

Special Report: Seizing Opportunities in Private Debt

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Private Credit

Solid returns. Downside Protection. Inflation hedge. Private debt can offer all three – and the current vintage may be the best the industry has seen in two decades. In this report we find out why.

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Overview

As of mid 2023, institutional investors are grappling with an evolving set of challenges stemming from global monetary tightening and its profound impact on the macroeconomic landscape. As worries over supply chain issues fade, investor focus has shifted to more familiar issues like persistent inflation, the possibility of additional interest-rate hikes by the U.S. Fed and ECB, and a potential recession.

Given these headwinds, investors are confronted with a challenge in trying to optimize portfolios to ensure downside protection while also achieving their return objectives. Many investors are therefore increasing their allocations to alternative and private-market asset classes to achieve their portfolio goals, with private debt serving as a demonstrated choice given its resilience and outperformance vs traditional fixed income in a higher interest rate environment. Institutions have long viewed private debt as a go-to vehicle when seeking to gain reliable returns during periods of market turbulence or slower economic growth. Private debt has shown to provide portfolio diversification, a hedge against inflation, and provide downside protection in difficult economic conditions and periods of higher market volatility.

To get a bead on the status of the private debt market in the U.S. and the opportunities it holds for institutional investors, we spoke with **Vivek Mathew**, Head of Asset Management at Antares Capital.

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Q & A With Vivek Mathew, Head of Asset Management, Antares Capital

What's the current status of the private debt market in the U.S.?

Vivek Mathew: The overall private debt market is positioned quite well on a relative basis. It's a difficult, volatile, uncertain time, but the fundamentals and technicals in our industry are strong.

As new public leveraged loan issuance stalls, private credit is attracting larger and higher quality financings with direct lenders being able to capture better economics and terms on new loans. M&A activity has been tepid due to economic uncertainty, but pent-up demand has been building with North American focused private-equity buyout dry powder up 20% in 2022, according to Preqin. Plus, there remain plenty of targets available given still low P.E. penetration – especially once buyer and seller valuation expectations see some convergence. Meanwhile, middle market companies continue to demonstrate their resilience in the face of headwinds. Antares' portfolio companies are continuing to see healthy revenue growth on average and across almost all sectors based on financials available as of the first quarter of 2023. EBITDA is also growing on average, although there is increasing dispersion among sectors.

Private debt has grown rapidly because more investors see the value of having it be part of a core allocation of alternatives, especially given the protection it offers against economic headwinds. In a volatile environment, being first lien in the capital structure provides enhanced protection. And, private debt provides a natural inflation hedge, which is a vital feature for institutional investors.

Is that inflation hedge due to the floating rate offered by private debt?

Mathew: Yes, the floating rate helps protect against valuation volatility vs in other asset classes, like fixed income that are losing value. In private debt, you're participating in these rate increases and getting a higher yield.

But other factors offer protection, as well. For example, private debt tends to focus on industries that are inflation resistant and not cyclical. Secondly, being senior in the capital structure allows you to be repaid first and allows for control of the terms and conditions. And, because we only lend to companies that are owned by private equity firms, we can benefit from potential additional capital support for a troubled company during difficult times.

The fallout from the banking crisis continues. What impacts do you think this fallout will ultimately have on the private debt industry?

Mathew: Overall, the positions that regional banks are currently in are amplifying the technicals in favor of private credit. In the short to medium term, there's obviously a need for credit in the market. Syndicated markets are challenged and there's a general lack of confidence, so more people are looking for a private credit solution. We see private credit

as an important stabilizing force for the U.S. economy in the face of recent regional bank woes.

As for longer-term impacts, I think we will see scale mattering more. Large asset managers and asset gatherers will be more systemically important. Bigger players in private credit will likely continue to get bigger, and some of the smaller players will not be as competitive. From a regulatory standpoint, it wouldn't be surprising to us if more attention is paid as private credit lenders become increasingly important to the credit eco system.

While these issues will affect the private credit industry as a whole, they won't have a significant impact on Antares. As an RIA, we're SEC regulated in many ways, and we have incredibly tight governance requirements from CPP Investments, our majority owner. Additionally, our financial health and strength, and our capital position are key differentiators for us, and we believe these will insulate Antares from many of the challenges stemming from the banking crisis fallout, economic recession, and other adversities that the private debt space may face in the near future.

Speaking of a recession, how do you think a major economic slowdown will affect private credit?

Mathew: We expect a mild recession in the second half of 2023, and we expect losses to increase. But we think the losses will be manageable, especially relative to how investors are getting paid for the risk. Ultimately, for investors in private debt, we believe the compensation from rates, spreads, fees and, ultimately, increased returns will more than offset the increased losses from a mild recession. And this is helped by the quality of the current vintage of private debt which is benefiting from higher yields, better terms, and lower leverage. It may be the strongest vintage we've seen in our 26 years.

But it's important to note that investors won't have an easy glide path to these higher returns, as many have enjoyed in the last several years. With the challenges ahead, we expect to see a significant dispersion in returns, and investors need to pay attention to this.

How can institutional investors achieve the optimal returns in that wider dispersion?

Mathew: Choosing a seasoned manager with proven restructuring capabilities is an important element. Over the last few years, almost everyone in private credit did pretty well, right? But if you look at historical data, the dispersion of returns becomes very big in volatile environments. And in the coming year, we expect to see more defaults, losses, restructuring, and workouts. Guiding companies through these hurdles takes extremely specific skills, and relatively few managers have those abilities.

For example, many firms will say they have strong workout capabilities, but most don't.

Maintaining a workout team in both good and challenging times is a very high fixed-cost option. Managers must make a long-term decision to invest in that and say, “when the time occurs, this team is going to be really valuable.” Firms like ours do that.

As I mentioned, the current vintage of private debt offers the best opportunity that we’ve seen in a very long time. But not every manager will seize this opportunity and hit the return. There’s going to be greater dispersion, and investors need a manager that’s been through a number of cycles and has exceptional restructuring capabilities to achieve the best outcomes.

What do you say to institutional investors who are wary of allocating to private credit due to the denominator effect?

Mathew: Investors certainly think about the denominator effect when it comes to allocating to private markets, and this limits them. Institutional investors may feel that they’re under-invested in alternatives, or they’d like to put more into private markets – but the fear that a drop in their public holdings will leave them over-weighted in private markets prevents them from doing exactly what they want to do.

What investors are asking is, “Despite the denominator effect, does it make sense, given the challenges ahead, to put aside the potential for upside for just a portion of your portfolio and possibly achieve very solid expected returns of 10 to 13%, with a high floor, while being senior in the capital structure?” Rather than swinging for the fences, that’s probably a very prudent thing to do in this environment.

We believe that by allocating to private credit and being senior in the capital structure, you can absorb an awful lot of volatility and defaults and still come out well ahead. Getting a very solid absolute return with a floor in the high single digits is not a bad place to be.

Could you offer a few insights into the strategic positions in the Antares portfolio?

Mathew: Of course. More than 40% of our book is software, business services and healthcare because, as I said earlier, they tend to be non-cyclical and are quite inflation resistant. None are heavy users of commodities, for example. I think the current market environment has generally validated the strategic design of our portfolio, and our experience to-date has shown us that our approach offers protection against both recession and inflation.

Now, where are we seeing some cracks? We’re seeing more challenged deals in industries that have not recovered fully from the pandemic. This includes certain consumers sectors, such as food and beverage. Another is the aerospace sector, which still has supply chain issues. And inventory surplus is also causing weakness in some retail companies, but fortunately for most of the private credit industry, including Antares, is not overly exposed

to these businesses.

What was the most important recent adjustment you made to the portfolio?

Mathew: After Russia invaded Ukraine, we began avoiding companies with heavy exposures to China. As with most managers in North America, we have very limited exposure to Russia or Ukraine. But along with this European war, many people believe that a potential China-Taiwan conflict is one of the biggest geopolitical risks we face, and I agree. We said, “if the Russian invasion provides a reason for China to attack Taiwan, that may lead to an economic conflict between China and the U.S.” So, we stopped looking at companies with a high customer or supplier concentration in China, based on parameters we created. This was an important adjustment for us to make, and I was proud that we made that move quickly.

*Listen to the podcast “**Private credit: A Standout That Stands Under Pressure**” for more insights from Vivek Mathew.*

[Learn more about investment opportunities in private debt.](#)

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Private Debt by the Numbers

[See more market insights from Antares.](#)

Sources

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