How to avoid the preferred equity pitfalls

**Analysis**

It’s a type of financing that is becoming increasingly popular but those using it for the first time need to familiarise themselves with structural idiosyncrasies.

Private equity sponsors and other leveraged issuers are increasingly using debt-like non-convertible preferred equity to supplement their operating company-level financings in leveraged transactions.

Preferred equity allows sponsors to place additional leverage on a portfolio company without increasing the cash interest burden as a result of the favourable payment-in-kind feature. It is also designed to receive full or partial equity credit from the rating agencies and opco lenders. However, the market for preferred equity terms and documentation is still developing, and the unique features of this product that make it so popular also create potential traps for unfamiliar investors and their advisers.

Preferred equity provides additional financing firepower, especially for larger investments, add-on portfolio company acquisitions, dividend recapitalisations and other situations in which the sponsor may not be able to otherwise sufficiently fill the gap in the financing structure with common equity. It is typically provided by private debt funds, including traditional mezzanine or opportunistic funds that customarily supply junior capital, as well as direct lenders that have previously focused solely on the senior portion of the capital structure.

Preferred equity provides these funds with an additional avenue to deploy capital into higher yielding instruments, or even offer a packaged financing solution, together with either another form of junior capital (such as a second-lien loan or private high-yield notes) or a senior unitranche facility.

**Pref vs other credit products**

Preferred equity instruments are generally designed to mirror other credit products and contain certain similar features. These features may include:

- A fixed (or sometimes floating) dividend rate
- An upfront discount to the face amount
- Call protection applicable to both optional and mandatory redemptions
- Affirmative and negative covenants.

Unlike conventional convertible preferred equity, debt-like preferred equity instruments generally do not participate in any upside (unless paired with warrants or a common equity co-invest). These preferred equity instruments also differ from other credit products by often providing enhanced information rights (such as a board observer right or monthly financials), reduced remedies (typically limited to a step-up in rate of around 2 percent per annum or more upon any default, as well as specific performance and other rights at law and equity).

While some preferred equity instruments (generally those that sit behind a unitranche or other entirely private opco financing) include a set mandatory redemption date, most include a combination of event-driven mandatory redemption provisions (upon any IPO including a direct listing or SPAC merger to ensure that the sponsor cannot exit prior to the preferred equity holders), change of control, bankruptcy events and, in unrated deals, cross acceleration to opco debt or an opco payment default at maturity.

In addition, these instruments include a step-up in the dividend rate (typically 1 percent per annum increases on the seventh or eighth anniversary and continuing until redemption) and a contractual right to demand that the issuer pursue a sale or IPO of the...
company and redeem the preferred equity with the proceeds. A failure to consummate such sale or IPO could result in a rate step-up and the ability of the preferred equity investors to force such sale or IPO through contractual drag-along and control rights.

Preferred equity instruments may provide for additional remedies (generally in mid-market deals and other situations in which pref equity investors have enhanced negotiating leverage) such as custodial baskets for management covenant breaches, springing board seats or other more punitive provisions, including heavier default rates or step-ups.

A key feature of these preferred equity instruments is the ability to pay in kind the entirety of the dividend payments by compounding the dividend (typically quarterly, and more rarely, semi-annually) and increasing the liquidation preference (or principal) of the instrument in lieu of paying such dividends in cash.

As a result, unlike unitranche loans (which receive both cash interest payments and amortisation payments) or a second-lien loan or unsecured bond (which receive high coupon cash interest payments), preferred equity investors may not receive any cash returns on their investment until the final redemption. They are therefore more focused on limiting returns to the common holders and generally bargain for much tighter restrictions or outright prohibitions on dividends, junior equity repurchases and other returns of capital to the junior equity than are typical for other private credit instruments.

More specifically, the typical debt-like preferred equity instrument generally prohibits any restricted payments or other transfers of value at all (including through back-door investments in unrestricted subsidiaries), other than customary baskets for management stock repurchases, certain holding company expenses and management fees. This prohibition is based on the theory that the pref equity should be redeemed before any cash goes to the common equity holders. Despite some erosion of protections and terms in the markets, investors generally hold firm on this.

Traps for the unwary
Unlike other credit products, preferred equity instruments take a structurally subordinated position in the capital structure, often as the last layer ahead of the common equity without any subsidiary credit support. As a result, while sponsors and issuers often re-frame that the debt covenant track the corresponding covenant in unitranche or other senior opco financing (and often request a cushion to it), many of the baskets and features of these covenants that do not concern guaranteed and secured senior lenders can prove to be a trap for the unwary investor.

For example, senior lenders often allow for greater additional junior debt in reliance on their senior position, but this debt is priming to the preferred equity holder and accepting the same senior debt covenant in a pref equity instrument can often lead to unintended results (such as permitting unrestricted amounts of priming opco preferred and disqualified equity, unlimited shareholder debt at holdings and failing to include other senior instruments in the calculation of leverage ratios).

Many preferred equity providers therefore simplify their debt incurrence covenants by subjecting all opco debt incurrence to an aggregate total leverage ratio cap, with dollar baskets only available for access to the borrower's revolving credit facility, capital leases and refinancing debt. In addition, pref equity documentation generally contains anti-layering provisions that prohibit the priming debt or equity at the preferred issuer or any holding companies between it and opco.

Anti-layering protections may also extend to prohibiting layers of both a market and equity-based context, is preferred equity and the next most senior instrument in the capital structure (other than certain customary instruments as capital leases), in a manner similar to a second lien style anti-layering covenant.

Preferred equity instruments generally include other customary covenants, including passive holding company covenants, restrictions on charter amendments, affiliate transactions, investments, asset sales, and restrictive agreements, and limits on purchases of senior debt by affiliates of the issuer.

In addition, given the higher yield often attached to these instruments, lesser frequency of investment opportunities compared with senior secured deals, greater negotiating power and greater opportunity costs of a withdrawn investment, preferred investors also generally receive enhanced deal-away protection in commitment papers compared with a unitranche financing, with a no-shop provision paired with exclusivity as common constructs for preferred financings.

Despite the rocky market conditions, debt-like preferred equity issuance has continued in volume, including in larger $1 billion-plus tranche sizes. We expect it will have staying power in the market as we continue through the credit cycle.

Understanding pref equity terms from both a market and structural context is essential to avoiding potential pitfalls down the road.

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