2018

SUBORDINATED CAPITAL FOR REAL ESTATE – AN ESTABLISHED MARKET

WE PROVIDE TRANSPARENCY

® FAP MEZZANINE REPORT

In the 4th edition of the FAP Mezzanine Report in front of you, we provide further transparency on the rapidly growing market segment for subordinate financing. This year's report reflects the views of 59 of the 136 capital providers active in the segment. These market participants alone have provided EUR 3.9bn of mezzanine capital over the last twelve months and the total for 2018 is expected to reached up to EUR 6 billion!

It remains the case this year that capital is seeking the right investment. Successfully matching borrowers and capital providers remains the central challenge.

The market for subordinate financing has now grown into an independent asset class of significant size and recognition throughout the real estate sector and will remain a fascinating and highly competitive segment going forward. Institutional capital providers are surging into the market while family offices and crowd capital are increasingly important players. With increasing capital inflows, falling returns and growing flexibility in financing structures, the market is evolving.

"Mezzanine" has now established itself as an independent investment asset class in a changing financing market. This is underlined, besides the consistently increasing volumes, by demand from capital providers for our real estate debt investment platform "FAP Invest". In addition to offering deal-by-deal investments in debt, the platform also advises capital providers via separate account structures.

The FAP Mezzanine Fund launched this year represents the third pillar of investment in debt, offering an approach that fills a crucial gap in financing for defensive mezzanine strategies in the investment and real estate development segments. Hence, FAP Group offers both borrowers and capital providers a unique platform that we will continue to expand.

The trend in the mezzanine segment in 2018 is: more capital, more risk, more optimism!

Curth-C. Flatow
Managing Partner

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CURRENT **MARKET TRENDS**: **MORE** CAPITAL, **MORE** RISK, **MORE** OPTIMISM**!**

The market for subordinate financing is growing significantly. The 59 capital providers taking part in this report provided subordinated capital totalling EUR 3.9bn over the last twelve months (previous year EUR 2.6bn) and are expected to provide up to EUR 6bn in 2018 as a whole.

Capital providers are optimistic about the market over the next twelve to eighteen months, expecting volumes to remain at a consistently high level or to show positive growth.

In view of the sustained historically low interest rate landscape in the capital markets, investment volumes and pressure to invest have remained high during the reporting period. The 6-month EURIBOR interest rate has remained more or less unchanged for some time at -0.26% (as of August 2018). Five-year EURIBOR has also proven almost immovable at its current level of 0.27% (as of August 2018). In these circumstances, it is not uncommon for negative interest rates to be passed on to borrowers in the senior loan segment.

Interest rates/returns on subordinated loans are also falling modestly on average. This is attributable to the significant competition for suitable investments in the segment at present.

Against a background of constant capital inflows from pension contributions, institutional investors are directing their policyholders into the market. However, they are increasingly conservative in their provision of capital and are investing directly to a lesser extent in favour of increasing allocations to appropriate specialist funds.

Family offices (multi-family offices) represent a stable constant in the market as a financially strong and entrepreneurial backbone in the development segment in particular.

It is striking once again this year that international capital providers continue to play a scarcely discernible role in this market in Germany. The strength of international loan funds lies in the provision of large volumes with conservative LTVs and is primarily benefiting European and/or global real estate financing structures.

Various crowdfunding platforms now represent established subordinate financing providers. Besides the traditional crowd capital, these players are increasingly providing volume above the crowd ceiling of EUR 2.5m.

It is noteworthy that the market's appetite for risk is increasing with equity contributions falling by up to 25% year on year, capital providers becoming more flexible and capital tranches becoming larger.

Capital providers are deploying their available capital more flexibly and are increasingly investing in both existing property and development projects.

Offices remain the most favoured sector for investment. The remaining sectors have witnessed significant shifts compared with 2017 in favour of the entire residential sector (residential, hotels, micro-apartments, etc.) as well as retail/shopping developments.

More than half of providers now provide capital throughout Germany, including B and C-cities.

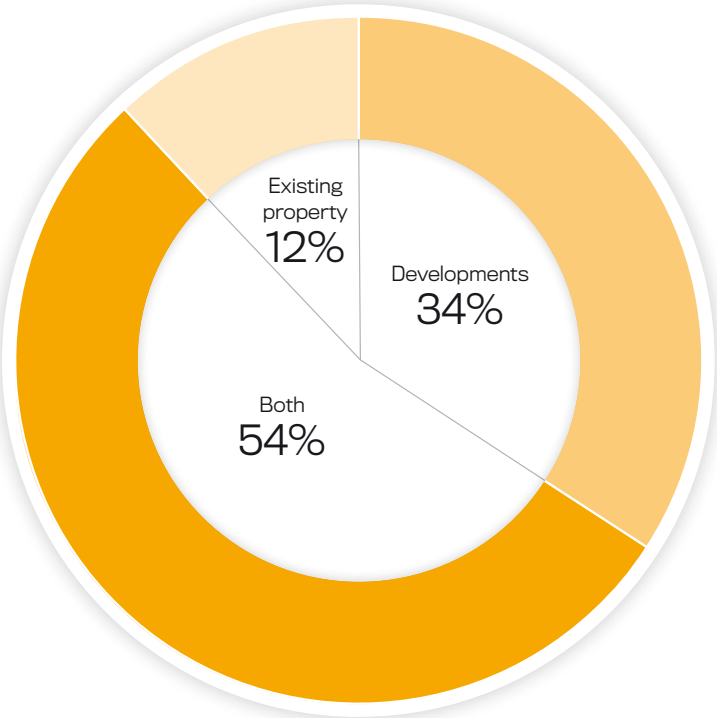
The successful traditional German providers are pursuing the all-pervading topic of digitisation in the sector as a low priority at present.

TRANSACTION VOLUME **RISES** FURTHER

Capital remains available in many forms and individual structures this year. Specialist funds in particular are providing capital as an all-in-one solution for financing requirements via their whole-loan offerings in order to retain a significant mezzanine portion on their books upon subsequent restructuring of the financing.

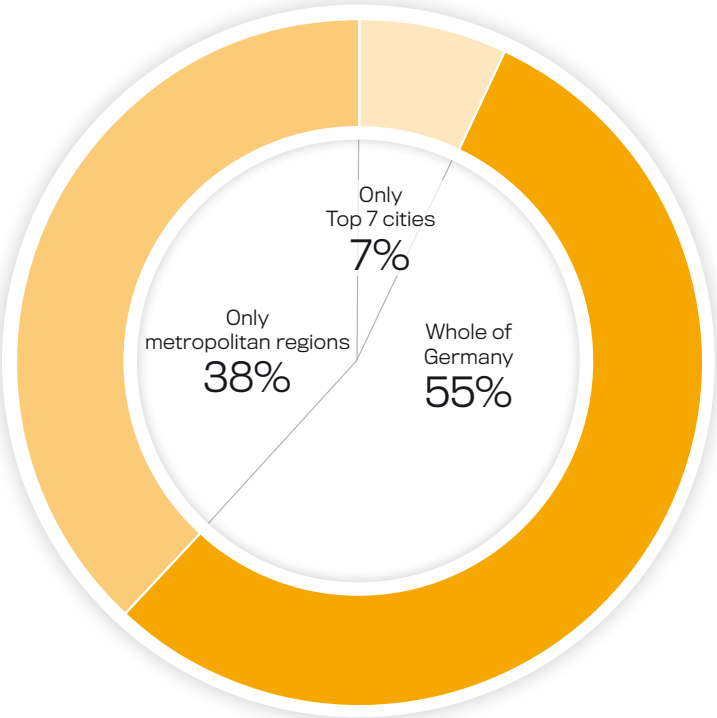
This trend is also reflected in the transaction volume. Over the last twelve months, the market participants surveyed for this report alone allocated EUR 3.9bn to subordinated capital for financing existing property and development projects. This enabled the completion of real estate investments totalling approx. EUR 26bn.

CAPITAL PROVIDERS ARE **FLEXIBLE**



The increasing flexibility of capital providers is crucial to success when seeking a/the suitable investment and is reflected in the increasing number of investors active in both segments (52% last year).

B AND C LOCATIONS ARE ALSO ATTRACTIVE



More than half of providers now provide capital for real estate financing throughout Germany, i.e. including economically strong C-cities. Likewise, B and C locations within these cities are also witnessing increasing capital allocations.

Metropolitan regions are currently defined by the regions of the largest German conurbations and are distributed across the majority of Germany.

THE MARKET HAS AN **APPETITE FOR RISK – EQUITY** REQUIREMENTS **ARE FALLING**

More than 80% of providers (56% in 2017) now offer capital for existing property up to an LTV of 90%+. In general, more capital providers than last year are willing to honour such high lending ratios provided that the property, location, real estate investor and business plan, as well an exit via sale or refinancing, are convincing.

90%+

On average, 8% – 10% of the market value must be contributed by the initiator. This represents a decrease in equity contributions of approx. 25% compared with 2017!

8–10%

SELECTIVELY **STRONG** APPETITE FOR RISK – **LOW** EQUITY REQUIREMENTS

The clear majority of providers (81%) finance development projects at between 90% – 95% of total investment cost (TIC).

90–95%

By implication, this normally requires equity of 5% – 10%.

5–10%

Depending on the strategy and attitude to risk of the provider, loan-to-cost (LTC) ratios of up to 100% are also increasingly being offered. In all cases, the track record of the developer, combined with the plausibility of the business plan and the exit feasibility of the development project, determine the size of the equity contribution.

FULL **REPORT**

The FAP MEZZANINE REPORT 2018 is available now with the following additional content as a paid download from the iz-shop at www.iz-shop.de.

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