EXPERT Q&A

Fragmented European lending markets present opportunities for debt funds looking at non-performing loans and distressed debt, but local focus is a must, say Arrow Global's Zach Lewy and Davide Stecchi

The granular credit opportunity in Europe

Q How would you characterise the European banking market at present and how does its fragmented nature create structural challenges for both lenders and borrowers?

Zach Levy: Europe is split into 44 countries and it is frequently the case that local champions dominate the lending markets and, despite dominating in one country, have little presence elsewhere. There are 6,000 banks on the continent, including around 400 in Italy alone. So that is an intense segmentation that makes the whole banking business a very local activity.

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Our business model is aligned to that, with local teams on the ground servicing around €70 billion of assets in local structures. We are focused on 13 specialist platforms across five countries – the UK, Ireland, the Netherlands, Italy and Portugal – and we aim to be very strong in our countries of choice. We have strong capabilities in consumer loans, mortgages and other real estate credit, and small business loans, while in the Netherlands we own the largest specialty buy-to-let lender, in Portugal the largest real estate developer, in Italy the largest securitisation trustee, and so on.

We have aligned to the fragmented banking industry and, by having that local infrastructure, we think we are relevant to about 90 percent of typical European retail banking and a good strategic partner to more than 200 bank clients.

The average European bank is 2.5 times more capital intensive than the average US bank, because US banks can securitise or otherwise transfer the risk on the majority of their assets into the capital markets. Those risks sit on the balance sheets in Europe, because of fragmentation that is difficult to unpick. We look at that and conclude we need to be local champions and face into that Italian or Portuguese lender, making sure we have the capability to support them in their local market.

Q What impact has the economic dislocation associated with covid had on banks' appetite to lend and the future provision of NPLs?

Davide Stecchi: In the wake of covid, there will be a certain segment of the European market that will be materially underserved going forward, if not completely ignored by the banking system. The banks tend to react with fear to dislocation, so they will strengthen controls and tighten requirements, leaving borrowers that cannot tick all the boxes to fall off the radar.

That creates an opportunity for alternative lenders and special situations funds to support companies on the edge of survival or in need of working capital. State interventions will expire soon, creating further stress and potentially a wave of bankruptcies, particularly in countries that have not yet fully digested the previous crisis. We expect to see a move from alternative lending to big sales of portfolios of non-performing loans, as we saw a decade ago.

Q Where does Arrow currently see the greatest opportunity to invest in European private debt as a result of these dynamics?

ZL: We exist to help improve the efficiency of the European banking sector generally, and there are two sides to that. On the bank side, consumer positions require a heavy ESG focus and regulatory awareness, because if you are dealing with individuals and the economic impact of covid, you are seeing people hit inequitably. Lots of industries have been hit by stark shutdowns, so banks have needed to help their customers. We have taken on about €15 billion of assets that we are now servicing on behalf of the banks as a result of those challenges.

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>
> **ZACH LEWY**

If you look at small business loans, the same rules apply, maybe to even greater extremes. Those used to be more stable and benefit more from aggregation, but during covid that's been choppy for certain sectors and created challenges for banks. In many cases, there has been a desire on the part of banks to crystallise losses but a need to provide ongoing support in line with government policy.

What can we do? We have securitised our residential mortgage portfolio quite significantly, because you still have investors looking for yield and the middle class housing market has probably never been more buoyant. We have also been super busy in bankruptcy, where we are seeing no need for banks to speculate about government support; if the position is static, there is no decision to make. If a loan has become permanently non-performing, they may as well sell, while on the buy side, we can diligence a frozen asset.

We have also seen quite a lot of single real estate deals get resolved, with unfinished building projects getting restructured, for example. And we were early movers in the buy-to-let industry and now have a strong platform in both the UK and Ireland doing those deals.

Transactions are getting done, but not incrementally across all asset classes, just in sectors where the banks

Q How can private credit managers capitalise on the granular and deeply local nature of the European market?

DS: There are two main advantages of being local. First, we can react to the market faster, because we can feel the economy on a day-to-day basis and don't have to wait for government announcements. Second, we can identify and attract opportunities through our granular insights across the market. Different approaches will be relevant to different asset classes in different markets, because covid does not impact all assets in the same way. We are well placed to anticipate what's going to happen and to benefit at various stages of the cycle.

Given the fragmentation of the market, the diversity of credits and the inefficiencies in the system, it is not possible to translate market practice in one country and necessarily apply lessons learned elsewhere. Even if you are really great in one European market, that doesn't mean you can export that expertise.

Instead, what you gain over time is experience, reputation and a network in a local market, plus a bank of data that is a clear advantage of being local and is a massive barrier to new entrants. You can't buy that insight without literally buying the servicer or asset manager.

have a need for reform and have found buyers willing to step in to resolve situations in a way that is additive. If you were to add up the non-performing exposures that banks hold, including non-performing loans sold but yet to be resolved and non-core assets the banks have already determined they want to sell, plus discontinued product lines or joint ventures on run-off, that totals more than €2 trillion in assets today. About a quarter of that is in our five focus countries.

The business model of these banks is structurally challenged and there is a lot of work to do over the years to come.

Q What are the underwriting challenges in this growing market, how do they vary across the region, and what mitigants are there?

DS: One of the challenges of our business model is that when you do granular deals at scale, you have a lot of deals to do, a lot of things to price, lots of data and lots of management. What we do is a niche product but the non-performing loans business is a mature business, even if you are often dealing with unsophisticated sellers. To do well, you need to look closely at the quality of the collateral, because most of the time you can cherry pick what you want to buy. But still you need a profound amount of time, experience, skills and data, some of which you can address through your local platform by having the right talent with the right connections.

The second big challenge is that when you have bought the asset, you need to manage it. A good execution plan is just as important as a good acquisition strategy, and again the answer to mitigating the risk lies in being a local champion. If you do 50 deals, you need a good platform to stay on top of things. As the world moves towards more and more regulation, the sellers feel better if you are managing the investment with a local company that knows the domestic rules and regulations.

In short, the granularity of the opportunity means the issues are many and the mitigants are many, but the answer mostly lies in having a strong local team with deep expertise and knowledge.

Q What potential do you see for private credit to expand market share going forward, and how do you think the European landscape will evolve?

ZL: This industry is an evolving, dynamic and competitive place. You have highly motivated people with lots of skills operating inside regulatory frameworks but trying to figure out how to add value to the banking system against a challenging backdrop. In the time we have been doing this, the ability to add value has expanded. You now see strategies where people buy unfinished buildings, finish them and sell them on, for example.

The fundamental trend is the value-add from the buyer is going up dramatically, and in Europe that comes from combining country-level capabilities with asset class capabilities. You can be really good at real estate development in the Algarve but that is irrelevant to real estate development in Copenhagen. So, the challenge for private credit is to harness that value-add on an asset class basis and translate it in a way that applies on a local level. It is incredibly difficult to export a successful business model across Europe, but not impossible.

We have done 997 deals over the last 16 years and invested €6.4 billion in total capital. We have averaged 17 percent IRR and lost money on just 1.7 percent of our deals, so we are delivering near-equity returns in the high teens against almost investment grade levels of risk. In November we held the final close on Arrow Credit Opportunities I, the largest first-time credit fund ever raised, and we see the opportunity in the European non-performing loan and distressed debt market continuing to be very large. ■

Zach Lewy is CEO and chief investment officer at Arrow Global and Davide Stecchi is managing director underwriting