Investment
INSIGHTS

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A SELECTIVE APPROACH TO PRIVATE CREDIT OPPORTUNITIES

With the volatility in the public markets persisting due to concerns about the COVID-19 variant and the potential impacts of higher inflation, institutional investors have continued to seek out alternative assets that provide diversification and an attractive risk-return profile.

For an increasing number of investors, the solution has been middle-market private debt, an asset class that proved its resilience amid the uncertainty of the pandemic last year and exhibited default rates that remain relatively low, according to Tyler Lindblad, chief credit officer at Antares Capital. Investors appreciate the yield that private debt can offer, its illiquidity premium relative to public debt and the speed with which a deal can close relative to the longer timeframe to secure bank financing.

"When COVID hit, there was initially great concern in private debt," Lindblad said. "But private equity sponsors were really able to manage their portfolio companies well, cutting their expenses and supporting the companies with additional injections of equity."

Besides seeing that resilient corporate performance, many investors are realizing that middle-market debt portfolios are tied to the rebounding U.S. economy, added Lindblad. "The U.S. economy is in a strong position, and it continues to get stronger, given consumer spending and the potential for another stimulus package out of Washington," he said. "Although there will be some modest pressure for interest rates to go up, relative to historical levels, interest rates are still very low."

A majority of institutional investors are relatively bullish on the economy, Lindblad noted. Nearly 60% of sponsors — the private equity firms that back the borrowers — and three-quarters of investors said that they had confidence in the performance of the global economy over the next year and that a 2021 U.S. recession is "very unlikely," according to a survey conducted earlier this year by Antares Capital.

HIGHLY-FOCUSED STRATEGY

Given that overall macroeconomic view, investors who want to diversify their portfolios are considering allocations to private debt, which has seen a strong increase in deal flow, Lindblad said. Other factors driving a pickup in deal flow include the potential for additional fiscal stimulus and a large amount of dry powder at private-equity firms.

Even as private debt has become a larger and more competitive market, Antares Capital — which manages one of the largest, most diversified portfolios in middle-market private debt — has kept its overall strategy largely consistent in its extreme focus on selectivity in credit decisions by disciplined underwriters with decades of experience, Lindblad said.

"It starts with our sponsor coverage team, which has strong relationships in the industry along with significant deal flow, from which we can be very selective and choose what we think are the highest-quality companies." Those companies are typically established firms in stable industries where they have leading market-share positions and a diversified customer and supplier base, Lindblad pointed out.

> *The best way to protect yourself from risks is to lend money to high-quality companies and to make sure that you have a diversified portfolio.*

Then the firm looks at the loan-to-value of any potential deals. "We've really seen that as purchase prices continue to rise and the amount of equity to support those companies is increasing — even though debt multiples have increased modestly — the loan-to-values have actually come down," Lindblad said. "That's something very important to us: the amount of equity capital support below us in the capital structure."

DILIGENT RISK PERSPECTIVE

The bulk of Antares Capital's portfolio is in industries such as software, business services and health care, which offer recurring revenue and business models that aren't tied to raw materials and don't face labor constraints, Lindblad said.

"There are more and more companies [in these industries] that are being traded and owned by private equity, and that enables us to continue to be highly selective."

Of course, like many asset classes, risks remain in the private credit space, he added, including a slower-than-expected economic recovery, supply-chain issues and the impact of COVID-19 variants.

"The best way to protect yourself from [these types of] risks is to lend money to high-quality companies and to make sure that you have a diversified portfolio," Lindblad said.

Some of the recent spikes in inflation could also pose a headwind in some industries, he pointed out. Private debt investors need to take potential inflationary impacts into account when deciding whether a deal makes sense. For Antares Capital, that has meant looking into how and where a company sources its raw materials and determining whether it is positioned to pass along inevitable price increases or whether it would have to absorb these increases

The firm has also instituted a more formalized approach to environmental, social and governance analysis in recent years, incorporating ESG diligence into a scorecard format that is used in all underwriting, for new borrowers and material new money transactions for existing borrowers. That scorecard looks at environmental issues, human capital dynamics, governance issues and corporate leadership aspects.

"We use that scorecard to make a determination as to whether there's a high, medium or low risk on anything of significance that's uncovered during the diligence process."

Antares Capital closed 139 private credit transactions in the first half of this year, totaling $11 billion in financing commitments to middle-market, private equity-backed companies. That follows more than 220 transactions and $14 billion in financing commitments last year, according to the company.

INTEREST IN UNITRANCHES

Over the past year, one area that investors have been particularly interested in has been the unitranche strategy, which is a hybrid loan structure that combines senior and subordinated debt. While the unitranche market has been growing for nearly a decade, it has exploded over the last year, Lindblad said. In the first half of 2021, it accounted for 37 transactions at Antares Capital, across 25 private equity sponsors.

"We're seeing that sponsors are finding that the unitranche execution provides speed and certainty [that] is attractive." It involves "a smaller group of lenders that the sponsor knows and is becoming more comfortable with, and it is also well-suited to the roll-up strategies that are becoming more prevalent in the market today, where sponsors pay big prices and then seek to really arbitrage those prices down through add-on acquisitions."

Investors also see unitranche strategies as a more efficient investment. "We have seen certain firms that have a second-lien orientation use a unitranche strategy to move up-market, up to the capital structure combined with the first lien," Lindblad said. "They find that the combined risk is more attractive with a unitranche than just a straight second-lien strategy."

Still, it's not the preferred route for every sponsor. "While unitranche is certainly becoming more and more popular among large sponsors, there remains a core group of middle-market sponsors that value a more traditional execution relying on a small group of lenders or utilizing our syndication expertise to bring in institutional investors," Lindblad added. "The amount that you can commit to a transaction is becoming more and more of a significant differentiator." ■

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