Preferred Equity: Another Option in the Fund Finance Toolkit

Introduction

The market for private equity (PE) secondaries, or the buying and selling of pre-existing PE fund interests, has grown rapidly over the past decade—by one estimate, at a CAGR of approximately 40% from 2013 to 2018.[1] Within this sophisticated market, traditional secondaries, in which limited partners (LPs) sell their PE fund interests to third parties, have proven to be a relatively dependable source of liquidity for LPs looking to exit a fund early in most market conditions. As with many aspects of the global economy, however, the market for traditional secondaries is now experiencing a period of depressed activity and an uncertain future. Some commentators predict an uptick in these transactions in the second half of 2020, beginning shortly after the publication of Q2 financial reports, but others expect activity to remain depressed until at least the beginning of 2021. Meanwhile, PE portfolio companies and LPs are experiencing the same degree of acute liquidity stress that is upsetting businesses in all industries around the world.

In a world marked by weak demand for traditional secondaries and widespread cash shortages, PE general partners (GPs) may look for creative solutions to address the liquidity needs of both LPs and portfolio companies. Preferred equity financings, one relatively less-developed facet of the broader secondaries market, may provide an avenue of relief. Importantly, these transactions have the potential to generate liquidity while minimizing disruptions to existing capital structures and fund economics, without reliance on third-party demand for existing fund interests.

Structuring and Use of Proceeds

Preferred equity is an equity instrument with a priority claim to a company's distributions, up to a certain multiple of capital invested, ranking generally between debt and ordinary equity. While these securities are often unsecured and covenant-light, preferred equity holders may also receive additional rights more favourable than those enjoyed by holders of ordinary equity, including governance rights and the ability to control certain operational aspects of the underlying assets.

In the fund finance context, GPs can employ preferred equity in a variety of ways to accomplish diverse goals. For example, the proceeds of a preferred equity issuance at the fund level might be

used for distributions to existing LPs, allowing them to obtain some degree of liquidity without selling their fund interests and thereby maintaining an interest in the portfolio's upside. Alternatively, and particularly relevant during the COVID-19 pandemic, preferred equity issued at the portfolio company level (typically through a new subsidiary interposed between the fund and the portfolio company) can generate liquidity for operations and deleveraging, as well as for add-on acquisitions, as an effective alternative to debt. The ability to obtain capital without looking to debt financing is particularly valuable in the current situation, in which the credit markets have tightened since the onset of the pandemic.

Key Issues

In exchange for the flexibility that this alternative provides, the parties to any preferred equity financing must consider certain key issues. The principal gating item for GPs may be the level of LP support for a transaction, which can also drive structuring considerations. The issuance of preferred equity at the fund level will almost certainly require the consent of existing LPs. Necessary amendments to a fund's limited partnership agreement may also impact provisions that typically require more than a majority of LP consent to amend (e.g., distribution provisions), increasing the level of LP support required for a transaction.

As the preferred return on a new issuance of preferred equity will rank senior to existing LP interests, and LPs may otherwise not buy into the GP's rationale for the deal, LP consent may be difficult to obtain. Preferred equity issued at the portfolio company level provides an alternative that may not require amendment to the fund's limited partnership agreement, thereby reducing transaction expense and increasing transaction certainty. GPs should take care, however, to understand the impact of a preferred equity financing at the portfolio company level on the fund’s limited partnership agreement, as this type of transaction could nonetheless require amendments to certain provisions of that agreement and corresponding LP consent.

The terms of the preferred equity itself can be another hurdle to consummating a transaction. In addition to a preferred return on investment, preferred equity investors will often require rights above and beyond those afforded to holders of ordinary equity. At the portfolio company level, they may include consent rights over "reserved matters" ranging from asset acquisitions to the incurrence of debt above a threshold amount, potentially giving preferred equity investors substantial control over the day-to-day business of underlying assets. Preferred equity providers may also acquire board or observer seats at entities throughout the structure. The terms of a preferred equity investment could therefore significantly impact the operation and value of a fund's underlying assets and, in particular, the existing LPs' ability to realize upside value given the new equity's preferred return. Typically, these rights are the subject of extensive negotiation.

In light of these impacts on LPs and on underlying asset value, it is critical for GPs to disclose properly the terms of a preferred equity financing to existing LPs. Assuming the GP is not also a preferred investor, the conflicts inherent in a more standard GP-led secondary transaction will not be present as the GP is not on both sides of the transaction. That said, the existence of a new preferred return may effectively increase the GP's hurdle amount, which could create an incentive for the GP to hold assets for longer periods of time in the hope of obtaining exit valuations higher than may otherwise have been acceptable. Such conflicts of interest should be disclosed to LPs when seeking applicable consents, and GPs should take care to identify whether transactions involving such conflicts require specific approvals under the fund's governing documents.

Conclusion

Interest in preferred equity financing is growing as market participants increasingly view it as a viable, flexible alternative to other fund finance options. As this structure continues to be deployed in a variety of contexts, market participants can expect certain recommendations and industry standards to emerge and evolve; it is possible that standard-setting associations may provide some instruction in the future. Last year's guidance from the Institutional Limited Partners Association on GP-led fund restructurings may be instructive[2]—there, market participants engaged in healthy debate around transaction processes and key issues like conflicts of interest for a period of time, before the publication of certain recommended practices. As GPs and LPs alike explore the benefits and drawbacks of preferred equity financings over the coming years, we expect increased interest in this solution as part of the growing fund finance market.

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Endnotes

[1] Preqin, "*Secondary Market Update H1 2019*", available at: https://docs.preqin.com/reports/Preqin-Secondary-Market-Update-H1-2019.pdf.

[2] Institutional Limited Partners Association, "*GP-led Secondary Fund Restructurings: Considerations for Limited and General Partners*" (April 2019), available at: https://ilpa.org/wp-content/uploads/2019/04/ILPA-Guidance-on-GP-Led-Secondary-Fund-Restructurings-Apr-2019-FINAL.pdf.

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