NAV finance

How preferred equity can enhance private debt returns

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> *"What's in a name? That which we call a rose, by any other name would smell as sweet."*
>
> ~ WILLIAM SHAKESPEARE

What Shakespeare is alluding to is that naming conventions do not necessarily reflect, or need to describe, what they really are.

Naming conventions do not necessarily reflect, or need to describe, what they really are

There are actually many cases of incorrect or "inappropriate" naming conventions known as misnomers. These are often quite interesting (albeit confusing): For example, Bombay duck is actually a fish. However, Starfish and Jellyfish are not fish and French fries originate from Belgium (apparently).

Such misnomers got the research team at 17Capital thinking – we specialise in a product called preferred equity which empirically behaves more like debt rather than "equity" and has attracted investor appetite specifically to achieve stable, contractual returns rather than being exposed to equity risk.[1]

As we explore in this report, these debt-like traits are further enhanced when considered in the context of NAV finance. This type of financing benefits from access to diversified asset pools managed by highly regarded private equity managers who want to hold and grow the assets they manage.

NAV finance has now established a growing presence within private credit allocations. In this report we will look to demonstrate that the merits of preferred equity, despite a naming convention born in the 19th century, delivers strong, stable returns, low loss ratios and strong downside protection that is consistent with private debt investing rather than equity.

Preferred equity despite its naming convention born in the 19th century, demonstrates characteristics consistent with private debt rather than equity

Our 15-year track record across more than 90 investments allows us to test this thesis and allows us to share our empirical data and insights with investors. While we will admit it is not as interesting as Bombay duck or "French" / Belgium fries, when it comes to the allocation of preferred equity within the credit landscape, perhaps we might reach the same conclusion as the Bard himself, *"What's in a name"*?

1 Source: Nuveen "Fixed income perspective: preferred securities" (December 2022).

PREFERRED EQUITY WITHIN NAV FINANCE

1. An introduction

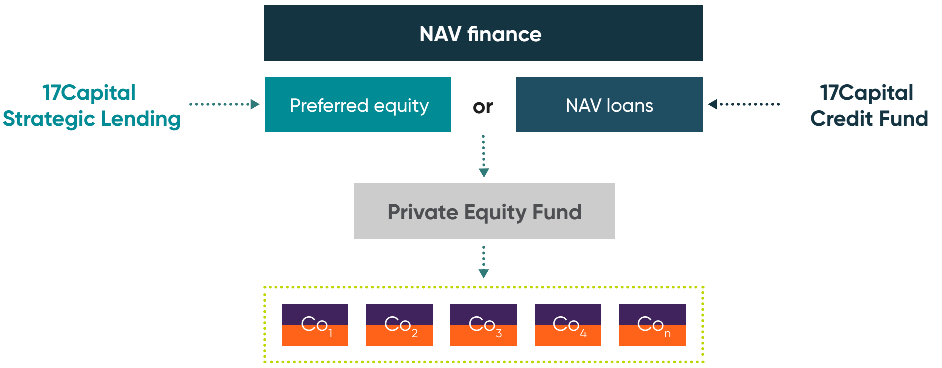
NAV finance has been part of the growth of private debt

While the growth and definition of "private debt" is now well established (non-bank, non-publicly traded debt) there is no universally agreed template that encapsulates the diversity of strategies within this growing, multi-faceted asset class which now offers a distinct range of investment opportunities for private debt investors.

NAV finance has been part of that growth and optionality to investors, and in this report we examine the overall positioning of preferred equity within this market.

NAV finance is executed through two separate, distinct formats – higher returning preferred equity (which we refer to as 17Capital Strategic Lending) and NAV loans (17Capital Credit Fund). NAV finance is uniquely characterized by accessing cashflows from diversified portfolios, in contrast to "traditional" credit offerings which typically have recourse to a single entity, as shown below:

Figure 1: Illustrative NAV finance structure



CONSOLIDATED EQUITY VALUE

INDIVIDUAL COMPANY EQUITY

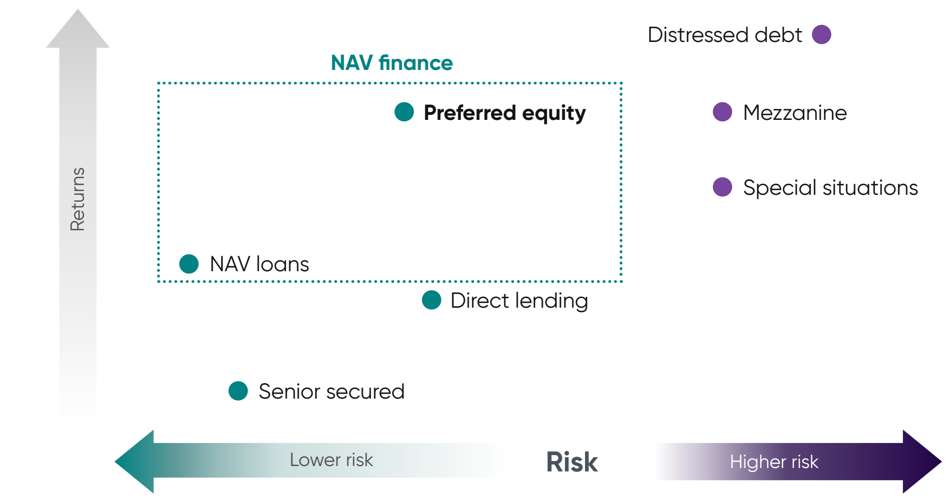
INDIVIDUAL COMPANY DEBT

Source: 17Capital

As we will evidence throughout this report, whether delivered via "NAV loans" or "Preferred equity" the same key investment fundamentals equally apply, albeit delivering appropriate risk-adjusted returns for investors and being clearly differentiated offerings for potential borrowers in terms of advance rates (LTV), flexibility and cost.

In this report, we examine the overall positioning of Preferred equity within the private debt landscape

Figure 2: Preferred equity and comparative risk-adjusted returns



Source: 17Capital

PREFERRED EQUITY

2. From railways to PE portfolios

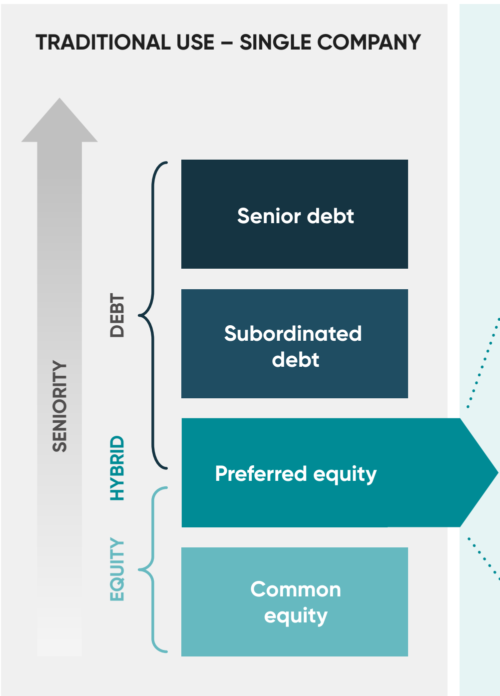
Preferred equity has been part of the financing landscape since the mid 19th century, originally to support construction projects (railroads, canals, etc.).[2] Over time, preferred equity's growing market acceptance has resulted in it becoming a more common source of capital utilized across industries, particularly in financial services.

A recent innovation has been the use of preferred equity finance within the private equity ecosystem as part of the wider NAV finance landscape we outlined above.

The use of preferred equity has evolved from individual projects, to single companies, to becoming part of diversified portfolios as shown below. A common trait throughout however has been the same "bond" like features noted above: its contractual returns, the senior position to common equity and the flexibility of its structure.

Preferred equity has evolved to become a key part of the financial toolkit for the private equity ecosystem given its flexibility

Figure 3: The 200-year evolution of preferred equity



NEW INNOVATION – NAV FINANCE

		Preferred equity[3]	Section
Maximum financing flexibility	Average LTV	~40%	6
	Maturity	Implied	4
	Security & Covenants	Unsecured	5
Cost to borrower / returns to investors	Returns IRR	Mid-to-high teens	5
	Returns Volatility	Low	5
Downside protection	Collateral	Diversified portfolios	6
	Distributions	Senior to common equity	6

Source: 17Capital

We will explore the above topics in turn, starting with some sample use cases for borrowers of preferred equity, underpinning the rationale for the higher cost of the financing. We will then explore the dynamics for investors in terms of high absolute returns and the strong downside protections which should appeal to private credit investors.

2 Drinkard, T., A primer on preferred stocks.

3 Preferred equity parameters based on 17Capital Fund 5 (inception - present).

PREFERRED EQUITY

3. A tool for growth

Preferred equity has unique relevance across different private equity participants

In the context of NAV finance, the use case for preferred equity has unique relevance across different private equity participants, namely management companies, funds and institutional investors.

Despite the broad spectrum of end users, in all cases the preferred equity investment remains senior within the capital structure and has priority over a diversified set of cashflows as and when they arise. The rationale for utilizing the product is often shared and centred on investors seeking to maximize value creation and growth within their portfolio, as illustrated below.

Figure 4: Use cases for growth

SHARED OBJECTIVE	UNLOCK FURTHER GROWTH		
COMMON THEMES	✓ Conviction in asset pool	✓ Looking for non-dilutive alternatives to a sale	✓ Strong alignment
SAMPLE USE CASES	**MANAGEMENT COMPANY** ✓ Manager looking to launch a new strategy ✓ GP team wanting to increase % commitment to next Fund	**FUND / PORTFOLIO** ✓ Fully called fund, looking to continue executing its buy & build strategy via new platform and follow-on investments	**INVESTOR** ✓ Family office looking to augment its private equity exposure via co-investments and fund commitments
KEY OBJECTIVE	Preferred equity enabled the Manager to increase skin-in-the game	Preferred equity enabled GP to make further investments	Preferred equity enabled LP to commit more capital

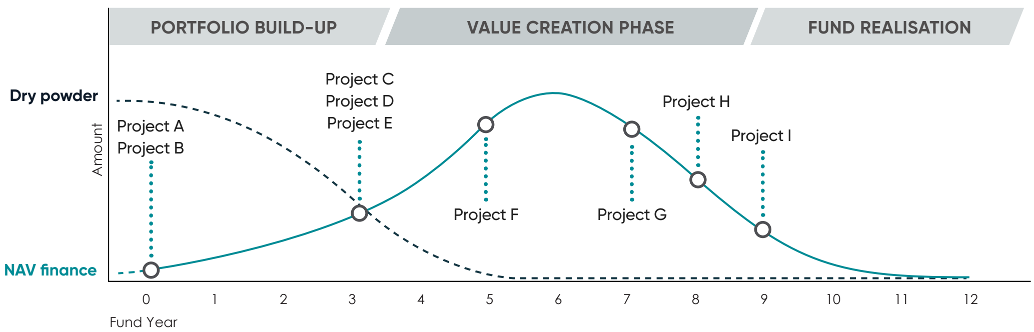
Source: 17Capital

Across all cases, it is clear that the counterparty looking to use preferred equity is a high conviction borrower, is focused on growing its underlying assets and values the flexibility of the preferred equity instrument in doing so. As such, this creates strong alignment with the preferred equity provider.

Preferred equity appeals to high conviction borrowers, looking to maximize value across their investment lifecycle

In the graphic below, we illustrate real use cases where 17Capital Fund 5 loaned to counterparties seeking this benefit, which further illustrates the maintained relevance of preferred equity across the private equity fund lifecycle.

Figure 5: NAV finance during the fund lifecycle



Source: 17Capital

While we have seen that the use cases for the preferred equity product can be very broad, we will now examine the empirical evidence and downside protection inherent to these investments which deliver strong, risk-adjusted returns for investors.[4]

4 Past performance is not indicative of future performance.

PREFERRED EQUITY

4. The de-facto maturity effect

One of the characteristics often highlighted of preferred equity compared to say secured credit, is the absence of a defined maturity date. While this is undoubtedly correct, below we consider the empirical evidence of *contractual* versus *observed* maturities over a 15-year period.

We consider the empirical evidence of contractual versus observed maturities over a 15-year period

Looking at 17Capital's exit track record across all preferred equity investments,[5] we note the average duration until final repayment is ~3.7 years which, as you might expect, closely aligns with the minimum multiple achieved for preferred equity investments.

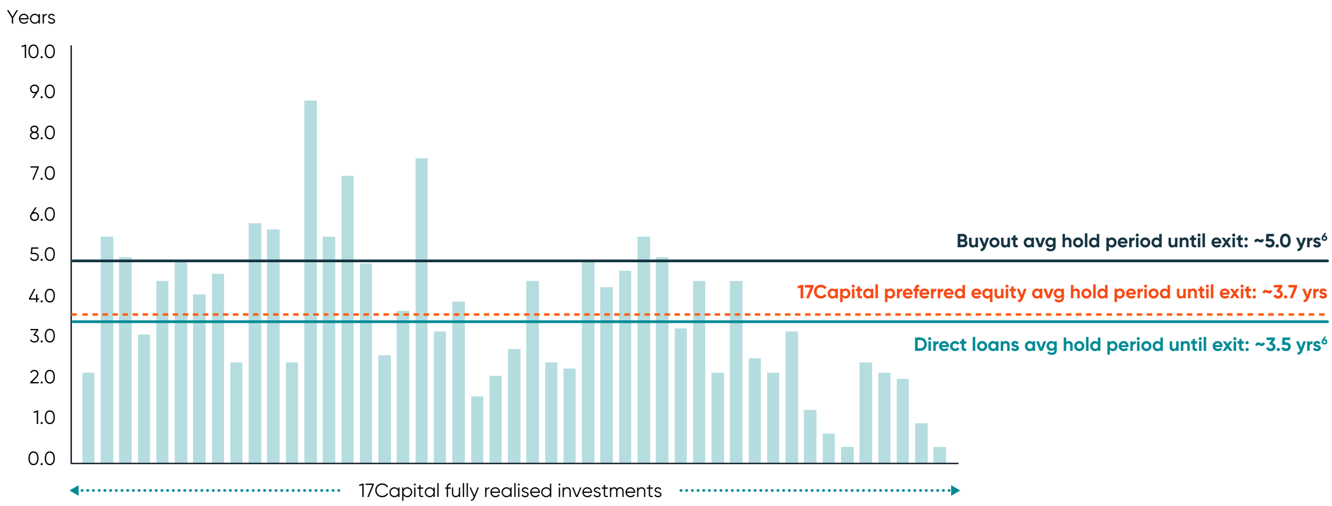
This suggests close alignment between the borrower and lender and creates, in effect, a de-facto maturity profile – borrowers are incentivised by the compounding higher cost of capital to manage their own exit timelines (particularly for close ended funds) while the lender has seniority over initial cashflows until repaid with subsequent distributions being retained by the borrower.

The de-facto maturity profile is consistent with the credit landscape, as evidenced by the average life of direct loans being ~3.5 years while the average hold period of traditional buyout investments has been ~5 years.[6]

17Capital's ~3.7-year average hold for preferred equity investments is aligned with credit maturity profiles

For investors in the strategy, this "credit" like maturity profile is important as it offers enhanced cashflow visibility and less volatility given the shorter duration relative to traditional private equity investments.

Figure 6: 17Capital's hold period of fully realised investments[6]



Source: 17Capital

5 47 exits at time of analysis since inception.

6 Private Credit: Differentiated Performance in the Midst of Rising Interest Rates" by Ares Management (July 2022).

PREFERRED EQUITY

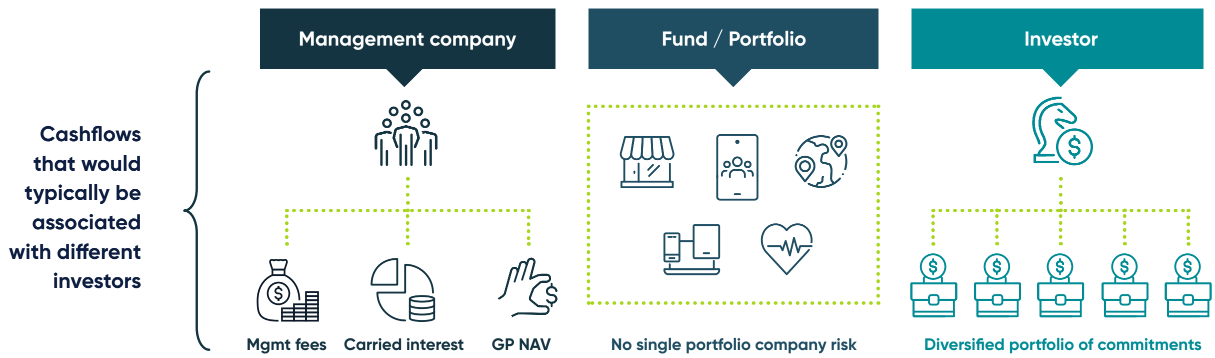
5. Unsecured but undaunted

There is strong evidence that preferred equity exhibits robust downside protection

The other characteristic that differentiates preferred equity in the context of NAV finance is the absence of security and covenants. This is correct for preferred equity and this flexibility is reflected in, among other things, higher interest rates and minimum return on capital.

However, there is strong evidence that preferred equity investments exhibit robust downside protection mechanics more akin to other private debt strategies – namely, low (or zero) loss ratios and low volatility of returns.

Figure 7: Diversified repayment streams

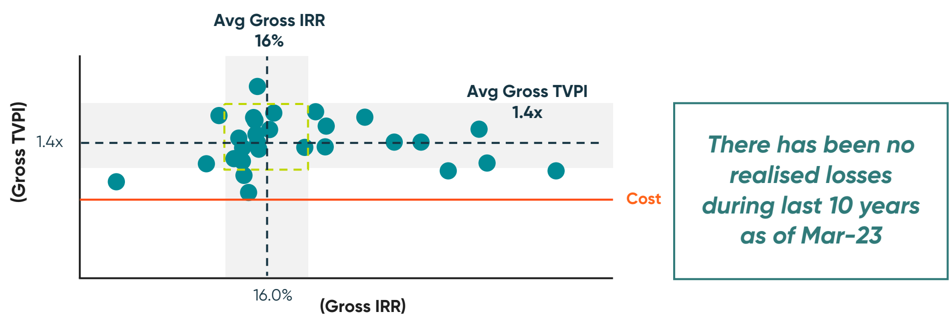


The "portfolio effect" created by these diversified exposures creates inherently greater "security" for the lender. This is further supported by the low loss ratio of the strategy, which would be most comparable to the average capital loss ratio for European corporate debt of ~2% (average default rate of ~3%) and low volatility of returns further analysed in Figure 8.[7]

The "portfolio effect" created by these diversified exposures creates inherently greater "security" for the lender

As the preferred equity return is contractual, the fixed PIK interest rate will result in little volatility in the expected returns across transactions. Using the empirical evidence of 17Capital's own investment performance over a 10-year period, the chart below supports a more "credit" like profile rather than equity .

Figure 8: 17Capital realized investments track record (last 10 years to Mar-23)[8]



For investors in the strategy, the diversification and contractual return of these preferred equity investments have resulted in consistent and attractive risk-adjusted returns.

7 Source: S&P, Loss rate is the product of (1-recover rate) and default rate. Average default rate of 2.9% based on December 2007 to December 2021 data

8 Past performance is not an indicative of future performance.

PREFERRED EQUITY

6. Downside protection

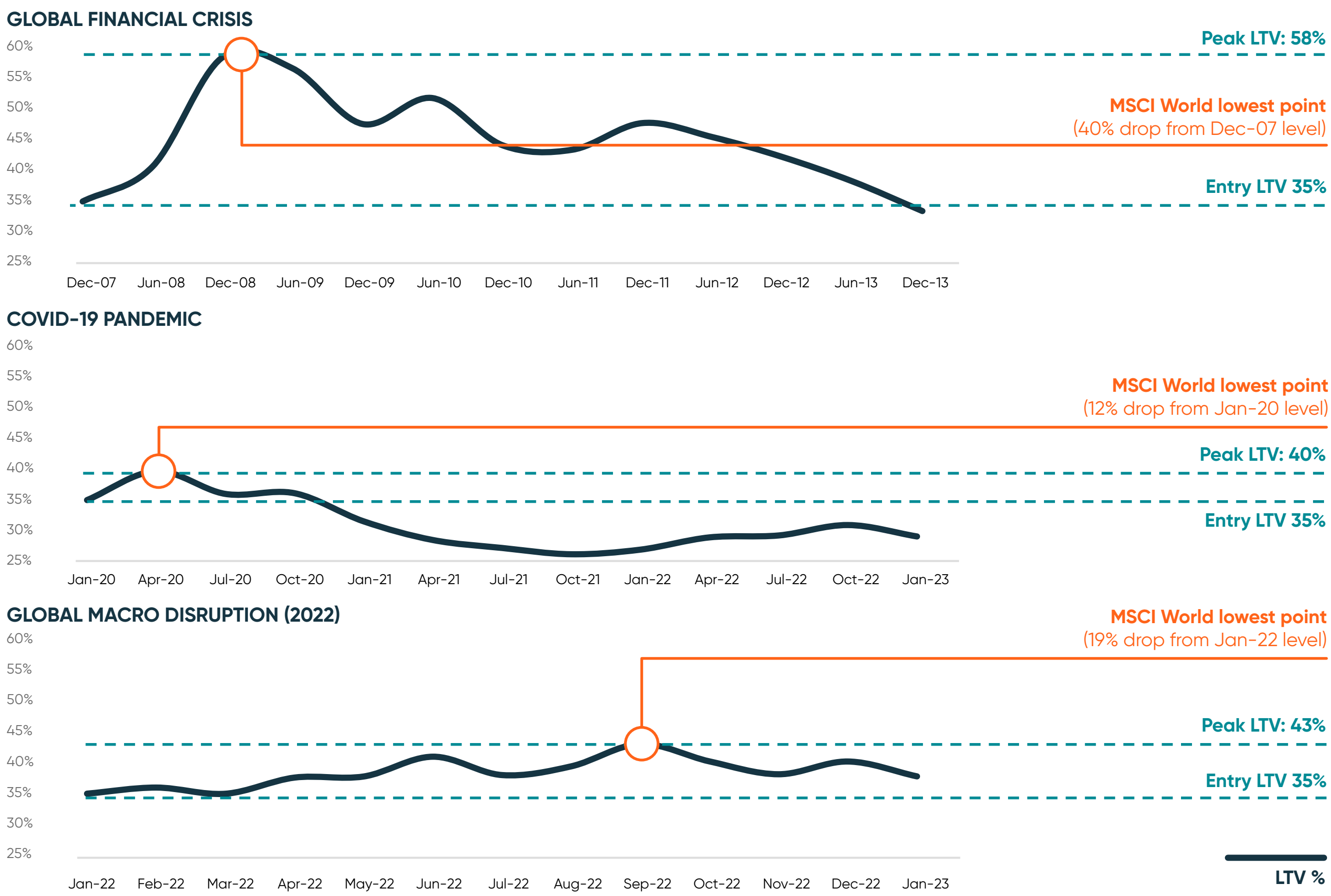
Downside protection underpins the resilience of NAV finance strategies, which also encapsulates preferred equity, as previously outlined.

We can analyse the impact on overall risk (measured through changes in LTV) during three periods of economic stress over the past 15 years, most notably the Global Financial Crisis of 2008 but also during the Covid-19 pandemic and the market volatility experienced in 2022.

Whilst the catalyst for these events were clearly very different, one consistent theme we can acknowledge below is that the downside protection afforded to preferred equity investments remains resilient across all cases and is reflected in the zero loss ratio performance we observed in Figure 8.

Downside protection underpins the resilience of the asset class, even during periods of significant market disruption

Figure 9: Preferred equity resilience during select periods of economic stress (illustrative)



Given the priority access to diversified cashflows that is inherit to NAV finance, the underlying investments would continue to accrue in-line with the contractual returns with no capital losses.

Taken together, this further supports the assertion of enhanced risk-adjusted returns for investors in NAV finance generally but also confirms that this equally applies to preferred equity financing while delivering higher absolute returns.[9]

Significant equity cushion ensures preferred equity investments would continue to perform strongly

9 Past performance is not an indicator of future performance.

PREFERRED EQUITY

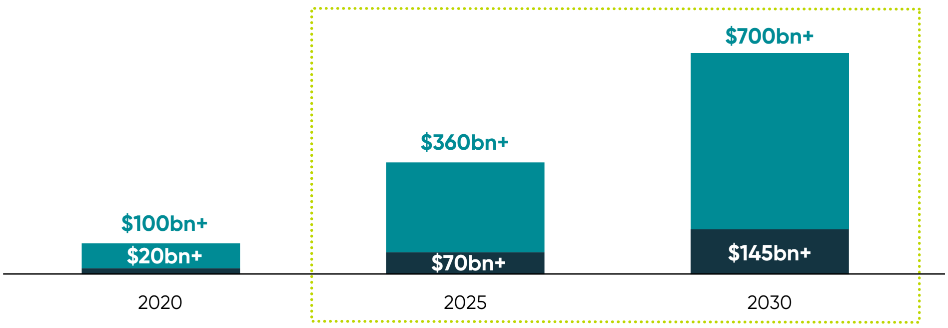
7. Market opportunity & deal flow (1/2)

The scale of unrealised private equity assets and adoption by larger managers are key drivers of meaningful growth

As explored in our previous publication,[10] NAV finance is applicable to a large and diversified audience and is relevant for an extended period across various stages of the fund lifecycle as demonstrated in Figure 5.

Cumulatively we expect this to derive a NAV finance market opportunity of over $700bn by 2030 across all asset classes. The demand for preferred equity within the overall market will be a function primarily of the factors we explored earlier, namely, quantum required (as measured by LTV), flexibility and the ability to generate returns in excess of the cost of capital.

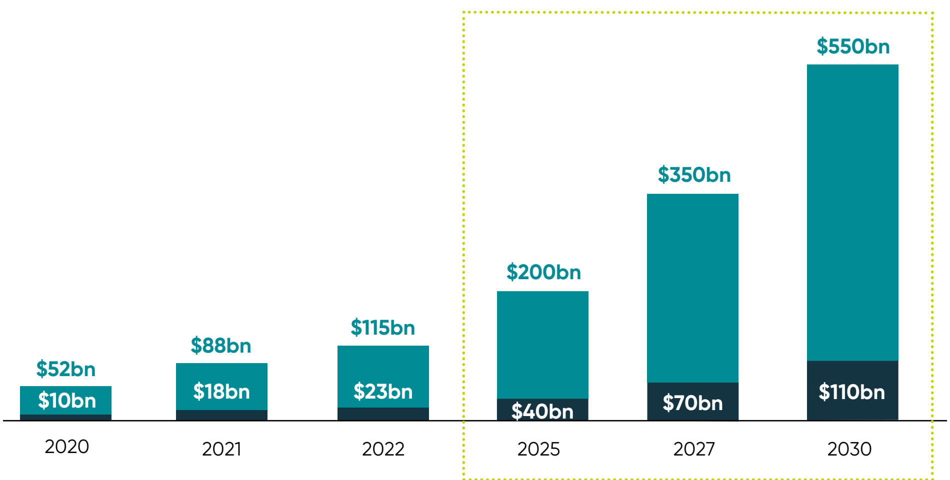
Figure 10: NAV finance projected growth across all private equity asset classes[11]



While the upward trajectory of NAV finance can be witnessed over the last 15 years, increased adoption by large private equity managers have accelerated the trend over recent years.

Based on the above analysis, the $100bn market opportunity across all asset classes in 2020 has already been exceeded in 2022 for private equity buyout alone and we would expect those strategies to remain the leading user of preferred equity going forward. Updated forecasts for 2025 and 2030 demonstrates a growing, sizeable market for preferred equity providers and below we look at a sample of specific market drivers.

Figure 11: NAV finance private equity buyouts accelerate market growth[12]



10 "NAV Lending: The emerging opportunity for private debt investors", first published in July 2021.

11 17Capital analysis produced with 2020 market data provided by Preqin.

12 17Capital analysis produced with 2022 market data provided by Preqin.

7. Market opportunity & deal flow (2/2)

Underlying industry trends have been and will continue to be the catalyst for market growth, mainly driven by;

(i) **Underlying industry growth** in private equity AUM, which is set to exceed $11trn by 2026, up from an estimated $5trn at the end of 2021.[13]

(ii) **Increasing adoption** as private equity managers and investors incorporate NAV finance into their broader financing "toolkit" in much the same way as we have seen in other markets such as subscription finance and GP-led continuation vehicles.

Below, we look at how these broader industry trends will create increased financing needs across different stakeholders outlined in the prior sections:

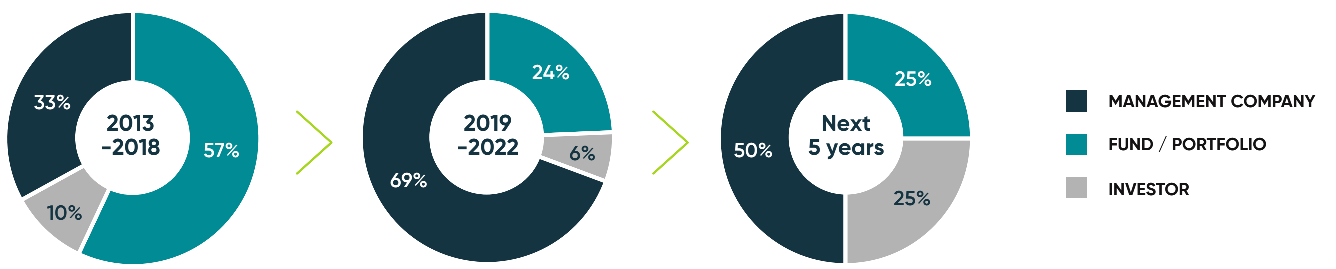
- **Management Company:** AUM growth will increasingly present financing challenges for managers to meet future, often larger commitments and to potentially expand their offering through product and geographic diversification or through M&A. For managers with conviction in their franchise, preferred equity serves as an attractive non-dilutive source of capital to support that growth and expansion.
- **Funds:** The life span of private equity funds is continuing to increase. More than half (57%) of the U.S. private equity funds that closed in 2007 were still actively holding assets at the end of March 2021.[14] Figure 5 highlights that financing needs arise long after the initial investment period.
- **Investors:** In the same way that we have seen sustained growth in the secondary market to provide a "sale" option for investors, we would also anticipate an uptick in the use of non-dilutive financing as an alternative to selling for investors with conviction in their private equity portfolios and the managers they back.

The above considerations are not in any way exhaustive, and it is inevitable that the use case for preferred equity will pivot over time driven by prevailing macroeconomic events and industry factors. Such shifts have been evident historically and can be expected in the future, as outlined below in Figure 12.

Positive market dynamics are supported by underlying industry growth and increased adoption

For preferred equity providers (and investors) this dynamic and shifting landscape results in a continuously robust market opportunity, adapting to the ever-changing needs of the counterparties

Figure 12: **17Capital's deal flow evolution**



Source: 17Capital

13 Preqin, 2022 Global Alternatives Report (www.preqin.com/insights/2022-preqin-global-alternatives-reports).

14 WSJ: "Aging Private Equity Funds Test Investor Patience". Published June 2022.

PREFERRED EQUITY

Conclusion

It is the characteristics, performance and outlook of any strategy that will ultimately drive investor allocation decisions

Pont Neuf in Paris was completed in 1606 and is the oldest surviving bridge in the city. It's name translates as the "New Bridge", as a naming convention it is clearly inaccurate, but does it matter?

The debate around naming conventions is not unique to the case of preferred equity within the NAV finance landscape. We note the thought leadership of Nuveen in exploring the correct "classification" for CLO equity given it "sits at the intersection of at least three key asset grouping" namely fixed income, opportunistic credit and broad alternatives.[15]

It is the characteristics, performance and outlook for any strategy that will ultimately drive investor allocation decisions, in-line with their own strategic objectives. In this report, we have looked to examine the fundamentals of preferred equity within the landscape of NAV finance to assist in that allocation assessment.

Although we can trace the origins of preferred equity to the mid 1800's, the evolution of the product to financing private equity portfolio has been quite transformative in providing a unique alternative to borrowers whose key objective is to grow and retain their portfolios rather than selling.

NAV finance will become a significant standalone asset class by 2030 and preferred equity will play a significant role in that growth

Sophisticated investors will identify high absolute returns, low volatility, robust downside protection in a market with strong growth dynamics as the key tenets for allocation. We examined how their key investment principles were much more aligned to private debt than other possible classifications.

Private debt is a broad church, and we increasingly see appetite for NAV finance to be part of that landscape. Relating to the forecasts presented in Section 7, we believe NAV finance will become a significant standalone asset class within private credit by 2030 and the use of preferred equity will play a significant role in that growth given the debt like characteristics we evidenced in this paper.

Perhaps the real conclusion, therefore, is that the naming convention remains less relevant compared to the empirical evidence of how something really is. In this instance, it is as simple as thinking of preferred equity as nothing more than a lending strategy – for us at least, we settled on "Strategic Lending", but then again, "What's in a name?".

15 Nuveen publishing in Summer 2021: "CLO Equity: Where does it fit in investor allocation?".

Contacts

We hope you have found this report interesting. If you would like to discuss any of the points raised, or would like to find out more about investing in this asset class, please do not hesitate to contact Martin, Pauline, Drew or Alejandro in 17Capital's Investor Relations team.

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17Capital is a dedicated NAV finance provider and covers the entire capital structure, providing a wide range of financing options via two complementary formats: NAV loans and Preferred equity. 17Capital works with high-quality investors in private equity and structures its financings to meet its clients' objectives, while maintaining an alignment of interests.

Founded in 2008, 17Capital operates from London and New York and has completed more than 90 portfolio financing transactions. 17Capital has raised $11bn+ across six successive funds and mandates, investing $9bn+ since inception. In 2022, Oaktree acquired a majority interest in 17Capital. The partnership gives 17Capital access to Oaktree's deep global network. 17Capital continues to operate as an independent business, with its own product offerings and investment, marketing, and support teams.

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