Prime time for real estate credit: Insights from Arrow Global

Richard Roberts, head of origination and M&A at Arrow Global, explains how managers with a nuanced, local, and socially responsible approach can capitalise on opportunities in the real estate credit sector

THE TRANSITION FROM an era of cheap credit to one characterised by elevated base rates has reshaped the investment landscape. In this new environment, our real estate lending strategies offering flexible financing solutions appeal to investors as they benefit from the floating-rate nature of most loans. Our commitment to collaborating with strong sponsors to consistently deliver innovative, solutions-orientated investments throughout market cycles positions us well amongst lenders.

The withdrawal of banks from certain types of lending, driven by the capital demands of the Basel 3.1 regulations, has opened up new avenues for the private credit markets. These banks now prioritise either mass market lending in the form of residential mortgages, personal loans and credit cards, or services for large, platinum clients, leaving a gap that private credit is uniquely positioned to fill. Our strength lies in our local presence and expertise, allowing us to step into areas that require an intimate understanding of the market intricacies and operational complexity.

Geographically, in the diverse landscape of European private debt, the role of private credit varies significantly across regions. In Southern Europe, for example, where banks are grappling with financial hurdles and balance sheet constraints, private credit becomes a good alternative to assist with client relationships without overextending their capabilities. Conversely, in Northern Europe, the focus is on optimising cost-income ratios and asset efficiency, with banks often avoiding the operationally intensive lending required in sectors like agriculture, construction or small business lending. Here, private credit steps in to handle the 'last mile' of lending, supported by wholesale financing from banks. This interplay between banks and private credit managers has become a cornerstone of the European financial ecosystem, with private lenders playing a crucial role in various capacities – be it as primary lenders in some regions or as partners in managing overflow lending or acquiring distressed assets in others.

In the growing but fragmented landscape of European private credit, with over 4,500 monetary financial institutions in the euro area, the significance of localised insight and asset specialisation cannot be overstated. At Arrow Global, our approach to real estate lending and opportunistic credit is rooted in a deep understanding of local markets. This understanding enables us to opportunistically harvest investment opportunities in granular, off-market transactions. Central to our local understanding is our ownership and operation of 20 servicing platforms, managing approximately €80bn (£69bn) of third-party assets. This franchise not only provides us with a proprietary view of the market dynamics, but also uniquely positions us to identify and act on opportunities with precision and depth benefiting from a deep knowledge of local courts, banks, notaries, developers, service providers, and the tax and regulatory frameworks.

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The sources of deal flow in today's market are as diverse as they are dynamic. While the spotlight often falls on the commercial real estate sector, or large publicly traded non-performing loans, we opt to focus our attention on sectors where our strengths can be fully utilised. Living sector assets, especially in regions like southern Europe, present value-add opportunities, particularly in hospitality credit, where our expertise runs deep.

In our lending business, we target sectors with strong underlying fundamentals, preferring liquid residential collateral, where there is a chronic undersupply across our markets. This focus supports long-term price resilience, enabling us to engage in attractively priced business ventures that benefit from favourable covenants and collateral, offering robust protection across all market cycles. The provision of conservative 60 per cent loan-to-value senior financing on properties like an apartment block in Rotterdam's up-and-coming Katendrecht district or Manchester's fashionable Northern Quarter reflects our confidence in these types of investments, independent of broader economic sentiment.

Our opportunistic credit strategies benefit immensely from our local platforms, which provide unparalleled insight into non-performing loans, distressed opportunities, and specialist credit situations. We excel in identifying and capitalising on deals backed by tangible assets including real estate backed credit and cash in court, where our on-the-ground presence enables us to value, access and liquidate, or add value to the underlying collateral. Such enhancements while holding the assets may include, for example, updating planning permissions, licencing a hotel to a leading operator brand, and making wholesale improvements to accommodation and leisure facilities. If the European market was entirely efficient, these strategies might not yield such interesting returns. However, the reality is a highly fragmented market, ripe with local, granular opportunities. This deep fragmentation is best illustrated by the fact that Europe has multiple languages, supervisory authorities, legal frameworks, judicial systems and tax regimes, as well as different cultures, customer behaviours and business practices.

The resilience of credit quality within private debt portfolios amidst current economic conditions is a testament to the improved lending standards since the global financial crisis and is reflected in investor confidence in the asset class with 91 per cent expecting it to perform better or the same this year. While higher performance is a function of higher interest rates, it also suggests impairments and defaults are not an issue for investors.

Institutional investors are increasingly recognising the strategic value of private debt in refinancing scenarios, especially as the landscape shifts away from traditional bank financing. They understand that it's a good time to provide senior secured capital to borrowers who are delivering assets that are in short supply. Our locally driven model, which underscores local relationships and operational depth, aligns well with investors in search of reliable and insightful investment partners.

Beyond financial metrics, a successful investment programme must also address broader societal and environmental concerns. Our commitments to ESG principles, guided by the Principles of Responsible Investment and validated through standards such as GRESB, which assesses ESG performance data and peer benchmarks, is integral to our investment decisions. This reflects our dedication to make a positive impact on the communities and markets we operate in.

As we look to the future, the landscape for real estate lending and opportunistic credit in Europe is set to grow further, with an emphasis on specialisation, deep market knowledge and a commitment to sustainable and ethical investment practices. In this evolving landscape, our localised approach and strategic focus on niche sectors equip us to continue delivering value to our investors while delivering positive societal impacts.

More broadly, managers who embrace a nuanced, local, and socially responsible approach will be best positioned to capitalise on the European credit opportunity, thereby delivering substantial value to investors. ■

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