

Although the economy likely to power ahead through 2021, headwinds appear to be rising

Antares Capital Keynote

On track for a strong 2021...

In H1 2021, middle-market loan volume for PE-backed companies of \$73 billion was up 60% YoY and is on pace to about match near-record 2017 levels, according to Refinitiv LPC data. Although volume is still trailing the 2018 peak of \$183 billion, annualized deal count of 1,302 in H1 2021 is on pace to edge 2018 peak levels. Meanwhile, direct lenders continue to grow their volume beyond the bounds of the middle market, with “large corporate” unitranche volume—above middle-market revenue or deal size of \$500 million—hitting a record level of \$10.6 billion in Q2 2021.

...But risks of COVID-19 waves and other potential headwinds linger

At the time of this writing in mid-August, a still-massive flood of liquidity will likely continue carrying the tide of favorable economic and earnings growth momentum through the balance of 2021; however, the range of visibility ahead has grown cloudier. The Delta variant surge currently slowing the pace of the reopening progress across most states will hopefully begin to ebb if the US follows the UK’s pattern, especially given the recent FDA approval of the Pfizer vaccine, but the possibility of new vaccine-resistant variants emerging remains a real threat. Also, while the Delta variant may temper “hot demand”-related inflation (e.g., witness the sharp drop in the University of Michigan’s consumer confidence in August), inflation nevertheless remains a concern as the virus continues to plague supply chains, particularly abroad. Meanwhile, Federal Reserve System tapering and the prospect of rising taxes are coming into focus as 2022 approaches. Add to this a potential escalation of geopolitical tensions, a looming debt ceiling standoff, and ever-rising cyber security threats, and one thing is clear—the future remains uncertain. Some say bull markets like to climb a wall of worry. If so, it appears markets have plenty to feed on.



Tim Lyne

Chief Operating Officer
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Lyne is a founding partner of Antares. He is responsible for leading the company's sponsor coverage, capital markets and enterprise risk activities, as well as the operations and technology functions.

Lyne is a member of Antares' Investment Committee.

Q&A with Tim Lyne, COO

What trends are you seeing in terms of deal activity, and do you expect those trends to continue?

Antares' deal pipeline is robust, having risen pretty steadily to mid-August highs not seen since the peak levels of Q2 and Q3 of 2019. Activity has picked up broadly across most sectors. Our top four industry exposure areas—business services, healthcare, technology, and financial services—are collectively up sharply YTD-July 2021 when compared to the same periods in 2020 and 2019. Our tech-related funding activity has seen strong growth and has led in terms of our LBO and add-on specific volume YTD-July. We have also seen an uptick in somewhat more cyclical areas such as consumer goods, construction, and transportation, although these are smaller areas of exposure for us.

Our pipeline tends to provide good visibility on deal volume out about one to two months, suggesting a strong Q3 likely followed by an active Q4, as sellers rush to close deals ahead of possible 2022 capital gains tax hikes. In Refinitiv LPC's 3Q21 Middle Market Lender Survey, 85% of direct lender respondents noted they expect a rise in H2 2021 M&A lending activity, compared to H1 2021.

Q&A: Antares Capital

What has been happening with competition in terms of spreads, leverage, and deal terms?

While deal activity has been booming, competition has also heated up as capital has been attracted back into loan markets with spreads and terms largely back to pre-COVID-19 levels. According to Refinitiv LPC data, spreads on first lien loans in the US-sponsored middle market (direct lending and syndicated combined) ticked up slightly from Q1 2021 to 520 basis points in Q2 2021 but remained only modestly above pre-pandemic spreads around the 495 basis-point range in Q4 2019 and Q1 2021. Leverage on middle-market LBOs (direct and syndicated combined) climbed to an average of 5.0x in H1 2021, compared to 4.4x in 2020 and 4.9x in 2019; however, equity share of purchase price multiples also rose to 6.9x in H1 2021, compared to 6.5x in 2020 and 6.35x in 2019, leaving loan-to-value ratios still reasonably attractive. Also, improving EBITDA should lead to downward pressure on leverage and purchase price multiples. Covenant-lite rose to 10% of syndicated-sponsored middle-market loan volume in Q2 2021, compared to 6% in Q1 2021, but this was still modestly below the 12% to 13% range seen between Q4 2019 and Q1 2020 and well below the Q4 2017 peak of 37%. Still, cov-lite has been creeping into the non-syndicated direct lending middle market, including unitranche deals. There has also been some increased flexibility regarding acceptance of EBITDA add-backs, including COVID-19-related add-backs where the rebound has been validated out. Delayed-draw term loans have also grown in size and terms have become more aggressive.

On balance, we still see attractive deals from a risk/reward perspective but remain selective, doing only a low, single-digit percentage of the new borrower deals we see—in fact, a slightly smaller percentage in H1 2021 than we did on average over the 2019 to 2020 period. We also benefit from a position of incumbency in terms of deal flow from our large middle-market portfolio of around 475 borrowers that we know quite well. More than 75% of the deals we have done YTD-July have come from within our portfolio.

What impact is the Delta variant having on borrowers? Are defaults likely to rise?

Select industries such as aerospace, travel & hospitality, fitness, and clothing/apparel remain challenged as the Delta variant has slowed reopening and normalization efforts. It is possible defaults could tick back up moderately in the months ahead for some of these sectors as well as others, particularly if the virus' impact lingers or worsens. Default rates have dropped to a

remarkably low level of just 0.47% as of August on an LTM basis for the S&P/LSTA leveraged loan index. By LCD's measure, which does not include distressed exchanges, the leveraged loan market has remained default-free for five straight months through July. However, in LCD's most recent loan investor survey as of June 2021, the average respondent expected the loan default rate to rise to 1.77% by mid-2022—52 basis points higher than the default rate at the time of the survey. While this is still a relatively low default rate, it is clear not all companies are out of the woods.

On the positive side, the software segment continues to benefit from accelerated adoption of digital products and services that have progressively become key to competitive success, particularly for distribution, consumer goods & retail, and automotive-related sectors.

What about inflation? Are companies in your portfolio facing labor shortages?

We have been closely monitoring cost inflation in our portfolio across sectors. Raw material costs have been the most prevalent concern, followed by labor shortages, supply chain bottlenecks, and freight costs.

Fortunately, although raw material input prices remain generally high, some are beginning to normalize to historic levels. Also, many industries—including consumer goods & retail, environmental, and chemical—that have been experiencing raw material increases have generally been able to successfully mitigate these through price increases; however, some industries such as containers & packaging, capital equipment, and manufacturing may be prone to experiencing time lags due to their ability to pass through price increases.

On the labor cost front, some pressure has been building, particularly in skilled industries. Transportation and logistics costs have also risen across many sectors, given both international and domestic supply chain bottlenecks.

We expect the US economic recovery will continue to power ahead, and that inflation will ebb throughout the year as supply catches up with demand. However, unfavorable COVID-19 developments and/or the potential for policy missteps could lead to unwanted outcomes. These include a possible sharp economic growth slowdown or even contraction, as a recently flattening yield curve might suggest, or an inflationary scenario as supply chains are hit. Solid credit discipline and underwriting remain as critical as ever.

Strength is in selectivity.

While lingering and potentially new COVID-related challenges remain, certain trends indicate a continued return to pre-COVID levels is ahead. In this issue's Q&A, Tim Lyne, COO, Antares, offers our expectations for the remainder of the year, not just as they relate to the broader middle market but also our own portfolio and deal pipeline.

Read the full Q&A in this issue.

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