Alternative Mezzanine Lenders: New Kids on the Block

Julian M. Wise
Partner, Real Estate Group
Schulte Roth & Zabel LLP

Daniel M. Aires
Associate, Real Estate Group
Schulte Roth & Zabel LLP

Aaron Schwed
Associate, Real Estate Group
Schulte Roth & Zabel LLP

During the past year, the United States real estate industry has seen many newcomers enter the field of mezzanine lending. In some cases, as a result of the increase in regulations governing traditional banks (as more particularly described below), traditional banks' inability to continue making generous mortgage loans has created mezzanine lending opportunities for "alternative lenders." These alternative lenders include private equity funds, real estate investment trusts and, in some cases, private developers/operators. Naturally, there has been a rush to fill the void created as a result of, among other things, mortgage loan originators limiting the size of their loans to loan-to-value ratios (LTV) of 50% to 60%, prompting some to wonder whether the mezzanine lending market is oversaturated. However, the increased competition facing mezzanine lenders is tied to a variety of factors, including the underlying location of the property, property type, identity of the sponsor and the lenders' reputation within the industry. Yet, unless new regulations are passed to govern the alternative lending field, alternative lenders will continue to capture a larger share of the market.

Mezzanine lenders in primary markets such as New York, Chicago, Los Angeles and Miami face the greatest threat from competitors. With more lenders vying for the same deals, lenders are engaging in more aggressive underwriting, which results in downward pressure on yields. Notwithstanding this increased competition, additional opportunities continue to arise for alternative lenders as many traditional banks have exited the construction and development deal space. Furthermore, the impending high-volume maturation of commercial mortgages over the next few years should produce healthy borrower demand for mezzanine debt. However, since mezzanine debt transactions are heavily negotiated (given the mezzanine lender's first-loss position), lenders that can execute quickly, in addition to possessing established real estate operating experience, will be better positioned to succeed in this competitive field.

The Banking Industry

Since the 2008 recession, the banking industry has faced increased scrutiny and regulation, in the form of Dodd-Frank and Basel III, among others. These regulatory regimes have limited the ability of traditional banks to originate loans secured by real estate by forcing them to hold more capital on their books (which, theoretically, reduces the risk that lenders will engage in "shoddy" underwriting). Consequently, traditional banks are becoming increasingly sensitive to which types of deals they are willing to hold on their books (and which types of sponsors they're willing to finance).

If a traditional bank agrees to enter into a financing arrangement secured by real property, the new regulatory landscape requires structural changes to both the underwriting and origination process. Prior to 2008, traditional banks would routinely lend up to 85% of the LTV. Now, many traditional banks are hesitant to exceed an LTV of more than 50% to 60%. This has forced borrowers to seek mezzanine debt in order to fill capital stack gaps, thereby avoiding having to contribute more of their own equity into a deal. Accordingly, many analysts believe that there will continue to be healthy demand for mezzanine debt.

The Rise of Alternative Lenders

Alternative lenders, who are not subject to the aforementioned regulatory requirements, have jumped in to fill this gap. These alternative lenders are mostly private equity firms and real estate investor groups, some of whom remain active in the mortgage loan origination space, though others have decreased their mortgage loan originations amidst what they consider to be an overheated market. Given their mandates to deploy increasing amounts of excess capital, many of these groups are turning to the mezzanine space with the hope of attracting higher yields. While taking the mezzanine (or junior) position comes with increased risk, because mezzanine lenders have their own collateral, they have the ability to foreclose under the Uniform Commercial Code. Consequently, if the loan goes sideways, a mezzanine lender will be able to take control of the borrower in 30-60 days (and thereby control of the property) under the Uniform Commercial Code, whereas a mortgage lender is forced to navigate the often lengthy judicial foreclosure process.

Additionally, alternative lenders offer borrowers a number of advantages compared to traditional banks. The first is their ability to execute quickly. Whereas traditional banks and their "compliance" departments often slow the pace of closing to a crawl, alternative lenders aren't saddled with layers of rigid oversight. This is especially important when a borrower is using the funds to acquire a piece of property (or interest in real property), as many purchase and sale agreements contain "time is of the essence" clauses.

Furthermore, alternative lenders can aid borrowers in obtaining additional capital. For example, an alternative lender with strong real estate operational experience who agrees to provide mezzanine financing on a construction deal will often provide greater comfort to a traditional bank considering originating mortgage financing on the same deal. The presence of an alternative lender in the mezzanine position enhances a mortgage lender's outlook, as the

"Notwithstanding this increased competition, additional opportunities continue to arise for alternative lenders as many traditional banks have exited the construction and development deal space."

mortgage lender can recognize that, if necessary, the mezzanine lender has the capability (and experience) to complete the project.

Markets

While the number of alternative lenders vying for deals continues to increase across the country, the biggest increases are taking place in the primary markets (New York, Chicago, Los Angeles and Miami). In these markets, lenders are sometimes reducing pricing, limiting covenants and increasing their LTV ratios in order to outbid their competitors. As a result, the quest for double-digit yields continues to shrink.

The secondary and tertiary markets remain less competitive and continue to provide opportunities for alternative lenders willing to take on higher-risk projects. In addition to higher returns, lenders in these markets generally have more negotiating power. As such, these markets will likely continue to be an attractive option for mezzanine lenders willing to take on added risk and looking to avoid the excess crowding plaguing the primary markets.

Relationships

While pricing is almost always the determining factor for borrowers when sourcing debt, in a transaction with both mortgage and mezzanine debt, a mortgage lender will almost always have the right to consent to the borrower's choice of mezzanine lender. This is where an alternative lender's reputation and experience become increasingly important, as mortgage lenders are unlikely to agree unless the mezzanine lender has a proven track record.

One illustration that highlights the importance of both a lender's reputation and experience arises in the context of the negotiation of intercreditor agreements. Mezzanine lenders who partner up with traditional banks for the first time often experience difficult, drawn-out negotiations over the terms of this complex agreement, which sets forth the various rights and remedies of the respective lenders. However, in a situation where the parties have previously completed a deal together, they will generally be able to avoid much of the negotiation process by simply relying on precedent. This can be an important component for borrowers concerned about a lender's ability to execute. Consequently, mezzanine lenders who have successfully built relationships and partnerships within the industry will be better positioned to capitalize on future lending opportunities.

Deal Types

While an increase in bidders for deals has driven down prices, opportunities remain for lenders willing to enter some of the more risky sectors of the mezzanine debt markets. For example, as traditional banks continue to withdraw from originating debt in connection with construction or new development projects (choosing instead to focus on more straightforward acquisitions and refinancings), alternative lenders continue to increase originations for these types of deals. Mezzanine lending in the construction arena often requires an "active" lender with strong real estate operational experience, which is a natural fit for many alternative lenders. Given the increase in peer-to-peer lending, the question remains as to whether this is a temporary phenomenon or indicative of a more seismic shift in the industry. Nonetheless, unless the newly enacted regulatory schemes are loosened or eliminated, alternative lenders will continue to seize these opportunities.

One concern that has emerged regarding peer-to-peer financing in the construction field is "predatory lending." Borrowers have become increasingly wary of "lenders" who they view as originating mezzanine financing solely with an eye toward eventually seizing control of the borrower (and thereby the property). Consequently, if a borrower views his or her mezzanine lender to be "predatory," depending on the leverage of the borrower, the lender may be confronted with restrictive contract clauses during the negotiation process, all aimed at heavily obstructing the lender's ability to foreclose and take over the project. The rise of predatory lenders continues to provide opportunities for alternative lenders with proven track records and solid reputations.

Alternative Sources of Capital

Borrowers who are unsatisfied with the current options for mezzanine funding have been increasingly searching for creative and alternative ways to finance their deals. Over the past decade, a number of well-known established investors and developers have turned to alternative financing options such as EB-5 and foreign bond markets. Although closing a transaction navigating these routes is often time-consuming and fraught with regulatory hurdles, borrowers appear to be willing to endure the process given the significant pricing differential compared to the pricing offered by traditional banks. While mezzanine debt typically carries double-digit interest rates, some borrowers have been able to secure rates as low as 3% or 4% from these alternative sources. However, as demand for these sources has intensified, rates have increased. For example, EB-5 capital currently carries a rate in the neighborhood of 7%. Moreover, with the constant influx of newcomers to the mezzanine lending space, mezzanine interest rates continue to fall, further shrinking the interest rate differential. Thus, borrowers looking to avoid a protracted process will likely continue to pursue "traditional" mezzanine financing.

Looking Ahead

Demand for mezzanine debt should continue to increase over the next few years due to the looming wave of loan maturities. Industry experts expect nearly $1 trillion worth of commercial mortgages to mature over the next three years, likely creating a shortfall between maturing loans and the amount of senior debt available for refinancing. This gap should create considerable opportunity for mezzanine lenders.

According to the Commercial Observer, in 2015, alternative lenders originated 68% more mortgage and mezzanine debt than they did in 2014. Unless a new regulatory regime is created to regulate the alternative lending space, alternative lenders will continue to gain a greater share of the mezzanine lending market. Finally, though some mezzanine lenders are bound to face significant challenges in originating mezzanine debt in primary markets, lenders who remain flexible (regarding location, project type and identity of the sponsor) will continue to seize opportunities provided by an ever-shrinking and over-regulated traditional banking system. ■