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Growth in Third Party Preferred Equity Financing — Flexibility Leads the Way

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The trend of direct lenders providing preferred equity financing to support sponsors and operating companies has only accelerated in the two years since we first wrote on the topic (available here). Preferred equity instruments in general provide flexible, bespoke structures that are used in a variety of situations. This article focuses on "structured preferred equity" instruments that have effectively lengthened the leverage profile of private companies. It is generally structured as a covenant-protected, payment-in-kind instrument that often does not participate in the common equity returns of the investment. These instruments provide significant flexibility to direct lenders and sponsors and, if structured correctly, can avoid being treated as indebtedness for accounting and ratings agency purposes. As we continue to see growth in this product, we highlight five key considerations to keep in mind when structuring these instruments:

1. Flexibility is a Double-Edged Sword.

Structured preferred equity is often the appropriate vehicle to solve bespoke investment theses in large part because it is an extraordinarily flexible tool. The inherent flexibility is often ideal for the private direct lending market because it allows investors, sponsors and management to craft a unique instrument to meet the needs of a particular situation. Structured preferred equity is usually intended to provide debt-like returns to investors (similar to a PIK-interest debt instrument) while retaining equity treatment for credit covenant compliance, accounting and/or ratings agency purposes. However, the flexibility can also lead to pitfalls when the various investment objectives clash with each other. It is crucial to work closely with the accountants and the legal and financial advisors to craft redemption and repayment provisions to protect the equity treatment of the instrument. For example, a redemption provision that provides for mandatory repayment prior to the maturity of a Company's underlying debt is generally counted as debt for ratings agency, accounting and covenant purposes.

2. Lack of Debt-Like Legal Protections.

In addition, it is important for investors to note that while the investment thesis of a structured preferred equity investment often resembles that of their debt investments, the legal protections of a preferred equity instrument are not the same as that of a debt instrument. In a restructuring, a structured preferred equity investment is structurally and contractually junior in priority to all of the company's debt obligations (including trade creditors). Further, the holders of preferred equity also lack the same level of creditor's rights that debtholders have, including the panoply of creditor rights in a bankruptcy context or remedies to otherwise enforce payments of interest or principal. This is often a trade-off investors are willing to accept in return for the higher yield that structured preferred equity instruments generally provide. In addition, while the instrument is junior to all debt obligations, the liquidation preference protects its seniority vis-à-vis the common shareholders.

3. Investment Exit Considerations.

Structured preferred equity instruments often include debt-like exit scenarios, such as change of control protection and time-based redemption or "forced sale" obligations, because investors are seeking debt-like return profiles. While change of control provisions are generally accepted provided they are drafted to comply with the Issuers other debt instruments, time-based redemption provisions and forced sale provisions must be carefully crafted so as not to interfere with debt repayment obligations and provide the Company with enough flexibility to ensure equity treatment. For example, a time-based redemption provision is often difficult to include as it makes it difficult for the Company to refinance any debt to extend maturity outside the preferred equity, which is often solved by increasing coupons as time goes on to incentivize the Issuer to redeem an increasingly expensive source of capital.

4. The Efficient Breach Conundrum.

In addition, the lack of true creditor protections and Delaware case law opens up preferred equity holders to the potential risk that a board of directors may choose to "efficiently" breach their obligations in order to protect the ultimate value of the common equity. Courts have recognized that an efficient breach can, in certain circumstances, be an acceptable exercise of the fiduciary duties that directors owe to common shareholders. Importantly, while the directors may use these provisions to delay potential repayment obligations, the liquidation preference of the preferred equity vis-a-vis the common shareholders is still protected, the risk is that payment is delayed in an effort to preserve the value of the enterprise. In order to compensate investors for this risk, many instruments include increasing coupons as time goes on to offset some of the risk related to efficient breaches.

5. "Upside" Participation.

The flexibility of an equity instrument can provide an opportunity to participate in the equity upside of a growing company in a single investment with the debt-like returns of a PIK-instrument. This can take the form of a side-by-side issuance of warrants (which, of course, can also be issued in conjunction with a more traditional debt instrument) or by crafting a convertible preferred equity instrument. Issuers may prefer a convertible preferred structure provides because it attaches the "debt-like" economics and the "equity upside" economics together in a single instrument. That being said, investors should consider whether there is an advantage to separate instruments as it may allow the equity upside and the debt like economics to be transferred separately in the future (subject to any transfer restrictions included in the transaction).

The still-developing market for structured preferred equity instruments remains murky territory for many alternative credit providers and their counsel. The key to understanding and protecting your interests as a preferred equity investor is making sure that you are working with parties who are experienced at negotiating third party preferred equity financings.

Our market-leading Private Credit Group and Capital Markets Group are both among the most sophisticated in the market. We craft solutions for our clients by taking full advantage of our formidable finance, securities, tax and private equity experience. Structuring third party preferred equity investments is another example of the firm harnessing our experience and skill to customize bespoke financing solutions on behalf of our clients. Please feel free to contact any of the team members listed with any questions.

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