Schulte Roth&Zabel

SRZ INSIGHT

Midyear Update — Trends in Private Equity Funds

Despite the COVID-19 pandemic and difficulties associated with virtual diligence and fund-raising, private equity fund sponsors successfully raised significant capital in 2020, and the asset class has continued to attract fresh capital in 2021, with Preqin reporting some $188 billion raised across 452 funds in the first quarter, up from $163 billion and 431 funds in Q1 2020.[1] A key to this success is the manner in which private equity managers quickly adapted to virtual fundraising, in addition to other factors such as an increasing level of investor tolerance for very large fund sizes in the private equity space.

The data indicates that an investment in a first-time private equity fund is sometimes rewarded with outperformance. PitchBook reports, for example, that as of Q2 2020, 17.7% of first-time private equity funds had an IRR of more than 25%, compared with 11.3% for funds that were a "fund IV" or later.[2] For investors capable of writing significant checks, an investment in a first-time fund will usually also mean a greater chance of influencing fund terms or gaining access to attractive co-investment opportunities. Nevertheless, as we observed in earlier market trends reports, 2020 saw more established private equity sponsors deploy their more extensive networks and human resources to extend their fundraising advantage over nascent private equity firms.

In terms of investment focus and investor demand, private equity funds are targeting industries that were particularly hard-hit by and related to COVID-19, such as airlines, hospitality, healthcare, fintech and commercial real estate. We continue to see investor interest in the illiquid investments held by core real estate funds and other long-term or perpetual fund structures. Assets held by core real estate funds, for example, allow for long-term investments, while simultaneously providing income through rents and other cash flows. This income assists sponsors to permit investors liquidity, if needed.

Warehousing

In terms of trends in fund terms, provisions allowing the "warehousing" of investments for a new fund pending a closing have been expanded to allow affiliated funds to warehouse for one another (as compared to the management company warehousing an investment while a fund is being raised). Warehousing in this manner is useful for those private equity fund sponsors who see a current opportunity but have not yet raised the capital to exploit it. We see similar expansion in provisions regarding co-investments, where a fund is permitted to purchase an entire investment and then sell down a portion of the investment being acquired to co-investors, including affiliated funds, after the closing. We continue to see warehousing across private equity, venture capital and other closed-end

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[1] *See* "Private Equity Recovers After Turbulent Year," *Preqin*, available here.

[2] *See* "LPs Bet on Emerging Fund Managers," *PitchBook*, available here.

fund categories, including credit funds, where a sponsor's strategy may involve amassing a pool of credit instruments for subsequent syndication.

SPAC IPOs Slowing, but Back-End Opportunities Persist

The fourth quarter of 2020 and first quarter of 2021 were extremely active periods for SPAC IPOs (with SPAC IPOs representing over 50% of the entire IPO market during the first quarter of 2021), but more recently the SPAC IPO market has slowed dramatically, due to recent SEC guidance suggesting that SPAC warrants be treated as liabilities rather than as equity. The static arising from this SEC guidance has also created challenges for post-IPO SPACs that are looking to complete business combinations, and has also dampened SPAC PIPE investment opportunities.

In particular, many SPACs will likely be required to restate their previously issued audited financial statements in order to address the concerns raised by the SEC. Target businesses will themselves also be subject to liability treatment for any outstanding SPAC warrants post-business combination.

Notwithstanding these issues, the sheer number of SPACs that completed IPOs during the six months through March 2021 means there is still ample opportunity for private equity sponsors to locate potential SPAC acquirers for their portfolio companies, and activity in IPOs, back-end business combinations and SPAC PIPE investments should all pick back up during the third quarter of 2021 after the SEC issues more detailed guidance, although the SPAC IPO market may lag slightly while the queue of existing SPACs is cleared through the completion of business combinations, and SPAC PIPE opportunities may be on more investor-friendly terms. Notably, we believe that the number of confidentially submitted SPAC IPOs is likely two to three times the number that have publicly filed but not yet completed IPOs.

Irrespective of how the SPAC market is being accessed by sponsors — for example, SPAC investments as part of an investment program, or launching SPACs independently —sponsors need to ensure that attention is paid to the conflicts created by these arrangements, and consider whether this type of investing is consistent with the existing investment strategy of their fund as marketed to investors. If this type of investing is not consistent with the existing investment strategy, the fund documents will need to be updated, possibly with investor consent.

There are also a number of potential tax issues. Non-U.S. funds and funds with non-U.S. partners should consider potential FIRPTA implications relating to their SPAC investments (including warrants), if they might own or be treated as owning more than 5% of the SPAC. Taxable U.S. investors in SPACs that are organized outside of the United States should consider the application of the passive foreign investment company (PFIC) rules, including that a "qualified electing fund" election cannot be made on an option on a PFIC (including the conversion feature in convertible debt). In addition, managers that are sponsoring SPACs or that are investing in other SPAC sponsors should consider the additional tax considerations relating to those activities.

Rescuing Portfolio Companies — Watch for Conflicts of Interest

During the COVID-19 pandemic, we saw private equity fund sponsors try to raise emergency capital for their portfolio companies. We also saw private equity funds for whom portions of the portfolio remained illiquid past the scheduled expiration date of the fund. Although not limited to a rescue scenario, some sponsors raised continuation or "follow-on" funds as a means of holding assets for a

more extended period. The structuring of a rescue financing, or a continuation or follow-on fund, involves a number of potential conflicts of interest for a sponsor, which need to be approached thoughtfully.

If you have any questions concerning this *Insight*, please contact your attorney at Schulte Roth & Zabel.

SRZ lawyers regularly author articles, alerts and publications, providing their updated, timely views of the market trends affecting private funds and drawing on SRZ's decades of experience as the market-leading law firm serving the alternative investment management industry. For more market insights on current and emerging trends in the private funds industry, read SRZ's Private Funds Market Trends Report for June 2021.

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com

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