Rewriting the Credit Playbook

Hello, everyone. I'm Mao Dong, Co-Head of Portfolio Management and Head of Portfolio Research at PGIM Multi-Asset Solutions. I'm looking forward to moderating our discussion today. There are few asset classes that has generated as much attention and capital flow in recent years as credit. And as credit markets expand into new segments of the economy, the dividing line between public and private credit is fading away. And this is underpinning the next phase of the growth in the credit market and credit life cycle, and it's also providing opportunities for investors to diversify and seek to enhance returns through a more holistic set of exposures in the credit spectrum. But given that nearly 90% of global companies today are private and there are increasing debt financing through non-bank lenders, it's becoming nearly impossible to talk about broad exposures without including private credit or private market in that discussion. Investors are finding opportunities across middle market, large cap direct lending, real estate debt, structured credit both in the public space and in the form of private asset-based finance, and there's also been a proliferation of investments through vehicles including BDCs, evergreen funds, interval funds, and rated feeder structures, which are making private credit more available to a greater array of investors. Meanwhile, we've seen recent actions by major players that also highlight this shift. So, there's clearly a fundamental breaking down of the traditional barriers that defies public and private investments. Though the exact timeline is somewhat debatable, the overall trend is certainly clear and undeniable. We've highlighted a lot of the opportunities, but there's certainly risk, and that form of risk comes in increasing complexity in this space in the form of regulatory oversight, risk assessments. And so with added complexity, investors need to think and rethink the playbook for evaluating opportunities and risk in their credit portfolios. So, to discuss all of this, I'm excited and delighted to have three of my colleagues from PGIM who are really subject matter experts in their respective universes across the public and private spectrum. So, I'll start by asking each one of them to introduce themselves, their businesses and perhaps we can start with John, followed by Josh and Kaustub. John, over to you?

Great. Thanks, Mao, and great to be with everybody this morning. So, my name is Josh Jacobs. I am in our PGIM real estate business, and I oversee our structured debt strategy. So, I'm looking forward to talking to you all more about commercial real estate.

Josh?

Thanks, Mao. Great to be here with John and Kaustub and with everyone today. So, Josh Shipley, Executive Managing Director with our private credit business, so this is an exciting topic for us. The private credit arm within PGIM is about $105 billion portfolio. We invest across corporate investment grade and below investment grade real assets, which is core infrastructure, energy, power, credit tenant leases and some structured credit and also direct lending and mezzanine. We invest about 15 billion a year through our regional office network. We have 16 global regional offices, which we'll talk a little bit about today. And in my current role, I oversee our European origination efforts and sit on our direct lending investment committee, so looking forward to the chat today.

Great. And finally, Kaustub.

Thanks, Mao, and thanks, everyone, for being here. So, Kaustub Samant. I've been at PGIM for about three years now. I head up securitized products research. We manage a portfolio of more than $100 billion of public and private securitized products. So, that spans mortgage-backed securities, commercial mortgage-backed securities, asset-backed securities, CLOs, as well as kind of private ABF type investments. The team is about 30-plus people across the research side as well as the portfolio management side and the deal team side. I'm looking forward to talking to you about kind of the public markets and that intersection between public markets and then sort of private ABF.

Great. Thank you all for the intro. Now, before we dive into the discussion, I'd like to take care of a few housekeeping items. On your screen are multiple boxes including a Q&A box, so we encourage you all to submit questions at any time. And also, there's an on-demand version of the webcast and a written summary that'll be available after today's event for those who may be interested. So, let's dive right in. First, I want to set the stage because when we talk about credit universe and like I mentioned, it's blossomed into such a significant universe that's characterized by innovation across strategies, vehicles. And so, these days when we talk about credit, you're not simply referring to your traditional corporate credit. So, to better orient our audience, I'd like each one of you to start and kind of briefly describe your respective universes, asset classes, and define what the kind of characteristics including opportunities and risks are in each of your asset classes. So, maybe we'll start with Kaustub on public securitized credit and also in general kind of securitized credit including private.

Sure, yeah. So, just at a high level, this is sort of our bread and butter. This is what we did for 20-plus years sort of public securitized credit. At a high level, why is the asset class appealing? I think firstly just from a relative value perspective, it just carries better than corporate credit. So, if you just think about same rating, same duration, the securitized product department was generally going to carry better than comparable assets in this environment, and that sort of basis changes from environment to environment. Maybe here right now, maybe 40 or 50 basis -- like AAA securitized -- maybe 45 basis points wider than comparable IG kind of corps. So, at a high level, that's definitely kind of appealing. So, the counter typically is like, "Well, it is less liquid." And I think that's true. There's definitely part of that is sort of liquidity. And as you get towards the more esoteric or the more structurally nuanced part of securitized credit market, yeah, it's definitely less liquid than sort of corporate credit. But really why that sort of basis exists we think is because of kind of a structural under allocation to securitized credit. So, if you think about the agg as a whole, the agg doesn't include everything in the securitized products universe. It doesn't include something like CMBS, single-asset single-borrower. All of the non-MBC RMBS products or all of the non-agency mortgage-backed securities are not included within the agg. Floating rate securities sometimes are not included as well at the agg. So, what that means is if you are just a passive agg buyer, you're sort of structurally under allocated to securitized credit. But if all of securitized credit was in the agg, we think it's like 10% of the index. So, that sort of I think structural underallocation like is why you have that sort of carry pick up that securitized credit gives you versus other assets that sort of may be more prevalent within the agg. The other thing that we like about securitized credit is the risk diversification. So, just as an example, there's this narrative and I think we sort of agree with the narrative that U.S. housing is very strong. So, how do you go about expressing that view? Yes, you can buy sort of home biller bonds, you can buy home biller equity or you can go and buy mortgage-backed securities, which give you direct exposure to that consumer that is the actual homeowner and your sort of credit risk outcome is purely dependent on that individual decision to kind of walk away from their house. And then, the value of which you're going to liquidate that asset. So, from a credit risk perspective, you're very diversified. And when you think about the structure itself, it's tranched up. There are different ratings cuts. So, yes, you may like the U.S. housing consumer, you may like that borrower, but you may want to be short duration at higher up in the cap structure. Well, you can do that. If you want to be below IG and really take on more risk because you really like that profile and you think, "Okay, I want to express that view by buying below IG risk and long duration," but you can do that too. So, from a market perspective, it allows you to take kind of a top-down view on sort of macro themes that allows you to kind of marry that with sort of what you want in your portfolio. From a risk perspective, I think the credit risks are sort of paramount in my mind as sort of a credit research analyst, and I think that's true for kind of any asset. Obviously, risk is it, and we try and sort of minimize that by really doing a lot of sort of upfront due diligence on issuers of sponsors and collateral and so on. I think it's important to have kind of a deep bench to be able to do that sort of analysis.

The other risk that we really do think about particularly at the top of the capital structure is your convexity risk. So, particularly in within the mortgage space, as you lend to homeowners, you basically do have the risk of borrowers refying and sort of refying quicker than what you expect. So, getting the prepayments and so on, that's another risk that you need to be mindful of. But the third really is structural. I mean, you are buying the structured securities. They're structured and tranched up. So, understanding those cash flows, understanding situations in which your principle or your interest is going to get burned off, these are all things you need to sort of either price for or just be cognizant of as you go into these investments. I think that's why I think having a big team that can do this deep dive and do this analysis just helps you kind of navigate this better. You're not simply just putting on sort of just a top-down view. You're really are taking bottoms-up as well.

Yeah. Thanks, Kaustub. I mean, this is why at the top you mentioned that credit has just blossomed into so many different segments of the economy and I think securitized credit is really a manifestation of that. So, maybe we'll turn to Josh. Josh, could you touch on direct lending both across kind of middle market and large market and kind of what you're seeing in terms of opportunities and risk?

Yeah. Thanks, Mao. And maybe before I get into direct lending kind of taking a step back. Really, the private credit market is just a wide span. You have public and private issuers. For example, we lend over 5 billion to the FTSE 350 and I think private credit in general is -- Kaustub cost was talking about structured solutions and in your opening comments, Mao, you were talking about how big this market can be. It really is solutions oriented. It really gives issuers the opportunity to structure deals that work for their capital structure and for their company. And when you think about it, there's about 4,000 public companies in the U.S. There's probably 10 times the amount of private companies that are 100 million of revenues or more that that can use institutional financing. If you look at Europe, I think the opportunity set is even greater. You have a lot of private companies, a smaller public market, and I think the banks still dominate the balance sheets. When you think about ways for institutional investors to come in and structure solutions, I think there really is a ton of upside. When you think about differentiators -- I want to kind of build on what Kaustub was saying -- I really think the differentiator is in private credit. And when we get into specifically middle market and direct lending and private credit, it's going to be the ability to source unique and proprietary deal flow and to have strong disciplined credit underwriting. As Kaustub said, whether it's a large public company or a small private company, you have to understand the underlying fundamentals. You have to have information symmetry and be able to make the right credit decisions. So, I think differentiators in this market will come from organizations that have deep benches as Kaustub said. And I think with PGIM, one of the benefits we have is an incredibly deep and talented public fixed income team with sector-specific knowledge and industry-specific knowledge. And then, at our PGIM private credit, we've been lending in the middle market for 100 years and outside of the U.S. for 25 years. So, I think the depth of our understanding of the market and ability to really dig in and really get the underwriting correct is going to be a differentiator in the private market. I think from an issuer's perspective, they benefit as well. These are capital solutions. There's more stability in the private market. We'll get into that I'm sure in a few questions later today and some of the recent noise, but this market tends to be stable through all cycles. And then from an investor perspective, yeah, we're going to offer a premium. Particularly in the middle market when you're looking at direct lending compared to the BSL or large cap market, you'll tend to get a greater premium and spread, you tend to get covenants which afford you protection and get you a seat at the table whether it's with sponsors or sponsorless transactions to restructure loans, build in cushion, and you also will get more diversity. Again, I think a lot of the players are solely focused on the large cap market. You're buying loans with the same types of sponsors and the same issuers as a lot of your peers. If you go down to the middle market or even the lower middle market like our Deerpath colleagues and you can see companies even down 10 to 30 million, you're going to get more diversity across your portfolio. So, I think from that perspective, investors have a lot of benefit. And I think the key risk for investors is the liquidity. But I think as you pointed out, Mao, in some of your opening comments and we'll get in later today, some of the innovation on structuring not only from a covenant and underwriting perspective, but innovation on the fund structure perspective is I think removing a little bit of that liquidity risk.

Great. Thanks, Josh. And then last but not least, John, can you wrap up the overview with commercial real estate debt?

Yeah, great. Thanks, Mao. So, what I would say at the outset is that PGIM has always believed that of course real estate is an important component of any investor's portfolio. We have $200 billion of assets under management for our investors to real estate and half of that would be allocated to real estate private credit strategy. And I think one of the things that maybe is not known by a broad investor universe is just the overall size of this market. So, it's an almost $5 trillion market, which makes it a significant component of the overall fixed income universe. And what that allows for is really investors can get a wide range of investment options and get exposure to a lot of different segments of the U.S. economy such as housing, retail to consumer, e-commerce. And then, I would say in addition to some of those kind of bigger sectors, you can get exposure to some of those harder to reach segments such as a self-storage or senior living or student housing. And so, that makes it we think a really interesting asset class. I think some of the other benefits really of commercial real estate in addition to some of the things mentioned by my colleagues earlier is that commercial real estate is collateralized and secured by real assets. And so, what we think that does is it allows for really better downside protection and oftentimes more favorable credit outcomes if situations don't go as planned. I think also what you get is very predictable income streams, which in today's market environment I think is really valued by investors. You've got equity at risk first and you've got really steady monthly payment from borrowers that drive returns back to investors. And so, that's been a really valuable component, and they're all income returns. I think as well interesting about commercial real estate is if you evaluate it against other asset classes that Josh and Kaustub talked about, it's very low correlation. So, it really adds a nice diversifier within a portfolio across other fixed income asset classes. And so, by adding commercial real estate in addition to the other product, it's really complimentary we think to the portfolio and adds that particular benefit. And then, maybe the last comment I would make is within commercial real estate, it's not just plain vanilla in today's world. So, commercial real estate can offer everything from a core mortgage that looks and acts very much like an investment grade public fixed income instrument all the way to more structured products that have subordinate debt positions that really offer equity-like return. So, I think an investor can get a broad range of risk return depending on their appetite and how it fits within their portfolio. And so, the one downside or the one risk I guess I would highlight here for the audience is that -- one is the illiquidity that Josh mentioned where again if an investor -- and we look at that two different ways. One, if an investor plans to make the investment and holds to maturity, that's actually a nice way to generate some additional alpha and premium in a portfolio. However, if during that hold period there's a need for additional liquidity, then that can create some additional challenges by holding a private mortgage. So, again, it depends on the needs of the investor, but that's one of the factors I think that gets considered.

That's great. Thanks, Sean. And so now that we've kind of set the stage on the respective credit asset classes I'll call it, obviously different parts of your businesses and your universes are going through their respective life cycles. If we think through structural credit, private credit, direct lending, and commercial real estate, they're really kind of at different parts of both recovery and peak phase of expansion. So, I think we should better understand what that means in the current environment. And so, maybe continuing on your description of commercial real estate, John, could you touch on the commercial real estate market? It's been through changes given COVID and just generally a more elevated interest rate environment over the past few years.

Do you think the CRE market has bottomed out? And on a related note, what are some of the opportunities and risks as you kind of look ahead given a lot of the policy uncertainties, etc.? So, if you could touch on some of the current trends that you're seeing in your environment and opportunities, that would be great.

Great. So, yeah, Mao, you mentioned two different events that have definitely created and shifted some of the trends within commercial real estate. So, both were sort of different, although they had different impacts on the industry. So, first was COVID, which was an event that we would take the view really just accelerated trends that were already occurring in the market. And so, what I mean by that is really office was already trying to figure out in the new modern workspace how are we going to utilize office. And so, obviously COVID and the work from home dramatically shifted the dynamics of that sector. And then, also e-commerce is the other big one where we were buying a lot of our goods and the way in which we get our goods and consume them had big impacts on the real estate. So, that was really COVID, and we came out of that I think and we're getting close to I think finding a bottom and stabilizing in office. When it comes to the events of the last couple years and the rising interest rates, I think that real estate was clearly disproportionately impacted by that because it's a more highly levered asset class. And so, as interest rates run up in a more highly levered asset class, that had an impact on value. So, we think globally values have reset since their peak at about 20%, maybe 25% depending on which numbers you're looking at. And so, this has clearly been a challenge for investors and created a lot of headline risk around commercial real estate. We do believe that when you look at valuations and you look at the data that the current levels that real estate is pricing are reflective of the new normalized interest rate environment. So, that's one of the things that informs our broad-based view that real estate values have a bottom or very close to a bottom. So, that makes it a really interesting entry point, we think. The other aspect that I would highlight about real estate is that while you had the higher interest rates and the valuation reset, which I think different from other sectors creates this entry point, you still had a very strong macroeconomy that has driven underlying fundamentals at most asset classes. And so, I think it's really important when you think about real estate to not paint it with a broad brush and the headlines around offices and the challenges there. That's just one relatively small sector within the overall real estate universe, and the rest of these sectors are actually performing very well. And you actually have this dynamic going into the next several years where because of the challenging capital stacks and the cost of capital, very few developments were started over the last couple of years. So, as we absorb the developments from 2021 and 2020, you're going to be entering into a period where there's not a lot of new starts and that's going to drive we think underlying fundamentals in a really way. So, we do think that real estate today has some characteristics that would make it a really attractive asset class. So, looking at kind of where we see opportunities is we really like and we're being mindful of some of the volatility that's entered into the market with the tariff discussion. And so, the way we're shifting our portfolios and thinking about it is really going into some of the more defensive asset classes such as the living sector, which would be the multifamily space, the senior housing space, student housing space, and probably staying away from some of the higher volatility asset classes like hotel right now, although we do think that as the market stabilizes and values again demonstrate that that they are at this bottom that we'll find interesting opportunities across all the sectors. The other space that I think we really like is some of subordinate debt positions where you can go into a market today where liquidity is just now returning and you're able to get attachment points that are much more attractive as the banks have pulled back and have been more rigid in terms of how they deploy their capital. And so, there's a need for someone like a non-bank lender to come in and fill out the capital stack and get probably outsized returns for doing that in this kind of an environment. So, that's where we think there's a real opportunity and we're very excited about kind of where we sit in the sector today much more so than where we were two years ago.

That's right, John. Thank you. So, maybe I'll turn to Josh. Similar question, but obviously private credit and specifically direct lending, it's really kind of different part of the cycle I'll call it just because everywhere you turn, there is a mention of private credit and the expansion there. But obviously, we're going through this period of incredible uncertainty and we've seen public market spreads widen recently particularly down in the capital stack below investment grade as a result of the volatility. Can you share if and how that has played out in the private credit market? And are there areas that you're seeing opportunities as a result of this? At the same time, are there risks that you're trying to manage for?

Sure, yeah. It's a great question, Mao. I think generally it's been a good place to be in private credit the last 5-plus years and you've seen a lot of capital rush in, you've seen a lot of new players, but we really haven't been faced with a recession. So, I don't think the market has truly been tested. And what you've seen during this time particularly in the large cap space is you've seen really high leverage attachment points. You've seen sponsors getting aggressive. You've seen the rising interest rates cause a lot of stress on the ability to service cash flows. Because of that, you've seen a lot of structures that maybe have a higher PIK interest component or you've seen sponsors needing relief on interest. So, I think fundamentally we were already heading into a situation where I think a little bit of stress on the system was really going to prove out how some of this would play out. I think in terms of some of the recent noise, really the private market again I go back to, it tends to be more stable. I think it's too early to tell. I think absolutely the recent noise will challenge us. Kaustub said earlier on our underwriting they're very focused on anything tariff or supply chain related. But generally speaking over the past four to six weeks, you haven't seen a lot of cracks. You've not seen a significant winding of spreads in the private market. I think deals that were already largely baked, they continue to move forward. And the lenders in this private credit universe, particularly direct lending space, they kind of stood by their term sheets and they stood by their deals and they moved those forward. I think for companies that are really subject to and at risk from a tariff perspective and a supply chain perspective, yeah, some of those deals I think probably slowed or maybe were recut.

But in many cases particularly on the sponsor side, I think a sponsor was relooking at those deals. We've talked to sponsors and consultants recently and even management teams. They're rerunning their projection models almost daily depending on what's being said in the news. So, when you can't really think through the underlying credit fundamentals and the impact on the business, it obviously makes it difficult to underwrite. I think one of the things that John mentioned too is one of the big spaces in private credit we haven't talked a lot about is infrastructure and core infrastructure. And I think like real estate, those are backed by real assets. There's good downside protection. These are often critical infrastructure needs whether it's renewable power, whether it's a toll road, whether it's an airport where you have stability with where global trade and global travel is, and I think in this market those offer really interesting opportunities and is another area where I think private credit will continue to take market share from banks. Again, as John said, banks continue to be a little bit more risk off, continue to pull back a bit, and it allows institutional lenders like ourselves to come in and structure solutions that can work for borrowers. From an opportunity perspective, I think we see a lot of opportunity in the middle market across the globe, particularly in Europe. I think in Europe, you have a few larger funds focused on kind of the up market when we're talking about direct lending specifically. But in the middle market, I think there's a little bit less competition. And again, I think companies there need to invest. I think if anything, some of this policy change might bring the EU together more, have them invest more, which could be an opportunity for us because they're going to need the capital to do so. So, I think we would say Europe is a good opportunity both in the direct lending space, but also in the infrastructure space. I think as John mentioned, we think unique solutions and structuring subordinated debt, hold co-loans and more complex structures allows borrowers and sponsors more access to capital, and I think we can bring solutions that will allow them to layer some of that capital in and really maximize their returns. I think you'll see more in the secondaries and club deal kind of market I think as some of the public market or BSL market pulls back. I think you see institutional investors jump in and try to solve those solutions, again back to the steady and stability within the market. From a risk perspective, I think the biggest thing is how do you underwrite. It's tough to underwrite in this environment when you really don't know what's going to happen the next day, particularly if you're a business that's global and you have a global supply chain. So, we're absolutely looking at our portfolio, looking at companies with consumer exposure, looking at companies that are exporting and importing from other markets and trying to determine how to underwrite. I think you have a lot of lever companies coming into this recession. Interest rates are still high. And if there's a looming recession, I think you'll see some balance sheets that'll break. Again, I go back to if sponsors and investors like ourselves are willing to start a deal with a component of PIK interest, it probably shows that there's a little bit too much debt and leverage on a balance sheet if you can't even kind of cover your interest costs. And I think the last thing that's likely to be the biggest impact is the slowdown in M&A. With this uncertainty, you're going to see management teams of private-owned companies slow down their process given the uncertainty. You're absolutely going to see sponsors slow down. And I think for investors that are solely relying on sponsored deal flow, you're going to see another dip in just the absolute volume in the market. I think a benefit of our 15 global office network is we do about half of our transactions annually in the direct lending space on a sponsor list basis, so I think we'll create a larger deal funnel. But I think inevitably, M&A will be down across the markets during this uncertainty and that'll lead to fewer kind of primary opportunities.

Yeah, I think you hit on a lot of great points. It's in a matter of four to six weeks. It's too soon to tell what's going to break underneath, and having a rigorous underwriting process is the best way to again help mitigate those type of risks. So, Kaustub, maybe I'll turn to you.

We talked about earlier if we simply talk about the diversity of collateral pools within structured credit, you could probably spent days talking about it. But if you could summarize for us, what are you seeing in terms of biggest opportunities and risk in the structured credit space?

Yeah, sure. So, I think a lot of the themes that sort of John and Josh talked about obviously resonate with me as well and are sort of applicable to securitized credit. As you said, Mao, there are just a ton of different subsectors within securitized credit. If I had to boil it to like a few themes, I would think ABS and RMBS, the asset-backed security market, the mortgage-backed security market, you kind of are dealing with mostly the consumer type exposure. Your CMBS exposure or your CMBS allocation is really going to be driven by sort of themes in CRE. So, a lot of things John kind of talked I think we generally agree with. And we go to CLOs, you're sort of tackling with more corporate risk. I think on the ABS and RMBS side, we generally like the higher end consumer here. They're still well positioned out of everyone to sort of deal with tariff rates and a potential recession. So, that consumer that is kind of your 745 consumer in the U.S., typically a homeowner, I think is very well positioned from that perspective. And so, we'd like a lot of the RMBS sectors. We think of a hard asset that's also held up from a pricing perspective, which is the house. And so, the things that we like there are essentially borrowers that are locked into these very low rate mortgages and need other forms of financing of their house. So, think of someone who needs to renovate like an office and they want to take out a second lien mortgage. Well, that borrower just needs to renovate their house because that's the house they're going to be stuck in because they have this great first deal mortgage. They probably don't want to exit that house. And so, the story makes sense. If you take that same concept and apply it to the asset-backed securities market, well, hey, that borrower may also want a home improvement loan like their HVAC breaks down and they have a big repair and need financing for that. Well, that borrower again is the same borrower that you're lending to just in different forms. And so, what we try and do is connect kind of that top-down theme with kind of how we can get that exposure in sort of different markets. So, that's one theme is sort of sticking with that high quality consumer in the U.S. that is a homeowner. I think on the subprime consumer side, there have obviously been a lot of headlines about how the subprime consumer is weak, and that's generally the case. Subprime consumers are in some form of recession always, but we have seen delinquency there, so we're definitely mindful of that. I think how we try to play that space is really either get a lot of structural protection. So, here, I'm thinking of we do lend in kind of subprime auto. We think the structures there are very solid. We're not going to the bottom of the capital structure. When we're going to the belly of the capital structure, we've got a lot of structural support. And so, that's one way where you can sort of get exposure to that borrower without necessarily taking a lot of risk or we lend to that same borrower, but in the unsecured consumer space, but with very select operators who we've underwritten in a kind of a deep way and we like their form of lending for various reasons. So, I think that's how you need to be more selective as you go down in credit kind of for the consumer given the environment that we're in. If we focus non-U.S., I think a lot of lending that happens in Europe and Australia on the consumer side tends to just lean naturally towards the prime side of things just because of how the capital markets are set up. And so, we like a lot of stories there frankly including the mortgage space, the auto space, and even sort of the consumer loan side of things as well. CMBS agree with a lot of what John said. We do participate very heavily in the single-asset single-borrower space. There, we do a deep credit of the actual property like industrials there a lot, selective on office, selective on retail. Agreed with John on sort of hotels and sort of the volatility inherent in that cash flow just making it sometimes a tougher underwrite than maybe industrials.

And on the CLO side, AAA CLOs, just going back to what I said my first response, liquidity is important to our portfolios and AAA CLOs are still kind of one of the most liquid assets out there. So, it's liquid, it's high quality, it's very hard to break. So, that tends to be kind of a co-allocation for us just for that higher carry, higher quality liquid asset within the portfolio. I think from a risk perspective, obviously tariffs are a concern. And I think the first order impact of tariffs may be felt in certain kind of small subsectors within each of these verticals. But frankly, I don't think there's like a major impact from tariffs from any one vertical. I think the big concern from tariffs is really kind of that second order effect, which sort of Josh and John both referenced, which is, "Do these tariffs lead to a recession?" And then, when they lead to recession, well, I guess that typically does come with hard unemployment, weaker spending, and all of those things will naturally kind of filter through into worse performance within our space. I think just in terms of how we select for assets at the very start with the way I talked about just that high quality consumer, being more mindful of the risk we're taking if we go to more subprime, I think we should weather that okay. But naturally as you enter into a recession, you will see worse credit performance and that is kind of the risk that's sort of top of mind, which is like, "How does the consumer weather higher costs and job loss to the extent that that that does happen?"

Yeah. Thanks, Kaustub. That's a great summary. Like you said, it really comes down to the consumer and the corporate reaction function at the end of the day. And when the dust settles, if there is a trade deal, it all comes down to kind of that final impact to the bottom line. So, now, we've touched on kind of the current market environment. Obviously, a very topical area to focus on is that convergence between private and public markets. And so, as credit markets expand to these new segments, really that dividing line is fading. And so, maybe we'll continue on that discussion with you, Kaustub. One of the areas at least most apparent in some of the client discussions that we've been having on the multi asset side is really that convergence in the structured credit space. Asset-based finance feels like a term that's again very topical in the news all the time. And so, can you help us kind of touch on that and how that's kind of merging really with the public structure credit space?

Yeah, I think it's helpful there when you talk about asset-based finance just to talk about like the tailwinds, kind of what's driving that interest and why that's happened. I think John really summarized this really well where banks are essentially stepping back from lending, the more balance sheet constraint than they have been in the past, and this has really been a theme that's been emerging post-GFC. Capital regulations are higher. That's more stress testing on bank balance sheets, so they have to kind of step away from certain markets. Even if you think about kind of single family mortgages, which you would think that's kind of a staple bank product that used to be a 70% bank dominated product 10-plus years ago, if you look it now, it's sort of 80% non-bank. So, there's been this emergence of or switching from lending away from banks to sort of the non-bank space. And at the same time as my colleagues just mentioned, there has been this technological evolution in terms of how this lending is occurring. So, just look at the consumer for a second. It used to be for a long time that you're borrowing as a consumer was really on the mortgage side or really on the credit card side. Well, guess what? Now, you can buy stuff on buy now, pay later. You can take on unsecured consumer loans. You can do point of sale type financing. In other words, someone's selling you that HVAC system. You're not putting that on a credit card. You're taking out a home improvement loan. And all this type of lending is happening by sort of fintech lenders that are originators in the space that a lot of these guys' deep expertise comes from the banking space. So, they're not just forming these originators just to get these loans out, but they have that deep expertise in credit, but don't necessarily have the same balance sheet that they did on the bank side of things. So, what that creates is the banks stepping away, more origination happening away from banks, more of this fintech type lending happening, and that's really where sort of ABF comes in. We as investors and the way these traits typically work is we as investors know these originators from the public side or we know the people involved because we've been in these markets for 20-plus years. So, either we approach them or they approach us and they say, "Look, our business is really originating these loans, managing the credit, but we need we don't have the balance sheet for this. Can you either buy these loans from our balance sheet straight up or can we do this in some sort of forward flow way?" So, in other words, buy these loans over a period of time so you have some permanent capital take out. And from an originator perspective, kind of the benefit of that is simply their size. So, they can sell and transact with us very, very quickly in large size as opposed to going to the ABS market and doing this crunched up and getting abated in some cases and going through the whole kind of syndication process. There's also a certainty of execution. So, you're not waiting to sort of aggregate all these loans up on your balance sheet and then sell them. As you're originating, you're typically selling these loans to kind of forward flow partners. And then on top of that, they build up a long-term partnership that they really do value. This isn't just someone who is going to be with them just for one trade, but would be with them for the long run. And I think from an investor perspective, what it tends to offer we find is you can be extremely selective in terms of who you want to partner with. So, we as investors have a lot of the kind of long-term themes that I've been talking about, like we like the homeowner, we like the high quality consumer, we like the European consumer, we like we like certain themes in the CRE market. We can express all of that in the ABF market by approaching originators in those spaces that you really like. And on top of that, when you do do that, you have access to basically their entire -- that's what we typically ask for is access to the entire origination book. So, we have a sense of how their collateral is performing across different cycles, different stratospheres. So, you can be very selective in types of the collateral that you actually want to seek out as well.

And the third is it offers a lot of structural flexibility too. So, you are not simply buying a transaction in the public markets. You're doing this bilaterally. So, you can structure it how we want. And oftentimes, what we ask for is if we don't agree on losses, well, guess what? We're going to try and get some sort of structural protection there. That way, we can sort of bridge the gap between where we think losses will shake out in a particular deal versus what the originator will shake out. So, there are these types of like structural features that we can get in our transactions that are oftentimes not available within the public space. So, I think it's oftentimes a combination of either higher spread because you're getting this sort of giving the originator access to size in terms of takeout or you can get better credit in terms of collateral or in structure. The one thing I would say is obviously, Mao, exactly what you said, which is there's been a lot of excitement in this asset class. And like in the public space, it is very important to be disciplined because these are long-term takeouts. It's takes a long time and it takes a lot of work to do this work because you really have to dig into not just the collateral, but even before that with deep diligence of the actual originator. Go to the collateral balance sheet. You have to then be able to understand where loans are pricing and why and which you want to select. And then, you're structuring these deals oftentimes by yourself as well. So, you're not just doing the collateral selection, but you're doing the structural selection as well and the structural creation. So, a lot of the things that a bank would typically do or a dealer would typically do are being done by investors by themselves. So, you need that deep bench. I think it becomes even more important in the private ABS space and you need that sort of expertise in these asset classes, which is I think what we have at PGIM.

Yeah, that's very clear and helpful, Kaustub. Josh, I'll turn to you. What are you seeing in the direct lending space? You mentioned innovation across vehicles, structuring, so perhaps touch on some of that and kind of what else you're seeing.

Yeah. And some of Kaustub's points are just spot on. And frankly within our private capital group, we've been doing these structured solutions for decades. And so, this convergence that you're seeing, you are seeing a lot more asset managers come into the private ADF, come into these structured solutions. And as Kaustub said, focus on bilateral relationships, long-term relationships where you're bringing solutions. And we think about on the structured credit side what we've been doing for decades is structuring transactions like securitizing receivable flow or securitizing export flow. You think about the sports industry where you see more and more private equity and private credit into the sports industry, securitizing the revenues coming from media rights or stadium financing. So, I think that the blurring lines are that you're seeing more and more asset managers recognize the benefits of structuring solutions and bringing capital solutions that come with a premium, come with deep knowledge of the counterparty you have across the table from you, and I think that convergence is just causing more competition and the proliferation of the market overall. When you think of the direct lending space, you're absolutely seeing that convergence particularly as you get in from kind of the BSL market to the large cap market and even into the upper middle market where you see a lot of blurring lines of the types of investors, the types of deals that you see. From our middle market portfolio, we have covenants in every single deal, we have lower attachment points. But more and more even in the middle market, you're starting to see especially in the upper middle market some covenant light deals and some I think giving on structuring considerations as people chase deals and as there's more money coming into the market. I think to your last point, Mao, and I think what we were getting at with kind of structuring of fund solutions is, yeah, illiquidity was the biggest issue with these and access to investors. And so, I think what you're seeing particularly with a lot of direct lending investors and funds like ourselves is unique solutions. And whether that's solutions to try to get to the private wealth market so you're seeing BBCs, you're seeing evergreen funds, interval funds, ways to get to just a broader access of opportunities through CLOs or CFOs where maybe you're tranching up different solutions, frankly solutions that can be from the public side, from the real estate side or from private direct lending. You're seeing solutions that are geared towards specific countries or insurers whether it's rated feeders to benefit insurance companies coming in and help with capital charges. You're seeing a lot of focus on fund formation when it comes to ESG characteristics and other regulatory oversight in Europe. So, yeah, I think what you're seeing is from an asset management perspective is you have to be creative with your solutions. You have to find different ways to get access to different investors. Especially if you can continue to deploy the capital, you're going to have plenty of opportunities. So, these solutions and unique solutions are definitely a new part of our market.

That's right. Thanks, Josh. John, any final thoughts on the convergence and what you're seeing in your market and more broadly?

Yeah, I'll just maybe touch on I think as Josh pointed out, we're definitely seeing for insurance company capital specifically a need to go through alternative vehicles like a rated feeder to really structure something that's capital efficient for them. So, I think that's very specific to the insurance company space, but I would say kind of an example where you're seeing this converging, one of the strategies that we find really popular with investors and that we execute is a levered loan senior strategy. So, we really like the idea and the ability to go in and structure a senior loan on a private side. Kaustub said it in a bilateral discussion where we can really evaluate an individual transaction, we can underwrite the credit and understand the sponsor, have a direct relationship and structure the deal the way we think is appropriate based upon those variables. And so, historically what you would do in that strategy is you would go and then back lever that loan with a bank through a repo facility or loan on loan and that would enhance the return in a way that was really attractive to an investor without really increasing the risk materially. And so, what you're seeing now that's becoming very popular instead of going to the banks to do that, a lot of managers are issuing a pool of these private senior loans to the CLO market where it can be rated and be offered to the public as a way to get that back-end leverage. And so, we think this makes a lot of sense in that you're still able to structure and make a private investment that you think is going to generate the best risk adjusted return. And then, you get the back-end leverage where investors can come in and say, "Well, I like the strategy, but I would rather participate in the AAA tranche there and get paid according to that." And so, you're seeing that emerge and grow that market as it relates to CRE where that market has existed certainly in the corporate space for a lot of years as well. So, that's one of the really interesting ways I think that you're seeing it real time of how managers are really utilizing both the private capabilities along with the public to ultimately deliver something that makes a lot of sense for the investors.

Yeah. That's great, John. And you touched on the structuring and obviously the increased transparency as a result of greater regulatory oversight and data requests, and these are some things that if I jump in from a multi-asset space what we're seeing from our end clients like insurers are requests for more data, more transparency, which obviously the underlying loan characteristics and credit risk may be similar, but it is in bilateral transaction sometimes there isn't as much transparency. And so, I think we're going to see a trend towards a greater need for transparency to get rating agencies comfortable and the clarity and the education there is going to be critical. Maybe I'll chime in and wrap up with one final thought from what we're seeing on our client side is there's an increasingly move away from allocations into distinct asset classes and more allocation in terms of objective. So, an example, "Give me a spread of 200 to 300 basis points over SOFR," as opposed to, "I want IG corporates, I want structural credit." And so, that actually ties to the original point that I think all of our speakers have touched on is there is much more of a need for an integrated solution that really kind of crosses the public and private spectrum and frankly greater flexibility to try to achieve that objective, but no longer are we seeing very clear delineation of allocation across asset classes. It's more of an allocation to objectives if I can frame it that way. So, I know we're coming up on time. And so, we may need to wrap this up, but we're obviously getting questions from the audience. One question that we saw is, "How is insurance capital shaping private markets?" And so, maybe in the final minute I have, I'll try to take that on to give our speakers a bit of a breather.

I'd say insurers have always played a significant role in how the private credit has evolved over the past century when part of the driver is that insurance capital does represent a source of more permanent capital and the range of long-term liabilities that insurers have provides an ideal source of funding for private credit and their long-term nature means that insurer investments in private credit tend to be more stable. And so, the suitability of insurance capital for private credit and its stickiness are one key reason why asset managers tend to be drawn to the insurers. But at the same time, I think this convergence between public and private credit also means that insurers can better express their allocation decisions like I said in the form of objectives. That also means that they're no longer having to face the issue of trying to decide what is the right capital allocation to specific asset classes. And so, in some way, they're mutually symbiotic relationships as the private credit market has evolved has also helped shape how insurers are allocating capital. And so, it's a very interesting phenomenon that we're seeing across the space. And as more types of investors as Josh mentioned like retail, private wealth and other institutional investors kind of come into the space, it'll be really interesting see how this space shapes in the foreseeable future. So, maybe with that, we are about out of time. And so, I want to thank all of our panelists for sharing their expertise today and to everyone who joined us for this timely and far-reaching discussion. If you're interested in PGIM's latest insights and on the ongoing convergence of public and private credit, please click on the link on your screen or alternatively you can visit pgim.com. Thank you and have a great day.

Thanks, everyone.

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