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Mezzanine Financing on the Upswing as Industry Sees More Construction

BY BETH MATTSON-TEIG | JANUARY 14, 2015

Borrowers have a growing appetite for mezzanine loans that is fueled by redevelopment and refinancing activity, as well as the return of new construction.

Terra Capital Partners, a New York-based fund manager, has seen its mezzanine lending volume double over the past year and the firm expects that volume to double again in 2015. Although Terra Capital Partners does not disclose its total lending volume, it provided mezzanine or bridge financing on about 40 different projects last year. Mezzanine capital typically goes higher on the “capital stack” of project financing, layering on top of a first mortgage to provide a borrower with higher leverage.

The surge in activity at Terra Capital is due in part to growing momentum at the firm, including more fundraising success and the ability to make larger loans. In the past year, the size of the loans the company has also doubled from between $5 million and $15 million up to $20 million and $30 million. That growth is a reflection of more activity in the market. “The general direction of the market is one of increased volume,” says Terra Capital CEO Bruce Batkin.

There is still a tremendous amount of loans that are maturing and transactions that are getting recapitalized, as well as new transactions involving redevelopment and new construction, says Jeffrey Fastov, a senior principal at Square Mile Capital Management, a diversified real estate investment firm based in New York City. “So, we expect very, very high activity levels for the next few years,” he says. “We also think that the banks, while more aggressive recently, will still be somewhat constrained in what they do, because regulators are very, very focused on asset quality.”

Square Mile Capital added mezzanine lending to its repertoire in 2012. The firm provided $300 million in mezz loans last year and expects to exceed that level in 2015. “It is more competitive than it was, but we’re still finding very good investments with good credit characteristics and good return profiles,” says Fastov. Square Mile typically does deals where the target yield is greater than 10 percent.

Filling a gap

Mezzanine lenders are finding ample opportunities in a market where traditional lenders remain conservative in the amount of leverage they are willing to provide. “The regulatory issues have had a profound negative impact on banks’ ability to lend against real estate, particularly against value-added real estate and new construction,” says Batkin. That creates a greater opportunity for non-regulated, non-deposit private capital to step in and help to finance new construction, he says.

The return of construction is sparking more demand for mezzanine financing. “A lot of the sponsors need capital that goes beyond where a commercial bank construction loan will go,” notes Fastov. Banks will typically provide 60 or 65 percent leverage on a property, while mezzanine lenders will go up to 75 or 80 percent with a non-recourse loan.

A year ago, Terra Capital would not have considered a development deal. But the firm has gained confidence in the momentum of the economic recovery. Terra Capital has provided mezzanine or bridge loans for land acquisition and pre-development costs on four deals over the past several months, and Batkin expects development projects to be a bigger part of its business in 2015.

For example, Terra Capital provided a $25 million mezzanine loan to the Witkoff Group last November to fund the acquisition and pre-development of a 1.4-acre site in West Hollywood, Calif. Witkoff plans to demolish an existing building to build a mixed-use project that will include a new 190-unit Marriott EDITION hotel and 20 condo units.

Mezz lenders also expect to see more business coming from the looming wave of loan maturities. Ten-year loans made at the peak of the market in 2005, 2006 and 2007 are coming due and will need to be refinanced. According to Trepp, more than $300 billion in conduit CMBS loans will mature in 2015, 2016 and 2017. That volume is more than 2.5 times the amount that matured in the last three years. There will be opportunities for mezzanine lenders to provide additional leverage to some of those legacy loans as they are refinanced.

Although it has traditionally been difficult to quantify the exact volume of mezzanine lending, one measure that shows some correlation is the amount of private equity flowing to real estate debt funds. In 2014, 14 North American-focused real estate debt funds raised $11.6 billion in fresh capital, which is up from $8.8 billion in fundraising in 2013 and nearly triple the $3.6 billion that was raised in 2012, according to data from London-based research firm Preqin.

That flow of capital indicates more money coming into debt financing, and some of that money is certainly directed at mezzanine lending. Despite the added competition, mid-market players such as Terra Capital and Square Mile both see ample opportunities ahead.

“I think most of the heavy competition is in the larger, more glamour deals,” says Batkin. There are a few lenders, such as the REITs, that don’t like to put out less than $40 million in a mezzanine deal. So those deals, particularly for core assets in major metros, are being aggressively pursued and commanding single digit yields, he says. Smaller deals and deals in secondary and tertiary markets tend to be less competitive.