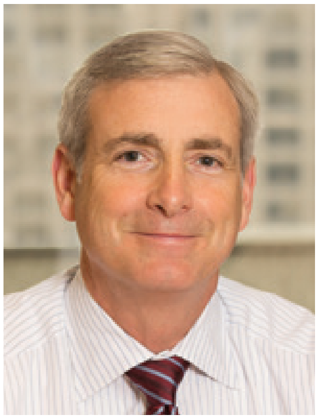
KEYNOTE INTERVIEW

Deals are down, but confidence is growing



Unless you happen to be a covid-resistant business, the chances of a successful deal at the moment may be slim, but the period ahead looks promising in many ways. David Brackett of Antares Capital takes the temperature of the market

There is little argument that covid-19 has taken a severe toll in areas such as dealmaking and fundraising. However, there are signs that portfolios are coming through this challenging period and showing better performance than expected.

Could this ultimately be seen as the time when private debt proved it could adapt and even flourish in a downturn?

Private Debt Investor canvassed the views of David Brackett, chief executive officer of Antares Capital, the US-based mid-market credit manager.

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Q How has dealflow been weathering the pandemic?

Our early August pipeline stands at about 45 percent of pre-covid levels. Those companies that are able to trade well or obtain financing at this point in time are generally covid-insulated. For example, we see a lot of activity around the software space where companies continue to have high recurring revenue streams as well as adoption of new technologies, which has been accelerated in some ways because of the covid environment.

We're also seeing dealflow from essential services companies, such as healthcare. Then there are some sectors that you don't necessarily think of as essential, like refuse collection or logistics activities, that just go on regardless of external factors, and we see deals happening in those areas as well. But, unfortunately, that's just a sliver of the economy and our expectation is that for some period of time we will be limiting ourselves to that smaller slice of the economy which is largely unimpacted by covid.

Q What are the key trends you're seeing in deals in areas such as spreads, yields, leverage and terms?

The fewer opportunities that do exist are very attractive compared with pre-covid. They're down probably a turn of leverage, pricing for traditional first-lien senior debt is up anywhere from 75 to 125 basis points, while terms are not dramatically improved but are better with regard to adjustments and addbacks.

The bottom line is that covid, just like the global financial crisis, provides lenders with the ultimate litmus test of company performance.

We had to go through 10 years of estimating what the impact of a downturn would be and now that we're in the middle of one you can see how specific companies fare. This environment makes it easier to make those tougher credit calls.

Q And what is the covenant environment now like?

In the mid-market where we play, covenant-lite was the outlier. It's on the fringes of the mid-market, companies with $50 million to $100 million of EBITDA, where it waxes and wanes over time in terms of whether they can access the market on a covenant-lite basis or not.

At this moment in time it's more challenging for those companies to be able to do that.

But there continues to be a lot of capital in our space and it's not lost on third-party investors that yields are compelling and terms more advantageous.

Our investors often tell us that it's the right time to deploy capital and we agree with that. Some thought there would be a swing towards far more conservative agreements and that covenant-lite would be banished, but I think competitive forces will keep things largely in balance and we won't see a dramatic shift.

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Q Can you foresee dealflow picking up at all?

Deals we're seeing right now are mainly for covid-insulated companies. But the other area where we're seeing activity is around portfolio add-ons.

Of our deal activity, 70 percent historically has come from our portfolio and I would expect the pendulum to swing even more in that direction.

We expect perhaps an even higher percentage of our activity will be portfolio related – at least in the near term – as our sponsors and borrowers capitalise on add-on opportunities where valuations are now more attractive compared to 12-24 months ago.

Some sellers of smaller add-on companies may be facing significant struggles, given stresses from the current covid environment.

We also are beginning to see some more sponsor-to-sponsor activity, where the prospective buyer already knows the company well and the selling sponsor is willing to roll a portion of their equity into the new transaction.

Q How do you go about doing due diligence on an increasingly 'remote' basis?

In many ways the world had begun changing from a due diligence perspective pre-covid. Lenders used to visit companies and have a full day's meeting with management, plant tours and very extensive in-person experiences. In the past five years, we've seen increased sophistication around the auction processes that investment banks run including so-called 'fireside chats' that are often conducted by telephone or maybe through video.

Covid will accelerate some of the trends we'd already seen with respect to due diligence processes. We would expect to still be able to visit companies and management teams but we're trying to figure out exactly how that happens in a covid world.

Q How do you expect default rates to pan out in the period ahead?

Initially, when the crisis hit, we had an expectation that defaults would be at the higher end of the 5-10 percent range. But there has been tremendous discipline and changes made by borrowers around cost structures and liquidity such that they've gotten on top of this situation quite quickly. We've been pleasantly surprised by portfolio performance and defaults will probably be closer to the lower end of the range as a result.

What we're likely to find is that this environment will play out over a longer period of time than we thought, so as opposed to it having a severe and very deep but short impact, it will be longer in duration and, likely, a bit uneven depending upon industry segment.

Q How are you reading developments in the CLO market?

About half of our funding comes from collateralised loan obligations so we're very closely watching and monitoring that market but we don't see

Q How central is diversity for private debt companies, especially in light of recent developments?

The murder of George Floyd has brought social injustice and racism to the fore. Prior to this, companies certainly were making progress around diversity and inclusion but now it's accelerated, and many recognise that we need to do better. The conversations we have been having both internally and externally have been eye opening and humbling.

Private equity and private debt continue to be white male-dominated yet 75 percent of people entering the workforce today are diverse and our asset classes are failing to reflect that. If we want to track and retain the best people, we need to start looking more like how the world looks. That's a commitment we've made as a firm going forward.

In the past, I think among many managers there was a kind of passivism of intent. From now on the focus will be much more about accountability so that we identify how we promote our managers, compensate people, and create an inclusive and diverse environment. That's Antares's plan. Externally, we have to rely on the sponsors but we're looking forward to engaging more with them about what they are doing in areas such as diversity and environmental, social and governance, how are they changing the conversation and how they are driving change.

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over-collateralisation tests tipping into the red. We have the benefit of experiencing the last cycle where CLOs came through it quite well. There are some players that may have challenges but overall CLOs will prove to be a pretty solid funding source.

The market is reopening and, while spreads are a little wider, they are not as wide as you would have anticipated if concerns around over-collateralisation tests were beginning to bear out. Investors are starting to conclude that the market can operate successfully through this environment.

Q What's your take on the private debt fundraising scene in the US?

The first quarter of 2020 was subdued as investors were focusing their energy elsewhere and waiting to see how the crisis would play out. Now they're in two camps – those that want to wait until the market nearly fully recovers and those that see opportunity.

The latter group is seeking opportunistic plays and has devoted resources to distressed and deeply distressed strategies. Anecdotally, it seems there hasn't been much opportunity because there's so much capital to support companies. Sponsors have a lot of dry powder that they're prepared to commit.

While there is a lot of talk about opportunistic strategies, it's questionable how much of that will translate into action. I think what people will realise is how compelling the mid-market is because defaults are lower than expected, sponsors are stepping up and companies and borrowers are reactive and responsive.

Q What are investors keen to talk about in this environment?

First and foremost, investors want to make sure you have the dry powder to deploy capital in what is not yet a target-rich environment but will be increasingly attractive. We have focused on our liquidity and capital base and are in a good position. Having CPP Investments as our partner is obviously a differentiator, as they give us the ultimate long-term perspective.

We've also been investing time with our banks. Our clients have been reaching out to say this could be a time of opportunity, we need you to be flexible and work with us, and we've had those same conversations with our banks and had very strong support. They're looking at their portfolios and assessing the performance of loans to entities like ourselves and they too are saying – just like investors – that this continues to be a very strongly performing asset class in the face of all the challenges externally. ■