PGIM India Mutual Fund

PGIM Global Asset Management + Reuters Plus

OUTFRONT

# CREDIT SQUEEZE

## FROM DISTRESS AND DISLOCATIONS TO STEEP DISCOUNTS

As credit conditions tighten, opportunities are emerging for smart investors. With banks cutting back on lending, pricing dislocations are appearing in financial markets. This looks like a repeat of previous economic cycles, when investors with patient capital have benefited from uncertainty.

SUMMER 2023

# INTRODUCTION

**46%**

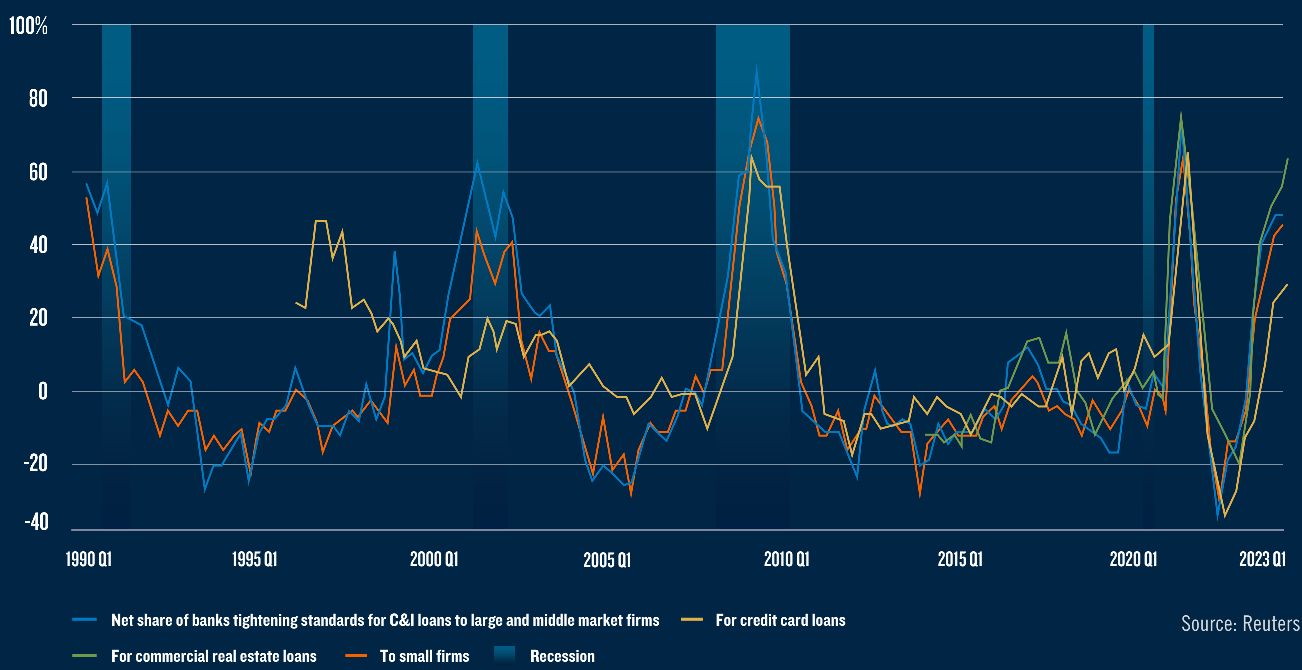
**of U.S. banks**

**tightened lending standards in the first three months of 2023 for a key category of business loans to medium and large businesses, according to a 2023 Federal Reserve survey of bank loan officers. While not as severe as feared, this credit squeeze nonetheless showed the effect of interest rate rises and bank failures. Similarly, credit is tightening in Europe, reaching levels not seen in a decade, although in Asia only Australia is rapidly increasing rates.**

Yet what's a credit squeeze for some is always an opportunity for others. As the Fed, European Central Bank and Bank of England have rapidly hiked interest rates to quell inflation, so the wave of bank failures that started with Silicon Valley Bank has further curtailed credit. As this happens, a shortage of capital and flight from risk is already leading to higher returns in some areas of the markets. Whether in private credit, real estate or the secondaries markets, yields are increasing while some assets are trading at substantial discounts. It's a buyer's market for savvy, specialist investors.

**Lending Conditions**

The Federal Reserve's Senior Loan Officers Opinion Survey shows the share of banks restricting credit for different types of lending.




Source: Reuters

Note: Questions have been added to the survey over time so not all extend for the full series. Blue bars denote recession.

## CHAPTER 1

# PARCHED DEBT MARKETS PAY UP FOR LIQUIDITY

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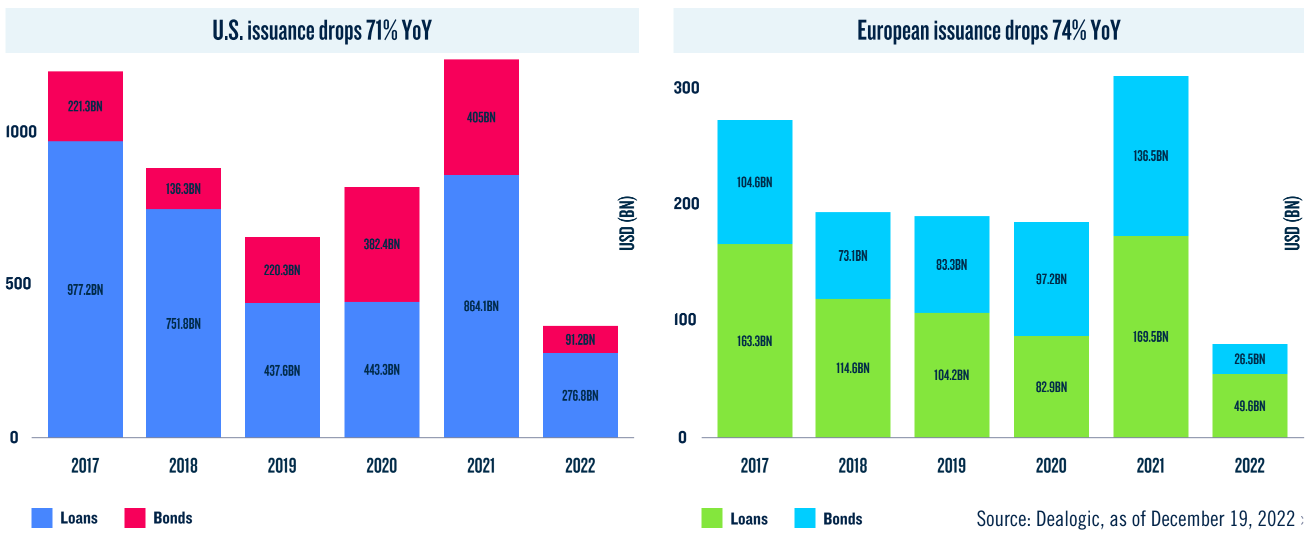
**With debt markets parched of financial liquidity, expert debt market investors are finding attractive ways to put their capital to work for higher returns.**

Just as banks have cut back on lending, direct lending or private credit funds are finding new opportunities. Banks have struggled to offload debt they provided to fund big takeovers, including Elon Musk's buyout of Twitter. That's allowing funds to enter the market and make loans with high yields of 6 or 7 percentage points over the floating rate benchmark, or roughly 11% or 12% in total.

**Collapsing leveraged loan and high yield bond issuance show the declining appetite for risk.**

There are further signs of distress in debt markets, as some junk bonds trade at significant discounts to par value and banks struggle to offload leveraged finance loans.

### Sharp Declines in Loan and Bond Volumes



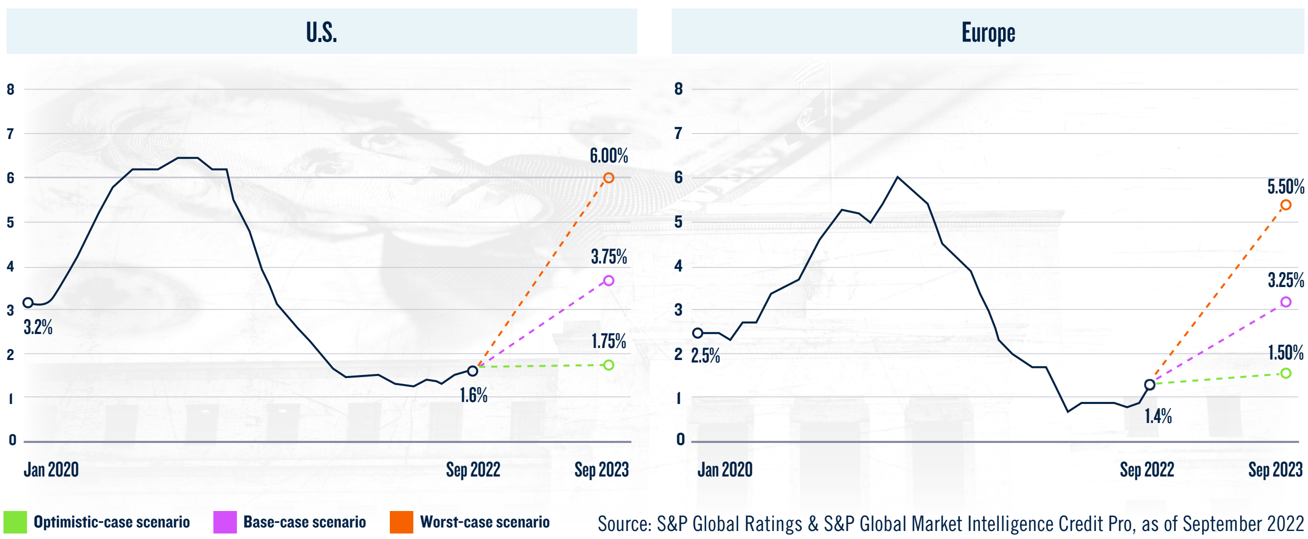

Source: Dealogic, as of December 19, 2022

## At the same time, the quality of credit is weakening across the U.S. and Europe.

Rating agency Standard & Poor's expects the trailing 12-month speculative-grade corporate default rates in the U.S. and Europe in Q3 2023 to be more than double those in September 2022, bringing defaults close to their long-run averages.

**Depending on the length and depth of any downturn in the U.S. and Europe, it seems likely that there will be more companies facing financial difficulties or defaults on their loans. That's likely to create opportunities in debt markets for rescue financing and opportunistic lending, as well as further distressed debt special situations.**

### Speculative-Grade Corporate Default Rates




Source: S&P Global Ratings & S&P Global Market Intelligence Credit Pro, as of September 2022

# $1.4 TRILLION

The amount of rescue financing opportunities that PGIM Fixed Income estimates could emerge if a recession occurs that resembles those that used to happen before the global financial crisis ushered in a decade of supereasy monetary policy.

“A generation of investors only know a central bank backstop. We think those days are gone. So our view is that over the next 10 years, we think the best place to generate uncorrelated high return or equity-like return profiles is by owning the debt of companies. How that manifests itself is going to be a range of outcomes, whether you're full-on distressed or some sort of creative solution. Specifically, we're focused on what the private equity community has done more recently. There's a number of really good companies and really good sponsors out there that have a need for a solution.”

**RYAN KELLY**

Head of Special Situations for PGIM Fixed Income

Source: PGIM

CHAPTER 2

# COMMERCIAL REAL ESTATE: A BUYER'S MARKET

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**After more than a year of rising interest rates, cracks are beginning to show in commercial real estate. There are fears of a wave of forced selling from over-extended asset owners that creates a downward spiral in asset prices.**

Yet as with all previous downturns in real estate, pockets of opportunity may begin to emerge. Where might the opportunities lie for investors?

“

The most important impacts of a recent sentiment shift may be on debt pricing and availability. Real estate debt will remain scarce as large banks face pressures from regulators and regional banks become even more risk-averse. That will lead to more opportunities for non-bank lenders to originate loans that generate attractive returns. That probably won't be enough, meaning there will also be near-term opportunities to provide rescue capital to owners that need liquidity as their debts mature and for owners to purchase loans from banks, and other lenders, at steep discounts.”

**LEE MENIFEE**

Head of Americas Investment Research for PGIM Real Estate

Source: PGIM

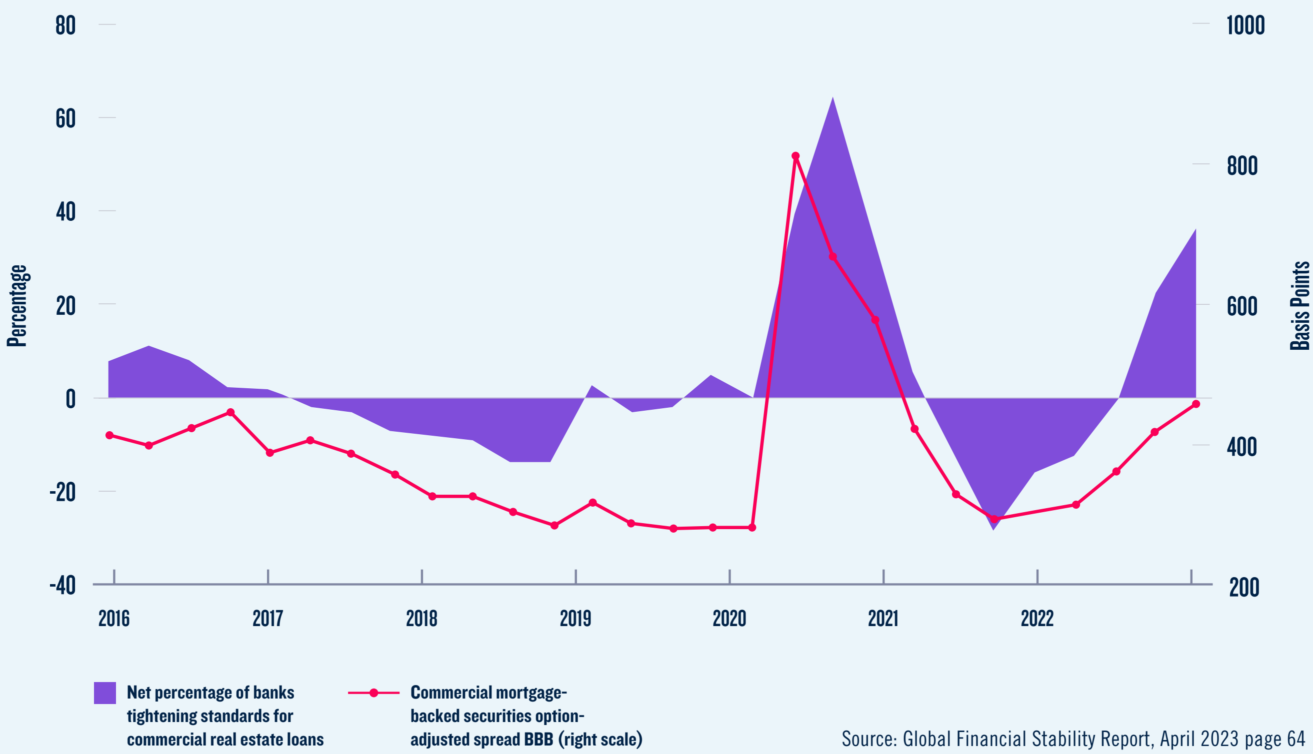
**Banks' tightening lending standards will make it tougher for real estate owners to refinance the trillions of dollars in loans due before the end of 2025.**

Spreads of U.S. CMBS over Treasury bonds jumped to about 450 basis points at the end of 2022. Similarly, financing costs of senior loans in Europe's core offices rose to about 350 basis points in 2022's second quarter, over 200 basis points higher than in 2021.

U.S. banks on alert over falling real estate valuations. FT, April 22, 2023. Almost a third of the $4.5tn in U.S. commercial real estate debt comes due before the end of 2025, according to Morgan Stanley analysts.

## Credit Standards for US Commercial Real Estate Loans and Funding Conditions for Commercial Mortgage-Backed Securities

Small banks have grown their CRE portfolio more aggressively than large banks since the pandemic




Source: Global Financial Stability Report, April 2023 page 64

> I see losses hitting on the equity side and some distressed debt. And so, as we navigate through this uncertain environment, and the global reset of real estate values, it will be important to focus on long-term sustainable growth and resilient income. This repricing is also happening at different speeds around the world. So, understanding the timing around when to enter the market across different sectors and regions, and the bifurcation of good versus poor assets and locations, will be critical in this environment."

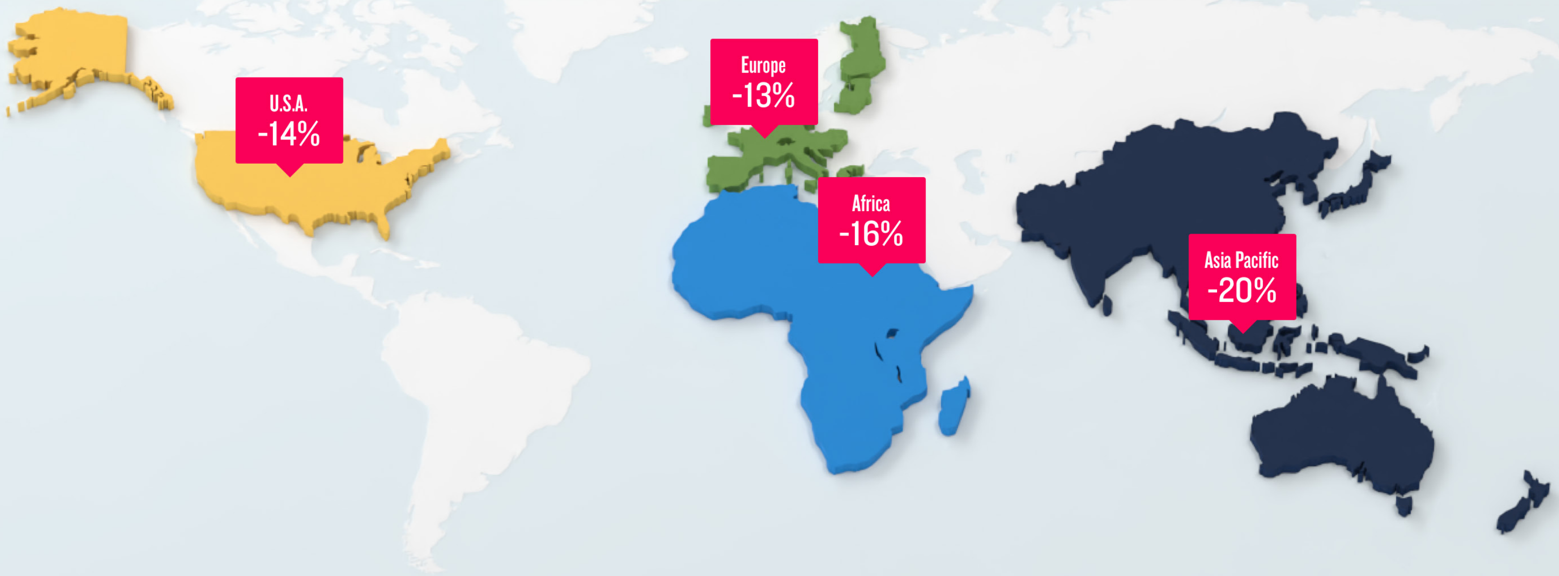
**RAIMONDO AMABILE**
**Chief Investment Officer at PGIM Real Estate**

Source: PGIM

**Looking specifically at office buildings, Amabile says they face the perfect storm of weaker underlying demand for space, higher construction and maintenance costs, fewer potential buyers or lenders and higher interest charges.**

Older offices, especially, face these headwinds. Variable loan interest rates starting from 4% across Europe and 6% in the UK are higher than yields, as of June 2023.

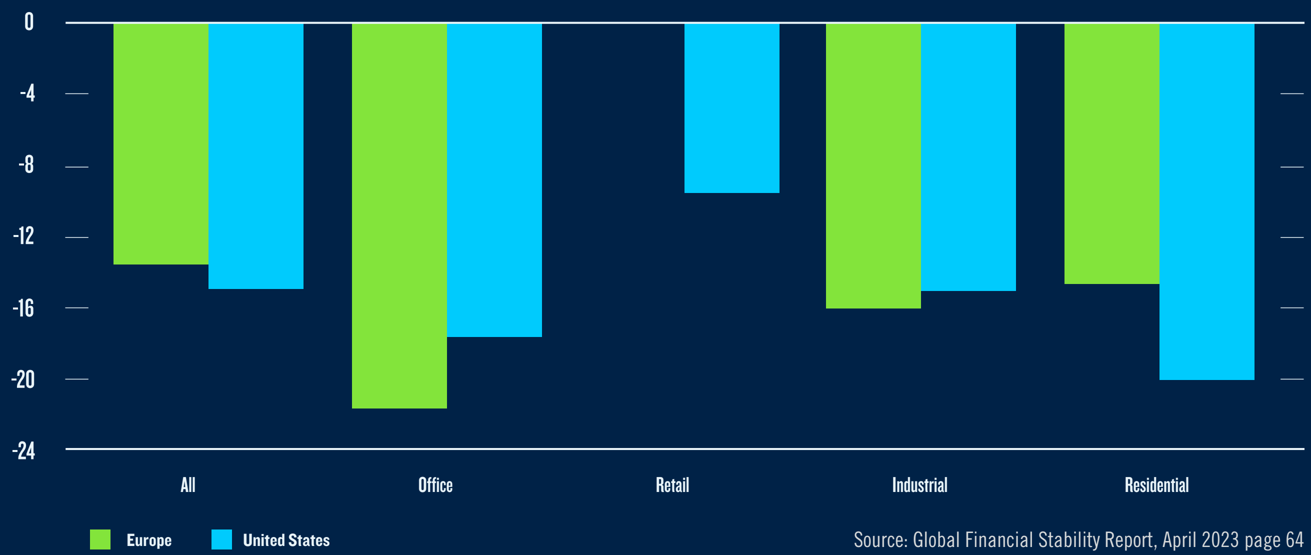
# Significant Price Corrections in Public Real Estate Markets (2022-2023)




Source: Global Financial Stability Report, April 2023 page 62

## Commercial Property Price Index Trends Year Over Year % Change (2022 to 2023)

The correction in real estate investment fund trusts' pricing has been sizable across sectors.




Source: Global Financial Stability Report, April 2023 page 64

## In real estate, several owners of office towers in Europe are either restructuring debt or selling.

And major U.S. property investors have handed back towers in Los Angeles and New York to their bank lenders.

## Over time, there are likely to be falls in some valuations and some distressed debt.

Investors will have opportunities to provide rescue capital or to acquire assets at lower valuations.


## CHAPTER 3

# BARGAIN PRICES IN PRIVATE EQUITY SECONDARIES

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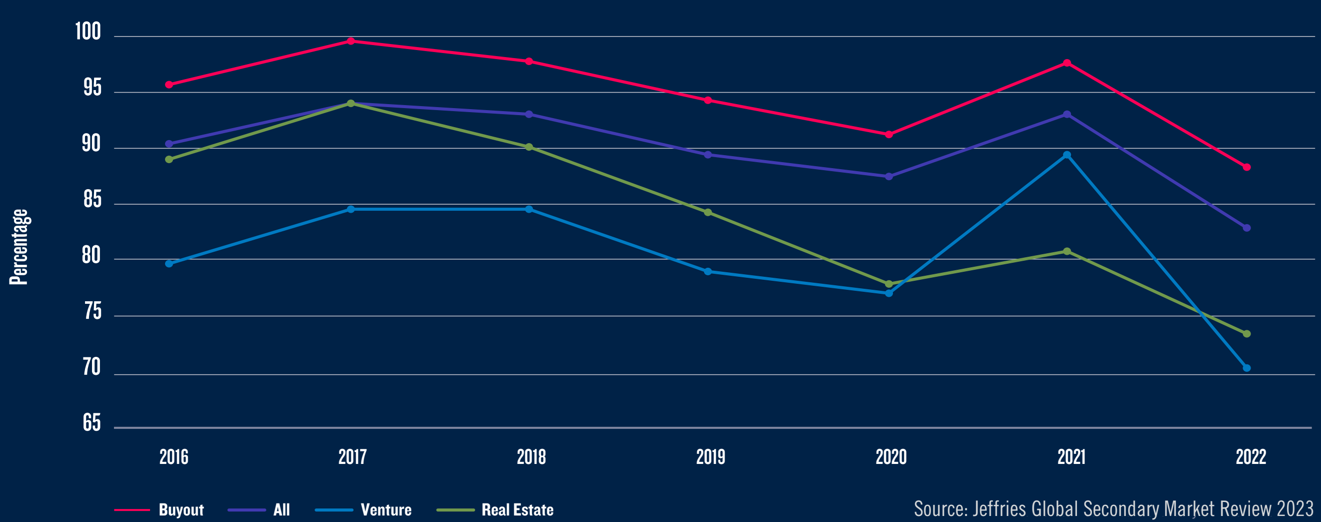
**In private equity, the secondary market is showing significant discounts, valuing high-quality assets at bargain prices. Some institutional investors are selling to rebalance portfolios hit by declines in public equity markets. Additionally, there's skepticism about private company valuations, difficulties in exiting investments and increased buyer selectivity.**

Investors are buying secondary private equity limited partnership portfolios at the most substantial markdowns in years, according to the Jefferies Global Secondary Market Review.

**Pricing Reversal in 2022**



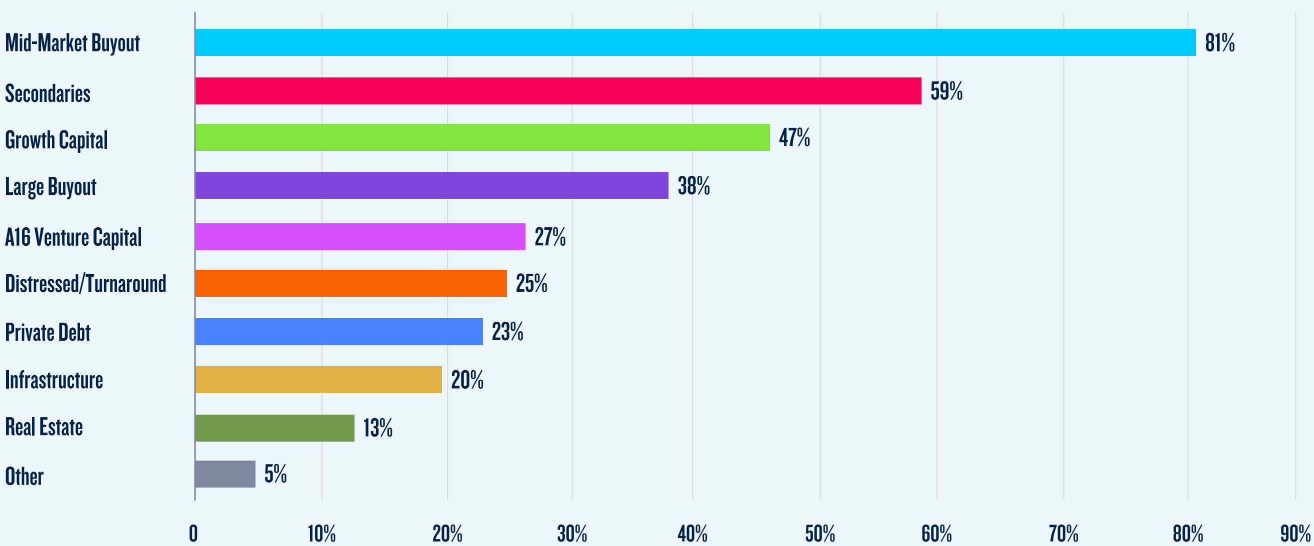

Source: Jefferies Global Secondary Market Review 2023

## Amid the flight from so-called long duration assets, which may take many years to become profitable, the pricing for venture capital portfolios suffered the largest drop of any strategy in history.

Reflecting commercial real estate's perfect storm, portfolios sold for 71% of NAV – a discount approaching 30%. Geographically, discounts were smallest for North American funds (pricing at 84% of NAV) and largest in Asia and emerging markets (65% of NAV).

Reflecting the significant opportunities on offer and likelihood of recession, investors are beginning to turn to secondaries, which were the second most popular private equity strategy in Montana Capital Partners' Annual Investor Survey 2022.

### What Are Your Strategic Preferences in the Current Market Environment? (Survey of Institutional Investors)




Source: montana capital partners Annual Investor Survey 2022

**A tight liquidity environment is expected to lead to more sales of secondary portfolios in 2023.**

Many LPs are likely to use secondary sales to balance negative cashflows in their private equity programs caused by imbalance between continued capital calls and limited capital distribution.

**Meanwhile, with increased interest costs, secondary strategies that do not rely on portfolio leverage will likely do better, which differentiates most mid-market players from the larger end of the market.**

And with greater liquidity pressure, less sophisticated sellers are likely to come to market, which will benefit investors who focus on the smaller and less-institutional end of the market and who can take the time to craft creative structures for smaller sellers.

# CONCLUSION

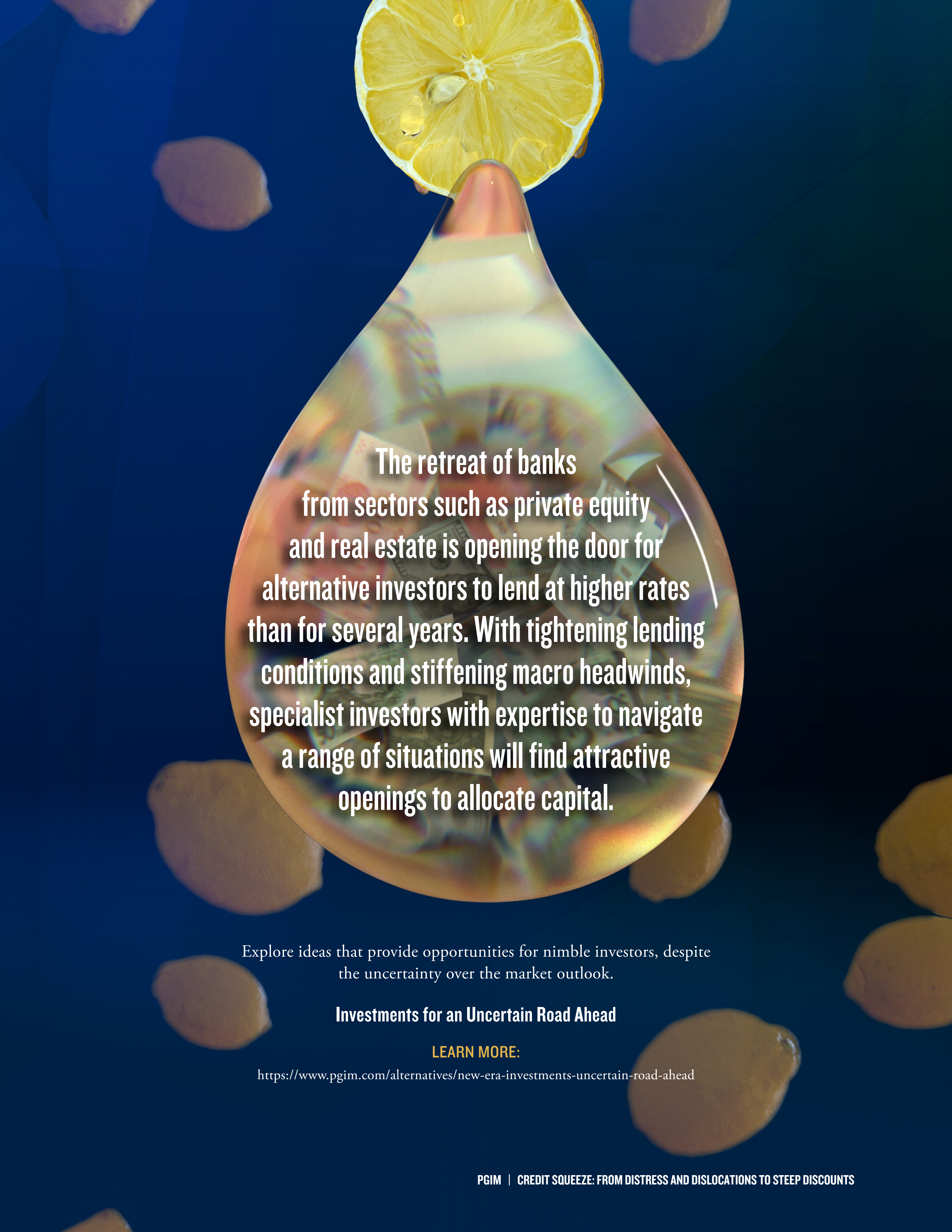
**2023's credit squeeze is already leading to a return to value for some assets. The extent of any following economic downturn will determine how great the opportunities are that follow.**

Speaking at the Milken Institute Conference at the beginning of May, the day after the First Republic rescue, PGIM chief executive David Hunt predicted that the implications for the U.S. economy were just starting, as banking regulation increased:

> "What that will do is…further hinder the supply of credit that's going into the economy. And I think that we are going to see now a real slowing that begins to happen to aggregate demand because of the decrease in the supply of credit that's coming in."

**DAVID HUNT**
President and Chief Executive Officer, PGIM

Source: PGIM


The retreat of banks from sectors such as private equity and real estate is opening the door for alternative investors to lend at higher rates than for several years. With tightening lending conditions and stiffening macro headwinds, specialist investors with expertise to navigate a range of situations will find attractive openings to allocate capital.
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