Commercial Real Estate Mezzanine Finance: An Update

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The Sears Tower, the tallest building in the U.S., sold for approximately $900 million in March 2004. This transaction is noteworthy not just because of its size, but also for the amount of third-party financing used in its purchase. Third-party financing is rumored to have accounted for $825 million or 92% of the total cost. If so, the new owners provided only $75 million to gain control of one of the world’s most prominent assets. How is this possible? Mezzanine finance: the portion of a transaction’s capital structure that lies between the first mortgage and the equity owner of the property and its residual cash flows.

The commercial real estate mezzanine finance market continues to evolve rapidly. Since we first wrote on this subject in late 2003, mezzanine finance providers have become more aggressive, closing transactions at lower current yields, lower total rates of return, and with higher total loan-to-value structures[1]. Other aspects of the mezzanine market have also changed. Generalities about deal structure and pricing have become less useful, as transactions become more provider- or deal-specific. As a result, users of mezzanine finance need to gain familiarity with the niches individual providers have chosen, and providers need to determine where they can add the most value.

This paper summarizes pricing discussions Heitman has had with several mezzanine providers. It also revisits the size of the market, indicating potential for continued growth in the mezzanine finance market.

**Pricing**

Heitman conducted interviews with three mezzanine finance providers in September 2004 regarding their programs and their perceptions of market pricing and returns. A mezzanine deal can have elements of equity and debt, and real estate professionals continue to experiment with innovative structures. The mezzanine market has two primary segments:

- **B-Notes** These are subordinate positions in mortgage financings, usually on stabilized properties with consistent cash flow. A B-Note is created, for example, when a lender makes an 85% loan-to-value (LTV) loan and separates the investment-grade, first-mortgage position (typically up to 75% LTV) from the piece that brings the capital structure to the 85% level. The mortgage originator sells the first-mortgage piece or the B-Note (or both), depending on its return objectives. The B-Note holder’s security rests in its ability to foreclose on the property, after curing the first mortgagee’s position. The length of loan usually coincides with the term of the first mortgage.

- Mezzanine finance This is a senior position in a joint venture partnership. The security is usually a lien on the partnership that owns the property, rather than on the property. Because the mezzanine finance holder has an indirect claim on the asset, he/she requires a greater return. Most mezzanine finance is provided on a three-to-five-year basis for properties offering a value-creation opportunity, such as a development, redevelopment or lease-up situation.

The following table summarizes current rates and deal structure at various levels of risk in the capital structure. The first-mortgage position is presented as a benchmark for comparison; first-mortgage finance is available from banks and life insurance companies at LTVs of up to 75% and from conduit lenders at LTVs of up to 80%. First-mortgage lenders currently provide capital at 5.15%-6.5% annual interest rates, usually with no origination fee.

Though first-mortgage lenders are increasingly aggressive, providing financing at greater LTV levels, B-Note lenders and mezzanine providers target different borrowers and extend financing at different risk profiles, varying return structures and different IRR requirements. Greater detail follows in the paragraphs below.

The B-Note portion of a mortgage generates yields of Treasuries plus 250-350 basis points on the incremental slice of the capital structure, indicating 7%-8% yields. The B-Note provider often operates in tandem with the first-mortgage lender (or is simultaneously the first-mortgage lender) and provides the borrower with a single loan application and underwriting process. The ability to foreclose on the property gives the B-Note lender greater willingness to extend the loan for seven to ten years and take an incremental return above that of the first-mortgage position.

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Mezzanine Finance Transaction Pricing
September 30, 2004

<table>
<thead>
<tr>
<th>Loan to</th>
<th>Current</th>
<th>Origination</th>
<th>Exit</th>
<th>Participation</th>
<th>IRR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>Pay</td>
<td>Fee</td>
<td>Fee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>First Mortgage*</td>
<td>65-60%</td>
<td>5.15-6.0%</td>
<td>0-0.5%</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>B-Note</td>
<td>65-65%</td>
<td>7.0%</td>
<td>0-0.5%</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Mezzanine Debt</td>
<td>75-85%</td>
<td>8.5-7.5%</td>
<td>1-2%</td>
<td>Usually none</td>
<td>Accrual feature</td>
</tr>
<tr>
<td>Participating Mortgage</td>
<td>80-92%</td>
<td>8-9%</td>
<td>1-2%</td>
<td>Varies</td>
<td>Accrual, Share of Profits</td>
</tr>
<tr>
<td>Preferred Equity</td>
<td>90-95%</td>
<td>9-11%</td>
<td>1-3%</td>
<td>1-4%</td>
<td>Accrual, Share of Profits</td>
</tr>
</tbody>
</table>

* For comparison. Not a mezzanine position.

Mezzanine finance providers often offer multiple programs, as illustrated below.

Provider A: This provider runs two programs -- a commingled fund and a separate account. The provider has a relationship with a money-center bank to allow it to close first mortgage and mezzanine-finance positions in one transaction. The commingled fund’s portfolio manager wants to place $20-$30 million in a single deal, implying a property valuation of $100 million or more. The fund’s strategy allows it to provide up to 85% LTV and it can extend financing to developers. The usual term on the mezzanine portion of the deal is three to five years and the mezzanine return is a straight yield of LIBOR + 8%-9% on most transactions. This translates into a 9%-12% IRR. For development loans, where there is no property-level cash flow, the loan balance accrues.

The same provider also originates mezzanine finance on behalf of a separate account client with more-aggressive parameters. The typical transaction has capital structure of up to 92% financed, a two- to three-year life and carries a current pay of LIBOR + 200-900 basis points. The loan will accrue if cash flow is not sufficient to keep the debt service current. Fees and a lookback feature bring the total IRR to the mid- to upper-teens. The provider will work with condominium developers in selected markets where the borrower has established a track record.

Provider B: In this program, the borrower/equity owner makes one application for a desired level of financing. If, for example, the equity owner wants to finance 95% of the property, he or she will go through the underwriting process once. The provider quotes an all-in rate and then divides the loan. The first-mortgage position is sold to a bank or syndicated to other investors. The next 15-25% remains on the provider’s books as part of its investment portfolio. Most transactions from this source involve $2-$15 million of mezzanine finance, making it a middle-market program.

Overall returns vary according to risk levels. Mezzanine positions that bring the capital structure to 95% financed require greater returns and have the following characteristics:

- A 2% origination fee
- A 10% current-pay coupon
- A lookback feature whereby the loan accrues to a 15% yield
- An overall IRR in the upper-teens

This provider relies less on participation fees because it often sees less upside potential at the exit. The provider wants to take its cash flow earlier in the lifecycle of the property.

The same provider originates transactions that bring the capital structure to a 75%-90% LTV range. At 75%-85% LTV, the IRR for the portion of the capital structure above the first mortgage remains in the low teens. In the 85%-90% LTV range, the IRR for the incremental piece of financing reaches the mid- to upper-teens, depending on property type and strategy.

Provider C: This provider extends financing to owners of properties subject to first mortgages originated by banks or insurance companies. Banks and insurance companies cooperate with this mezzanine provider because of its track record as a property owner that can add value if the borrower encounters difficulty. The mezzanine provider will finance existing office, multifamily, and hotels as well as condominium development, bringing the capital structure to a 75-90% LTV. The provider requires a 1%-2% origination fee and an 8%-9% current-pay coupon with an accrual feature to bring the overall IRR on the mezzanine piece to 12-13%, down from 14-15% last year.

Structured Transactions: Heitman has been working on a structured equity transaction with characteristics of a mezzanine deal, indicating how mezzanine finance has filtered through the rest of the real estate finance market. Its terms include:

- A $115-million specialty property portfolio subject to a $50-million loan (43% LTV).
- The portfolio owner brings in an investor to split the $65 million of equity in a 70/30 partnership. The owner and
the investor negotiate a joint venture agreement outlining fees, returns, and security.

- The investor's position brings the financed capital structure to 84%. The owner keeps 16% of the total capital structure as equity.
- The portfolio is assumed to be held for five years, during which it is expected to generate a leveraged IRR of 11.6%.
- The investor piece earns an 8% running yield with an 8.5% guaranteed lookback.
- The investor's total IRR can go as high as 10% (based on participation in sale or refinance proceeds) but no higher. The upside is limited in exchange for the downside protection at not less than 8.5%.

The equity owner agrees to provide the 8.5%-return guarantee. Per the joint venture agreement, the equity owner must come out of pocket if portfolio cash flows do not suffice.

Some providers prefer to structure transactions without downside protection, allowing them to earn greater returns. The return “collar” of the previous deal reflects the preferences of one Heitman client.

Other Trends: The mezzanine market is becoming more like the CMBS market. Mezzanine providers are slicing the mezzanine position into smaller segments with better-defined risk characteristics. Rather than one mezzanine position, a transaction might now have two or three tranches of junior debt with declining priority of claims on cash flow and increasing levels of return. For example, in a property with a 65% first position and a 10% equity slice, the 25% mezzanine position can be divided into two pieces. The holder of the “A” mezzanine piece will receive cash flow as if it has initiated a mezzanine loan to bring the capital structure to 75-80%. With the equity owner and the “B” mezzanine piece absorbing cash flow shortfalls first, the returns to the “A” piece will be lower, but higher than those to the first-mortgage provider. The “B” piece holder takes the 80%-90% slice of the capital structure, protected by the equity owner’s 10%. The greater exposure to potential cash flow shortfalls means that the “B” piece earns a return in excess of that generated by the “A” position.

Inter-creditor and joint venture agreements, always important in mezzanine finance, become critical where the mezzanine positions have been divided. The collateral is the interest in a limited-liability entity that owns the real estate, rather than a lien on the physical property, reducing options for the entity holding the mezzanine position in case of default.

Sizing the Market

In our previous paper, we pegged the potential size of the mezzanine finance market at $337 billion, based on commercial mortgages originated from sources like banks and life insurance companies that don’t have onerous restrictions or practical concerns that prevent their borrowers from using mezzanine finance. We estimated that the mezzanine market had a total of $50 billion in outstanding transactions ($10 billion of which were likely to mature and require refinancing), meaning that providers had room to originate another $297 billion of mezzanine transactions.

<table>
<thead>
<tr>
<th>Potential Mezzanine Market Estimate</th>
<th>30-Jun-04</th>
<th>31-Mar-03</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Mortgages divided by 68%</td>
<td>1,556.7</td>
<td>1346.9</td>
</tr>
<tr>
<td>Total Investment RE times 17%</td>
<td>2,289.3</td>
<td>1980.7</td>
</tr>
<tr>
<td>Potential Mezzanine Position</td>
<td>389.2</td>
<td>336.7</td>
</tr>
<tr>
<td>Current Mezzanine Market</td>
<td>55.0</td>
<td>50.0</td>
</tr>
<tr>
<td>Mezzanine Candidates</td>
<td>334.2</td>
<td>286.7</td>
</tr>
<tr>
<td>Mezzanine Refi candidates</td>
<td>11.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Estimated Total Potential Market</td>
<td>345.2</td>
<td>296.7</td>
</tr>
<tr>
<td>Percent change in Market</td>
<td>16%</td>
<td></td>
</tr>
</tbody>
</table>

*Loan to value ratio per ACLI, September 30, 2004
** Gap between current LTV and Mezzanine LTV of 85%

Source: Federal Reserve Board, ACLI, Heitman Research

As the table above shows, the potential size of the mezzanine finance market has grown by approximately $47 billion in the past 18 months by our estimate. Using the methodology from our previous paper and Federal Reserve Board data through June 30, 2004, we conclude that the mezzanine market now has the potential to reach $389 billion, up from $337 billion. Increasing the estimate of the current total market to $55 billion and assuming $11 billion (20% of the outstanding total) in mezzanine refinance potential each year, we conclude that mezzanine finance providers can originate another $345 billion of transactions.

Our estimate of the size of the outstanding market came through summing the mezzanine finance programs in the
market. Fitch Ratings provides confirmation that this estimate
approximates reality. The market, according to Fitch, totaled
$37.3 billion by the end of 2002, more than twice the level as
of 1998. Applying the same growth rate (27.5% annually) to
the 2002 number results in a total mezzanine market of $57
billion as of September 30, 2004. The $55-billion estimate
remains reasonable, though the actual balance outstanding is a
source of debate.

Investment Implications

Mezzanine finance remains an important and growing segment
of the real estate capital market as more property owners use it
and more providers emerge to supply it. This has several
implications for real estate investors, including:

- More competition for assets. Mezzanine finance availability
  expands the universe of buyers with the ability to close
  transactions of any size. The Sears Tower provides an
  immediate example: While only a limited number of
  buyers have $300-350 million of equity to make such a
  purchase using standard first-mortgage financing; a larger
  set of investors have $75 million to bid for the asset. The
  same logic holds for smaller assets - more prospective
  buyers can compete.

- Downward pressure on expected returns for real estate
  assets. Increased competition for properties and increased
  capital flows into the asset class have led to lower overall
  returns. The emergence of mezzanine finance is one of
  several factors pushing expected real estate returns lower.
  (Other factors include low interest rates, disappointing
  returns in stocks and bonds, and desire for current
  income.)

- Greater segmentation of risks. Mezzanine finance has
  allowed investors to bear only those risks they understand
  and can underwrite. The tranching of CMBS classes and
  mezzanine-finance positions is an example of the trend
  toward pricing risk more appropriately. Better
  segmentation of risk implies better pricing.

- Opportunity to reduce portfolio risk. An investor with a
  given amount of equity for real estate investment can buy
  more real estate assets (achieving greater diversification)
  using first mortgage and mezzanine-finance positions than
  using first-mortgage finance alone.

- Greater financial risk at the property level. While
  mezzanine finance can allow an investor to reduce risk at
  the portfolio level, this diversification carries the price of
  increased financial risk at the property level as the LTV
  increases and the debt-service coverage ratio decreases.

Despite some challenges, we continue to see opportunities for
favorable performance in the mezzanine market. Heitman has
structured mezzanine transactions since 1994, having
negotiated joint venture investments and investment programs
on behalf of clients and commingled funds. We continue to
work with real estate owners, operators and developers to
provide mezzanine finance in selected situations.

Conclusion

The mezzanine market continues to grow, and not just in size.
Its potential size has increased by some $52 billion, to $389
billion as of September 30, 2004, representing 15% growth.
The market is increasingly complex and specialized. Greater
understanding of the risks associated with the mezzanine
position in general, and increased segmentation of the risks
in particular allows providers to participate in the sector that
most closely matches their risk/return preferences. Better risk
control brings more capital to the sector and, concurrently,
lowers returns, particularly for the primary property types.
Growing competition drives providers to compete on return and,
equally important, to distinguish themselves in their product
offerings. Providers look to serve a focused niche with deal
structures that meet borrowers' needs. In the process,
mezzanine providers protect themselves and their capital by
pursuing transactions they understand and that provide
compensation for the risks they are bearing.

A final note on what the rise of mezzanine finance means for
institutional investors. Property investors, particularly those
that focus on the primary property types, increasingly find
themselves bidding against parties whose buying power is
enhanced with mezzanine finance. Unleveraged and modestly
leveraged investors have difficulty competing in these
situations. As a result, investors operating with lower levels of
leverage need to develop strategies for how to acquire
properties at reasonable pricing in the current capital-market
environment. Relevant strategies include partnerships with
operating companies that can provide access to off-market
transactions. In another approach, many institutions have
expanded their definition of real estate to include specialty
property types, such as student housing, medical office and self
storage, that have not captured as much investor attention.

Gamshausen's article, "Will Mezz Get Messy?" The Slatin Report, July