Fairness Opinions in Capital Infusion Transactions

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The economic ripple effects of COVID-19 are already being felt in private equity (PE) portfolios around the world. While some portfolio companies are expected to successfully weather this challenging time without requiring incremental capital by working through liquidity constraints with lenders, other companies will face existential distress. In the middle of this spectrum are companies that need to raise incremental capital to survive COVID-19.

Those companies may not be able to turn to their incumbent bank or non-bank lenders, which are facing liquidity challenges of their own. Lenders are preserving capital in anticipation of the deteriorating credit quality of their existing borrowers and the effects this will have on fund-level credit facilities. In addition to struggles with traditional lending options, many of the Small Business Administration (SBA) options included in the CARES Act are not currently available to private equity portfolio companies due to SBA Affiliation Rules.

The rescue capital providers who are open for business include special situation investors that specialize in distressed situations who can close quickly. But speed comes at a high cost: not only is this capital expensive from a return perspective, but may come with a board seat and a voice at the table on top of the complication of the capital structure with the introduction of structured equity or mezzanine debt.

As an alternative to a third-party funded capital infusion, portfolio companies may choose to raise capital from their private equity sponsor. The advantages to this sponsor funded recapitalization are clear: avoidance of new stakeholders, lack of information asymmetry, speed to close, ability to put capital to work in a challenging environment and lower transaction costs. However, the drawbacks to these affiliate party transactions are also clear and present challenges for GPs to navigate. In circumstances where a portfolio company is owned by a fund that is fully drawn, the GP may choose, despite the inherent conflicts, to fund the capital infusion from a newer vintage successor fund.

The risks of cross-fund investing are enhanced in the current environment due to (i) difficulties in determining the COVID-19 impact on portfolio company value today in part due to uncertainty surrounding the timing and magnitude of the recovery, and (ii) the substantial dilution to the predecessor fund which is often inherent in distressed capital infusion transactions. As a result, now more than ever sponsors are turning to independent financial advisors to assist in the valuation and security structuring process, and to provide a fairness opinion for the benefit of the GP, LPACs, funds and other investors.

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Common affiliate party transactions include:

- New capital being invested in a predecessor fund portfolio company by a successor fund
- New capital being invested in a portfolio company where there remains a significant minority investor
- Mergers of portfolio companies, potentially owned by different funds
- Transactions involving companies where the GP is invested in the debt and equity in the same portfolio company
- Debt for equity exchanges
- Backstopped rights offerings

The benefits of an independent fairness opinion to GPs and portfolio company board members include:

- Conflicts of interest mitigation
- Discharge of GP's fiduciary duties to funds and portco shareholders
- Improve transparency and disclosure for LPs and LPACs and demonstration of the transaction rationale
- Demonstration of best corporate governance practices
- Establish a line of defense in potential SEC investigations of affiliate party transactions

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