Has private debt reached saturation?

From its compelling risk-adjusted returns to its diverse array of strategies, private debt has a lot to offer. **Vivek Mathew**, senior managing director and head of asset management and funding at Antares Capital, explains why LPs hunger for more exposure

As private debt reaches maturity, more and more new asset managers are entering the market, vying for a limited – but growing – pool of LP capital. With so much money going into different direct lending strategies, can the asset class maintain its appeal among investors looking to commit additional resources? Antares Capital's Vivek Mathews thinks it can.

Q Do mid-market loans remain an attractive asset class? Why?

The short answer is yes. The surge of capital coming into the mid-market loan space may have narrowed the gap on some metrics that underscore the appeal of the asset class; but the mid-market loan space is still comparatively attractive.

There are a few reasons why investors find the mid-market senior loan space alluring: high risk- adjusted returns relative to most other asset classes, portfolio diversification benefits and floating interest rate exposure.

Q How do mid-market loans compare to the broadly syndicated loan market?

Mid-market loans typically offer a yield premium versus broadly syndicated loans. Many buy-and-hold institutional investors are happy to trade liquidity off for higher yield – especially since liquidity has dried up in times of crisis when it's most needed.

According to Thomson Reuters LPC, the average mid-market loan yield premium over broadly syndicated loans narrowed to 0.7 percent, as of August, versus an average of 1.06 percent in the first half of 2018, and a long-term average of about 1 percent – but the premium remains.

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Q How does the volatility of mid-market loans compare to other debt investment options?

Mid-market loans typically exhibit lower volatility reflecting their floating rates (eg, lower duration risk), seniority in the capital structure and the buy-and-hold nature of the mid-market loan investor base. Their yield premium, combined with this lower volatility, account for mid-market loans' historically higher Sharpe ratio versus broadly syndicated loans and high yield bonds.

Q How do mid-market loans perform in downside scenarios compared with broadly syndicated loans?

Senior mid-market loans have experienced lower default and higher recovery rates historically mainly due to more lender friendly terms and structure, lower leverage and seniority in the capital structure. Default rates remain quite low and recovery rates for mid-market loans are still higher than in the broadly syndicated market, through the first quarter of the year, according to recent LCD data.

Q Are there any risks that mid-market loan investors should keep their eye on?

Looking forward, investors have become increasingly wary about looser terms – such as covenant-lite – and higher leverage bleeding down into the mid-market. While this is clearly a valid concern, it's important to note that cov-lite is still much less prevalent and leverage is still lower in the mid-market versus the broadly syndicated market for large corporate issuers.

Also, equity contributions as a share of LBO financings have been rising over the last several years to the 45-55 percent range for the mid-market as of the second quarter versus about 35 percent for large corporate issuers.

Q Do mid-market loans help investors diversify their investment mix?

Mid-market loans continue to offer portfolio diversification benefits and are particularly attractive in the current rising-interest-rate environment given their floating-rate structure.

In a recent piece entitled: "The end is near for private credit, right?", Hamilton Lane's global head of private credit, Drew Schardt, says: "The data suggests that heading into and coming out of an economic cycle is when private credit crushes it." He notes floating rates, downside protection and risk mitigation as factors that help generate outperformance. That said, history has shown a wide dispersion of performance among lenders.

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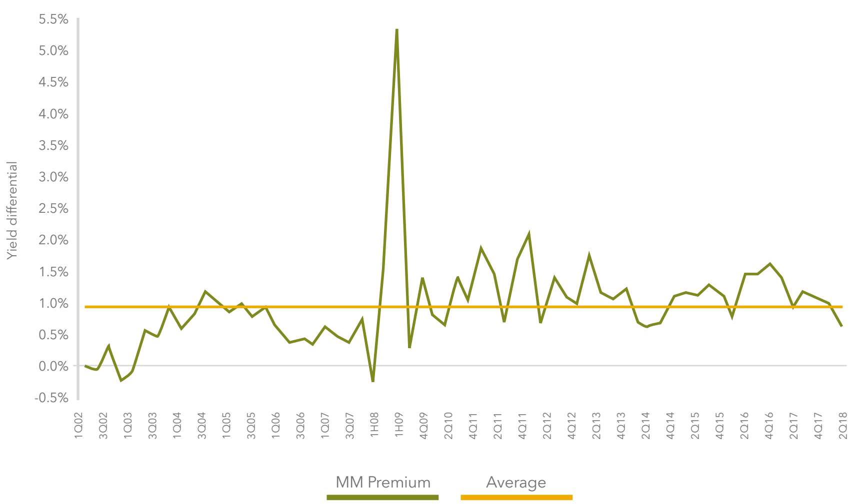
MIDDLE MARKET YIELD PREMIUM



Source: Thomson Reuters

Clearly, it is ever more important for investors to align with the few seasoned managers that have a track record of success across cycles and the scale – in terms of origination capabilities and portfolio size – necessary to allow them to be selective in the current environment. Scale should also include dedicated workout capabilities that enhance recoveries where issues do arise.

Q Private credit has seen an influx of LPs seeking a better risk-return profile. Are there now fewer new LPs that could potentially enter the asset class?

There is still a large, untapped LP base for private credit. Many LPs are new to the asset class and have no exposure. Most of those that do have exposure are looking to increase it. According to *PDI*, only around 45 percent of investors surveyed had an active mandate for investing in direct lending funds coming into 2018.

On *PDI*'s latest count, there are 2,300-plus institutional investors actively investing in private debt or planning to. This number increased by 200 over 2017 and is up 800 since 2016. Looking forward, the majority of the private debt investors *PDI* surveyed in September 2017 said they planned to increase or maintain their allocations in the next 12 months.

Q Private debt now has a lot of dry powder. How does this compare with the level of unused capital in private equity?

While direct lending dry powder has been growing along with the broader asset class, the ratio of direct lending dry powder targeting North American private equity dry powder has actually been pretty stable over the last few years.

In addition, future loan demand implied by high amounts of private equity dry powder looks favorable relative to mid-market loan volume. According to Pitchbook, North American private equity

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dry powder was $553 billion in 2017 – up from $500 billion in 2016 and $463 billion in 2015. Granted a 55:45 debt-to-equity ratio, this would imply future North American private equity-related loan demand of $675 billion – a large portion of which would be aimed at the mid-market. By comparison, Thomson Reuters LPC data shows an annual run rate of US new money mid-market loan issuance, including private and club loans, in the $125 billion-$140 billion range since 2017, up from $90 billion and $74 billion in 2016 and 2015, respectively.

Q How does the growth of private credit's deal pipeline look?

Of course, there will be cycles, but the secular growth case continues to look appealing – particularly in the sponsored mid-market space where we play. According to Pitchbook, there are almost 7,750 private equity-backed companies in the US across all sizes and nearly 200,000 "mid-market" businesses. with revenue in the $10 million-$1 billion range, according to the National Center for the Middle Market.

This would seem to suggest there is still plenty of room for growth in the sponsored mid-market. Meanwhile, according to *Pitchbook*, it is estimated that 10,000 baby boomers retire every day, with one US Census Bureau report estimating that most baby boomers will be of retirement age by 2029. We believe this will provide private equity sponsors with new deal sourcing prospects from smaller, family-owned businesses that will require funding in the future.

Q What transaction type have you seen the most of this year?

The year started off with a lot of refinancing and repricing activity, but M&A-related volume picked up sharply moving into the summer months. By the end of the second quarter of 2018, Antares' total open deal pipeline was up over 20 percent year on year. One change we saw in May and June was a shift to more investor-friendly terms, with spreads flexing wider and terms tightening for some deals due to a surge in loan supply.

Spreads have widened by 25-50 basis points, and the current in-market calendar is made up primarily of leveraged buyout and M&A-related financings, with re-pricings recently much less prevalent. Whether this marks a sustained shift in the market, or is more of a temporary occurrence, has yet to be determined, but normally there is a pick-up post Labor Day.

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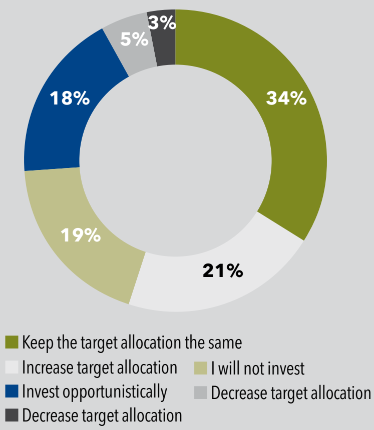
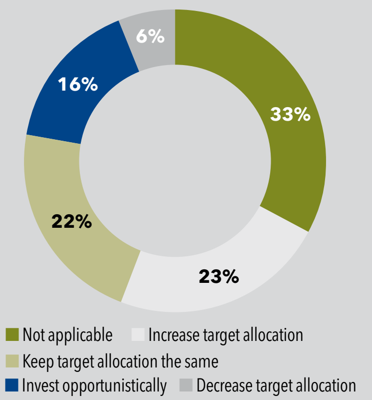
HOW DO INVESTORS PLAN TO ALLOCATE TO THE FOLLOWING ASSET CLASSES OVER THE NEXT 12 MONTHS?



REGARDING PRIVATE DEBT, HOW DO INVESTORS PLAN TO ALLOCATE TO THE FOLLOWING STRATEGIES OVER THE NEXT 12 MONTHS?



Source: Private Debt Investor, Annual LP Survey 2017

Q What is the best source of dealflow for credit managers at this point in the cycle?

We think it's important to have the scale and strong origination capability to be in a position to see and potentially lead all the deals out there that are in one's strike zone so as to avoid adverse selection, particularly late in cycle. It's also critical to have a large portfolio of vetted credits as a source of incumbent dealflow, particularly with the significant growth in add-on activity seen in recent years. ■