MESILA CAPITAL

Mezzanine Loan - A Primer

Mezzanine loans play a crucial role in securing investments in private real estate and offer a return between senior debt and equity. Mezzanine receives interest on the amount extended to the equity investor and in some cases a percentage of the equity. Mezzanine ranks ahead of the equity invested and in lieu of such receives the equity as the underlying security to the investment in the event of non-payment of the interest or principal.

This is part 3 of a 3 part series dealing with investments in real estate.

At its essence, real estate (or a company) is financed by and large, through a combination of three separate sources: - Senior Debt/Loans, Mezzanine & Equity. This is usually referred to as the capital structure.

The capital structure is how the capital or finance of the company is ranked i.e. preference and has important implications for the eventual profits, tax and investment returns of the company.

As its name belies the Mezzanine (also known as Preferred, Bridge Finance are all used interchangeably within this explanation) from the Latin middle ranks second in line in order of repayment of its obligations is sandwiched between the Senior Loan and before Equity, which ranks last.

Mezzanine debt is comprised of two components principal or the amount lent and interest or the return on the amount lent. Mezzanine was originally called hybrid owing to its dual nature of having equity like returns replete with a pledge over the company assets post senior debt repayment. Bridge finance is the most flexible of all three and is mostly used to bridge or complete the total amount of equity required.

Preferred ranks second in seniority, due to its "hold over" the shares or equity of the company which are provided as collateral. This results in the company being afforded more equity at albeit a higher cost of capital than senior debt, however the absence of such would make the investment unfeasible.

Returns on mezzanine debt, especially in real estate are usually in the low to high teens, providing the second cheapest funding source out of all three options.

Mezzanine in real estate is generally employed for two main objectives. The first is to finance new construction be it residential or commercial. The second is to meet capital short falls.

A developer wanting to build a block of residential apartments requires a significant amount of capital to undertake such a project. The bank will require that the developer "put up" his own capital (in the form of equity, see Equity - part 3) but the developer may lack the total amount of equity required and will source a mezzanine investor to fill the short fall. As the development ensues and apartments are sold to buyers both the interest and principal components of the mezzanine layer are repaid only after senior loan repayment but prior to the developer's interest. The Mezzanine can be repaid after a short period of time between 6-18 months, subject to the investment and its needs.