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Pre-Capitalized Securities:

An Evolving Capital Markets Solution

Introduction

Capital markets participants increasingly seek financing solutions that provide certainty of funding, balance-sheet efficiency and structural flexibility without sacrificing transparency or investor protection. As the need for more tailored financing solutions grows, pre-capitalized securities ("P-Caps") have emerged as a compelling structure.

P-Caps provide off-balance-sheet, pre-funded capital through a bankruptcy-remote vehicle, combining high-grade collateral with contingent exchange mechanics that allow sponsors to defer actual borrowing until needed. Originally developed as a contingent-capital product used primarily by insurance companies, P-Caps have evolved into a liquidity solution as well with applications extending beyond their traditional corporate- and insurance-sector origins.

Last year, the United Mexican States ("Mexico") executed a landmark U.S.$12 billion P-Caps transaction, representing the first sovereign use of P-Caps, the largest P-Caps issuance in history, and the first executed by a non-U.S. sponsor and through an offshore SPV structure. The transaction demonstrated how an established contingent-capital structure could be adapted into an immediate off-balance-sheet liquidity solution, in this case for a strategic state-owned enterprise ("SOE").

This article provides an overview of the mechanics of traditional P-Caps, the adaptations implemented in Mexico's transaction, evolving P-Caps structures, and key considerations relevant to sponsors evaluating similar structures.

Strategic Advantages of P-Caps

Balance Sheet Optimization:
Off-balance-sheet treatment enables entities to maintain key financial ratios, preserve debt capacity, manage leverage and provide strategic support without immediate recognition.

Liquidity on Demand:
Sponsors have immediate or deferred access to pre-funded, high-grade liquid collateral without reliance on market windows or issuer-specific conditions.

Long-Dated Capital Access:
P-Caps allow for long-term access to capital, with tenors that can extend well beyond traditional revolving credit facilities.

Interest Rate Protection:
P-Caps lock in fixed-rate funding in advance, mitigating future rate volatility – particularly advantageous when structured during lower-rate environments.

Enhanced Market Access:
Allows sponsors to access more efficient financing than traditional alternatives, tapping into institutional investor bases that might otherwise be constrained by sector- or credit-specific limitations.

Tailored Structural Mechanics:
P-Caps can be customized through mandatory and optional issuance triggers, substitute payment mechanics and refresh, assignment and collateral posting features, allowing sponsors to align the structure with specific financing, regulatory or operational objectives.

Constructive Rating Treatment:
P-Caps typically track ratings of the sponsor's senior debt, offering investors a risk profile equivalent to a sponsor's senior credit with added collateralization and yield. Rating agencies generally view P-Caps as a credit positive due to improved access to liquidity, particularly in times of stress.

Understanding P-Caps: Structure and Strategic Value

At their core, P-Caps combine pre-funded, high-grade collateral, a bankruptcy-remote structure and contingent exchange mechanics to create an off-balance-sheet source of contingent liquidity. The structure is well-suited for entities seeking to supplement capital structures, improve liquidity flexibility or secure long-dated funding without incurring immediate leverage. The structure can be adapted to address a wide variety of sector- and sponsor-specific requirements.

P-Caps historically have been most relevant where sponsors prioritize:

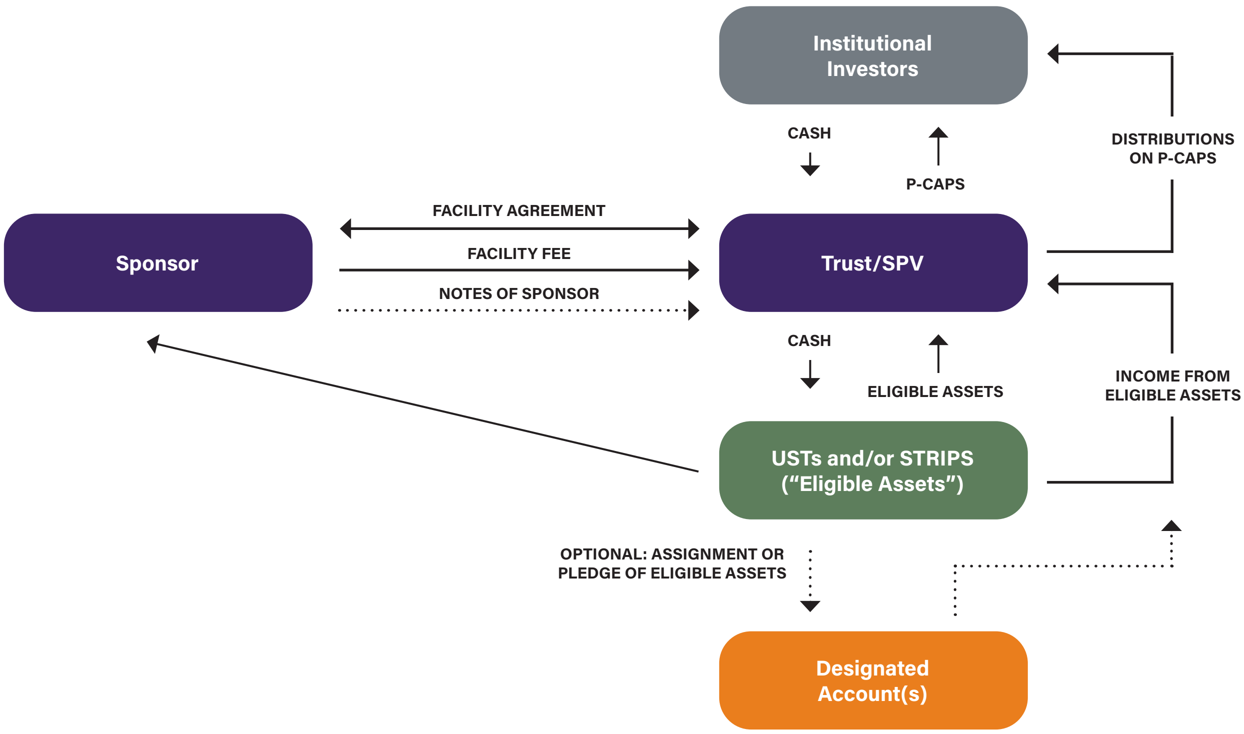
- certainty of funding,
- long-dated contingent liquidity,
- balance-sheet optimization,
- interest rate protection, and/or
- particular regulatory or rating agency considerations not addressed effectively through traditional financing instruments.

Institutional investors have historically viewed P-Caps favorably due to the combination of:

- high-quality collateral,
- transparent structural mechanics,
- enhanced yield relative to comparable senior debt, and
- clearly defined contractual recourse.

The pre-funded and automatic nature of P-Caps structures can also reduce uncertainty regarding liquidity availability during periods of market stress. Because P-Caps involve additional complexity and structuring considerations relative to conventional debt instruments, they generally are most appropriate where those structural benefits provide meaningful value to the sponsor.

Traditional Structure



The evolution of P-Caps into increasingly bespoke financing tools is best understood against the backdrop of the traditional structure, which generally includes the following components:

Trust/SPV Formation. A statutory trust or other special purpose vehicle is established to issue the P-Caps and hold eligible assets.

P-Caps Issuance. The trust issues P-Caps to institutional buyers.

Eligible Assets. Proceeds are invested in high-quality collateral (typically a portfolio of U.S. Treasury securities and/or STRIPS (“eligible assets”)), the return on which, together with a “facility fee” from the sponsor, funds payments on the P-Caps.

Standby Facility. The trust and the sponsor enter into a facility agreement, pursuant to which the sponsor pays periodic facility fees in exchange for the right (the “issuance right”) to issue notes to the trust in exchange for the eligible assets. Functionally, this arrangement resembles a contingent issuance option that allows the sponsor to lock in funding economics while deferring actual borrowing until needed.

Draw Mechanics. When the issuance right is exercised, the trust acquires the sponsor’s notes in exchange for eligible assets, providing the sponsor with highly liquid assets that are readily monetizable for cash or that can be loaned or posted as collateral. The sponsor’s notes, if issued, and the P-Caps share the same maturity and payment profile.

Traditional Structure

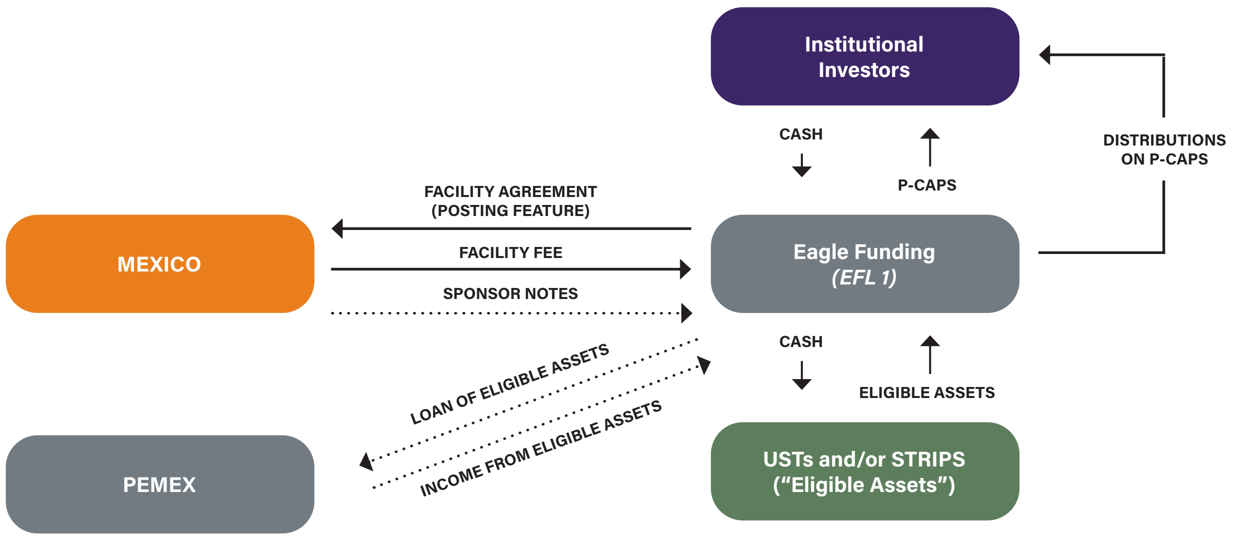
Automatic / Mandatory Triggers. Specified events, including bankruptcy events, payment defaults, breaches of financial thresholds or certain changes of control, require issuance of the sponsor's notes to the trust.

Optional Features. Certain structures permit:

- facility refresh (permitting multiple draw/repayment cycles),
- assignment of issuance rights,
- loan or pledge of eligible assets, and
- substitute payment arrangements.

The result is a pre-funded, contingent liquidity facility that generally remains off-balance-sheet to the sponsor unless exercised or triggered.

Mexico's Sovereign P-Caps – A Structural Evolution



Mexico's 2025 P-Caps transaction represented an important evolution of the traditional model, adapting the product to meet sovereign financing objectives, in this case supporting an SOE. The transaction allowed Mexico to provide state-owned Petróleos Mexicanos ("Pemex") immediate liquidity without direct sovereign borrowing or a guarantee.

The approach simultaneously provided investors with transparent structural mechanics, robust collateral and contractual sovereign "step-up" protection.

Although structured to preserve Mexico's fiscal flexibility and avoid direct sovereign borrowing at inception, rating agencies generally viewed the transaction as constructive support for Pemex and economically equivalent to incremental financing for Pemex on improved terms.

Structural Adaptations

Adapting P-Caps to the sovereign context was made possible by fundamental structural changes across multiple dimensions:

Jurisdiction / Listing / Indenture Approach. Unlike the traditional structure where equity interests in a trust are issued, the Mexico transaction utilized a Luxembourg-domiciled SPV that issued debt securities under an indenture and that were listed on the Luxembourg Stock Exchange. This approach reflected sovereign-specific tax, jurisdictional and distribution considerations that differed materially from the traditional model.

Triangulated Liquidity Structure. Rather than providing contingent liquidity directly to the sponsor, the structure created a multi-party arrangement in which Mexico acted as facilitator, Pemex received liquidity support, and investors obtained contingent sovereign recourse under specified circumstances. The SPV used issuance proceeds to purchase eligible assets, which were subsequently delivered to Pemex through securities-lending arrangements. Pemex then monetized those assets through repurchase transactions with major financial institutions, generating immediate U.S.-dollar liquidity.

Event-Driven Issuance Mechanics. Mexico established a committed structure to deliver eligible assets to Pemex, which reduced discretionary uncertainty and reinforced investor confidence. Event-driven triggers were customized, requiring automatic issuance of Mexico's senior notes upon occurrence of specified events. The automatic, event-driven nature of these mechanics was also important from a rating agency perspective. This feature reinforced the link between the P-Caps and Mexico's sovereign credit profile while supporting the intended accounting and rating agency treatment.

Market Reception and Impact

The transaction was well received by institutional investors. Demand exceeded the initial target size, allowing the offering to be upsized to U.S.$12 billion, by far the largest issuance of P-Caps. Following announcement and closing, Pemex's existing bonds rallied on investor confidence that the liquidity support would reduce near-term refinancing risk.

Several structural features contributed to market acceptance:

- high-quality U.S. Treasury collateral providing predictable cash flows;
- objective, documented trigger mechanics, including automatic sovereign step-up mechanics aligned with rating agency treatment objectives;
- established repo counterparties providing operational certainty and execution credibility;
- transparent disclosure; and
- clearly defined sovereign recourse.

For Mexico, the structure provided a mechanism to support a strategically important SOE while preserving fiscal flexibility and avoiding direct sovereign borrowing at inception.

For Pemex, the transaction improved near-term liquidity and reduced refinancing pressure. The P-Caps priced materially tighter than Pemex's standalone borrowing costs and resulted in an improved ratings profile for Pemex's outstanding bonds.

For investors, the transaction provided enhanced yield relative to traditional sovereign debt with contractual recourse mechanics and high-quality collateralization.

Although sovereign P-Caps remain an emerging market development, Mexico's transaction demonstrated the structure's ability to address complex sovereign financing challenges within an institutional capital markets framework.

Potential Applications

Mexico's transaction highlighted the adaptability of the P-Caps structure beyond its traditional insurance-sector origins to address financing challenges involving contingent liquidity, balance-sheet management and pre-funded credit support. Although bespoke structural adaptations remain an evolving market development, several features of Mexico's transaction may have broader relevance across capital markets.

In the sovereign and quasi-sovereign context, P-Caps may be particularly relevant where governments or public-sector entities seek to support strategically important enterprises or infrastructure programs while managing fiscal constraints and preserving market access. Potential applications could include contingent liquidity facilities for SOEs, infrastructure-related financing programs or other situations where sponsors seek to separate immediate liquidity support from direct sovereign borrowing at inception.

The Mexico transaction also illustrated how P-Caps can integrate with securities-lending, repo and collateral-management arrangements to facilitate efficient liquidity transfer while preserving structural protections for investors. Those mechanics may be relevant in other contexts involving high-quality collateral, contingent funding obligations and long-dated liquidity planning.

Outside of the sovereign context, P-Caps may continue to evolve as a specialized tool for sponsors operating in capital-intensive and highly regulated industries, including financial institutions, insurance companies, utilities and energy and infrastructure sponsors, where funding certainty, long-dated contingent liquidity and balance-sheet efficiency are particularly important. In those contexts, P-Caps may offer advantages over conventional standby facilities or unsecured contingent financing structures, particularly where rating agency, accounting or regulatory considerations are significant.

The adaptability of the structure also introduces significant transaction-specific considerations. The viability of any application depends heavily on sponsor-specific objectives, legal and regulatory considerations, accounting treatment, collateral mechanics and investor requirements. As a result, successful transactions require careful structuring and coordination across capital markets, structured finance, tax, regulatory and disclosure disciplines.

Conclusion

P-Caps have evolved from a niche contingent-capital product into a highly adaptable capital-markets framework capable of delivering both long-dated contingent capital and contingent liquidity solutions. Whether used by corporates, sovereigns or other sponsors, P-Caps offer a flexible financing structure to address a broad range of objectives. Mexico's U.S.$12 billion sovereign transaction demonstrated that, with disciplined structuring and transparent documentation, P-Caps can be adapted successfully beyond their traditional applications. The transaction's strong market reception – reflected in oversubscribed demand, favorable pricing and positive rating agency commentary – also confirmed meaningful institutional investor interest in well-structured financing solutions supported by sound economics and clear legal mechanics.

The structural flexibility that makes P-Caps attractive also requires careful coordination across multiple disciplines. Effective execution requires expertise across capital markets, structured finance, derivatives, tax and regulatory disciplines, as well as careful consideration of rating agency and accounting implications. As sponsors continue to evaluate alternatives to traditional financing structures, P-Caps are likely to become an increasingly important component of the broader capital markets landscape.

Authors' Note

The authors served as structuring counsel for the initial purchasers in Mexico's P-Caps transaction.

Willkie was recognized at the LatinFinance Deals of the Year Awards for its role advising on this transaction, which was awarded Financing Innovation of the Year.

The views expressed herein are attributable to the authors alone, and they do not reflect the views, positions or opinions of Willkie Farr & Gallagher LLP or other attorneys at the firm, nor the views, positions or opinions of the initial purchasers, Mexico or any other party.

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