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Alert

Private Equity Sponsors — Considerations for Private Equity Sponsors related to the Effects of COVID-19

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For the private equity industry, the coronavirus pandemic ("COVID-19") is expected to pose challenges. But the industry has expected a downturn, and many participants view this as a time of opportunity and a chance to apply the lessons learned from the global financial crisis.

Impact of Travel Restrictions

The immediate consequence of COVID-19 is the impact of travel restrictions — primarily on sourcing and diligencing deals and on fundraising. Large private equity sponsors were among the first to announce remote working measures, and this movement has now extended to the management teams of portfolio companies and investors, but delays and inefficiencies will result. Potential government shut-downs and the resulting closure of regulatory agencies also will be likely to slow deals that are in process and awaiting approval. Fundraising from existing investors, for whom face-to-face interaction may be less critical than for first time investors, may still be possible. Fundraising from new investors may be difficult until travel restrictions and work from home requirements are lifted. If these restrictions continue for an extended period, fund sponsors are likely to seek investor approval for both longer fundraising periods and investment periods in order to deploy committed capital. It is too early to tell whether these restrictions will result in the extension of the terms of private equity funds.

Vulnerable Sectors — Importance of Balance Sheet Depth and Borrowing Capacity

The current situation is a threat to existing portfolio companies, particularly those in industries that will be hard hit as travel and entertainment expenditures are reduced — airlines, hotels, cinemas and the sports industry are already beginning to suffer. The private education industry may also come under pressure as school closures commence. In this environment, private equity firms that learned the lessons of the global financial crisis in relation to maintaining strong balance sheets and utilizing prudent levels of leverage will fare better than those that have been more aggressive in these areas. Now is the time to confirm the availability of credit lines for portfolio companies and consider drawing on credit lines where appropriate.

Fund sponsors should review the terms of their funds' governing agreements and their agreements with investors, including co-investors, to ensure they understand the leverage limits and how these can be exceeded if necessary. Leverage limits are typically measured at the time leverage is incurred, but declines in asset values can make it difficult to incur additional leverage, and replacement leverage is often problematic for the same reason. Similarly, fund sponsors should check whether other extraordinary portfolio company actions require investor consent (including from co-investors). If fund sponsors need investor approval, they should make sure communication lines are open, especially since investors may be busy and hard to reach.

Buying Opportunities

Despite these immediate concerns, the current dislocation will present opportunities, and in the longer term the private equity industry has strong reason to feel positive about the outlook. In the global financial crisis, funds that had sufficient capital to put to work did well, and those that were able to acquire deeply-discounted assets were strong performers in that vintage. The industry is sitting on record levels of dry powder (currently estimated at $2 trillion), and several of the world's largest fund sponsors have just closed flagship funds of record size. Given the recent years of record-high valuations, these fund sponsors will feel optimistic about hunting for deals as prices decrease, particularly in a low interest rate environment and with access to financing from the private credit industry. The immediate reaction of many of our clients to the recent significant market movements has been to prioritize the search for new investment opportunities.

At the same time, many of our clients will also face challenges in carrying out exit strategies for their existing portfolios. Funds that are lenders are structuring covenants and other protections to protect against a deepening impact of COVID-19 on borrowers.

Other Limitations in Fund Documentation

The current dislocation will not only affect the number and pricing of investment opportunities. It will also have short and potentially longer term impacts on the types of investment opportunities fund sponsors may wish to pursue, as certain industries thrive and others suffer in current conditions and as the COVID-19 crisis eases. In evaluating new opportunities, fund sponsors should consider the nature of the investment strategy and risk factors that were disclosed to investors in their fund's offering documents as well as the investment limitations in their governing agreements. If the COVID-19 crisis has materially affected a fund's original investment strategy and the fund sponsor feels the need to change direction, the fund sponsor should analyze the breadth of the investment purpose stated in the documents to determine its ability to shift the investment focus of existing funds, or alternatively, the level of consent (whether of investors or the limited partner advisory committee) required to change the investment purpose. It should be noted that such significant amendments are often difficult to obtain. Fund sponsors should be keeping a close eye on other restrictions or terms on which they might seek to rely in a new investment landscape, such as provisions governing recycling and follow-on investments. Portfolio companies may be in need of additional equity capital as well as credit lines as a consequence of the COVID-19 crisis. Now is the time to consider which strategic amendments to fund documents might be required. Alternatively, fund sponsors may wish to form new funds to pursue new opportunities, which will require evaluation of their key persons' time commitment covenants, successor fund covenants and provisions relating to allocation of investment opportunities and, of course, the impact on fundraising noted above from restrictions on work and travel.

Management of Conflicts

Additionally, the current credit dislocation increases the likelihood that fund sponsors may wish to invest in different levels of a portfolio company's capital structure. In some cases, these new investments may be made through different funds. Rescue refinancings, purchases of distressed debt and similar credit strategies can create fiduciary issues for fund sponsors trying to balance the best interests of investors in credit products with those of investors in their private equity funds. Fund sponsors will need to focus on the promises made to investors in existing funds with respect to management of these types of conflicts and the fiduciary overlay created by law.

New Products

The current environment may also enable some fund sponsors with distressed opportunity strategies to activate "flex" funds that they raised specifically to invest upon a credit dislocation. That dislocation has now arrived. This may also be a good time for fund sponsors in many strategies to consider launching co-investment "spillover" funds to pursue opportunities that exceed concentration limits in existing funds.

Marketing

Closings

Periods of uncertainty are usually accompanied by significant slowdowns in both deal execution and fundraising, and we should expect the current situation to be similar. We can expect significant disruption until there is consensus that stability has resumed. In the very short term, fund sponsors should therefore focus on achieving what they can before deals and fundraising slow to a point where further activity ceases — for example those with fund closings pending should prepare for closings when physical meetings are not possible; e-signature systems such as DocuSign may prove helpful in this regard.

Risk Disclosures

Those fund sponsors still actively marketing products should also look at their risk disclosures to ensure that they add additional risk factors that capture the possible impacts on their business. Risk factors will likely need to be updated to address the general risks presented by the COVID-19 pandemic as well as any specific risks to which the particular fund is exposed (e.g., investments in travel, hospitality, sports or entertainment companies or properties).

Valuations and Performance Information

Disclosure of valuations and past performance is another area that fund sponsors with funds currently in the market should consider. Current market conditions may have a material effect on the accuracy of disclosure of past performance and the most recent valuations of unrealized assets, and fund sponsors may need to add appropriate caveats, particularly if past performance resulted from investment in industries or regions disproportionately affected by current events including COVID-19 and the pricing war in the oil and gas sector.

Operational Challenges

Reporting

Operationally, fund sponsors will need to consider how portfolio monitoring and reporting will be maintained if most or all of their teams are working from home. Things as basic as whether team members have adequate home working arrangements are important, as well as more complex questions such as how data security can be maintained in a remote working environment.[1] The closing of offices at investment firms and their service providers also creates challenges for timely reporting. Given the intense focus on, and elevation of, the quality of fund administration and operations industry-wide since the global financial crisis, it is unclear how investors and regulators will react to delays or

[1] "Cyber Security — Homeland Security Warns of Coronavirus-Related Cybersecurity Risks — Considerations for Private Fund Managers," *SRZ Alert*, March 16, 2020, available here.

reductions in reporting. We have seen instances of regulators taking steps to grant extensions and other leniency in response to the reality that many personnel are now working remotely.[2] Fund sponsors should consult with counsel if they anticipate that reporting obligations or other regulatory obligations will not be met.

Business Continuity Plans

In addition to evaluating the effectiveness of their own business continuity arrangements, fund sponsors should evaluate the steps being taken by portfolio companies and relevant counterparties. In this regard, the addition of specialist "operating partners" (a role fulfilled by a person with industry experience who is usually seconded to a portfolio company by a private equity owner to drive the 100-day plan for a new acquisition or lead the turnaround of a struggling asset) to many fund sponsors' teams since the global financial crisis should be of great assistance.

Conclusion

There are a number of challenges facing the private equity industry given the current global situation, but fund sponsors that are prepared can weather the crisis and take advantage of the opportunities presented. History tells us that there is always light at the end of the tunnel. We must be cautious in the present, but ready to move quickly when that light arrives.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[2] "Form ADV — Coronavirus Update for Private Fund Managers — Limited SEC Form ADV and Form PF Filing Relief," *SRZ Alert*, March 15, 2020, available here.