EXPERT Q&A

Special situations investing in Europe is changing, says Ahmed Hamdani, founder and managing partner at Zetland Capital

Capturing European dislocations in a new macro environment

Q The economic environment has changed materially – how is special situations evolving?

Recapping the current macro environment doesn't require too much time. We've had more than a decade of cheap debt – many borrowers overlevered. Now, rates have risen to their highest point in over 20 years following rampant inflation, and growth is low.

In sum, what we have today is a good old-fashioned economic slowdown, rather than a systemic shock. This is something we haven't had within the memory of many investors. For much of the period since the global financial crisis, special situations and deep value investors could get away with 'buying the dip'. You saw a specific shock – Lehman, covid – asset pricing came down, there was a predictable policy response and prices rebounded.

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In a protracted slowdown, with no central banks coming to the rescue with QE, the required cadence to investing changes. You still get the initial shock in the liquid markets, but you don't get central banks 'healing' the system before that shock can filter down into private asset pricing. That is now happening – but private assets take about two years to reprice lower.

During those two years, the lack of consensus creates a massive bid-ask spread – sellers still want to get paid yesterday's price but there are no buyers willing to pay it and transaction volumes collapse. When you add a lot of leverage and impending maturities into that story, the result is a wave of borrowers who know they have a liability problem, don't want to sell assets at new (lower) prices, so need an alternative solution.

That creates a much more interesting lending environment. You no longer have to delve into niche, esoteric areas to make the higher returns we target. We can make them by lending to established borrowers in stable sectors with fundamentally healthy businesses/asset portfolios, and taking very high-quality collateral.

Q Can you give us some examples of the opportunities you're seeing?

Certainly. As a special situations investor, our role is to bring capital to parts of the market where it isn't flowing properly. At Zetland, we do that across corporate and asset-backed investments (primarily real estate).

We have a thematic approach. So, in the past, southern European real estate was a theme – we saw interesting opportunities in single non-performing loans as banks cleaned up their balance sheets. Then covid created very different opportunities – initially on the corporate side through liquid markets, then in high-quality assets in sectors such as leisure, travel and hospitality.

Today, with the lending thematic, we are really looking at two things: rescue financings to solve borrowers' liability issues without having to sell assets at depressed pricing; and growth financings to performing corporates/asset holders who have little to no actual stress but who have lost access to capital as the banks pull back.

In real estate, it is more rescue financings, and in corporates, it is more growth financings. Geographically, it's Northern and Western Europe. Put simply, that's where most of the aggressive lending of the last decade happened. Southern Europe is actually holding up quite well and we're seeing fewer opportunities there than in the past.

Q How does the opportunity set differ between US and European markets?

We see three key differences between the US and Europe. The first is growth – both in the last few years and looking forward. The US is simply a much stronger economy. Concerns around a hard landing in the US are pretty much gone, and growth expectations for 2024-25 are at healthy levels.

It is a different story in Europe. Growth has been consistently lower in recent years and expectations for 2024-25 continue trending down, especially in the most export-driven markets, such as Germany, which is flirting with recession along with the UK.

As a special situations investor, we look for areas of the economy where capital is not flowing properly. There are far more of these when an overlevered system cannot get back to growth; borrowers can't grow into the aggressive capital structures they created when debt was cheap, so they start to have problems they can't solve through traditional sources of finance.

The second is credit markets. Financing is still dominated by banks in Europe – there are far fewer non-bank lenders, and capital markets are shallower (and only really open to the largest borrowers). The reverse is true in the US, where there are far more non-bank solutions open to borrowers. Put simply, when banks pull back in Europe, smaller borrowers lose access to finance and economic growth is stymied.

"You no longer have to delve into niche, esoteric areas to make the higher returns"

Finally, there are fewer investors doing what we do and with less dry powder. Well over two-thirds of the special situations capital that's been raised has been for large US funds and global mega-funds. Less than 20 percent has been raised for Europe, and even less for lower mid-market opportunities, so it's inherently less competed.

We like being in that lower mid-market segment. We invest anything from €20 million to €50 million-plus, partnering with LP co-investors. There are fewer funds offering solutions in that size bracket, so we can find interesting bilateral transactions where flexibility and creativity are rewarded with higher pricing.

Q How do you underwrite the opportunities that you see and how do you think about downside protection?

We believe quite strongly that outperformance in this environment is not going to come from capturing higher yields. Everyone can do that now. When this window has closed and we're looking back at everyone's scorecards, the managers who outperformed will be those that kept losses low.

For us, everything we do is about downside protection. Our cumulative loss ratio is 0.14 percent. There are things we've done that haven't worked out – that's the nature of special situations investing – but we've recovered almost all our principal.

In practice, that typically means a few things: looking at underwritable cashflow to ensure affordability of debt; structuring documentation to ensure we provide the solution our counterparties need but protect our investors' capital if things don't

work out; and taking high-quality collateral.

The real difference today is the quality of collateral we're secured against. It's very hard to underwrite pricing in real estate right now; the V in LTV may still have a way to fall in a lot of cases. So we've limited the scope of what we can accept to prime assets, where we know there will always be a bid at a reliable price. Luxury hospitality assets in key travel destinations and prime residential assets in major European cities are a good example. We know these are assets where – should things not go according to plan – we will have bids at a price that returns our capital.

Q Can you talk more about structuring? How does a special situations loan differ from a loan written by a more traditional direct lender?

The problem that we're solving for is always a mixture of two things: timing pressure and a cashflow issue.

We have the flexibility to do that through everything from senior, subordinated, unitranche, debt with minority equity/warrants, part-cash/part-PIK with the ability to toggle if cashflow is restricted, financing an interest reserve account alongside our loan… There's a lot we can do.

Regardless of the bespoke solution we create, we always game out what happens in the event of default. We look at exactly how that scenario plays out and ensure we have a clear glidepath to securing collateral and protecting principal. It's a different way of structuring loan documentation versus a vanilla direct lending transaction.

Q How do you manage the emotional element to this, with borrowers that are facing the loss of their assets or business?

The nature of what we do is that we're engaging with people at a highly stressful time. These are not purely financial transactions. You have to build trust – especially in Europe, where there are so many founder or family-run businesses and often a deep sense of personal identity intertwined with the assets.

You have to spend a lot of time understanding who you're working with, what's important to them in any potential solution, and what will give them the comfort they need to trust you as a partner. It's personal, it takes time and you can't do it in a spreadsheet.

Q How important is operational capability in all of this?

Fundamentally, we're investing through debt, so you could assume that we don't really need that operating knowhow. But we've actually built the firm from completely the opposite viewpoint. We have turnaround specialists in-house to help in corporate situations, and trained architects and surveyors to help in our real estate transactions.

They bring us a more nuanced underwrite when we're assessing an investment, but they also give us the ability to go in, take a board position and identify problems early to drive recovery and value creation. When you are lending, things will not always work out, and having these resources in-house allows us to offer a more rounded proposition to borrowers. ■

Q How do you see the economic cycle unfolding over the next few years, and how do you expect to leverage opportunities moving forward?

This level of change, not just in the cost of capital but also in the quantum available, is going to cause a significant period of adjustment. There will be a lot of capital structures that need refinancing and/or restructuring, both in real estate and on corporates.

It's also self-sustaining. While everyone's busy healing their balance sheets, it's very difficult to generate growth. So we expect a relatively protracted period of low growth in Europe and a continued need for creative financing. That makes it a very interesting time for investors like ourselves, and there is a lot for us to do.