Debt-Like Preferred Equity in Real Estate Financing

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In the evolving landscape of real estate financing, preferred equity has emerged as a compelling alternative to traditional senior debt and mezzanine loans. While mezzanine loans have long been a popular choice for bridging financing gaps, preferred equity "with debt-like features" is gaining traction due to its unique benefits and flexibility. This article explores the growing appeal of debt-like preferred equity, its structure and how it compares to mezzanine financing.

Preferred equity represents an equity investment that is particularly attractive to borrowers as it often comes at a lower cost than common equity and can provide a bridge financing solution. Although preferred equity investors frequently do not share in the upside of the property (or their share is capped), a mandatory minimum return (minimum multiple) is a common feature of preferred equity.

Key Features of Debt-Like Preferred Equity

- **Principal:** Capital contribution
- **Debt Service:** Can be structured with a mandatory monthly current pay return (hard pay), accrual (soft pay) or a mixture of both
- **Security and Remedies:** Often unsecured, unlike mezzanine loans, but upon the occurrence of an event of default, the preferred investor retains contractual rights to take control of the asset and force a sale (drag to market), so enforcement of the preferred investor's rights occurs through judicial enforcement of the operative documents, rather than foreclosure
- **Recourse:** Preferred equity is often structured with "bad boy" recourse carveout guaranties and environmental indemnities analogous to carveout guaranties in mezzanine and mortgage loans, which help mitigate the preferred investor's risk as compared to common equity investment
- **Tax Treatment:** Can be structured as either debt or equity for tax purposes
- **Intercreditor Rights:** When preferred equity is behind senior debt, the preferred investor will require a "recognition agreement" (analogous to an intercreditor agreement) from the senior lender, which will address rights of cure, loan purchase rights, permitted transfers and other issues typically found in an intercreditor agreement

The Appeal of Preferred Equity

Lower Cost of Capital

Preferred equity is often more cost-effective than common equity, making it an attractive option for borrowers looking for short-term financing in situations where mezzanine or other subordinate debt may not be an option. Similar to a loan, preferred equity is often structured with a mandatory minimum return and a mandatory redemption date that can be prepaid (i.e., the common equity has the right to "take out" the preferred equity by paying a fixed return).

Attractive to Debt Funds

The higher yields associated with preferred equity make it an appealing option for debt funds and other investors seeking better returns. These higher yields are particularly attractive in a market where traditional senior debt offers lower interest rates due to its lower risk profile.

Agency Financing

Preferred equity is often available behind agency financing, where opportunities for subordinate secured financing can be limited due to agency restrictions on subordinated debt. Preferred equity can be a more viable option for borrowers who need additional capital but are constrained by these restrictions.

Conclusion

Preferred equity is becoming an increasingly popular tool in real estate financing, offering flexibility, lower costs and attractive yields. While mezzanine loans continue to play a vital role, the unique benefits of preferred equity make it a compelling option for both borrowers and investors. As the market continues to evolve, understanding the nuances of these financing structures will be crucial for real estate professionals seeking to optimize their capital stacks.

CONTACTS

For more information, contact your Katten attorney or any of the following attorneys.

Scott A. Hovanyetz
+1.212.940.6768
scott.hovanyetz@katten.com