

Risk and Reward: *The Powerful Duo of Mezzanine Debt and Seniors Housing*

Owner/operators of seniors housing and care need access to creative, flexible, and timely capital. Mezzanine debt can provide the mechanism for these owners/operators to acquire, develop, refinance or bridge value-add opportunities.

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Today, seniors housing is viewed as one of the best choices for investment, by both new entrants to the market and industry veterans alike. While the industry faces short-term occupancy challenges in some areas of the country, these assets have proven they can weather downturns and recessions better than other commercial real estate classes. As a result, the industry is booming in a way it never has before.

To state the obvious, developing, acquiring, renovating or expanding a seniors housing asset requires capital. What's not so obvious is what kind of capital; the options for both debt and equity financing can be overwhelming. Securing additional equity can often be problematic, as it may take longer to raise and close, restrict a project or company's plans for growth and dilute the owner's equity interest. Senior debt, on the other hand, can also not go as far as an owner/operator needs it to as they continue to tighten their lending belts. However, there is another kind

of debt that can bridge the senior loan and also provides an attractive alternative to contributing or raising additional equity. This option is mezzanine debt.

Mezzanine debt provides a solution for owner/operators facing capital challenges and financing gaps related to various project types; this type of debt also helps growing organizations that lack access to traditional lines of credit or other assets to lend against. Ultimately, it is flexible, short-term, non-dilutive capital.

Solving a Capital Conundrum

While mezzanine debt may not be one of the first options that owner/operators consider, many use it as a means to leverage their personal equity and invest in growth opportunities. Using mezzanine capital can provide the owner—oftentimes a successful entrepreneur with limited ability to contribute personal equity—greater control of their own destiny.

Mezzanine debt can also be used to obtain more attractive senior mortgage terms. For example, mezzanine debt can sometimes be used to lower the loan to value ("LTV") of the senior mortgage to the point where the senior lender no longer requires personal guarantees or additional reserves. In addition, mezzanine debt can often fill the gap on value-add projects when the loan proceeds from a senior lender are insufficient to close. In many cases, once the value of the asset has increased, the senior lender may increase their loan (typically through an earn out) thereby paying down or paying off the mezzanine loan.



Mezzanine Debt

- Used as short-term, non-dilutive bridge financing
- Can be used for physical plant upgrades or working capital
- Quick time to close

Many projects that are otherwise well-capitalized may need additional funds for a variety of situations. Mezzanine lenders typically have more flexible capital than traditional debt and equity structures and often think “outside the box” when it comes to structuring a solution. For example, mezzanine debt can be tapped to improve the physical plant, invest in marketing to reposition an asset or provide general working capital to turn around an underperforming asset. Mezzanine debt can provide more proceeds and leverage in these complicated, fast-moving situations where the capability to close quickly is imperative.

“We look at opportunities in one of three ways: first, a light value-add scenario is a situation where an owner/operator is typically acquiring a facility and optimizing expenses and/or modestly growing census. In this scenario, the owner/operator typically refinances out the entire capital stack in 12-24 months. The second way we look at an opportunity is a heavy-value add. This is a more challenging turnaround where the owner/operator is looking to renovate a facility and/or substantially grow revenue. In this scenario, the owner/operator typically refinances out the capital stack in 24-36 months. The third way is new construction, where we are providing capital to build and stabilize the asset. These situations typically have the longest duration of 36-60 months. In all three scenarios, we work closely with our borrowers to structure the appropriate terms and amount of debt to quickly meet their financing needs.” —Eric Smith, founding partner, Locust Point Capital.

Growing senior living owner/operators can use mezzanine capital as part of a strategy to grow further, faster; they then can leverage long-term financing through HUD or other institutional debt sources as a takeout strategy for various portions of the capital stack. A successful short-term bridge to take-out strategy means owner/operators

can repeat the winning strategy to marry the opportunistic capital, knowing the risks and allowing the owner/operator to retain the upside long term. As the owner/operators and mezzanine lenders build their partnerships through multiple transactions, the owner/operators can grow faster and the mezzanine lenders can lend to them quicker.

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- **Second**, a heavy-value add is a more challenging turnaround where the owner is looking to renovate a facility and/or grow revenue
- **Third**, a new construction, where we are providing capital to build and stabilize the asset.

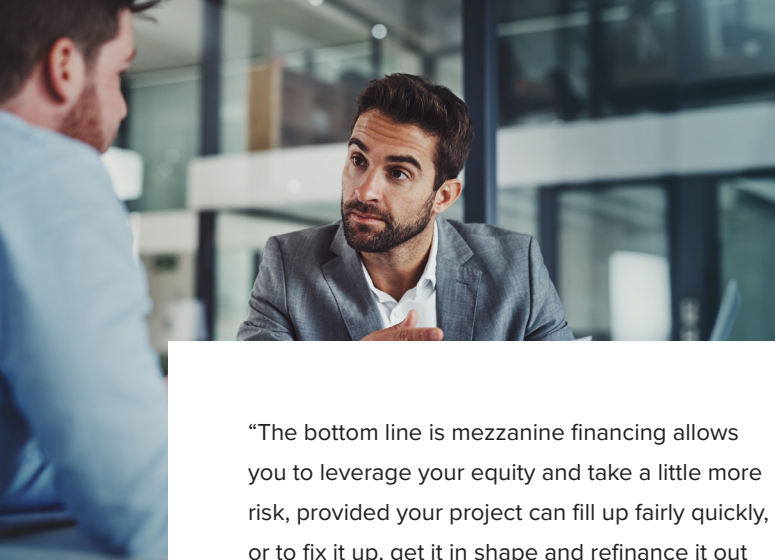


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“The bottom line is mezzanine financing allows you to leverage your equity and take a little more risk, provided your project can fill up fairly quickly, or to fix it up, get it in shape and refinance it out faster. You can get into more deals with fewer dollars on your own, and in the past, it has allowed me to do more projects at the same time by spreading my equity. Once each project is stabilized, I can refinance the mezzanine out and in some cases, get more equity out for other projects.” -- Win Porter, President of Medical Development Corp., developer of assisted living and independent living

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WIN PORTER, PRESIDENT, MEDICAL DEVELOPMENT CORP.

Owner/operators looking to work with mezzanine debt need to have a solid understanding of their current capital structure; ensure that the existing debt and equity holders fully comprehend why the additional layer of capital is needed; and, most importantly, feel secure with the entity providing it. As more participants come into the seniors housing investment arena, the variety of

stakeholders and parties involved in a project can add layers of complexity from a legal, regulatory and financial standpoint. Working with an experienced mezzanine lender to navigate these peculiarities is crucial. A strong mezzanine lender can bring a level of sophistication that can help all parties involved when difficult conversations may be necessary about the realities of an existing project or new opportunity.

One of the key features of mezzanine debt is its flexibility to be used in a variety of situations. Mezzanine lenders are often pulled into deals after the rest of the capital has been secured. In certain cases, an equity participant drops out or the senior lender lowers their loan proceeds, leaving the owner/operator to make up the difference.

“In many value add acquisition opportunities, the owner/operator has an expedited deadline,” Smith said. “In some cases, the owner/operator needs additional funds in order to close the transaction. In these situations, we can step in and provide that solution-oriented stretch capital needed to get the deal done.”

Industry Experience Matters

With more debt and equity players attracted to seniors housing, finding and working with the right lender is no easy task. The industry is specialized; unlike commercial real estate; the success of a project hinges on the ability to execute operationally, blending hospitality with increasingly complex health care services. By working with an experienced lender who has been through all of the economic cycles and looked at thousands of deals, owner/operators can use their mezzanine partner as a trusted advisor.

Mezzanine Capital to the Rescue: One Scenario

Some owner/operators are bound to be approached by brokers, other lenders and industry colleagues about new, value-add acquisitions and opportunities. The acquirer may be an experienced operator but not have enough liquidity to satisfy traditional bank underwriting, or it might not be feasible to wait for that process.

Mezzanine financing can fund the difference between their cash-on-hand and equity requirements by the senior lender to consummate the transaction. In situations like this, a relationship with an experienced lender that can act quickly could be the difference between winning and losing the deal. Nevertheless, a complex deal as outlined above needs a sophisticated network to execute that expeditiously and get the deal done.

“I brought the Locust Point team down to Florida for a potential deal essentially to use as a sounding board,” said Porter. “They validated my opinions giving me three or four different routes. If they didn’t buy in, I probably would have walked away from the deal.”

Mezzanine lenders typically have a strong due diligence team that is aligned with their investments, including:

- Attorneys to navigate complicated legal structures including the inter-creditor agreement
- Market experts who understand the dynamics of a particular asset and area
- Consultants to help achieve the desired outcome to transform assets into solid investments, structured and stabilized for long-term success

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**ERIC SMITH, FOUNDING PARTNER,
LOCUST POINT CAPITAL**

While some projects may require only one part of a lender’s network, other projects may rely on the lenders’ institutional knowledge, especially in times of need. As challenges arise, active

communication among all parties to align with a common goal can help avoid misunderstandings, confusion and—in the worst case—loss of capital if a project fails to be completed or achieve stability.

“Working with an experienced mezzanine lender that understands the cyclical nature of the industry and has worked through multiple business cycles is paramount,”

says Smith. “When challenges arise, you want a mezzanine lender that will work with you and roll up their sleeves to find a solution. You want a mezzanine lender who is an expert; who has seen it all, and can pull from their experience, not be panicked in a challenging time that requires calmness and certainty. You want a trusted partner.”



Go In With Eyes Open

Investing in seniors housing assets is not without risk, and mezzanine capital is no exception.

Interest rates for mezzanine debt are typically higher than rates for bank financing or institutional funding. However, owner/operators are advised to look beyond the initial “sticker shock” that can occur. While senior debt is currently priced between 300 bps to 400 bps over London Interbank Offered Rate (LIBOR), mezzanine debt is typically priced in the low to mid-teens. Owner/operators need to understand the true cost of the capital on a blended basis, or the weighted average rate paid for the entirety of the capital stack to the true cost of the capital.

Depending on where the senior and mezzanine debt is priced and also depending on the total leverage of the transaction, the blended cost of capital is typically around 7% - 8% for up to 90% financing.

While this may seem high, it is typically less than where equity is priced and is also, most importantly, non-dilutive and short-term. Knowing all their options, owner/operators can make an informed decision on which makes the most sense: mezzanine financing, new equity capital or selling an ownership interest.

“I’ve done deals where I’ve had equity partners and mezzanine financing alleviates a lot of the headaches you have to deal with when you have equity partners. It also costs you a lot less than giving away a percentage of the actual project,” says Porter.

Owner/operators should always examine their underlying strategy to ensure that their thesis makes economic sense, and that they realistically have the means to execute on an investment. Debt and equity carry their share of risks and going in with eyes wide open means a borrower is aware of the consequences that may occur in the event of a default or other unforeseen challenges. Knowing these risks is the first step in lessening the odds of an unwanted outcome.

Seizing the Moment

With newer, inexperienced operators coming into the senior living industry and over-development in certain geographic areas, opportunities to acquire some of these distressed assets will create business opportunities. For existing owners/operators, having access to a comprehensive capital plan for these types of assets can help grow their businesses. Working with a lending partner like Locust Point Capital can help across the board, from providing expert opinions to providing solution-oriented, non-dilutive capital.

About Locust Point Capital

Locust Point Capital is an alternative asset manager firm headquartered in Red Bank, New Jersey, with an office in Washington D.C. led by a management team with deep experience in investing in the seniors housing and care sector, the firm provides tailored capital solutions to owner/operators that need short-term non-dilutive capital in order to execute their business plans. Locust Point Capital offers subordinate debt, preferred equity, and opportunistic senior mortgage loans for acquisitions, refinancing, recapitalizations, new construction, capital investment, or working capital. Additional information about Locust Point Capital is available at www.locustpointcapital.com.



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