KEYNOTE INTERVIEW

Borrowers seek a bridge to better times ahead

FAP Group managing partner Curth-C Flatow identifies the trends driving a new type of bridge lending in Germany and outlines the options available to borrowers

Berlin-headquartered FAP Group provides debt advisory services to real estate sector sponsors in the German market, as well as managing a €300 million Luxembourg-domiciled debt fund and debt club deals through its lending arm, FAP Invest. Over the past 12 months the firm has had many enquiries from borrowers asking whether bridge financing is available, says managing partner Curth-C Flatow. "The perception is that securing such loans will be challenging. Traditional banks are not offering this type of financing. But some alternative lenders, including our own debt fund, will do so if the leverage point is not too high."

SPONSOR
FAP GROUP

Q How would you describe the bridge finance currently being provided in the German market?

Historically, a bridging loan might have been used to finance a purchase for a six- or nine-month period while a sponsor negotiated a longer-term bank loan. More recently, the term of bridging loans has been between 12 and 36 months, and in the last year we have seen greater demand for bridging loans towards the longer end of that spectrum. Borrowers increasingly see it as a bridge to an exit or subsequent long-term refinancing.

In 2023, we have not seen any requests for bridging loans of less than 24 months' duration. Borrowers want to feel confident they will not have to refinance until the current difficult market conditions have improved. Due to a lack of transactions, there are currently very few buyers that require traditional bridge financing. If there were buyers, there would probably be strong demand for that type of loan because, in this market, it takes much longer to secure bank financing.

From application to drawdown

takes two or three times longer than before. When the market reaches the point where the gap between buyer and seller price expectations closes, there may well be good opportunities to provide traditional bridge financing again.

Q How does bridge financing differ from more mainstream financing?

The borrower can get more leverage than the traditional banks would offer, and for a shorter term. Loan-to-value may be up to 70-75 percent, depending on the cashflow, whereas for the same deal the banks would offer 60-65 percent. And German banks are generally unwilling to provide short-term finance in any case. Bridge financing is also more expensive. The interest rate for a five-year loan from a traditional lender would be lower, at 5-6 percent.

Q In what sort of circumstances is bridge financing required?

Borrowers are using bridge finance to solve a current or anticipated problem. For example, a developer that does not want to sell at the price they can expect right now might take out a bridging loan in the expectation that the market will improve in two or three years. Or a borrower may need bridge finance when an existing lender is unwilling or unable to refinance a loan that is coming towards the end of its term. This may be because the lender wants its capital back because its debt vehicle is maturing, or in the case of a bank, it might be reducing its exposure to the real estate market, or to a particular asset class.

Q Is 'bridge-to-exit' financing – enabling developers with almost complete schemes to buy time rather than refinance or sell – a growing market in Germany, where some development schemes have stalled?

There was always some demand for bridge lending from developers that were nearing completion of a project, and which thought by holding onto the property a bit longer a better price might be achieved. In today's market, developers are trying to avoid selling at a low price. The developer may calculate that, while the value of the scheme has not been completely eroded, its exit value has fallen by 10 or 20 percent, so they take out a 24-36-month loan until such time as they can achieve a better price.

For a developer to secure that finance the project needs to be substantially built or let, with a period of perhaps six to nine months before handover to the tenants. The loan will be based on the project's actual value today at a loan-to-value of around 65 percent. A borrower is unlikely to secure debt at a higher leverage point than that.

Refinancing senior development

Q Do such deals merely push difficult refinancings back? When are borrowers typically bridging until?

We can see from the terms borrowers are requesting that they no longer believe there will be a recovery before the end of 2024. They are taking an increasingly conservative view it may be 2025 or 2026, and they are trying to bridge until then. Lenders may become more conservative in the next six to nine months, depending on what happens to asset values.

As a lender, we are cautious about how values will change over the next 12 months. But there is still lots of capital in the market, and the appetite to invest in debt in these times is high. You can get better returns due to increased interest rates, and you are not investing at the top of the cycle. Market values have corrected, or will correct, and if you are investing at 65 percent LTV that offers a very attractive risk buffer.

"In 2023, we have not seen any requests for bridging loans of less than 24 months' duration. Borrowers want to feel confident they will not have to refinance until the current difficult market conditions have improved"

> *"Getting bridge financing for assets that do not have an ESG angle is very challenging. I doubt that a sponsor would be able to find finance for a 'brown' asset or portfolio"*

loans is a good opportunity for debt providers. It will be a newly built property, usually with good ESG credentials, and they are financing it at 65 percent of the actual market value, not the prospective market value, which gives them a significant risk buffer and a decent preferred return for senior secured debt.

Q Is the increasing use of bridge finance a symptom of a market in which it is difficult or unattractive for borrowers to refinance for the usual five-year term?

In many cases, to refinance in the current market borrowers need to inject substantial equity into the capital structure at the leverage point they are getting today, which is usually 65 or 70 percent of the current market value. This capital injection is needed most in circumstances where whole loans have been granted at high LTVs based on peak market values.

A loan of 85 percent LTV at past values might translate to 90-95 percent today – too high a leverage point for refinancing or for bridge lending. Instead of injecting that capital themselves the sponsor might instead choose to work with a preferred equity partner. Highly leveraged borrowers are being squeezed from both sides because not only have LTVs reduced, but market values are also falling.

Q What bridge solutions are available in the German market today?

Loans are typically structured as senior secured bridge finance with a first charge, and often also with other securities such as a share pledge. We have not seen any lenders providing bridging debt without a senior secured position.

In terms of pricing, there is a broad range. If the lender needs to finance their loan on the capital markets, pricing is usually determined on a Euribor basis with a margin on top. If the lender is a debt fund, which has already raised the capital it needs, it will usually have a fixed, all-in coupon. That does not apply in all cases, however, because some debt funds may feel they can profit from using a Euribor basis in the current market environment. With the three-month Euribor rate currently at around 3.9 percent, and 300-500 basis points of margin, that means a return for the lender in the high single digits, between the 6-9 percent mark in total.

For existing properties approaching refinancing, bridge lenders have a strong focus on running cashflows or increasing prospective cashflows. Alternative lenders can provide loans with more creative structuring than would be possible for banks, taking into account cashflows that will increase in year two or three, or creating an interest reserve account to protect against cashflow shortfall. Often, to create more security, a bridge lender will ask for a cash trap, which means cashflows will be ring-fenced in the accounts and not paid out as dividends during that time.

Getting bridge financing for assets that do not have an ESG angle is very challenging. I doubt that a sponsor would be able to find finance for a 'brown' asset or portfolio. Many lenders in this part of the market are strongly ESG-focused, and bridge financing is not about funding a brown-to-green transition, it is about buying time until the market improves.

Q What type of lenders are providing bridge financing in Germany?

Mainly debt fund managers, investment banks and foreign banks. Some of the major institutional investors, such as insurance companies or pension funds, are open for business too, but they are highly selective. I am not aware of any German banks providing bridge lending. German banks were never bridge lenders, even when the market was healthier. They usually required five-year terms. But also bank lending is more restricted now. Regulation has forced them to offer lower leverage, and they have also become more risk averse.

Those lenders that are willing to play in the bridging market can achieve very attractive returns, however. They can get either an all-in coupon or a very good margin over Euribor for a short period of time at actual market values, at around 65 percent LTV.

This is why we have seen some capital providers and lenders, often from the UK, which have not done business in the past in Germany, entering the market. They can ask for the same margins or debt yields that they have required in the past, at a leverage point at which they would not have been able to compete with German banks in a booming market. This has created opportunities for international debt funds with a pan-European lending strategy unable to close deals in Germany in the past. ■