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US PE Middle Market Report

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Your Guide Forward

In this environment, experience sets players apart.

Private credit has been shown to be a standout in stressful times, but current market pressures illustrate that the make-or-break factor for lenders (and the investors that trust in them) is capabilities grounded in experience. In this issue, Timothy Lyne, CEO of Antares Capital, speaks frankly about the benefits of working with a large, established player.

Read the article in this issue >

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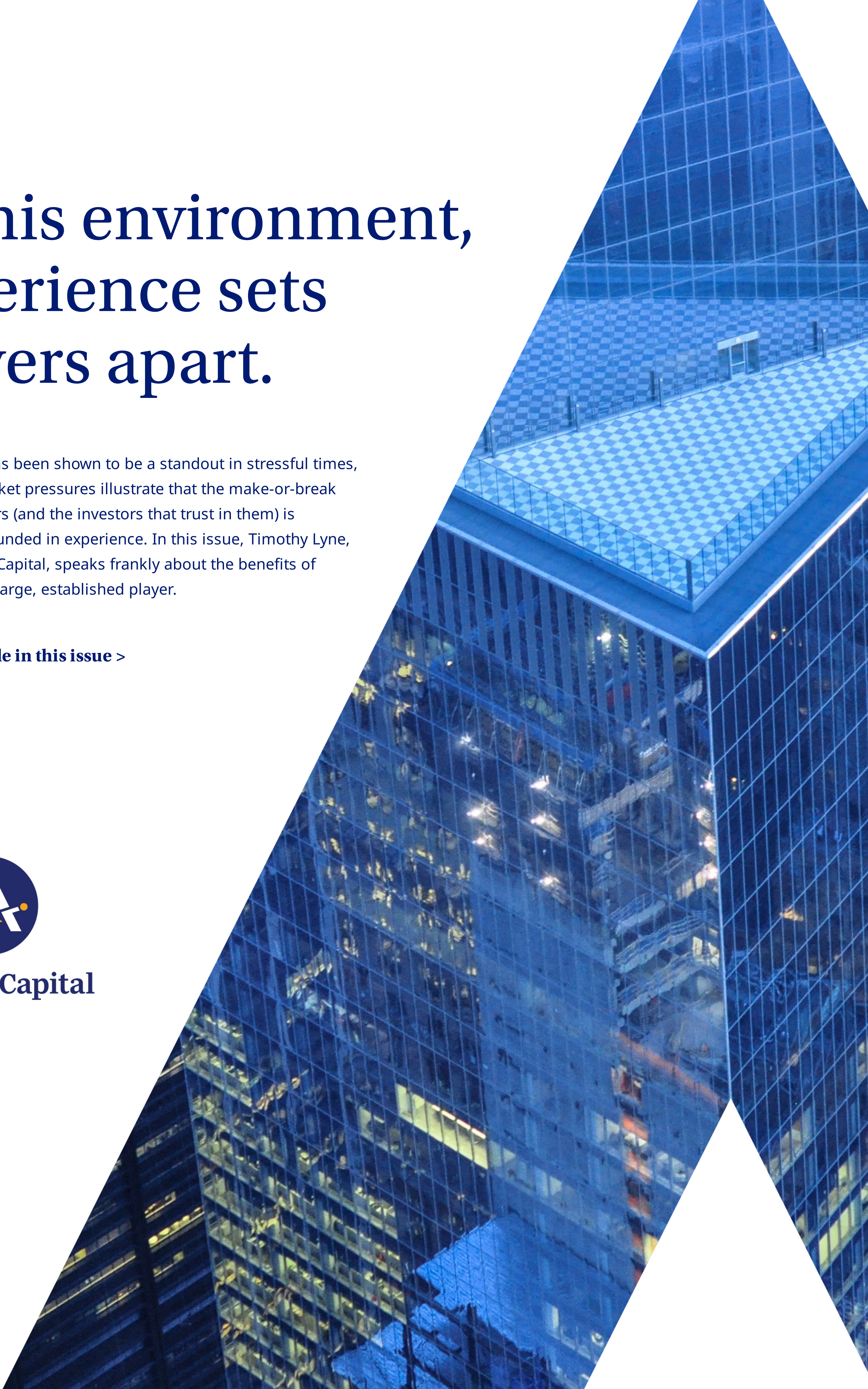


A WORD FROM ANTARES CAPITAL

Banking on private credit

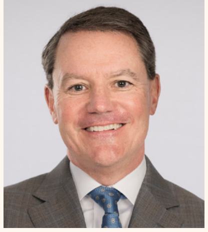
No shortage of bricks in the wall of worry

As of this writing in early June, debt-ceiling brinksmanship has been resolved at least for another two years; however, other bricks in the "wall of worry" do not appear to have such a clear expiration date. Regional banks, for example, continue to face pressure: The KBW Regional Banking Index is down near YTD lows as of mid-May, including a few names down 50% to 75%. Predictably, the Federal Reserve's (the Fed's) quarterly Senior Loan Officer Opinion Survey published in May indicated a credit crunch may lay ahead,[1] with tighter lending standards expected for commercial industrial loans and consumer mortgages and credit. Clearly, economic headwinds are still blowing. Meanwhile, geopolitical flashpoints such as the war in Ukraine, intensifying conflict in Sudan, and tensions with China continue to loom large.

Will it all "work out"?

While not all is doom and gloom, and with some reasons to cheer (including falling inflation in the face of still-decent service sector growth as of late and a possible end to Fed rate hikes), the odds of a mild recession arriving within the next several months look pretty high. In fact, the S&P 500 has already been in an earnings recession of sorts with Q1 2023 earnings down about 2% YoY—the second quarter in a row of negative growth, albeit less bad than markets had generally expected. Even if the US manages to skirt a recession, interest rate coverage ratios look increasingly compressed. Amendments, defaults, and losses will most likely rise and drive increasing performance variance among lenders.

While we expect private credit as an asset class to shine as it usually does during times of stress with higher yields more than offsetting losses, lenders that have been less selective and credit disciplined will likely start to lag in performance. Robust, dedicated work-out capabilities, which many lack, will also no doubt come to the fore as an increasing differentiator of performance. For those without such assets, things may not "work out" so well.



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, CEO of Antares Capital

Do you see recent regional bank failures and a possible credit crunch ahead as a threat or an opportunity for direct lenders?

It's really something of a double-edged sword. Banks and nonbank lenders live in a somewhat symbiotic relationship. Nonbank lenders compete with banks, but we also depend on them both directly and indirectly.

On the one hand, lowered bank risk appetite and likely increased regulatory constraints should provide more opportunities for private credit to fill the void—a trend that has been underway since we got into the business more than 25 years ago. We believe that private credit will once again prove to be a critical stabilizing source of capital for the US economy, much as it was through the COVID-19 pandemic and other previous downturns.

On the other hand, banks are an important source of capital for nonbank lenders. To the degree banks pull back here, we believe that larger, more established and scaled private credit players with strong equity backing and a diverse set of funding sources will benefit relative to smaller, less established players that may see their funding diminish and/or see their cost of capital rise on a relative basis.

1: "Senior Loan Officer Opinion Survey on Bank Lending Practices," Board of Governors of the Federal Reserve System, May 8, 2023.

Finally, bank health is critical to the broader economy, which of course can have implications for the cash flow of nonbanks' borrowers. Right now, the regional bank fallout appears to be contained and may actually be helping the Fed in its efforts to cool the economy and inflation. However, the sector still appears to be walking on eggshells and necessitates close monitoring. Bank consolidation and branch closures, which seem likely, can also have an impact on local communities with a ripple through to the broader economy. Clearly, a healthy banking system is critical to the macroeconomic outlook.

Interest coverage ratios have been falling. How is Antares' portfolio performing?

A sample of our portfolio suggests continued, albeit slower, YoY revenue and EBITDA growth trends for the portfolio on average; however, performance varies among sectors/companies, with some starting to see negative growth sequentially and even YoY. Our risk ratings have remained relatively stable since December 2022, as has revolver utilization, but our watch list and early-warning lists have ticked up a bit. In short, our portfolio performance is holding up well but showing some pockets of rising stress, which is to be expected given economic headwinds and higher interest rates.

Based on a sampling of several leading public business-development companies that have reported Q1 2023 results, interest coverage ratios appear to be close to 2.0x on average on a last 12-month (LTM) basis but more in the 1.5x-1.9x range based on the most recent quarter. Data released by Lincoln International for Q1 2023 shows a fixed-charge coverage ratio (FCCR) for names in their database of only 1.26x on an LTM basis and only 1.04x assuming a 5.5% base rate.[2] Of course, while telling at a high level, the average ratios aren't too informative by themselves. What matters most is understanding the liquidity, resiliency, and likely sponsor support of credits at a more granular borrower-by-borrower level in the "tail" of those with FCCR below 0.9x. Having done just such an analysis for our portfolio, we continue to expect our net loss rates to rise but remain within a manageable range and, importantly, far below the pickup in yield the portfolio has seen over the past year or so.

What is the outlook for PE deal activity? Do you see any signs of a pickup?

Private equity deal activity has been somewhat tepid, with Refinitiv LPC reporting a sponsored middle-market loan volume of only $19 billion in Q1 2023—down roughly 40% both QoQ and YoY.[3] Data from KBRA Direct Lending Deals suggests direct lending volume also remained anemic in April.[4] Add-on activity has been better than leveraged buyout activity on a relative basis, which plays to our strength with a large portfolio of incumbent opportunities, but activity is down YoY there as well. On the positive side, we are seeing some signs of life for the US institutional loan pipeline, which has risen as of the third week of May to its highest level YTD (albeit still well down from a year ago), as reported by Refinitiv LPC.

Looking forward, it's hard to predict when M&A activity will begin to pick up, but it is clear that pent-up PE deal demand is building, as evidenced by a 20% rise in North American-focused PE buyout dry powder at year-end 2022 versus 2021, per Preqin data. We also hear from investment bankers of stacks of deals on hold in backlog awaiting more favorable market conditions and more convergence on buyer and seller valuation expectations. Once it becomes more apparent that financing costs have peaked and that economic headwinds are abating, we expect PE-related M&A activity to sharply recover.

2: "Private Market Perspectives: U.S. Edition," Lincoln International, May 2023.
3: "1Q23 Sponsored Middle Market Private Deal Analysis," Refinitiv LPC, April 2023.
4: "DLD Insights & Outlook April 2023: U.S. Sponsored Deals," KBRA Direct Lending Deals, April 2023.