KEYNOTE INTERVIEW

Taking the temperature of the market

Antares' Compass surveys give a detailed snapshot of the private debt market. The firm's chief executive, David Brackett, discusses the conditions facing investors today

Q This year, Antares' Compass survey suggested a fair share of borrowers were concerned about the prospects of a recession. Are you seeing any signs of a slowdown or cracks in the portfolio?

Our portfolio, which is one of the largest and most diversified in the middle market, continues to perform well. Credit metrics, including loss, default and non-earning trends, remain favourable and watch-list balances are low/stable, and down somewhat of late as a percentage of total assets. This aligns with what we're seeing in the markets with the S&P/LSTA leveraged loan Trailing Twelve Month default rate at a seven-year low of 1 percent in May. That said, certain flagging macroeconomic indicators, including ongoing trade tensions, suggest growing reasons for concern about the prospects for growth over the next 18 months. Fortunately, recent warning signs have not been lost on the Fed which has pivoted from planned interest rate hikes to cuts.

SPONSOR

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Q What have you been seeing in terms of M&A? The Compass survey suggested activity would be down modestly in 2019. If that is so, is there a danger of too much capital chasing too few deals?

Middle-market M&A and related loan activity has suffered so far in 2019 from the fallout of the 2018 year-end stock and loan market swoon, as well as increased economic uncertainty. In H1 2019, according to Refinitiv LPC, M&A-related syndicated middle-market loan issuance was down 21 percent year on year. So, supply has fallen but demand appears to be down too.

In H1 2019, according to LCD/Lipper, there has been $18 billion of net loan mutual fund and ETF outflows versus $8 billion in inflows in H1 2018. CLO issuance is down $4 billion, although middle-market CLO issuance is actually up $1 billion. That said, clearly the market is still generally flush with capital as evidenced by rising purchase price multiples and slightly higher leverage. On the fundraising side, data from *PDI* shows US direct lending fundraising of $16.11 billion in H1 2019, up 10 percent versus H1 2018.

Looking forward, we've recently seen a healthy pick-up in our pipeline following the Fed's pivot to rate cuts and the stock market's ensuing rally.

Nevertheless, on balance, we continue to expect middle-market M&A activity to be down modestly in 2019.

Q The Compass survey indicated an anticipated widening of spreads for the broadly syndicated market in 2019. What do you think accounts for that? What about spreads in the middle market?

Spreads had spiked in late 2018 as the stock market corrected and volatility spiked, no doubt influencing expectations for 2019 at the time of our survey.

However, spreads have since tightened. LCD shows B+/B total spreads having fallen from a spiked level of LIBOR plus 579 in December 2018 to LIBOR plus 424 as at June 2019.

Nevertheless, LIBOR plus 420 is still up versus LIBOR plus 391 in June 2018 and an average of about LIBOR plus 390 for 2018, so expectations of higher spreads in 2019 versus 2018 seem well founded.

Spreads in the middle market have been more stable, but also appear to be up year over year.

According to Refinitiv LPC data, the middle-market yield premium over large corporate yield averaged above 1 percent in Q2 2019, which is in line with the long-term average seen since 2002.

"The odds of a recession have been rising, but interest rate cuts by the Fed may help provide a second wind"

Q What is the significance in the Compass survey of more investors seemingly wanting to change their allocation mix?

There was a modest shift toward more fixed-rate exposure (eg, high yield) versus floating rate loans, which is completely understandable given the Fed's pivot from envisioning as many as three rate hikes in 2019 to now cutting rates.

Such tactical allocation shifts are perfectly normal. However, we believe the secular trend of increasing allocation by institutional investors to private debt markets will continue, as evidenced by *PDI*'s own 2019 *Perspectives* survey, which shows 29 percent of investors plan to increase their private debt allocation target against 12 percent that plan on decreasing their target (with the balance holding steady).

Q Healthcare and tech show up as two industries expected to see the fastest growth in 2019 in your survey. What's driving this growth and, as a lender, what key attributes do you look for in a borrower in these industries?

We've definitely seen deal activity in our pipeline pick back up in these two large segments over the last few months. Both sectors are appealing to private equity sponsors because they offer significant secular growth drivers, opportunities for value creation, and relative recession resistance and high free cashflow (depending on the sub-sector).

Shifting healthcare

Landscape drives opportunity for value creation

BUSINESS MODEL

- Continued shift from 'fee for service' to 'value-based care'
- Perception shift to focus on the social detriments of health (eg, nutrition, housing, transportation)
- Industry consolidation through M&A
- Continued trend towards outsourcing services
- Consumers responsible for greater share of payments (ie, high deductible plans)
- Shift from high-cost to low-cost settings

TECHNOLOGICAL

- Digitisation (eg, electronic medical records/electronic health records, greater analytics to support outcomes, artificial intelligence)
- Increased healthcare IT solutions and applications
- Greater focus on revenue cycle management

CULTURAL

- Serving the growing ageing population
- Generational preference for on-demand services (eg, telehealth, urgent care)
- Refocus on patients as consumers
- Employers' increasing involvement in employees' healthcare
- Work habits and needs of new versus retiring physicians
- Increased demand for treating behavioural health issues

In tech, there is tremendous growth and scalability in software as well as customer stickiness that is very attractive to sponsors. It is one of the largest industries in our portfolio and has been a dedicated area of focus for us. We continue to see increasing dealflow from newer funds exclusively focused on the sector as well as from more established funds that have recently entered the space and expect outsized growth and frequency of fundraising in the space.

Like all of the credits we work with at Antares, we are very diligent with our underwriting within this sector. With software we look for a sticky, highly recurring revenue base (ideally 90 percent-plus). We want strong customer and revenue retention, both on a gross and net basis. Importantly, we look at the retention stats closely to determine how they are calculated when presented to us. Do they include customer down-sells or just outright losses as an example? We want a clear view of the full picture.

We also spend a good amount of time on the end market. You can have a fantastic recurring revenue base, market leading retention, great technology; but if the end market is at risk for any reason, such as consolidation or outright obsolescence in the future, the headline stats of today can rapidly become worthless and that is where you can have real capital risk.

For communications deals, we look at market positioning, customer metrics and cohort analysis around the uptake of increasing services over time, long-term contractual revenue, the strength of infrastructure network, ongoing capex requirement and market positioning.

> *"We believe the secular trend of increasing allocation by institutional investors to private debt markets will continue"*

Q What about healthcare?

In healthcare, in addition to favourable demographic trends, you are seeing business model, technological, cultural and regulatory shifts that offer sponsors opportunities for value creation.

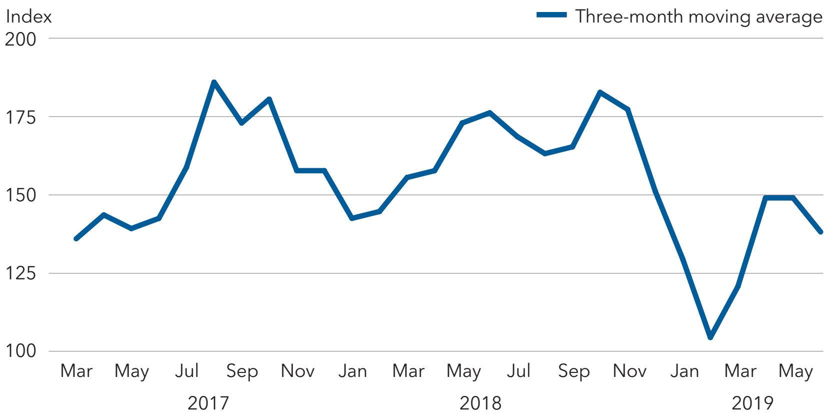
In terms of what we look for as a lender, there are specifics related to the various industry sub-sectors that are too broad to cover here. Healthcare is a very large (circa 20 percent of GDP) and diverse industry ranging from physician practice management to medical devices, healthcare IT, pharma, consumer, and so on. However, in general, areas we find particularly attractive have high barriers to entry and high switching costs (eg, FDA approval, preferred suppliers) and relatively non-cyclical or recession-resistant attributes. Within these sectors, we look for players with an experienced management team, a strong physician-retention strategy, sticky customer relationships and a dominant market share within the geographies they operate.

Q When do you expect the next downturn to come?

While no one can really predict that, it's important to be prepared because what we do know is that it will come. What we see is that the odds of a recession have been rising, but interest rate cuts by the Fed may help provide a second wind for the longest expansion in US history. Regardless, with looser terms, higher leverage and aggressive EBITDA addbacks, now is a time to be especially careful, selective and prepared for the worst. You want to be in a position to take advantage of opportunities when the downcycle inevitably arrives.

Antares has been through many cycles and we have a playbook that identifies how we shift our resources, including people and capital, to best position our business. We have a solid capital base with enough cash on hand and access to additional capital to withstand any upcoming turbulence allowing us to do what we've done in the past – support our borrowers and sponsors as we take advantage of market opportunities resulting from under-capitalised competitors. ■

M&A activity picked up in Q2 2019, according to the Antares Sponsored Middle Market M&A Deal Seen Index



Jan 2017 = 100; based on Antares M&A-related seen deal count (ie, won, lost or passed on); three month moving average
Source: Antares Compass Survey

To view the latest Compass report looking at macro economic indicators and key metrics from the Antares portfolio, visit: https://bit.ly/2OJtMMf