RISK ASSESMENT

& PORTFOLIO MANAGEMENT

IDB IDB | Invest IDB | LAB

SESSION OVERVIEW

- What do institutional investors look for
- Key pillars of a Due Diligence
- Key risk areas from an LP point of view
- Key elements that influence the LP and GP relationship

RISK ASSESMENT

Risk Assessment:
Institutional Investor's Fund Assessment

What to expect of a typical IDBI DD process
Key risk analysis areas
Common red flags for institutional investors

Overall Strategy

General Remarks and Exposure to risk

Fund Type: Private Equity (Execution and Exit risk), Private Debt (Credit and FX risk), Hybrid – different types of expertise required.

Macro, Political risk: What is the macroeconomic outlook? How exposed is the fund to macro volatility, political or regulatory shocks, and FX risk—and are these risks actively managed?

Legal Considerations: What is the proposed LP Structure at the vehicle level? In which jurisdictions is it established. Any legal/regulatory concerns at the investee level?

Overall Strategy

General Remarks and Exposure to risk

Fund Size: preferably above $50 million (below for IDB Lab)

Investees: Size and stage of target companies / Controlling vs minority stakes, governance rights, Sourcing strategy? Pipeline?

Investor base: Other investors? Clear, proactive and consistent communication — especially when performance deviates from plan?

Investment Strategy

- **Thesis:** Is there a clear rationale for why the fund?, why these sectors and markets were chosen, and why the timing makes sense?
- How does the purpose of the Fund align with IDB Invest objectives (geography, target sectors).

- **Strategy:** How will the Thesis be transformed into a portfolio of successful investees? Deal sourcing (primary, partnering with other institutions?)

- **Process:** Is there a defined, repeatable investment process that shows how opportunities are sourced, reviewed, approved or rejected?

- **Exit Strategies:** Are exits actively prepared throughout the investment lifecycle? / Market liquidity?

Governance and fund economics

Governance in Decision Making: Is CG aligned with international practice? Role of the LPAC? Other CG considerations/risks (from Legal Matrix?)

Fund Economics: Are expected returns realistic once fees, leverage, and non-management-fee expenses are fully considered? / Fund expenses?

ESG/KYC Considerations: Capacity/capability to manage ESG/compliance risks?

Investment Guidelines: Investment limits? Is the fund allowed to have leverage?

Sponsor and Team

Can this fund execute? Can the team manage?

Track Record: Does the Sponsor's track record demonstrate repeatable performance across market cycles (1st time vs established managers)

Team: Is the team appropriately sized and experienced for the strategy. Has the team worked together in the past? Back-office/monitoring capabilities?

Key People: LPs invest in people managing funds. What happens to decision-making and continuity if one or more key individuals leave?

Alignment of interests: Does the fund have capital at stake? Are there performance driven incentives?

PORTFOLIO MANAGEMENT

Do you know the name of this movie?

Source: www.IMDB.com

Hints:
The movie is turning 60
The guy in the red poncho is turning 96
The title portrays what LPs and GPs might face during the fund's life

Portfolio Management: Institutional Investor's view after becoming an LP

LPs and GP are now in a "10-year marriage", ruled by the fund's documentation and fundamentally supported by the TRUST developed among the parties.

TRUST is a primal pillar to navigate the GOOD the BAD and the UGLY…

1: Too sweet of a deal

A fund has a majority stake (75%) on a QSR chain. The investment had good performance (2.2x MOIC and 50% IRR)

Investors linked to the GP offered to buy 80% of the Fund's stake

The Fund will keep 20% to capture "additional upside"

Price offered slightly above recent peer transactions and to be validated by "independent investment banker"

GP argued that "additional value creation will take more time (beyond the fund's terms), and it was a good timing and good price.

The fund had +4 years to go!

1: Too sweet of a deal

Topic: GP's Fiduciary Duty

Elements to reflect upon:

The GP selling to himself a successful fund investment (red flag)

Fiduciary duty in doubt? Work a strong exit in 3 years vs. good deal for them

As LPs we need to be sure that the GP understands its role and duty

Weak mitigants: price validated by "independent investment banker" (hired by the Fund/GP) ?

2: The not too Key Person

One of the GP's team members, included in the " Key Person" clause, resigns

He is taking a c-level role in an investee company of a fund managed by the same GP (but different from the one we are invested in)

GP argued that there was no need for a replacement as: "has been dedicated to this investee company almost full time, during the last two years". "There is no impact on the team's execution capacity

2: The not too Key Person

Topic: Transparency

Elements to reflect upon:

An LP is " buying" into a team that can execute an investment thesis

The team is based on pillars (key persons), that play a primal role in the fund's success

Was this person sold as a Key Person (but from the beginning he wasn't)

Why was this person not dedicating the agreed time? It took them two years to share that with the LPs

How easy is to replace a key person in the " middle of the road" ?

3: YES, We will do it… ..

A new investment entails a relatively high environmental risk (LPs have a more conservative assessment than the GP)

LP's granted green light to the capital call, conditioned to the engagement of consultant, that will develop an action plan to mitigate the risks

This action plan was to be ready BEFORE the execution of the main CAPEX for the project. (GP should not transfer money to the company)

The GP took forever to hire the consultant, and the CAPEX could not be delayed any further. Finally, the action plan came "late" with limited impact and leverage for its implementation.

3: YES, We will do it… ..

Topic: Know Your LP / Transparency

Elements to reflect upon:

LPs might provide flexibility to facilitate the GP's investment role

Agreements linked to this flexibility should be always honored

Failure to so, will close the option for additional flexibility needs and deteriorate the LP/GP relationship

E&S risk management is critical for some institutional clients (e.g. DFI). Negligence on this topic is a clear red flag

4: Its just numbers… ..(compilation of true stories)

45-page quarterly report, with no IRR, DPI, TVPI, sector concentration, distributions…..

Charts don't add up, don't match with the previous quarter, don't show updated information

One investee company gradually increased its valuation…1.5x, 2.0x, 3.0x….. And the, suddenly becomes a write-off

A 420 days discussion between the GP and the auditor

LPs begging for agreed reports…. Really?

GP providing false commitment figures to reach a "1st closing"

4: Its just numbers… ..(compilation of true stories)

Topic: Information for LPs

Elements to reflect upon:

Information/reporting plays a key and should have these attributes:

- Complete /Comprehensive
- Relevant
- Consistent
- Reliable
- On Time!
- Truthful (e.g. legal consequences)

5: Showing your true colors

A GP's main shareholder decided not to honor its fund commitment (that was material)

After the two one-year extensions, the GP informed the LPs that they want to step out and end any with the fund

When reaching late funds stages, GP negotiates a deal aimed to repay its own debts (only), with a poor deal for the GPs

When facing a legal process against the fund, the GP concentrates on defending their own interest.

5: Showing your true colors

Topic: Character / Fiduciary Duty

Elements to reflect upon:

As a GP you live up to your results and your reputation

The way GPs manage challenging situations will create a stamp for the future

6: Knowing your LPA back and forward

GP’s sending Capital Calls that clearly infringe the investment policy

Ignoring the need of a WAC for certain fund situation

Not knowing who should take certain decision and its requirements (time, majority, etc)

Not calling a LPAC when required by the documentation

6: Knowing your LPA back and forward

Topic: Master the Fund's documentation

<u>Elements to reflect upon:</u>

LPs lose credibility on the GP and the capacity to manage the fund under the agreed rules

LPs will doubt of any decision-making communication from the GP

LP will enter a " catch me if you can" dynamc with the GP

Transparency

Information to LPs

Know your LPs

Fiduciary Duty

Character

Master the LPA

Build/Create TRUST