Flexibility Is Key In Hybrid Capital Investment Strategies

By **Daniel Mathias** (April 3, 2024)

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In recent months, we have seen Blackstone announce that its tactical opportunities business raised $5.2 billion of capital commitments for its fourth flagship comingled fund, this being a substantially higher amount than its third fund. General Atlantic held a final close in the first quarter of this year for its second strategic capital fund, raising $2.7 billion — approximately 23% more than the amount raised for its previous fund.

We now understand Apollo Global Management aims to raise at least $6 billion for its third hybrid value fund — which, again, would be a significant increase on the $4.6 billion raised for its previous hybrid value fund. These examples, as well as others, appear to reflect an ongoing trend.

Imagine business owners considering a potential private capital fundraise. Their plan doesn't fit into the typical strategy of a private credit fund but it also doesn't fit into a private equity buyout fund.

Some owners of strong and high-growth businesses may be reluctant to give up control but also insistent on not wanting to take on more private debt. Others may be dealing with a distressed or over-levered businesses, which require some short-term capital support not otherwise available in the market.

Where can they go? Flexible or hybrid capital funds have become a solution for certain owners.

Key features for such flexible capital investments typically include:

- A noncontrol capital infusion;
- A bespoke instrument designed on a case-by-case basis;
- A hybrid between equity and debt; and
- A so-called all-weather approach — that is, a strategy that permits investments in both distressed situations, as well as upcycle investment in a variety of businesses — in terms of sectors and geographies.

Each investment will have its own nuances and requirements. The type of instruments can include:

- Common equity with strong downside protection;
- Preferred equity — either convertible or nonconvertible;
- Convertible notes;
- Structured debt or warrants; or
- Any combination of these.

Each firm focused on such strategy will vary in where on the equity-debt spectrum it sits. The focus is usually to provide a more hands-on partner approach than a traditional private

credit investment, while equally providing further downside protection than achieved in a typical private equity buyout.

Hybrid capital providers can take board seats, leverage their data and networks to bring in operating partners, and upsize their investments for future mergers and acquisitions or growth initiatives.

Based on the continued increase in limited partnership commitments for such strategies within some of the world's largest preferred equity sponsors, investors seem eager to be exposed to new opportunities that do not naturally fit within the traditional flagship funds.

Sponsors are equally focused on thinking innovatively and creatively to find ways to add diversification and offer flexible products.

Some traditional limited partnerships sometimes struggle to allocate to hybrid capital as they have a credit bucket and an equity bucket, but this strategy sits in between. This may evolve in the coming years within the limited partnership community.

What appears likely is that we will continue to see innovation in the variety of hybrid funds, both in terms of strategies and how they are structured — e.g., traditional closed-end format, or an evergreen fund with some form of withdrawals.

Structured products can provide access to situations that may not otherwise be available to investors. Convertible debt and preferred equity can provide some leeway to combine a form of partnership and ownership, along with steady income.

This, balanced with downside protection against risks inherent in traditional equity investments, is attractive to some investors. Notwithstanding the rising popularity of hybrid funds however, such funds are not expected to, or intended to, replace traditional private equity funds.

For founders and companies themselves, it is critical to plan in advance, be organized and be prepared to describe a business plan that connects their future strategy with its current financial needs. Investors will expect a detailed and compelling story.

Investors will also expect a strong grasp on the fundamentals, including current business needs and the intended market strategy. Companies must be prepared to balance between valuation and terms and understand important components such as valuation, liquidation preference, payment in kind dividends, covenants, redemption and governance.

Advisers must deliver deep experience and dedicated teams to founders and companies. This is important to not only support the opportunities provided by such potential investments and be able to accurately document the negotiated terms, but to also provide protection from possible threats.

Principals must understand how these instruments may differ from traditional investments, especially with regard to potential conflicts, events of default, financial difficulties or possible insolvency scenarios. As noted, these capital solutions are bespoke and require thoughtful guidance to accurately structure and fit within the existing capital structure.

The complexity and possible range of structures available means that principals need to consider how they may work in different scenarios and outcomes.

The advantage for such hybrid funds is their inherent flexible nature. This should provide opportunities to quickly anticipate changes in market dynamics and respond accordingly in a fast-paced environment. Their advantage may also however be their disadvantage.

If you are not a traditional private credit fund, not necessarily a traditional growth equity fund, and not a long-term family office investment firm, what is your value proposition and risk-return profile?

It likely requires providing clarity to the existing owners on the terms of the investment structure and the ultimate investment objective. Communication with existing shareholders on expectations and approach is critical, both in the preinvestment phase and post-investment phase.

While the investment strategy is flexible, it is still of course typically designed with a required exit intended within a similar time frame as found in a more traditional private equity buyout fund.

The rationale behind the strategy is that it is precisely not a one-size-fits all approach. This is intentional. In an uncertain environment, this has obvious benefits. Strong alignment between the principals, the respective advisers and an understanding of the future business plan is therefore paramount to achieving successful outcomes.

The legal documentations are less standardized, with recognized hybrid instruments differing vastly across jurisdictions, and they are often less battle-tested in restructuring scenarios. Given the bespoke nature of each investment, the devil is in the detailed drafting and structuring.

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