

Mezzanine and Equity Financing For Real Estate Deals:

Historically, foreign entities have been willing to invest in the U.S. real estate market either as the senior lender to the project or as an equity player. Recently, foreign investors have shown a greater willingness to also provide the mezzanine financing for U.S. real estate projects. This article discusses the business and legal differences and risks associated with this type of financing as compared with equity financing.

What is Mezzanine Financing

If the owner developer has a reasonable amount of the equity required, mezzanine financing will provide an excellent way to execute the business plan and control the outcome of the project.

Mezzanine financing is generally a type of subordinate debt financing that provides financing between the senior loan and the equity in a venture or project. Generally, mezzanine financing takes the form of a second mortgage loan that provides the sliver of financing from 75 to 90 percent of the total capital requirements.

The following example describes the concept of mezzanine financing. Assume that a project has an existing cash flow of \$1 million and a projected cash flow of \$1.35 million. The acquisition price is \$10 million. Additional capital will be required for redevelopment costs including lease up and tenant leasehold improvement of \$1 million (redevelopment costs). A number of lenders are willing to provide \$7.5 million of financing at, for example, 6-7 percent interest. The mezzanine loan would be for \$1.5 million, which would advance between 75 and 90 percent of the acquisition costs and 90 percent of the redevelopment costs. The owner-operator is required to fund 10 percent of the acquisition cost and 10 percent of the redevelopment cost. The senior lender will fund 75 percent of the capital (\$7.5 million), the mezzanine lender will fund between 75 percent and 90 percent of the capital (\$1.5 million), and up to 90 percent of the redevelopment costs (\$900,000).

This is a very traditional mezzanine loan providing higher risk capital, in a value-added transaction, thereby increasing the returns to the equity.

This part of the article describes (1) the different types of mezzanine financing, (2) the returns that investors who make mezzanine loans seek, (3) the different forms the mezzanine financing will take, and (4) how the return will be structured,

Types of Mezzanine financing

Mezzanine loans assume many different structures.

1. *Traditional mezzanine in a value-added transaction.* This is the most common form of mezzanine financing and is illustrated by the earlier example. It is generally a loan in which property will have debt service coverage after meeting the requirements of the first mortgage and the mezzanine loan of at least 1.1 to 1. The loans range from 75 percent to 90 percent of the capital structure.
2. *Traditional second mortgage financing for existing stabilized properties.* These are loans made to existing properties for acquisitions and are generally provided by conduit lenders in order to secure the first mortgage financing. They provide additional leverage for acquisitions.
3. *Interim senior loans that provide up to 90 percent of the capital requirements.* For example, if the original example had one lender, instead of two, providing the total of \$10.9 million, the loan would be an interim senior loan.
4. *Preferred. Equity.* Many long term fixed rate lenders often do not want the mezzanine in the form of debt; therefore the mezzanine lender becomes an investor in the owner of the borrower and has a preferred return and a liquidation preference prior to the equity investors. In the original example, instead of the \$1.5 million to \$2.4 million investment being debt, the investor would receive preferred stock, a membership in an LLC, or partnership interests that would provide for a preferred return to the investor. In the event of sale, refinance, etc., the investor would be paid its principal before the equity holder.
5. *Equity structured as debt.* Frequently, an equity investor wants the investment structured as debt. This will give it better protection in the event of bankruptcy and, if there is environmental risk, a debt structure provides the investor with better protection. An example of this would be an equity investor investing in a project where the investor is providing up to 97 percent to 98 percent of the capital structure and the project contemplates an environmental cleanup. Congress, in 1997 legislation, provided that a lender assumes no environmental liability if it forecloses on property with "hazardous" waste if it proceeds to liquidate its position within two years. Therefore the equity investor would make its investment as a loan. However, the loan must have normal lender controls as opposed to equity controls and it should not have more than 50 percent of the residual economics or it will be deemed equity even if it is structured as debt.

Returns Sought by Investors

Generally, the returns run from 10 percent and higher depending how high up in the capital structure the mezzanine investor is contributing and the perceived risk. Some examples include:

1. *Loans for acquisition of stabilized returns.* These loans are made by conduit lenders generally up to 90 percent of the capital structure with debt service coverage of at least 1.1 to 1.0. These loans generally cost 4 percent to 7 percent over the London Inter-Bank Offer Rate (LIBOR), or fixed 10-12 % plus points.
2. *Interim loans that are made by lenders who are making first mortgage loans up to 90 percent of the capital structure.* These loans (1) require returns that blend the senior component and the mezzanine component, (2) generally have existing debt coverage of at least 1.1 to 1, and (3) are less than 90 percent of the capital structure. Typically such loans require a 1 percent origination fee, a 1 percent to 2 percent exit fee, and 200 to 325 over LIBOR depending on the perceived risk and the type of investment. Apartments and retail get the lowest spreads, whereas suburban offices and hotels require the highest spreads.
3. *Traditional mezzanine loans for value-added projects.* If the loan is up to 90 percent of the capital requirements, the loan requires interest rates in the 11 percent to 16 percent range. If the loan goes to 90 percent of the capital structure and debt service coverage exceeds 1.1 to 1.0, depending on the perceived risk, the returns will be higher. If debt service coverage is less than 1.1 to 1.0, the returns will go up.

If the investor is exceeding 90 percent of the capital structure and going up to 95 percent, the returns generally are in excess of 20%. If it is equity structured as debt, the returns to capital should have minimum returns of 10-12% with a participation in cash flow with returns exceeding 25 percent.

If the investment is structured -as preferred equity the returns to the investor will be similar to the debt structure with a slight premium due to the perceived increased legal risk.

Legal Structure and Legal Differences of the different forms of Mezzanine Loans

Mezzanine loans were originally only second mortgages but the needs of the senior lenders have changed that, resulting in additional complexities.

1. *Second mortgage that is forecloseable.* This is the most traditional structure to the investor and generally requires a lower return to the investor. However, many first mortgages restrict this type of investing. Primarily used when there is construction risk so that the lender: 1) will have a priority over intervening liens of mechanics; 2) allow the lender to appoint a receiver in the event of default, which gives the lender more control of the property after default; and 3) gives the Lender better position in a bankruptcy proceeding.
2. *Second mortgage that is nonforecloseable.* This is a very common structure where the lender gets a mortgage, which it cannot foreclose and gets

additional security such as an assignment of the ownership interests. In the event of default, the investor cannot foreclose the mortgage, but does foreclose on the ownership interest and takes over the ownership of the borrower, subject to the liens and whatever problems exist. The security is not as good, the perceived risk increases, and the rate of return required, increases. Many investors prefer the nonforecloseable second mortgage to loan structures such as assignment of ownership interests without a mortgage, because the investors are deemed secured creditors in the event of bankruptcy and they have better protection in the event of hazardous waste issues.

3. *Assignment of ownership interests without a mortgage.* This form is the same as "second mortgage that is nonforecloseable" except there is no mortgage. An understanding of the legal structure of the assignment is important. The investor generally gets an assignment of the owner's interest in the borrower. The structure is the Borrower is owned by another parent entity and the lender takes as security the ownership interests in the parent entity.
4. *Preferred ownership of interest.* This structure is not a loan; therefore there can be no foreclosure. Under the ownership agreement (e.g., stockholder agreement, operating agreement, partnership agreement), the investor makes its investment and receives a preferred return as opposed to interest. In the event of nonpayment or breach or some other affirmative or negative covenant (e.g., performance or default in mortgages), the preferred owner dilutes the equity, takes over management control, or buys out the equity pursuant to a buy-sell agreement. This structure has the least protection but can grant the investor more control in the event of default and it will effectively block any bankruptcy because the investor gets a seat on the board of directors or managers and has the right to veto bankruptcy. From a lenders prospective, it is potentially more difficult to get control because the investor will make contract claim and the resolution of that could substantially delay the process.

Intercreditor Agreements

Mezzanine lenders require an agreement from the first mortgagee or senior lender which gives them notice of any default and gives them generally the right to cure the defaults which the borrower has under the senior lender documents and to work out their problems with the borrower. Mezzanine lenders generally have the right to foreclose and terminate the interest of the borrower or to solve the problem in a work out. If they foreclose out the interest of the borrower, frequently they must get consent of the senior lender to sell to a new potential borrower before he forecloses. Many senior lenders don't want to allow the mezzanine lender to foreclose out the interest of the borrower during the time that construction is taking place and most mezzanine lenders will not agree to that. Some of the other issues that come up are the request of the senior lender that the mezzanine lender "stand still" for a period of time. Many senior lenders want to have the mezzanine lender grant them the right to vote their interest during a borrower bankruptcy. The obligation to "stand still" and the right to vote the interest of the mezzanine lender in

bankruptcy are frequently given by mezzanine lenders in corporate transactions, but almost never in real estate transactions.

Distribution of Cash flow

The structure of the distribution varies. Generally, most mezzanine transactions have a minimum interest payment of between 9 and .12 with origination fees of 1 percent to 3 percent. Thereafter, the typical transaction requires a share of cash flow, which sometimes has a cap on the return. Some of the lenders have big exit fees either in addition to or in lieu of the sharing in excess cash flow but provide that all excess cash flow goes to interest or amortization.

All the transactions require the investor to get its minimum return monthly, return of capital and exit fees before the developer gets any cash flow of consequence.

Equity

True equity comes in various forms. The most important characteristic about equity is that it shares in profits and does not have a “guaranteed return” which if not paid triggers a default, with the consequential loss of equity. Mezzanine lenders require that they get paid from first available cash flow and before the developer gets any real distributions, while equity is paid parri passu with the developer until certain returns are achieved and then the developer gets a larger share of the distributions. Equity generally finances the riskiest part of the capital structure (sometimes as much as 100% of the capital requirements) and generally is seeking returns in excess of 20%. It also has more controls over the operations and decision making of the ownership entity.

Typical Structure

Equity generally has an ownership of the entity, which has title to the property. The investor has certain degree of control from the right to veto or approve all actions (which is typical) to the right to cause any actions (becoming more frequent). Generally the more money the developer invests in a project: (a) the greater control it will have over the project, and (b) the better returns or promote to the owner/ developer. Many investors today are seeking IRR based returns. They are seeking preferred returns generally in the 10-15% range depending on asset class and how high up in the capital structure the investor is going. .

Equity Structured as Debt See above of debt.

Legal Issues

Some of the important legal issues in the negotiations are:

1-Controls. Most investors want at least the right to veto any major decisions required to be made and most agreements contain a laundry list of major decisions, but budget approval, sale, refinance are in every agreement.

2- Performance Standards. Used to be a very hard negotiated topic, now most investors provide for two types of removal. In the first its totally up to the investor and if the developer is removed, he keeps all of his promotes and economic benefits but is no longer then Manager. The second is called generally Management Default and it comes as the result of breaching material parts of its obligations or “ bad boy “ acts such as embezzlement, commingling, bankruptcy and the like. In that event the developer will be removed from its management role, lose its “promote”, lose any management fees, developer fees and the Buy Sell (see below) will be triggered.

3-Buy Sell. Every agreement has a way for the parties to terminate if they don't get along, sometimes the agreement will provide that the Buy Sell will not be triggered for a certain period of time or until a certain event is reached eg completion of construction. The Buy Sell can provide for: (1) a Shot Gun Buy Cell, which means that either party may offer to buy the other one out. The initiating party will name a price and then the other party will have the right to purchase the interest of the initiating party at the offered price; (2) Right to Match or Right of First Refusal. Here one party wants out, so it finds a potential buyer and then after it has negotiated a potential price, the other partner has the right to match the outside price. There are many other variations of these two themes. Generally the investor wants the “Shot Gun” because it favors the stronger partner and of course the developer wants the Right to Match

Advantages to Equity:

- 1) Developer usually need less cash
- 2) In the event of default or actual receipt of returns less than projected or less than the mezzanine lender requires, there no loss of equity through foreclosure and you don't have a debt forgiveness tax liability
- 3) Mezzanine is additional leverage with all its risks
- 4) No need for intercreditor and subordination agreement with senior lender.
- 5) More equity might result in better senior loan terms.
- 6) Some senior lenders simply don't like mezzanine loans behind them, or won't allow an assignment of the partnership interests.
- 7) No personal guaranties (as there might be with mezzanine).

Advantages to Mezzanine

- 1) When the returns are bigger, it's generally better to put up more capital and keep a larger portion of the profits.

- 2) Mezzanine doesn't share in the profits, and their return is capped,
- 3) Mezzanine has much less control, of the day-to-day operation; they are a lender with lender controls similar to a first mortgagee (albeit somewhat tighter)
- 4) The mezzanine investors return requirements are usually less than the equity investor's requirements, (Preferred Equity returns are slightly higher but similar to mezzanine, generally without participation in cash flow or the return is capped).

Summary of General Reasons to Choose Either Mezzanine or Equity:

1. One or the other may be a requirement of the senior lender (won't allow mezzanine behind them; can't work out an intercreditor; etc.), or might influence the cost of the senior.
2. Developer wants to keep as much upside as possible, in which case Mezzanine (or Preferred Equity) is preferable.
3. Developer just doesn't want an equity partner, nor is willing to cede control.
4. Developer just doesn't like more debt, or is unwilling to guaranty anything.

For all the reasons that a borrower may prefer equity versus mezzanine, the lender may have the same or opposite reasons to desire equity versus mezzanine. Some lenders will just not do equity, or, they may not be willing to make a distinction between pure equity and preferred equity ("equity is equity"). Also, lenders often have Loan to Cost and Loan to Value limits above which they will stop viewing something as mezzanine and start expecting an equity return (e.g. a lender may decide that anything about 90% requires equity returns).