Mezz Lenders Eye Higher Rates, Lower Risk

By Bob Mura

COMMERCIAL MORTGAGE ALERT

High-yield lenders foresee rising demand for subordinate debt once the commercial real estate market begins to thaw.

For the moment, the mezzanine-lending business has been upended by the economic effects of the coronavirus pandemic, as property trades and financings have largely stalled due to uncertainty about cashflows and valuations. But before long, industry pros say, borrowers will be looking for mezzanine debt to help refinance maturing loans, finish projects or raise cash to weather the recession. And lenders see an opportunity to boost returns while reducing credit risk.

Commercial Mortgage Alert's ninth annual survey of mezzanine lenders has identified 157 shops that provide high-yield subordinate debt on commercial properties (see list on Pages 11-30). The count is virtually the same as a year ago, when the market was booming and some mezzanine lenders complained that competition was getting too stiff to make the play worthwhile.

Pros say they expect a major shakeout amid tough lending conditions over the next 12-18 months. Many shops are sitting on the sidelines, waiting for the crisis to pass.

"In January, I would be one of 30 guys quoting a deal — now, I'm probably one of three," said managing director **Michael Comparato**, the head of real estate at **Benefit Street Partners**. The REIT's mezzanine-lending team currently is focusing primarily on apartment properties, including projects where the borrower needs to fill a gap in construction financing.

Shops that are staying active are adjusting their pricing and leverage requirements to account for the uncertain environment.

"No lender is in a great hurry right now to deploy any money," said **Warren de Haan**, a managing partner at **Acore Capital**. "We need time to recalibrate risk," he said. "Lenders are more conservative. Whenever that happens, the cost for the borrowers will go up, at least in the short term."

Insiders said prospective mezzanine loans are being quoted at spreads 100-200 bp higher, and at loan-to-value ratios 3-5 percentage points lower, than before the onset of the pandemic. Some lenders said the prevailing spreads would be 300-500 bp above pre-crisis levels except for the reduced leverage, cash-out prohibitions and other recent adjustments tied to heightened credit risk.

"A lower amount of risk merits a higher return in this environment," a managing director at one loan shop said.

Some lending pros said they expect the combination of tighter credit standards and higher returns to persist long after the pandemic subsides and overall lending picks up again — especially in the hard-hit hotel and retail sectors.

Given the murky outlook for the commercial real estate market and the economy in general, a number of mezzanine lenders responding to Commercial Mortgage Alert's survey indicated they expect annual origination volumes to be flat or below last year's levels, and many declined to provide estimates. An originator at one shop said one reason he'll likely write fewer mezzanine loans this year is that he can reach his return goals by writing senior loans at today's higher coupons.

Other firms are keeping their sights set high. **Brookfield Real Estate, Goldman Sachs, J.P. Morgan** and Goldman's merchant-banking division are each projecting $1.5 billion or more of originations in 2020. Eight others are shooting for $1 billion apiece.

The survey tracks lenders that write or arrange mezzanine loans, B-notes and preferred equity structured like mezzanine debt. The origination tallies provided by participating banks, insurers, investment managers, fund operators, mortgage REITs and other lenders couldn't be independently verified.

Many lenders provide "stretch" financing, originating both senior and junior debt and then selling one or the other to a third party. Survey respondents were asked to supply totals only for subordinate debt, but some likely mixed in senior debt, inflating their numbers.

The plunge in real estate acquisitions since March has hampered efforts by mezzanine shops to find lending opportunities — and to gauge valuations by scrutinizing comparable equity and debt transactions. The recent proliferation of forbearances and maturity extensions on existing loans has eased pressure on borrowers to sell or recapitalize properties, further slowing transactions.

"There is an increased risk premium for doing business in this environment," said **Toby Cobb**, a managing partner at **3650 REIT**. "If someone is not forced to do a transaction, then they won't."

Issuance of commercial MBS and commercial real estate CLOs has revived to a limited extent, and Cobb said that has shed some light on pricing of senior loans and bonds. But the deals seen so far have been collateralized almost entirely by debt originated before the crisis. "Nobody can really pinpoint where value is right now," Cobb added. "If they do, they're being too aggressive."

Lenders are also looking to loan sales for clues to prevailing views on property values and credit quality. While offerings of both performing and distressed debt have started to pick up in the secondary market, a number of mezzanine-debt pros said they need to see a lot more trades before drawing any conclusions.

Loan sales are expected to ramp up sharply over the next few months. That will also help reduce competition among mezzanine-debt originators, as many will find it easier to achieve their high-yield return targets by purchasing outstanding loans at a discount.

The lack of comparable transactions notwithstanding, a number of lenders who plan to remain focused on mezzanine-debt originations said they're pursuing opportunities that didn't exist just three month ago. For example, they might provide subordinate debt to replace future-funding commitments that other lenders have cut off due to virus-related concerns.

"The opportunity for mezzanine lenders is now," said one industry veteran. "They're supposed to be the most creative lenders out there . . . They should just grow up, do their homework and get it done."

Over the next year or two, mezzanine lenders are likely to be called upon to fill the gap in loan proceeds as borrowers get hit with a double-whammy: declining property values and reduced loan-to-value limits imposed by senior lenders.

"There's always someone who wants a little more loan proceeds and is prepared to pay for it," said **Richard Mack**, chief executive of **Mack Real Estate**. "I think there will be more of a need for mezzanine lending than there was before the virus hit," he said. "There is a need for someone to provide relief capital."

At **Madison Realty Capital**, "we're seeing a lot of demand in recapitalization situations involving partner buyouts and new partners coming in," said managing principal **Josh Zegen**. "I prefer taking out the first lender, upsizing the deal and working to address the various issues." Mezzanine lenders could also be a crucial source of rescue capital for borrowers dealing with cost overruns on construction or redevelopment projects, he added.