NATIONAL REAL ESTATE Investor

PRI

Powered by

Mezzanine Lenders Gain Leverage

By Joe Gose

Aug 1, 2007 12:00 PM

To steal a Monday Night Football line from NFL Hall of Fame quarterback "Dandy" Don Meredith, "The Party's Over." Tighter underwriting standards, rising interest rates, and intensifying rating agency and bond buyer scrutiny in the commercial mortgage-backed securities (CMBS) market signal the end of a frothy period that might best be described as lenders gone wild.

Mezzanine and other subordinated debt lenders couldn't be happier. Although the changes have created pricing disarray in the capital markets that likely won't settle for months, mezz experts anticipate a slight jump in returns as the cost of subordinated capital grows between 25 and 200 basis points, depending on several factors including risk, project type, and the borrower's track record and relationship with the lender, experts say.

Additionally, analysts expect bond buyers of commercial real estate collateralized debt obligations (CDOs) to demand higher yields for subordinated loan products, which also will increase the cost of mezz. The bottom line is that pricier financing and the general capital markets shakeout will finally compress historically high asset prices.

"There's definitely a lot of action that's going on that's increasing the cost of capital," acknowledges Jeff Friedman, CEO of Mesa West Capital in Los Angeles, a variable-rate bridge loan lender. "The whole financing structure has changed."

Indeed, the more intense focus on loans is giving subordinated debt lenders more financing opportunities as the need for additional capital grows among borrowers. Borrowers typically use mezzanine and other subordinated financing to fill the gap between senior secured financing and equity, a strategy known as "leveraging" debt.

Over the past few years, borrowers have increasingly tapped the relatively cheap funding. Moody's Investors Service reports that $3.2 billion of mezz was securitized in CDOs last year compared with $25.6 million in 2004. That's just a sliver of the market; it doesn't include billions of dollars that lenders keep in their own portfolios.

But now senior lenders are no longer willing to loan as much money to fund projects as they were only a few months ago. That's leaving bigger financing gaps.

Crafting solutions

Los Angeles-based J.H. Snyder, a private property investor, last spring contracted to buy the three-building, 330,000 sq. ft. LAX Business Center in El Segundo, Calif., for $63 million. The company, which is pursuing a strategy to renovate and lease up a property that is 40% vacant, initially received a first mortgage commitment from an East Coast lender to fund 75% of the property's cost. Later, amid the capital market upheaval, the lender backed away.

The solution: Mesa West packaged a three-year, floating-rate bridge loan with Greenwich, Conn.-based RBS Greenwich Capital in which Greenwich provided senior debt for up to roughly 40% of the asset's purchase.

Mesa West financed the riskier portion of the debt, which was split into upfront funding of $17 million and a commitment to provide $14 million in additional capital to pay for tenant and capital improvements as the property

leases up. Once all the capital is deployed, total financing will amount to some 80% of the property's value.

The loan featured a blended interest rate of roughly 7.25%, or 190 basis points over the 30-day London Interbank Offered Rate (LIBOR): Greenwich's "A" loan and Mesa West's "B" loan cost about 65 and 350 basis points over LIBOR, respectively.

Greenwich's low-level participation stemmed from trepidation over lease-up risk and how much of its loan the rating agencies would consider investment grade. The apprehension was well founded. In a prime illustration of the capital market's further tightening, rating agencies did indeed reduce the amount of what they considered investment-grade debt. Mesa West, however, agreed to buy Greenwich's loan in just such a scenario.

Six months ago, real estate buyers of a similar value-add property would have used interest-only, fixed-rate financing to achieve a cheaper rate by some 150 basis points, Friedman says. But developers face a tradeoff now that rating agencies and bond buyers are pushing back on fixed-rate funding of those deals. That's giving lenders like Mesa West a chance to fill the void.

"Senior lenders aren't stepping up to 75% or 80% of leverage anymore — that ship has sailed," explains C. Drew Planting, a senior partner with J.H. Snyder, who arranged LAX Business Center's acquisition. "The leverage is still available." But, he concedes, borrowers are paying more for subordinated debt than they were a few months ago.

Costs creeping up

Mortgage experts say the cost of all forms of capital is increasing in light of higher interest rates and heightened scrutiny by the rating agencies. The 10-year Treasury yield, for example, was hovering around 5.1% in mid-July, an increase of nearly 50 basis points since April 30.

While borrowers are paying an additional 25 to 100 basis points or more for mezz compared with a few months ago, they're also using more mezz today than in the past, which is also increasing debt costs. Still, the brimming coffers of mezz lenders should provide enough competition to prevent dramatic price swings (*see sidebar p. 35*).

To finance relatively lower loan-to-value (LTV) levels — say 65% to 80% of a project's value — borrowers can still get an interest rate of less than 10%, for example. Borrowers using mezz to fund up to 90% or 95% of a property's value may pay a rate in the low to mid-teens or give the lender a cut of the cash flow or other so-called kicker.

Property price fallout

Experts also anticipate spreads increasing in the commercial real estate collateralized debt obligation (CDO) market, where lenders frequently pool and sell mezz, bridge and other loans. In February, for example, Mesa West issued a CDO in which bond buyers acquired 90% of the lender's loans at 36 basis points over LIBOR, Friedman says. The spread for that deal today likely has widened to around 65 basis points, he adds, and bond buyers would only acquire some 85% of the pool.

Yet exactly how much the CDO spreads will increase remains a question. Uncertainty in the CDO market has sidelined CDO issuers, and securitizations have dropped sharply over the last several months, notes Jim Shanahan, a senior analyst of specialty and mortgage finance for Wachovia Capital Markets in a recent research report.

Capital Trust, Gramercy Capital Corp. and other big mortgage real estate investment trusts (REITs) don't expect the deal flow of CDOs to pick up again until after Labor Day, according to the report.

Ultimately, the extra capital costs will reduce property prices from their historic highs, debt experts predict. Buyers won't be able to generate the same cash flow that they once could when the relatively cheap cost of capital and lax underwriting standards enabled them to pay lofty prices. Still, sellers have yet to acknowledge the pricing pressures, say seasoned industry players.

"It's all rolling downhill — the lenders are getting the news to the borrowers and it's going to eventually get to the sellers," says Jay Rollins, CEO of Denver-based JCR Capital, a fledgling lending firm that provides equity as well as senior and mezzanine debt. "We haven't seen it yet, but the increased cost of financing is going to translate into a decrease in asset valuations and asset purchase prices."

Additionally, rating agencies and bond buyers of subordinated debt are increasingly frowning upon fixed-rate, interest-only loans. They're pushing lenders to amortize loans, which would force borrowers to pay principal plus interest, says Gary Mozer, a managing director with George Smith Partners, a Los Angeles real estate investment-banking firm that arranges loans.

That's reducing the amount of proceeds borrowers can secure, which will also impair a borrower's ability to justify paying high property prices, especially leveraged buyers of high-priced, stabilized properties.

Up until a few months ago, buyers of those properties relied on cheap capital to eek out a cash-on-cash return of around 6%, adds Mozer, whose firm arranged $4.2 billion of financings in 2006.

But the combination of amortization, rising interest rates and widespread anticipation of slowing, or even stalling, asset appreciation has clouded exit strategies for such buildings. Lenders, rating agencies and bond buyers worry that a sale or refinance may not cover the debt if a property fails to perform.

Mozer should know. In May, he and other George Smith members all but escaped the capital market clampdown when they arranged some $37 million in financing for Santa Monica, Calif.-based Doerken Properties Inc. The funding financed Doerken Properties' purchase of the 141,310 sq. ft. Commonwealth Shopping Center from New Hyde Park, N.Y.-based Kimco Realty Corp., a retail REIT. The grocery-anchored project, near Sacramento, is 97.5% occupied.

Doerken Properties received a fixed-rate, interest-only loan for five years that represented 95% of the project's cost. The debt comprised a $33.2 million senior loan at an interest rate of roughly 6% and a $3.9 million mezz loan at a rate of 10%. The lender, Greenwich Capital, also received a preferred return and a 35% pari passu profit participation as part of the mezz terms.

Despite the turmoil hitting the capital markets at the time, Greenwich had already started marketing a loan pool for securitization that included the Commonwealth center financing, says Allen Lynch, president of Doerken Properties. Lynch doesn't expect to receive the same terms going forward and acknowledges that Greenwich required a larger profit participation than originally planned.

Lynch credits the company's longstanding relationship with Greenwich's Los Angeles office for the successful closing. “Our timing was fortuitous,” adds Lynch. “It would have been a lot more difficult had we not been part of that pool.”

Joe Gose is a Kansas City-based writer.

Borrowers can't always get what they want

The commercial real estate mortgage market's big push to re-introduce underwriting discipline among senior lenders has jolted the investment world, giving subordinated debt lenders more leverage to deny aggressive borrowers.

Until recently, borrowers routinely won favorable terms such as fixed-rate loans with interest-only terms for five or 10 years, even for risky deals. But today the new risk-reward equation benefits providers of riskier financing.

“More disciplined underwriting at the senior debt level has made our job easier,” says Jim Mazzarelli, managing director with Chicago-based Transwestern Investment Co., a provider of equity and mezz debt.

In today's market, mezz providers are generally generating returns ranging from just below 10% to the mid-teens, depending on risk, the project type, borrower and other conditions.

Several providers have raised or continue to raise more funds to finance subordinated positions, too. Transwestern Investment, for example, which oversees a $300 million mezz fund, has started another round of mezz capital raising.

Today's senior lenders are putting more of a premium on mezz providers who have proven real estate operating capabilities. That's because mezz and other subordinated debt providers typically secure their loans with an interest in the property's ownership group. Thus, a mezz lender steps into the owner's shoes in case of a default.

Case in point: Last year bridge and mezz loan provider Mountain Funding of Charlotte, N.C., took over four failed condo conversions in Florida from Boca Raton-based Bay Communities Real Estate. Mountain Funding had provided $178 million for the projects.

From a borrower's perspective, certainty of execution has become a concern, says Mazzarelli, who operates out of Transwestern's Atlanta office. That stems from senior lenders pulling back from loan commitments after sponsors had paid non-refundable deposits for acquisitions. Borrowers then scrambled to find mezz or other subordinated financing to make up the funding shortage.

Earlier this year, a senior lender required a Chicago office building buyer to increase its equity stake to $38 million from $33 million, Mazzarelli says. In the end, Transwestern financed the deal, but not all buyers left hanging will be so lucky. “The demand for mezz has gone up,” Mazzarelli says, “but whether you can underwrite it is a different story.”
— **Joe Gose**