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Preferred Equity – The Best of Both Worlds?

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Preferred equity is a tool employed by dedicated funds and traditional secondary investors to provide liquidity and funding solutions to managers with portfolios of assets looking for a solution which allows them to retain the majority of the upside and avoid giving up control of the portfolio in a down-side scenario, either where the manager is looking to accelerate liquidity or invest more capital.

Whilst preferred equity has some down-side protection, it provides significantly more flexibility to managers than traditional debt, which typically comes at a lower LTV, with a repayment profile, a set maturity date, and collateral over all or part of the portfolio and covenants. Preferred equity lacks these features, making it more akin to equity but ranks senior to the equity in terms of cash-flow until the preferred return is achieved. After this, all of the upside accrues to the equity holders.

Preferred equity bridges the gap between traditional debt and equity, and it is easy to see why dedicated vehicles to this strategy have been so successful in the last 15 years or so. Before the emergence of preferred equity in or around 2006, managers with liquidity or capital requirements had the choice of either selling assets, thereby removing any potential upside, or adding leverage to their portfolios, and the closest investors came to a preferred equity product was via single-asset or holdco financings. Dedicated vehicles have now taken this model and transformed the way it is used in private equity. Investors can now gain exposure to private equity through this hybrid tool, which carries the upside potential of private equity returns over a shorter investment period with volatility reduced as a result of the downside protections. Sound like the beginnings of the secondaries market? This is still a relatively small segment of the secondaries market (albeit it is acknowledged that not all pref deals are necessarily counted in the global secondary figures and, if they were, the number would be significantly higher) but one which is growing rapidly, accounting for an estimated 5% of global secondary deal activity last year and with the number of secondary funds exploring this as an alternative investment increasing day by day.

Where and when is preferred equity relevant?

Although the secondaries market has evolved as an efficient and effective trading ground for the sale of private equity portfolios, a traditional sale isn't necessarily the right solution for all managers. Where a manager still sees value and upside in the underlying portfolio, it may be that holding onto those assets to allow them to mature and generate further returns – rather than embarking on a traditional sale – is in the best interests of the investors. Preferred equity is also a powerful source of capital to release liquidity in the portfolio or provide additional investment capacity without leveraging the portfolio directly. We are also seeing an increasing number of acquisitions supported by a preferred equity solution.

How is debt finance used to support these transactions?

Private markets managers are on the whole very familiar with how to use subscription lines and who to approach as a provider. Finding a debt provider to lend on a non-recourse basis purely against a fund portfolio, particularly in the primary private equity space, is much more difficult and requires a financial institution to have end-to-end capabilities to diligence and analyse the credit of the underlying portfolio of investments, the underlying leverage and the impact on the potential financing. Finding a debt provider able to lever a preferred equity interest is almost impossible. We were privileged to have worked on a ground-breaking transaction in 2019 with Investec, Palamon Capital Partners and Pomona Capital on a back-levered preferred equity financing which allowed for the creation of significant liquidity for investors whilst avoiding the creation of additional leverage in the portfolio. The use of leverage as part of the structure was a key component in significantly driving down the blended cost of the preferred equity instrument, thus making the returns attractive from both Palamon's and Pomona's perspectives.

Summary

As the secondary market is continuing to evolve and innovate, so too are the financing solutions following it. Secondary funds and primary funds are using the tools available in the secondary market and more often relying on finance providers to partner with them to provide fire-power in competitive acquisition processes and to unlock liquidity and value in their assets. The menu of solutions have increased significantly, and we suspect this time next year we will be discussing even more innovative and bespoke structures and processes.