Schulte Roth & Zabel

Private Funds

Ideas for Raising New Capital During the COVID-19 Dislocation

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I. Introduction

As COVID-19 continues to disrupt the financial markets, private fund managers of all stripes (including private equity, hedge, direct lending and credit) are seeing opportunities to invest at prices that represent significant markdowns. Those with dry powder are readying themselves for a potential buying spree once conditions stabilize and pricing becomes more predictable. However, for those without dry powder, that were already fundraising or that were about to commence a new fundraising, COVID-19 has unsettled well-laid plans. These managers are looking for ways to raise new capital quickly and efficiently so as not to miss the perceived opportunities.

For managers that want to raise new capital in the short-term, it will be considerably easier to do so from existing investors rather than new investors, for the simple reason that it is presently very difficult for investors to conduct their customary due diligence for new mandates — they cannot meet the key team members face-to-face or conduct other forms of physical due diligence, such as site visits. Existing investors will likely not require the same level of in-person diligence. They often find it acceptable to diligence a new fund or investment over video or teleconferences, given they are familiar with the manager and its products, prior performance and infrastructure.

In this note, we will discuss fundraising alternatives, a recent government initiative ("TALF 2.0," as we refer to it) and additional practicalities that warrant consideration by managers seeking to raise new capital, as well as certain steps that managers can take to increase their chances of fundraising success.[1] We believe *adversity breeds creativity.* By using the lessons of past crises, borrowing features from tried-and-tested structures, and thinking creatively, we can help managers to best position themselves during the COVID-19 dislocation.

II. Fundraising Alternatives

A. New Funds or Variations on Flagship Funds

i. New Blind Pools

1. Possible, but May Require Concession

a. Managers that enjoy strong relationships with their investor base may be able to raise new blind pool funds during the dislocation. However, new blind pool launches, even those that include repeat business from existing investors, typically involve several months' work. In order to truncate the process and get back to deal-making quickly, managers that choose this option may need new features to tempt wary investors, as many did in the wake of the global financial crisis. Benefits such as "early bird discounts" and preferred co-investment rights worked in 2010-11 and will be tried again in 2020-21. In addition,

[1] This *Alert* does not attempt to discuss the many considerations of relevance to open-end fund managers seeking to avoid or address investor redemptions or to closed-end managers seeking more time to deploy committed capital. For a discussion of these and other items, *see* the *Alerts* for managers of hedge funds and credit, direct lending and distressed funds, available here, and private equity sponsors, available here.

managers may have to accept some downsizing relative to prior fund launches.

2. Other Options

    a. Alternatives for managers that would rather not attempt to build a new fund complex from scratch, depending on the manager's reasons for raising capital, include "annex" and "top-up" funds, "sidecar" co-investment funds, variations on existing funds (often referred to in this *Alert* as "flagship funds") and series or segregated portfolio company platforms. Each of these is likely to be significantly faster than a new blind pool fund launch, and if investors will move quickly, some of these can be up and running in weeks if not sooner.

ii. Annex and Top-Up Funds

1. Features — Annex Funds

    a. The "annex" fund is generally used to raise new capital for investments in existing portfolio companies of the flagship fund, and was a feature of the private equity and venture capital fund landscape after the global financial crisis (and, previously, the dot-com bubble). Managers that form annex funds will usually cause the vehicle to offer interests first to existing investors on a pro rata basis and then to third-party investors.

    b. The terms of annex funds usually include a significantly reduced management fee and performance-based compensation terms that net profits and losses of the annex fund against profits and losses of the flagship fund for purposes of determining the manager's carried interest (or, if applicable, annual incentive allocation). This is partly in recognition of the "good money after bad" concern associated with annex funds where the existing portfolio is perceived to be in distress. In some cases, transaction and monitoring fees are also forgone by the manager.

2. Features — Top-Up Funds

    a. A close relative of the annex fund, the "top-up" or "overage" fund is a product that invests alongside the undrawn commitments of the flagship fund in new investments. This product is also most often used by private equity and venture capital fund managers.

    b. As top-up funds are often an easier sell to investors, they tend to have more typical fee terms, but, generally, no management fees are charged until capital is drawn.

3. Considerations

    a. Both annex and top-up funds can be established quickly and efficiently, as their documents can be based in large part upon the documents of the flagship fund. But managers thinking about annex or top-up funds in the current environment can expect existing investors to have concerns. A number of actual and potential conflicts of interest must be appropriately addressed.

    b. In the context of annex and top-up funds that are created to invest alongside illiquid products (e.g., buy-out funds or closed-end (private equity-style) funds focused on real estate), the documents for the flagship fund likely provide that opportunities are owed exclusively to the flagship unless concentration or follow-on limitations have been reached. This may mean the manager requires a limited partner advisory committee or investor consent to permit the annex or top-up fund to co-invest.

    c. Even if consent requirements are not obstacles, because existing investors may have their own liquidity issues and insufficient capital to invest in the new product, they can be expected to pay careful attention to, in the case of an annex fund, the value attributed to the flagship fund assets in which the annex fund will invest, and, in the case of a top-up fund, the allocation methodologies employed going forward to share opportunities among the products. Independent valuation of assets may be required as part of a consent process or in order to allay these general concerns.

iii. "Sidecar" Co-Investment Funds

1. Features

    a. Managers typically expressly disclose to their flagship fund investors the prospect that, if an investment is deemed too large or otherwise inappropriate for the fund, the opportunity to co-invest alongside the flagship fund may be given to other products of the manager or third parties. A "sidecar" is a co-investment vehicle established by a manager to invest in one or more such "co-investment opportunities" (sometimes "overflow fund" is the term used for those sidecars whose mandate covers multiple co-investment opportunities).

    b. Sidecars may be blind pools or not (i.e., the manager may disclose the target assets to investors up front), and may be commingled or "funds-of-one." For hedge fund and liquid credit managers, sidecars can be a means of attracting capital to fund illiquid investment opportunities (e.g., in the activist and

distressed credit space). For private equity, venture capital or illiquid credit fund managers, sidecars can be useful if the flagship fund is subject to concentration limits.

c. Sidecars are most often structured as closed-end funds with a "back-ended" carried interest, paid to the manager only when all capital invested has been returned to the investor (and sometimes only after a preferred return). However, for certain sidecars that will invest in publicly traded securities, the manager might provide for a more hedge fund-like annual incentive allocation, based on realized and unrealized gains.

d. Fee rates, and the potential for netting with the flagship fund, depend on the rationale for the sidecar's formation and the time sensitivity, among other factors. For example:

    i. For sidecars in the nature of "best ideas" or "higher conviction" funds (more commonly launched by managers of hedge funds and other liquid strategies), fees are more likely to mirror the fees in the flagship fund.

    ii. In a case where capital is needed from investors in order to close a transaction (e.g., a control transaction), fees may be lower or, in some cases, zero (the bargaining power lies more with the investors than the manager).

    iii. When capital is used to enhance a strategy (e.g., an activist co-investment), fees are typically lower than the flagship fund, but the discount is usually smaller than in the preceding example.

    iv. Sidecars established for multiple co-investment opportunities will sometimes accept capital commitments and charge management fees on commitments. Alternatively, and perhaps more commonly for sidecars that make a single investment, the management fee is charged on either contributed capital, actively invested capital or net asset value.

2. Considerations

    a. In many cases, sidecars are offered to a more limited number of investors than is typical of a flagship fund and, therefore, the process for launching a sidecar, if investor demand is not an issue, can be very quick and efficient (in terms of timing, one to two weeks is not unheard of). In many cases, managers can do so without producing a full PPM (see discussion below).

b. Managers thinking about a sidecar need to review the co-investment-related disclosures in the offering documents of their flagship fund, and any relevant side letter provisions, to determine whether they are obligated to offer the right to participate in the sidecar to existing investors.

iv. Variations on Flagship Funds

1. Features

a. Opportunities

i. In the current environment, there should be opportunities for some managers to quickly and efficiently attract capital to variations on flagship funds. Narrower sector or geographic mandates and shorter windows for calling capital for investment and harvesting could be potentially attractive features. That said, depending on the nature of the flagship fund, adding variations may be more difficult (see “Considerations,” below).

b. Examples

i. We regularly work with managers across the private equity, hedge, direct lending and credit fund landscape to launch variations on flagship funds. We have worked with clients to launch:

1. In the hedge fund space, long-only versions of flagship long/short equity funds, sometimes providing that the performance-based compensation is due to the manager only if the product outperforms a benchmark;

2. Funds-of-one, for institutional investors to invest alongside the flagship fund;

3. Products, commingled and funds-of-one, that offer exposure to a specific subset of a flagship fund’s investment strategy;

4. More concentrated, “best ideas,” versions of flagship funds (again, more commonly for managers of hedge funds and other liquid strategies);

5. Versions that have a more limited geographic mandate than the flagship; and

6. In the hedge fund space, versions that have side-pocket mechanics as the distinguishing feature.

c. Structures

i. In terms of structure, variations are either:

1. A truly separate product (i.e., a new legal entity), but one with governing documents that are closely modeled on those of the flagship fund; or
2. A separate "sleeve" of the flagship fund (i.e., a new class or series of the existing legal entity).

2. Considerations

a. Each of these approaches (separate product or separate sleeve) can often be implemented without the consent of existing investors. However, closed-end fund managers will generally have a harder time taking this action unilaterally.

b. Given that closed-end funds do not permit withdrawals, investors in closed-end funds naturally will negotiate for a narrow devotion of time standard for key investment professionals and some degree of assurance as to the flagship fund's exclusive right to receive opportunities that fall within its mandate, although usually subject to certain concentration limits. "Successor fund" limitations may also be obstacles to be addressed via limited partner or advisory committee consent in the case of such funds. Compliance with these covenants/limitations is obviously critical as a fiduciary, contractual and investor relations matter.

c. Therefore, as with annex funds and top-up funds, where a fund formed as a variation on a flagship fund will invest alongside the flagship fund or otherwise has an overlapping strategy, managers need to carefully consider their fund documents and their policies and procedures for addressing potential conflicts in the allocation of investment opportunities.

d. In addition, in the case of the separate sleeve option, care must be taken to disclose the risk of cross-class liabilities and, in certain situations, consent may be required, particularly if either the flagship fund's investment strategy or the new sleeve's investment strategy involves leverage.

e. Furthermore, true separate series require considerable care in accounting and record-keeping in order to ensure separation of liabilities (an exception being a new class that would add material risk for investors in the current class(es), e.g., the cross-collateralization risk discussed above).

v. Series/Segregated Portfolio Company Platforms

1. Features

a. Another option, which has gained currency in recent years and has potential under the current conditions, is the separate series fund (Delaware) or segregated portfolio company (Cayman Islands) platform.

b. This alternative involves separate series and/or segregated portfolios being established to pursue each investment and/or investment strategy in which the fund complex invests. Each such “portfolio” is segregated from the others in reliance on local law and treated for U.S. tax and other purposes as an entirely different entity.

c. Whereas in a typical fund structure, classes of interests are subject to cross-collateralization risks, this structure generally enables “ring-fencing” of liabilities incurred by individual portfolios.

d. There is considerable flexibility in this structure. The offering and governing documents will establish that each portfolio may differ from the others with respect to numerous terms and features, and those differences will be made clear to investors from the portfolio-specific offering materials, which will supplement or amend (or disclaim the application of) the provisions of the base documents.

e. Depending on the extent to which the menu of terms is set forth in the governing document, the portfolio-specific materials can take the form of a short appendix or term sheet, written on an exception basis. This “supplement” is deemed part of the governing documents, but trumps in the event of inconsistency. If new mandates involve risks or conflicts that are not addressed in the main offering materials, the supplements can address those matters on a case-by-case basis.

f. The platform, though it usually has an indefinite term, does not need to be confined to products that have open-end fund terms. For example, a hedge fund manager may envisage using the product for both liquid and illiquid opportunities. If so, we can include in the menu of terms the flexibility to incorporate into a given portfolio “private equity”-type features, including capital commitments, fixed investment periods, performance-based compensation in the form of a carried interest based on realized investment proceeds, tax distributions and no voluntary withdrawals. Those features can be provided for in the base documents and incorporated by reference into the terms of the given portfolio.

2. Considerations

    a. Certainly, the initial set-up of this type of fund requires a full suite of documentation comparable (in terms of effort) to a traditional blind pool launch, as well as some additional creativity. But we have several managers that have been successfully deploying this structure for many years and, therefore, we are well-placed to assist managers to build these products efficiently. Further, once operative, the launch of each individual portfolio can be completed very quickly — even more so if one individual portfolio is a successor to an earlier portfolio or part of a cluster of similar but customized strategies.

    b. A possible downside worth considering is that these structures involve the potential for duplicated efforts in vendor agreements and account establishment. In addition, lenders and investors may need to be walked through their operation, if not already familiar. But, for many managers, having the ability to launch multiple bespoke products quickly based on short-form documentation may outweigh such considerations.

B. Secondary Opportunities

i. Logistical Challenges

1. In the current environment, we think secondary fund managers may be able to launch new blind pool funds in the manner outlined above and that investors will see the possibilities of buying secondary interests at distressed prices, but that managers that try to launch secondary strategies will face logistical challenges. General partner-led secondaries, "strip sales" and other structured secondaries may be hindered by the necessity for investors to conduct in-person due diligence, not to mention the likelihood of asset prices remaining volatile for some time.

ii. Big Players Have the Advantage

1. However, this may not be true of all secondary strategies. The leading secondaries funds have exposure to a great many large and middle-market funds. Therefore, we think they will be less dependent than others on in-person due diligence. They have record levels of dry powder and can therefore close deals now. Further, their deal flows should be significant, given the predicted liquidity crisis and dislocation caused by the denominator effect of declining stock markets will create buying opportunities and put many managers under greater pressure to liquidate superannuated funds.

iii. We Expect a Rebound

1. In any event, when social distancing and travel bans are no longer obstacles and volatility subsides, we expect secondary activity to return

very strongly, with secondary buyers very actively pursuing deals and many opportunities for both buyers and sellers. It is well-known that fund vintages which coincide with an emergence from a financial crisis are usually among the best-performing vintages, and managers will be keen to raise fresh capital as early as possible following the subsidence of the COVID-19 crisis. Managers with assets to sell will be motivated to kick-start the next round of fundraising by returning money to investors fast enough for investors to reinvest in the manager's new product.

III. TALF 2.0!

A. A New TALF Program

i. Readers may recall the Term Asset-Backed Securities Loan Facility of 2009, called "TALF" for short and referred to here as "TALF 1.0." It was viewed by many as a successful, bipartisan feature of the economic recovery effort after the global financial crisis. TALF worked by providing financing to investors willing to invest in securitizations backed by a wide range of loans (e.g., auto loans and student loans). It worked then, it should work again now. On March 23, 2020, the Federal Reserve announced a new TALF program to support the economy.[2] TALF 2.0 (our name, not the government's) will be established to "support the flow of credit to consumers and businesses" and the term sheet for the latest TALF program has already been circulated to certain of our clients.

B. Solid Opportunity for Credit Funds

i. Credit fund managers in particular would be well served to start thinking about the structure and documents needed for a closed-end credit fund or sleeve and be ready to go. The structure of such a fund would likely need a subsidiary for each group of troubled assets purchased by the new fund. Following the TALF 1.0 playbook, the subsidiary would be the counterparty to the non-recourse, asset-based leverage offered by the seller. Managers should note that if their master fund is a non-U.S. fund, the structure will still work if the manager forms a U.S. subsidiary below the master fund to hold the TALF assets, but managers should be mindful that several limitations, at both the federal and state levels, exist with respect to the deductibility of interest expense for applicable tax purposes.

IV. Getting to a Closing Quickly: The PPM-less Fund Launch?

A. The "Super-Subdoc"

i. Where there is a single investor and speed is a consideration, we will often discuss with clients the possibility of raising capital for a new fund or sleeve with a "super-subdoc" (subscription document) rather than the longer, traditional PPM. A super-subdoc would generally consist of the manager's usual form of subscription document, plus (i) a term sheet describing the terms of the new product (albeit not always critical if investors will be party to a partnership

[2] *See* the press release issued by the Board of Governors of the Federal Reserve System: "Federal Reserve announces extensive new measures to support the economy" (March 23, 2020) (available here).

agreement); (ii) a description of the investment program; and (iii) conflicts, tax aspects, ERISA and risk factor disclosures and offering legends (the level of detail in the latter being somewhat dependent on the intended investors and their willingness to provide "big boy" (acceptance of risk) acknowledgements).

B. Limitations

i. While the super-subdoc sometimes makes sense, a PPM serves an important role in terms of providing certainty as to the basis upon which an investment was made and preventing selective disclosure and style drift.

C. PPM Supplements

i. Using a PPM supplement, rather than a full PPM update, may also be a means of saving time and costs. We have assisted managers to go to market quickly with a PPM supplement for long-only and other sleeves; even the more complex side-pocket sleeves. The PPM supplement works quickly and well where the information in the flagship PPM is still current and most of it is relevant to the new open-end sleeve and can, therefore, be cross-referenced for the reader. The PPM supplement approach also makes sense where the majority of the new capital will be raised from existing investors who are already familiar with the manager's flagship fund PPM.

V. Other Challenges and Considerations

As noted in certain of the SRZ Market Conditions Working Group's earlier *Alerts* (available here) and webinars, some challenges and considerations will be common to any attempt to attract new investor capital in the current environment. For example:

A. Fundraising Timelines

i. Notwithstanding the relative speed and efficiency of some of the above alternatives, timelines for fundraising will undoubtedly be impacted by the pandemic.

B. Valuations

i. There are several valuation-related items for managers to consider (see prior *Alerts* available here). In particular, to pursue any fundraising that pertains to an existing fund and its assets, managers will need to be comfortable that their valuation inputs and processes are sufficiently robust. In times of such volatility, it is important to think about the impact of recent shifts in value.

C. Updated Risk Factors and Other Disclosures

i. All offering materials need to be complete and accurate and fairly disclose material risks for investors. In light of COVID-19, we are assisting many managers to include risk factors relating to health crises generally and COVID-19 specifically. In addition, we are recommending to managers that they consider the extent to which COVID-19 requires updates to be made to or additional disclosures or commentary to be included in performance information or materials, including case studies.

ii. Depending on the approach taken to fundraising and deployment of funds raised, other risk factors in offering materials may require revisions. For example, has an industry sector described as an area of particular interest been hard-hit in the wake of the pandemic and is that appropriately addressed? If the new capital raised will be deployed on a tight timeframe, does the offering material appropriately address the risk that, at times, investment analyses and due diligence, negotiations and decisions may be undertaken on an expedited basis? There are several such possibilities.

iii. The impact of short-selling bans may be another factor to review. In this regard, see the numerous recent *Alerts* posted on our COVID-19 Resource Center, available here.

D. New DDQ Request

i. Many managers have long included a basic description of their business continuity and disaster recovery plans in pro forma DDQs or bespoke responses to investor questionnaires. Managers can now expect investors to request information regarding the manager's response to this pandemic. If the crisis has exposed room for improvement in business continuity plans or other policies, the rationale for any changes should be recorded for future reference.

E. Selective Disclosure

i. There are risks associated with any selective disclosure of information to investors. This is a significant item, as managers will undoubtedly receive inquiries regarding a number of matters; the impact of the crisis on the portfolio, the success or otherwise in implementing business continuity plans, and even the health of key persons have already been areas of inquiry.

F. Subscription Documents — E-Signatures and Notarization

i. Subscription documents should be revised, if necessary, to contemplate e-signature and, given the potential logistical difficulties, managers should discuss with their administrators whether notarization requirements can be waived.

G. Dealing Dates

i. Some managers, in the ordinary course, have been willing to accept subscriptions as of the first day of a month even if the capital has reached the fund on the second or third business day of a month. While extreme volatility persists, we recommend this practice be avoided.

VI. Conclusion

Although the duration and lasting effects of the COVID-19 pandemic remain highly uncertain, we expect many (if not a majority of) investment managers will seek to raise new investor capital, including to pursue new opportunities amid the current market dislocation. The prevailing view is that the pandemic will adversely impact fundraising for at least the next several months,[3] but not for everyone — strategies perceived to be non-market correlated or otherwise well-

[3] For example, see the Eaton Partners LP survey (results released March 17, 2020) (available here), and "Covid-19: Are first-time funds off the table?," Private Equity International (March 18, 2020) (available at here).

positioned to take advantage of current conditions may still do well. There are several fundraising options and steps that all managers can take to increase their chances of fundraising success. At Schulte Roth & Zabel, we will continue to monitor the impact of the pandemic on fundraising and other matters of interest to our investment manager clients.

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Please see our other Schulte Roth & Zabel *Alerts* relevant to investment managers, posted on our COVID-19 Resource Center, available here.

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