Proskauer

Guide to “Recycling” Options for Fund Managers

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The ongoing COVID-19 crisis is presenting fund managers with numerous challenges. One key challenge is to make sure that their portfolio companies have sufficient capital available to weather this particular storm. But how can fund managers ensure the liquidity required by their funds and portfolio companies is available?

Proskauer’s leading Private Investment Funds team examines the ‘recycling’ options available in the market and outlines the main considerations fund managers should keep in mind when considering liquidity options.

Fund recycling explained

When fund managers find their portfolios in need of additional funding they can seek financing from multiple sources of alternative capital to help them get through challenging periods. These would include co-investments, annex or top-up vehicles, borrowing from third party lenders, GP-led secondary transactions, ‘preferred-equity’ solutions, reinvesting cash received by the fund from investments and/or maximising their funds’ undrawn commitments through recalling previously distributed cash. This ‘recycling’ allows fund managers to inject much needed short term capital.

Recycling options

The recycling options available to a fund will depend on what is included in the fund’s governing documents. These are some of the most commonly available options to recycle distributions:

1. Amounts drawn for investment or another purpose but ultimately returned to investors unused
2. Amounts returned to investors following the admission of subsequent closers
3. Distributions received from investments within the fund’s investment period
4. Distributions received from investments which are realised shortly after being acquired

5. Distributions received from underwriting transactions and bridging investments, where such investments are syndicated or realised within a certain time period
6. Amounts received up to the amount paid as the fund's management fee, establishment costs, and operating expenses

To the extent these options are not already being fully exploited by a fund, they can be used to provide a reasonably substantial increase to the amount of capital that can be deployed in a relatively short time frame.

Top three limitations

One. Fund managers should remember that, generally, any limitations already applied to the drawdown of capital from investors will equally apply to recycling options. So, if the fund's investment period has expired, for example, there may be limits on the timing, and amount, of follow-on investments.

Two. A fund may have extensive recycling provisions at its disposal, but there will be limits on how much it can utilise.

A few common recycling limitations include:

1. Individual commitments: an investor's outstanding drawn commitment may not exceed the investor's initial commitment
2. Collective commitments: at a group level, aggregate invested capital in portfolio companies may not exceed a certain percentage of aggregate investor commitments.
3. Portfolio company: at a portfolio company level, the fund may only invest a certain aggregate amount in any one portfolio company or geography.

Three. A fund's ability to recall distributions for recycling may also depend on whether distribution notices have specified that such amounts can be recycled. A lack of notice at the time of distribution that a fund may recall these amounts for the purposes of recycling may limit the ability of the fund to re-draw them. The issue can be whether the drafting of the right to recall is conditional on notice having been given at the time of the distribution or reads as a separate, information right.

With these limitations in mind, we are seeing fund managers reach out to their investor base to seek amendments to their funds' governing documents in order to broaden the existing recycling provisions. This is particularly important if a fund is already fully exploiting its existing recycling abilities. We have found that investors may be open to an amendment if the rationale for such changes and the intended benefit for the fund as a whole are clearly explained; as ever, *communication is key*.

Some popular amendments include:

1. Seeking to include all amounts previously distributed within permitted recycling, i.e., so that more proceeds that have already been distributed are retrospectively available to be recycled.
2. Seeking to include all amounts of future distributions within permitted recycling, i.e., so that increased amounts that may be distributed in the future will be available to be recycled.
3. Waiver of any time or aggregate amount limits on follow-on investments.
4. Adjustments to investment limitations to allow additional capital to be deployed.

The level of consent required from investors to make these amendments will depend on the interpretation of the amendment provision in a fund's governing documents. This should be considered carefully in light of the impact on investors.

Financing considerations

Where a subscription facility is in place, fund managers should determine the extent to which recallable capital is included in the facility's borrowing base. A number of lenders specifically require recallable capital to be ignored when calculating uncalled commitments for the purposes of the borrowing base, meaning that funds will not get any increase in borrowing capacity from the existence of recallable capital. However, where there is no specific provision in the facility agreement excluding recallable capital that has been added back to undrawn commitments, and the fund's governing documents permit recallable capital to be used to repay debt, such amounts should be treated in the same way as other uncalled commitments.

Fund managers who are looking to amend their funds' governing documents to include modified recycling provisions should also consider if these changes require lender consent under any credit facility. Even in cases where lender consent is not required, lenders often require up-to-date copies of all fund documents following amendments.

Planning for the future

The global economic impact of COVID-19 presents fund managers with a challenging environment, with some of their portfolio companies needing quick injections of short-term cash. For fund managers, recycling has become one of the most efficient ways to help them weather the impact of the current crisis.

Key to its success will be ensuring the use of every possible fund recycling option to its fullest as part of their crisis management toolkit, in addition to other external sources of funding. Fund managers should also maintain consistent communication with their stakeholders to ensure clarity and cooperation through these uncertain times.

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