Global Debt Market Update: Key Perspectives and Trends
Global Debt Market Update

After an active 2018, global commercial real estate markets remain liquid though investors are increasingly selective and cautious.

**Fundraising by private closed-end real estate debt funds has totaled US$14.9 billion, with 17 funds closing in the first half of the year.**

With a further 73 funds still slated to close, seeking a combined US$31.2 billion, the market remains active. In line with the trend seen across much of the real estate private equity space, investors have increasingly flocked to the biggest debt funds. Between 2010 and 2014, 38% of all capital raised by private closed-end real estate debt funds went to funds that closed at US$1 billion or more. For the period from 2015 to YTD 2019 this figure is an increased 52%.

**Closed-end private real estate debt fundraising volume**

The majority of the private real estate debt capital raised so far in 2019 is expected to be allocated to markets within the U.S., in line with the trend seen historically. Since 2010, more than two-thirds of all private closed-end debt capital raised has targeted U.S. markets. Up until 2018, CMBS, first mortgages, senior debt, and mezzanine financing have been the most targeted debt products, however, 2019 has seen capital target funds that focus on non-performing and sub-performing loans and distressed debt, an indication that some investors have concerns over cycle longevity.

**Aggregate value of negative yielding debt rises to US$15.5 trillion**

The proliferation of negative yielding debt has been rapid. This year alone the total value of all bonds trading with negative yields has nearly doubled, rising by 85% to US$15.5 trillion, an all-time high.

But it’s not just in mature markets, many of which are facing stubbornly low inflation and tepid growth, that we’ve seen the rise of negative yielding debt. Emerging markets such as Poland, the Czech Republic and Hungary have also had negative yielding offerings in recent months. The trend has not been limited to sovereign debt; significant chunks of the European corporate bond market now trade with negative yields. With many central banks expected to continue easing monetary policy in the coming months, the bond rally looks likely to continue.

**Source:** Bloomberg

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Are debt markets ready to phase out LIBOR?

In 2017, the Financial Conduct Authority announced that starting from 2021 it would no longer require institutions to provide LIBOR quotes, effectively phasing out its use as a benchmark interest rate. With over US$370 trillion in financial products tied to LIBOR, including a considerable volume of commercial real estate loans, the change has significant implications for the industry. Many contracts which were originally priced in LIBOR will have to be renegotiated and some borrowers may face higher rates.

While the Federal Reserve’s ‘Secured Overnight Financing Rate’ (SOFR) has been chosen in the U.S., the Bank of England’s ‘Sterling Overnight Interbank Average’ (SONIA) is the preferred benchmark in the UK. Meanwhile there are separate rates in Japan and Switzerland while the European Central Bank is currently developing its own index. While both SOFR and SONIA will be entirely transaction based, as opposed to LIBOR which was not, and provide greater transparency and confidence, the shift could lead to market instability.

U.S. themes

Total originations rise in H1 2019

U.S. debt markets remain liquid and active as the first half of 2019 saw a total of US$277.2 billion in debt origination, an increase of 10.6% from the same period last year. The continued strength of the commercial real estate market, combined with falling long term rates, has supported the uptick in activity in debt markets so far this year.

Commercial banks remain the largest lenders, representing nearly a third of all originations in H1 2019. Originations for government sponsored enterprises and life insurance companies continued at record paces during the first half of the year, as did originations of loans backed by multifamily and industrial properties.

The CMBS market remains healthy though lending slowed by 10.9% during the first half of 2019. Nevertheless, conduit lending is expected to pick up in the remaining months of the year with seven transactions totaling US$7.2 billion expected to close in September. With a further US$5 billion tentatively scheduled for October, the conduit market looks set for a strong finish to the year.

Total U.S. originations by lender type

Source: Mortgage Bankers Association
Interest-only structures gaining prevalence

Interest-only structures are dominating new CMBS issuance. In 2011 and 2012, fully amortizing loans made up the majority of new issuance, representing an average of 76% of originations in those two years. Since then, interest-only amortization structures have become increasingly prominent, not only overtaking fully amortizing loans but coming to make up 53% of all originations in 2019.

The increase in interest-only loans comes at a time when real estate markets remain liquid, competition for lending has increased, and refinancing opportunities are lower relative to a few years ago. With more capital now available for fewer transactions, lenders are loosening underwriting standards leading to an increased number of interest-only transactions.

Preference for fixed-rate loans hits new high

Debt is abundant throughout the capital stack. Debt markets continue to be extremely liquid thus far in 2019. Borrowers are increasingly opting for fixed rate vs. floating rate loans at historic levels due to interest rate volatility. Lenders are ever conscious of the collateral which has increased the need for mezzanine loans or preferred equity.

Insurers remain competitive

Insurance companies remain competitive in the debt space and continue to be a great source of capital. Nearly all insurance companies are on pace to reach their 2019 allocations, many of which had increased their allocations from 2018.

Multiple insurance companies have separate account programs, providing additional liquidity and abundant options of capital for origination. Insurance companies are able to provide capital for 3,5,7,10,15,20, and 30 year mortgages. Insurance company originations totaled US$39 billion in the first half of 2019, up 1% from the same period last year.

Banks hungry to lend

Commercial Banks are aggressive for commercial real estate loans. Banks are competing for both fixed (3,5,7, and 10 year terms) and floating rate debt as well. Banks continue to be aggressive on transitional properties and those with stable cash flow. They are very active for construction and pre-stabilized deals and continue to offer very low yields/spreads. Bank originations in H1 2019 are up 12% year-on-year, to US$49 billion.

Share of U.S. CMBS issuance by amortization type

Source: Bloomberg
European themes

Rise of alternative lenders

Traditional investment banks are operating with more caution with the lingering impacts of the global financial crisis having increased regulation for banks, resulting in a more limited real estate lending environment. The dynamics between long established real estate debt investors and newer lenders are shifting. New lenders such as debt funds and asset managers - "other lenders" outside the conventional lending regulation of banks and insurers - are growing.

In the UK for example, although domestic banks retain the largest share of origination volumes their share has shrunk and stabilized to around 40%. Furthermore, the diversification of lenders has increased from 10 years ago with other lenders increasing their share of originations to 11% in 2018.

Slowing investment market increasing competition for lending

Among other factors, upward pricing pressure has squeezed returns and decreased the volume of equity investment activity in Europe. As a result, there is growing interest for debt capital investment strategies as debt yields increasingly match the appetite of investors’ risk-adjusted return profile.

US$13.6 billion in private debt dry powder is available globally to invest in Europe. However, with the number of trades slowing in 2019 due to global uncertainty, Brexit, and trade wars, among other factors, margin compression and, in rare instances, a drift towards covenant-lite loans has been witnessed, as more lenders compete for fewer deals. As a result, covenant packages comprising of LTV, interest coverage, or debt service requirements are increasingly being waived at origination by U.S. investment banks for best in class sponsors.

Signs of continued weakness in the retail sector

The current state of the retail market in Europe has left lenders cautious to originate loans. The share of outstanding retail property debt in the UK fell from 27% of total debt in 2007 to just 15% in 2018. The challenge remains that secular trends and falling values, alongside a lack of comparable transactions has created uncertainty for lenders.

Whereas senior LTVs reached upwards of 85% prior to the crisis, leverage levels for new originations in the last six to 12 months have stabilized between 40% and 50%. There are, however, many existing retail loans that are above this leverage point due to declining property values in the sector. In addition, debt funds and other value-add or opportunistic lenders are pricing in considerable margin premiums to finance retail assets.

Share of total UK originations by lender type

Source: Cass Commercial Real Estate Lending Survey
Some segments of the European debt market have reached a point of maturity, including selected core markets such as Paris, Dublin and Amsterdam. Core assets in countries such as Belgium and Spain still offer value given their strong fundamentals. Tightening lending regulations following the GFC have no longer made leverage a key risk factor which has stabilized LTVs between 50% and 60% from 70% to 75% in 2007 for senior debt. A greater emphasis on margin compression has been driven by the increased capital chasing fewer deals, especially in core markets such as Germany and the UK.

European debt market highlights by country

United Kingdom

- Despite uncertainty surrounding Brexit and softening of the investment market, year-on-year loan originations increased 12% in 2018 to £45 billion. Non-bank lenders have been particularly active and have helped to push forward origination volumes since the GFC, and now make up between 30% and 40% of total originations.
- Average LTV ratios have settled in at around 55% to 60% across most sectors and regions although the upper boundaries exceed this and can reach upwards of 70% to 75% LTV for stretch senior debt. Prior to the GFC, the outstanding loan book was closer to 80% for senior prime assets.

France

- Financing of commercial real estate remains dominated by the major French banks such as BPCE, Crédit Agricole Group, Crédit Mutuel, etc., and also the public investment bank BPIfrance.
- New non-bank players have played an increasingly important role in lending with the introduction of the European ELTIF Regulation in 2016 which allowed French investment funds to grant loans. Since then, there has been an increase in the value of unitranche, mezzanine and subordinated debt issued by French institutions, while the value of senior debt issued has stayed relatively stable. As senior debt is usually financed by banks, the increase in the other types of debt could be explained by the new regulation.

Germany

- Lending volumes for 2019 are expected to be similar to 2018. Regulatory oversight remains high, as does pressure on margins in the competitive banking sector. The view from a majority of market participants remains that the real estate cycle is at a peak.
- While real estate capital values in Germany keep rising in most segments, many banks have reduced their tolerance to take on risk while others have reduced the LTVs they are willing to lend on.

Netherlands

- Financing remains liquid and repayments have been replenished, but overall the Dutch financing market is not experiencing the robust growth that other regions in Europe have. This is mainly due to the fact that Dutch banks are generally unwilling to meaningfully expand their existing loan books.
- Investors seeking debt are welcoming the increasing presence of German lenders who generally offer lower margins, alongside competitive covenant structures and relatively quick execution processes compared to domestic lenders and other cross-border debt funds.
Asia Pacific themes

Banks still lead the way in Asia Pacific

Banks still lead public and private trades in debt for real estate in Asia Pacific. This is mainly because the bulk of deals are well capitalized and generally stabilized. Only recently has there been an increase in demand for development finance or finance for value-add assets as investors seek yield.

The higher up the risk curve one goes the harder it is to get conventional credit. We have seen the non-bank market evolving and becoming more institutional in Asia Pacific. Though this is common in the U.S. and is becoming increasingly so in EMEA, debt orientated investment platforms are still steadily developing in the Asia Pacific markets.

Benchmark rates trending lower

Yield curves across major markets have flattened out, which has improved financing costs and fixed rates for investors on medium term debt facilities. The most notable change is in Australia, where the benchmark (government bond curve) has fallen 140-160 bps at the 3-5 year terms since the start of the year. The Reserve Bank of Australia has also cut the overnight base rate to a record low of 1.00%. Elsewhere in the region, benchmark yields have been falling, albeit at varying levels. Typically, five year rates have fallen by 25 basis points to 100 basis points across core Asian markets.

Change in benchmark rate curve (Dec 18 to August 19)

Source: Australian Prudential Regulation Association

Regulatory pressure builds in some markets

On the lending side, we continue to see more activity in the market from non-bank lenders and offshore lenders, as regulatory disconnects and distressed opportunities open up new avenues to deploy capital. Banks remain strong in core-stabilized deals, but leverage limits remain under pressure and development finance has become more selective.

Regulators continue to apply more pressure on banks to clean up their NPL books in markets such as China and India, which has opened up opportunities for non-bank lenders to provide alternative solutions for more distressed projects. China has also reportedly made moves to restrict credit from other funding sources for developers, including the issuance of bonds and ABS.

Non-bank lending continues to grow

The presence of non-bank lenders also continues to expand, with debt funds and insurers leading the way. A number of traditional real estate investors have also set up new debt platforms for more structured deals and distressed assets, as well as NPL portfolios. Non-bank lenders have also been active in financing alternative asset class deals, as banks remain cautious on less established sectors, particularly those that are more operationally intensive.

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Asia Pacific debt market highlights by country

**Australia**
- Offshore banks in Australia have become a prominent lending source, as domestic banks concentrate their focus on the residential market.
- Given the relatively wide lending margins on commercial debt, banks from China, Singapore and Japan have been very active in expanding their presence in Australia.
- Foreign banks have increased their total loan exposure in Australia by over 200% between March 2015 and March 2019, surpassing AUD $50 billion.

**China**
- A greater number of debt investors are turning their attention toward China with tightening onshore credit controls giving rise to offshore platforms looking for ‘mezzanine’ structures for well-capitalized institutional clients.

**India**
- The Reserve Bank of India has halted its restructuring program for banks which are being forced to apply stricter lending criteria to prevent any addition to their NPL pile. This balance sheet pressure has caused banks’ commercial real estate exposures to flatline over the last two years.
- Non-bank financial companies initially stepped in to fill the void, but looser lending standards and oversupply in some areas of the market have led to additional distress.
- Equity investors are looking closely at developer acquisition or land banking opportunities due to the dislocation in the market, which will create new opportunities for lenders to deploy capital.

**All other markets**
- Singapore, Korea and Japan continue to enjoy strong highly liquid bank credit markets with strong client relationships built up over many years being favored over new comers.
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