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2019 SUBORDINATED CAPITAL FOR REAL ESTATE – A VITAL ASSET CLASS

WE PROVIDE TRANSPARENCY

®FAP MEZZANINE REPORT

In this, the fifth edition of the FAP Mezzanine Report, we once again present the current trends in the rapidly maturing market segment for subordinate financing. This year's report reflects the views of 53 of the 146 capital providers active in the segment. These market participants alone have provided EUR 5.8bn of mezzanine capital over the last twelve months, which has been used to complete a development volume of EUR 38bn.

The market for subordinate financing has now established itself as an independent asset class of significant size in the real estate sector. Overall, the market is becoming more dynamic. In light of interest rates and the associated pressure on margins, the segment is also becoming increasingly competitive, albeit market participants are becoming more cautious and discerning when it comes to deals.

Institutional capital providers and international operators are pouring into the market and family offices and crowd capital players expanding their positions. While the market is rapidly evolving, successfully closing a deal requires significant willingness to compromise. Trust is once again becoming a central criterion of a financing partnership.

Mezzanine capital has now taken on a vital function for real estate projects. It has become an integral and regular feature of financing deals. Besides the stable volumes, this is also evidenced by demand from capital providers for our real estate debt investment platform, which offers both deal-by-deal investments and separate account structures.

With our FAP Mezzanine Fund, launched last year, we have been able to fill a crucial gap in financing for defensive mezzanine strategies in the investment and real estate development segments. Thus, FAP offers both borrowers and capital providers a unique platform providing real estate investors with a structured route to various sources of capital and facilitating deals!

The trend in the mezzanine segment in 2019 is: more cautious players, fewer deals, bigger tickets, lower margins, longer maturities, more flexibility and willingness to compromise!

Curth-C. Flatow
Managing Partner

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BIGGER TICKETS, **FEWER** DEALS, **LOWER** MARGINS, **LONGER** MATURITIES

The market for subordinate financing is evolving rapidly. This is not quite so true of growth in market volume but is rather more applicable to capital providers and their behaviour, which is described below.

We are witnessing stabilisation at a high level. While growth rates have fallen marginally short of our projections, the average ticket size has increased. The number of market participants also continues to rise, resulting in increased pressure on margins. Consequently, interest rate / yield expectations have often been left unfulfilled.

There are now 146 institutions operating as subordinated capital providers. Companies, particularly from Anglo-Saxon territories, that have exited the German mezzanine market have been replaced by other international investors and funds. International interest in the German real estate market is growing!

Investors remain optimistic, although this optimism is now on the whole more cautious. This is attributable to the late stage of the market cycle, (global) financial and economic conditions, the scarcity of available and affordable properties, the low capacity of construction companies and the shortage of resources in terms of specialised personnel.

For investors, it is becoming increasingly difficult to find suitable deals, to price these at an appropriate risk/return ratio and to implement them within the specified budget. While the number of deals is lower, however, the volume is trending higher.

Investors and capital providers are being forced to act more flexibly. Consequently, trust and security are playing an even more prominent role than previously.

Capital providers have become even more willing to compromise in order to successfully close deals. Requirements in respect of “hard” equity are diminishing and are being replaced more frequently with guarantees or higher pre-sale rates, for example.

The intrinsic risk potential of a project is frequently no longer discernible via the interest rate. The various forms of financing are being compressed and blended. Boundaries regarding interest rate expectations and security requirements between different forms of financing are becoming blurred.

Mezzanine capital has now taken on a vital function. No mezzanine, no more deals. It is now a “normal” component of financing and effectively a core product.

Corresponding funds are becoming more and more interesting from a risk perspective although not so much from a yield perspective. Mezzanine debt is now considered a risk-averse investment by market participants.

Pressure on margins in development projects is resulting in a “blending” of existing components among finance providers. There is a noticeably greater willingness to offer whole-loan solutions.

Office and residential financing (of all kinds) sit at the top of the popularity ranking. Securing sites is becoming increasingly important.

The trend towards Top 7 and metropolitan markets, as well as peripheral locations within such cities, has resumed.

THE **MEZZANINE MARKET** IS PROVING **AGILE** AND **STABLE**

This year, too, capital has been available via a wide range of facets and individual structuring.

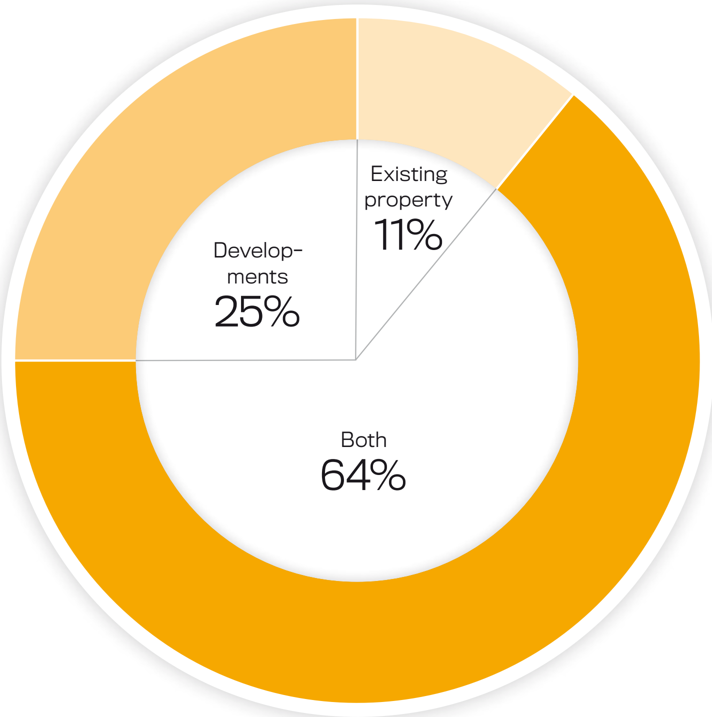
The participants in this report alone have provided mezzanine capital totalling EUR 5.8bn for financing existing property and developments over the last twelve months, which has been used to complete a development volume of EUR 38bn.

We have witnessed intensive activity in terms of verifying financing projects. It has become significantly more challenging for capital providers to find suitable deals for their specific risk/return profiles.

Overall, the number of deals has fallen while the average volume of financing has increased. Although growth expectations have not been entirely fulfilled, on the whole the market has stabilised at a high level.

The number of market participants continues to rise. Foreign institutions from Asia in particular are seeking direct access to the German market for whole-loan and mezzanine financing. Positive premiums on currency hedging and a secure national economy in international comparison are making debt investments in Germany increasingly attractive. German institutions, on the other hand, are more frequently choosing the indirect route via subscriptions to fund products.

FINANCE PROVIDERS HAVE HAD TO BECOME **MORE FLEXIBLE** AGAIN

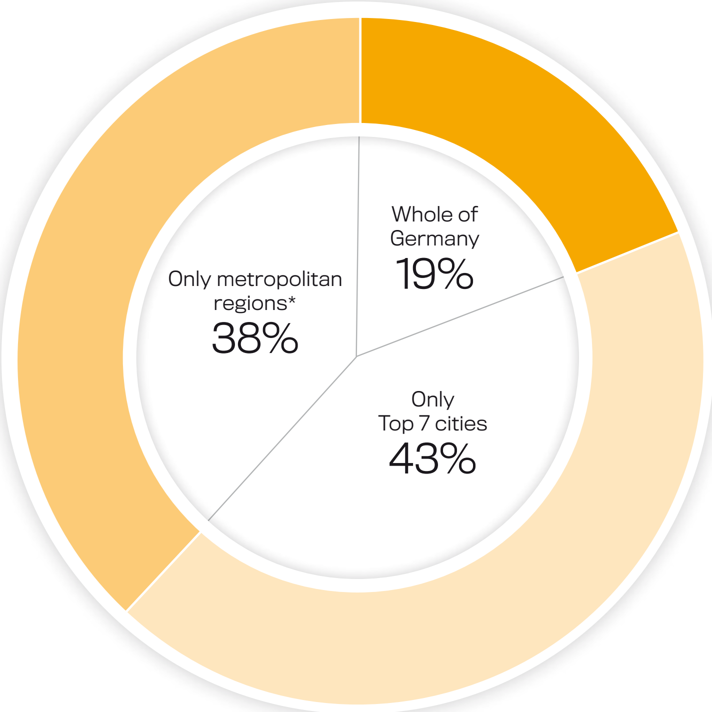


In view of market developments (pressure on margins, price growth, availability), capital providers have had to become even more flexible.

The percentage of finance providers that previously only funded developments and are now also financing existing property has increased, with 64% of providers (last year: 54%) now financing both segments.

The prevailing pressure on margins is also having an effect on finance providers when it comes to developments, resulting in an increased "blending rate" of existing components particularly owing to liquidity and security reasons.

MAJOR CITIES ARE IN DEMAND



There has been a significant change in terms of preferred locations. All providers are investing in the Top 7 cities.

There has been a significant increase in providers that only finance Top 7 or metropolitan locations compared with last year, which is particularly attributable to the new, mostly institutional providers in the market. 43% (last year: 7%) of providers are focusing exclusively on the Top 7 cities. Experienced providers will also finance B and C locations in such markets or peripheral locations bordering the major cities ("commuter belt") provided that these are suitably attractive (transport links, infrastructure, price structure). This is particularly due to increased engagement from institutional investors and a scarcity of suitable properties.

Certain providers are also shifting their attention to C regions surrounding major cities, based upon regional or internal know-how, provided that the project and quality of the developer are suitably attractive. Only 19% (last year: 55%) are still active throughout the whole of Germany. 74% are providing finance in B regions and 26% in C regions.

*Definitions in the glossary

EQUITY **REQUIREMENTS** ARE **FALLING** FURTHER

More than 80% of providers (80% in 2018, 56% in 2017) are now offering capital for existing property up to an LTV of 90%+. In line with last year, capital providers are generally 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%+

While equity requirements still stood at 8-10% last year, initiators have had to contribute an average of only 5-7% of market value this year.

5-7%

Experience and trust within the financing partnership are having a noticeably positive effect on equity requirements and conditions. This has made financing of up to 100% possible on follow-up deals between familiar partners.

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

The majority of providers are financing development projects at between 90% and 95% of total investment cost. This reflects a continuation of the trend from last year in terms of risk appetite.

90 – 95%

Equity requirements have fallen slightly further. Initiators are now normally required to contribute just 5–7% (last year: 5–10%). In addition, there is an increasing willingness to replace “hard equity” via compensation (pre-sale rate, guarantees).

5 – 7%

FULL REPORT

The FAP MEZZANINE REPORT 2019 is available now with the following additional content as a paid download from the iz-shop at www.iz-shop.de.

A GLOBAL NETWORK FOR CAPITAL AND FINANCE

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