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UPDATE

Private Capital - Key Fund Takeaways from the IBA Conference

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In March 2023, members of Mourant's global funds team attended the International Bar Association's excellent 21st Annual International Conference on Private Investment Funds in London. The Conference offered the opportunity for global funds lawyers to share recent experiences and hear from leading fund sponsors and their GCs. Given Mourant's strategic focus on private capital and building on our Private Capital Perspectives Podcast Series, we're pleased to share some key takeaways from the conference.

What have been the biggest changes in the Private Capital industry since 2019 IBA conference?

2019 to 2022 saw a period of rapid growth and innovation (in fund terms, structuring etc.) but converging with a steady increase in regulatory pressure. On the whole, the private capital industry has fared better than other industries in terms of managing post-Covid labour issues as Covid has driven the push towards technological workplace flexibility, albeit with attendant IT security risks. Regulation has made its presence felt in the sphere of M&A activity, which has become more complicated and political as enhanced national security and FDI clearances have emerged. Brexit has caused a shift in operations for some managers. 2020 marked an unexpectedly massive deployment year against the backdrop of Covid.

Current headwinds

As 2023 progresses, we can look back to H2 2022 to see a significant fall-back in fundraising, deal activity, relative to the buoyancy of 2020 and 2021. This has been driven by high inflation and rising interest rates as all the usual assumptions underpinning the unprecedented growth in 2020 and 2021 have come to be re-assessed. Deal conditions remain difficult, with reluctant sellers who don't yet want to lower valuations facing off against buyers whose costs of capital have risen and whose access to finance has been constrained. The recent SVB collapse is ultimately a symptom of the altered interest rate environment and may further constrain access to finance in the months ahead. Asset hold periods will inevitably extend.

When will markets and activity levels stabilise?

The sense amongst IBA commentators was that the current adverse market conditions will likely persist through 2023, particularly in light of the SVB collapse and the possibility of other banks and adjacent businesses coming under pressure. But compared to the 2008/2010 crash, market conditions are not as severe, the industry can now absorb shocks more easily and there is confidence that GPs will see the upside potential of investing through this cycle and the huge wall of capital and investment pressure will likely force more activity later in the year. DPI (total capital return) remains highly important to LPs and they will want to see GPs taking the right opportunities to buy and sell assets notwithstanding the downturn.

Many GPs at the IBA conference were optimistic about the medium term, pointing to strong pipelines and good opportunities, particularly in the context of technology (with AI pointing towards a new 'Industrial Revolution') and sustainable investments. They also pointed to the emergence of alternative financing sources, with opportunities in the private credit market offsetting constraints on bank lending.

As one commentator put it: outperformance still sells and there's lots of creative work going on within GPs to deliver it.

Fundraising

There was already evidence of LP exhaustion in 2022 following the frenzied activity of 2020 and 2021, even before the altered inflationary and interest rate environment cooled the market. Although fundraising numbers for 2022 were lower than 2021, they look reasonable in an historical context. As we enter into 2023, there is a sense that the era of 'one and done' has ended, at least for a time. Larger GPs remain keen to grow their AuM and have swept-up significant tickets but with so many managers in the market, only marginal space has been left for small to mid-sized GPs. Many LPs are feeling the need to sustain a larger liquidity buffer, therefore writing smaller tickets. The growth rate of larger GPs is starting to stall and they, and many small to mid-sized GPs in the market, are extending their launch times. Although many GPs are eventually hitting their fundraising targets, hard caps are becoming a thing of the past (other than for perhaps 20% to 30% of GPs), with a fair amount of secret adjusting down and, where hard caps are set, they are often being lowered (eg to only 5% above target). One placement agent predicted that around 75% of the capital raised in 2022 would be raised in 2023 but that the current slow-down feels like a '2 to 3 year problem'.

The tougher fundraising environment is having a number of industry impacts. GPs are now looking for more flexible fundraising timing from their LPs and, generally speaking, that is being accepted. 18-month fundraising periods plus extensions are becoming acceptable in fund LPAs.

Those longer fundraising periods are giving rise to new concerns however, including disruption to fundraising and investment teams as projects get backed-up and LP question investment valuations during the fundraising period, with admitted LPs wanting values written-up and incoming investors wanting them written down. Use of sub-line facilities may smooth those equalisation issues but sub-lines may prove harder to obtain where there is a longer fundraising period.

Against a backdrop of slower fundraising, some GPs are thinking creatively to accelerate their investment programmes, including participation in 'co-controlled' deals with other sponsors.

Growing LP power?

Tougher fundraising conditions are also pointing to an increase in LP power, with more LPA negotiation and more and longer LP side letters (with bespoke ESG reporting requests from LPs a key theme). GPs are seeing a deeper LP focus on portfolio company valuations and deal value whilst public markets are suppressed. Co-investment requests are also on the rise, with varying degrees of complexity - see below. One commentator speculated whether the 2% management fee might come under pressure in private equity in the same way that it has in the real estate and credit fund markets, albeit offset against a step-up in carry in a more volatile market.

Fund and portfolio company finance

For a number of commentators, pre-SVB collapse, the use of sub-line facilities has been frequent and they have become largely uncontroversial, particularly during the fundraising period where they have helped limit equalisation rate changes. Credit facility use has become much more varied and sophisticated and, thus far, investors have been reasonably accepting.

Since 2022, terms and pricing have shifted towards banks but GPs have generally been able to secure finance.

There was a sense that, although perceived as presenting a very limited credit risk to banks given strong LP covenants, because sub-line finance offers lenders lower margins, some providers have fallen away. As mentioned above, it was also remarked that it may become harder to obtain sub-line funding against the backdrop of longer fundraise periods.

As regards the impact of the SVB collapse, one commentator expressed the hope that it would prove isolated but some agreed there is likely to be more LP scrutiny of financing arrangements and more innovative financings will likely be ratcheted back given shifting risk appetites. Fund finance will remain a core part of the business but it will become harder to implement.

In respect of NAV facilities, not all commentators were supportive of their use but it was recognised that, having initially emerged as a means of managing distressed scenarios, like the expansion of the secondaries market, NAV facilities have now become more mainstream, representing a diverse and creative universe. Some felt their use was now at an inflection point, with some LPs becoming more cautious, but it's clear they can provide useful and helpful financing flexibility to be assessed on a case-by-case basis.

In the context of deal finance, some have employed more innovative deal structures because of financing constraints and it was felt that credit fund GPs will enjoy possibilities to expand given likely bank market shrinkage and tougher lending terms.

Where portfolio companies bank and whether they rely on a single provider will come under scrutiny. Whilst the central bank and regulator step-ins on SVB have been very helpful, pressure on smaller banks is now being felt given heightened risk management and diversifications concerns.

Borrowing limits: LPA trends

Although fund LPA borrowing limits set at around 20% to 25% of commitments have remained common, there is evidence of borrowing limits increasing to 30% in more cases. There is also a sense of LPs and lenders entertaining more flexibility around borrowing periods, with more unlimited terms being seen beyond the more standard 12 month or 6 month terms.

Use of continuation deals to bolster liquidity

One commentator saw continuation deals emerging as a genuine fourth exit option for GPs - they are now entrenched and will very likely continue. Although the longer term implications of recycling assets has yet to be fully understood, investors appear to be more understanding now there is ILPA guidance in this area. That said, some felt it will prove challenging to 'pre-bake' continuation deal conditions into LPAs (particularly without LPAC consent) in what is an ever-changing market.

Recycling terms - more flexibility

It was remarked upon that many sponsors are seeking more recycling flexibility given external market constraints and that, used properly, recycling can and should add value for both GPs and LPs. That enhanced flexibility might be reflected in a move towards longer recycling periods. The credit fund arena is where the greatest flexibility around recycling terms is being seen.

The use of recycling certainly requires enhanced LP transparency as to how recycled proceeds are to be used. And its use will vary depending on fund strategy, being tolerated more readily by LPs in cash generative funds.

Secondaries interest grows

There appears to be more LP interest in secondary transactions and more evidence of GP interest in offering discounts. Multi-asset secondaries deals are becoming of greater interest relative to single asset deals. Much of the increased activity is being driven by high quality GPs undertaking high quality asset deals.

In terms of LPA drafting to facilitate secondaries transactions, there was discussion of the LPA terms that are starting to emerge, particularly around whether IAC approval is needed or not, the allocation of expenses, carry roll over and third party investor participation. There were contrasting views on whether IAC approval would be needed – some thought it inevitable and not worth contesting in LP negotiations, with others suggesting GPs can avoid going to the IAC if they provide fairness opinions and a third party investor is taking a reasonably large stake. One to watch…

Co-investment – ubiquitous and growing in complexity

There was a clear sense that more LPs want more co-investment opportunities, particularly in the credit space. Co-investment is becoming a key feature and co-investment structuring is becoming more sophisticated, with some structures looking like small fund raises. More LPs are starting to build capability to manage their co-investments internally whilst others remain content to outsource. GPs are also ramping up their ability to offer co-investment, including through the creation of single managed accounts (SMAs) for investors.

The increasing complexity around co-investment arrangements reflects diverging LP requirements – one size rarely fits all. New developments include:

1.1. overflow vehicles launched post-closing, with multiple investors – here complications can arise around management of LP op-outs and allocations and whether the sponsor retains investment discretion or not; and

1.2. 'funds of one' for multiple co-investments by a single LP, sometimes the vehicle and sometimes managed by the LP in-house and sometimes by the GP. It provides an opportunity for LPs to participate quickly through a vehicle that's ready to go.

Some larger sponsors are seeing 'priority' co-invest groups or clubs emerging, with 'waterfalls' of co-investors where the largest LPs take priority, but it was noted that allocations and op-outs can be difficult to negotiate and agree in these scenarios.

There is some variety in allocation of broken deal expenses between funds and co-investment vehicles. In the main they are being borne by the fund on the basis of clear PPM disclosure, but new regulations emerging in the US may mark a switch towards *pro rata* allocation between funds and co-investment vehicles. Allocation of expenses to SMAs is more common.

Fund-level GP fees are generally not also being charged to PE co-invest vehicles which remain largely 'fee free' but in some cases administration fees and some carry may be charged to co-invest vehicles, particularly where created for new LPs.

Some great deals are being negotiated by LPs, but will there be a lasting effect of concessions given in the current market? That remains to be seen.

Managing capital structure conflicts

There was interesting discussion around the management of conflicts of interest arising where there are multiple investments in a single asset by multiple funds and vehicles all advised by a single advisor. In these situations the handling of portfolio company bankruptcy scenarios is a particular concern, in terms of managing differing outcomes for equity and debt holders advised by a single advisor. The issues to consider can include use of ethical walls, setting internal policy position limits, setting notification thresholds and determining whether clearance of such conflicts requires IAC consent or notification – the latter may be more tolerable where the PPM discloses the possibility of such conflicts arising. In some cases caps may be imposed on the permitted size of debt investments and sometimes agreements are reached between the connected parties on voting mechanics (ie with no ability to vote on an equity stake if the group does not have control of the portfolio company). Some larger sponsors simply do not allow their debt and equity funds to invest in the same portfolio companies.

Risk management

A combination of factors has placed real pressure on sponsor and portfolio company risk management functions in recent years, with the build-out of risk management capability front of mind for sponsors and their GCs – it's commanding a huge effort.

Larger sponsors have seen significant growth in their risk management teams (beyond the GC group function), with significant investment in technology for risk management systems and controls and the collation and sharing of data appropriately throughout the sponsor group. Creative solutions for managing legal risk are often needed, particularly in smaller sponsors, given the desire for separation between the risk management and deal teams.

Particular new areas of risk management focus have been sanctions monitoring (and responding to LP information requests around Russian exposures) and investor ultimate beneficial owner information gathering. At the portfolio company level, monitoring cyber risk, ESG compliance and data protection compliance have become more time consuming, with examples shared of highly sophisticated phishing attacks which under-score the need to upgrade portfolio company and service provider IT due diligence. The SVB collapse has flagged the importance of risk management and will likely place more pressure around banking diversification. LPs are requiring more (and more robust) information and speedier response times. For larger sponsors with hundreds of portfolio companies, technology is key to managing risk management and reporting across their portfolio company platform. As one GC put it, GPs need to bear in mind that the reputational risk attaching to their portfolio companies will likely extend to GPs and their funds.

ESG

There was much discussion of the complexities of ESG compliance against a backdrop of divergent global rules and LP requirements in relation to ESG reporting. The ESG elements of LP side letters are becoming ever more demanding and complex and it's becoming harder to satisfy all LPs. There was also debate around shifting ESG compliance norms against the backdrop of the EU's SFDR. There was a general sense that most PE firms are moving towards the pragmatic alternative of Article 8 SFDR compliance, although some investors still prefer the 'stamp' of Article 9 which had seemed the default route a year or so ago. There has certainly been a movement away from Article 6 compliance with reporting.

In terms of managing the ESG compliance burden, where larger sponsors have built centralised global marketing and operations in the EU, that has given rise to much higher levels of EU SFDR scrutiny, with a challenging impact on collating data from their investment teams. It was agreed that sponsors of any scale now need a dedicated ESG person or team, distinct from the GC team.

New products - more evergreen funds?

A number of the larger sponsors present at the conference confirmed they are already 'multi-product' providers, able to build AuM by expanding their offering to their investor base, with some providing PE, infrastructure, sustainability, core-plus RE, credit and direct lending products under one roof. But whilst looking for these opportunities to expand the product range, it remains important to nurture and repeat their existing, successful products.

There was much discussion of creating evergreen or permanent capital fund products, offering enhanced liquidity for investors and less cyclicality for GPs. Some larger sponsors are adding them to their product list and some LPs are curious about them, particularly family offices. One commentator flagged, however, that the 5 or 6 year lock-ups common to evergreen products constrain the enhanced liquidity they offer.

In general, the sense was that evergreen products will remain a small proportion of the private capital industry and the 10 year fund, with extensions, will likely continue to be the norm, albeit with some longer life funds and more continuation funds emerging.

Tapping retail investors

With most sponsors looking for new sources of capital, it's unsurprising that some larger multi-product sponsors benefiting from larger balance sheets and/or insurance arms have been exploring retail investor strategies, including the growing 'mass affluent' market. One large sponsor had been running an investment trust product since 2007 as a means of offering public market liquidity and retail investor access. But upgrading to insurance company or similar status to access the retail market brings with it increased regulatory hurdles and the need for an adjusted risk management framework suitable for retail investors. It is clear that sponsors will require greater human resource to follow the retail investor opportunity.

Smaller GPs may explore enhanced access to the retail market indirectly in reliance on suitably licenced intermediaries such as wealth managers and pension funds, and they will likely watch on and learn as larger sponsors seek to navigate more direct access to the retail environment.

There was generally a sense of nervousness at the increased regulatory implications of offering to retail, with the SEC confirming its enhanced focus on private capital investors as the nature of the investor base shifts. With more retail ($1m/2m ticket) investors expected, GP knowledge of its client base will be important and sponsors can expect an increased SEC focus on investor identity and suitability in regulatory exams. Potential liquidity mismatch issues and appropriate ESG disclosures for the retail market will also need to be carefully considered.

Trends in hedge, hybrid and other open-ended funds

Hedge fund performance was negative overall in 2022, largely as a result of market turmoil impacting equity and event-driven strategies in particular (not to mention crypto). However, there were pockets of success given the variety of asset classes and strategies represented, including commodities and global macro, which were able to benefit from the market volatility. Coupled with a challenging fundraising environment, redemptions exceeded subscriptions, disproportionately affecting smaller managers. On the other hand, some redeeming investors sought to revoke their redemption notices, which was met with mixed responses. Of the investor inflows, there has been a flight to quality, with interest being seen from North American and Canadian pension plans and Middle Eastern investors in particular. SMAs have become the current flavour of the month for family offices and bank platforms who don't want to be exposed to other investors' redemptions, want greater transparency and, to a lesser extent, their own terms, but as a *quid pro quo* managers are seeking to lock up investors for longer periods (12 months rather than 60 days).

A couple of trends have emerged in relation to fees. Managers are, where able, making use of modified high water marks (HWM) to smooth over the business risk of having insufficient capital where budgets have assumed a certain level of performance fee. Some managers are also allowing investors to buy into the HWM as a sweetener to invest.

From a regulatory perspective, managers have been frustrated by the new US Marketing Rule, which requires net performance to be disclosed whenever gross performance is presented, even on an attribution or per asset basis, which has led to unhelpful results that are potentially misleading but for the extensive accompanying methodology disclosures. There is also industry wide concern about the proposed US Private Funds Advisor Rules, which will, if enacted in their proposed form, limit a manager's ability to pass through certain compliance and investigation expenses. This would impact hedge fund platforms that pass through costs to investors, resulting in a potential change in terms.

Finally, the impact of SVB's collapse has also been felt in the alternatives space, including in relation to sub lines, investor defaults and, where funds hold unencumbered cash with faltering banks, the hard decision of whether to continue to maintain deposits at such banks and risk a loss or to move deposits to other bank accounts held by the manager and risk regulatory enforcement for breach of the SEC's Custody Rule. Accordingly, greater scrutiny is being placed on these issues by investors and consultants.

What are the biggest challenges and most exciting opportunities for GCs over the next 12 months and how can lawyers help?

For the GC of one large sponsor, the biggest challenge lay in managing technology and data - scraping the right data and feeding it into upgraded risk management systems, but the unusual market conditions are also creating lots of interesting investment opportunities.

Another commented that the GC seems to have become the quarterback for every back office process, given regulatory expansion. GCs need more help, more resources and more external advice. Against that backdrop, it's becoming harder for GCs to spend time on deal execution.

Elsewhere, there was nervous anticipation as to where new SEC rules will land. That, and the regulatory risks emerging from macro situations, will be a big area of focus over the next 12 months. Has the SVB collapse been caused by a regulatory gap that will precipitate new regulations? Close attention will also be paid to likely enhanced regulation of the alternative credit space.

On the positive side, one GC commented that the industry is now far more mature, with a greater appreciation of the mounting regulatory challenges, so GC resource requests are more likely to be listened to.

For more information on Mourant's Private Capital Perspectives or to share your insights, please feel free to contact us.

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