FINDING BALANCE

THE POST-COVID LANDSCAPE FOR FINANCIAL INSTITUTIONS

Financial Sponsors

Part 3

Resilience Recovery Renewal

OVERVIEW

At a high-level while organizations are still relatively well capitalized and liquid, the position could deteriorate.

Welcome to our third briefing about how COVID-19 will affect financial institutions and its impact on current industry trends. **In this edition, we focus on financial sponsors, which is a diverse subsector including asset managers, private equity/credit funds and institutional investors including sovereign wealth funds.**. As well as sharing our own opinions, we reference the views of external commentators. As always, please bear in mind that our views are based on hypotheses that may change in a rapidly developing situation and there are doubtless other perspectives.

Financial sponsors have to date demonstrated considerable resilience during the pandemic.[1] In the case of private equity managers, after initially focusing on portfolio company triage, most have now turned their attention back to investing, adapting their approach to deal making in light of the new realities of travel restrictions and government lockdowns.

Clearly, however, there are sectors of the market - retail, hospitality, luxury goods, energy, healthcare services, office and retail real estate - which continue to suffer. For managers investing heavily in these segments, the road to recovery will be slow. Questions remain as to how much support private equity and other real asset funds will need to provide to their portfolio companies and assets, with those in the worst affected sectors of the economy incurring significant losses and/or liquidity constraints during lockdown.

Private equity has been excluded from many government support programmes such as the US Paycheck Protection Program, instead having to fund cash needs in their portfolios themselves. For their part, managers of open-ended funds (particularly in real estate) saw substantial outflows of funds in the first few months of the pandemic through high levels of redemption requests, raising liquidity issues and exposing investors to possible "fire sales." Since then, some investment funds (e.g., environmental, social and governance (ESG), exchange-traded, taxable-bonds and sector-equity targeting tech and health) have experienced a notable influx of new monies as many investors seek to benefit from, rather than flee, the volatility of the financial markets.

There are considerable opportunities for financial sponsors as economies move from the resilience stage of the crisis to, hopefully, recovery and renewal.

First and foremost, there is the considerable amount of **dry powder** available to private equity and credit funds to invest; the question is one of timing and identifying the best prospects. The success of their business models is also being shaped by existing industry trends which themselves are being impacted by COVID-19.

The phenomena of **rising global indebtedness** is both a risk and an opportunity to a subsector which is often referred to collectively as shadow banking; one that has experienced continual growth since the 2008 financial crisis.

The **impact of increasing regulatory scrutiny, new technology and the rise of environmental, social and governance (ESG) concerns** all need to be taken account of by those leading the industry.

Finally, the asset management sector is seeing **continuing pressure to provide value**, which is exemplified by the trend towards low cost, passive funds. In light of these pressures and the need for scale, mid-tier and smaller asset managers are facing increasing industry consolidation.[2]

Private equity/credit funds, asset management and sovereign wealth funds

These are the key themes affecting different constituents of this sub-sector

Dry powder

There is significant liquid wealth, cash or its equivalent, which could be invested.

Globally, the Bank of England estimates that **private equity alone has available USD 1.5 trillion of unused committed capital** to invest into companies that require finance.[3] However, there remains a disconnect in the market. There are still few assets available to acquire, due in part to the concern of sellers that the market has not stabilised and the difficulty of buyers engaging targets given ongoing restrictions on travel. While many fund managers are looking for distressed opportunities, we have yet to see a large increase in bankruptcies and insolvencies that could generate opportunities. This is not to say they will not materialise, but there has not yet been a significant amount of investment activity. That said, a number of sponsors, particularly in the higher end of the market, have been quite active - seeking to put money to work in a down-market. **Some transactions, like PIPEs and other structured capital investments continue to draw the attention of sponsors who would traditionally look to take control positions**.

Credit markets have rebounded. In the early stages of the pandemic, we saw few new loan facilities being provided as lenders had to tend to existing credits, and credit funds could find better returns trading in outstanding debt. This has changed and leveraged finance is now available in the market on terms almost as good as before the pandemic. We have seen a significant return of the leveraged recapitalisation market with interest rates near all-time lows and governments providing significant liquidity in the market.

As for fundraising, while some funds, particularly credit and tech-focused funds, have continued to raise money without difficulty, there is evidence that many are now taking longer to reach their fundraising targets. **Many managers are also being forced to retain underperforming portfolio** companies until they are better placed to maximise returns, which may affect their ability to raise new funds. In this light, we are seeing an uptick in general partner-led secondary transactions and other liquidity solutions to provide exit opportunities for those investors who require liquidity, and to allow managers to time the liquidation of their portfolios to take advantage of favourable market conditions.

Sovereign Wealth Funds

Sovereign Wealth Funds face many of the same issues as private equity and the asset management / pension funds sector.

Nonetheless, because of their deeper pockets and following the maxim that cash is king, they are generally in a better position to identify and act on opportunities resulting from the pandemic. This could be through acquiring equity stakes in viable corporates at a discount on financial markets or by private equity investment (a growing trend in recent years) into re-organisations and refinancings. According to research by State Street, **SWFs were either overweight cash or underweight equities before the pandemic**. Rather than exhibiting risk aversion in a falling market, they sold fixed-income securities to buy equities – thereby rebalancing their portfolios and maintaining their asset-class allocations.[4] The International Forum of Sovereign Wealth Funds, consistent with its founding "Santiago Principles," has emphasized that SWFs are long-term investors that can play an important role in stabilising national economies and the global financial system[5] The pandemic has also seen a fundamental re-appraisal of the role of some sovereign wealth funds, particularly in countries that have needed to turn to new sources of capital to provide emergency support to their economies. A number of countries are also establishing sovereign funds for the first time with a view to financing the development of strategic domestic sectors. Often these are not countries endowed with natural sources of wealth such as oil, so they are instead focused on creating a capital base through the transfer of state assets to the fund and raising further capital in the international financial markets.

Shadow banking: taking market share from the banks

Many banks are anxious to protect their balance sheets.

While banks may be stronger than in 2008, many are still anxious to protect their balance sheets and will be unable to match the speed and flexibility of alternative lenders and credit funds. Moreover, **post-financial crisis banking regulation will continue to limit banks' access to leveraged finance markets**. Debt funds do not operate under the same restrictions and capital requirements as regulated banks and, as such, are in a better position to continue to grow their market share. As shadow banking is not regarded as a quasi-utility, unlike a bank whose activities must be supervised and not readily allowed to fail, such investors holding cash should be better placed to choose the best investment opportunities presented by the COVID-19 crisis.

Liquidity and redemptions

Asset management and pension funds are at risk of a significant impact on the value of the funds they manage and the resulting income from falling asset prices.

After substantial falls in March 2020, **financial markets have stabilised for the moment and rallied, particularly in the United States**. It remains possible that further volatility will be seen as markets react to the continuing progress of the COVID-19 disease and its effect on the economy, especially over predictions as to the nature of the likely recovery. In such a scenario, investors in open-ended funds - particularly in real estate funds which have invested in office and retail - might seek to redeem the whole or part of their holdings, therefore necessitating the careful management of the liquidity risks that come with large outflows of funds. Regulators have publicly supported the gating of redemptions when it is in the interests of investors and in any event have said they would expect managers to use the full range of liquidity management tools (e.g., gates/deferred redemptions, swing pricing) available to them.

The economic environment for financial sponsors

Another consequence is an increased incidence of litigation and we are already seeing disputes arising out of company restructurings.

In recent years a global investment surge has driven a rising debt burden. Naturally, when the economic environment deteriorates, as is happening with COVID-19, so may credit quality and the risk of default. The risks to which financial sponsors are exposed arise, in part, from increasingly competitive lending between credit funds that has tempted them to engage in heightened risk taking or writing business outside their core markets. **Of particular concern, however, is the amount of no, or low, covenant indebtedness in the market held by many private credit funds**.

Private funds can be more exposed through portfolio companies than banks, which are more constrained in their lending by regulation. Funding and liquidity pressures may also see a reduction in the availability of wholesale financing and/or a mismatch between asset maturities and liabilities. Another consequence is an increased incidence of litigation and we are already seeing disputes arising out of company restructurings.[6]

In this context, the lockdowns imposed by governments to tackle the current public health emergency and the consequent disruption to the economy are bringing the viability of many corporates into question, if not now, then as governments lift the life support of state intervention. One academic study has found that private equity managers consider that "40%" of their portfolio companies are "moderately negatively affected" and 10% are "very negatively affected" by the pandemic."[7]

To give a sense of the level of debt in major economies, a survey by TheCityUK estimated that by March 2021, **the level of "unsustainable debt" owed by UK private corporates would amount to between GBP 90 to GBP 105 billion**. Substantial amounts of new capital will therefore be required whether via new equity and/or restructured debt.[8] For businesses that are judged to remain viable private equity through credit funds should be well placed to intervene and benefit being less expensive than traditional lenders and able to act more quickly.

Increasing regulatory scrutiny of financial sponsors

Even prior to COVID-19, the issue of liquidity stress testing for funds was gaining in importance with regulators

As a result of COVID-19, the phenomenon of shadow banking is likely to gain in importance. According to the Financial Stability Board's annual 2019 report, non-bank financial intermediation represented 13.6% of total global financial assets. Also of note is that **investment funds and money market funds are large providers of short-term credit to banks**. In some quarters shadow banking has always been controversial. In the EU, the sector was seen as opaque and viewed with suspicion.

After the 2008 financial crisis measures to increase reporting obligations and to regulate alternative investment funds were introduced, although the sector and, in particular, **private equity remains largely unregulated in comparison to banking**. Prior to the pandemic, it was thought unlikely that this scrutiny would lead to increased regulation in many jurisdictions, but this could change if a wave of defaults were to pose systemic risks to the financial sector as a whole. This is especially likely in India, which has experienced defaults to date, and in China where there is a greater degree of inter-relationship with banks.

In the EU, greater controls may be imposed on alternative lenders. These could extend to further reporting requirements and restrictions on leverage. European authorities reviewing the Alternative Investment Fund Manager's Directive have identified a range of possible "improvements" including further tightening of leverage rules. Other important changes would introduce a framework for loan origination and further steps on liquidity management.[9] If implemented these would have significant impacts on how much private equity and alternative funds generally can invest and potentially the structures used.

Even prior to COVID-19, the issue of liquidity stress testing for funds was gaining in importance with regulators following IOSCO's Principles of Liquidity Risk Management for Collective Investment Schemes. Concerns over illiquid opened-ended funds in current volatile markets has provided added impetus.[10]

As for financial institutions generally, the trend towards requiring those organisations (which are regulated) to act in their clients' best interests over and above strict contractual obligations - paying close attention to their regulators' expectations - has received added momentum from COVID-19. For the retail funds sector, the need for improved transparency over investment strategies, governance and charges will only grow in importance. As in the 2008 financial crisis, **conditions of market stress and the use of business continuity regimes can present heightened exposure to conduct risk, as well as financial crime, such as market abuse and fraud**. While regulators have shown flexibility, over matters such as reporting deadlines, they are taking a tougher approach over risks of market abuse and financial crime. Where relevant, organisations should take all practical steps to reduce these risks, for example, employing enhanced monitoring or retrospective reviews.

Tax change may also be coming to private equity and hedge fund managers in the US as the issue of "carried interest" is high up on the Democratic Party's political agenda. In broad terms, the concession allows general partners and investment managers to be taxed on performance fees, not as income but as capital gains and at preferential rates.

Greener financial institutions

Until recently private equity has trailed other sectors in terms of taking into account ESG matters

Financial sponsors face increasing commercial and competitive pressure to prefer sustainable lending and investments. **Around 30 percent of global assets under management - around USD 31 trillion - are ESG-principled investments and this figure will only rise**. It is fair to say that until recently private equity has trailed other sectors in terms of taking into account ESG matters when allocating capital. However, such terms are now a key requirement of many limited partners. Increasingly, limited partners have the right to walk away if ESG investment mandates are breached and portfolio companies can obtain improved financing terms depending on their ESG performance.[11] In addition, the listing of many top fund managers means that they are now subject to public company requirements with respect to ESG matters - hastening the inclusion of ESG in the investment process.

Private equity is increasingly sponsoring impact funds to focus on investments with an explicit focus on creating social or environmental benefits. These funds often base their approach on the voluntary UN supported Principles for Responsible Investment and many advisors are in the market offering their services to build metrics to measure the social impact of these funds.

Other voluntary initiatives include the recommendations of the Task Force on Climate Related Financial Disclosures (TCFD) that are now being supplemented by mandatory disclosure requirements. A good example is the European Commission's Action Plan on Sustainable Finance affecting organisations that either manage or advise on regulated investments. New regulations will seek to reduce the incidence of greenwashing through better classification of the environmental impact of investments in corporates and introduce new duties of disclosure to investors. EU asset managers and investment advisers will have to amend their policies and procedures to be compliant.

It is fair to say that asset managers in Europe have embraced ESG to a greater extent than their equivalents in the US and Asia-Pacific.[12] Going against the trend, the US Department of Labor wants pension administrators to take account of ESG factors only if they are "material economic considerations under generally accepted investment theories."[13] This has met significant industry opposition and this policy may change depending on the outcome of the US elections in November.

In the light of the pandemic, contrary to the fears of many, we have not seen a retreat from steps to arrest climate change - quite the opposite. 2020 may well turn out to be a landmark year strengthening the sector's commitment to change - in particular outside energy intensive industries such as oil. Many investors have been concerned that the damage to the economy brought on by COVID-19 could be repeated by global warming.[14] Interestingly, there is anecdotal evidence that ESG funds have suffered less from recent COVID-19 inspired market volatility on financial markets. In fact, reflecting supply chain issues, demand for investments that reflect social and governance standards has significantly increased.[15]

This year funds with above-average sustainability ratings have seen big inflows and now hold USD 4.6 trillion in assets globally.[16] More generally, corporates that have stronger, more resilient business models, especially as regards their ESG footprint, may represent better value to financial institutions in the longer term. There is evidence that the return on investment can be higher when ESG considerations are factored into the decision making process.[17]

THE FUTURE CHALLENGES FOR FINANCIAL SPONSORS

A gap is developing between the largest asset managers and others in terms of performance giving impetus to industry consolidation.

COVID-19 has thrown up all sorts of challenges to the task of raising capital to invest; from sovereigns, institutional, family offices or retail investors, to aligning redemption with liquidity and maturity and, of course, fulfilling investment mandates, while remaining compliant where applicable with regulatory obligations. While SWFs, for example, have deep pockets given the extent of the economic shock some sovereigns have required their funds to pivot more to active intervention in national economies including borrowing funds to invest in strategic sectors.

Private equity's task of picking winners and losers must be undertaken in a more uncertain economic and political environment, but is tempered by the potential for more investment opportunities. Funds listed on financial markets must contend with the risk of significantly higher volatility (although this is helpful for some hedge fund strategies), pressure on fees and increasing regulatory scrutiny of their liquidity management. Here also, a gap is developing between the largest asset managers and others in terms of performance giving impetus to industry consolidation.

Society as a whole sees the sector as having a key role in supporting and promoting the shift to sustainable investment by ensuring the integration of ESG factors across its core activities and providing disclosure to investors. To pursue ESG friendly investments, asset managers must analyse large amounts of unstructured and incompatible data.

It is here that technology can help. AI can efficiently and quickly process huge amounts of data to apply to ESG investing.[18] Besides sustainable investments, other changes, such as the rise of passive investing in the asset management sphere, require business models to evolve and adapt. AI is being used across portfolio management and client outreach to make front and back offices more efficient, as well as identifying investment opportunities (for active strategies), reporting to clients and responding to the regulatory imperative of better monitoring employee conduct risks.[19] And of course, financial sponsors are also making significant investments in the technology space, raising significant funds to focus on mature tech companies, especially those operating in the cloud sector of the market.

Endnotes

1 KPMG/AIMA, Agile and resilient: Alternative investments embrace the new reality, Global Hedge Fund Survey: COVID-19 special edition, September 2020 [no link].

2 Financial Times, BlackRock kicks off earnings for fund management industry in tumult, 12 October 2020.

3 Bank of England, Opening Statement, Joint Financial Stability and Monetary Report, 7 May 2020.

4 International Forum of SWFs, SWFs and Institutional Investors Maintain Exposure to Risk Assets in the Face of Covid, 14 May 2020; State Street, Pandemic, No Panic: Evidence from Institutional Investor Flows.

5 International Forum of SWFs, IFSWF Supports Members through the COVID-19 Crisis, 23 April 2020.

6 Financial Times, Private equity gags on its own medicine in contentious debt battles, 30 July 2020.

7 NBER Working Paper No w27889, Private Equity and COVID-19, 7 October 2020.

8 TheCityUK, Recapitalising the post-COVID-19 economy, 11 May 2020.

9 European Securities and Markets Authority, Review of AIFMD, 18 August 2020.

10 Bank of England, Financial Policy Summary and Record of the Financial Policy Committee, 8 October 2020.

11 Blackpeak, Private Equity and ESG, 29 June 2020.

12 Financial Times, Climate change: asset managers join forces with the eco-warriors, 26 July 2020.

13 U.S. Department of Labor, New Investment Duties Rule, 23 June 2020.

14 Financial Times, Climate change: asset managers join forces with the eco-warriors, 26 July 2020.

15 BusinessGreen, How COVID-19 is refocussing sustainable finance, 16 April 2020.

16 Bank of England, Speech by Andrew Hauser, Exec. Director, Markets to Investment Association, 16 October 2020.

17 Khan, Mozaffar N, George Serafeim, and Aaron Yoon, Corporate Sustainability: First Evidence on Materiality, Harvard Business School Working Paper, No. 15-073, March 2015.

18 Accenture, Reimagining Sustainable Investing with AI, 2020.

19 Deloitte, AI, The next frontier for investment management firms, 2020.

Baker McKenzie helps clients overcome the challenges of competing in the global economy.

We solve complex legal problems across borders and practice areas. Our unique culture, developed over 70 years, enables our 13,000 people to understand local markets and navigate multiple jurisdictions, working together as trusted colleagues and friends to instill confidence in our clients.

Baker McKenzie.

bakermckenzie.com