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PRIVATE EQUITY NEWS & ANALYSIS

Extensions, recycling provisions featuring more in LPAs – Paul, Weiss report

The SEC's proposed private funds reforms are also 'influencing' the market, especially around prohibited activities and GP-led deals, says Paul, Weiss partner Marco Masotti.

Top managers are keeping their funds open longer and engaging in "game theory" as the congested fundraising market makes raising capital tougher, new research has revealed.

The study of fund terms conducted by law firm Paul, Weiss, Rifkind, Wharton & Garrison found the offering period of 83 percent of private equity funds surveyed is 12 months – in line with 85 percent last year – although extensions beyond the period are often requested by the GP.

"What you do see in a market like this is a baked-in ability for GPs to extend, as opposed to going to all investors and seeking amendments. So, you might have the GP do [a six-month extension] and thereafter, the LPAC needs to approve," Marco Masotti, who leads the private funds group at Paul, Weiss, told Private Equity International.

He added: "We're so used to closing funds quickly, the market is effectively just returning to normalcy."

Last year was a standout one for private equity, with some $733 billion gathered by funds across buyouts, venture capital, growth equity, secondaries and other strategies. Meanwhile, some 1,051 private equity funds gathered $516.9 billion in the first three quarters of 2022 – the second-highest Q1-Q3 total on record, according to PEI's latest quarterly fundraising report.

Overcrowding in the market, LPs' overexposure to private equity assets, heightened volatility and macroeconomic uncertainty have, however, dampened the outlook for fundraising moving forward.

Due to the impact of the denominator effect and the sheer number of GPs in the market, Apollo Global Management is keeping its 10th flagship fund open until the first half of 2023 to accommodate LPs' annual allocation budgets. Early this year, the Carlyle Group also warned of longer fundraising timelines, especially in the corporate PE segment of the market.

Masotti expects to see more extension mechanisms built into fund documents. "Everyone in the marketplace is acknowledging that it's crowded, there are macroeconomic challenges, it's going to take longer – and that's okay."

What's more, the US Securities and Exchange Commission's ambitious private funds reform agenda – which enhances disclosure requirements and outlines rules around prohibited activities and GP-led secondaries transactions – is "influencing" the negotiations of terms between LPs and GPs, according to the Paul, Weiss report.

"It really is a market of process and game theory [a theoretical framework designed to encourage strategic decision-making] in a more challenged and crowded environment where LPs have bandwidth issues. Timing is everything," Masotti said. He added that his team spends a lot of time, with military precision, trying to outline what an offering looks like with their clients – from when to go out and how long the fundraise is, to which LPs to approach first.

Affiliate title Regulatory Compliance Watch reported on Friday that SEC chairman Gary Gensler plans to dial back on these reforms. Nonetheless, among the proposed rules that would have a significant impact on GPs' operations are prohibitions around indemnification and exculpation. "If the proposed indemnification standard is adopted, it will change the liability exposure of GPs significantly," according to the report.

"The customary gross negligence standard has been a feature of the marketplace for decades and allows GPs to exercise their business judgment in transactions that inherently entail risk."

As reflected in the survey, all PE funds contain a gross negligence standard carve-out from indemnification provisions, which has remained consistent with previous years. That standard of care acts as an insurance policy that protects GPs so they can take investment risks and generate returns for investors. Changing it would affect how GPs function, Masotti told PEI in an interview in March.

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The SEC's proposals have been put to public review, with final rules yet to be published.

Of all the fund terms analysed in Paul, Weiss's report, a headline management fee rate of between 1.5 percent and 1.75 percent, preferred return of 8 percent and a carried interest rate of 20 percent remain the norm for PE funds. More than half of survey respondents provide a GP commitment of 3-5 percent of total commitments to the fund, in line with the previous year. The vast majority of funds – 90 percent – distribute carry on a deal-by-deal basis.

Data for the survey came from the fund agreements of about 50 recently raised PE funds with a minimum target of $3 billion. Most are focused on the US market.

When it comes to recycling provisions in a tougher fundraising market, every bit counts. All PE funds in the survey allow the recycling of capital, with 42 percent permitting recycling where capital is returned within 18 months of investment.

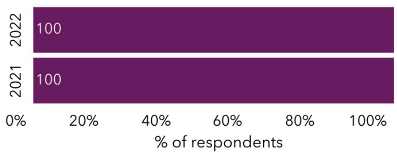
Despite a muted capital raising outlook, Masotti said fundraising volumes are likely to increase in late-2023 once the valuation adjustments come in.

"There's so much of the world's investment assets that need to be managed, and private equity is one of those asset classes that people look to for returns. More sophisticated investors are going to start committing again – because what history shows is that you get the outperformance in the years when markets are turbulent," he said.

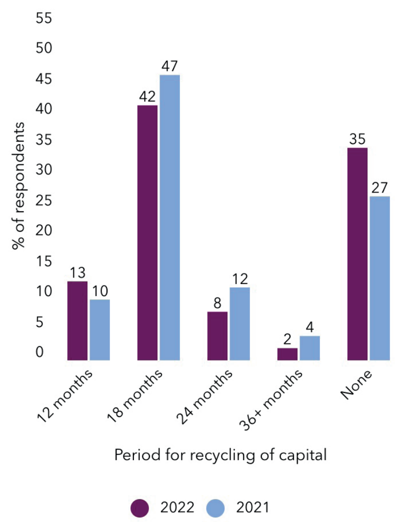
PAUL WEISS: FUND TERMS SURVEY

The offering period for 83% of funds surveyed is 12 months, in line with last year

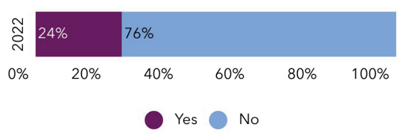
In both years, all PE funds surveyed have a gross negligence standard carve-out from the indemnification provisions



More than 40% of PE funds surveyed permit recycling, where capital is returned within 18 months of investment



The majority of PE funds are including disclosures on and provisions for continuation funds



Source: *2022 Private Equity Fundraising: Key Trends and Market Survey*, Paul, Weiss, Rifkind, Wharton & Garrison