Private debt in Europe: fit for purpose

Arrow Global CEO Zach Lewy explains the attraction of private debt in Europe and why higher-return strategies like distressed debt are less risky than some people think

Do LPs need much convincing to invest in private debt?
There's a consensus now that the different forms of private debt yield a healthy variable spread above reference rates. Investors are accessing yields solidly in the double-digits for well-protected investments.

The case for investing in the areas of private debt where we work, real estate credit, is very compelling. Now, one can lend against real estate assets and earn higher returns with credit than equity was earning when buying similar assets 3–4 years ago. That's why we're seeing a considerable allocation shift in favor of credit.

When rates were low, private credit grew as investors sought yield. How have higher rates impacted that trend?
We'd say the case against fixed income has actually weakened in the last three years. We've spent a lot of time with investors this year, and from those conversations, it seems the smart move is from low yield to high yield. This doesn't necessarily mean being risk-on, as we're rather bearish on the macro.

The point is that there was a lot of fixed income, as well as some real estate and dividend stocks, where investors were trying to be precise at low cap rate numbers asymptotic to zero. The capital value impact magnifies as you move yields within lower bands. For example, the capital value of an asset needs to move materially to change a 2% yield to a 5% yield in the context of rising interest rates.

What we're seeing now is an awakening of analysis that says investors are far more at risk to yield impairments the closer to zero they are. If an asset seems solid and yields nine, for example, it's not necessarily a catastrophe if rates go from 2% to 5% even if it's been levered a bit. But if an office building yields 2% and interest rates increase from 2% to 4%, the asset begins to look stranded.

What are the attractions of private debt in Europe?
Private debt plays a different role in different markets. In Southern Europe, the banks have limited financial capacity and serious balance sheet challenges. Banks don't want to give up their relationships, so they utilize private credit where they lack the skills or capacity to execute.

In Northern Europe, the goal is to be as cost-income ratio-efficient and risk-weighted asset-efficient as possible. Banks don't really want to do the last mile of operationally intensive lending on things like agriculture, bridging, construction, or SMEs. Big teams are necessary, and those assets come with high-risk weightings. Private credit can do that last mile and banks can finance it wholesale.

Zach Lewy
Founder, CEO, CIO
Arrow Global

Private credit is now entrenched, and lenders fulfill an industrial purpose. We are the last mile of lending in certain countries, overflow lenders in others, and the buyers of distressed assets in many cases. The systems have become intertwined; the banks do what they're good at, and we do what we're good at.

How big do you think the distressed debt segment will become?
It's very cyclical, and none of us are perfect macro forecasters. We do try to assess where the macro risks are, but whether those risks crystallize, and whether they crystallize in a short or long timeframe, are questions that must be approached with a very high degree of humility.

There will be waves of primary distress, then secondary distress, influenced by how macro factors play their way through the system and the reality trickles through the various refinancing timelines. We'll observe the actual numbers over time, but they will be large.

The secondary market is easier to analyze as the feedstock already exists and it's just the propensity to sell rates being tracked. We're emerging from an era that has had a significant level of credit creation, so the secondary market is set to be vibrant.

There'll be ample supply for those wanting to allocate to distressed debt. There'll also be a ton of credit to buy at sensible spreads and, given that the price on the screen is reflective of high base rates, it's likely to have an embedded yield. Managers who have access to both primary and secondary markets will be looking at high single digits and low double digits for relatively safe assets, while other players have a very strong and differentiated franchise and aspire to do better.

Is distressed debt risky?
It's important to separate the components of the return and of the risk decision. However, the prevailing starting point is negative: this didn't work for the borrower, and it likely didn't work for the lender, who has chosen to sell it. Investors

need to be realistic, sober, and grounded. This asset has been adversely selected three times before they even step up to the plate.

So, there is risk by definition, which brings the question of how to make it safer. First, buy at a discount. Second, be the first money out. The quality of the underlying collateral is crucial, and it's also helpful if the borrower has some capacity to solve the situation.

To give you an example, if a bank's original loan was at 70% loan-to-value (LTV) and they sell you the debt at $0.30 on the dollar, you're a 21% LTV looking through to the underlying collateral. If you're the first money out, at a 21% LTV with decent collateral, and the other issues that affect repayment aren't adverse, you can feel pretty good about the world. Your propensity to get paid is high. There's a lot of space to be wrong, still get your money back and, where you get it really, really, right, you could earn almost a five-times multiple.

Our numbers show this is very safe. We've only lost money on 1.4% of the 3,000-plus deals we've done in the past 20 years, and when we do lose any principal on a deal, we've got an average of 91% of our money back. The devil is in the detail of the country, asset class, seller, paper, collateral, and borrower type, but distressed debt has a track record of being extremely safe. We've never had a year with a return below 10%. As such, perceived risk may not represent the reality in the category.

Which is the better market for private debt: Europe or the US?

Europe has a number of favorable things going for it, but we wouldn't outright say it's a better market. Europe is a historically safe place to earn income, such as in residential real estate, because of housing shortages and the high quality of life, which means demand stays high.

On the corporate side, fragmentation and complexity mean it's more profitable, but not more scalable. In private debt, returns can come from the underlying individual position and then the aggregation and capital structure efficiency. The market is much less efficient in Europe than in the US, which means higher returns if you can access it. That's our preferred way of generating a return, and why we're in Europe with 19 local platforms.

The challenge is that it's difficult to aggregate those transactions into a homogeneous pool that can then be securitized or sold with yield compression. In the US, you might earn less on each individual unit, but if you have 800,000 units and efficiently securitize them, you can make a good return. That trade is drastically harder to execute in Europe.

They're two different investing models. We address the European reality strongly in how we run our business. We own these 19 local platforms and believe in owning the last mile of operational activity because, with Europe so fragmented, you have to be local to understand the assets.

How do you approach the market opportunity in Europe?

We are constantly growing and evolving our platform. In the last two years, we've acquired four platforms and sold two. We want to own the local leaders in their areas. It's like a matrix, where we have the countries on the columns and the different asset types on the rows. So, there's a chessboard with 44 countries on the columns, and a huge list of rows. Some of those squares lead to fantastic things, while others not so much.

We feel we've designed something that works in Europe. It's taken us 20 years, but we've implemented and proven an approach that fits well with the reality on the ground. There are not many billion-euro single-sale transactions and, when there is one, there's usually many interested buyers, and it's the deal of a generation for the seller, who will run a big auction with lots of advisors.

We think the best opportunities are the smaller, local ones. That's just the nature of the continent's underlying reality. We've built an operating model with the 19 local platforms and 2,000 employees, and have done 3,000 deals, of which around 80% were bilateral, and more than 90% have asset backing.

We raised the largest distressed fund in the world in the first quarter, closing on €2.75bn in under eight months. We hit the hard cap and could have raised much more. It's a realistic, sobering view of where the world may be going, but a recognition that Europe will be interesting and that the way we approach it, with this local model is, in many people's view, the right way.

Zach Lewy has over 25 years' executive experience in investment management and asset servicing. Zach founded **Arrow Global** in 2005 and serves as Group CEO and CIO of Arrow. Zach has supervised over 1,000 deals at Arrow and is a lead Principal in Arrow's fund manager. Prior to joining Arrow, he was an Officer of Sallie Mae, a Director at Vertex (the BPO division of United Utilities), and a Founder and Executive Director of 7C (a UK BPO company acquired by Vertex). Zach was previously the Chair of the UK Debt Buyers Association and was named an Ernst and Young Entrepreneur of the Year in 2010. He graduated from Princeton University with a BA in Economics with Honours and a Certificate in Applied and Computational Mathematics with Honours.