PEAK INSIGHTS

2018 U.S. CRE Permanent Debt Market Outlook

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Foreword from the Executive Office

To our Valued Clients, Partners, and Prospects:

2017 was an exciting year for PGIM Real Estate Finance. In addition to changing our name to reflect our considerable global and domestic capabilities, we had a very successful year meeting our clients' commercial, multifamily, and agricultural financing needs. To further solidify our reputation as a best-in-class partner, we continue to invest in improvements that will provide our clients with even greater value. In today’s complex macro environment, we recognize the need to have the best possible information with which to make educated decisions. This inaugural ‘Peak Insights’ piece is our first step toward providing you with just that.

In 2018, we look forward to maintaining our many long-standing relationships and cultivating exciting new ones as well.

David Durning
President & Chief Executive Officer
Note from Chief Investment Officer page 4

2018 is set to be a good year to borrow. Lenders need to remain disciplined given the mature phase of the credit cycle.

Paige Hood, Chief Investment Officer and Senior Portfolio Manager

Debt Market Themes and Outlook page 5

Plenty of liquidity will lead to spread compression. Return of market volatility could dampen origination levels.

Alison Jacobs, Director of Research and Thought Leadership

Breadth of Capital

Portfolio page 6

Strong life insurance company demand will lead to tighter credit spreads and select secondary market lending.

Christine Haskins, Managing Director, Portfolio Management
Marcia Diaz, Managing Director, Head of Global Originations

CMBS page 7

Spread compression and rising rates will make CMBS more competitive with other capital sources.

Alison Jacobs, Director of Research and Thought Leadership

Agency page 8

Agencies will have another strong year and will focus on uncapped business.

Michael McRoberts, Managing Director, Conventional Fannie Mae and Freddie Mac

FHA page 9

HUD will continue to provide liquidity to the multifamily and healthcare space.

Hal Collett, Managing Director, FHA and Affordable Lending

Affordable page 10

Agencies and FHA remain committed to supporting affordable housing.

Hal Collett, Managing Director, FHA and Affordable Lending
We entered 2017 under a backdrop of caution. Domestic and global political uncertainty was high. There was a lot of discussion around where we are in the cycle and how much longer the “good times” could last. Every conversation about real estate seemed to start and end with the demise of retail. And yet, 2017 proved to be a good year for borrowers and lenders alike. Borrowers benefited from relatively stable interest rates and abundant liquidity that led to tighter credit spreads. Lenders benefited from a wave of loan maturities, respectable acquisition volume, and borrowers looking to recapitalize given slowing equity appreciation and the prospect of rising interest rates.

We move into 2018 with many reasons to feel confident. Global economies are firing on all cylinders. Domestically, stocks recently reached an all-time high, consumer confidence is elevated, unemployment is low, and newly passed tax reform should give the U.S. economy a short-term boost. By most accounts, the cycle has been extended.

2018 OUTLOOK

But it’s not all blue sky on the horizon. Interest rates are set to rise further, increasing the cost to borrow and potentially putting downward pressure on property values. With acquisition activity declining and fewer loan maturities, particularly in CMBS, loan demand will be lower in 2018. A return to a more volatile capital markets setting, which has characterized much of the post-GFC recovery, or unforeseen geo-political events could impair origination volumes.

Ample liquidity in the debt capital markets — driven by lenders having more money to put to work than borrowers need — will compress credit spreads and may lead to looser loan structures and credit metrics. While a positive for borrowers in the short term, lack of lender discipline may create refinancing issues down the road.

Lenders will need to exercise restraint as credit spreads compress, competition increases, and we remain late in the economic and real estate cycles.

Paige Hood, Chief Investment Officer and Senior Portfolio Manager
Liquidity
Debt capital markets are awash with liquidity. Lower transaction volume and a decline in loan maturities will create a supply-demand imbalance that favors borrowers.

Inflation concerns or the return of market volatility could negatively impact lending volumes. Reduced bond-buying support from the Federal Reserve may put pressure on credit spreads during the second half of 2018.

Interest Rates
Interest rates are expected to rise further in 2018, partially or completely offsetting any savings gained from a flattening credit curve. Floating-rate loans will become meaningfully more expensive. Rising interest rates will make CMBS and agency debt more competitive with that of banks and life companies.

Demand Drivers
Transaction volume is expected to remain subdued in 2018 and could be adversely impacted if interest rates rise substantially.

Re-capitalizations should be a popular option for borrowers who either can’t sell their asset at the price they want or prefer to hold their asset over purchasing another one given record price levels in many markets. Slowing CRE equity appreciation will also fuel demand for higher leverage loans.

Borrowers with prepayable floating-rate loans may opt to refinance into longer-term, fixed-rate debt.

Robust M&A activity may lead to opportunities to finance large real estate portfolios.

Credit Standards
Lenders will compete on pricing and loan terms, which may lead to looser credit standards and more favorable structures for borrowers.

Interest-only remains prevalent in the market place and may lead to refinancing difficulties in a rising interest rate environment.

Alison Jacobs, Director of Research and Thought Leadership
Top-Down View of 2017

Life companies had one of the highest volume origination years post-GFC. Lenders favored multifamily and industrial properties, while office demand was stable to slightly weaker. Demand for retail was weaker. Robust lender competition led to meaningful spread compression.

The Climb Up 2018

Portfolio lenders are looking to maintain or increase their appetite and will be focused on getting their money out. Life companies with larger appetites will need to expand into secondary markets or take on additional risk in terms of lease up, lease rollover, or lending on property types with more yield.

Strong competition will lead to credit spreads compressing further. Underwriting terms have stayed disciplined with some softening around the edges. We expect the trend of offering interest-only periods and more prepayment flexibility to continue.

Lenders will continue to focus on properties in major markets. Given strong real estate fundamentals, some lenders may follow their best borrowers into, and finance the best properties in, select secondary markets.

Robust appetite for apartments and industrial will continue. Grocery-anchored retail remains well-regarded, but there is an increased focus on location and anchor sales. Regional malls and lifestyle centers will be tough to finance.

Caution persists around lending in office markets with high industry concentrations. Primary market offices with strong job growth remain attractive; however, lenders will be discerning about what types of non-traditional office space they finance. Lenders will selectively finance suburban offices.

Tools To Help Your Ascent

- Fixed-rate loan terms of up to 20 years.
- Significant pricing credit given for fast amortization.
- Partial- or full-term interest-only loan terms.
- Rate lock as soon as loan application is executed.
- Forward rate locks of up to 12 months.

Potential Avalanches

- Life companies may reduce commercial mortgage allocations if spread compression makes mortgages less attractive than public fixed-income alternatives.
- Could see increased competition if regulations impacting bank and CMBS lenders are relaxed or repealed.

Christine Haskins, Managing Director, Portfolio Management

Marcia Diaz, Managing Director, Head of Global Originations
Top-Down View of 2017

The CMBS market found its footing after new risk retention rules were implemented. Total issuance exceeded $83 billion, a 25%+ increase over 2016 levels. Conduit issuance was about even, while single-asset, single-borrower (SASB) issuance increased by more than 85%. CMBS loan pricing benefited from a flattening credit curve and low spread volatility. Loan credit fundamentals stayed flat-to-improved.

The Climb Up 2018

Lower originations are expected due to a dramatic drop-off in CMBS loan maturities and a slowdown in CRE transaction volumes. Spread compression and rising rates during the first half of 2018 should make CMBS more competitive with other capital sources. Spreads may widen during the second half of the year as the Federal Reserve begins to unwind its balance sheet.

Banks continue to compete with non-bank conduit lenders by issuing “bank-originated only” CMBS that generally achieves tighter pricing. Banks can translate this cost savings into lower loan coupons for borrowers.

The SASB market is expected to remain strong and could benefit from increased M&A activity. Pricing for floating-rate SASB may benefit from increased investor demand if inflation concerns arise. SASB remains an attractive option to finance larger hotel and office properties or portfolios.

Credit fundamentals are expected to stay flat but may deteriorate amidst heightened lending competition. Lenders will likely continue to compete by offering full-term interest only (“pre-amortized”) loan terms instead of higher leverage loans with amortization.

Maximum LTVs remain slightly under 60%, with some exceptions made for high quality properties or less volatile property types. Retail will likely remain difficult to finance. Hotel lending is down due to concerns about RevPAR having peaked. Office lenders are focused on CBD locations.

Tools To Help Your Ascent

- Fixed-rate loan terms of up to 10 years.
- Partial- or full-term interest-only periods.
- Select secondary or tertiary market lending.
- Can originate loan size of up to $1 billion.

Potential Avalanches

- Broader market volatility could negatively impact CMBS credit spreads and lead to less certainty around loan proceeds and pricing.
- Inflation concerns may dampen CMBS bond investor demand for long-duration paper.

“Can originate loan size of up to $1 billion”

Alison Jacobs, Director of Research and Thought Leadership

Top-Down View of 2017

Fannie Mae and Freddie Mac had a record origination year, combining to originate $140 billion of loans.¹ Business growth was focused in areas important to FHFA: green lending, affordable housing, and undersized markets. This approach maximized the agencies’ ability to originate loans excluded from their lending caps and resulted in total production that was almost double their cap limits.

The Climb Up 2018

The agencies are poised to maintain their role as leading multifamily lenders in 2018, although volume is expected to be slightly lower. They will maintain their dominance in financing of multifamily portfolios totaling $1 billion or more. They should also benefit from borrowers refinancing floating-rate loans, for which originations have increased over the past several years, into longer-term, fixed-rate loans.

With their lending cap reduced to $35 billion each, the agencies will focus on growing exclusionary business. Both agencies should continue to see a surge of interest in their small balance loan programs. Freddie Mac’s recently increased maximum loan size to $7.5 million will allow more borrowers to participate. Green lending, which has been a huge growth driver over the past two years, remains appealing and offers borrowers attractive pricing and proceeds.

Millennials and baby boomers who continue to rent apartments are driving solid multifamily fundamentals.

New apartment supply is expected to peak in 2018 and could cause some short-term weakness, especially in Class-A product, in certain markets. New construction is settling down.

Tools To Help Your Ascent

- Fixed-rate loan terms up to 10 years with a maximum LTV of 80%.
- Partial- or full-term interest-only loan terms.
- Pricing discounts for “green,” affordable, and small balance loans.
- No minimum or maximum loan size. Supplemental financing programmatically available.
- Early rate locks.

Potential Avalanches

- New legislation around housing finance reform, while unlikely to be passed in 2018, may cause some disruption.
- Agency caps could be reduced if overall agency multifamily lending market share becomes too large.

¹ Source: Fannie Mae and Freddie Mac.

Michael McRoberts,
Managing Director,
Conventional Fannie Mae and Freddie Mac
Top-Down View of 2017

FHA had a strong multifamily and healthcare lending year. It issued over $15 billion of multifamily initial endorsements, a 37% increase over 2016. Over 60% of these were market rate, of which half benefited from the “green” designation.¹ Healthcare and senior housing initial endorsements totaled $3.4 billion, an over 20% increase from the prior year.²

The Climb Up 2018

Origination volume is expected to decline slightly. HUD will continue to be focused on workforce, affordable, and green lending. Rising interest rates may heighten demand as borrowers seek to lock in long-term, fixed-rate financing. Given banks’ pared back construction lending, we expect increased demand for FHA’s construction program 221(d)(4) to continue.

Construction-to-permanent loans under the 221(d)(4) program will remain popular, as it allows borrowers to lock in long-term, fixed-rate financing upfront without requiring a re-underwriting or appraisal when the loan converts to permanent financing. Private lender “bridge-to-FHA” programs are increasingly popular to finance acquisitions and repositions with an expected HUD takeout.

Recent changes to FHA’s healthcare programs allow borrowers to recapture equity without two years of debt “seasoning” as was previously required.

Tools For Your Ascent

- Fixed-rate, fully amortizing loan terms of up to 40 years.
- No yield maintenance. Openly pre-payable after 10 years.
- Full leverage, fully assumable loans with minimum DSCR as low as 1.11x.³
- Construction-to-permanent loans available with no re-underwriting or appraisal required.
- “Green” and affordable MIP discounts for multifamily properties.

Potential Avalanches

- HUD is increasingly wary of over-supply in certain markets and has increased its scrutiny of loans applying to its 221(d)(4) construction program.
- HUD origination timelines are typically longer than other capital sources. However, HUD recently completed its “Multifamily for Tomorrow” transformation, which simplified its organizational structure. Some improvements have already been observed, and we anticipate HUD timelines to decrease further going forward.

Hal Collett,
Managing Director,
FHA and Affordable Lending

² Source: HUD Office of Residential Care Facilities.
³ Debt service coverage, loan-to-cost, and loan-to-value vary by property affordability component.
**AFFORDABLE**

**Top-Down View of 2017**

Fannie Mae, Freddie Mac, and FHA all saw increases in their affordable lending production in 2017. Fannie Mae’s affordable production totaled $6.8 billion. Of this, a record high $5.4 billion was financed through its Multifamily Affordable Housing (MAH) program, representing a 26% increase over 2016 levels.\(^1\) Through its Targeted Affordable Housing (TAH) program, Freddie Mac originated a record high $8.6 billion of affordable loans, a more than 50% increase from 2016.\(^1\) FHA affordable housing totaled more than $5.3 billion and represented 38% of multifamily initial endorsements.\(^2\)

Despite increased lending activity, overall sales of LIHTC and Section 8 properties likely decreased, and a general shortage of affordable housing nationwide has resulted in up to 1 in 3 Americans living in housing they can’t afford.\(^3\)

**The Climb Up 2018**

Fannie and Freddie’s “Duty to Serve” will drive continued emphasis on workforce housing and other new rental products/income brackets that are considered affordable and underserved. This focus will continue to increase production opportunities in the affordable housing space. Both Fannie Mae and Freddie Mac have been developing and marketing new products to increase affordable volume. They have both announced their intent to re-enter the LIHTC market, increasing liquidity in that space. Fannie and Freddie also offer bridge products with shortened prepayment terms that should remain popular for acquisition and rehabilitation deals.

FHA will continue to see interest in its affordable products, which offer substantial MIP discounts and the ability to lock in a long, fixed-rate loan term.

**Tools To Help Your Ascent**

- Fixed-rate loan terms of up to 30 to 40 years.
- Fannie Mae and Freddie Mac pricing discounts that vary depending on loan leverage.
- FHA reduction in MIP by up to 45 bps.
- Potentially higher loan proceeds than those of market-rate properties.

**Potential Avalanches**

- Despite great need, the development and preservation of affordable units is difficult because of high development and rehabilitation costs.
- The uncertainty around tax reform’s impact on the value of LIHTC may lead to lower near-term transaction and financing volume. Fannie Mae and Freddie Mac are evaluating their programs and exploring ways to mitigate any negative impact tax reform may have.

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1. Source: Fannie Mae and Freddie Mac.
3. Source: Fannie Mae “Multifamily Affordable Commentary: Sales of LIHTC and Section 8 Properties Slowed in First Half 2017.”
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