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## Apartment Finance Today

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# Up the Stack and Back

APARTMENT FINANCE TODAY • January/February 2012

**New construction, defensive refis will drive a rising demand for mezz and preferred equity in 2012.**

**BY JERRY ASCIERTO**

The demand for structured-finance products such as mezzanine and preferred equity is expected to balloon in 2012, for reasons of both exuberance and fear.

As fundamentals improve, developers are furiously sketching out plans for new construction and value-add deals. But many financiers, still nursing a hangover from the downturn, are only willing to lend or invest so far up the capital stack. So mortgage brokers are reporting an uptick in mezz and preferred-equity activity on the vanguard of optimism.

But a greater need lurks at the other end of the spectrum, as a wave of maturing, overly aggressive debt comes due. In 2007, nearly \$230 billion in commercial mortgage-backed securities (CMBS) was issued as the commercial real estate markets soared. A full reckoning starts this year—a slew of five-year balloon loans taken at the height of the market will soon pop.

“We’ve all seen the charts regarding maturities scheduled between now and 2017—it’s like a hockey stick,” says Kevin Smith, who leads the Alternative Capital Division of New York-based Centerline Capital Group. “There’s going to be a huge gap between where deals are underwritten today and the equity that’s provided—there’s going to be a huge need for preferred equity or mezz.”

The 2007 vintage of CMBS loans was one of the sourest in terms of underwriting standards, and about \$15.5 billion of those will mature this year, according to New York-based monitoring agency Trepp. Already, more than one in four of the five-year CMBS loans issued in 2007 are in special servicing, and Trepp expects the majority of what remains also to wind up there.

This problem isn’t limited to the CMBS industry. Banks, life insurance companies, private funds, and the government-sponsored enterprises (GSEs) were forced to compete with conduit lenders during the boom, and a chunk of those aggressive loans will also join the defensive-refinancing parade.

“NOIs are off from peak, appraisers are gun-shy and coming in below value, and lenders are all doing trailing analyses—all of which result in lower proceeds,” says Dave Valger, founder of New York-based preferred-equity provider DVO Real Estate Holdings. “In my estimation, roughly half of all the debt that will need to be refinanced won’t be able to get the same level



**PEARL OF A DEAL:** Pearlmark Real Estate Partners

provided an \$8.1 million mezzanine loan to Crescent Resources in December for its construction of the 303-unit Circle Ninth Street in Durham, N.C.

*Photo: Crescent Resources*

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Time will tell whether there's enough permanent debt in the market to address the acute rise in demand. But at the upper end of the loan-to-value (LTV) ratio, mezzanine and preferred-equity providers are looking at the next few years as a window of opportunity to invest capital highly profitably.

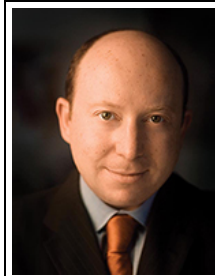
### Mezzanine Debt

Mezzanine debt for multifamily deals is generally pricing in the 10 percent to 14 percent range, reaching up to about 85 percent in the capital stack. But the mezzanine space has been quiet for some time, for several reasons.

Fannie Mae and Freddie Mac re introduced their mezz programs in 2010 to much fanfare, but they've failed to get much traction.

Freddie's program in particular has had a tough time, mainly because the mezz providers involved are all multifamily operators. Borrowers aren't especially keen to open their books to a competitor. Fannie Mae's version hasn't gone very far in the market either. The company isn't issuing waivers to allow mezz to go behind existing deals, for instance.

The GSEs' mezz programs are quite different from what they offered back in the halcyon days of five years ago, when acquisition-rehab was all the rage. Today, the programs are pretty



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—DAVE VALGER, founder, DVO Real Estate Holdings

much reserved for refinancing. Most borrowers are finding much more luck with private mezz lenders, such as RCG Longview and Pearlmark Real Estate Partners.

Early in 2011, conduits would lend a first mortgage up to 65 percent LTV, then provide a B-note that would reach up to 75 percent or 80 percent leverage and hold the B-note in a fund. But on the back end of securitized debt, mezz remains a dirty word to CMBS investors, as reluctant A- and B-piece buyers price up for any loan that includes mezz. Life insurance companies also generally frown on deals that include mezzanine financing.

Preferred-equity deals, instead, have become more common inhabitants of the upper reaches of the capital stack.

### Preferred Equity

Preferred-equity providers are generally asking for mid- to high-teens returns all-in. And the supply of preferred equity, as well as the demand, has certainly changed over the past five years.

"Five years ago, there wasn't a need to get additional equity to recapitalize transactions— lenders were chomping at the bit to give you more money at a lower price," says Valger. "Preferred equity used to be what people called it when they wanted to disguise the mezzanine debt, so the senior lender wouldn't notice. Today, it's a completely different part of the capital stack, and it's more transparent."

After almost a decade with mezzanine provider RCG Longview, Valger branched out recently in opening DVO. DVO is looking to invest preferred equity and, in some cases, joint-venture equity in the \$3 million to \$10 million range for B-minus to A-minus assets in several major markets across the country.

Many owners have done all the right things but will still find themselves with a funding shortfall. Valuations, not to mention the LTV levels offered, were much higher a few years ago, so borrowers could simply get more proceeds than they can now. Someone who borrowed \$20 million five years ago may only be able to get a \$16 million mortgage today—and options are limited in terms of filling that gap.

Valger sees a lot of opportunity to inject some capital into this expected wave of defensive refinancings.

"There's a ton of capital in the Class A space, and there's a lot of money for distress, but the majority of multifamily real estate is garden and mid-rise, B assets," says Valger. "And the 40 percent or more of Americans who live in multifamily housing will continue to live in multifamily housing. And a lot of those deals will need to get refinanced."