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Deleveraging Techniques & Third Party Preferred Equity

Quick Takes

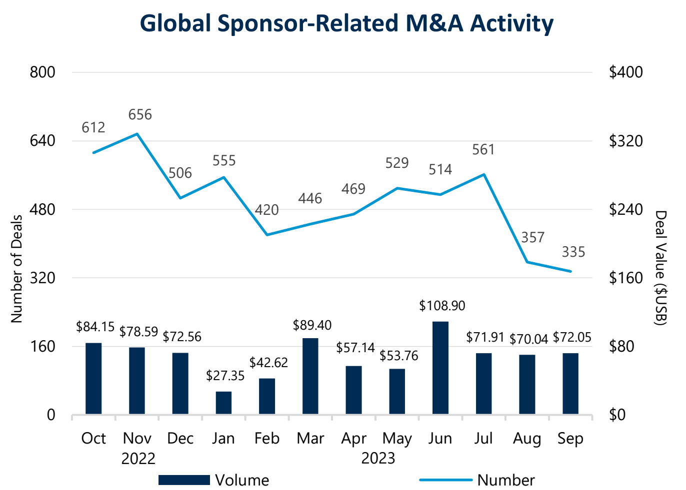
Many private equity sponsors and their portfolio companies have begun to consider capital structure solutions to delever as their debt is expected to mature in this high interest rate environment. In this article, we focus on one such solution: the issuance of preferred equity to third parties.

In market news, after a slow start to the year for global and U.S. sponsor-backed M&A, total deal values have been consistent with those seen in the latter half of 2022, however, the number of deals has seen a general decline since the fourth quarter of 2022.

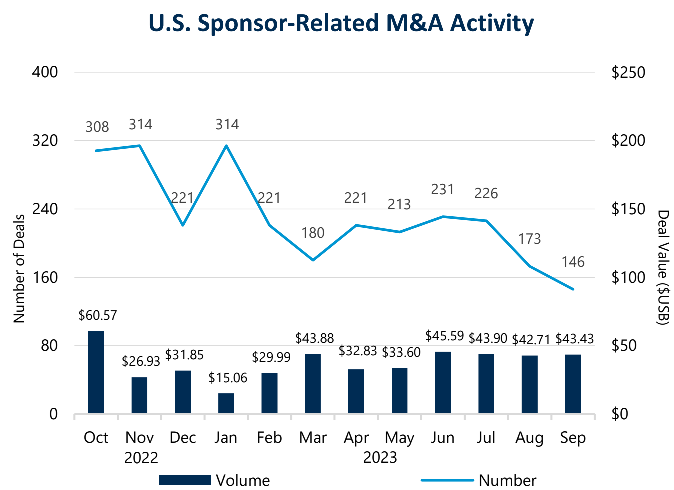
During the early days of the COVID-19 pandemic, the Federal Reserve stepped in to limit the potential economic damage by cutting interest rates to near zero. Borrowers (including private equity-backed companies) benefited, and hundreds of billions of dollars of debt were issued. In an effort to combat the subsequent inflation, in 2022 the Federal Reserve began raising interest rates, which have now climbed to the highest levels since 2001. A large wall of debt will mature over the next couple of years, and many lenders are requiring that their borrowers delever. Even if not required by lenders, many private equity sponsors and their portfolio companies have begun to consider capital structure solutions as their debt matures in this higher interest rate environment.

Some possible solutions include: (i) for private equity sponsors themselves to provide the capital, though it is not always appealing or possible to call capital, increasing the sponsor's invested capital and exposure to the asset; (ii) net asset value ("NAV") financing, which adds more leverage to the overall package of assets; and (iii) issuing unsecured debt, which may currently be too expensive and otherwise unattractive to senior lenders for various reasons including that this would still increase the leverage of the company and will generally still need to be serviced with interest payments.

Here, we focus instead on a fourth, potentially more attractive, option: the issuance of preferred equity to third parties. Preferred equity presents a hybrid solution that offers flexibility for investors, private equity funds and portfolio companies to create bespoke instruments to fit the needs of the particular situation as they navigate the deleveraging process.



Source: Dealogic[1]



Source: Dealogic[1]

What Are the Key Terms of Third Party Preferred Equity?

There are several terms with respect to third party preferred equity transactions that investors, private equity funds and portfolio companies should note. Some of these terms include:

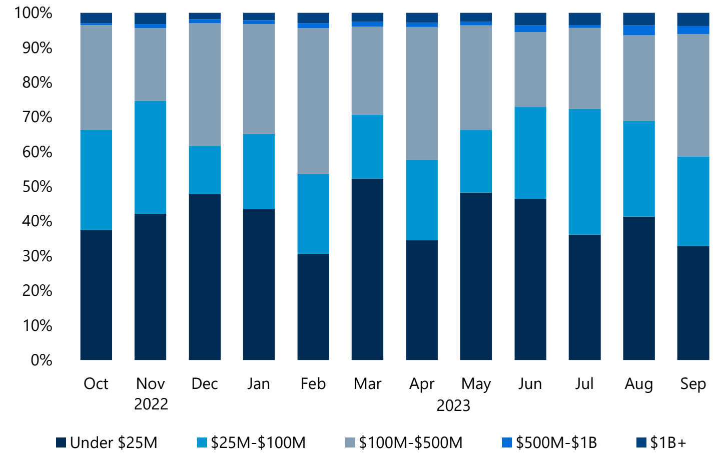
Term (Perpetual Preferred v. Mandatory Redemption)
Ratings agencies use a hybrid analysis to determine how much equity credit any specific preferred equity instrument receives. The more "equity like" the preferred stock, the more equity credit it will receive. Perpetual preferred equity is considered more "equity like" in that there is no maturity date or similar balance sheet burden except, in some cases, upon significant corporate events such as a public offering, a change of control or bankruptcy. This makes perpetual preferred equity, as opposed to preferred equity with a mandatory redemption date, more appealing in the deleveraging context.

Optional Redemption
Some preferred equity instruments allow for optional redemption by the issuer. This gives the issuer the ability to call the preferred shares if the issuer has the desire and means to do so. Note that depending on how the preferred equity instrument is drafted, optional redemption may only be available to the issuer once certain dates have passed or a minimum multiple on invested capital has been achieved. However, some of those instruments may also provide for an otherwise unavailable earlier redemption by way of a "make whole" provision, meaning that the issuer can redeem the preferred equity at this earlier time as long as the pre-negotiated minimum is paid.

Dividends and Liquidity
The return on some of these preferred equity instruments may function like a typical dividend, having a fixed return that behaves like interest on a loan. Alternatively, and helpful in the current interest rate environment, they are structured to be paid in kind ("PIK"), allowing the investment to compound and for the liquidation preference to increase instead of requiring immediate cash payment. An advantage of preferred equity over debt in this context is the ability of the issuer to suspend dividends for a time if there are better uses for cash. Both of these features allow for the issuer to keep more cash on hand than a typical debt instrument would permit. Note, however, that a potential drawback is that, unlike interest payments to a creditor, dividends paid to preferred equity holders are subject to fraudulent conveyance law and board approval.

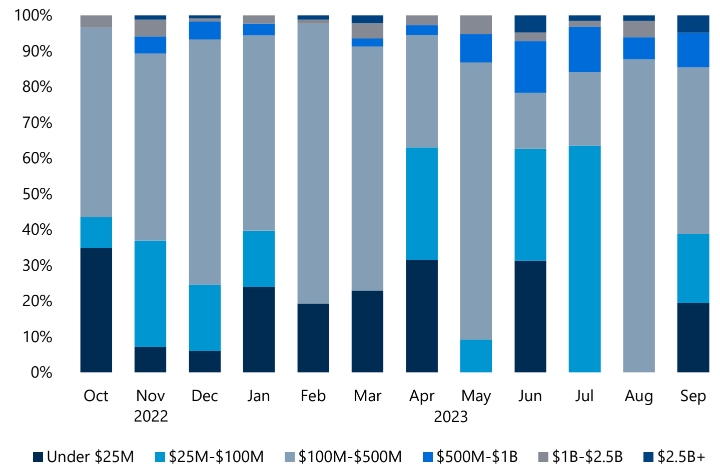
While the term can be long and the structure of the preferred equity instrument may not provide the investor

U.S. Sponsor-Backed M&A by Size



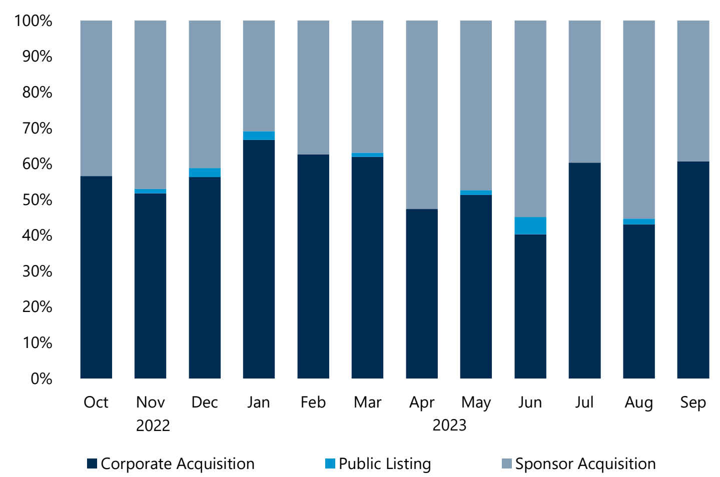
Source: PitchBook Data, Inc.[2]

U.S. Sponsor-Backed Exits by Size



Source: PitchBook Data, Inc.[2]

U.S. Sponsor-Backed Exits by Type



Source: PitchBook Data, Inc.[2]

with payment until the final redemption, investors may still negotiate for liquidity rights or other favorable terms in the event of non-redemption. Given this, many of these instruments provide for: (i) a dividend rate increase at certain times over the preferred equity's life, and (ii) contractual rights allowing the holders to demand that the issuer pursue a public offering or a sale, and then requiring use of the proceeds to redeem the preferred equity. If this process were to fail, it could lead to another dividend increase or allow the preferred holders to force a sale or public offering through previously negotiated contractual rights (e.g., drag along or control rights).

Convertibility

Investors may seek to capture upside by negotiating for their stock to be convertible. If convertible for such purpose, investors can convert their shares into common stock, usually based upon the liquidation preference, any PIK and any make whole over an agreed price per common share (based on the value at the time of the financing). Investors may also seek to capture upside through either warrants issued in connection with the investment or a co-invest in the company's common stock. Issuers may seek convertibility in a public offering in order to satisfy the preferred with public common stock. In such case, the conversion price is often negotiated to be based upon the public offering price.

Treatment in a Public Offering

As a public offering is a significant corporate event, it is important to consider how one would like these preferred equity investments to be handled if one occurs. As noted above, one option is to structure the preferred equity to convert to common stock upon a public offering. This allows investors to participate in any upside, but also makes the value of the preferred equity dependent on the performance of the common stock. Given this uncertainty, some investors may prefer that the preferred equity instead stay in place, or be mandatorily redeemed for cash by the issuer, in the event of a public offering.

Negative Covenants

Negative covenants included in preferred equity instruments tend to be less onerous than those associated with debt, but investors will often still seek certain fundamental protections and certain operational protections. Key considerations here center around preserving cash for the preferred equity holders before any distributions or dividends to common equity holders (e.g., by including restrictions on distributions, dividends or junior equity repurchases). Other covenants may include limits on indebtedness and affiliate transactions, in addition to anti-layering covenants, tax structure covenants and other governance rights such as veto or approval rights over certain non-ordinary course transactions.

"Foreclosure"

Unlike secured creditors, holders of preferred equity cannot "foreclose" upon the issuer's assets and their rights are very different from, and slightly more dubious than, those of secured or unsecured creditors in the event of bankruptcy. This is because creditors can simply accelerate their debt and get an enforceable judgment. While preferred equity instruments for private companies can be drafted such that they provide for other remedies, the preferred equity holders must still sue for specific performance in order to enforce those remedies. Examples of these potential remedies include that certain covenant breaches may give rise to board flips, such that the board construct changes or a specifically empowered special committee is created, or a dividend rate increase akin to a default interest rate with a loan, often tailored to the circumstances. It is worth noting that in the context of a deleveraging transaction, a change of control may trigger debt acceleration or put provisions in a company's credit agreements or indentures.

Other Rights and Considerations

While the above outlines key considerations with respect to preferred equity instruments, they are not the only considerations. Many investors will ask for some package of information rights (e.g., access to books, records or monthly financials), board rights (e.g., the ability to appoint directors, board observers or committee members), registration rights and preemptive rights. Note that investors are often able to secure board representation depending on the size of their investment relative to the value of the company.

Another aspect to consider with respect to these transactions is the tax treatment differences between debt and preferred equity, and structuring the economics of a preferred interest requires careful tax planning. Company or sponsor payments on interest expenses under their debt may be tax deductible, which effectively allows them to recoup a portion of the payment in tax savings. In contrast, preferred equity cash or PIK dividends are paid out using after-tax dollars meaning that they do not offer a tax reduction for the issuer. Moreover, the dividends are often structured to be PIK dividends or to accrue, thereby causing the liquidation preference to increase over time, which could lead to phantom income.

Looking Forward

Given the longer term of these instruments, a prospective company or investor will have a relationship with their counterpart for an extended period of time (and often with misaligned interests), including by likely having them on their board or with specific consent rights related to the operation of the business. As such, it is important to understand one another's respective interests and goals before deciding whether to accept third party preferred financing. Preferred financing is, however, a flexible and appealing solution to many who need to delever or are otherwise concerned about their debt maturing, and provides many options to address the needs of both the issuer and the investor.

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1 Sponsor categorization determined by Dealogic; as of October 10, 2023. Deal volume by dollar value is calculated from the subset of deals that include a disclosed deal value. Paul, Weiss has not reviewed data for accuracy.

2 Data provided by PitchBook Data, Inc. as of October 19, 2023. PitchBook's current data methodology includes all announced or completed deals or exits. Sponsor and exit type categorizations determined by PitchBook. Paul, Weiss has not reviewed data for accuracy.

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