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# COMMERCIAL REAL ESTATE MEZZANINE FINANCE: MARKET OPPORTUNITIES

*By David E. Watkins, David J. Hartzell, and Dean A. Egerter*

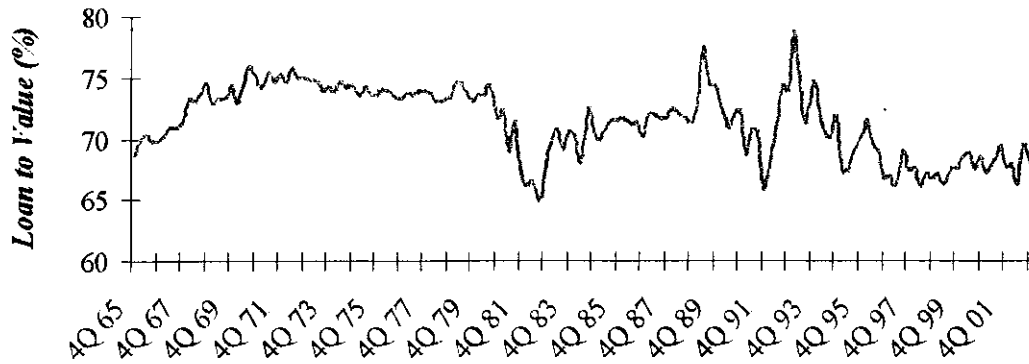
**David E. Watkins, CFA, and Dean A. Egerter** are senior vice presidents with Heitman Real Estate Investment Management in Chicago, IL.

**David Hartzell** is a professor of finance at the Kenan-Flagler Business School at the University of North Carolina, Chapel Hill.  
(E-mail: [dave\\_hartzell@unc.edu](mailto:dave_hartzell@unc.edu))

Mezzanine finance has become an important source of capital for commercial real estate acquisitions, development, and refinancings, as traditional first mortgage providers have become more reluctant to finance projects at loan-to-value (LTV) ratios in excess of 65%. The increased conservatism of lenders, partly in response to regulatory requirements and partly in response to commercial mortgage-backed securities (CMBS) market demands, has created a gap between what lenders will provide and what borrowers want from debt sources. Mezzanine finance has emerged to fill the gap. The result has been increased segmentation of the capital structure for specific real estate transactions. The challenge for finance providers is to price the mezzanine segment to provide compensation for the risk taken.

This paper provides background on the mezzanine finance market including changes in the first mortgage market that helped push the mezzanine market into greater prominence. We identify the primary situations in which mezzanine finance can play a role and discuss the risks and implications of extending mezzanine finance. We posit that examination of a borrower's motivations for using mezzanine finance provides insight on risk for potential providers of capital.

Exhibit 1  
Loan-to-Value Ratio, 1965-2003



Source: ACLI, Heitman Research

Mezzanine finance can offer favorable risk/reward opportunities for investors, but we do not embrace providing mezzanine finance in all situations. We recommend providing mezzanine finance to those borrowers whose interests are aligned with those of the mezzanine provider and the first mortgage lender. We do not recommend lending to those borrowers where moral hazard appears to be significant.

### FIRST MORTGAGE MARKET DEVELOPMENTS

In order to understand the mezzanine market, a brief review of changes in the first mortgage market will be helpful.

A typical real estate deal is financed with a combination of debt and equity. In the 1980s, some lenders were willing to provide mortgage loans at loan-to-value or loan-to-cost (LTC) ratios of up to 95%, with the investor/owner providing the rest of the capital required for property purchase as equity. Some of these 95% LTC/LTV loans turned into loans with LTVs in excess of 100% as property market and capital market fundamentals deteriorated. In 1989, average LTV ratios exceeded 75%, according to the American Council of Life Insurance (ACLI).

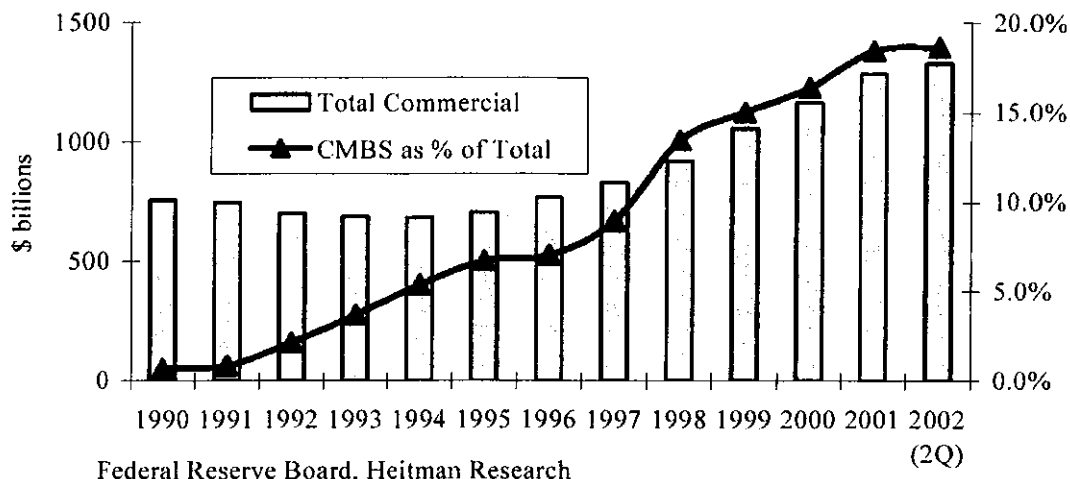
More recently, lenders have taken a more conservative approach to underwriting mortgage debt, with the average loan-to-value ratio falling to between 65% and 70% (Exhibit 1). In first quarter 2003, the average LTV was 67%, according to the ACLI. While insurance companies are not the only providers of commercial mortgage finance, they are an important source and give an indication of underwriting standards in the market.

Capital reserve regulations have played an important role behind increased lender conservatism. The Office of the Comptroller of the Currency (OCC), the national banking regulator, has developed a set of bank lending guidelines and an approach to calculating the amount of risk-based capital in the bank's asset portfolio. The "at-risk" schedule indicates the amount of reserves (as a percentage of the loan) that must be set aside for each category of loan. Commercial real estate loans with less than 75% LTV ratios incur a capital charge equivalent to that of investing in BBB-rated (investment grade) bonds. Loans with greater than 75% LTV ratios are assessed greater capital charges. Therefore, banks typically make loans that are less than the 75% LTV threshold.

A different governing body regulates insurance companies but follows a similar approach. The National Association of Insurance Commissioners (NAIC) has developed guidelines for state agencies to use in regulating insurance company investments. NAIC guidelines are similar to those of the OCC, with a minor difference on mezzanine finance. Though mezzanine loans and first mortgage loans are currently treated the same from an at-risk perspective, the NAIC has been contemplating a change for several years and insurance companies have largely aligned their practices in anticipation of the expected revision.

The CMBS market's development is another factor that has encouraged greater conservatism on the part of lenders. Securitized pools of real estate loans must undergo rating agency review in order to be saleable. The rating agencies rate the tranches according to the characteristics of the underlying

Exhibit 2  
CMBS Outstanding as % of Total Commercial Real Estate Loans



ing collateral pool of mortgages and the structure of the securities (i.e., subordination and credit protection). As they analyze each loan for its inherent risk, rating agencies and the buyers of the unrated and non-investment grade tranches (B-piece buyers) wield influence in determining underwriting standards on the individual loans that form the collateral. This process has pushed lenders toward greater uniformity in the mortgage market. LTVs and debt service coverage ratios have become more conservative as a result, especially if the loan is headed for a pool to be securitized.

The growing significance of the CMBS market has fostered the change. Securitized real estate loans made up approximately 18% of the total commercial real estate loan volume outstanding as of March 31, 2003 (Exhibit 2). This is up from less than 1% in 1990. The standards pushed by the CMBS market have filtered through the lending universe, motivating first mortgage lenders to evaluate risk/reward more prudently.

### MEZZANINE MARKET BASICS

With regulated lenders becoming more conservative, many equity investors are not satisfied with the amount of debt available to finance their properties. Lenders require that the owner provide 30-35% of the value of the property, while many borrowers prefer to limit their equity investments to 10-15% of value. In a stable operating environment, owners find it difficult to contribute a large share of equity and also earn returns on their capital in line with those of the recent past. Mezzanine

finance providers deliver additional capital to fill the gap between what the owner wants to borrow and what the first mortgage lender is willing to provide.

In occupying the middle ground, mezzanine finance providers bear greater risk than do first mortgagees, but less risk than equity owners. This reflects the priority of claims on cash flows. First mortgages have first claim on cash flow, mezzanine providers are next in line, and equity investors receive the residual. In the event of borrower default, mezzanine providers have an option to assume the first mortgage obligation. This option must be exercised or the first mortgage lender can foreclose on the mezzanine position and the owner. Alternatively, the mezzanine provider can choose to walk away from the bad investment without the obligations of the original owner (the borrower) or the new owner (the first mortgage lender).

The current pay financing cost of the capital structure increases when mezzanine is introduced and overall debt service coverage ratios decrease and loan-to-value ratios increase. For bearing risk greater than that of first mortgagees, mezzanine finance providers receive an expected return in excess of that of first mortgages, typically in the 8-20%+ range, depending on the part of the capital structure they are providing and the risks inherent in the underlying property.

Mezzanine finance, by definition, defies generalization—there is no typical or standard deal structure. Each financing consists of unique terms and conditions that depend on the preferences of the user and provider and that emerge from a highly negotiated process. The mezzanine piece can be structured as debt or equity, depending on how much capital the owner wants and how much control the owner wants to cede to the mezzanine partner. Second trust debt and junior debt are common names for mezzanine finance, structured as debt, that typically bring the total LTV ratio as high as 85%. Preferred equity and gap equity are common names for equity-type financings that bring the capital structure above 85% LTV.

### EXAMPLES OF MEZZANINE FINANCE DEAL TERMS

In all the scenarios indicated below, assume the owner (also referred to as the sponsor) has a stabilized property and has secured first mortgage financing at 70% LTV.

In the most straightforward approach, the mezzanine finance provider offers a debt instrument, often called junior debt, to the property investor or owner. In this case, the first mortgage and mezzanine financing range from 70-80% all-in loan to value. Given the nature of the fixed-income contract, and the relatively low, from a historical perspective, loan-to-value ratio, mezzanine lenders typically receive a fixed-income yield, currently in the 8-12% range. In this example, the mezzanine finance provider is purely a lender to the borrower.

Other owners seek greater loan-to-value ratios, and are willing to share participation in the cash flows of the property. For example, filling the financing gap to bring the property to an 80-90% LTV, often called participating debt or preferred equity, typically includes a fixed-income component and a small participation or exit fee. This type of financing will offer the mezzanine lender a current yield that is slightly lower than that of the junior debt vehicle described above, and a participation in the cash flows of the project. The current-pay interest rate on this type of mezzanine debt ranges from 9% to 11%. The deal typically includes participation of 10-15% in the property's operating cash flows and sale or refinance proceeds that can raise the overall mezzanine IRR to 15-18%.

In the case of preferred equity, the borrower and mezzanine finance provider usually enter into a

joint venture agreement in order to effect the transaction. A joint venture agreement can give the mezzanine finance provider more control over the operations of the property, as well as spell out participation, lookback and other terms. Moreover, the JV agreement can expedite the mezzanine provider's ability to take over the property in the event of default and can enable the mezzanine position to keep the first mortgagee from foreclosing and taking control of the property.

Mezzanine financing that fills the financing gap to the 91% to 95% LTV range, often referred to as gap equity, implies that the mezzanine finance provider bears equity risk. The equity owner and the mezzanine provider negotiate a joint venture that offers a current pay interest rate of 9-11%, a lookback provision that raises the yield to 14-18%, and 15-30% of the total proceeds at disposition or refinance. IRRs in this latter type of deal can exceed 20%. The mezzanine provider takes greater risk but has more control and can earn greater overall returns.

### FORM OF SECURITY

Security in the property varies depending on the nature of the deal that the borrower and lender have struck. In general, the better the security the lower the return.

Mezzanine deals that are structured as debt instruments usually have one of the following forms of collateral:

- *Second deed of trust*—This is the most desirable to the lender and provides the most concrete form of collateral. A second deed allows the mezzanine lender to foreclose on the property if the owner defaults on payments to the mezzanine lender. The first mortgage lender typically does not allow this type of arrangement with a second lender, and therefore this type of security is rare.
- *Assignment of partnership interest*—The most common form of debt security in the mezzanine finance universe, the lender can take the borrower's interest in the property in the event of default. Effectively the mezzanine lender becomes the equity owner and assumes the obligations to the first mortgage lender.
- *Cash flow note*—The lender receives all cash flow from the property in exchange for the mez-

zanine loan proceeds and a percentage of the proceeds from sale of the property. The cash flow note is not a recorded instrument and typically does not need an intercreditor agreement. This is also called a soft second.

Deals structured as equity have a different set of characteristics. Equity deals are joint ventures between the equity/owner and the mezzanine lender that are guided by the partnership agreements. Major provisions in the partnership agreements cover decision-making authority and specify decisions that require approval from the mezzanine partner. The owner/sponsor has significantly less overall control over the project and may lose all control if the property does not perform as expected.

Owners sacrifice flexibility, control, upside potential, and will pay more for the capital. In return, they are required to contribute less cash (sometimes as little as 3-5% of the total property value) and they take on a partner who might be able to help them if the property starts to falter.

#### **INTERCREDITOR AGREEMENT**

The first mortgage lender and the mezzanine provider negotiate the intercreditor agreement, which provides for communication between the first mortgage lender and the mezzanine finance provider, and gives certain rights to the mezzanine provider in default events. Many first mortgage lenders, including almost all conduit lenders, refuse to negotiate intercreditor agreements, especially if the loan has already closed. In fact, conduit loan documentation routinely prohibits selling or transferring more than 49% equity ownership in the property to a partner. Some non-conduit lenders take the attitude that their interests are already covered in the agreement with the borrower and there is no need to complicate matters by bringing in an additional financial partner with objectives that might not align with those of the lender.

Other lenders take the view and realize that mezzanine lender can bring value to the deal. The additional capital can allow the owner to pay leasing commissions or tenant improvements to bring in a new tenant, renovate the lobby, or pursue other value-added strategies. In this case, particularly when the mezzanine provider is an experienced real estate owner/operator, the first mortgage lender will welcome the participation of the mezzanine provider. The experience factor can be

important, as sometimes-reluctant first mortgage lenders can be persuaded that it is in their best interests to deal with an experienced group, especially if the property defaults.

The mezzanine finance provider typically negotiates for several elements in the intercreditor agreement. These include:

- Notification of non-payment or default on the first mortgage. The mezzanine lender wants to know -- from someone other than the owner -- that the property is being managed professionally.
- The right to cure any default on the first mortgage. The mezzanine position wants to protect itself by taking over the property and not allowing the first mortgage to foreclose and take possession.
- The right to foreclose on the property if the owner fails to pay the mezzanine position. First lenders hardly ever agree to this clause, as a building that is in foreclosure creates uncertainty among existing tenants (who might elect not to pay rent) and prospective tenants (who might view the property as tainted and unstable).

In summary, intercreditor agreements can be difficult to attain, but can benefit the mezzanine finance provider greatly.

#### **TERMS AND EXIT STRATEGY**

The most common mezzanine financing vehicles provide for maturities of two to three years, with the possibility of extension beyond that for one-year periods. If a borrower wishes to extend the mezzanine financing, the lender typically charges a significant fee to protect its IRR.

Takeout of the mezzanine financing can occur in several ways. The best case for the first mortgage lender and mezzanine provider is when the borrower pays back the principal, interest and fees owed to both sources of capital. This can happen when the property is sold and the proceeds pay off the first and mezzanine positions, or when the property's value and cashflows increase enough to allow a new first mortgage to pay both the original first mortgage and the mezzanine provider.

Another possible exit is for the property cash flows to cover all of the debt service on the first mortgage

but not all of the current pay portion of the mezzanine. In this case the borrower and the mezzanine finance provider will negotiate an outcome. The borrower usually wants to delay foreclosure as long as possible in order to participate in a future upswing in property-level cash flow or property value. The mezzanine finance documentation and the joint venture agreement become critical at this stage in determining the outcome. The borrower and the mezzanine position will either restructure the mezzanine obligation or the mezzanine position will take title to the property. At that point, the mezzanine position will need to meet with the first mortgage lender because the property has most likely gone into technical default for breaching debt service coverage or loan to value ratios. The intercreditor agreement will be critical at this stage.

The final scenario is when the cash flows decline to a level inadequate to meet the debt service on the first mortgage. In this case, the mezzanine position will have already assumed the role as the equity owner of the property and will negotiate a workout with the first mortgage lender. The mezzanine position, in some cases, will fund cash flow shortfalls if prospects for a turnaround are favorable. In other cases the first mortgage lender will take possession of the property. As in the previous scenario, the intercreditor agreement plays an important role.

In many cases, the mezzanine financing ends at the time of refinancing. Refinancing both the first mortgage and mezzanine positions is favorable to the mezzanine finance provider and the borrower, in that sale of the property is not required. Given the illiquidity of private real estate markets, sale at a specific time to coincide with a mezzanine term may not be possible. That said, however, sale of the property to pay back the first and mezzanine loan can be the best execution.

A refinancing takeout can only be achieved when the value of the property has increased to the extent that the balance of the new first mortgage will be adequate to pay off both the original and mezzanine positions and can be underwritten at traditional loan to value ratios. For example, a lender who refinances will look for an LTV in the 65-70% range, and debt coverage ratios within current underwriting standards. For this to happen a value creation event needs to occur: rents have to increase, expenses have to decline, or capitalization rates have to decrease. To help, mezzanine loans

may be fully or partially amortizing, which reduces the loan balance while debt service payments are being made. More typically, however, the mezzanine position takes a current pay, interest-only position and participates in a look-back provision, cash flows above certain levels, or exit fees.

## **SIZING THE MEZZANINE FINANCE MARKET**

The mezzanine finance market lacks a ready source of aggregate data, as it is not tracked by any industry group or government entity. Instead, we estimate the size of the potential market based on our view of the realistic candidates for mezzanine financing. While our estimate of the size of the potential market is grounded in facts, we can only speculate about the actual size of the current market.

A reasonable place to start is with the universe of all commercial real estate, which PricewaterhouseCoopers estimates to be approximately \$4.6 trillion as of October 31, 2002. This pool of real estate, however, includes properties that are unlikely to be candidates for mezzanine finance, and we therefore exclude them. For example, pension funds, opportunity funds and REITs maintain conservative capital structures on their holdings, using debt at LTV ratios that can be achieved by borrowing from first mortgage lenders. Other property owners prefer to keep their holdings 100% debt-free. Corporate-owned real estate assets represent another large slice of the real estate universe that are not candidates for mezzanine finance; these properties are typically financed under the corporation's overall capital structure. The \$4.6 trillion universe also includes small properties that exist beneath our threshold of interest and properties in nontraditional classes such as marinas, bank branches, and storefront retail with office or residential above. All of these latter types are eliminated.

The assets we eliminate undoubtedly represent a sizable share of the overall real estate universe, but we are unable to quantify their total value with any precision. Although we don't have a sound basis for aggregating the value of the excluded properties, we nevertheless conclude that the universe of potential property for mezzanine finance is something less than \$4.6 trillion. We therefore take a different approach.

Exhibit 3  
**Commercial Mortgages Appropriate for Mezzanine Finance**  
 31-Mar-03

Multifamily

Source of Mortgages	Commercial	Residential	Total
Commercial Banks	719.5		96.8
Savings & Loans	82.7	69.8	
Life Insurance Companies	195.4		36.9
Government Sponsored Entities		49.2	
Mortgage Pools		96.6	
Total (\$ billions)	997.6	349.3	1,346.9

Source: Federal Reserve Board, Heitman Research

Excludes ABS and other categories deemed to be inappropriate in a mezzanine framework.

**Alternate Approach:** In the alternate approach to sizing the potential mezzanine finance market, we start with data from the Federal Reserve Board on commercial and multifamily residential mortgages. Properties that have qualified for loans from banks, insurance companies and savings and loans meet our criteria as targets for mezzanine finance. The Fed estimates that total commercial mortgage finance outstanding totaled \$1.9 trillion as of March 31, 2003. Grossing up this \$1.9 trillion of real estate debt (using a 68% LTV ratio, as discussed below) to the total value of property encumbered by the mortgages gives an upper limit to the potential universe of investable property for mezzanine finance. The upper limit is therefore approximately \$1.9 trillion divided by 68% or \$2.8 trillion.

This grossed-up number is likely too large, however, as it includes property subject to loans made by conduit lenders and sold via the public markets as CMBS. CMBS documentation and covenants make mezzanine financing on securitized loans difficult—not impossible—but difficult enough to justify excluding them from the universe. Instead, we focus on loans made by commercial banks, savings & loans (S&Ls), life insurance companies (LICs), government sponsored entities (GSEs), and other pools. Outstanding mortgages (both commercial and multifamily residential) in our subset totaled \$1.3 trillion (Exhibit 3).

The next step is to determine a reasonable total value of the properties subject to the \$1.3 trillion of mortgages, which will then lead us to an estimate for the total potential mezzanine market (Exhibit

4). Conservative mortgage lending underwriting that has characterized the real estate finance world in the past decade suggests that LTV ratios average less than 70%. As indicated previously, the ACLI data on LICs' underwriting standards indicates that the average LTV in first quarter 2003 was 68%. While other types of lenders might use different underwriting standards, we conclude that the overall LIC LTV provides a reasonable proxy for the market's LTV. Grossing up \$1.3 trillion of commercial mortgages by 68% results in a mezzanine financeable real estate universe of \$2.0 trillion. At an LTV of 85%, which is a standard mezzanine finance and first mortgage capital structure, mezzanine lenders could potentially provide 17% of the total real estate value. This suggests that the potential size of the mezzanine finance market approximates \$337 billion (Exhibit 4).

Uncertainty surrounds the size of the current market. No reliable estimates of the current size of the market are available, but our best guess is that the amount of mezzanine financing outstanding approximates \$40-50 billion. We base our estimate on a review of industry publications that describe activity. Subtracting our estimate of a current market of \$50 billion from the \$337 billion estimate of the potential size of the mezzanine market leaves \$287 billion.

A portion of properties that have a mezzanine position in place will need to be refinanced each year, though the amount refinanced is likely to be less than the amount of mezzanine finance expirations. With the typical mezzanine term of 3-4 years,

Exhibit 4  
**Potential Market Estimate**  
 31-Mar-03

Total Mortgages	1,346.9
divided by	68%*
Total Investment RE	1,980.7
times	17%**
Potential Mezzanine Position	336.7
Current Mezzanine Market	50.0
Mezzanine Candidates	286.7
Mezzanine Refi candidates (20% of current market)	10.0
Estimated Total Potential Market	296.7

\*Loan to value ratio per ACLI; \*\* Gap between current LTV and Mezzanine LTV of 85%

Source: Federal Reserve Board, ACLI, Heitman Research

potentially 25-33% of all mezzanine financings are candidates for refinance. In reality, fewer mezzanine refinancings actually close, as owners are more likely to roll the mezzanine piece into a first mortgage if enough value has been created, or sell the property and pay off the mezzanine provider and the first mortgage provider. Alternatively, the owner will extend the existing mezzanine loan, after paying a fee.

We therefore estimate that 15-20% (rather than 25-33%) of the total outstanding mezzanine universe represents candidates for refinance annually. If the outstanding market for mezzanine finance is \$50 billion, then annual refinance volume will be \$7.5-10 billion (15% or 20% of \$50 billion). Annual mezzanine finance activity includes the refinance amount plus the amount of the remaining \$287 billion of the potential market captured in the given year. We therefore conclude that the total amount of potential mezzanine finance activity is approximately \$297 billion.

While our number seems large, we view it as a conservative estimate. Some suggest using 90% as the third-party-financed capital structure. The potential portion of mezzanine finance would total 22% (90% less 68%), rather than 17% as assumed above, increasing the overall size by almost \$100 billion. Moreover, the average LTV is likely to be less than 68% on average because of conservative borrowing, valuation increases, and amortization of principal—all of which decrease the LTV of outstanding loans and increase the size of the potential mezzanine market. The potential market could therefore be as large as \$375-450 billion.

On the other hand, we conclude that the potential market is not that big. Many properties are not appropriate candidates for mezzanine finance because they are located in markets that have unfavorable current conditions such as declining rents or increasing vacancies. In addition, the \$1.3 trillion in subset of commercial and multi-family mortgages (referenced above) most likely includes loans on properties not appropriate for mezzanine finance, (eg, small and nontraditional commercial properties). Further, many mezzanine financiers will provide capital only if the entire debt capital structure—both first mortgage and mezzanine piece—can be refinanced in two or three years. Similarly, a property that has a long-term lease with a single tenant that has negotiated flat rents over the term will not be a candidate for mezzanine financing, unless the owner plans to sell the asset at the time of or prior to expiration of the mezzanine term.

Our estimate of market size differs from that of others who have made attempts to quantify the mezzanine market. For example, Prudential Real Estate Investors concluded that the potential mezzanine market is \$65-135 billion with annual demand for \$18-34 billion. PREI assumes that 10-15% of the \$4.6 trillion real estate universe has mezzanine financing as part of its capital structure and that mezzanine represents 15-20% of the value of the property with mezzanine finance in place. PREI includes below investment grade CMBS tranches in its estimate, which increases their estimate. PREI's overall number comes out lower than ours, but is based on a different set of assumptions.



## SITUATIONS FOR USE OF MEZZANINE FINANCE

Mezzanine finance users and their motivations differ, and these differences merit discussion. For purposes of this paper, properties fall into the stabilized, value-add, or development category, with each group having specific characteristics that make them more or less attractive to mezzanine finance providers.

**Stabilized Properties**—Stabilized properties are the most common in the investable real estate universe. Under our definition, these are operational, fully-leased properties that generate cash flow adequate to service a mortgage and provide a return to the equity owner. Stabilized properties are candidates for mezzanine finance when their cash flows can support an LTV greater than that of the typical first mortgage. Owners of stabilized assets will seek mezzanine financing to leverage their returns or limit their at-risk capital.

Mezzanine finance for stabilized properties occurs in two primary situations:

- A buyer seeks financing related to acquiring a property; and
- An owner wants to take equity out of a property.

In the first case, the buyer either doesn't have or prefers not to allocate the entire amount of the equity required by the first mortgage lender in order to close the transaction. The mezzanine financing piece serves as gap or supplemental equity, even though it may be structured as a second mortgage. In the latter case, the owner looks to mezzanine, allowing the owner to realize a return of capital on an existing investment that has increased in value. The owner, in effect, is selling all or a portion of the owner's at-risk capital to another entity, the mezzanine provider.

**Non-stabilized or Value-Added Properties**—A second category of mezzanine finance opportunity is value-add properties. These are situations in which the cash flow in place is not stabilized. We acknowledge that mezzanine financing has no place in non-stabilized property where cash flows are expected to decrease. We therefore only consider situations where the borrower has identified an opportunity to create value by executing a plan to increase cash flow to a greater level of stabilization.

Existing assets can be undervalued (and therefore candidates for a value-add strategy) for a variety of reasons. Sometimes the asset is underutilized and therefore undervalued because of below market rents paid by significant tenants whose leases expire in the near term and who are likely to renew their leases at (higher) market rates. In other cases the building has significant vacancy and requires leasing activity and tenant build-out or leasing commissions. Other owners plan to make moderate capital expenditures to reposition the property as a higher class and therefore capture greater rents.

We note that execution risk on value-added strategies is significant, thus the operator/owner ability and experience are important investment criteria that must be underwritten. As in our analysis of stabilized properties, mezzanine finance can be provided in two value-add situations:

- Existing owner needs capital to execute value-add strategy; and
- New buyer seeks to execute value-add strategy.

In both cases the owner has a plan to create value over a pre-determined period of time, and needs capital in excess of what a typical first mortgage lender will provide to implement the plan. We prefer providing mezzanine finance to new buyers as this latter situation allows for better measurement of the equity contribution of the owner and better specification of the risk/reward tradeoffs across the capital structure. Providing mezzanine finance to an existing owner looking to execute a value-added strategy raises the same moral hazard issues discussed below.

**Development**—Development of commercial property is risky. Developers must build to a budgeted cost and then stabilize properties through lease up. In general, developers are heavy users of leverage in their strategy execution. In a weakening property performance environment, construction lenders are increasingly wary of how their loan, originated on a loan-to-cost basis, will be viewed once the asset is stabilized and valued in a disposition or a long-term refinance. Mezzanine plays a role as construction lenders become more conservative and developers look to be fairly compensated for their risks. Mezzanine is recommended in development situations, but only under certain circumstances. The mezzanine provider is advised to:

Exhibit 5  
**Mezzanine Finance Situations**

Type of Situation	Risks	Favored Mezzanine Strategy	Structure/Returns
Stabilized Property Refinance	<p>Stability of cash flow</p> <p>Relative returns to equity and mezzanine hard to compare</p> <p>Low borrower's basis in the property after refinance can create moral hazard</p>	No. Moral hazard issues.	If contemplated, preference is to structure as equity with kick out rights of general partner.
Stabilized Property Acquisition	<p>Stability of cash flow</p> <p>Is cost = value</p> <p>Principal risk on reference/sale</p> <p>High leverage mezzanine investment can create mis-alignment w/ borrower</p>	Yes. Situation allows comparison of relative risk/rewards for mezzanine and equity to help in structuring preferred return.	Long-term mezzanine investment situation. Amount of term refinance risk dictates rate. Mixture of debt and equity return.
Non-stabilized Property w/ negative cash flow trends	<p>Stabilized value is lower, but how low</p> <p>Borrower motivation</p> <p>Projecting cash flow</p> <p>Market/sub-market risk</p> <p>Property risk</p>	No. Hard to imagine a situation where this is an attractive strategy for a non-control investor.	N/A
Value-add Refinance	<p>Going-in value is subjective</p> <p>Relative returns hard to measure</p> <p>Low borrower's basis in the property after refinance can create moral hazards borrower self-selecting?</p>	No. Potential moral hazard.	If contemplated, strong rights to kick out partner are a must. Lack of borrower commitment/fresh equity to property is a major concern.
Value-add Acquisition	<p>Is cost = value</p> <p>Value-add business plan execution</p> <p>Timing of execution</p> <p>Does capping projected stabilized cash flow at exit create alignment between mezzanine and borrower?</p>	Yes w/ existing sponsors who have executed strategy before in property type and market. Alignment with borrower based on relative share of profits for equity risk taken is important to quantify.	Make term of investment slightly longer than business plan. Define exit alternatives upfront. Examine share of "equity" provided to transaction to determine percentage of profits at exit. Structure with declining percentages above target returns.
Development	<p>Execution risk to develop</p> <p>Execution risk to lease to stabilization</p> <p>Timing of execution</p> <p>Market/sub-market risk</p> <p>Property risk</p>	Yes. Mezzanine term should be for the time to create initial cash flow stabilization. Easier to structure with merchant builders than long-term holders. Alignment with borrower based on relative share of profits for equity risk taken is important to quantify.	Greater variability of outcomes from higher execution risk requires higher return for relative slice of the capital structure. Should cap upside only in exchange for high preferred return.

- understand the amount of equity being contributed by the owner and its ability to recapture it through development, management, and lease-up fees;
- evaluate returns expected by each of the slices of the capital structure; and
- have a pre-determined plan for exit (i.e., return of invested capital) at or shortly after initial stabilization.

## RISKS

A number of risks are common to all real estate projects, and some are particularly relevant from the mezzanine finance provider's perspective. These risks include:

- **Tenant risk**—the risk that tenants go bankrupt and are no longer obligated to pay rent, impairing a property's ability to service debt;
- **Market risk**—the risk that market conditions change for the worse and that vacancy rates increase or market rents decline at time of refinance, leading to an inability to pay off in-place financing; and
- **Capital market risk**—the risk that capitalization rates increase and valuations decline, leading to inability or unwillingness to pay off financed positions.

**Moral Hazard**—One incremental risk that applies to any situation with a borrower and a lender is referred to as moral hazard. Put simply, moral hazard is the risk that the borrower's behavior will run counter to the interests of the lender. Moral hazard is a risk that increases as the borrower's stake in the property decreases. As the owner's share of equity declines, he/she has less incentive to manage the property to generate steady, consistent payouts to cover debt service on the first and mezzanine finance positions. Instead the owner treats its ownership position more like an option and is tempted to pursue strategies with greater potential payoffs, but with significantly greater risk. First mortgage lenders attempt to mitigate moral hazard by requiring significant equity participation from the borrower, thus the 65% LTV ratios. Mezzanine finance providers bear greater risk from moral hazard, as their capital position will suffer loss before the first mortgage.

**Moral Hazard-Stabilized Property**—The level of moral hazard provides a framework for evaluating types of borrowers. Consider stabilized properties.

Owners of stabilized properties using mezzanine finance to cash out equity from their properties pose a greater risk than do owners seeking a higher LTV/LTC in the acquisition of a stabilized property. Value in the refinance/equity cash-out case is subject to the vagaries of the appraisal and valuation process, and concluded value can be overestimated, resulting in little likelihood of eventually recovering the mezzanine amount at a refinance or sale of the property.

The owner of a stabilized property might use mezzanine financing to eliminate/limit downside equity exposure of property ownership. With mezzanine finance, the owner can take out equity in a property without incurring sale-related tax liabilities. Moreover, he/she can maintain residual ownership of property level cash flows, capture value in excess of the first and mezzanine positions, and continue to earn property management fees.

For example, assume a property was purchased five years ago for \$10 million using a 65% first mortgage and the property has now increased in value to \$15 million. The owner can secure new first mortgage debt and mezzanine financing that will bring the overall LTV to 80%, allowing him/her to effectively capture the difference between the value of the property and the balance of the loan. The owner will end up with its original \$3.5 million of equity and an additional \$2 million in cash, assuming the original mortgage had no amortization. The owner, moreover, will retain equity ownership of the property, avoid capital gains tax, and keep the management contract for the property. Having cashed out of its original investment, the owner now is less aligned with the first mortgage lender and the mezzanine provider. With a smaller slice of the cash flow and residual value, the owner's motivation can shift to pursuing a high-risk/high return strategy that provides at least enough to protect the management fee income stream.

A stabilized property's acquirer has less moral hazard than does the refinancing owner, as long as the mezzanine provider makes the borrower contribute meaningful equity in relation to the property management fee that the owner will be earning. Significantly, the loan to value ratio is better defined in the acquisition scenario, being determined by an arm's length transaction between willing buyer and seller. Moreover, the acquirer, the first mortgage lender, and the mezzanine finance

provider are allocating capital at the same time to a property that they have all evaluated and concluded makes economic sense.

**Moral Hazard-Value-Add**—Compared to stabilized properties, value-add properties have a different risk profile and are typically more appealing to lenders from a moral hazard perspective. Foremost, the mezzanine provider extends financing based on actual costs of the project, as opposed to an appraised value. (Owners often receive a credit for contributing land or developer fees, but we ignore these complicating factors in this analysis.) The advantage is that the owner of the project will be far more careful about managing expenditures when he/she has an expected payoff that is tied to the success of the finished product, and when he/she is contributing a portion of the costs of the deal.

**Moral Hazard-Development**—Development deals are similar to value-add although often different in magnitude and time requirement. The sponsor initiates a development project because he/she thinks the IRR will be favorable. The sponsor has a plan and a specific timetable for completion of construction, leaseup and securing permanent financing. The owner uses mezzanine finance to cover a portion of construction costs, tenant improvements, leasing commissions, and other capital expenditures. As in the stabilized property acquisition, it is critical that the owner has significant equity at risk (relative to development fees earned) in order to mitigate moral hazard.

Mezzanine finance providers can evaluate the project and draw their own conclusions as to whether they think the owner will perform the construction according to the plan and then determine the likelihood of the property achieving the rents and leasing activity that has been projected. If the conclusion is positive, then the mezzanine provider expects to be repaid when the owner receives permanent financing at standard LTV ratios—enough value will have been created for the construction lender and the mezzanine provider to be paid off.

**Value-Add and Development-Additional Risks**—The risks present in any value-add transaction include tenant risk, market risk and capital market risk, as highlighted above, as well as:

- Plan risk: the risk that the owner has specified a flawed plan;
- Execution risk: the uncertainty regarding the owner's ability to execute the plan;

- Timing risk: the risk that the plan and its execution will encounter unanticipated delays; and
- Exit risk: the risk that the capital market will have changed and first mortgage underwriting will no longer provide enough capital to take out the construction loan and the mezzanine loan.

Pricing of value-add development and redevelopment mezzanine transactions needs to reflect and compensate the provider for the additional risks.

## IMPLICATIONS FOR TRANSACTION SIZE FOR THE MEZZANINE FINANCE PROVIDER

**Large Loans (Greater than \$15 million)**—Acceptable deal size is a primary consideration for mezzanine providers. Assuming a 20% mezzanine piece of the capital structure between 65% and 85% LTC/LTV, the property has to be valued at \$75 million in order to generate a \$15 million mezzanine investment.

Advantages include:

- Large loans allow an organization to put capital to work quickly and at less cost per dollar invested, as the lender must go through the same steps to close a \$50 million mezzanine loan as it does to close a \$1 million loan.
- The properties on which large loans are made tend to be more institutional quality and have higher profiles and will garner industry press and publicity for the mezzanine lender.
- The large loan market is such that once a mezzanine provider has established credibility, B-note and other deal sources will actively bring transactions to the provider for evaluation.

Disadvantages include:

- Properties that can support a \$15 million mezzanine position are less common and the flow of transactions are less frequent.
- The portfolio of a large mezzanine loan provider is by nature less diversified by property type (concentrations in office and hotels) and more than likely by geography (concentrations in CBD office in 1st tier MSA).
- The number of potential capital sources creates competitive bidding situations that drive down returns.

**Small Loans (Less than \$15 million)**—A less competitive and potentially more attractive area for a new mezzanine finance entrant is small mezzanine loans. Using the logic above, a small loan program entails transactions on properties valued between \$10-75 million.

Advantages include:

- Providers of small mezzanine loans are more likely to be able to create property type and geographic diversification.
- Borrowers at this level tend to know fewer sources of capital, making the deal process less competitive.
- The \$10-75 million transaction segment is the most active and vibrant trading market for real estate property helping a lender see deal flow and enabling exits.
- The \$10-75 million first mortgage market is the most competitive allowing mezzanine lenders to leverage off of low cost/higher leverage first mortgage debt to generate mezzanine returns.

Disadvantages include:

- Sourcing is important, especially to create a national diversified portfolio of loans.
- Small loan size means that the mezzanine provider must originate a large number of transactions in order to place a substantial amount of capital.

## CONCLUSION

The mezzanine financing market represents an opportunity for both lenders and borrowers. Given our estimate of potential market size of \$297 billion, and current outstanding volume estimated at \$50 billion, the market has a long way to go until

borrower appetite for mezzanine finance is satisfied. However, many aspects of mezzanine financing must be considered prior to either lending or borrowing. This paper identifies situations where mezzanine finance may be a reasonable strategy, pointing out important components of deal structure and potential returns, and also describing the risks that mezzanine providers must acknowledge and underwrite.

Deal terms vary and are highly negotiated, resulting in a market characterized by a lack of uniformity. Mezzanine finance providers take 80% of the equity in a real estate transaction, resulting in LTV ratios, when combined with the first mortgage position, of 70-95%. Returns to the mezzanine finance provider are structured with a range of terms. Varying levels of origination fees, current pay coupons, cash flow participation, lookback provisions, and exit fees are typical components that can be adjusted according the parties' wishes.

One characteristics does not vary across deals: the importance of understanding and underwriting risk. Mezzanine providers are advised to determine the borrower's motivation for tapping mezzanine capital. Extending a mezzanine loan to allow a borrower to cash out of a stabilized property is not recommended as a strategy. Creating a clear joint venture agreement and negotiating an intercreditor agreement and structuring the payoff to align the owner's interests with those of the financial partners are important aspects of a mezzanine transaction that can be profitable for all parties concerned. Structured properly, with the right partner and the right property, mezzanine finance investments are likely to generate favorable returns.