
KEYNOTE INTERVIEW

The rise of preferred equity



As GP-led secondaries establish themselves as an accepted route to liquidity, the intersection with preferred equity financing is gaining prominence, says Simpson Thacher & Bartlett's [Drew Harmon](#)

Q The global PE secondaries market has expanded significantly in recent years. What trends are driving that and how do you see that market evolving?

The primary driver behind the expansion is the profound liquidity paradox that the industry is facing. More than half of all buyout investments have been held for four years or longer at this point. It has created a massive backlog of unrealised investments, and notwithstanding all the continuation vehicle transactions we have seen, there is a lot of demand from LPs to create liquidity. Even as we start to see more

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buyout activity, more strategic sales and the IPO market starting to open up, there remains significant work to be done.

Long ago, secondaries were seen as an outgrowth of zombie funds and had a bad reputation. Now we hear about GP-led secondaries as the primary exit outlet for trophy assets. The secondaries market really is a new piece in the broader toolkit available to both GPs and LPs, and the growth we have seen looks set to continue.

Still, that is only one piece of the puzzle. GP-led secondaries can be used in distressed scenarios, in normal scenarios and for trophy assets. They provide an additional tool for generating liquidity in the same way that funds might otherwise use NAV loans, tender offers or traditional LP-led portfolio sales.

We are seeing that as the GP-led market grows and matures, LPs are increasingly emboldened to demand liquidity and hold GPs to account when exit markets are more challenging. What ultimately differentiates successful outcomes, then, is having an adviser who understands how these

tools interact – legally, commercially and from an LP perspective – and who can navigate that complexity in real time.

Q The growth of GP-led deals is also bringing an increased demand for structured secondary capital, including preferred equity. How is that dynamic influencing the market?

This is part of a broader structural shift, whereby GP-leds are becoming the primary means by which managers are looking to achieve realisations. In an era where we have learned that traditional M&A and IPO markets are temperamental, GP-leds have become the constant. Firms are now underwriting with these transactions in mind, not just using them as a tool for managing duration.

As much as secondaries are exploding, we also see the increasing use of preferred equity up and down the fund structure, by managers of all shapes and sizes. Preferred equity is a third way for sponsors to navigate the gap between common equity and low-flexibility senior debt.

When you start looking at the toolbox of capital and liquidity solutions that are available to managers, preferred equity emerges as a useful tool in cases where managers perceive their assets to be undervalued and want to generate liquidity while retaining some upside.

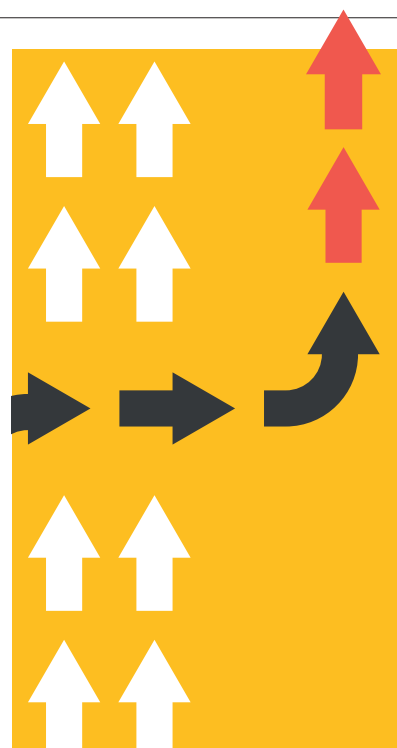
Our role is often less about selling a particular structure and more about helping sponsors understand the trade-offs across the full menu of options – and then executing the right one cleanly.

In one recent transaction, for example, we helped a sponsor layer preferred equity below the fund alongside existing NAV financing, allowing LPs to retain full upside while solving an immediate capital need. Neither pure debt nor a traditional secondary would have achieved that.

Q What types of sponsors are best suited to managing preferred equity and executing GP-led transactions?

More than half of the preferred equity mandates we have handled in the past year began without a predetermined structure; circumstances ultimately guided us to the right solution, whether preferred equity or debt. That agnosticism is itself a differentiator, in that those managers that can think about capital holistically and work with advisers who can support that level of sophistication will be best positioned to navigate the next phase of private markets.

Preferred equity is not always the answer – there are a lot of variables in play, and sometimes a NAV loan or selling a GP stake will be more appropriate. But the managers using preferred equity typically view it as the right tool for a particular situation, irrespective of their size, AUM or investment strategy.



Q What are the most common use cases for preferred equity?

We really see preferred equity being used in three key manners, with the first being management company preferred equity. This is where management companies use their existing fee streams, fund interests and carry as collateral and borrow against those through a preferred equity structure. That can be used to create working capital or, more commonly, to fund the outsized GP commitments that have become especially valued in the current fundraising market.

The second use case is the typical below-the-fund preferred equity issuance, where a fund runs out of dry powder but still has capital needs. In that scenario, the sponsor can issue preferred equity via a holding vehicle

below the fund, usually in collaboration with the LPAC. That's a way for the common investors, the LPs, to retain that upside but bring in a new capital partner below the fund. It works in the same way they might otherwise get a NAV loan.

Finally, the third and most interesting new use case is preferred equity being used as a fundraising tool. A manager can now set up a feeder fund that issues preferred equity instruments directly to third-party investors, which creates the potential to open up a fund to a whole new set of investors. An SPV is created that comprises a senior debt tranche, a preferred equity tranche and a common equity tranche, effectively allowing a manager to tranche a fundraising and allowing investors to pick and choose their exposure. The preferred equity tranche

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in particular has attracted strong interest from insurance companies and family offices seeking yield with defined downside protection – investors who would not otherwise access a traditional LP commitment.

That is just emerging as a use case for preferred equity in fundraising, but we are hearing a lot of GPs now asking about that. We are already seeing early adoption among top-tier managers and expect that to accelerate meaningfully in the near term.

Q What are the factors influencing competitive dynamics and buyer interest in these deals?

The driving factor is the search for yield. Preferred equity has provided a really interesting opportunity for non-traditional investors in the secondaries space to get access to that.

Three years ago, there were probably one third of the number of preferred equity investors that you have today. We have seen insurance companies coming into these deals, as well as credit funds, credit secondaries

funds, family offices, balance sheets and, now, increasingly, sovereign wealth funds too.

What is interesting about the expansion of buyers is that the complexity premium associated with these deals has increased substantially. We are seeing the most successful preferred equity investors win deals by being the most creative in terms of structuring.

When you think about why a sponsor might choose preferred equity over a traditional loan, that typically comes from a desire not only to retain upside in the investment, but also to maintain operational flexibility as compared to debt. Because the investor here is an equity investor rather than a debt investor, you tend to see more creative solutions when it comes to covenants. Payment-in-kind (PIK) interest is very common here, and penalties for breaches of covenants typically involve things like increased PIK interest. So, in all use cases, preferred equity provides the manager with more flexibility than it might otherwise have.

Q How do LPs tend to view preferred equity, and how are GPs engaging with their investors around it?

We are seeing a lot more constructive dialogue with LPs. For the same reasons that GPs are attracted to preferred equity, LPs are as well.

In instances of management company preferred equity, this is allowing increased alignment via outsized GP commitments. As long as there is transparency and LPs are aware of the deal, we tend to find a pretty positive reception from LPs.

When it's below-the-fund liquidity, the same factors that might motivate a sponsor to choose preferred equity over a partial realisation are also driving LPs to come on board, as they'll retain upside even if the interest is higher than traditional debt. That said, not every situation resolves neatly: we have seen cases where LP pushback centred on perceived misalignment between

the preferred investor's return hurdle and the fund's long-term value creation thesis. Those situations require careful structuring and early LPAC engagement to reach workable terms.

The use of preferred equity as a fundraising tool is still in its infancy, so it remains to be seen how LPs will respond. However, LPs are generally excited by optionality, so all of this really comes down to transparency and good interactions with the LPAC.

The more people look at this as a tool that can be used in lieu of a NAV loan, alongside existing leverage, the more they are pulling different levers to optimise outcomes. A GP can have an open conversation with investors about which tool is appropriate in any given situation during the lifecycle of a fund.

It is also worth noting that the integration of fund finance and secondaries is one of the most important trends in private markets currently, as people look at this broader set of liquidity solutions as a single spectrum, rather than as siloes. Clients are not coming to us asking about loans or secondaries anymore. They are coming with a need for a capital solution, and we are right-sizing the answer for each set of circumstances.

Q How do you see the integration of secondaries, fund finance and preferred equity evolving from here?

The interesting thing is that fund managers today have reached a point where they can manage their capital stack with the same precision as a public company, because they now have a full set of capital solutions available to them.

Fund finance and secondaries are integrating in a way that's really exciting. It's not a competition between one or the other, but a spectrum that is only going to continue to gain traction. ■

Drew Harmon is a partner and head of GP advisory at Simpson Thacher & Bartlett