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Professional Perspective

Preferred Equity: Flexible Financing Solutions

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Preferred equity has emerged as a viable supplement, and in some instances alternative, to traditional debt financing and GP-led secondary liquidity processes. This highly customizable form of financing is essentially a hybrid debt and equity product, and is particularly relevant now as private fund sponsors and limited partners (LPs) navigate the economic dislocation resulting from the Covid-19 pandemic.

Overview

The current macroeconomic environment has presented many challenges to private fund sponsors and LPs seeking liquidity solutions. Uncertainty regarding valuations, increased levels of portfolio risk, LP creditworthiness concerns, including increased risk of LP defaults, and other related factors are of concern to lenders. This has led to lenders increasing pricing, requiring more robust covenant protections and generally being more selective with respect to traditional subscription-backed and NAV-based fund credit facilities. Given the central role fund financing plays in many core aspects of fund operations, preferred equity has become a sought after liquidity solution for private fund sponsors and LPs alike.

Preferred Equity Structures

Preferred equity transactions typically involve a simple structure and bespoke terms that make it an especially desirable financing option in today's market. In its simplest form, a standard preferred equity deal consists of the issuance of a new security, such as new interests in an existing private fund or a newly formed special purpose vehicle (SPV) created by a private fund sponsor to hold specific investments, by a party desiring liquidity or additional capital to a purchaser, who is the preferred equity provider. The preferred equity provider receives a priority on distributions until it has received proceeds from the underlying portfolio in an amount equal to its capital contribution plus a minimum rate of return or multiple on its investment.

Fund-Level Finance

A private fund sponsor can use preferred equity for a wide variety of fund-level purposes. These include to support one or more of the fund's underlying portfolio companies, repay subscription-based credit facilities or other debt at the fund or portfolio company level, as a reserve to increase its cash on hand and/or minimize or delay capital calls, or to make distributions to the LPs. All of this is done while preserving upside exposure to the underlying portfolio and avoiding debt servicing obligations and typical lender-required covenants.

In a typical fund-level preferred equity arrangement, the private fund sponsor will insert a newly-formed SPV between the fund and its underlying portfolio companies, if such an SPV is not already in place, with the fund and the preferred equity provider as partners or members of the newly-formed SPV. The preferred equity provider will typically receive a priority on distributions until the agreed upon return has been achieved and, in certain situations, retain certain “upside” sharing of subsequent proceeds pursuant to a negotiated distribution waterfall. Alternatively, the private fund sponsor can also admit the preferred equity provider to the fund directly, with the preferred equity provider being issued a new class of interests with priority over the other partners, although this structure may require a greater level of LP involvement.

Secondary Transactions

In some situations, an LP may be in need of liquidity to fulfill short-term capital call obligations or other payment obligations, wish to rebalance its portfolio, or otherwise have a desire to lock in realized gains with respect to the subject portfolio, but wish to retain a portion of the upside in its long-term equity interests in the applicable funds. In these situations, a newly-formed SPV may be created to hold the underlying fund interests being “sold” by the LP.

The preferred equity provider and the selling LP will be partners or members of the SPV, with the preferred equity provider typically assuming some or full responsibility for future capital calls. In return, the preferred equity provider receives a priority on future distributions until the agreed upon return has been achieved and, in certain situations, retaining upside sharing of subsequent proceeds pursuant to a negotiated distribution waterfall.

These types of transactions will often require the general partners of the underlying funds to consent to the proposed transfers of the fund interests from the LP to the SPV. However, in certain circumstances a general partner's consent may not be unreasonably withheld in connection with an "affiliate" transfer so long as the selling LP retains control of the newly-formed SPV that is acquiring the applicable fund interests. In rare circumstances, the general partner's consent may not be required at all. However, it is important for LPs seeking a preferred equity solution to carefully review the limited partnership agreements and other governing documents of the applicable funds to confirm that any transfer impediments, such as rights of first refusal, are resolved and any required general partner consents are obtained.

Sponsor-Level Finance

Although private fund sponsors and LPs have traditionally used preferred equity for fund-level and secondary liquidity needs, sponsors have also been taking advantage of preferred equity for capital needs at the sponsor level. For example, a preferred equity provider may provide financing directly to the private fund sponsor itself to help support ongoing operations or succession planning. The preferred equity provider may agree to provide liquidity to general partner entities or to the partners of such general partner entities to cover capital contribution obligations to its funds. The structure of sponsor-level preferred equity arrangements will vary considerably depending on the objectives and context of the financing.

Terms and Protections

The terms of preferred equity fund financing solutions are bespoke, highly customizable, and are largely based on the needs of the recipient and the preferred equity provider's risk assessment of the underlying portfolio. The focus of the preferred equity provider's risk assessment will depend on the context and objectives of the transaction, with the quality of the private fund sponsor, the underlying portfolio, and the fund's LP base typically among the most important. It is not uncommon for the preferred equity provider to provide capital in an amount equal to 20 – 65% of the underlying portfolio value, thus providing a significant capital infusion for the recipient.

The cost of preferred equity financing solutions is generally more expensive than senior debt, often in the realm of 8-12% per annum with a target return in the vicinity of 1.3x, and often requires the private fund sponsor or seller to forego a portion of the future upside in a portfolio. However, preferred equity transactions typically do not require agreement between the preferred equity provider and private fund sponsor or seller regarding a given portfolio company's valuation or any discount to NAV. This advantage is particularly relevant in the current environment, where establishing a consensus on accurate and reliable valuations is difficult at best. Moreover, preferred equity arrangements do not feature typical debt-like covenants, servicing costs or a fixed repayment term.

Depending on the transaction, the preferred equity provider will likely require certain protections such as enforcement, mandatory redemption and consent rights, board or observer seats, or other safeguards. Similarly, there may be structural issues to be addressed depending on, among other things, the governing documents of the fund or its portfolio investments. Also, unlike a GP-led secondary, a preferred equity transaction does not typically include a reset of fund economics or other material modifications to fund terms or governance provisions, such as the length of the fund's term or investment period, recycling restrictions, follow-on limitations, or similar considerations. Accordingly, private fund sponsors seeking to materially alter a fund's terms or otherwise add flexibility to an existing investment mandate may wish to consider pursuing traditional GP-led liquidity processes, such as a GP-led restructuring for "whole fund" liquidity needs or a continuation fund for liquidity needs relating to one or more specific fund portfolio companies.

Certain Legal Considerations

Aside from economic and other commercial factors, there are a number of legal considerations to be mindful of when determining whether preferred equity is an appropriate financing solution for a specific situation. In particular, a traditional preferred equity fund financing transaction will typically result in the direct or indirect dilution of existing LPs in the underlying equity of the fund's portfolio.

When considering whether to seek a preferred equity financing, a private fund sponsor should consider the existing fund's structure and governing documents. The establishment of an SPV, the issuance of new equity at the fund or SPV level, the transfer of assets from the fund to an SPV, and borrowing or financing limitations may require LP engagement and possibly the consent of the LP advisory committee (LPAC) or a specified percentage of LPs. Additionally, the governing documents of the fund's portfolio companies should also be examined, as there may be certain transfer restrictions, such as rights of first refusal, tag rights or drag rights, or change in control issues that must be addressed.

If the fund currently holds its portfolio companies through an SPV below the fund and the governing documents of the fund permit syndication of interests in the underlying portfolio, the structuring of the preferred equity financing and LP consent considerations may be significantly easier to navigate or altogether unnecessary. However, even if the fund's governing documents provide the required flexibility from a legal perspective, LP discussions and consents should be considered as an investor relations matter. Additionally, the private fund sponsor should carefully consider how the capital infusion will be used and whether the interests of the general partner, the existing LPs and the new preferred equity provider will be aligned. To this end, careful consideration should be given to the existence of any conflicts of interest, such as if the private fund sponsor will be receiving carried interest as a result of distributions to the LPs funded by the preferred equity provider. Further, the private fund sponsor should confirm that adequate disclosure is made and applicable consents obtained before moving forward. Private fund sponsors should also review their existing credit facility agreements to ensure that the issuance of the preferred equity will not conflict with, or trigger a default under, such agreements.

Careful consideration should also be given to the tax and other regulatory implications of the issuance of preferred equity in a fund structure. Experienced legal and tax advisors should be engaged early in the process to ensure that the transfer of the fund's assets to a newly-formed SPV, if applicable, would not create a taxable event. Further, it will be important to ensure that the preferred equity is treated as equity rather than debt for U.S. federal income tax purposes. This is especially true if the fund has tax-exempt LPs.

If the fund has tax-exempt LPs, the private fund sponsor will want to ensure that such LPs do not incur unrelated business taxable income (UBTI) or unrelated debt financed income (UDFI). The sponsor will also want to ensure that the preferred equity arrangement otherwise complies with any covenants to avoid the incurrence of UBTI and UDFI in the fund's governing documents or side letters.

In structures where the preferred equity is issued by a U.S. corporate SPV held by the fund, the parties should also consider structuring around cashless dividends, particularly for funds that do not generate current income. The parties will need to evaluate the appropriate tax treatment of the value of a payment-in-kind dividend (i.e., as a dividend or as capital gain), and address withholding considerations associated with payments under the preferred equity arrangement.

Properly structuring the preferred equity financing such that it is treated as equity rather than debt will also be an important consideration for certain private fund sponsors for purposes of maintaining compliance with the Alternative Investment Fund Managers Directive, if applicable, which imposes additional reporting and operational requirements on funds employing "leverage".

Conclusion

As private fund sponsors and LPs alike adjust to the new post-Covid-19 environment in which we find ourselves, preferred equity financing deal flow has been increasing rapidly. Given the cash-flow and liquidity issues that certain private fund sponsors, funds, portfolio companies and LPs are now facing, the challenges with respect to determining valuations of portfolio companies, and the difficulties certain private fund sponsors may encounter in securing new lines of credit, it is not surprising that preferred equity is emerging as a viable and increasingly desirable alternative.

Unlike debt, preferred equity does not require an agreement on, or a discount to, NAV, nor does it carry the typical lender-required covenants or servicing payments associated with debt. As traditional lending markets tighten and GP-led secondary processes encounter delays due to pricing risk and valuation challenges, preferred equity's bespoke terms and highly-customizable nature, along with the relative ability of preferred equity providers to move quickly to close transactions and secure capital, make it an appealing alternative and one that may be useful for both offensive (e.g., proactively supporting portfolio companies, making distributions to LPs, and enhancing a fund's IRR) and defensive (e.g., building up cash reserves, delaying capital calls to assist LPs with cash management and/or avoid defaults) purposes.