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Marketing

Current Challenges and Constraints in Accessing Capital for PE Funds and Investments

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Three of the last four years (2019, 2021 and 2022) were the biggest for PE fundraising in terms of capital raised. As measured by deal volume, the last two years also rank as the best in the history of PE dealmaking. The tide is turning, however, as both areas have slowed significantly due to a variety of factors, including the cash squeeze from a slowdown in amounts distributed and an increase in paid-in capital; the "denominator effect" caused by volatility in public markets; ongoing macroeconomic and geopolitical instability; rising interest rates; and increasing regulations (particularly in the U.S.). Assets managers will need to become more adept at navigating these issues.

This article highlights the troubling trends that asset managers are confronting in their fundraising efforts, with a focus on increased U.S. regulations and a growing movement against environment, social and governance (ESG) investing. In addition, it will highlight different approaches asset managers can take to navigate those difficult situations, including to pursue alternative sources of deal funding and obtain more flexible fundraising terms.

See "SEC's Fall 2022 Reg Flex Agendas Offer No Relief From Relentless Rulemaking" (Feb. 23, 2023); and "PE in a Recession: Fortify Existing Funds in Accordance With Fund Terms, Obtain Liquidity and Manage Skittish Investors (Part Two of Three)" (Sep. 27, 2022).

Current State of the Fundraising Market

LPs continue to face constraints on their ability to commit capital to PE funds. In recent years, after a period of rapid deployment, GPs have been returning to the market more quickly and, until recently, seeking ever-larger pools of capital. On average, GPs were raising new funds every three years rather than every five years and increasing their fund sizes by 50% compared with their prior fund vintage. Those aggressive measures put a strain on LP resources to review the volume of investments.

At the same time, LPs have seen their exposure to PE increase and, combined with the significant amount of recently deployed capital that is yet to be realised, volatility in the public markets that has left many LPs' investment portfolios over-allocated to PE (*i.e.*, the denominator effect). That is despite an increasing appetite for alternative investments in recent years.

Macroeconomic instability has also spurred a flight to quality as LPs focus their resources on established teams with proven track records, prioritising existing GP relationships over first time fund managers and new relationships. Large, experienced GPs are reaping the rewards, as commitments to funds larger than $5 billion assets under management (AUM) comprised 57% of the total capital raised in 2022 according to Bain Capital, with 93% of those funds reaching their targets and, in the aggregate, raising 15% more than their stated target.

By contrast, only 50% of smaller funds reached their targets and experienced GPs whose funds were under $5 billion AUM collectively raised 9% less capital than they targeted in 2022. Although 2022 was the third highest on record in terms of overall capital raised, the number of funds that held their final close in 2022 dropped by a third year over year to the lowest level since 2016.

See "How Key PE Fund Terms Are Being Shaped by Current Fundraising Challenges, Liquidity Needs and Distinct Shifts in the Market" (Feb. 9, 2023).

Deal Funding: Recent Trends and 2023 Outlook

GPs are collectively sitting on a huge war chest of dry powder. Private capital at the start of 2023 was at record levels, with $3.7 trillion available to spend ($1.1 trillion available to PE funds) according to Bain Capital.

In the buyout space, however, the rising cost of debt (and the associated increased underwriting risk) led to a slump in leveraged transactions financed by traditional lenders, as syndicated loans for leveraged buyouts in Europe and the U.S. fell by over 50% in 2021 compared with the previous year. Given that high deal value typically benefits from large leverage transactions, the average deal size in 2021 was impacted and fell by nearly a quarter per Bain Capital.

That funding gap has been partly filled by alternative private credit lenders, who have remained willing to provide capital for larger transactions in club deals (albeit at lower levels, requiring borrowers to have a greater share of skin in the game). There have also been instances of GPs underwriting entire deals themselves, with the option to refinance at a later time as conditions normalise. GPs have also improved the feasibility of smaller deals through add-ons, which can be financed at the portfolio company level (where borrowing from traditional sources may still be available) and utilised as part of a buy-and-build strategy.

See "Trends in Private Credit Structures, Terms and Adoption Amidst Its Growth During a Challenging Market" (Apr. 6, 2023).

Ongoing economic uncertainty may also be resulting in a slowing of exits amidst uncertain valuations, which has a knock-on effect on available capital due to a lack of distributions to investors.

GPs relying on recyclable proceeds have had fewer options than in previous recent years, due to reduced demand from strategic buyers and tightening IPO markets. To overcome those issues, GPs have increasingly explored the use of net asset value facilities, which can free up capital later in a fund's life for reinvestment. Rising interest rates eat into GPs' margins, however, and, together with the ongoing economic instability, some lenders are reassessing their exposure to the area.

Challenges Raising Funds in the U.S.

GPs raising funds in the U.S. face additional complications from significant ongoing regulatory changes. There is a growing, partisan, "anti-ESG" movement at both the state and federal levels, along with new regulatory rules proposed by the SEC that will increase the burden of compliance by private funds.

In each case, the burden is likely to be proportionate to the size and scale of a GP and its U.S. presence. Although small- and medium-sized GPs with no U.S. presence and/or a limited U.S. AUM may see a marginal impact to their U.S. regulatory burden, a meaningful impact will be felt by GPs that are registered investment advisers (RIAs) and/or managing significant U.S. institutional capital. Ultimately, the barriers to entry and to scale are likely to increase due to the new regulatory requirements faced by GPs.

Anti-ESG Movement

State Level

Against the backdrop of a global consensus that has trended toward a "pro-ESG" investment framework, particularly in Europe, the recent ideological ESG divide unfolding at the U.S. state level demands attention. Although the U.S. has historically lagged behind Europe and other jurisdictions when it comes to ESG, over the past two years U.S. states have significantly upped the ante by enacting ESG-related legislation at record levels.

The "anti-ESG" movement has largely taken two main forms:

- an effort to prevent the discrimination or boycotting of specific industries of economic importance to certain regions, such as oil, natural gas or firearms (*i.e.*, anti-boycotting); and
- an effort to prohibit the consideration of E, S or G factors as part of a state entity's investment process (*i.e.*, ESG prohibition).

See "What Fund Managers Should Know About the Anti-ESG Movement Targeting State Pension Plans" (Oct. 4, 2022).

For example, Texas was an early adopter of anti-boycotting and passed S.B. 13 in 2021, preventing public entities (*e.g.*, state governmental pension funds) from investing in publicly listed companies that are deemed by the Texas Comptroller to boycott the fossil fuel and hydrocarbon industry.

Texas legislation also requires any Texas public entity entering into large contracts to receive a written representation from the contracting counterpart that it does not – and will not during the term of the contract – boycott Texas energy companies.

The second iteration of the anti-ESG movement has been championed by states such as Florida that have proposed legislation to require state and local retirement assets to be invested based solely on pecuniary factors without consideration of ESG factors. Florida House Bill 3 introduced in February 2023 would, among other things, require investment advisers or managers of Florida state governmental plans to annually certify that their investment decisions do not put other objectives (*e.g.*, ESG factors) ahead of pecuniary interests.

Texas has proposed an analogous bill, S.B. 1446, that would require similar certifications from any agent or portfolio manager of a Texas pension plan. Texas' proposed ESG prohibition goes further, however, by making "participation in, affiliation with, or status as a signatory to any coalition, initiative, joint statement of principles, or agreement" evidence of a violation of the law's prohibition of ESG investing. It is unclear whether that requirement would, in effect, prohibit a manager from being a signatory to an ESG-related association or initiative, or if it would compromise a manager's ability to enter into certain side letters or to invest in companies – or alongside other investors – that have their own ESG initiatives.

Federal Level

It is also important to note that the U.S. anti-ESG movement has taken root at the federal level. Although U.S. state public pension plans are governed by state legislation, U.S. private-sector employer plans (*e.g.*, 401(k) plans) are subject to federal law – primarily, the Employee Retirement Income Security Act of 1974 (ERISA).

In addition, federal administrations differ on ESG. Whereas the Trump administration issued a U.S. Department of Labor (DOL) rule requiring ERISA plan fiduciaries to only consider pecuniary factors when investing, the Biden administration overturned the rule to allow ESG factors to be considered alongside pecuniary factors. Biden's stance further inflamed the anti-ESG movement, as both houses of the U.S. Congress voted to overturn Biden's rule on March 1, 2023. Biden subsequently vetoed that legislation, proclaiming that "there is extensive evidence showing that [ESG] factors can have a material impact on markets, industries, and businesses." Congress attempted to override Biden's veto on March 23, 2023, but fell short of the required two-thirds vote.

See "DOL Proposes Rule Favoring Inclusion of ESG Factors in Pension Plan Investment Decisions, Further Negating Contrary Trump-Era Guidance" (Nov. 30, 2021).

Overarching Considerations

Most of the proposed anti-ESG legislation at the state level has not yet been passed into law. Although U.S. state governmental plans are not subject to ERISA or the DOL's ESG rules, certain governmental plans are subject to rules that are like ERISA and that are generally interpreted con-

sistently with ERISA. It remains to be seen how such state laws that restrict consideration of ESG factors will be interpreted or applied. In any event, it is apparent the anti-ESG movement will continue to grow at a rapid pace, particularly as the U.S. nears a presidential election in 2024.

Going forward, fund managers hoping to raise U.S. capital must actively stay abreast of ESG developments (often with the assistance of counsel) at both the U.S. federal and state levels, particularly if managers also fundraise in jurisdictions such as Europe which are normatively pro-ESG and must therefore navigate the complexities of conflicting ESG regimes.

U.S. Private Fund Regulation

Over the last few years, the SEC has considerably shifted its approach to regulating private funds by moving from a disclosure-based framework (where informed investor consent is dispositive) to prescriptive rulemaking (where certain types of conduct are prohibited regardless of informed consent).

The SEC has released numerous rule proposals that would significantly increase regulations applicable to the private funds industry, which has historically operated with limited regulations. The changes will bring the private funds industry closer to the environment enjoyed by retail investors, which requires enhanced reporting, has prescribed expectations on how certain activities should be conducted and offers much less freedom to contract. 2023 will mark a key year in the SEC's more rigorous scrutiny and enforcement of the U.S. funds market.

Since the start of 2022, the SEC has proposed the following rules, which have yet to be adopted but are expected to be finalized in 2023:

- Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews;
- Enhanced Disclosures by Certain Investment Advisers and Investment Companies about ESG Investment Practices;
- Safeguarding Advisory Client Assets;
- Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies;
- Outsourcing by Investment Advisers; and
- Amendments to Form PF.

As a recent example, the SEC's amended Rule 206(4)-1 under the Investment Advisers Act of 1940 (Marketing Rule) went into effect in November 2022. The amended Marketing Rule was an effort to modernize an outdated set of requirements for advertising investment advisory services in the digital age. Firms subject to the Marketing Rule have increased disclosure requirements and must modify their performance information to comply with specific requirements relating to fees and expenses. The Marketing Rule will reshape industry practices and indirectly impose change on all fund managers, including unregistered advisers and exempt reporting advisers that are not obligated to adhere to its requirements. Further, the same can be said for the various other proposed rules that

are only applicable to registered advisers, as they also have the potential to shape GP practices and shift market norms.

See "A Checklist for Advisers to Guide Compliance With the Marketing Rule" (Oct. 25, 2022); and "Eleven 'Top of Mind' Questions and Misconceptions Surrounding the New Marketing Rule" (Mar. 22, 2022).

Although each of the proposed rules may significantly impact advisers, the proposed Private Fund Advisers rule, if adopted, would mark the most considerable change. Generally, the reporting requirements would only be applicable to RIAs, while the prohibited activities would be applicable to all advisers. The reporting requirements would necessitate additional operational resources and ultimately result in additional costs, while the categories of prohibited activities would force GPs to abandon longstanding industry practices. In each case, up-and-coming GPs would face new and significant barriers to entry.

See our three-part series on the proposed Private Fund Advisers rules: "Overview of the Proposal and the Importance of Industry Comments" (May 24, 2022); "General Observations" (May 31, 2022); and "Rule-Specific Concerns and Next Steps" (Jun. 7, 2022).

If adopted, the prohibited activities in the proposed Private Fund Advisers rule will impact all advisers. The rule would restrict GPs' ability to:

- charge specific categories of expenses to a fund;
- limit liability through certain types of exculpatory and indemnification;
- impose limits on GP clawbacks;
- borrow from fund investors (including, potentially, certain reimbursements);
- allocate expenses on a non-pro rata basis (*e.g.*, broken-deal/abort fees where there is a binding letter from a co-investor); and
- certain preferential treatment (*e.g.*, liquidity and information rights).

See "The Continuing Trend – and Potential Ramifications – of Increasing Private Fund Manager Obligations" (Sep. 20, 2022).

The proposed Private Fund Advisers rule has received a significant number of comments from GPs and LPs alike pushing back on the scope of the rule. Whether or not the rule is adopted in its current form, the proposal – and the other rules proposed by the SEC – make it clear that fund managers seeking U.S. capital should quickly consult with U.S. regulatory counsel to assess their regulatory compliance.

Market Solutions to Current Challenges

For GPs, overcoming the aforementioned challenges faced by the industry will require forethought and flexibility at all stages of the fund lifecycle.

Fundraising

A growing number of PE funds are already taking up to 18 months to fundraise, as opposed to the traditional 12-month fundraising period set forth in partnership agreements. Therefore, at the outset of a fundraise it is prudent to build in the ability to extend fundraising periods beyond the periods typically set out in the fund documents. That is especially useful when an extended period would straddle a new calendar year of LP allocations.

Fund managers currently mid-fundraise can also seek fundraising period extensions from LPs well in advance of the final closing date. Sympathetic LPs have recently been receptive to agreeing to fund extensions given the current fundraising market, provided the GPs clearly explain why the extensions are beneficial to the LP base, the anticipated pipeline of prospective investors and the impact the extensions may have on management fees.

Some GPs may wish to explore accessing capital from new jurisdictions where LPs are not constrained by allocations or resources, or look to alternative pools of capital that are increasingly seeking access to PE (*e.g.*, family offices and private wealth capital) as part of the ongoing "democratisation" of the asset class. In addition, institutional investors are expected to engage in an increased amount of secondary transactions to free up their capacity to make further commitments. When GPs are involved in those transactions, they may seek a stapled commitment to their next vintage from LPs .

See our two-part series on high net worth individuals and PE: "Access All Areas?" (Dec. 14, 2021); and "The Road to Retail" (Dec. 21, 2021); as well as "PE in a Recession: Tips for Tailoring Fundraising Efforts, Anticipating Demand for Secondaries and Managing Co-Investments (Part One of Three)" (Sep. 20, 2022).

For GPs fundraising in the U.S., the proposed SEC rules and anti-ESG movement will likely lead to a significant increase in regulatory costs and burden. To the extent any such costs are being passed down to fund clients, GPs should review their fund documents with fund and U.S. regulatory counsel to ensure that expense provisions are adequately granular and properly disclosed to LPs. GPs should also review whether certain regulatory expense practices may ultimately constitute prohibited activities (*e.g.*, the proposed Private Fund Advisers rule would prohibit charging fund clients for expenses from regulatory examinations or investigations).

Deal Funding

As seen during the coronavirus pandemic, when access to conventional debt is limited, GPs can seek broader recycling powers under their fund documents as an alternative source of liquidity to fund follow-on investments. To that end, the volume of GP-led transactions (*e.g.*, continuation funds) has also been increasing over the last five years and looks set to continue as an additional means of supporting current portfolios and providing additional capital for specific assets or groups of assets.

See "Emerging Trends in the Evolving Continuation Fund Market" (Jul. 12, 2022).

It goes without saying, that staying abreast of regulatory and market changes in jurisdictions where funds operate and source capital will be key for all GPs.

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