Unlocking the private debt opportunity: my perspective on opportunity and growth

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Private debt is at an exciting stage in its development, with momentum building across various sectors as banks continue to scale back from traditional lending roles. This shift presents unique opportunities for private credit lenders, who are stepping up to fill the void with innovative solutions and disciplined strategies.

Within the private debt sector however, some sectors are thriving while others, such as office real estate and corporate credit, are presently less in demand. This contrast arises primarily from macroeconomic factors that have created a mixed landscape for lenders. As a result, while there are attractive opportunities for private credit lenders, a disciplined and selective approach is essential for success.

The current environment is defined by elevated interest rates—a situation we haven't experienced in nearly two decades. From a lender's perspective, this creates a 'golden moment,' if not a golden age, for private credit. The shift in asset allocation towards private credit is undeniable, but it's crucial to recognise that this moment doesn't apply uniformly across all sectors.

For instance, the corporate credit sector, especially in leveraged buyouts (LBOs), is experiencing a slowdown. With the higher cost of borrowing, the economics of LBOs have become less attractive, leading to fewer realisations and redemptions. Since a significant portion of private credit is tied up in corporate credit, particularly in LBOs, this slowdown means that, despite higher interest rates, returns are not as robust as in previous cycles. This slowdown, influenced by broader macroeconomic conditions, has created an environment that is less favourable for lenders heavily exposed to this type of debt.

Conversely, real estate lending presents a more nuanced picture. Office real estate, in particular, is grappling with the ongoing effects of remote work, which has dramatically reduced demand for office space. This trend has led to a sustained downturn in the office real estate market, making it a challenging area for lenders. Those who have extended credit in this sector are not necessarily benefiting from higher interest rates; instead, they are facing potential impairments as the value of office properties declines.

Residential real estate, especially in Europe, on the other hand, offers strong opportunities for asset-backed lending. This sector benefits from a long-term structural shortage of housing and net migration, which has created a very favourable supply-demand dynamic. In many European markets, there is a profound shortage of residential units, driving up demand and consequently the value of these assets. This shortage provides a helpful tailwind for lenders, as the likelihood of profitable exits and realisations in residential real estate is much higher. Similarly, the last-mile logistics sector, driven by the growth of e-commerce, is experiencing strong demand for warehouse and distribution space, creating opportunities for asset-backed lenders.

Furthermore, the shift towards remote work has also transformed the hospitality sector and southern European real estate markets into attractive areas for investment. As more people migrate from northern to southern Europe in search of a better work-life balance, lower living costs, and favourable climates, the demand for residential and hospitality properties in these regions is on the rise. This trend has opened new opportunities for lenders able to capitalise on these shifts. Arrow Global's deep local expertise and platform-based approach position us to effectively navigate and benefit from these post-pandemic changes, particularly in southern Europe, where we are seeing robust growth in the hospitality sector and increasing interest in residential investments.

Moreover, the retreat of traditional banks from certain lending areas is creating new opportunities for private credit lenders, particularly in local markets and operationally intensive lending such as litigation finance, bridge lending, electric vehicle infrastructure, and construction and agricultural lending. This trend has been accelerated by increased regulatory capital requirements, which have made certain types of lending less attractive for banks. As banks pull back, private credit lenders are stepping in to fill the gap, especially in areas that require deep local knowledge and operational expertise, particularly for complex, granular assets.

In this context, the fragmented European market, with its 44 countries, 24 languages, and 7,000 banks, success hinges on local expertise. Arrow Global's platform-based approach, with 22 platforms across Europe managing approximately €90 billion in assets, underscores the importance of having a strong presence and deep understanding of local markets. Our business model, built on this local knowledge, allows us to originate and manage investments in the lower mid-market, a space where operational capability is crucial.

Inflation, which has subsided but remains a concern, also plays a role in shaping opportunities for asset-backed lending. In sectors like residential real estate and logistics, inflation often works in favour of lenders, as the value of underlying assets tends to rise in an inflationary environment. This makes asset-backed lending an attractive proposition, as lenders can benefit from both higher interest rates and the appreciation of underlying assets.

To navigate this complex environment, lenders must maintain discipline and be highly selective in their investments. While the benefits of higher interest rates are clear, not all lenders are seeing equal rewards. The key is to approach lending thoughtfully, building portfolios that can capitalise on the current macroeconomic conditions without falling into the trap of pursuing short-term gains at the expense of long-term value.

An important aspect of this disciplined approach is maintaining prudent loan-to-value (LTV) ratios. For example, LTV ratios at 60% provide a vital buffer, reducing the risk of loss by ensuring that the value of the collateral exceeds the loan amount, even in adverse market conditions. Lenders must also carefully assess the value and liquidity of the assets they are financing, ensuring they have a clear exit strategy. This means not only evaluating current market conditions but also considering how these conditions might change over time. The goal is to build a diversified, liquid portfolio that can weather economic shifts while delivering consistent returns.

As private credit continues to evolve, I believe that asset-backed lending will continue to become an ever increasingly important part of the market. Traditional corporate credit, while still a significant component of private debt, is likely to see a shift towards more asset-backed structures as lenders seek to protect themselves from the volatility of corporate credit markets. This shift is already occurring among institutional investors, who are beginning to allocate more capital towards asset-backed lending.

In conclusion, while the idea of a golden age for private debt may be premature, there are certainly very attractive opportunities for lenders who can find their specialism and execute with discipline. The key is to focus on sectors with favourable supply-demand dynamics, maintain a strong local presence, and adhere to the fundamentals of asset-backed lending. By doing so, lenders can not only navigate the challenges of the current market but also position themselves for long-term success.

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