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With all the capital available in N.Y., property owners may be in a mezzanine state of mind

There is no denying that New York City is one of the most attractive investment markets to real estate investors (perhaps second only to Washington, D.C.). This explains why high profile properties like the GM Building can trade for $1.4 billion (a record in the U.S.). It is reported that Deutsche Bank provided a $900 million first mortgage, and that Vornado Realty Trust and Soros Fund Management LLC provided various levels of mezzanine funding totaling $250 million.

Both Vornado and Soros must be confident of a refinancing exit strategy to retire their relatively short-term debt. After all, mezzanine financing does present attractive returns for lenders, compared to first mortgage financing, however, being in the middle (or in some cases, close to the top) of the capital structure does pose obvious risks. Mezzanine lenders (at least those that do not want to actually become property owners) underwrite their debt from an equity, as well as, a credit perspective.

Real estate mezzanine financing, once a cottage industry, has become a major financing tool in New York, and most major markets in the U.S. The number of mezzanine lenders has grown exponentially in the past several years. While exact numbers are not available, it is estimated that over $25 billion in "mezz" proceeds are currently available in a plethora of funds, which is being provided by insurance companies, pension funds, real estate opportunity funds and private capital. There are mezzanine lenders with special niches based upon the size of the funding, the amount of leverage, asset class and location. Some lenders structure their debt as "preferred equity", others as pure second mortgages. Still others blend their mezzanine loan into the first mortgage as a "b-piece". Mezzanine debt can be an innovative vehicle to property owners seeking to maximize debt proceeds for new construction, acquisition or recapitalization. Mezzanine funding typically provides between 70%-90% (higher in certain transactions) of the required capital in a transaction. At minimum, mezzanine lenders require a pledge of the owner's partnership interest. Most also require an "inter-creditor agreement" with the first mortgage lender, which provides the mezzanine lender notice and cure rights if the property owner defaults on the underlying first mortgage. The term preferred equity is more often than not a euphemism for mezzanine debt, with the same remedies available to mezzanine lenders.

Depending on typical underwriting criteria (i.e. property, market, tenancy, borrower), and the degree of leverage, most borrowers are charged between 12%-20% for the financing on small to mid-sized deals, while large mezzanine transfer trade in the LIBOR and 400-800 band. Yields are changed in a combination of front-end and back-end fees and coupon rate. Notwithstanding, the high interest rates, property owners typically do not have to share any profits with the mezzanine lenders other than to repay them the rate of return negotiated when they borrowed the money. Many mezzanine lenders are flexible in that if the current cash flow from a property is not sufficient to pay the interest cost, they allow interest to accrue until such time that the property can either support the interest cost or is sold. No, mezzanine lenders are not altruistic. Interest that is not currently paid is compounded at the coupon rate and must be paid when funds are available. The maturity of these loans never exceeds the term of the underlying first mortgage, and the term usually averages 3-5 years (sometimes as long as 7 years).

With New York as a favored real estate market, and U.S. economic recovery appearing to be picking up a full head of steam, (albeit with employment just barely puffing smoke), it is no surprise that most mezzanine lenders have a favorable bias towards the New York Metropolitan Area. In fact, a majority of mezzanine lenders are either headquartered or have offices in New York. If you own, or are acquiring a Class A office property with credit quality tenants and long-term leases, you can probably sell lottery tickets to potential mezzanine lenders for the chance to make you a loan. Demand for quality retail, multifamily and condo conversion properties in the New York MSA are extremely high as well. With corporate travel picking up, there might even be a market for hotel repositioning… someday. With all the mezzanine capital available in New York, savvy property owners and investors might have reason to sing that Billy Joel classic (A New York State of Mind), but with a different twist.

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