

# EMEA Mezzanine Lending Market

H1 2011

## Quick Stats

	H1 11
Average LTV	82.8%
Average IRR	15.9%

## Hot Topics

- 69 mezzanine lenders are active across EMEA today.
- Discretionary Asset Managers (private equity shops, specialised debt funds and other investment funds) dominate the scene.
- Lenders mainly seek opportunities in Western Europe with an emphasis on the UK and Germany.
- A number of funds are currently raising equity for specific junior and mezzanine lending.
- The market is becoming more diversified with certain players willing to take and appropriately price different types of risk.

## OVERVIEW

### Mezzanine pricing is increasingly competitive

Pricing has come down due to increased lender competition and less than anticipated distress in the market. At the height of the crisis, lenders sought opportunistic returns 20-25% for mezzanine capital; however, today the average required return is 15.9%.

### 69 mezzanine lenders active in the market today

Our study shows that in the EMEA region there are 69 mezzanine lenders actively looking for opportunities. Of these, six have publicly announced deals in 2010 and Q1 2011, completing nine transactions amounting to an investment volume of €450 million, although of course the actual number is higher.

During the downturn, over 100 lenders expressed interest in providing mezzanine financing. However many had unrealistic return expectations or inadequate origination platforms and were weeded out, although some may choose to remain in the market by investing indirectly into debt funds.

CBRE expects the market to rationalise further in 2011 as it matures. The number of active lenders will reduce but greater correlation between investor expectations and market realities should see more transactions completed.

### Discretionary Asset Managers dominate the market

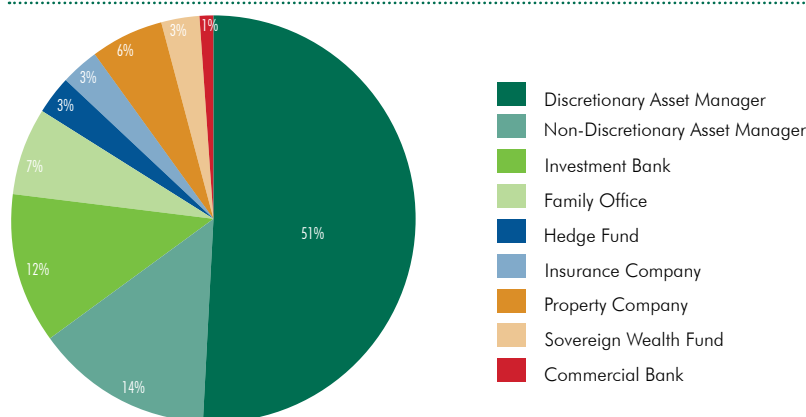
A wide array of debt providers have emerged across EMEA since the downturn. However, despite the variety of players, the market is dominated by discretionary asset managers, who make up 51% of active mezzanine lenders.

### LTVs and Coupon

Although mezzanine transactions are not widely publicised, especially if they involve refinancing or restructuring, CBRE estimates that, on average, the loans originated over the last five quarters covered LTVs of up to 75%. However, there are signs that this level is increasing and our survey revealed that the average maximum LTV lenders are currently willing to provide is 82.8%.

The majority of mezzanine lenders structure remuneration through a current paid interest component (on average 6.5%) and an accrued portion of the interest income (Payment In Kind or "PIK"), which averages 5.5% across all categories of lenders. The remainder of the return for the mezzanine debt is typically generated through upfront and exit fees.

### EMEA MEZZANINE LENDING MARKET, H1 2011



## ABOUT THE REPORT

This is the first report of its type to look at the EMEA mezzanine real estate debt market in terms of lender appetite and parameters. This report has been compiled by CB Richard Ellis' Debt Advisory team to monitor the capacity of the EMEA market and will now be published twice a year.

## LENDERS IN THE EARLY DOWNTURN

Investor interest in high yielding debt products, notably mezzanine and preferred equity, increased significantly during 2008 and 2009 when the mainstream real estate lending market came to a virtual standstill. As traditional senior lenders retreated from the market a significant funding gap emerged. This provided an opportunity to introduce alternative sources of funding for refinancing or restructuring and many foresaw the birth of a European market for mezzanine debt similar to that in the US after the 90's crisis.

Several asset managers then attempted to raise equity for mezzanine funds, expecting that a wave of distressed deals would hit the market and that opportunistic returns could be achieved for low-risk investments. However, this surge of distress never materialised and the opportunity to lend against core assets in prime locations for opportunistic returns never actually arose.

Of those who were not able to deploy their capital, some returned the money to their investors, some successfully invested in deeply discounted CMBS notes, but most broadened their investment criteria to target more value-add opportunities or have adjusted their return expectations to better suit the product they target (e.g. prime vs. secondary; core vs. value-add).

## EMEA MEZZANINE LENDING MARKET BY LENDER TYPE, H1 2011

LENDER TYPE	ACTIVELY LENDING	AS %
Discretionary Asset Manager	35	51%
Non-Discretionary Asset Manager	10	14%
Investment Bank	8	12%
Family Offices	5	7%
Property Company	4	6%
Hedge Fund	2	3%
Insurance Company	2	3%
Sovereign Wealth Fund	2	3%
Commercial Bank	1	1%
<b>TOTAL</b>	<b>69</b>	<b>100%</b>

## LENDERS ACTIVE TODAY...

Two-thirds of mezzanine lenders in EMEA today are asset managers (discretionary or non-discretionary). These include private equity shops, specialised debt funds and investment funds. Of these, the vast majority have a discretionary mandate. Institutional players (investment banks, commercial banks, insurance companies and sovereign wealth funds) account for 19% of the EMEA market.

The smaller players in the market, hedge funds, property companies and family offices, are in the market for differing reasons. Hedge funds mostly focus on sizeable real estate transactions involving a single highly credit worthy corporate tenant, which are still scarce in the market. Property companies and family offices are interested in the opportunity to gain exposure to the EMEA commercial real estate market through debt as it can provide better returns on risk-adjusted basis compared to direct equity investment. Importantly, most of them also have dedicated funding and management platforms to originate debt.

## ...AND THE BORROWERS PERSPECTIVE

While unrealistic pricing made it prohibitive for borrowers to even consider mezzanine debt as source of capital back in 2008, increasing competition from lenders and the lack of distressed or other investment opportunities has now pushed the price of mezzanine finance down substantially.

As a result, an increasing number of borrowers now utilise mezzanine debt as an effective way to secure additional capital to finance asset acquisitions or refinance/restructure existing deals, enhancing their overall return, or protecting their equity upside.

According to our study, the additional mezzanine component can contribute up to an aggregate LTV of 82.8% potentially rising to as much as 90%. However, it is important to note the LTV offered to borrowers today varies significantly across different the different debt providers, of which the key drivers are: appetite for risk, quality and location of the underlying asset, the strength of the property cash flow, and the sponsor’s track record.

## REQUIRED RETURNS

Across the lenders, return requirements average at 15.9%. This disguises a significant range, with the cheapest single lender surveyed seeking 10% per annum and the most expensive, 20%. However, clearly these two lenders would be looking at very different mezzanine lending opportunities, both in terms of the property involved and the deal structure.

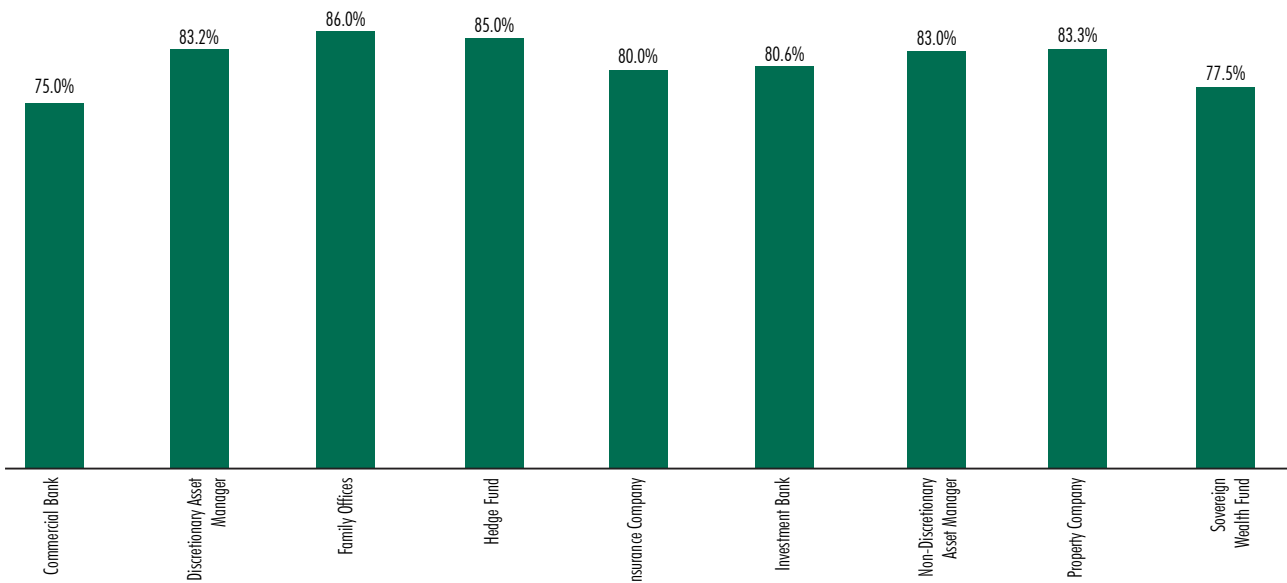
The majority of mezzanine lenders structure remuneration through current paid interest and accrued/capitalised interest (PIK). The rest of the return is typically generated through upfront and exit fees.

The current paid portion of the interest on a mezzanine loan varies substantially ranging from 3% to a maximum of 9% depending on the specific project risk. The average current paid portion is 6.5%. Some players do not need current paid interest; these are the ones that can usually invest into non-income producing assets, such as development projects, where the interest will have to be fully accrued.

The accrued component of the interest typically ranges from 3% to almost 9.8% across the various lenders categories and averages 5.5%. It is fair to say that lenders which favour a higher PIK component versus the cash paid component, such as property companies and family offices, can generally deploy capital on riskier deals like recapitalizations of distressed development projects.

At the top of the return range are players who target assets with a strong value-add component. These lenders accounting for 40% of the discretionary and non-discretionary asset manager pool, tend to structure loans with no or low-single digit coupon and a high single- or double-digit PIK, together with fixed exit fees or incentive component (usually a look back IRR promote or equity share). More comparable to preferred equity structures, these lenders rely on capital appreciation to achieve a higher return as they bear a semi-equity risk.

## AVERAGE LTV BY LENDER TYPE, H1 2011



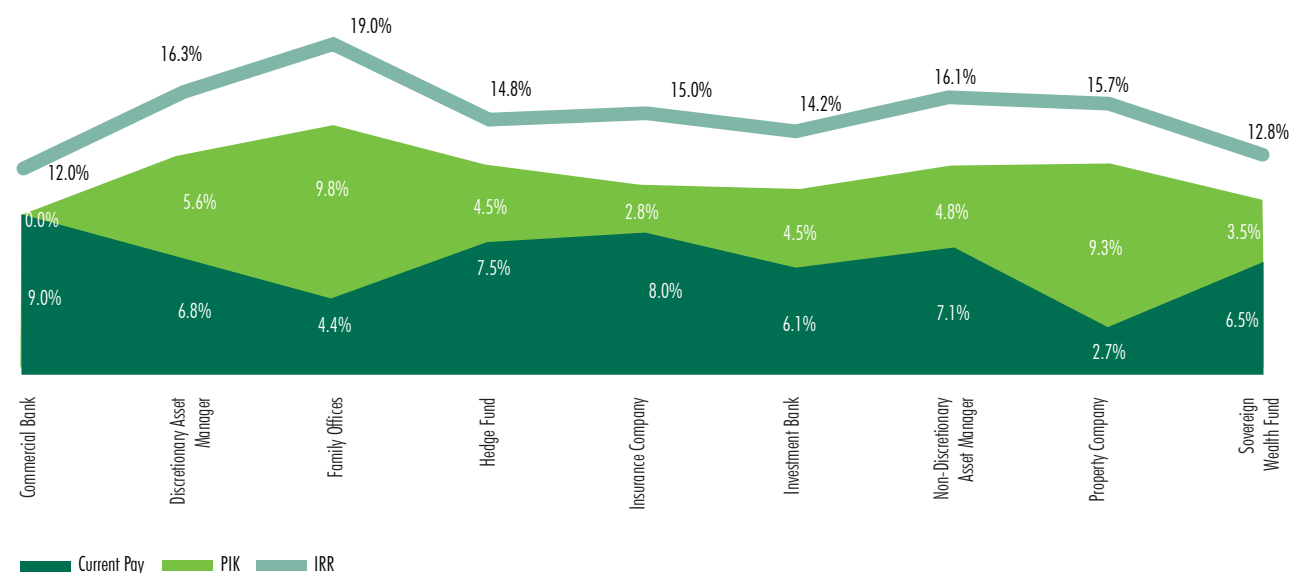
At the other end of the spectrum are the more institutional investors such as commercial banks, sovereign wealth funds and insurance companies. These target assets with stable cash flows and tend to structure loans with a high single-digit cash paid coupon and little or no PIK component. Closer to conventional mezzanine loans, the upside for the debt in this instance is limited and the cost for the borrower is certain.

The growing maturity of the mezzanine debt market is evident in a more highly segmented market. As well as providing additional finance on more stable assets, lenders are able to target 'riskier' assets (with appropriately priced debt). The market is slowly becoming more diversified with certain players willing to take and appropriately price different types of risk.

**CURRENT PAY AND PIK RANGE BY LENDER TYPE, H1 2011**

LENDER TYPE	CURRENT PAY RANGE	PIK RANGE
Discretionary Asset Manager	0-14%	0-15%
Non-Discretionary Asset Manager	5-10%	0-10%
Investment Bank	3-10%	0-10%
Family Offices	0-7%	4-15%
Property Company	0-8%	3-15%
Hedge Fund	7-8%	4-5%
Insurance Company	8%	2.5-3%
Sovereign Wealth Fund	3-10%	0-7%
Commercial Bank	9%	0%
<b>AVERAGE</b>	<b>6.5%</b>	<b>5.6%</b>

**AVERAGE TOTAL RETURN BREAKDOWN BY LENDER TYPE, H1 2011**



## JURISDICTIONS OF FOCUS

The greatest interest from lenders revolves around the UK, France and Germany as these are perceived as the most liquid markets, with many of these lenders physically present in each of these countries.

Our study shows that a small percentage lends exclusively to a single market - only 13% of all lenders are focusing only on their local market.

Virtually all (97%) of the mezzanine lenders in EMEA would finance UK based assets, although only 9 are focused exclusively on the UK. 78% of all lenders are prepared to finance assets in both the UK and Germany. This figure drops to 53% for lending against assets in the UK, Germany and France and 18 of the active 69 lenders wish to gain exposure across all of Europe.

## DEBT FUND RAISING ACTIVITY

There are reportedly 13 players, including investment managers, insurance companies and property companies, actively raising equity for different mezzanine funds. The investment rationale lies in the belief that the risk adjusted returns from investing in mezzanine debt can be more attractive than those from direct investment in property with a comparable yield. A strong product differentiation accommodating different investors' risk appetite has already emerged. This may lead to more successful raisings than we have seen previously and certainly points to a more mature market.

Mezzanine funds can be divided (broadly) into three categories:

The so called "stretched senior" or senior "B" loan programmes usually target 50-75% LTV loans secured against high quality real estate in prime locations, with an emphasis on the strength of a property's cash flow and quality of sponsorship. The risk adjusted return offered here is usually a high single-digit. There are only two funds out of the 13 currently in the market dedicated specifically to this strategy. CBRE believes more players will be interested in providing this sort of capital going forward as most of the transactions in today's investment market involve assets at the prime-end of the spectrum and this is expected to remain the case in the immediate future.

Around two thirds of the funds currently raising equity are seeking value-add/core-plus deals. These players will target the 65% to 85% portion of the capital stack and promise to deliver investors an IRR of 12% to 15%. Their focus is on income producing properties, in prime or secondary locations, with the value-add component generally coming from repositioning the asset through capex or lease restructuring opportunities.

The opportunistic/special situation funds, currently four of the debt funds raising equity, can go as high as 90% LTV, providing mezzanine debt and preferred equity. These funds usually target recapitalization of highly leveraged deals, although they will fund developments selectively.

## OUTLOOK

We have already started to see greater differentiation with an increasing number of players ready to offer a cheaper, core type product that can be deployed at the prime end of the market.

After a quiet start to 2011, greater correlation between investor expectations and market realities should see more deals done utilising mezzanine debt in 2011, while at the same time the market will continue to rationalise.

The number of players will contract to a core of committed lenders, with clearly defined strategies: mezzanine vs. preferred equity vs. junior debt (so called 'stretched senior'). With this, we also expect to see a further stabilisation in terms of risk adjusted pricing to around a 10-15% return spectrum.

Reflecting the risk appetite of investors into mezzanine debt, the UK and Germany will remain their core focus for the foreseeable future with France and the Netherlands following on in the league table. There is less appetite among mezzanine lenders for Southern Europe compared to northern Europe 44% of active lenders would selectively originate deals in either Spain, Italy, Portugal or Greece although mostly on a case by case basis, due to the ongoing economic uncertainty in the area.

Providing debt for transactions with a strong value-add component or in secondary locations, is the only way that mezzanine debt players can achieve returns in the mid to high teens. However, at present, such transactions are limited in number and there remains a gap between lenders' return expectations and borrowers' ability to pay, which will hinder activity at this end of the market for the short to medium term.

Of the lenders who were not able to deploy the capital raised in 2008, many are no longer interested in originating mezzanine loans. However, it is possible that players such as some family offices, high net worth individuals, property companies and possibly pension funds will make a comeback or debut as investors in debt funds rather than as direct lenders, providing further momentum to the current equity raising activity of debt funds. In this way they can still participate in the market without having to build an execution or underwriting capability.

The mezzanine debt market across EMEA is at a fascinating stage – appetite exists on both the demand and supply side of the equation. However, exactly how and to what extent we will see the market grow is, as yet, unclear. Undoubtedly we will see many changes before a 'conventional' market is established.

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