PRIVATE EQUITY

The Appeal of Flexible Capital Solutions

Introduction

Markets and economies move up and down. But no matter where they are in the cycle, companies will always need capital—whether it's to spur growth, shore up their defenses or access liquidity to support their corporate initiatives (see Figure 1).

Since the global financial crisis, it has been more difficult for companies to access traditional forms of capital. And while the private markets increasingly have filled the void, flexible capital solutions have emerged as a strong alternative for companies with specific needs.

Flexible capital is a global, all-weather solution that sits between private credit and private equity. The key is customization: A company teams up with a strategic partner who provides alternative sources of capital to help execute its vision.

For investors, it combines the essential elements of both debt and equity in a hybrid, tailored investment structure with a focus on strong downside protection, along with upside potential tied to equity performance.

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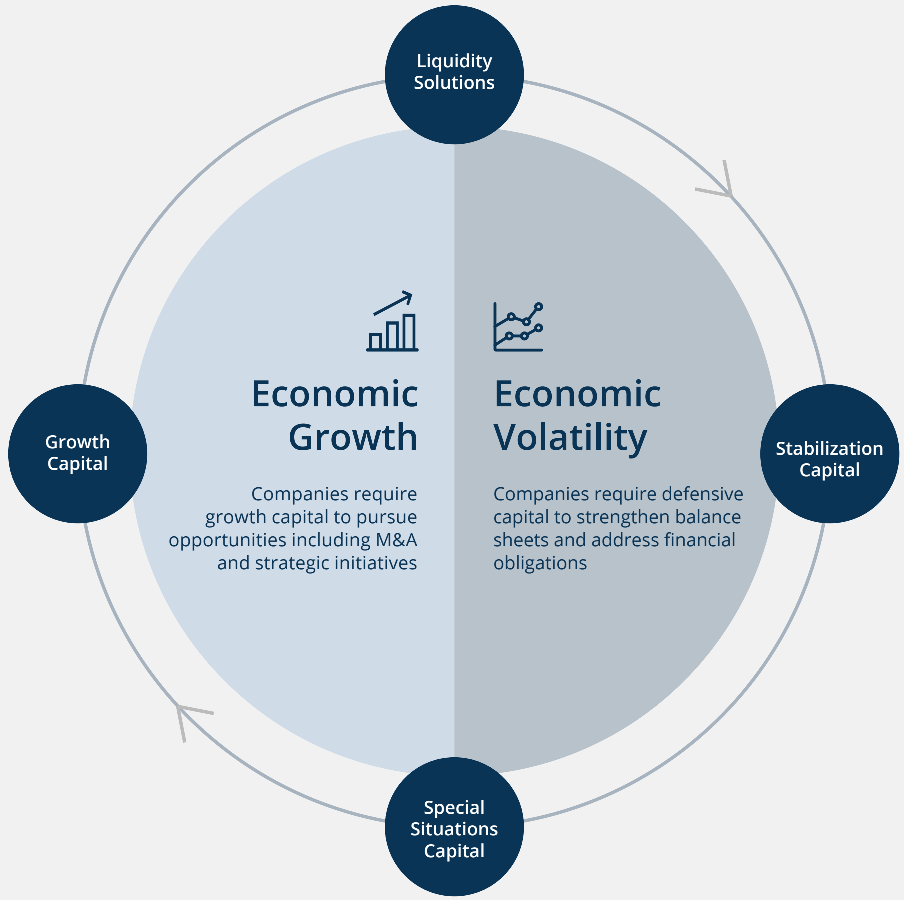
FIGURE 1

Flexible Solutions Across Economic Cycles



Traditional Capital Sources Are Falling Short

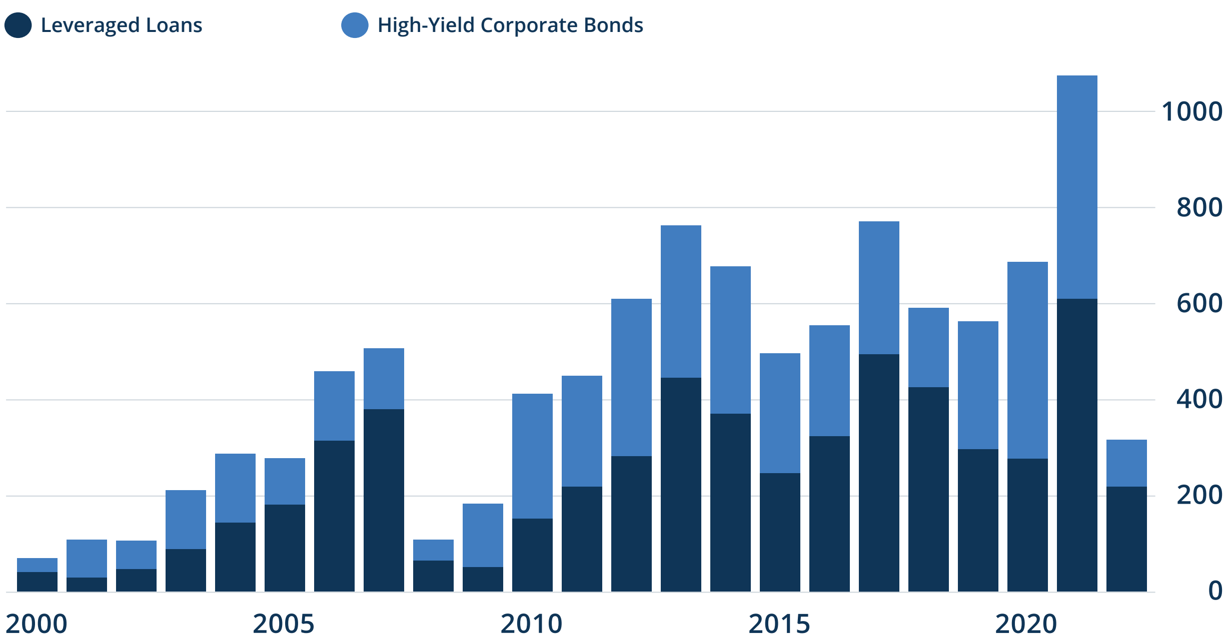
Since late 2021, the cost of issuing both equity and debt have increased. This has led to a significant decrease in capital issuances.

In the U.S., for example, financial conditions have tightened dramatically following the Federal Reserve's determined effort to curb elevated inflation. The more tentative mood in credit markets can be seen in both high-yield corporate bond issuances and leveraged loan issuances. Combined, they have slid to the lowest level since the financial crisis (see Figure 2). Meanwhile, the increased cost of capital has translated directly into lower equity valuations, and by extension, a weaker IPO market.[1]

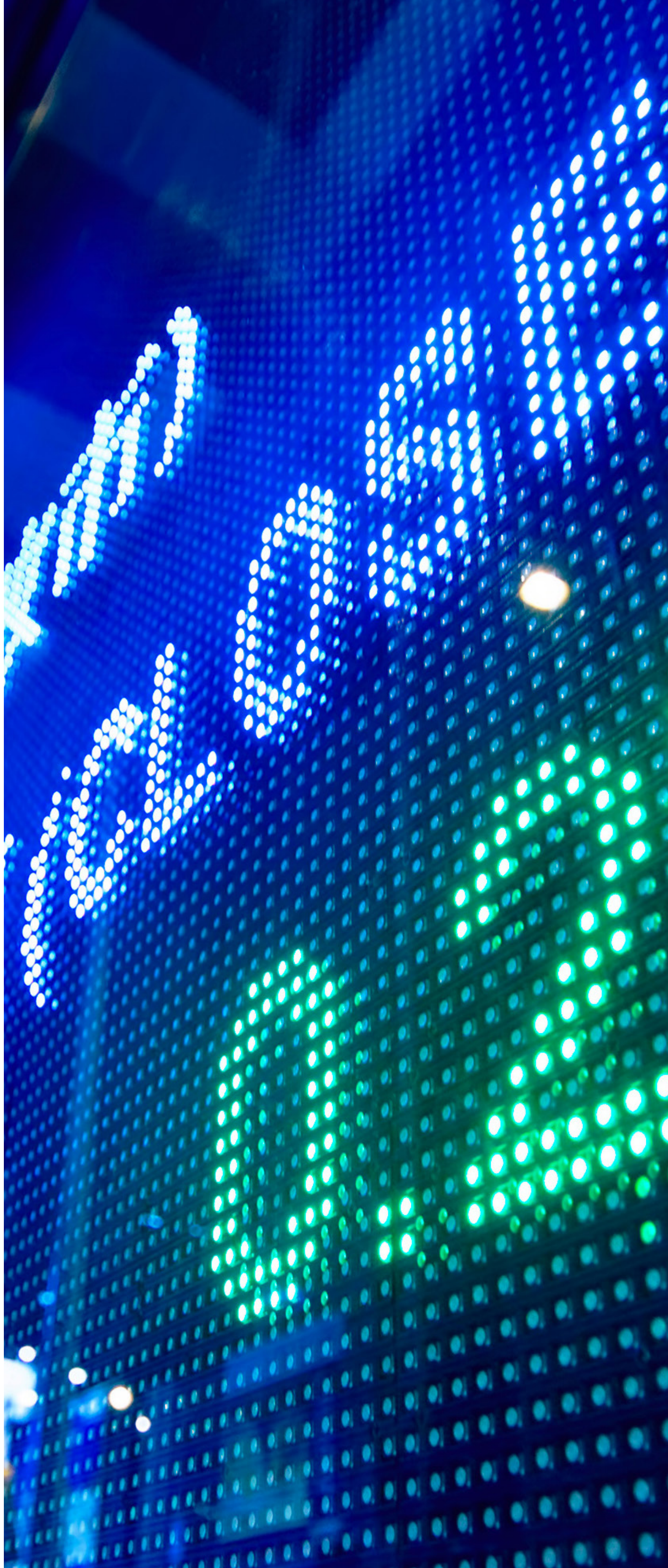
FIGURE 2

High-Yield Bond and Loan Sales Reach Lowest Levels Since Financial Crisis

New issuance in the U.S. by year (bil. $)



Source: Refinitiv, LCD and the *Financial Times*



More Companies Are Turning to Alternative Solutions

One alternative is the private credit, or private debt, market. Accounting for $1.2 trillion of capital globally, the private debt market now matches the sizes of the leveraged loan and high yield markets (see Figure 3).

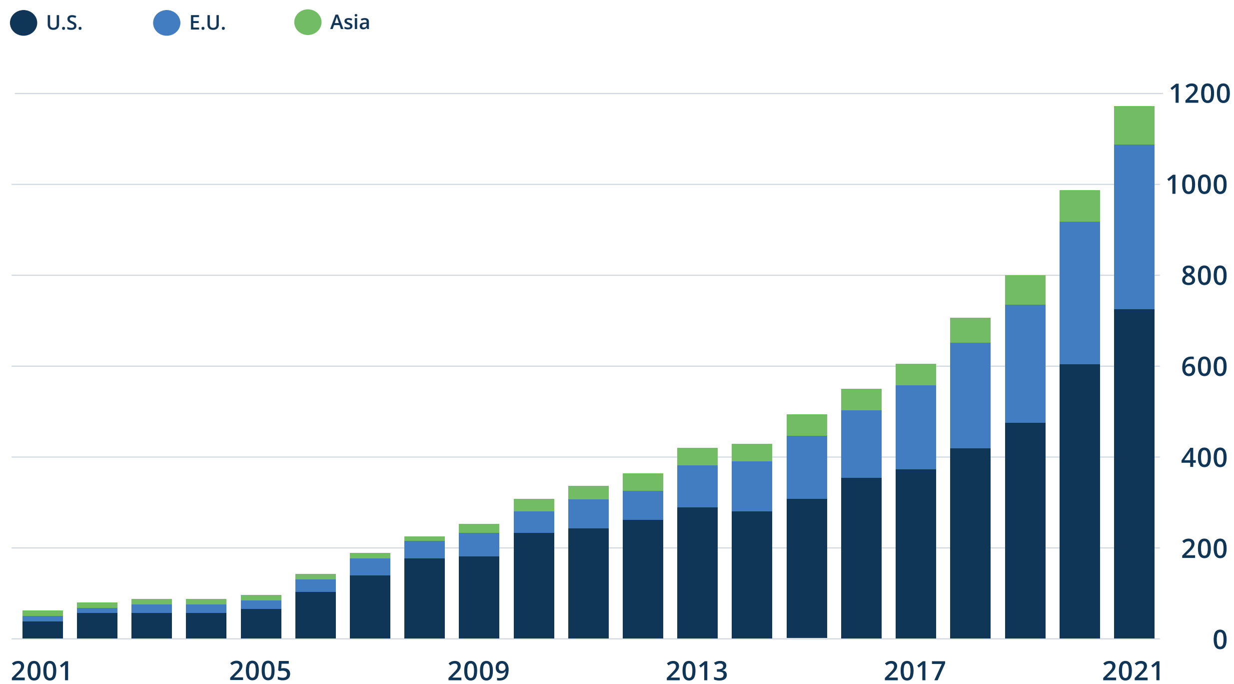
"The increasing relevance of private debt," wrote Bank of America Global Research in October 2022, "has taken a toll on other sources of capital for leveraged corporates. The ensuing disintermediation is visible all through the last decade, though the biggest leap forward has materialized today on the back of a pullback in syndicated markets. Private debt has gone from providing 2% of the aggregate capital provided by leveraged companies in 2012 to 20%+ levels YTD."[2]

Companies could also choose to tap the private equity market to access capital, but they need to be willing to dilute their equity ownership of the business. Not to mention that the cost of capital tends be more expensive, especially if the market timing means that management needs to issue equity well below the company's intrinsic value.

FIGURE 3

Private Debt Capital Has Grown to the Size of the Institutional Loan Market

AUM by region (bil. $)



Source: Preqin and BofA Global Research

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Finding a Middle Ground Between Debt and Equity

Structured capital solutions span the middle ground between debt and equity (see Figure 4). And because they are customized through a negotiation process, each structured capital solution is unique.

FIGURE 4

Solutions Along the Debt-to-Equity Spectrum

A more debt-like instrument, such as preferred stock plus warrants, can be used to right-size a company's leverage, while giving the capital provider downside protection over other equity owners.

This downside protection comes from the comfort of where one's capital is—in other words, a higher position in the capital stack. For example, if the capital provider's last dollar, loan-to-value is 60% of a company's total enterprise value, 40% of the value could erode from that business, but the capital provider would still get its last dollar out.

In a debt-like investment, most of the capital provider's return comes from consistent preferred equity dividends, which tend to be higher than those for a more equity-like structured instrument. Meanwhile, the warrants offer some additional upside to the underlying preferred return if the long-term equity story for that business plays out.

This debt type of investment often saves the capital provider and the target company from having to agree on a valuation for the business. This helps facilitate transactions where valuation expectations between the two parties are not aligned.

Alternatively, a capital provider investing in a more equity-like instrument, like a convertible preferred, inherently believes that the underlying equity value of a business will grow materially over the long term. This equity-like investment would have a lower running cost of capital but would generate a higher amount of the overall return from the equity component.

This allows the capital provider to support the company's growth strategy while participating in its share of the business's profitability. These types of solutions tend to work well for a misunderstood, dislocated business, where the capital provider and the counterparty roughly agree on where the valuation lives. In other words, structured capital can reduce the market timing risk found in traditional private equity by offering a premium valuation in exchange for downside protection.

The Opportunity Set Is Wide

Today, structured capital solutions are essentially another capital source for both public and private companies to choose from. But importantly, they are more flexible than other options.
They can:

- Maximize flexibility within a capital structure—and stabilize or repair a company's balance sheet
- Provide growth capital to support a large strategic acquisition or a roll-up type acquisition strategy, or to provide development capital
- Supply access to capital, especially where "blunt" instruments, like high yield bonds, leveraged loans or equity issuance, might not be the best option
- Limit the cost of capital and dilution for public companies that want to grow or acquire other businesses, but don't want to take on more debt or issue more common equity
- Allow a company to gain a strategic partner—who can assist with operations, acquisitions, capital markets, etc.—while still maintaining control

As a result, structured capital solutions appeal to a wide variety of companies. These can include private, founder- or management-owned businesses that want to maintain control and upside, private-equity-backed companies where the sponsor is looking for access to incremental capital, and more.

Today, we see opportunities to provide flexible capital in several industries. Take the global healthcare services sector, which at $8 trillion is roughly equivalent to 33% of U.S. GDP. For higher growth, higher quality healthcare businesses, valuations can be in the mid- to high-teens—around 16x EV/EBITDA, for example. Many private equity sponsors like to put a good amount of leverage on businesses, but they will probably only get six turns of leverage from the banks (i.e., 6x debt/EBITDA). Thus, while a sponsor might view this flexible and strategic capital as relatively expensive, it also knows that high-quality healthcare businesses tend to grow and accrete value at a rate that would exceed this cost of this capital.

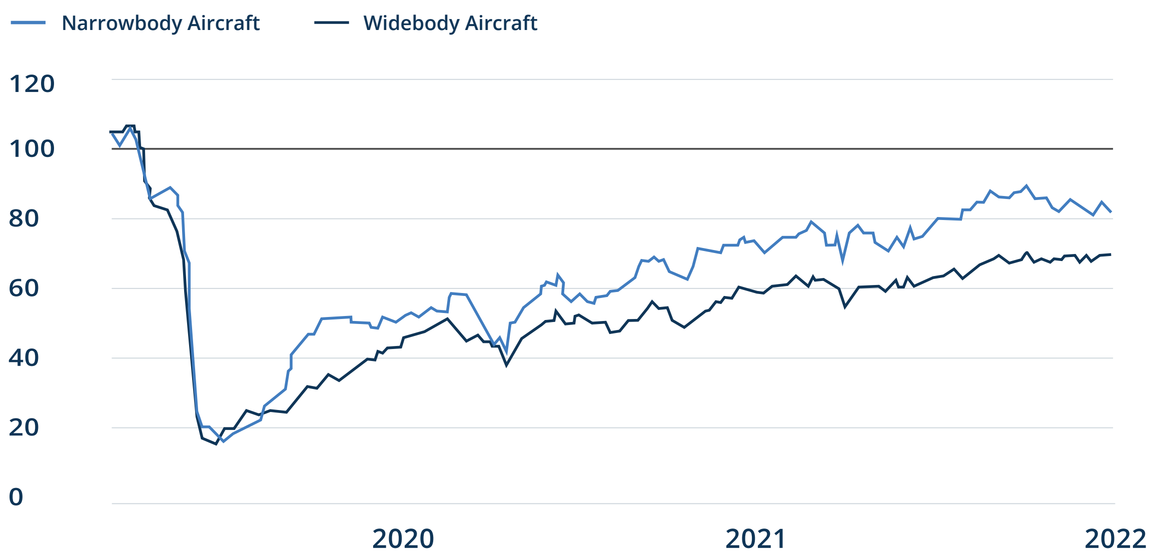
In addition to the strategic value this capital partner might bring, the sponsor creates accretive leverage.

Aviation is another sector that could benefit from flexible capital. This sector, where private equity has historically been involved, should grow at a GDP-plus type rate. However, as a result of challenges caused by the pandemic, flight activity has been delayed, and world daily flights are still not back to 2019 levels (see Figure 5).[3] With some players in the aviation space facing significant debt maturities in the next few years, flexible capital could be an option to fill a funding gap.

FIGURE 5

Daily Flight Levels Have Still Not Recovered

No. of flights as a % of 2019 levels



Providing Meaningful Capital—With Protective Features

Flexible capital offers an attractive solution for companies and investors alike—and expands the universe of solutions across private debt and private equity.

More than ever, companies are looking for meaningful capital and partnership, without having to take on more debt or dilute their equity ownership. As corporate boards and management teams become more sophisticated and comfortable with assessing possible financing options, more are seeking out new types of solutions.

For investors, flexible and strategic capital solutions cover an attractive middle ground between debt and equity. Since part or all of the return is contractual, these investments can include downside protection with more upside exposure than traditional debt. And since these transactions are often highly negotiated, the inclusion of other protective features—like board seats or consent rights—only enhances the appeal of the asset class. Capital providers can assist in influencing a company's overall strategy without taking full control—and help drive great outcomes.

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1 Goldman Sachs, "2023 U.S. Equity Outlook: Paradise Lost," November 21, 2022.
2 BofA Global Research, "The present and future of Private Debt," October 24, 2022.
3 Bernstein Research, "Commercial Aircraft: Airline traffic recovery…," November 29, 2022.

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