

THE RISE OF MEZZANINE DEBT

Following tighter regulatory requirements from senior lenders, property investors and developers can consider mezzanine debt to secure finance. Trident real estate's **COSTA ARGYROU** and **SHIRLEY SONG** explain the risks and benefits.

Mezzanine debt is set to become an important source of capital for real estate investors and developers looking to refinance following the tougher capital regulatory requirements and tighter underwriting by the big four banks.

Mezzanine finance bridges the gap between senior debt and equity investment, with the mezzanine lender sitting above equity in the capital structure but subordinated to the senior debt. Mezzanine finance appeals to a certain 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.

While mezzanine finance has the benefit of increasing a borrower's expected return for equity, and reducing equity needs, this comes at a cost in the form of higher debt repayments (impacting cash on cash returns), 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 the additional risk and transaction complications involved. Recent research conducted by the Centre of Private Equity Research (CEPRES)¹ shows that, on average, mezzanine loans have a default rate² of 16.1%.

¹ See Centre of Private Equity Research. Private Debt Market Report Q2/2015. Rep. Munich: CEPRES GmbH, 2015. Web.

² 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.

STRICTER LENDING PAVES THE WAY FOR ALTERNATIVE FUNDING

The Sydney property market is currently a hotly debated topic. Price growth of 17% and 14% over the last two years respectively has lifted the median house price to an estimated \$960,000 at June 2015³. 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, the Australian Prudential Regulation Authority (APRA) has increased

³ BIS Shrapnel. "Residential Property Prospects 2015-2018". N.p., June 2015. Web.

the capital requirements on banks, with the average risk weight on Australian residential mortgage exposures increasing from approximately 16% to 25%.

APRA's regulatory requirements have had an immediate impact on the Australian housing market, with auction clearance rates slipping to 62.1% for the December quarter of 2015 according to CoreLogic RP Data. Buyers are slowly regaining leverage as the pendulum begins to swing back, but still 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

In real estate, mezzanine finance is used in three distinct categories—property development, investment properties and value-add properties.

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 \$1.37 trillion dollars, enjoying an increase of 8.4% for the year⁴.

In the 12 months leading up to August 2015, the total value of building approvals for residential construction equated to \$65.39 billion, according

⁴ Australian Bureau of Statistics (ABS) 2015, "Housing Finance Australia, Aug 2015", Australian Bureau of Statistics, Canberra.

to the ABS. This reflected an increase of 14.7% year-on-year.

The rapid growth in housing finance has corresponded with a stronger demand for mezzanine

up to 50%⁵. The development sector was one of the hardest hit during the downturn. Defaulting mezzanine loans were a major contributing factor to Octaviar subsequently being placed

REAL ESTATE PLAYERS MUST UNDERSTAND THAT THE INTRODUCTION OF MEZZANINE DEBT WILL RESULT IN A LESS ROBUST FINANCIAL STRUCTURE AND A HEIGHTENED SENSITIVITY TO MACRO-ECONOMIC HEADWINDS.

debt. We expect this demand to accelerate in the near term for several reasons, including increasingly strict lending policies by the big four banks, the surge in construction and property development, the low interest rate environment, and the unattractive alternatives to mezzanine debt such as introducing an equity joint venture partner, resulting in the ceding of control and profits to third parties.

Real Estate players must understand that the introduction of mezzanine debt will result in a less robust financial structure and a heightened sensitivity to macro-economic headwinds.

The demise of Octaviar presents a cautionary tale of the heightened risks associated with mezzanine lending. Octaviar, formerly known as MFS Limited, was a Queensland based property finance group. As a specialist mezzanine lender, Octaviar raised funds from retail investors, promising high yields of up to 8% per annum. The impact of the Global Financial Crisis (GFC) resulted in the collapse of the Queensland property market, with asset values falling by

into liquidation. As one disappointed retail investor explained, "I am bitterly disillusioned ... that our hard-earned savings were going into mezzanine loans for shonky, over-gear Australian developers who, when things got tough, disappeared into a mix of smoke and mirrors."⁶

TYPICAL DEAL TERMS

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

⁵ According to Ferrier Hodgson, in their paper titled "Queensland Property Buffeted by An Ill Wind", the GFC may have initiated Queensland's property market downturn, but the sector suffered multiple blows ranging from lower levels of net migration to the downturn in tourism, the devastating Queensland floods and Cyclone Yasi, along with an ongoing lack of finance.

⁶ "Investors Back Octaviar Offer of Cash Payout". Stuff. N.p., n.d. Web. 07 Jan. 2016.

conditions typically mirror the senior lender's requirements.

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 depend on the type of project and its risk, however, plus the experience of the borrower, leverage levels, loan size and 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%. 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 one 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

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%.

for commercial property, leads to lower first mortgage leverage.

AN ANALYST'S TASK – A HYPOTHETICAL 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 capitalise 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 metres 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 one 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 CoreLogic RP Data and comparable transactions, a going-out capitalisation rate of 8% is used, representing a sales price in year four of \$56,243,200.

An interest-only bank bill business loan of 65% of leverage is available. 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 five 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.

Tables 2 and 3 depict the cash flows and performance measurements when modelling our hypothetical case study with and without mezzanine debt. Our analysis shows it is accretive to the

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			Sources		
		LTV			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%

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%				

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.

The cash-on-cash returns to SREF in years one and two are lower as a result of the introduction of mezzanine debt (13.85% and 14.76% as opposed to 12.32% and

14.45%) because of the subordination of returns from the equity. The mezzanine borrower is prioritised, 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.

EXIT STRATEGY OF MEZZANINE LENDER

Mezzanine financing generally has a short- to medium-term maturity of two to five years, while property investors 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 under water, 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,

between the mezzanine lender and the senior financier.

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

in order to discharge the debt, interest and other fees owing to the senior lender. Any residual funds remaining 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

Sophisticated quality underwriting by mezzanine lenders is critical for real estate investing in the current lending environment, with a strong focus on exit strategies and timing, in addition to the past record and experience of the real estate borrower.

Real estate players must analyse 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, capitalisation 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. ■

This article has been reduced for publication. To access the full original paper with more details, visit <http://bit.ly/1mYLFDe>.

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.

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 capitalised during the duration of the project. On the pre-sales settlement date, the 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 funding⁷.

MEZZANINE LENDER RIGHTS AND REMEDIES

In the event of a default, a mezzanine lender is restricted by those limitations set out in the 'Priority Deed'. The Priority Deed is an important document governing the relationship

mezzanine lenders can bring value to the table, particularly where the mezzanine lender is an experienced real estate player. Active mezzanine managers may reduce default rates with better access to information and earlier intervention strategies, as well as terms structured to protect on the downside, and by ensuring a seat at the table in the event of default⁸.

Unlike the senior lender, a mezzanine lender will not be permitted to enforce their security. Often the 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)⁹.

Should the mezzanine lender not wish to exercise its right to cure or take out the senior loan when default is subsisting, the senior lender may appoint a receiver to realise the secured property

⁸ "Mezzanine Debt Offers the Best of Both Worlds...or Does It?" Investment Magazine. N.p., 4 Sept. 2009. Web.

⁹ 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.

⁷ 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.



SENIOR DEBT

This is typically the majority of the stack. Senior debt is generally secured by the property, which serves as collateral for the loan. The risk of senior debt is the lowest of all of the layers in the stack due to its security interest in the collateral.



EQUITY

In these instances, two or more persons may contribute equity in a real estate investment. This may take the form of a joint venture, joint tenancy, tenants in common, partnership, trust, et al. Equity may be structured in a pari passu manner, or take on some of the characteristics of subordinated debt, or a range of options in between.



PREFERRED EQUITY

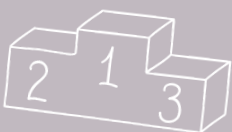
Under this arrangement, the investor makes its investment and receives a preferred return (in the form of fixed annual payback as opposed to interest payments) and can potentially participate in the upside or profits of the project. In the event of non-payment or breach, the preferred owner dilutes the equity, or buys out the equity. This sort of finance is common in the US.

FINANCING OPTIONS FOR REAL ESTATE DEVELOPMENTS

Information supplied by Trident Real Estate Capital.

MEZZANINE FINANCING

The term refers to debt, subordinated to the senior debt. The mezzanine debt may be further split into different ranking tranches in larger project. Each tranche of mezzanine debt may be ranked in accordance with where it sits in the capital stack and each tranche may have different characteristics, which can be tailored to meet an investor's preference. Rates of return are tied to seniority.



CROWD FUNDING

Crowd funding involves the pooling of financial resources from many different individuals to convert an idea into a project or business. This can rely on a few large donors, or many small ones. Funding needs and purposes are communicated broadly, in a forum where this can be evaluated by the 'crowd', or audience, usually carried out on the Internet.



BONDS (SECURED DEBTS)

Stricter lending requirements have resulted in large and reputable developers tapping into the capital markets as a source of finance. Bonds are typically issued at a fixed rate and maturity, and generally secured against the overall asset backing of the company. Where there is an existing bank loan, the securitisation of the bond instead relies on a 'negative pledge' that works to contain the issuing company's debt level.

