Private Real Estate Credit: Navigating Opportunities in a Shifting Landscape

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The private credit market is set to reach nearly $3 trillion in the next five years, with private real estate credit climbing to $400 billion globally.[1] Already a $1.9 trillion industry, private credit has grown rapidly, highlighting its rising appeal to investors, with real estate credit playing a key role (Exhibit 1).

In a significant shift for the US commercial real estate (CRE) market, the Federal Reserve (Fed) recently cut interest rates by 50 basis points, marking its first reduction since the pandemic. This move comes as the sector emerges from eight consecutive quarters of valuation declines,[2] leaving investors cautious, but eyeing potential opportunities as valuations approach a cyclical bottom.

For private real estate credit investors, this environment presents a compelling opportunity to capitalize on lower borrowing costs, recalibrated valuations, and the prospect of stronger future returns. However, with a changing economic backdrop, investors could benefit from matching strategies to local market dynamics.

Investment Strategies to Consider

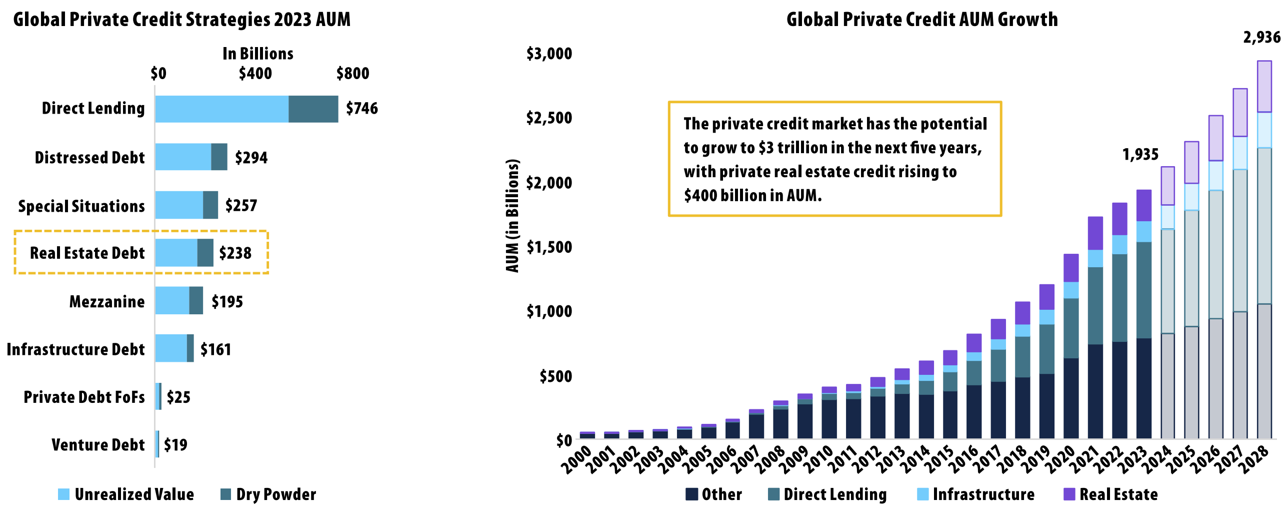
For investors thinking about their strategies in this evolving landscape, several approaches merit consideration.

Core Commercial Mortgages

This strategy focuses on senior secured loans, specifically investment-grade[3] commercial mortgages. It benefits from current elevated interest rates, allowing investors to build portfolios with attractive all-in coupons. Although rates are expected to ease, they are set to remain structurally higher in the next cycle, offering continued opportunities for strong yields. Focusing on assets in resilient cities and sectors could also add an additional layer of protection against market volatility, making this strategy well suited for investors seeking stable, income-oriented returns with lower risk.

1. Data refers to closed-end commingled funds only (source: Preqin). The total size of the private credit market will be larger because it also includes open-end funds and separate accounts.
2. The NCREIF All Property Index, a benchmark for institutional real estate, has fallen 18.5% from 2Q22 to 2Q24 (source: NCREIF).
3. Investment-grade equivalents would be suitable if not rated.

Exhibit 1: Private Credit to Reach $3 Trillion



Sources: Preqin, PGIM Real Estate; as of November 2024
Notes: Data refers to closed-end commingled funds only. The total size of the private credit market will be larger because it will also include open-end funds and separate accounts. "Other" includes distressed debt, special situations, mezzanine, private debt funds of funds, and venture debt. Shaded bars depict forecasts. Forecasts are not guaranteed and may not be a reliable indicator of future results.


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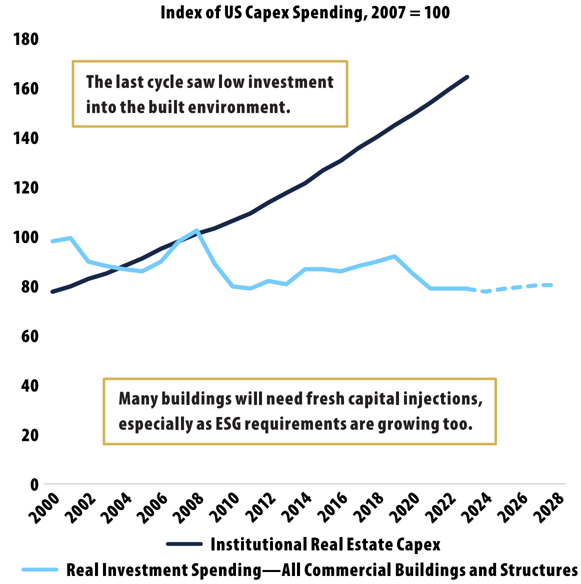
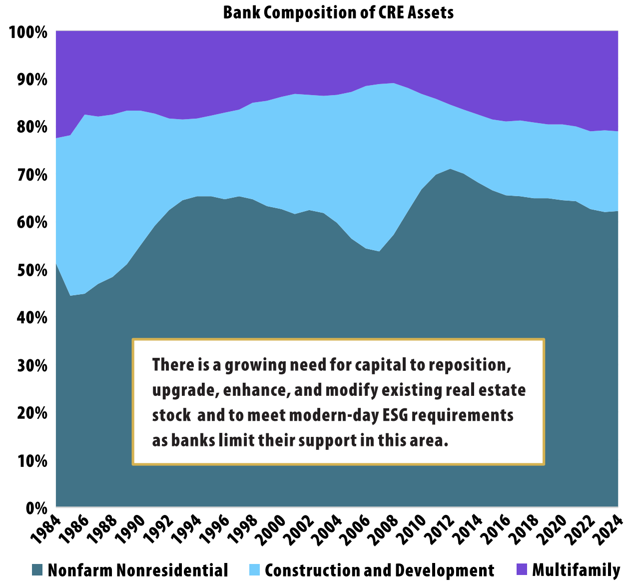
Exhibit 2: Need for Value-Added Financing





Sources: FDIC, MSCI, OECD, Oxford Economics, PGIM Real Estate; as of November 2024.
Note: Forecasts are not guaranteed and may not be a reliable indicator of future results.

High-Yield Credit—Transitional Real Estate

This strategy, which involves senior secured or subordinate loans linked to properties undergoing light transition, stands to gain from a rebound in real estate markets. With lower interest rates and a revived commercial mortgage-backed security (CMBS) and CRE collateralized loan obligation (CLO) market, leverage can also enhance returns. These favorable trends improve the risk profile, making this strategy attractive for investors seeking higher-potential returns with slightly more risk.

High-Yield Credit—Value-Added Real Estate

This strategy, which includes senior secured subordinate loans or preferred equity tied to properties undergoing significant transition or construction, will also benefit from the real estate cycle's upswing and cheaper leverage. For investors with a higher risk tolerance focused on total return, this strategy provides significant upside potential, especially in areas such as senior development finance and mezzanine debt.

Both high-yield strategies address the growing need for capital to reposition, upgrade, enhance, and modify existing real estate stock, particularly given low capital expenditure in the last cycle and increasing environmental, social, and governance (ESG) requirements (Exhibit 2). While often associated with transitional or value-added properties, high-yield lending also serves core real estate when borrowers seek leverage beyond what is available in the core commercial mortgage market.

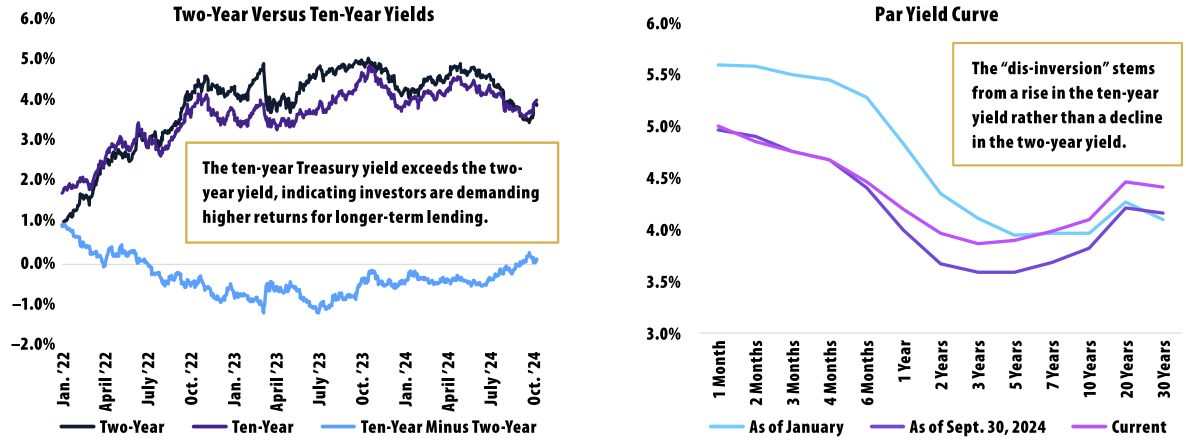
Return to a More Normalized Interest Rate Environment

The Fed's recent cut, bringing the benchmark rate to 4.75% to 5%, has reshaped the yield curve, with the ten-year Treasury yield surpassing the two-year yield for the first time in more than two years. This "dis-inversion," stemming from a rise in the ten-year yield rather than a fall in the two-year, suggests that factors beyond near-term Fed rate expectations are influencing market dynamics.

The return of the ten-year term premium and a steepening yield curve point to a normalization of market expectations, reducing the likelihood of aggressive rate cuts (Exhibit 3). Estimates of the neutral rate range from 2.4% to 3.8%,[4] indicating that rates will be higher than in the last cycle. This creates a favorable environment for private credit strategies, which stand to benefit from structurally higher yields going forward.

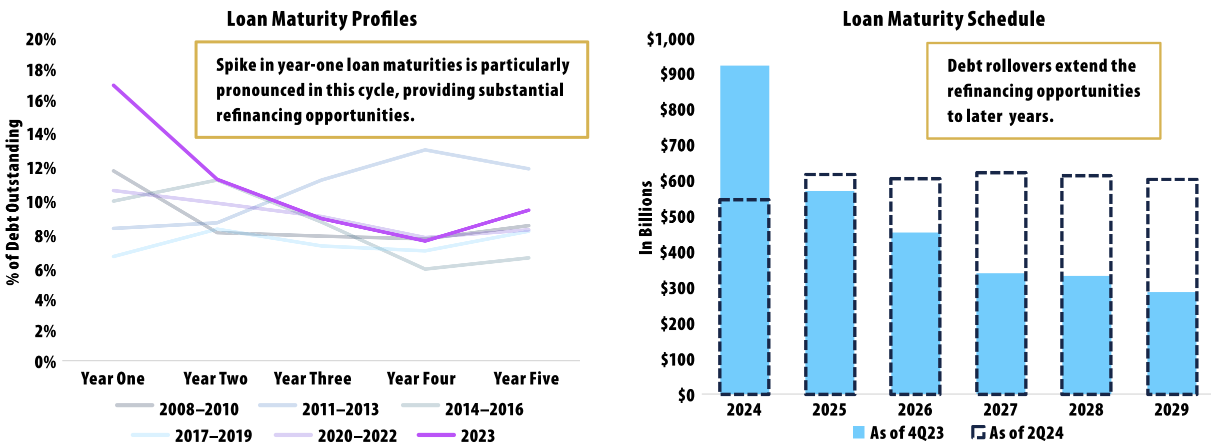
4. Board of Governors of the Federal Reserve System, Summary of Economic Projections, Sept. 18, 2024.

Exhibit 3: Return of the Term Premium



Sources: US Department of the Treasury, Bloomberg, PGIM Real Estate; as of November 2024, current as of Oct. 10, 2024

Exhibit 4: Substantial Debt Rollovers



Sources: Mortgage Bankers Association, Trepp Inc., PGIM Real Estate; as of November 2024
Note: Forecasts are not guaranteed and may not be a reliable indicator of future results.

Market Dynamics and a Trillion-Dollar Catalyst

The return to a more normalized interest rate environment will drive increased activity in the CRE debt market, which is already showing signs of revival. Year-to-date private-label CMBS and CRE CLO issuance has reached $83.1 billion, more than double the figure from the same period in 2023.[5] This resurgence has created a more favorable climate for credit investors, particularly those strategically using leverage to enhance returns.[6]

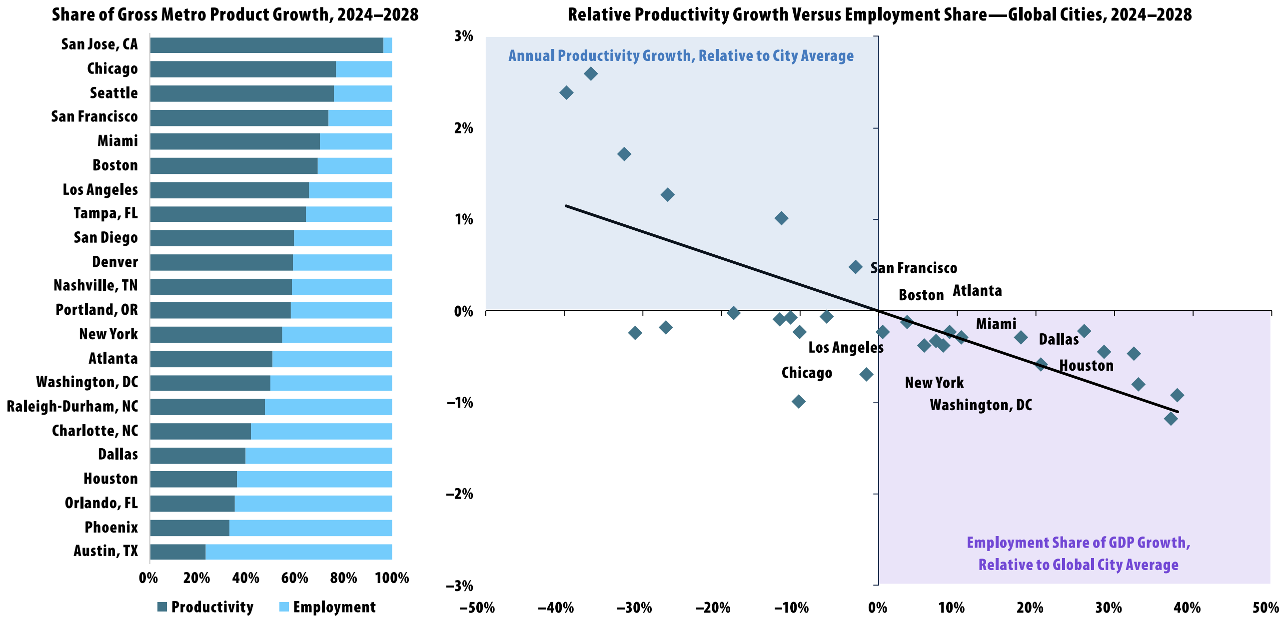
As this momentum builds, the market faces a substantial catalyst: approximately $1 trillion in CRE loans is set to mature over the next two years (Exhibit 4). Most of these loans were originated in a near-zero interest rate environment and are held by banks facing ongoing regulatory uncertainty. This scenario presents a substantial funding gap for alternative capital sources to fill.[7]

Shifting Regulatory Landscape

The regulatory landscape is a big driver behind the private credit opportunity, but it also adds a layer of complexity. Recent announcements from the Fed indicate a potential easing of regulatory burdens on banks, with the revised Basel III Endgame proposal aiming to support the flow of credit to the economy.

5. CRE Finance Council, MarketMetrics, Oct. 4, 2024.
6. "The Strategic Use of Leverage in Real Estate Debt Funds," PGIM Real Estate, Jan. 4, 2024.
7. "US CRE Debt: Why the Funding Gap May Be Larger Than We Think," PGIM Real Estate, March 21, 2024.

Exhibit 5: City Dynamics Offer High Income Growth and Downside Protection



Sources: OECD, Oxford Economics, PGIM Real Estate; as of November 2024
Note: Forecasts are not guaranteed and may not be a reliable indicator of future results.

The original proposal called for raising capital requirements by 16% on average for banks with more than $100 billion in assets and 19% for the largest firms. The revised plan, however, exempts banks below $250 billion in assets from most new rules and reduces risk weights for key asset classes.

As a result, capital requirements would rise just 9% for the largest banks and minimally or not at all for smaller ones. Because the largest banks hold significant dollar amounts of CRE loans, even a 9% increase in capital requirements could hamper their flow of credit to the real estate sector, further widening the funding gap.

Real Estate Outlook: A New Cycle Driven by Income And Rent Growth

Real estate values are expected to hit a cyclical bottom this year and rebound thereafter as cap rate expansion ends. In the next cycle, higher income and rent growth will drive returns rather than cap rate compression, which drove the last cycle. This bodes well for private credit investments that favor stable and predictable income streams.

When deciding where to allocate capital, private credit investors should consider city dynamics because different cities exhibit distinct growth models. In the next cycle, productivity will take on a greater role in driving economic growth, especially as aging populations and shrinking workforces shift the focus toward technological advancements. These trends will influence local market dynamics: productivity-driven cities will see higher but more volatile real rental growth, and employment-driven cities will see steadier, though lower, rental growth (Exhibit 5).

To navigate this landscape, core credit strategies could focus on markets with strong employment growth, offering stability and resilience for steady, low-risk returns. In contrast, high-yield strategies could target cities with higher productivity and growth potential, where returns are higher but with increased risk. A diversified approach, blending both strategies, could deliver strong income growth while maintaining downside protection.

Key Factors Shaping the Private Credit Landscape

In summary, several key factors are shaping the landscape for private credit investments:

- **Normalizing Interest Rates:** The reemergence of the term premium will lead to more-predictable financing costs and stable valuations.

- **Substantial Debt Rollover:** A significant amount of debt is set to mature in the coming years, creating opportunities as banks pull back.
- **Viable Debt Financing:** As interest rates decline, debt financing becomes more feasible and accretive to transactions.
- **Stronger NOI Growth:** Expected NOI growth will boost cash flows and improve debt service coverage.
- **Improved Loan-to-Value Ratios:** Projected value growth after 2024 will enhance loan-to-value ratios on existing debt.

Together, these factors will strengthen credit profiles, will increase equity cushions, and could provide a better risk-reward balance for CRE credit investments.

Navigating the Shifting Landscape

As the market approaches a turning point, private real estate credit strategies offer an attractive income-driven investment alternative. With forecast real estate value growth driven more by income and rent growth than yield compression, credit strategies provide an opportunity to generate priority returns with creditor-friendly structures and significant downside protection.

The key for investors is to remain vigilant and adaptable. By focusing on value creation through resilient income growth and maintaining a deep understanding of market fundamentals, credit risk, and interest rate sensitivity, investors can position themselves to capitalize on the opportunities presented by this dynamic market environment while managing the inherent risks.

With the outlook for private real estate credit and the opportunities that arise with it, the private credit market could reach $3 trillion within five years. ■

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