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Mezzanine Finance: A Borrower's Perspective

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Over the last 12 to 18 months, we have heard the same story told over and over again: Borrowers facing acquisition opportunities, product improvement plan (PIP) requirements/renovation, or refinancing of their hotels have found that loan proceeds, more often than not, fell short of the required amount. The culprit of this phenomenon is easy to explain. Property values, as a function of operating cash flow, have declined somewhat proportionately to the decline in top-line revenues. Moreover, in the face of uncertainties surrounding the outlook on asset's operating bottom-line, inflation, and interest rates, lenders have taken a defensive stand and have begun applying more stringent underwriting parameters on loan applications. During roughly this same period, we have heard the ubiquitous buzz words: ***mezzanine finance***. Mezzanine finance can be loosely defined as a type of debt financing in which a lender's recourse is subordinate to that of the in-place senior loan. In response to the capital needs of the market, lenders, either acting individually or by teaming up with other capital sources, have devised a structure that allows borrowers to obtain their required loan proceeds, while still meeting the lenders' strict underwriting parameters. Mezzanine finance presents an opportunity for borrowers to access additional capital above and beyond what conventional financing provides. Although not considered a new marvel of financial engineering, mezzanine finance has grown in popularity in the face of the recent hotel market downturn. We have seen a proliferation of lenders offering mezzanine financing in today's hotel lending market. The wide-array of alternative financial products offered can broadly categorized as follows:

1. **Mezzanine loan**; in its "true" form, the loan is secured by 100% ownership interests in the borrowing entity. Essentially, it is treated as a partnership loan and not recorded as a lien on the collateral property.
2. **Second lien mortgage**; generally preferred by banks, this type of subordinated financing is secured by a second deed of trust on the collateral property.
3. **Preferred equity**; it appears more like equity, but the return profile mimics that of debt. This form of subordinated financing collects its debt service in the form of a preferred return on the dollar invested. In many instances, debt service payments are cumulative.

Now the question is: How do borrowers take advantage of this opportunity? From a borrower's perspective, there are several limiting conditions that determine which of these financial products make the most sense. Without attempting to provide an exhaustive list, below are some conditions that are applicable in most refinancing situations. First is the **total capitalization** of the collateral. For hotel properties, the combined senior and mezzanine debt can be as high as 85% of the collateral's market value, while the most common scenario in today's market is between 70% and 75% loan-to-value (LTV). The higher the combined LTV, the riskier the mezzanine component is from the mezzanine lender's standpoint. Obviously, the higher risk translates to higher interest rate on the subordinated loan. The **type of senior loan**, whether it is part of a commercial mortgage-backed securities (CMBS) pool or resides on the portfolio lender's balance sheet, is also a factor. Rating agencies, such as Standard & Poors and Moody's, dictate a good deal of underwriting parameters that are then applied by conduit lenders. Securitized loans typically include covenants limiting the amount of subordinated financing allowed. Additionally, these covenants may restrict the pledge of ownership interests of the single purpose, bankruptcy remote entity (SPE) commonly associated with securitized loans. On the other hand, portfolio lenders who are not subject to rating agencies' parameters often offer more flexibility in structuring mezzanine financing. All types of subordinated financing will require an **inter-creditor agreement** between the senior and subordinate lenders. The **character of mezzanine lender** (creditability, capacity, etc.) may positively, or negatively, affect the senior lender's view of the overall risks associated with the property. The inter-creditor agreement between the two lenders will provide for a wide-ranging number of issues. Of primary importance will

Summary

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be how the creditors deal with default, including the notice of default of the senior loan and right to cure in the event of a default. Furthermore, there are instances in which the two loans may be cross-defaulted, meaning that a default (especially monetary default) under either loan will trigger a default on the other loan, even if debt service and other required reserve payments are current. In the event of default, recourse for mezzanine lenders typically involves taking over the ownership of the borrowing entity and the control of the collateral property. Certain **type of collateral** (i.e. flagged vs. non-flagged, limited- vs. full-service, subordinated management agreement, location, etc.) may be appealing to certain lenders, and not so appealing to others. This is usually the case when the mezzanine lender is affiliated with a hotel owner/operator company. Often, when a borrower obtains a mezzanine loan, cash flows from the property are insufficient to service both loans, especially when the mezzanine loan is at its "full note rate" (i.e. the interest rate quoted in the promissory note). A common solution to this is a **current vs. accrual payments** structure. In this scenario, the mezzanine lender will provide for a lower "pay rate" which must be paid currently, with the difference between the two rates accruing to the note. It is important to understand that this accrual amount compounds at the full note rate, and is capitalized into the outstanding principal balance. The result is a rapidly increasing mezzanine loan balance, which ideally must be matched by proportionate growth in net income (and thus, the market value of the collateral) to keep the overall LTV ratio at an acceptable level. Because of the relatively expensive pricing on these loans, mezzanine finance should be viewed only as a short-term solution with a clear, attainable **exit strategy**. The terms of the mezzanine loan often mirror those of the senior loan. Therefore, it is prudent to expect that a future refinancing, or sale of the property, will provide enough proceeds to pay-off both the senior and mezzanine loans. It is clear that mezzanine finance provides borrowers with access to capital which otherwise would not be available under conventional lending parameters. With these considerations in mind, borrowers can prudently pick the various options that best fit not only their immediate capital needs, but also the unique financial and operational circumstances surrounding their hotel investments.