In Brief

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Assessing Private Equity Fund Amendments in the Current Environment

As the ripple effects of the COVID-19 pandemic continue to be felt throughout the global economy, it is becoming evident that liquidity will once again be a critical component of success for private equity fund managers. During and immediately following the Global Financial Crisis ("GFC") we observed that the difference between the success and failure of a private equity fund was frequently a function of whether the fund had ample liquidity to enable it to deploy capital both defensively and offensively to support its portfolio companies. In our analysis and observations, we saw that many of the funds that were most impacted were those that were fully invested entering the GFC and, as a result, unable to inject equity into their portfolio companies to cure breaches of debt covenants resulting from declines in revenue and EBITDA. Conversely, many funds that were only partially invested or had generous recycling provisions, not only had the capital to play defense with their existing portfolio companies, but were also able to make accretive add-on acquisitions to enable their companies to take market share and expand their footprints into new geographies.

PROPOSED AMENDMENTS

In the current environment, we are seeing private equity funds take aggressive action to ensure ample liquidity to both protect and enhance value. In addition to enacting a variety of portfolio company-specific measures, such as cost-cutting and drawing down on revolving lines of credit from lenders, General Partners ("GPs") have started approaching their Limited Partners ("LPs") with a series of proposed amendments designed to provide funds with added flexibility to deploy capital.

These amendments include proposals for a number of solutions, including:

Enhanced recycling provisions

Often, funds are only permitted to recycle certain types of distributions, such as returns of capital, during a particular timeframe (most commonly, the investment period). Funds are now seeking greater flexibility to recycle different types of distributions, including gains, income and dividends, and to loosen limitations on the amount of recycled capital that can be put to work (one common example we see is that aggregate capital deployed cannot exceed 120% of commitments).

Modifications to concentration limits

Add-on acquisitions and defensive equity cures may conflict with geographic or other concentration limitations contained in a fund's governing documents (e.g., 20% cap on non-U.S. investments).

Expanded ability to purchase portfolio company debt

Some funds have limits on the amount of debt versus equity that can be acquired (e.g., 10% cap on debt purchases for an equity buyout fund). Other firms with multiple

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CASE STUDY: ENHANCED RECYCLING

Background
A middle market buyout manager has a strong historical track record over multiple funds and market cycles and is seeking to improve its ability to defensively deploy capital into its existing portfolio companies, while looking offensively for areas of opportunities (e.g., add-on investments at attractive valuations). The manager's Fund IV is mid-way through its life (i.e., post-investment period) and has limited dry powder to put to work.

As a solution, the GP proposes to amend Fund IV's limited partnership agreement to adjust the recallable capital calculation (i.e., distributions that are subject to recall and thereby increase remaining commitment) to include not only return of capital payments, but also dividend and interest payments.

The proposed incremental recallable capital represents under 10% of the fund size and will not incur management fees. Additionally, the amendment also proposes to conservatively loosen the parameters of Fund IV's single investment concentration limit test.

GCM Grosvenor Consideration Process
In reviewing this amendment, GCM Grosvenor considered a variety of factors, including GP quality/reputation, market conditions, track record and GP/LP alignment.

Positives
- Strong manager with cycle-tested reputation
- Longstanding relationship (commitments to multiple funds with this GP)
- No management fees on incremental recycled capital
- Potential to protect portfolio companies that need additional capital, while providing flexibility to be opportunistic with add-on investments

Negatives
- Offensive investments (e.g., add-on investments) at this stage have the potential to increase the fund's lifespan
- Rapidly changing market conditions could lead to further deterioration of certain portfolio companies to which additional capital will be deployed

Decision
Approve the amendment.

Case study for illustrative purposes only.

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strategies may have conflict provisions that preclude both their debt and equity funds from acquiring portfolio company debt, thereby limiting the equity fund's ability to buy mispriced debt.

Debt and structured equity at the fund level

A number of relatively new structured solutions have appeared, including those in which debt or preferred equity is added at the fund level rather than at the portfolio company level. In these types of transactions, the entire fund serves as collateral for the security, not just the individual portfolio company; as a result, these types of transactions can be less costly than a debt or preferred equity solution for a single portfolio company.

EVALUATING AMENDMENTS

In order to most effectively evaluate the proposals from GPs seeking increased flexibility in the current market environment, we believe that it is critical to have a well-developed framework in place. While the decision to approve or reject one of these requests is ultimately one that requires an evaluation of all of the relevant facts and circumstances, there are a number of elements that we consider as part of our assessment:

Manager Quality

Historical Performance

What is the GP's track record? A strong historical track record is often a testament to a GP's ability to successfully navigate complex situations by making sound operating and investment decisions.

Performance in Periods of Turmoil

Putting more capital to work with a cycle-tested manager helps potentially mitigate the risk of putting money into investments that may not have a high likelihood of future profitability.

Continued Support of Manager

Is this a manager that merits continued to support? Passing on an amendment may have negative implications on an investor's ongoing relationship with a GP. Ultimately, passing on an amendment may be the right decision, but before making such a decision, it is important to consider the full picture and make a balanced decision.

Scope

Implications of Proposal

Examining the proposed recycling amount relative to both NAV and original commitments is recommended, as it provides an indication of the significance of the additional capital deployment. Additionally, if the amendment is not approved, will the potential write-downs/write-offs result in meaningful impairment to the overall value of the fund? In certain situations, the potential to generate incremental value from the recycling may be outweighed by the risk of investing additional capital.

Intended Use of Recycling Proceeds

Does the proposal put more of the fund at risk by "throwing good money after bad?" Not all companies will succeed in these difficult times and, as a result, it may be advisable to ask the GP for a detailed plan specifying which portfolio companies will receive additional capital and how they plan to make use of such capital. That said, too many restrictions placed on a GP may in turn hinder the GP's ability to be nimble in this environment.

Playing Offense, Defense, or Both

Does the GP intend to use additional capital purely to cure breaches of debt covenants, or will the capital be used to make add-on acquisitions at attractive prices? Given the fluidity of the current situation, many GPs are looking to do both, but understanding a GP's strategy will help evaluate the potential implications of the incremental capital on the fund's performance and/or tenure.

Alignment of Interests

Current Performance Relative to Preferred Return Hurdle

How close is the GP to achieving carried interest in a fund? Does the proposal give the GP a "free option" to earn carry in an underperforming fund by recycling prior distributions into troubled companies that have a low probability of success, but potentially large upside potential? Essentially, it is important to ascertain whether a GP is risking carried interest or trying to achieve it.

Charging Fees on Incremental Capital

Will the GP earn management fees on the additional recycled capital? If so, what is the magnitude of the fee-earning recycled capital? It is important to look at the full picture, considering the fund's stage of life as well as other potential sources of management fees, such as successor funds.

Conflict Mitigation

Do the provisions of the amendment adequately ensure the continued alignment of interest between LPs and the GP? Additionally, it is prudent to examine the GP's other funds and verticals to ensure that conflicts are appropriately addressed. For example, will there be limitations on a debt fund's ability to invest in the equity fund's portfolio company debt?

SUMMARY

The current pandemic environment's effect on valuations and liquidity is undoubtedly a top-of-mind consideration for most, if not all, private equity investors. It is important, however, not to lose sight of the indirect impact that the current market has had on other less obvious areas, including the need to amend certain fund terms in order to provide the right GPs with increased liquidity and the ability to be opportunistic in this unprecedented environment.

While it can be daunting for investors to evaluate the recent deluge of fund amendments in the required turnaround times (which are often quite short), leveraging partners like GCM Grosvenor that have the resources and depth of experience necessary to fully assess these types of amendments can prove to be quite beneficial. As always, we welcome the opportunity to partner with other LPs and encourage you to reach out to us with any questions or requests for further discussion on this very timely subject.

ABOUT GCM GROSVENOR

GCM Grosvenor is a global alternative investment firm with $57 billion in assets under management in hedge fund strategies, private equity, infrastructure, real estate, credit, and multi-asset class opportunistic investments. The firm has specialized in alternatives since 1971 and is dedicated to unlocking value for clients by leveraging its cross-asset class and flexible investment platform.

GCM Grosvenor's experienced team of approximately 500 professionals from diverse backgrounds serves a global client base of institutional and high net worth investors. The firm is headquartered in Chicago, with offices in New York, Los Angeles, London, Tokyo, Hong Kong, and Seoul.

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