DEBTWIRE

Mezz construction loans open new frontier for CRE finance

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Mezzanine construction loan financing — a high-risk, but high-yielding form of debt on properties not yet producing cash — has opened a new frontier in commercial real estate lending during the past year, according to a real estate attorney, a lender and a loan broker.

The junior loans, which start at a 10% rate, mimic other mezzanine loans in that they package degrees of risk (and reward) into separate parcels, according to the broker. The loans are typically made for about three years and run co-terminus with a senior construction mortgage, but the lender has no property income stream to rely upon while it is being built, he said.

"It's a bit of a specialty," said John Garth, managing director at Pembrook Capital Management, a balance sheet lender offering USD 5m–USD 20m slices of mezzanine construction debt behind a senior mortgage of up to 85% of a project's cost.

"We got into it because we had development expertise [and the ability] to finish a construction project [if it runs] into trouble."

The Macquarie Group and Pearlmark Real Estate are among the short list of other lenders active in the sector, according to the broker. Requests for comment from both were not returned.
Ability to complete a prerequisite — for now

Second-lien lending has its own benefits and risks, but the new niche of construction mezzanine finance largely puts a lender on the hook for a project's completion, said Jeffrey Lenobel, chair of Schulte Roth & Zabel's Real Estate Group.

"My guess is that most of the construction loans with mezzanine [components] are not going to be sold until a building is completed, or substantially completed," Lenobel said.

He pointed to mothballed, half-built buildings in New York City after the collapse of Lehman Brothers as one hazard for construction lenders. But in a fresh twist, if needed, the 30-day UCC provisions of today's construction mezzanine loans would allow a junior lender to quickly step in to finish a building, he said.

Pembrook has focused on what it knows, meaning ground-up apartment construction in major cities that have strong apartment markets with clear evidence of demand for new units, such as Manhattan, Chicago, Boston, Los Angeles, Miami, downtown San Francisco, Seattle, Silicon Valley and Washington DC, according to Garth.

For condos, it's a narrower swath of top-tier primary markets that already have a well-established condo market. "We don't want to finance a project and have a competitor come in across the street and depress our rents," he said, noting that Pembrook only lends based on today's rents — not future projections — and expects to be taken out inside of 36 months.

A world of change from 12 months ago

Heated competition among lenders and paltry QE3-era yields have US commercial real estate originators battling for territory and pushing the envelope on risk, as reported (see article, 31 May). As of April, USD 85.6bn in closed-end funds were targeting US real estate, according to a May Preqin report.

In one high-profile example, Debtwire ABS reported a year ago that developers behind the roughly USD 1bn project to build a slim, 1,396-ft residential tower on Manhattan's vacant former Drake Hotel site in midtown Manhattan had pitched a rare construction loan CMBS financing to the ratings agencies, as reported (see article, 25 June).

That didn't come to fruition. But five months later, UK hedge fund manager Christopher Hohn supplied the CIM Group, which is leading the project dubbed "432 Park Avenue," with up to USD 400m in construction loan financing, according to New York City Department of Finance records.
The luxury development is scheduled to rise by 2015 as the nation's tallest residential tower. So far, USD 60m in debt has been drawn from the financing, which was supplied by Dublin-based Talos Capital Limited, an affiliate of Hohm's The Children's Investment Fund, according to the filing. A request for comment from Hohm's fund was not returned.

For its part, Pembrook targets smaller construction projects for its mezzanine platform, typically keeping to the USD 60-USD 80m range, according to Garth.

by Joy Wiltermuth