Why private debt will continue to enjoy its moment in the sun

Identifying niche markets where demand exceeds supply is the key to delivering consistently high, low risk returns from private debt

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What factors have contributed to private debt experiencing its most favorable return environment since 2009?
There's two core factors. The first is obviously rising interest rates. It's a more lucrative time to be a lender on new deals, while the use of floating-rate facilities in private debt have protected investors as rates have risen.

The second is that there's a maturing equilibrium between where different types of balance sheets support the economy. It's become clearer what fits comfortably inside of a bank: products like mass market mortgages, plain vanilla foreign exchange swaps, credit cards, and so on. Then there are the bits that fit insurance company balance sheets, and those that suit capital markets.

Private credit works for the things that don't fit in any of the other categories. In general, it's operationally intensive activities like construction lending, bridge lending, non-standard mortgages, lending to private equity deals, and restructuring capital. Private debt steps in where you need a real business partner with an operational commercial skill set. It's not a phrase you hear any more, but merchant bank covers it. Within private credit, there are category specialists doing real estate credit, or sponsor credit, or restructurings, and they really focus their expertise on those areas.

So, the returns are partly because the rising tide of rates has floated all boats, but also because the way that the market has evolved and matured means there are private debt firms with very strong market leadership and share in certain key categories like agricultural lending, affordable housing, construction, bridge lending. It's not going to make the front page of the Financial Times, but its economically fundamental and core to the mission of many businesses.

What's the attraction of private debt for investors?
Private debt is really attractive right now. I've talked with many investors who were earning 4–6% returns on their core commercial real estate portfolio. Now, they can earn 10% on senior loans to a safe part of the housing market. Private credit is taking part of the pie from real assets, and from certain parts of private equity and venture capital. If we can earn 10–12% for our investors doing very safe 60% LTV-specialist lending against residential collateral, that's a very attractive allocation of capital.

There are a lot of strategies that have investor support. Direct lending to corporates is still the largest, followed by core real estate credit. But then you have specialist areas like litigation finance, bridge lending, construction and agricultural lending, and risk capital trades with banks that benefit from the current market conditions.

But I don't see investors rushing to be experimental at this point in the cycle. There are enough categories in which managers with 10- and 15-year track records are delivering double-digit yields. With base rates at five, there are plenty of liquid, safe options returning 6–7%. So, for a structure that is a five- or 10-year illiquid commitment with a bit of risk in it, investors need a double-digit return. And there are plenty of established strategies that meet that criteria, so investors do not need to go looking to the frontier.

Despite a softer landing than feared in many countries, the economy is still challenging. How can managers minimize the risk and impact of defaults?
The key for us is picking those parts of the market where supply and demand are in our favor, which means identifying sectors and sub-sectors in particular markets. In real estate, for example, offices have quite an uncertain future, retail has been going through radical transitions, hospitality is having a moment in the sun, logistics goes from strength to strength, while core housing has the tension between affordability and pent-up demand.

Once you've picked categories where you feel good about supply and demand, you can gain exposure and lend on sensible terms.

There's also capacity to handle restructurings. Since we set up Arrow, we've lived through Brexit, a pandemic, the eurozone crisis, and the GFC. We're getting used to waking up in the morning, seeing there's a new political surprise or a global macro change, and asking: what are the right tactics to preserve value? That playbook is mature and well-

practiced. So, if you pick categories where supply-demand is in your favor on the way in and keep a cool head and manage from experience, then it tends to go well.

The main thing that having supply and demand in your favor is that the asset you hold will likely have fundamental liquidity. If you stick to the most liquid collaterals and an LTV that's cautious, you've protected yourself in a very fundamental way, because the security itself is liquid. You can get out of it, for value, and in a reasonable timeframe. And the cautious LTV gives you enough protection that when you do sell it, even if you take a 10% hit against the value of the collateral, you're not going to suffer a loss of return.

So, the key to us is finding those categories that meet those two criteria, where the collateral itself is high quality or liquid, and where the entry price is safe. Then we try to add value while we own it, for example by updating planning permissions, licensing a hotel to a leading brand, and improvements to the facilities. If the European market was hugely efficient, you wouldn't earn interesting returns with those tactics. But it's not. It's very fragmented and local – a patchwork quilt of granular opportunities.

Arrow's investment manager, AGG Capital Management, recently acquired AFE (Anacap Financial Europe). Is this the start of a wave of refinancing opportunities?

It's an interesting area, but it's hard to know how long it will last and how big they'll be. But if you have capital (and we were lucky enough to raise a €3bn fund last year) you have the flexibility to step in and operate efficiently. These restructurings come with a lot of requirements, and you need to be pretty big to get them right.

We're enthusiastic about the opportunity. Do I think we're one of the ones that can be effective in this environment? Yes. Will it be a big opportunity? That depends on exogenous factors like central banks and governments, as much as it does on markets. There will be epicenters of activity in categories that have gone through change, like offices. But just how interesting it gets will depend on those external factors.

There's a perception available investor capital in private debt is insufficient compared to the investment opportunities present, despite buoyant fundraising. Is this true, and if so, where are the emerging sources of capital for private debt managers?

The private credit market is, in any substantial sense, only 15 years old. And investors are working out the right allocations for the future. Go back 15 years and everyone understood why private equity was an asset class. Some people understood why venture capital was. But they didn't understand private credit. They saw credit as a liquid thing. But now many investors, particularly insurance companies and other institutions with very permanent capital, are seeing that the compounding benefits of private credit are very attractive.

And so are the income benefits. Pension funds have more and more baby boomers drawing cash out of the system and are realizing that private equity and venture don't pay out cash every year. As time goes by, there's more appreciation of why private credit should be a bigger percentage of investors balance sheets.

You've talked about why private debt is a great investment, but what is its role in the wider economy?

It's vital for a strong, functioning economy, and where you find dynamism and growth, there will be private debt finance. If we describe the world we hope to see 10 years from now, with decarbonization, electric vehicles, people able to get on the housing ladder, food security with capitalized local supply chains that can compete, data centers powering AI – these are all areas where private credit will arguably be the majority of the capital that funds those changes.

We see real demand from investors to be at the forefront of those changes. They see that private markets can be a very direct route to achieving those goals, in a different way from public markets. Public markets have an advantage because the reporting is public and that can put a spotlight on issues. But in private markets you can really dictate where the money goes.

Private markets will be a force for a lot of that social change and in creating a better economy in the future. If the market works correctly, projects will succeed economically and deliver really positive outcomes for communities. I'm very optimistic about that and I see it every day across the European countries Arrow works in.

Arrow Global was founded in 2005 by **Zach Lewy**, CEO, CIO, with the ambition of creating Europe's leading private credit and real estate investment platform. Arrow's platform franchise creates sustainable value across a range of alternative asset classes including opportunistic credit, real estate lending, and real estate equity. With the added benefit of key European regulatory licences, it services approximately €80bn of third-party AUM.

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