Antares Capital

PART 1 OF A SERIES

Creating Alpha in Private Credit

The term "alpha" in investing typically refers to the excess incremental return a manager achieves above an appropriate benchmark return (i.e. beta) specific to the asset class. However, in the context of this "creating alpha" series, we ("we" or "our" referring to Antares Capital) will also be considering the term "alpha" more liberally in terms of "value creation" across the ecosystem of our stakeholders. This first installment in our series will cover generating alpha in portfolios for investors from a credit/risk management perspective. In future installments, we will also cover topics of alpha in terms of creating value for private equity sponsors and borrowers (which can tie back to creating alpha for investors), capturing relative value, and optimizing investment products and structures to meet investor needs.

The Cardinal Rule: Avoid Net Losses

We believe that creating alpha in private credit primarily amounts to avoiding losses since markets are pretty efficient at pricing spreads and upside is generally capped at the return of principal and interest. This is a bit of an oversimplification since there are segments of private credit where spread pricing may be less efficient (e.g. in opportunistic and distressed lending and other select niche segments like litigation finance, etc.), but the scope of our discussion here will be focused on direct lending.

For direct lenders, we believe avoiding losses requires excellence in the management of deal related activities including sourcing, screening, structuring, and monitoring, amendments and workout.

Reflects Antares' beliefs unless otherwise cited with a source.

The Deal Funnel and the Keys to Selectivity

Seeing all deals enables the best selection

From our experience, creating alpha in private credit starts with sourcing deals. Being able to see and compete across the broadest set of opportunities within a lender's strike zone is critical to allow for the lender to optimize its selection of credits. Within the sponsor backed market, long established relationships of trust and reliability through cycles, demonstrated capabilities, the scale to lead manage best in class execution and take large hold positions are all prerequisites to getting on the short list of preferred lenders. We believe scale in originations is also required to cover hundreds of sponsors to "see" most of the deals coming to market. Origination coverage is even more daunting for direct lenders covering non-sponsored markets that may have many thousands of targets, many of which may not produce active deal flow.

Winning deals: Lead roles may enhance economics and risk management

It is our opinion that having a recognized capability to lead best in class execution does not only enable seeing a broad breadth of deals – it is also critical to garnering better deal economics, leading on document term negotiations, ensuring information access, and potentially being in the lead negotiating position if amendments or restructuring is needed after the deal is done. These factors have implications for the economics and risk management of deals that are important to creating alpha for investors.

Deal Screenings and Due Diligence: Critical to try and get it right upfront

We believe it's particularly critical in direct lending to get selection right upfront since loans are generally intended to be held to maturity or until a refinancing event. Unlike in the broadly syndicated liquid credit markets, a credit manager typically has very limited ability to sell a direct loan if it decides there has been some negative discovery or development. In addition, returns in direct lending are primarily driven by interest income and return of principal and it can take a lot of interest income across many loans to make up for principal loss on just one loan. Unlike venture investing where we have seen that one 10x home run investment can offset 10 losers, in direct lending, there is little to no upside to loans – only the return of principal and interest – so relative performance is all about avoiding losses (note, this is somewhat less true in Broadly Syndicated Loan (BSL) secondary trading where there can be "par building" upside – a topic for later installments).

We believe knowing which credits are most attractive and worthy of “leaning in on” in a competitive situation requires deep underwriting and industry expertise and experience through multiple cycles. Picking the right credits also requires credit discipline – i.e. not straying from one’s credit box to chase deals out of pressure to achieve higher yields or to allocate excessive dry powder (which may be caused by excessive fundraising and lack of alignment with investor interests). Finally, we think picking the right credits entails a focus on responsible investing in keeping with building a portfolio of strong and resilient credits that have a path of sustainable growth for a lender to finance and grow with over the long term.

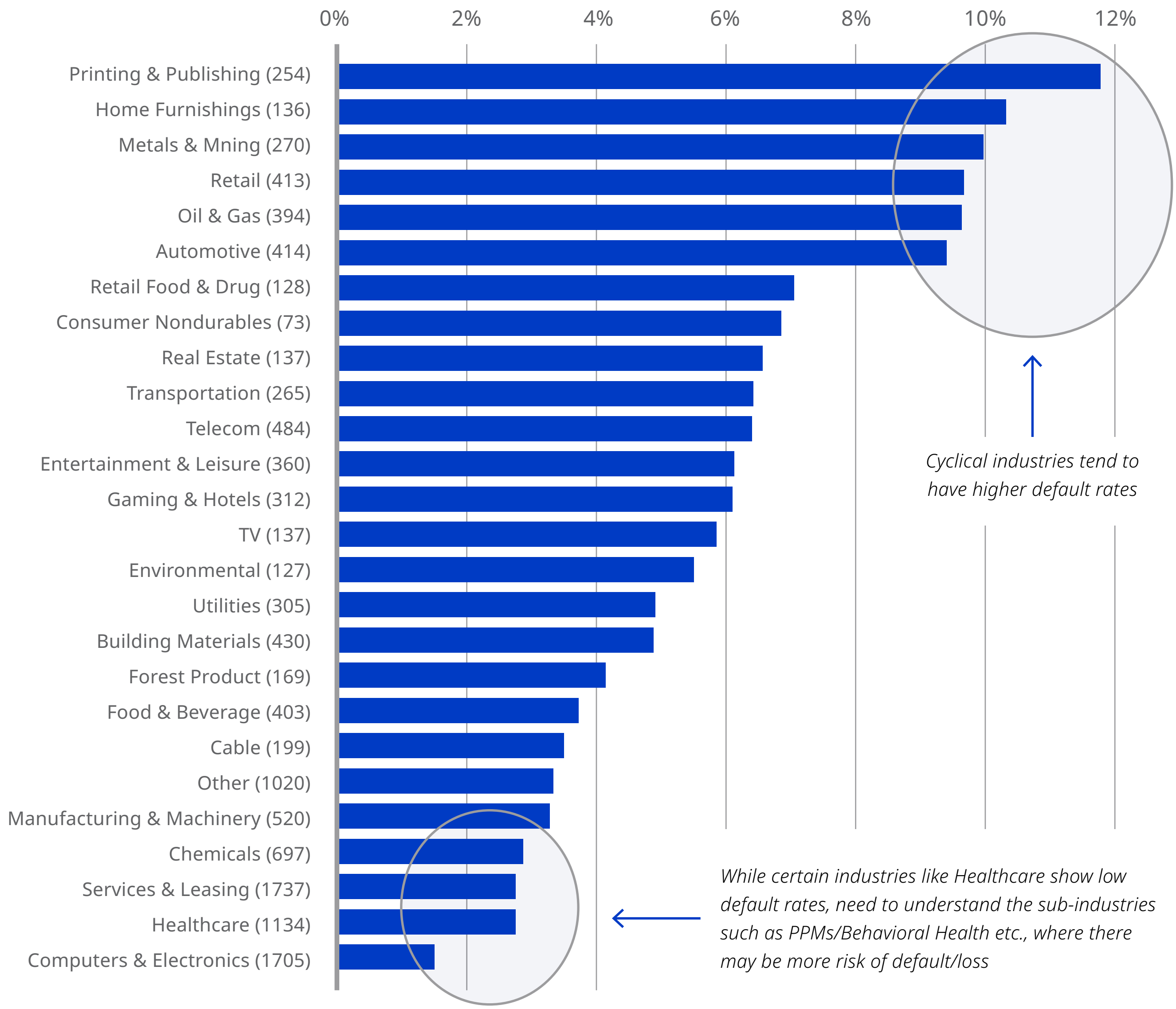
Sample of important considerations in underwriting[1]

Factor	Considerations
Differentiation	Make sure the borrower has a differentiated value proposition that allows for pricing power and helps prevent switching/market share loss.
EBITDA add-backs	Heavily scrutinize adjustments and separate what is easily defensible from what is more speculative.
Leadership	Be sure management is strong / stable and aligned and not too difficult to unseat if necessary.
Pricing Power	Determine if the borrower has pricing power and ability to pass through costs quickly. Check for adequate pricing pass through mechanisms and frequency of cadence for resets in its customer contracts.
Supply chain relationships	Be sure borrower has adequate diversity of sourcing options and/or is not too dependent on overseas sourcing with long lead times that may be ill matched against the possibility of shorter term sales fluctuations.
Operational complexity	Understand the tradeoff of diversity vs. complexity. Too many SKUs / contract manufacturing partners / brands under one roof can lead to unnecessary operational and ERP complexities, especially in manufacturing. Operational complexities also can result in longer, more difficult management transitions and / or inefficiencies when pivoting strategies.
IT Infrastructure	Try to determine if the borrower has adequate controls and IT infrastructure with special focus on roll-ups/acquisitions to make sure there is a robust ERP system integration plan.
Crossover lenders	Be sure lenders or their affiliates that participate in both the 1L and 2L debt or senior and subordinated debt (crossover lenders) do not make up too much of the lender base for risk of misalignment with 1L only interests.
Minority equity sales	Scrutinize minority equity sales, especially to lesser-known sponsors, with an eye toward potential conflicts of interest. Having multiple sponsors adds consensus risk.
Covenants	Make sure covenants are adequate in view of company and capital structure specifics to allow 1L lenders to “get to the table” to negotiate with the sponsor early enough to preserve value should problems arise.

Portfolio Construction and Diversification

We also believe optimizing portfolio construction is another critical driver of alpha in private credit. This entails being highly diversified and avoiding industries and industry subsegments that may be highly cyclical and/or prone to defaults (see Leverage Loan Default Rates by Count chart). In addition, it is our experience that having established concentration limits and guardrail exposure limits on certain other risk parameters (e.g. Cov-lite, Annual Recurring Revenue (ARR) loans, 2nd lien, regional exposure, company size, etc.) is also important to maintaining credit discipline.

Leverage Loan Default Rates by Count (2015-1Q 2023)[2]



Portfolio Monitoring and Management (including Amendments)

We believe getting ahead of potential borrower liquidity issues and working closely with sponsors and borrowers to respond to their needs over the life of a loan is another important driver of alpha.

On the portfolio monitoring side, we believe it is important not just to keep a vigilant eye on borrower financials, but to monitor leading indicators of performance and to perform periodic stress test scenario analysis with focus on specific factors of acute interest. This might entail stressing assumptions with respect to a borrower's supply chain (e.g. during Covid), input costs and pricing power (e.g. during an inflation spike), higher interest costs and other relevant assumptions. This enables the identification of where the "tail" risk resides in a portfolio (i.e. which credits have a high-risk rating or are at risk of migrating to a high-risk rating) and allows the portfolio management and workout teams to know where they should be most focused.

Potential Performance Deterioration Factors and Warning Signs[1]

EXTERNAL FACTORS

- Pandemics and/or geopolitical strife
- Industry challenges
- Change in competitive landscape
- Regulatory / exogenous event
- Economic change
- Customer consolidation
- Commodity price volatility
- Technological advances resulting in product obsolescence

INTERNAL FACTORS

- Poor management
- Integration issues (i.e., acquisition, ERP system)
- Employee turnover and morale issues
- Operational challenges

WARNING SIGNS

- Late or delayed financial reporting
- Financial covenant defaults
- Increases or changes in borrowing patterns (e.g., significant increase in revolver utilization)
- Setting up new facilities (e.g., accounts receivable securitization/factoring, real estate loans) and/or terming out of revolver to create liquidity.
- Overconfident management in the face of challenge
- Questionable rationale/support for ongoing strategy
- Unexpected change or turnover in management or top sales personnel
- Loss of a key customer or vendor
- Competitor(s) exhibiting distress
- Change in auditors
- Rating downgrade(s) and pressure on trading price
- Slowing accounts receivable collections and/or inventory turnover and/or rising A/P

On the portfolio management and credit advisory side, we think alpha can be generated by proactive discussions/negotiations with sponsors and borrowers on amendments. Some amendments can be fairly mundane, but others can be more significant/material in providing borrowers more flexibility to execute on their strategic plans and/or potentially lowering risk of covenant or payment default risk (ideally while improving deal economics for the lender). Amendments may include covenant holidays/resets, add-ons (that don't require incremental loan funding but require lender approval), modest maturity extensions (<1 year), change in definitions and baskets, etc.

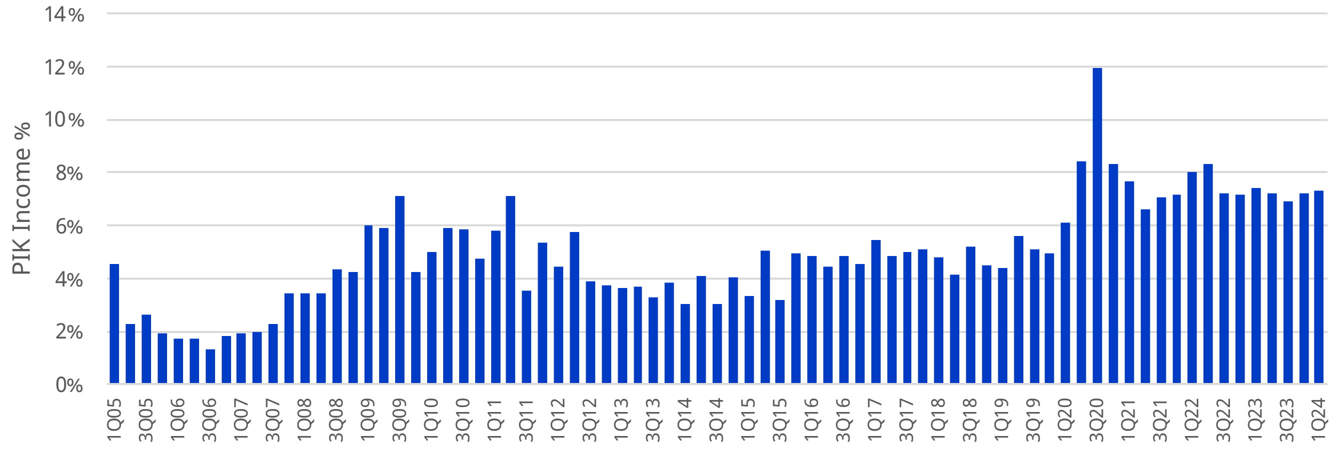
Amendments tend to be an area where direct lending shines because it is typically easier for a borrower to work with one or a small group of trusted and solutions-oriented direct lenders versus dealing with a large group of lenders in a syndicated transaction where achieving consensus can be more challenging.

In 2023, of the 740+ amendments Lincoln International tracked, over 20% involved maturity extensions, almost 15% covenant holidays, over half pricing changes (including PIK) and over one-third involved sponsor equity infusions (source: Lincoln International Private Market Webinar March 2024).

Sample of Potential Negotiated Amendment Terms[1]

Amendment term	Material Modification
Change in yield (spread, Floor, Fees, Grid)	Possibly
Interest Payment Forbearance / Waived / Deferred (incl. PIK)	Yes
Principal Payment Forbearance / Waived / Deferred (prior to due date)	Possibly
ECF Payment Forbearance / Waived / Deferred (prior to due date)	Possibly
Maturity Extension	Possibly
Change in Priority / Priming Facility	Possibly
Change EBITDA or Leverage Definition / Covenant Levels	Possibly

Rising levels of non-cash Payment-in-Kind or "PIK" interest can be a sign of rising risk/stress in a portfolio.[3]



Note: Antares believes PIK as shown may be somewhat understated given the advent of new, synthetic PIK structures where some are creating DDTLs to pay cash interest so don't have to show PIK.

How We Work to Maximize Recoveries in Workout

Even if a lender does a good job of screening for good credits, some will inevitably default for any number of reasons – some of which may not have been foreseeable. When a loan defaults, we believe maximizing recoveries becomes a critical aim and a source of alpha in the relative performance among lenders.

When looking at the tradable leverage loan markets, many credit rating agencies determine loss given default by the price or mark of the loan 30 days after default. While we think this methodology makes sense in the liquid credit market where loan participants may simply sell their loan interest, it may be less reflective of the ultimate recoveries direct lenders can achieve via workout efforts often in constructive partnership with sponsors to maximize value preservation. This is one of the attractions of private debt to sponsors – i.e. the ability to work with a small group of trusted lenders versus a large and often unwieldy and conflicted set of players and interests in a large loan syndicate.

Credit Advisory Solutions[1]

CAPITAL SUPPORT & MODIFICATION

- Credit agreement modifications are coupled with capital support from the sponsor
- This is typically pursued when either leverage is substantially above perceived market for the credit or there are liquidity challenges
- Support can be via direct investment or guaranty

SALE, REFINANCE OR CAPITAL RAISE PROCESS

- Pursued when the sponsor is either unable or unwilling to invest further in the business, but there is a perceived market for investment from a third-party
- Executed through a refinancing of the lender debt, capital infusion in exchange for ownership or through the acquisition of the credit's assets/equity

LENDER-LED SOLUTIONS

- Utilized when market interest or value is below the lenders' perceived long-term value of the asset
- Solutions can include capital infusion by the lenders, restructuring of debt obligations, or debt-for-equity conversions and change of ownership to the lender group

Note: The ordering of the options above provides a general idea of the frequency of each option; the first two are the most frequently used solutions, although these approaches may not provide a finite solution to underlying credit challenges. Lender-led solutions and liquidations will be considered, typically in a situation where the sponsor is unable/unwilling to invest further capital.

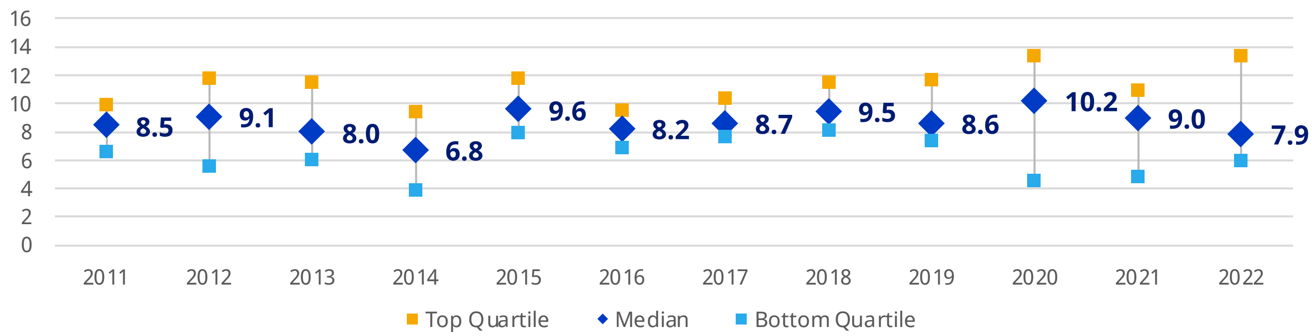
Conclusion

There are about 750 direct lending managers in North America according to Preqin's database but it is our belief that only a select few have:

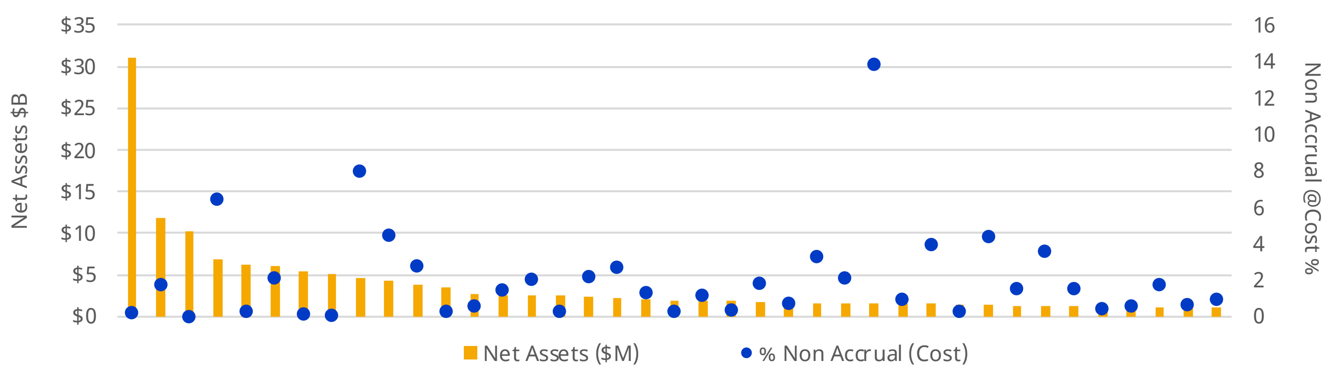
- Scale (e.g. >$50B AUM), lead lender capabilities and very long-established sponsor relationships that enable a first look at deals (thereby avoiding negative selection) and/or significant portfolio incumbency advantages.
- Experience through multiple cycles. Most direct lenders have come onto the scene after the Global Financial Crisis (GFC)…a period of mostly low interest rates and low default rates.
- Dedicated and experienced workout teams.

Just as it is important for lenders to be selective in the loans they originate, so too should LPs be selective in picking their GPs, as relative return performance (i.e. alpha) appears likely to see increased dispersion in the period ahead.

North American Direct Lending Fund IRRs by Vintage [4]



Non-Accrual Rates for BDCs with >$1B in Net Assets as of 1Q24 [5]



Footnotes & Disclosures:

[1] Source: Antares. Based on Antares beliefs

[2] Source: Pitchbook LCD

[3] Source: Cliffwater Direct Lending Index

[4] Source: Preqin

[5] Source: LSEG LPC

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