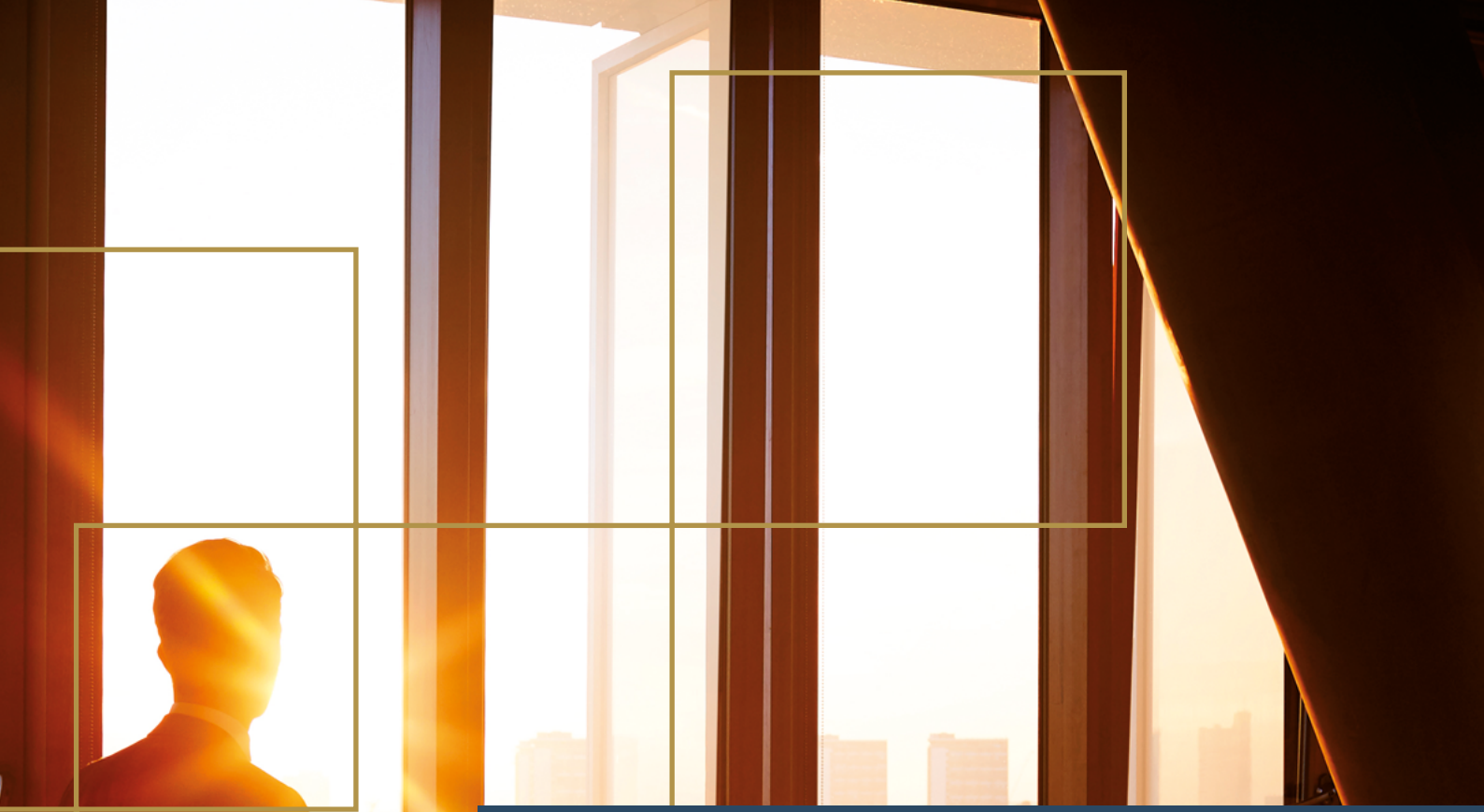

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FAP Mezzanine Report 2022

Subordinated Capital For Real Estate –
A Market With Perspectives
Despite Turbulent Times.
We create transparency.

Hanno Kowalski
Managing Partner

Kim Jana Hesse
Head of Capital Partners

The war in Ukraine is leaving its mark also on the otherwise quite resilient German real estate market. Many market participants believed that they could cope with the coronavirus, inflation and supply chain problems – but then the war started and the industry fell into a state of shock similar to the beginning of the coronavirus pandemic.

While subordinated financing was previously an integral part of many loans, it is now evolving into a key factor that often determines the success and viability of project developments and real estate acquisitions. In many cases, banks are no longer the predictable partner that developers and investors have relied on in the past. Even solid, low-risk and professionally prepared projects are now financed only to a limited extent. Pre-letting rates, the borrower's level of equity and the structure of general contractor agreements have become more important as a result. Existing buildings are more likely to be financed than project developments. The trend toward whole loans is continuing.

We count 159 active investors in the subordinated financing market segment – a similar number to the previous year. However, the number of institutional players in the direct business again declined slightly, while the number of loan funds increased. 55 market participants took part in our survey and extended EUR 5.5 billion in mezzanine financing in the reporting period (previous year: EUR 6.1 billion).

These figures reflect the hesitancy of the industry caused by the challenging conditions. Investors are relying on the time factor and waiting to make new investments. But the overall sentiment is cautiously optimistic. Not investing at all is not an option for alternative lenders. The current situation is also generating a lot of new momentum, with demand for alternative financing clearly on the rise.

Since investors' coffers are well filled, there can be no talk of a credit crisis. The willingness to invest in the real estate private debt asset class is thus also increasing.

There is still no sign of the much-discussed drop in purchase prices as interest rates rise. Our survey participants are also not yet expecting a significant correction in market prices. The interest rate increases have not yet filtered through to alternative financing. The starting point for subordinated capital in conjunction with senior is falling, meaning that – with moderate LTV and LTC caps – risk appears manageable and attractive returns can continue to be achieved.

The boundary between senior and junior is becoming more fluid. For borrowers in particular, the difference is becoming increasingly unclear, as terms and conditions can be compared only to a limited extent. In turn this means the consulting business related to structuring major financing is growing steadily.

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Contents

CURRENT MARKET TRENDS

New uncertainties strengthening the mezzanine business

Coronavirus, the war in Ukraine, inflation and disrupted supply chains – the level of general uncertainty has once again significantly increased compared to our last report. Alternative lenders are therefore increasingly stepping into the breach for banks. Added to this are rising interest rates. It now often makes sense for borrowers to approach alternative lenders, as the interest rate difference with banks is relatively limited. This is particularly true for whole loans.

In this report, it is necessary for us to distinguish between the period before the outbreak of the Ukraine war and the period afterwards. Before the war began in mid-February, the financing and market situation, which had been disrupted by the pandemic, had largely recovered. Sentiment was decidedly positive. The pandemic was more or less over – at least that was the hope. Then came the outbreak of the Ukraine war on 24 February 2022. The industry went into a state of shock, similar to the beginning of the first lockdown resulting from the coronavirus in 2020.

All subordinated lenders we surveyed expect the war to have a negative impact on the real estate market. They assume a market shakeout in which only strong projects or professional project developers will be able to hold their own. At the same time, they emphasise that the current conditions are having a positive impact on their own business model, as demand for alternative capital is increasing – partly to compensate for lower debt financing ratios, but also because banks are becoming increasingly cautious.

International prospects

The plan of some Anglo-Saxon investors to regain a foothold in the German market by financing somewhat unpopular asset classes such as hotels, restaurants and retail did not work out during the reporting period. However, the rise in interest rates is now providing them with renewed opportunities for financing.

For Asian investors, travel restrictions, which made visits and thus financing in Germany virtually impossible last year, have been lifted. But here, too, the war in Europe remains an inhibiting factor. Asian investors remain open to German deals – but they have to be top projects.

Interest rate development

The majority of participants surveyed say they are thinking about higher interest or return expectations. Since the survey was conducted between March and July 2022, there is no visible impact of the interest rate increase in this report.

Financing problems for project developments

Financing project developments has clearly become more difficult. The reasons for this include an increased time risk due to supply bottlenecks for construction materials, an increased risk of reaching capacity limits with employees, rising construction costs or a lack of equity on the part of developers. But project financing is not completely off the table.

The key factors here are the pre-letting rate, the conclusion of a general contractor agreement or the award status in the case of individual awards, and sufficient equity capitalisation on the part of the developer.

Residential at the top, hotels rising in favour

Residential remains lenders favourite, even outside A and B cities. The reluctance to invest in hotels is declining slightly. More lenders are again willing to support hotel projects, with a clear preference for leisure over business hotels.

In office properties, good locations in the top 7 cities with high pre-letting rates and promising concepts are gaining ground. In general, ESG criteria are gaining in importance, while non-food retail continues to struggle.

Demand for whole loans on the rise

Demand for whole loan solutions is growing, and with it the number of lenders offering these solutions in addition to mezzanine capital. This is fuelled by rising interest rates, which are narrowing the gap between bank rates and the whole loan rate offered by alternative lenders.

Tickets remain large despite smaller overall volume

Our survey participants extended EUR 5.5 billion in mezzanine financing in 2021 (2020: EUR 6.1 billion). As expected, the volume of individual tickets grew again, while the total number of deals fell at the same time. The trend toward larger tickets is likely to continue in the future.

The total volume will also rise again due to the increasing restraint of senior lenders – though admittedly this rise will be only moderate, as a more restrictive allocation of capital and a more intensive examination of the properties can be assumed overall. High-risk projects will have a much harder time finding the right lenders.

The number of requests for alternative capital increased during the survey period. This will continue to intensify in the coming months. There is still sufficient capital in the market to meet this increasing demand.

Improved range of financing

In addition to traditional subordinated loans or whole loans, club deals with senior lenders are on the rise. This is where subordinated lenders and banks join forces – the joint financing provides the borrower with an attractive blended rate. At the same time, it saves the often lengthy discussion about subordinated collateral or intercreditor agreements (ICAs) because this is agreed directly between the financing partners. Security trustees are involved to manage the collateral and also to take on paying agent functions for interest payments, etc.

While this type of cooperation between subordinated financier and bank was virtually impossible just a few years ago, today both sides are showing themselves to be increasingly open to it.

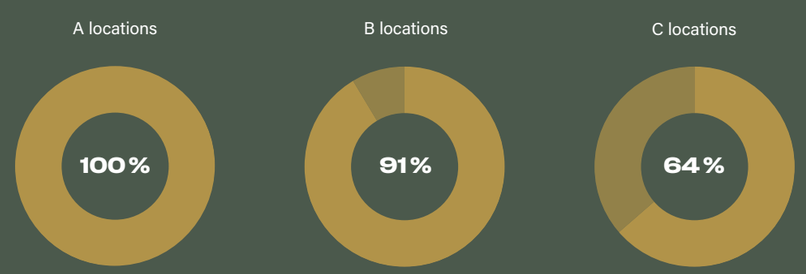
Even if the trend towards larger tickets continues, there is still good supply for smaller projects. A number of subordinated financiers have specialised in small tickets, as the competition is still manageable here.

Financing still possible for all locations

As in the previous year, the top 7 cities and metropolitan regions are most popular, but many lenders are also active nationwide. All respondents finance projects in A locations, 91 percent also in B locations and as many as 64 percent in C locations.

In principle, all investors are prepared to finance projects in the top 7 or even the top 10 cities, even in B and C locations. This willingness then tends to decline in B and C cities. The situation is different for international Anglo-Saxon lenders, who expect a correspondingly higher return when financing projects in B and C locations in B and C cities.

There is also a difference in the individual asset classes. Residential properties in A, B and C cities are often financed in B and C locations, while offices are mainly financed in A locations and in A cities. In the end, however, it is always the track record of the developer or investor that is decisive. With sufficient experience and expertise in special locations and asset classes, borrowers can also find a suitable lender in C locations.



How is mezzanine capital secured?

There is not much new in the forms of security for mezzanine capital. Classic collateral instruments such as the subordinated land charge, the assignment of company shares or the call option have become established in recent years and continue to be demanded by a majority of lenders.

Some lenders also expect personal guarantees from the beneficial owner to ensure their involvement in the project. In practice, however, this remains the exception rather than the rule. The majority of financing is provided on a non-recourse basis.

In the case of subordinated land charges, an intercreditor agreement (ICA) with the senior lender is required. A portion of the participants surveyed remain willing to waive subordinated land charges and ICAs to avoid the need for coordination with the senior lender. Often, the financing is then provided at the holding company level – or the "pass-through" to the property is ensured by a pledge of shares.

The increasing popularity of whole loans suits both lenders and borrowers, as it avoids the usually lengthy coordination processes between senior and junior. When two or more lenders provide club deals, the borrower benefits from an even simpler collateralisation process: here, the total land charge is regularly entered in the land register and the two investors regulate the division of the collateral in the event of liquidation without involving the borrower. The agreed collateral is then usually managed by security trustees on behalf of both parties.

In the current market situation, the agreement of cost-overrun guarantees for project developments has become even more important. Almost none of the investors would like to do without them at present. By contrast, collateralisation through golden shares, i.e. shares with extended rights, has all but disappeared from the market.

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

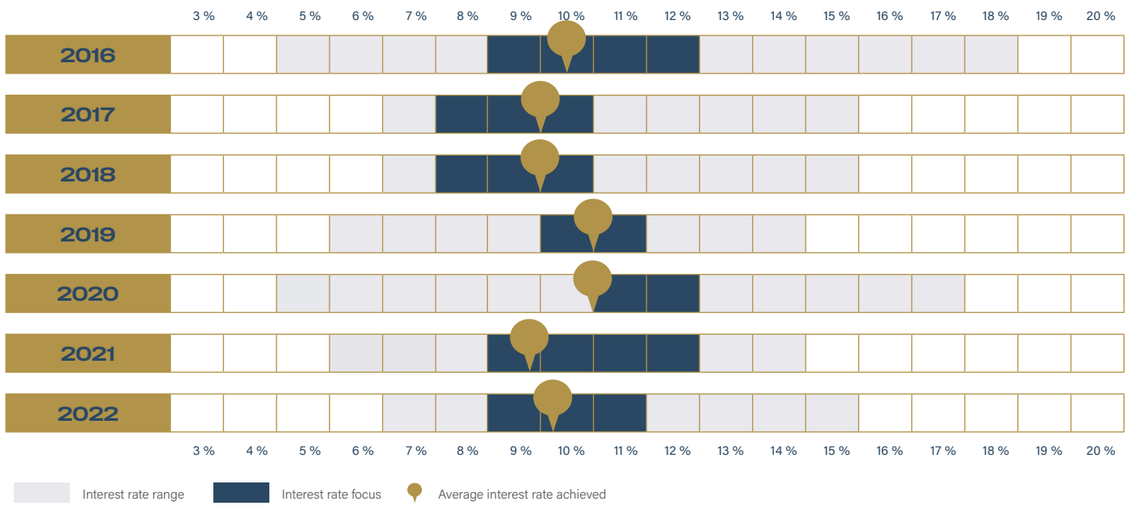
Development of interest rates for existing properties

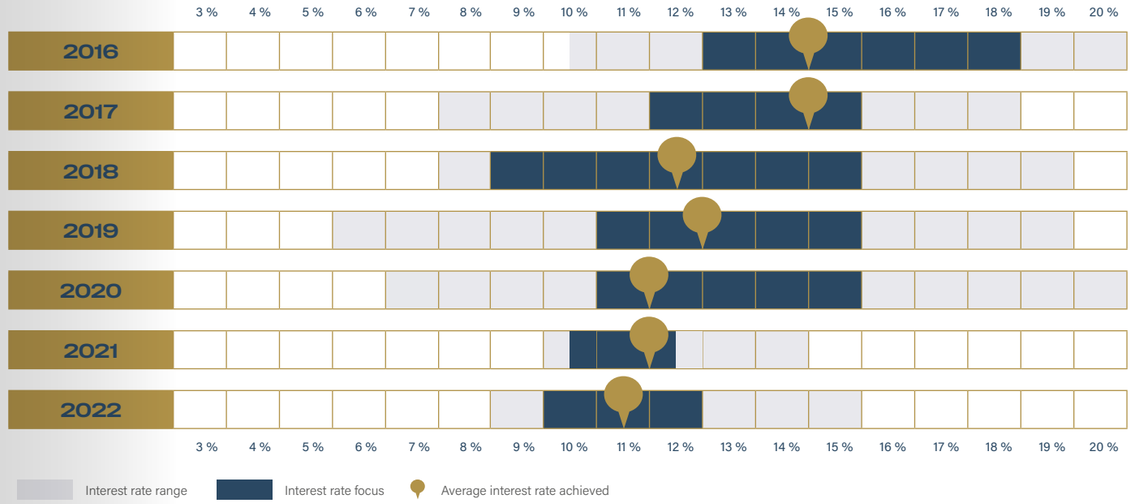
The average overall interest rate for existing properties is currently 10.33 percent, slightly higher than last year's 9.75 percent. The interest rate range starts at 7 percent and ends at 15 percent in the current period under review – last year it started at 6 percent. The main interest rate is between 9 and 11 percent.

The wide range again illustrates the diverse spectrum of capital providers on the mezzanine market. For example, the return expectations of Anglo-Saxon investors are for the most part significantly higher than those of German institutional investors.

Asian investors tend to be active in the whole loan sector and are therefore not included in this analysis.

The slight increase in interest rates is due to the impact of the pandemic. It does not yet reflect current market events in terms of inflation, construction costs, interest rate hikes and the Ukraine war. For the end of 2022 and the beginning of 2023, we expect a further increase in the overall interest rate, as many capital providers are already considering an increase in returns.





Development of interest rates for project developments

At 11.5 percent, the average interest rate for project developments has also hardly changed compared with the previous year (12 percent). The slight decline is due not to lower interest rates, but rather to the fact that hardly any high-risk projects with correspondingly higher interest rates are still being realised. The interest rate range this year is between 9 and 15 percent (previous year: 10 to 14 percent). The interest rate focus is on 10 to 12 percent.

Mezzanine tranches above 15 percent are the absolute exception due to the large number of investors on the market. In addition, only solid project developments could be financed during the pandemic.

Interest rates are expected to rise in the coming months, not only to reflect the general rise in interest rates, but also because financing project developments is considered to be significantly riskier in the current market environment. Projects with a high risk profile and semi-professional developers will be very difficult to finance in the coming months.

Full Report

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