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Ten years with the FAP Mezzanine Report: subordinated capital in transition

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Our FAP Mezzanine Report is celebrating its 10th anniversary. With this issue – which we have deliberately enriched with a few guest contributions – we are heralding a new era. As the title suggests, the market for subordinated financing has changed significantly over the last 10 years. Let's take a quick look back.

The year is 2014 and the market for mezzanine capital is heating up. Our 2014 report states: "At least 900 million euros in mezzanine capital was invested in Germany in 2014. The trend is clearly upwards."

Five years later, in 2019, we were talking about 5.8 billion euros in mezzanine capital. Institutional investors and international providers pushed into the market, family offices and crowd-funding platforms expanded their position. Mezzanine capital took on a vital function for real estate projects.

Another five years later, when we have more or less arrived in the here and now, the tide has turned completely. Mezzanine capital is being viewed with a critical eye as a result of the turmoil on the property markets and the difficiulties at some debt funds. It now plays a subordinate role.

This trend needs to be taken into account. Accordingly, in our anniversary issue we take a general look at the topic of "alternative financing". Whole loans and stretched senior engagements are playing an increasingly important role for the participants in our survey. This is because the appetite for risk has declined significantly and pure subordinated financing is often simply no longer an option.

In addition, many senior secured loans have now reached an interest rate level that was previously reserved for mezzanine. And who wants to take on the special risks of mezzanine under these conditions?

Increasing focus on whole loans
As in previous years, the participants in our survey are both national and international investors who provide commercial property financing for Germany, either directly or indirectly. A total of 73 capital providers were interviewed, and 59 stated that they were still active in the debt sector. So, 20 per cent of those surveyed have therefore left the property loan business for the time being. 10 per cent are focusing purely on whole loans and no longer on subordinated financing, and some interviewees even made statements such as "The market for mezzanine capital is dead".

Overall, the trend from last year is continuing: many lenders are still cautious or no longer issuing new capital at all. This restraint is reflected in low financing ratios and more comprehensive due dilligence, but also in increasing requirements for pre-letting and pre-sales quotas or regarding construction cost certainty.

Many debt funds are also faced with the challenge that loans granted in the past not being repaid on time and therefore capital is not available for new loans. Overall, raising funds is currently proving difficult.

Market environment remains challenging
So, crisis mode as the new normal? The crisis is certainly not over yet. But where exactly do we stand? Has the low point already been reached? And when can we expect a recovery? These questions remain (as yet) unanswered.

In general, the market is still considered to be difficult. Market values are now falling significantly – both on the basis of residual values and factors that buyers are prepared to pay. However, there are hardly any suitable comparative figures due to the lack of transactions. Project developments and investments in existing properties often cannot be calculated on the basis of current valuations.

Loan prolongation and refinancing are also proving to be difficult, which indicates an increased number of non-performing loans (NPLs). We have not yet seen any NPL sales by banks, but this could change quickly. Some alternative lenders are waiting for this and positioning themselves accordingly.

The first interest rate cut by the European Central Bank (ECB) in June 2024 had already been fully priced in and was therefore merely seen as confirmation that the peak in interest rates has been reached. It is by no means certain that further cuts will follow in the near future. So it remains to be seen when a more sustained downward trend will occur. Many market participants assume that it will take even longer than previously expected. International investors are more optimistic: they are increasingly looking to the German market and hope to gain a better foothold there than in the past.

Our conclusion: The situation remains exciting. But our round table discussion (page 22) also shows that the situation is improving. Overall, the trend from last year is continuing: the restraint among lenders continues to be noticeable and is particularly evident in the increased demands made regarding projects.

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Devaluations characterise 2024

Everyone was talking about increases of central bank rates last year, but we are now speculating about interest rate cuts. The first interest rate cut by the ECB in June of this year is by no means seen by the 73 participants in our survey as the start of a downward trend, but merely as confirmation that the interest rate peak has probably been reached for this cycle. However, hardly anyone expects more favourable financing conditions from the banks or any real relief.

At the same time, property prices are continuing to fall. There are falling values across the board, and we are seeing clearly negative changes in value compared to the previous year. Accordingly, experts are adjusting the originally estimated exit factors. The falling yield values are making it difficult or even impossible to finance many projects because numerous developers, especially in ongoing projects, are still making calculations with values that are old and therefore too high. In particular, developers who purchased at the highest prices are finding it difficult to obtain financing for their projects from banks or alternative investors.

Subordinated capital now only for top projects

Of the survey participants who provided either only mezzanine or mezzanine and whole loan capital, 20 per cent have stopped providing capital completely. Only a few lenders are still providing mezzanine capital at all and then only for top projects. 11 per cent of respondents stated that they are no longer providing subordinated capital and are concentrating exclusively on senior secured capital. Loan defaults, not least caused by the insolvency of various developers, have once again highlighted the risks of mezzanine. As a result, individual lenders with a high risk profile have already disappeared from the market.

A total of 14 per cent of the active participants in our survey stated that they are only issuing senior secured loans, and 21 per cent of respondents continue to concentrate on issuing subordinated capital and are thus focusing on this niche. The remaining market participants are (partially) expanding their spectrum and issuing both types of loans.

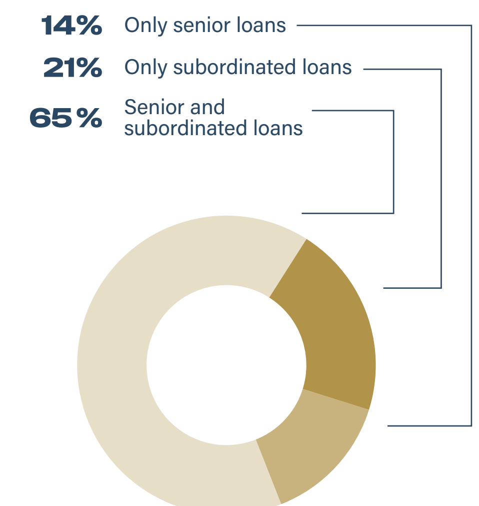
The restraint among banks and their unpredictable processing times play into the hands of active alternative lenders. These are receiving an increasing number of enquiries – especially since the second quarter of 2024. Despite the often higher interest rates, they can attract attention thanks to their fast processing times. However, the situation is not without its challenges: many providers stated that their capacities are limited because the lengthy processing of existing engagements ties up resources. Delayed repayments also mean that there is often a lack of capital for new loans.

Cherry picking is continuing

Those with sufficient capital and resources can cherry pick the best projects in the current situation. The cherry picking already identified in the last report is continuing.

Given the wealth of opportunities, even Anglo-Saxon investors are getting a taste for it again. They are now being presented with projects that they would never have seen in the past – because back then these projects would have traditionally been handled by a bank.

The hotel asset class is becoming more popular again. Offices continue to have a hard time. Only the absolute top locations and properties with a strong focus on ESG are performing acceptably in this area.



Even less mezzanine and smaller tickets

Our survey was conducted between March and the end of May 2024. As expected, the allocation of mezzanine capital fell significantly once again in 2023. The reasons for this are obvious: a low number of transactions coupled with scepticism regarding new project development, driven by rising construction costs and the threat of insolvencies. Many banks now no longer like to even see mezzanine capital as part of the financing structure. The provision of subordinated collateral is often not desired; in the event of a default, dealing with the subordinated capital provider is avoided and hard equity is preferred instead. This makes it more difficult for junior lender to provide capital.

Overall, the number of financing requests received in 2023 was well below the previous year's level and has only started to pick up again since the end of the first quarter of 2024. Many requests were also not profitable from a lenders perspective. At the same time, the frequent lack of liquidity among alternative lenders led to a significantly lower lending volume. This is because regularly expected loan repayments were delayed or did not materialise at all. As a result, ticket sizes have continued to shrink – but this was and is good for the sense of security among many providers of financing.

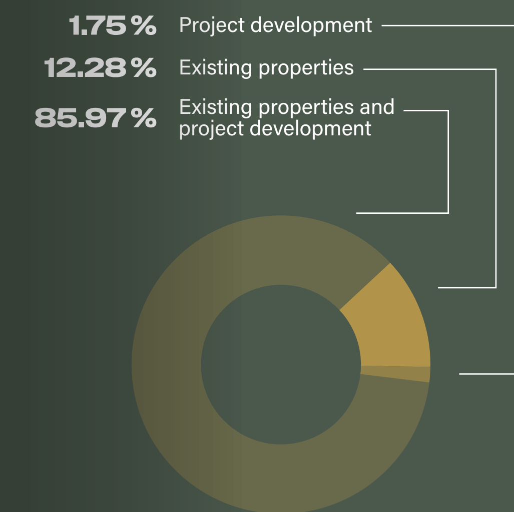
Diversification is playing an even greater role in risk management than before.

The situation is slightly different among international lenders. They are still looking for big tickets in order to do well with whole loans in particular. From 100 million euros and upwards, competition becomes less intense. Few national lenders offer such ticket sizes, so cherry picking is also possible here.

The increasing popularity of whole loans is obvious. Although the financing amounts have also fallen here, they are at the same level as traditional bank financing was in the past in terms of the ratio. In addition, alternative investors are proving to be popular thanks to faster processing times. And the financing costs for whole loans and traditional bank financing are no longer so far apart.

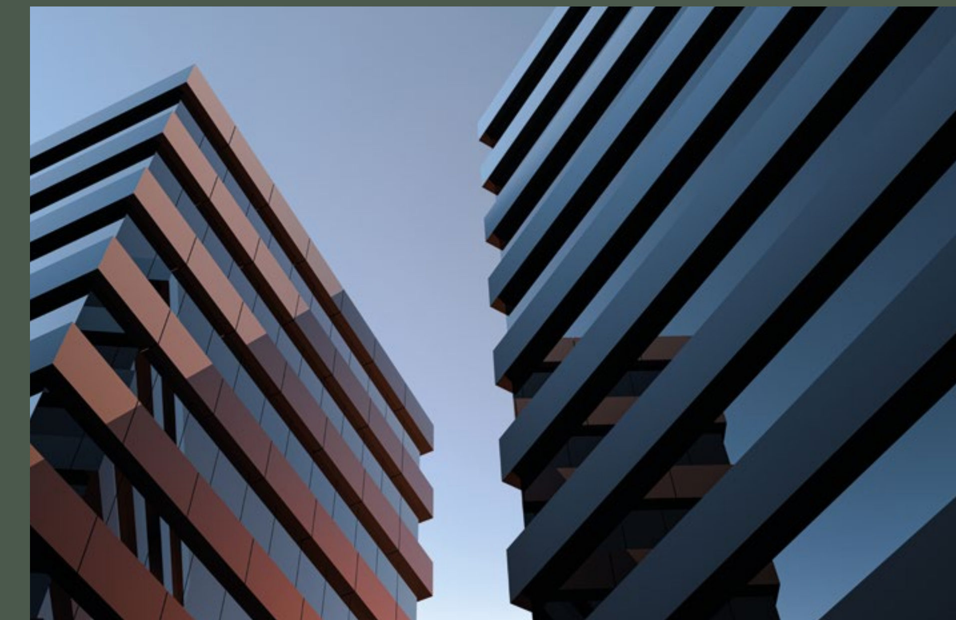
The total financing volume in the German market is almost impossible to determine. The willingness to provide information on the volume transacted has declined significantly. It is also difficult to recognise the shift from previously subordinated capital tranches that are now part of new whole loan structures.

Capital almost only for existing properties



The majority of lenders continue to focus on existing properties with cash flow in good locations. However, 86 per cent of the participants surveyed can also imagine financing selected project developments. A very small proportion concentrates exclusively on developments – in particular to utilise niches and achieve higher margins. However, these clearly remain the exception.

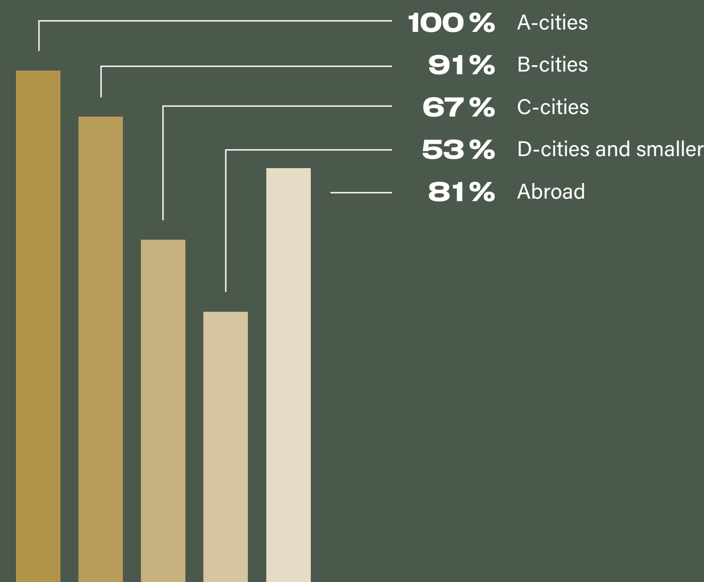
At the same time, there is a considerable need for financing for project developments. In practice, however, the willingness to provide financing is limited to selected projects with strong key economic data.



Focus on A and B cities, and Europe

When asked about their willingness to finance in terms of location, all survey participants stated that they are active in A cities (the main urban centres in Germany). A total of 91 per cent are active in A and B cities. There is significantly less willingness to finance in C cities (67 per cent) and D cities (53 per cent). This means that just under half of those surveyed (47 per cent) do not finance in D cities. International investors in particular favour the large cities that are known outside Germany.

For the first time, we enquired about the willingness to finance projects abroad. 81 per cent of investors support projects in other countries; the focus here is on Europe, in particular Western Europe and the Nordics.

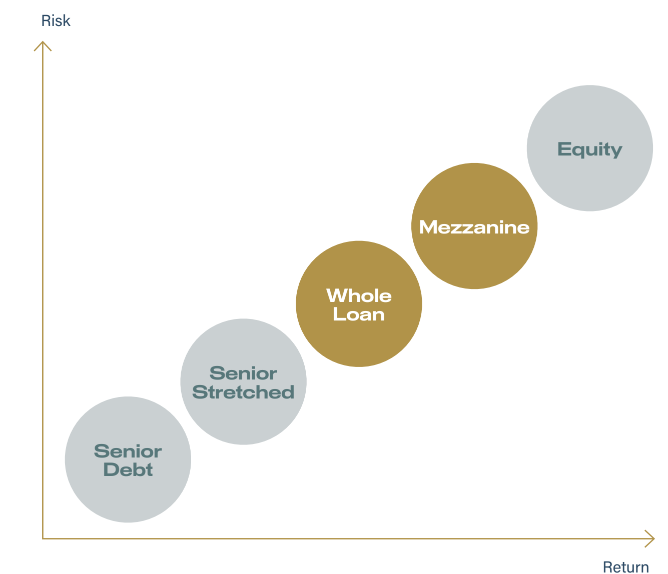


Financing ratios continue to decline

The financing ratios for mezzanine capital have changed significantly, as the ratios from traditional senior capital providers have fallen once again year-on-year. As a result, the starting point for mezzanine capital is also slipping further downwards. This should actually be a good prerequisite for the allocation of subordinated capital, as it reduces the supposed level of risk. But this is not yet reflected in activism. Whole loans remain the preferred alternative (for the time being).

The equity portion rises accordingly, and not just arithmetically. Often "hard" equity is required, i.e. amounts to be brought in from cash that can only be replaced to a small extent by imputed profits.

Mezzanine in the capital stack is therefore actually partly in loan-to-value regions that were labelled "stretched senior" not so long ago. Anglo-Saxon investors in particular are capitalising on this. In an international comparison, their loan-to-value (LTV) and loan-to-cost (LTC) concepts have generally not been realised in Germany. They are positioning themselves in the current environment. It is becoming increasingly difficult to distinguish between whole loan and stretched senior.



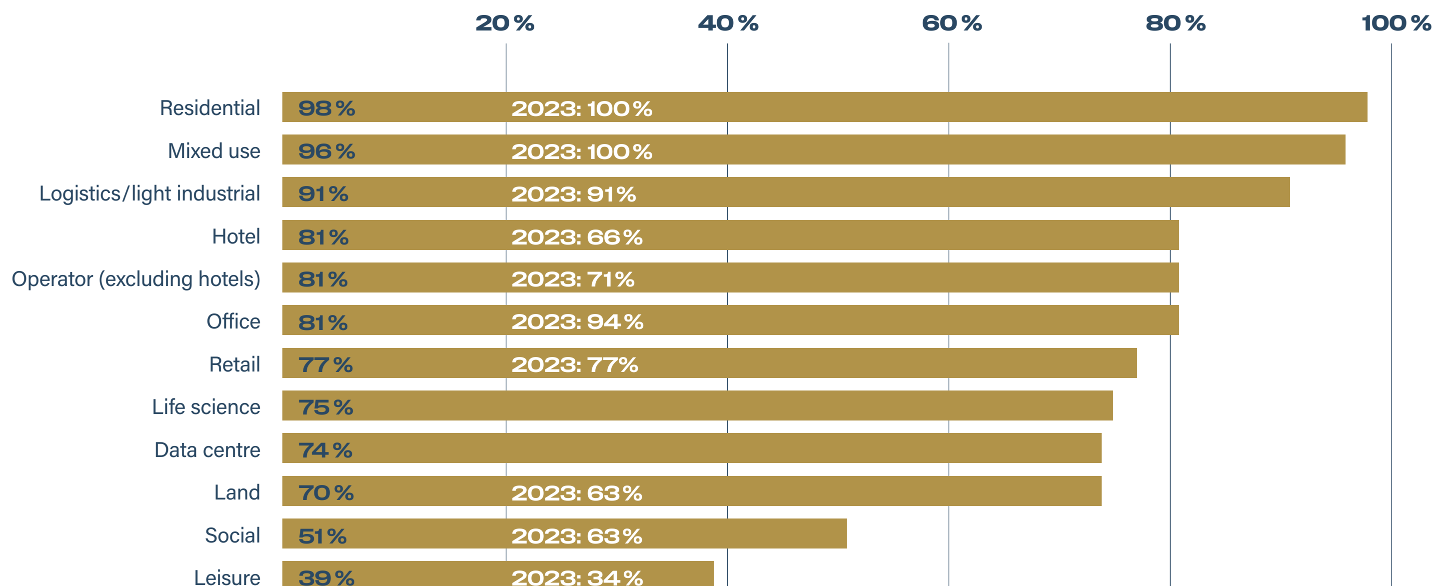
Office losing, hotel winning

Residential and mixed use remain the most popular asset classes, closely followed by logistics/ light industrial. 81 per cent of survey respondents are still interested in the asset class office – but this is significantly fewer than in the previous year (2023: 94 per cent). The uncertainty surrounding office properties is undeniable – even the current "back to the office" trend is not providing sufficient support. Residential on the other hand, is currently considered crisis-proof.

Offices can be of interest if they are in prime locations in the central business district (CBD), fulfil strict ESG (environmental, social and governance) requirements and have a good occupancy rate. The demand for ESG-compliant offices is expected to increase, driven by companies that want to fulfil their commitment to sustainability.

The hotel asset class is becoming significantly more popular with an increase of 15 percentage points compared to the previous year. The "corona shock" is over. Demand in the logistics segment remains high.

This year, we surveyed the data centre and life science asset classes for the first time, as demand is expected to increase significantly in these areas. At 74 and 75 per cent, they are already of interest among alternative lender. The financing of building plots is also still on offer, provided that development rights are available.



Whole loans: The better alternative?

Whole loans remain a sought-after product for both investors and borrowers in the current market situation. They combine different classes of debt capital into one overall financing arrangement.

Whole loans are often provided by a single lender or in the form of club deals. In such cases, a lender usually acts as the "syndicate leader" and central point of contact for the borrower.

In the past year, whole loans often offered financing ratios that were common for senior financing before the property-crisis compared to bank financing. In the current market environment, the financing maturities for whole loans and traditional senior financing are no longer particularly far apart. However, the slightly higher loan amount often makes a decisive difference with regard to the ability to realise the financing application.

Then there is the speed factor that was already mentioned. Processing times at banks have become significantly longer, which means that the reliability factor, which is often so important for borrowers, is suffering. Alternative investors can score points over banks here thanks to short processing times from signing the term sheet to payment. The greater flexibility, for example with regard to interest rate regulations, repayments and terms, also speaks in favour of alternative lenders. As a result, whole loans are increasingly gaining ground over traditional bank financing, despite the supposedly higher capital costs.

Mezzanine tranches are currently hard to come by – which is of course also fuelling the trend towards whole loans. They are often the only chance to achieve a higher ratio than with a classic bank loan.

Last but not least: With the whole loan, there is no need for the often lengthy coordination between senior and subordinate. An intercreditor agreement is usually not required.

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