FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Sherwood Parentco 'BB-'/Stable on Arrow Acquisition; Senior Debt 'BB-(EXP)'

Mon 25 Oct, 2021 - 6:14 AM ET

Fitch Ratings - London - 25 Oct 2021: Fitch Ratings has assigned Sherwood Parentco Limited (Arrow) a Long-Term Issuer Default Rating (IDR) of 'BB-' with a Stable Outlook. Fitch has also assigned an expected long-term rating of 'BB-(EXP)' to senior secured debt to be issued by Sherwood Financing Plc and guaranteed by Arrow (among other Sherwood entities). The assignment of a final issue rating is contingent on the receipt of final documents conforming to the information already received.

Arrow is the parent company of Sherwood Acquisitions Limited, a UK-based entity set up by TDR Capital LLC (and owned by investment funds managed by TDR Capital LLC) to acquire Arrow Global Group Plc, a UK-based debt purchaser and investor in non-performing loans (NPLs). As the top holding company producing consolidated accounts within a restricted banking group, Fitch has assigned the Long-Term IDR at the level of Arrow rather than at the level of Sherwood Acquisition Limited.

The acquisition, valuing Arrow Global Group Plc's ordinary share capital at GBP565 million, was completed on 12 October 2021. As part of the acquisition, Sherwood Acquisitions Limited set up EUR975 million and GBP400 million one-year extendable senior secured bridge facilities which it intends to refinance through the issue of around GBP1.2 billion-equivalent in euro fixed- and floating-rate and sterling fixed- rate senior secured notes.

KEY RATING DRIVERS

LONG-TERM IDR

High Leverage: Arrow's Long-Term IDR is constrained by high cash flow leverage with a gross debt/adjusted EBITDA ratio as calculated by Fitch of around 5.8x at end-1H21 (based on annualised 1H21 adjusted EBITDA), equating to a capitalisation and leverage score of 'b and below'. Fitch expects Arrow's outstanding gross debt to remain broadly unchanged following the planned debt issue and cash flow leverage as of end-2021 to improve to around 5x, largely as a result of improving cash EBITDA on the back of resilient collections and improving revenue in the fund-management and servicing segments.

Similar to many European peers', Arrow's tangible equity position is negative, following material inorganic growth, which Fitch expects to remain the case under the new ownership. This is reflected in Fitch's capitalisation and leverage assessment.

Credible Franchise, Evolving Business Model: Arrow's franchise, measured by both estimated remaining collections (ERC) and adjusted EBITDA, is moderately smaller than those of higher-rated peers and concentrated on a relatively small number of markets, notably the UK, Ireland, Portugal, Italy and the Netherlands.

However, Fitch's assessment of Arrow's franchise and business model also considers the company's recently launched fund- and investment-management (FIM) business line, which in our view has good growth prospects and is less capital-intensive than traditional debt purchasing but is also subject to the execution risk (Arrow launched its first flagship fund, ACO 1, in 2019). Unlike many peers, Arrow largely targets smaller and often off-market transactions, which are less price- sensitive than more standard auction-led transactions.

Sizeable 2020 Impairments; 1H21 Recovery: In 2020, Arrow's adjusted EBITDA margin and pre-tax profitability were negatively affected by sizeable pandemic-related portfolio-investment impairment charges in 2Q20. In Fitch's view, this partly reflects Arrow's portfolio composition with meaningful exposure to secured assets in southern Europe (affected by lengthy court closures) but also management's prudent ERC reforecasting in 2Q20 as reflected in Arrow's actual collections consistently exceeding reforecast ERC since 2H20. Under its new, more asset-light business model, impairment charges will likely have a less noticeable impact on overall profitability (Arrow targets more than 50% of EBITDA from capital-light activities by end-2025), supporting increased revenue and earnings stability.

Cohesive but Ambitious Capital-Light Strategy: Unlike most of its peers, Arrow is transitioning from a conventional debt purchaser to primarily a manager of funds investing in NPL portfolios as well as servicer of these assets. Own balance-sheet usage will largely be limited to co-investments in funds (at around 25% of total fund size in the case of ACO 1 but with expectations that the co-investment ratio will reduce to around 10% in the case of follow-on funds). While Arrow can point to a long record of acceptable collection performance, management's plans for follow-on funds and hence funds under management (FuM) growth are, in our view, ambitious (FuM of more than EUR10 billion by end-2025) and sensitive to any meaningful collection under-performance.

Governance Unchanged Following Delisting: In line with most listed peers, Arrow operates a three-lines-of-defence model supported by various board committees. All new investments are approved by the company's investment committee, and ERC and portfolio investments are valued both internally and with an external auditor's attendance. Following its delisting and new ownership, Fitch expects Arrow's governance structure to remain broadly in place, supporting our view of the company's risk and corporate governance. With some exceptions, Arrow's senior management team has generally fairly short tenors with the company, but extensive professional experience in the relevant sectors.

Long-Dated Funding Profile; Adequate Coverage: Arrow's EBITDA coverage ratio is acceptable and the company benefits from a long-dated post-transaction funding profile (no bond maturities until 2026) and sound contingent liquidity through a long-dated undrawn GBP285 million revolving credit facility (RCF). However, Fitch's assessment of its funding, liquidity and coverage score also considers its almost entirely secured funding profile (limiting its financial flexibility) and the wholesale nature of its funding sources.

Arrow's funding, liquidity and coverage benchmark ratio has remained within Fitch's 'bb' range in the last four financial years. Under Fitch's base case, we project the ratio to remain within the 'bb' range until 2024.

SENIOR SECURED DEBT

As Arrow's planned senior secured notes are the company's main outstanding debt class (and effectively junior to Arrow's sizeable RCF), Fitch has equalised the notes' ratings with the Long-Term IDR, indicating average recoveries for the notes.

RATING SENSITIVITIES

LONG-TERM IDR

Factors that could, individually or collectively, lead to positive rating action/upgrade:

As Arrow's Long-Term IDR is currently constrained by leverage, any positive rating action would require a material and sustained improvement in the gross leverage ratio to well within Fitch's 'bb' benchmark range (gross debt/adjusted EBITDA between 2.5x and 3.5x). In addition, an upgrade could be supported by a successful implementation of Arrow's capital-light asset management strategy, for instance, through a successful rollout of the follow-on fund to ACO 1 in 2022.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Material delays in rolling out its capital-light strategy (including delays in anticipated fundraising or capital deployment in follow-on funds), in particular if impairing Arrow's deleveraging potential or indicative of general collection under-performance, would put pressure on Arrow's ratings.

Inability to meet its 2023 leverage guidance of net leverage (net debt/ adjusted EBITDA) of 3.0x to 3.5x, could also put pressure on ratings.

Material collection under-performance, in particular, if it leads to further meaningful portfolio impairments, could be rating-negative. A material increase in risk appetite or weakening of risk or corporate governance, following its delisting, albeit not expected by Fitch, would also put pressure on ratings.

SENIOR SECURED DEBT

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The expected rating of the senior secured notes is principally sensitive to a change in Arrow's Long-Term IDR and an upgrade of the Long-Term IDR would likely be mirrored in an upgrade of the notes. In addition, improved recovery expectations, for instance, through a larger layer of junior debt, could lead Fitch to notch up the notes from Arrow's Long-Term IDR.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A downgrade of the Long-Term IDR would likely be mirrored in a downgrade of the notes. In addition, worsening recovery expectations, for instance, through a larger layer of structurally senior debt, could lead Fitch to notch down the notes from the Long-Term IDR.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Arrow has an ESG Relevance Score of '4' for 'Financial Transparency' due to the significance of internal modelling to portfolio valuations and associated metrics such as estimated remaining collections. However, this is a feature of the debt-purchasing sector as a whole, and not specific to Arrow. This has a moderately negative impact on the credit profile, and is relevant to the rating in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING

ENTITY/DEBT	RATING		
Sherwood Parentco Limited	LT IDR	BB- Rating Outlook Stable	New Rating
Sherwood Financing Plc			
• senior secured	LT	BB-(EXP)	Expected Rating

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Christian Kuendig
Senior Director
Primary Rating Analyst
+44 20 3530 1399
christian.kuendig@fitchratings.com
Fitch Ratings Ltd
30 North Colonnade, Canary Wharf London E14 5GN

David Pierce
Director
Secondary Rating Analyst
+44 20 3530 1014
david.pierce@fitchratings.com

Mark Young
Managing Director
Committee Chairperson
+44 20 3530 1318
mark.young@fitchratings.com

MEDIA CONTACTS

Louisa Williams
London

+44 20 3530 2452
louisa.williams@thefitchgroup.com

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

Non-Bank Financial Institutions Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

DISCLAIMER

RATINGS COMPANY (OR BRANCH OF SUCH A COMPANY) OR ANCILLARY SERVICE(S) CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH RATINGS WEBSITE.

READ LESS

COPYRIGHT

subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Non-Bank Financial Institutions Europe United Kingdom