EXPERT Q&A

Despite the macro pressures, these are the best of times for those prepared to be selective and understand where the best deals reside, says Zach Lewy, CEO, CIO of Arrow Global

Eyeing opportunity in choppy macro conditions

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Q What is your view on the global investment landscape for 2023 and beyond?

It is a landscape in transition from a zero-interest rate world to a more stabilised higher interest rate world. Whether that shift turns out to be transitory – which seems unlikely – or permanent remains to be seen and makes no difference for 2023, because for now the story is one of transition.

What that means for low-yielding investments that used to substitute for bonds is that it is going to be very difficult, while for high-yielding investments you are going to have to look at collateral risk with more cynicism as to whether an asset will prove resilient in the face of macroeconomic transition.

Some investment themes will rise above the macro challenges, like energy transition and agricultural activities for example, and others that have been out of fashion for many years, like corporate-grade bonds, will be able to earn good rates in the new environment and so will create new opportunity.

But for me it is transition that is the key word: people that were previously allocated around high-growth equity and other yield-chasing assets are now going to pick a different configuration of positions because the shape of the risk and return has moved with the macro. Whether assets are impacted by recession, higher interest rates, inflation, the war, the energy crisis or the geopolitical uncertainty, that return of volatility and transition is what will characterise the year ahead.

Q How is the current global macroeconomic landscape affecting private credit?

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 carved out its own areas now where it plays a key role in the industrial 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 today, being operationally intensive, but sit much better in private credit, and they all look set to do well in the current market.

Some other aspects of private credit that are more tied to corporate earnings, such as sponsored M&A and leveraged buyout finance, might see existing assets struggling to do so well in the coming year and look less attractive. But those areas are less of a focus for our business.

Q Where are the investment opportunities in today's market with low growth, high inflation and high interest rates?

To me, those characteristics of the current market are what leads me to move against corporate lending and towards specialty finance. Things like agricultural lending, bridge lending and construction loans do well in this environment, but more broadly the outlook and opportunity set very much depends on whether high unemployment actually materialises.

For now, it is startling to see that despite the period of poor economic growth and high inflation that we have seen, we are still not seeing that result in anything resembling high unemployment, and in fact employment figures continue to grow in major economies – the US economy added 517,000 new jobs in January 2023 alone with unemployment falling to 3.4 percent. We need to see how that unemployment picture settles in order to understand the whole equation.

"Some investment themes will rise above the macro challenges, like energy transition and agricultural activities"

If the stock market booms and the job market continues to boom, it is going to be a real challenge for central banks to get inflation down and they will have to take more decisive action on interest rates, which of course impacts investment strategies.

Q How can managers find creative ways to deploy capital as interest rates increase and the cost of financing rises?

Because Arrow is more focused on investing in asset-related products – either discounts to hard assets like non-performing loans or bank finance or asset finance in areas like construction and bridging loans – we usually make more money as these things happen. Where that is more problematic for our strategies is if house prices fall significantly; but if unemployment doesn't break it is hard to see house prices breaking. The chronic undersupply in UK housing, not to mention across Europe, provides a wide margin of security and inflation hedge. We will see.

Q Where will you be focusing your efforts in 2023?

We have so far been focusing on Tier 1 assets where banks have to get out, so we have invested about £300 million ($365 million; €339 million) over the past three months in that class of opportunities. There may also be an interesting flow of secondaries where funds got extensions for covid and have now run out of time and need to sell.

We are following our footprint, so that means we are doing some UK construction, some Portuguese mortgages, some Irish real estate, Italian bankruptcy and some Dutch mortgages right now. Those are markets where we have best-in-class expertise and experience and understand our categories inside out. 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. If you are deep into the local markets you can cherry pick those opportunities with much more certainty.

At the moment our pipeline is three times bigger than it was this time last year, so there are plenty of opportunities to do well. If you have the local footprint to source those deals and the flexibility in your strategy to be able to respond, that is a powerful combination in this kind of market.

We are also continuing to expand the ESG elements of what we do, looking at some really interesting opportunities in energy transition that we think move the needle and represent good returns. We are really enthusiastic about that space for the year ahead.

The other point is that not all investing is macro related. It is important to appreciate that the macro affects all investments but not all investment theses are driven by the macro. So, whether you buy music rights, YouTube rights or agricultural loans, the macro can be more or less irrelevant. Yes, the macro matters but it is not always a key element.

In this kind of climate you come back to focusing much more on business fundamentals, like franchise quality. For managers, the key questions are around how good your franchise is, do you see good deals, do you see enough opportunities, how forensic is your underwriting – those are things that transcend whether the economy is going up or down. You just have to pick your opportunities defensively and get back to fundamentals in your investment disciplines, which means focusing on elements like building a good corporate culture and finding and developing talent and expertise in your core markets and asset classes.

Q What is key when it comes to identifying investment opportunities in real estate debt?

Clearly the first question in real estate debt is what level of risk you want to wear, and what type of risk. Do you want to back offices, residential or hospitality, and do you want to do that in Southern Europe, Northern Europe or elsewhere. A big chunk of identifying the opportunities is figuring out where you want to be, and that is a matrix, in that you might like Portuguese hospitality, but you might not like hospitality in another market.

It is often very hard to speculate in advance in a way that completely knows with certainty how those different components of a strategy will play out. In that sense you have to focus on just sticking to your fundamentals, so residential is clearly safer than commercial – 'heads on beds' does well because people need somewhere to sleep, for example. You are looking for those assets that represent safety and are worth grabbing.

> *"It is important to appreciate that the macro affects all investments but not all investment theses are driven by the macro"*

The other key factor is to have a good franchise, with teams on the ground, to get ahead of the risks and opportunities in a local market and originate good deals. A current example is energy efficiency in the UK, because in the UK there are lots of offices that do not currently meet energy efficiency standards there is a good opportunity to get into that part of the market and support that push towards energy efficiency. That seems like a particularly safe place if there are new rules around, like minimum standards for energy consumption, and those rules mean many offices need upgrading. Commercial real estate with a high energy efficiency, for example, commands a much higher premium and occupancy than inefficient buildings; it's about investing in assets that are likely to attract high demand, and partnering with institutions that concur with our theses of sustainable investments.

Q What is the impact of continued periods of volatility in the market now and how are those affecting returns?

The good news is that you get a real grade. If you're in school and the test is too easy, everyone gets 100 percent, and it is meaningless. If you are an investor today dealing with volatility and uncertainty, it will be much clearer who are the outperformers.

Certain strategies do better in volatility and good managers can navigate to those, while risky assets will trade at a discount and managers can adjust their strategies accordingly. But certain other things will not go out of style, so if you are focusing on collateral quality, investing in a good margin of safety with solid money multiples, those elements will always lead you to a stronger result during periods of volatility. 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.

Q How is Arrow Global navigating the investing environment and sourcing the best risk-adjusted returns for its investors?

We have a farming model rather than a hunting model, and that really helps. We have some 2,500 employees in our business, servicing €79 billion of assets across 18 local asset management and servicing platforms, and those deep local approaches mean we can use our on-the-ground knowledge to positively select attractive assets. That is a really good place to be versus having to punt into the uncertainty of these moments.

We are combining that investment discipline with a strong local footprint that allows us to identify attractive opportunities on which we can capitalise. We also have a central portfolio management team working alongside those local platforms, who are the experts in their specific classes, to help drive lifecycle value and help with control, governance, reporting as well as pure asset optimisation. ■