# Does Mezzanine Real Estate Investing Make Sense Today?

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Draft

Mezzanine real estate investing is like any other investment; before investing you should understand the risks and rewards and determine if today's rewards properly compensate for the risks. Superior investment opportunities result from identifying those investments where rewards provide a premium to actual risks because of inefficiencies in the flow of capital and/or information.

Mezzanine real estate investing is a simple concept: investment in debt, equity, or hybrid debt/equity positions subordinate to the first mortgage and senior to the property owners' equity. Accordingly, mezzanine investors are less secure than first mortgage holders but more secure than property owners.

Mezzanine debt is not new. Investors have utilized varying combinations and structures of debt and equity to finance real estate investments for decades. However, during much of the 1980's, first-mortgage lenders would provide higher-leverage first-mortgage debt to tax-motivated investors, limiting the need for "mezzanine" level investment structures.

In the early 1990s, real estate capital became scarce, inducing significant investment opportunities that created the need for alternative capital structures. It was at this time that the term "mezzanine" came into vogue, as Wall Street and other sophisticated investors adopted the commonly used corporate finance term to the real estate industry.

Mezzanine real estate investments have performed extremely well over the last eight years as investors have taken advantage of rising property values, enhanced mezzanine structures, and improved risk management practices. Today, with real estate markets maturing, many Wall Street firms out of the mezzanine real estate financing business, and new mezzanine investment "funds" hitting the market, it is an appropriate time to ask whether mezzanine real estate investing still makes sense.

In this article, we define the different types of mezzanine real estate investing and describe their risk-and-reward attributes. We also evaluate specific investment considerations for institutional investors as they begin to consider mezzanine investment opportunities.

## WHAT IS MEZZANINE REAL ESTATE INVESTING?

The key to prudent mezzanine investing lies in carefully defining the types of mezzanine investments so as to insure proper consideration of the balance between promised rewards and actual risks.

Mezzanine financing has been described as "a range of risks rather than a vehicle or structure."[1] Accordingly, many in the industry have defined the different types of mezzanine investing by the level of risks undertaken, as measured by loan-to-value and loan-to-cost ratios. For example, investing in the 70%-80% loan-to-value or loan-to-cost slice is lower in

## EXHIBIT 1

**Mezzanine Real Estate Investing — Risks and Rewards**

| Mezzanine Investment Type | Property Characteristics | Typical Deal Structures | Total Return Expectations* | Key Risk Issues |
|---|---|---|---|---|
| **Stabilized** | • Existing cash flow<br>• Limited lease-up risk<br>• Minor rehabilitation or repositioning | • 70% to 85% LTV piece<br>• No participation in cash flow or residual value<br>• 3 to 7-year term<br>• Exit through refi or mortgage amortization.<br>• Cash flow sweep/lockbox | 14% to 18% IRR | • Severe value decline<br>• Magnitude and timing of cash flow<br>• Interest rate risk<br>• Quality of underwriting<br>• Management control |
| **Value – Added** | • Some existing cash flow<br>• Moderate rehabilitation, repositioning.<br>• Moderate to substantial lease-up, releasing required<br>• Completed property will represent 75% to 80% loan to value based upon the total capital structure | • 70% to 95% LTC piece<br>• 10% to 15% interest rate, with participation in cash flow and/or residual value<br>• 18 month to 3-year term<br>• Exit through refi or sale<br>• Value creation should allow return of 100% of capital through refi. | 18% to 25% IRR | • Severe value decline<br>• Magnitude and timing of cash flow<br>• Interest rate risk<br>• Quality of underwriting<br>• Exit timing<br>• Management control |
| **Development** | • No existing cash flow<br>• To-be-built property<br>• Completed property will represent 75% - 80% loan to value based upon the total capital structure | • 70% to 95% LTC piece<br>• Participation in cash flow and residual value<br>• 3 year term<br>• Exit through refi, sale, or "presale"<br>• Value creation should allow return of 100% of capital through refi. | 20% to 30% IRR | • Significant value decline<br>• Magnitude and timing of cash flows<br>• Financial risk<br>• Quality of underwriting<br>• Exit timing<br>• Development risk<br>• Construction risk<br>• Management control |
| **Securitized** | • Mortgages securitized by a pool of properties.<br>• Existing cash flow<br>• Stabilized underlying assets | • 70% to 75% LTV tranche of CMBS<br>• 10-year term | 20% to 25% IRR | • Severe value decline<br>• Financial risk<br>• Quality of underwriting<br>• Management quality<br>• Cross-defaulted first loss<br>• Management Control |

*Returns presume leverage at the property level but not at the "fund" or investor level. Returns are net of 1% asset management fee and 20% of profits typically paid to sponsor.
Source: The Muldavin Company.

risk than a mezzanine investment that provides capital up to a 95% loan to value and loan to cost ratio. Given the wide range of risk and return available in mezzanine investments, this investment category calls for further definition.

We separate mezzanine real estate investing into four distinct types, incorporating both risks and investment purpose in a single definition. As presented in Exhibit 1, the four types of mezzanine investment are:

- ***Stabilized:*** Existing property with acceptable current cash flow coverage to the mezzanine investment.
- ***Value added:*** Existing asset with moderate to substantial lease-up and/or releasing risk. Generally requires some cosmetic rehabilitation.
- ***Development:*** To-be-built property with substantial development, construction, and lease-up risk.
- ***Stabilized mortgage pool:*** Typically associated with the purchase of the unrated class of CMBS, these investments are similar to stabilized mezzanine but on a pool basis.

These definitions provide an immediate link to the type of property and nature of the risks involved in each type of mezzanine investing. Loan-to-value and loan-to-cost ratios by themselves inadequately describe the risks in a mezzanine investment. As shown in Exhibit 1, loan-to-value ratios overlap significantly among the four types of mezzanine real estate investments. More important, the new definitions can also be directly linked to specific return expectations.

### Deal Structures

Mezzanine real estate investments have customized deal structures based on the strengths of the borrower and property, the level and timing of capital required, and other project-specific issues. However, as shown in Exhibit 1, each mezzanine investment type we have identified has certain deal structure commonalities.

For example, stabilized mezzanine investments do not typically receive participation in cash flow or residual

value and provide a longer loan term, reflective of traditional debt investment. Value added and development mezzanine investments often cover up to 90% or 95% of a property's initial capital and typically incorporate participation in cash flow and residual value. Loan terms are typically eighteen to thirty-six months, with refinancing or sale used as an exit strategy. Last, securitized mezzanine investments are commercial-mortgage-backed securities, with the complex pool-based structuring requirements typical of these deals.

It is important to understand that most mezzanine real estate investments appear to borrowers as a single higher-interest-rate mortgage. For example, in the first quarter of 2000, a borrower could typically obtain a mortgage at approximately 8.5% for 75% of the value of a property. However, given the need for additional capital, the borrower may be interested in a loan to value (LTV) of 90% and is willing to pay interest rates of 10% or more for such a loan. When the 90% LTV loan is originated, the higher-return mezzanine-level investment for the 75%-90% slice of the loan can be bifurcated from the first mortgage to create a separate "mezzanine" investment.

Accordingly, many mezzanine real estate investments are created from bifurcated portions of larger first mortgages, which are sold to traditional lenders or securitized by a CMBS sponsor. Mezzanine investments can be made on top of existing first mortgages in some circumstances, but in most cases, including most "conduit" loans headed for the commercial-mortgage-backed securities markets, intercreditor agreements and other first mortgage restrictions limit this practice.

### Key Risk Issues

Mezzanine investing risks are similar to those found in other real estate investments, but they incorporate both debt and equity risk characteristics depending on the particular type and structure of the investment. Key risk issues include:

- value changes;
- magnitude and timing of cash flow;
- financial risk;
- quality of underwriting;
- management control;
- exit timing;
- management quality;
- development risk; and,
- construction risk.

Clearly, the most important risk comes from a severe market downturn that would affect the magnitude and timing of cash flows as well as the value of the asset. Given the risk position between the first mortgage and straight equity investment, investors must carefully look at the current conditions of the market cycle and expected market swings to determine appropriate return premiums for investing at the mezzanine level.

The quality and methodology of underwriting is also a critical risk of mezzanine real estate investing. How detailed is the underwriting on each asset? Are property values and cash flows based on optimistic projections of market change, or are they realistic and appropriate? Most important, mezzanine real estate investments need to be underwritten from an equity perspective, with specialized understanding of management and control issues as well as specific focus on a timely exit.

Last, for mezzanine investments with a strong debt component, financial risks resulting from increasing interest rates must also be taken into consideration. Appropriate controls need to be in place to deal with potential problems in this area.

### Return Expectations

Return expectations vary significantly based upon the structure of a particular mezzanine investment. Required returns will increase as the level of lease-up and/or construction risk increases. Returns will also increase as the loan-to-value level increases. Accordingly, a 95% loan-to-cost mezzanine investment for a new construction project would have the highest return expectations, and a 70% to 80% mezzanine loan-to-value on a stabilized asset would have the lowest return expectations, as shown in Exhibit 1.

Return expectations will also vary within each type of mezzanine real estate investment, based on the size of the investment, the financial strength of the property and borrower, and the certainty of the exit strategy and loan payoff of the mezzanine investment. For example, return expectations will be higher if investors assume more risk in the exit strategy.

Investor returns are typically cited net of a 1%-1.5% asset management fee and a 20% profit participation after the investor has received a preferred return of 8%-10%. For example, a stabilized mezzanine investment could provide an expected return to investors of 16% after payment of the asset management fees, assuming the underlying investment achieved an 18.5% return.

A final factor influencing investor returns is leverage at the "fund" level. Returns that are already leveraged at the property level can be further enhanced by leveraging the pool of capital used to invest in mezzanine opportunities.

## DOES MEZZANINE INVESTING MAKE SENSE TODAY?

To answer this question, we examine the size and sustainability of the demand for mezzanine investment by borrowers, the supply and trends in both the debt and equity real estate capital markets, and, last, whether investment risks are manageable.

### Borrower Demand for Mezzanine Capital

Borrower demand for mezzanine real estate financing is strong today and should continue for some time. Despite the seemingly high cost of the mezzanine piece of real estate financing, which may run from 15% to 25% or higher, there are numerous factors, that make mezzanine real estate financing an attractive alternative for borrowers.

One way to think about the demand for mezzanine real estate financing is not to think about how many borrowers want to borrow money at a cost of 20% or more, but rather, how many borrowers would be willing to pay approximately 200 to 300 basis points more for a few years in order to increase their loan proceeds from 70% to 85% or 90% of value. The answer to that question is more positive and is in fact what typically occurs in a mezzanine real estate financing, where the first mortgage piece of the loan is bifurcated from the higher-risk, higher-returning portion of the loan.

Opportunistic investments that rely solely on dramatic market changes or severe capital market deficiencies — such as seen in the middle and late 1990s — are largely gone. However, opportunities that capitalize on revitalizing properties and creative financing will continue to be available in the market.

Specific factors that support the demand for mezzanine real estate financing include borrower's desires to limit equity dilution, the constriction of the conduit market, continued tight underwriting by traditional lenders, the substantial size of the rehabilitation and repositioning market, higher interest rate levels, and borrower timing issues. These factors are discussed below.

- ***Access to mezzanine debt and equity:*** Real estate investors currently have limited access to hybrid debt/equity financing, creating strong pricing for this class of investment.
- ***Constriction of the conduit market:*** Conduit lenders now require greater equity and have shown an aversion to more risky projects after the dramatic decline of the CMBS market in August of 1998, thereby increasing demand for mezzanine real estate financing.
- ***Tight underwriting by traditional lenders:*** Commercial banks and life insurance companies have continued to underwrite on a relatively conservative basis, limiting loan proceeds.
- ***Substantial size of existing acquisition and repositioning market:*** Significant opportunities exist to acquire and reposition mismanaged and undervalued properties in what continues to be a fragmented marketplace for buyers and sellers.
- ***Higher interest rates:*** With interest rates rising, property cash flows have not been able to support the level of debt many borrowers desire, increasing the demand for mezzanine financing.
- ***Borrower timing issues:*** Mezzanine financing is often used when a potential borrower confronts a timing issue, such as an option payment coming due or an equity partner that pulls out late in a transaction. These types of opportunities are expected to persist.

The overall decline in commercial mortgages in 2000 because of higher interest rates and declining refinancing volumes should not significantly reduce the size of the mezzanine market. First, while interest rates range in the 8% to 9% range today, rates are still significantly lower than the average of 11.6% for the whole decade of the 1980s and are consistent with average rates for the 1990s. Most important, higher interest rates make larger loan-to-value financing more difficult, shifting some financing volume to mezzanine equity participation structures.

Most mezzanine financing demand comes from the turnaround or repositioning market. Consequently, declines in refinancing volume do not affect the market as significantly as they do the mortgage market for stabilized assets. Additionally, for some life insurance and bank loan borrowers with longer-term, low-interest loans, mezzanine financing provides an alternative to extract cash from their properties without having to refinance their low-rate first mortgage, if the first mortgage permits it.

In addition to the factors discussed above, the market for smaller mezzanine financings in the $2 million to $8 million range has been largely untapped during much of the 1990s. The mezzanine real estate financing market has been largely driven by Wall Street investment banks. Accordingly, the availability of $10 million plus mezzanine financing for larger, sophisticated borrowers was reasonably available, and many utilized this type of financing. However, the availability of mezzanine capital for the middle- and smaller-size property markets has not been as efficient. As more mezzanine capital becomes available to mid- and -smaller-size borrowers, substantial additional demand should be realized.

To understand the overall potential size of the mezzanine financing market, we look at the total value of non-corporate-owned commercial real estate. Estimates of the corporate real estate market range from $2 trillion to $3 trillion, but for the purposes of our analysis, we assume corporations would be unlikely to utilize project based mezzanine financing. The noncorporate market currently totals approximately $2 trillion, of which $1.3 trillion is encumbered by debt, leaving $700 billion of equity.[2] Assuming mezzanine underwriting up to 85% of total value, there exists $400 billion of potential mezzanine investment opportunities, not including new development investments. It should be noted that more than 60% of this market consists of properties with total capitalization of less than $20 million, where capital flows are least efficient.[3]

To try to understand the potential capacity of the mezzanine financing market on an annual basis, we looked at total mortgage origination activity. Mortgage originations have averaged approximately $400 billion per year during the last few years. Assuming that 2% - 3% of the volume of these mortgage originations was for mezzanine financing, the annual capacity of the mezzanine financing market would be between $8 billion and $12 billion.[4]

Although these numbers are quite rough, they do indicate a substantial investment opportunity for those investors specializing in this financing sector. This market could grow even larger over time as access becomes more efficient and borrowers continue to look for ways to maximize the use of their equity.

### Real Estate Capital Supply Trends

The growing supply of mezzanine real estate capital — as evidenced by Capital Trust and Citigroup Investment's launching of a $1 billion-plus mezzanine debt fund, the movement of Massachusetts Mutual into the business, and continuing activity by opportunity funds — raises the question about the ability of the mezzanine real estate financing market to absorb the capital.

The mezzanine real estate financing market should be able to absorb current supply because the overall supply of capital for the mezzanine real estate market is still limited. Most important, traditional commercial bank and life insurance company lenders have not been significantly involved in this market, sticking to lower-risk mortgage investments because of regulatory and other business reasons.

The investment banking community, the other major source for this type of risk capital, has also reduced its commitment to the market in recent years. Many of the major investment banks that were extremely active in this marketplace in the mid-1990s, like Nomura and First Boston, have either left the market or reduced their commitments.

Other evidence of the limited capital available for the mezzanine debt market can be seen in the lower-rated and unrated CMBS market, where the number of buyers for such "mezzanine"-level investments is still quite small.

Importantly, the supply of capital to the mezzanine real estate financing market has not been uniform in recent years. Midsize and smaller regional owners have not had the same access to mezzanine real estate capital as the larger property owners.

Today, while there are select providers of mezzanine capital for smaller properties, this market is still underserved relative to the larger, better-capitalized properties and borrowers. This inefficiency, and the general transactional inefficiency for smaller properties, creates significant opportunities in property types, sizes, and regions that may not have traditionally been seen as target opportunities.

### Are Risks Manageable Today?

Mezzanine real estate investing risks are better understood and more manageable today than ever. Investors and lenders are capable of making better investment decisions, which has resulted in less overbuilding and more moderate market cycles. Nonetheless, when evaluating a mezzanine investment strategy, an investor must determine whether or not the increased yields justify the commensurate risk.

Each of the different types of mezzanine investing, from stabilized to securitized, have different levels and types of risks. However, there are risk characteristics and management responses common to all four types. In this section, we examine five of the most critical types of risk

and what mezzanine investors are doing today to manage these risks. The five areas we examine include market risks, sponsor-quality risks, underwriting risks, financial risks, and deal structuring risks.

### Market Risks

The most critical risk to a mezzanine investment is the risk of capital loss resulting from a severe decline in the magnitude and timing of cash flows and related value losses. Given the opportunistic nature of mezzanine real estate investing, traditional diversification-related risk measures, such as return volatility, are less applicable.

Most knowledgeable market observers believe that we have reached a mature point in the real estate property market cycles overall, with rents and value growth moderating from recent years. The question is how deep the next down cycle is going to be. For example, if property values decline more than 25%, as they did in some property types and markets during the late 1980s and early 1990s, mezzanine-level real estate investments could face significant capital losses.

Given substantial changes in the structure of the real estate property and capital markets during the last ten years and the current balance in the markets, the level of market risk today is dramatically less than experienced in the last market cycle. Most market observers believe that the markets are in equilibrium today, and are expected to continue to be in equilibrium, for the next few years:

- "We argue that investors are oversimplifying real estate market dynamics. In contrast to the early 1990's, real estate markets are currently in a state of relative supply and demand balance, allowing us to safely predict stable or strong real estate market conditions for the next several years." (Kenneth Rosen and Matthew Anderson, *Pension Real Estate Quarterly*, Fall 1999).[5]
- "Many markets seem to be moving back and forth around our peak/equilibrium position as supply seeks to meet growing, but changing, demand. The increased information available to all market participants should help to avoid any sustained overbuilding in markets and should mean that the markets will be more efficient and less volatile than was the case historically." (Glenn Mueller, *Real Estate Market Cycle Monitor*, February 2000).[6]
- "If the US enters a downturn in the next two years, the impact on real estate is likely to be mild." (Marc Louargand, *Pension Real Estate Quarterly*, Winter 2000).[7]

The extremes that the real estate markets experienced during the last fifteen years were unprecedented, driven by severe volatility in real estate capital flows, as shown in Exhibit 2. Capital flows today, and in recent years, have been well within inflation-adjusted norms for the last twenty years. Better information, tax law changes, financial institution regulations, and the development of the real estate securities markets provide a strong foundation for the expectation of a less volatile future for the real estate capital and property markets.

While property markets are expected to be less volatile, volatility by tenants — particularly technology tenants — will continue, requiring borrowers to plan for greater capital expenditures. Given the short maturities and capital expenditure orientation of most mezzanine debt, these risks should be mitigated for mezzanine finance investors.

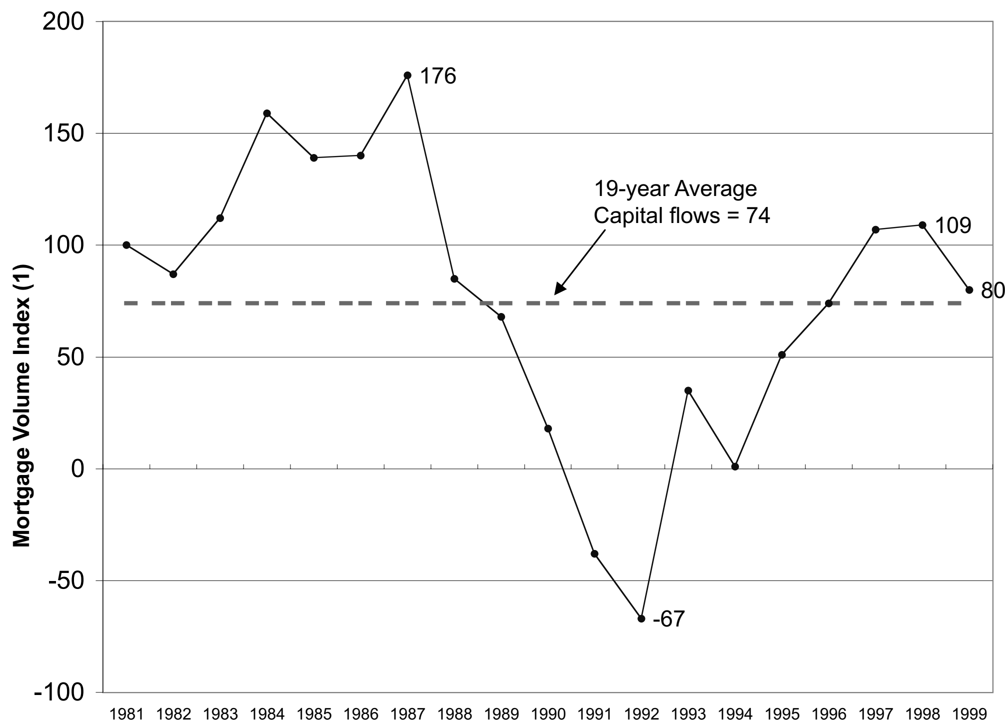
Recent delinquency rates on commercial mortgages have also been the lowest in history. In the second quarter of 1999, delinquency rates reached a thirty-four-year historic low of 0.39%, shattering the old mark of 0.55% established in 1969. Mortgage delinquency rates have been below 1% for nearly three years after reaching highs near 7% in the early 1990s.[8]

Another factor tempering potential losses resulting from a declining property cycle is the generally short (eighteen to thirty-six-month) amortization period of most mezzanine real estate financing. Value declines do not happen overnight. Mezzanine underwriters' ability to project market changes over three years is much better than for traditional seven- to ten- year terms of first-mortgage lenders. Additionally, with substantially improved market information and analytic models, the real estate markets are more efficient than in the past.

### Underwriting Risks

Sophisticated, quality underwriting is critical to mezzanine real estate investing. Most mezzanine financing needs to be underwritten like equity, with a strong focus on timing and exit strategies and on related control and management issues in the event of property or borrower non-performance.

## EXHIBIT 2
**Overall Capital Flows Near Historic Norms**




(1)Inflation adjusted net mortgage capital flows index. Base year 1981 = 100.
Source: Adapted from The Roulac Group's "Capital Flows," *The Pension Real Estate Quarterly*, Winter 2000.

Underwriting today is generally more conservative than during the late 1980s and the early 1990s when significant problems occurred. Analysis of projected results is much more conservative, with a focus on existing market conditions rather than a projection of continually better market conditions. Legal, environmental, and market risks are better understood today by participants who learned through experience in the down-market cycle.

Direct mezzanine investing or investment in a "fund" has some underwriting advantages over CMBS investment. Greater detail and specific analysis on each asset is possible. CMBS pools have some diversification advantages, but the underwriting quality does not equate to specific property underwriting.

### Financial Risks

Financial risks, created primarily by the upward movement of interest rates, can be managed in a number of ways in a mezzanine real estate investment. To protect the investors concerned about the effect of increasing interest rates on the value of the debt component of their investment, most mezzanine real estate investing today is written on a floating rate basis, adjusting with LIBOR. Concerns about the effects of rising interest rates on borrower economics are managed through interest rate "caps" or "collars," which limit the speed and magnitude of interest rate increases to a borrower.

Substantially increasing interest rates could still create a problem because of the potential negative effects on liquidity and exit strategies as well as rate caps. However, given general expectations of slightly increasing and then moderating interest rates over the next few years, financial risk does not appear to be a significant issue.

### Deal Structuring Risks

Substantial progress has been made in reducing risks through enhanced deal structures. The biggest improvements have been in the focus on control and management

issues in the event of potential problems. Mezzanine investors need to structure deals with controls that guarantee them input into major decisions should certain events or agreed-upon performance hurdles not occur. This would include "rights of notice and cure" through a recognition or inter-creditor agreement that would give the investor the right to take possession and cure problems in the event of default on the first mortgage.

Most mezzanine real estate investments today also avoid difficult intercreditor agreement problems with the first-mortgage lender through simultaneous closings. By originating in combination with first mortgages, intercreditor loan agreements can be written to avoid potential conflicts.

Mezzanine investments are often structured through an assignment of the ownership interest in the borrowing entity. This structure enables the mezzanine investor to quickly gain control of the property in the event of default by the borrower. Unlike a deed of trust, which can take 90 -120 days to foreclose, an assignment evidenced by a UCC filing can take as little as ten days to remove a defaulted borrower and gain control of the underlying asset.

Mezzanine investment funds can also limit risk through diversification. This can occur through the origination of numerous smaller loans, as well as by potentially limiting the percentage of the fund allocated to a particular investment or borrower.

The enhancements to mezzanine real estate investment structures are primarily a result of experience. With the tremendous volatility in the markets during the last ten years, various real estate financing structures have been tested under a range of performance scenarios, enabling borrowers, mezzanine finance providers, and their attorneys to better understand potential risks and address them in deal structures.

## INVESTMENT CONSIDERATIONS FOR INSTITUTIONAL INVESTORS

Mezzanine real estate investing is not just a fad. Borrowers have always demanded mezzanine-style real estate financing, but it is just since the early 1990s that the term "mezzanine" has taken hold. As discussed above, numerous factors indicate that the demand for mezzanine real estate financing will continue.

Mezzanine real estate investment, by virtue of its risk-and-reward profile, is primarily utilized as a yield enhancer rather than a diversifier. However, given the participations in cash flow and residual value of many mezzanine investments, it also shares some of the inflation protection benefits of equity real estate.

Mezzanine real estate investment, while often characterized as "mezzanine debt," is really a specialty investment with more equity — than debt-like features. Accordingly, an investment in a mezzanine real estate financing could be allocated as "opportunistic" real estate equity, an alternative high-yield investment, or some other specialty real estate investment. Accordingly, mezzanine real estate investing may be done by pension funds ranging from those with little or no real estate allocation to those with a significant allocation and expertise in the real estate markets.

The appropriate investment approach will depend on an institutional investor's experience and comfort with such investment. Investors or pension funds can invest directly with borrowers, in targeted mezzanine private placements, through separate accounts with investment managers, in "opportunity funds," in funds targeted to the un-rated CMBS market, or in a number of new institutionally-focused mezzanine real estate investment funds. Each of these investment options has pluses and minuses depending on which part of the risk-and-reward spectrum an investor wants to focus on, as well as the desired level of control and participation in the investment process.

Monitoring the performance of a mezzanine real estate fund is difficult, given the lack of appropriate benchmarks and the significant differences in risks and rewards among the four types of mezzanine real estate investment. A critical starting point in monitoring investment performance is to be able to clearly categorize the specific risks and expected rewards of the different types of mezzanine investments within a particular mezzanine real estate fund. Specific returns generated by a fund can only be evaluated consistent with the risks that were undertaken to achieve the return.

Given these difficulties, one alternative is to try to put a box around the specific types of mezzanine real estate investing a particular fund can do. While this may work in some circumstances, it may also increase risks or limit the performance of the fund because a significant part of what one is buying in a mezzanine real estate fund is the deal-making and structuring skills of the sponsors. A sponsor with the ability to identify and negotiate the best possible deals, within a somewhat broad range of risks and rewards, may generate better results than one more structured in its risk parameters.

## CONCLUSIONS

Mezzanine real estate financing is a legitimate investment in today's market. Strong borrower demand, moderate flows of new mezzanine capital, and well-understood risks provide the platform for rewarding investment. Perhaps most important, projections of less volatile real estate and property market cycles in the future suggest that the critical market risks that go along with mezzanine financing may be overstated, creating the opportunity for returns that more than compensate for actual risks.

Pension funds and other investors should consider mezzanine real estate investment as they do other opportunistic, high-yield investments, understanding that substantial risks do exist but that substantial returns are also available in the market today

## ENDNOTES

[1]Jennifer Petch. "Somewhere Between Debt and Equity." *The Institutional Real Estate Letter*, March 1997.

[2]"Capital Flows." *Investment and Real Estate Capital Market Report*, December 1999.

[3]Estimate based on total volume of sale transactions in 1998 as reported by COMPs.com.

[4]The 2%-3% market-capture assumption and resulting market size of $8 billion to $12 billion is a rough estimate confirmed by our knowledge of current market trends. It also appears reasonable in that the $400 billion of debt originations implies approximately $170 billion of equity at a 70% loan-to-value ratio. If only 5% of the equity in these deals is converted to a less expensive mezzanine structure, the market would be $8.5 billion.

[5]Kenneth Rosen and Matthew Anderson. "The Coming Real Estate Cycle Peak — This Time It's Different." *PREA Quarterly,* Fall 1999.

[6]Glenn Mueller. "Equity Research." Legg Mason. *Real Estate Cycle Monitor*, February 2000.

[7]Marc Louargand. "Real Estate in the Next Recession Revisited." *PREA Quarterly*, Winter 2000.

[8]"Mortgage Loan Portfolio Profile." American Council of Life Insurance, June 30, 1999.