E X P E R T Q & A

The bulk of underlying collateral in Europe is real estate – a useful form of protection in inflationary times, says John Calvao, fund principal at Arrow Global

The value of collateral in European private debt

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Q Private credit has emerged in Europe from a niche to a mainstream asset class. What's behind this transition?

Investors are always chasing yield, which has encouraged the flight to private markets and especially to private credit. Private credit firms have expanded as the asset class has become better understood and more central to the financial ecosystem, with greater familiarity helping to boost investor appetite.

But it is far from straightforward. There are nuances to understanding private credit strategies in Europe, plus different languages, varying legal systems, tax regimes and credit recovery regulation. In public markets, you can simply read an analyst's report to get up to speed; in private credit, each deal has its own peculiarities, and the landscape requires local expertise: you need to understand the geography, the regulator and much more.

The significant bank retrenchment across Europe is opening up the opportunity even further. The banks don't want to do the complex deals, so operationally-intensive assets are very well placed to fall into this expanding opportunity.

Q Where are private debt funds seeing the most opportunities in Europe? What strategies do you anticipate will be most successful in 2023 and 2024?

One of the biggest opportunities is that the banks are retreating while there is still a big lending need. There is going to be significant demand for lending to corporates, SMEs and private companies looking to build or sustain their businesses. These would have typically turned to local banks for financing.

As interest rates rise and markets face pressures – whether in relation to the Ukraine war, inflation, supply chains or from elsewhere – it has an impact on the banks' appetite to lend and on the affordability of borrowing.

That, in turn, creates all kinds of opportunities for businesses like Arrow to grow and consolidate market share

and to invest into the underlying collateral. Good examples here include the role of bridge financing to help companies overcome short-term financing limitations as well as opportunities for restructurings to take advantage of distressed situations.

That has produced some really good deals in the last 18 months and provided underlying collateral of a quality that is not generally available in a downturn – interesting plays around hospitality and leisure, for example. Typically, these deals would have gone to banks in the past, but we are stepping in and lending at rates that are really attractive for us.

Interestingly, we are yet to see the full fallout from covid. Those assets that struggled during the pandemic will take a while to become distressed opportunities in the banking sector, but eventually banks will have to mark those portfolios down, at which point the assets will become distressed and need working out. That can take 24 months to become an opportunity, and we expect these should start to come through this year.

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Q What changes are managers and investors making to their strategies in order to safeguard their investments?

Managers can better safeguard their investments if they have strong

Q In today’s uncertain economic and geopolitical environment, what are the advantages of investing in assets backed by real estate collateral?

In inflationary times, you tend to see a flight to hard assets, so if you have been acquiring those when times were good you are now pricing those really well. Our thesis has always been to have our investments done with really good underlying collateral because the reality is that you are always going to go through cycles, and it is better to do that with quality hard assets.

Across Europe, the bulk of underlying collateral is real estate, and almost all lending is backed by real estate. Europe is quite different to the US in the extent to which it is based on real estate. If you are playing in European private credit, you need to be in this space – 90 percent of our deals are backed by hard collateral that tends not to lose value.

The world continues to grow in population, and lack of housing supply continues to be a problem, with shortages in London, Dublin, Amsterdam and many other European cities. If the UK government hit its target of building 300,000 homes a year, it would still take 50 years to fill the country’s 4.3 million housing backlog, for example, according to research from the Centre for Cities.

underlying collateral. Some managers have a challenge around end-of-life funds that need to divest, and many of those funds asked for extensions so they did not have to sell in the distressed environment of covid. That stressed environment never really went away, so you will see managers selling assets now, potentially at lower valuations than anticipated.

That creates opportunities for asset managers like us with around €80 billion of third-party assets under management. We can buy the assets that we want to invest in going forward. Managers are aware that the world is not going to get better in the next two years, so if you are an opportunistic player with strong local teams, this is the time to pick up attractive assets.

Across our network, we have great insights into how local markets are behaving, in terms of disposals but also who is buying and at what relative levels. If you are sitting on good collateral, this climate might hurt a bit on timing, but that asset is still going to be a great asset in three years' time. We will see a lot of work by managers to sell deteriorating assets, while others will step up and take advantage of that dislocation.

Q ESG in Europe is arguably more advanced than in the US, APAC, or the Middle East. How have investors incorporated sustainability into their decision-making processes? How has this affected due diligence, for example?

Investors are all incorporating ESG into their decision-making now, and more so every day. Europe is definitely ahead of the US, but LPs everywhere are making this more of a priority because it is the right thing to do – we stand by that as an organisation.

We are looking to add much more ESG flavour to our deals, in areas like affordable housing in particular. All our construction projects are focused on trying to be as sustainable as possible, making greater use of renewable energy and taking steps to reduce energy consumption. At the highest level, it is important that everyone knows how much it matters to us as a business, and we are looking to capture opportunities coming out of the transition to a low-carbon economy.

Five years ago, when we were diligencing an opportunity to invest in a hotel in southern Portugal, we would never have thought about introducing solar panels, which are now a must-have, or re-foresting or recycling water for the golf courses. Today, we are taking all of that seriously and factoring it into our investment decision-making.

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Q How does having local teams help you identify the best opportunities?

Having previously worked as Arrow's Portugal country manager, and in the same role in Italy, I believe in our local focus and see it as the only way to do this. It is impossible for one person or team to understand all the nuances it takes to invest capital in so many asset classes and geographies across Europe, especially when you are looking for the best investment at one particular time in the cycle.

With local feet on the ground, we know about things earlier than anybody else. We are in the fabric of the financial systems and legal systems of the countries in which we operate, and we know more about which investments make sense and why. That local expertise is why LPs invest with us because we have platforms and people in the countries we operate in, and they make the difference.

Bilateral deals in the five countries we favour – the UK, Ireland, the Netherlands, Portugal, and Italy – account for about 80 percent of our investments. That is because our presence in these countries allows us to go directly to local opportunities, communicating in the language and understanding all the customs, regulations, and taxes. While we continue to have a European market dominated by local banks with large balance sheets, the non-performing credit opportunity will require that presence.

Q How do you assess the quality of your investments?

Obviously, we look at how our investments perform over time. But we also do a lot of repeat business, buying from the same sellers, so in those cases we assess the quality of the investments based on our familiarity with the products and knowing how we will tackle them from a servicing perspective.

The only way to be sure of the quality of an investment is to make sure you have local professionals that have worked in the same space for a long time. Then you can rely on your track record to make sure you work well to come to a good resolution and hit your business targets.

Our disciplined asset selection has delivered a strong record, with an average 18 percent gross IRR since 2010 with a sub 1.5 percent loss rate. Underpinning this performance, our highly selective investing, underwriting approach and proprietary dealflow has delivered a 102 percent cumulative underwriting outperformance over 18 years, which is why our investors trust us to get the job done. ■