Newsletter (9) - Restructuring in Private Equity

(1) Introduction

In this week's edition of our newsletter, we take a closer look at restructuring strategies in private equity (PE). Some firms restructure out of necessity, others to create value, and some do both. Leveraging alternative strategic interventions can help restore stability and unlock value.

We begin with an overview of Liability Management Strategies and how PE firms reduce debt with minimal cash. Then, we explore private equity Recapitalization and its role in optimizing capital structures. Finally, we examine Alternative Liquidity Solutions that allow for creative restructuring beyond traditional exits.

(2) Liability Management Strategies

There are two primary tools used when restructuring debt without deploying large cash reserves: Debt for Equity Swaps and Payment in Kind (PIK) Interest Structures. The choice of approach depends on the company's financial condition, long-term viability, and creditor risk tolerance.

A debt for equity swap restructures outstanding debt into equity, reducing liabilities while giving creditors an ownership stake in the company's future. This strategy is particularly relevant when the PE firm itself is a lender, as the potential equity upside may outweigh the recoverable value of the debt. However, it comes with risks since creditors move lower in the capital structure, losing liquidation priority. Hence, before converting debt into equity, lenders assess if the company's distress is temporary or terminal. If the business is fundamentally viable but burdened by short-term debt constraints, creditors may accept equity in exchange for extending maturities, effectively transforming short-term obligations into longer-term investments. This shift allows the company to stabilize and benefit from future upside while giving creditors a path to eventual recovery. If debt is written off, a swap may be a last chance for recovery over insolvency.

PIK interest provides short-term liquidity relief by allowing companies to defer cash interest payments, capitalizing them into the loan principal instead. This avoids immediate cash outflows and gives the company breathing room to recover. However, in PIK structures interest accrues, thereby increasing both future interest payments and the principal remaining. PIK is most useful when a company is facing temporary cash flow constraints but is expected to generate stronger earnings in the future. Lenders often impose strict PIK covenants, as excessive deferrals signal financial instability. If not carefully managed, the growing debt burden can push companies into unsustainable leverage levels, restricting future financing options.

Each strategy serves a distinct purpose but shares the goal of stabilizing portfolio companies, preserving value, and avoiding short sales or distressed exits. Debt for equity swaps are most effective when long-term upside exists but short-term liquidity is constrained, while PIK structures provide immediate flexibility but increase debt obligations over time. In both cases, liability management is essential to maintaining financial control and maximizing recovery potential.

(3) Private Equity Recapitalization: Optimizing Capital Structures
Private equity recapitalizations optimize returns beyond underperforming assets. To extract liquidity prior to an exit without sacrificing ownership, responding to extended holding periods, PE firms adjust the equity-to-debt ratio, for a value-accretive exit. Consequently, the strategy for optimizing capital structures depends on the financial position of the company, which determines whether the recapitalization through debt or equity is feasible.
If a firm cannot exit at the target exit multiple, yet showcases a resilient cash flow management, PE firms can employ dividend recapitalizations. The strategy involves incurring additional debt to fund cash distributions to investors, offering LPs tangible and earlier returns without losing ownership or risking a distressed exit in an underperforming market environment. Exemplifying this strategy is KKR's 2021 UFC dividend recap, backed by strong cash flow, preceded by a successful IPO. This immediate distribution of cash boosted DPI (Distributed to Paid-In Capital), now more emphasized alongside IRR, per Moonfare. This is because DPI offers a transparent picture of actual cash returns. Its growing relevance reflects investors prioritizing realized returns over paper returns, reinforcing the need to accelerate exit cycles. However, the risk of taking additional debt makes the strategy unviable for portfolio companies with higher cash flow volatility or systematic distress.
When opting for more leverage at the portfolio company level is unsustainable, NAV (net asset value) financing offers an alternative to tap into additional liquidity by securing debt against the entire fund's diversified asset pool. It enables General Partners to access capital without affecting the capital structure from an individual company. Apollo launched a $4B NAV loan pipeline in 2023 to enhance liquidity, fund operations, and distribute LP returns. Lenders will provide financing based on key metrics such as portfolio composition, fund performance and asset quality. Due to a higher risk profile, Loan-to-Value (LTV) ratios in NAV financing at the fund level often range between 5% and 30%. Higher asset valuation volatility, low liquidity and the risk of poor exits all contribute to lower LTV ratios being offered than in traditional debt vehicles.
The optimization of capital structures comes with inherent risks and PE firms must strive to find a balance between leveraging opportunities and ensuring financial stability to maximize returns. Beyond revitalizing underperforming assets, restructuring extends holding periods to create value across market cycles.

(4) Alternative Liquidity Solutions: Creative Restructuring Outside Traditional Exits
Businesses frequently use sale-leaseback agreements to obtain liquidity without taking on more debt. This strategy enables businesses to unlock capital by selling and leasing back owned assets, such as real estate. Sale-leasebacks are typically used by financially distressed companies, but recently, they have also been used to free up capital to fund expansion. Despite upfront capital, previously owned assets will require companies to pay rent, thereby

eroding operational profitability. These lease obligations are viewed as liabilities under IFRS 16, thereby affecting leverage ratios and limiting future capital access. Red Lobster (RL) sold and leased back 500 restaurants to American Realty for $1.5B in 2014, exemplifying sale-leaseback risks. While originally the influx in capital helped RL fund expansion and the costly endless shrimp promotion, inflation-linked leases largely contributed to its following distress, resulting in Chapter 11 Bankruptcy in 2024. Consequently, sale-leasebacks come with a dangerous trade-off for firms: while providing important liquidity to stabilize a distressed company, the potential for higher lease obligations to tarnish operational performance often outweighs the benefits. Hence, restructuring investors must weigh cash inflow against operational risks.

Beyond sale-leasebacks, companies can explore Holding Companies (HoldCo) and asset-backed financing (ABF). In this structure, the HoldCo owns an Operating Company (OpCo), which leases assets from a Property Company (PropCo). Then, HoldCo raises debt using OpCo cash flow, PropCo assets, or ABF on inventory, IP, or receivables. Through these structured finance layers, the HoldCo is able to service debt through dividends or lease payments from its subordinate operational entities. Here, the HoldCo can issue different layers of debt with low leverage ratios (secured vs. unsecured), optimizing their cost of capital. The interesting feature of such a structure is that if the OpCo struggles, the PropCo retains control of key assets, shielding them from immediate creditor claims, known as ring-fencing. Hence, with this operational structure, firms can raise money without having to sell off important operational divisions. For these reasons, PE firms frequently use this structure for struggling portfolio companies. For example, Subway (owned by Roark Capital) raised $3.35B via AB-Bonds in April 2024, the largest securitization of its kind. This funded working-capital and expansion without key asset sales, thereby helping fuel further expansion in an ever-competitive fast-food industry.

In summary, both sale-leasebacks and HoldCo-PropCo structures provide liquidity solutions, particularly for asset-heavy businesses looking to unlock capital while maintaining operational control. Though they offer short-term relief, they do not fix fundamental weaknesses and hence, may be unsustainable.

(5) Conclusion

Private equity firms leverage liability management, recapitalization, and alternative liquidity solutions to navigate extended holding periods, optimize capital structures, and sustain value creation. With rising macroeconomic pressures and constrained liquidity, restructuring has become increasingly important. However, its success depends on the financial and operational profile of each company. When executed effectively, restructuring can unlock significant value while mitigating risks, positioning portfolio companies for strong, value-accretive exits.