Antares Capital

Five *in* Five

Steve Rubinstein, Senior Portfolio Manager at Antares, shares his views on the recent Fed decision, implications for direct lending performance and Antares' approach to constructing all-weather portfolios.

1 The Federal Reserve elected for an aggressive start to its first easing campaign in four years, reducing the benchmark rate by 50 bps at its recent meeting. Is the 'higher for longer' narrative still intact?

Fed Chair Jerome Powell indicated at his Jackson Hole speech in August that interest rates were set to move lower this year. While the magnitude of the first cut was larger than some projected, the reality is that the Fed is just now adjusting to where the forward SOFR curve was in August. The median rate estimate for 2025 is now between 3.25-3.5% with a gradual path towards a floor of 2.75-3% in 2026. Importantly, this 'normalized' level remains well above the average LIBOR rate of less than 1% from 2008 to early 2022.[1]

We agree with the Fed's base case of a soft landing for the U.S. economy. The macroeconomic data that we see and the trends from our private credit portfolio suggest growth may be slowing but the economy is likely to avoid a recession over the coming months. We therefore believe the Fed will be inclined to keep interest rates at an elevated level for an extended period.

2 What is the state of the private credit market and what are the implications of lower base rates?

We think private credit is in a good spot right now. YTD 3Q24 credit trends including borrower liquidity, gross EBITDA margins and first lien leverage ratios have all remained broadly stable. According to Cliffwater LLC, the trailing four quarter default rate is at 1.9% for private credit loans as of 2Q24, below the 10-year average of 2.8%. Additionally, non-accruals are at low levels, and we believe interest coverage ratios have troughed and are positioned to move higher now that base rates have started to decline.[2]

The projected decline in lower base rates and subsequent reduced interest burden together with positive economic activity should support continued revenue and EBITDA growth for our portfolio companies. We believe M&A activity is poised to accelerate and credit spreads may widen compared to current levels which will offset some of the decline in base rates.

We believe that a gradual shift to lower base rates will strengthen the momentum within private credit and continue to support strong risk-adjusted performance.

3 While we believe a soft landing for the U.S. economy is likely, history would suggest a less benign outcome is possible. How can private credit potentially help investors if a less benign outcome were to materialize?

Historically, senior-secured private credit loans outperform other similar fixed income investments in periods of economic stress. If you look at prior periods of financial market dislocation, including the global financial crisis, COVID and the 2022 bear market, direct lending outperformed both high yield and broadly syndicated loans (BSL).[3] Direct loans tend to be the senior-most debt in a company's capital structure, typically secured by first-lien claims on assets, which in an adverse scenario can result in higher recovery rates compared to BSL and high yield.

We believe private credit can function as an all-weather investment within a portfolio by providing incremental income generation, an inflation hedge and fixed income diversifier with historically low or negative correlation to traditional equity and fixed income investments.

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> *Steve Rubinstein*
> *Senior Portfolio Manager, Antares Capital*

4 How do you approach constructing all-weather portfolios that can perform irrespective of the macro environment?

We favor companies in non-cyclical industries that have limited commodity exposure and are less sensitive to inflationary pressure. We look for stable demand for the product or service in all market conditions, which results in more predictable cash flows. We avoid businesses with customer, supplier, or product concentrations.

We also focus on portfolio diversification at the borrower level by typically keeping fund level investments below 1% each. We diversify by industry and lean towards sectors and companies that generate more recurring and recessionary resistant revenue, such as healthcare consumables and mission critical software providers. The companies we lend to are backed by private equity sponsors who are investing significant equity in the business, helping to keep loan-to-values low (LTVs), with current vintage LTVs ~40%.[4]

Ultimately, we look to generate consistent net returns and current income by maintaining diverse portfolios of first lien loans. We have a cycle tested investment process that allows us to construct portfolios with the potential to achieve low defaults and low credit losses.

5 In private credit, alpha is derived from minimizing losses and maximizing recoveries. What are some of the characteristics that an LP should look for in a GP to assess their ability to create alpha?

Avoiding losses and maximizing recoveries in stressed situations requires a robust process from start to finish. LPs should look for a private credit manager with a track record of excellence in managing all deal related activities including deal sourcing, screening, monitoring and workouts if necessary.

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Deal screening: Speed and certainty are critical and it's important to get it right up front. In private credit, credit selection is important since the loans tend to be held until maturity or a refinancing event. Having extensive capabilities to prove out the underwriting thesis and evaluate that each borrower will be able to generate consistent free cash flow on a long-term basis is necessary to identify credits that are the most compelling and worthy of leaning in on in a competitive situation.

Portfolio monitoring: Access to real-time information after the loan has closed and direct access to the sponsor and the management team is critical to getting ahead of potential borrower liquidity issues. Working closely with sponsors and borrowers to respond to their needs over the life of the loan is an important driver to minimize losses. It's also important to monitor leading indicators of performance and perform periodic stress tests and scenario analysis.

Credit Advisory: When a loan defaults, maximizing recovery becomes a leading source of alpha. A large and tenured team of credit advisory professionals with experience across multiple credit cycles helps to achieve control over the restructuring process, not exit at the first sign of trouble and obtain significant capital support from private equity sponsors.

1. *Chatham Financial as of September 18, 2024*
2. *Cliffwater LLC as of August 13th,2024*
3. *Direct lending = Cliffwater Direct Lending Index, BSL = Credit Suisse Leveraged Loan Index, High Yield = Bloomberg Barclays U.S. High Yield Index*
4. *Loan-to-value is only being presented for closed transactions related to acquisitions*

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ABOUT *Antares Capital*

Founded in 1996, Antares is an experienced and cycle-tested alternative asset manager and a leading provider of financing for private equity-backed borrowers. With one of the most seasoned teams in the industry, Antares is focused on delivering attractive risk-adjusted returns for investors and creating long-term value for stakeholders. The firm manages $71B of capital under management and administration as of June 30, 2024, and maintains offices in Atlanta, Chicago, Los Angeles, New York, Toronto and London. Visit Antares at www.antares.com or follow the company on LinkedIn at http://www.linkedin.com/company/antares-capital-lp. Antares Capital is a subsidiary of Antares Holdings LP, (collectively, "Antares"). Antares Capital London Limited is an appointed representative of Langham Hall Fund Management LLP, an entity which is authorized and regulated by the Financial Conduct Authority of the UK.