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The Increasing Use of Preferred Equity in Financing Acquisitions


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Introduction

Over the course of 2021 and continuing into 2022, private equity sponsors have been incredibly active in executing M&A transactions, with most of those transactions being financed in part through debt incurred at the operating company ("opco"). To supplement these opco-level debt facilities, sponsors pursuing an acquisition increasingly have sought incremental financing in the form of capital at a parent or holding company ("holdco") level above the opco, particularly in the form of preferred equity. The use of preferred equity as a component of a larger acquisition financing package has accelerated recently, driven largely by the combination of sponsors looking to further leverage their portfolio investments (which is particularly important for sponsors where the portfolio investment has a high acquisition multiple), coupled with an increasing number of financing sources willing and able to provide this form of capital. Direct lenders, in particular, are well suited to invest in preferred equity in these situations due to their broad investment mandates and, in many cases, longstanding relationships with private equity sponsors. This greater use of preferred equity in the context of both syndicated and direct financing structures has led to increased complexity in acquisition financing structures and negotiations. In this chapter, we explore this trend in greater detail.

Varieties of Preferred Equity in Financing Acquisitions

Preferred equity has long been a popular investment for institutional investors, including venture capital funds, SPAC investors and private equity sponsors, in part due to its flexibility as a financial instrument providing some combination of protection *vis-à-vis* common equity and a stated return (similar to debt) and, in some cases, potential upside participation (akin to common equity). In its most basic form, preferred equity is an ownership interest in an entity (the "issuer") that ranks senior to the issuer's common equity interests with respect to the rights to receive (i) distributions from the issuer in the form of dividends, and (ii) payments with respect to the equity interests upon an issuer's liquidation, bankruptcy or dissolution. This senior ranking is often referred to as the preferred equity's "liquidation preference" (or, in the terms of the preferred itself, a "stated amount"). In a liquidation, the liquidation preference ensures that the preferred equity is paid in full before any distributions are made for the benefit of holders of common equity. Outside of a liquidation, the covenants in the definitive documentation for preferred equity often significantly limit the amount of distributions that may be made to holders of common equity, with certain exceptions (e.g., for tax distributions) that are often much more limited than the exceptions to the dividends covenant included within opco debt.

The liquidation preference concept is applicable not only as between holders of an issuer's preferred equity and its common equity, but also as between multiple classes of preferred equity of the same issuer. In such a scenario, a given class of preferred equity may rank senior, or junior, to the other classes depending on the hierarchy of each class's specific liquidation preference. Moreover, preferred equity, like all equity securities, is junior in right of payment to any debt of the issuer (and structurally subordinated to any debt at the typically highly leveraged opco and other subsidiaries of the issuer). This places the preferred investor lower in the capital structure of the overall business enterprise and in a structurally junior position to lenders at either the issuer or operating subsidiaries of the enterprise.

All preferred equity will have these basic features in common, but the terms of preferred equity issued in a particular transaction will be shaped by negotiation between an issuer and an investor, with different forms offering an investor a different mix of rights and returns. While all share a liquidation preference over common equity, a common form in recent acquisition financing transactions offers the investor a stated or contractual return – principally a liquidation preference, often a declining premium for optional redemption by the issuer, and a dividend rate – with negotiated terms of redemption, but with little or no participation in equity upside beyond those contractually agreed amounts. Others may share more significantly in equity upside, typically through conversion rights and/or a participating interest in the equity value on an agreed basis. Accordingly, the protection afforded to a holder of preferred equity through the liquidation preference is often coupled with one or more features to effect that return, and may include (i) periodic dividends at a specified rate, accruing and compounding if not paid in cash, thereby increasing the stated value (and liquidation preference) of the investment,[1] (ii) mandatory redemption rights of the holders under certain circumstances,[2] (iii) optional redemption rights of the issuer, typically at a negotiated premium, and/or (iv) the right to convert the preferred equity into common equity and/or to participate in dividends paid with respect to the issuer's common equity. Of course, the mix among these elements, and the degree to which the investor seeks its return through a fixed return or an equity upside, will be the subject of negotiation between the sponsor/issuer and the investor.[3]

In an acquisition financing, the issuer of preferred equity is a parent or holdco above the opco at which the primary acquisition loans and/or bonds are incurred. The cash proceeds of the preferred equity are, in turn, contributed by the issuer to opco and used, together with the proceeds of the opco acquisition debt (and common equity contributed by the sponsor and related parties), to consummate the acquisition. The preferred equity supplements the common equity cash contribution required by the sponsor in a leveraged buyout, even though in some cases the opco debt provides that proceeds from the preferred equity count toward the minimum equity cash contribution (which is typically a negotiated point between sponsors and opco lenders). While the size of the preferred equity (as a percentage of opco's EBITDA) differs from deal to deal, it is not uncommon in recent transactions for the initial stated value to equal or even exceed 100% of EBITDA for the four quarters prior to closing.

Select Terms

Preferred equity issued in connection with recent acquisition financings typically is structured with cumulative dividends, which may be set at a fixed or floating rate that is often several hundred basis points (or more) higher than the market interest rate/coupon for second lien debt or unsecured bonds issued by opco. The dividends compound periodically and are payable "in kind" (if not paid in cash), thereby increasing the stated value/liquidation preference. The terms of the preferred will typically provide incentives for the issuer to redeem, including a dividend rate that increases after a number of years, and trigger events, which may include an IPO or change of control, allowing the investor an opportunity to mandatorily redeem.

Where the opco acquisition financing is rated by rating agencies (which is almost always the case for syndicated financings), having the preferred equity receive "equity treatment" from the relevant agencies has been considered imperative for the opco debt to receive the desired ratings. There are a number of preferred equity terms that factor into this determination, including, to name a few, whether the preferred equity has a stated maturity date and whether the preferred equity has a cross-acceleration provision to the opco debt. It would be highly uncommon where opco ratings are needed for the preferred equity to have a maturity date; in those cases, the preferred equity is perpetual in nature (i.e., the preferred equity does not have a stated maturity date and terminates only after the liquidation preference, together with any accrued and unpaid dividends and any applicable premium, has been satisfied in full through redemption). On the other hand, where opco ratings are not needed (and typically they are not needed in direct lending opco financings), it is not uncommon for the preferred equity to have a stated maturity date. The preferred holders may also have a mandatory redemption right triggered by an acceleration of opco debt (often referred to as a "cross-acceleration" clause in substance), a feature that the rating agencies have traditionally weighed as favoring treatment of the preferred instrument more like debt than equity. Nonetheless, preferred equity in recent acquisition financings has often included this type of cross-acceleration clause, even where there is a need for the opco debt to be rated and for the preferred instrument to receive equity treatment.

In addition to the fundamental items above, there are numerous key business terms that are negotiated by preferred equityholders in the acquisition financing context, including optional redemption premiums, sale and IPO demand rights, negative covenants (often structured as "consent rights"), anti-layering provisions and tax treatment. Anti-layering and related provisions are a particularly important protection for investors to limit the structural subordination referred to above beyond that inherent in a holding company instrument in a leveraged capital structure. Protections include:

- capping the maximum amount of opco debt (by imposing opco-level-specific total leverage ratio tests and debt baskets);
- limiting the incurrence of issuer debt (sometimes prohibited altogether through an issuer-level debt covenant or via a passive "holdco" covenant, which is often a separate but overlapping protection);
- restricting additional issuer preferred equity (although sometimes this is permitted so long as the additional preferred equity is junior to the initial preferred equity);
- minimizing restricted payments that the issuer may make to its common equityholders (often prohibited subject to limited exceptions, e.g., required tax distributions); and
- prohibiting the incurrence of debt, the issuance of preferred equity or the issuance of common equity to persons other than the issuer, in each case by entities between opco and the issuer (typically addressed through an anti-layering covenant and/or a passive "holdco" covenant).

Given the importance of these protections to the ultimate payment of the liquidation preference, investors pay special attention to the interrelated provisions above to ensure robust and complete anti-layering and related protections.

Conclusion

As large acquisition financings continue to come to market in 2022, we expect to continue to see the use of preferred equity as an important component. The use of preferred equity in certain acquisitions with high multiples enables sponsors to execute those transactions with appropriate leverage from the standpoint of the sponsor's equity investment but with reduced impact on the ratings of the related opco debt. Law firms that represent sponsors have quickly adapted to the inclusion of preferred equity as part of a conventional financing package, especially for large-cap transactions, including by sending high-level financing "grids" to multiple financing sources and using other competitive measures that for years have been one of the hallmarks of the opco debt components of acquisition financings. Through these continued negotiations, we expect that some of the parties' expectations and thus the basic parameters of preferred equity may become more regularized, with issuers and investors focusing their attention on the variables – including, of course, economic terms – and variations required for the particular transaction at hand. As this happens, it will be important to stay focused on key structural protections, including those noted above, as well as the implication for the preferred equity of ever greater flexibility in opco financings which often form the basis of the negative covenants and consent provisions of the preferred equity.

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Endnotes

1. While some traditional forms of preferred equity will put a premium on cash dividends and impose certain incentives to payment in that form (e.g., no distributions on common while preferred cash dividends are in arrears), many or even most of the instruments discussed in this chapter will be structured with the expectation that in the ordinary course dividends may be capitalized rather than current cash-pay.
2. A preferred equity investor's ability to realize the benefits of any mandatory redemption rights may be limited where doing so would render the issuer insolvent or impair its capital. This risk is even more pronounced where – as is most often the case – the issuer itself does not generate cash and instead relies upon distributions from opco and other subsidiaries as its main source of capital. The determination of whether an issuer (or its opco subsidiary) has sufficient surplus capital to pay dividends to preferred stockholders or to redeem preferred equity is subject to the discretion of the issuer's board of directors, to whom judges have historically given wide deference.
3. In an acquisition financing context, preferred equity is often issued at a discount to its stated value, offering the investor a further avenue for profit regardless of the mix between the fixed rate of return (dividends) and the more variable (conversion or equity upside).

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