Mezzanine finance on the comeback in commercial property

by Mike Wood | 08 Apr 2021

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Australia's property boom is bringing mezzanine finance back into the broking industry, according on one of the country's leading independent commercial property financers.

Stamford Capital have noted a significant upsurge in secondary finance deals as major banks return to the property development market after several years on the sidelines.

Mezzanine finance was once a common part of the broker's arsenal of products, but has taken a backseat in recent years as Big Four lenders shied away from apartment and unit development deals.

"Mezzanine finance, or second mortgage, are debt instruments that exist in capital stacks that are most often used in project financing, but sometimes used in the financing of existing assets," said Mike Hynes, Joint Managing Director at Stamford Capital.

"It's a subordinate debt instrument: the 'second' part of second mortgage implies that the bank is considered the first mortgagee, so it's debt capital that sits secured, but in second position, subordinate to the primary lender. It tends to be a fixed cost instrument that charges a rate of interest and doesn't usually participate in profit."

"It's a tool most often used by developers that want to be capital-savvy. Using debt instead of equity allows developers to drive their equity further. Organised, capital-savvy developers will bring in subordinate debt at the right juncture to relive their equity so they can be doing multiple projects rather than having capital concentrated on a single project."

Hynes explained how the market changed as a result of bank's reluctance to take on risk after the Global Financial Crisis and subsequently, the exit of foreign investment from the Australian market.

"Post-GFC, as the market was recovering, we still had a reasonably buoyant residential market, particularly apartments," he said. That was largely driven by foreign investors. In 2014/15, people would launched 200 units and they would sell out in a weekend. It was a pretty frothy market."

"The banks took some crazy positions pre-GFC and learned their lessons, and they've never retreated from their position. Then the regulator and the Royal Commission came in. The banks raised the bar back to where they required pre-sales for developments: if you were building 100 units, you had to sell half of them before you could bring in financing."

"That was the market until three years ago. Then the arse fell out of the market, because of the capital controls out of Beijing that stopped Chinese citizens buying real estate and the market evaporated overnight. The banks didn't adjust their credit

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policy: if you didn't have the pre-sale, you didn't get the financing. That's still the case. It's binary and they don't play at the edges.”

“What happened then was the non banks entered into the commercial real estate space. They saw that the banks wouldn't fund projects that the non banks were willing to take the market risk on to deliver units that they believed would be sold on completion. The dynamic has been that the bulk of project financing without pre-sales has been out of the non bank sector. That money is materially more expensive that borrowing from the bank.”

“The dynamic that we see now is that the residential market is back, and it's pretty bloody hot. People can get pre-sales again. We think that means that the banks will come back into the market as a lender for development projects.”

“If you buy a first mortgage of a bank and second mortgage off a mezzanine lender, the blend of those two interest rates is, from what we're seeing, still materially cheaper than the non bank alternative. You're borrowing the same money, but the banks coming back means that that cocktail is looking more attractive. We've already seen it in the flow of our business: we haven't seen mezzanine in three or four years, but we are now.”

This could create a new strategy for brokers to get a deal for their clients, and to double their outcomes too.

“One project can now yield two different deals, which presents a real opportunity for brokers,” said Hynes. :It aligns with what their customer needs. If developers can get equivalent leverage at a cheaper cost, even if it's two deals rather than one, money is money. Money coming into a development deal doesn't add a lot of value, it just pays bills. If it can be brought in cheaper, it'll only make sense to borrow cheaper capital.”

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