E X P E R T Q & A

Non-performing loans, bankruptcy claims and bridging finance are among the niche strategies set to outperform in 2023, says Zach Lewy, founder, CEO and CIO at Arrow Global

Targeting the distressed opportunity

Q How are the current macroeconomic challenges around rising inflation, energy costs, labour and supply chains impacting private credit fundraising across Europe?

From the fundraising perspective, it is slanting most investors' focus towards opportunistic distress and value-add strategies. Investors want to use this more dislocated moment to ensure they have managers, funds and strategies that are well suited to profiting during these times. For us, it has been a fundraising positive. We have successfully raised more capital during the dislocation and continue to see strong momentum with global institutional investors attracted to the European debt opportunity.

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In terms of private credit, the impact of dislocation on fundraising depends on why an investor is looking at private credit in the first place, and whether the vision is a substitute for bonds. In a lot of the private credit spectrum the discussion starts with bond yields at 3 percent and private bank loans yielding 5 percent, so the investor is giving up a bit of liquidity in exchange for a pickup in returns. In that narrow part of the market, where private credit is taking similar risks to the bond market, usually around corporate credit, the opportunity is less compelling today.

The bond markets have updated and there are pretty good returns available where you don't have to embrace illiquidity or private credit structures. It is probably the first time in a decade that that comparison has come out favourably to the public bond markets over private credit.

On the other hand, for parts of the private credit market where there is no listed bond alternative – like bridging finance, distressed non-performing loans, bankruptcy claims or litigation finance for example – right now is super interesting. Yields have all moved, so there are significant premiums.

We have seen some fantastic deals in

the last 60 days where there isn't obvious competing capital and we really like the returns we are seeing in distressed, in bankruptcy claims, and 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.

Q Data in the *PDI Perspectives* report indicates some signs of weakening demand for private debt, even though LPs say it has performed well against benchmarks. What are you observing when it comes to LP sentiment towards the asset class?

All investors that we see are going through their allocations, distributions and pie charts, and we have seen a range of responses. People that are inclined to invest in real estate have moved to where the credit part of the real estate investment spectrum is now more interesting, and the relative risk-adjusted returns are pretty high right now.

The parts of the fundraising market that are succeeding are those that represent good value in a fragile world and can generate healthy returns that blend with the rest of an investor's portfolio.

Q How can GPs and LPs plan for an increasingly challenging environment, and how might we expect allocations and portfolio compositions to change?

Obviously, investors will be more focused on distressed dislocation funds and things set up to be well-orientated to this environment, always favouring managers that have been doing distress for years and have deep franchises in it.

There will also be a lot of allocations into ESG and impact, because there will be a deep polarisation of the social narrative in these difficult times. Investors will be looking to make money by deploying into asset classes where the distress favours the investor, while also making sure they fulfil their corporate social responsibilities and ESG commitments in parallel.

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"Strategies that are countercyclical or earning higher unlevered returns are going to be well placed"

The parts of the investment spectrum that are impacted the most are the low yielding parts and those that are levered. When the investor is trying to earn high unlevered returns, the interest rate going up from zero to 3 percent doesn't matter much if they are earning an unlevered 18 percent, but it matters massively if they are earning an unlevered 4 percent. Direct lending strategies that yield 3 percent are going to be smashed in this environment, whereas strategies that are countercyclical or earning higher unlevered returns are going to be well placed to benefit.

Q What can the more niche strategies do for portfolios and to address concentration risk?

Those are really well-positioned to profit from being highly targeted on what is happening and the very specific circumstances of interest rate changes, recession and macroeconomic challenges. Niche strategies have the benefit of being almost uniquely targeted to benefit from the changes.

When you talk about niche strategies you are picking with a pinpoint the exact risk that you want and the exact risk you don't. Take bridging finance as an example. If you set up a structure doing bridge loans against commercial and residential real estate, you can pick the relatively low loan-to-value assets that you like. Bridge loans to agricultural land, which is relatively stable in value, are really attractive today. You couldn't run a whole portfolio of that, as there is not enough around, but if you could add that as a special overlay it is going to be very different to the general macro cycle.

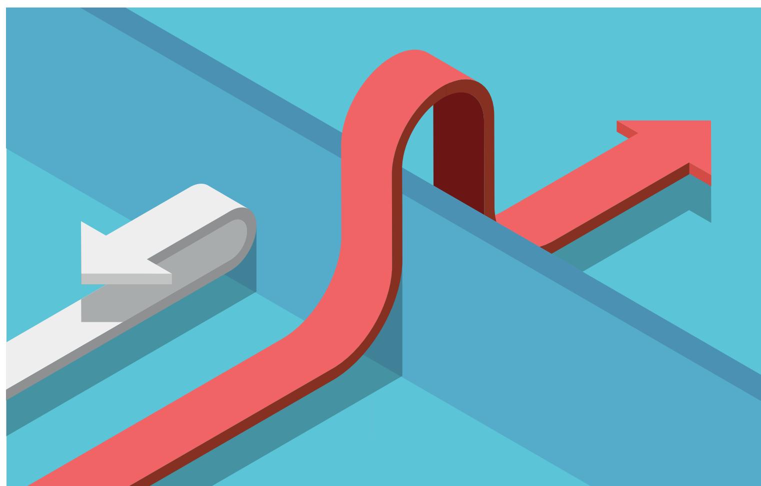
There are good opportunities for managers that have access to franchises that can offer those specialist returns, either through best-ideas funds or more thematic specialist investment products that investors can use to improve and boost their portfolios. Other very interesting niches in this environment include distressed mortgages and bankruptcies.

There are several other specialist ESG products that will resonate. There is still going to be a huge focus on energy transition and decarbonisation. Most people won't build whole portfolios around that, but investors can find specialist products with good returns and take a good ESG position.

Q How can managers address pockets of prolonged stress and distress? How might these challenges and opportunities vary from what we have seen in the past?

We haven't had rising interest rates for a long time so there is quite a lot of room to identify parts of the market that are going to reprice. For example, commercial real estate used to yield 2, 3, 4 or 5 percent at a time when bonds were yielding zero or negative returns, but once bonds are yielding 2, 3, 4 or 5 percent, real estate value has to adjust significantly to compete.

There are some great opportunities to look at asset classes that are most directly affected by the change in interest rates, which are primarily leveraged buyouts that blow up because the debt can't refinance or commercial real estate that blows up because the higher yield level gets totally repriced by the change in interest rate. Managers are looking for those things that could be effective in a world of zero interest rates but have become very obviously completely ineffective in a world where rates are going up.



Q What does the opportunity look like in non-performing loans, and how can private credit capitalise on that opportunity?

That opportunity looks really good. A moment like this is going to be tough for borrowers so there are a lot of non-performing exposures and those will exacerbate going forward.

Having 18 local specialist platforms and £70 billion ($85 billion; €79 billion) of third-party, capital-light income that we service gives us a front row seat to see and invest in the most interesting opportunities. Those are neither easily visible nor constantly available, and the optimal moment to get involved in each situation varies.

Private credit will end up backing a number of us who are experts to participate in this moment, where there are good returns on offer relative to the risk. Appetite will depend on what investors are looking for: primary risk in new situations; secondaries where people need to get out of situations that have gone bad; or opportunities in more specialist niches like agricultural real estate.

Most private credit investors have spent a reasonable amount of institutional time interviewing and getting to know different players in distressed. They are not going to look for new relationships, but will pull out the Rolodex of people they have met over the past decade and back the managers they consider best placed to deliver.

We have seen a surge in interest in distressed, and that will likely last for years. Private credit will have been getting involved in lots of low-yielding bond alternatives and will now find that a lot less interesting. The focus will shift to distressed, bankruptcy and other parts of the market that benefit from a negative macroeconomic climate and offer specialist returns.

Q How is Europe currently perceived versus other geographies around the world? What are investors looking for here, and are there any trends elsewhere that may be heading to Europe?

People come to Europe for income, not growth. The parts of the credit spectrum that will resonate in Europe are things that offer attractive income characteristics. That is not going to come from big capital gains or from growth or venture, so it is reasonable to expect we will see a focus on managers that can offer attractive income strategies out of Europe that maximise the macro.

In specialist areas there are themes coming over from elsewhere. For example, you can debate how life sciences are going to evolve in Europe, and some European countries have bigger residential rental markets, and in those asset classes you can look at how themes have evolved in other parts of the world. Investors have to look at the specific areas they want to try and earn returns from and make sure the footprint of a manager and their expertise fits the specifics of that opportunity. Having deep local presence is particularly compelling in the European context and we feel we are well placed with our 18 strategies underpinned by selective investing, underwriting insight and propriety dealflow to maximise the current opportunity set. ■