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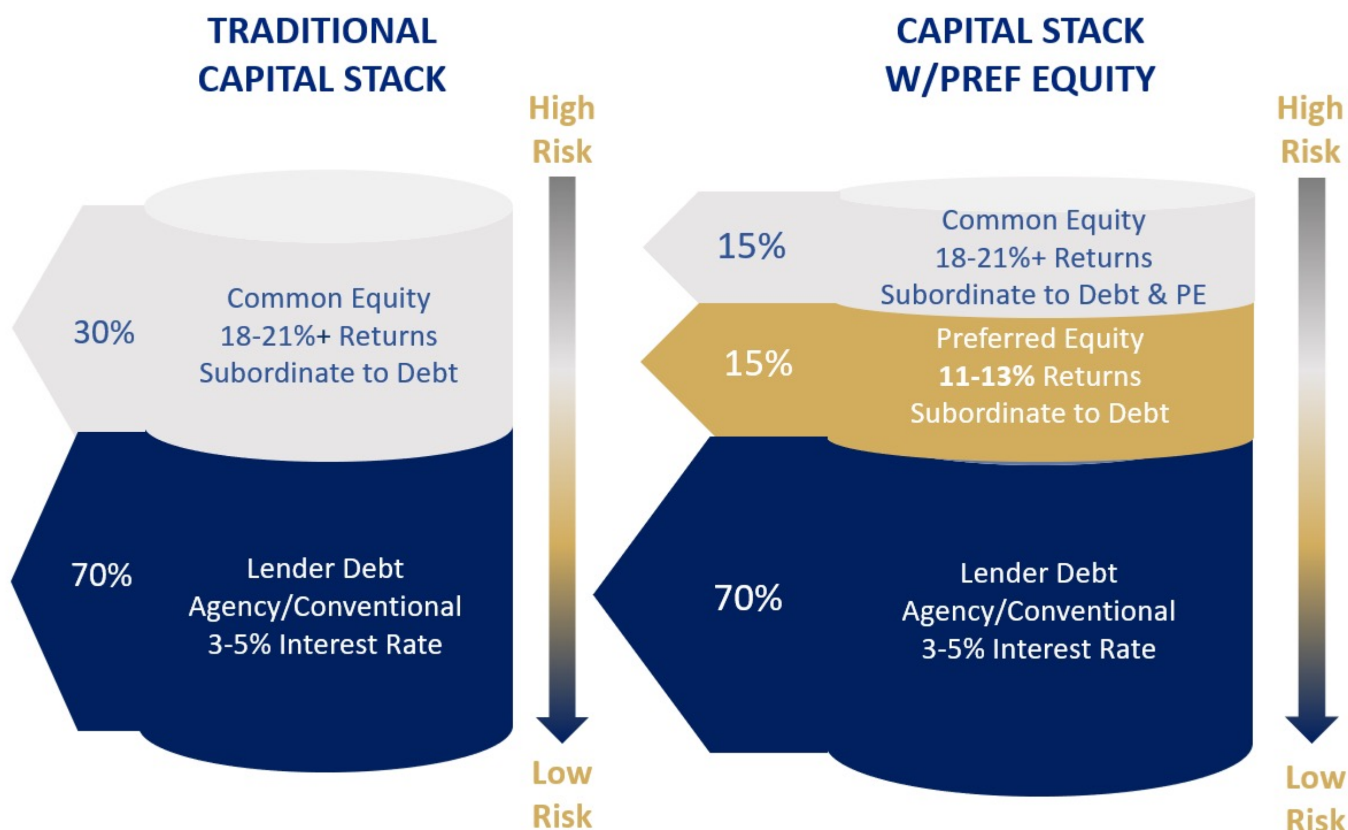
CASE STUDY ON THE USE OF PREFERRED EQUITY FOR MULTIFAMILY ACQUISITIONS

Many of you know that our firm has been providing information on the “dos and don’ts” of Preferred Equity. However, we have had numerous requests regarding a “case study” to better understand how Preferred Equity (PE) can help sponsors in determining what their total costs of capital will be (the “Capital Stack”).

WHAT IS PREFERRED EQUITY?

Preferred Equity, or PE, is a portion of the capital needed to fund and operate an asset. In our case, the asset is a multifamily, cash flowing, 90%+ economic occupied asset. PE has debt-like protections and equity-like returns. On the capital stack, PE sits above the lender and underneath private capital. Private capital is the capital that sponsors traditionally raise under a Reg D filing.

In the example below you can see that after debt, the remaining amount of the traditional "Common Equity" or private capital accounts for 30% of the capital stack. To the right, we show that the Common Equity is essentially reduced by 50% with PE sitting right above debt at 15% of the total capital needed. What does this accomplish for the sponsors? In a vacuum, the sponsors have to raise 50% of what they were going to raise on a traditional capital stack scenario. Additionally, the PE portion is most likely at a lower cost than what is projected for Common Equity or private capital. Therefore, under the right circumstances, sponsors can reduce the amount of private capital they have to raise and reduce their blended costs of capital because the costs of PE will most likely be less than private capital.



WHAT DO THE NUMBERS LOOK LIKE?

Below, I have created a very basic scenario comparing a capital stack using preferred equity and private capital vs a capital stack using only private capital for the non-debt portion.

First, let's set out the inputs used for the example below:

- 200 Unit Apartment Complex
- 90%+ Economic Occupancy
- Purchase Price/Unit - $130k
- Reno/Unit - $6k
- Closing Costs – 2% of Purchase Price
- CapEx/OpEx Reserves - $200k
- Sales Price (5 yrs) - $36.5m
- Closing Costs for Sale – 5%
- 8% Pref to Members
- 13% PE return (6.5% Current Pay remainder is accruing until term)
- 75/25 Split Members/Manager

Asset	123 Any MF	Mo Int Payment	
# Units	200		
Purchase Price $/Unit	$ 130,000		
Reno $/Unit	$ 6,000		
Purchase Price	$ 26,000,000		
Reno Costs	$ 1,200,000		
Closing Costs (2%)	$ 520,000		
Reserves $250/Unit	$ 50,000		
2 Months OpEx Reserve	$ 150,000		
Total Costs	$ 27,920,000		
Loan Amount (% of Purchase Price)	75.00%		
Loan Amount ($ of Purchase Price)	$ 19,500,000		
Loan Rate	3.50%	$ 56,875	
Loan Amount (% of Reno Costs)	0.00%		
Loan Amount for Reno Costs	$ -		
Total Loan Amount	$ 19,500,000		
Capital Needed	$ 8,420,000	$ 56,133	8% Pref
Projected IRR	20%		
Estimated Pref Equity Rate	13%		
Exit Price in 5 Yrs	$ 36,500,000		
Closing Costs	$ (1,825,000)		
Payoff of Loan Amount	$ (19,500,000)		
Payoff Accrued PE (6.5 @ 5 yrs)	$ (2,736,500)		
Net Proceeds	$ 12,438,500		
Payoff Capital/PE	$ (8,420,000)		
Net Proceeds after payment of Capital	$ 4,018,500		
Members Sharing Ratio	75%		
Manager Sharing Ratio	25%		

	No Preferred Equity				Preferred Equity				
	% of Cap Stack	Cost of Capital	Cost Blend	Cost Per Month	% of Cap Stack	Cost of Capital	Cost Blend	Cost Per Month	
Loan	69.84%	3.50%	2.44%	$ 56,875	69.84%	3.50%	2.44%	$ 56,875	
Preferred Equity	0.00%			$ -	15.08%	13.00%	1.96%	$ 52,813	6.5% Current Pay
Private Capital	30.16%	20.00%	6.03%	$ 56,133	15.08%	20.00%	3.02%	$ 28,067	8% Pref
Total	100.00%		8.48%	$ 113,008	100.00%		7.42%	$ 137,754	$ 24,746 Cost/month
Private Capital Amt	$ 8,420,000				$ 4,210,000				
5-yr Cost of Cap				$6,780,500				$ 8,265,250	
	Sale								
	Distributions to Members			$3,013,875				$ 3,013,875	
	Distributions to Manager			$1,004,625				$ 1,004,625	
				$4,018,500				$ 4,018,500	
	Total Cash Flow to Investors			$3,368,000				$ 1,684,000	
	Net Proceeds to Investors			$3,013,875				$ 3,013,875	
	Total Distributions to Investors			$6,381,875				$ 4,697,875	
	Equity Multiple			1.76				2.12	
	Annualized ROI			15.16%				22.32%	

WHAT DO THE NUMBERS LOOK LIKE?

Second, as a reminder, these numbers are based on a case study and do not take into account any fluctuations during the 5-yr hold period. Additionally, it is assumed, for purposes of this scenario, that the debt is Interest/Only to make the calculations simple. Looking at the left column of calculations without utilizing PE, we note the following:

- Total Cost is $27.92m
- Debt equals 69.84% of Total Cost
- Private Capital is the remaining 30.16%
- Assumption is a projected 20% IRR for Private Capital (include cash flow and % of Net Proceeds from Sale)
- The blended costs of 100% of the $27.92m is 8.48%
- With the assumptions above, this example should yield an Equity Multiple of 1.76 and an annualized return on investment of 15.16%

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Total Distributions to Investors				$6,381,875				$ 4,697,875	
Equity Multiple				1.76				2.12	
Annualized ROI				15.16%				22.32%	

The right column uses the exact same numbers as the left side; except that the Private Capital is split 50/50 with PE. Again, the only thing changing is the 30.16% Private Capital is split equally with PE. PE will only cost the sponsor 13% annually vs the projected 20% for Private Capital. Notice that the blended costs of capital for the same deal decreases to 7.42%. That is a reduction of 1.06% annually. While that does not sound like much, over a 5-yr period, that equates to a cost savings of $1.48m to the fund. Again, assuming that there is not an adjustment of the 75/25 split when using PE, the equity multiple for the investors goes from 1.76x to 2.12x and the projected annualized ROI increases from 15.16% to 22.32%.

Looks like a no-brainer, right? Not necessarily. PE should only be looked at on cash flowing assets that not only meet the lender's DSCR but also the PE's DSCR (which is obviously going to be higher as they are anticipating monthly payments equivalent to 6.5% ROI annually from cash flow). **IT IS IMPORTANT TO NOTE THAT PE, WILL ALWAYS BE PAID BEFORE ANYTHING GOES TO PRIVATE CAPITAL (JUST LIKE DEBT).**

BLENDING YOUR CAPITAL STACK IS LIKE CREATING A GREAT BLENDED WINE

In the preceding example above, we have one scenario where investors are getting a 1.76x multiple over 5 years and the PE side shows investors receiving a 2.12x multiple. As a sponsor, you will need to decide several things here:

- Can you service the debt, the PE current pay and still pay investors some of the cash flow?
- Can you raise capital with a 1.76x equity multiple over 5 yrs?
- Is a 2.12x equity multiple more than what the market is paying currently? If so, do you change the splits from 75/25 to 70/30?
- Are the restrictive provisions in PE worth the decreased stress of raising 2x the private capital?
- Do you offer more for the asset (assuming you are going to use PE) and reduce the equity multiple to 2.0x? Still good for investors and maybe you have a better chance of getting the asset?

I am not going to answer the questions above. Those are business decisions that each sponsor should evaluate in order determine if PE is the right way to go and how much PE makes sense, based on amount, rate and fees. Too often, we are seeing clients exploring PE towards the end of their acquisition process when either (i) they don't receive as much debt commitment as expected; and/or (ii) they are not able to raise the private capital as easily as anticipated. It is critical that sponsors look at PE when they are underwriting cash flowing opportunities before submitting a Letter of Intent. As you can see from our example, there are significant differences in the numbers between using and not using PE. PE could very well make an unworkable deal workable (given the right situation).

I do plan on having a webinar soon to go through a scenario like this "live" with a GP that has quite a bit of experience with PE. As usual, if you have any questions, please feel free to reach out to us at team@kaliserlaw.com.

MERRILL KALISER

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Merrill has refined his practice to focus on corporate representation, commercial real estate, SEC syndications, acquisitions and mergers, and venture capital/business start-ups. He has successfully launched three private equity funds that have raised over $60M in funds to purchase single family residential portfolios and multifamily in tertiary markets throughout Texas and the country. He oversees and manages two of these funds along with a property management company.

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