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Looking Behind the Curtain at Mezzanine Financing

Mezzanine financing has come a long way. It started as a way for lenders to participate in the acquisition and development of properties without the burden of day-to-day operations. Later, it became a way for lenders to become substitute borrowers in the event that the original borrowers could not meet their obligations, thus earning a high yield. Today, mezzanine financing is a much more complicated, and dangerous, market. Low interest rates and easily available capital have reduced the need for traditional mezzanine lending. This new breed of mezzanine lenders is using the collateralized debt obligation (CDO) market to leverage returns, which minimizes market exposure to interest-rate volatility and margin calls as a result of periodic mark-to-market requirements. Whereas lenders had previously concentrated on yield and exit strategy, now the focus has shifted to concentrating on yield, leveraged yield and term default probability. In all practicality, the mezzanine lender has become an interest-only buyer, less reliant on receiving full repayment of the principal.

Knowing this, mezzanine financing still remains a popular feature in many CMBS loans and appears to be here to stay. Mezzanine debt is one of the few ways for lenders to access higher yields no longer available on senior debt. Borrowers want it for the flexibility provided to purchase properties with less than 20% equity and in many cases to get additional financing during the term of the loan. Mezzanine financing also offers attractive yields to investors while providing options in the event of default and foreclosure that are not available to investors in junior mortgage debt.

Given the current state of both the CMBS market and the mezzanine financing market, there are some key considerations that become important in evaluating mezzanine debt to ensure the proper structure and to protect the position of CMBS investors in the senior debt.

- **Does the mezzanine holder have asset-management capability and the financial strength to run the property?** DBRS treats mezzanine debt secured by the borrower's interest in the property as equity. Since mezzanine holders can become the eventual borrowers, it is important to ensure they have sufficient ability to manage the asset and clout to conduct leasing activity plus financial wherewithal equal to the original borrower.
- **What are the mezzanine holder's motivations?** An investor who plans to hold the instrument through the life of the vehicle and understands real estate is different from a holder who plans to sell or leverage the instrument with a CDO immediately upon acquisition. The latter investors may have already realized much of their yield while reducing their exposure and are less concerned with the ultimate recovery of the full principal amount.
- **How much is the borrower relying on the mezzanine financing?** The borrower should be able to service the mortgage and the mezzanine debt and still maintain a meaningful investment in the property.
- **Are the proper agreements in place?** Intercreditor agreements should ensure that the control rights of the mezzanine holder will not impede on the rights of the trust while maintaining the effective operation of the property. Mezzanine investors should also have cure rights and the option to purchase the mortgage at par in the event of default.
- **Are the limitations on transfer adequate?** There are numerous limitations on the transfer of the mezzanine debt. In the event of a transfer, a replacement mezzanine holder should be as equally qualified and capable as the current holder, with reasonable tests in place to ensure this.

The abundance and availability of capital is now at an all-time high. However, this has not always been the case and may not be in the future. In analyzing mortgage debt that includes mezzanine financing, DBRS addresses the likelihood of refinancing in a less favorable economic environment. It is surprising how few transactions have plausible plans to create value whereby cash flow increases sufficiently to refinance all mezzanine and mortgage debt at balloon.

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This week, DBRS released Version 1 of its Annex A Advisor (the Advisor). The Advisor is a tool that stratifies the loans within CMBS transactions and highlights where investors may want to focus their analysis. The latest version is available at <http://www.dbrs.com/annexaadvisor>.