An exciting opportunity for the right Private Credit strategy

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2023 looks like we will continue to see macroeconomic challenges such as rising inflation and ongoing high energy costs. Despite this, investors are still planning to invest more capital into private credit, partly driven by a view that it is the right place to be in a more difficult economic environment, and to target alternative allocations which are still being built out.

From an allocation perspective, inflation is pushing most investors' focus towards opportunistic distress and value-add strategies. For firms like ours, the dislocation has allowed us to raise more capital and we continue to see strong momentum with global institutional investors attracted to the European debt opportunity. Within private credit, the impact of dislocation on fundraising depends on why an investor is looking at private credit in the first place. Across a lot of the private credit spectrum, the discussion often starts with bond yields at 3% and private bank loans yielding 5%, so the investor is giving up a bit of liquidity in exchange for a pickup in returns. The bond markets have since updated and there are good returns available where you do not have to embrace illiquidity or private credit structures. It is probably the first time in a decade that that comparison has come out as favourable to the public bond markets over private credit.

On the other hand, parts of the private credit market where there are no listed bond alternatives, such as bridging finance, distressed non-performing loans, bankruptcy claims, and litigation finance, are becoming more compelling for investors. Yields have all developed well, so there are significant premiums to be made. We have seen fantastic deals in the last 90 days where there is not any obvious competing capital, as seen by the positive returns in the distressed and bankruptcy claim segments, as well as in some other parts of the market only available to private credit. Those now reflect very different pricing dynamics to anything we have seen since 2009.

Our view of the investment landscape for 2023 and coming years is one that is transitional, shifting from a zero-interest rate to a more stabilised higher interest rate world. This means that low-yielding investments that were a substitute for bonds are going to become increasingly difficult, whilst high-yielding investments will force investors to look at collateral risk with more cynicism, better understanding whether an asset will prove resilient in the face of this macroeconomic transition.

Investors that were previously interested in high-growth equity and other yield-chasing assets are now going to have to pick a different mix of positions because the shape of the risk and return has moved with the macro environment. This has also led investors to look for new opportunities in a market with low growth, high inflation, and high interest rates. Some are even moving away from certain sectors such as corporate lending, and now favouring specialty finance.

We have noticed a wide range of LP responses to these circumstances, these institutional investors have been forced to devise new plans to adapt to this increasingly challenging environment. Investors have been more focused on distressed dislocation funds, favouring managers with local experience. Moreover, because of the polarisation of the social narrative which often resurfaces in distressed period, investors will inevitably place more allocations into social responsibility, ensuring that their portfolios are fulfilling their ESG responsibilities.

In this kind of climate, we have found investors

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focusing much more on business fundamentals such as franchise quality, deal opportunities, and building a good corporate culture. Managers are reconsidering their investment strategies, favouring those that are more likely to succeed in times of volatility. Risky assets will begin to trade at increased discounts, making managers adjust their strategies accordingly. Similarly, safer assets with strong teams on the ground, who are investing in a good margin of safety with solid money multiples, will typically lead to stronger results and higher selling prices.

Managers now need to find creative ways to deploy capital as interest rates increase and as the cost of financing rises. They just have to pick their opportunities defensively and focus on the fundamentals of their investment disciplines. Another way to address concentration risks is to use niche strategies, which are almost uniquely targeted to benefit from these changes, pinpointing the exact risks that you want and the exact risks you don't. These niche and hyper-specialised sectors provide access to expert franchises which can provide specialist returns, which investors can use to improve their portfolios. This is seen in the rise of specialist ESG products, accompanied by a huge focus on energy transition and decarbonisation.

Private credit used to be a place where you could earn a little bit more yield than in public fixed income, and that remains true. But private credit has now carved out a key role in the financial ecosystem, in strategies like bridge lending, non-performing loans, construction lending, bankruptcy, agricultural lending, and small business loans. All of those are challenging areas for the banks, being operationally intensive, but sit much better in private credit, and they are all set to do well in the current market.

A moment like this is going to be tough for borrowers, so there are a lot of non-performing exposures and those will only exacerbate going forward. Having 18 local specialist platforms and more than £79 billion of third-party capital-light income that we service gives Arrow a front row seat to see and invest in the most interesting opportunities. Private credit will end up backing managers who are experts to participate in this moment, where there are good returns on offer relative to the risk. Appetite will ultimately depend on what investors are looking for.

Arrow has been able to source the best risk-adjusted returns for our investors in this challenging environment thanks to our use of a farming model (rather than a hunting model), which focuses on nurturing deep local approaches, and using our on-the-ground knowledge to positively select attractive assets. This selective investing, underwriting insight and propriety dealflow has delivered a 18% gross IRR[1] since 2010 and we are continuing to combine that investment discipline with a strong local footprint to identify attractive opportunities on which we can capitalise. There are a decent number of opportunities in Southern Europe at the moment, but we are really focused on five-star assets, which means hospitality in prime tourism zones and office and residential real estate in locations that are right where people want to be.

We are also continuing to expand the ESG elements of what we do, looking at opportunities in the energy transition that balance a commitment to sustainability and good returns. Our close ties to local markets will continue to support us in our origination strategy and to find the best off-market opportunities. If you have the local footprint to source good deals and the flexibility in your strategy to be able to respond, you will do well in this kind of market.

FOOTNOTE

1 Gross IRR' based on lifetime return calculations, using collections up to 30 June 2022, future cash flow projections and allocated costs (based on today's platform). 'Gross IRR' represents annualised return rate before taking into account fund level expenses.