Key Takeaways from IAA Webinar: Private Equity Fund Managers and the COVID-19 Liquidity Crunch

21 May 2020

Private equity fund managers and their investors seeking to manage the financial impact of the COVID-19 pandemic are considering options to preserve financial flexibility for their present and future needs. On May 13, 2020, senior Debevoise lawyers Andrew M. Ahern, Ramya S. Tiller and Andrew C. Rearick participated in a webinar hosted by the Investment Adviser Association (the "IAA"), which was moderated by IAA Associate General Counsel Monique S. Botkin. Below are key highlights of the discussion.

While The Pandemic Has Resulted in Some Disruptions and Uncertainty in the Market, Activity Continues. While the COVID-19 pandemic presents unique challenges to private equity fund managers and investors, the primary fundraising market has remained active as sponsors have continued, and in some cases accelerated, fundraisings that had been launched prior to the outbreak and associated lockdowns. Although secondary market activity has slowed, largely due to uncertainties surrounding valuations, interest in secondary solutions remains robust as sponsors and secondary buyers evaluate strategic ways to obtain liquidity for portfolios. An increase in secondary activity is likely in the second half of 2020. The fund finance market also remains active in the traditional sense as sponsors continue to put in place new subscription facilities and proactively extend existing ones (although with higher pricing and some other lender-favorable terms). Sponsors are, however, also evaluating how they can leverage their existing portfolio assets opportunistically through NAV and other bespoke fund finance solutions.

A Range of Solutions Are Available to Increase Fund-level Liquidity. Several options may be used alone or in combination to meet financing needs. These options include (1) amending the fund governing documents; (2) raising new investment vehicles; (3)

obtaining a NAV facility; (4) structured equity solutions, such as issuing preferred equity interests in the fund's portfolio; and (5) GP-led fund restructuring transactions.

Amending Fund Terms. The simplest solution for increasing fund-level liquidity is to draw down additional capital from limited partners. Depending upon what stage a fund is in, an amendment to the fund documents could be required to access additional capital. Key terms to consider amending include fund recycling provisions, follow-on limitations and concentration limits. Although an amendment can be relatively simple to execute and largely preserves the existing commercial deal between LPs and the GP, it may not provide a solution in all circumstances.

Raising New Capital. As an additional alternative, a sponsor may elect to set up a new vehicle to invest follow-on capital into the existing portfolio companies (e.g., a sidecar or annex fund). When establishing these vehicles, sponsors need to consider issues related to valuation, economics and conflicts of interest with the existing fund. The sponsor may offer investors in the existing fund the opportunity to invest in the sidecar or annex fund before seeking capital from other new investors.

Establishing a NAV Facility. NAV facilities have traditionally been used more by secondary funds and credit funds, since lenders typically prefer to lend against more liquid assets. In the last couple of years, however, some lenders increasingly have been willing to lend to other private equity funds against their private equity portfolio investments. Below are some considerations relating to using a NAV facility to obtain additional liquidity in the current crisis:

- *Structuring NAV Facilities*. NAV facilities have traditionally been an attractive option because of low rates and limited restrictions on the fund. Additionally, limited partner consent is typically not required (although this depends on the terms of the fund documents). However, lenders will require that the financing structure works for them from an enforcement perspective, and that may mean restructuring the investments of the fund underneath a new holding company or making other structural accommodations.

- *Extended Business Diligence*. Sponsors should expect that it will now take longer than usual to put a new NAV facility in place given uncertainty around valuation and timing of exit events.

- *Financial Covenants/Eligibility Criteria*. Sponsors should carefully negotiate the eligibility criteria and the loan-to-value and other financial covenants given the risk of non-compliance in the current environment where asset values are shrinking and defaults in the underlying investments are more likely. Since the NAV facility is typically secured by the underlying portfolio, a sponsor risks giving up control in the event of a default.

Issuing Structured Equity. As an alternative form of leverage, a sponsor may consider bringing in a secondary investor to provide capital to the fund in the form of structured equity. In this scenario, the secondary investor provides capital to the fund in return for priority distribution rights from all or part of the underlying portfolio.

- *Considerations*. Offering structured equity has the potential to offer the fund flexible economic terms (e.g., no specified maturity and may avoid third-party consents). Historically, structured equity has been used as a way to accelerate distributions to investors and maintain the same economic deal with limited partners at the fund level, but increasingly sponsors are exploring ways to utilize structured equity to increase capital available to the portfolio. As an additional advantage, the equity offered is typically unsecured and contains limited covenants. On the other hand, structured equity typically has a higher cost of capital than, for example, a NAV facility, and is tied to the term of the fund. So for sponsors who may need more time with the underlying portfolio in addition to more capital, it may not be an optimal solution as compared to, for example, a fund restructuring.

Fund Restructuring. Another potential option is for a manager to transfer all or part of the underlying portfolio to a continuation fund capitalized by new equity investors and existing limited partners who elect to participate. Existing investors can roll over their interest in the new portfolio or receive cash offered by the secondary buyer. A fund restructuring offers maximum flexibility with respect to adjusting the structure and terms of the transaction and provides the ability to raise additional capital for the portfolio from the secondary investors. However, a fund restructuring is a complex transaction that requires significantly more sponsor involvement and time commitment.

These represent a few of the options available for fund managers and investors to consider. Fund managers will want to consider the fund's industry and particular circumstances when weighing options. As valuations settle down and more certainty emerges as to what the road ahead looks like, the market could become very active once again.

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Please do not hesitate to contact us with any questions.

NEW YORK


Jonathan Adler
jadler@debevoise.com


Andrew M. Ahern
amahern@debevoise.com


Kenneth J. Berman
kjberman@debevoise.com

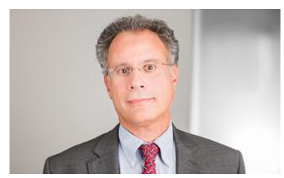

Lorna Bowen
lbowen@debevoise.com


E. Drew Dutton
eddutton@debevoise.com

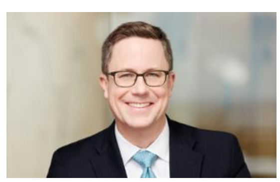

Jane Engelhardt
jengelhardt@debevoise.com

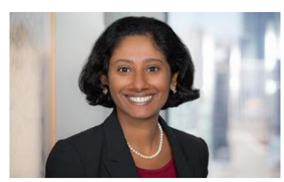

Andrew Ford
aford@debevoise.com

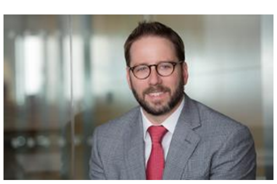

Marc Ponchione
mponchione@debevoise.com

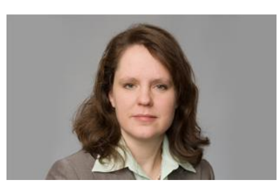

David J. Schwartz
djschwartz@debevoise.com


Rebecca F. Silberstein
rfsilberstein@debevoise.com


Justin Storms
jstorms@debevoise.com


Ramya S. Tiller
rstiller@debevoise.com


Michael P. McGuigan
mpmcguigan@debevoise.com


Margaret M. O'Neill
mmoneill@debevoise.com


Daniel Randazzo
drandazzo@debevoise.com

Julie Baine Stem
jbstem@debevoise.com

LONDON

Katherine Ashton
kashton@debevoise.com

Geoffrey P. Burgess
gpburgess@debevoise.com

Geoffrey Kittredge
gkittredge@debevoise.com

John W. Rife III
jrife@debevoise.com

Thomas Smith
tsmith@debevoise.com

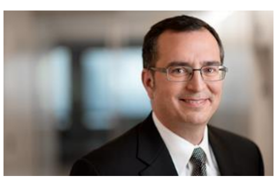
Patricia Volhard
pvolhard@debevoise.com

Andrew C. Rearick
acrearick@debevoise.com

HONG KONG

Gavin Anderson
ganderson@debevoise.com

TOKYO



Ezra Borut
eborut@debevoise.com