

## Mezzanine Loans Become Common in The New World Of Structured Financing

*Lenders, investors and borrowers are embracing this sometimes high-cost product offering from a growing list of players.*

**By W. Joseph Caton**

No doubt, the proliferation of structured finance products has added new dimensions to the art of the commercial real estate finance deal. Add to that the entrance of risk mitigation rocket scientists from Wall Street, and the mix of traunched out subordinated products gives life to virtually any imaginable commercial property acquisition, refinancing or construction deal today.

The presence of mezzanine financing has certainly been felt among lenders, investors and borrowers alike. The number of players in this space—once identified as a niche finance product—has grown exponentially over the past few years, and both the compression in returns and the variety of mezzanine financing flavors bear out those results.

Furthermore, mezzanine lending has been traunched out to the level that there are senior/subordinated characteristics to the products themselves, in order to meet the needs and demands of different project sponsors and institutional lenders/investors.

*Commercial Mortgage Insight* has set its sights for this

month of the thoughts of industry players in the mezzanine finance world—to get some idea of what tools these professionals are using to remain competitive, as well as their outlook for the business in the months and years to come.

“With a mezzanine products, a borrower has the ability to retain 100 percent ownership in a project and control of major decisions regarding an investment,” explains James Merkel, managing director of Columbus, Ohio-based Rock-Bridge Capital LLC, a provider of mezzanine products.



*Tremont Realty Capital arranged a \$3,940,000 mezzanine loan for La Valencia, an apartment complex located in Dallas, TX.*

“It can enable the property owner to leverage returns and existing cash, which that owner

can then invest in multiple properties. Essentially, mezzanine financing simplifies a transaction by limiting the number of equity partners and enabling the borrower to retain 100 percent of the tax benefits,” he says.

Given the pace at which commercial real estate prices have been rising in some asset types and the insatiable appetite by private and institutional investors, demand for this specialty subordination product has grown significantly—giving rise to the creation of several mezzanine investment funds.

Merkel’s company has been actively involved in the capitalization of such funds, as well as sourcing and making mezzanine loans.

### **Risk and returns**

Surely, returns in the high teens—even for a product as transparent as commercial real estate—as its inherent risk.

For one thing, the mezzanine player does not hold an equity interest and generally has minimal up-side potential in the success of any deal.

“While the equity play is not there for mezzanine lenders, you

have to remember that these lenders are generally in the game for the short run and are betting on an increase in property valuation or continued excess cash flow to make money," states Jeff Weidel, senior vice president and co-managing director in the San Francisco office of NorthMarq Capital LLC. NorthMarq also arranges and structures mezzanine deals for a variety of asset types.

Weidel indicates that mezzanine players have different appetites for risk in these deals. He explains that in this office, for instance, he has life company clients that are interested in taking a loan from 65% to 75%, and no further.

"That is the extent to which they may be willing to take a risk, and they would leave the business of taking the loan up to 90-plus percent to the players with more of an appetite for risk," he declares.

Weidel points to the fact that just about every aspect of the commercial real estate finance world now has an overabundance of capital, and the footrace for "perfecting the security" of these assets is on. In the case of the conservative life companies, for example he says that many are more than happy with high single-digit returns for good-quality properties. He sees little interest for some of the high-risk plays he has personally witnessed.

RockBridge's Merkel thinks the burden of risk mitigation is on the mezzanine lender, and the nature of the business should be well understood before jumping in. He points to the quality of both the asset and the sponsor as the key factors in mitigating risk.

"The collateral for mezzanine financing is generally the borrower's pledge of the partnership interests," he says.

"A mezzanine capital provider must be comfortable with the collateral and ensure that the loan documents enable the lender to have the ability and the rights to protect the collateral vis-à-vis the equity. It is critical that a lender provide mezzanine financing to borrowers with high integrity, as they are relying on the quality of the borrower to mitigate investment risk, Merkel says."

Clearly, the risk assumed by a mezzanine player lies in the performance of the security asset. It is in the vital interest if these lenders to clearly understand the nature of the property's operations.

"Since mezzanine financing goes deeper in the capital structure than first mortgage and more senior subordinated financing- resulting in a higher risk position to the mezzanine capital provider- the provider further elevates its risk if it does not have a good understanding of the underlying investment," Merkel says.

### ***Enters Wall Street***

Wall Street has also weighed in on mezzanine lending and investment business, this making the available structures of these products even more sophisticated and, at times, more complex.

"Wall Street is increasing its share of this business," Weidel indicates. "You have to remember that the whole concept of perfecting the security came from Wall Street and they- more than anybody else in this busi-

ness- have the best handle on mitigating risk," he says.

Merkel agrees that Wall Street brings a level of sophistication to the business, which will likely cause a shakeout among weaker players.

"Wall Street and the capital markets are very active in originating and buying mezzanine pieces," he says. "They can take this product and trauche it out to the extent that there is a piece with just the appropriate level of risk for each individual investor."

As the rating agencies become more comfortable with the use of mezzanine products in the structuring and financing of deals, it is inevitable that their analysts will soon enough weigh in on the proliferation of this products in deals- both portfolio loans and securitized conduit investments.

"Although many consider mezzanine financing to cover all forms of subordinated debt, there can be varied levels within the mezzanine debt," Merkel says.

"Lower-leveraged subordinate debt may have a second lien on the property, whereas higher-leveraged pieces are more like preferred equity, and are secured by an assignment or partnership interests," responds Merkel when asked for his perspective in the difference between ordinary subordinated debt and mezzanine debt.

"Stronger debt service coverage transactions tend to attract coupon-only pricing, while higher-leveraged transactions tend to attract priding that is participating in nature," explains Merkel. He sees the influence of Wall Street continuing to affect this business profoundly- includ-

ing what he calls the weeding out of “fly-by-night” players.

### ***Minimal control***

As lenders and investors rush to join the ranks of providers for mezzanine loans, some fundamental issues must first be well understood. For one thing, the mezzanine lender would have a difficult time getting a favorable response from a senior lender. Inter-credit agreements between straight subordinated lenders and senior note holders are quite common and easily negotiated.

On the other hand, the mezzanine player comes to the table relying solely on the performance of the asset and the ability of the sponsor to secure its piece of the lending structure. North-Marq’s Weidel says senior lenders would welcome a mezzanine position by a well-know investor, such as a big Wall Street name.

He also indicated that once a senior lender gets wind that a well-capitalized mezzanine lender is only in the process to trade it out in the near term, the inter-creditor agreement could be in jeopardy instantly.

“It’s one things for a well-known investment banking name to come in as a mezzanine lender behind a senior lender. However, if that big-name player- such as a big investment banker on Wall Street- does no intend to stick around and see the deal perform in the interest of the senior lender, then don’t expect that senior holder to be accommodative to the mezzanine player,” Weidel says.

Asked if a mezzanine lender can ever be called upon to step in and cure a borrower default, Merkel states, “Mezzanine funds

are the first dollars at risk [after the equity]. As such, mezzanine lenders must be prepared to play the role of special servicer of sorts.”

He believes that the biggest reason why a senior note holder would embrace a substantial mezzanine player is to step in and fill the role of the sponsor- should be need for that action become necessary.

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## In Their Own Words: Mezzanine Structures

*Tom Lorenzini*  
*Managing Director*  
*Tremont Realty Capital*



**CMI:** When you look at this business, what is your fundamental take on its benefits to borrowers?

**Lorenzini:** Mezzanine debt allows borrowers to increase the amount of leverage on a particular property. It typically stretches to acquisitions or development projects—which means a lower overall equity requirement of the sponsor. In many respects it is cheap equity. Typically mezzanine financing—since it is debt—will carry a capped return unlike equity, which will participate in the overall success of the project. So if a borrower hits a home run, he or she can keep more of the upside while capping the return to the mezzanine debt lender.

**CMI:** So what's the downside here?

**Lorenzini:** Lending institutions need to make sure there is a defined exit strategy to repay the mezzanine debt. In development deals, that can be a sale of the asset. They must know up front that a projected sale price provides enough money to repay the senior mortgage, mezzanine debt and equity position, in addition to providing a return to the equity.

If a refinance is the exit, the lender (senior or mezz) must be comfortable with projections that there is enough demonstrable upside to allow a refinance in the 75% to 80% range to cover both the senior and the mezz lender.

One of the biggest mistakes a lender can make today is misreading the market and overleveraging an asset. For instance, a building can be 70% occupied today, but that does not mean there is upside to lease the project to 90%. It will not happen if the comparable projects in that overall market are only 70% occupied.

Senior lenders also have to make sure they are comfortable with the mezzanine lender running the property in the event there is a default. A mezz lender could be called upon to step into the shoes of the owner, and that can be a tall order to fill. Many mezz lenders are simply finan-

cial institutions looking at returns and do not have real estate owner operators on their team—so if there is a problem they may not have the in-house ability to solve that asset management problem. Once that function must be outsourced, the cost can get of control in a hurry.

**CMI:** Under what circumstances would you walk away from a mezzanine financing opportunity?

**Lorenzini:** Once again, mezzanine would not work well in markets or assets with deteriorating economics.

If a project is financed up to 85% or 95% of today's value, and the project occupancy or cash flow suffers thereafter, its value will decline and the project will effectively be financed 100% or higher.

Also, mezzanine debt works well on the four primary asset classes of multifamily, retail, office and industrial. There is a more liquid market for dispositions in the event the asset needs to be sold.

**CMI:** When you sit down with a project sponsor, how well do they typically understand this product?

**Lorenzini:** This capitalization tool has really become mainstream over the past five years. Borrowers, in general, are very familiar with mezzanine capital and have come to understand the benefits.

With the proliferation of the mezzanine debt market, many first mortgage lenders now offer mezzanine debt, thereby offering their clients one-stop shopping.

Having said that, many borrowers might not even be aware that they are using mezzanine debt. Some senior lenders may close on a high-leverage senior loan and then bifurcate the loan into a more traditional senior mortgage and a mezzanine piece. They will then sell the mezzanine loan to a separate lending institution. How's that for one-stop shopping?

**CMI: What do you see as the net effect from so many new lenders (and investors) at the mezzanine door?**

**Lorenzini:** Like anything else, when competition heats up, margins get compressed. Competition is healthy, but it requires discipline to make sure that you are not mis-pricing transactions and taking on too much risk for the reward.

New mezzanine lenders often have very large transaction costs as their attorneys build and negotiate loan document- especially an intercreditor agreement with the senior lender. That is typically the most difficult document to negotiate.

**CMI: How have margin spreads on mezzanine financing fared during the past year?**

**Lorenzini:** Over the past year, we have seen spreads compressed by about 150 to 200 basis points, and they appear to have stabilized. However, continued increases in LIBOR and Treasury rates could force a further compression of mezz spreads.

That said, not all mezzanine debt is created equal. While spreads in general have come in, it may be the case that returns on hotel mezzanine paper have come in from 16% to 14%, while multifamily returns have moved from 13% to 11%. Also, spreads on smaller mezzanine loans (\$1 million to \$5 million) have been fairly inelastic.

**CMI: Is Wall Street buying or originating mezzanine pieces for their high-yield investment clients?**

**Lorenzini:** Yes. Just about all of the investment banks which have conduit operations are originating mezzanine debt. Many originate and sell off. Several of them like the returns and are willing to keep the assets on their books, while still others securitize the paper. MezzCap is a third-party mezzanine lender that originates and securitizes small mezzanine loans (less than \$3 million). Tremont, on the other hand holds and services the loans in their funds.

**CMI: And what do you perceive as the competitive edge in mezzanine financing?**

**Lorenzini:** Mezzanine lenders that have true real estate expertise, are best suited to ride out any potential storms in this space. Many mezz lenders sim-

ply employ a trader mentality and only look at yields versus the nuances of the underlying real estate. Those lenders that have equity experience in real estate- possibly as owners- have a leg up on the competition, as they can better understand and underwrite a borrower's business plan.

**CMI: Finally, let's go back to Wall Street for a moment. What are the rating agencies and CMBS analysts saying about the flood of new money finding its way into mezzanine financing?**

**Lorenzini:** The rating agencies have become more comfortable with mezzanine debt over the last couple of years. However, they remain concerned about overall leverage. The concern is that if a property is overleveraged and the cash flow after debt service is too thin, the likelihood of a default increases.

To help offset this risk, the agencies and analysts are looking through to the mezzanine lender to determine if they have the ability to solve any problems that may arise, thereby keeping the senior current and at an appropriate LTV.

Ironically, a highly capitalized mezzanine lender with real estate experience can actually enhance a loan and help a borrower achieve a better senior loan.

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