COVID-19: PRIVATE EQUITY SPONSORS - NAVIGATING FUNDRAISING AND FUND-LEVEL MATTERS IN CHALLENGING TIMES

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Investment Management Alert

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The private equity industry has seen substantial growth and success since the global financial crisis of 2008. For the first time in over a decade, private equity sponsors are now entering what may be an extended period of market volatility, tightened credit markets, and industry-specific challenges that may well eclipse the last crisis. Now is the time for sponsors to evaluate the current environment and proactively assess the funds they manage to determine how to best navigate the financial challenges that lie ahead. Below, we provide insight on a number of issues that sponsors can and should be considering.

REASSESS OFFERING, INVESTMENT, AND FUND LIFE PERIODS

Sponsors will want to assess the flexibility they have in the timing and duration of fund offerings that are either in process or about to commence. Depending on the circumstances, a private equity fund sponsor may want to extend an imminent final closing date in order to, for instance, allow potential investors additional time to make commitment decisions or to gain additional time to reach the fund's target raise. In other cases, market shifts may create investment opportunities not previously available that could accelerate investor interest to make a commitment sooner rather than later. Similarly, there may be strong reasons to move up interim closing dates if sponsors want to lock in investors now or capitalize on investment opportunities that require additional commitments in the near term.

The same is true where a fund is nearing the end of its investment period. As has happened in past periods of economic stress, recent events are having a significant impact on the economy and on private equity portfolio companies. An extension of a soon-to-expire investment period can allow sponsors breathing room to pursue new opportunities for the fund or give sponsors more flexibility to make additional investments into portfolio companies that may need rapid additional financial support.

All of these circumstances should drive private equity sponsors to take a careful look at their available options. Both the offering period and the investment period are typically delineated in a private equity fund's limited partnership agreement ("LPA") or similar governing document. The LPA will sometimes allow the sponsor to unilaterally extend the offering period by a set period of time or more commonly will permit the fund sponsor to extend both the offering and investment periods with the consent of limited partners ("LPs") or the limited partner advisory committee ("LPAC"). To the extent that the sponsor effectively communicates to LPs the need for such extensions, they may well be receptive to such requests as being in the best interests of the fund and its stakeholders. Although investment periods are not typically subject to unilateral extensions, sponsors whose funds are still in the offering process may want to consider including in the LPA short, conditional (i.e., where warranted by demonstrated market conditions) unilateral extensions, or with LPAC consent.

For private equity funds nearing the end of their terms, sponsors should evaluate their ability to unilaterally extend the term of the fund or, if that mechanism is not available, consider making the case to extend the term through LP consent so as to allow the sponsor time to manage remaining portfolio investments through the market turbulence that is expected to continue over the coming months. Lending options may also need to be explored, either under existing fund documentation or by way of amendment or waiver of existing restrictions. Some LPAs provide flexibility to allow for loans from LPs. Offering existing LPs the opportunity to participate in additional financings, through either a loan, an annex fund, or other arrangements, can solve liquidity challenges in markets where credit will be scarce.

REEVALUATE DISCLOSURES IN ONGOING OFFERINGS

Sponsors with offerings in process should assess the need for updating private placement memorandum ("PPM") disclosures. In addition to addressing the risks that the current pandemic and future public health events may have on the sponsor, the private equity fund, and its investments, sponsors should consider whether there is a need to reevaluate PPM disclosure regarding investment strategy, targeted performance, market analysis, and other matters that could be impacted by current events. Sponsors should also review existing risk disclosures on industry- and investment-specific risks to determine if any adjustments are warranted.

REASSESS LPA PROVISIONS FOR ENHANCING LIQUIDITY FLEXIBILITY

Anticipating the need for greater liquidity for portfolio investments, sponsors should evaluate their LPA provisions governing recycling (i.e., providing that sponsors can recall distributions that represent a return of capital within 18–24 months of the distribution to reinvest in additional investments) and follow-on investments (which are often limited to a specified percentage of commitments to the fund). Waivers or amendments of these provisions can be sought where circumstances warrant asking LPs for increased flexibility to meet unanticipated financing needs. Sponsors with new fund launches should reevaluate these provisions and assess whether anticipated market uncertainty justifies departing from more traditional provisions. In this manner, sponsors can better prepare the funds they manage to serve as alternative financing sources for portfolio companies through recycling and follow-on investments.

At the same time, accessing additional liquidity through these steps or by calling additional capital may put financial pressure on some LPs and strain their ability to meet capital calls. While default provisions rarely are used, sponsors should review their LPAs' default provisions and assess the remedies that are available for protection of the fund and other LPs, with the hope, of course, that these measures will not be needed.

INCREASE COMMUNICATIONS WITH LIMITED PARTNERS AND PORTFOLIO COMPANIES

Sponsors and LPs have a common interest in greater communication during periods of market volatility such as the current one. Sponsors should consider proactively updating LPs about the impact of recent events on current and future investments, performance of the fund and of individual portfolio companies, and related matters, and may want to accelerate routine updates such as quarterly reports. Regardless, sponsors should expect to see more inquiries from LPs seeking information about such matters as well as seeking more information about the sponsor's business continuity plans and the impact that an extended remote-work period will have on the sponsor's day-to-day operations, its ability to monitor existing investments, and to find new investing opportunities. In some instances, it may be advisable to reach out to the fund's LPAC to proactively discuss the status of investments, investments in the sponsor's pipeline, and any needed deviations from investment restrictions due to market fluctuations. Communications with significant LPs in this manner can prompt helpful input from the fund's stakeholders.

With increased investor communication will come the need for rapid and accurate updates from portfolio companies on performance in order to provide LPs a clear (or as clear as can be) picture, including whether there are any immediate needs for financing. To the extent that portfolio companies continue to slow operations as a result of pandemic-related government restrictions and remote work challenges, fund sponsors need to be proactive in understanding these evolving situations and, where warranted, exercise a heightened level of oversight under the circumstances.

Financial statements and quarterly reporting of many funds require the timely delivery of information from portfolio companies, which may now take longer than expected. Sponsors should review their fund documents to determine what flexibility they have regarding delivery timelines and whether increased communication is needed with LPs about financial statements and expected delivery timing. Given the extraordinary circumstances, sponsors should not hesitate to proactively advise LPs of potential delays in reporting and/or seek extensions of such deadlines.

PAY ATTENTION TO REGULATORY CONSIDERATIONS

As sponsors with a December 31 fiscal-year end reach the 120-day deadline imposed by the Custody Rule for delivery of audited annual financial statements (180 days for funds-of-funds), sponsors should consider proactively working with their auditors to ensure the timely completion of the audit so that the sponsor can comply with its obligations under the Advisers Act.

Given the nature of private equity investments, valuations typically do not fluctuate significantly from quarter to quarter. However, in these turbulent markets, sponsors need to pay close attention to portfolio company valuations and should expect greater regulatory scrutiny from SEC examiners in the coming months and years on the values and fund performance reported by the sponsor in this time of market uncertainty and volatility, particularly if the performance is being used in the marketing of a new fund.

As to SEC filings, the SEC recently issued an order providing relief from upcoming Form ADV and Form PF filing and delivery obligations where the applicable deadline cannot be met due to COVID-19. Sponsors that needs to take advantage of such relief can extend the deadline to May 14 with respect to Form ADV and June 13 with respect to Form PF by notifying the SEC and disclosing on its website that it is relying on the order.

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These are just some of the considerations that sponsors should focus on as market turbulence unfolds and uncertainty remains. Please don't hesitate to contact us for further insights.

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