Salvation Capital: Prudent Investment or Salvation Sinkhole?

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On April 17, 2020, Dechert's Private Equity practice presented "Salvation Capital: Prudent Investment or Salvation Sinkhole?" an episode of the firm's COVID-19 Coronavirus Business Impact Broadcast Series. The episode featured Naz Zilkha, an M&A partner, and Samantha Koplik, a Leveraged Finance partner, both in the firm's New York office.

The presenters gave a high-level overview of important factors that should be analyzed when considering and structuring capital infusions to fund a portfolio company's operations and/or refinance its indebtedness in these uncertain times.

HIGHLIGHTS FROM THE EPISODE

Sources of Salvation Capital

If a PE fund has the ability to call additional capital from its limited partners, it must decide how best to deploy such capital under the circumstances and whether doing so is prudent. If the fund does not have sufficient undrawn capital commitments, the fund sponsor can fund capital itself or seek additional commitments from existing or third party investors, with any new investment likely being on preferred terms senior to existing investors. Finally, if a PE fund has its own credit facility or available credit, to the extent that such credit facility or other credit becomes unavailable, the PE fund may be forced to call capital from its limited partners or seek other capital even when it would prefer not to do so.

Process and Governance Considerations

Salvation investments can present various conflicts for the private equity sponsor, including that limited partners who do not participate can be significantly diluted and any co-investment by a PE sponsor alongside the fund may be made on different terms to those offered to existing investors. Such investments may also require, among other things: (i) heightened disclosure to LPs due to a portfolio company's limited ability to provide forecasts during the ongoing pandemic, (ii) LPs and certain investors be provided rights to participate in the capital raise on the same terms as the sponsor or a third party, (iii) a third-party fairness opinion if the proposed investment is considered a related-party transaction, or (iv) waivers, amendments or forbearance undertakings from a portfolio company's lenders. The timing of any such investment must be considered if the portfolio company has immediate liquidity needs.

Form of Capital Infusion

The form of capital infusion must take into account the portfolio company's existing capital structure. A common form of salvation capital is an equity cure, which allows a sponsor to infuse additional capital in the form of common or non-disqualified preferred equity for the sole purpose of curing a financial covenant default. However, an equity cure does not provide a long-term capital solution for a company with ongoing liquidity needs. Longer-term measures can include injecting capital through a preferred equity investment or an unsecured subordinated debt investment. With each of these options, the sponsor will need to consider the economic factors of issue price, yield and redemption or repayment features.