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2020 SUBORDINATED CAPITAL FOR REAL ESTATE – AN INDEPENDENT SECTOR

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® FAP MEZZANINE REPORT

This year, our survey for the FAP Mezzanine Report focused closely on events surrounding the coronavirus pandemic. It was important for us in this, the 6th edition of the report, to communicate trends shaped by current impressions of market activity.

According to our observations, there are currently at least 155 capital providers active in the market segment for subordinate financing. The 53 that participated in this report provided EUR 6.9bn of mezzanine capital during the reporting period, enabling a development volume of more than EUR 40bn.

Hence, growth has remained somewhat behind the expectations of market participants but has simultaneously confirmed that mezzanine capital has become a sector that acts as an important source of capital even – or precisely – in a crisis.

The further increase in the number of institutional capital providers in particular is having a broadly stabilising effect on the German market for financing existing property and developments. International providers and family offices frequently facilitate the financing of non-core assets and keep the market moving.

In addition to the responses of survey participants, demand for real estate debt investments on our platform is also confirming current trends. Investors are seeking to optimise their sourcing capacities via FAP, both on a deal-by-deal basis and using separate account structures, and to ensure a manageable deal flow aligned with their investment criteria.

The trends in the mezzanine segment in 2020 are:

- The reticence of banks is opening up new opportunities for subordinate financing providers,
- Modest increase in returns or lower risk exposure,
- Further growth despite the coronavirus crisis with flexibility and speed being paid for.

Curth-C. Flatow
Managing Partner

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OPPORTUNITIES IN THE CRISIS – **SUBORDINATE FINANCING PROVIDERS** CONTINUE TO PROSPER

Interest in the German market for subordinate financing continues to grow. We can currently identify 155 active players, which is 9 more than in last year's report. The number of funds and international capital providers has particularly increased yet further.

While there was an increasing departure of providers from Anglo-Saxon countries in recent years, these have returned during the course of the coronavirus crisis. Despite their higher expected returns, they have seen an opportunity to re-establish themselves in the German market.

While the great euphoria had already evaporated somewhat in 2019, participants in our survey were still expecting the market to stabilise at the beginning of 2020. Their cautious optimism was only completely halted by the outbreak of the coronavirus pandemic.

Initially, the majority of providers focused on the valuation of their existing portfolio. Any new financing was deferred. The hotel and retail sectors particularly suffered from this reticence with the onset of lockdown. However, even financing of office properties became more difficult during the course of the crisis. There was also a clearly identifiable reticence in this sector depending on the tenant structure and varying estimates of future demand for office space in times of rapidly increasing home office use.

However, it is in this very reluctance that many subordinate financing providers have seen their opportunity, stepping into the breach where banks are either no longer providing any financing or are only offering low loan-to-value ratios. They are also frequently offering bridging finance at interest rates previously reserved for mezzanine capital. Both the spectrum of interest rates and the bandwidth of lending ratios have expanded significantly.

There remains a noticeable trend towards bigger tickets. And, with an increasing concentration on financing developments and existing property in major German cities, and often exclusively in the Top 7 cities, the number of individual tickets is also decreasing. The financing volume per investment is increasing. At the same time, many capital providers are seeking to achieve an optimal balance of expenditure and benefits for themselves via longer maturities.

This trend also illustrates that mezzanine capital has become a fundamental component of real estate financing in Germany. It is now indispensable as a form of financing and the coronavirus crisis has further highlighted the important role of mezzanine capital providers in financing. They intervene where banks are no longer available as a source of capital or are only active to a limited extent.

Alternative capital providers are also responding flexibly to market trends in other ways. Since co-ordination of the security structure between senior and junior debt in creditor agreements is often difficult to arrange and increasingly time-consuming, whole-loan solutions are enjoying increasing popularity. These are increasingly being offered by the capital partners surveyed. If the interest rates are compared with the blended rate of traditional senior/junior combinations, the costs of capital of the two financing variants scarcely differ.

One victim of the coronavirus to be lamented, however, is the issue of sustainability. While most capital providers have recognised this as a trend-setting issue for some time and everybody agrees that it will become increasingly important over the coming years, ESG criteria* are scarcely taken into account in the selection of deals or in pricing.

*Definition in the glossary

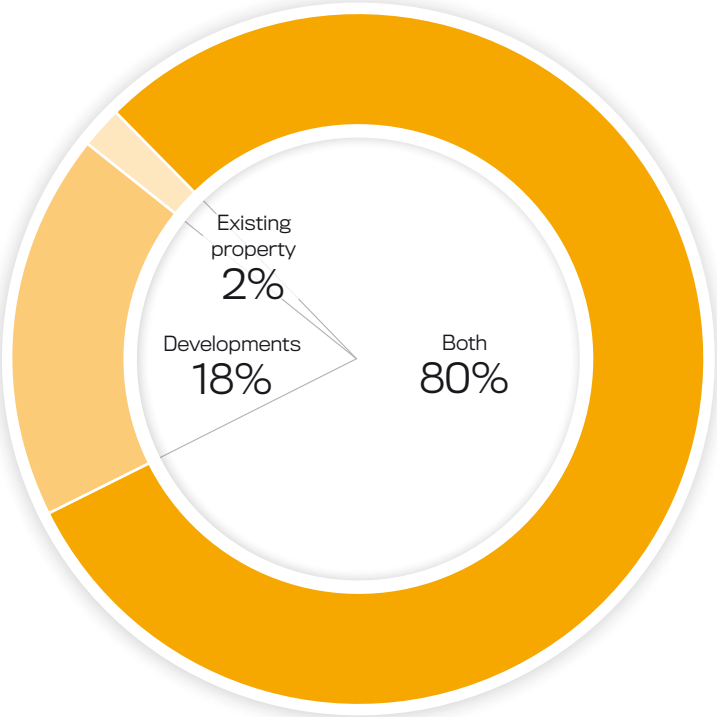
THE MEZZANINE MARKET IS PROVING STRONGER AND MORE **STABLE** THAN EVER

The participants surveyed for this report provided a loan volume of EUR 6.9bn for financing existing property and developments over the last year. This represents another significant increase on the total of EUR 5.8bn in last year's report. Consequently, non-banks have become indispensable as capital providers in the financing market.

While last year's total of EUR 5.8bn of subordinated capital facilitated a development volume of EUR 38bn, the 19% of additional mezzanine capital provided this year only produced a 6% increase in total development volume. The proportion of subordinated capital in overall financing is increasing. This is attributable to both lower starting points on traditional bank loans and the fact that maximum LTV/LTC limits are still being used wherever possible.

There remains sufficient capital available for further investments. However, capital providers state that the increased number of financing enquiries has been associated with a decline in the average quality of deals. The selection of suitable investments is more difficult and good deal sourcing has become a growing challenge.

FINANCE PROVIDERS ARE BEING EVEN MORE **FLEXIBLE**



Besides flexibility in terms of the structure of security and capital, increasing flexibility is also being sought in the investment segments. The majority of capital partners surveyed now state that they are active in both existing property and developments.

Compared with the 25% last year, just 18% of capital providers now concentrate exclusively on financing development projects. Few providers are now omitting to incorporate existing property and the associated benefits in terms of risk and liquidity. Overall, however, these are attributable to the fluid transition between both segments. Classic value-add scenarios, for example, comprising the re-positioning of existing property via optimisation of the tenant structure and the necessary structural works, can be considered as both the financing of existing property and developments.

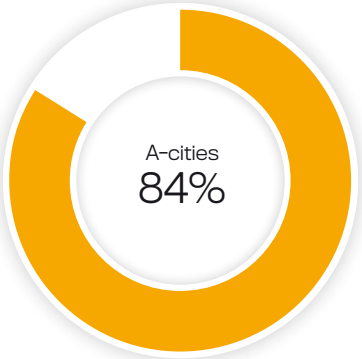
CAPITAL FOR ALMOST **EVERY LOCATION**

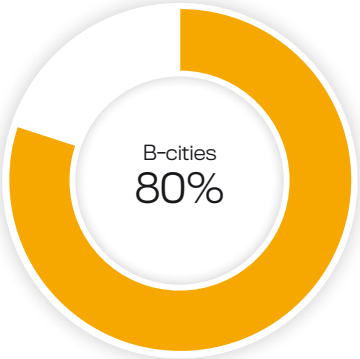
This year's survey demonstrates that the Top 7 cities and metropolitan regions* have not lost popularity. Even finance providers with a nationwide approach show a strong preference for investments in major cities. Almost half of market participants state that they only invest in the Top 7 cities or metropolitan regions. 32% of respondents stated that they only provided finance in the Top 7 cities during the reporting period. This compares with just 10% last year.

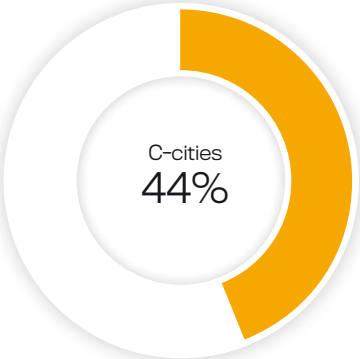
Institutional investors in particular are restricting their commitments to major German cities with positive population growth. This has obvious infrastructural benefits and growth potential. Investments outside of the German metropolitan regions are being serviced almost exclusively by local providers with specific local knowledge.

More than 80% of capital providers surveyed cover both A-cities and B-cities. A striking statistic, however, is the percentage of providers that do not exclude C-cities. This stands at 44% this year,compared with just 26% last year.

Financing of C-cities in metropolitan regions is no longer an obstacle to most providers since appropriate experience on the part of the borrower allows them to expect a positive outcome.







*Definitions in the glossary

HOW IS MEZZANINE **CAPITAL BEING SECURED?**

The forms of security presented here are agreed individually between capital provider and borrower. When incorporating an ICA, there may also be necessary co-ordination with the senior finance provider involved.

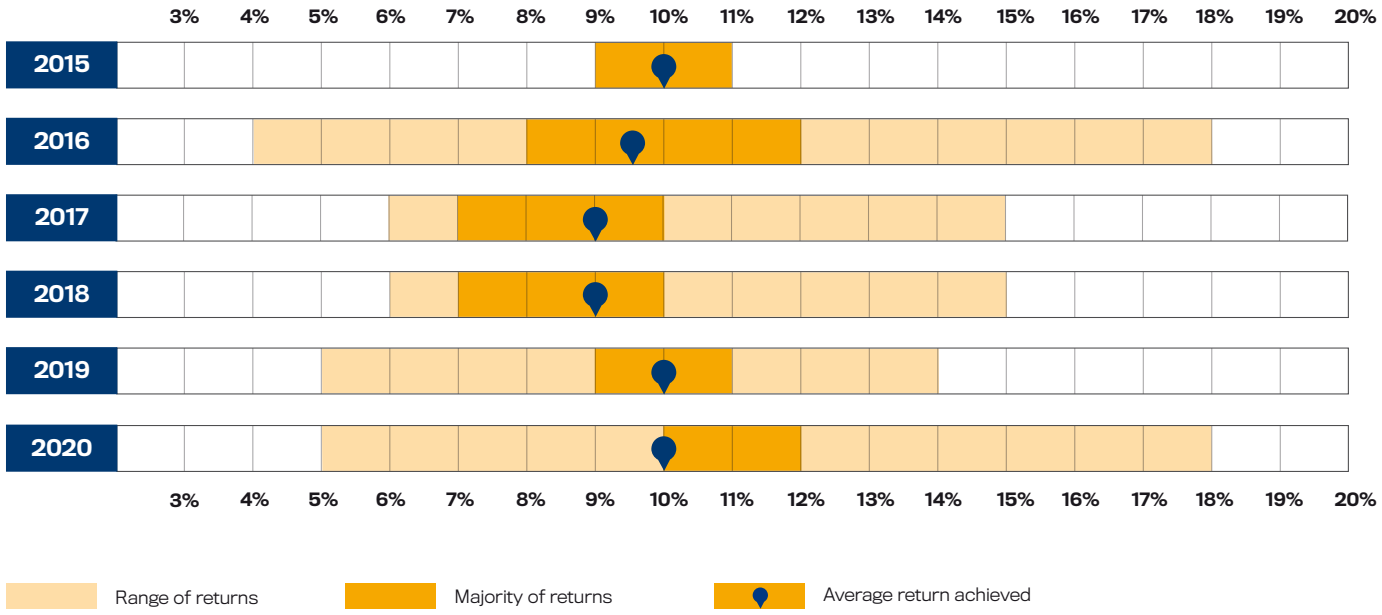
On development projects, the securing of completion via cost-overrun guarantees from the developer or rights of entry or rights to a say for the capital provider in the project company are now standard practice.

	FAMILY OFFICES	FINANCIAL INSTITUTIONS	FUNDS	INSTITUTIONAL INVESTORS
Land charge	✓	✓	✓	✓
Assignment of company shares	✓	✓	✓	✓
Personal guarantees	✓	✗	✓	✓
Other / innovations	✗	✗	✓	✗
Call option	✓	✓	✓	✓
Golden share	✗	✗	✓	✗
ICA	✓	✓	✓	✓

TRENDS IN RETURNS FROM 2015 TO 2020: EXISTING PROPERTIES

The average overall return (IRR) this year stands at 10%, which is in line with last year. However, the majority of returns has shifted significantly and now ranges between 10% and 12%.

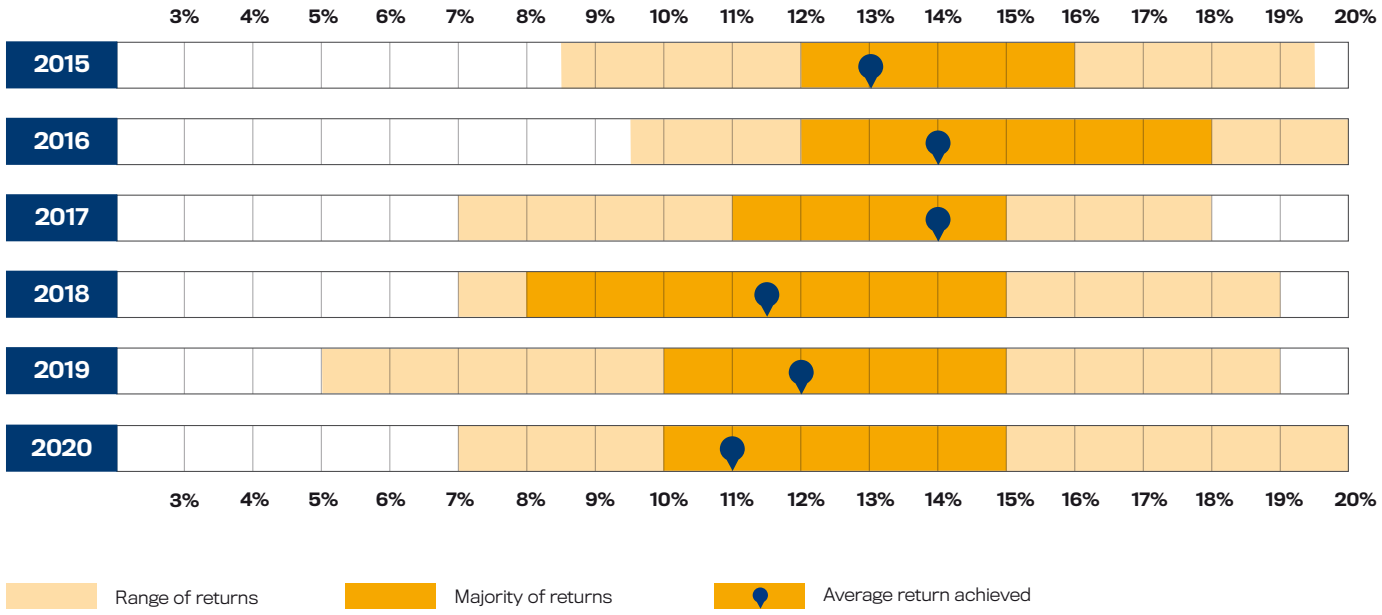
It is also noteworthy that the range of returns extends widely from 5% to 18%. This demonstrates the broad risk spectrum serviced by mezzanine capital. Financing on existing property by institutional investors for properties with good cash flow in prime locations remains possible at 5% on subordinated capital. On the other hand, loan funds in particular state that they have been providing capital for properties difficult to finance owing to the coronavirus crisis (e.g. hotels). In such case, expected returns are then significantly above 10%.



TRENDS IN RETURNS FROM 2015 TO 2020: DEVELOPMENTS

The range of returns here also remains wide, extending from 7% to 20%. The limited number of development projects attracted significant competition for financing and drove the IRR last year to as much as 5% (!). The coronavirus crisis has gone some way to restoring normality, resulting in risk-adjusted minimum returns.

At the same time, the average return achieved of 11% is the lowest since the survey was initiated in 2015. Many finance providers state that they are concentrating on larger projects in good locations. This allows them to reduce their risk exposure, while rewarding themselves for increase market risk via interest rate premiums.



FULL **REPORT**

The FAP MEZZANINE REPORT 2020 is available now with the following additional content as a paid download from the iz-shop at www.iz-shop.de.

Data and institutions

Institutional investors

- FAP Invest GmbH
- Regional coverage
- Maximum LTC
- Importance of ESG criteria

Detailed analysis of the overall market

- Mezzanine is a standard component
- Mezzanine is taking on a vital function
- Distribution by investment sector
- A clear focus on cities
- The market for mezzanine capital is growing
- Optimism has evaporated

Detailed analysis of existing property

- Sectors
- Capital tranches
- Lending ratios
- Financing maturities

Detailed analysis of developments

- Sectors
- Capital tranches
- Lending ratios
- Financing maturities

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