Recapitalizing an Investment Without Refinancing

There are many reasons a sponsor might decide to recapitalize an existing investment rather than refinance it, such as buying out a partner, reducing overall common equity, or financing a large value-add program without adding more common equity. Often, a sponsor will not want to refinance the existing mortgage loan due to favorable interest rate, costs associated with a new mortgage loan, or even having recently taken out that loan. In those cases, preferred equity can provide a less expensive alternative to a refinance.

Partner Buyout

If there are multiple partners involved in the common equity, one or more of them may request to be bought out of their investment in the property. Sometimes, part of the sponsorship 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. In those cases, it can be expensive to replace an exiting partner with more common equity and the remaining partners want to be able to accomplish the buyout without also having to refinance the mortgage loan. 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. 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.

Reducing Common Equity

A sponsor may wish to reduce their own amount of common equity in a deal without having to refinance their mortgage loan. One reason this is attractive to sponsors is that it enables them to put that money to work in expanding their portfolio. By adding preferred equity to their existing deal, sponsors have the benefit of cashing out some of their own funds as well as raise their leverage for better returns.

If a sponsor has a mortgage loan that has a favorable interest rate, for instance, they may not want to refinance at a potentially higher rate in order to reduce their common equity in a deal. By adding preferred equity, a sponsor can retain their existing mortgage loan while still reducing their overall equity. Another reason a sponsor may choose to use preferred equity to cash out their own equity in a deal is to avoid paying fees associated with paying off an existing loan and obtaining a new loan. Since these can be substantial, sponsors may decide to use preferred equity in those cases.

Financing a Value-Add Program

Many sponsors choose to implement a value-add program at a property after their mortgage loan has closed. Whether the loan was recently obtained, or the sponsor has held the property for a period of time, it may not be cost-effective to refinance their mortgage loan to include capital for a value-add component or to use their own capital to do so.

In the above scenario, adding preferred equity to an existing deal in order to fund a value-add program at a property can help sponsors avoid the costs associated with refinancing their existing loan or accomplishing the value-add either through an injection of common equity or out of a property's cash flow. Preferred equity is often a less expensive option open to sponsors who wish to go this route in order to perform renovations at a property.

What It All Means

Two of the most common reasons sponsors may consider adding preferred equity to an existing deal relate to common equity costs and retaining an existing mortgage loan. Mortgage loans can be expensive to refinance or just inconvenient, so sponsors often look for a way to keep their existing loan while still implementing a value-add component, cashing out common equity, or buying out partners. Since there are often high costs associated with each of these, adding preferred equity to a deal can help sponsors avoid having to refinance a senior loan by instead recapitalizing their own position.