Q&A: Antares Capital's David Brackett & John Martin

David Brackett

Dave is a managing partner and co-CEO of Antares Capital. He is a member of Antares' Investment Committee as well as Antares' Board of Directors.

Previously, Dave served as president and CEO for GE Antares. He was a founding partner when Antares was formed in 1996. Prior to starting Antares, Dave was a senior executive with Heller Financial.

He began his career at Continental Illinois National Bank. Dave graduated from the University of Denver, and earned an MBA from Northwestern University's Kellogg Graduate School of Management.

John Martin

John is a managing partner and co-CEO of Antares Capital. John is a member of Antares' Investment Committee as well as Antares' Board of Directors. He was a founding partner when Antares was formed in 1996.

Previously, John was the leader of GE's Global Capital Markets. He also served as president and CEO for GE Antares. Prior to forming Antares, John was a senior executive with Heller Financial.

He began his career with Continental Illinois National Bank. John earned his BBA in finance from the University of Notre Dame.

Amid an active yet pricey dealmaking environment for PE firms, what key trends in the lending market for US middle-market companies will be most impactful in 2018?

The capital markets for loans remain wide open for business with favorable pricing and terms. This is perhaps a mixed blessing for middle-market PE firms looking to do deals. On the positive side, favorable capital markets foster deal flow and allow PE firms to bid competitively against strategic competitors who are increasingly flush with cash. We are seeing increased repricing/refi activity, which had already boomed early last year in the broadly syndicated market, but has become more prevalent of late in the middle market. Meanwhile, terms continue to loosen and spreads to narrow. Of course, on the negative side, easy access to capital has also contributed to the rise in LBO purchase price multiples that are making it increasingly difficult for PE investors to hit their return targets. Consequently, PE firms have been increasingly turning to add-on acquisitions as a means of averaging down their purchase price multiples and/or increasing platform value creation opportunities.

While our working assumption is that capital market conditions will remain favorable, as history has demonstrated, the window can close quickly if markets get spooked for any number of reasons. This is why we, as a lender, feel it is critical to be able to offer our sponsor clients multiple financing solutions that allow for the best execution in any market condition whether that entails leveraging our deep capital markets distribution capabilities, private club deal networks or unitranche execution capabilities (e.g., Antares Bain Capital Complete Financing Solution (ABCS)).

One of the broader macro trends we've seen in PE dealmaking has been the popularity of secondary buyouts. With regard to helping finance these transactions, what's Antares' perspective on their benefits and challenges?

Sponsor-to-sponsor activity has picked up over the last few years, reflecting pressures to put dry powder to work on the buy side and desire for sponsors to exit aging investments on the sell side.

Sponsors have increasingly been fishing for deals in each other's portfolios because they know potentially promising companies will come up for sale in three or more years. This allows them to focus early due diligence efforts and potentially improve their bidding position when auction time comes—or perhaps even preempt the auction process. In fact, often sponsors that lost out in the initial auction may bid again the next time the company comes up for sale, having already done the initial due diligence and found the business attractive. We even see cases where the sponsor owned the company before and is buying it again.

PitchBook stats show over 50% of middle-market exit volume being secondary buyouts, which appears to be directionally in line with what we see. Also, a large proportion of our SBO volume is related to companies already in our portfolio, which underscores the competitive advantage that comes with having one of the largest sponsored middle-market loan portfolios in the industry.

From a lender perspective, while every deal is unique, as a generalization, SBOs are viewed favorably since the credit is usually seasoned and well-understood with a track record of revenue & EBITDA growth. However, one must scrutinize EBITDA add-backs and add-forwards in the context of the next sponsor owner's phase 2 or 3 of value creation, as much of the low-hanging fruit has likely already been picked by the original sponsor owner.

Recently, it appears that cov-lite incidence varies widely across different segments of the market. What trends in covenants are you seeing across the US middle market? What other important trends in structuring are you tracking?

Covenant-lite structures, which have traditionally been common in the large corporate/broadly syndicated loan market, have increasingly penetrated into the sponsored middle market, rising from 9% of sponsored middle-market issuance in 2016 to 26% in 2017 and to 37% in 4Q 2017. Traditionally cov-lite was rare for companies in the sub-$50 million EBITDA range, but now it is more common in the $40 million-$50 million zone.

While covenants are important to lenders to help mitigate potential losses, historically, lender success has been more reliant on picking solid credits than enforcing convenants. In our case, the vast majority of cov-lite deals we've done in the last year or so have been with portfolio companies whose credits we know well.

Of course, EBITDA add-backs and add-forwards and loosening of other terms (e.g., around restricted payments and incremental debt capacity) are other important areas of challenge for lenders in the current environment.

As Antares' most recent Compass Report details, leverage levels remain a significant area of concern for many. How are these concerns best mitigated in the current environment by firms such as Antares?

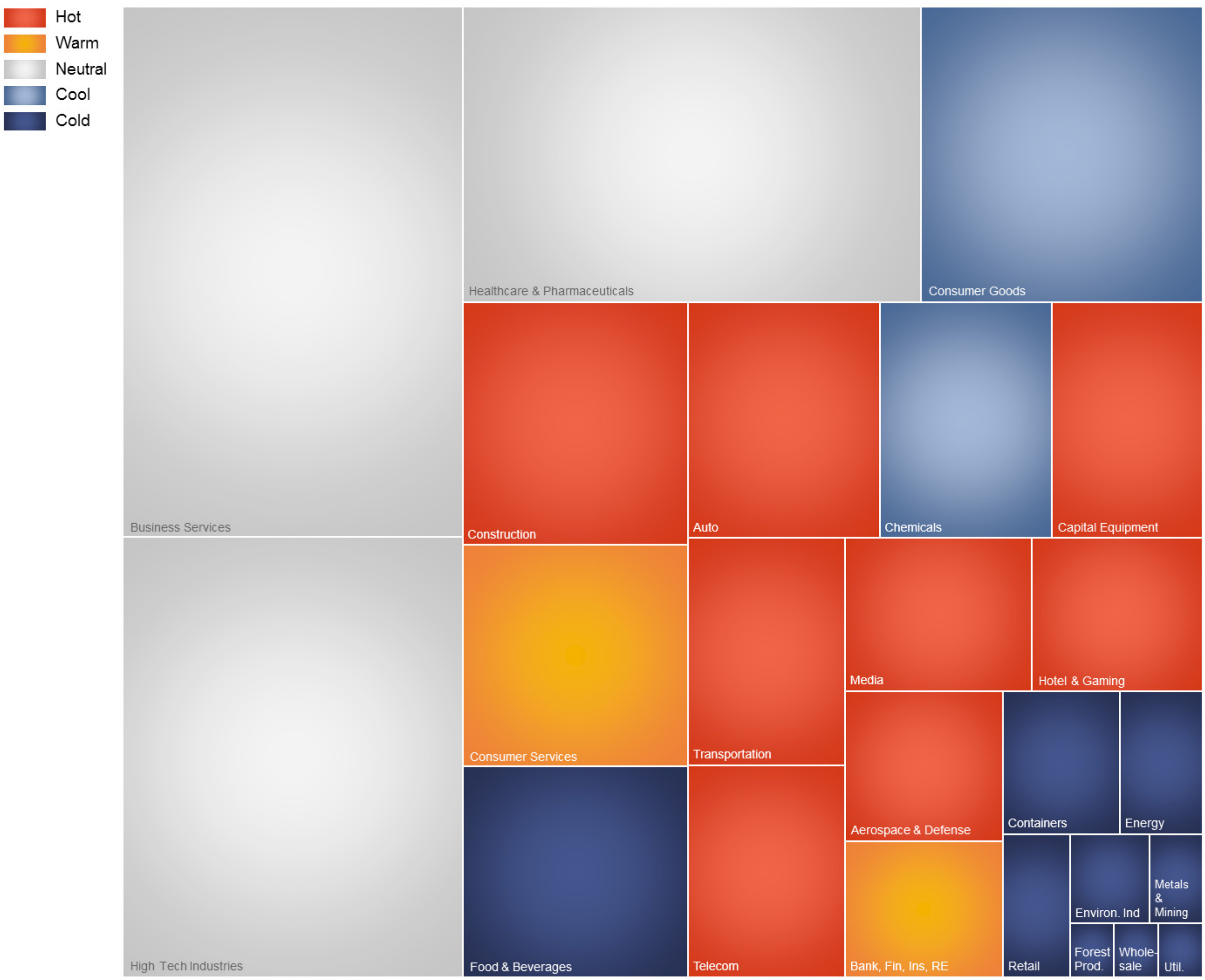
While leverage levels have crept upward on middle-market LBOs in terms of debt to EBITDA, they remain below broadly syndicated deal levels, particularly in the private/club deal market. Also, equity contributions to middle-market LBOs have risen meaningfully along with enterprise valuations. Finally, debt service measures remain favorable given low interest rates. Of course, if interest rates were to spike, that could change, but in general leverage levels do not seem unreasonably high. Also, there may well be exceptions where unrealistic EBITDA add-backs/add-forwards mask true debt leverage. The best way to mitigate the issue of rising debt leverage is credit discipline gleaned over decades of experience through various cycles. Its also critical to long-term performance to have solid work-out capabilities to mitigate losses whenever the downcycle does come—a capability many new lending entrants lack.

With regard to recent evolution in adjustments of earnings and other similar measures, how significantly are such changes affecting overall leverage levels?

EBITDA add-backs and add-forwards have become increasingly prevalent and can have a material impact on leverage measures. Some claim that regulated lenders have used such add-backs as a way to be able to get around leveraged lending guidelines (LLG). There are various firms (e.g., Covenant Review; Proskauer) that report on EBITDA adjustment measures. For example, in its 2017 report, Proskauer shows an upward migration in deals toward the high end of the cap range for run-rate synergies. Specifically, 85% of the deals it tracked in 2H 2017 had a cap on run-rate synergy expenses of between 20%-29.9% (the higher end of the cap range) versus 58% of deals in 1H 2017. Likewise, the cap on non-recurring expense has also been trending higher, as has been the percentage of deals with no cap.

M&A Heatmap: Antares Capital's M&A loan activity deal count by industry trend[1]

M&A activity cooled modestly the last four months through March 2018 versus the prior four months through November 2017, largely reflecting sluggish activity in January and February 2018; however, activity picked up sharply in March, and the open pipeline in April (not reflected in heatmap) is also up year over year, with high-tech industries (including software and services) heating up recently.



1: Compares Antares Capital's M&A-related funded and lost deal count in trailing four-month period ending March 31, 2018, versus four-month period ending November 30, 2017. Does not include open pipeline. Size of box is proportionate to deal count. Color indicates whether activity heated up or cooled down during periods compared to. Moody's-based industry categorization.