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### Finance Series Part IV: Potential Uses of Mezzanine Financing

By: Michelle Napoli

Honolulu—Avalon Development Co. is not your typical TIC sponsor in that the tenant-in-common transactions it puts together are usually the result of pairing up two 1031 exchange clients when one isn't able to buy a desired property on its own. But a recent deal put together by the Honolulu company is an interesting example of one potential use of mezzanine financing for TIC structured transactions.

In the deal, which saw two 1031 clients and Avalon invest in Mariner's Alley—a 12,038-sf resort retail center in Lahaina, Maui—mezzanine financing was borrowed from Merrill Lynch Mortgage Capital Inc. coterminus with a standard mortgage. The total financing of \$13.2 million, arranged by Holliday Fenoglio Fowler LP, had an attractive blended rate, says Avalon managing director Christine Camp Friedman, allowing the investors to achieve an LTV of 85% and still get positive leverage for the deal. “We bought the property at a 7.8% cap; with the leveraging, the return on equity is in excess of 10%,” she notes. And the property still has upside, with a vacant lot the investors plan to develop in the future.

A more typical TIC sponsor's use of mezzanine and/or bridge financing, however, is likely to enable it to buy a property first and then focus on syndicating to investors and putting permanent financing in place. The financing can “enable a sponsor to enter into a contract, purchase a property and take it down and, subsequent to that, syndicate it, bring in the tenant-in-common investors and place permanent debt on it,” notes Frank Satterfield, principal of Houston-based Harbor Capital Group. “In the competitive marketplace out there, the sellers are trying to keep the time frames that these properties are under contract to a minimum. So if you negotiate a contract for a property and take it down in 60 days, you get a bridge loan for an interim period of time and you bring in a mezz loan on top of it, and you can cover up to 90% of your purchase price.”



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In this way, mezzanine “makes it much more orderly and [possible] to take these properties down in a sequential fashion,” Satterfield adds. “It gives them an advantage.”

Satterfield is currently working on several deals with a mezz piece and permanent financing in place at same time, with the idea that the mezzanine financing is short-term and will be replaced when TIC investors' equity comes in; the deals are on the street, so he could not discuss much detail. One is a \$100-million, four-property TIC financing transaction that included senior debt from MetLife and a mezz loan from KeyBank Real Estate Capital and MetLife. Harbor Capital was recently named a loan correspondent for Philadelphia-based RAIT Investment Trust, which specializes in offering mezzanine and bridge financing for mid-sized commercial properties, as well.

Despite the benefits, there is one major potential downside: mezz finance does plump up incremental costs to an overall TIC deal. “It does add a little bit of cost to the deal,” Satterfield acknowledges. “And as a sponsor you need to know your exit strategy from the facility. It has repaid and it has to be repaid in a fashion that is timely or it's going to get real expensive. You have to have your lenders on board; they must know your business inside and out and be very comfortable with it.

“It may be more costly, but at the same time it does allow you the ability to concentrate on each aspect of your business while you're going through the process,” Satterfield adds. “You get to concentrate on your due diligence while not having to also work on your syndication and everything else at the same time. It enables you then to concentrate on the closing aspect of the deal without having to worry about the syndication and the permanent loan at the same time. It adds a little bit of orderliness to it and takes a little bit of the time constraints and time pressure off of the sponsors.”