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REAL ESTATE MONITOR

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MEZZANINE FINANCING PLAYS IMPORTANT ROLE

By John Tax

It is expected that mezzanine financing, which fills the gap between senior financing and equity, will play a major role in the next few years as short-term mortgages come due in what continues to be a weak market. As senior lenders continue to be more conservative in renewing mortgages, borrowers will need to find cash from other sources. This will serve to create good opportunities for mezzanine lenders.

MEZZANINE LOANS: EXPLAINED

The term "mezzanine loan" refers to a special type of junior real estate financing that takes the form of debt unsecured by a second mortgage (the word literally means a story in a building between the ground floor and the upper floor). A mezzanine loan cannot be secured by a second mortgage because this would be unacceptable to the senior lender. The senior lender would be unwilling to assume the additional risk that a junior mortgagee would raise legal obstacles to the senior lender's remedies in the event of a default by the borrower. Thus, the mezzanine lender must utilize forms of security other than a mortgage. The most common security is a pledge by the property owners of their equity. For example, if the property is owned by a limited partnership, the limited partners would pledge their interests as security for the mezzanine loan. As a result, a default of the mezzanine loan would not involve the real estate itself.

HIGHER RETURN

Because of the lesser degree of security for the loan, the mezzanine lender usually will insist on a higher return than for a traditional second mortgage. The exact return will depend on the risk level of the particular investment.

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BDO's Real Estate and Hospitality Services practice consists of multi-disciplined professionals, well-versed in compliance and consulting matters. Our professionals have many years of experience in financial reporting and accounting, tax and auditing issues and are continually updating their knowledge and, therefore, are in a position to give timely and accurate advice.

MORTGAGE INTEREST DEDUCTIBLE

By Robert Klein

In Rose v. Commissioner, TC Summary Opinion 2011-117, the Tax Court ruled that homeowners were entitled to mortgage interest deductions for a house under construction.

BACKGROUND

In 2005 the taxpayers began looking for property along the Florida coastline to build a vacation home. The Roses entered into a contract in January 2006 which provided that the existing house would be torn down before closing. The taxpayers intended to build a new house on the lot.

To facilitate the purchase of the property the Roses took out a mortgage. The couple closed on the property in March 2006 when the previously existing house had been demolished, and the property consisted of vacant land.

In order to build a new house on the property, the taxpayers were required to obtain a construction permit from the Florida Department of Environmental Protection. Among other requirements, the process required that applicants exhibit the proposed building met hurricane and flood standards. After a lengthy process, the department ultimately granted the construction permit in February 2008, almost two years from the date the property was purchased.

By 2008 the residential real estate market in Florida had significantly changed. In order for the taxpayers to proceed with their construction plans, an additional bank loan was needed to cover construction costs. Due to the change in market conditions, the Roses were unable to secure financing that would allow them to proceed with their plans. Therefore, the couple sold the property for a loss in June 2009. The IRS claimed the mortgage interest expense deducted on the 2006 and 2007 tax returns was not qualified residence interest, and therefore disallowed the deductions.

RULING

For taxpayers other than a corporation, a deduction is not allowed for personal interest except for qualified residence interest. This type of interest is any interest that is paid or accrued during the tax year on acquisition debt or home equity debt. Acquisition debt is debt secured by a qualified residence, and incurred in acquiring, constructing or substantially improving the qualified residence. A qualified residence is the principal residence of the taxpayer, and one other residence selected by the taxpayer which is used as a residence.

Under Treasury regulations regarding qualified residence interest, a taxpayer may treat a residence that is under construction as a qualified residence for a period of up to 24 months, if the residence becomes a qualified residence at the time it is ready for occupancy.

The court decided the case based upon the interpretation of "under construction," which is not defined in the statute or the regulations. The Roses contended that the term is broad enough to include permit application, doing prepatory measures and drawing up plans for construction. The IRS contended the term should be more narrowly defined as requiring a physical building process to begin.

The court ruled that extensive work and planning had been undertaken by the Roses in engaging multiple building and design professionals. Therefore the property was under construction as a residence in 2006 and 2007, and the mortgage interest on the acquisition was accordingly deductible.

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MEZZANINE FINANCING

For example, consider an income property subject to a first mortgage with a 70 percent loan value (LTV) ratio. A mezzanine loan that raises the LTV to 55 percent for a term of up to seven years might produce an 18 percent internal rate of return (IRR). The purposes of entering into such a loan might be to secure additional funds for renovating or modernizing the property or to provide gap financing until before the current first mortgage matures and can be refinanced. At the opposite extreme, a mezzanine loan enables a developer to show the 30 percent cushion often required by a construction lender.

In addition to the higher return, the mezzanine lender will want some recourse other than a foreclosure in the event of default. The most common remedy is the right of the mezzanine lender to take control of the borrowing entity. In addition, the mezzanine lender often insists on a guarantee by the equity holders.

INTER-CREDITOR AGREEMENT

Once the mezzanine lender has reached an agreement with the borrower, the next step often is to negotiate an agreement with the senior lender. Such an agreement may be required by the terms of the senior loan even though the mezzanine lender has no lien on the property. The senior lender may welcome the role of the mezzanine lender, who would have the incentive to cure defaults by the borrower in order to prevent a foreclosure that would result in a loss to the mezzanine lender.

The mezzanine lender, however, often will want an inter-creditor agreement in any case in order to obtain certain promises from the senior lender, most notably the right to have notice of any defaults by the borrower, plus the right to cure defaults in order to prevent a foreclosure. In addition, the mezzanine lender may want the right, in the event the senior lender begins a foreclosure proceeding, to purchase the senior loan at a price equal to all amounts then due under the loan. Another request by the mezzanine lender might be that any increase of modification of the senior loan must be subject to the mezzanine lender's consent.

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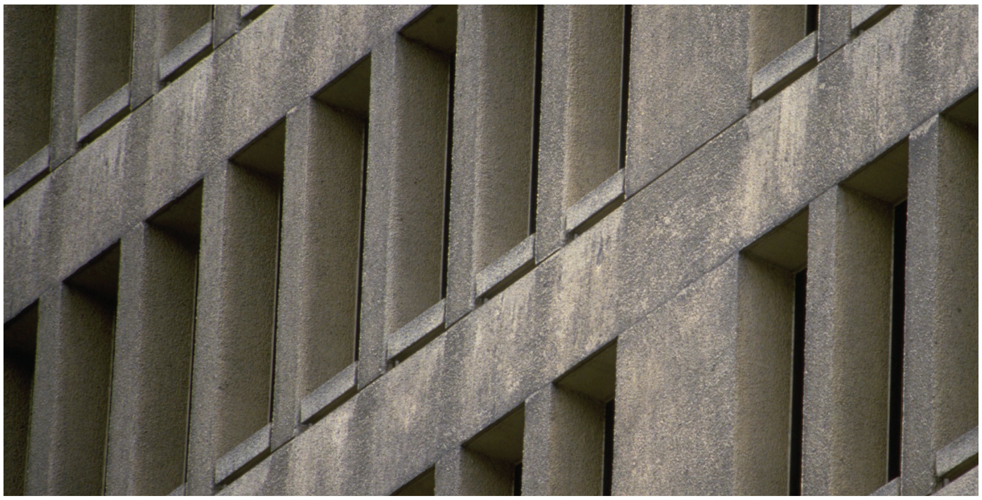
DISTRESSED REAL ESTATE: MANAGING THE PROPERTY



By David Tevlin

WHETHER IT IS OWNED BY THE ORIGINAL DEVELOPER, A SUBSEQUENT PURCHASER OR A FORMER LENDER, DISTRESSED PROPERTY REQUIRES INTENSIVE MANAGEMENT.

The first step is the same as in considering a workout: Evaluate the root causes of the problem. To the extent the problems are with the property, as opposed to the market, the cost of fixing them must be assessed. This means evaluating the cost of tenant improvements that will be needed to make the space rentable. It means talking to tenants about their level of satisfaction with the property and its management.

Next, it is important to study the cost structure of the property and to look for potential cost reductions. In a difficult market, many management companies may reduce fees. Property tax abatements may be possible, particularly where a property has declined in value from its last assessment. Older buildings may benefit substantially from an energy audit and replacement of antiquated heating, ventilation and air conditioning. On the tenant side, check if rents are being properly charged (particularly in buildings with rent escalation clauses, since this should not be taken for granted). Every line item in the budget must be checked against industry norms and historical experience, and decisions made about possible savings.

Although this kind of active management is difficult and time-consuming, it is crucial for distressed properties. Many lenders are ill-equipped to undertake this type of operation, and are better off negotiating a restructuring if the borrower is an experienced manager. Other lenders, of course, have developed sophisticated management skills and are no longer put off by the challenge of managing a troubled project

▶OPTIONS FOR DISTRESSED REAL ESTATE

Once a real estate project is in trouble, the lender and borrower must consider potential resolutions. Possible outcomes range from a hostile, court-imposed judgment to a consensual negotiated agreement.

The major possibilities include the following four options:

1. **Consensual Workout.** The optimal solution is often a workout in which the lender gives the borrower additional time, and perhaps additional funds, in exchange for a share of the upside potential and the provision of additional collateral by the borrower.

2. **Deed in lieu of foreclosure.** If the borrower and lender cannot agree to a workout, they may agree that the lender should get the property by a consensual deed granted by the borrower, typically in exchange for a release from all liability on the loan.

3. **Foreclosure.** Foreclosure is generally pursued when the borrower and lender can no longer work together cooperatively. It is the lender's means of having the mortgaged property applied to satisfy the debt.

4. **Bankruptcy.** In cases where the borrower has no other choice, it may choose bankruptcy as a means to stop foreclosure and attempt to force the lender into a restructuring or other compromise that the lender would not accept outside of bankruptcy.

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LEASES: RENEWAL OPTIONS

By Brian Bader

The market value of an income property is strongly affected by renewals currently paid under existing leases. The longer the remaining term of the lease, the greater the impact on value. So a landlord who grants a renewal option to a tenant must use every effort to ensure the renewal rent will approximate the market level at the time the option is exercised. In a weak rental market as at present, the tenant will use his bargaining position to keep future rents as low as possible. But the landlord must not forget the tenant is the one with the option, having the right to decline renewing the lease if at that time the rent is above market levels. The landlord will not have that opportunity.

Assuming the landlord is willing to grant a renewal option because of a tenant's reputation and credit rating, what are the alternatives in setting the future rental? Five alternatives are described below.

- Initial rent increased by percentage change in the Consumer Price Index (CPI)
- Same formula except the base rent is increased by a fraction of the percentage change in CPI
- Same formula except that the CPI increase is applied to the base rent minus the expense stop
- A fixed renewal rent
- Market rent at the time of renewal

▶FULL CPI INCREASE

Having the renewal rent equal (1) the initial rent increased by (2) the full percentage change in the CPI has one overwhelming advantage for the landlord. It protects his profit share of the rent dollar against the erosion caused by inflation. By comparison, increasing the rent merely by operating cost increases (the approach favored by the tenant) will mean no increase in the landlord's cash flow.

On the other hand, the change in the CPI can be wholly unrelated to changes in the operating costs of the particular building so that use of this approach can hurt rather than help the landlord. In addition, the tenant is likely to reject this approach for reasons set forth in the next paragraph.

▶PARTIAL CPI INCREASE

Having the renewal rent equal (1) the initial rent increased by (2) only a fraction of the change in the CPI reflects the fact that (usually) the debt service component of the rent will be a fixed amount during both the initial and renewal term and therefore should not be increased. In addition, the CPI (being a consumer index) is likely to outrun the increase in operating costs of a building.

For these reasons, use of a partial CPI factor may be acceptable to the tenant and may be the best deal the landlord can negotiate.

▶CPI PLUS OPERATING COST INCREASE

The tenant may seek to have the CPI percentage apply only to that portion of the rent that represents the landlord's net cash flow, with the remainder of the rent to be increased on renewal in accordance with changes in operating costs of the particular building.

This protects the tenant against a runaway rent if the CPI rises sharply.

▶FIXED RENEWAL RENTAL

At the time the initial lease is executed, the parties may agree on a fixed rental for the renewal term. If the rent figure turns out to be below market, the tenant will exercise the option; if the rent is above market, the landlord is likely to lose the tenant or be forced to renegotiate the rent. Consequently, setting a fixed renewal rent is a pure gamble for the landlord.

▶RENT TO BE DETERMINED

Finally, the renewal rental may be left for determination at the time the option is exercised, subject to some objective formula (or subject to an appraisal, which in turn should be in accordance with specified standards set down in the lease).

From the landlord's point of view, the standard should be the rental the landlord is asking for comparable space in the same building at the time of renewal. The tenant should be given the benefit of any concessions the landlord is offering at that time. On the other hand, points out Adreon, the renewal rental should not be tied to either:

- The rents other tenants in the building are paying at the time of renewal, since those rentals may not reflect current market conditions
- Rents being paid in other buildings in the area, since the landlord would then be substituting the judgment of others for his own in setting rents

▶TIME OF NOTICE

A related matter of concern in a renewal option is the minimum period of notice to be given by the tenant. The landlord needs to know where he stands as soon as possible and should ask for nine months' written notice of renewal. The tenant will want as short a notice period as possible; six months may be a reasonable compromise.

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FOUR REAL ESTATE FINANCING PLANS

By Alvin Arnold

Real estate investors and lenders have shown great ingenuity in creating new financing formats to fit rapidly changing economic scenarios. Right now, a wide variety of opinions exist as to whether we are facing renewed inflation, an extended period of disinflation or a series of rebounds from one to another. Depending on the point of view, one or another of the following four popular financing techniques will be preferred by an investor or lender.

▶MINI-PERMANENT LOAN

The mini-perm loan is intended for a developer who needs construction financing plus protection against sharp interest rate rises during the early years of operation. This type of loan runs from seven to 10 years; hence its name. For example, during the construction period (say, three years), the developer will pay interest on the funds advanced. Then during the next five years,, the developer pays a fixed negotiated rate. Finally, the loan can be prepaid without penalty. The advantage to the developer is that he has five years after construction to negotiate a satisfactory permanent loan and upon doing so, being able to pay off the mini-perm loan.

▶BULLET LOAN

A borrower who anticipates renewed inflation will be interested in a bullet loan. This type of loan carries a fixed rate, no equity participation, and may run from five to 15 years. Shorter maturities are interest-only, while longer maturities may require some amortization. No prepayment is normally permitted since the loans, commonly made by life insurance companies, are used to offset guaranteed income contracts made by the life companies to pension funds and other tax-exempt investors. Interest rates may be one or two percentage points over the prime rate.

▶BOWTIE LOANS

Income-property owners normally are loath to enter into floating rate loans since rising interest rates can play havoc with their cash flow position. On the other hand, a floating rate loan offers protection during economic downturns, when lower interest payments help offset declining rent revenues. The bowtie loan can solve both problems since it carries a floating rate but with a provision that all interest above a fixed minimum will be deferred to the maturity of the loan. Loan terms run between five and 10 years and the loans may be secured by first or second mortgages. They may require no amortization and permit prepayment with no or a small penalty. Lenders making this type of loan may be finance companies, commercial banks and thrift institutions. The "bowtie loan" derives from the fact that the prime (and related) interest rates constantly move up and down in irregular patterns and the bowtie loan seeks to smooth the impact on borrowers by deferring a portion of high interest rates until maturity.

▶CONVERTIBLE MORTGAGES

The convertible mortgage gives the lender the opportunity to acquire a future equity interest in the property. Owners prefer it to giving an immediate equity interest to the lender since the owner then keeps the tax benefits from depreciation and interest until the conversion point, which may be 10 or 15 years in the future. In addition, no tax need be paid on realized gain until the conversion. On the other hand, the lender is assured of a fixed interest return during the loan period that has priority over any payments to the owner. In one approach, the owner receives a below-market interest rate in exchange for which the lender has an option to convert the loan to 50 percent (or more) ownership at a designated future time. Alternatively, the lender may call the loan at that time, renew the loan under specified terms (including the right to participate in cash flow and resale proceeds), or in some cases buy the entire property at a price to be fixed according to an agreed formula.

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