Asset Management Toolkit: COVID-19 Response

Funds Department

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Introduction

The global COVID-19 pandemic is an unprecedented situation that will have a long-term impact on the asset management industry, stretching well beyond the current period of lockdown.

As we move from the immediate response to medium and long-term planning, careful and measured analysis will be required by GCs, CFOs and COOs to consider the implications for the funds that are being managed and the asset management businesses being operated.

This briefing note is intended to assist with that planning by providing a checklist of issues to be considered.

To consider

- The immediate response for funds and asset management firms to the situation arising from the COVID-19 lockdown, including crisis management
- Medium-term planning, including the preparation needed to respond to an uncertain economic situation and the resulting challenges
- The longer term implications, including how to make the most of future opportunities

Immediate crisis management

Since the lockdown began, we have witnessed a number of different issues needing to be addressed by fund managers across all asset classes. Set out below is a summary of the key points you should be considering.

Investor Relations

Communications

The importance of letting LPs know how the investment portfolio is coping with the crisis should not be underestimated. It would also be prudent to discuss what the likely cash requirements will be as this will help LPs with their own cash management. Whilst the direct and personal touch is always important, GPs should ensure they are being consistent with the types of information and responses that are being provided to investors to mitigate selective disclosure issues.

Fundraising

There will be a drop in the amount of commitments raised in 2020. If a GP is currently fundraising, it would be sensible to be proactive and close investors into the fund as quickly as possible – even if this means more closings. Subscription facilities can be used to alleviate the practicalities of multiple equalisations.The environment tomorrow may be less certain than today. Further, we are seeing some GPs that are mid-fundraise with exposure to assets that are materially impacted by current events: it remains to be seen how that plays out, but in these situations we are advising GPs on a range of options including fundraising extensions, equalising new money at a valuation less than cost or hiving out the affected assets so that new LPs do not have exposure to them.

Operational Considerations

Valuations

The challenge of valuing assets in the current situation has been well-documented. Bodies like IPEV have issued special valuation guidance to help GPs provide the fair value information that they need. **See the IPEV special guidance here.**

Substance requirements

Substance requirements can be regulatory or relate to taxation. Key fund jurisdictions have relaxed (or it is expected will relax) aspects of these rules and/or published temporary guidance on how to comply with substance-based rules. In the UK, HMRC has emphasised that it will view **company residency** and **permanent establishment** issues in the round and not by reference to a one-off decision in the "wrong" place, but has not changed the rules themselves. We can talk you through the issues that arise in jurisdictions such as: UK; Luxembourg; **Ireland**; **Channel Islands.**

Force majeure

Many businesses have looked at reviewing their key commercial contracts to identify which contain force majeure provisions that could be triggered by the COVID-19 pandemic. We have developed a tool that allows contracts to be uploaded in bulk and be reviewed automatically, with a report indicating which contracts should be prioritised. If you would like further information, please do get in contact.

Monitoring the impact of different stimulus packages

The UK Response

The rapid global spread of the COVID-19 virus has resulted in significant market volatility and is placing an immense strain on the business community. **See the guidance** on our website designed to provide some answers to key operational and legal questions, and practical advice for your business in the face of the current crisis.

Relaxing the lockdown

The UK Government is under increasing pressure to set out how it proposes to manage a possible easing of the COVID-19 lockdown in order to allow more everyday activities to resume, particularly economic activity. We think it makes sense to look ahead to how the lockdown might be eased so that businesses can take appropriate steps to prepare, which we have set out **here.**

Global Restrictions

At a time when restrictive measures are being implemented by governments across the globe in response to COVID-19, we understand it is difficult for organisations to keep abreast of these developments. We are keeping a high level map up to date to encapsulate all the changes which you can find **here.**

Signing and closing logistics

Because of the lockdown restrictions, there is potential for disruption when signatories are forced to work remotely. This may relate to signing or witnessing key documents or holding fund closings through to more mundane matters such as providing KYC documents (including certified copies) or filing documents with statutory or regulatory bodies. Whilst it is usually possible to find solutions, particularly the use of platforms like DocuSign, the process inevitably takes longer and requires more planning. Further advice can be found **here.**

Regulatory requirements

Financial regulators have been taking action to address the implications of the crisis. In some cases, these include supervisory flexibility and forbearance in respect of certain regulatory obligations such as the 10% reporting rule and reporting to regulators and investors. In other cases, additional restrictions and requirements have been imposed such as the short selling restrictions in a number of EU jurisdictions. Further information can be found **here.**

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Immediate crisis management

Liquidity and Risk Management

Liquidity options

GPs should carefully consider what liquidity they are likely to need, both as the pandemic evolves and in its immediate aftermath. This is likely to include emergency funding for portfolio companies whose business has been hit by the pandemic. Is there sufficient liquidity in the fund as things stand? If not, the developing markets of NAV facilities and preferred equity are tailor-made for this situation. **You can find an overview of the different options here.**

Review any current fund-level facilities

GPs should review any fund-level facilities in the context of the pandemic. Matters to consider include: (1) are there any current or prospective breaches, for example as a result of a fall in valuations or an adjustment of the borrowing base due to certain investors being subject to an exclusion event; (2) are the facilities uncommitted and, if so, is there any merit in seeking to get some or all of them committed; and (3) is there merit in drawing the facilities in full now (most GPs have elected not to do so and we are of the view that this is generally speaking the correct approach). If you need help analysing these issues, please do get in contact.

Derivatives (at the fund level)

These can contain covenants which could be breached by sharp drops in the NAV of the fund, triggering termination rights for counterparties. Trading documentation should be checked to ensure that this is not the case or, if it is, that waivers are obtained. We can help you with this.

Future planning issues

Set out below are a number of key issues to consider over the medium term in order to adjust and respond to the COVID-19 crisis.

Liquidity and Risk Management

Analyse follow-on capacity for the fund

We are already helping clients with a lot of analysis on follow-on capacity for the fund and what 'recycling' is permitted under the fund documents. There may be some distributions that have been made historically which are, under the LPA, recyclable. Clearly, any GP needs to approach this in a responsible manner and be sensitive to the reaction of the LPs, but it may be possible to generate some additional liquidity without needing extra sources of capital.

Exchange rate fluctuations

We have seen increased volatility in foreign exchange rates. It will be important to look at existing arrangements (which could now be out of the money, perhaps significantly) as well as what arrangements should be put in place for the future (to lock in certainty, particularly if acquiring or disposing of an asset).

Operational Considerations

Check diversification limits

The fund documents may have restrictions on how much can be invested in different assets or geographies. As funds adjust to the crisis, it will be important to know what and where the fund can invest to comply with these requirements.

Extensions

It may be necessary for a GP to consider extending the investment period for a particular fund, or the overall term of the fund to provide more time to exit the remaining portfolio. There will be different consents and requirements to do this, which will need to be checked in order to plan properly.

Active management of the portfolio

Increasingly, GPs are looking at options to sell particular investments, hive-off specific assets into other vehicles or consider longer-term liquidity solutions for the portfolio. Early analysis of these issues from a commercial and legal perspective is important. Don't forget to think about the income based carried interest rules too: if you sell an investment sooner than expected, this could have an impact on the fund's average asset holding period and this could be relevant to the UK tax rates that apply to carried interest returns.

LPA amendments

Some of the mid-term planning may involve changes to fund documents. As a result, GPs are beginning to ask us about the process for making amendments. You should consider the thresholds for approvals and which groups of investors will need to be 'on-board' to approve changes. Should you be beginning to signpost your proposals to amend the LPA, for example with the LPAC? Are there any third-parties that would also need to give consent, e.g. lenders?

Remote working

With talk of second and possible third peaks in the COVID-19 pandemic over the next 12–18 months, it is likely that there will be additional periods of enforced restrictions or lockdowns. You should continue to monitor if key staff have the right resources and equipment to work remotely during this period. Asset management teams are often drawn from across the globe: if the head office is dispersed for the medium or long-term with individuals working from their home countries instead of from your usual base (e.g. a London head office), then this could trigger local tax and regulatory headaches. Also, it would be appropriate to check with service providers (lawyers, accountants, auditors, fund administrators) how their systems have coped with the lockdown.

Investor Relations

Speak to investors

Speak to investors about the timing and frequency of future capital calls. This will reduce surprises both for the GP and the LPs. If there is a risk that an investor may default, there are various strategies that can be implemented e.g. putting in place a subscription facility, delaying or reducing some investment activity or permitting LP transfers. In 2009, there were very few significant defaults by investors, partly because GPs and LPs worked together to get through the crisis.

Carry arrangements

Depending on how the crisis develops, it is possible that for certain funds the carried interest arrangements will be 'underwater'. This may necessitate a debate between the GP and LPs on whether to re-calibrate the scheme to provide the necessary incentives.

On-site meetings

Given the continuing travel restrictions and the need for social distancing, it is likely that the number of face-to-face investor meetings will decrease. This will give rise to challenges when organising due diligence meetings with existing or potential investors (which previously would have entailed on-site visits), to holding LPAC meetings through to hosting annual investor meetings. Investors will come to expect virtual solutions, but GPs will need to ensure they offer a technologically sound and robust solution (including understanding privacy and confidentiality restrictions). At the moment, it seems unlikely that these solutions will be a temporary fix for the next couple of months but rather could be needed into 2021 and, if travel becomes less frequent for investors, possibly beyond.

Fundraising planning

From talking to institutional investors, it is clear that there is a degree of optimism about the investment opportunities over the next 18–24 months. Analysis shows that alternative assets have generated strong returns during and after prior downturns and investors will not want to miss out. GPs should, therefore, be carefully planning their next fundraising, laying the groundwork with investors and making sure there is an allocation for the next fund.

Longer term considerations

It is clearly very difficult to predict the future impact of the COVID-19 crisis. However, it is possible to look to the lessons learnt from previous market disruptions, particularly the Global Financial Crisis and the recession that followed the dot-com crash.

Investment opportunities may change

Certain sectors are likely to be more attractive to investors, such as healthcare, life sciences and logistics. Companies that provide tech-enabled solutions for social-distancing policies will be highly prized. Given the possible downturn, there is likely to be an increased focus on distressed debt and special situations funds. Conversely, certain sectors such as retail, leisure, travel and energy may be less appealing.

Secondary activity

Although there is expected to be a dip in secondary activity as an immediate response to the crisis (partly arising out of the difficulty in valuing assets), longer-term it is likely that there will be an overall increase in the number of secondary transactions as LPs look to manage their portfolios and also deal with the denominator effect from the fall in the public markets. It's likely that GP-led solutions will form part of the response to the crisis, with certain assets and portfolios requiring more time and capital to maximise value.

Fundraising will be more challenging and take more effort

Raising for first-time funds will be even more difficult as LPs focus on existing relationships. This will be partly the natural reaction to concentrate on incumbent relationships but also will be a practical response to the difficulty of holding face-to-face meetings with new GPs. Even for established managers, the timing of going to the market will be important. Different fundraising strategies will be needed to ensure momentum within the fundraising process (for example, early-bird discounts on fees, giving LPs access to funds that operate different strategies and strengthening the investor-protection package for LPs).

It seems sensible to expect more regulation and changes in tax policy

Historically, this has been the response of governments to a financial crisis and even before the current crisis the UK government had suggested that there would be a review of the UK tax and regulatory regime for funds. It would be prudent for asset managers to prepare for this now, including coordinating with industry bodies so that a joined-up response can be made to proposed future changes.

Expect there to be a focus on ethics when governments implement their policies

Our view is that the COVID-19 crisis will change key aspects of the social contract. Taxes will almost inevitably rise to cover the cost of rescue packages and financial stimulus for business and this, coupled with the key role played by public services, will mean that business will need to contribute its fair share of tax. Even before COVID-19, the UK Chancellor of the Exchequer had announced an investment in HMRC's resources. We expect that the increased pressure on the Exchequer will mean more tax enquiries and investigations and we can help with these.

COVID-19 is not just an economic crisis but a socio-economic one

This is different from, for example, the GFC in 2007–2009, so it is likely that there will be a wider societal response rather than just a financial response. Asset managers should plan for an increased focus in society on areas like impact investing. In particular, we expect that the current focus on sustainability and the forthcoming sustainability legislation will continue to be a big priority for asset managers and LPs.

Using derivatives to gain exposure to assets or create leverage

An increasing number of managers are looking to use derivatives, such as total return swaps (TRS), to gain exposure to assets that they cannot acquire physically or to create leverage by taking economic exposure via a bank intermediary. The legal and regulatory considerations are complex but surmountable and we can help you with this.

For other COVID-19 related materials on our website click **here.**

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