Hard Preferred Equity or Soft Preferred Equity?

Though there is not an “official” definition for the structures sometimes referred to as “hard” or “soft” preferred equity, there are characteristics that agencies tend to view as making a deal one or the other. This can matter quite a bit when adding preferred equity to a transaction, as it can be the difference between having the addition approved or denied by the agency lender.

Hard Preferred Equity – What is It?

Some of the characteristics which may lead an agency lender to view a structure as “hard” preferred equity include requiring a minimum return each month out of the excess cash flow, the ability to replace the Manager (sometimes referred to as a takeover right) for reasons other than a failure to pay the minimum return, and the ability to force a sale of the Property without the Manager’s consent.

Soft Preferred Equity – What is It?

By contrast, a deal may be considered a “soft” preferred equity structure if it lacks the above characteristics, although agency positions on these characteristics can change. The important thing to know about structuring a “soft” preferred equity deal is that it will have provisions to compensate for giving up those “hard” structure rights. However, there is no true concept of a “soft” structure by agency standards, so sponsors should be aware that just avoiding the items mentioned above may not lead to agency approval of a deal structure.

How to Choose a Structure

One way to choose between a “hard” preferred equity structure and a soft preferred equity structure is to consider the terms of the senior loan. If the loan will use a floating interest rate, a sponsor may want to go the “soft” route when structuring its preferred equity. On the other hand, just because the senior loan will use a fixed rate doesn’t guarantee that an agency lender will approve a “hard” structure.

Another indication is which agency execution is chosen for the senior loan. Certain agency positions will tend to favor the “soft” structure and the preferred equity provider should be familiar with this and able to advise sponsors accordingly. This is more of an unwritten rule rather than something that is explicitly stated, so sponsors shouldn’t assume that using a particular agency execution will lock them into a structure automatically.

Why Does This Matter?

Sponsors often obtain several quotes when looking to finance a senior loan; they may receive quotes based on agency execution, interest rate type, and loan term, for instance. When considering whether the loan terms are more favorable, a sponsor who is looking to add preferred equity should find out from the preferred equity provider whether choosing a certain quote will make the preferred equity deal more expensive or more complex in its structure. A lower interest rate may look enticing, but if a sponsor is adding preferred equity, they should find out whether the agency execution will affect how the preferred equity deal is structured.

All this matters because the changes necessary in a "soft" preferred equity structure may affect cash flows and the sponsor's waterfall to its investors. Knowing up front whether they will have to adjust their internal structure will help sponsors understand the impact of a particular deal structure on their investment.

What It All Means

There are quite a few factors that go into choosing the structure of a preferred equity investment. Knowing how a senior execution may affect the terms of the preferred equity investment can help sponsors choose the loan and preferred equity structure that best suits their investment needs.