MARCH 2024 | INVESTMENT RESEARCH

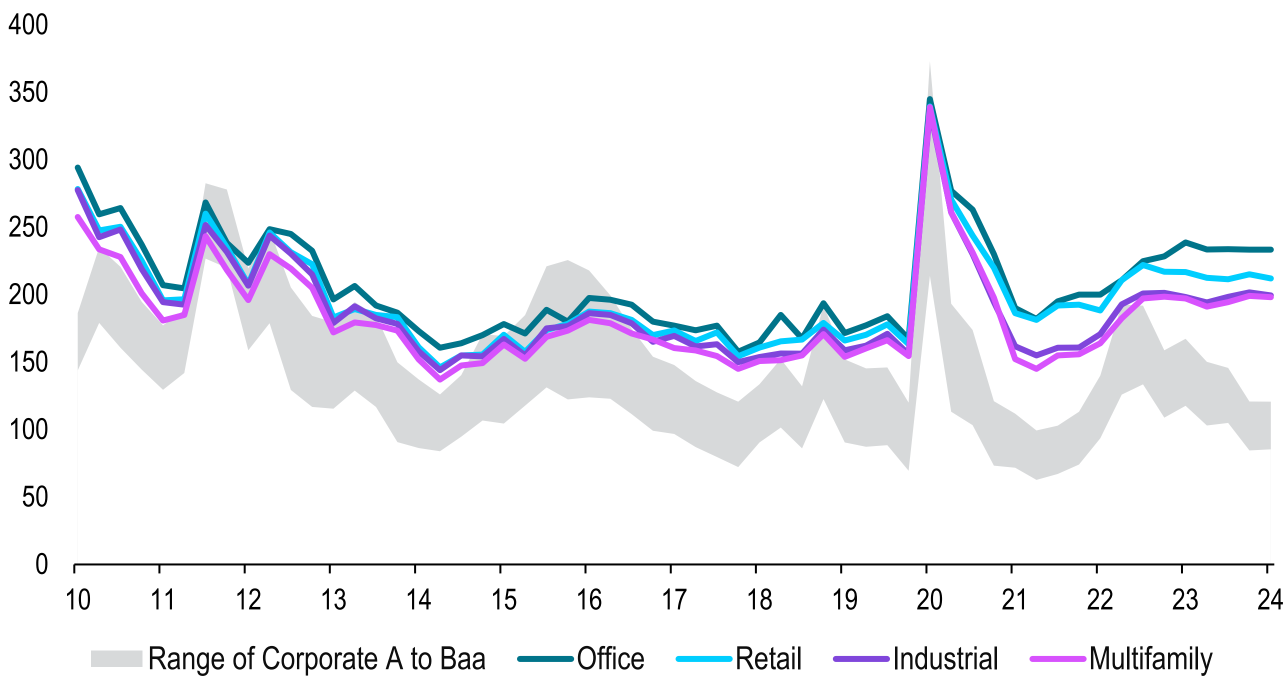
U.S. CRE Debt: Is Now the Time to Invest in CRE Debt Amid Historically High Spreads?

Executive Summary

- Historically wide CRE spreads present an attractive entry point for investors.
- Significant premium offered by CRE debt compared to corporate bonds (**Exhibit 1**).
- Anticipated interest rate cuts could tighten spreads and boost investment values.
- Lower rates and expected rental growth will drive positive credit migration.
- Now is a compelling time for investors with built-in positive appreciation.

Exhibit 1: Current Private CRE Spreads Wide on a Historical Basis

Private CRE Debt 10Y Fixed Rate vs Corporate A to Baa



CRE debt refers to bank balance sheet spreads on 60-65% LTV, amortizing, 10-Year, fixed rate loans.
Source: Bloomberg, CREFC, Trepp, PGIM Real Estate. As of March 2024.

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Wider spreads signify opportunities for substantial rewards in the CRE debt market

Amidst the Federal Reserve's plan to reduce interest rates later this year according to its latest economic projections[1], the commercial real estate (CRE) debt market presents a compelling investment opportunity. Data from the fourth quarter of 2023 posted spreads significantly higher than historical averages, exceeding the one standard deviation range, and showcasing a broader spectrum compared to history (**Exhibit 2**). This presents an attractive entry point for investors, considering the potential for higher yields across a wide range of risk and return profiles.

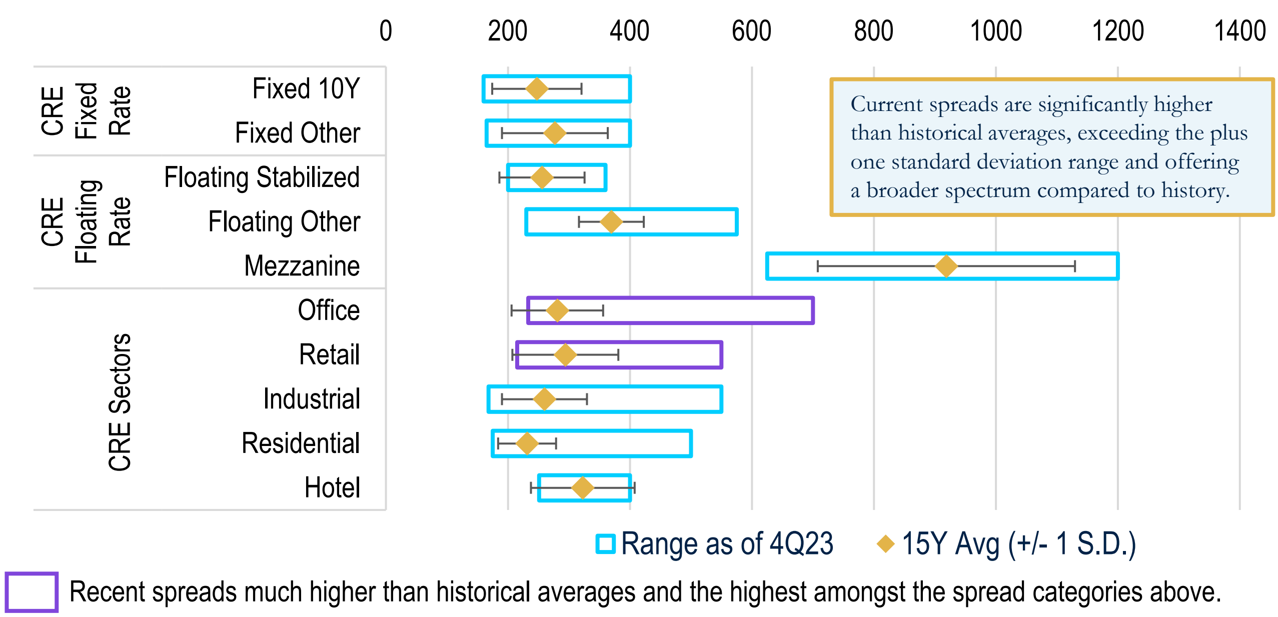
Examining CRE 10-year fixed rate spreads against corporate A to Baa rates reveals a significant premium for CRE debt (**Exhibit 1**). This premium has remained consistently higher than average and is expected to persist, offering sustained opportunities for higher yields compared to corporate bonds of similar credit quality.

The appeal of wider spreads lies in their dual nature: they indicate increased risk perception while promising higher potential returns. Anticipated interest rate cuts by the Fed could tighten spreads and boost investment values. Notably, CMBS spreads have already tightened, and private CRE debt is expected to follow suit. This presents strategic advantages for investors, particularly as spreads are expected to narrow from current highs.

In summary, while caution is necessary due to wider spreads, they also signify opportunities for substantial rewards, especially considering the above norm delta between corporate and CRE spreads. The resilience of CRE income creates plentiful opportunities, especially in sectors with strong fundamentals, like retail, which has navigated structural shifts through COVID and now has a brighter outlook. Additionally, lower interest rates should ease refinancing and valuation pressures, with most sectors poised for rental growth as fundamentals remain solid. In turn this will drive positive credit migration.

Exhibit 2: Private CRE Debt Spreads 4Q23 Versus Historical (2008-2023)

Private CRE Debt Spread Ranges as of 4Q23 vs. Historical Spreads (2008-2023)



Source: CREFC, Trepp, Giliberto-Levy, Cushman & Wakefield, Chatham Financial, ACLI, PGIM Real Estate. As of March 2024.

[1]Board of Governors of the Federal Reserve System, Summary of Economic Projections, 19-20 March 2024.

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Important information *(continued)*

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