Q3 2023

US

US PE Middle Market Report

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A WORD FROM ANTARES
The (Fed) pause that refreshes?

Moderating inflation amid resilient US economic growth and a Federal Reserve (Fed) pause in interest rate hikes has boosted optimism in the plausibility of a soft-landing scenario in 2024. On October 26, the Bureau of Economic Analysis reported robust real US GDP growth of 4.9% in Q2—the strongest pace since Q4 2021,[5] when the economy was still rebounding from COVID-19. Meanwhile, inflation has continued to ebb, with headline Consumer Price Index (CPI) falling to 3.2% in October and core CPI rising at a three-month annualized basis pace of just 3.4% in October—a level not too far above the Fed's 2.0% to 2.5% official target (a target some would argue should be lifted closer to 3%). Looking forward, most economists project real GDP growth to slow to a 0% to 2% range in the quarters ahead, but an outright recession is no longer the consensus forecast over the next 12 months.

Accompanying the improved outlook for growth has been a recognition that interest rates may stay high for longer. Although the Fed paused hiking the federal funds rate for a second month in a row in November, rates further out in time on the curve have risen over the course of 2023. As of this writing in mid-November, the Secured Overnight Financing Rate (SOFR) is expected to remain more elevated at closer to 4% through 2025 and beyond versus expectations from only a few months ago that SOFR would fall to closer to 3% in the out years.

On balance, higher growth and higher-for-longer interest rate expectations are favorable for private credit. Less risk of recession is positive for credit, and higher-for-longer base rates should help keep yields aloft. However, the outlook is not without its caveats. Private equity deal activity may continue to face headwinds in a world of slow growth and 4% base rates, and some borrowers may continue to struggle. Also, although recession risks have waned, they remain elevated with the lagged impact of the fastest pace of rate hikes in four decades still rolling through the economy. Meanwhile, wars and geopolitical risks, political dysfunction, deficits, and election-year uncertainties continue to loom large.

"The pause that refreshes" was a slogan launched by Coca-Cola in 1929, the year that kicked off the great depression.[6]

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. His previous roles include Chief Operating Officer and Head of Asset Management for Antares.

While the outlook appears decidedly sunnier these days, we continue to anticipate that credit discipline, selectivity, and strong workout capabilities will remain critical to credit success in the year ahead, with performance dispersion among lenders likely to widen.

Q&A with Timothy Lyne, Antares Capital CEO

Has there been any pickup in private equity deal activity? What are the implications of a higher-for-longer interest rate environment for private equity M&A looking forward?

US sponsored middle-market M&A-related loan volume picked up sequentially in Q3, particularly for add-on volume, which was up 33% versus only a 6% rise for leveraged buyouts. Still, M&A-related loan volume remained depressed compared with one year ago; it is down over 40% both in Q3 and Q3 YTD, according to Refinitiv LPC data.[7]

Pre-Labor Day expectations for a surge in M&A activity in the normally seasonally strong Q4 have waned lately, but we still expect some improvement in Q4 versus Q3. For 2024, interest rate stability, waning recession worries, and the turn of the calendar should all help stimulate deal activity, especially given a backdrop of a strong pipeline of deals waiting to get done, high private equity dry powder, and growing LP demands for a return of capital. However, the higher cost of capital, election-year uncertainties, and other risks will remain headwinds. On balance, there will likely be at least a modest pickup in M&A activity in 2024.

5: "Gross Domestic Product, Third Quarter 2023 (Advanced Estimate)," Bureau of Economic Analysis, October 26, 2023.
6: "History of Coca-Cola Advertising Slogans," The Coca-Cola Company, n.d., accessed November 15, 2023.
7: " 3Q23 US Sponsored Middle Market Private Deal Analysis," Refinitiv LPC, n.d., accessed November 18, 2023.

What about the implications of higher-for-longer interest rates for private credit default rates and returns?

Higher-for-longer interest rates imply higher-for-longer private credit floating-rate yield, which is a plus for investment returns. On the other hand, higher-for-longer rates in and of themselves could imply higher loan loss rates insofar as they represent an incremental drain on borrowers' cash flows. However, higher-for-longer rates presumably suggest an incrementally stronger economy and more favorable earnings prospects. Also, while rates in the out years on the SOFR curve have risen, they remain down from current levels, suggesting some interest rate relief is still on the way for borrowers.

On balance, the picture continues to look favorable for private credit:

On the yield side—which some consider the "beta" component of returns—if you take the current long-term SOFR rate of near 4% in the forward curve and tack on some reasonable spread and original issue discount assumption for private credit loans, you get a working assumption on what your longer-term yield might be. In Q3, spreads on sponsored middle-market first-lien term loans dipped to 655 basis points from 669 in Q2, but they remained elevated versus an average of near 550 basis points over the last decade, according to Refinitiv LPC data.[8]

On the loss side, 2024 default rate forecasts by credit rating agencies have generally held steady in recent months at levels that are up from 2023 but still quite manageable. Fitch Ratings recently lowered its institutional leverage loan default expectations to 3.0% to 3.5% for 2023 while maintaining its 3.5% to 4.5% forecast for 2024.[9] This compares to a recent peak of 4.5% in 2020 during COVID-19—a "stress test" period through which private credit ended up performing well.

Of course, private credit default and loan loss rates—which many consider to be the "alpha" component of returns—will differ among lenders. Indeed, while two first-lien term loans might offer the same yield at underwriting, one may end up defaulting and the other, not. Furthermore, recovery rates on loans that default will also vary among lenders. This is why selectivity, diversification, credit discipline, and dedicated and experienced workout capabilities are so critical to lender performance.

How is private equity coping with liquidity stress?

Lincoln International's proprietary Q3 2023 US private company data shows 30% of private company borrowers with an average interest coverage ratio of less than 1.0x pro forma a 5.5% base rate,[10] so clearly some borrowers are facing stress. However, sponsors have a lot of skin in the game and have been managing well, with Q3 YoY last 12 months (LTM) EBITDA growth across Lincoln's private companies database stable at 4.2% QoQ.[11] Amendment activity aimed at giving borrowers more breathing room and extending PE's investment lifecycle is up, but it's important to note that such amendments typically come with fees, upward repricing, and/or sponsor equity infusions, which can help lift private credit returns on older vintages.

Some have been suggesting that as private credit has grown, it has become a source of systemic risk. Do you agree?

We do not believe private credit poses systemic risk. If anything, private credit plays more of a role as a shock absorber than shock creator as we saw most recently following regional bank failures. Of course, that is not to say there won't be credit default cycles—there always have been and always will be. We have had a lot of experience navigating them over our 25+ years in business. However, we believe private credit risks are well understood, diversified, and well distributed among sophisticated investors with no daily redemptions for private closed-end funds that could lead to "runs" like we saw on regional bank deposits. In fact, during the pandemic stress period, the US Government Accountability Office studied the issue and confirmed that US financial regulatory agencies had not found leveraged lending to significantly threaten financial stability.[12]

8: " 3Q23 US Sponsored Middle Market Private Deal Analysis," Refinitiv LPC, n.d., accessed November 18, 2023.
9: "Lowering 2023 U.S. LF Default Forecasts on Better Macro; 2024 Unchanged," Fitch Ratings, October 5, 2023.
10: "Supplemental Deck Valuation Assumptions," Lincoln International, Q3 2023.
11: "Lincoln Private Market Index Increases Marginally on Higher Fundamental Performance Despite Multiple Pressure," Lincoln International, November 2023.
12: "The Role of Private Credit in U.S. Capital Markets," Proskauer, March 31, 2022.