

CREDIT CONVERGENCE

The Blurring of Public and Private Credit

Chapter One - Credit Convergence – Introduction

Matt Douglass – Chief Executive Officer, PGIM Private Capital

The \$80 trillion global credit market is growing fast. This is being driven by a private credit market that is rapidly expanding in support of broader global economic growth, replacing financing that has historically been provided by commercial banks.

Private credit is expanding across many industrial and consumer sectors of the economy, but also into new segments from energy transition like solar parks and the power grid, to data centers and supporting the continued digital evolution of the world, to agriculture like farms, wineries and the family owned companies operating across a broad range of industries.

Increased regulations mean that banks are lending less and investors are stepping in to fill the gap. As an example, this graph shows how non-bank loans now account for nearly three quarters of global leveraged loan volume. Private credit will grow and expand as the line between public and private credit continues to blur. The growing convergence between the two is further expanding the opportunity set for investors, as the markets for, among other things, direct lending, NAB lending and securitised credit like asset-based finance continue to grow.

This transformation is leading to creative lending solutions, and the emergence of both a new range of credit investments and investment vehicles such as rated feeders, BDCs and evergreen funds that are enhancing the attractiveness of the asset class and opening up the availability of the asset class to new investors.

John Jacobs – Senior Portfolio Manager, Real Estate Private Credit, PGIM Real Estate

Now that banks are pulling back in many regions and sectors, there is a growing opportunity for others to fill the space. These lenders are finding creative structures to not only solve the capital needs of borrowers, but also allow investors the ability to access this alternative asset class and achieve attractive returns. Investors are able to customise their risk and returns by participating in different parts of the capital stack. Here's my colleague Jonathan Butler in London.

Jonathan Butler – Co-head of Global Leveraged Finance, PGIM Fixed Income

A company with the flexibility to borrow from more than one channel will explore whether bank-syndicated loans, high yield bonds or private credit suits at best. If you want the lowest cost of debt, syndicated loans are often the best way to go. If you're willing to pay for something more bespoke than a private solution, makes more sense. The private credit market has experienced significant growth over the past two decades, post the global financial crisis, with its share of US leveraged finance increasing substantially.

Recently, some of these private solutions have been close to \$5 billion in some transactions.

Matt Douglass – Chief Executive Officer, PGIM Private Capital

Private credit has actually existed for a long time, with insurance companies providing this form of financing to many companies for decades. PGIM's history in private credit goes back to the first half of the last century. However, in the last 10 to 20 years, other institutional investors have emerged to provide credit to the same issuers and borrowers. But the source of funding is now coming from other pools of capital, such as sovereign wealth funds and pensions.

These investors are seeing less and less of a distinction between public and private credit, and instead are looking for experienced credit managers who can provide access to a complete range of credit solutions and opportunities. For example, investors can increase diversification by getting unique access to a range of asset classes, where cheap pricing premiums and structural enhancements associated with more illiquid assets. We're getting access to structured credit and scale across assets.

Chapter Two – The Converging World of Credit: Risk and Return

Matt Douglass – Chief Executive Officer, PGIM Private Capital

While the worlds of public and private credit are converging, an important relationship still remains between access, complexity and illiquidity relative to return. As managers get access to more illiquid assets, and provide structuring and crunching capabilities, they can achieve premium returns for investors. PGIM has a long history investing in private credit, where we provide investors with exposure to credit investments they may not otherwise be able to find.

We achieve these investor objectives through a focus on the corporate and infrastructural middle market, where we have investments in over a thousand companies invest over \$15 billion per year. The middle market offers investors attractive yields, portfolio diversification through access to unique issuers, and downside protection from carefully structured covenants on the loans. We see a wealth of opportunity in the middle market, particularly from family owned companies.

These businesses comprise about 90% of private U.S. and European companies, and they tend to be conservatively run and operate in a wide range of industries. We utilise our global origination network to source credit assets across the US, Europe, Australia and Latin America, by having a local presence and strong relationships with owners and management teams. We're able to achieve attractive pricing in terms that work together to provide long-term value for investors.

In addition, given the illiquid nature of private credit, having the experience of working through challenging situations to maximise value is important. So there are attractive economics to be earned in this market, but a credit manager must be able to originate, underwrite, and then manage these loans to deliver on that investor value proposition. The middle market has always been, and remains a sweet spot in private credit.

As you can see from this chart, it's important to note that the private credit market is growing fast in the UK, Continental Europe and elsewhere. While the US private credit market is the most developed and

continues to grow. In Europe, there are differences between countries regulations, capital availability and market constructs, and this dynamic provides an attractive opportunity to source private credit investments.

We've invested over \$20 billion of private credit across more than 200 issuers over the last five years in Europe, and we think there's still meaningful room to grow into the market.

Jonathan Butler – Co-head of Global Leveraged Finance, PGIM Fixed Income

At PGIM, we have a large presence in Europe with offices in London and across the continent. We're one of the largest institutional lenders, and we see many transactions from the region. Because of 28 bankruptcy codes, difference in currencies between the UK and the eurozone and other currencies, there is inefficiency in the European markets. That inefficiency means that you can often get paid excess returns to what you'll find in the US markets.

Chapter Three - Credit Transformation in Real Estate

John Jacobs – Senior Portfolio Manager, Real Estate Private Credit, PGIM Real Estate

Let's revisit the banking sector's role in lending markets. While the political winds have more recently shifted in the US, we believe the longer-term trend of increased banking regulations and a more rigid approach to lending will continue. An estimated 10 to 15% of the almost \$5 trillion commercial real estate financing market now comes from non-bank alternative lenders, and is expected to continue to grow in the future.

Meanwhile, in Europe, as you can see from this chart, the opportunity for alternative lenders is even greater. Banks are the dominant source for real estate loans in the European markets, but the trend is clear non-bank lenders are growing their market share from the region's heavily-regulated banks. These new sources of capital are providing important solutions and helping to create a more dynamic capital market.

Take construction loans, for example. Previously, a bank would have lent with 65% leverage, but now may be limited to 50 or 55%. We recently came into a 300 property, multifamily apartment project, where there wasn't enough debt capital for the project to be built. We provided a mezzanine loan to fill the gap left between the senior bank and the equity.

This solution met both the needs of the investor, who was willing to sit in the middle of the capital stack in exchange for a double digit return, and the developer who needed the additional capital to build the project. Another added benefit of private real estate credit, is that it helps a diversified investors portfolio in two ways. First, by providing exposure to an asset class whose performance has low correlation to other asset classes in both the public and private sectors. And two, it creates more investment opportunities to different areas of the US economy, such as data centres, senior housing and self-storage - areas that might otherwise be hard to access.

For investors, the value of a manager like PGIM in real estate credit, is that we're able to directly originate and structure our own investments. This allows us not only access to unique and proprietary deal flow, but

more importantly, enables us to customise each investment to make sure that the returns and the structure match the overall risk.

Overall, within real estate credit, you can get a return of 8 to 12%, depending on your level of risk tolerance. This represents a great opportunity for investors to achieve attractive returns with strong downside protection.

Chapter Four - Credit Markets in Transition – Asset-based Finance

Matt Douglass – Chief Executive Officer, PGIM Private Capital

While much of the discussion in recent years around trends and private credit has been focused on PE backed and higher leverage companies, there is a large emerging opportunity in investment grade, private asset-based finance. Private ABF is a dynamic and expanding space for investors, and PGIM has operated in this market for years. Here's more from Jonathan Butler.

Jonathan Butler – Co-head of Global Leveraged Finance, PGIM Fixed Income

Some banks have pulled back lending to segments of the securitisation space. This makes private securitisations appealing to some investors, as you can have a significant yield pickup. One factor contributing to the acceleration of private asset-based financing, is the growing size, scale, and sophistication of firms within the asset management industry. What sets asset managers such as PGIM apart is our long track record and scale, in structured credit markets.

Asset sourcing is important and, by being a longstanding structured credit investor, we have many relationships with asset-based originators that provide the source of these assets. Growth in private ABS is most noticeable in the US. While this is drawing significant investor demand, private credit assets such as car loans and aviation leases can be pulled, crunched and securitised. Diversifying the credit solutions available to investors. Demand for these assets is creating some competition. But that said, the margins on these loans relative to corporate credit assets can be very compelling and attractive, particularly if structured appropriately.

Chapter Five - Credit Outlook

John Jacobs – Senior Portfolio Manager, Real Estate Private Credit, PGIM Real Estate

Real estate values have reset the past couple of years and interest rates are now easing, bringing down the cost of capital and jumpstarting transaction activity in 2025. The returns relative to the risk are very compelling right now in real estate credit. We are seeing our pipelines grow, with fantastic lending opportunities at attractive reset collateral valuations. This will be a catalyst for the sector to grow and for investors to achieve outsized returns in the coming years.

Jonathan Butler – Co-head of Global Leveraged Finance, PGIM Fixed Income

There is more room for private financial products. There are plenty of investors that haven't been investing in private credit so far. What's more, there are investors who are growing their allocations to private credit.

All of that will drive growth, creating greater capacity in the private credit markets. Credit is about loss avoidance, making manager selection important. Since the financial crisis, there's been a slippage in lending standards across all markets.

You've seen leverage creep higher. You've seen earnings adjustments increase. You're seeing greater covenant headroom. What is important, as an experienced manager, is identifying what the risks are and being selective about what you buy. Inevitably, there will be another credit shock or indeed a forthcoming recession.

Matt Douglass – Chief Executive Officer, PGIM Private Capital

As the credit convergence continues, blurring the lines between public and private credit, asset managers are adapting by expanding the credit offering and providing a broader set of solutions. Large, experienced credit managers with capabilities in both public and private credit, are in the position to offer investors what they are seeking. Deployment, both in scale and uniqueness, and strong underwriting cultures, will be the key for investors.

Managers who can deliver on these fronts will be best positioned to meet investors' objectives. Now and into the future.

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