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Get ready to reap the benefits of private credit 2.0

As banks continue to derisk, the opportunity set for private credit funds is growing exponentially, but success outside of direct lending requires a new approach and a different business model

Zach Lewy
Founder, CEO, CIO,
Arrow Global

What factors are driving the growth in distressed debt investment opportunities in Europe?
The factors driving distressed debt investment opportunities in Europe vary widely across countries due to unique economic pressures. For instance, Germany, historically advantaged by affordable energy and low interest rates, now faces pressures due to rising input costs, particularly in its heavily industrial and construction-focused economy. This has created significant financial strain, a trend seen in other manufacturing-oriented northern European economies as well.

In sectors like real estate, especially residential construction, rising interest rates and housing shortages across multiple regions have disrupted growth, however, we are seeing renewed activity as interest rates decrease. In countries where pre-sale deposits are commonly used to fund projects, construction has been particularly affected by the combination of higher costs and a slowdown in pre-sales.

On a broader level, macroeconomic trends like aging populations, labor shortages, rising defense costs, and the ongoing energy crisis are creating additional pressure across sectors. However, certain bright spots, such as tourism and stable sectors like agriculture, continue to offer opportunity and resilience.

Interest rates remain a dominant factor from a distress perspective. When rates were zero or negative, banks, facing minimal opportunity costs, were often reluctant to address awkward loan positions. It was essentially a marriage of convenience. But now, as the cost of loan extensions rises, certain borrowers face greater strain, leading to a surge in restructurings – an area where we are highly active.

What role do non-core banking assets play in Europe's current private debt market?
For a whole host of regulatory reasons, it's possible – trending towards probable – that the role of banks has fundamentally shifted. Banks are starting to function more like utilities, shifting much of their risk management activities into their asset management arms. Here, they aren't subject to the same capital requirements and can focus on increasing fee income.

This shift benefits us greatly, as capital for high-risk investments is increasingly channeled toward private credit and third-party asset management. Given the ongoing response to the Global Financial Crisis, there's little debate left on the role banks should play. Core banking activities are contracting, and as a result, other lending categories – construction loans, bridge loans, agricultural loans, buy-to-let mortgages, specialized mortgage products, margin loans, leveraged buyouts, and similar areas – are becoming non-core and increasingly open to private capital.

Which sectors in Europe are most likely to experience an increase in non-performing loans, and why?
Some industries are super complicated, and they suffer more in challenging times. For example, airlines face a range of challenges, from strict regulatory oversight to high capital expenditures, extensive inventory and marketing costs, exposure to fuel and commodity price fluctuations, and complex financing needs. Managing these variables is a significant challenge, especially in the current environment.

The office sector is another area facing difficulties, impacted by shifting demand patterns and a growing realization among investors that office properties are not a reliable substitute for bonds. This combination of changing demand and limited investment reliability is a deeply negative double impact on the sector.

Nonetheless, certain areas present opportunities. Tourism, for example, is booming, although the question remains whether this trend is structural or cyclical. With people more mobile and the rise of 'work from anywhere,' economic activity is shifting in new directions, creating unique opportunities across sectors.

In retail, while investment in shopping malls has slowed, locations that meet daily needs retail and are proximate to consumers remain promising. E-commerce comprises 21% of European retail, yet large portions of the remaining 79% are still highly valuable.

Green energy capex is another area showing strong demand. Although the ESG agenda has decelerated, particularly in the US, renewable installations, such as solar panels, continue to be popular as people invest in sustainability.

Arrow has been recognized for its successful track record in distressed situations. What are the key success factors?
You need to know your circle of competency. Success in distressed situations requires a deep understanding of core competencies. While it's crucial to know the relevant processes

and strategies, true expertise comes from accurately assessing asset value and knowing what you're willing to pay. With a team of 3,000 people across 22 platforms, we have the skills and resources to capitalize on these opportunities effectively.

Beyond valuing the asset, a key success factor is the technical skill to manage it and implement value-add steps that ultimately drive a profitable exit. These three competencies – valuing, managing, and exiting – are essential for delivering strong returns.

We can do that well against granular asset-backed real estate in most countries in Europe. We can do it against tourism and hospitality assets because of the different platforms we own. We can do it in parts of real estate and in mortgages. We prefer real assets as collateral over corporate exposures, which aligns with our focus on sectors where we can leverage our strengths and available resources. It's about knowing what you can do and having the resources to do it.

Is this private credit's golden moment? Will it last?

Is this a golden moment? There's certainly extensive potential ahead. Five years ago, private credit was one bucket and most of it was direct lending. Now it's clearly evolving and diversifying. There's direct lending, real estate lending, construction lending, litigation finance, capex finance, and infrastructure debt, to name a few. Private credit is significantly broader now, and I do believe it's going to be a huge asset class.

And It's important to stress that much of private credit remains symbiotic with traditional banks. Banks aren't exiting the private credit space; they simply don't wish to act as last-mile lenders in every activity. But they will still be there providing capital behind the scenes.

We are moving toward a stable equilibrium where private credit often fulfills the last-mile lender role outside mass-market categories. In cases where banks seek exposure to these specialized sectors, they are likely to do so through warehousing or loan-on-loan leverage.

While the generational opportunity in direct lending may be behind us, we are in a second wave, expanding into new categories and with an exceptionally long runway of growth ahead.

How does asset-based lending compare to corporate lending, and what are the key factors for success in this area?

I'm hugely in favor of asset-based loans. Asset-based lending is a compelling area for investment. Would you rather lend at 3–4 times corporate earnings or at a 60% loan-to-value on a property?

When you look at the metrics, asset-based lending is superior to corporate lending, though the model is inherently less scalable. You must be local. The assets physically exist in the real world, and it's regulated in most jurisdictions, so you need the local expertise and compliance position.

This development represents an exciting evolution for us, as it aligns with our local platform-led approach. Asset-based lending differs from corporate private credit, which necessitates a different business model and distinct operational structures.

What trends are you excited about in real estate credit across Europe?

Real estate is a big boom area. Banks are exiting specialty lending categories, creating a gap that funds are ready to fill. Bridge loans, construction loans, agricultural loans, mixed-use mortgages, and other products are increasingly shifting into the realm of fund-based lending.

This shift presents unique opportunities, especially for funds with the expertise and structure to handle complex real estate transactions across varied European markets.

How will changes in the interest rate environment affect private credit?

Rising rates obviously benefited private credit, as most loans are floating rate. However, we have safeguards for when rates decline. For example, we may lend at SONIA plus 400 basis points but with a floor of 300bps on SONIA, or there's a minimum multiple on redemption, or a redemption fee. These are different ways of achieving the same minimum return from those activities.

While it may be demanding to replicate the returns seen at higher rates, there are enough tools available to continue delivering strong results for investors, regardless of the interest rate environment.

The ESG movement has lost some momentum. Is ESG still important to you?

Lending aligns very well with ESG goals, allowing for comprehensive assessments using sustainability scorecards. For instance, in real estate, around 60% of European housing stock dates to before 1980. As the market shifts to newer, energy-efficient stock, we see improvements in insulation, heating sources, energy provision, and other sustainability measures.

Aligning lending practices with ESG standards is essential. As private market players continue to grow and extend into other categories, they will play an ever larger role in social causes. We have participated in multiple affordable housing deals, bringing clear benefits to local communities and aligning with municipal objectives.

Our operational model means we have literally thousands of people in these local communities, allowing us to engage meaningfully and act as positive contributors to the local economies. This approach supports our long-term relationships, as community engagement, local planning support, and sustainable impact are crucial. There are questions about measurement and trade-offs but being a positive force in the regions where our employees, their families, and our clients live is central to running a business like ours.

Arrow Global was founded in 2005 by **Zach Lewy**, CEO, CIO, with the ambition of creating Europe's leading private credit and real estate investment platform. Arrow's platform franchise creates sustainable value across a range of alternative asset classes including opportunistic credit, real estate lending, and real estate equity. With the added benefit of key European regulatory licences, it services approximately €90bn of third-party AUM.