Property Week

FINANCE

Can mezzanine debt plug the refinancing gap?

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Before the global financial crisis, borrowers could easily source bank debt at loan-to-value (LTV) ratios of up to 75%, including senior debt in the 60% to 65% LTV range. But in today's far more conservative lending market, in the wake of Basel II and III banking regulations brought in after the financial crash, LTVs on senior debt have fallen to the 50% to 55% level.

As a result, European borrowers have had to find new non-bank sources of capital such as mezzanine finance to fill the gap in the capital stack left by banks' retreat from lending at

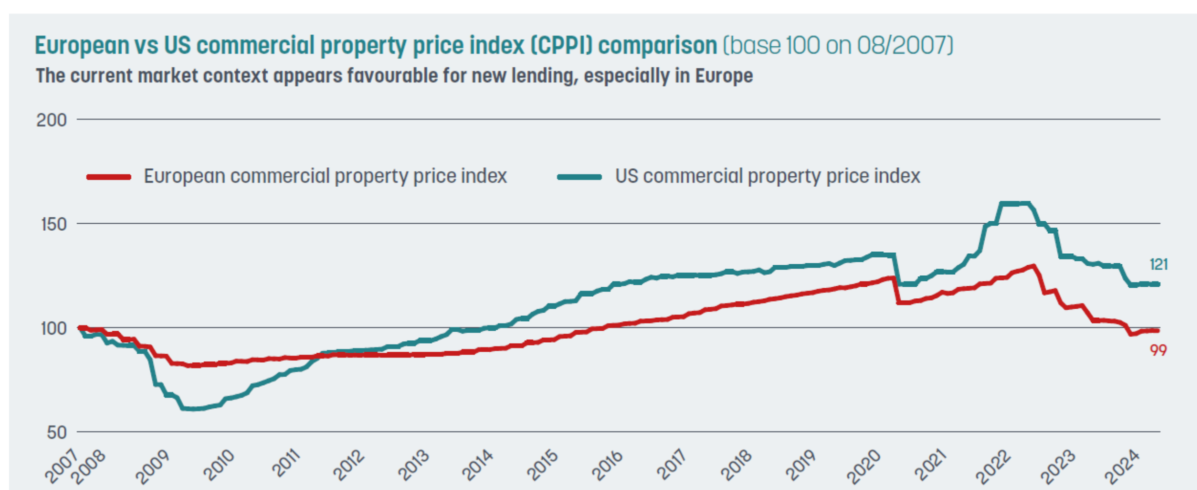
higher LTVs. Mezzanine finance, also known as junior debt, bridges the gap between senior debt and equity, providing essential capital.

Mezzanine ranks behind the senior loan position in the capital stack and takes a higher risk, which is compensated by a higher return than the senior loan. Unlike equity financing, mezzanine lenders do not have ownership rights over the asset being lent against, but do have the option to convert their slice of the overall debt to equity if the borrower defaults, offering a safety net. Mezzanine debt also carries higher interest rates than senior debt and has more flexible terms and covenants.

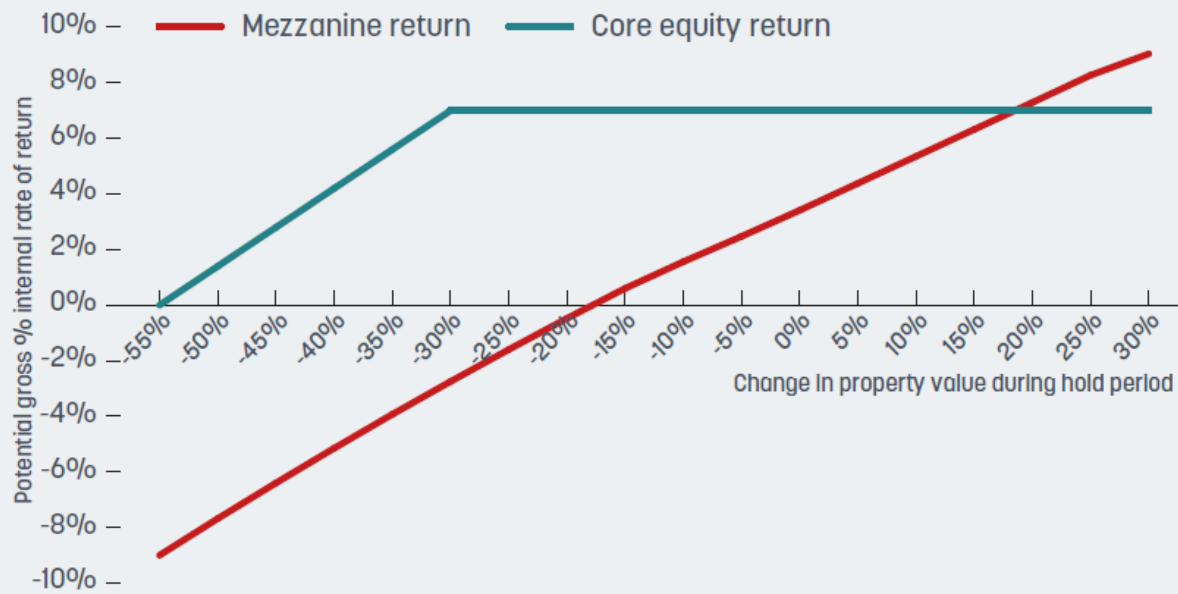
Mezzanine finance can help borrowers leverage up and free some equity to use for other projects
Neal Moy, Paragon Bank

Neal Moy, managing director of development finance at Paragon Bank, says: "Mezzanine finance can help borrowers leverage up and free some equity from a scheme to use for other projects."

Today, with around €2trn (£1.7trn) of commercial real estate debt outstanding in Europe, a key question is the extent to which mezzanine finance can help plug the funding gap expected to materialise when the time comes to refinance a wave of maturing loans written between 2019 and 2022. If borrowers cannot refinance these loans, they will be forced to sell assets to repay them.



"The refinancing gap will require equity investors to inject more equity into a deal, unless some lenders are ready to offer a higher quantum of debt," says Christophe Montcerisier, head of real estate debt in BNP Paribas Asset Management's private debt and real assets investment division. "Theoretically, mezzanine borrowers should contribute to bridging the gap for willing equity investors."



Mezzanine finance emerged as a viable option when interest rates fell to historic lows after 2009. This left borrowers with large amounts of surplus cash after servicing senior debt, which they could use to pay higher mezzanine debt rates. But the mezzanine debt equation is no longer so appealing now that interest rates are higher, eroding the amount of surplus cash left after servicing senior debt, so it requires more consideration from borrowers.

However, TAB chief executive and founder Duncan Kreeger says that despite the higher cost of mezzanine debt, the flexibility and leverage it offers for larger projects still make this form of junior debt “highly appealing”.

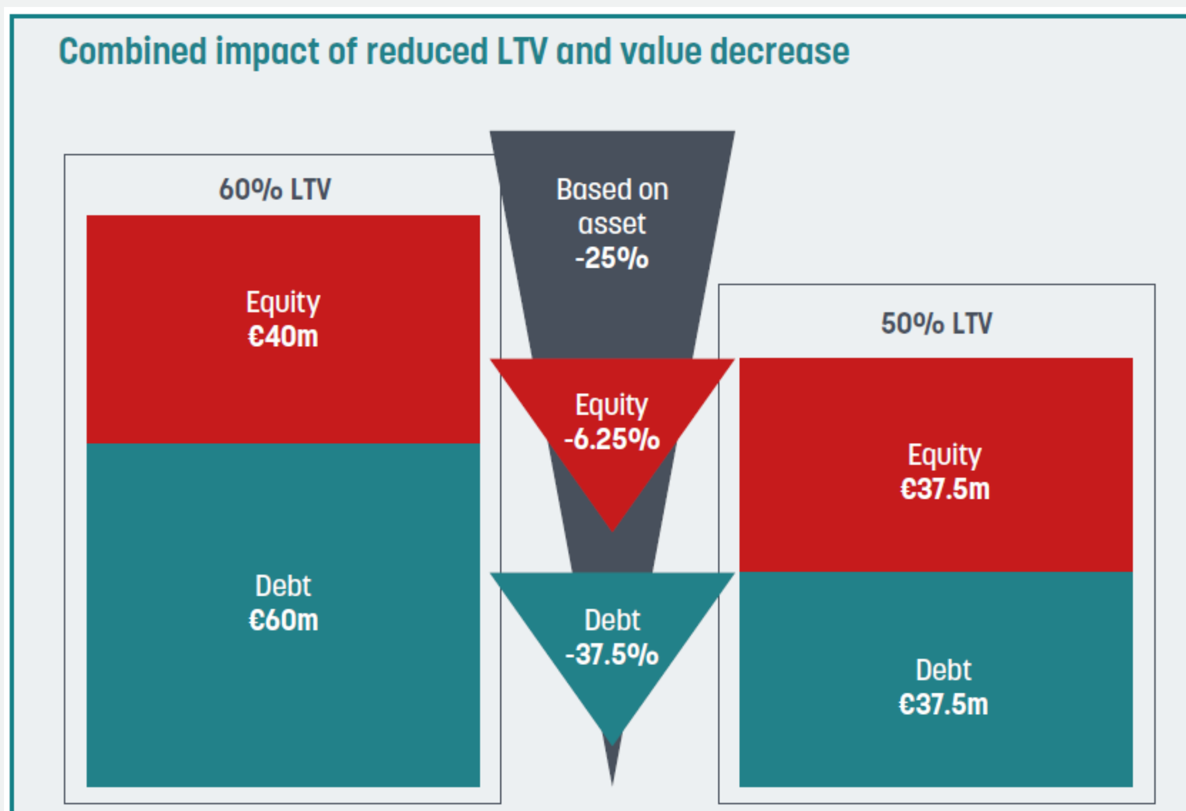
Kreeger adds that demand for mezzanine finance is rising as bank lenders impose stricter criteria. This is opening up opportunities for borrowers, while debt investors “are drawn to attractive mezzanine loan yields, which are outperforming other fixed-income investments”.

Higher-risk financing

The prevalence of non-performing loans is likely to increase in the coming years, offering alternative lenders a “potential opportunity” to provide loan workout and restructuring services including mezzanine debt, says Alexander Oswatitsch, head of real estate debt, Europe, at DWS.

“Mezzanine will be an important source of debt financing, in particular for non-core and higher-risk business plans,” he says.

Mind the refinancing gap



As commercial real estate loans usually have a maturity of four to five years, 20% to 25% of loans mature each year and will be repaid through asset sales or refinancing. Assuming refinancing is the option, many lenders are likely to face a financing gap.

For example, in the above graph, a 60% loan-to-value (LTV) senior loan is granted in 2019 for a property worth €100m, with a 2024 maturity date and no loan amortisation.

Assuming the property's value has fallen 25% to €75m by 2024, and senior lenders have lowered the quantum of debt they will lend on the asset from 60% to 50%, the purchaser can now only borrow up to half the property cost, so the loan amount falls from €60m to €37.5m.

This leaves a €22.5m refinancing gap: €60m of initial debt minus €37.5m of debt quantum in today's market.

Christophe Montcerisier, BNP Paribas Asset Management's head of real estate debt, says such refinancing gaps "open the door to non-bank lenders, who may be able to increase their market share in Europe in the next few years, via senior lending strategies or more junior ones such as mezzanine".

Montcerisier adds that as real estate values may be close to bottoming out, investing in mezzanine is attractive for lenders, as it is less volatile than equity. And in many cases, as property values rise, the returns may not differ from those offered by equity.

Meanwhile, Edward Alexson, chief operating officer at Iron Bridge Finance, reports a "notable increase" in demand for mezzanine debt from developers, as higher construction costs and interest rates, along with slower sales of completed assets, put pressure on their ability to find equity for new projects.

Alexson says a lack of available land with planning permission is also squeezing developers' profit margins. This means that after securing senior debt, they still have to contribute 20% to 25% of the total cost to start a new project. "Many developers are likely to have cash tied up in developments and we are seeing more frequent requests from established developers that have not used mezzanine finance before," he adds.

Jackie Bowie, managing partner and EMEA head at Chatham Financial, says: "Depending on the market environment, certain assets will be more difficult to fund using standard bank debt. Currently, offices fit into that because there is not a massive appetite to fund those projects, particularly at higher LTVs. Borrowers for offices are more likely to top up funding with mezzanine to fill the gap between the senior debt and equity."

Alice Harman, senior lender in Investec's corporate team, adds: "It will be interesting to see how mezzanine finance might aid the debate on how to fund the costs of defending UK office stock from obsolescence. However, I don't think we've seen how that funding gap will be solved for yet."

Mathew Crowther, senior portfolio manager for the PRECap debt fund series at PGIM Real Estate, says non-bank lenders have an "historic opportunity to help provide the capital required to upgrade environmental and energy standards of UK office assets", which is "substantial but unlikely to be available from banks, given regulatory pressures".

A versatile tool

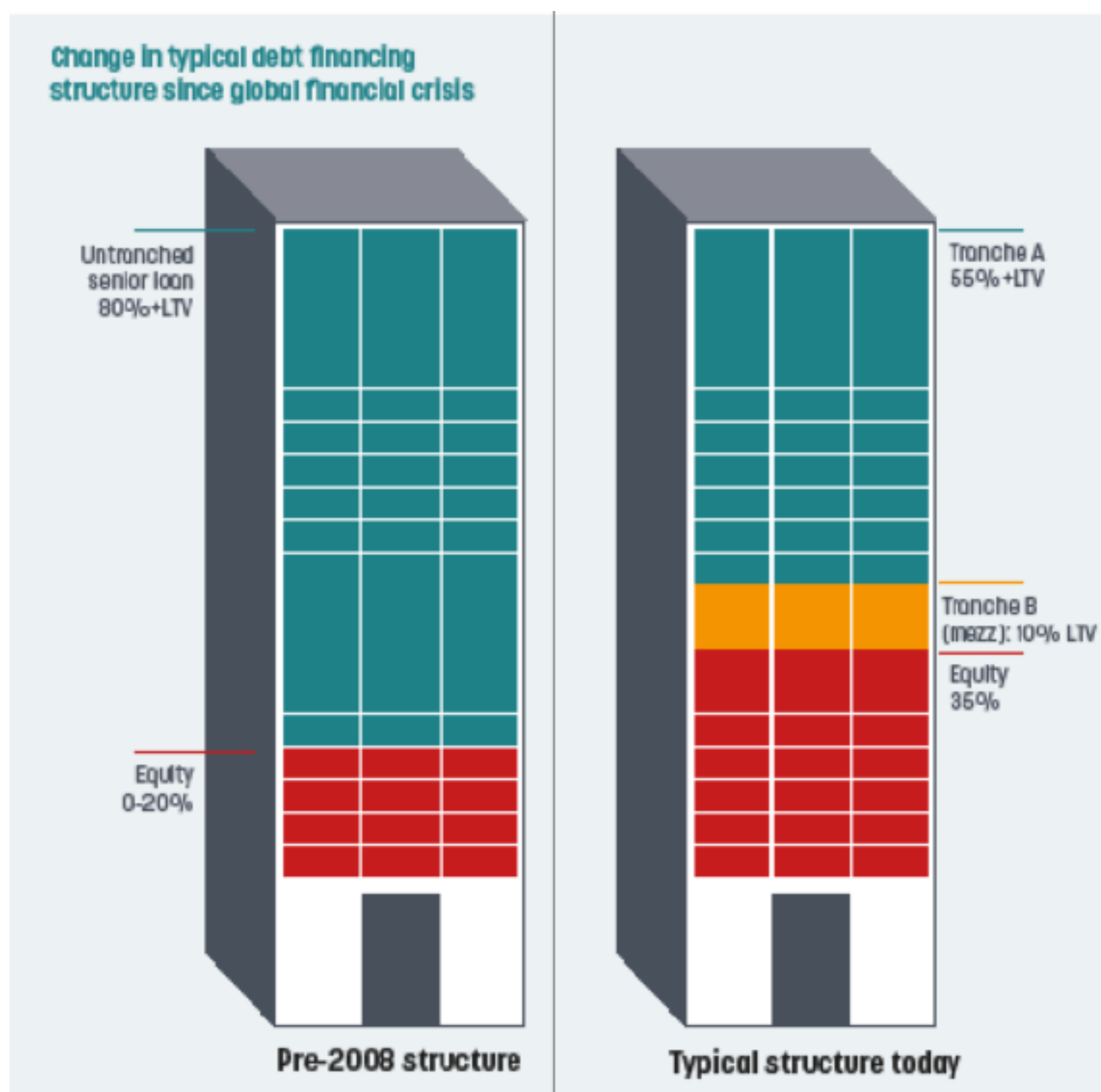
Mezzanine is a versatile slice of the capital stack, so terms such as pricing and leverage can vary widely. Iron Bridge Finance provides top-up mezzanine development finance up to 75% loan to gross development value (GDV), with a minimal increase on the interest rate charged by the senior lender. In today's market, 75% loan-to-GDV funding is available at annual interest rates starting at 11%.

Alexson says: "Our offer enables developers to invest less equity in each development, so they can stretch their funds across more developments."

Mezzanine can be a versatile real estate financial tool and a vital piece of funding stacks
Andrew Antoniades, CBRE

David Gorleku, managing director and head of Europe originations at Blackstone Real Estate Debt Strategies, says: “The combined cost of a mezzanine loan and a low-LTV bank loan or securitisation can be lower than a single-tranche whole loan, even at moderate leverage levels.”

CBRE lends around £700m a year, with mezzanine loans comprising a handful of that total. CBRE head of lending Andrew Antoniades says: “Mezzanine debt is a versatile financial tool for real estate, and it can be a vital piece of many funding stacks. It’s a matter of perspective and recognising that mezzanine is a useful tool, but it needs handling both practically and commercially.”



Mezzanine debt interest rates stand at 16% to 20%, says Doug King, chief commercial officer and co-founder at boutique lender ASK Partners, but adds that "there are some deals out there with rates in the low 20s".

Given today's higher interest rates and all-in debt costs, Crowther says mezzanine is best suited to sectors where rents are rising faster because of higher inflation. He highlights living sectors with shorter-term tenancies of six to 12 months, where rents rise more often, so total rental income grows faster, making it easier to service mezzanine finance's higher debt costs.

Meanwhile, Antoniades says: "Mezzanine has always been a useful instrument but hasn't yet achieved its full potential in the market."

He adds that mezzanine debt still faces scepticism or a lack of understanding from many borrowers: "Its biggest challenge, aside from its cost, is its structural complication. Even in simple deals, it adds a layer of structural complication, legal work and negotiation. That will always be the case, by its nature."

In today's market, with values bottoming out, King says business is fairly buoyant for banks, so there might be a trend towards senior lenders wanting more equity in the capital stack rather than a mezzanine tranche, which can be disruptive and makes negotiating intercreditor agreements more complicated. "Therefore, perhaps lending terms for mezzanine finance might get watered down significantly" in intercreditor agreements, he notes.

But he adds that once the market starts to pick up, there will be more debt options for borrowers, so banks will not be able to dictate the terms of intercreditor agreements so forcefully. "There will always be a place for mezzanine finance," King concludes.

Damien Hughes, senior director of property finance at OakNorth Bank, says: "I disagree that mezzanine finance hasn't taken off yet. It's not a slam dunk, but mezzanine continues to hold a place in the more structured development space. Lenders will be more cautious on the opportunities they go into. For example, there are headwinds in the office sector, so the key for OakNorth is to lend off a rebased value."

Moy adds: "There is always likely to be a space for mezzanine finance alongside senior debt, providing the numbers work for all parties, as it enables developers to raise extra capital against their equity if they need to invest more in the existing scheme or a new one."

How mezzanine differs from other types of real estate financing

Christophe Montcerisier, head of real estate debt in BNP Paribas Asset Management's private debt and real assets investment division, writes: Unlike senior commercial real estate debt, mezzanine usually doesn't benefit from a first lien – the right of a person or financial organisation to have first claim on assets if debt is not paid – on the property, but rather a junior lien. The equity buffer is also reduced compared with senior loans. The higher risks associated with these features usually go hand in hand with higher returns for lenders able to take the additional risk, making the loans more expensive.

Today's regulatory environment makes it almost impossible for banks to grant mezzanine loans as it is too costly. Only debt funds or institutional investors, such as pension funds, can deploy capital on this type of loan.

The differences between senior debt and mezzanine schemes for borrowers:

Depending on deal parameters, mezzanine can help bridge gaps between the quantum of debt senior lenders offered before property values fell after 2022, and today – limiting the amount of additional equity required.

Mezzanine coupons can be current, i.e. paid in cash regularly by the borrower, or capitalised, i.e. accumulated and repaid at the end of the term. While the cost to equity investors is higher, it is expected to be lower than the cost of capital.

The differences between equity and mezzanine for lenders:

Unlike commercial real estate (CRE) equity, mezzanine benefits from a buffer to equity value drops, and in the event of liquidation, mezzanine lenders have priority in repayment over equity holders.

Mezzanine borrowers typically only experience loss when the value of the asset falls more than 30%. Exposure to junior CRE debt can be a lower-volatility solution for investors and can also complement an existing CRE equity allocation for investors.

The differences between equity and mezzanine schemes for borrowers:

As a hybrid tool, sitting in between equity and senior debt features, mezzanine is often accounted as debt in the capital structure, and will require sufficient cashflow for repayment. It will prevent equity dilution for the borrower.