Preferred Equity

2016 Regional Seller Workshops

Freddie Mac
MULTIFAMILY

What is Preferred Equity?

Common Equity → Preferred Equity → Mezzanine Debt

Preferred Equity	Debt (Inc. Mezzanine Debt)
Investment of capital	Investment is a loan
Unsecured	Secured
From / to a member or partner	Lender / borrower relationship
Investor expects a preferred rate of return	Lender expects interest and amortization
Investor may have rights no other investor has	Lender has default remedies in cases of nonpayment
Terms are in a partnership or operating agreement	Terms are in a loan and/or intercreditor agreement

Why Do We Care?

- If we are underwriting the preferred equity, and we like the investor why do we care?

  » **Alignment of Interests**
  - Potential influence on management decisions
  - Preferred Return vs. Investment in Property

  » **Potential for Conflict**

When Does Preferred Equity Need to be Identified?

When should you identify a Preferred Equity structure?

AS SOON AS POSSIBLE!

- Ideally, prior to quote, the borrower should complete the Borrower's Equity Questionnaire and Certification (in appendix)
  - **Certainty of execution** – if we have identified preferred equity at the time of quote, borrower can be sure of the spread and loan size
  - **Avoid delays** – providing preferred equity details earlier reduces underwriting and pricing timelines

Borrower Equity Questionnaire

- If borrower does not fill out Borrower Questionnaire the quote will assume that there is not any preferred equity
  - Seller's application should include the question:

    Do you intend to use preferred equity?
  - Seller's application should then note that preferred equity reported after the quote may impact the spread and/or loan size
- If borrower answered "yes or maybe," but did not complete the Questionnaire prior to quote/application, the Questionnaire must be completed prior to index lock or early rate lock

Preferred Equity: How to Spot It

- What is the difference between hard pay preferred equity and soft pay preferred equity?
  - When we hear soft pay preferred equity, we think **common equity.**
  - Common equity characteristics
    - Return on the equity investment is payable only out of net cash flow OR
    - Allows forgiveness or accrual of any return not paid because of a lack of net cash flow.

Preferred Equity: How to Spot It, Cont'd

- Preferred Equity (Hard Pay) has at least one of the following attributes:
  - » The preferred return must be paid even if there is insufficient net cash flow, with no provision for forgiveness or accrual
  - » A set redemption date (unless more than 1 year after loan maturity)
  - » The right to exercise a control takeover based on the Property's inability to meet quantifiable performance measures such as occupancy or DSCR
  - » Investor may require a forced sale if the preferred return or the preferred contribution is not paid

Hard Pay Preferred Equity

- Hard Pay Preferred Equity Underwriting Requirements:
  - Mortgage + Preferred Equity investment must be ≤ 90% of property value
  - For fixed rate loans, NOI must be ≥ amortizing debt service + Hard Pay by 1.05x
  - For floating-rate loans, NOI must be ≥ amortizing debt service based on the comparable fixed rate + Hard Pay by 1.05x
- If the Preferred Equity return changes during the loan term, use the weighted average of all Preferred Equity returns to calculate Hard Pay coverage

Redemption Dates

- If the Preferred Equity investment has a set redemption date during the loan term, the combined leverage threshold must be ≤ 85% at redemption
  - Based on remaining UPB of loan, preferred equity investment and projected accrued return on Preferred Equity relative to current value

Redemption Dates

- Redemption dates are permitted as follows:
  - Loan term ≤ 5 years. Redemption Date may not be:
    - During the term of the mortgage, or
    - Within 1 year after the maturity date
  - Loan term > 5 years. Redemption Date may not be:
    - During the first 2 years of the mortgage,
    - During the last 2 years of the mortgage, or
    - Within 1 year after the maturity date

Buy-Sell and/or Preferred Equity Analysis

- Buy-Sell and/or Preferred Equity Analysis is now needed:
  - Every time a buy-sell right is requested
  - If there is Preferred Equity, even if no buy-sell right is requested

Buy-Sell and/or Preferred Equity Analysis, Cont'd

- The Analysis is used to determine if there are rights available to the preferred equity investor that are not acceptable, such as:
  - The ability to take over management of the subject property because of failure of another property owned by the same sponsor to attain certain measurable economic thresholds (Cross default)
  - The ability to extinguish the manager's management right as well as its equity interest
  - The right to change the terms of the preferred equity after the loan is originated unless the changes are already contemplated in the organizational documents and have been approved by Freddie Mac

Buy-Sell and/or Preferred Equity Analysis, Cont'd

- The Analysis is also used to determine whether the equity is common equity (soft pay) or preferred equity (hard pay) and if preferred equity, whether it should be sized as hard pay or partial hard pay
  - The Buy-Sell analysis no longer uses the terminology "preferred equity," "hard pay," "partial hard pay" or "soft pay"
  - Freddie Mac will examine the terms of the transaction and make the determination rather than relying on the labels used

Is This Preferred Equity?

- The equity partner may receive a higher return than the other partners (50/50 until 10% IRR is met, then 60/40 until 12% IRR is met).
- The equity partner has the right to require a forced sale after 4 years. The proceeds of the sale are distributed in the same manner as the net cash flow.

ANSWER:

NO – The higher return on equity until the IRR is met is a fairly standard common equity structure seen in many joint ventures. Just having the right to require a forced sale would not by itself put this into the preferred equity category

Is This an Acceptable Preferred Equity Structure?

- The equity provider made its contribution into a joint venture that was an indirect owner of both "X" borrower and "Y", a related sponsor
- The Freddie Mac loans were not cross collateralized. The preferred return was required to be paid only if there was sufficient net cash flow
- The equity provider had the right to replace the manager of X if the occupancy at property X or at the related property Y went below 85%

ANSWER:

NO – The failure to meet a measurable, economic trigger at another **property, property Y, cannot trigger the change of management at property X**

Is This an Acceptable Preferred Equity Structure?

- The preferred equity provider is making an equity contribution into the joint venture member of 4 borrowers that will receive cross collateralized loans
- The preferred equity provider has the right to take over the management of the joint venture and thus take over the management of all of the properties if the net operating income at any property is not sufficient to pay the preferred return

ANSWER:

YES – This is acceptable because the underlying Freddie Mac loans will be cross collateralized

Is This an Acceptable Preferred Equity Structure?

- The preferred equity provider had the right to take over management if the manager failed to comply with the business plan
- The business plan contained measurable economic triggers

ANSWER:

POSSIBLY OK – This may be an acceptable structure depending on the terms of the business plan. If the measurable economic triggers are acceptable then it will be underwritten as hard pay preferred equity