Striking a balance

The US market may be crowded, but not all managers are being drawn to non-sponsored deals and niche strategies. **Timothy Lyne**, senior managing director and head of the asset management group at Antares Capital, makes the case for sponsored senior debt

Q Do you think the market is getting crowded and, if so, what do you think are the major factors behind this?

TL: The short answer is yes, many managers have been attempting to enter the sponsored space over the last few years. But we believe sponsored credit is still a great place to be. Rising institutional investor interest in private debt has funded new entrants to the direct lending mid-market. However, we are seeing new entrants most active in two places: first, leading transactions that market incumbents decline and second, purchasing portions of incumbents' lead-left transactions that they choose to distribute.

In the sponsored mid-market credit space, long-term relationships among sponsors and a small group of incumbent direct lenders create high barriers to entry. In our last survey of over 200 private equity sponsors, we asked them to describe the three primary factors that are most important in choosing a financing partner. The top three responses were relationship, price and consistency – with relationship being the most frequently cited response.

Timothy Lyne

"IN THE SPONSORED MID-MARKET CREDIT SPACE, LONG-TERM RELATIONSHIPS AMONG SPONSORS AND A SMALL GROUP OF INCUMBENT DIRECT LENDERS CREATE HIGH BARRIERS TO ENTRY"

Sponsors value incumbents who can move quickly, are consistent in their credit behaviour and have demonstrated a track record of reliability, both at initial closing and with post-close acquisition financing to support platform growth. This is a very common investment thesis in today's high private equity purchase price environment.

So yes, we are seeing new entrants at the margin of what we do. But that is not materially impacting the competitive landscape in the core mid-market, which remains very clubby and long-term relationship driven.

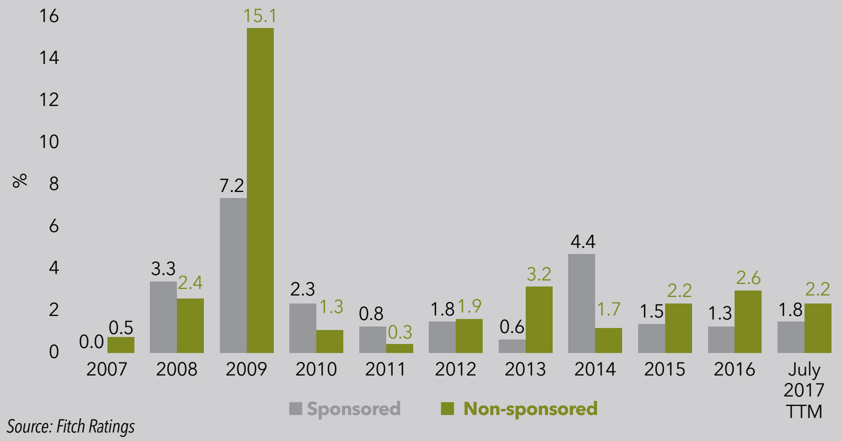
Q More private debt managers are pursuing non-sponsored deals. Have you been tempted to pursue this strategy?

TL: No. Our view is that non-sponsored private debt is a higher risk strategy that is not adequately compensated, and it is only becoming more competitive as managers find they cannot sufficiently penetrate and deploy capital into the sponsored market.

Similarly, in the current private equity environment, we are seeing some sponsors come down market, and believe what used

CALCULATING RISKS

The non-sponsored leveraged loan default rate was more than double the sponsored default rate at its peak of 15% through the last recession



Source: Fitch Ratings

to be top tier non-sponsored borrowers are now becoming private equity owned earlier in their growth cycles. Through the last recession, we saw non-sponsored company default rates peak at 15.1 percent versus 7.2 percent for sponsored – so more than double – according to Fitch.

So now is not a tempting time for us to pursue a non-sponsored strategy.

Q Are there any sectors, or strategies, where you think competition is greatest?

TL: We see greater competition at the bookends of our business, not the core. This relates back to the inability of most new entrants to directly source the top tier credits in the core mid-market. The majority of new entrants are investing where they can get access, and that typically means buying into upper mid-market deals, which have seen greater pressure on price and terms. Or that could mean directly originating lower quality credits in the sponsored or non-sponsored markets that incumbents have chosen to decline.

Absent unique circumstances, most sponsors are not going to replace an incumbent lender who they have worked with, or who perhaps has worked with the borrower's management team, for many years. The incumbent lenders have information, speed and consistency advantages over new entrants.

And sponsors don't typically choose to inject financing risk into their portfolio investments with a new entrant lender. When they do accept this risk, it is not typically by choice – and instead because incumbent lenders have declined financing for credit reasons and they must turn to alternatives.

Many new entrants have recently raised a lot of capital they need to invest, and they are finding it difficult to deploy. They are faced with the unenviable choice between continuing to sideline that capital or stretching their credit box for promised yields at higher risk points. The latter choice is more difficult for investors to identify. And many new managers today are hoping that investors won't identify the higher risk the managers are choosing. They're effectively making a bet on a continued low default environment over the next three to five years.

"IF A MANAGER DOES NOT HAVE DEFENSIBLE, SUSTAINABLE SOURCING ADVANTAGES, THEN THEIR PORTFOLIO PERFORMANCE IS MUCH MORE EXPOSED TO CAPITAL SUPPLY AND DEMAND IMBALANCES AND CREDIT CYCLES"

Q Some firms claim there is a supply and demand disconnect in the mid-market. Is there enough senior debt capital being raised to meet borrower demand?

TL: We have seen a material increase in the level of senior-only and unitranche direct lending in the sponsor mid-market space, and fewer senior and mezzanine financing structures utilised.

Two key factors behind this increase – going back to our high purchase price multiple environment – are speed and post-close flexibility. At close, sponsors value working with a single known lead-left

SPONSORED DEBT

agent that can solve the entire debt capital structure, and not waste time mediating inter-creditor issues among senior and junior financing providers.

Secondly, and perhaps more importantly, sponsors value the financial flexibility of all-senior and unitranche capital structures to make further material acquisitions and other investments critical to their investment thesis, without costly call protection that mezzanine lenders typically seek. Mezzanine works better in a buy-and-hold private equity environment. And, today, we are mostly seeing buy-and-build where mezzanine is a less attractive financing solution.

Q What do you see as the biggest risks for a manager that chooses to pursue a senior debt strategy?

TL: We believe the biggest risk for a manager pursuing a senior debt strategy is its ability to repeatedly source top tier credits in all market environments. If a manager does not have defensible, sustainable sourcing advantages then their portfolio performance is much more exposed to capital supply and demand imbalances and credit cycles.

The pendulum of covenants and credit terms swings back and forth, and presently, it leans more in favour of borrowers. But credit terms – tight or loose – can't save any manager from a poor credit decision. This is why it's extremely important for institutional investors to look past the headline 'selection statistic', where essentially every manager claims to be highly selective and do a single-digit percentage of the opportunities they review.

Prudent investors go to the next level and require a deeper understanding of the review and selection process. Did the manager decline those deals for documented credit reasons or were they actually never in the running to win that opportunity? How does the credit profile of the deals they declined compare to those they won? Are credit standards consistent over time or ebb and flow with capital supply and demand?

450

Number of unique borrowers within Antares' portfolio

Q Do you think challenges facing the private debt market are purely about the cycle and will managers need to work harder to generate returns?

TL: Yes, managers will need to work harder to generate returns. Certainly we appreciate that we are a long way into the economic recovery, and that factors into financing structures and terms we are willing to accept. But we are not looking to time cycles at Antares; instead we are highly focused on choosing top tier credits on a daily basis.

Antares continues to retain its league table position in the sponsored mid-market space not by standing still and being content. We're constantly striving for year over year improvement – and that's with the existing advantage of a large portfolio of approximately 450 unique borrowers, the majority of which we are lead-left agent. Even with this incumbency advantage there is a lot of hard work across our more than 300 investment professionals and employees. We appreciate the difficulty and discipline required around this, and expect that it is an even more challenging task for a smaller manager that's only been operating in the private debt market a few years.

"THE KEY DRIVER OF HIGH SUSTAINED ACTIVITY HAS BEEN AN IMPROVING GLOBAL ECONOMY, A FLOOD OF DOLLARS INTO PRIVATE EQUITY, LOW DEFAULT RATES, AND CONTINUALLY CHEAP FINANCING COSTS"

Q Do you expect the capital markets rally following the US election to wane given the uncertainty of tax reform or infrastructure spending?

TL: The market appears to have been moving largely independently of tax and infrastructure. There may have been a little initial euphoria, but most observers now have lowered their expectations for any sizeable tax reform or infrastructure spending. And many are likely not baking such optimistic assumptions into their financial projections underlying the purchase price multiples they are willing to pay. The key driver of high sustained activity has been an improving global economy, a flood of dollars into private equity, low default rates and continually cheap financing costs.

Q More fund managers are entering the market but many LPs are looking to reduce the number of GPs relationships. Does this concern you?

TL: No. We understand LP interests in diversity across managers in a given strategy. But we also understand that once an LP decides they have sufficient comparable experience and has found a long-term, reliable partner, they will consolidate managers and use their pricing power.

The key to this decision relates to the biggest risk to a manager we discussed earlier: can the manager continue to prudently invest the additional capital without changing their credit box or investment strategy, in all market environments? No doubt this trend will be concerning for many managers, particularly the many managers who are not directly originating their own investments today. ■