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A WORD FROM ANTARES CAPITAL

Private credit: Your all-weather friend

A dream come true?

Thus far, the US economy has proven to be remarkably resilient in the face of the fastest pace of interest rate hikes seen in about four decades. Real GDP growth of 2.4% in Q2 2023 surprised on the upside—in part encouragingly driven by a remarkable 3.7% seasonally adjusted annual rate jump QoQ in nonfarm productivity. Q3 2023 is looking potentially even more vibrant, based on the Atlanta Federal Reserve's (Fed's) most recent GDPNow real GDP growth estimate of over 4%. Meanwhile, inflation continues to wane, with the Consumer Price Index (CPI) down to a lower-than-expected 3.2% reading in July. Is such vibrant growth and subdued inflation an unlikely soft or no landing dream come true or just a fleeting head fake?

Beware the lag

While the recent stream of generally positive economic data is certainly heartening, it's probably premature to jump on the "no recession" bandwagon. The steep rise in interest rates to a 22-year high and recent bank credit tightening will take time to flow through the economy. Historically, a recession has typically followed a prolonged inversion of the US 2-year to 10-year Treasury yield curve by roughly 18 months. With inversion having started in earnest in July 2022, that would put arrival time for a recession in early Q1 2024. Recessions have also tended to follow the last in a series of Fed rate hikes by three to six months, and July's hike to a 22-year high may well be its last. Finally, fiscal-stimulus-induced excess household savings—which peaked at over $2 trillion in mid-2021—has been dwindling and is expected to be depleted by early 2024.

On the positive side, credit tightening following the regional bank failures, productivity gains, recession in Europe, and a slowdown in China are all deflationary forces that should help alleviate the need for further interest rate hikes and pave the way for eventual rate cuts. Currently, the forward interest rate curve would suggest that rates have peaked and are on a smooth glide path toward more normal levels by 2025. Of course, there could yet be foul weather ahead reflecting further regional banking and/or commercial real estate woes, a rekindling of inflation due to strong growth, or supply side shocks and/or geopolitical strife. While it's fine for equity investors to dream of the upside, you may find better all-weather friends among lenders that worry about the downside.

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.

Q&A with Timothy Lyne, Antares CEO

What is your latest read on PE investment activity? Are the stronger-than-expected growth and diminished odds of recession helping?

US middle-market leveraged buyout (LBO) loan volume remained depressed in Q2 2023 at only about $6 billion—down 26% versus Q1 2023 and down 60% versus Q2 2022;[12] however, add-ons have been a relative bright spot, rising 10% in Q2 2023 versus Q1 2023 and slightly exceeding LBO volume for the first time since Q3 2020. The pickup in add-on activity plays well to our strengths and incumbency advantage as PE investors look to average down their LBO platform acquisition multiples and create value via synergies. We have one of the largest middle-market portfolios in the business, with over 70% of our deal flow coming from our portfolio.

Looking forward, it's a bit tricky to try and read the tea leaves on the direction of PE investment activity—especially during the seasonal summer doldrums of August; however, to your question, the resilience of the US economy and growing consensus that the Fed may be finished hiking rates no doubt

[12] "Refinitiv LPC's 2Q23 Private Deals Analysis," Refinitiv, July 2023.

helps improve investor sentiment. A recent survey by Grant Thornton of M&A professionals and PE investors showed 99% of respondents expecting deal volume to increase in H2 2023, although only 11% forecast a "significant" increase.[13] In another survey conducted by Lincoln International in Q2 2023, 82% of private market investment professionals indicated they expect transaction activity to return to "normal" levels by H1 2024.[14] We also hear from investment banks of a significant backlog of deals, and PE dry powder levels remain high. On the institutional demand side, syndicated market activity has continued to pick up, with higher secondary loan pricing, a recent pickup in collateralized loan obligation (CLO) issuance, and improved fund flow helping drive interest in new issuance.

For our part, we remain very much open for business and see encouraging signs of increased activity, including a nice recent pickup in staple financings—another incumbency advantage from our large portfolio. While there has been some modest spread pressure, spread per unit of leverage remains near the highs of the past decade. We continue to view the current environment as yielding a great loan vintage, and hopefully, we'll start to be able to harvest some more grapes.

What insights can you share about how your borrowers are faring in the current environment?

We continue to see revenue growth across our portfolio, with most companies having had success in mitigating cost inflation with price increases. However, EBITDA growth has slowed and is lagging in a few areas. Industry segments facing pressure include aerospace & defense, select retail goods & services segments, and physician management practices (PPMs).

On the positive side, there are signs that cost inflation is abating with margins stabilizing. At a recent annual event we held for borrowers, an informal survey of executive attendees indicated that the impact of raw material costs and supply chain issues has shifted favorably from a "significant" to "slight" negative impact, with some even seeing a positive impact. Hiring and retaining labor remains a challenge, yet there has been some improvement versus one year ago.

Has the outlook for defaults and losses changed, and how have sponsors been dealing with troubled investments?

As you would know, the latest Q2 2023 Pitchbook-LCD Leverage Finance Survey loan default rate forecast for the next 12 months was unchanged from its prior survey at 2.5% to 3.0%, which compares to the current default rate of 1.4% as of August and the long run average of about 2.7%. Of course, forecasts differ, but base case numbers look manageable.

Resilient growth and declining inflation certainly help the default outlook, but interest costs have been rising and many companies are still facing cash flow pressures. Lincoln International's database of private companies shows average interest coverage of just 1.19x in Q3 2023 assuming a 5.5% Secured Overnight Financing Rate (SOFR) base rate with almost one-third of companies below 1.0x on a weighted average basis.

The good news is sponsors have generally been managing cash flow and liquidity well via better working capital and capital expenditure management in many cases. Sponsors and direct lenders appear to have been working well together to get ahead of the problem—particularly in instances wherein foreseeable stress has been purely related to base interest rate increases versus operating performance issues. Lenders have been accepting amendments (for example, covenant or pricing amendments and maturity extensions, among other things) in exchange for fees/better economics, with sponsors often contributing more equity when needed.

Interestingly, KBRA Direct Lending Deals has recently started tracking US direct lending defaults, and in its June report noted that it expects the sponsor-backed direct lending default rate of 2.5% by count at year-end 2023 to be less than a 4% rate for high-yield and 5.5% rate for leveraged loans.[15] Some of the reasons for this include: first, a lack of trading in direct loans that could otherwise allow investors into the fold that may have opposing agendas; and second, the willingness of a small club of buy-and-hold-oriented direct lenders to work constructively with sponsors that have substantial skin in the game. We think this underscores direct lending's appeal to both sponsors and investors.

[13] "M&A Professionals Predict a Continued Jump in Deal Volume," Grant Thornton, August 11, 2023.
[14] "Lincoln Private Market Index Gains Ground Amid Stable Private Company Growth," Business Wire, August 8, 2023.
[15] "DLD Default Report: US Direct Lending," KBRA, August 10, 2023.