

Sorting Out Mezzanine Financing

Know the ingredients of this complex commercial product

By **Joseph Bonora**, CEO, Joseph Scott Financial

AS MORE MONEY FLOWS INTO REAL-estate-related investments, new and innovative financing products are following. In commercial real estate, mezzanine financing continues to be a hot topic.

So what exactly is mezzanine financing, anyway?

To begin answering this question, we must look at the characteristics that make up mezzanine financing.

What it is

By definition, a mezzanine loan is a hybrid of debt and equity, generally subordinate to any senior debt. It is often used to fund expanding companies. Given the loan's subordinate position, the lender usually receives a higher coupon rate than what would be on the senior debt.

Mezzanine financing usually contains a convertible feature, which allows the lender to realize any gains associated with a project's success, which could further increase the total yield. The lender also can switch to ownership or equity interest in the company if the loan is not paid by the agreed-upon date.

This is what makes mezzanine financing attractive to investors and lenders — it offers the yield of an equity investment, with the protection of being in a creditor position.

So how can mezzanine financing benefit your clients? Given the continued tightening of banks and senior lenders with respect to their loan to values (LTVs), borrowers are forced to put more capital into projects. Many commercial borrowers, including developers and individual investors, are looking to use as much leverage as possible, keeping them liquid and hopefully, maximizing returns.

Depending on the type of project the borrower



is getting into, however, high leverage may not always be the best way to structure the deal. It may cause negative cash flow or eat up most of the potential profits.

Mezzanine financing can be provided to the borrower quickly, with little or no collateral and with minimal due diligence. Because this type of funding can be a valuable tool for investors and developers, it is a product you should be familiar with and that you should be comfortable explaining to potential clients.

Although by its nature mezzanine financing

has no set terms or structures, there are some common deal terms used in these real estate transactions.

Straight debt instrument

This is the most-common financing for stabilized properties, and it is also the easiest to understand. The mezzanine lender takes a subordinate, or junior, lien position, usually to a combined loan to value (CLTV) of as high as 85 percent.

In this scenario, the lender has no equity participation in the project's cash flow and no say in the project management. Depending on the CLTV, project type and borrower strength, yields typically fall within the 9-percent to 13-percent range, with terms matching those of the senior note.



Joseph Bonora is the CEO of Joseph Scott Financial, a commercial and residential real estate lender. Specializing in acquisition and development, as well as in value-add transactions, Joseph Scott Financial provides debt-and-equity-placement, strategic-advisory and real estate investment-banking services. To reach Bonora, e-mail jbonora@josephscott.com or call (813) 968-5002. For more information, visit www.josephscott.com.

Continued ...

REPRINTED FROM *SCOTSMAN GUIDE* COMMERCIAL EDITION AND SCOTSMANGUIDE.COM, FEBRUARY 2007

All rights reserved. Third-party reproduction for redistribution is prohibited without contractual consent from Scotsman Publishing Inc.

Mezzanine Financing

... Continued

Participation note

When borrowers seek higher leverage and are willing to give up some of the cash flow or equity for it, mezzanine lenders can structure the loan as a participating debt instrument, which is a debt/equity hybrid, of sorts. By doing this, borrowers can usually get as much as a 90-percent CLTV, but they do give up some potential of a good project.

Lenders consider the higher risk when calculating the coupon rate and percentage of equity they will request from the borrower. Generally, they will require a greater yield. On a standard, stabilized transaction, the mezzanine lender will look for a 15-percent to 18-percent overall internal rate of return but may require a higher return for transactions it deems riskier.

Preferred equity

One step shy of a pure equity play, the preferred-equity structure gives the mezzanine lender some control over the project, along with a greater equity position. The borrower and lender usually enter into a partnership or joint-venture agreement, which defines the role each party will play, the equity ownership of each and any other terms.

Although many borrowers do not like giving up control of their projects, most are willing to if it means they don't have to commit substantial capital to the project.

On the other side of the equation, the mezzanine lender enjoys more control, a higher overall yield and the ability to step in and take over the property in the event of default. This is in exchange for the lender assuming greater risk with the high CLTV and limited borrower capital.

Uses for mezzanine finance

Investors once used mezzanine financing almost exclusively for corporate-finance deals. Today, they have found many uses for it in real estate. Stabilized properties, value-adds and new development are the three main types of mezzanine real estate transactions.

In the case of stabilized properties, the mezzanine piece is usually a straight debt instrument, subordinate to the senior note, with no equity component. This is the most common and straightforward type of mezzanine financing, as it contains the least amount of risk and is the easiest for borrowers and lenders to understand.

Mezzanine financing will only work if the stabilized property generates enough cash flow

to cover the debt service of the first mortgage and the mezzanine piece, along with the operating expenses. And it must provide the owner with a return.

Value-add, or nonstabilized properties, are properties where cash flow is not stabilized. This could be for any number of reasons — for example, when a property requires significant improvements to attract new tenants and increase lease rates. A borrower who has identified a potential opportunity to reposition a property would look to a mezzanine lender for the capital — more than what the senior lender will commit — needed to create value.

The mezzanine lender will look closely at the borrowers' and/or the project managers' résumés when underwriting the deal. Therefore, it is important for both parties to have experience and expertise in value-add investments.

Development deals are considered the riskiest of these three transaction types. As such, they are the most challenging to structure and require the most due diligence by lenders. Because developers, by nature, like to use heavy leverage on their projects, mezzanine financing is often a key component of the capital stack.

In development deals, mezzanine financing often takes the form of preferred equity rather than straight debt. This is because of two main factors: the lender's need to achieve a higher rate of return because of risk and the lender's desire to participate in the decision-making process and project management. The lender wants to do whatever it can to protect its investment.

Ultimately, the level of complexity varies between transactions. Basically, the more moving parts a transaction has, the more difficult it becomes to structure the capital stack to include mezzanine financing.



Mezzanine financing plays a big role in commercial real estate deals. Remember, as more residential loan officers move to commercial, the way to stay one step ahead is to educate yourself, learn as much as you can and continue to grow as a professional. 