Structured Equity:
A Flexible Capital Solution for Private Equity Sponsors

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Private equity sponsors need significant capital to pursue their objectives of driving growth and generating attractive returns for investors. Structured equity is emerging as a flexible financing tool to secure that capital. This article explores two of the more common forms of structured equity: company-level preferred equity and fund-level preferred equity.

Company-level Preferred Equity

Company-level preferred equity consists of capital that is provided directly to a company in exchange for a fixed dividend and priority in liquidation. Preferred equity sits behind debt but ahead of common equity in a company's capital structure. Preferred equity often includes some form of upside participation, which could take a number of forms including warrants, a conversion feature or an attached common equity co-investment.

The dividend on company-level preferred equity is often paid-in-kind (PIK), meaning that it accrues and is paid upon redemption rather than on a periodic basis. This frees up company cash flow for growth or other needs. There are typically little to no financial covenants required but issuers do often require certain governance or observer rights. The terms of these investments are negotiated between the capital provider and the company and can be highly customized to meet the needs of the parties in any situation.

Structured equity is often used as a financing tool to support M&A. For example, if an established platform is able to make add-on acquisitions at 7x EBITDA, it can typically debt finance up to 5x EBITDA and can utilize structured equity to finance the additional ~1-2x EBITDA, limiting the additional equity capital needed by the private equity sponsor. Attractive platforms are often valued at 10x+ EBITDA, making structured equity an attractive solution that is less dilutive than raising additional common equity.

Other common uses of structured equity at the company level include supporting the initial financing of a platform investment, financing a buyout of minority partners and supporting a dividend recapitalization. Under the appropriate circumstances, structured capital can be an attractive financing tool to support portfolio company growth.

Fund-level Preferred Equity

Fund-level preferred equity involves capital provided to a private equity fund or a continuation vehicle using the net asset value of the portfolio as unsecured collateral. The preferred equity instrument has a priority position in the distribution waterfall until the capital is repaid together with a fixed contracted return. The capital provider sometimes receives a small residual equity participation.

Fund-level preferred equity often has more flexible terms, often with limited or no financial or operating covenants and no change in governance at the company level. It can also be less costly than company-level financing given the risk is diversified across a portfolio of assets.

Private equity sponsors have been utilizing fund-level preferred equity solutions for a number of reasons, including to support portfolio company follow-on acquisitions, to provide liquidity for limited partners of the fund or for defensive purposes and to strengthen the cash position of one or more of the fund's portfolio companies.

For example, an older vintage fund that has called much of its capital from limited partners or is outside its investment period may look to fund-level financing as a tool to support ongoing growth opportunities in the portfolio. If the fund is beyond its investment period, it may not be able to meet its financing needs by calling capital from limited partners so it may utilize a fund-level preferred equity solution.

As private equity sponsors evaluate their liquidity and growth needs in the COVID-19 era, structured equity, including both fund-level preferred equity and company-level preferred equity, is a tool worth considering. It is a flexible solution that in the right circumstance can be an accretive source of financing for sponsor backed portfolio companies.

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