EXPERT Q&A

Portfolio compositions are evolving in Europe to give greater weight to real asset-backed credit. Accessing that opportunity requires on-the-ground expertise, say Arrow Global's Zach Lewy and John Calvao

Why local knowledge counts in Europe

The private debt industry in Europe has historically been dominated by corporate credit. But, as the continent faces the prospects of economic turmoil, credit backed by real estate assets has an opportunity to grow in prominence.

Zach Lewy, CEO and CIO of Arrow Global, and John Calvao, the fund principal at the firm, explain that they have found success by focusing on smaller deals across five European countries. Their approach relies on having large specialist teams on the ground, who can use their local knowledge to assess risks and spot opportunities.

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Q What advantages do you gain by investing in assets backed by real estate collateral?

Zach Lewy: Private credit has historically been dominated by corporate credit, but I think in the future there's also a chance for private credit to be a very influential part of asset-related credit. The typical way that investors build their portfolios in Europe differs from how they actually see the world. Most types of bonds and loans are underpinned by corporate earnings. And if you discuss with investors whether they have confidence in Italian or French corporate earnings, especially heading into a recession, you find that people do have legitimate doubts about the credit resilience.

But people are hugely confident that there's a very sustained base of demand for high-quality real estate in Europe. Who doesn't want to own one of the spots on Place des Vosges or in Sloane Square?

So, I feel like the music will change and portfolio compositions will evolve in Europe to give greater weight to real asset-backed credit. The barrier to that is that to be a good investor in the Place des Vosges or Sloane Square, you need to be a local expert. That's a much more operationally intensive requirement.

Our strategy is to be present in those markets and make the very attractive risk-adjusted return of that local real estate available to investors in those locations. As part of that, we will open up for them more asset credit than they currently have, because the only thing that's been available is corporate credit.

Q How do you assess the quality of collateral?

John Calvao: In our most recent fund, over 90 percent of the investments are backed by real estate, cash in court orother mixed securities. It's central to our investment thesis. And when we're underwriting deals, it's super important to have very good collateral and to have the ability to monetise that collateral in the future, if needed. You might have a piece of property that looks great, but it might have been built without a licence and would probably be worth zero. So, being able to assess the quality of the collateral is at the heart of what we do.

We own multiple platforms across the five countries where we operate, many of which have been operating for 15-20 years, and we have around 2,500 people working for us in total across these 18 platforms. We rely heavily on our local teams to evaluate the collateral and also to understand the market conditions and the legal aspects of deals. There's no way we could do that, especially for the smaller deals that we prefer, without having local teams on the ground.

Q How does having specialist local teams help you identify deals and tap into opportunities?

ZL: We can use our servicing economy of scale to access transaction sizes of as little as €3 million. That allows us to play in areas where the traditional Mayfair-based manager just can't efficiently transact. When you look at a big global fund, they might have raised \$5 billion and have 40 employees. We've raised \$1.7 billion with 2,500 employees. We are in a completely different category and we can play at the local level.

Being local and having the right local franchises at a granular level across Europe is more compatible with how the European market operates. If you are sitting in London and trying to find a mega deal, you might have to wait a very long time.

JC: Having local platforms allows you to pick the deals you want to do to some extent, as opposed to being shown a portfolio that gets put out to an auction. We have done some very large transactions off market. We do a lot of secondary trades – being local and having the expertise to better understand why assets haven't sold to date enables us to operate in that secondary market very effectively.

Q One of the countries you focus on is Portugal. What kind of opportunities do you see there?

ZL: We have just been visiting some of the sites that we own in Portugal and it's hard not to feel optimistic. In the hospitality sector, there's a backlog of people who want foreign holidays. That demand is already pushing activity in Portugal beyond pre-pandemic levels.

Q Southern European markets like Portugal are often perceived as riskier. What are the key elements to being able to invest successfully in the Portuguese market?

JC: Portugal is a small country, it has around 10 million inhabitants. It's a country where being local is especially important. You need to be on the ground with people who understand the language and culture, not to mention the courts and legal system.

ZL: In terms of managing risk, the key is simply to have the best assets you can and stay cognisant of the macro picture. The best solution to those kinds of risks is to invest in assets that have relatively short lives. If your assets are paying back, they are amortising, so you are reducing your exposure over time. If you are taking 10 years of risk with no interim return, then clearly, you are far more exposed.

Obviously, you want to maintain a sensible portfolio construction, with sensible exposure to particular asset classes, jurisdictions, or other parameters. At the end of the day, hypothetically, if Portugal were to fall out of the eurozone, that is going to have an impact. But if you have got the higher quality collaterals in that country, you're more immune from that kind of a downdraft. So, it's a combination of asset quality, portfolio composition, having the right limits and keeping duration short.

JC: The Portuguese business is one of our more robust businesses. I think we are approaching a thousand employees in Portugal. We are a major, major player in that in that market.

We have created quite a few verticals there and it puts us in a very strong position in the marketplace. We have an anchor servicing platform, Whitestar, which mostly operates in the residential space, but also covers performing and non-performing loans. Then we have a real estate management company, Norfin, as well as a company that specialises in corporate restructuring, Restart, and we have several assets in the hospitality space in our fund.

Q Turning to migration risks when moving portfolios from sellers to buyers – what are the key things to consider?

JC: In terms of getting a deal right, migration is priority number one. You don't want to get that wrong because it could create a massive problem for you – legal problems, regulatory problems and obviously problems from a performance perspective.

A lot has changed in the last few years. The banks have become much more experienced, and sellers have become much more experienced at moving data. Regulators have also focused on this a lot more. Our platforms have an enormous amount of experience, doing this for the last 15-20 years in some cases. They have ported thousands of different sellers over the years. They have seen every system migration you can imagine. They have done every seller migration you can imagine. Banks even come to us sometimes to help with migrations, because they recognise our capability and our capacity to migrate the relevant data.

Q Are there any other private credit strategies that are particularly attractive in the current environment?

ZL: We are very optimistic about the role that private credit can play in the European economy. We have never been busier across a range of different activities. One of the interesting strategies is bridge lending. There are some long-standing operators whose loss rates are infinitesimal, but are able to charge a large convenience premium for the nature of bridge lending. If you have got a deep origination machine, you get paid very strong returns for that.

"We're very optimistic about the role that private credit can play in the European economy"

ZACH LEWY

Another one to highlight is construction lending. It's got a lot of risk, in the sense that rising costs, rising interest rates and supply-chain disruptions can all bring challenges. So, are banks really going to be the best operator of that risk? I think actually there's a very interesting place for specialist firms in lending to construction. Plus, there's a significant amount of bankruptcy activity in construction – as well as in sectors like transport, travel, retail and offices, so that provides opportunities on the distressed and restructuring side.

Also, more and more investments will go into the energy transition, particularly in asset finance. It's a trillion-dollar theme. As you go building by building, you see so many compelling use cases for energy investments that need to be funded. For example, today not many people in hot countries have air conditioning that gets switched on and off through a motion detector. But five years from now, having air conditioning that doesn't work through motion detectors will probably be seen as unacceptable. So, a lot of these dynamics will go from nascent to mainstream at a very rapid rate.

"The Portuguese business is one of our more robust businesses"

JOHN CALVAO

Going back to our original thesis though, the more local you are, the more you will be able to originate, service and optimise these assets as they present themselves. This local presence has allowed us to generate a strong track record delivering an average gross 18 percent IRR for more than ten years with a sub 1.5 percent loss rate. ■