nyrej

# Funding the equity gap: A re-examination of all funding sources can be beneficial to borrowers

July 13, 2009 - Financial Digest

With the credit markets frozen and conduit lending a thing of the past, the light at the end of the tunnel for commercial property owners looking to refinance, acquire new property or fund tenant improvements, has come in the form of secondary financing. Between today and the end of 2012, over $1.1 trillion of commercial mortgages are scheduled to mature. Projected declines in property values and lower leverage offered by first mortgage lenders will require additional equity contributions to refinance a sizable portion of these assets. In June, only 38% of maturing securitized mortgages were able to be refinanced, and this may only be the tip of the iceberg of commercial mortgage meltdown that is to come.

The word "mezzanine" conjures negative images for most real estate owners, as these lenders have recently made several appearances in the press foreclosing on over-leveraged loans made during the market peak. However, given the constrained lending environment, it behooves borrowers to give a second look to preferred equity and mezzanine sources as a way to fill the equity gap in property capital structures.

Risk premiums have increased in all areas of commercial real estate. This has become especially pronounced with respect to new mortgage proceeds. Often, borrowers either fail to deconstruct competing term sheets to calculate incremental borrowing costs between offers or neglect to factor in the possibility of a blended rate between a junior and senior mortgage. Given the challenge in attracting additional equity to any project (doctors at the country club no longer seem as interested in real estate investments), the capital offered through including a junior mortgage position offers a reasonable means to maintaining much-needed leverage.

Even with a mezzanine interest rate in the teens, borrowers are still able to achieve positive leverage on their equity position. For example, basing on underwriting a property at a capitalization rate of 10, a 50% LTV mortgage at 7%, when blended with an additional 15% LTV of mezzanine money at 15% offers a combined 65% LTV mortgage at around 8.85%.

Borrowers often fail to explore these blended rates, higher leverage offerings with multiple lenders either because they feel such structures may not be permitted or because they still hold onto the belief that they may be able to secure senior financing at levels seen several years ago.

Early discussion with a lender will often clear the picture as to the type of secondary financing permitted, and in most cases creative providers of junior financing can up with methods that do not violate any senior loan agreements. Lenders may have venders they suggest approaching or may be willing to entertain allowing additional debt for property improvements or some other value-added contribution. A structure that includes participation and feels like preferred equity can also ease concerns as less financial stress will ultimately be placed on the property.

All parties involved in the asset, should recognize that value is maximized for all involved by maintaining a strong NOI and property appearance. Combating the capital shortfalls expected over the next few years will be a continual challenge for mortgage bankers and property owners. It will take some ingenuity and the re-examination of all available funding sources to keep some properties afloat. From that vantage point, suffering a few percentage point declines in ROI due to more expensive mortgage money is a far superior outcome than losing a property due to an inability to find sufficient capital when a mortgage comes due.

Stephen Liadis is the director of fund acquisitions for Dalfen America Corp., Charlotte, N.C.