PIMCO

Opportunities in Private Credit: Stepping In as Banks Step Out

AUTHORS

Jamie Weinstein
Portfolio Manager,
Corporate Special Situations

John Murray
Portfolio Manager,
Global Private Real Estate

Jason Steiner
Portfolio Manager,
Private Lending and
Opportunistic Strategies

Kris Kraus
Portfolio Manager,
Specialty Finance

As banks pull back from many types of lending, demand for capital is outpacing supply, providing the best potential opportunities in private credit since the GFC.

Key Points

- Banks are retrenching amid liquidity constraints, regulatory scrutiny, and higher cost structures.
- In the wake of a bank retreat, demand for capital has outstripped supply, reducing competition in many markets and creating new opportunities and a potentially stronger position for private credit investors.
- We expect increasing opportunities are likely within private credit in specialty finance, senior corporate loans, and commercial real estate.
- The next few years may be some of the best vintages across the private opportunity set since the GFC for investors with a wide range of objectives, in our view.

Fallout from the most rapid rise in interest rates in four decades may be creating the best environment for private credit investors since the global financial crisis (GFC).

Banks are retreating in the face of liquidity constraints, regulatory scrutiny, and higher cost structures. Sharply higher interest rates have raised borrowing costs, removing excess liquidity across the economy and prompting more depositors to move savings into higher-interest accounts. Additionally, the first major reform in bank regulation in over a decade – if passed – would take effect next year and increase capital requirements at a time when bank capital is already at a premium.

As bank retrenchment creates a void in lending markets, private capital has been able to step in, providing a stable and longer-term source of funding to banks while also aiding banks in reducing the overall size of their balance sheet.

A company of Allianz

Amid these shifting dynamics, it is crucial to make two important distinctions when assessing the private market opportunity set.

First we must distinguish between the existing stock of credit and future credit origination. We expect the current interest rate environment to put pressure on much of the existing stock of credit – particularly corporate and commercial real estate-related credit that was originated in an environment of abundant supply and low interest rates. Bank retrenchment has reduced competition in many markets, creating new origination opportunities and a stronger position for the remaining lenders.

Second, we must differentiate between technical pressures on banks facing liquidity challenges, and fundamental pressures affecting the assets themselves. Consumer balance sheets have proven remarkably resilient, having locked in historically low fixed mortgage rates, and many companies have refinanced higher-interest-rate bonds by issuing low-coupon, long-term, fixed-rate bonds. Thus, while banks face pressure in a variety of asset-based finance areas backed by both consumer and non-consumer collateral, the fundamentals of the assets themselves are actually quite solid. In contrast, fundamental weakness is becoming apparent in areas of corporate credit, where highly leveraged borrowers are straining to meet floating-rate interest payments or looming debt maturities. We believe the stress will worsen and spread as fiscal policy turns contractionary and the economy softens, which can create opportunities for private credit investors.

Real estate markets also face unique challenges: $3.6 trillion of commercial real estate (CRE) loans are maturing in the U.S. and Europe through 2025, many of which may not qualify for extensions.[1] Compounding the issue of bank retrenchment has been similar declines by other lenders typically relied upon for financing, such as publicly listed mortgage REITs and CMBS issuers, which face their own fair share of challenges. As a result, we expect the opportunity set in real estate-related credit to remain outsized relative to real estate equity over the investing cycle.

1 US CRE maturity data: Morgan Stanley; UK and European CRE maturities: JLL.

INVESTMENT IMPLICATIONS

As demand for capital outpaces supply, investors stand to benefit from the combination of liquidity-driven opportunities in private credit, as well as more complex transactions that solve capital structure challenges for corporate and real estate borrowers. Critical to this is a broad definition of the opportunity set in private credit, which looks across specialty finance, real estate and corporate credit. Patience is also key, because many of these opportunities will arise over the coming months and years as asset owners face uncertain monetary policy, potential slowing growth, and elevated geopolitical tensions. In this nascent stage of the stress cycle, we favor raising liquidity while preparing to take advantage of valuation overshoots and dislocations.

Specialty finance. Specialty finance – collateral-based loans to consumers and small and midsize businesses – gained critical mass after the GFC, filling the liquidity gap left as banks retrenched across sectors, especially in residential mortgages. Many specialty lenders, however, rely on short-term, low-cost bank lines of credit (known as warehouses) to fund the loans they originate and on functioning securitization markets to sell into. Amid recent liquidity pressures, regional banks have cut warehouse lines of credit, while securitization markets have been muted – underscoring specialty lenders' need for diversified sources of stable capital.

We see opportunities for private credit investors to provide capital in three ways: to banks – which are still originating loans, though on a far smaller scale; to nonbank lenders; and directly to borrowers. Our highest-conviction sectors are residential mortgage credit, solar and home improvement lending, equipment finance, and aircraft leasing. Pricing has become more attractive as available bank capital shrinks and demand for specialty lending rises – the beginning of what we believe will be a secular trend.

The sector represents an exciting opportunity, in our view, with potentially higher risk-adjusted returns than other private asset classes, such as private corporate lending and equities. Amid today's uncertain inflation and interest rate trajectories, the shorter-duration of the assets may lessen volatility, with principal paying down over time rather than in a bullet payment at maturity. In addition, the wide variety of loans and borrower types offers potentially deep diversification, historically generating low investment return correlations to markets, the economy, and one another.[2]

2 Preqin as of 30 June 2023

Senior corporate loans. Corporate leverage has soared, most notably in the market for senior floating-rate loans, which has tripled in size since the GFC to nearly $3 trillion.[3] In particular, we expect to see growing stress in the private segment of the loan market. Many of these borrowers are smaller, highly leveraged companies that have less access to capital markets and are more vulnerable to economic downturns. Sharply higher interest rates may leave many of these below-investment-grade borrowers struggling to meet higher debt-service costs.

This fundamental stress for borrowers may contribute to a broader liquidity shortfall which, in our view, likely intensifies as private debt fund managers (known as direct lenders) that invest in senior loans are forced to remove their nonperforming loans from the collateral pools that banks lend against. As a result, we anticipate a growing number of managers may be compelled to sell underperforming credits at a significant discount as they seek to upgrade credit quality, maintain a target yield distribution to investors, and avoid lengthy and time-consuming restructuring processes.

As traditional sources of liquidity contract, opportunistic credit managers can step in to fill large liquidity gaps and demand wider spreads and stricter covenants. We anticipate growing opportunities for investors to either purchase these loans at a discount or to refinance companies directly with more flexible loans and capital structures.

Commercial real estate. The CRE market is the most severely dislocated it has been since the GFC, yet fundamentals outside of the office sector have largely held up thus far. To be sure, the current dislocation derives from the capital markets. Rising interest rates have compressed valuations, induced ongoing financial market volatility, and curtailed liquidity in public and private debt and equity.

Private credit opportunities are emerging, spanning performing to nonperforming credit in both public and private debt. Importantly, the current dynamics are providing lenders an opportunity to originate and acquire loans secured by higher-quality collateral, with stricter loan covenants, at lower loan-to-value ratios with a higher all-in return potential.

Within performing credit, we're seeing an immediate surge in transitional lending, or loans on projects in lease-up, redevelopment, and construction. Transitional loans currently generate high single-digit to low-teens returns with modest and in some cases no leverage. We also see banks selling performing loans at attractive discounts to manage liquidity and capital ratios and get ahead of future potential problems, and selling what we would call sub-performing loans or those likely to struggle to repay at maturity.

We have also observed a growing need for rescue capital both at the asset and holding company level. This is creating attractive opportunities to provide bridge capital in the form of preferred equity and mezzanine debt.

CONCLUSION

As private credit investors, this is the environment we've been waiting for. The unprecedented pace of interest rate hikes and resulting volatility are providing abundant potential opportunities in the liquid public markets now, and private opportunities are beginning to materialize in market areas where underwriting became lax. The next few years will be great vintages, we believe, across the private opportunity set for a wide range of investor objectives. With demand for capital outstripping supply, investors won't need to take large risks, in our view, to generate compelling returns.

3 S&P LCD as of 31 December 2022

PIMCO

***All investments** contain risk and may lose value. **Private credit** involves an investment in non-publically traded securities which are subject to illiquidity risk. Portfolios that invest in private credit may be leveraged and may engage in speculative investment practices that increase the risk of investment loss. Investments in Private Credit may also be subject to real estate-related risks, which include new regulatory or legislative developments, the attractiveness and location of properties, the financial condition of tenants, potential liability under environmental and other laws, as well as natural disasters and other factors beyond a manager's control. **Mortgage and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee there is no assurance that private guarantors will meet their obligations. Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in **distressed companies** (both debt and equity) is speculative and may be subject to greater levels of credit, issuer and liquidity risks, and the repayment of default obligations contains significant uncertainties; such companies may be engaged in restructurings or bankruptcy proceedings. **Diversification** does not ensure against loss.*

Statements concerning financial market trends or portfolio strategies are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions or are appropriate for all investors and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.Forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, as an offer or solicitation, nor as the purchase or sale of any financial instrument. Forecasts and estimates have certain inherent limitations, and unlike an actual performance record, do not reflect actual trading, liquidity constraints, fees, and/or other costs. In addition, references to future results should not be construed as an estimate or promise of results that a client portfolio may achieve.

This material contains the current opinions of the manager and such opinions are subject to change without notice. This material is distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

PIMCO as a general matter provides services to qualified institutions, financial intermediaries and institutional investors. Individual investors should contact their own financial professional to determine the most appropriate investment options for their financial situation. This is not an offer to any person in any jurisdiction where unlawful or unauthorized. | **Pacific Investment Management Company LLC**, 650 Newport Center Drive, Newport Beach, CA 92660 is regulated by the United States Securities and Exchange Commission. | **PIMCO Europe Ltd (Company No. 2604517, 11 Baker Street, London W1U 3AH, United Kingdom)** is authorised and regulated by the Financial Conduct Authority (FCA) (12 Endeavour Square, London E20 1JN) in the UK. The services provided by PIMCO Europe Ltd are not available to retail investors, who should not rely on this communication but contact their financial adviser. | **PIMCO Europe GmbH (Company No. 192083, Seidlstr. 24-24a, 80335 Munich, Germany), PIMCO Europe GmbH Italian Branch (Company No. 10005170963, Corso Vittorio Emanuele II, 37/Piano 5, 20122 Milano, Italy), PIMCO Europe GmbH Irish Branch (Company No. 909462, 57B Harcourt Street Dublin D02 F721, Ireland), PIMCO Europe GmbH UK Branch (Company No. FC037712, 11 Baker Street, London W1U 3AH, UK), PIMCO Europe GmbH Spanish Branch (N.I.F. W2765338E, Paseo de la Castellana 43, Oficina 05-111, 28046 Madrid, Spain) and PIMCO Europe GmbH French Branch (Company No. 918745621 R.C.S. Paris, 50–52 Boulevard Haussmann, 75009 Paris, France)** are authorised and regulated by the German Federal Financial Supervisory Authority (BaFin) (Marie- Curie-Str. 24-28, 60439 Frankfurt am Main) in Germany in accordance with Section 15 of the German Securities Institutions Act (WpIG). The Italian Branch, Irish Branch, UK Branch, Spanish Branch and French Branch are additionally supervised by: (1) Italian Branch: the Commissione Nazionale per le Società e la Borsa (CONSOB) (Giovanni Battista Martini, 3 - 00198 Rome) in accordance with Article 27 of the Italian Consolidated Financial Act; (2) Irish Branch: the Central Bank of Ireland (New Wapping Street, North Wall Quay, Dublin 1 D01 F7X3) in accordance with Regulation 43 of the European Union (Markets in Financial Instruments) Regulations 2017, as amended; (3) UK Branch: the Financial Conduct Authority (FCA) (12 Endeavour Square, London E20 1JN); (4) Spanish Branch: the Comisión Nacional del Mercado de Valores (CNMV) (Edison, 4, 28006 Madrid) in accordance with obligations stipulated in articles 168 and 203 to 224, as well as obligations contained in Tile V, Section I of the Law on the Securities Market (LSM) and in articles 111, 114 and 117 of Royal Decree 217/2008, respectively and (5) French Branch: ACPR/Banque de France (4 Place de Budapest, CS 92459, 75436 Paris Cedex 09) in accordance with Art. 35 of Directive 2014/65/EU on markets in financial instruments and under the surveillance of ACPR and AMF. The services provided by PIMCO Europe GmbH are available only to professional clients as defined in Section 67 para. 2 German Securities Trading Act (WpHG). They are not available to individual investors, who should not rely on this communication. | **PIMCO (Schweiz) GmbH (registered in Switzerland, Company No. CH-020.4.038.582-2, Brandschenkestrasse 41 Zurich 8002, Switzerland)**. The services provided by PIMCO (Schweiz) GmbH are not available to retail investors, who should not rely on this communication but contact their financial adviser. | **PIMCO Asia Pte Ltd** (8 Marina View, #30-01, Asia Square Tower 1, Singapore 018960, Registration No. 199804652K) is regulated by the Monetary Authority of Singapore as a holder of a capital markets services licence and an exempt financial adviser. The asset management services and investment products are not available to persons where provision of such services and products is unauthorised. | **PIMCO Asia Limited** (Suite 2201, 22nd Floor, Two International Finance Centre, No. 8 Finance Street, Central, Hong Kong) is licensed by the Securities and Futures Commission for Types 1, 4 and 9 regulated activities under the Securities and Futures Ordinance. PIMCO Asia Limited is registered as a cross-border discretionary investment manager with the Financial Supervisory Commission of Korea (Registration No. 08-02-307). The asset management services and investment products are not available to persons where provision of such services and products is unauthorised. | **PIMCO Investment Management (Shanghai) Limited.** Office address: Suite 7204, Shanghai Tower, 479 Lujiazui Ring Road, Pudong, Shanghai 200120, China (Unified social credit code: 91310115MA1K41MU72) is registered with Asset Management Association of China as Private Fund Manager (Registration No. P1071502, Type: Other). | **PIMCO Australia Pty Ltd** ABN 54 084 280 508, AFSL 246862. This publication has been prepared without taking into account the objectives, financial situation or needs of investors. Before making an investment decision, investors should obtain professional advice and consider whether the information contained herein is appropriate having regard to their objectives, financial situation and needs. To the extent it involves Pacific Investment Management Co LLC (PIMCO LLC) providing financial services to wholesale clients, PIMCO LLC is exempt from the requirement to hold an Australian financial services licence in respect of financial services provided to wholesale clients in Australia. PIMCO LLC is regulated by the Securities and Exchange Commission under US laws, which differ from Australian laws. | **PIMCO Japan Ltd**, Financial Instruments Business Registration Number is Director of Kanto Local Finance Bureau (Financial Instruments Firm) No. 382. PIMCO Japan Ltd is a member of Japan Investment Advisers Association, The Investment Trusts Association, Japan and Type II Financial Instruments Firms Association. All investments contain risk. There is no guarantee that the principal amount of the investment will be preserved, or that a certain return will be realized; the investment could suffer a loss. All profits and losses incur to the investor. The amounts, maximum amounts and calculation methodologies of each type of fee and expense and their total amounts will vary depending on the investment strategy, the status of investment performance, period of management and outstanding balance of assets and thus such fees and expenses cannot be set forth herein. | **PIMCO Taiwan Limited** is an independently operated and managed company. The reference number of business license of the company approved by the competent authority is (112) Jin Guan Tou Gu Xin Zi No. 015 . The registered address of the company is 40F., No.68, Sec. 5, Zhongxiao East Rd., Xinyi District, Taipei City 110, Taiwan (R.O.C.), and the telephone number is +886 2 8729-5500. | **PIMCO Canada Corp.** (199 Bay Street, Suite 2050, Commerce Court Station, P.O. Box 363, Toronto, ON, M5L 1G2) services and products may only be available in certain provinces or territories of Canada and only through dealers authorized for that purpose. | No part of this publication may be reproduced in any form, or referred to in any other publication, without express written permission. PIMCO is a trademark of Allianz Asset Management of America LLC in the United States and throughout the world. ©2023, PIMCO.

Investment Products
Not FDIC Insured | May Lose Value | Not Bank Guaranteed

PC606_ 3880151

CMR2023-1103-3207188