FEATURE

Preferred stock gives a new twist to PE financing

Brand names of the buyout industry offer flexible capital with compelling coupons, says *Eric Uhlfelder* in New York

A new twist in private equity financing is attracting both issuers and investors. Industry heavyweights KKR, Carlyle and Apollo have over the past 18 months started to issue US preferred shares — income securities that pay a much higher coupon than traditional corporate debt.

The securities have the flexibility, however, of being called by the issuer at par after five years or they can remain outstanding at a set interest rate, for as long as the issuer likes. These preferred shares are exchange-traded and thus liquid.

"We're seeing an unusual phenomenon here: junk-size yields through industry-leading investment-rated borrowers," says Michael Dixon, fixed-income portfolio manager of the $800m Yorktown Multi-Asset Income fund. Mr Dixon has had positions in several of the issues.

Private equity groups are tapping the preferred market for various reasons, including seeding investments and to help meet capital commitments to large buyout funds. With solid underwriter backing and little need for roadshows, the capital-raising process can be highly efficient.

Martin Kelly, Apollo chief financial officer, says it has allowed the company to diversify its capital structure with permanent financing at an attractive price. "With this enhanced flexibility, it's allowing us to pursue strategic capital initiatives," he says.

The securities fly below most investors' radars because few analysts and brokerages track preferreds. Size also explains why these new offerings have been missed.KKR, Carlyle and Apollo collectively run more than a half a trillion dollars. According to Preqin, an industry data tracker, committed uninvested capital across the private equity industry is at record levels. These numbers dwarf recent preferred capital raisings.

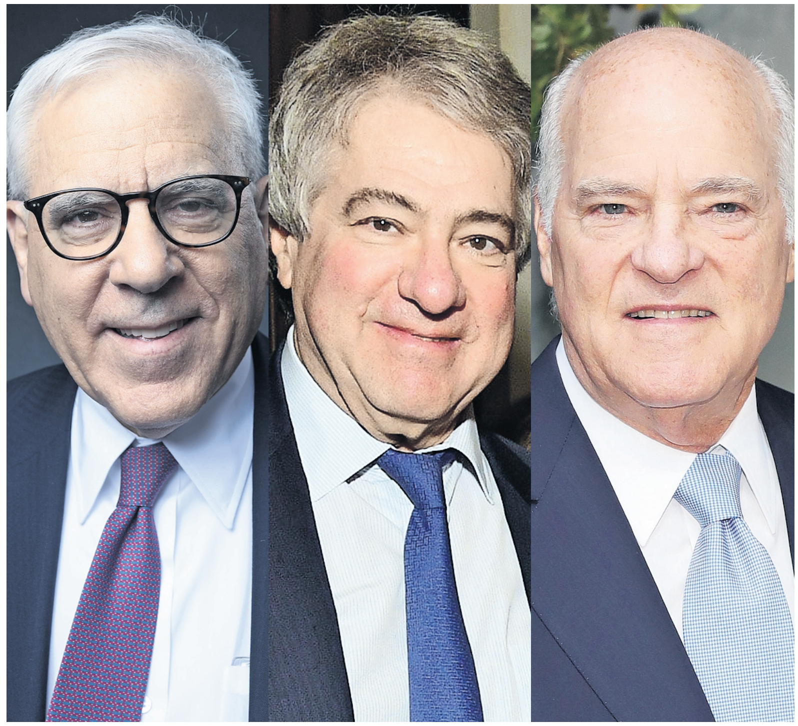
KKR brought out two issues in 2016 worth $500m with coupon yields of 6.75 and 6.5 per cent. (KKR also took over its formerly independent financial holding company, which has an outstanding $325m issue with a 7.38% coupon, which was called in January). Apollo raised $275m last year with a 6.38 per cent coupon. Carlyle's $400m offering came out in September paying 5.88 per cent.

Mr Dixon believes one reason for these attractive yields from such long-established names is that these securities were among the private equity industry's initial preferred offerings.

The first out of the gate tend to pay higher-paying coupons. As market attention and familiarity has grown and credit spreads have shrunk, so have coupons. The high yields may also have resulted from more restricted investor interest caused by the private equity groups' partnership structure. This makes it more challenging to understand matters such as revenue and liability recognition, affecting assessment of current and forward financial conditions. In addition, there are fewer analysts deciphering the numbers and trends compared with other major financials.

Another factor driving up initial yield may be lower-than-expected preferred credit ratings. Preferred ratings are backed into from these managers' corporate credit ratings, which range from A to BBB+. Investment-grade alternative managers typically see their preferred grades rated two notches lower (BBB+ to BBB-) because they are further down the capital structure.

Looking at leverage and cash flow also explains these credit ratings. Meghan Neenan, managing director of financial institutions at Fitch, the rating agency, excludes performance fees and investment income in assessing leverage and debt service coverage because of their variability. "But we treat these preferreds entirely as equity," she says, "not impacting debt or leverage."



David Rubenstein of Carlyle, Leon Black of Apollo and Henry Kravis of KKR

Buyout groups tap US preferred market

Issuer	Ticker	Date issued	Asset size ($m)	Coupon	Current Price	Current Yield	Call date	Yield to Call
Apollo Global Mgmt	APO pr A	09-Mar-17	275	6.38	25.54	6.24	15-Mar-22	6.00
Carlyle	TCGP	15-Sep-17	400	5.88	24.40	6.02	15-Sep-22	6.67
KKR	KKR pr A	28-Mar-16	345	6.75	26.93	6.27	15-Jun-21	4.54
KKR	KKR pr B	27-Jun-16	155	6.50	26.70	6.08	15-Sep-21	4.69

Source: Bloomberg

Sebnem Caglayan, director of financial services ratings at Standard & Poor's, takes a hybrid approach in assessing KKR, Carlyle and Apollo, recognising half preferred proceeds as debt in calculating leverage. S&P, though, recognises half the manager's net realised performance fees in determining cash flow that can support dividend payment and creditworthiness.

While both agencies rate Carlyle's and KKR's preferreds the same, S&P assigns Apollo's issue a BBB+ rating versus Fitch's BBB. An equally important reason explaining higher yields is because the US preferred market is poorly tracked. Lack of analyst coverage, familiarity with its idiosyncratic features, and even knowledge of their exchange-traded tickers puts this asset class at a marketing disadvantage.

According to a report by Cohen & Steers, the New York asset manager, the preferred market is valued at $880bn, made up of exchange-traded securities and institutionally traded preferreds.

Primary issuers are banks, insurers, financial services companies, utilities and real estate groups. Cohen & Steers reported last year that the average current yield of investment-grade preferreds was 5.6 per cent.

Equivalently rated corporate and municipal bonds were paying 3.4 per cent and 10-year Treasuries about 2.5 per cent. Only junk bonds yielded more, having paid 6.5 per cent.

6.75%
The coupon yield for one of the two 2016 issues by KKR. The second issue had a yield of 6.5%

BBB+
The S&P rating for Apollo's issue. Fitch goes for BBB. Both agencies rate Carlyle and KKR the same

Many US preferred investors get an after-tax boost because a large number of issues pay dividends that qualify for the 15 to 20 per cent tax rate. Corporate debt interest is taxed at a much higher personal rate.

Many factors influence the value of preferred shares, led by interest rate trends and events affecting corporate credit. Most don't mature, which means investors have to be mindful of the effect of rising interest rates. Call features, typically starting five years out, can mitigate that risk but there may be little incentive to call when borrowing costs are rising.

Because they aren't debt, preferreds can miss payments without triggering default covenants. Markets, however, do not respond well to such suspensions.

Kevin Conery, preferred trading desk analyst at Piper Jaffray, says: "If this were to happen, it would have significant repercussions on all the PE's funding and stock, whose dividend would also likely be suspended. All this would raise the cost of capital."

For large private equity groups, he thinks the probability of a preferred dividend miss is low because he believes an issuer would tap every financial well to avoid this.

Mr Dixon expects more of these offerings, which have attracted strong market support. This was evident in Carlyle's last issue when demand doubled the initial capital raising target.