The many faces of mezzanine debt

Whether structured as equity or debt, this financing vehicle has proven valuable

By Jeffrey Sands

While the capital markets have rebounded significantly from the disruptions caused by the financial crisis of 2008 through 2010, the underwriting criteria have tightened considerably. The pre-2008 standard financing equation of 80 percent debt and 20 percent equity has changed.

While equity is becoming more available, many equity providers are looking for additional financial commitments from their operating and/or development partners, and many debt lenders have introduced tighter lending standards reducing the size of loans.

These developments have combined to put additional capital demands on many senior housing owners and developers. In response to these capital demands, several experienced senior housing financiers are now providing what is often referred to as mezzanine financing.

While the term has become more common, there is no standard definition of mezzanine financing. It can be structured as debt or equity, as needed, and it can be a useful tool for bridging financing gaps or making the overall capital structure more efficient.

Mezzanine financing in a debt setting

The most common form of mezzanine financing is straight subordinate debt. In its simplest iteration, this is a subordinate loan that serves to increase the debt leverage on the project. It may or may not be secured by a second mortgage.

Most likely, the mezzanine financing (or subordinate debt) will be secured by a pledge of the ownership interests of the entity owning the project. Typical uses of this subordinate debt include:

1 Buying down senior debt covenants

In both the construction and the acquisition settings, it is often the case that the lower the senior lender's loan-to-value ratio (LTV), the better the terms on the senior loan. For example, there have been several occasions where subordinate financing has been used to lower the senior lender's LTV to a point where the senior lender was willing to drop its requirement for personal guarantees or for additional reserves (both of which can be an anathema to owners and developers).

Subordinate debt also has been used in cases where the senior lender has an issue with current valuation (maybe because of a recent drop in operating performance) and just cannot get to the financing threshold necessary to make the deal work.

Often, the subordinate debt is structured so that when the project's value increases, the senior lender has the ability to increase its debt (through an earnout) and pay down the more expensive subordinate debt.

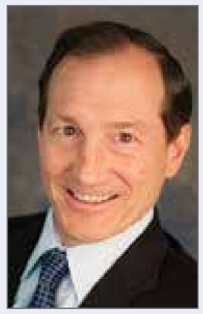
2 Anticipating a HUD or other takeout

Often, especially in nursing home acquisitions, the ultimate financing plan is to improve operations and then refinance with either HUD or another agency lender. These agency lenders often have rules, which effectively provide that they will only refinance outstanding debt (i.e. not allow the owners to "cash out" their equity).

In such cases, it is often advisable to increase the debt on the project — through the use of subordinate debt — to maximize the potential amount that can be refinanced with HUD or other agencies.

3 Reduce the overall cost of capital

Many people balk at the cost of mezzanine financing. While there are many factors that go into pricing, typical subordinate debt may carry an interest rate in the low teens. When compared to the cost of senior debt at 5 to 6 percent, this looks very expensive. However, when looked at in comparison to the cost of equity (often higher than 20 percent), subordinate debt can look like a bargain.



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Mezzanine financing in an equity setting

There are situations that arise where an owner cannot utilize subordinate debt to complete the so-called "capital stack," a term used to describe all of the components of the financing of a project. For example, some banks will simply not permit any subordinate financing as part of their underwriting criteria.

Also, some institutional equity partners have strict limits on leverage. Finally, in the nursing home setting, some state regulations either limit debt or require certain minimum equity contributions. In such cases, mezzanine financing in the form of preferred equity is often used.

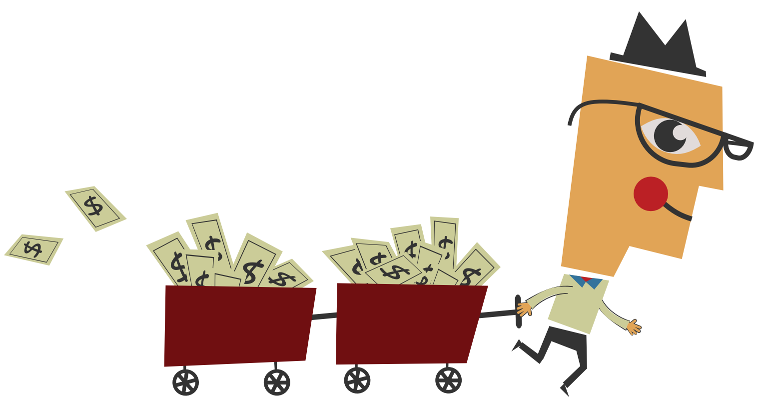
Often this preferred equity looks and acts like debt. It often has a required minimum annual return (the equivalent of interest on debt) and may have minimum repayment obligations (the equivalent of principal payments on debt).

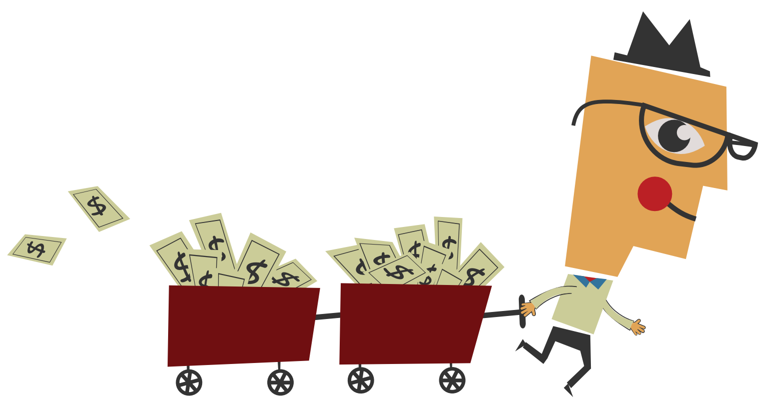
In addition, there is often a "put feature," which allows the investor/lender to "put" the investment back with the owner on a certain date, much like a final maturity. If required payments are not made, the preferred equity investor usually will have the right to foreclose on the common equity's ownership interests, like a mortgage in a debt setting.

Here are some of the more common uses of preferred equity:

1 To fund general partner (GP) equity

As mentioned previously, institutional sources of equity are looking for their partners to have a certain amount of capital at risk in joint-venture deals. A typical institutional partner (a REIT in a RIDEA structure or private equity investor) may want the operating partner — often referred to as the general partner from the old days when limited partnerships were popular — to invest 10 to 20 percent of the equity capital.





In return for sourcing the opportunity and running the joint venture, the GP will often receive a "promoted interest" or a "promote" — meaning that once the institution achieves a certain return, the GP will begin receiving a disproportionate share of the cash flow.

While a 20 percent co-investment does not sound like much, if the transaction requires $75 million of equity, the GP needs to come up with $15 million to get the deal done. Many groups in this position utilize preferred equity to meet this need. In the example of the GP needing to come up with $15 million, a typical structure would have the GP create a new company to hold the GP's interest in the project.

This entity would be funded with $5 million of common equity invested by the GP owner and $10 million of preferred equity from a mezzanine lender. The preferred equity would have a "preference" on cash flow. A typical example would be that the preferred equity receives 100 percent of the cash flow until the preferred equity has received a current return of 8 percent.

After that time, cash would be split based on equity contributed (i.e. one-third to common equity and two-thirds to preferred equity). In return for receiving the preference, the preferred equity investor would give the GP owner a bigger share of the "promoted interest."

2 To meet lending requirements of agency financing

Some agencies, like Fannie Mae, have strict limitations on subordinate debt. If an owner is refinancing with Fannie Mae and does not qualify for the anticipated loan amount, there is generally no option to add subordinate debt to bridge the gap.

Instead, the owner has limited choices:

- invest more equity;
- engage a partner; or
- look for a preferred equity investor.

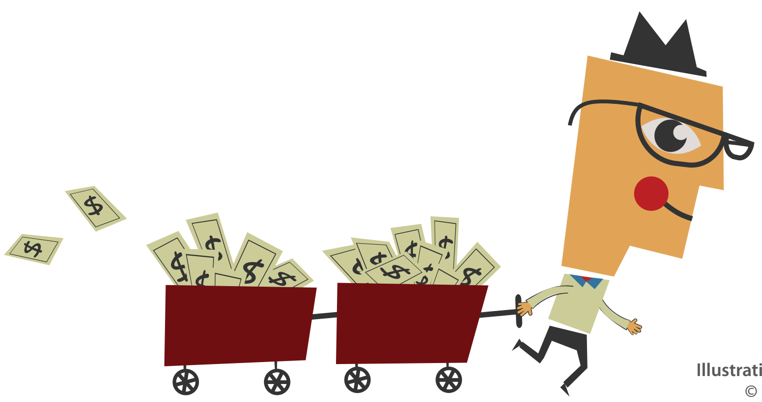
The preferred equity often is the desired route for several reasons. First, it allows the owner to maintain his or her equity for future projects. Second, since preferred equity is generally meant to be repaid at some point, the use of this "bridge" equity avoids the owner needing to take on a new partner with a continuing interest in the business.

Study your options

While capital is flowing into the seniors housing and long-term care space, there are still gaps that an experienced mezzanine lender can help fill for both developers and owners. There are several reputable lenders with experience in providing mezzanine financing in the seniors housing business. These lenders cater to all sizes and types of investments.

A properly executed mezzanine investment can improve the efficiency of the capital stack by substituting subordinate debt or preferred equity for more expensive common equity. It can also be an alternative to an owner who needs to raise capital to complete a transaction but does not want to enlist a new permanent partner.

Look for a reputable mezzanine provider that is flexible, can meet your needs and brings industry experience to the table. ■



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