

Q&A: Antares Capital

Optimism serves as a highly effective vaccine for the economy...

Lately, middle-market PE deal activity has cooled from Q4 2020's record pace, but the outlook nevertheless remains favorable for 2021. Based on our recent Fifth Annual Compass Survey of PE sponsors, borrowers, and investors, confidence in the US economy is high. In fact, it is up from the already high reading from our early 2020 pre-pandemic survey—and up even more for the global economy. Previous worries of a possible COVID-19 next-wave-induced downturn seem to have evaporated, and default rate expectations have declined with most 2021 US GDP growth estimates near 5%. Given this reassuring backdrop, most of our survey respondents expect M&A activity will rise over the next 12 months—especially given the specter of higher capital gains tax rates looming in 2022.

...but beware of side effects.

Anxiety over inflation may seem undue with the 10-year treasury note yield at 1.4% at time of writing—and some transitory inflation and a steepening yield curve would be welcome tell-tails of an entrenching recovery. However, stretched valuations could become vulnerable to a “taper tantrum” narrative from those lamenting froth (e.g. green bubbles, SPAC bubbles) from too much stimulus as inoculated consumers emerge from their winter dens, ready to take vacations with stimulus checks in hand. Even if inflation proves to be as tamable and transient as hoped, supply chain constraints and rising input costs could squeeze margins for certain borrowers short on pricing power. As the pandemic determined winners and losers in the downturn of 2020, so it may in differing ways in the upturn of 2021.

The private debt market appears to have passed 2020's stress test with flying colors, but another shock, such as virus mutations or Sunburst hack fallout, could come at any time. As a lender, it's okay to be optimistic, but it's never a good time to be complacent.

Q&A with Dave Brackett

With 2020 in hindsight, how do you feel private debt performed? Any key learnings to take moving forward?



Dave Brackett

Chief Executive Officer
Antares Capital

Dave is a member of Antares' Investment Committee as well as Antares' Board of Directors. Previously, Dave served as president and CEO for GE Antares. He was a founding partner when Antares was formed in 1996. Prior to starting Antares, Dave was a senior executive with Heller Financial.

There was variance among lenders, but in general, private debt as an asset class appears to have performed quite well through the COVID-19 stress test. Credit rating agencies have been cutting their default rate forecasts from initially dire levels that were near those of the global financial crisis to more benign levels. Public business development company nonaccruals have been trending down since their peak in Q2 2020. For our part, given such a challenging year, we are happy that losses net of recoveries were consistent with our low historical average.

In terms of lessons learned, the experience certainly reinforced our preference for sponsor-backed companies and our biases on industry exposure. Our sponsors were very agile in supporting their companies and infusing equity when needed. Also, certain environmental, social, and corporate governance-related (ESG) considerations such as increased focus on employee health and safety and supply chain sustainability came to the forefront. The period also underscored that strong governance and controls over ESG factors are indicative of a more mindful management team that can better monitor potential risk factors to drive business resilience.

What is the outlook for 2021? Can you share some of your findings from your recent Compass Survey?

The outlook for 2021 looks bright. Based on our Fifth Annual Compass Survey completed in February 2021, 75% of sponsors, 65% of borrowers, and 79% of investors are confident in the US economy over the next 12 months. These readings were generally above last year's pre-pandemic survey results, with a higher percentage of the mix now very confident. Confidence in the global economy rose more sharply YoY, though it is still below the levels of confidence in the US economy. On the flip

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side, compared with 2020's survey, a greater majority see a recession as unlikely or very unlikely in 2021. The earnings outlook also looks bullish, with 87%+ of borrowers expecting to see moderate to strong revenue and EBITDA growth over the next 12 months. Given such favorable trends, it is unsurprising that most—53%—of investors surveyed expect default rates to end 2021 below 4%—with 85% expecting them to fall below 5%.

On the deal activity front, 74% of investors expect leveraged loan volume to increase this year versus only 19% in our early 2020 survey. Most—42%—expect an increase in the range of 3%-10%, with 32% predicting a rise of over 10%. This no doubt reflects expectations of higher M&A activity, with 65% of sponsors and 53% of investors expecting a pickup in M&A versus readings of only 17% and 21%, respectively, in the survey one year ago.

Coverage of the pandemic's impact on portfolios has been expansive. Are you seeing any second- and third-order impacts that may be underappreciated?

Since the pandemic hit, we have been closely tracking COVID-19's impact on our borrowers with heat maps that aggregate our borrowers up to the industry level. There are all kinds of secondary and tertiary impacts at the industry level—good or bad depending on which side of the K-shaped recovery you are on—such as restaurant shutdowns affecting food distributors and packaging companies, among others. Most of these impacts have been dissipating; our watch list counts are way down.

As the pandemic ebbs and demand rebounds, supply chain issues and rising raw material and labor costs are areas that may come into increasing focus. Prices for raw materials such as copper, silver, lumber, and other key inputs have already risen sharply. Some areas have been starved of capital, and many supply chains remain unsettled and face bottleneck issues. For example, a well-publicized shortage of semiconductor chips has already caused auto production cuts, which can ripple through to other areas. In our Compass Survey, supply chain management and rising costs were among the top of the list of external challenges anticipated in the year ahead.

How is the competitive landscape shaping up for private debt?

The pandemic played well to the strengths of the larger, established direct lenders. Investors sought comfort in allocating to experienced players with long track records, strong relationships, and the ability to mine add-on deal

flow from their large, well-diversified portfolios of known credits. Q4 2020 was a particularly attractive period for deal flow for those able to go on offense, with high-quality companies issuing at attractive terms and spreads.

In Q1 2021, loan markets have become more issuer friendly as loan demand surged and new issue supply slackened. On the demand side, loan ETF and mutual fund net flows turned significantly positive in January 2021 for the first time since September 2018, with collateralized loan obligation (CLO) issuance continuing its rise. This has led to spread pressure, which has been most acute in broadly syndicated loans. This pressure has been rippling down into the upper middle market, but lately, core-middle-market spreads have been stable.

Looking forward, a slight majority—53%—of investors polled in our Compass Survey expect middle-market spreads to decline by 50-100 basis points over the next 12 months, while 47% expect middle-market spreads to hold flat at around 50 basis points. Recent spread pressure may abate in H2 2021 if M&A-related new issuance activity picks up as expected.