

COLUMN



## Everything you need to know about preferred equity

*Ben Yeoh from Goodwin provides a succinct overview of how preferred equity waterfalls work*

Companies raise capital from a variety of sources ranging from vanilla equity issuances, to leverage, to a variety of complex structures that fall in between a pure equity position and a pure debt position, such as preferred equity. In the venture capital funds space, we also see this intermediate level of capital in a fund's equivalent of the capital stack – the fund waterfall.

**How does it work?** A preferred equity waterfall functions like a typical venture capital waterfall: investors are repaid the capital they contributed, and then receive a preferred return, which the fund manager then catches up on, before all other profits are shared, typically 80% to investors and 20% to the fund manager.

The twist is that a preferred equity waterfall inserts a position which receives a minimum return on capital contributed, in priority to the returns of all other investors. This priority position increases the risk for the other investors should the fund fail to generate sufficient returns, analogous to an insolvency situation in a company, but usually brings some additional reward.

**Effects** A preferred equity waterfall therefore creates two levels of risk/reward that differ from a traditional fund interest. Lower risk for the preferred equity

position, and higher risk for the non-preferred position.

Based on the rationale for intermediate capital, you would expect non-preferred investors are compensated for the increased risk in some form. In the British Business Bank's ECF or Enterprise Capital Scheme (which is used by over 30 venture funds in the UK), this is exactly what happens. To compensate non-preferred investors, the holder of the preferred equity position effectively assigns a portion of their right to profits further down the waterfall to the non-preferred investors.

Alternatively, you would expect that the preferred investor is required to bring some additional value to the fund in exchange for its privileged position. We also see this where the preferred partner has contributed seed assets, sourced investors, underwritten or contributed a significant portion of equity. During the life of a fund, we also see preferred equity where a new investor de-risks current investors' positions by returning capital to investors, in exchange for a preference on future distributions plus a premium.

**Benefits** The intermediate positions created by a preferred equity waterfall can be attractive to investors for whom traditional fund interests are either too risky, or not risky enough. It is also flexible and the precise risk/reward trade-offs

can be calibrated in each waterfall to match investor preferences. This allows a fund manager to tap additional pools of capital.

**Complexities** Preferred equity waterfalls do introduce additional complexity into the fundraising process. For example, the interests of different holders of equity may be misaligned if the fund is underwater. In such a situation, holders of the preferred equity may favour more risky investments to give them a return on their preferred equity position, while other investors may favour cutting their losses.

Thought also needs to be given to the proportion of preferred equity investors to regular investors. A preferred equity position ahead of 90% of other investors is materially less risky than a preferred equity position ahead of only 50% of investors, and the former should therefore require a higher assignment of profits or value add from the preferred investor. Consideration is needed to ensure an appropriate balance.

**Navigation** Managers can successfully navigate these complexities and successfully raise a fund with a preferred equity waterfall. We expect preferred equity waterfalls will remain a feature of the funds market, particularly as it is a useful tool to match the risk of a fund investment to the risk appetite of investors. ♦