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FAP Mezzanine Report 2021

Subordinated Capital for Real Estate –
Expansion of an Established Asset Class
We create transparency.

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The world is still under the influence of the coronavirus pandemic. Even though large parts of the real estate industry have come through the crisis well so far, the pandemic is not leaving individual asset classes unscathed. These particularly include non-food retail and hotels.

In this environment, banks are continuing to act with caution and are showing restraint in granting senior financing. Senior lending by banks declined by an average of 20% over the past twelve months. Subordinated financiers were usually able to close the resulting gap and also stepped in when the institutions offered too low loan-to-value ratios. During the period under review, financing was particularly sought for bridge financing for project developments until building permits were submitted.

According to our observations, we count 155 investors active in the market segment for subordinated financing, the same as in the previous year. Fifty-five of them took part in the survey for our report and extended EUR 6.1bn in mezzanine capital in the reporting period – slightly less than in the previous year (EUR 6.9bn).

A closer look at the survey results reveals that some institutional investors have decided to stop providing subordinated finance directly. They remain loyal to the asset class, but now invest only via loan funds. Their number and activity increased significantly in recent months. Overall, a "professionalisation" of the market can be seen, which is not least due to the increasing number of loan funds.

The findings in 2021 show that demand for mezzanine capital is rising, but it is mainly well-prepared and solidly structured financing with an appropriate collateral concept that is being implemented. The share of smaller mezzanine tranches of up to EUR 5m is decreasing. Overall, the average loan size continued to climb, while the absolute number of transactions declined.

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CURRENT MARKET TRENDS

Mezzanine investors step into the breach for banks; loan funds on the rise

Even though we counted 155 subordinated financiers active on the German market both this year and last year, the market is on the move. New financiers have joined, while others have deliberately abandoned direct lending and traditional mezzanine loans.

Institutional investors in particular are increasingly playing the asset class through loan funds. The reasons include that, in their view, mezzanine lending has become too costly, and it is increasingly difficult to achieve sufficient risk diversification. Investors who are active in this asset class for the first time have also predominantly opted for loan funds.

As already indicated in the last report, providers from the English-speaking region had hoped to regain a foothold in the German market during the coronavirus crisis. While they still expected to find a return level in line with their expectations in 2020, this year they tried to assert themselves with certain asset classes. These include hotels, retail and restaurants – in other words, anything that is not particularly popular with local operators at the moment.

Overall, we can see that after a brief hesitancy at the beginning of the pandemic in Q2 2020, capital lending had returned to normal by Q4 2020. Investors for subordinated financing were again increasingly on the lookout for new projects by then at the latest. There is clearly still sufficient capital in the market.

And since it has now become more difficult to obtain closed financing for the building construction phase – especially for project developments – subordinated financiers have often stepped into the breach with bridge loans and bridged the time. For this reason alone, the financing activity of many alternative lenders has not collapsed, but remains at least at the level of the previous year.

On the other hand, some Asian investors are still having a hard time. Due to travel restrictions and the requirement to inspect the properties to be financed themselves, it was still virtually impossible to arrange financing in Germany. The fact that this group of investors has just had negative experiences with non-performing mezzanine loans in the USA also had a braking effect.

The briefly higher return and interest rate expectations have normalised. On average, it is back at the same level as before the pandemic – although risk-adjusted it is still a good 0.5% above the level of the prior-year period.

Individual asset classes are continuing to struggle. These include hotels and retail in particular. Even before the coronavirus pandemic, neither asset class was a favourite among subordinated financiers. This trend was reinforced by further lockdowns. However, we also felt a slight reluctance to finance office properties. The increasing use of home offices and the continuing uncertainty as to what space will be needed at all in the future made assessment difficult at times. But here, too, the market has visibly normalised – not least because many mezzanine providers have stepped in and countered the reluctance of banks to provide senior financing with higher mezzanine tranches. In good locations and with corresponding pre-letting rates, the office asset class continues to be popular.

The clear crisis winner is and remains the residential asset class. Overall, the trend toward larger tickets is continuing. And of course, top locations such as the top 7 cities continue to enjoy great popularity.

One final note is that demand for whole-loan solutions is on the rise. More and more providers appreciate the advantages of no reconciliation between senior and junior capital investors and consider whole-loan solutions as a good alternative to the classic senior plus mezzanine financing structure.

Coronavirus depresses total volume – trend toward larger tickets

The participants surveyed for this report provided a loan volume of EUR 6.1bn for portfolio and project development financing in 2020, slightly less than in the previous year (EUR 6.9bn).

Given the 20% decline in the volume of lending by senior financiers, this is again a strong result. Mezzanine capital continues to play a very important role in the viability of real estate investments and developments. For 2021, as well as next year, we anticipate a significant increase in volume, which is expected to also exceed the previous peak of EUR 6.9bn from 2019.

In recent months, many subordinated financiers have issued significantly less capital than originally planned. The coronavirus-related restraint in the second and third quarters could not be made up for in Q4 2020. Providers that typically serve smaller volumes were particularly cautious during the pandemic. Overall, it can be seen that ticket sizes are noticeably increasing, while total loan volumes are not. In principle, there is sufficient capital available, but in the area of subordinated financing it is concentrated in larger transactions.

Since financiers receive enough inquiries, but the review effort per deal has increased significantly at the same time, they prefer to focus on a few large transactions rather than many small ones. High costs for small loan volumes – this simply does not pay off for many subordinated financiers. And this is also where the wheat is separated from the chaff: small developers are in the market with mezzanine deals of EUR 2m to EUR 8m via few professional intermediaries. On the other hand, medium-sized and large developers as well as investors make significantly more professional financing requests.

Numerous digitalisation attempts for smaller mezzanine tranches have been observed in recent months, but these are still primarily technology-driven and without tangible success. But who knows, perhaps tokenisation will close the gap.

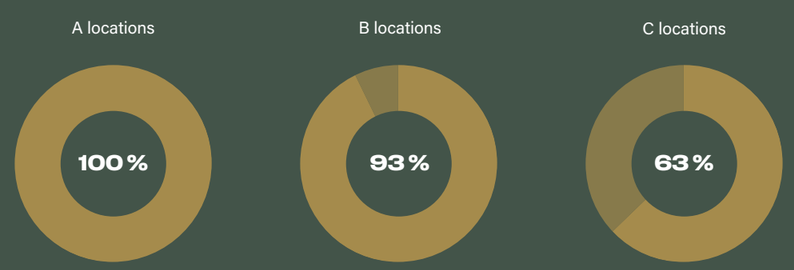
However, mezzanine deals are often complex and require a professional risk analysis and collateral strategy – these are not really feasible for "small money".

C locations are becoming "socially acceptable"

The top 7 cities and metropolitan regions continue to enjoy great popularity. All market participants surveyed are active there. Thirty-five percent of market participants said that they limit their subordinated loans to properties located in a metropolitan region. Institutional investors in particular were frequently heard to prefer major cities with at least 250,000 inhabitants and a positive population trend.

Last year, institutional investors were still focusing on the top 7 cities, but in the competition for attractive financing, location requirements have been relaxed somewhat. In this year's survey, for example, only 10% of investors said they were considering only the top 7 cities. In 2020, the figure was still a good 30%.

A similar picture emerges when analysing locations. While in 2020 more than half of the investors did not provide financing for properties in C locations, this year it is only 37%. With a suitable track record, i.e. corresponding experience in dealing with existing properties or demonstrable expertise in the development of properties in C locations, suitable financing can also be found there. However, these should then at least be located in a metropolitan region.



How is mezzanine capital secured?

The forms of hedging described above are agreed individually between the investor and the borrower. An ICA (intercreditor agreement) is usually involved in the necessary coordination with the senior financier involved.

All investors like to request subordinate land charges, the assignment of company shares or call options as collateral. Golden shares, i.e. shares with extended rights, have lost all importance. They are no longer mentioned by any investor as possible collateral.

Respondents state that coordination between the parties in senior-junior structures is becoming easier in some cases. For many banks, subordinated capital is no longer an exotic product, but a standard component of financing. And yet, in quite a few cases, the coordination between senior and junior remains complicated and long. But few want to do without it, especially when a subordinate land charge has to be waived.

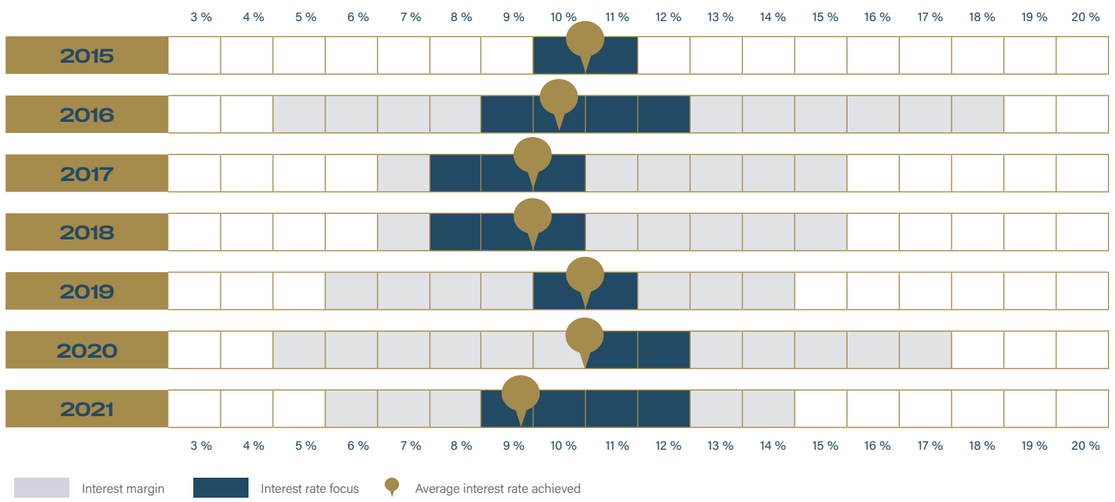
To avoid completion risks, cost-overrun guarantees are common practice in project developments. Whole loans are becoming increasingly popular as a way of avoiding the long coordination process with the senior.

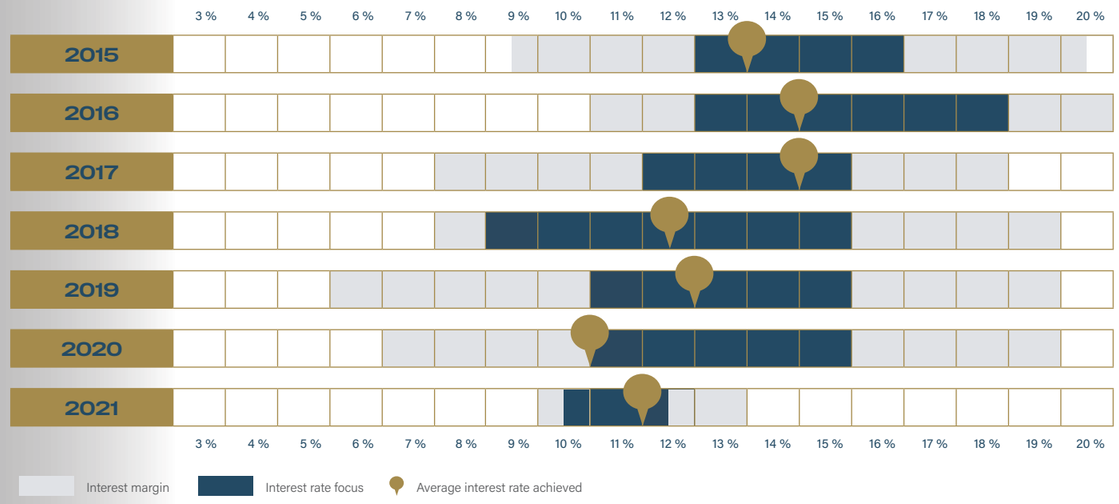
	Family offices	Financial institutions	Funds	Institutional investors
Land charge	✓	✓	✓	✓
Assignment of company shares	✓	✓	✓	✓
Personal guarantees	✓	✓	✓	✓
Others / innovations	✗	✗	✗	✗
Call option	✓	✓	✓	✓
Golden share	✗	✗	✗	✗
ICA	✓	✓	✓	✓

Development of interest rates between 2015 and 2021: existing properties

At 9.75%, the average overall interest (IRR) this year is only slightly below the level of the previous year. At 6% to 15%, the interest rate range for mezzanine capital remains similarly broad as in the previous year (5% to 18%). It illustrates the wide risk spectrum in which mezzanine capital is granted.

The focus of interest rates is much more difficult to narrow down than in previous years. This is likely mainly due to the increasing heterogeneity of the market. From German institutional addresses to credit funds from English-speaking countries, numerous providers are active in the market for subordinated financing.





Development of interest rates between 2015 and 2021: Project development

In contrast to portfolio financing, the interest rate range for project development financing has narrowed considerably. Whereas in the previous year it was between 7% and 20%, it now varies between just 10% and 14%.

The focus of interest rates is also within a narrow range of 10.5% to 12.5%. At around 12%, the average interest rate achieved is higher than the previous year's figure of 11%.

The figures reflect the fact that project developments could not be implemented with no or very low equity investment. Mezzanine tranches of 15% to 20% were virtually non-existent. At the same time, it is evident that the coronavirus-related competition for good project development financing has stopped the pressure on interest rates. Interest rates of 7% or lower are a thing of the past for the time being.

While in the past increased completion risks were priced in via the interest rate, projects with a higher risk profile were barely financeable during the pandemic.

FULL REPORT

The FAP MEZZANINE REPORT 2021 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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