Alternative Solutions for Financial Sponsors in a Challenging LBO Market: A Look at Tailored Investment Models

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In light of the current macro-economic climate, including the high-interest rate environment in Europe and the United States, traditional leveraged buyouts face an increasing number of obstacles. As sponsors look to deploy the record levels of capital raised in recent years, and with large valuation gaps persisting between sellers and financial sponsors, alternative structures as a means to invest such capital and provide liquidity to willing sellers are becoming more popular.

Partnership/Non-Control Investments

One of the increasingly common investment strategies emerging in the market is the "partnership" model, where sponsors take a non-controlling equity stake in the target while existing owners retain significant equity and control of the business. Some key considerations for sponsors looking to pursue a non-control partnership structure include the following:

- **Alignment on investment thesis:** Tailoring the terms of a partnership investment to serve the interests of incumbent shareholders with potentially contrasting interests to the incoming financial sponsor is one of the key challenges to these investment structures. As with any successful partnership, it is important that the parties agree, at the outset, on the core tenets of the arrangement. Early-stage alignment on investment rationale, business strategy, contemplated hold period, exit strategy and tax planning will help to yield a more fruitful partnership. The appropriate rights and protections that reflect such fundamentals need to be incorporated into the shareholders' agreement (or similar arrangements) between the sponsor and the existing shareholder(s) to avoid conflicts later on in the life of the investment.

- **Future funding needs, transfers and exit:** Sponsors will want to ensure they have the opportunity to acquire further shares in the target, both in the event that the business requires further capital, and possibly in the event that the partner shareholder looks to transfer, in whole or in part, its interests in the company. As such, sponsors may wish to negotiate pre-emption rights on new share issuances, as well as rights of first offer and/or refusal upon a proposed transfer by the partner shareholder, depending on the dynamics of the partnership and the partner's willingness to agree to such terms (which may be viewed as an encumbrance on the partner's ability to transfer its shares).

Equally important to financial investors is the path to exit, whether via a private sale of the company or public offering. Sponsors should ensure that the shareholders' agreement clearly sets out how and when the exit process may be initiated, and how decision-making in connection with such process (such as the appointment of a financial adviser) is allocated between the parties. Notwithstanding its non-control position, the sponsor may have greater experience of exit processes, and so may be well-positioned to negotiate meaningful rights (relative to the parties' percentage holdings) in relation to such matters.

- **Decision-making and governance:** The composition and decision-making of the board of directors (and, if applicable, certain committees of the board) is another area of focus for sponsors in partnership transactions. While a sponsor may not control the board (or any such board committees) in a non-control partnership structure, it will, provided its shareholding is sufficiently significant, want to ensure that an appropriate set of "reserved matters" (i.e., decisions requiring the consent of the sponsor's director nominee(s)) is catered for in the transaction documentation. Sponsor reserved matters commonly consist of strategic actions (e.g., acquisitions, disposals and entering into new lines of business), budget and business plan approval, and transactions between other shareholders (and their affiliates) and the target company. The precise scope of such matters will be a matter of negotiation and will depend, in part, on the investment thesis for the transaction and the parties' relative ownership stakes.

  The significance of a robust set of reserved matters in a partnership structure is accentuated by the fact that, unlike in the traditional buyout model, a sponsor will not have full control of the make-up of the portfolio company's senior management team. Reserved matters represent a useful tool for the sponsor to exert some degree of control over the day-to-day operations of the business that it may not otherwise have.

Preferred Equity Investments

One of the tools increasingly used by sponsors to implement bespoke investments, such as in a partnership model, is preferred equity securities. While the specific terms of any given preferred equity security can be highly customised to the parties' commercial deal, and therefore will vary from transaction to transaction (e.g., one preferred equity instrument might have more equity-like features than debt-like features, or vice versa), in its most basic form preferred equity is senior in interest to ordinary shares, but subordinate to debt, and carries a fixed coupon providing the holder with a guaranteed return. Below, we explore some of the common characteristics of preferred equity structures:

- **Tailor-made instruments:** These customised instruments can offer significant flexibility in their structuring and terms, particularly as regards the economics and return profile of an investment, and can essentially take whichever form the parties agree to. It is this highly tailored aspect of preferred equity that sponsors find increasingly attractive and that has contributed to preferred equity having become a key weapon in the arsenal of financial sponsors when considering investments in both publicly listed and private companies.

- **Dividend rights:** A fixed dividend is typically paid in respect of preferred equity in cash or, at the issuer's election, in kind (via the issuance of additional preferred equity or via accruals), or a combination of the two. It is customarily paid in preference to any dividends payable on ordinary equity. When negotiating the terms of the preferred instrument, sponsors should be mindful of any rights of the issuer to "catch up" and pay accrued dividend payments from prior payment periods, as this could deny the upside of ordinary share appreciation by diverting cash away from the business that could otherwise be used to increase the value of the business. Participating preferred equity gives holders the right to receive preferred dividends, and also to participate in distributions made on the company's ordinary equity, on an as-converted basis (i.e., in an amount equal to what the holder would receive if the preferred was converted into ordinary shares immediately before payment of the relevant distribution).

- **Liquidation preference:** For debt-like preferred equity, the holder's entitlement upon a liquidation event is generally equal to the initial cost of the preferred instrument plus any accrued and unpaid coupon (i.e., the "liquidation value"), which amount will be paid to the preferred holder in priority to any payments made in respect of ordinary shares. For equity-like or participating preferred, the holder's entitlement is generally equal to the greater of the liquidation value and the amount that the holder would receive if the preferred was converted into ordinary shares immediately before liquidation (i.e., on an as-converted basis).

- **Conversion:** At its issuance, the preferred instrument has a fixed return, the initial cost of the investment plus the dividend. It is relatively common, however, to structure the preferred to allow it to participate in future value appreciation through its conversion into ordinary shares at an agreed price. The instrument's terms can also provide for mandatory or automatic conversion, triggered upon exceeding a particular time-based or value-based threshold. While sponsors may seek to reduce the scope of mandatory conversion events, thereby prolonging the life of their senior equity instrument, the other shareholders will want to force the conversion of the preferred equity into ordinary shares sooner rather than later, so as to remove the sponsor's preferential right to cash flows, whether on a distribution, return of capital or otherwise. Conversion rights are more limited in debt-like preferred instruments.

- **Redemptions:** Equity-like preferred instruments are often perpetual, without any redemption rights or "maturity date". Yet, in respect of debt-like preferred equity, holders may have a right to require redemption by the issuer upon certain trigger events. Some issuers may also have call rights to redeem the preferred equity after a negotiated period (e.g., after five to seven years, or longer at eight to 12 years) and often at a significant premium to the instrument's liquidation value.

- **Voting and governance:** Preferred equity can be voting or non-voting, or carry rights to vote as a separate class on particular topics (similar to shareholder reserved matters commonly seen in ordinary equity investments, described above). To complement any such voting rights, depending on the size of the stake held by the sponsor, the preferred instrument might also entitle the sponsor to board and/or board committee representation. Covenants focused on governance and shareholder protections for the sponsor are typically seen in equity-like preferred, whereas debt-like instruments include covenants focused on the policing of the issuer's financial condition (similar to restrictions over asset sales and the incurrence of debt, which traditional lenders would want to see).

- **Default:** The rights of the preferred equity holder upon a default by the issuer will need to be pre-negotiated by the parties to ensure that the sponsor is adequately protected in such circumstances. If the preferred instrument is structured as an equity instrument (as is often the case), the holder will not be entitled to call a default to demand repayment (and even in the case of a debt-like instrument, any accelerated repayment right would typically remain subordinate to the rights of other creditors). It is therefore important to structure the holder's rights. While such rights will differ from instrument to instrument (and may also depend on what is, and what is not, permitted under the terms of the issuer's constitutional documents and/or financing documents), they may include an increase to the dividend payable on the preferred, a springing board appointment right for the preferred holder, a forced sale of the issuer or a forced capital raise to finance the instrument's redemption.

When contemplating a preferred equity investment, a sponsor should consider which characteristics it requires in the instrument and should also weigh up the potential advantages and disadvantages of such an instrument versus subscribing for ordinary equity or a traditional debt security.

Considered next to ordinary equity, preferred equity has inherent downside protection through the liquidation preference and its prescribed yield. Such characteristics can allow parties' valuation gaps to be bridged more easily, as sponsors may be more willing to agree to a non-controlling stake at a higher price in return for a guaranteed return. On the other hand, despite the parties' commercial intentions, preferred equity may be characterised as debt, which may present an issue from a balance sheet perspective, contravene contractual anti-indebtedness covenants, trigger adverse rating agency treatment and/or lead to different tax treatment of distributions made in respect of the preferred equity.

When compared to debt, the potentially higher coupon paid on a preferred instrument, the upside potential in an equity investment and its characterisation as equity on the balance sheet might make it a more attractive option to a sponsor. At the same time, however, the preferred equity would sit lower down in the capital structure to traditional debt, leaving the sponsor with less protection against debt holders in an enforcement scenario.

Concluding Thoughts

In a more challenging leveraged buyout market, we are seeing increasingly varied investment structures being implemented by sponsors in the European market as they seek to invest their dry powder, and we predict that this trend will continue.

Provided that a particular structure, whether a non-control partnership investment effected through an ordinary equity instrument or a preferred equity instrument, or a variation of either of the two, reflects, and indeed protects, a sponsor's investment thesis, such structure may be worth pursuing, even if it is a departure from the firm's traditional strategy. As the market matures in respect of such investment structures, sponsors who are familiar with their characteristics (and associated pitfalls) will be best positioned to take advantage of opportunities that might not otherwise be readily identifiable in the context of a traditional buyout strategy.

In particular, preferred equity investments in the context of private investments in public equity ("PIPEs") remain less common in Europe than in the United States, due, in part, to a perceived lack of familiarity and institutional investor sentiment, as well as legal and regulatory constraints applicable across the major European jurisdictions. Such instruments, however, are gaining ground on this side of the Atlantic as sponsors and their advisers identify and implement an increasing number of workarounds to such perceived constraints.

We would be happy to discuss these structures (and any alternatives) with any sponsor considering implementing a particular customised investment structure.

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Please do not hesitate to contact us with any questions.



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