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FAP Mezzanine Report 2023

Subordinated Capital for Real Estate – Mezzanine is Turning into Stretched Senior

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The turmoil on the real estate markets – with higher interest rates, lengthy decision-making channels, elevated construction costs and plummeting transaction volumes – is having an impact on the market for mezzanine financing as well. Lenders' appetite for risk has diminished significantly, as have the financing ratios of the more risk-averse banks. This is giving rise to more attractive starting points for subordinated tranches and a better baseline situation for collateral.

On the whole, our latest survey of mezzanine investors revealed a clear abandonment of project developments in favour of existing properties. Debt yield, a key ratio that was often disregarded in previous years when extending mezzanine tranches, is coming to the fore. The higher it is, the better for lenders. Uncertain times cause people to reflect on many of the old values, which is resulting in the current situation whereby cash flow really counts for something again!

This also explains why pure plot financing is hardly ever being backed by loans anymore. In the past, investors saw this as a lucrative business, as considerable value appreciation could be achieved during the planning permission phase. But rising interest rates are reducing the residual values of plots, ongoing cash flows are not generally a requirement for plot investments, and the processes involved – from the preliminary building permit to the building construction phase – are becoming extremely protracted in many cases. As a result, mezzanine or whole loan financing is no longer being used for land banking investments today. Loans to purchase plot with a loan-to-value (LTV) of 50 percent have become the absolute exception.

Consequently, either average plot prices will have to go down significantly or buyers will find themselves back in a situation where they are having to provide considerably more equity for the purchase to get financing that can be paid off comfortably under the current terms and conditions. There is a risk that existing plot financing will come under pressure if the building construction phase does not happen immediately – or in special situations where the plot supply meets a specific need. Plots in the top 7 cities and in A locations in general still have an advantage.

The short supply and the focus on central locations in the development of office space and attractive residential areas would appear, in some cases, to be bolstering market prices – and not just for plots. Project developments are more likely to manage without additional equity investment if they are based in prime locations.

But this situation is also presenting opportunities for mezzanine lenders. Thanks to higher equity ratios, on the one hand, and lower bank LTV ratios, on the other, they are getting into the capital stack in a more comfortable zone from a risk perspective than they had been in the preceding boom years. This may well yield unimagined growth opportunities for alternative lenders in the near future. But this will require properties in Germany to find their new market price and, on that basis, for project developers, investors and banks to become more decisive again.

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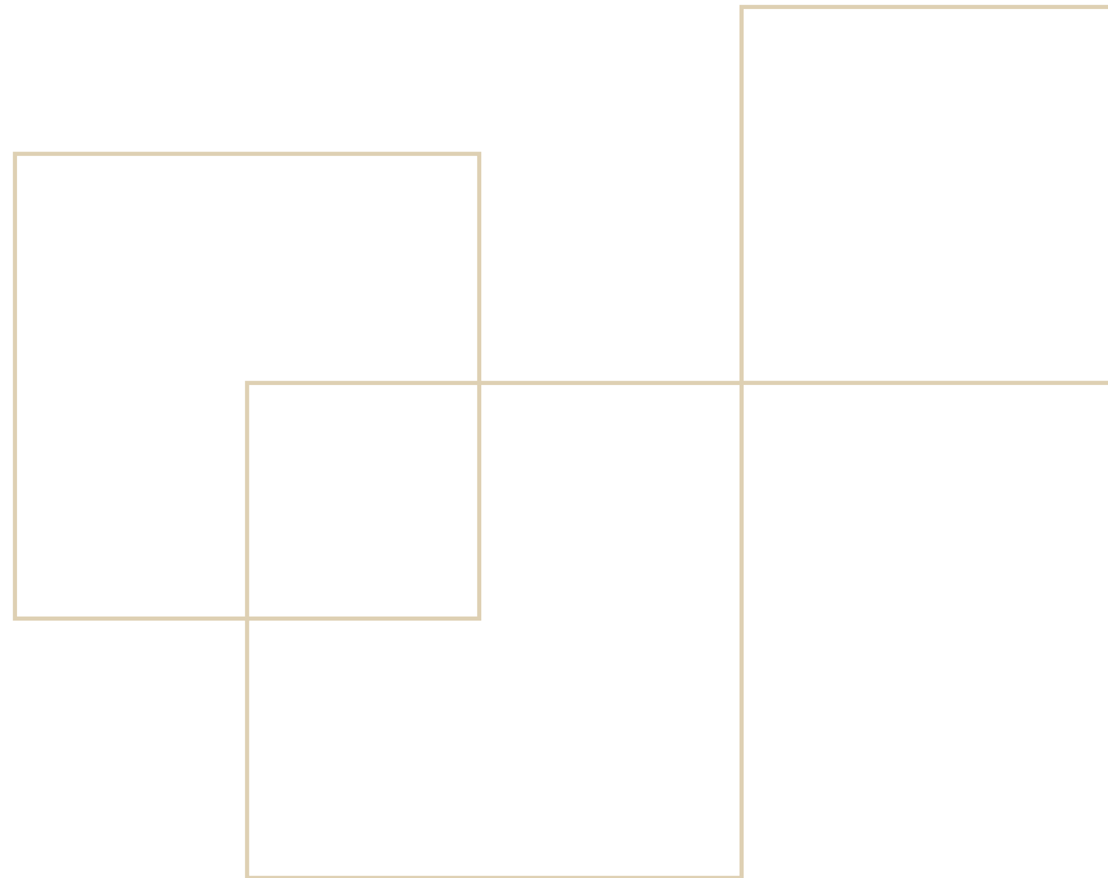

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Welcome to a new world

We are living in a new world in which the capital market is characterised by recurring key interest rate hikes and growing restraint of participants – and this is having a corresponding impact on the financing terms and conditions being offered by banks and by alternative lenders. The main thing that is new is the speed at which the interest rate hikes have affected the real estate market.

On average, real estate properties have greatly depreciated in value in recent months. Alongside the soaring interest rates, factors such as the initiation of the energy transformation and the growing focus on sustainability characteristics are also causing significant uncertainty. The capital costs of alternative lenders and banks are increasingly converging. At the same time, the appetite for risk is diminishing and financing ratios are shrinking. This development is affecting conventional banks and alternative lenders alike.

Cherry picking: 1A location and residential

The restraint being exercised by banks is undoubtedly benefiting alternative lenders. They are seeing significantly higher demand for their services, which gives them the ability to be selective, strive for higher margins and cherry-pick the best projects. The residential asset class remains a point of focus. Office properties have become less popular, with many tenants scaling back their office space as home working has become widespread. Retail spaces, hotels and restaurants are more sought-after again since the end of the coronavirus pandemic, although their placement continues to be difficult – more difficult than before the pandemic in any case. It is no surprise that "good location" is becoming more important again on the list of framework conditions, with many lenders focusing on A and B cities and their prime locations.

Project financing only with sufficient equity

Obtaining finance for project developments has become even tougher, and virtually impossible without sufficient equity. Soaring material and construction costs mean that some projects are experiencing financial difficulties and are no longer making a profit. Alternative lenders are using the situation to their advantage and are getting in the queue for non-performing and distressed loans.

The search for suitable project financing is requiring a much greater outlay overall. Investors and developers are increasingly turning to financial advisors for support.

Smaller ticket sizes

Large transactions are few and far between at the moment, and the lower volume of capital available is being divided into smaller tranches. But small tranches of less than EUR 5 million are often not worth the significant amount of effort involved. Structuring the agreements is usually just as labour-intensive and expensive irrespective of the volume – because people still feel the need to document a solid and reliable collateral structure. Developers are very seldom willing to pay the high percentage unit costs in relation to the small financing volume.

The growing appeal of whole loans

Whole loans offered by alternative lenders have become more attractive again to lenders and borrowers alike. In many cases, they are gaining the position that pure senior loans were occupying just one year ago. Whole loans are the only way of achieving the financing ratios that senior loans alone were once capable of achieving. Not only this, but the handling is far easier overall than combining senior and mezzanine tranches.

Total volume not quantifiable, ticket sizes getting smaller

Our survey was conducted in the period from February to June 2023. The first finding was that it is hard to determine the volume of mezzanine financing in Germany at present. Although there was a flood of financing applications in the fourth quarter of 2022 and the first quarter of 2023, a large number of these applications could not be implemented within the desired project parameters. Only a very small number of real estate finance deals were closed. Significantly longer negotiating periods meant that acquisition financing talks often went on for so long that transaction certainty could not be guaranteed as interest rates continued to rise.

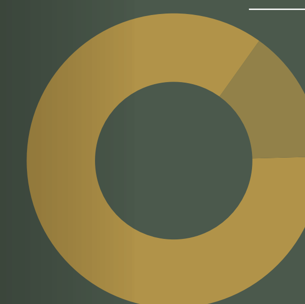
At the same time, many lenders were focusing their efforts on extending maturing loans. Originally scheduled loan repayments were not made and this often resulted in a shortage of liquidity for new disbursements.

It is clear that financing ticket sizes have become smaller overall. There were next to no large transactions, and the free subordinated capital available was invested in a more diversified manner.

Barely any capital for project developments

14.71 % Existing properties

85.29 % Existing properties and project developments



The mezzanine market is in crisis. Many subordinated finance deals are making no secret of the need for a write-down, but the timing of our report was too early to catch specific loan defaults. How about new voluntary property valuations? Negative. Many developers, but also lenders, are sticking by the values on the most recent appraisal reports and hoping that the covenants remain tacit for as long as possible before a new market value is determined. This approach will work until the lender's next reporting date comes around and a property revaluation will be inevitable.

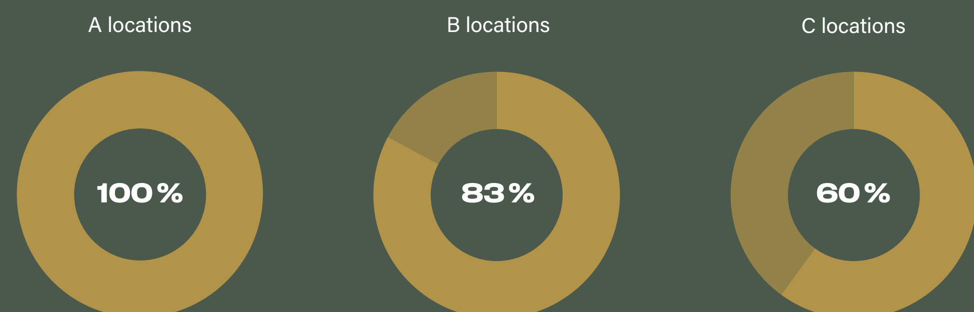
Few are still willing to provide mezzanine capital for project developments, and if they are, they are only willing to commit to a much lower loan-to-cost (LTC) limit. New project development finance deals are only feasible where there is a massive injection of equity. There are no mezzanine providers focusing exclusively on project developments right now. The risk is simply too high.

Not only this, but the significant difference between the implied future market values in the business models and the multiples that are actually attainable is making reliable forecasting practically impossible. So project developments are falling by the wayside, as subordinated lenders switch to existing properties.

The focus is on A

Mezzanine lenders are focusing squarely on prime locations, with many concentrating their efforts on A and B cities. This trend has been evident for many months now. The top 7 locations are especially popular. All the lenders that responded to our survey are active in A locations in these top 7.

B locations still work, although the number of willing finance partners for these locations has gone down by around 8 percentage points to 83 percent. We have also witnessed a slightly smaller decline, from 64 to 60 percent, for financing of C locations as well.

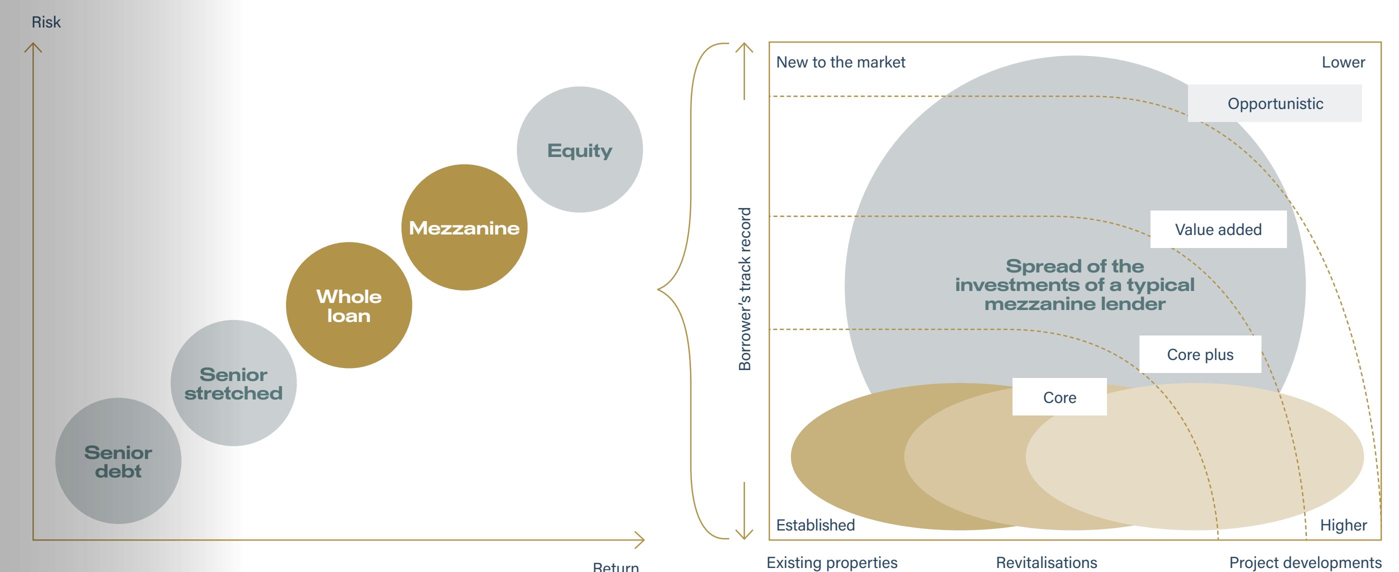


Mezzanine does not equal mezzanine

Although mezzanine capital is still heavily dependent on equity, and from a senior lender's perspective is counted as equity, there is a broad range of risk associated with mezzanine capital. On the one hand, the starting point for the subordinated tranche plays an important role – in other words, from what financing ratio does the subordinated tranche start to border on the senior tranche? The amount of hard equity being contributed is also key. However, the purpose of the financing should not be sidelined. Is subordinated capital being used for a core or core plus property that will generate cash flow that can be used to make the ongoing interest payments? Or is the capital being used to fund a revitalisation, an asset that has no rental income, entails a letting risk and is perhaps even still lacking a building permit?

In the current market phase, there is subordinated finance with a risk profile that is similar to that of a stretched senior tranche. This is particularly the case where the subordinated finance is in the form of a whole loan and senior collateral is being issued. In most of these cases, the subordination ratio can be derived indirectly from the underlying syndicate agreement.

Therefore, it is not always correct to equate mezzanine capital to high-risk capital. Clear distinctions need to be made.



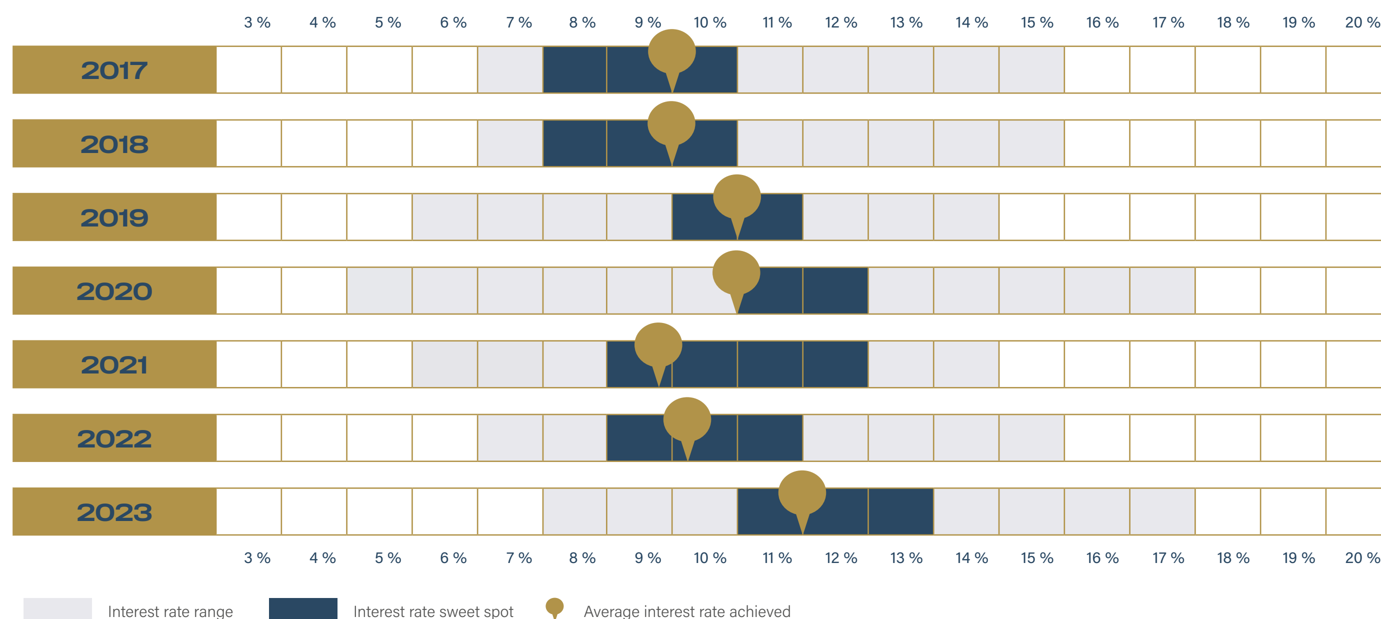
Significant increase in subordinated loan interest rates as well

Interest rates for subordinated loans have gone up considerably overall. In absolute terms, however, they have not increased at quite as fast a rate as the European Central Bank (ECB) has been hiking key interest rates since July 2022. This reflects the fact that very few mezzanine tranches are being refinanced on the capital market and so are not being calculated on the basis of purchase price plus margin. By the same token, there is limited comparability of interest rates with the previous year, with new tranches being awarded on the basis of lower LTV and LTC limits.

This year's report does not make a distinction between interest rates for existing properties and for project developments. Too few mezzanine tranches are being awarded for project developments currently to include them as a relevant influencing factor. The chart shows the figures for existing properties for 2017 through 2022 for the purpose of approximate comparability with the results from 2023.

The average annual interest rate for mezzanine capital in 2023 is 12 percent. Capital is most frequently being disbursed at an interest rate of between 11 and 13 percent per annum. Annual interest rates range from 8 to 17 percent.

By way of comparison, in 2022 the overall interest rate for existing properties was just above 10 percent per annum, while project developments had an average interest rate of 11.5 percent per annum. Annual interest rates for 2022 ranged from 7 to 15 percent for existing properties and from 9 to 15 percent for project developments.



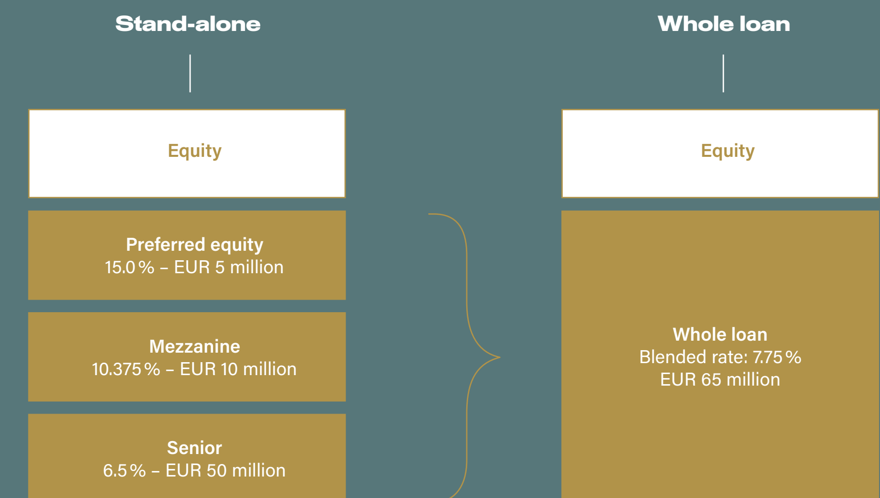
Structure of whole loans: easy and affordable

Whole loans combine different loan capital classes within a single product, and mainly comprise conventional senior financing in combination with a subordinated tranche. This can come from a single lender, but can also come in the form of club deals or syndicated loans as well. In these cases, one lender usually acts as the primary point of contact for the borrower. As the facility agent, this lender manages the debt finance for a fee.

From the investors' perspective, this makes whole loans easier to manage than separate sub-loans, and they are similar to conventional bank loans in many respects. Particularly where the borrower is concerned, they make coordination and processing a great deal simpler.

At the moment, whole loans (versus bank loans) offer financing ratios that are in many cases similar to those of senior finance before the hike in interest rates started. Like with direct subordinated financing, mezzanine capital is invested indirectly and is not directly evident to the borrower in the stretched senior position. Within a whole loan, the boundaries between senior and junior capital are fluid.

Interest rates for whole loans are often based on this calculated distribution of tranches, and this can sometimes make them appear slightly more expensive to borrowers. But when you also factor in the mezzanine premiums included, at second glance they often yield attractive interest rates in an LTV and LTC range of between 65 and 95 percent.



At the moment, many projects can only be financed through whole loans; borrowers barely have any choice in the current market environment. The main thing that matters is finding a financing partner who will provide the required liquidity. With stand-alone mezzanine tranches simply not available as a complement to senior financing, using whole loans becomes the first and often only choice.

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