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Optimizing capital structure: A mezzanine primer

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For the last few years, one of the most significant trends in real estate finance has been the growing use of mezzanine bedt and third-party equity, which can provide for more efficient and cost-effective capital structures.

Developers need to access their equity alternative when deciding just how to capitalize a particular project or property.

There is some debate about what constitutes mezzanine debt and what constitutes an equity investment, but generally it breaks down as follows: Mezzanine debt is any capital contribution to the total real estate transaction (development, acquisition, or re-capitalization) that is placed behind the senior mortgage loan, but in front of the equity. This usually translates into the slice of the capital stack from 75 percent of cost to 85 percent or 90 percent of cost. We generally consider any targeted capital contribution in excess of 90% to be equity or at least "playing in the equity structure" even if structured as mezzanine debt.

Capital providers make the distinctions outlined above because they are trying to stratify the total capital structure into various risk tranches and then match the distinct risk profiles of each tranche with the appropriate yield requirement.

Obviously, the tranche of the capital stack that is above 80% of cost/value is riskier than the tranche of capital that is under 65% of cost/value. That is why senior lenders only charge single digit interest rates, whereas a mezzanine lender may require a double-digit yield and an equity investor will require a return in excess of a mezzanine lender (all other things being equal).

In addition, mezzanine debt usually has a capped yield, with the upside reserved for the developer/sponsor. Equity investors on the other hand, may require some minimum yield on the invested capital plus a participation in the ownership of the real estate.

In all cases, the yields required by the various capital providers for both mezzanine and equity are determined by the risk profile of the project to be capitalized.

As a general rule, development projects are perceived as riskier than existing assets, therefore developers should be prepared to pay mezzanine lenders and third-party equity investors a much higher yield than someone who is buying an existing cash flowing asset.

Collateral and today's yield requirements

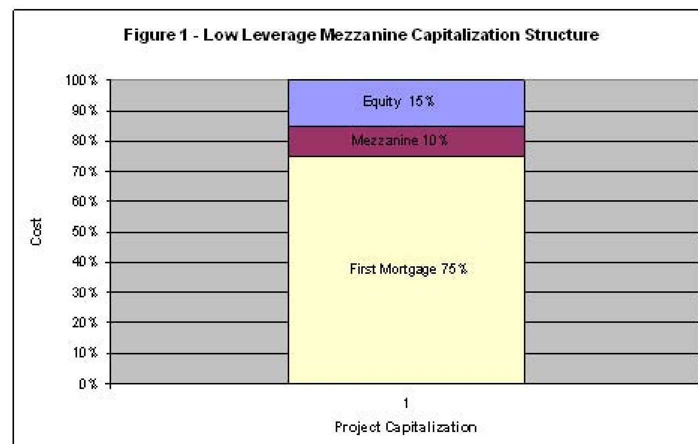
Mezzanine loans are generally secured by an assignment of the membership interests in the borrowing entity. In many cases, the mezzanine lender also requires an intercreditor agreement signed by the senior lender. Mezzanine is usually construed as a loan where the lender's rights are terminated upon repayment.

Equity investments, on the other hand, are generally secured by either actual ownership rights in the borrowing entity or assignments of all of the member rights in the borrowing entity. Equity typically cannot be pre-paid and is usually only terminated when the real estate is sold.

In today's market, mezzanine lenders generally require between 10% and 18% returns on their invested capital. These returns are often comprised of several components including front-end fees, exit fees and interest rate.

If lenders are providing a mezzanine loan up to 85 percent of value on an existing large apartment complex that carries a 75 percent LTV senior loan, the lender's required yield may only be 10 percernt , because the asset class and capital tranche (75 percent to 85 percent) is perceived as less risky than other property types and higher leverage capital tranches.

In this example, the developer would provide the first 15 percent of capital (equity), the mezzanine lender would provide the next 10 percent and the senior lender would provide the balance (see figure 1).



Other mezzanine lenders might provide up to 90 percent

of the capital requirements (see figure 2).

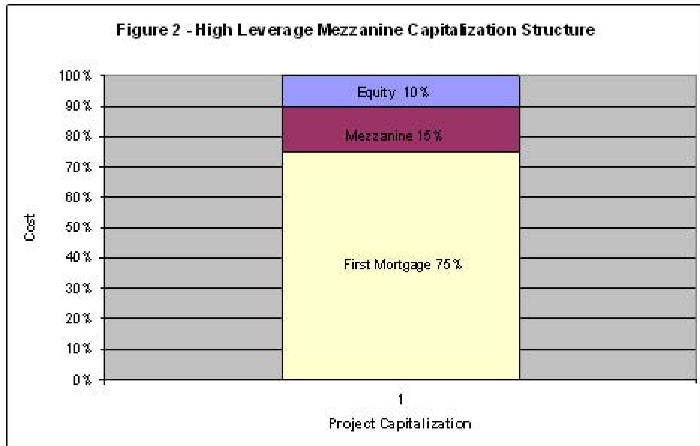


Figure 2 - High Leverage Mezzanine Capitalization Structure

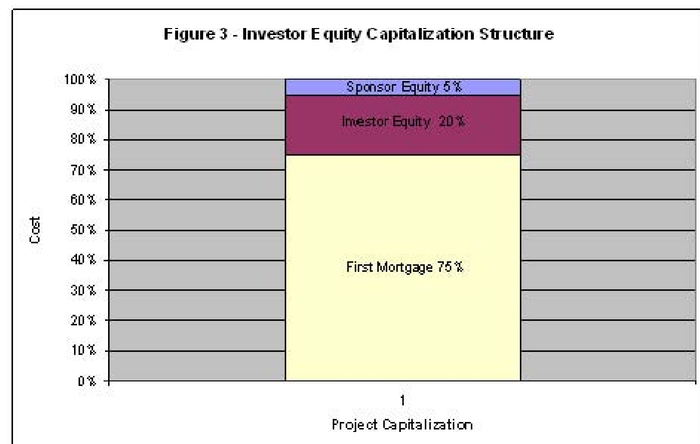


Figure 3 - Investor Equity Capitalization Structure

Our firm recently completed such a transaction for two multi-family projects. A mortgage broker brought us transaction with an 80 percent first mortgage and we funded the mezz slice between 80 percent and 90 percent coterminous with the 10-year senior mortgage at a yield in the 11 percent range.

Equity carries more weight

As you might imagine, equity investors generally require returns in excess of those for mezzanine lenders.

In very stable, existing assets equity providers might be willing to accept returns in the low double digits but for development deals their required returns could be as high as 25 percent or more (annual IRR). Generally, the equity investor earns a preferred return and shares in the upside of the transaction.

One common equity structure is for the third-party equity investor to provide 80 percent to 90 percent of the equity gap. If the senior loan funds to 75 percent of cost, then the equity gap would be 25 percent of cost. 80 percent of 25 percent is 20 percent, with the developer or sponsor responsible for the remaining 5 percent (see figure 3).

In a $20 million transaction, the latter structure would translate into a $15 million first mortgage loan, a $4 million third-party equity investment, and a $1 million developer equity investment.

In exchange for the $4 million of capital, the equity investor might receive a "preferred return" of anywhere between 8 percent and 15 percent, with most being in the low teens.

After the required preferred return is satisfied, proceeds from operations, refinancing and/or sale are usually split according to a predetermined distribution of proceeds or "waterfall" of return hurdles and splits.

In our example the investor contributed 80 percent of the required equity and the developer put in 20 percent. So, the proceeds could be split 80/20 until both parties receive their principal back plus a 13 percen return (with the investor getting his first, i.e. preferred), after which the developer could be "promoted" up to 30 percent of the remaining cash flow.

A waterfall can be very simple with only one or two different levels (or promotes), or it can be quite complex with several different defined return hurdles and splits.

Developers must be realistic with partners

In any event, the equity investor is trying to achieve some minimum required return between his preferred return requirement and the waterfall of project proceeds based on his underwriting of the project and business plan.

One should note that equity investors, mezzanine lenders and senior lenders all tend to be more conservative in their outlook than real estate developers. Hence, there may be material differences of opinions about the estimates of the equity investor's return at their introduction to the project. It is common that a developer's rosier outlook will lead him to believe that the equity investor's preferred return and waterfall requirements will lead to excessive yields for the equity investor.

Some developers need to assess their equity alternatives when deciding just how to capitalize a particular project or property. Some developers are flush with cash and use 100 percent of their own money to fulfill the equity requirements. Most aren't in that enviable position or feel that they should "keep some of their powder dry" for other potential projects. Other developers use "friends and family" money for their equity needs. This can be exhausting and stressful keeping non-real estate partners informed and educated about real estate projects and their common pitfalls and hurdles.

Also, many friends and family partners will want ownership stakes equal to their pro rata equity investment in a project, thereby producing economics that are less beneficial to a developer than the previously outlined mezzanine and/or equity products which either cap the lender's return or actively promote the developer's position over time.

Hybrids and stratification

Once fairly defined, we are now seeing more and more hybrid mezz/equity structures offered in the marketplace.

For example, some mezzanine lenders structure their mezzanine as a loan with a participating "kicker". Conversely, some equity investors are now structuring their equity with a capped rate of return, which allows the ever-optimistic developer to reap all of the upside in a project (over the capped equity investor's return).

So, we are seeing a blurring of the traditional line that once separated mezzanine from equity.

In addition to, and somewhat contrary to, this hybridization of the mezz/equity world, we are also seeing many more real estate transactions that use both mezzanine debt and third-party equity to reach an optimal capitalization structure.

In fact, stratification has gone even further, with senior loans now being divided into A-pieces and B-pieces, with one or more mezzanine tranches above them and third-party equity and sponsor equity layered on top

of the mezzanine. One such transaction financed by Tremont was the development of a luxury condominium project in River North. The 176 unit project had a total cost of $57 million. The capital stack was bifurcated into four separate and distinct pieces.

A local bank funded a 74 percent loan-to-cost senior loan. This note was tranched into an A note up to 60 percent and a B note up to 74 percent, a mezzanine loan was then provided from 74 percent to 95 percent with final piece 5 percent being provided by the developer in the form of cash equity.

The mezzanine loan carried a “high teens” coupon due to the perception of being up in the equity space. The borrower liked the idea that he financed 95 percent of the capital stack without having to give up the upside and eliminated the need for investor party equity.

This was also possible because banks have a low cost of funds based on their depositors’ risk expectations for passbook, CD and money market accounts. That is why banks can make senior loans at low single-digit interest rates and still produce adequate returns for their shareholders.

Conversely, opportunity funds market their funds as higher risk/higher return vehicles, while other players like endowments and pension funds play somewhere in between.

The bottom line is that for larger transactions, it makes sense in many instances to optimize the capital structure with several different tranches of financing to obtain the lowest total cost of capital for the real estate developer/sponsor.

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