CORONAVIRUS RESOURCE CENTER

COVID-19 and Private Equity: The Impact of Financing Disruptions on Private Equity Portfolio Companies and Funds

March 31, 2020

The stress that COVID-19 is placing on financial markets is reverberating through the private equity industry. On March 26, 2020, Debevoise's Private Equity Group held its first briefing on how the crisis is affecting deals, liquidity, fundraising and more. To access the on-demand recording, please click here. Highlights of the presentation include the following:

THE CURRENT DEAL MARKET

Kevin M. Schmidt and Jeffrey E. Ross

Put down the pencils and pivot. For the vast majority of pending M&A transactions, it's "pencils down" in the face of practical difficulties in conducting due diligence, uncertainty regarding the economic outlook for target companies, regulatory clearance bottlenecks and limited availability of debt financing.

Deal professionals are adapting by pivoting to portfolio company add-ons that may not require new debt or that can be handled entirely though sponsor equity. Also, private investment in public equity (PIPE) deals are getting more attention as public companies face liquidity constraints, as are minority investments into private sponsor portfolio companies, in order to accept offer partial liquidity to the incumbent investors or to delever. For investors whose overall thesis is unchanged by COVID-19, the distressed trading levels in the secondary debt market makes buying back portfolio company debt an appealing option (especially if levered on the back end by a fund-level debt facility).

In pre-close purgatory, it's 2008 all over again. Just as in the global financial crisis, parties caught between signing and closing are scrutinizing contracts as they debate

what constitutes a material adverse event, whether the marketing period has commenced and whether the target is solvent. Lenders, for their part, are coming to the table with off-commitment requests, such as tightening of financial covenants, adding anti-cash hording covenants and establishing caps on add-backs to EBITDA for COVID-related nonrecurring costs and expenses.

Beneath the surface, however, the consensus is that there is little similarity with conditions a dozen years ago, given that financial institutions have stronger balance sheets and have exercised tighter management over their exposure in the deals they have committed to finance.

IMPLICATIONS OF GOVERNMENT ACTION

Jeffrey E. Ross and Simon Witney

In the United States, heavy fiscal artillery but fine print. While the CARES Act provides much-needed fiscal stimuli for the country as a whole, the impact on private equity is unclear. The specifics regarding how and to what extent the Small Business Administration's affiliation rules will apply in determining the 500-employee eligibility limit for $350 billion in small business loans remain unclear, but it appears likely that these rules will limit access to this program for most sponsored portfolio companies. Similarly, guidance from The Treasury and the Federal Reserve is needed regarding the strings attached to the $500 billion being put toward buying corporate debt from originators, although these strings will likely include limits on dividends and stock buybacks, executive compensation and workforce reduction.

Europe takes a multipronged approach. Compared with the United States, European state assistance casts a wider net. The European Union has relaxed the state aid restrictions usually applicable to EU member states, enabling governments to provide a range of grants, interest-free loans, and government-backed commercial paper directly to companies in distress. While some of these measures have strings attached too (such as requirements to retain workers), at least in principal, many of them are open to PE-backed companies. In addition, European governments have also loosened regulations regarding audit and filing deadlines, competition rules and corporate governance—particularly insolvency regulations that could force directors to take steps against the longer-term health of the economy.

PORTFOLIO COMPANY FINANCING

Jeffrey E. Ross, Scott B. Selinger and Simon Witney

Draw down, but mind the ratios. Sponsors have lost no time assessing the liquidity of their portfolio companies and developing strategies to preserve existing liquidity and identify new liquidity sources. For many, the first step was defensively drawing down on revolving credit lines—driven less by concerns over counterparty risk than the possibility that, depending on how the crisis progresses, lenders could attempt to invoke MAE clauses as a basis for refusing to make funds available. For the moment, at least, lenders seem to be taking seriously their funding obligations, as well as potential lender liability for refusing to fund.

Defensive withdrawals are not without cost, however: In addition to interest expense, borrowers must closely monitor their ability to comply with springing and maintenance covenants going forward. Given the rise in default activism, the uncertainty of the COVID situation only heightens the importance of scrupulously maintaining covenant compliance. Similarly, ABL revolvers need to be monitored to avoid the negative consequences of availability falling below agreed thresholds.

Open the distressed debt playbook. Beyond securing existing liquidity (and, of course, cutting costing), funds are considering the pages of the distressed debt playbook such as: incurring priming debt, debt with an inside maturity date, incentivizing lenders to defer interest and using incremental capacity for *pari passu* debt (depending on existing MFN pricing protections).

Stepping in from the top. Finally, sponsors are looking for ways to make supportive follow-on investments, either in the form of cash infusions or by supporting new third-party financing. Some of the approaches are straightforward and don't require investor consent, while others are more creative: recycling proceeds, including cash previously distributed; reopening closed funds; offering co-investment opportunities to specific investors; and raising top-up funds. For all of these, however, it is important to scrutinize fund documents, manage potential conflicts of interest and secure LP approval where needed.

FUND-LEVEL FINANCING

Thomas Smith

For capital call financing, relatively business as usual. To a large extent, the material disruptions that have hit portfolio company financing have not migrated up to the fund level; capital call financing is still flowing. But there are nuances. Some lenders are

increasing pricing as their cost of capital has increased. Some lender credit committees are being more conservative with regard to approving larger financings, making for tighter capital availability for mega funds. There is a bias by lenders toward current sponsor relationships, raising the bar for first-time lending arrangements. And lenders are wary of sponsors stockpiling facilities that won't get used for six months or more. Notwithstanding these headwinds, existing transactions are closing and we have seen multiple new transactions come to fruition.

Despite the health of the capital call financing market, there are still strategic moves for sponsors to make. Sponsors would be wise to protect existing capital call agreements, extending maturities now regardless of their end date to ensure continuity. And they should consider keeping some of the line undrawn, to retain a source of liquidity for when needed.

NAV continues to move upstream. The pre-crisis move toward using NAV facilities at the fund level continues. For existing fund level NAV lines, given the uncertainty around valuations, sponsors should closely examine the headroom they have in their LTV covenants, and consider sources of cash should the need to pay down the loan arise. In addition, sponsors should be aware that the status of their portfolio companies could impact their fund level NAV facilities; if portfolio companies are at risk of insolvency or have to take mitigating actions with respect to their downstream leverage (such as deferring interest payments), there well could be knock-on implications to fund level NAV financing.

Separately, private equity sponsors in need of liquidity to support downstream investments may find that fund level NAV financing is a potential solution. Although there are, again, headwinds (such as issues with valuations of assets), NAV financing to private equity funds is growing and there are lenders looking for transactions in this market.

IMPACT ON SPONSOR FUNDS

Rebecca F. Silberstein and Jonathan Adler

Balancing communication with confidentiality. Sponsors are making it a priority to have frequent, candid and informative communications with their LPs. The emphasis on transparency, however, requires care regarding the dissemination of confidential portfolio company information, particularly given that many LPs are subject to FOIA requests. Sponsors need to check partnership agreements and side letters to see what sort of confidentiality protections are included.

Active fundraising is continuing but adapting. While launches of new primary products might be delayed, existing products are maintaining momentum. Indeed, while some LPs may be scaling back commitments for the moment, others are accelerating participation, looking to put money to work with strategies they perceive to be well positioned to take advantage of current market dynamics. Notably, while new investors are frequently sidelined by due diligence challenges during the slowdown, many investment committees, working by conference call, are continuing to evaluate new investments. In addition, we are seeing a surge of interest in credit strategies, in particular for funds of one and separately managed accounts, with a premium on sponsors that are able to execute on these quickly.

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For more information regarding the coronavirus, please visit our Coronavirus Resource Center.

Please do not hesitate to contact us with any questions.

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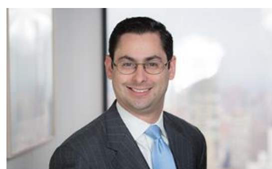

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