Analysis

E X P E R T   C O M M E N T A R Y

Banks' reticence to provide high leverage is creating a mezzanine funding gap in Germany, writes Hanno Kowalski, managing partner of Berlin-based debt provider FAP Invest

Germany's mezzanine opportunity is growing

Germany, often considered to be 'over-banked', has one of the most competitive real estate financing markets in the world.

For senior and stretched-senior loans, it is almost impossible to beat domestic banks' pricing, due to their ability to refinance via the country's Pfandbrief covered bond market. To do business in Germany, international senior lenders need to be prepared to work within these very low margins.

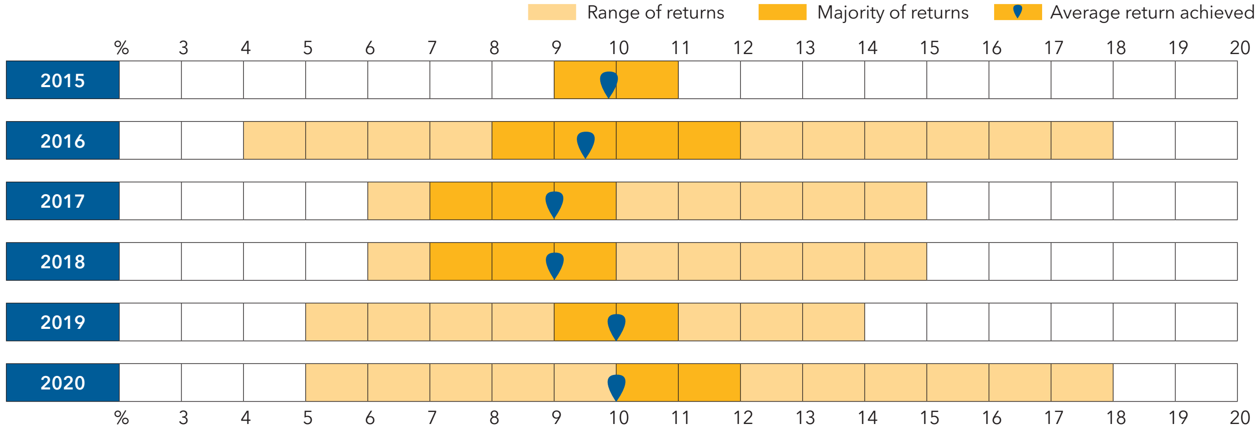
However, the opportunities in the gaps left by these competitive lenders – smaller deals, or those outside the core markets – are widening.

The covid-19 pandemic has intensified banks' reluctance – caused by incoming Basel IV regulation – to finance certain types of asset. It means a lot of financing activity has been put on hold for the time being. These assets, such as hotels and retail, have been suffering since the start of lockdowns, but even the financing of offices is becoming increasingly difficult.

To a large degree, banks have also stepped away from financing land banking deals, lending against buildings which lack an existing cashflow, funding office developments with low pre-let rates, and capitalising early-stage developments in general. Some banks in certain parts of the market are no longer providing finance at all, while others are taking much longer to make decisions. With some term sheets being withdrawn for no comprehensible reason, some have simply become less reliable partners.

While banks used to offer loan-to-value ratios of more than 50 percent – in some cases they would go up to 70 percent – they are now more comfortable sticking close to the 50 percent mark. It is precisely this reluctance that many subordinated financiers see as an opportunity. They step into the breach where banks either no longer provide finance at all or offer low loan-to-value ratios. Such lenders often offer bridge finance at interest rates previously reserved for mezzanine tranches.

Mezzanine lending in Germany generated a wide range of returns



Source: FAP Mezzanine Report 2020

Germany is a difficult market to crack for debt fund managers and investors. However, by staying away, they miss out on exposure to real estate in a large and stable market with a strong economy. Germany has a very active and liquid market, which allows for higher LTV and loan-to-cost ratios than virtually anywhere else in Europe. In addition, almost every loan will find refinancing when needed. Here are some key considerations about Germany's mezzanine lending market.

There is a growing opportunity set

The opportunities in the subordinated finance segment in Germany are growing. The latest FAP Mezzanine Report, published in January and covering 2020, showed that around 155 capital providers were active in the subordinated financing market in Germany.

Some 53 of them took part in our annual survey on lending conditions in the country's mezzanine market. Together, they provided €6.9 billion in mezzanine capital in the preceding 12 months – 19 percent more than in the 12 months prior to that. It means projects with a volume of €40 billion were financed.

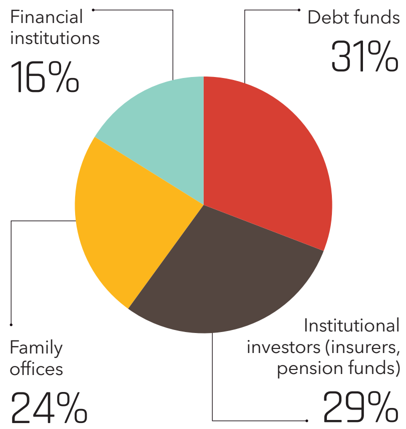
We counted nine additional providers of subordinated capital in Germany, compared with 2019. In addition, we have already seen several new players looking to profit from opportunities in the alternative financing market emerge this year. The growing number of institutional capital providers is having a stabilising effect on the German market for portfolio and project financing. Meanwhile, international capital providers and family offices continue to be the main enablers of non-core projects.

Whole loans are growing in popularity

It is not only the number of market participants that has increased. More and more capital is available for alternative financing structures. A trend which emerged from the study was the increasing popularity of whole loans.

The co-ordination of the collateral structure between senior and junior debt in the credit agreement is often very difficult and usually takes a lot of time to arrange. With whole loans, senior debt is effectively granted with a higher LTV ratio. These loans are increasingly common in the offers the capital partners we surveyed provide. If you compare the interest rates of such loans with the blended rate of classic senior-junior combinations, there is hardly any difference in the cost of capital between the two financing options.

Debt funds are the largest active group of lenders in Germany's mezzanine lending market



Source: FAP Mezzanine Report 2020

There is room for improvement on ESG

The study also revealed interesting findings about environmental, social and governance factors in Germany's mezzanine lending market. Even though sustainability is increasingly important in investment decisions, it has not fed through to mezzanine real estate debt – yet.

ESG criteria have played virtually no role to date in this part of the market. The financing of a project development or real estate investment is predominantly influenced by the classic industry standard valuation criteria. The potential risk of a property underperforming because it does not conform to ESG criteria is mostly considered negligible due to the mainly short-term profile of mezzanine loans.

Opportunities are found in multiple locations

Due to its decentralised system of government, which means Germany has several major cities, the market offers a variety of geographic opportunities to mezzanine investors. The seven largest cities and metropolitan regions continue to be top of investors' lists. Large institutions tend to limit their activities to the major cities with their strong economic pull and positive population trends.

Investments outside the main German metropolitan locations are almost always supported by local capital providers with on-the-ground expertise and detailed knowledge of the location. More than 80 percent of the investors we surveyed in our Mezzanine Report were involved in 'A' and 'B' cities, with even 'C' cities not taboo.

The question facing lenders is how to access opportunities in such locations. Opportunities are ample, for example in bridge loans, land bank financing or special situations. But lenders often need access to mid-sized developers and local investors that are simply not visible outside the country, or even their home region. The German Mittelstand, the country's backbone of small and medium-sized enterprises, also plays a major role in its real estate markets. Another difficulty lenders face is that local co-operative and savings banks also tend to be less flexible on their intercreditor agreements than larger banks.

For investors that are unable or unwilling to build a local presence, another option is to partner with a local advisor with a proven track record and an established network. This kind of relationship can provide access to deals before they even hit the market, as well as add a layer of security. Local, high-quality servicing capabilities will also enable a closer proximity to the sponsor and thus decrease risk across the loan portfolio significantly.

155

Number of capital providers active in Germany's subordinated real estate debt market in 2020, nine more than a year earlier

€6.9bn

Volume of mezzanine capital provided in Germany in the year prior to the report by the 53 survey participants, up from €5.8bn in the 2019 report

10%

Average internal rate of return generated by German mezzanine lending

11%

Average IRR for the mezzanine portion of development loans – the lowest since the survey began in 2015

Source: FAP Mezzanine Report 2020

The market generates sizeable subordinated debt deals

Our report showed the average financing volume per deal in Germany increased significantly, while the number of deals declined compared with the previous year. The sweet spot for mezzanine deals lies in the €15 million-€50 million bracket. To sidestep competition in this size band, investors can look at smaller deals, although they must consider that smaller deals require the same amount of attention and resources as larger transactions. Whole loans should have a minimum volume of €20 million and mezzanine a minimum of €10 million in order to not be too granular.

The mid-market provides ticket sizes with strong returns from high-quality sponsors. That segment also includes more real estate investors and developers that are open to doing business with alternative lenders and that have actively started to look at the provision of capital by institutional investors. With a trusted partner, these kinds of local structures can be used to full capacity, meaning investors can easily deploy a loan volume of €300 million-€500 million per year.

International entrants expect to grow their market share

In our 2019 Mezzanine Report, 64 percent of respondents expected the German market to develop positively. A year later, 58 percent anticipated a slight downturn. None of the respondents expected demand to increase. The euphoria of the past few years seems to be over. Against the backdrop of lockdowns and the economic slowdown, many investors want to wait and see how the market develops.

However, the mood is better among international investors. They expect the market to stay stable, or even improve. UK and US players are counting on the restraint of German investors and are looking to increase their market share.

Despite or because of market uncertainty, alternative financing solutions have become indispensable in the German real estate market. Mezzanine has become a standard component and whole loan solutions are on the rise. At the same time, the distinctions between forms of financing are becoming increasingly blurred – senior, stretched senior, whole loan, mezzanine and preferred equity are more difficult to distinguish from one another. The field of subordinated financing is becoming broader – and with that, so are the opportunities for engagement. ■