CLIFFORD

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'DECODING' THE SECONDARY MARKET

PART II: PREFERRED EQUITY

MAY 2020

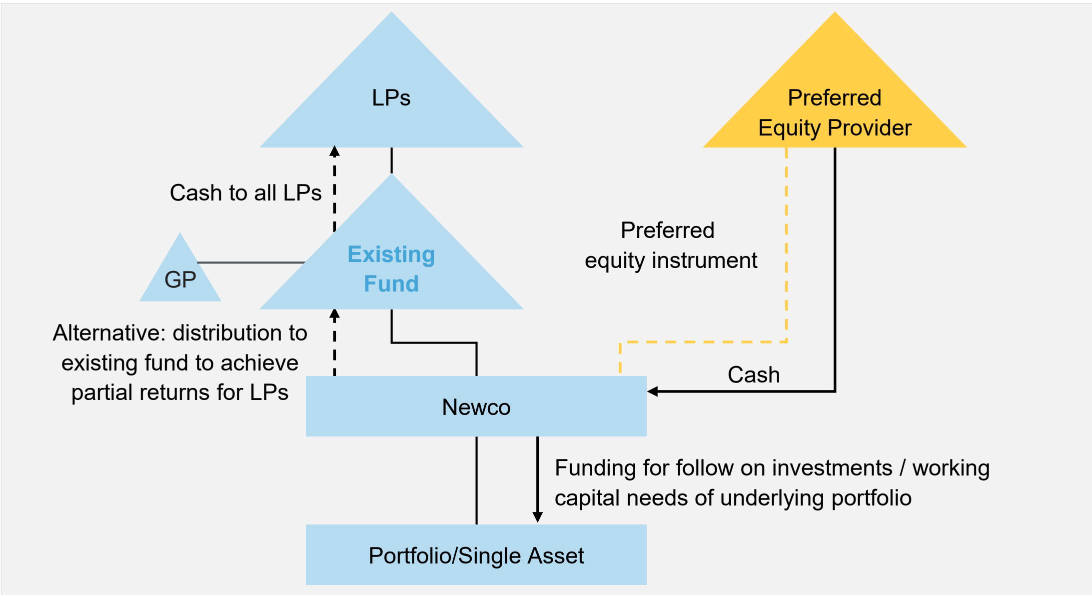
PREFERRED EQUITY

Investors and portfolio companies are grappling with short and medium-term liquidity challenges. There is a tension between cashflow needs of the underlying portfolios and availability of funding. Preferred equity can provide an alternative source of equity financing to bridge possible funding challenges at the fund level, either on a portfolio basis or for individual assets.

As Part II of Clifford Chance's series on 'Decoding' The Secondary Market, the Secondaries team explore some of the key features of preferred equity solutions.

What is Preferred Equity:

Provision of cash by preferred equity provider who, in return, will hold equity instruments with a preferred return over a portfolio or single asset. These instruments typically have priority over the common equity held by LPs in the proceeds waterfall. Cash funding typically up to 50% LTV.



Typical structuring steps:

1 Existing fund transfers a portfolio of assets or single asset to a newly established vehicle ("**Newco**") in return for equity in Newco.

2 Newco issues preferred equity instrument to preferred equity provider in exchange for cash.

3 Newco contributes cash to underlying portfolio/asset to meet working capital needs or make follow on investments.

Key drivers for GPs:

- Additional investment capacity and access to cash for underlying portfolio whilst avoiding NAV discounts or capital calls from existing LPs.
- Potential carry liquidity, or potential to avoid/reduce carry clawback.
- In contrast to GP-led secondary transactions or debt financing, GPs may have broader flexibility around LP engagement or ability to focus on a smaller number of key investors, dependent on the transaction and the fund documents.

Key drivers for LPs:

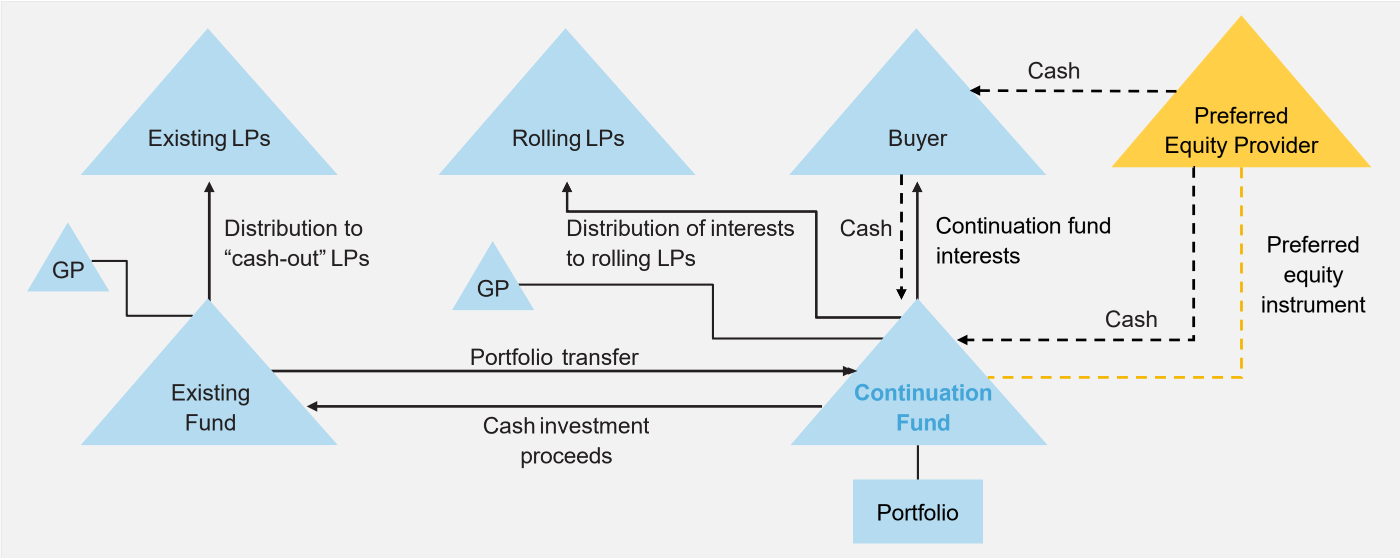
- Liquidity at the fund level without sell down of fund position.
- Retains future upside of fund performance once preferred return is achieved.
- Mitigates further capital commitments to private fund assets in line with internal allocation limits, particularly where LP is experiencing the 'denominator effect' due to a fall in value of liquid assets.

Benefits over debt/other credit solutions:

- More downside control retained by GP/ fund in contrast to bridge debt financing.
- No security over assets or LP commitments; lower risk of LP giveback.
- No servicing of cash interest.
- Limited maintenance and financial covenant.
- More flexibility in waterfall structure/ proceeds sharing.
- No fixed term for repayment.

ALTERNATIVE STRUCTURES

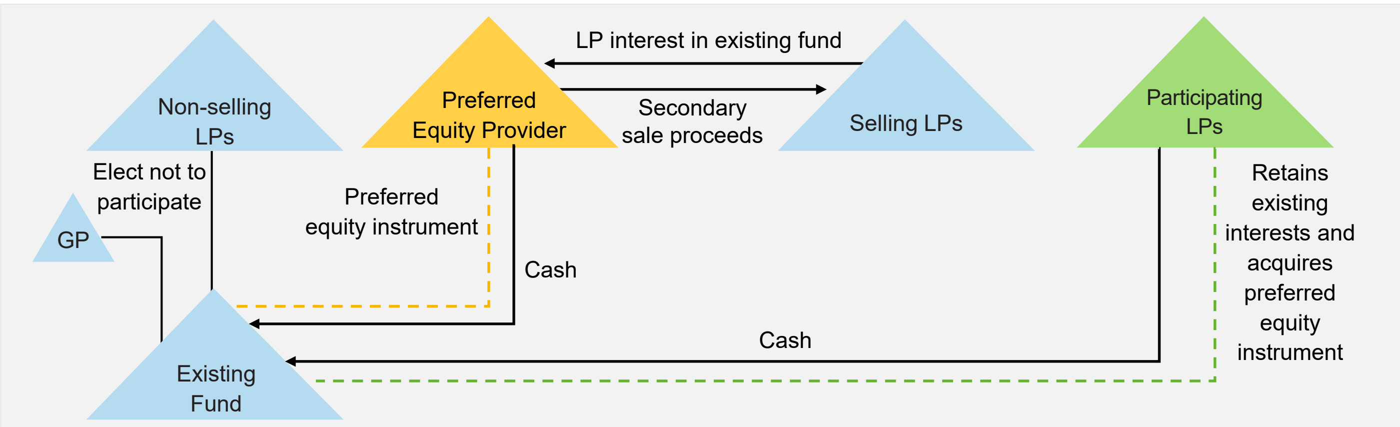
(1): COMBINED WITH GP-LED SECONDARY WITH NEW CONTINUATION FUND



Combined with GP-led secondary transaction: Preferred equity solutions can be combined with GP-led secondaries to **maximise optionality** and early liquidity for existing LPs. A preferred equity provider may acquire the entire continuation fund and sell-down the common equity to its LPs and/or other secondary buyers, or simply fund a secondary buyer in the transaction by way of preferred equity.

Pre-transaction consents: As with GP-led secondaries, **change of control or transfer restrictions** in underlying equity or debt documents may be triggered (including exit provisions under MIP documents). This can often be mitigated where the GP of existing fund retains control of the SPV or new continuation fund. Depending on the transaction structuring and the existing fund documents, there may be scope for GP to run a **streamlined consent process** at the fund level, focusing on engagement with key investors.

(2): FUND-LEVEL FINANCING WITH PARTICIPATING LPS



Fund-level financing with LP exit option: A preferred equity provider may provide direct financing to an existing fund in return for the preferred instrument. Existing LPs have **optionality** to (a) provide additional cash and participate in the preferred equity alongside the preferred equity provider, (b) remain invested in the fund without participating (and agree to rank behind the preferred equity holders) or (c) sell their entire interest in the fund to the preferred equity provider (and/or a separate secondary buyer).

Fund-level consents: Whilst likely to require a **broader range of fund-level consents** and more active LP engagement, this structure typically involves fewer change of control or transfer restrictions in underlying equity or debt documents triggered (depending on the transaction structure and the size of any transferred investor commitments). Giving LPs the flexibility to choose their level of involvement, including a full sale of their interest, can assist with LP discussions.

PREFERRED EQUITY
KEY ISSUES

Protections for preferred equity provider: Typically the preferred equity provider would impose **LTV covenants** as well as veto rights (for example, over any significant asset-level acquisition, disposal or indebtedness). Additional protections include board/observer seats, call protection, step-in or mandatory redemption/put option rights in default scenarios, etc. LTV covenant test may be by reference to the fund's internal valuation or third-party calculations.

Waterfall adjustment and ratchet: The waterfall may be **adjusted by LTV and/or diversification tests**. Other events could also trigger LTV adjustments (e.g. breach of negative pledge or borrowing restrictions, insolvency, GP replacement, change of control over the fund, agreed amount not being distributed within target timeline, etc.). If the preferred return is not realised before the agreed time, a ratchet may also be triggered.

Distribution waterfall: Fund management fees and fund expenses are typically paid first, followed by either a pure **preferred return** to preferred equity provider **up to the agreed threshold**, or a blended return in agreed proportions between the preferred equity provider, the LPs (fund) and the GP/carry LP up to a threshold. Further distributions are generally then returned to LPs (fund) and the GP/carry LP under the common equity arrangement.

Conflicts of interest: As preferred equity arrangements may result in a **loss of future upside** for the fund, conflicts of interest are relevant. There can be **tension** between: (i) a GP's duties owed to LPs to maximise returns for the fund as a whole; (ii) the GP's desire to secure liquidity for key investors; and (iii) the liquidity needs of the portfolio company.

Tax considerations: Different tax issues can arise depending on the structure adopted. Insertion of a Newco within the structure may give rise to capital gains for existing LPs plus transfer taxes – although **"roll-over" reliefs may be available**. The on-going tax efficient repatriation of cash to existing LPs and the new preferred equity provider must be considered in each case. Rolling LPs (and the fund executive team) in a Continuation Fund structure will be keen to ensure tax roll-over treatment where possible. Fund-level exit options can also give rise to transfer and withholding taxes – U.S. taxes in particular are an issue to be grappled with in most transactions regardless of the identity or tax profile of the selling or new LPs. Impact on tax structuring of portfolio companies' holding structure will also need to be analysed.

Other Preferred Equity Scenarios

LP-led preferred equity solutions: In addition to GP-led structures, a **single LP with a cross-fund portfolio of LP interests** may seek preferred equity solutions. In this scenario, the preferred equity provider would typically extend a one-off payment or a revolving facility to that single LP. In exchange, the preferred equity provider would have priority on a preferred return basis over distributions received across that LP's portfolio. This allows for an LP to achieve accelerated liquidity and/or meet further capital calls where it would otherwise not be able to do so.

Preferred equity funding to help "follow the money": Early-stage investors in successful and now large venture capital assets may turn to preferred equity providers to **avoid dilution** of their stake **in further funding rounds**. The preferred equity provider could provide capital to enable an investor to fund on a pre-emptive offering and thereby bridge any gap in financing that might otherwise exist. This allows the investor to fulfil its pre-emption rights whilst defraying risk and bringing in new capital, which can carry its own economics with the investor.

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