The Covid-19 pandemic has caused significant disruption to the global economy, and the asset management industry is no exception. Fund sponsors have been focusing significant time, efforts and resources supporting their portfolio investments through the crisis. While the fundamentals of many portfolio companies and assets are still strong, businesses are facing a cash flow crunch – whether that is due to direct impacts of closure by government action, reduced trade volumes due to social distancing measures or reduced consumer confidence, numbers of employees able to work, or key suppliers being impacted.

Access to additional funding may therefore be the difference between survival and collapse, and not just in the short term – as the initial wave of measures are being relaxed, many businesses will require an injection of capital to restart, having held off payments to suppliers and others to conserve cash during lockdowns, as well as factoring in the impact of continuing social distancing and other measures on profitability.

Governments around the world have put in place a number of measures to tackle the social and economic impact of Covid-19 (our overview of some of these can be accessed here). While these have had huge success in some areas (for example, in the UK the employment furlough scheme has been widely utilised), access to other support measures has been hit and miss for companies backed by private fund capital. Perhaps that is in part because some governments have looked at the funds industry as being able to help its own, seeing the “record dry powder” levels of funding for readily accessible cash that can be ploughed into any portfolio company. Governments in some cases also initially sought to aggregate portfolio companies under common ownership and control, counting those companies as having higher turnover and thereby taking them out of many of the schemes. There have also been challenges for governments to identify rapid growth venture-backed companies from those businesses which may have failed in any case when looking simply at metrics and, in some cases, governments have taken longer to devise rescue measures for the former to guard against propping up the latter. In those cases, there have also been concerns about state aid rules, particularly in the EU. That being said, many governments have been responsive to feedback from the funds industry and the measures available have been evolving, although the rollout of these initiatives may not come in time for some businesses, even if they can access them.

Where does that leave many portfolio companies? Access to traditional bank loans and refinancings, or debt from alternative credit providers may or may not be possible, particularly if companies are already heavily leveraged (see our separate note on considerations of the impact of Covid-19 under a leveraged loan facility agreement for financial sponsors). For many companies, including those who have been able to access government support measures in the form of loans, the additional debt burden incurred in response to Covid-19 will place serious constraints on their ability to recover. In the UK, TheCityUK (the industry-led body representing UK-based financial and related professional services) has established a Recapitalisation Group to understand and identify mechanisms to support the recapitalisation of UK businesses. It published an interim update on 8 June covering its early-stage thinking on how the private sector can support UK SMEs to manage unsustainable debt built up during the Covid-19 pandemic, which is accessible here.

In this note we consider some of the options fund sponsors will have available to them to provide cash injections into portfolio companies in need of funding, both in the short term and the longer term.
Financing options within current fund structure

Fund governing documents may provide a number of tools to enable additional capital and financing to be provided to portfolio investments. The available options will vary depending on the stage in the relevant fund’s life-cycle, as well as investor appetite to provide sponsors with more time and/or capital to devote to the relevant portfolio. Many of the options discussed will require investor consent (or investor advisory committee approval), and we therefore recommend that sponsors (i) review their existing documents carefully and (ii) liaise early and openly with investors to get them on board.

Sponsors may consider one or more of the following approaches:

- **Follow-on Investments**: In the short-term, sponsors may use follow-on investments to infuse capital into existing portfolio companies. For those funds still within their investment periods, sponsors may be required to amend, or seek a waiver of, investment restrictions if a proposed follow-on investment into existing portfolio companies would exceed diversification or concentration limits. For funds no longer in their investment periods, the level of follow-on investment that is possible will likely be capped, and the level of available undrawn commitments may be limited. Sponsors may need to consider amendments to the fund terms to achieve the desired level of follow-on investments.

- **Extend the Investment Period**: Funds approaching the end of their investment period may seek to amend their fund documents to extend the investment period to provide additional time to draw commitments. This measure will be particularly useful for funds with significant levels of undrawn capital or those that permit recycling during the investment period. Sponsors should note that investors may seek to attach conditions to any extension, such as a step-down in management fees.

- **Reinvestment and Recycling**: Funds may seek to reinvest proceeds from existing investments back into the portfolio to the extent that this is permissible under the fund documentation. Recycling can provide additional capital without requiring investors to increase their commitment (which may require additional internal approvals) and ensures their interests in underlying investments are not diluted. Nevertheless, the widespread impact of the pandemic may, in turn, create a liquidity squeeze for certain investors who find that the level of distributions they are receiving is decreasing, while they experience an increase in capital call requests. For many fund sponsors, there will be limitations on the ability to recycle capital; therefore, consent from investors may be required to enable sponsors to plug in meaningful amounts of additional capital. Sponsors will need to be able to convince investors that expanding reinvestment and recycling authority will protect the value of their investments rather than potentially contributing further capital to unprofitable investments.

- **Borrowing**: In the context of historically low interest rates, sponsors may view additional credit facilities as another means of strengthening and/or stabilising portfolio companies. If necessary, sponsors may want to seek investor approvals to permit additional indebtedness and/or to extend time limits on outstanding borrowings.

- **Sponsor Capital**: Sponsors with strong balance sheets could examine the possibility of putting their own capital into deals to shore up distressed portfolio investments by increasing the level of their sponsor commitment to the relevant fund. Sponsors should carefully review their fund documents before considering this approach, as there will usually be restrictions on the sponsor’s ability to increase its exposure to specific deals or increase their commitment after final closing without investor consent due to the potential conflicts of interest that may arise.

- **Extend the Fund Term**: Sitting alongside some of the measures noted above, mature funds may consider term extensions to secure additional time for portfolio investments to recover from any short-term depreciation in value. Investors may be open to a term extension if sponsors can demonstrate that the extension will be used to support and navigate strained portfolio companies through the instability. Sponsors should expect some investors to seek to negotiate reductions to the management fee during any such extension and/or to fetter the discretion of the sponsor during this period.
Cross-fund transactions and GP-led restructurings

As an alternative to seeking ways to provide extra financing to a portfolio company, some sponsors may consider causing the asset to be either sold to another fund, or via a GP-led restructuring to a bespoke successor vehicle, within its stable which may be better placed to supply the company with a fresh cash injection.

This may be particularly attractive where the existing fund is reaching the end of its life, cannot draw more capital and needs to realise its assets, in a market environment where it may generally be more difficult to find buyers or sell portfolio investments at attractive prices. In addition, the buying fund acquires an asset which the sponsor already knows well and believes can still produce attractive returns. Transactions of this kind raise significant potential conflicts of interest and sponsors will need to be very careful to take into account the related legal and regulatory issues before embarking on them. The consequences of getting it wrong could be severe, including potential for liability to disadvantaged investors, regulatory censure and reputational damage.

In these circumstances, fund managers will have legal, fiduciary and/or regulatory duties to act in the best interests of each of their clients. Where two funds or other vehicles managed by the same sponsor deal with each other, questions as to whether the transaction is in the individual interests of both funds come into sharp focus. Conflict with the sponsor’s own interests may also arise, in particular the impact on fund economics. The sponsor will need to make efforts to ensure that neither the buying or selling fund is disadvantaged at the expense of the other.

The price at which the sale is made will be a key issue. Some external means of setting the price which does not depend entirely on the sponsor’s judgment is likely to be required – whether that be through a third-party valuation, some form of auction process or other mechanism. Even if a price can be found that appears to represent a fair balance between the interests of the selling and buying funds, a sponsor might still need to ask itself whether, in a buyer’s market, the buying fund could have done better than achieving a “fair balance” had it instead deployed its capital in a third party transaction. It should also consider whether the timing of any such sale fundamentally favours one fund over another – particularly given the potential for volatility in the price of assets that might result if the global economy is able to bounce back sharply from Covid-19 disruption; how will the transaction look if prices increase sharply in the near future? Sponsors should recognise that transactions which turn out with hindsight to have been more beneficial to one fund than the other will be subject to increased scrutiny, increasing the importance of having given full consideration to the interests of both funds up front and recording the reasons for the decisions that have been made.

In addition to general requirements to avoid or manage conflicts of interest, sponsors will need to comply with any specific requirements in fund documentation (including side letters) that control transactions with affiliated funds, or conflicts of interests more generally. Do the fund documents need to be amended? Commonly such transactions would require consent of investors in both funds, either through a vote of all investors or a vote of the investor advisory committee. In addition, sponsors may be subject to specific regulatory requirements in relation to cross fund transactions of this kind – for example, sponsors of US funds or non-US funds with US investors may have a regulatory obligation to obtain prior client consent under the Investment Advisers Act of 1940. Even if not specifically required, sponsors may consider obtaining investor consent to transactions of this nature in any event, as a protective measure, or at least formally consulting with investors. Investors with representatives on fund advisory committees that are asked to approve such transactions may be concerned about any liability attaching to them if they approve (or decline) a transaction which turns out to have adverse consequences for the fund; depending on the level of investor concerns that are raised in such circumstances, a broader consent of the investor population might be preferable. Sponsors will in any event need to be sensitive to investor views around transactions of this nature before embarking upon them.
Another option to support portfolio investments in funds which are beyond their investment period, or have no further available capital, can be to establish a “top-up” or “annex” to the main fund. This can provide an injection of fresh capital for existing investments, which can give funds the time to support those portfolio companies needing a longer cash runway in this current economic climate.

These types of funds can be unpopular with investors unless the proposition is a strong one. However, whereas in the global financial crisis there were concerns about propping up ailing companies by using top-up funds, the reasons for portfolio companies needing an injection of capital now may not necessarily indicate any underlying issues with the company itself, and therefore sponsors considering this option should speak with existing investors to gauge reaction and to explain the value proposition. Formal investor consent will need to be obtained before going ahead with raising a top-up fund.

Sponsors should offer the top-up fund to all existing investors to take up on a pro rata basis, then further allocations to existing investors if not all investors take up the option. If further capital is still required, then new investors can be sought. In cases where not all investors take up their pro rata share, and in particular if new investors are brought in, sponsors will be faced with conflict and valuation questions similar to those described on the previous page. The sponsor will need to make efforts to ensure that neither the main fund nor top-up fund is disadvantaged at the expense of the other. In addition, top-up funds should be bound to divest on the same terms as the main fund when exit opportunities arise. Top-up funds can be set up to take a proportionate slice of all the main fund’s assets, or alternatively could cherry-pick assets in need of rescue financing – in the latter case, some sponsors may wish to explore with investors whether that can be done on a ‘preferred equity’ basis.

Top-up funds can be a practical solution to a practical problem. The important factor here is to provide new capital for struggling portfolio companies, and sponsors and investors alike will need to be practical about their expectations. Sponsors should expect to significantly reduce or even forgo management fees and also take a reduced carry in the top-up fund. Investors may have to accept dilution if this preserves the valuation of the portfolio companies to which they are already exposed.
A number of sponsors have recently brought to market dislocation funds specifically aimed at targeting opportunities derived from Covid-19. In our experience, the majority of these funds are operating in the credit space and targeting both primary and secondary opportunities presented, in particular, by smaller businesses like SMEs which have no or limited access to government support measures and hence are at risk of failure if no private financing can be found.

Reacting to the need to deploy capital quickly, sponsors have prioritised speed-to-market to ensure funds are available for deployment as opportunities present themselves. This has been reflected in extremely short initial fundraising periods prior to a first close being called, often relying on the support of one, or a small number, of institutional investors with which the sponsor has longer standing relationships.

The need to get to market quickly has also driven sponsor approaches to fund terms. Generally, in order to minimise negotiation and ensure a short fundraising period, sponsors have presented a commercial and legal package which does not deviate significantly from the terms of prior flagship and similar funds with which their investor bases are familiar. Having said that, the specific opportunity set targeted by these funds has meant that key features of that package have needed to be appropriately tailored, including:

- **Investment policies and restrictions:** as dislocation funds are being formed to take advantage of specific opportunities, investors are particularly focused on how the investment policy is framed. Sponsors have been trying to incorporate sufficient flexibility to be able to invest in opportunities that arise, whereas investors are trying to ensure that sponsors operate within their geographic and sector skill sets as well as clearly define how much primary and secondary exposure the fund will take on.

- **Fundraising period:** the offer period for many dislocation funds is much shorter than traditional funds, and three to six months is increasingly common. Despite this, where the strategy of such funds includes a focus on purchasing distressed credit opportunities, the equalisation payment made by subsequent investors often either incorporates reimbursement for portfolio appreciation or sees them investing at a price which reflects the then current value rather than cost of purchase.

- **Investment period:** in keeping with a commercial proposition based around targeting current opportunities, investment periods for these funds are typically one to two years.

- **Vintages:** in some cases, sponsors are building in technology to offer a series of (often one year) vintages to enable multiple pools of capital to be directed at ongoing opportunities with different return profiles. In these funds, the economics are often run on a vintage by vintage basis on the basis that each vintage operates in a manner similar to an individual fund, albeit with the ability to recycle capital from one vintage to another.

- **Term:** consistent with the shortened offer and investment period, the term of these funds usually provides for a two to three year harvest period.

- **Conflicts:** given that sponsors raising these funds will almost certainly be already operating prior funds with overlapping investment policies, the approach to conflicts and allocation is a key consideration for investors and sponsors alike, with the need to balance appropriate sponsor flexibility with an investor desire to ensure the dislocation fund receives an appropriate portion of deals within its investment policy.

What is important to remember in connection with these funds is that they are being created in a rapidly evolving political and economic environment, and hence sponsors will continue to innovate to match the opportunities that present themselves whilst otherwise trying to keep the fundraising process as smooth and efficient as possible.
GP-led secondary transactions have become an increasingly important part of the secondary market over the last five years or so. While the current crisis hasn’t yet led to an acceleration of such transactions, we expect that GP-led secondaries and portfolio restructurings will be an important tool for sponsors dealing with the impact of portfolio companies in distress due to Covid-19, as they can provide additional time for portfolio companies to recover and/or provide an opportunity to inject fresh capital.

In the current environment, existing investors with confidence in the relevant assets benefit by being able to maintain the status quo by rolling over the terms of their existing investment, whereas those for whom liquidity is more important benefit by achieving an exit. Accordingly, such GP-led secondary transactions should provide a balance in terms of meeting the desire of those existing investors to exit the fund in line with the initial investment proposition, while offering opportunities to existing and new investors to gain exposure to the relevant assets which are expected to provide positive investment returns over a longer period.

Key to arranging a successful GP-led secondary transaction is arriving at a fair price for the interests to be transferred. Detailed consideration will need to be given to the financial condition and future prospects of the portfolio companies, and sponsors will face similar considerations regarding valuation options and conflicts of interests as are discussed earlier in this note in the context of selling assets from an earlier fund to a later fund. Early and detailed disclosure to the investor advisory committee and investors more generally will be vital, with the investor advisory committee potentially taking on an oversight role in the process. Sponsors may also consider the Institutional Limited Partners Association (ILPA) guidance on GP-led secondaries.

In terms of the secondary transaction process, the buyers of the interests will need to perform focussed due diligence on the underlying fund documents, and will likely want to take on all side letter rights that already exist and are capable of being transferred with the interests. Issues of concern include any required notice periods for the transfers, any rights of first refusal in favour of the fund sponsor, any transfer expenses to be covered, any residual liabilities to which the seller is subject, any alternative investment vehicle (AIV) interests involved that need to transfer to the buyer, any existing credit facilities relating to the fund interests and borrowing base inclusion of the seller as well as any LP giveback rights that may apply to the seller.
ESG and reputational considerations

Whatever method sponsors and investors look to for providing additional capital to portfolio companies, the pandemic is above all a human and social crisis.

The way businesses respond in the short-term will likely be judged in the longer-term, not least from a reputational and ESG lens. Sponsors will need to consider the social impact of their decisions and whether they are doing the “right thing”, particularly by individuals who work in their portfolio companies, and consider how the funds industry can help to fuel the economic recovery. Institutional investors, many of whom are subject to their own ESG requirements and expectations, will need to have similar considerations in mind.

Related materials

This note supplements the wide array of Linklaters’ Covid-19 related resources which can be accessed here. In particular, we have notes on:

- Commercial and Legal Considerations for Private Fund Managers and their Investors (US version)
- Commercial and Legal Considerations for Private Fund Managers and their Investors (European version)
- DOs and DON’Ts for Financial Sponsors
- Considerations of the impact of Covid-19 under a leveraged loan facility agreement for financial sponsors
- Financial Sponsors – Putting Capital to Work in Uncertain Time
- Summary of global government support measures
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