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Add Mezzanine and Equity Knowledge to **Boost Your Bottom Line**

By David E. Ross

In today's competitive environment, mortgage brokers can differentiate themselves and add to their bottom lines by focusing on knowledge of, and relationships in, the mezzanine and equity financing arena. Once you have become competent with mezzanine and equity structures, yields, uses, and programs, or have aligned yourself with someone who is experienced in this area of real estate finance, you will find that it is easier to add value to your clients' financing transactions. In fact, you will find that properly working mezzanine/equity components of a project's capital structure should allow you to control the senior debt component of most financing requests, as well. Therefore mortgage brokers can add value in the mezzanine/equity sphere, get senior debt deals that they would not have obtained without doing the mezzanine/equity component, and subsequently increase revenues.



As lenders and mortgage advisors, my partners and I have seen our share of real estate development and acquisition transactions over the past two decades. One trend that we all witnessed is the growing use of mezzanine debt and third-party institutional and non-institutional equity investment in real estate transactions. Let's examine the differences between mezzanine and equity investments and how they are used to capitalize real estate, as well as some examples of each.

Mezzanine Debt vs. Equity Investment

There is some debate about what constitutes mezzanine debt and what constitutes an equity investment, but in our company we generally break it 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 (borrower equity or borrower and third-party equity). What that usually translates into is the piece of the capital stack from around 75 percent of cost to 90 percent of cost. We generally consider any capital contribution to the total real estate transaction that reaches in excess of 90% to be equity or at least "playing in the equity structure."

The reason capital providers make the distinction outlined above is because they are trying to stratify the total real estate capital structure into various risk tranches and then to match the different risk profiles associated with each tranche with the appropriate yield requirement. Obviously, the tranche of the capital stack that is above 85 percent of cost and/or value is perceived to be much riskier than the tranche of capital that is under 65 percent of cost and/or value. That is why a senior lender only charges interest in the single digits in today's market, whereas a mezzanine

lender will require yields in the double digits and an equity investor will require a return in excess of a mezzanine lender (all other things being equal).

In addition, mezzanine debt is usually structured to require only a capped yield or return to the mezzanine lender, with most or all of the upside reserved for the real estate 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 (that is, a share of all cash flows from the operations of the real estate and a share of the capital gains from a sale).

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In all cases, the yields or returns required by the capital providers for both mezzanine and equity are determined by the risk profile of the specific real estate 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 or return than someone who is buying an existing stabilized property.

Collateral

Mezzanine loans are generally secured by an assignment of the membership interests in the borrowing entity (for example, 100 percent of the voting stock in Main Street Real Estate, LLC). In many cases, the mezzanine lender also requires a second mortgage and an inter-creditor agreement signed by the senior lender. Mezzanine is usually construed as a loan in which 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. Operating agreements document the relationship among the parties and their respective responsibilities and obligations. There is no need for a second mortgage because the investors are truly equity (owners). Sometimes equity investors require some kind of letter of recognition from the senior lender stating that it is not an event of default if the investor takes over control of the borrowing entity.

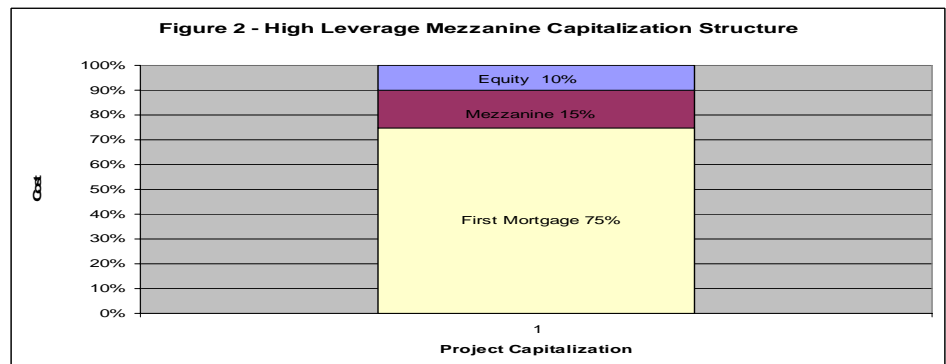
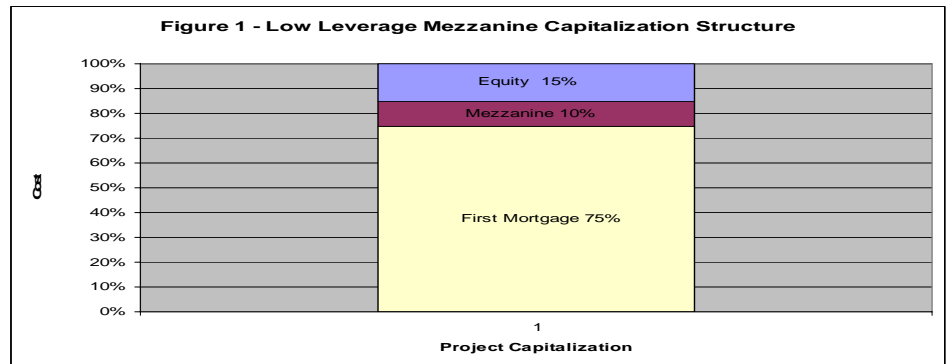
Today's Yield Requirements

In today's market, mezzanine lenders are generally requiring between 10 percent and 20 percent returns (that translates into annual IRR) on their invested capital. If they are providing a mezzanine loan up to 85 percent of value on an existing large apartment complex that carries a senior loan equal to 75 percent of value, the lender's required yield may only be 10 percent because the asset class and capital tranche (75 percent to 85 percent) is perceived as less risky than other property or project types and capital tranches. If this example was real, the developer would provide or arrange the first 15 percent of capital or equity in the project, 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). Note that mezzanine lenders can

achieve their targeted returns through several components of the loan, including front-end fees, exit fees, interest rate and/or asset management fees. They may also require a "pay rate" (interest payments lower than the accrual rate) through the initial term of the mezzanine loan.

As you might imagine, equity investors in today's market generally require in excess of the returns outlined above for mezzanine lenders. In very stable existing assets, equity providers might be able to get as low as 14 percent, but for development deals, their required returns could be as high as 30

million first mortgage loan, a \$4 million third-party equity investment and a \$1million developer equity investment. In exchange for the \$4 million of capital, the equity investor might receive a "preferred return" on his money of anywhere between 8 percent and 18 percent, with most being in the low teens. The term "preferred return" refers to the fact that, upon sale or refinance of the property, the investor will get his/her investment back plus a required preferred return before the developer gets his/her investment back and any return. After the required preferred return is satisfied, proceeds



percent or more (annual IRR). And, generally, the equity investor gets a preferred return and shares in the upside of the transaction (shares in the benefits of ownership).

One common equity structure is for the third-party equity investor to provide 80 percent to 90 percent of the equity gap. The equity gap is the capital required after senior debt financing. If the senior loan goes to 75 percent of cost, then the equity gap would be 25 percent of cost. Eighty 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

from operations, refinancing and/or sale are usually split according to a predetermined "waterfall" of return hurdles and splits.

Remember, 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 percent 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 or many different defined

return hurdles and splits. However, developers should note that it is very rare for any equity investor to allow a developer to get promoted to greater than a 50 percent split of project ownership (proceeds).

In any event, the equity investor is trying to achieve some minimum required target 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. That is why they are not real estate developers. Hence, there

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." Or conversely, some equity investors are now

sometimes low single-digit interest rates and still produce adequate returns for their depositors as well as for their shareholders. Conversely, opportunity funds market their funds as higher risk and higher return vehicles, while other players, like mutual funds and pension funds, play somewhere in between. The bottom line is that, in many instances for larger transactions, it makes sense to try to optimize the capital structure with several different tranches of financing and/or equity to get the lowest total cost of funds for the real estate developer/sponsor.

Mezzanine and Equity Transactions

The following are examples of mezzanine and equity transactions:

• **Industrial Portfolio Acquisition**

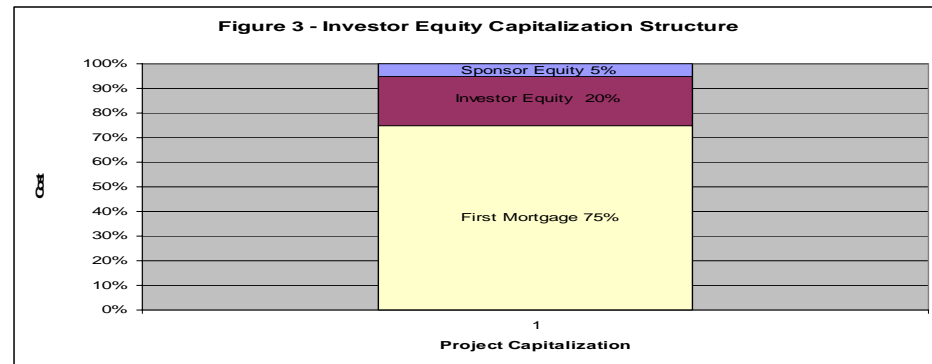
A client wanted to acquire a portfolio of 23 industrial properties for \$61.5 million. The lender arranged a \$48.35 million senior loan comprised of an A-note and B-note that provided almost 80 percent of cost leverage. On top of the senior loan, the lender placed a \$6.8 million mezzanine loan, which gave the borrower 90 percent financing in aggregate. The mezzanine loan was priced in the mid-teens and provided the borrower with the capital necessary to bridge the gap between his available equity and the senior debt.

• **Retail Preferred Equity Recapitalization**

A retail developer/owner was seeking to recapitalize an existing stabilized shopping center in Atlanta to access trapped equity. He had an existing senior mortgage with steep prepayment penalties. The lender arranged an \$8 million preferred equity investment with a low single-digit current preferred pay requirement and all-in low teens IRR requirement. The preferred equity investment allowed the developer to access the trapped cash for other projects and uses.

• **Condominium Development**

A long-time client was seeking equity to develop a speculative townhouse condominium project in Greater Boston. The senior debt was being provided by a local bank on a revolving basis. A lender arranged the \$1.75 million equity



may be material differences of opinions about the estimates of the equity investor's return at the 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. However, it is very rare that any equity investor or mezzanine lender will fully buy into a developer's economic projections.

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. Keeping non-real estate partners informed and educated about real estate projects and their common pitfalls and hurdles can be exhausting and stressful. Also, many

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. Each layer of this capital puzzle is seeking the risk-reward tranche appropriate to the capital that it has to deploy. 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

investment through a lender in a mezzanine-type structure. The mezzanine lender provided 80 percent of the equity requirement in a format that capped the lender's return at mid-twenties and allowed the developer to reap all the benefits of trying to "hit a home run" (condo price increases, faster sales, lower costs, etc.).

- ***Land Recapitalization***

A condominium developer owned a parcel of land that was phase II of a planned condominium project on the coast of Florida. The land was fully approved for residential development, and the value of the land had increased over the years as the general residential market appreciated. The developer was seeking a \$10 million loan that would eventually subordinate to a future \$35 million construction loan. The developer's cash equity in the phase II land was less than the \$10 million request. The lender arranged a mezzanine loan that would subordinate to a future construction loan and was structured to accrue a capped interest rate for the term of the mezzanine loan. The \$10 million mezzanine loan provided the developer with needed working capital to move forward with both phase I and phase II of the residential development without the need to bring on an equity partner.

Conclusion

The examples noted above are well-constructed examples of mezzanine and/or equity transactions. However, in each instance one can see how the developer/sponsor benefited from its use. Regardless of whether it is a development or existing property acquisition, if it is viable, there is a mezzanine or equity product that should benefit the developer/sponsor by providing funds to cover a good portion of the equity gap at a yield commensurate with the risk of the project and the tranche being financed. The developer's goal should be the optimization of the project capital structure, whereby he/she benefits from fitting the best suited and structured senior debt with the best fitting mezzanine/equity product. And, the mortgage broker's role should be to

advise the developer client on just how to optimize their capital structure.

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