Hybrid Horizons: Hybrid Capital Market Trends

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Hybrid Capital — financing instruments such as debt-like preferred equity and Holdco notes that sit between pure equity and traditional debt instruments — is becoming an increasingly important product class for companies seeking private capital. Issuers turn to Hybrid Capital to address growth and liquidity needs while maintaining flexibility, governance control and investor alignment.

This is the first installment in a series of “Hybrid Horizons” articles we are publishing, focused on today’s Hybrid Capital market. Our first article provides an overview of market trends, which are discussed below.

Market Acceptance

Once a niche product for challenged financing situations, Hybrid Capital has become accepted as a common feature in acquisition financing and middle-market capital finance. As early Hybrid Capital investments have matured and track records have been built, both issuers and investors have become more comfortable with the product class. Similarly, senior lenders have become more comfortable with Hybrid Capital as non-leverage-impairing capital supporting their loans.

Influx of Capital

In large part due to the market acceptance of Hybrid Capital and investor desire for enhanced, risk-adjusted returns, the market has seen an unprecedented amount of capital flow into Hybrid Capital investment vehicles. A-list managers are raising funds with double-digit billions of dollars to spend on Hybrid Capital, and the trend of increased dry powder for Hybrid Capital has also hit middle-market and lower-middle-market funds. This is evidence that the market for Hybrid Capital has arrived and, in a self-fulfilling way, evidence that it is here to stay.

Hybrid Capital as a Liquidity Solution

With today's higher-interest rate environment, many companies are turning to Hybrid Capital to enhance liquidity. Many companies are refinancing debt with accruing or pay-in-kind Hybrid Capital instruments, relieving them of the liquidity-draining burdens of amortization and interest payments required by their traditional debt financing. Similarly, proceeds of Hybrid Capital are being used to fund upcoming debt payments or pay down debt in order to obtain accommodations from lenders. Hybrid Capital's more traditional use as a financing tool for growth capital and add-on acquisitions has also been boosted in today's environment, given its liquidity advantages over traditional debt and its non-dilutive impact as compared to traditional equity.

Leveraged Distributions in an Exit-Challenged Environment

The M&A market for private companies has been challenged for several years, leaving sponsors invested in successful companies without an attractive path to provide returns to their investors. Hybrid Capital is one solution sponsors are turning to. It allows portfolio companies to raise capital without ceding control, the way a traditional equity infusion would be structured, and it allows existing equity to retain upside growth without the dilution associated with bringing in true equity dollars.

Special Situations

Hybrid Capital is a flexible tool that is often used to invest in troubled companies. Interest rate increases, the recent poor M&A market and operational challenges in some sectors of the economy have left many companies with no viable path forward for the current owners. Special situations investors often use Hybrid Capital to structure rescue financing, which often includes conversion features to achieve equity returns while retaining priority treatment for investors concerned about potential downsides. Increasingly, in the public markets, creative use of conversion caps in convertible hybrid instruments can both facilitate compliance with stock exchange rules and address otherwise applicable SEC rules that may otherwise render a special situation unsuitable for investment.

Conclusion

Many factors are driving the acceptance and increased use of Hybrid Capital. Several factors, such as the influx of capital by A-list investors and acceptance in the market, for example, combine to suggest that the market will grow and be sustained for the foreseeable future.

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