Q+A: Maslow, Bergen and Arrow on bridge and development lending amid rising construction distress

28 Jul 2022 | by Amy Finch

A new inflationary environment will shake up business loans, says Maslow's Ellis Sher

Maslow Capital CEO Ellis Sher

From its start in unsecured debt purchasing, European investor and asset manager Arrow Global has travelled far across the investment landscape.

The successful €1.7bn fundraise for Arrow Credit Opportunities 1, which concluded in Q3 2020, marked a key milestone in the group’s transition to a capital-light, fund management model. In March 2021, the group was taken private in a £563m takeover by TDR Capital.

In the last year, the investor has delved deeper into alternative lending. It launched Bergen Finance, a dedicated UK bridging loan business, at the end of 2021, looking to capitalise on a market which has grown by more than 400% since 2013 to exceed £5bn per annum.

Arrow then bought a significant minority stake in Maslow Capital, a leading provider of UK real estate development finance, with ambitions to grow across the UK and European “living sectors”, *React News* revealed in January of this year.

Although a less benign inflation environment presents risk, the disruption to so-called “zombie businesses” also creates opportunities for independent lenders who can provide them with capital, says Andrew Ward, managing director at Bergen Finance.

React chatted with Ward, as well as Ellis Sher, CEO of Maslow, and Max Lewis, principal at Arrow Global, about rising costs of construction, a new interest environment and European expansion plans.

What’s the rationale behind the Bergen Finance model and the £1m to £30m deal size range?

Andrew Ward: My co-director Andrew Hogan and I have set up our own small private finance houses. Bank debt tends to be large institutional debt, which is more rigid.

Our proposition to the market is that you’re dealing with a small team at Bergen who are quick, efficient and can be flexible to turn things around, but we have the backing of the Arrow Group and the multi-billion balance sheet behind us to enable us to do significant deals.

I think that, combined with the fact that we’re able to operate throughout the UK and Ireland and we’re able to deal in most situations and most sectors gives us a bit of a USP in that side of the sector.

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> ANDREW WARD, BERGEN FINANCE

Max Lewis: There are still good opportunities to lend against good collateral to borrowers that need that extra bit of help – be it because their business is growing rapidly and they require capital to fuel that, or that they find themselves in a situation where there is a degree of distress (like a restructuring) where they need to raise capital and they have the right kind of assets to lend against.

Do you see more acquisitions on the horizon?

ML: Acquisitions aren't something that we have to do. We're in the fortunate position of having great and expandable businesses that grow organically. That said, it's never something that we rule out, but I think it's completely viable that these two platforms, as well as our joint-venture partners, can take us to a wonderful place.

At the time of the acquisition, Maslow and Arrow agreed to using the stake to fuel international expansion. How's that going?

Ellis Sher: I'm not in a huge rush. You must first build local infrastructure and knowledge to provide relevant insights. Inflation and labour shortages, for example, in the UK are not the same as in continental Europe.

You can get into a bad habit of imposing your domestic knowledge, which has no equivalent application. I'm very minded that it's hard enough to manage construction risk when it's under your nose because there's so many moving parts to delivering an asset.

At the moment, we are domestically focused, ensuring we manage the portfolio through these inflationary times. Now is not the time to take the eye off the ball.

And do you see more international expansion from the Arrow perspective?

ML: We're starting to dip our toes in the market, especially in areas like Portugal, and there are likely to be more expansions. We are looking at selective ways of plugging into our local infrastructure in our key geographies outside the UK (Portugal, Ireland, Italy and Netherlands). But we are using the local team who understand the markets to originate business and manage it in a profitable way. That local knowledge and the relationships that come with it are completely critical.

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AW: There are lots of differences in terms of structure, particularly things like financial legal structure. In the UK, as lenders, we are quite fortunate that we have a system that allows us to appoint a restructuring professional. In Europe, there are an awful lot more legal intricacies to that process, and clearly that is where the local knowledge comes in from my side.

ML: What I'd probably say is this: don't be surprised if you see the Bergen branding exposed in other countries at some stage in the future. However, if that happens, it'll certainly have a very local flavour to that business. It'll be run by local industry veterans.

How are rising construction costs and interest rates affecting the lending market?

ES: We're having to look into a crystal ball a lot more. We have become accustomed to underwriting in environments where interest rates, purchasing of construction materials and gross development values are relatively benign. As much as I would love to believe that the world will continue with the growth that we've benefited from, we are alive to the challenges the industry faces.

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The overarching structural deficiency in the number of people that need housing versus the number of houses means that despite the headwinds of interest rates and inflation, it's still a market with considerable momentum and compelling long-term growth prospects to focus on.

We have seen developers land-bank sites, sell or return to planning as the higher cost environment renders their existing plans redundant. The current challengers will only serve to slow down housing delivering further and while the government has good intentions when it comes to the delivery of new homes, the planning system is so unwieldly that the supply side is only going to get worse in the medium term.

Nexus Residential obtained £19.5m in development financing from Maslow Capital inJune for the completion of its One Baltic Square residential scheme in Liverpool

Institutional capital is likely to require higher spreads for the risk that they're taking as they come under pressure from their investors.

But I caveat that with the unusually high levels of competition and liquidity. This may well distort the picture in the short term until such time that lenders start to incur losses. This usually takes two years or so on development credit.

How are you planning for that?

ES: We're navigating that by insisting that construction costs are locked down. We are super focused on the solvency of the delivery partners. We're going to see a lot more insolvency in the sector over the next 12-24 months, that's a given. The margins are simply too thin to be able to survive some of the fixed-price commitments provided a few years ago.

The impact of rising interest rates on development credit is not quite as material to the cost of a project as you might think as it's only levied on the drawn component meaning. Interest rates will have more of an impact on bullet loans.

Are you already accounting for that in your business model?

ES: When we started our business 13 years ago, all we did was step into stalled projects where developers and contractors had gone into administration/work-out and required recapitalisation. We found places to successfully deploy capital in that environment, but in our own environment where we've got a mixture of fixed-price contracts and self-build projects, I am confident that our team's experience and the underwriting standards we have will hold up, but I recognise the need to monitor positions in near real time.

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In terms of the distribution of our book, we didn't actually do much business purposefully in 2020 because we didn't really understand where value was at.

We therefore have a slightly aged book which, consequently, has less exposure to the latest construction inflation. We have enough headroom in our projects to absorb cost increases, with a weighted average LTV of 60%, dropping to circa 45% with pre-contracted sales.

What are the opportunities for independent lenders?

AW: We're looking at industrial property, all kinds of special situations, leisure, land, hotels, pubs.

Trying to look from the prospect of an independent lender, looking back to the early 2000s, it was boom time for asset-based lending in general across the balance sheet because you had a huge churn in businesses. And we haven't had that over the past 12 to 15 years because of that low-inflation environment. We've had thousands of so-called zombie businesses just ticking along.

Maslow is funding Renaker to deliver Manchester's Elizabeth Tower, which reaches 52 storeys

It creates risk as well, but I think it creates opportunity for the independent lenders who can recognise those businesses who may need to start again by acquiring assets, and that certainly is part of what we do.

Still, the UK business lending market is driven by what the main clearing banks do. Are they going to get any more flexible in the near future? I think that's a definitive no.