MEZZ: THE TRIUMPHANT RETURN

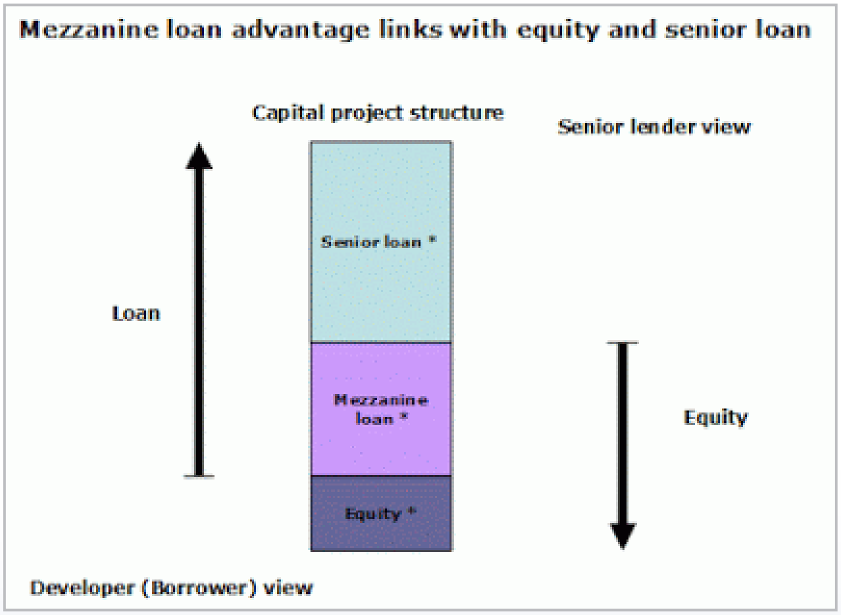
Eric Hawthorn, Director of Communications, Llenrock Group February 13, 2015

Let's talk about mezzanine capital, an important financing instrument in the commercial real estate world. About six years ago, Llenrock Blog's Dave Jacobs called "mezz" a new four-letter word. Which is to say it had become a taboo topic in the CRE industry.

Why would he make this claim? Well, the piece was published in early 2009, the nadir of the Great Recession: Lehman Brothers had already gone belly-up and economic conditions throughout the U.S. and throughout the world were bleak: companies were folding or cutting jobs, mortgages were being defaulted on, lenders were watching billions of dollars in MBS and CMBS and balance sheet debt turn sour, the job market had tanked, and the CRE financing faucet had been switched off for even the most conservative real estate endeavors. If you were in the finance business in early 2009, you no doubt remember: deals were not being done, period.

LEST WE FORGET

Let's look briefly at how mezz debt works to see what exactly happened to it in 2008-2009, which will hopefully give us a better perspective on the instrument's performance in 2015 (which, if you hadn't gathered from the title of today's post, is much, much better).



Here's mezzanine financing in five bullet points:

- For real estate purposes, mezz financing is subordinate debt (typically unsecured) that usually costs more than secured/senior debt; mezz carries greater risk.
- In the event of a default, mezz is repaid after all senior obligations have been met.

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‣ Commonly used by developers as a supplement to a first mortgage or construction loan (the term mezzanine refers to an intermediary structure, an in-between feature, like the lower-level balcony of a theater–also known as a mezzanine)
‣ Many diversified and specialized lenders like mezz financing because it gives them efficient recourse in the event of a default on the loan: while foreclosure proceedings can take a really long time, mezz lenders can usually seize the collateral (e.g. the asset or borrowing venture itself) in a much shorter period of time.
‣ In a credit environment in which lenders have strict leverage parameters (e.g. right now) mezz is a good way to fill the gap in the capital stack without pouring more of a principal/sponsor's own (typically limited) equity into the deal.

So what happened in the financial downturn and real estate crisis? Let's put it this way: mezzanine financing is a strong capital resource in a stable market because it is flexible and affordable enough (compared to straight equity) to meet the borrower's needs while offering the lender attractive returns and the option to convert the debt to what is essentially an equity stake in the event of default. No lender of mezz or anything else is particularly interested in owning real estate: lenders are lenders, they're not landlords. But if they do end up owning a stake in a CRE asset, they like being able to turn around and sell it real quickly to recoup their losses. That scenario is fine unless every lender ends up with a stake in a property that they can't sell as real estate values continue to plummet–as we saw six years ago. When the real estate market tanked, mezz lenders suffered with everyone else.

But times have changed. The economy is recovering steadily, the real estate market has seen increased tenancy and cap rate compression in a variety of asset classes, and developers are (as of the last couple years, in particular) beginning to build new product once again. That means it's time for mezz to make its long-awaited comeback, as CoStar Group reports:

> *From REITs to the largest private-equity and hedge funds, major players in the real estate capital markets are responding to a growing appetite for mezzanine debt at current attractive interest rates to recapitalize existing loans and fund new construction projects.*
>
> *Driving the surge in demand for mezzanine debt are the growing number of investors searching for creative ways to enter commercial real estate investments throughout the capital stack…*

2015 is a curious period in our real estate cycle. Lenders, investors, and developers are more bullish than they were in 2010, for instance, but they're typically more conservative than they were at the pre-recession peak. As CRE and REIT investments gain greater popularity and legitimacy in the investment

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world, some professionals worry that CRE values are once again rising too fast. For some, getting their skin in the game by sourcing mezz capital for other people's projects is quite attractive, offering both solid revenue and a safer position in the event of a downturn. Mezz is back. But remember: as we saw in 2009, not even this kind of capital is impervious to a severe downturn.

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