

Return of the hybrid: the rise of structured equity solutions

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Structured equity is a hybrid financial instrument combining elements of debt and equity, tailored to align with a company's specific financing needs and a sponsor's or investor's objectives. The form of capital will typically rank behind funded debt in order of repayment but in front of common equity.

The popularity of these instruments has surged; offering companies a flexible capital solution that preserves valuation and is less dilutive than traditional equity, while ensuring sponsors secure downside protections and certain rights in return for their investment. Structured equity provides a compelling financing alternative for companies navigating growth transitions, equity recapitalizations, or strategic shareholder liquidity events.

However, these sophisticated instruments require experienced financial and legal advisors to achieve the desired effect. In this article, we will explore the various configurations structured equity can take, the means for creating these instruments, typical sponsor and investor rights and protections, considerations for issuers, as well as key covenants.

Configurations of structured equity

Structured equity can take many forms. While commonly structured as redeemable preferred shares, it can take the form of equity-linked debt such as convertible debt or debt and warrants or otherwise include senior equity such as preferred shares (sometimes convertible into common equity) or preferred shares and warrants. Although these bespoke instruments vary in their structure, a common objective is to enable companies to access additional capital without burdening, or to deleverage, their balance sheet.

Creating structured equity instruments

A structured equity transaction is often executed through a direct investment into the target company or otherwise through a joint-venture vehicle (JV) depending on the nature of the sponsor's investment. A JV transaction structure is most common in capital-intensive industries such as telecom, data centres, clean energy, energy transition, infrastructure, oil and gas and real estate where the company is looking to reduce its capital outlays for large capital investment projects while retaining control of the underlying assets. For example, in the early stages of a project, structured equity may allow a company to accelerate its growth, something that might not be feasible if the company were to rely purely on funding with free cash flow. A JV structure can also be combined with a carve-out transaction whereby a company spins out a non-core business unit to fund or deleverage its core activities or to

provide a liquidity event to its long-time investors.

Typical sponsor and investor rights and protections

In a structured equity transaction, investor rights and protections tend to be the most heavily negotiated aspects of the transaction. While they can vary from transaction to transaction, common rights and protections observed when negotiating structured equity transactions are summarized below. Both parties have an interest in structuring these instruments carefully to avoid “debt-like” characterizations that could negatively impact the company’s covenant compliance or ratings. Engaging counsel early in the negotiation and the drafting of these documents is advisable to protect against any adverse or unintended consequences.

Sponsors who are looking to secure a stable rate of return on their investment, will often negotiate for rights to safeguard, monetize and monitor their investment:

- **Priority rights over distributions:** A sponsor will typically negotiate for a preferred dividend that provides them with a recurring percentage of invested capital; in some instances, the right may contemplate increases in the distributions over the length of the investment period. These are critical to structured equity’s appeal for sponsors who are often looking for annuity-like returns and downside protection. The terms of the preferred dividend may require that they be paid in cash or paid in kind (PIK).
- **Guaranteed payments / minimum return:** Structured equity transactions typically include a mechanism to ensure that the sponsor receives a certain level of return on their investment, regardless of the company’s performance. This often takes the form of an obligation for the company to pay a specified amount or a stated internal rate of return (IRR), often expressed as a percentage of invested capital. The preferred dividends and minimum return often work together to enhance investor protection and return certainty. These sometimes manifest themselves as “liquidation preferences”.
- **Exit rights:** Investors typically negotiate a suite of exit rights to ensure a clear pathway to realizing the value of their investment. The most common exit rights include
 - *Put option or redemption right:* A put option or redemption right provides the investor the right to exit the investment, typically at a pre-determined price, such as a floor return. In practice, this functions as a form of downside insurance. The right may be triggered after a certain period of time or upon the occurrence of specific events, such as a material breach by the company. The put may be to the issuer or, less often, to another equity holder of the issuer.
 - *Drag-along and tag-along rights:* Customary in these transactions are the right of the company to compel the investor to join a sale of the company, typically on the same terms and conditions offered to the company (drag-along) or the right of the investor to participate in a sale on the same terms and conditions as the company (tag-along). Any forced sale would typically be subject to the liquidation preferences attached to the preferred shares. Also, there may be certain triggers (such as the passage of time) that allow the or trigger a sale process of the whole company.

- **Sale process:** Investors may reserve the right to either sell their equity unencumbered, or trigger a sale process after a set number of years (e.g., five years after closing the initial investment) or other triggers, whereby the board of directors would be obliged to retain financial advisors to canvass the market and solicit offers for the company or the JV from interested parties, whether strategic buyers or financial sponsors.
- **Preemptive rights:** Preemptive rights provide investors the opportunity to maintain their ownership percentage when new equity-backed securities are issued, thereby protecting them from the dilutive effect of future capital raising.
- **Liquidation preference:** A sponsor will typically require that in the event of any liquidation, sale or winding up of the company, the investor will be entitled to receive, in preference to all other equity holders of the company, its investment back, sometimes with a multiple of invested capital or accrued dividends, after which any remaining distributions will be issued to other junior equity holders at the company.
- **Upside participation / warrant coverage:** Structured equity investments may include warrant coverage, giving an investor the right to purchase additional shares, usually common shares, at a set price for a certain period of time.
- **Consent rights:** For as long as they hold their investment, a sponsor may wish to be consulted in the event, and their approval sought in advance, of a significant action or important decision of the company regarding its business. Consent rights will typically specify the applicable events to which a sponsor should be consulted or have approval, including
 - fundamental changes, such as a change-of-control transaction or divestiture(s) issuing new classes of securities ranking in priority or *pari passu* to the class of securities issued as part of the structured equity transaction
 - incurring additional indebtedness in excess of prescribed thresholds
 - declaring dividends or distributions on any equity securities
 - amending, entering into, or terminating any material contracts
 - conducting M&A activity in excess of certain valuation thresholds for the tuck-in targets or
 - taking certain other material business decisions outside the ordinary course. Certain step-in rights may be negotiated in certain events of default or where cumulative breaches occur.
- **Springing rights:** A sponsor may negotiate for a springing right tied to the occurrence of a specific event that would give rise to additional control rights for the investors. Types of events that could give rise to springing rights include a failure to exercise a redemption right, a breach of transaction documents, an acceleration or default event under a debt facility, a key person event or the company being placed into bankruptcy.
- **Board appointment rights:** Towards ensuring oversight over their investment, sponsors will often require the right to appoint one or more directors and/or non-voting observers to the board of the target or JV. Negotiated board appointments may be structured to include the right to committee representation or that sponsor appointees be required to achieve a quorum. Typically, these rights will be proportionate to the investor's interest

and subject to the sponsor's continued investment.

- **Structuring premium:** A sponsor may require a structuring premium to be paid upon issuance of the structured equity amount calculated as a percentage of the invested capital.

Considerations for target companies

Generally, in addition to the company's desire to secure the investment at favourable terms, the company will want to ensure that the underlying investor agreements do not overly restrict its control over the day-to-day operations of the business. The company will also want to ensure that there are controls on the transferability of the structured equity it has issued and that all the rights described above are subject to minimum ownership by the sponsor. Depending on various factors, including the life of the project and the investment horizon of the sponsor, the company will also typically negotiate for a call option at a predetermined price or IRR to acquire the stake held by the sponsor. Frequently these will be included when the company expects a future liquidity event or valuation inflection point. In some circumstances, a call option may be incentivized, for example by a contractually agreed material increase in distributions to the investor after a period of time, enhancing the visibility of the exit for the sponsor. Companies should be mindful to all scenarios when negotiating a call option, including in an adverse scenario where a lower-than-expected IRR is achieved. The call option will often be coupled with a right of the investors to trigger a sale auction if the call option is not exercised during its scheduled exercise period in order to permit the investors to exit the investment. The minimum return of the investors would typically be protected in this sale auction and paid preferentially to other investor's returns.

Covenants

A company by and large will have far greater control over the business than the financial sponsor. In a JV construct, the company, for example, will typically be the most important counterparty for the JV. Sponsors will often navigate this risk by negotiating for covenants that enable them to have greater step-in rights in the event of a covenant breach or otherwise trigger a buy-out if such breach is not cured by the company.

Operating covenants that are typical include

- **Restrictions on indebtedness:** to prevent over-leverage that could impair distributions or the company's or JV's valuation.
- **Budget and capital investment:** sponsors may ask companies to covenant to spend only in the ordinary course or otherwise seek consent over extraordinary budget items or other major expenditures so as to ensure alignment with business plans.
- **No dividend to common equity without preferred distribution:** enforced through waterfall structures, sponsors may include a covenant that ensures the company protects the priority of its preferred returns.

Other covenants that may be included are financial or performance covenants, such as maximum total leverage, minimum EBITDA, minimum liquidity requirements, or affirmative covenants, such as providing regular financial reporting.

Conclusion

When thoughtfully structured, these transactions offer transformative capital solutions. For companies and financial sponsors alike, the key lies in customizing the right balance of flexibility, governance and downside protection.

As the appetite for these instruments grow, given the sophistication and bespoke nature of these instruments, financial and legal advice is critical to ensuring that parties are able to effectively navigate these deal dynamics while achieving their intended objectives. Osler has a wealth of experience acting on structured equity transaction mandates. For additional information, please contact the authors.