate is to deliver commercial returns to institutional investors; drive transformation through fund managers and portfolio companies; and job creation as a result of focussing on investing in mid-sized, privately-owned companies for growth.

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