KEYNOTE INTERVIEW

Serving up stability with senior debt

Staying at the top of the capital structure provides an attractive balance between risk and return during turbulent times, says Antares Capital's Timothy Lyne

Amid the economic carnage brought about by covid-19, it should come as no surprise that many investors have been tempted by a safety-first approach. While global private debt fundraising sunk to its lowest level since 2014 last year, senior-debt focused strategies accounted for 40 percent of the capital raised – their highest-ever level.

Timothy Lyne, chief operating officer at Antares, sees a bright future for private debt investing in senior debt in particular. With more and more investors attracted to the asset class as the economic recovery gathers steam and M&A volumes pick up, Lyne spoke to *Private Debt Investor* about the benefits of a senior-focused strategy.

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Q Senior debt performed strongly in 2020, relative to private debt fundraising as a whole. Why do you think that was?

Investors throughout the world are searching for yield, given the low interest rate environment, and senior debt offers an attractive risk-return option. With senior debt you're at the top of the capital structure with rights and remedies that we and many LPs find important. Senior debt offers substantially lower loss-given default than junior debt, which is an important consideration when chasing yields.

The other thing to consider is the opportunity to put larger dollar amounts to work within the sponsored senior space, which is significantly larger than the junior market. Also, GPs have the opportunity to review thousands of deals and select a very small percentage in which to invest yet are still able to build a very diversified portfolio for LPs with low concentrations.

Q How does a senior debt strategy fare in the mid-market, especially with yields being driven lower?

Sponsored middle market debt has been our focus for 25 years for a reason. Middle market deals tend to have more covenants versus the broadly syndicated market, thereby providing a higher level of security for those investing.

The middle market has also offered about a 100 basis point yield premium on average over the past decade or so versus the broadly syndicated market. That premium has been even higher over the last few quarters, and that's for institutional middle market loans. The premium would probably be higher if you included private deals. The assumption historically by some was that that differential was a risk premium – I would argue that it's really an illiquidity premium. If it were related to risk, defaults and losses would be higher in the middle market than in BSL.

But what the research shows us is that if anything, middle market loans have had lower default rates and loss-given default. So that spread differential is truly just related to liquidity – BSL deals have liquidity, middle market deals do not.

In terms of yield deterioration, there has not been much within the core middle market of late. In loans to companies with under $35million-$40 million in EBITDA, yields have held up well. That said, syndicated deal executions have seen some deterioration in spreads, as well as unitranche. Within the broadly syndicated market, and what I would deem to be the upper middle market, we are seeing yields being impacted a bit more dramatically. I see it simply as a supply-demand situation with too much money chasing too few deals. However, that imbalance should ease in the second half of the year which we expect to be really strong from an M&A volume perspective.

Q During the pandemic, how have you reassured LPs that you are able to manage your portfolio effectively?

We believe it's even more important than ever before to over-communicate. Why wouldn't you? Communication is paramount, it's critical in this business environment. We aim to be forthright and tell our LPs what we're seeing, when we're seeing it. No surprises.

Many of our sponsor relationships date back 15-20 plus years and LP relationships go back several years now. In 2020, we were able to raise a very large flagship fund, primarily utilising Zoom and Teams – which shows how times have changed. The investors in the fund were able to talk to our sponsors, and they could talk to other investors, so they were able to complete their due diligence on Antares.

Q Given the competitiveness of the market at this time, how do you stay ahead?

It goes back to our focus on sponsored debt, experience and selectivity. During the pandemic, sponsors stepped up in a huge way, in multiple areas. They reacted quicker than we've ever seen them react before in terms of bolstering liquidity, cutting costs and investing dollars where needed. That sponsor support made a big difference in how things ultimately played out for many middle market companies.

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We also make it a priority to stay close to our sponsors, so even during a time of lower M&A volume, we ensure we're seeing the majority of opportunities coming to market and are able to select only the best companies in which to invest.

The other thing that's hugely important is the size of our portfolio, which today is just under 500 companies and generates approximately 70 percent of our dealflow. Last year, when there was a sudden drop in M&A demand, we were still executing add-on acquisitions with sponsors and management teams that we know well. If you don't have a large portfolio, your access to such add-on deal activity will be limited.

We're seeing more and more that LPs are cautious about committing dollars to new players because covid has proved that experience and selectivity matter. Generally, when you see new lenders in the market leading a deal of a couple of hundred-million-dollars, you can assume the major players in the market have either passed on the opportunity or they don't feel that the risk-return is in line.

Q Senior debt investing is a way to mitigate the risk – but are investors concerned about private debt more generally in such uncertain times?

We've had an incredibly quick rebound, and we think it's a sustained rebound. In April or May 2020, I'd never have thought our portfolio would be in as good a shape as it is today.

Investors around the world, in general, are under-allocated to private debt. Many of those who have invested are looking to add to their allocations and those who haven't invested are looking to commit to the asset class. We expect very strong GDP growth in 2021, and we expect the private debt class overall to perform really well in 2021 and over the next few years.

The one other area where I believe you'll see more growth in private debt allocation is within the retail investor space. We're beginning to hear more about this and some GPs are starting to target the retail investor segment. We're likely going to see more high-net-worth individuals, maybe even people a little below that level, increasingly allocating to private debt through their brokers.

Q With so much liquidity in the system, there is an expectation that inflation will increase – is that a risk for senior debt investors?

From a loan investor perspective, inflation is certainly a happier worry than deflation. We structure deals with rate floors to protect from deflation. In contrast to fixed-rate bonds, loans are floating interest rate instruments, which is an attractive attribute if you are worried rates will rise since you get to participate in that rise during the term of the loan. Net loan mutual fund inflows have surged of late, no doubt reflecting this dynamic.

We expect there will probably be a bit of a spike in inflation in the coming months – just look at the surge in copper, silver and lumber prices of late. Demand will likely surge as inoculated consumers start to take vacations and spend their stimulus dollars and the supply chains will take a while to catch up.

However, there is still plenty of slack in the labour force and the Fed can always tighten gradually – so at this point, we aren't too worried that inflation will become really entrenched and damaging. That said, we could be in for a bumpy ride in "taper tantrum" related market volatility. Also, from a credit perspective, you need to carefully consider trends in raw material and labour costs, as well as a borrower's ability to pass through those costs.

Q Another important trend is ESG. Are you expecting to see more pressure for ESG criteria to be written into loans?

Obviously, ESG is incredibly important, it's a huge focus. Europe is ahead of the US, but even in the US, investors are asking about borrower ESG policies, so there's definitely a heightened awareness taking hold. I feel like there has been a significant shift just in the past year, both by LPs throughout the world and GPs.

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Ten or 15 years ago, we weren't using the acronym ESG, but we've always had elements of negative screening on certain sectors and have always cared a lot about potential material environmental liabilities, product liabilities, labour relations, governance issues and so forth. We formalised our ESG policy in 2018 and more recently have been providing more training and resources to our deal teams. Our ESG scorecard now requires deal teams to provide commentary and assessment of material ESG factors in every investment related to new platforms. It's an area of ongoing development.

As far as tying ESG criteria into loan docs, you are already seeing some of this in Europe, with lenders tying rates to certain ESG metrics – the better the ESG metrics, the lower the rate. I think that's probably going to happen in the coming years in the US private debt industry as well, which we welcome. ■

Timothy Lyne is chief operating officer at Antares Capital, the US fund manager