
REAL ESTATE FUND MANAGER

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PREFERRED EQUITY PLAYS A GREATER ROLE IN CAPITAL STACK

THE IMPLEMENTATION OF BASLE III HAS RAISED MANY QUESTIONS, NOT LEAST FOR THE WAY REAL ESTATE LENDERS NEED TO ARRANGE CONSTRUCTION LOANS IN THE FUTURE. **SHERRY HSIEH** REPORTS

The implementation of Basle III is changing the way real estate lenders are structuring construction loans. “The Basle III regulations have increased the risk based capital charges associated with bank financing of development deals which can be categorized as [high volatility commercial real estate]. The composition of the capital stack and the amount of borrower cash equity in development deal is receiving more scrutiny from the senior lenders,” said James Henderson, CIO of Cornerstone Real Estate Advisors’s alternative investments group.

“We have observed a number of banks interpreting the regulations in manner that is shifting them away from mezzanine financing in the stack, now requiring it to be structured as preferred equity.”

Mezzanine debt has traditionally been preferred by lenders given the more favorable foreclosure rights under the Uniform Credit Code in situations where there is a default. Many of the structured finance shops that have historically

deployed mezzanine are trying to incorporate many features of the traditional mezzanine structure into preferred equity, Henderson said, explaining that this is tending to decrease the amount of first mortgage money in the capital stack. "The way the regulations are being interpreted and implemented by senior lenders is all over the map," he said.

Banks are responding in varying degrees to one of the lesser-noted components of Basel III, which provides a framework for so-called HVCRE such as construction loans. The guidelines were instituted in January and the effects are absolutely being born out in the market place, said Douglas Heitner, a partner in the real estate group at New York law firm Kasowitz Benson Torres & Friedman. "[The borrowers] are not saying 'We want preferred not mezzanine,' this is being driven by the senior lenders who are saying, 'I can't have mezzanine behind me,'" he added.

Preferred equity providers are asking the exact same control rights as the mortgage and mezzanine lenders are receiving, in the form of operating covenants that encompass no additional debt, no liens, transfer restrictions and construction administration, according to Heitner. "We have seen many preferred equity providers ask for the right to buy the sponsor's equity for \$1, which is an effort to replicate mezzanine foreclosure," he added.

One unresolved question is related to a 15% equity requirement from the borrower, another newly implemented component of Basle III. In the past, a portion of the 15% equity requirement could be filled by appreciated land. "But now banks are interpreting the new regulations to require land to be contributed at cost, which in many cases puts a developer in a position where there's a need for dollars in the capital stack that wasn't there previously," Henderson said. Furthermore, the 15% equity in the deal as measured against the value of the property upon completion compounds the need for alternative capital sources. The question of if subordinate debt can be included in this 15% equity requirement appears to be open to interpretation by the banks, he added.

This shift has also led more non-traditional lenders to fill in the gap in situations that are too risky or complex for banks. "With the increase in the number of debt platforms, we are seeing fierce competitions that resulted in borrower-favorable conditions," said Ari Hirt, a managing director in the debt and equity finance group at Mission Capital Advisors. The firm has seen situations with leverage of up to 90% and floating-rate pricing as low as 1%, he added.

Mission arranged one of the more complex structures to date when it advised on a rare deal that carries multiple layers of subordinated debt. The firm represented sponsors Property Markets Group, Kamran Hakim and New Valley on the 2014 deal, backed by the Queens Plaza South in Long Island City, and arranged \$148.45m in non-recourse financing for the development of the 44-story, 391-apartment rental tower at 23-10 Queens Plaza South.

“The biggest challenge in structuring a deal with multiple layers of subordinated debt is ensuring that each capital provider has adequate rights and remedies,” said Hirt. Deutsche Bank provided the construction financing, which represented 70% of the total capitalization, and NorthStar Realty Finance, the first mortgage land lender, provided a \$40.25m mezzanine loan. The total financing was \$188.7m, or about 90% of the total project capitalization.

While the leverage was high, there are several mitigating factors, Hirt said. The sponsors are extremely experienced and were able to buy the land for less than \$200 per square foot. The deal was also far enough along in the development stage to reduce some of the associated risks with construction, he added.

But despite non-traditional lenders’ willingness to tackle a variety of debt and equity combinations, banks still dominate commercial originations. Indeed, banks accounted for 37% of the total volume in 2014, and in 2015, despite the dip, the 29% of non-agency commercial lending surpassed that of conduits, life companies and other lenders, which each captured 20% and 26% of the market, according to a report published by CBRE Capital Markets.

“Some of the healthy banks are willing to withstand the 150% capital charge associated with HVCRE if they are achieving attractive margins on a particular deal, but most banks appear to avoid this. The net effect seems to be an increase in demand for subordinate debt and a shift towards structuring what previously was mezzanine as preferred equity even though they occupy the same spot within the capital stack and have generally similar economics,” said Henderson. “But this does not mean the market is frothy or overly creative. For the most part there’s a reasonable amount of discipline in the migration from mezzanine to preferred. Should a provider of preferred be compensated more than mezzanine – yes, slightly, but whether the market bears that out remains to be seen,” he concluded.