



# Role of Mezzanine Debt in Real Asset Financing: Introduction, European Market, and Impact of Interest Rates

# Introduction to Mezzanine Debt

## Understanding Mezzanine Debt and its critical role in bridging Financing Gaps for Real Assets

### The Role of Mezzanine Debt in Real Asset Financing

Mezzanine debt plays a crucial role in real asset financing, being particularly useful in large-scale real estate developments, infrastructure projects, and energy assets, where capital requirements exceed the limits of senior lenders but where owners prefer to limit equity dilution. Some of the key roles of mezzanine debt in real asset financing are:

- **Bridging the Capital Gap:** Mezzanine debt helps bridge the gap between the senior loan (typically 60-70% loan-to-cost) and the equity investment by the sponsor. This allows developers and investors to reduce the amount of equity they need to contribute, improving their return on equity (ROE).
- **Enhancing Capital Structure:** Since mezzanine debt is subordinate to senior debt but ranks above equity, it enables asset owners to maximize leverage without significantly diluting ownership. Investors can use it to enhance returns while preserving equity stakes.
- **Flexible & Structured Financing:** Unlike traditional bank loans, mezzanine financing offers flexible repayment structures, such as interest deferrals or payment-in-kind (PIK) interest. This is particularly useful for real asset projects with a construction period, seasonality or where cash flows may be delayed.
- **Facilitating Development & Acquisition Financing:** In real assets, mezzanine debt is often used to finance asset acquisitions, redevelopment projects, or large-scale infrastructure developments. It allows sponsors to secure funding beyond what senior lenders are willing to provide.
- **Providing Higher-Yield Debt Investment Opportunities:** Institutional investors, such as private credit or real estate/infrastructure investment funds, often seek mezzanine debt as a higher-yield fixed-income investment. Returns on mezzanine debt typically range from 8% to 15%, reflecting its higher risk appetite compared to senior debt, such as financing of dividend recaps or accepting merchant exposure on the cashflows.
- **Risk Mitigation for Senior Lenders:** Senior lenders are more willing to provide financing when mezzanine debt absorbs part of the risk. This structured approach helps balance the risk-return tradeoff for all parties involved.

**Mezzanine Debt is a strategic tool in real asset financing, enabling sponsors to optimize capital structures, enhance returns, and secure funding beyond traditional lending limits. While it carries higher costs and risks, it remains a valuable instrument for capital-intensive projects that require flexible funding solutions.**

### Current Investor Market Trend

- Mezzanine debt financing in Europe has attracted a diverse group of investors, including specialized mezzanine funds, insurance companies, and pension funds.
- These investors are drawn to the potential for higher returns compared to traditional debt instruments, as mezzanine debt often offers returns between 8% to 15% per year.
- Mezz Financing typically takes the form of bonds or loans and is appealing to buy-and-hold investors. These investors have a risk-return appetite resembling the position in the capital structure, attracting potential interest from equity-focused investors as well.
- With traditional banks imposing stricter lending criteria, companies are turning to mezzanine financing as a viable alternative. This shift provides businesses with the necessary capital without significant equity dilution.

**Apart from banks, alternative lenders have emerged as key players in European mezzanine debt financing, offering diverse and flexible funding options that cater to the evolving needs of businesses across various sectors.**

Source(s): Proprietary Research

# Benefit of Mezzanine Debt Financing in WACC Reduction

Exploring how Mezzanine Debt enhances Capital Efficiency and lowers Weighted Average Cost of Capital (WACC)

## How can Mezzanine Debt reduce WACC?

### Cost Efficiency Benefits

- **Lower Cost than Equity:** Mezzanine debt is cheaper than equity (10-30%), reducing the overall cost of capital.
- **Tax Deductibility:** Interest payments on mezzanine debt are tax-deductible, lowering the effective cost of financing.
- **Optimized Debt-to-Equity Ratio:** A balanced capital structure improves financing terms and investor confidence.

### Growth and Value Enhancement

- **Non-Dilutive Capital:** Raises funds without diluting ownership, preserving shareholder value.
- **Supports Expansion and Profitability:** Provides capital for growth, leading to higher valuations and reduced relative cost of capital.
- **Enhances Leverage for better Returns:** Allows companies to use leverage strategically for increased financial efficiency.

## Example of how Mezzanine Debt reduces WACC

WACC represents the weighted average cost of capital as a function of interest on debt and return on equity a company must pay to satisfy its debt and equity investors. Since equity is typically more expensive than debt, introducing mezzanine debt into the capital mix can lead to a lower overall cost of capital as shown below:

**Scenario: An independent power producer (IPP) is constructing a solar power plant with EUR 100m CapEx. To finance the project, the IPP has two options:**

### 1. Pure Senior Debt & Equity Financing:

- Senior debt (Bank Loan): 60% (EUR 60m) at 4% interest
- Equity: 40% (EUR 40m) with an expected return of 20%
- Corporate tax rate: 30%
- WACC calculation:  $(60\% \times 4\% \times (1-30\%)) + (40\% \times 20\%) = 9.68\% \text{ WACC}$

### 2. With Mezzanine Debt Integration:

- Senior debt: 60% (EUR 60m) at 4% interest and *mezzanine debt*: 20% (EUR 20m) at 8% interest
- Equity: 20% (EUR 20m) with an expected return of 20%
- Corporate tax rate: 30%
- WACC Calculation:  $(60\% \times 4\% \times (1-30\%)) + (20\% \times 8\% \times (1-30\%)) + (20\% \times 20\%) = 6.8\% \text{ WACC}$

**Result:** WACC is **reduced by 30%** (here: 2.88%-points) by introducing mezzanine debt.  
The benefit arises because debt is cheaper than equity, compounded by the tax shield.

### Key Takeaways:

1. **Tax Shield Effect:** The after-tax cost of mezzanine and senior debt is lower than equity, while preserving equity ownership, leading to a more efficient capital structure.
2. **Higher Post-Tax Profits:** Lower WACC increases the company's net income and overall valuation.
3. **Balanced Capital Structure:** While too much mezzanine debt increases financial risk, the optimal mix of senior, mezzanine, and equity can maximize returns while keeping financing costs low.

Source(s): Proprietary Research and r2's Internal Assessment

# Impact of Interest Rates On Mezzanine Debt Financing Market

## Understanding the Impact of Interest Rates on Mezzanine Debt Market and the growing Opportunity amid Rate cuts

### How Interest Rates impact Mezzanine Debt Financing

The overall volume of mezzanine financing tends to be lower in a rising interest rate environment due to higher costs, reduced debt capacity, and more conservative lending practices, while the volume is higher when interest rates fall, as lower borrowing costs and improved project economics make mezzanine financing more attractive to both borrowers and lenders.

**In case of lower rate scenario**, mezzanine financing becomes a more attractive option for both lenders and borrowers compared to senior debt and equity due to following reasons:

- **Relative increase of cost advantage vs. equity:** Interest on mezz debt is usually a function of base rate plus margin. Hence, declining interest rates reduce mezzanine costs correspondingly, and, with inelastic cost of equity, compounding the economic advantage of mezz debt over equity.
- **Relative increase of yield advantage vs. senior debt:** For investors, it becomes more attractive to move into mezzanine financing when interest rates decline, as the relative value of mezz vs. senior increases when the base rate goes down, with margin and hence yield pick up vs. senior becoming more important in the equation.

**To conclude, in a low-interest-rate environment, mezzanine financing becomes a sweet spot between rigid senior debt and expensive equity. It offers cheaper rates than before, higher leverage without equity dilution and more flexible terms vs. senior debt.**

### Interest Rates poised for Reduction in 2025 and beyond

#### Global Interest Rate Outlook

- Central banks worldwide are expected to reduce interest rates in response to slowing global growth and moderating inflation.
- According to the IMF's January 2025 World Economic Outlook, inflation is projected to decline to 4.2% in 2025 and 3.5% in 2026, prompting central banks to ease monetary policy.
- The Bank of England, U.S. Federal Reserve, and European Central Bank are expected to pivot toward rate cuts to support economic activity.

#### Why Interest Rates Are Expected to Decline

- **Falling Inflation:** Eurozone inflation has declined to 2.4% in February 2025, reducing the need for restrictive monetary policies. However, ECB President Lagarde warns that achieving a stable 2% inflation rate remains uncertain due to economic volatility.
- **Slower Economic Growth:** The eurozone's economic growth is expected to slow from 1.1% to 0.7% in 2025, impacted by weak exports and trade tensions. Potential U.S. trade conflicts could further dampen economic activity, while increased spending on defence could provide a balancing boost.<sup>1</sup>
- **Monetary Policy Shift:** Since June 2024, the ECB has implemented six rate cuts, lowering the deposit facility rate to 2.5%. While further cuts remain possible, policymakers stress the importance of flexibility in response to evolving economic conditions.
- **Financial Market Expectations:** Market analysts predict the ECB will cautiously adjust interest rates, balancing economic growth and inflation control. Lower rates are expected to improve liquidity, reduce borrowing costs, and support businesses and consumers across Europe.

**Key Takeaway:** Falling interest rates will expand the mezzanine debt market both from demand and supply side with cheaper financing rates for borrowers and increased relative premium for investors .

<sup>1</sup> We expect the German defence & infrastructure initiative to raise Eurozone yields, with increasing demand for private capital including mezzanine debt in these asset classes.  
Source(s): Reuters, ECB Report, IMF World Outlook 2025, and Proprietary Research

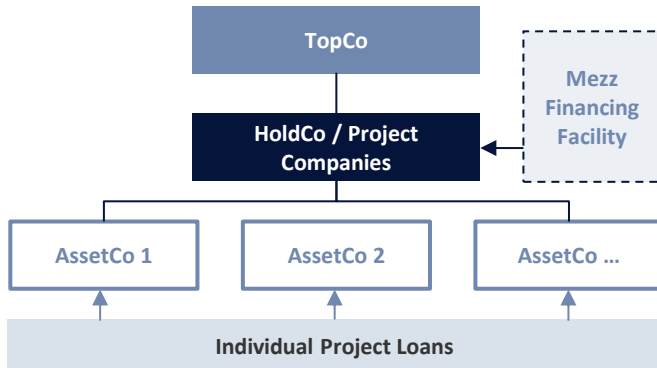


# Potential Structures and Indicative Terms

## An Overview of structural Options and indicative Terms for Real Asset Mezzanine Debt Financing

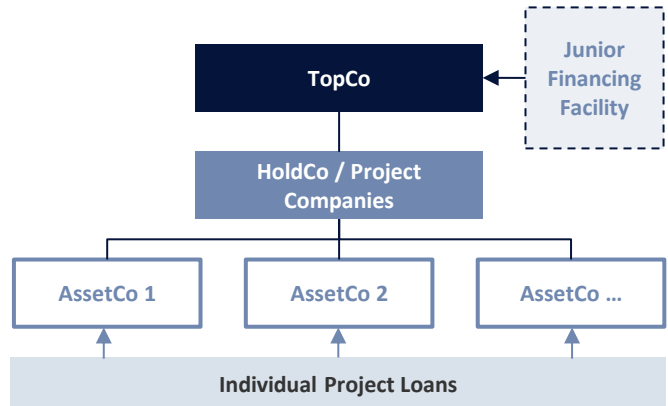
### Structural Options

#### A. HoldCo at Intermediate Level



- Financing granted at the level of HoldCo
- Interest + principal are funded from projects' cash flows without recourse to TopCo
- Formally, financing will be senior at HoldCo but structurally subordinated to project loans
- Mezz Debt will replace project equity
- Secured against shares in HoldCo and 2nd pledge in AssetCo

#### B. Junior Debt at TopCo Level



- Financing granted at the level of TopCo
- Interest + principal are funded from overall corporate cash flow, exposed to non-project risks
- Financing will be structurally subordinated to project loans and corporate debt
- Junior Debt to replace project equity
- Secured against 2nd pledge over shares of HoldCo and AssetCo

### Indicative Terms for Energy Transition Assets

|                                    |                                 |
|------------------------------------|---------------------------------|
| Term                               | 5-7 years                       |
| Make-Whole Period                  | 2-3 years                       |
| Amortisation                       | Bullet or Soft Bullet           |
| Modelling Tenor                    | Adjusted to assets' useful life |
| Margin / Interest Rate             | mid-swap +350 – 700 bps         |
| Investor Fees                      | +/- 1%                          |
| WACC (5 Years Term, 2.5% mid-swap) | 6.2% - 9.7%                     |

Source(s): Proprietary Research and r2's Internal Assessment

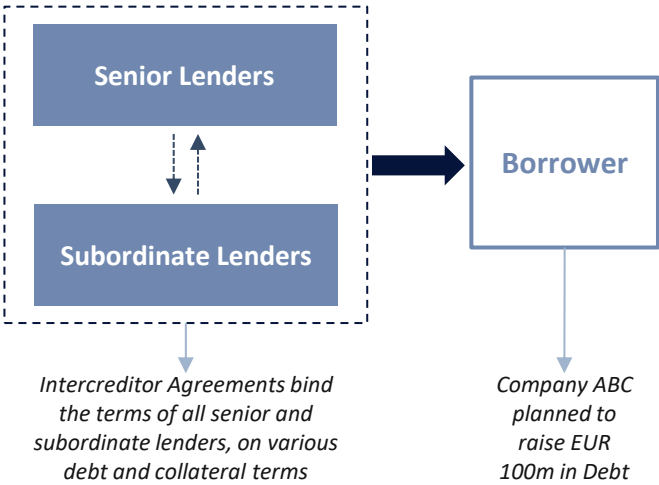
# Intercreditor Agreements in Mezzanine Debt Financing

## Defining Rights and Priorities in Intercreditor Agreements

### What are Intercreditor Agreements (ICAs)?

Given its subordinate nature, mezzanine debt introduces complexities regarding repayment, control rights, and risk-sharing between senior and mezzanine lenders.

Intercreditor agreements (ICAs) are critical in mezzanine financing as they establish a structured framework for managing these complexities. These agreements define the relationship between senior and mezzanine lenders by outlining their respective rights, obligations, and priorities in scenarios such as loan defaults, restructuring, or insolvency. By providing clarity and reducing ambiguity, ICAs help prevent disputes, ensure smooth financial operations, and safeguard the interests of both lenders and borrowers.



### Key Functions of Intercreditor Agreements

#### Priority of Claims and Debt Repayment

ICAs define repayment priority, ensuring senior lenders receive funds first. This reduces senior lender risk while mezzanine lenders accept subordination for higher returns, preventing conflicts and enabling structured debt settlements.

#### Control Rights and Decision-Making Authority

ICAs establish lender control over financial decisions, with senior lenders having greater influence. Mezzanine lenders may negotiate protections, ensuring structured decision-making during defaults, asset sales, or borrower restructuring situations.

#### Payment Blockage and Standstill Provisions

Senior lenders may block mezzanine payments during borrower defaults. Standstill provisions delay mezzanine enforcement actions, allowing senior lenders time to restructure debt, ensuring stability, and preventing rushed, conflicting recovery actions.

#### Equity Participation and Dilution Protection

ICAs govern mezzanine lenders' equity participation, defining conversion rights and dilution protection. These provisions prevent excessive ownership dilution when senior lenders convert debt into equity, maintaining fairness in distressed scenarios.

#### Amendment and Waiver Rights

ICAs require lender consent for loan modifications, ensuring fairness. Waiver provisions allow covenant breaches to be temporarily resolved, preventing unnecessary defaults while maintaining stability and lender interests.

#### Enforcement Rights and Default Remedies

ICAs outline lender actions in borrower defaults. Senior lenders enforce first, while mezzanine lenders may wait. This structured approach prevents conflicts, ensuring orderly debt recovery and financial stability.

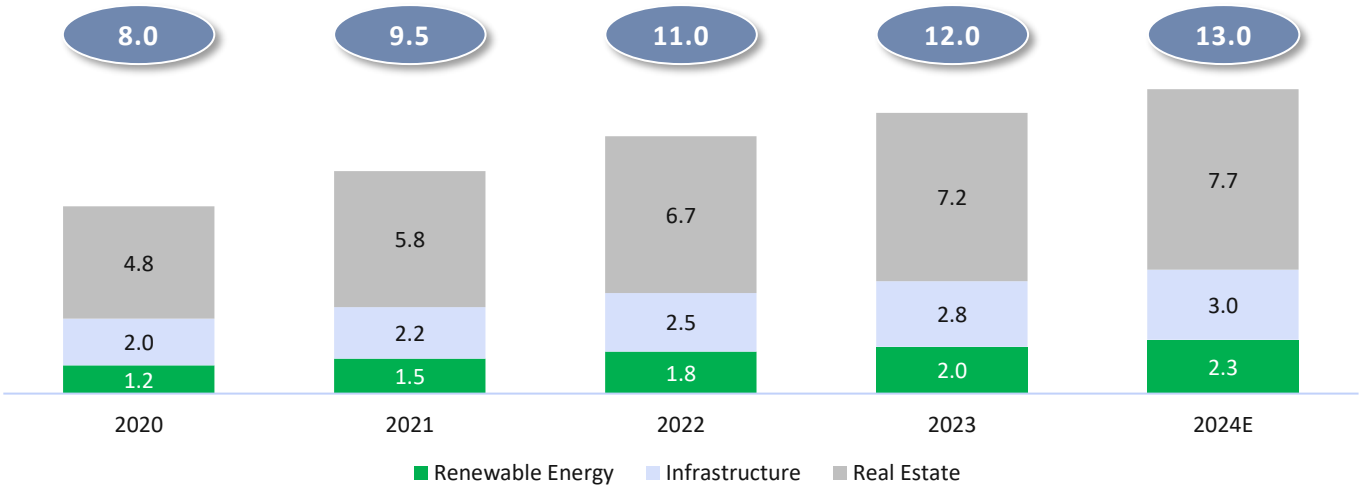
Source(s): American Association of Private Lenders, Proprietary Research and r2's Internal Assessment

# European Market for Mezzanine Debt for Real Assets

## Trends and Opportunities in the European Mezzanine Debt Financing Market for Real Assets

### Overview

The graph below shows approximate annual volumes of mezzanine financing (in EUR bn) from 2020 to 2024 across Europe, broken down by three major industries: **renewable energy, infrastructure, and real estate**:



### Key Insights and Trends in the Market

#### Renewable Energy

The renewable sector shows steady growth in mezzanine financing, driven by the rapid expansion of solar, wind, and other green energy projects. Increasing policy support and investor interest in sustainability have helped boost capital flows.

#### Infrastructure

Infrastructure projects spanning transportation, utilities, and digital connectivity, have seen a moderate but consistent rise in mezzanine deals. These transactions often support large-scale projects that require a blend of senior debt and more flexible mezzanine layers.

#### Real Estate

Real estate remains the largest segment by volume. The sector benefits from mezzanine financing to bridge equity gaps in development and acquisition, allowing sponsors to optimize leverage while preserving control.

### Conclusion

Mezzanine debt plays an important role in the financing of real assets in Europe. It can help sponsors to recycle their equity, lower their cost of capital and generally, increase financial flexibility.

A financial technique initially applied in real estate financing, it has gained increasing importance in other real asset classes, such as infrastructure or renewable energy assets.

The rise of mezz debt has spurred the surge of dedicated mezz debt providers, such as debt funds, which close the gap between the risk-return appetite of senior lenders and equity investors.

With the expected decline of interest rates in Europe in the coming years, mezz debt will likely expand its volumes and increase its relevance for sponsors and investors alike.

Source(s): PwC, Deloitte, Industry Associations, Proprietary Research and r2's Internal Assessment

# Real Assets Mezzanine Debt Financing Transactions

Examples of selected Mezzanine Financings in Europe in the past few Years

| Deal Date | Location | Sponsor                    | Investor  | Deal Description  | Deal Size (EUR m) |
|-----------|----------|----------------------------|---|---|-------------------|
| Jul-24    | Poland   | DL Invest                  | Invesco Real Estate Europe Fund III                 | Invesco Real Estate Europe Fund III issued a EUR 20m mezzanine loan secured against a new 124,000 square meter logistics facility in Psary, Poland.             | 20                |
| Mar-24    | Germany  | Coversol Solar Investments | ETIC Partners                                       | Coversol Solar Investments secured EUR 30m in financing for its 29 MWp Italian rooftop solar portfolio, comprising EUR 6m in mezzanine debt from ETIC Partners. | 6                 |
| Oct-23    | Germany  | Münch Energie              | Prime Capital AG                                    | Münch Energie Group secured a mezzanine financing for a photovoltaic portfolio of approximately 125 MW.   | 21                |
| Jul-23    | Germany  | Umwelt Management AG       | RIVE Private Investment                             | The company closed a EUR 9m mezzanine facility, to refinance two German wind farms, producing renewable energy for 15,000 households.                           | 9                 |
| Jul-23    | Germany  | MaxSolar GmbH              | Infranity, I Squared Capital, and Rivage Investment | MaxSolar secured EUR 410m mezzanine financing from international infrastructure investors for its German solar portfolio.                                       | 410               |

Source(s): Press Releases and Proprietary Research



# About the Authors



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Stefan has 25 years of experience in international structured finance, specializing in asset-based finance and energy transition. With a proven track record in managing transactions up to EUR 500 million, he brings expertise in equity, DevEx, Mezz Debt, Whole Loan, and Construction Finance for Energy Transition assets.



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