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THE FUNDING GAP: IS MEZZANINE LENDING THE SOLUTION?

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INTRODUCTION

The global financial crisis and the subsequent economic downturn resulted in significant structural changes to the global real estate market. Three in particular have combined to widen the debt funding gap in the market today:

- the fall in property values and returns;
- the overexposure of key senior lenders; and
- the introduction of the Basel III banking legislation, which has put far more onerous constraints on banks' appetite and ability to lend.

Borrowers, therefore, now require greater amounts of capital to secure debt financing from banks for either refinancing or new investments. With traditional channels for raising capital and debt severely constrained for the foreseeable future, investment opportunities for new investors to selectively and profitably bridge this funding gap have been created.

Mezzanine finance sits in the space between low risk senior lending and full equity investment risk. It is, therefore, possible for mezzanine lenders to recoup higher returns on their debt provision than senior lenders as they occupy the space directly above them on the risk curve.

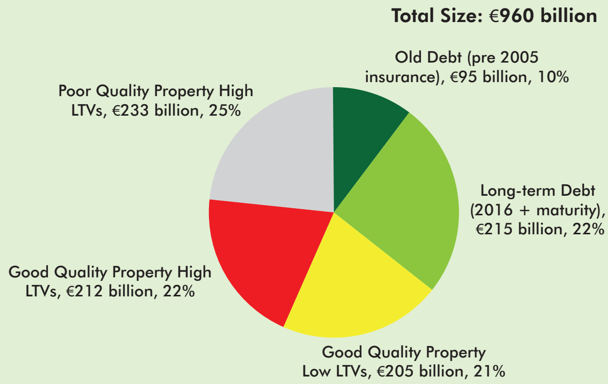
In the post-Lehman era over 100 mezzanine lenders have emerged across Europe and the UK. Typically these are:

- property investors seeking real estate exposure not available in the direct investment market due to the scarcity of quality investment stock;
- non-discretionary asset managers backed either by high net worth individuals or institutional investors; and
- specialist debt investment funds.

Mezzanine lenders have been widely discussed as the 'solution' to the funding gap – but can and will they be the answer to the industry's hunger for debt? Many are new to this area and do not have the infrastructure in place to make a real impact in the market. There are numerous segments of the market where mezzanine lenders could deploy capital and each carries differing rewards and risks. This report looks at where they might be most active and why.

There is currently €960 billion of outstanding commercial real estate (CRE) debt in Europe. Clearly not all of this will require, or be suitable for refinancing. Some will not be supported by security of a sufficient quality to facilitate a refinance and some will have a low LTV, allowing ready extension, pay down or refinancing at only a senior debt level.

European Commerical Real Estate: Current Profile of Outstanding Debt



Source: CB Richard Ellis

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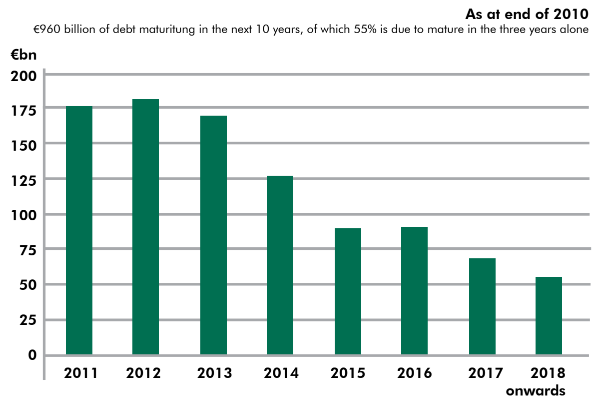
Examining the profile of outstanding European CRE debt illustrates that of the €960 billion, 22% is long-term debt with a maturity date of 2016 or later (please see chart on page 1) and a similar proportion (25%) consists of loans secured by poor quality property with high LTVs. Currently the opportunity for mezzanine finance to play a significant role in debt refinancing lies with existing debt on good quality property with high LTVs, which comprises around 22% of the total outstanding. These assets can attract senior debt on market terms, but often not at a sufficiently high LTV to replace all the maturing debt.

MEZZANINE AS THE ANSWER TO THE REFINANCING WALL

The refinancing wall is the large spike in CRE debt maturities (requiring extension or refinancing) in the next 36 months to the end of 2013. Almost €530 billion of European CRE debt is due to mature in the next three years, which represents over half the total debt outstanding.

European Commerical Real Estate: Debt Maturity Profile



Source: CB Richard Ellis. De Montfort University

To date, mezzanine lending activity has been successful in refinancing loans originated before the credit crunch, enabling many real estate investors to restructure their capital stack without diluting their equity. With the opportunity provided by the prevalence of LTV covenant breaches (which without any new debt would require hard-to-find equity injections) in today's market, it is likely that refinancing of existing debt will remain the core market for mezzanine lenders.

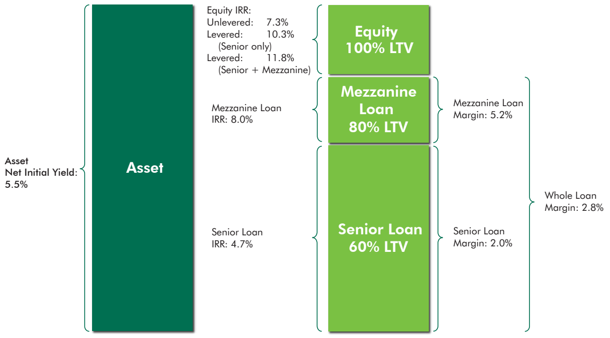
Mezzanine lenders are currently very active in this space, filling the gap between borrower equity and fresh senior debt of 60/65%, usually providing finance on an additional 20% of value, bringing total debt to 80/85% LTV. In this area, mezzanine lending returns are very attractive due to the fact that senior lenders are no longer prepared to occupy this risk space. Mezzanine IRRs range from 10% to 15% depending on the location of the property, rating of the tenant, length of the contracted rental income, the quality of the sponsor and the downside protection offered by the existing equity "cushion" (usually a buffer of between 15% and 20%). This return is made through interest and one-off fees, with interest charged at a significantly higher margin than on senior debt.

In the current market, mezzanine lending can provide an effective, if expensive, solution for highly indebted borrowers, it allows them to retain their property and avoid painful liquidation or never-ending restructuring negotiations with potentially unmotivated existing lenders.

CAN MEZZANINE DEBT ASSIST BUYERS INVESTING IN ACQUISITIONS REQUIRING HIGH LEVERAGE?

Acquisition financing for well located properties, leased on a long term basis to creditworthy tenants and bought by a reputable and experienced sponsor is every mezzanine lender's ideal. Unfortunately, this type of transaction would only provide an IRR of between 7% and 10%, as shown in the example below. Most mezzanine funds, however, have investors with higher return expectations than such an investment would support, making their money too expensive to borrow.

Example capital stack on a typical real estate investment:



NB Assumed senior debt finance at a 2% margin over a 5 year swap with a 1% arrangement fee and amortisation of 1% p.a. Mezzanine debt assumes a 5.2% margin over a 5 year swap with a 1.5% arrangement fee and amortisation at 1% p.a.

In the example above a property showing a 5.5% net initial yield with 2.5% fixed annual rental uplifts can provide an unlevered IRR of 7.3% for equity. This equity return can be increased to 10.3% when senior debt is obtained and 11.8% if senior and mezzanine debt is incorporated.

Due to the mismatch between the return requirements of active mezzanine lenders and those of property buyers, we have understandably observed little activity in the acquisition finance space to date. It is likely that mezzanine lending will work for acquisitions when they are able to start financing secondary properties, which can generate equity returns of 20% or higher. Lenders are likely to enter this market only when competition increases between mezzanine providers and either prime product becomes increasingly scarce for property buyers or risk appetite increases.

Alternatively, if expectations are adjusted to accept returns of 7% to 10% IRR to finance 60/65% to 80/85% LTV, mezzanine financing could be employed in acquisitions of prime assets, which are inherently less risky. However, so far, there has been no indication that mezzanine lenders will be able to offer this kind of inexpensive liquidity. The main reason such money has not been raised yet is that equity investors in mezzanine funds look to maximise total returns, rather than risk-adjusted returns.

Lending money is by definition less risky than investing in property directly because equity is always eroded first when values fall, providing a buffer which protects the debt and the lender. The amount of protection depends on the size of the buffer, and therefore the LTV. A more useful comparator for an investment in a debt fund versus an investment in a property fund is risk adjusted return, taking account of the LTV. Unfortunately risk-adjusted return varies from investor to investor and is complex to calculate. However, the basic principle is that, as the LTV (a good indicator of risk) of the investment increases, the IRR should also increase to maintain the same risk-adjusted return.

Taking account of the different exposure of equity and debt to the risk of capital values falling is important; for an identical transaction the risk-adjusted returns will vary according to your position in the capital stack. For example, if you invest in property via an equity fund achieving a 10% IRR, your risk-adjusted return is 10% as you are exposed to the full equity risk. If you were to invest instead in a mezzanine fund lending at our 80% LTV to achieve the same 10% IRR you would be making the same absolute return but, due to the equity buffer, at a lower level of risk. Therefore, in simple terms, the risk-adjusted return would be 12.5% (10% IRR divided by 80% LTV) when assuming a constant relationship between capital and risk. The reason is that, by lending at 80%, you have moved down the risk curve. In reality such a simplistic approach may not be accurate as the capital stack position up to 80% LTV incorporates both senior (circa 0-60% LTV) and mezzanine (circa 60-80% LTV) risk. This approach does, however, demonstrate that a direct comparison of the absolute IRRs of an equity investment in a direct property fund with one in a debt fund would be misleading - you have to incorporate the risk.

WILL MEZZANINE LENDERS BECOME ACTIVE IN DEVELOPMENT FINANCE?

There is no reason why mezzanine would not be suitable for financing developments with a credible business plan, a high exit value and a reputable sponsor. To date, mezzanine lenders

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have paid little attention to this segment of the market due to the fact that most look for an income return.

The small amount of debt finance invested in development is currently being provided by opportunistic investors. The increased risk associated with development demands a high IRR, which, in most cases, is so close to an equity return, that mezzanine finance is unattractive for developers.

Looking forward, some increase in mezzanine development financing seems likely as the returns can be very attractive, ranging from 15%-18%. Loan to cost can range between 50%-70% and, on stabilisation, should result in a LTV of between 50%-65%. Based on the unpredictability of the current market we expect mezzanine development lending will be the last debt market product to experience significant growth. Currently, the opportunities available in the refinancing of investment loans limit entrants to this area of the market.

TRENDS FOR 2011, 2012 AND 2013: THE YEARS OF THE MATURITY MOUNTAIN

Mezzanine lending is undoubtedly attractive to investors due to a) the returns that certain types of investments can make, b) regulation making debt rather than direct real estate investment more attractive and c) the withdrawal of the traditional lenders (and therefore the 'competition'). Mezzanine lending also offers these companies a good opportunity to diversify their investment portfolio and balance risk exposure.

Mezzanine lending will gradually become more widely accepted by both fund investors (who will need to accept lower returns in exchange for moving down the risk curve) and property investors, who will need to assess accurately the multiple capital sources available at different levels in the capital stack. This process has already begun, and it is likely that there will be a significant uplift in the participation of mezzanine lenders in the real estate debt markets in 2011 and 2012.

Activity among mezzanine lenders is expected to continue to be mainly in the refinancing space as achievable returns most closely match their existing requirements. Currently opportunities exist for mezzanine players to take an increased role in the refinance of good secondary property with strong sponsors, good tenancy and longevity of income streams. As attitudes change and competition in the market increases we expect to see them branch out further into acquisition financing and eventually development financing.

Mezzanine will not be the only solution to the funding gap, as new senior lenders will also be required. Current senior lenders are likely to retrench further as banks will need to have much higher liquidity and capital reserves under the new Basel III regulations. This will impact upon banks' ability not only to refinance outstanding debt, but also their ability to provide capital to new borrowers in the investment market.

As the number and type of lenders in the market increases, financing will become more complex, with transactions potentially involving several debt sources. Each lender might be driven by different investment criteria, risk measurements and funding models making negotiation of terms more difficult. There is a clear role for specialist debt advisors to aid borrowers in the assessment of new opportunities and navigate these complex negotiations.

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