PRESS RELEASE

FAP Mezzanine Report 2023

Alternative financiers more cautious, with lower risk appetite and greater focus on reliability of cash flows

- **Cherry picking: only top-notch, stable development projects are considered, plot financing almost impossible**
- **Mixed-use and residential clearly preferred over office and logistics**
- **Reversal of past trend towards ever larger financing ticket sizes**
- **Mezzanine often shifting into less risky stretched senior position**

Berlin, 4 October 2023 – FAP Group's newly published ninth annual FAP Mezzanine Report reveals that providers of alternative finance in the German market have not been immune to high inflation, increased interest rates and falling market values. In fact, the first defaults in existing debt financings have started to have an impact. Almost all institutional investors have ceased direct mezzanine capital financings. Likewise, the proportion of respondents with a positive future outlook has fallen significantly. Nevertheless, some 40 per cent of survey participants (previous year: 53 per cent) expect increasing demand for alternative financing solutions over the next twelve months.

It should come as no surprise that the current market situation and, in particular, the widespread lending reluctance of banks open new opportunities for alternative lenders. An increasing variety of financing alternatives coupled with rising interest rates and reduced market values of many properties means that mezzanine capital is now applied to finance a tranche of the capital stack that was previously regarded as "stretched senior". This means an absolute improvement of risk/return for investors above the relative enhancement.

"In the current market phase, it really stands out which debt funds have mastered the craft of providing subordinated capital. Major differences in quality are now becoming apparent that no one wanted to acknowledge before," says Hanno Kowalski, Managing Partner at FAP Invest. "In particular, investments in development debt have been running into problems where the financing is not in place all the way through to project completion. The same applies to financings not based on true value actually created through construction during the term of the loan, along with valuations that can actually be realised in the event of a sale."

That is why the market is turning away from development projects in favour of existing properties. Project financing is only available with a higher equity investment. The past era in which financiers were keen to invest in undeveloped land, speculating on high returns through development or attaining building approval, likewise seems to be completely over. This change in the market environment also means that debt yield, a key measure that was often overlooked in the issuance of mezzanine tranches in past years, is once again in focus. Alternative financiers are also taking an increasingly close look at cash flows.

While the trend in recent years was clearly towards larger ticket sizes, alternative financing transactions are now becoming significantly smaller: only around six per cent of survey participants are granting financings in excess of EUR 100 million; in 2022 there were twice as many. The preferred deal size for most alternative financiers is currently between EUR 10 and 50 million.

Equity capital requirements increasing – financing terms shortening

While last year's FAP Mezzanine Report found that the average loan-to-value (LTV) for existing properties was just under 85 per cent, the average LTV has now dropped to 80.6 percent. For alternative financiers to even consider a project, the expectation is now that the equity contribution must be at least 15 per cent – and the trend is rising. This is likewise reflected in the average loan-to-cost (LTC) of 84.4 per cent (prior year: 87.5 per cent).

"In the current market phase, mezzanine is effectively moving further down in the capital stack. So, from a risk standpoint, there is a quality of deals coming to market that has not existed in recent years," says Kim Jana Hesse, Head of Capital Partners at FAP Finance.

From the perspective of both lenders and borrowers, whole loans have become even more attractive. With their mix of classic senior and supplementary subordinated financing, these loan structures are often occupying the position held by pure senior loans just a year ago. Thus, financings that in the past were arranged as pure senior debt now require whole loan solutions.

Focus on residential and mixed-use – strong growth in hotels and leisure facilities

All survey participants reported that they supported the "mixed-use" and "residential" asset classes. While office properties were in second place last year, they have now slipped to third place, although 94 percent of those surveyed are nevertheless still active in offices. The survey found a strikingly strong recovery of interest in hotels and leisure properties: 66 per cent of participants reported that they are financing hotel properties, an increase of 20 percentage points over the prior year, while 34 per cent said that they are financing leisure facilities, compared to just 11 per cent in 2022. As to the widely popular residential asset class, the focus is particularly on A and B cities, with a particular enthusiasm for prime locations.

The investor surveys for FAP Group's ninth annual FAP Mezzanine Report were conducted between February and June 2023. For the first time since the introduction of the Mezzanine Report, FAP Group was not able to measure and report the volume of mezzanine debt this year because the number of completed financings was too small, as were the sizes of the individual deals. There were virtually no large transactions, and where used, subordinated capital was employed in a more varied and creative way.

Further information may be found at www.fap-group.com

We will gladly send a copy of the complete report upon enquiry.

About FAP

The FAP Group is an independent advisory company that specialises in raising and structuring capital for real estate investments and project developments. The Group comprises FAP Invest, a leading real estate investment platform for institutional investors with a focus on debt products, FAP Finance, which provides advice on all capital and financing issues to borrowers, and FAP Syndication & Capital Markets, an independent syndication desk which brings single lenders and groups of lenders together and offers access to raising debt capital on the capital market. FAP structures conventional debt finance as well as mezzanine, equity and capital market products. These services secure the overall financing from debt capital and – if necessary – equity substitutes. FAP, headquartered in Berlin, was founded in 2005 by Curth-C. Flatow. The group has since advised and structured capital with a volume of over €17 billion.

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