Navigating Negotiations

With patience and cunning, mezzanine lenders can reach mutually beneficial agreements with senior lenders

By **Daniel Edrei,** director and principal, Meecorp Capital Markets

FOR A LONG TIME, MEZZANINE financing was more of an industry buzz-term than an actual employed product. Many senior debt lenders shied away from it and viewed it simply as the incurring of additional debt. They also worried that trigger-happy mezzanine lenders would push reasonable transactions into foreclosure and mar an otherwise appealing securitization.

The tide has begun to turn. Many senior lenders are recognizing the value of having a subordinate with deep pockets and much at stake. After all, mezzanine lenders are the ones sitting closest to the top of the capital pyramid — the first to lose in the event of default. Moreover, astute mezzanine lenders often insist on investing their capital directly into the real estate, which appreciates the value.

To keep mezzanine players in a deal, senior lenders have become more flexible in their intercreditor terms. The terms of intercreditor agreements are still fluctuating, but mezzanine lenders with patience and good navigational skills can remain afloat through negotiations with senior lenders.

Plotting negotiations

Intercreditor-agreement terms play a crucial role in a transaction's feasibility. While the economy is stable, interest rates are increasing and construction is slowing down. Sale prices appear to be near or at their peak in this market cycle. This atmosphere generates much well-founded caution.

Mezzanine lenders could end up treading water if they are not covered in their underwriting and in their ability to negotiate favorable contingency plans with senior lenders. As such, they will want the right to cure. If the senior debt goes into default, the senior lender will inform the mezzanine lender and allow it to make good on the borrowers' debt.

Often, mezzanine lenders start negotiations with a boilerplate document from the senior lender that awards no rights whatsoever. Like any negotiation, concessions between senior and mezzanine lenders can be as much of an opportunity for savvy negotiators as they are a challenge.

For example, a mezzanine lender might agree to allow the senior

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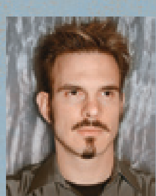

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lender to recover 100 percent of its investment before any mezzanine debt is paid off. In exchange, that lender might get the ironclad intercreditor agreement it wants. Perhaps it won't have to service debt if there is a default.

There are many ways to put together an agreement to benefit the senior and mezzanine lender while accounting for the interests and appetites of each party. These interests relate to typical underwriting variables such as property type, location, strength of the borrowing entity and the transaction's upside. The senior lender may be comfortable with the mezzanine lender's ability to assume ownership and to turn around a failing property in case of default. The mezzanine lender may appreciate having the ability to assume senior debt or believe that the senior lender will provide additional inexpensive funds to stabilize a transaction, should it begin to waver.

Protecting your investment

Consider the following terms and their roles in the deal.

- **Warrants:** In using the borrowers' pledge of stock, you accept warrants to purchase that stock for a nominal amount. Lenders, however, must be careful not to become an equity player. There are problems and legal liabilities that come with being both at once.
- **Second liens:** In the beginning, mezzanine financing was collateralized exclusively by a pledge of the borrowers' stock. There was no junior subordinate lien. Many banks now are more flexible, allowing mezzanine lenders the protection of a lien. For most lenders, having a second lien on the property feels more secure than a pledge of stock alone.
- **Last out:** Ideally, the senior lender wants to know that the senior debt will be paid off before the mezzanine lender receives anything. When considering releases such those as in condominium-construction loans, however, the units remaining after the senior debt is paid off may be less marketable. Thus, whenever possible, mezzanine lenders want to be paid down some amount from every release.

  That said, the combined loan to value of the debt instruments can be low enough that the mezzanine lender might stay in the deal long after the senior debt is paid. Sometimes a lender will switch hats from bridge lending to mezzanine lending and then back to bridge as lots are purchased, developed and sold.
- **Lines of credit:** Lenders love to structure mezzanine lines of credit for borrowers, especially for those with proven track records. There's real opportunity in doing so. Senior lenders are finding mezzanine lines of credit more acceptable for the same reasons.

  In addition, senior lenders want to know that borrowers have the money needed to close. Closings that fall through are expensive. So lenders may look at existing lines of credit positively and be more flexible regarding their own terms.

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Banks and commercial-mortgage-backed-securities lenders issuing the primary debt on commercial real estate recognize the value of mezzanine financing more today than they did just a few years ago. But the influx of lenders entering the mezzanine marketplace may result in hefty losses for some lenders in the near future.

Should there be a blip in the market and a decline in values, they may be forced to jump ship. After all, appetites can shift quickly for such specialized financing.

Lenders who believe in the property should structure every loan so they can make good on it, should there be a problem. That way, they can sit back and hold on until things change. If a loan goes amiss, they can take steps to limit the damages, put on a life vest and wait for the next ship to come in.