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The Rise of Mezzanine Debt

Highlights

- Mezzanine debt is set to become an important source of capital for real estate investors, developers and those looking to refinance following the tougher capital regulatory requirements introduced by the Australian Prudential Regulation Authority and tighter underwriting by the big four banks.
- Mezzanine providers will typically provide 10% more gearing than the senior lenders and at a cost from as low as 14% per annum, representing a relatively minor impact on total project costs.
- Mezzanine debt has the effect of boosting expected returns, reducing equity requirements and allowing real estate players to enter into larger real estate transactions.
- Increasing leverage also increase risk in any transaction. In fact, research conducted by the Centre of Private Equity Research shows that on average 16.1% of mezzanine loans will default!
- It is imperative for real estate players to understand the real risk of mezzanine debt in order to weigh up whether the expected return is commensurate with additional risk and transaction complications involved.

Introduction

Mezzanine debt is set to become an important source of capital for real estate investors, developers and those looking to refinance following the tougher capital regulatory requirements introduced by the Australian Prudential Regulation Authority ("APRA") and tighter underwriting by the big four banks.

Mezzanine finance bridges the gap between senior debt and equity investment. The mezzanine lender will sit above equity in the capital structure but be subordinated to the senior debt. Mezzanine finance appeals to a class of borrowers as it is cheaper than their own cost of equity and avoids the loss of control and potential complications introduced by an equity joint venture partner.

Mezzanine finance has the benefit of increasing a borrower's expected return for equity and reducing equity needs, however, this comes at a cost in the form of higher debt repayments (impacting cash on cash returns) and increasing the probability of default. Understanding the real risk of mezzanine debt is critical in order to weigh up whether the expected return is commensurate with additional risk and transaction complications involved.

Stricter Lending Requirements Pave the Way for Alternative Funding Sources

The property market in Sydney is a hotly debated topic at most family barbecues. Price growth of 17% and 14% in each of the last two years, respectively, has lifted the median house price to an estimated $960,000 at June 2015 [1]. In the short term, this price growth is expected to continue, albeit more moderately, given the low interest rate environment set by the Reserve Bank of Australia ("RBA"), the State's dwelling deficiency and strong investor demand.

To curb excessive risk taking in the property market, APRA has increased the capital requirements on banks requiring the average risk weight on Australian residential mortgage exposures to increase from approximately 16% to at least 25%. To achieve APRA's target, banks are using a number of strategies including:

- introducing higher interest rates for interest only loans, with National Australia Bank, for example, increasing its interest only rates by a total of 29 basis points;
- using a 2% interest rate buffer and a "floor" lending rate of 7% when assessing a borrowers' ability to service their loans; and
- decreasing loan-to-value ratios for investors, with Westpac slashing its LVRs from 95% to 80% for home loans. For a median $960,000 home, this change in LVR would mean a mandatory deposit of $192,000 in contrast to a $48,000 deposit before the stricter lending standards were implemented.

APRA's regulatory requirements have had an immediate impact on the Australian housing market, with auction clearance rates slipping to the low 60% range from week-to-week in Sydney in October 2015. Buyers are slowly regaining leverage as the pendulum finally begins to swing back, in an environment where finance is more difficult to secure and competition for the limited source of available capital becomes fierce. Unsurprisingly, the need for alternative funding sources is increasing.

Mezzanine Finance in Real Estate

Mezzanine debt has a variety of meanings. Most simply, mezzanine debt, as the name implies, occupies a position between the senior debt and equity. Mezzanine debt is subordinated to senior debt in all respects and carries a higher yield.

In real estate, mezzanine finance is used in three distinct categories:

- Property Development: where the mezzanine debt is secured by a second ranking registered mortgage over the project site and where a general security interest is taken over the secured property of the developing entity [2]. Both forms of security are subordinated to the senior lender's security;
- Investment Properties: these assets are fully leased properties that generate cash flows to service a mortgage. In this case, the mezzanine lender takes a second mortgage over the investment property and a second general security interest over the borrower's assets.
- Value Add Properties: these are generally non-stabilised properties with low rental income where the investor has identified a value add opportunity to increase net operating income and improve the yield on the asset. The value add proposition may involve significant capital expenditure to reposition the property. The mezzanine finance will be used to fund the reposition strategy.

[1] BIS Shrapnel. "Residential Property Prospects 2015 – 2018." N.p., June 2015. Web.

2 Mezzanine Lenders and Senior Debt providers will additionally request a personal guarantee particularly when dealing with private persons and groups of private persons who are pooling their money together and who lack the experience of the funds and institutions.

Typical Deal Terms of Mezzanine Finance

As a rule of thumb, a mezzanine provider will provide 10% more gearing than the senior debt provider. For example, in a development project, the mezzanine financier may lend up to 75% loan-to-value (net) and 90% loan-to-cost (and will often take a view on land value uplift). All other conditions typically mirror the senior lender's requirements including, (1) evidence of qualifying presale contracts demonstrating cover of 100% of bank funded debt, (2) valuation of the property on 'as if complete' basis, and (3) a bank appointed quantity surveyor report confirming that the construction can be completed for the amount and within the time frame specified within the building contract.

According to Nick Beckett, a director and head of mezzanine finance at Balmain Corporation, "In such deals, mezzanine lenders would receive a fixed income yield, in the 14% to 18% range as well as upfront fees of 1.5% to 3%." Pricing will, however, depend on the type of project and its risk, the experience of the borrower, the level of leverage, the size of the loan and the geographic location of the asset.

In a vanilla mezzanine deal for an investment asset, the mezzanine debt would increase the leverage from the standard 65% to 75% of cost to as high as 75% to 85% of cost. For bearing risk in excess of the first mortgage, the interest rate on the mezzanine debt generally ranges from 12% to 15%, with upfront fees being in the range of 1.5% to 3%. Such a capital structure usually results in very low to less than 1 times interest cover ratio on the subordinated debt. Until APRA's recent intervention, many investors had high gearing senior debt options available. As a result mezzanine debt in the investment real estate space was uncommon. This is now changing as stringent underwriting by the big four banks, particularly for commercial property, leads to lower first mortgage leverage.

MEZZANINE FINANCING

Risk and Reward investing in real estate sector (adjusted from Muldavin's research)

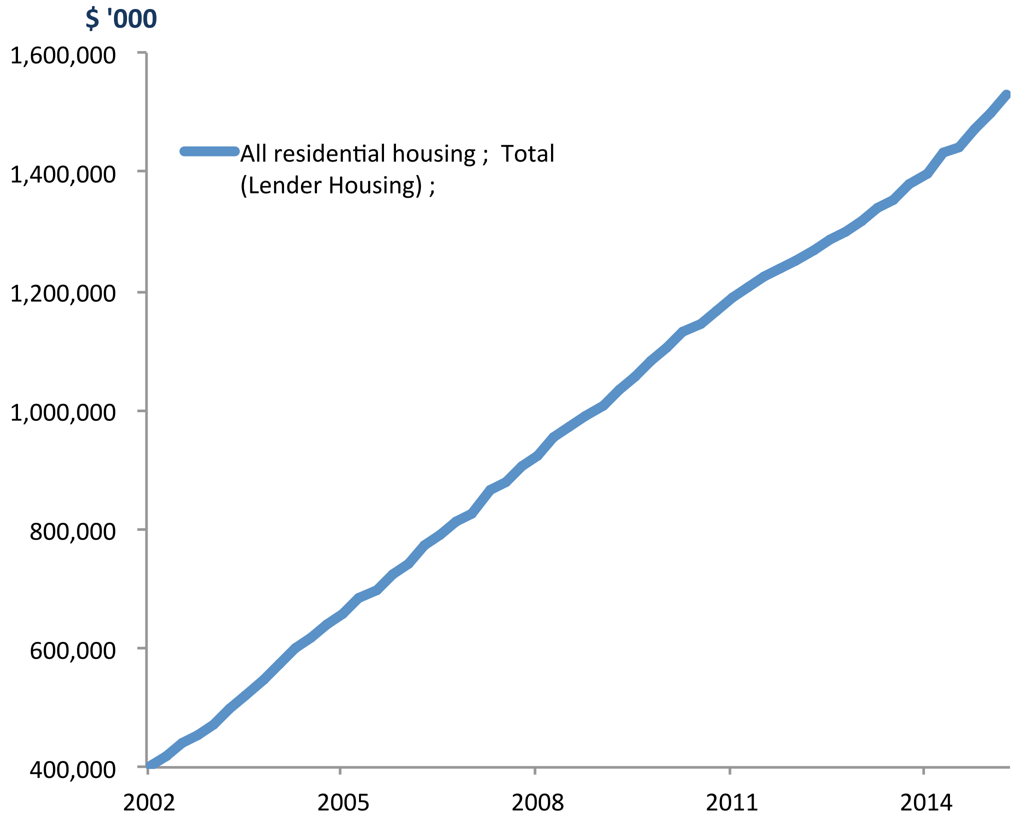
Mezzanine Investment Type	Property Characteristics	Typical Deal Structure	Total Return Expectations	Key Risk Issues
Investment Properties	• Ongoing Cash Flows • Almost Fully Leased • Minor retrofitting cost	• 75% to 85% LTV • No participation in residual cashflow or profit • Exit through sale or mortgage amortisation	12% to 15% IRR	• Tenant Default • Macroeconomic Risk • Interest Rate Risk • Business Cycle • Property Management
Value Add Opportunities	• Small amount of cashflow • Rehabilitation or Retrofit Required • Substantial Lease Up Required	• 80% to 90% of LTC • Exit through refinance or sale • 1.5 years to 3 year time horizon	15% to 20% IRR	• Cash Flow Management • Lease Up Risk • Interest Rate Risk • Construction Risk
Development	• No cashflow • Completed property will be 75%-80% loan to value based upon the total capital structure • To be constructed	• Up to 90% of LTC and 75% of LTV • Exit through presale settlement or refinancing to permanent loan • 1.5 to 3 year time horizon	15% to 25% IRR	• Cash Flow Management • Presales Settlement Risk • Interest Rate Risk • Construction Risk • Business Cycle • Construction Cost vs. Replacement Cost

Source: Adjusted from Tim Ballard and Scott Muldavin, 'Does mezzanine investing in real estate make sense today?' (2000) Real Estate Finance 1-9

Mezzanine Debt Set to Grow

The Australian residential real estate market is now worth $5.7 trillion dollars. In August 2015, the value of outstanding housing loans financed by banks reached of $1.37 trillion dollars, enjoying an increase of 8.4% for the year. [3]

Chart 1. Residential Housing: Total (Lender Housing)



Source: ABS

The rapid growth in housing finance has corresponded with a stronger demand for mezzanine debt. Trident Real Estate Capital expects this demand to accelerate in the near term for several reasons, including:

- Increasingly stricter lending policies by the big four banks. APRA will continue to roll out Basel Committee reforms, including the much anticipated net stable funding ratio,[4] which will limit access to highly geared senior debt;
- The surge in construction and property development, with more than 188,000 housing starts anticipated in 2016 according to the Housing Industry Association; [5]
- The ability for buyers to increase their expected return for equity by increasing the leverage on their investments (see the case study below, 'An Analyst's Task'), reduce their equity needs and enter into larger real estate transactions;
- The low interest rate environment set by the RBA means that investors are searching for higher yield. The high interest rate returns of mezzanine debt makes it an attractive investment option; and
- The unattractive alternatives to mezzanine debt. The alternative to mezzanine debt is to introduce an equity joint venture partner in the capital structure, which may mean ceding control and profits to third parties.

[3] Australian Bureau of Statistics (ABS) 2015, "Housing Finance Australia, Aug 2015," Australian Bureau of Statistics, Canberra.

[4] The introduction of the net stable funding ratio will limit a bank's reliance on short term wholesale funding and force up interest rates even further.

[5] HIA. "New Housing Outlook: July 2015." Https://hia.com.au/. N.p., July 2015. Web. It should be noted that in the 12 months leading up to August 2015, the total value of buildings approvals for residential construction equated to $65.39 billion according to the ABS.This reflected an increase of 14.7% year on year

An Analyst's Task - Case Study

Sydney Real Estate Fund (SREF) is a closed-end real estate investment fund focused on urban investments. The Fund's investment strategy is to identify and capitalize on the development, acquisition, repositioning, and adaptive reuse of urban real estate.

SREF has been approached with an investment memorandum titled 'The Rosebery'. The Rosebery is a multi-story class B office building with 10,000 square meters of net lettable area, which is fully leased. The purchase price for the building located in inner city, Sydney is $48,000,000. Selling costs (of 2%) plus additional capital improvements will bring the total purchase price up to $50,000,000. The net operating income (NOI) in year 1 is forecast to be $4,000,000 and this is set to increase by a fixed 4% per annum for the following four years.

Using RP Data and comparable transactions, a going-out capitalisation rate of 8% is used, representing a sales price in year 4 of $56,243,200.

An interest only bank bill business loan of 65% of leverage is available for purchase of The Rosebery. The interest on the debt is 2.75% above the Bank Bill Swap Bid Rate (BBSY) of 2.1%. SREF is now considering a mezzanine loan of $10,000,000 to increase the leverage on the asset to 85%; this interest-only loan carries a 15% interest rate and a 5 year term-to-maturity. In the alternative, SREF can raise equity equivalent to 35% of the total cost or $17,500,000. See Table 1 for the two alternative capital structures.

TABLE 1. FUNDING STRUCTURES

Capital Structure (With Mezzanine)				Capital Structure (Without Mezzanine)			
Uses				**Uses**			
Purchase Price		$48,000,000		Purchase Price		$48,000,000	
Clothing Costs & Expenses	2.0%	$960,000		Clothing Costs & Expenses	2.0%	$960,000	
Capital Improvements		$1,040,000	**Acq. Costs** $1,040,000	Capital Improvements		$1,040,000	**Acq. Costs** $1,040,000
Total Uses		**$50,000,000**		**Total Uses**		**$50,000,000**	

Sources		LTV	Sources		LTV
Senior Debt	$32,500,000	65.00%	Senior Debt	$32,500,000	65.00%
Mezzanine Debt	$10,000,000	20.00%	Total Equity	$17,500,000	35.00%
Total Equity	$7,500,000	15.00%			
Total Uses	**$50,000,000**	100.00%	**Total Uses**	**$50,000,000**	100.00%

Tables 2 and 3 depict the cash flows and performance measurements when modeling our hypothetical case study with and without mezzanine debt. Our analysis shows that the use of mezzanine debt is accretive to the overall equity returns, because the cost of the additional debt (15%) is less than the leverage return to equity (21.53%). Additionally, the overall returns to equity move from an internal rate of return of 21.53%, without mezzanine debt, to 28.63% with mezzanine debt.

TABLE 2. CASH FLOW MODEL (WITH MEZZANINE DEBT)

	Closing	Year 1	Year 2	Year 3	Year 4
NET OPERATING INCOME	($50,000,000)	$4,000,000	$4,160,000	$4,326,400	$4,499,456
Sale Proceeds					$56,243,200
Total Cash Flow Before Debt Service	($50,000,000)	$4,000,000	$4,160,000	$4,326,400	$60,742,656
Unleveraged Yield		**8.00%**	**8.32%**	**8.65%**	**9.00%**
Unleveraged IRR	**11.10%**				
SENIOR DEBT	**4.85%**				
Senior Debt Service Payments	$32,500,000	($1,576,250)	($1,576,250)	($1,576,250)	($1,576,250)
Cash Flow Available for Mezzanine Debt		$2,423,750	$2,583,750	$2,750,150	$2,923,206
MEZZANINE DEBT	**15.00%**				
Mezzanine Debt Service	$10,000,000	($1,500,000)	($1,500,000)	($1,500,000)	($1,500,000)
Cash Flow Available for Equity	($7,500,000)	$923,750	$1,083,750	$1,250,150	$1,423,206
Net Cash Flow From Sales Proceeds					$13,743,200
Before Tax Cash Flow	($7,500,000)	$923,750	$1,083,750	$1,250,150	$15,166,406
Cash on Cash Return		**12.32%**	**14.45%**	**16.67%**	**18.98%**
Leveraged IRR	**28.63%**				

TABLE 3. CASH FLOW MODEL (WITHOUT MEZZANINE DEBT)

	Closing	Year 1	Year 2	Year 3	Year 4
NET OPERATING INCOME	($50,000,000)	$4,000,000	$4,160,000	$4,326,400	$4,499,456
Sale Proceeds					$56,243,200
Total Cash Flow Before Debt Service	($50,000,000)	$4,000,000	$4,160,000	$4,326,400	$60,742,656
Unleveraged Yield		**8.00%**	**8.32%**	**8.65%**	**9.00%**
Unleveraged IRR	**11.10%**				
SENIOR DEBT	**4.85%**				
Senior Debt Service Payments	$32,500,000	($1,576,250)	($1,576,250)	($1,576,250)	($1,576,250)
Cash Flow Available for Equity		$2,423,750	$2,583,750	$2,750,150	$2,923,206
Net Cash Flow From Sales Proceeds					$23,743,200
Before Tax Cash Flow	($17,500,000)	$2,423,750	$2,583,750	$2,750,150	$26,666,406
Cash on Cash Return		**13.85%**	**14.76%**	**15.72%**	**16.70%**
Leveraged IRR	**21.53%**				

The cash on cash returns to SREF in Years 1 and 2 are lower as a result of the introduction of mezzanine debt (13.85% and 14.76% as opposed to 12.32% and 14.45%). This arises because of the subordination of returns from the equity. The mezzanine borrower is prioritized and grabs much of the cash flow in the early years of the investment. Where the borrower is not successful in raising the net operating income of the asset, the returns or cash flow to the equity holder could remain low and may even result in default in situations where vacancy in the investment asset increases as a result of a dip in the economic cycle.

Increasing leverage always brings additional risk and complications into deal structures as well as greater rewards in the form of higher expected equity returns.

Exit Strategy of Mezzanine Lender

Mezzanine financing generally has a short to medium term maturity of two to five years, while property investors, on the other hand, typically have a longer-term investment horizon. Conflict may, therefore, arise when the mezzanine loan expires. Forward planning and agreeing to a mutually convenient exit strategy should be a priority.

Paying down the mezzanine debt can occur in multiple ways. When a borrower sells the asset, assuming the subordinated debt is not underwater, the proceeds are used to repay the principal, interest and fees owed to the senior and mezzanine lender. Alternatively, where a property has made significant capital gains, this may result in a situation where refinancing allows a new first mortgage to take out the original senior and mezzanine provider.

In a development project scenario, the mezzanine debt will be introduced to fund part of the development costs, along with the construction loan. The mezzanine debt will have the interest capitalized during the duration of the project. On the pre-sales settlement date, the sale proceeds from the off the plan sales are used to pay down the construction loan along with the mezzanine debt (a balloon payment). Alternatively, refinancing and granting of the permanent loan post practical completion of the project means that new cheaper finance can generally replace the more costly construction loan and mezzanine funding [6].

The Priority Deed

The Priority Deed is an important document governing the relationship between the mezzanine lender and the senior financier. The deed will generally deal with the following matters:

- Establishment of relative priority so that a senior lender's securities have priority up to the sum of all the principal and generally all interest, costs, taxes and fees;
- Restrictions with respect to the ability of the borrower to make payments to the mezzanine lender. Mezzanine lenders will have the right to be paid establishment fees and other upfront costs but interest will be capitalized, typically, while the senior debt is outstanding and principal repayments to the mezzanine lender are usually not permitted;
- Financial Accommodation provisions which allow the senior debtor, without the consent of the mezzanine lender, to refinance or extend additional senior debt (usually up to 10% of the original senior debt);
- Provisions with respect to the right of the mezzanine lender to declare a default to ensure that interest accrues at the default rate (rather than to receive a repayment). The senior lender will often have the right to restrict the mezzanine lender's ability to accelerate their debt and enforce their security;
- Reciprocal information rights between the mezzanine lender and the senior lender in connection with any breach, default notice or any action taken to enforce a right under the securities. Mezzanine lenders may also seek the right to cure a default under the senior mortgage by, among other things, injecting additional debt or even equity into the structure.

[6] This assumes that enough value will have been created for the construction lender and mezzanine provider to be taken out at the conclusion of the project.

Many senior creditors will typically refuse to negotiate deeds of priority, particularly if the loan has already closed. However, senior creditors do often accept that mezzanine lenders can bring value to the table, particularly where the mezzanine lender is an experienced real estate player. Active mezzanine managers can reduce default rates, with better access to information and earlier intervention strategies, with terms structured to protect on the downside and by ensuring a seat at the table in the event of default .[7]

Mezzanine Lender's Rights and Remedies Upon a Borrower's Default

In the event of a default, a mezzanine lender is restricted by those limitations set out in the priority deed. Unlike the senior lender, a mezzanine lender will not be permitted to enforce their security. Most commonly, the mezzanine lender's only commercial alternative is to cure the default by refinancing the secured property or taking out the senior lender at par value (subject to all the prepayment penalties) .[8]

Should the mezzanine lender not wish to exercise its right to cure or take out the senior loan when an event of default is subsisting, the senior lender may appoint a receiver. The receiver will realise the secured property to discharge the debt, interest and other fees owing to the senior lender. If there are any residual funds remaining these are then used to repay the mezzanine lender in priority to the shareholders.

The senior lender may also appoint an administrator with a view of entering into a deed of company arrangement (a "DOCA"). A DOCA binds all stakeholders, including secured and unsecured creditors, and governs how the borrower's affairs may be dealt with. According to Ryan Spooner, a director at Ferrier Hodgson, "The terms of the DOCA are flexible with the majority of creditors motivated to accept a DOCA proposal on the basis that the return is greater than a liquidation or the agreement increases the prospects for a turnaround to occur."

Conclusion

Trident Real Estate Capital anticipates that APRA's efforts to improve the resolvability of systemic banking firms, will present an opportunity for mezzanine finance to plug the funding gap, with relatively low risk, by replacing senior debt.

The use of mezzanine debt by real estate players can lead to increasing expected returns, reducing equity requirements and entering into larger real estate transactions. The increased leverage, however, is accompanied by additional risks. Recent research conducted by the Centre of Private Equity Research (CEPRES)[9] shows that on average mezzanine loans have a default rate[10] of 16.1%.

Sophisticated quality underwriting by mezzanine lenders is critical for real estate investing, with a strong focus on exit strategies and timing as well as on the past record and experience of the real estate borrower.

Real estate players must analyze the downside scenarios when running their feasibility models. What are the consequences if property values decline as they did during the late 1980s and early 1990s? How are property cash flows, capitalization rates and exit strategies impacted by the upward movement of interest rates? Borrowers must decide if the increased returns justify the additional risks and costs that accompany the introduction of mezzanine debt.

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[7] "Mezzanine Debt Offers the Best of Both Worlds … or Does It?" Investment Magazine. N.p., 4 Sept. 2009. Web.

[8] A mezzanine lender will only exercise its right to cure defaults or its right to purchase the senior debt when the subordinated lender believes they can take control of the secured property and increase its value or where the secured property's value is greater than the sum of all outstanding security.

[9] See Centre of Private Equity Research. Private Debt Market Report Q/2 2015. Rep. Munich: CEPRES GmbH, 2015. Web.

[10] CEPRES defines the term default rate to mean the number of transactions with cash on cash multiple <1 divided by the number of all transactions.

Our Team

Trident Real Estate Capital is a real estate investment and advisory firm which is active in the Australian commercial and residential property market. We draw upon 30 years of real estate market experience and utilise an advanced suite of property data and analytical tools to provide client tailored specialist real estate advice including market assessments and forecasts, due diligence and location analysis to a variety of corporate, investor and institutional clients.

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