Buying Out an Existing Partner Using Preferred Equity

Often, the common equity in a multifamily deal consists of multiple partners. These equity partners may desire to exit a deal while the remaining partners want to remain. In these cases, the remaining equity partners will need to buy out the position of the exiting partner. There are several ways to accomplish this, including refinancing the mortgage loan, bringing in new common equity and contributing additional capital to cover the buyout. However, all those options can be cumbersome and expensive. That is where adding preferred equity can make sense.

Adding Preferred Equity to Avoid a Refinance

When the common equity involves more than one partner, one or more of them may request to be bought out of their interest in the property. Occasionally, some equity members may decide that they no longer wish to have one or more of the existing partners remain in the deal and will need to buy them out. Sponsors may want to refinance the mortgage loan to coincide with a partner buyout but replacing the exiting partner with new common equity can be expensive. Preferred equity can fill this need.

Preferred equity can be introduced into the capital stack to take the place of the exiting partner's common equity without triggering a refinance or a new capital raise by the remaining sponsors. A refinance can have significant costs associated with it, often making it a less desirable option for sponsors looking to buy out an equity partner. Raising additional equity can lower the returns for the non-exiting partners, making it a less desirable choice as well. Preferred equity can be a less expensive alternative. In these cases, the remaining partners likely will use a portion of the preferred equity to fund a cash-out with the proceeds from that cash-out going to pay off the exiting partner. Many mortgage lenders will approve this kind of transaction as long as it does not affect their rights or position.

Using a 'Cash-Out' Refinance

If the remaining sponsors want to use the opportunity to refinance the mortgage loan to take advantage of a more favorable rate environment or use a different mortgage lender, preferred equity can still reduce the cost of capital by allowing those sponsors to 'cash out' the exiting partner. As with the previous scenario, the remaining partners typically use a portion of the preferred equity proceeds to pay off the exiting partner and reduce their position in the capital stack.

What It All Means

When an equity partner chooses to exit a deal, the remaining partners have some choices in how to handle the partner buyout. Whether they choose to refinance the mortgage loan or not, preferred equity can help make up the capital stack by allowing less expensive capital to help buy out the exiting partner. Preferred equity can help the remaining equity partners avoid having to raise additional

common equity or take more debt from a mortgage lender. It can also help sponsors avoid having to refinance their mortgage loan to cover the cost of the partner buyout.