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Mezzanine loans may relieve credit crunch woes

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Before the savings and loan crisis of the late 1980s, developers routinely financed their projects using secondary mortgages secured by the same property as the main loan. But as the S&L crisis intensified and projects failed, lenders found themselves embroiled in messy workouts with many lenders all competing over the same collateral.

After the S&L crisis and into the 1990s, lenders got creative, using layers of promissory notes and security interests to avoid conflicts between secured lenders. This led to an apparently never-ending supply of project capital.

The real estate boom paved the way for even more lending creativity and an influx of lenders from Wall Street and foreign markets. Commercial mortgage backed securities — investment vehicles secured by highly leveraged pools of commercial real estate mortgages — provided great liquidity to real estate borrowers and contributed to the rapid rise of real estate values.

Times have changed. The highly leveraged CMBS market reached its breaking point in 2007, and the ensuing collapse effectively closed the all-you-can-borrow buffet. The world credit crisis since then has left even sound projects hungry for cash, and developers are required to infuse their own equity or risk the success of their projects.

The good news for borrowers is that mezzanine investors remain in the market to fill the gaps for projects stalled by the credit crunch. In 2008 alone, mezzanine funds raised more than \$40 billion, five times more than what was raised in 2007.

Unlike senior loans, primarily secured by the land and property improvements, mezzanine loans are secured by a pledge of ownership in the entity borrowing the money. For example, the ownership interests in a typical limited liability company that borrows money would be pledged to the mezzanine lender as security for repayment of the loan.

Since the mezzanine lender has no direct interest in the project itself, it must take measures to avoid a foreclosure by the senior lender because that would leave it with an interest in an LLC that has no value. That's why mezzanine lenders typically have the right to step in and take control of the borrower during a default of the senior loan — known as a cross-default.

Conversely, however, a default under the mezzanine loan does not typically trigger a default of the senior loan because a foreclosure by the mezzanine lender would only affect a change of control of the borrower.

The cross-default and other protections are put in an intercreditor agreement (ICA) between the

mezzanine and senior lenders. Regardless of intercreditor protections, the mezzanine lender is subordinate to the senior lender and takes the first hit when the borrower runs into trouble. For that reason, mezzanine lenders demand higher yields, typically ranging from 10 to 25 percent.

A variation on mezzanine debt is preferred equity. Both have the same place in the financing “stack,” but the preferred equity provider acquires actual ownership in the borrower, while the mezzanine lender acquires a pledge of ownership interests and requires a foreclosure of the pledge to obtain actual ownership.

Preferred equity holders often reserve the right to veto or approve “major decisions.” These rights are written into the project owner’s partnership or operating agreement. With actual ownership in the borrower, preferred equity lenders don’t need an ICA, but they bear the risk of project bankruptcy and foreclosure by the senior lender.

If over-leveraging is an issue, senior lenders and the rating agencies prefer to see preferred equity arrangements rather than mezzanine loans. Some senior lenders would rather not negotiate ICAs, leaving the project owner and preferred equity provider to work through their own remedies. Having more equity directly in the deal can also result in better senior loan terms. Finally, preferred equity typically does not demand the developer’s personal guaranty.

Here is the downside: Preferred equity typically costs more than mezzanine debt and usually demands a cut of profits on top of a guaranteed return.

Unlike the real estate recession of the early 1990s, commercial real estate today is not overbuilt. It’s over-financed, with multiple layers of complicated and often conflicting interests. Preferred equity may provide a means to consolidate, de-leverage and simplify a project’s capital structure.

Until the last skeleton is out of the closet, mortgage lenders will be reluctant to put more capital at risk. Moreover, by 2011 and beyond, the number of senior loan maturities will rise dramatically, increasing already stiff competition for limited senior funds. Real estate developers would be wise to prepare for rough times ahead and should consider proactive strategies that utilize mezzanine funding as a lifeline to stability.

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