THE MORTGAGE OBSERVER

APRIL 2013 ISSUE - **JOSHUA STEIN** IN THE NEWS - Online and Page 12 in The Mortgage Observer Magazine

Stein's Law

Mezzanine Lending, Post-Crash

How do you know when the commercial real estate financing market has gotten out of control and become irrationally exuberant?

If you're a mezzanine lender, you look for three things. First, have non-real-estate players such as hedge funds started to come into the mezzanine debt market? Second, has the deluge of new players caused a substantial drop in pricing? And third, are other funding sources offering to finance mezzanine lenders on very favorable terms?

In mid-2007, **Terra Capital Partners**, led by **Bruce Batkin**, noticed all three red flags waving in gale-force winds, and Terra sold its entire portfolio of nearly 100 mezzanine loans. Then Terra sat on the sidelines for two years.

Joshua Stein

Terra decided that the market had hit bottom in 2009 and started lending again. Today, first mortgage lenders want to lend again, but it's very much not like 2007 all over again. Proceeds are down, conservatism is up, and many borrowers find themselves with a gap between the equity they're willing to risk in a deal and the first mortgage financing they're able to find, even with traditional mortgage lenders—both portfolio and securitized—all looking for solid places to put money.

That's the gap that mezzanine lenders like Terra fill. Terra does it with its own equity capital, raised through a series of funds. Over the course of several conversations, Mr. Batkin told me that leverage isn't readily available for mezzanine lenders, but his deals already have enough inherent leverage in them based on their subordinate positions.

Each mezzanine loan is different, often involving real estate with a "story"—a turnaround, a portfolio assemblage, a new hotel in a pioneering location, a busted condo complex or, increasingly, financing the discounted payoff of a senior mortgage loan. A deal could involve an earn-out or other types of additional advances, potentially giving a borrower a technique to monetize short-term project success without needing to refinance conservative, simple, low-cost senior financing.

Because Terra's loans are typically complicated, requiring bespoke deal terms, Mr. Batkin said that Terra doesn't engage outside servicers. The firm also never sells its loans, the one huge exception being that single transaction in 2007 when it sold its entire portfolio.

From a senior lender's perspective, the existence of a mezzanine lender like Terra adds complexity to the capital stack, but it also produces significant benefits, not at all limited to the possibility of future mezzanine loan advances and the immediate obvious benefit of helping a borrower close a deal that otherwise might not have happened. If the property gets into trouble and the borrower doesn't want to or can't reinvest in it the mezzanine lender might. The mezzanine lender focuses an extra pair of eyes on the borrower, a strong dose of real estate expertise that may well help if the going gets rough.

A mezzanine loan carries a much higher risk than a mortgage loan, because it's structurally subordinate to the mortgage loan. The mezzanine lender must, at least in theory, stand ready to pay off the mortgage loan if the project gets into trouble and the mezzanine lender thinks there's still enough value in the underlying asset to support the mezzanine credit. In practice, it never works out that way, Mr. Batkin told me. Instead of facing a foreclosure on the senior loan, the mezzanine lender will always figure out how to negotiate with the senior lender, avoid acceleration or maturity of the senior loan, and live to fight another day—often minus the borrower.

According to Mr. Batkin, in underwriting a mezzanine loan, Terra will essentially reappraise the underlying property based on its own underwriting criteria. Terra then typically asks whether it would be comfortable owning the property based on a purchase price equal to the mezzanine loan plus the underlying mortgage loan. How does the total amount of those two loans compare with the conservative valuation of the property at the time? And, looking ahead to maturity of the mortgage loan, how much will the scheduled amortization on that loan reduce Terra's exposure and implied potential purchase price for the property?

Mr. Batkin said that Terra tries to focus on sub-debt loans between $3 million and $15 million. In today's market, he sees senior loans generally at anywhere from 60 percent to 75 percent of value. Terra's mezzanine financing will bring the debt stack to between 65 percent and 85 percent of value, with an average of 75 percent across the portfolio. In 2007, he said, the equivalent figure for mezzanine lending in the market as a whole was about 85 percent.

Mr. Batkin and I will continue our conversation about mezzanine financing, with an emphasis on how Terra structured a half-dozen specific mezzanine loans for six wildly different projects, at a luncheon program sponsored by the Mortgage Bankers Association of New York, on Thursday April 18, 2013.

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