Strategic Non-Control Capital: An Attractive, Growing Asset Class

The Covid-19 pandemic has accelerated demand for capital solutions that help businesses achieve their corporate objectives and align themselves with a strategic equity partner, without relinquishing control. We believe providing flexible capital and strategic partnership without taking control represents a unique and growing opportunity in private and public markets.

DEMAND FOR NON-CONTROL CAPITAL IS ON THE RISE

A significant funding shift is underway. Businesses are increasingly seeking capital by pursuing partnerships with sophisticated investors through non-control equity and equity-linked solutions. This form of funding requires no change of ownership, allowing companies to retain control of their businesses while avoiding additional strains on their balance sheets. Owners and management teams are seeking capital to grow their companies, surface value in strategic operating segments and/or stabilize operations, while not leveraging or exiting their business. The non-control capital being sought can be offensive in nature, with businesses seeking financing to help spur growth, or it can be more defensive, with businesses seeking stabilization or rescue capital.

We believe this trend represents a significant opportunity for investors to provide capital at scale to a growing set of high-quality businesses. We have found that a considerable capital void exists for businesses that are seeking flexible and creative capital solutions while also not wanting to cede ownership of their business through a buyout or risk financial stress by adding debt. Traditional capital markets may not match the scale or customization required in these cases. Companies seeking this form of capital want to maintain control and gain a strategic partner who is aligned with their goals, without taking on restrictions of additional leverage. We believe this opportunity in providing non-controlling strategic capital stakes is large and growing.

DEMAND FOR NON-CONTROL CAPITAL COMES IN VARIOUS FORMS

Strong companies are looking for strategic capital to help them take advantage of the dislocation in their markets, while weaker earnings and uncertainty are necessitating others to strengthen their balance sheets. Revenue and earnings per share for S&P 500 companies came in far lower in 2020 than a year earlier, marking a significant deviation from strong growth trends over the 10 years since the Global Financial Crisis (GFC).

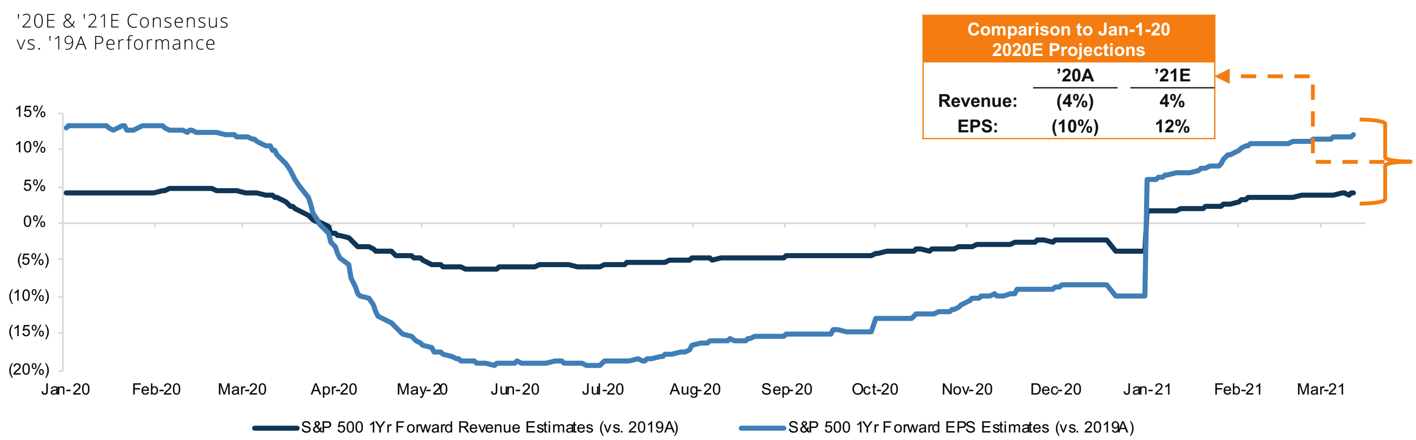
While earnings continue to grow, leverage levels remain elevated, requiring companies to decide how to continue funding their strategic objectives (see Figure 1). One well-established option is to sell equity via controlling stakes or meaningful minority stakes. Another is to continue taking on inexpensive debt—which runs the risk of constraining a company's balance sheet.

FIGURE 1

THE LOCKDOWN'S IMPACT ON REVENUES AND EARNINGS IN 2020 CREATED LIQUIDITY PRESSURES THAT WE BELIEVE WILL PERSIST

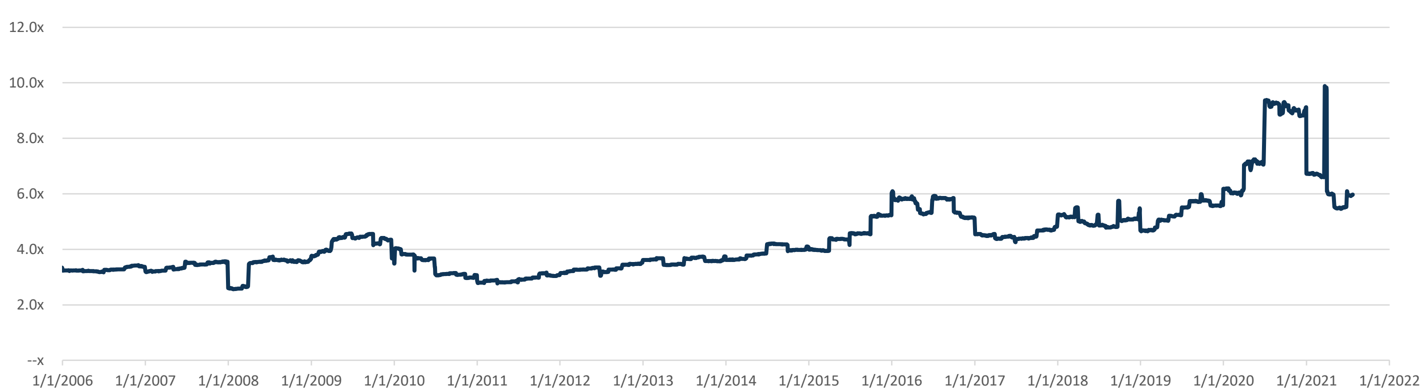
2020 S&P 500 revenue and EPS were less than 2019 performance

Projected Covid-19 Impact on Revenue and Earnings per Share



While the Covid spike has abated, leverage remains at elevated levels on the Russell 2000 index

Russell 2000 Net Debt to EBITDA



Source: Bloomberg.

A compelling alternative, however, is to sell hybrid securities—which offer investors some downside protection while allowing companies to achieve their valuation aspirations and also gain a partner aligned with their strategic vision, as outlined below:

PRIMARY USES OF STRATEGIC CAPITAL	**Growth capital** for companies that are intent on taking advantage of opportunities in the market	**Bespoke financing** to help surface value from differentiated segments of operations	**Liquidity solutions** for companies to stabilize operations during periods of uncertainty	**Rescue financing and capital solutions** for companies facing immediate challenges related to their capital structure
CONSTRAINTS ON COMPANIES SOLVED BY HYBRID CAPITAL	**Lack of access** to traditional capital markets	**Complexity** of operations and transaction execution	Need to **limit debt** on the balance sheet	Desire to **maintain control** of the business

VALUE-ADD PARTNERSHIP IS AN ENDURING OPPORTUNITY

The demand for non-controlling capital today is coming from companies that have growth opportunities and require capital to pursue them, as well as from companies that have been negatively impacted from Covid-19 lockdowns and are no longer able to access capital markets efficiently.

We see corporate demand for this type of capital continuing and growing from here, with capital markets generally struggling to keep pace (see Figure 2).

FIGURE 2

BUSINESSES IN EVERY ECONOMIC ENVIRONMENT NEED FLEXIBLE CAPITAL FROM A STRATEGIC PARTNER

MARKET ENVIRONMENT	INVESTING OPPORTUNITY
Dislocated	• Issuers challenged by lack of access to traditional forms of capital as macro and financial instability—and capital market uncertainty—make it difficult for investors to act quickly on issues surrounding pricing and size. • These situations present an opportunity to provide flexible, bespoke financing solutions to businesses facing complex situations.
Stable	• Growth-minded companies typically seek creative capital solutions to support expansion opportunities or facilitate next steps of the corporate life cycle. • Certain sectors or companies may experience disruption independently of the broader economic environment. Such opportunities require the same customized solutions approach as during dislocated environments.

DEEP DIVE: THE OPPORTUNITY IN TAKING MINORITY STAKES

We see a particularly compelling opportunity in providing flexible capital to predominantly healthy companies seeking bespoke financing solutions—without requiring the businesses to cede ownership. This opportunity involves delivering attractive, large-scale capital solutions to high-quality companies needing fresh equity for growth or help in upcoming development obligations due to a lack of capital markets access.

These firms either cannot access the public markets efficiently, or they choose not to. Instead of overleveraging themselves, they seek a strategic partner who can assume an active role in solving their complex capital needs. They can do so with non-control equity and equity-linked solutions that involve taking a minority stake and less aggressive equity upside in exchange for more protections, such as preference securities and credit-like downside protection. By shaping the financing solution and adding value to the business, the strategic partner should help drive returns for the entire equity ownership.

Similarly, we see the need for this type of capital with companies that must recapitalize because they are strained and overleveraged (see Figure 3).

FIGURE 3

WE SEE OPPORTUNITY ACROSS MULTIPLE INDUSTRIES AND MARKET SEGMENTS

INDUSTRY OR MARKET SEGMENT	OPPORTUNITY
Industrials	• Manufacturing businesses with ties to uncertain economic fundamentals continue to face challenges. • Significant investments required for automation and productivity gains necessitate capital investment. • Examples include companies across industrial manufacturing that have been significantly impacted by a decline in demand for capital goods across sectors, including aerospace and industrial manufacturing and packaging.
Real Estate	• Real estate and related assets linked to luxury consumer brands or "experiential spending" remain under stress. • High-end travel and leisure that saw revenues recently collapse face the prospect of a protracted recovery. • The pandemic has also impacted housing trends (e.g., migration out of cities) and associated consumer goods.
A Shift to Asset-Light Models	• Companies with models of outsourcing ownership and maintenance of hard assets are experiencing difficulties and seeking ways to lighten their balance sheets. • Aircraft, car and rail leasing businesses are large consumers of capital and have suffered amid a global decline in GDP. Over the medium term, access to capital is expected to become more difficult.
Infrastructure	• Dislocated assets requiring capital for committed development work and sustaining high fixed operating costs are impacted by the material slowdown in economic activity. • As the movement of people and goods slowed, primarily transportation-related assets that are GDP linked—e.g., airport operators—experienced revenue declines from lower landing fees and retail rents amid a meaningful drop in passenger traffic.
Regional Dislocation	• Dislocation in select emerging markets is resulting in limited liquidity from traditional capital providers. • Banks and non-banking finance companies across India are experiencing capital constraints—and diminishing status as large providers of liquidity—as foreign capital equity market outflows accelerate. • A massive increase in demand for credit across Brazil is leading to limits on new money, with liquidity going only to the highest-quality corporates.

We differentiate non-control equity from typical private equity and private debt investments (see Figure 4).

FIGURE 4

PROVIDING NON-CONTROL CAPITAL IS DIFFERENT THAN TRADITIONAL PRIVATE EQUITY OR PRIVATE CREDIT

	TYPICAL PRIVATE EQUITY BUYOUT FUND	MINORITY STAKE CAPITAL	TYPICAL PRIVATE CREDIT FUND
Ownership	Control equity or path to control	Non-control equity, with significant influence and minority protections	Non-control, with limited influence
Portfolio Concentration	Highly concentrated	Low concentration	Diversified
Equity Upside	Priced to earn a high return, with no sharing of future earnings	Allows for ongoing upside participation	Limited exposure to equity upside
Duration	Long term in nature, with 7–10 year holds and investors expecting to earn a 200% multiple of capital	Medium duration, with approximately 5-year holds and investors expecting to earn a 150–170% multiple of capital	Shorter duration, with investors expecting to earn a 130% multiple of capital
Value Drivers	Significant step change in EBITDA potential	Structured yield and equity upside through control-like enhancements	Structured yield and fees

Non-control equity, and equity-linked investments, can provide investors with private-equity-like returns, but with added downside protections characteristic of private credit investments. These protections arise from the structured nature of the investment, with its priority preference in the capital stack, as well as its potential governance and liquidity rights. Governance rights can include board representation and consent/veto rights, and frequently also include financial covenants or step-in rights that allow investors to maintain influence through control-like enhancements in an otherwise non-control investment. There also can be significant downside protection from a value standpoint, given that these investments tend to have lower buy-in multiples than a common equity investment.

AN ILLUSTRATIVE EXAMPLE OF PUTTING STRATEGIC GROWTH CAPITAL TO WORK

A hypothetical energy company was looking for strategic growth capital, but was not interested in raising equity (as it would be too dilutive), and raising capital in the traditional debt markets was unattractive (as the company was wary of the negative impacts of increasing leverage levels).

Instead, the company decided to seek out a strategic partner that could assist with mergers & acquisitions and growth prospects, but still allow the company to retain control of its business and maintain an acceptable balance sheet.

Upon executing a non-control capital transaction, the strategic partner worked closely with the company to add meaningful value across a number of areas. For example, the provider assisted senior management with their cost-improvement initiatives, assumed a seat on the board, and helped the company reset its capital allocation strategy. The strategic provider also assisted in evaluating and structuring the company's acquisition strategy, and helped enhance the efficiency of the company's operations.

INFLUENCING THE OUTCOMES FOR COMPANIES—AND INVESTORS

Non-control equity does not mean no influence. Rather, the opportunity is in securing preferential positions in a company's capital structure and structuring transactions with bespoke features that bring significant influence, allowing the strategic partner to potentially boost the value of the company with limited economic downside to investors.

These types of deals can be pooled together in funds that aim to provide attractive internal rates of return for investors, given the lack of a control premium and the value-add offered by capital providers in the form of strategic and operational expertise. Importantly, we do not see non-control equity as a replacement for income opportunities in a portfolio. Rather, we believe it should be considered as part of the private equity, opportunistic or general alternatives portion of a portfolio. We view it as a way to diversify within alternative investment allocations.

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