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The Marriage of Preferred Equity and Cash-In Refinancings

BY J.R. ENGLAND

In the last 24 months, the commercial real estate (CRE) industry observed an unprecedented rise in interest rates, coupled with CRE lenders making fewer loans with materially tighter lending requirements. Historically, CRE loans were made up to 65 percent of the value of the underlying real estate. Lenders have more recently retrenched and are making loans at only a 50 to 55 percent loan-to-value ratio. The result is that borrowers seeking to refinance are facing higher interest rates, and many new loans are often too small to repay prior loans, necessitating the borrower needing to contribute additional capital to refinance—hence the term "cash-in refinancing." However, many borrowers lack the additional capital required to close the gap and risk losing their properties to foreclosure at loan maturity.

To fill this capital gap, many borrowers are turning to preferred equity. Preferred equity is essentially an alternate form of financing, which is junior to senior mortgage financing. It is structured as an equity investment in a joint venture (JV) in which the JV directly or indirectly owns the investment property for which financing is sought. Although preferred equity often has characteristics similar to a loan, it is not a loan and is typically unsecured. Preferred equity is extremely flexible, and its features cover a broad spectrum. Certain preferred investments are debt-like (with required monthly payments, financial covenants, and a fixed repayment date), while others are equity-like (with no fixed repayment date and no payments due unless there is available cash flow).

Most preferred investments land somewhere in between. High-level features of preferred investments include that: (1) the preferred investor and the other party to the JV (i.e., a sponsor) are partners and their rights and obligations are governed pursuant to an operating agreement (or JV Agreement), (2) the sponsor is typically the day-to-day manager of the JV, subject to the preferred investor's right to approve major decisions, (3) a preferred investor is entitled to priority distributions ahead of the sponsor (and the preferred investment is entitled to a minimum return, which is typically *at least* 500 basis points higher than the interest rate on mortgage debt), (4) if the sponsor defaults, the preferred investor typically has the right to remove the sponsor as day-to-day manager and take over control of the JV, among other punitive remedies (including the right to force a sale of the underlying property and reduction in distributions to sponsor), (5) the sponsor typically provides a "bad boy" guaranty and environmental indemnity benefitting the preferred investor, and (6) the JV typically has a mandatory redemption date when the preferred investment must be repaid in full (typically, on the mortgage debt maturity date).

Additionally, if mortgage debt exists, the preferred investor will require its material rights under the JV Agreement to be acknowledged by the mortgage lender through either a separate recognition agreement or express provisions of the mortgage debt documents. The rights the preferred investor requires are similar to those set forth in a typical intercreditor agreement but also include recognition of the preferred investor's right to: (1) take over control of the JV (subject to providing a replacement guaranty to the mortgage lender), (2) terminate sponsor-affiliated contracts, and (3) make transfers of its direct or indirect equity interests in the JV. Due to the preferred investor's interests in the JV, mortgage lenders often separately underwrite the preferred investor and require that it meet certain financial standards and have experience in CRE management.

The rise in popularity of preferred equity transactions in the last 24 months is directly related to the deteriorating CRE lending market. Borrowers who had no reason to turn to preferred equity previously are now turning to preferred equity out of necessity. While a robust preferred equity market exists, borrowers should be aware that: (1) preferred investors will require a materially higher return than a typical mortgage lender, (2) sponsors are often required to cede greater control over the operation of their properties to the preferred investor than a typical mortgage lender would require, (3) preferred equity transactions are complex and more expensive to document than a mortgage loan, and (4) many lenders (particularly small lenders) may not be comfortable with or understand preferred equity transactions.

As a result, the sponsor should be open and transparent with the mortgage lender early in the process so the expectations of all parties are clear and any material issues are worked out as early as possible (before material dollars are spent). Preferred equity transactions can serve as a lifeline for borrowers, and the appetite and market for the same are growing. However, given the costs, risks, and complexity involved, employing skilled legal counsel is a must. **HN**

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