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Is Mezzanine Financing Still Relevant?

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Mezzanine financing is a mechanism by which real estate investors can pull additional equity out of their properties. Up until the early to mid-1990s, if investors wanted to borrow additional funds, they frequently would grant a second mortgage on their property to a party who was willing to lend the additional amounts. Over the past fifteen to twenty years, second mortgages have become far less common, as first mortgage lenders have prohibited the use of such vehicles.

While first mortgage lenders have generally prohibited borrowers from using second mortgages to pull equity out of the their properties, such first mortgage lenders have become much more comfortable with mezzanine financing. Frequently, with mezzanine financing, rather than the borrower granting a second mortgage on its property, the borrower collaterally assigns its partnership interests or its LLC membership interest to the mezzanine lender as security. For example, in the simple situation of a single-member LLC, the owner of that membership interest would collaterally assign it to the mezzanine lender. If the borrower were to default on the financing, the mezzanine lender would have the right to take over the LLC and become the owner of the property, subject to the first mortgage.

Mezzanine loans became very popular during the earlier years of this decade. During the real estate boon, borrowers would either use mezzanine financing to minimize their equity requirement in a project or, as borrowers saw their properties increase in value, they used mezzanine financing to pull their increasing equity out of the properties. Because of the subordinate nature of the financing, the mezzanine loan would carry a higher interest rate or a market rate of interest with an equity kicker, but borrowers were willing to agree to such terms so long as they could minimize their equity investment.

As we have learned over the past twelve to twenty-four months, real estate values don't always appreciate. The question becomes, “is there still a place for mezzanine loans in a down market?”

The answer is "yes." Today, if commercial lenders loan money to borrowers or agree to extend loans, they will limit the loan to value ratio to no more than 60%-65%, as opposed to the 75% to 80% that had until recently been the norm.

If lenders limit the loan to value ratio to 60%, borrowers will need to come up with

40% equity. If a borrower is merely extending a loan or is having to put additional equity into a loan because the first mortgage lender is “right-sizing” the loan, the borrower will need to find a mechanism for obtaining the additional equity. Mezzanine lenders are in a good position to provide such funds.

From the mezzanine lender's standpoint, the current state of the commercial real estate market offers it the opportunity to garner higher interest rates (or perhaps a market rate of interest with an equity kicker) while still only lending up to, for example, 80% of the property's current value. While the borrower may not be happy about having to pay the mezzanine lender's higher rate of interest or equity kicker, the borrower may be happy that it has found a source of funds that will allow it to continue to own the property.

If a borrower pursues mezzanine financing, the borrower will typically still need to obtain its lender's consent to the transaction. As a condition to granting its consent, that lender will often require that it and the mezzanine lender enter into an intercreditor agreement. If you would like to discuss how mezzanine financing might be helpful to you, feel free to call me or any of my Reinhart colleagues.