# Real estate debt lending

## Global Whole Loan market opportunity

**July 2023**

# EXECUTIVE SUMMARY:

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Whole Loans, an established strategy in the US and increasingly adopted in Europe, offer attractive risk-adjusted returns to investors with appetite for slightly higher Loan-to-Value (LTV) ratios relative to senior lending.

The risk management benefits of Whole Loans for lenders include the security of a senior mortgage, loan management flexibility, and defensive properties that reduce exposure to the original underlying asset value over time.

For borrowers, Whole Loans provide the opportunity to achieve higher leverage with a single-lender solution, offering affordability and positive implications for their equity costs.

The Whole Loan markets in the US, Europe, and Australia present distinct opportunities. The mature US market offers efficient deployment of capital, the evolving European market offers better pricing power for lenders, and the emerging Australian market is underserved, offering potential growth for non-bank lenders.

Future market conditions are expected to favour lenders due to two key factors: the impending need to refinance large volumes of maturing debt and the widening debt funding gap caused by declining property values and rising base rates. Whole Loans stand out as a key strategy to address these challenges and provide robust investment opportunities.

## A GLOBAL OPPORTUNITY

Taking the lead from the US, the European commercial real estate debt markets have evolved significantly over the last decade with a variety of products, strategies and lenders serving the industry. In more recent years, non-bank lenders have increasingly focused on Whole Loan debt strategies that benefit from first ranking mortgage security over the underlying asset, and lend at slightly higher LTVs than the levels at which banks and insurance lenders are able to given their more conservative regulatory constraints.

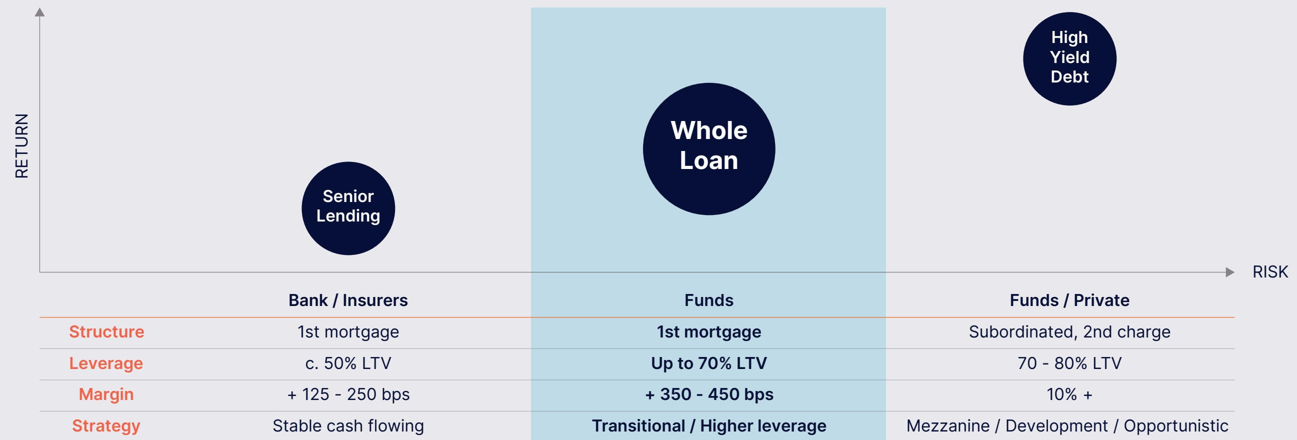
While it is challenging to be very prescriptive about the characteristics of Whole Loans, figure 1[1] provides general values in comparison to Senior and High Yield lending. Typical LTVs for Whole Loans are up to 70% and carry margins in the 350-450 bps range. Of course, these will vary across sectors and what might constitute a Whole Loan can vary significantly especially depending on how much traditional senior leverage is available by sector. Whole Loans have grown in popularity over the last few years both from a lender's perspective, and also because of demand from borrowers.

From the lender's perspective, Whole Loans retain the benefit of a senior mortgage and are typically provided by a single lender. These characteristics are an important risk management feature of these loans. The senior mortgage secures the priority ranking on all recoveries and as a single lender, there is greater flexibility to manage the loan over its life.

1 DRC Savills Investment Management LLP estimate as at Q1 2023

**FIGURE 1:**

What is a Whole Loan




| | Bank / Insurers | Funds | Funds / Private |
|---|---|---|---|
| Structure | 1st mortgage | **1st mortgage** | Subordinated, 2nd charge |
| Leverage | c. 50% LTV | **Up to 70% LTV** | 70 - 80% LTV |
| Margin | + 125 - 250 bps | **+ 350 - 450 bps** | 10% + |
| Strategy | Stable cash flowing | **Transitional / Higher leverage** | Mezzanine / Development / Opportunistic |

> Commercial real estate debt markets have evolved significantly over the last decade with a variety of products, strategies and lenders serving the industry.

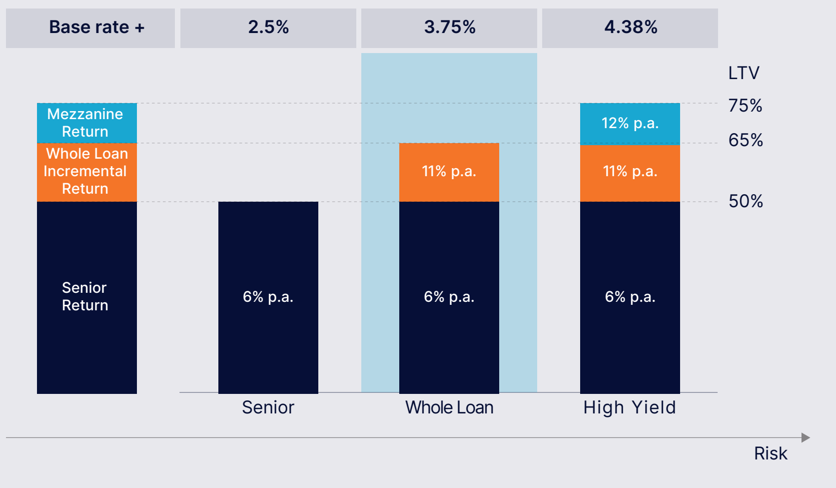
In terms of returns, figure 2[2] illustrates the incremental return for the extra leverage provided by a Whole Loan by comparing a Senior loan priced at base rate + 2.5% at 50% LTV with a Whole Loan priced at base rate + 3.75% at 65% LTV. The return on the extra piece of leverage in the Whole Loan that goes from 50-65% is more than 11%. The high incremental return reflects the fundamentally different cost of capital that the predominance of providers of Whole Loans have versus banks who dominate the senior market.

Another advantage for lenders are the defensive properties of cash paying loans. Whole Loans typically amortise over time reducing the principal outstanding, and when taking into account the interest income over the term, from an original capital deployed perspective, lender exposure to the original underlying asset value reduces significantly over time as amortisation and interest is received.

> From the lender's perspective, Whole Loans retain the benefit of a senior mortgage and are typically provided by a single lender. For borrowers, Whole Loans provide the ability to achieve higher leverage with a single lender solution.

**FIGURE 2:**

Attractive for Lender and Borrower




2 DRC Savills Investment Management LLP estimate as at Q1 2023

From the borrower perspective, Whole Loans provide the ability to achieve higher leverage with a single lender solution. This is particularly important given the current and future macroeconomic environment with most borrowers facing higher LTVs with their maturing loans. Furthermore, relative to most borrowers' cost of equity, Whole Loans are still affordable (just!) and accretive. The attractive characteristics of Whole Loans are found across the globe and geographic differences can offer some further diversity when investing in this strategy. The US is the largest and most established market, with a single legal framework and sophisticated borrower, lender and advisor base. Capital can be deployed quickly and efficiently, which leads to a more competitive pricing environment with multiple providers of loans and in general a tolerance for higher risk taking.

In Europe, the market is still in the process of maturing with a wide variety of different legal systems and market structures making it not as efficient as the US. While pricing power is better for lenders, it is arguably more difficult to source opportunities in Europe, meaning the origination reach of the debt manager becomes much more important. Less competition generally leads to a bit more return for the equivalent risk when compared to the US.

Finally, Australia is an interesting emerging opportunity with a lender friendly legal environment similar to the UK and a narrow heavily regulated banking sector. Historically, non-bank lenders in this market have focused on higher return opportunities, leaving the Whole Loan space underserved.

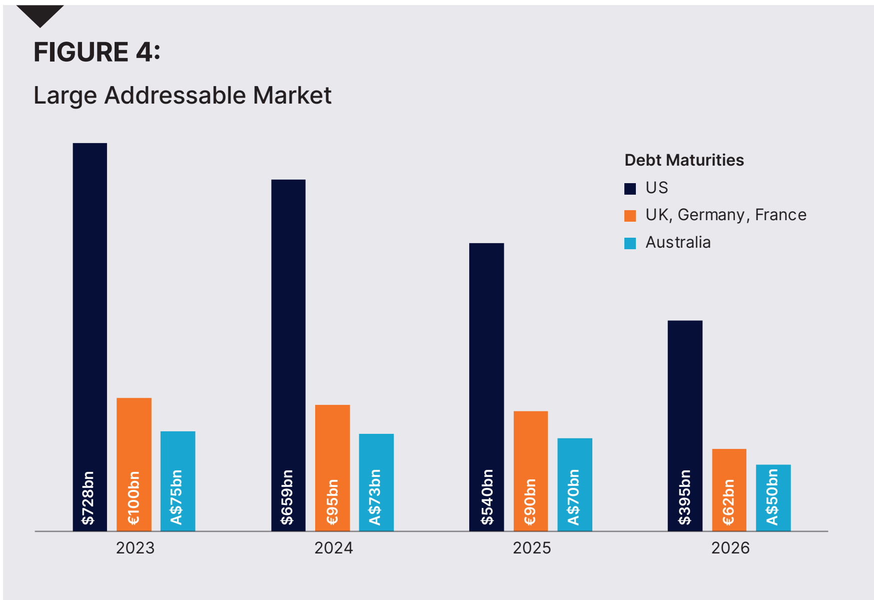
Figure 3[3] reflects the maturity of these markets in terms of diversity of lenders active in each geography. The variety of different types of non-bank lenders in the US offers clearly the most choice for borrowers. Some of the tools available in the US such as agency lenders do not exist in the rest of the world. Coming out of the GFC, Europe was dominated by banks, but this has evolved over time to become much more diversified. In some ways Australia looks a lot like the state of the market 10 years ago in Europe with banks still dominant thus leaving plenty of growth for non-bank lenders. The supply/demand imbalance is expected to be very much in the favour of lenders for the foreseeable future as a result of 2 key factors.

First, there is a large volume of debt maturing over the coming years across all the geographies that will need to be refinanced (Figure 4)[4]. Given the contraction in credit from banks hitting just as maturities are peaking, borrowers are more likely to seek financing from alternative lenders with capital to deploy. In general, these lenders can improve the quality and terms of their loans because of the reduced competition from the traditional lenders.

The second factor compounding upcoming maturities is the dual effect of lower underlying property values and the increase in base rates. This results in reduced available leverage for a given property and increases the funding gap (figure 5)[5]. i.e. the difference between the existing debt on a property and what is currently estimated to be available for refinance. The dramatic rise in base interest rates across most developed economies over the last 12 months means actual affordability of interest is in most cases the limiting factor in the amount of sustainable debt a property can carry.

**FIGURE 3:**
Lender Diversity Across Markets

3 [1] Mortgage Bankers Association (March 2023); [2] Bayes Business School (2022); [3] DRC Savills Investment Management LLP estimate as at Q1 2023.

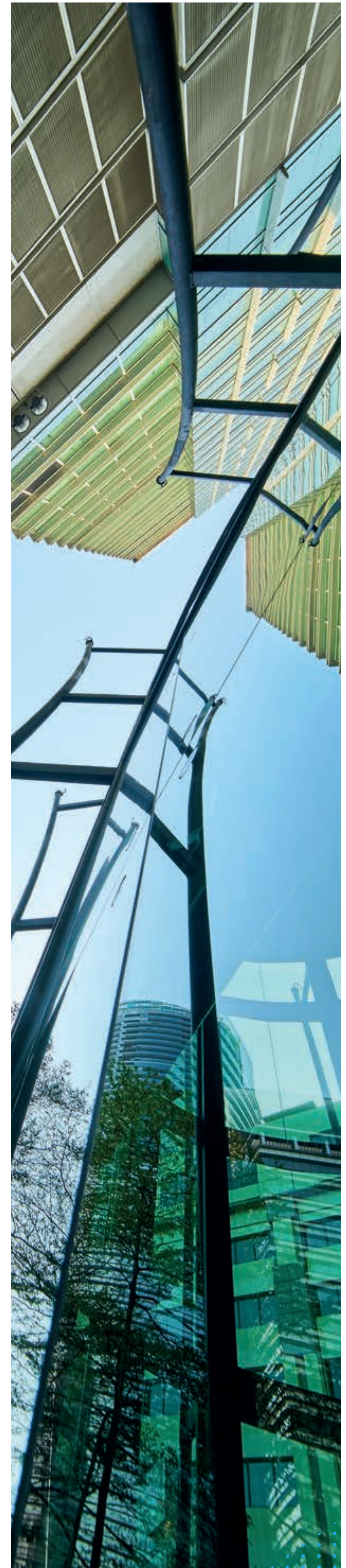


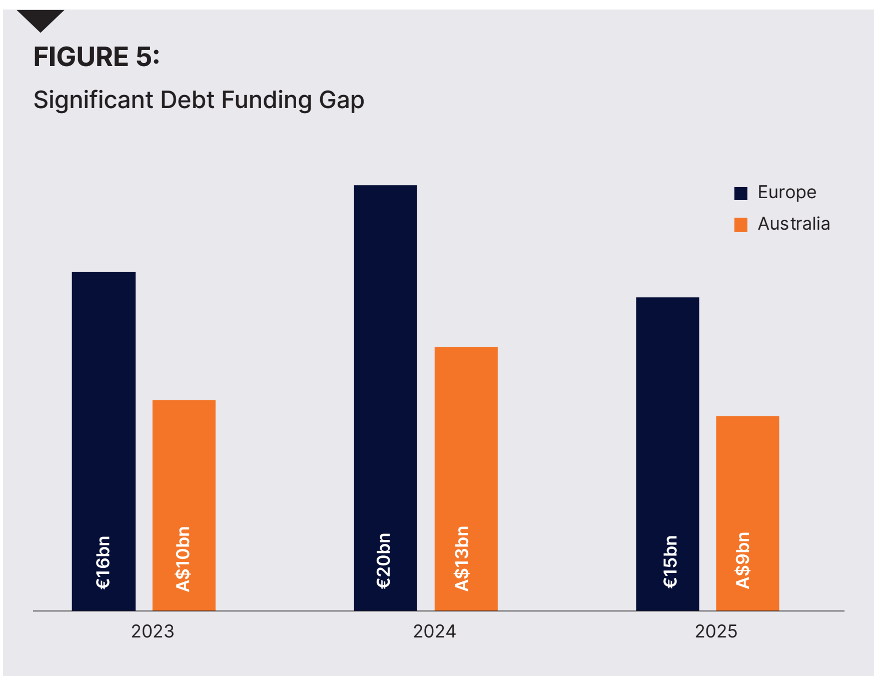

Borrowers lacking further equity to pay down existing debt will be driven to seek alternative financing strategies such as Whole Loans.

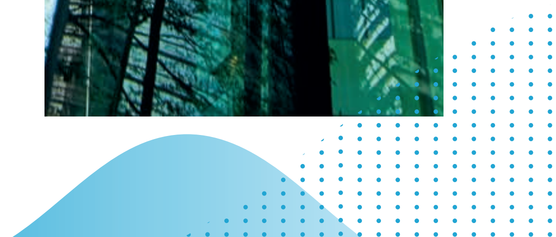
These two factors will result in Whole Loans playing a big part in the market opportunities emerging in real estate debt globally. Furthermore, supply/demand dynamics in real estate debt have become much more favourable for lenders in general. Investors looking to tap into Whole Loans can also gain geographic diversity and benefit from different market dynamics globally.

4 US/Europe: Mortgage Bankers Association (March 2023); Bayes Business School (2022); Banque de France and PwC (December 2021), Board of Governors of the Federal Reserve System (US): as of March 2023. Australia: DRC Savills Investment Management LLP estimate as at Q1 2023

5 Europe: AEW Monthly Research Report: January 2023.
Australia: DRC Savills Investment Management LLP estimate as at Q1 2023.





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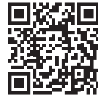

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