KEYNOTE INTERVIEW

Why structured equity is a tool for all seasons

In a high interest rate environment, structured equity is having its moment in the sun, but it is a strategy that works throughout the economic cycle, says Matt Shafer of Northleaf Capital Partners

Q What do we mean by structured equity?

Structured equity is a form of capital that ranks behind debt in order of repayment, but in front of common equity. There are a number of different forms that structured equity can take, but, generally speaking, interest accrues over time but is not charged in cash. It does not place a cash interest burden on the borrower or issuer of the security.

The return characteristics, as you might expect, sit somewhere between debt and equity. Because you are not getting ongoing cash interest and because structured equity ranks behind debt in terms of repayment, returns are meaningfully higher than for a conventional debt security or loan. However, because the investment ranks ahead of common equity, you are not taking as much risk on the ultimate valuation, but you also do not benefit from the full upside available.

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Q How has the use of structured equity evolved over the years?

An increase in interest rates and the burden that this places on borrowers means this is an instrument that is having its moment in the sun right now. However, structured equity is not something new. Firms have provided solutions that do not have a cash interest element to them and which rank in front of the equity for a long time.

Historically, structured equity has been used as a form of non-control equity investment. For example, it is often used by sponsors investing in founder-owned businesses to ensure their position ranks in front of the seller's rollover position. Yet while structured equity has been around for decades, it has not been systematically used at scale. There are a few dedicated funds and some other players that use the tool opportunistically, but this is still a relatively undercapitalised space.

We have been doing this systematically since 2018, with a particular focus on businesses owned by other private equity firms. At Northleaf, our ethos is to be a source of partnership capital for the private equity industry. We invest in secondaries, and we make primary commitments and co-investments, and we have a private credit business that primarily lends to sponsor-owned companies. We therefore see structured equity as a natural part of the continuum of partnership capital solutions we provide.

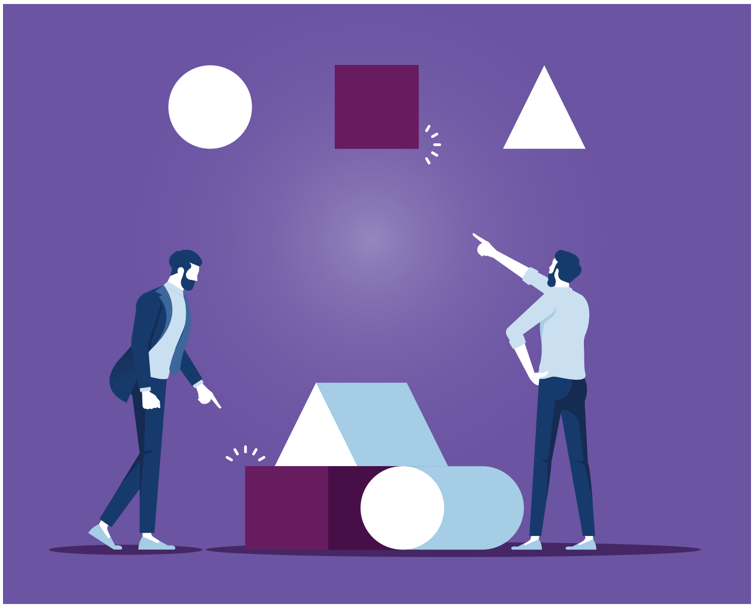
Q What was the rationale for structured equity when you began investing in this space?

We started doing structured equity investments in 2018, and obviously it was a very different economic environment from that which we are experiencing now. There was a relative abundance of cheap debt capital. However, some of our investors were becoming concerned about the multiples being paid by private equity funds, and the reliance on further multiple expansion for generating returns. They wanted to reduce the valuation risk they were taking.

In light of this, we started providing structured equity as an incremental turn or two of leverage to strong private equity-backed businesses in order to help them grow. We were allowing the sponsor to get additional leverage and, even though debt was cheap and abundant at that time, there were firms that valued this non-cash pay form of capital because it freed up cash to execute on their growth strategies. We completed 12 deals in the benign financing environment that existed between 2018 and early 2022. Those investments have generally been quite successful.

Q Why should LPs be thinking seriously about getting exposure to structured equity in the current environment?

Investors inevitably want to understand what they can get from structured equity that they cannot get from their debt investments or their equity investments. Clearly, the returns on offer are higher than that available from a conventional debt strategy. You are being compensated for taking a little more capital structure risk and for the relative scarcity and complexity of this type of funding. With regard to equity, investors are sacrificing some of the upside. However, private equity multiples remain high given the quality of businesses that are trading in the market right now. Structured equity is a great way to generate strong returns without taking that last dollar of equity value risk in what many believe to be an expensive market.



Q How is the rationale evolving now that we are in this more challenging economic environment?

There has clearly been a significant shift in the market brought about initially by inflation, and then the corresponding increase in interest rates. These factors have created two major needs.

First, the need for supplemental capital to support portfolio company growth. A business acquired with 6x leverage in 2021 when base rates were effectively zero has had its post interest cashflow cut approximately in half, just because of the increase in base rates, before you even consider company performance or widening credit spreads. That means there is a need to bring in another source of capital that will not put a cash interest burden on those companies in order to allow them to continue to grow.

The second major need is liquidity for investors. The increase in interest rates, coupled with macroeconomic and geopolitical uncertainty, has dramatically reduced the number of exits taking place and therefore the amount of capital flowing back to LPs. That has consequences for returns, because investments are being held for longer and are not growing as fast. It is also making fundraising more challenging because investors don't have access to the distributions they need in order to re-up to new funds. This is motivating private equity managers to use tools like structured equity to return capital, which both improves returns and better positions their next fund.

We are being highly selective in this environment and have only completed three deals since the inflation and interest rate environment changed, with meaningfully higher return expectations than we had previously been targeting. Two of those deals were to support portfolio company growth and one was to provide liquidity to investors through a dividend recap.

In all cases, the deals involved high-performing portfolio companies that were very important to their sponsors. I cannot emphasise enough that for us this is not a form of rescue finance. We see it as a way to provide growth capital or generate liquidity for investors in high-quality businesses backed by high-quality sponsors.

Q Growth capital and liquidity for investors are rationales for continuation funds and NAV loans. When and why would a structured equity deal make sense, as opposed to these other solutions?

That is something that we think about a lot because Northleaf provides NAV loans and supports sponsor-led continuation vehicles as well. Proceeds from NAV loans are indeed often used to support growth and to provide liquidity to investors. However, NAV loans require the cross-collateralisation of a private equity fund, and not all LPs and GPs like this approach given it is a less established form of capital when compared to structured equity.

Furthermore, while NAV lending offers great risk/reward characteristics and can be a less expensive alternative for a sponsor, those deals can be more complicated since LPs and GPs are less familiar with them. Given this, they can be time consuming and often require approval or at least communication with LPs.

> *"What is beautiful about structured equity is that there is no complexity at the fund level"*

What is beautiful about structured equity is that there is no complexity at the fund level. It is simply a form of capital that the sponsor can choose to issue from its portfolio company. It is therefore fast and easy to execute, although it may be a slightly more expensive solution compared to NAV loans.

Continuation vehicles also address investors' need for liquidity. However, this involves taking the assets out of the fund, which isn't always what LPs want. With structured equity, the asset can remain where it is while still allowing investors to benefit from an early return of capital and retain potential future upside.

Additionally, continuation vehicles do not address, at least in sufficient scale, the need for capital to support portfolio company growth. Furthermore, getting some unfunded capital together through a continuation vehicle may be suitable if you have a theoretical acquisitive growth strategy in mind. However, if there is a specific and imminent acquisition that needs to be funded, the timelines simply won't work.

Continuation vehicles can take a long time to complete and can also be unpredictable in terms of how much capital will ultimately be raised. A structured equity solution, by contrast, can be diligenced and documented in a normal deal timeframe.

Q How do you see the structured equity market evolving in this challenged economic environment and beyond?

We believe that interest rates may remain high for a meaningful period of time, and so maturities will need to be addressed on loans that have been made to portfolio companies. There will therefore continue to be a need for outside capital to support portfolio company growth.

Meanwhile, if and when interest rates come down, that is unfortunately likely to be in the context of a slowdown in economic growth. In that environment, there will continue to be a strain on portfolio companies' ability to generate cash to grow. That environment is also likely to produce some good opportunities for strong businesses to acquire weaker competitors and, again, structured equity will have an important role to play.

Finally, when we do return to a more benign economic outlook, we have evidence that this strategy will continue to work and that it will be valued by sponsors in that environment as well. Structured equity is a tool that makes sense throughout the economic cycle. ■

Matt Shafer is a managing director and head of capital solutions and US private equity at Northleaf Capital Partners