A WORD FROM ANTARES

The new old normal: Lower leverage and higher yields

Coming in for a landing

As with air travel, the most dangerous parts of the economic cycle are typically takeoffs and landings when pilot experience is critical.

Thus far, the Federal Reserve (the Fed) has had some success in dampening inflation and inflation expectations over the past several months without causing a recession. In fact, GDP growth remained aloft near 3% in Q4 2022. The latest readings were robust in January with regard to jobs and services, with payrolls up 517,000 and the Purchasing Managers Index (PMI) expansionary at 55.2%. However, indicators such as yield curve inversion and negative growth in The Conference Board's leading indicator suggest the odds of a recession remain elevated in the year ahead. Also, while the glide path to near 4% inflation seems reasonably at hand, China's reopening and energy shocks related to the Russia-Ukraine war could yet rekindle inflationary pressures. Finally, the question of whether the Fed may overshoot on tightening in the last mile of getting to its 2% inflation target remains open. While a "soft landing" or mild recession appears to be most likely, it's still best to stow your tray tables and keep your seat belts fastened.

The new old normal

While it remains unclear how hard or soft of a landing the Fed may stick in the near term, it does seem clear that the era of zero interest rates is likely over with broad implications for lenders and investors. Of course, zero-nominal interest rates were never "normal" and indeed undesirable from the Fed's perspective, but some investors may have understandably grown accustomed to a forgiving "risk-on" world of stimulative negative real rates, ever-rising valuation multiples, and near-zero default rates of the recent past. On the positive side for direct lending, the asset class' longer-term returns seem poised to benefit from a secular rise in base rates as dividend boosts at many business development companies (BDCs) would seem to confirm. Indeed, as leverage levels have come down, the average spread per unit of leverage for nonbank first-lien middle-market direct lending deals (excluding unitranche deals) reached 136 basis points in Q4 2022—its highest level in seven years since Refinitiv LPC began collecting private debt data. However, while this presents an attractive environment to prudently deploy capital, underwriting and credit discipline are likely to become increasingly important with performance variance among lenders likely to rise. Private debt remains attractive, but it may increasingly matter who is flying the plane.

Timothy Lyne

Chief Executive Officer
Antares Capital

Timothy is a founding partner of Antares. He is a member of Antares' Investment Committee and Antares' Board of Directors. Previous roles include chief operating officer and head of Asset Management for Antares.

Q&A with Timothy Lyne, Antares CEO

Middle-market PE deal activity dropped in Q4 2022. What are your expectations for 2023?

Yes, US-sponsored middle-market loan volume slowed considerably in Q4 2022, falling 25% from the prior quarter and 57% YoY. LBO volume specifically was down even more to its slowest pace since the dark days of COVID from Q2 to Q3 2020. This reflects several factors including more expensive financing with lower leverage and tighter terms, a largely closed syndicated market, lower direct lender hold-size appetite, heightened economic uncertainty, and a wider gulf between buyer and seller expectations.

Looking forward, as of early March, markets are digesting the fastest rise in interest rates seen in decades off a prolonged period of near-zero rates, so it may take some time to recalibrate. Recent surveys such as Katten's Middle Market PE Report and Refinitiv LPC's Q1 2023 Middle Market Lender Outlook show a range of projections for middle-market M&A activity for 2023, but mean expectations appear to be flattish versus 2022. For our part, we have seen a pickup in our pipeline in recent weeks but generally expect activity to remain tepid in H1 2023. Looking further out into H2 2023 and 2024, we see more hope for a pickup in M&A activity, assuming the Fed signals an end to rate hikes in the next few months as the forward curve would currently seem to suggest will happen. PE dry powder levels of $1.3 trillion in North America at year-end 2022 are up 26% versus 2021, with buyout-specific dry powder up 20% according to Preqin. Presumably, such pent-up PE capital and deal demand coupled with the opportunity to make acquisitions more toward the bottom of the cycle and at lower multiples will rekindle M&A activity if the clouds of economic uncertainty begin to dissipate.

You noted the syndicated market was largely closed in recent quarters. Do you expect syndicated markets will recover anytime soon?

There are still reportedly over $30 billion of hung loans on bank balance sheets yet to be cleared, but we have seen some hopeful signs of recovery, albeit from fairly depressed levels. Secondary loan prices with the Morningstar LSTA US Leveraged Loan Index are up about 3% in January and collateralized loan obligation (CLO) issuance has been strong. Yields in direct lending markets also widened in Q4 2022 relative to broadly syndicated markets, thus making syndicated executions appear incrementally more viable depending on the deal. In short, while much of the direct lending market's share gains appear to be secular, we do think syndicated markets will see some cyclical recovery in the year ahead, which could further grease the wheels for a pickup in M&A activity.

What trends are you seeing in your portfolio? Any signs yet of credit problems emerging?

Our portfolio has been performing well. The percentage of our portfolio in non-accrual status has remained low—down from an already low level in 2021—and our net loss rate has been near zero. We are seeing some headwinds building related to higher interest rates, labor shortages, and inflation, and our watchlist is up modestly with early warnings up a bit more, but both are still in a normal range versus prior years. The aerospace & defense, automotive, food & beverage, restaurant, and retail segments in particular are facing pressures, but we have relatively limited exposure to these sectors. "Flash" financials for a cohort of about one-quarter of our borrowers in late 2022 suggest some margin compression with growth flattening QoQ, but still decent EBITDA growth YoY driven by healthy double-digit revenue growth YoY, albeit inclusive of M&A activity. This picture seems somewhat consistent—at least on the revenue side—with recent year-end 2022 survey results released by the National Center for the Middle Market (NCMM), which showed 12.2% YoY revenue growth in Q4 2022 versus just 4.4% for the S&P 500.

Looking forward, consensus default rate expectations have been creeping up but remain pretty near the historical long-term average. For example, the latest Pitchbook LCD survey of loan market professionals in December 2022 shows the median trailing 12-month (TTM) default rate for the Morningstar LSTA US Leveraged Loan Index rising to a range of 2.0% to 2.5% by the end of 2023 from a low level of 0.8% as of January 2023. This compares to the 10-year trailing average of about 1.9% and the 20-year trailing average of about 2.7%. The outlook for 2024 is foggier at this point, but defaults could rise further even as the economy recovers, given a typical lag in defaults. Some industries will no doubt face more pressure than others. On the positive side, the NCMM's average middle-market company's revenue growth is still projected to be robust at 10% in Q4 2023; however, while the survey found 81% seeing growth in Q4 2022, only 58% are projected to see growth for Q4 2023, suggesting rising variance in the prospects for revenue growth among companies and segments. Also, although inflationary pressures appear to be abating, financing costs have continued to rise.

On balance, we expect default and amendment activity to rise over the next year or so but remain manageable. We continuously review our borrowers' financials and budgets—including assessment of unadjusted EBITDA and unadjusted potential cash burn—to get an early indication of where liquidity issues could be arising and proactively seek to get in front of sponsors to start discussions early. Our dedicated and experienced credit advisory team is focused solely on workouts and restructuring to maximize recoveries and has served us very well through downcycles over the past few decades. Of course, being highly selective, diligent, and experienced in underwriting; noncyclically biased; first-lien focused; and having a highly diversified portfolio with very low borrower concentrations also helps mitigate losses to begin with during rough patches. While there will undoubtably be some manageable credit headwinds ahead, with uncertainty comes opportunity.

2022 Annual US PE middle market lending league tables

Overall

Rank	Company	Deal count
1	Ares	181
2	Churchill	165
3	Antares Capital	163
4	Audax Private Debt	158
5	Twin Brook Capital Partners	135
6	Golub Capital	133
7	Barings	115
8	Monroe Capital	109
9	BMO Financial Group	100
10	PNC	98
11	Morgan Stanley Private Credit	92
12	Owl Rock	90
13	Varagon Capital Partners	75
14	Truist Financial	71
15	North Haven Private Income Fund BDC	69
16	Crescent Capital	68
16	Citizens Bank	68
18	MidCap Financial	63
19	Apollo Debt Solutions BDC	62
20	Blackstone Private Credit Fund BDC	60
21	Capital One	58
22	Fifth Third Bank	55
22	KeyBank	55
24	HPS Corporate Lending Fund BDC	54
25	NXT Capital	53

Source: PitchBook

Select roles*

Rank	Company	Deal count
1	Antares Capital	158
2	Twin Brook Capital Partners	132
3	Churchill	113
4	Golub Capital	110
5	Ares	92
6	Audax Private Debt	84
7	BMO Financial Group	82
8	PNC	76
9	Varagon Capital Partners	70
10	Truist Financial	65
11	Citizens Bank	62
12	Crescent Capital	59
13	Barings	57
14	Monroe Capital	48
14	Capital One	48
16	NXT Capital	43
16	MidCap Financial	43
18	Jefferies Group	42
18	Fifth Third Bank	42
20	KeyBank	41
21	The Carlyle Group	38
22	Wells Fargo	35
22	Morgan Stanley Private Credit	35
24	Bank of America	32
25	J.P. Morgan	28

Source: PitchBook
*Select roles comprise only bookrunners, lead arrangers, mandated lead arrangers, and all types of agents that are specifically listed within PitchBook.