

MEZZANINE FINANCING

Glenn Chwatt of Jericho State Fund Consulting LLC on the prospects of mezzanine financing



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Do you believe the US loan market is over heating? How would you gauge the appetite for mezzanine and sub mezzanine loans?

There are certainly areas of concern which have been well documented including the sub prime market and large private equity transactions but the commercial real estate market has remained quite stable. This is as a result of several factors including: low unemployment, relatively high construction costs resulting in less overbuilding, low interest rates and a conservative stance embraced by traditional commercial lenders owing to bloated residential balance sheets.

Hard money, first mortgages and mezzanine debt for commercial properties have continued to see strong demand. Owing to the negative media attention drawn by the real estate market, banks have been reluctant to enter into real estate transactions in certain markets. This has opened up the market for niche players and has increased the opportunity for them to offer bridge loans. As an example, borrowers who would have traditionally gone to banks for financing have approached Jericho State Fund Consulting LLC - this has enabled us to lend money to a first position at close to rates that we historically have obtained for second position mortgages.

The mezzanine lending environment is extremely competitive, what have been the consequences of this for player like you?

We focus on a niche in the marketplace where we are typically viewed more as an equity alternative than a debt instrument - although our collateral is secured through the recording of a lien on the property and receiving an assignment of all voting rights from the borrowing entity, which is almost always backed by a personal guarantee from the borrower. We also have the infrastructure and are known in the industry for having the capacity to close transactions in as few as three business days. This gives us the ability to dictate terms and conditions without concern for competition. We only consider special properties or situations where our bridge loan (less than 18 months) capabilities allow a borrower to reposition a property or move a development project to a stage, where more traditional lenders would become viable refinance options.

How much is currently being charged by equity providers and how much "cheaper" is it to get a mezzanine loan?

Equity investors provide the financing portion above the debt financing stack - typically providing between 10 and 20% of the equity and in return receive between 30 and 60% of the end profits, often with a preferred dividend return of 10-15% which is senior to the developer's equity. Our hard money, first position and mezzanine (second position) debt is typically a fixed rate of interest between 20 and 25% which results in substantial savings for a borrower that probably does not have to turn to equity investors, or can at least minimize their exposure to equity investors.

What are the different ways in which lenders can and do give mezzanine loans?

Mezzanine means different things to different people. We refer to mezzanine as financing which is subordinate to a first mortgage lien. Our mezzanine real estate financings have a recorded lien as the main component of collateral. We also require an assignment of the stock of the borrowing company, along with personal and corporate guarantees by any owners of 10% or greater of the equity. Furthermore, in order to lower the "loan to value" (LTV) profile of our mezzanine loans, Jericho, unlike traditional lenders, is willing to look beyond the property at issue for its collateral. Jericho is willing to take different properties owned by the borrower to secure a loan, lowering the LTV ratio of our loans with assets most lenders cannot otherwise consider.

How do mezzanine lenders secure their loans? (Rights to collateral in the waterfall scenario / sharing with primary lenders / collateral split)

Again, we always require an actual lien to be recorded and subsequently require an inter-creditor agreement with any senior lender. Within that inter-creditor agreement we document our right to procure any payments by the borrower in the event of a default. Additionally we arrange, and receive the ability to step into the borrower's shoes and maintain or complete the project, while servicing the senior debt and executing our pre-determined exit strategy which is contemplated at the onset of the underwriting process. We also typically require that the borrower maintains an interest reserve to cover not only our interest payments, but also the interest payments on the first loan for the life of our loan, almost eliminating the risk of a financial default on the first loan.

"Securitized mezzanine funds are often a train wreck waiting to happen because if a recession hits we will be likely to have a 10 per cent default spike, which means a further 20-30 per cent of a representative portfolio will be stressed."
 Comments...

Jericho has been in the business of providing real estate financing for 35 years. It has lived through a variety of economic environments, including tight credit, loose credit, overheated real estate markets, depressions, bull and bear stock markets, and inflationary and deflationary environments. This experience provides Jericho with the knowledge and experience in selecting and structuring loans without being susceptible to macro events. All loans that Jericho negotiates are well collateralised, covering us in the event of a major market drop. They are also short term in nature, making us much less susceptible to market moves as we are the first party the borrower is trying to remove from the picture. In addition, we are very selective with our loans - although we have the opportunity to invest in close to 10 - 20 loans a month, we historically have not invested in more than only a couple each month. We do not believe our portfolio would be greatly affected by a 10 per cent default spike, but in fact may further increase opportunities for us and similar niche lenders, as banks become even more fearful of entering the market.