Proskauer

Deep Dive Hybrid Capital Series: An introduction to Hybrid Capital Solutions – what they are, their use case and key protections

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Against the backdrop of an unstable interest rate environment, with valuation challenges and subdued M&A / IPO activity, hybrid capital solutions have gained popularity. These flexible financing structures are continuing to evolve to help provide solutions to market pressures faced by portfolio companies and their private equity investors. Continued market uncertainty means that a material change in new deal flow this year is unlikely, and in an effort to better position a fund for opportunities in a competitive market, we have seen numerous examples of private credit participants offering hybrid capital products. These financing solutions assist sponsors in maximising returns, monetising assets and re-equitising over-levered balance sheets, whilst also allowing for the deployment of additional “dry powder” for future growth.

In the first part of this Deep Dive article, Daniel Hendon (Partner) and Charlotte Boylin (Special Finance Counsel) in Proskauer's Private Credit Group in London and Adam Creed (Partner) in Proskauer's Private Equity Group in London, will explore the development of the use case for hybrid capital solutions in the current macroeconomic climate, provide an overview of certain hybrid capital structures deployed in the European private credit market (with further detail to follow in this Deep Dive Hybrid Capital series), and outline common key protections sought by investors in such structures.

Overview

- In recent years, demand for hybrid capital solutions have escalated for a number of reasons:
  As these structures can involve preferred equity and/or debt injected higher in the capital stack (but always junior to senior/unitranche debt), the flexibility of these solutions allow for tailored capital structures, blending debt and equity like instruments and accommodating portfolio company cashflow patterns.

- These products can provide a resolution for a variety of objectives where a sponsor is not in a position to exit from its investment, which may be due to a disconnect between buyers' and sellers' valuation of the asset. These objectives may include: (1) a need to return capital to existing investors; (2) the bridging of valuation gaps or delaying a valuation setting (and thus avoiding the implication of a future sale process); (3) a desire to de-lever an existing debt capital structure; (4) seeking additional leverage whilst avoiding additional interest payment burdens; and (5) the raising of additional capital to finance new investments and/or M&A where there may be restrictions on incurring further opco level debt or a sponsor itself cannot close a funding gap with common equity.
- Payment in kind ("PIK") debt at the holding company level is often deployed to allow for additional leverage on a portfolio group. These PIK instruments provide for the capitalisation of interest and therefore remove the burden associated with cash-pay interest requirements – thus alleviating immediate cashflow pressure and allowing for cash to be retained for reinvestments, operations and acquisitions (and without requiring compliance with more robust debt covenants at the operating group level).

The flexibility of hybrid capital instruments further strengthens the appeal of private credit as a financing solution compared to traditional bank syndicated or sole unitranche financings. They enable sponsors to retain their performing investments until potential exits materialise, whilst also presenting new opportunities for private credit providers.

Direct lenders who are able to facilitate hybrid capital solutions:

- can potentially divest more capital in these structures than compared to a "vanilla" unitranche transaction, whilst providing workable structures that meet the needs of their clients (indeed a driver for many credit funds in the market who continue to exceed fundraising targets, yet operate in an environment of heightened competition);
- are likely to benefit from increased returns by lending and/or investing deeper in the capital stack - the additional risk of being structurally subordinated creates a justification for charging higher pricing for the cost of capital, in addition to an escalation in negotiation power to secure downside protections; and
- present themselves with an opportunity to partake in high profile financings involving some of the less common industry sectors than compared to the more traditional sectors which we typically associate with direct lending. For example, we have seen a number of recent direct lending investments within the sports sector, in particular, the financing of football clubs is becoming more prevalent. In these deals, lenders may have limited choice and will need to accommodate the structure

required to ensure that specific sports-league rules and regulations are adhered to.

Common junior and hybrid debt structures in the European private credit market

Hybrid capital can be viewed on a sliding scale of debt and equity where various instruments possess more, or less debt versus equity characteristics. A common feature of these instruments is that they are typically junior in the capital stack - structurally subordinated to operating group debt by being issued at the holdco level (outside of the senior banking group on a syndicated or unitranche facility, which would not permit the incurrence of such instruments at that level) and senior to common shareholder equity.

Common instruments include holdco PIK debt, holdco preferred equity, non-convertible structured equity, subordinated / second lien / mezzanine debt, convertible notes and other preferred equity instruments and equity co-invest structures (where private credit lenders take equity shares (e.g. common equity or warrants) along with providing debt at the opco level). We have also seen more bespoke solutions such as “debt/equity kicker” contractual arrangements (where the direct lender is entitled to a portion of certain payments distributed to the shareholders residing above the banking group), opco PIK debt (where the sponsor and other investors fund directly to the opco level alongside the unitranche lenders (both under different instruments but with both sets of creditors sharing in the same security package)) and the introduction of the “Equity Option Deed” (a contractual embedding of control optionality to work as a solution to investment in riskier structures, or to help alleviate a lender’s concern about the downsides of a UK insolvency process). We will discuss some of these structures and solutions in subsequent publications of the Deep Dive Private Credit series and this Deep Dive Hybrid Capital series.

The lines between various hybrid capital instruments are often blurred in practice, with the terms often being deal specific and can sometimes blend a combination of debt and equity-like features. Consequently, we have seen protections for private credit investors become more robust as the opportunities in this area of the market develop.

Key protections for hybrid capital providers

Whilst the breadth of hybrid capital structures is wide, there remains a number of common protections which are sought irrespective of the types of instruments which may exist in any single transaction:

- ***Security***: in the European loan market, holdco instruments are typically secured, which differs to the US market where such instruments are commonly unsecured. As a minimum, the security package will include a charge over the shares in the holdco issuer and any intercompany receivables granted by its immediate shareholder, and, where applicable, an account pledge granted by the holdco issuer in respect of any material bank accounts.
- ***Enhanced information rights:*** lenders providing capital through a combination of instruments will usually benefit from information rights, often agreed with the sponsor in the form of a "good behaviour" side letter, or, in some instances, directly within the relevant instrument. In holdco PIK financings, this sometimes includes a right for PIK lenders to obtain copies of reports such as valuation reports in restructuring related situations that have been commissioned by the sponsor, opco group or senior lenders. Consultation and/or consent rights may also be afforded to lenders providing financing at a level above the opco group to provide them with added protection where restructuring negotiations or actions are underway, requiring the opco lenders to consult and/or collaborate with these additional stakeholders. Finally, in situations where a lender is providing both opco debt and an equity co-invest contribution, it is important to ensure that the information rights provided under the senior financing documents align with those included in the equity documents.
- ***Additional debt incurrence and anti-layering***: investors will seek to regulate the amount of debt that can be raised by a borrower both at the senior level and in any holdco PIK arrangements, as well as any priming by the operating subsidiaries – this can be achieved via financial maintenance covenants (testing overall group leverage) alongside caps on certain debt baskets negotiated for the operating companies. In addition, to protect the integrity of any enforcement procedure, anti-layering provisions will restrict any competing debt or equity instrument being interposed in the capital stack which would rank structurally senior to the junior / hybrid instrument, but junior to the senior / unitranche instrument. These protections also regulate against intermediate or additional subsidiaries, or existing intermediary holding companies incurring competing liabilities to the junior / hybrid instrument.
- ***Anti-short circuit***: these provisions restrict new shareholder injections (by way of equity or shareholder loans) from being structurally senior to the holdco / junior ranking instrument, ensuring that any new equity injections from the sponsor, and

any return of value to shareholders, pass-through the holdco issuer. This prevents any circumvention of the covenant package for amounts moving up whilst also avoiding competing shareholder claims sitting lower in the capital structure for amounts going down into the group.

- ***Governance***: hybrid instruments will usually grant investors board seats in more "equity-like" structures, or board observer rights in more "debt-like" structures, which is another way of giving private credit providers enhanced information and governance rights with respect to the operating group. In "equity-like" instruments, investors may be allotted shares with additional class specific consent rights which are often deal specific and negotiated on a case-by-case basis. Conversely, in "debt-like" instruments, the covenant package will often align with senior/unitranche financing terms for efficiency and consistency for the sponsor. Holdco PIK providers will often also benefit from equity cure rights (with a requirement for the borrower to downstream any such equity cure proceeds) which will enable them to cure a payment default or a financial covenant breach which may occur under the opco financing documents.
- **Stapling**: where opco and structurally subordinated junior lenders or equity providers are the same entities, stapling provisions may be included in both sets of documentation to ensure that any "take out" or transfers and assignments of one group of lenders / equity providers shall apply to the other group of lenders / equity providers (i.e. opco debt with equity co-investment or vice-versa, or opco debt with holdco PIK debt or vice-versa). Note that more "equity-like" structures will often have a 12-36 month lock-up in respect of potential transfers, whilst "debt-like" instruments have customary transfer restrictions applying for the life of the instrument, including in respect of competitors or distressed debt funds.

Conclusion

The increasing prevalence of hybrid capital reflects the adaptability and flexibility of private credit providers in meeting the needs of sponsors and borrowers in what continues to be an unpredictable market, whilst also allowing them to better meet their own investment targets in an increasingly competitive environment. The world of hybrid capital is still developing in Europe, but the rise of holdco / junior financings and a combination of varying hybrid capital structures showcase that growth opportunities exist for private credit lenders who are able to offer these more sophisticated solutions. In particular, there remains a growing need for private equity sponsors to resolve issues associated with exit delays caused by continued turbulent markets and no immediate backstop to the divergence of valuations which exists across today's M&A space. We look forward to bringing you the next part of this Deep Dive Hybrid Capital series, where we will explore these hybrid capital structures in further detail. In the interim, for related questions on this topic, please reach out to Daniel Hendon, Charlotte Boylin and Adam Creed.

Related Professionals

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