

E X P E R T Q & A

Ed Ford and Sacha Gofton-Salmond of law firm Travers Smith outline the pros and cons of preferred equity transactions



Preferred equity vs secondaries transactions: The GP's choice

Q Can you explain the difference between a straightforward secondaries transaction and a preferred equity transaction used to give LPs liquidity?

Ed Ford: A straightforward secondary sale typically involves a change in the ultimate ownership of a pool of assets; the selling LP(s) crystallize their position and exposure to future upside in a portfolio is held by the buyer. Conversely, in a preferred equity transaction, the existing LP base will typically receive a cash distribution (which is effectively supplied by the preferred equity provider) and retain exposure to the future upside in a portfolio, albeit that they generally only benefit from that upside once the preferred equity provider has been paid out.

Q What situation lends itself to a GP choosing preferred equity rather than a conventional secondaries transaction?

Sacha Gofton-Salmond: There are sever-

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al features of preferred equity that make it appealing to GPs. Firstly, it involves a fairly simple structure. There is no need for a new fund to be put in place with all the documentation that entails, as would be required on a GP-led secondary transaction. The existing fund vehicle and documents remain in place, but the wider structure will effectively have two classes of interest (one for the existing LPs and one for the preferred equity provider).

Secondly, discounts to NAV will not be relevant on a preferred equity transaction, which is helpful for a GP where they have existing LPs whose policy is not to “sell” at price less than 100 percent of NAV.

Another benefit is that, generally speaking and as compared with traditional bank debt, preferred equity terms will not include an obligation to service cash/pay interest,

there are no repayment dates and no security is required to be provided over fund assets. Of course, preferred equity transactions can also enhance IRR where partial liquidity is offered to existing LPs.

EF: The preferred equity process is generally easier to implement and involves fewer conflicts than a typical GP-led secondary. This means the GP can execute the transaction quickly and remain focused on their primary objective of generating value within the portfolio. Likewise, if the GP is trying to balance a need or desire to return cash to LPs with its view that there is more growth in a portfolio, then the relative ease of a preferred equity solution, the fact there is no discount to NAV and the fact that all LPs will hold their investment exposure to a later point on the J-curve may push a GP down that route.

Q Is preferred equity typically only used as a means to make

distributions to existing limited partners, or is it also used to raise new capital for the portfolio?

EF: As well as being used to give LPs (and potentially carried interest holders) a degree of liquidity ahead of an exit event at portfolio level, GPs can also use the cash to increase their follow-on capability and to maximize the amount of cash deployed within a fund structure. In that way, it can act as an alternative to leverage within a fund structure. One of the strengths of preferred equity is how flexible the providers are; our experience is that they will work closely with GPs to tailor a suitable product.

Preferred equity is not the only way to raise further capital for a portfolio – GPs looking for that option can also implement a GP-led secondary, with the secondary buyer and/or ‘rolling’ LPs providing further capital.

The banks are also starting to look at this space and already offer comparable liquidity products using debt.

Q You mentioned banks and secondaries players now operate in this space; are they all doing so?

SG-S: Not all secondaries players are providing preferred equity; some are currently not entering this market. But we are seeing more and more of the big secondaries players offering preferred equity products and think this space will continue to grow.

EF: It is definitely a growing space. Increasingly, groups with an equity-focused investment background (the secondary funds) are prepared to provide preferred equity. Likewise, we know that banks are looking at it and they already provide NAV-based lending products that replicate a preferred equity structure in a number of respects.

Ultimately, both the secondary funds and the banks have expertise in assessing the risk-reward profile relating to a fund’s asset pool, so to some extent it is inevitable that they will move into this space.

Q When weighing up transactions, is a preferred equity deal an easier route to take for the GP as limited partners are not presented with any choices?

EF: You are certainly minimizing, though not eliminating, conflicts of interest and the need for LP engagement. It is general-

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ly within your investment discretion as the manager of a fund to raise preferred equity; this does not typically require formal LP consent or the consent of the fund’s advisory committee and is unlikely to be subject to specific caps, controls and reporting requirements under the fund documentation as may be the case with more traditional leverage options.

That said, the reality is you need to get key LPs on board with the process because it affects the return profile of an LP’s investment. Certainly, the preferred equity process is not the same as doing a full-blown GP-led secondary transaction where the conflicts are everywhere you look and LP engagement is a strict requirement. It is a much more contained process: a much quicker process.

Q What are the legally sticky bits of preferred equity transactions?

EF: One of the key problems with this is that you effectively end up with two classes of LPs: the LPs who have put in the preferred equity and your other LPs. It may well be that those two classes of LPs are aligned, in which case this does not cause a problem, but there may be situations, for example on a large portfolio exit, where that alignment is skewed. That can put the GP in a tricky situation.

Equally, if a GP is raising preferred equity to provide its LPs with liquidity so that they will re-up into the GP’s next fund vintage, then there can be a potential conflict there: is the preferred equity solution being used in the fund’s best interests or the GP’s best interests?

SG-S: ILPA released its first set of guidelines on GP-led fund restructurings in April 2019 which focus on managing and addressing conflicts of interest in these types of scenarios. To an extent, the guidance is of application to preferred equity offerings. The introduction of these new guidelines highlights the importance of addressing concerns around how to manage conflicts and engage with the LPs. The guidelines are a welcome development in this sphere as they will encourage a dialogue on these issues.

EF: It is all very well us saying you need to act in the best interests of your LPs, and of course GPs do, but the reality is that each of your LPs will have slightly different views on liquidity offerings.

If you go back a few years, equity bridge facilities were a hot topic. There were certain LPs who were quite vocal in their opposition to those, whereas other LPs were in favor. The reality is that most LPs have not yet fully formed their views on preferred equity or the various other liquidity options provided in the form of NAV-based lending and, when they do, LPs will not all be in agreement, so there will always be a degree of conflict among LPs on the benefits of these structures.

Q Are there any other considerations when weighing preferred equity vs a secondaries transaction?

EF: One downside to preferred equity is that, arguably, it is not the most tailored solution. If a GP undertakes a full GP-led secondary then it will be possible to give each LP the option as to whether to exit the portfolio and take full liquidity, ‘roll’ and maintain full exposure to the portfolio or a combination of the two. That optionality means that you can develop neat, targeted solutions that, in theory, keep everyone happy.

The preferred equity option applies equally and proportionally across the LP base, so it is less bespoke as a result. The absence of repayment terms, acceleration rights and security will also make preferred equity options more expensive than the debt alternatives. ■

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