

Commercial Mortgage Insight

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Mezzanine Financing Perceived As A Popular And Useful Tool

BY JERRY DeMUTH

Mezzanine financing activity is exploding, with more property developers and owners looking to borrow and more lenders with money available for deals. And the forecast for 2002 is for continuing growth.

"Mezzanine seems to be a very in-vogue item in terms of the capital side," says Tom Fish of L.J. Melody & Company, Houston. "There's a lot of mezzanine money out there. There are several new funds of mezzanine money. And when you have low interest rates, it really facilitates the ability, economically, to do a mezzanine transaction because you have excess cash flow and debt service (on properties)."



Michael Szwajkowski

"We're seeing really good activity on mezzanine loan products," says Michael Szwajkowski, a managing director at Chevy Chase, Md.-based CapitalSource Finance. "We've gotten more inquiries and are working on more mezzanine loans than we were six months ago. So, we've seen very strong demand. And it's a niche that we're very aggressively trying to fill."

"Something like \$125 billion worth of fixed-rate, non-prepayable conduit loans have been made in the last several years, and during those years there's been pretty strong appreciation of real estate," Szwajkowski says.

"Even though the properties could handle more debt, they're not able to do that because they can't replace the senior. So, a mezzanine loan becomes a very attractive option because they're able to take cash

out of part of the appreciation," he adds.

And if the owner has a floating-rate first, a mez loan, combined with that low-interest-rate first, produces a blended rate not much higher than the rate on that first mortgage two years ago, Szwajkowski explains.

"Paying a 12 to 14 percent coupon" on a mezzanine loan, says Paul Horning, senior managing director at Key Global Capital, the equity finance division of Cleveland-based Key Commercial Real Estate, "is a lot more palatable than paying a multi-million dollar defeasance penalty and recasting the entire first."

Reasons for growth

"The general market for mezzanine has grown," says Shekar Narsimhan, a managing director at Prudential Mortgage Capital Co., Parsippany, N.J., explaining that this growth has occurred because of two factors.

First, with declining loan-to-value ratios, the need for equity capital has grown, and mezzanine loans can provide some of that money.

Second, since 1993, a large number (if not the majority) of commercial mortgages have been originated with significant prepayment penalties, so mez loans, at today's low rates, become an attractive way of taking cash out of a property.

Mez rates, always much higher than first mortgage rates, are much more acceptable today, he points out. "There's a much closer bonding in the market between borrowers' willingness to pay and what mezzanine money costs today than there was 12 months ago."

The increase in mez lending also has led to more competition, he notes.

"You can call two or three players and get pricing today," points out Narsimhan, who heads Prudential Real Estate Fixed Income Investors, Prudential's mezzanine lending unit. "So, there's some comparability. People can't just charge whatever they want."

Mez loans are being done:

- For property owners and purchasers to take money out of their properties for improvements, value added efforts or to acquire other properties,

- To bridge the amount of a first lien and the equity they are able to put into a newly acquired property, or

- To pay off a construction loan until they are able to obtain permanent financing or sell the property.

Importance of cash flow

Each lender has its own preference. But almost always lenders look to the expected cash flow as a source of repayment, rather than to the value of the equity itself. Property performance then must be high or seen as improving.

Often prepayment restrictions or penalties on existing first lien mortgages, taken out at what are now high interest rates, are leading property owners to seek mezzanine financing. However, this often brings the mez lender into negotiations with the first lien lender, whose loans may bar a second mortgage. Those negotiations then may result in a new first mortgage.

"Whatever resistance is out there,"



Shekar Narsimhan

says L.J. Melody's Fish, "is coming from either declining property performance or from first lien lenders that do not want to have a high amount of leverage on the property.

"First-lien lenders make a loan on a property at a specific loan-to-value with the intention of that loan-to-value going down. If all you do is add more debt in the form of a mezzanine, then their position is never improving and could be getting worse.

"So usually mezzanine lenders need some kind of intercreditor agreement that asks the first lien lender to acknowledge there is a mezzanine lender who might, in the case of a default, step into the borrower's position," Fish says.

Such an agreement, he points out, means the first lien lender can call the shots, including limiting what the mezzanine borrower can do with the funds.

"Mostly what's happening," Fish explains, "is they have to do it in conjunction with doing a new first lien. They can't just go and put a mezzanine on top of an existing first lien."

Intended uses

In the past, he says, mezzanine loans were used to recapture some of the borrower's equity to acquire another property, expand the borrower's business or fund property improvements. But now both first and mezzanine lenders are looking more carefully at intended uses.

"They would much rather it be put back into the existing property," Fish says, noting that, in such cases, mezzanine loans are easier to obtain.

But CapitalSource still doesn't look at the intended use of the funds, says Szwa-jkowski, although he admits uses typically are for either improvements or another transaction.

"We're underwriting the fundamentals of the deal so, at least in theory, what someone does with those proceeds is their business and not mine," he explains. "As long as the transaction underwrites to our requirements."

CapitalSource focuses on two- to five-year deals in the \$2 million to \$15 million range, underwriting to a 1.05 or 1.10 times debt coverage ratio and going up to 90% LTV.

"Today, this mezzanine product makes a lot of sense," he says, "particularly for people who've got floating rate senior debt in properties that have appreciated because anybody who's going to a LIBOR-based loan today has a pretty significant part of the capital structure of their deal floating at already historic lows.

"And while mezzanine money is more expensive than a floating rate senior, it's still an attractive cost of capital. And it helps them liberate some of the capital that's tied

up in a property."

CapitalSource does mez lending for multifamily, retail, industrial and office, including medical office, but is "cautious" on hotels, he says. "We look for a reasonably strong rent roll that doesn't have a high tenant concentration or lease-specific issues."

Prudential does mez loans, generally to existing customers who own or are purchasing properties. Terms are typically for five years, but for as long as seven or even 10 years, explains Narsimhan.

"We look at the borrower's capability to add value to the property, how much money are they putting in themselves, what is our overall leverage on the property – in other words, between their first mortgage plus our mezzanine financing. We want to see enough added value to support the mezzanine. And we want to see cash flows that will pay off our mezzanine at maturity.

"That's what distinguishes mezzanine from equity. We're not relying upon a sale of the property to get our money back with a return," Narsimhan says.

Redevelopment and repositioning

While CapitalSource and Prudential focus on existing owners of properties of most any type, Key Global Capital focuses on new construction and new acquisitions involving redevelopment or repositioning of the property, with Key taking more of a participation or partnership role. About 30% of those deals involve multifamily properties, and its main geographic focus is on the Sun Belt.

"Our product is a short-term transaction where there's always something going on on the value creation side to drive the returns, which we target at 20% IRR," explains Horning. "Within three years we're typically looking for our mezzanine to be repaid from a sale or a refinance or a combination."

On new construction, Key will provide the amount needed that is not provided by either the construction lender or the developer's equity. And on an acquisition or redevelopment, explains Horning, Key's limited partnership interest through its mezzanine loan falls between the first mortgage and the developer's equity position.

"Other products seem to be more cash flow oriented," he comments. "They'll do 65 to 90 percent (LTV) and just need a good coupon and a good projection for moderate appreciation.

"We have a look-back component which is typically designed to capture all the cash flow and to be paid before there's any repayment of the developer. We usually participate. But the higher the look-back return, the less the participation, which can be as low as 5 or 10 percent and rarely is over 25 percent."

Tailored loans

But not only do mez lenders vary from

each other in the type of mez products they offer and the conditions under which those loans are offered, but mez lenders often tailor their loans to each specific borrower. That is another reason property developers and owners are attracted to mezzanine financing – it can meet each borrower's unique needs. At the same time, this tailoring places special demands on lenders who are involved in mez financing.

"This is a catered financing business that has a high degree of specialization," says Prudential's Narsimhan. "We will structure each transaction around the deal and the needs of the customer rather than trying to put a term sheet out that says we can do A, B, C, D.

"While many people may choose to be in it, only a few ultimately will be able to play because it does require a specialized group managing the business and the risks associated with it. The asset management requirements are significantly different than for traditional first mortgage lending," Narsimhan says.

When construction loans and first liens prohibit second mortgages, Key usually has some form of intercreditor agreement with the other lender, under which two new loans are drawn up.

"Each one is crafted individually," explains Horning. "There doesn't seem to be any standard other than acknowledging one another and getting everybody's comfort with the structure."

More mez expected

Mezzanine lending is expected to increase further in 2002, despite or, perhaps, because of economic constrictions.

In 2002, says Horning, "Everybody's going to be looking at assumptions that, except for low interest rates, are getting more conservative. Underwriting cap rates are going higher. Absorption figures for a transaction are being elongated. This all translates into investors leaning toward mez, which is a little safer."

But with declining new construction and new purchases, Key's cap rates, to be conservative, are going to be notched higher. "That means to get the benefit of the doubt when you're underwriting a deal, you'll probably back off your cap rate. You're going to take a lot more value creation to get as comfortable with a deal as you were three, six, eight months ago.

"We think," he concludes, "the deals are going to be a little longer in the process because of the changing dynamics of the economy."

Still, he expects that Key, which did about \$80 million in mezzanine deals in 2001, will do at least \$100 million, or about 20 transactions, in 2002. ●

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