Strategize With Preferred Equity

This slice of the capital stack combines higher risks with higher rewards

By Ron Zimmerman

Compared to senior-debt and mezzanine financing, preferred equity is probably the least understood layer of commercial real estate financing and the most difficult to raise in a property's capital stack. One reason for this is that many potential preferred equity investors often fly under the radar of commercial mortgage brokers and project sponsors.

Potential preferred equity investors often include high net worth individuals, specialized wealth-management firms known as family offices, and other types of developers or investors who seek equity-like returns with less risk than common equity. Not only can commercial mortgage brokers tap into these financing sources to help structure preferred equity investments for their clients, there are techniques they can use to increase their fees and, in some cases, carve out and acquire interests in their clients' projects for a nominal investment.

Real estate developers and investors, often referred to as sponsors, may want or need to increase leverage above the amount that the sponsor can borrow from a senior lender. Sponsors can fill the gap between the senior debt and common equity by raising mezzanine or preferred equity financing.

Photo illustration by Karen Steichen

Mezzanine financing is a hybrid of debt and equity in which the borrower retains ownership control over the property and its associated business activities. Preferred equity, by contrast, provides a secondary investor with an ownership and decision-making stake in the business.

Often, senior lenders may preclude the use of subordinate debt — such as mezzanine financing. In such a case, sponsors need to raise preferred equity to address a lender's prohibition.

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Deal structures

Preferred equity is raised through a sponsor's ownership entity, such as a limited liability company (LLC), by issuing one or more classes of preferred equity membership interests. This type of financing can be structured in many ways to favor the sponsor by treating it as an equity-like investment, or to favor the preferred equity investor by treating it as a debt-like investment. Here is a sampling of the provisions that may be found in these deals.

Waterfall priority order. A preferred equity investor may prefer a senior/subordinate, or A/B structure, in which they receive their investment and preferred returns in full before the sponsor receives theirs. The sponsor, however, may want a "pari passu," or equal-footing arrangement, in which the sponsor and equity investor receive their distributions at the same time based on the proportional amounts they've invested in the LLC.

Recourse. The equity investor may require the sponsor to pledge their membership interests in the LLC over the entirety of the investment term, or until the sponsor reaches certain designated project milestones — such as obtaining entitlements, a certificate of occupancy, a minimum occupancy rate or stabilization of the property. The sponsor, on the other hand, may seek nonrecourse provisions in which the preferred equity investor has limited contractual rights that are contained in the LLC's operating agreement. In these cases, the sponsor will likely need to agree to "bad boy" carve-out provisions — focused on areas such as fraud, misappropriation of funds, waste, bankruptcy or environmental liabilities — and provide a completion guaranty for a development project.

Repayment schedule. The LLC may make periodic payments for some or all of the equity investors' returns, whether or not the LLC has generated the cash flow to make these payments. Any unpaid preferred returns accrue and are paid when cash flow is sufficient, or as a priority distribution once the property is sold or refinanced. But the sponsor may benefit if the preferred return is paid only from available cash flow after senior-debt payments, operating expenses and any amounts set aside as reserves, as agreed upon by the managers of the LLC. Again, any unpaid preferred returns accrue and are paid if and when funds are available — typically upon stabilization, refinance or sale of the property.

Control rights. The equity investor may seek exclusive authority to make certain decisions within the LLC — such as removing a manager, borrowing funds, selling the property and/or filing for bankruptcy — for an agreed-upon period of time. These rights also may be tied to any recourse provisions, such as the ones previously mentioned. The sponsor, however, may look to have any major decisions approved by the LLC's managers, including a manager appointed by the sponsor.

Capital-shortfall requirements. A manager appointed by the preferred equity investor may determine if the sponsor will be required to cover any capital shortfalls by loaning funds to the LLC. If the sponsor fails to make such a loan, the equity investor could have the right to purchase the sponsor's common interests in the LLC — and, possibly, their preferred interests as well — for nominal consideration. A more favorable arrangement for the sponsor, however, may call for them and the equity investor to fund any capital shortfalls on a proportional basis, based on their respective ownership interests in the LLC.

Membership interests

At or before closing, the sponsor and preferred equity investor will receive common membership interests by capitalizing the LLC for a nominal amount of money — $100, for example. Further, the sponsor and equity investor then receive preferred membership interests for their respective investments in the LLC. These membership interests provide for preferred returns at rates and terms negotiated by the parties.

The equity investor and sponsor, for example, could each purchase 50 percent of the common interests in the LLC. The equity investor may then contribute, say, 80 percent of the project equity and receive what is known as Class A preferred interest, with the sponsor investing 20 percent of the project equity and receiving the first-loss Class B preferred interest.

Typically, the sponsor would receive credit for any funds previously invested in the project and any additional cash that, taken together, equates to 20 percent of the project's total equity. Based on a 50/50 split of future profits, the sponsor effectively receives a 30 percent promoted interest in the project. Alternatively, the sponsor and equity investor may agree to a multi-tiered waterfall in which the sponsor earns a higher, stair-stepped percentage of profits when hitting certain project-level internal rates of return, or IRRs.

Multiple tiers

As described above, the LLC can issue two classes of preferred equity — Class A to the preferred equity investor and Class B to the sponsor. There is no limit, however, to how many classes of preferred interests the LLC can issue.

As a way to increase the sponsor's equity from the preferred equity investor's perspective, the LLC may issue one or more additional classes of preferred equity that are subordinate to the Class A interest. The sponsor would receive a Class C interest and the LLC would issue a Class B interest to one or more of the following parties.

Seller. When acquiring land for development purposes, for example, the sponsor may form a joint venture with the landowner and issue Class B preferred equity to that landowner in exchange for the land contributed to the joint venture.

General contractor. A contractor may agree to invest in the sponsor's project via preferred equity as a way to win the contract or increase their profits.

Lender. The sponsor could issue a Class B interest to a senior lender that is holding a nonperforming loan so the lender can pay off a portion or all of the outstanding balance. Alternatively, the sponsor and equity investor may agree to allow a lender to purchase a share

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of common interests in the LLC. In return, the lender may accept a discounted payoff by reducing the senior-loan amount and/or interest rate.

Mortgage broker. In lieu of receiving some or all of their fee at closing, a commercial mortgage broker may accept a Class B interest. The broker also may negotiate a purchase of common interests in the LLC. In the previous example, where the parties capitalized the LLC for a nominal price of $100, the broker would contribute $5 to receive a 5 percent stake.

Class A pricing

Depending on the financial strength of the sponsor and the preferred equity investor's perceived risk of the transaction, the investor may be satisfied with receiving a straight preferred return. This means they will earn a fixed return on their Class A investment by receiving periodic payments, similar to a loan, with any unpaid amounts accruing for additional returns.

Alternatively, many preferred investors are seeking to "ride on the coattails" of a sponsor's investment and want to share in project profits. In order to lock in a minimum return, a preferred equity investor could negotiate a predetermined "look-back" IRR — set at a higher rate than the preferred return — or minimum-profit participation.

With respect to establishing a minimum-profit participation, the sponsor could agree to provide one or more preferred equity holders with a minimum target price (MTP) that the sponsor would sell the underlying property for. Investors can calculate their common interests in the LLC by taking the sales price or the MTP, whichever is greater, and subtracting the number of preferred equity classes plus any other property liabilities. This number is then multiplied by the percent of common interests owned in the LLC to determine a dollar value.

Working with preferred equity can be an interesting and profitable service for commercial mortgage brokers to offer their clients. And by understanding how to raise preferred equity, brokers also may be able to negotiate and acquire an interest in the property for a nominal investment. ■

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