

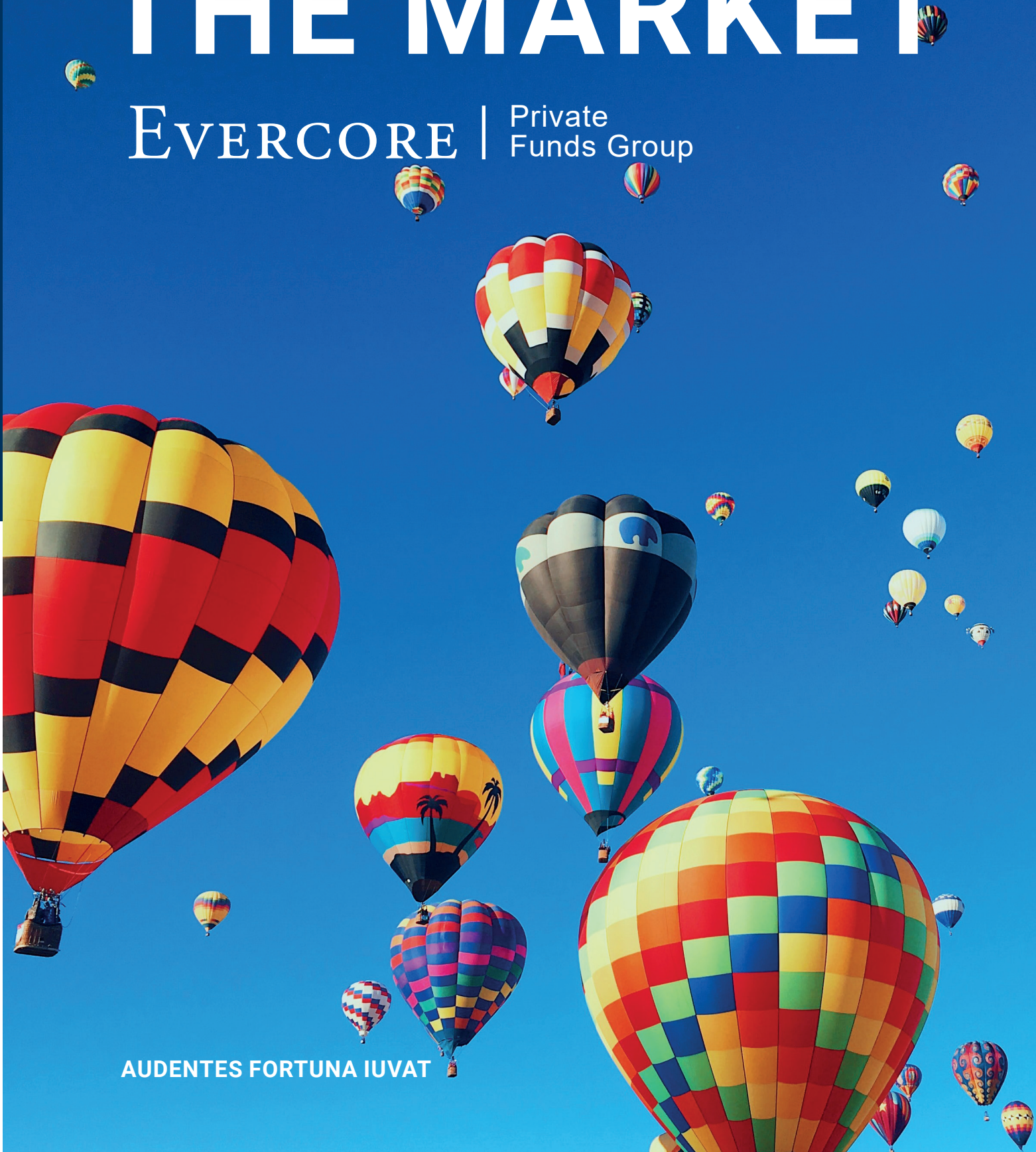
# STATE OF THE MARKET

EVERCORE | Private  
Funds Group

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STATE OF THE MARKET 2022

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Front cover photograph by Kyle Hinkson



# Key developments in fundraisings in 2021

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**A**gainst a backdrop of the delivery of the first Covid-19 vaccines, relatively low interest rates, high public market valuations, and general confidence in private equity, the first half of 2021 saw private equity fundraising accelerate to its fastest pace since the global financial crisis.<sup>2</sup> That pace is expected to remain strong through to the end of the year as workforces return to offices, city centres reawaken, and barriers to travel come down. Although fundraising discussions between sponsors and investors have largely shifted to a virtual environment and, as a result, the role of placement agents and other service providers in hosting and facilitating such discussions has increased in importance, the core issues that arise in a fundraising remain those related to economics, investor protections and governance.

- Economic discussions remain focussed on the size of the management fee (including discounts for timing and size and the impact of portfolio investment write-downs); distributions (including the speed of the catch-up); clawbacks (including their frequency and how they are secured); the size and funding of the sponsor's commitment; and the extent of reinvestment.
- Discussions around governance and investor protections continue to prioritise key person triggers, no-fault and for-cause removal thresholds and consequences, limited partner advisory committee composition, successor fund restrictions, and standards of care with respect to exculpation and indemnification provisions.
- Co-investment remains another key topic, with investors requesting priority access to co-investment opportunities on a no-fee/no-carry basis, and sponsors facilitating investor co-investment through the establishment of co-investment vehicles as aggregators or under bespoke separate account arrangements.
- Investors also continue to request increasingly customised, investor-specific reporting.

While the core issues that emerge in fundraising documentation continue to relate to economic alignment and traditional investor protections, certain 'frontier' topics have recently increased in prominence and are now regularly contemplated. Such topics include (i) the increased significance of environmental, social, and governance ("ESG") factors as a result of new regulatory and disclosure regimes and more extensive investor requirements in these areas, (ii) the use of credit arrangements and particularly net asset value facilities, (iii) the potential introduction of GP-led liquidity solutions, (iv) the ability of a sponsor to sell a minority stake in its business to GP-staking firms, (v) the increased offering of additional currency sleeves, and (vi) the increased focus on the potential for abusive tax arrangements.

## (1) ESG CONSIDERATIONS

ESG considerations, which have steadily risen in importance over the course of the last decade, have been brought into sharper relief as the enduring effects of the pandemic and climate change become more pronounced. Sponsors are being required to commit to ESG practices in response to regulatory action and investor demand, with a number now operating ESG-driven strategies.

The driving force behind ESG standards in private fundraisings has been the EU. The EU Disclosure Regulation, now in effect, requires EU and non-EU sponsors marketing fund products in the EU to disclose how sustainability risks are integrated into their investment decision-making processes. In addition, sponsors that operate products that specifically promote ESG criteria are required to make additional disclosures in their product documentation. Complementing this EU Disclosure Regulation, the EU Taxonomy Regulation will introduce uniform screening criteria to determine the extent to which an economic activity will qualify as environmentally sustainable. On the other side of the Atlantic, ESG is also expected to be a focus of the Biden administration, and the SEC has made a number of announcements in relation to ESG considerations, including in its 2021 priorities; this reflects new scrutiny of ESG-related matters and makes clear

the prominent role that evaluation of ESG-related risks and disclosures will play in examinations of SEC-registered investment advisers.

The arrival of the EU Disclosure Regulation is timely, coinciding with both increased worldwide concern on climate change and markedly increased allocations by investors to funds with environmental or social ambitions. The UK does not intend to adopt a law of equivalently broad scope, focusing its efforts for the time being on requiring larger asset managers to apply the mandatory climate change disclosure framework under the UK Financial Stability Board's Task Force on Climate-Related Financial Disclosures. This means that UK managers are required to report climate-related financial information, which the UK government believes will support investment decisions aligned with the transition to net zero emissions.

Apart from requiring that sponsors establish or enhance existing ESG policies, investors are requesting that sponsors address their specific ESG requirements in a variety of ways. These requests range from, on the one hand, confirmations in side letters that sponsors take into account ESG issues in the selection, retention and realisation of investments (*e.g.* requesting that sponsors holding themselves out as signatories to the PRI standards agree to continue to comply with such standards) to, on the other hand, acknowledging having read investors' ESG policies and agreeing to assist investors with their internal reporting obligations relating to ESG. At the furthest end of the spectrum, certain investors, such as development finance institutions, require enforceable rights in relation to their ESG policies and, in the most extreme cases, require a contractual right to cease funding if such policies are breached.

## (2) CREDIT ARRANGEMENTS

At the onset of the pandemic, sponsors turned their attention to their portfolio companies' ability to access capital, both through subscription lines and other types of financing, such as net asset value facilities. Despite initial fears to the contrary, investors did not default on their commitments, lenders

continued to lend, and unprecedented state intervention, including the introduction of measures such as furlough schemes, meant that such arrangements came to be seen not just as a means to raise funds as a defensive measure but, in some cases, to make opportunistic investments at a time of market dislocation. As the advantages of being able to put such facilities in place have become clearer over the course of the last year, both sponsors and investors have come to see the value in these arrangements and more closely scrutinise how they are regulated by fund documentation.

Managers operating in Europe and North America typically agree to cap aggregate fund-level indebtedness as a percentage of aggregate commitments. Managers operating in Europe also agree to place a one-year limit on subscription line borrowing as a result of AIFMD leverage reporting requirements.

### (3) GP-LED LIQUIDITY SOLUTIONS

The first half of 2021 saw GP-led transactions, and particularly transactions for single-assets, continue at the high velocity set during the second half of 2020. Nevertheless, investors continue to ask questions about process and transaction terms in such transactions, principally in relation to the valuation of the relevant asset in light of certain inherent conflicts of interest. Increasingly, fund restructurings and the process via which a fund's limited partner advisory committee or, more broadly, a fund's investors, may approve such a restructuring are a topic of discussion at the time investors make commitments to funds. Accordingly, such transactions are more frequently referenced in fund documentation. For example, conflicts provisions may include rules around what level of investor approval may be required in connection with certain types of transactions and expense provisions may specify which parties bear the costs of such transactions.

### (4) GP-STAKING TRANSACTIONS

The last decade has seen an increasing amount of capital raised to invest in minority stakes in sponsors and a growing number of firms pursuing this alternative investment strategy. Newer GP-staking firms are concentrating on sponsors at the lower and middle ends of the market, while the larger sponsors continue to target the more established industry participants.

As with GP-led transactions, the maturity of the market coincides with fund documents that more explicitly incorporate investors' perspectives on the sale of minority stakes. Investors often request consent rights in relation to the sale by a sponsor of minority positions in their business (or of the cash flows accruing to the business), whereas managers maintain that notification or consultation ri-

ghts should suffice and emphasise the advantages that a minority sale can bring to their business, including access to greater resources and growth potential. A key point of negotiation is the relevant percentage of stake that would trigger any prior notification, consultation or consent right.

### (5) FOREIGN CURRENCY SLEEVES

Investors increasingly request the flexibility to invest in a currency of choice (*e.g.* USD or EUR) and to receive distributions in such currency. As a result, sponsors are increasingly providing options to invest in their products in different currencies through the use of multi-currency sleeves, which can raise interesting questions with respect to alignment among investors, or between investors and the sponsor. By way of example, some investors may not have the treasury operations to manage complex hedging programmes (or wish to manage outsourced hedging operations), whereas other investors may not wish to have exposure to a sponsor's 'mandatory' hedging programme and would prefer to receive distributions in local currency, as they have developed back offices that include their own hedging programmes.

### (6) FOCUS ON ABUSIVE TAX ARRANGEMENTS

During investor negotiations, the tax landscape continues to evolve in the context of ever-increasing compliance burdens and the ongoing global concern with anti-abuse, including the next phase of the OECD's Base Erosion and Profit Shifting ("BEPS") initiative. Areas of current focus include EU Council Directive 2018/822 ("DAC6"), a reporting regime that requires funds (or more likely their advisers) to inform the EU tax authorities of arrangements that bear certain 'hallmarks' perceived to be indicative of aggressive tax planning. Although funds are unlikely to be required to file reports under DAC6, investors are, nonetheless, keen to be informed if this occurs and increasingly request side letter assurance to similar effect. In some instances, this can be due to an investor being resident in a jurisdiction such as Germany, in which obligations may fall on them if sponsors fail to meet their DAC6 obligations. In other cases, however, investors are more concerned with the need to be aware of association with structures regarded, properly or not, as potentially abusive.

Also of increasing importance are the hybrid mismatch rules introduced by various jurisdictions (through the Anti-Tax Avoidance Directive in the EU) in response to the original OECD BEPS initiative. Here again, investors are seeking to ensure that funds do not engage in arrangements perceived as nefarious. Equally, they may seek assurance that, to the extent hybrid mismatch problems arise, their cost is borne only by those inves-

tors creating the issues, which can be difficult to navigate in a typical fund's profit-sharing arrangement.

A further common point of discussion relates to filing obligations and assistance with claiming tax refunds. Investors have long been eager to avail themselves of sponsor assistance in these areas and increasing complexity has only, correspondingly, increased the need for this.

In light of the foregoing and other similar issues, an interesting dynamic has started to emerge. Sponsors generally strive to be helpful, but given the imprecise nature of many of the provisions they are now required to navigate, they are reluctant to be constrained by side letter language that could be unduly burdensome. This has resulted in a greater investor relations role for a sponsor's tax team, as they seek to provide alternative assurance to their investors and secure their confidence that sponsors are conscious of the changing tax landscape and the obligations and difficulties therein.

### CONCLUSION

Fundraising discussions continue to gravitate towards the traditional topics of economic sharing, investor protections, and alignment more generally. However, the frontier negotiation topics described in this article are of increasing importance, reflecting new regulation in areas such as ESG, developments in the use of credit facilities, the maturation of the markets in relation to GP-led secondaries and GP-staking transactions, as well as the increased focus on anti-abusive tax arrangements. Although discussion of these topics may not always end up in sponsors and their investors agreeing specific contractual restrictions, they are very much on the agenda for discussion. Consequently, investor relations and fund structuring teams, in addition to placement agents and other service providers, have a central role to play in this dynamic dialogue around the formation and deployment of capital in an increasingly complex and challenging world.

*This article provides summary information only and is not intended as legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed in this article.*

1. The authors acknowledge the contributions of John Anderson, Jenny Wheeler, and John Young with thanks
2. Private Equity International, Fundraising Report H1 2021, July 2021



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