E X P E R T   C O M M E N T A R Y

Strategic value and rapid growth in Europe mean that private debt is now a highly significant asset class, says Arrow Global Group's Zach Lewy

The enduring impact and opportunity

In recent years, the landscape of investment opportunities has undergone significant transformation. Over this period, for instance, the realm of private debt has not only proven resilient in the face of economic fluctuations but has also offered strong risk-adjusted returns. That's especially noteworthy in an era marked by rising interest rates and geopolitical tensions.

According to Moody's, the European and UK corporate private credit market has been growing at an impressive average rate of 21 percent per annum over the past decade, outpacing the US's 14 percent average annual growth rate (albeit from a lower starting point). This robust growth underscores the resilience and attractiveness of the private debt market, even as it faces economic fluctuations.

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When delving into the reasons behind the sustained success of private debt, it is essential to consider both the macroeconomic factors and the strategic positioning that have contributed to its prominence. The current environment, characterised by increasing interest rates, has undeniably created an attractive time to be an investor. The adaptability of private debt, especially through the use of floating-rate facilities, has provided a protective shield against the volatility of rising rates. This resilience is further bolstered by the asset class's unique ability to fill the gaps left by traditional financial sectors, catering to operationally intensive activities such as construction lending, bridge lending and restructuring capital.

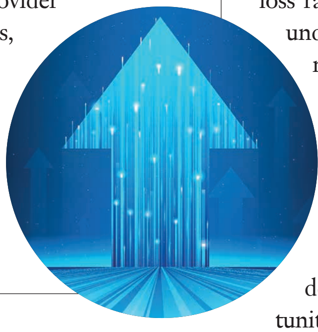
A broad reach

It's in these niches that private debt truly outperforms, offering specialised operational and commercial expertise that is often beyond the reach of conventional banking, insurance and capital markets. Corporate sponsors, on the other hand, are increasingly turning to private credit for its execution certainty, bespoke structuring, quick execution and higher leverage capabilities. This trend is a testament to the asset class's ability to meet

Private debt's growing social role

Beyond its financial merits, private debt plays a pivotal role in fueling economic growth and facilitating societal change

From decarbonisation and affordable housing to technology and infrastructure, private debt is often the majority capital provider for projects that drive positive change. In the coming years, I expect private debt to play an increasingly important role in mitigating the effects of changing demographics across developed economies, particularly in labour-intensive industries. This ability to quickly direct capital towards impactful endeavours helps distinguish private debt from other assets, underscoring its significance in shaping a dynamic and equitable economy.



the complex needs of businesses.

There is, after all, great strategic value in focusing on areas where traditional financial institutions are hesitant to lend. This focus not only facilitates robust returns but also underscores the fundamental role of private debt in supporting the growth plans of diverse businesses. Whether it's agricultural lending, affordable housing or electric vehicle charging infrastructure, the impact of private debt now extends far beyond the confines of financial statements, contributing to the very fabric of the economy.

From an investor's perspective, the appeal of private debt has never been more pronounced. The shift from traditional investment avenues offering modest returns to private debt strategies that deliver double-digit yields is something that often comes up in conversations with institutional investors.

This is not merely about higher returns; it's about recognising the value of safe, strategic investments in sectors with proven track records of performance. The economic landscape, marked by caution and a search for stability, has only amplified the attractiveness of private debt as a component of diversified investment portfolios.

This is evidenced by the latest investor sentiment, with 84 percent of investors reporting plans to commit the same amount or more to private debt in the next 12 months compared with last year, according to *Private Debt Investor's LP Perspectives* study. This decision is supported by the 89 percent who stated that performance has met or exceeded their benchmarks.

Catalysts for growth

What's more, regulatory factors and industry trends – such as Basel III, private credit fund securitisation and the revision of the European Long-Term Investment Fund (ELTIF) regulation – will act as a catalyst for growth and further broaden the investor base, supporting the notion that private debt is becoming an increasingly important part of diversified investment portfolios.

Risk management remains a cornerstone of a good private debt strategy, especially in an unpredictable economic climate. By focusing on sectors where supply and demand dynamics are structurally favourable, lending on sensible terms and incorporating stringent covenants, it is possible to significantly enhance investor and lender protection.

At Arrow, this approach, coupled with our capacity to manage restructurings effectively, has been instrumental in navigating through challenges such as Brexit, the pandemic and various global crises. The key lies in selecting high-quality, liquid collaterals and maintaining cautious loan-to-value ratios, ensuring that investments are not only secure but also capable of weathering economic distress. Our 19-year track record of investing approximately €10 billion, with an 18 percent gross unlevered IRR and a sub 1.5 percent loss rate across more than 3,000 deals, underscores the effectiveness of this risk management approach.

The recent acquisition of Anacap Financial Europe by funds managed by AGG Capital Management, a subsidiary of Arrow, is a testament to our belief in the potential of private debt. We're confident that opportunities to offer refinancing and recapitalisation are becoming more prevalent in this constantly evolving market. While external factors will influence the future landscape, that scope to capitalise on strategic investments remains resolute.

The evolution of the private credit market over the past 15 years, then, has gradually shifted investor sentiment towards the attractive risk-adjusted returns available in this asset class. Today, more investors recognise the strategic value of incorporating high-yield, long-duration assets with low market risk into their portfolios. This shift is particularly clear among institutions with permanent capital and income requirements, such as insurance companies and pension funds, which are now more appreciative of private debt's role in their investment strategies.

As we look to the future, the significance of private debt in the broader economic and social landscape will only grow. My optimism for this asset class stems not only from its financial performance but also from its ability to meet the complex needs of the modern economy and drive meaningful societal change. It's clear that the potential of private debt, as a key lever in European credit markets, has a long way to go. ■

Zach Lewy is the founder, CEO and CIO of Arrow Global Group