Comment

Why it’s always best to invest in markets where you have pricing power

It helps to keep local, forensic and cautious when building an alternative credit fund

By Zach Lewy
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The debt and real estate sectors have their own rules to play by. The risk and the customers involved are not like those associated with any other fund or asset, so you have to have the right methods to survive and thrive. With over 23 years as an investor, servicer, and manager in this space, I like to think that I have picked up a few strategies to best succeed in this exciting and diverse market.

Over the past year so much has changed for the Arrow Group, we have continued to deploy our first Arrow Credit Opportunities Fund to remarkable success, and we continue to build out our real-estate and fundraising specialisms across our core markets, which is central to our future investment strategies.

Arrow adopts a granular credit approach, where we own local platforms with a deep on-the-ground understanding of specific country’s legal, judicial and tax regimes and financial markets to leverage the best risk-adjusted return opportunities - mostly off-market dealflow due to our local insight and relationships with more than 200 banks and financial institutions. This strategy across Europe has allowed sees us operate 18 specialist platforms across our five main markets, providing proprietary and unique private credit sourcing capabilities, and delivering attractive returns for investors in multiple assets classes including NPLs and residential and commercial real estate. Our local platforms service our assets daily and our portfolio management ensures we optimise the value of those assets throughout their lifecycle.

During my career, I have been asked many times to share some of my experiences and key insights having worked, as a servicer and investor, in our markets continuously since 1998, and having personally overseen more than 1,000 deals collectively worth more than €8 billion. So, I have compiled some thoughts which I believe are essential to operate in the attractive but highly fragmented and granular European credit and real estate sector.

The first and foremost aspect of my, and therefore Arrow’s philosophy, is to wherever possible, be local and forensic. Credit and real estate happen on the ground and need to be diligenced and managed at the local level. Some fund managers like to sit in their offices in London and transact all over the European Continent and whilst this is management fee efficient, it is not the right way to carefully invest capital and manage risk in what is a fragmented European market. Being local and on the ground is key to finding the best deals, avoiding mistakes, and minimising risk for all parties involved.

When moving loan or real estate assets from one manager to another, migration risks are critical and need to be managed with stark accountabilities and careful oversight. When you move assets from one lender to another is when many root cause issues go wrong. Having careful migration templates, rigorous processes, and the best people supervising migrations is critical to success of the migration process and your investment staying stable.

A key strategy that we have used when entering new segments is to always do pilots before going big. Each European niche asset class has own peculiarities, and you want to make your mistakes in pilots before you scale exposures in any substantial manner.

Especially in the NPL space, the quality of the collateral is paramount. Deal teams can get too enamoured with the thrill of the chase or the complexities of the deal structure, but ultimately the underlying collateral is the source of repayment. It is best to avoid complexities, keep your eye on the collateral prize and lock it down with good legal security to best minimise your risk in the overall transaction.

It is key to build out a team that understand the space and have a hunger to learn. Find talent who love the business, because if they love the business, they will give their best each and every day. It is people with a particular set of commercial and value management skills and a passion for details and comprehensive execution alongside intellectual curiosity and energy who succeed in our business. They exist in every country and can be found if you look hard enough. Be relentless in finding that talent and keep and develop the good people you find into the future leaders of your business.

It is always best to invest in markets where you have pricing power. There are simple techniques that evidence your buyer-seller balance of power in these transactions. Test that equation and play where the advantages are stacked in your favor, otherwise avoid or exit. Investing where you are weak leads to performance dilution and mistakes which can be easily avoided.

Make sure to never split borrower groups or borrower connections in credit transactions. You want to control positions so look for those type of positions and avoid minority creditor positions. Wherever you can become a creditor, bring those voting rights together and do not let control get fragmented by splitting borrower groups.

Finally, repeat business is better in terms of risk management and returns for your investors. Treat your clients well and encourage repeat business. It is much better to do what you know repeatedly and not have to learn new risks unnecessarily to build out those relationships.

Building a successful alternative credit fund takes a well-thought-out strategy and the right team to execute it. Who knows yet what the new era of technology in the sector might bring, maybe in a few years we will count knowledge of AI or machine learning as an essential skill? For now, however, the best advice I can give is to stay local, forensic and cautious. It is philosophy that has delivered Arrow and our investors an average 18% gross IRR since 2010 with a sub 1.5% loss rate.

Zach Lewy is founder, CEO and CIO of Manchester-based debt investor Arrow Global