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REAL ESTATE INTELLIGENCE

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TOP STORY

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WILL MEZZ GET MESSY?

Steve Garmhausen

The expectation of rising interest rates is causing concern in the roaring business of mezzanine debt and related forms of financing. Mezz debt has roared into the real estate picture over the last several years, reaching \$37.3 billion by 2002, according to Fitch Ratings-double 1998 levels.

"There is a lot of concern among professionals that this favorable interest rate environment can snap back the other way," says Larry Fiedler, an adjunct professor at New York University's Real Estate Institute and president of JRM Development Enterprises. "There is a lot of concern that if you're junior to the CMBS mortgage, your cash flow is going to be taken from you as the interest rates go higher."

One high-stakes deal is the \$1.4 billion sale of the GM Building in Manhattan last year to Harry Macklowe. It has a floating rate senior debt component along with a floating mezz structure with a cap and a floor, Fiedler says.

A 2-point rise in Libor-which has been falling steadily for the past few years-would add more than 50% to the senior loan costs. Vornado Corp., which holds the mezz piece in the deal, should earn a return of 10% to 11%, but in the event of default would accede to the equity, Fiedler says.

(Mezz debt generally refers to the financing equity or debt between senior debt and unlimited equity. The terminology is loose; senior equity and preferred equity can look a lot like mezz debt.)

Joshua Stein, a real estate partner at the law firm of Latham & Watkins in New York, warns that the growth spurt in adopting such sophisticated financing instruments has moved more quickly than the legal instruments used to define them. In many cases, contract language has left lenders more exposed than they realize: "The sun has been shining for a decade," says Stein. "Nobody has really learned much about any defects in mezzanine loan structuring, and there are a lot of unknowns right now."

At the center of the issue - and suddenly more prominent than in years - are so-called nonrecourse carveout provisions, which protect lenders' interests in the event of a default. The carveouts make borrowers liable for specific elements of a property transaction, from destroyed or damaged collateral to uncollected



Joshua Stein

rent prior to a sale to site contamination.

"I don't think the business world recognizes how important they are," says Stein. "They are the motor that drives the borrower to behave themselves when a loan goes into default."

The provisions work fine for regular mortgage loans. The problem is that the same language is often used for mezz debt, says Stein.

Lenders fail to recognize that their collateral for mezz debt is not physical real estate but membership interest in a limited liability company. Carveouts in mezzanine deals need to specify that borrowers may not jeopardize their membership interest in the LLC, by amending the agreement or misapplying distributions from the company, for example.

"People have been negotiating deals that they don't remember can go into default," Stein says. "We're in an environment where I think you're going to see more defaults rather than fewer."

Mezz debt has been used for more than a decade, but along with B notes, has become a routine element in financing packages over the past year or so. Now, one-stop shopping is common: A packaged mortgage loan and mezz or "B piece" has become predominant where the senior debt accounts for 75% of the value, says Andrew Oliver, managing director and principal with Sonnenblick-Goldman Co., the New York-based real estate investment banking firm.

Too much money chasing too few deals has pushed real estate prices high and fed the leveraging of the past several years. But traditional buyers like pension funds are starting to adapt a hedging strategy, explains Fiedler.

Since they know that pricing is high, they can take the position that over 10 years prices won't appreciate. They are hedging by borrowing because they can get lower interest rates on 50% leverage.

"People who normally never borrow will borrow just to increase their current return," says Fiedler.