E X P E R T Q & A

Richard Roberts, head of origination and M&A at Arrow Global, reflects on some of the keys to investing successfully in stressed and distressed situations throughout the region

Tracking economic impact across Europe

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Q The economic outlook remains challenging, albeit with some emerging tailwinds such as falling energy costs, headline inflation easing and less economic disruption. What does this mean for private debt funds?

We are in a period of profound economic uncertainty and transition from a low interest rate, low inflation environment to a new reality, with a war in Europe and a market that can swing suddenly. Markets are fragile but headline non-performing loan levels in banks are down from over €1 trillion to sub €500 billion so the system has been temporarily de-risked. What the numbers don't show is a similar amount of NPLs that transferred outside the banking sector and into private debt investors, as well as new NPLs created by private lenders with different timeframes and reporting requirements to banks.

More worryingly though for lenders, banks are currently seeing material increases in stage two loans, the pre-cursor towards loans becoming non-performing. Those have gone from around 7 percent of European bank loans pre-pandemic to about 9.5 percent (or €2 trillion), representing future stock for distressed lenders and funds. Leading European banks currently have less than 5 percent NPLs so if nearly 10 percent additional assets are trending negative, there should be significant opportunities.

Whereas post-GFC in a low interest rate environment there was no immediate incentive to solve NPL issues, we expect more decisive actions this time round. Regulators will proactively encourage banks to take action while funds are expected to be swifter sellers than banks as they seek to maximise IRR, mitigate adverse performance to business plans and return capital as fund lives mature. Secondary sales of NPLs at funds' end of life are a core part of our business, so while our pipeline is far deeper than the past, you need to be highly selective.

Q Do you think some of the 'just raised' or 'just about to close' private debt vintages will struggle to make the expected returns if defaults aren't as bad as previously thought?

Private debt spans a range of strategies which will all perform differently. Although it is early in the current economic cycle, we expect there to be stress across multiple sectors but it will take a while to work through. After the GFC, few assets traded for at least five years, so it doesn't happen immediately. The end of the cheap debt era is bound to hit hard, but insolvencies haven't spiked yet and we haven't seen unemployment levels increase across Europe. If that happens, residential mortgage defaults occur and the spiral starts. The stage two loans figure I mentioned earlier going up towards 10 percent does not augur well.

If you are running a distressed fund, you need defaults to start going up to hit targets. For us, as a diversified, integrated player across five prioritised jurisdictions, pricing each asset class separately, we are able to build resilient, hard asset-backed portfolios with margins of safety on loans or asset purchase prices. In origination, we are seeing stress in real estate loans linked to floating rates and where collateral prices are down. We see rescue finance opportunities as existing lenders refuse to refinance loans and landlords known well to us seek bespoke financing packages, especially since we own real estate operating platforms that can add value beyond capital.

We try to avoid market trades or crowded trades, so about 75 percent of what we do comes through bilateral relationships. We own and operate 18 servicing platforms across Europe and we use local expertise to originate deals, making capital allocation decisions centrally.

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Q Which private credit asset classes are best placed to deliver strong performance?

Diversification is essential, especially in an uncertain environment. We see more resilience in granular asset-backed situations that have through-cycle options and multiple refinancing options. Loans or assets backed by residential real estate assets where there continues to be a chronic under-supply across Europe are particularly attractive, while we also like agricultural assets, which have provided an inflation hedge for years as well as affordable housing and hospitality in prime locations. In the UK, we like conservative bridge loans backed by hard real estate with liquidity and multiple exit options.

In Portugal, we have lent at attractive rates – sub-60 percent LTV – against tier-1 hospitality assets and resorts as well as buying and developing attractive land in the Algarve. We have around 1,000 people in our Portuguese operating businesses so know the market and have confidence in the investment thesis. Lending at 50-70 percent loan to values, against high-quality collateral with a strong margin of safety should be inflation-proof, especially given the benefits of higher floating benchmark rates.

We are less convinced by corporate cashflow lending or consumer finance, where we see regulatory risk at this point in the cycle and a lack of hard asset backing.

Q Operational capability is key in value creation – what's the secret to this?

LPs clearly have a wide choice when selecting asset managers so differentiation is key. There's a stark difference between investors who hire local partners to support them and those like us who own local platforms staffed by local origination and asset management experts who are upfront and close to the underlying assets. While we raise funds, make decisions, allocate capital and portfolio manage centrally, our differentiation and advantaged returns come from aligned, dedicated, in-country feet on the street, working with local counterparties, brokers, courts and end-asset buyers, effectively shaking out granular, off-market investment and exit opportunities, finding and closing deals that others don't see.

We focus on what we know, where we have in-country capabilities and where we've been successful since inception, delivering an 18 percent asset level IRR over the last 10 years with a sub-1.5 percent loss rate. Having invested approximately €0.5 billion building and assembling local platform infrastructure in the GP, we employ more than 2,500 people across Europe, the vast majority in these specialised, local operating platforms.

Q Arrow Global works across Europe, with a local footprint. Where are you seeing the most interesting opportunities?

In an evolving market, different

Q Do you expect ESG allocations to increase given the polarisation of the social narrative which often surfaces in a distressed period?

Our view is that ESG allocations will increase regardless of the socioeconomic narrative because it is the right thing to do to drive positive change. Returns from the sector have been positive and players with dedicated ESG allocations are doing well.

All funds are working to become more ESG relevant, even if they aren't running pure renewables or green energy-related funds. We are seeing positive feedback on our investment initiatives including improvements we're seeking to make to residential, commercial and hospitality assets we own, whether that be installing solar panels or improving energy efficiency. Ultimately, upgrading assets to achieve higher ESG ratings means they command a higher valuation premium, so you are future-proofing your assets and returns by doing the right thing.

For a local business like ours that relies on reputation, repeat business and a commitment to the markets we operate in, we have to behave properly towards our stakeholders, improving the environments we operate in and upgrading the infrastructure.

countries are moving at different speeds and banks and funds are responding differently. Certain banks are reducing NPLs more than others, so running a multi-asset, multi-country mix allows us to identify the most appropriate places to deploy capital through the cycle and thoughtfully select the best opportunities, backed by the best collateral.

In the UK, we are seeing bilateral lending opportunities in the real estate space, where owners face expiring facilities or falling asset values. Without our local capabilities we wouldn't be able to find those opportunities, structure them and get the right pricing.

We continue to see attractive opportunities to lend into real estate restructurings in Italy, buying existing bank credits at discounts and working with borrowers to restructure and right-size their portfolios. We continue to invest in secured residential and SME-backed NPLs across Europe and still like construction lending, which has benefited from rates going up.

In Portugal, a lot of assets remain held by banks. We have invested into several complex restructurings in the last few years and expect to do more of that.

Q Italy remains the biggest market for non-performing loans – what's the key to unlocking value in this market? Where are you seeing the best opportunities emerge?

Italian banks have been the largest European sellers of NPLs. Italy has also been innovative in issuing both stapled lending deals and government senior debt guarantees that have supported the movement of NPLs from banks to third parties, allowing Italian banks to rebuild capital and drive low headline NPL rates. This has also created a broad third-party servicing sector to facilitate trades in a way it hasn't in, say, France which also has significant bank NPLs.

In terms of unlocking value, it comes down to how well you diligence assets and the margins of safety applied through hard asset discounts. From the Arrow Italy perspective, we haven't seen compelling value bidding large portfolios of negatively selected, defaulted assets, where the bank couldn't rehabilitate the borrower and where loans are packaged into competitive on-market auctions. We've approached the Italian market from a different perspective. In Zenith, we own a €40 billion master servicer which gives us a unique view across a broad range of asset classes to inform our investments.

Separately, we deploy capital via our Europa Investimenti business, which forensically maps the market to determine situations it wants to work on and then typically aggregates smaller positions predominantly in bankruptcies and UTPs to build a portfolio that we want to own based on high quality collateral and path to success. There are situations where we have aggregated 10-plus positions in a single name from different banks and investors to create sizeable positions where we can drive effective resolutions. We track thousands of situations each year, target the ones with the right collateral and then forensically go after them. ■