KEYNOTE INTERVIEW

Preferred equity: A flexible form of leverage

Adapting the balance sheet of the investor to the various risk profiles of the underlying assets makes a lot of sense, says Pierre-Antoine de Selancy, managing partner of 17Capital

Q There's a marked change taking place in the way LPs construct their portfolios. What are you seeing?
Institutional investors are increasingly trying to think outside the box. They are trying to find new areas, white spaces between markets. That's a really interesting change and relatively recent.

17Capital does not chase the same returns as a secondaries fund and we don't have the same features as a credit fund. We sit in the middle, providing fund managers and investors with flexible leverage in the form of preferred equity. In the past, most of our investors have had to put us in a space that was not pre-allocated – we're not a buyout fund, we're not a secondary fund and we're not a pure direct lending opportunity. More and more we are working with investors who have the capacity to create that catch-all allocation.

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Q What form does this allocation take and which other strategies might be included?
There are many more opportunities that fall between markets. Institutional investors will increasingly have what might be known as 'alternative alternatives', or 'alternatives square'. They might put us in with the hedge fund portfolio, next to reinsurance or next to litigation funds.

It's really the pensions that are driving this. They have so much pressure to deploy capital that they have to be very creative. They have to find places with less competition, where there is less institutional money flowing in. The Canadians have always been ahead of the rest of the industry, alongside some US pensions and endowments.

Q What role does 17Capital play in the preferred equity market?
The secondaries market is for people who are looking to sell; we tend not to work with sellers. We work with people that want to keep their portfolio and improve its capital structure. In a private equity portfolio, you will have different levels of risk in each of the underlying companies. Some will be fairly mature and are ready to be sold in 12-18 months. Some will have been acquired more recently and come with much high-

er development risk. Adapting the balance sheet of the investor, whether it's a fund or a limited partner, to the various risk profiles of the underlying assets makes a lot of sense.

We've been operating for 12 years now and done 50 transactions, 23 full exits already. We've seen over $10 billion of dealflow last year, to give you an idea of the size of the market. And we see growth of 20-30 percent every year. The more players you have in the market, the more awareness grows among investors.

Q How has the typical preferred equity deal evolved since you formed in 2008?

Some of them look very similar [to how they did then]. Some clients we have worked with two or three times and we even use the same legal documentation. But we try to innovate and find more ways to be helpful to clients. Being helpful means providing the right amount of capital, making it available in the right way and having the right level of flexibility over time. In one transaction, we actually managed the portfolio on behalf of an investor. They had a very small team and did not want to sell. You need to understand why the transaction is taking place and what the driver is.

I don't think you can define a transaction by the legal documentation. It is defined by the level of risk taken and the type of return it should deliver for the investors. You can do preferred equity transactions with a 25 percent target IRR, where you take a lot of risk. You could have a big senior piece on a portfolio of venture assets. That's not what we do but it can work out very well.

> *"The Canadians have always been ahead of the rest of the industry, alongside some US pensions and endowments"*

Q Has the point in the cycle had any impact on the needs of potential clients?

We've started to see some institutional investors thinking, 'there might be market turbulence ahead.' Some of these managers remember 2009 and it was not a pleasant experience. If you were an LP with a portfolio at the limit of your exposure, it meant that you had to sell. All the people who bought then made a lot of money. People that remember these times want to have in place a structure where they can access cash just in case. It's not a trend yet – it probably accounts for a quarter of deals we see – but we are working more and more with limited partners in that direction.

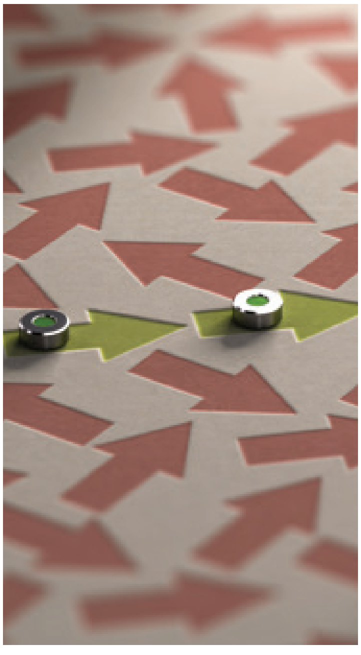
You don't want to wish for a downturn but would we be ready? Yes. At the very beginning we were focused on solving problems and helping people to not have to sell. Today it's much more focused on funding growth, but it can shift back.

Q How do you see the attitude of LPs towards preferred equity developing?

If you look at the ways in which companies held by buyout funds are funded, they will have short-term working capital, long-term equity, asset-backed financing, high-yield or convertible debt. There's a wide range of tools available.

One level up, among the shareholders, it is strikingly simple. It's long-term equity and sometimes a little bit of leverage. We are bringing tools that are already used at company level into the private equity industry. In the medium- and long term, the prospects are massive.

I met with a pension plan in the US a couple of months ago. The LP started by saying, 'we've been looking at your space for a few years now and we like it'. I did not even know it was already a 'space' for institutional investors. But they decided, in the same way that Dyal Capital and Petershill created an interesting part of the market, we are part of the same development in helping the industry improve its capital structure. I think a lot of institutional investors see that and will make room available for it. ■



Q How do you ensure alignment in preferred equity deals?

If you're putting leverage on a portfolio, you need to make sure that you are creating more value for the cost and that the deal driver is healthy. The world of private equity is built on leverage. It's a tool everyone knows intimately. You only use leverage if the value you can generate is higher than the cost of that leverage. Otherwise you should not do it.

People we work with are increasing their exposure. They take our money because they want to invest more in their next fund. It's a form of leverage in that it's increasing their commitment, and it reinforces the alignment of LPs and GPs. We don't claim to be cheap but we are the best and most relevant for good investors.