

Credit Squeeze Increases Demand For Small-Balance Secondary Loans

In the face of suddenly volatile credit markets, characterized by tightening underwriting standards and persistent low cap rates, demand appears to be increasing for secondary financing in the form of B-notes, mezzanine debt and preferred equity.

This demand is originating from both sides of the equation - senior lenders as well as borrowers. Securitization lenders are facing increased scrutiny from rating agencies and B-piece buyers, resulting in lower loan-to-value (LTV) first mortgages and increasing spreads.

Balance sheet lenders are taking advantage of the weakness in the commercial mortgage-backed securities (CMBS) and collateralized debt obligation (CDO) markets to reduce risk in their portfolios and/or achieve improved pricing for the risks they are still being asked to take.

These trends are requiring more equity in pending transactions. Borrowers accustomed to loose credit are facing a choice between injecting additional equity into transactions or seeking secondary financing to fill the gap between available senior loan proceeds and borrower's equity.

During this decade, a steady search for yield has compressed interest rates and cap rates ever lower. From 2000 to 2004, mezzanine demand was strong despite attractive interest rates.

Over the past three years, however, visible mezzanine demand has been muted by increasing senior loan proceeds and in-house mezzanine programs of senior lenders. Maximum senior loan proceeds climbed the ladder from 75% LTV up to a very common 85% LTV. Even 90% LTV first mortgages have been available.

The shift in credit markets not only has caused senior loan proceeds to compress, but is also expected to reduce appetite for risk - possibly slow-

Market conditions and reduced fixed lending costs have made certain types of small-balance mezzanine loans a particularly appealing option for borrowers and lenders alike.

BY RANCE S. GREGORY

ing the growth in senior lenders' in-house mezzanine programs.

For transactions above \$50 million, strong balance sheets and other financial resources of a typical borrower are such that a 5%-to-10% adjustment in first-mortgage proceeds may not cause an undue burden and put the borrower at risk of failing to close a transaction.

However, some portion of the large-



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balance borrower universe is driven by internal rate of return and thus may be motivated to seek secondary debt to achieve satisfactory financial leverage. For smaller borrowers, a 5%-to-10% shift in senior LTV proceeds may frequently cause greater strain. Even though the dollars are smaller, they are often more meaningful to the individual borrower.

For these purposes, it is fair to as-

sume that the average secondary financing loan approximates 5% to 10% of the value. Certainly, individual mezzanine loans are closed at greater or lesser percentages of a given capital structure, but the typical LTV of senior loans (65% to 80%) and relative pricing of senior and mezzanine loans (today averaging 6.5% and 10%, respectively) generally result in secondary loans sized according to 5% to 10% of the overall transaction.

Enter mezzanine

The large loan market is fully and competitively served by Wall Street lenders of both the senior and mezzanine variety. Yet the market remains inefficient for small mezzanine debt, represented by secondary loans (or preferred equity) under \$5 million.

This shortfall occurs because most



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professional mezzanine lenders operate at a scale where they cannot reasonably invest their massive funds by spending time on \$1 million-to-\$5 million secondary financings.

Five years ago, it was also true that the cost of documenting small-balance secondary financing was often prohibitive - particularly in cases where the senior lender and mezzanine lender had not worked together on prior transactions.

Fortunately, the continued development of standard intercreditor documentation, with a typical list of limited mezzanine lender rights - notice provisions, right to cure and right to buy the senior loan at par - has helped to bring down costs of the average mezzanine loan. The fixed costs, however, remain a larger percentage of the loan amount than with large-balance loans.

Further, the number of options and complexity of available structures has increased. Should a borrower seek to access a highly structured solution (for instance, a transaction involving multiple mezz tranches), costs will remain elevated.

But most small-balance borrowers are seeking a simple solution to a shortfall in proceeds. Mezzanine loans are probably the easiest solution for the borrower and mezzanine lender. Should the senior lender prohibit traditional secondary financing, preferred equity is often an option, but it can sometimes increase the difficulty and cost for the borrower and mezzanine lender.

Pre-baked intercreditor programs, including A/B note structures, have also contributed to the streamlining of the mezzanine loan process. Some of these programs may slow or disappear as senior lenders' tolerance of risk diminishes.

Still, the market will continue to benefit from the improved technology and knowledge base developed by junior and senior lenders over the past five years of closings involving complex loan structures.

The challenge for small-balance borrowers and their mortgage representatives is to identify small-balance mezzanine lenders that are acceptable to senior lenders in areas of sophistication, years of experience, financial capacity and operational expertise.

Minimizing risk

Some senior lenders, especially life insurance companies, view any transaction involving secondary financing to contain inherently more risk than a traditional transaction involving simple first-mortgage debt and borrower equity.

There is some logic to this thinking, particularly if the borrower is over-leveraging and putting itself at greater risk of default. However, this line of thought ignores that in a combined first-mortgage/mezzanine transaction, the senior lender now has two borrowers with a keen interest in preserving capital.

To the extent that the mezzanine lender has better credit than the borrower, the senior lender may actually have added protection against loss. This layer of insulation between borrower and senior lender is strongest when the mezzanine lender has both the financial wherewithal and operational expertise to work out trouble properties.

It is possible that all this recent spread-

ing of risk through securitization and an endless slicing and dicing of loans may have, in many cases, actually increased the downside potential of failed transactions by leaving no one party responsible for holding and servicing the loan.

But the added risk caused by creating distance between borrower and lender by adding dozens of stakeholders to the loan and by removing the original lender's skin from the game is vastly different from a simple tri-party transaction consisting of a senior loan, mezz loan and borrower equity.

First-mortgage providers who remain nervous about straight-over-tackle mezzanine financing are fundamentally concerned that there will be default involved in the transaction, as the provider's own risk of principal has likely not increased.

If the first-mortgage market stabilizes at a lower LTV and higher spread than was common during much of the past five years, savvy senior lenders may take advantage by issuing new loans at a more favorable risk/return relationship.

The market will seek a new level, and it may mean that the requirement for more equity in transactions becomes filled by secondary financing. If that is the case, senior lenders would be wise to continue teaming with experienced mezzanine lenders to control the process of selling down risk, rather than waiting for borrowers to take deals elsewhere or find hard money with which to over-leverage.

Borrowers who are not tracking market conditions closely may find themselves surprised by a re-traded



commitment letter in the case of loans under application, or quotes that do not match up with their underwriting in the case of new transactions.

The number of lenders providing nosebleed LTVs may be decreasing, and many borrowers will face a more difficult set of options, requiring them to choose between losing a deal or deposit, bringing in an equity partner and giving up a portion of a property's depreciation benefits and foregoing up to 50% of the profit potential, or locating a small-balance mezzanine lender to fill the gap between available senior loan proceeds and borrower's equity. In today's changing market, the last option may become increasingly attractive. ●

AGENDA

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at 22% and foreign investors at 18%.

Multifamily market

The apartment rental market - multifamily housing - anecdotally appears to be affected by an influx of single-family homes being offered for rent, cutting into the demand for apartment rentals, notes NAR. In addition, condos are being converted into rental units, particularly in markets such as Washington, D.C., and several areas of Florida.

At the same time, potential first-time home buyers are hesitant and staying in the rental market, supporting multifamily fundamentals until the lure of homeownership returns, the housing cycle changes and more buyers enter the housing market.

Multifamily vacancy rates are likely to average 5.9% in the fourth quarter, the same as the fourth quarter of 2006, and then ease to 5.6% by the end of next year. NAR expects that average rent will increase 2.9% this year and 3.8% in 2008, after a 4.1% rise last year.

Multifamily net absorption will probably total 209,200 units in 59 tracked metro areas this year - down from 229,400 in 2006 - but increase to 234,400 in 2008.

The areas with the lowest apartment vacancies include Northern New Jersey, Salt Lake City, Philadelphia, Pittsburgh, Los Angeles, Minneapolis and Nashville, Tenn., all with vacancy rates of 2.7% or less.

Multifamily transactions in the first seven months of this year totaled \$46.3 billion, compared with \$41.5 billion in the same period in 2006. According to the report, half of the purchases were by private investors, while condo converters accounted for only 3% of acquisitions. ●

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