ANTARES COMPASS

Charting the Direction of the Middle Market

Antares Capital

MARCH 2018 | 2ND ANNUAL REPORT

A unique, triangulated perspective on the middle market from our portfolio companies, private equity sponsors and loan investors

Antares Capital

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Tailwinds a Blowin'

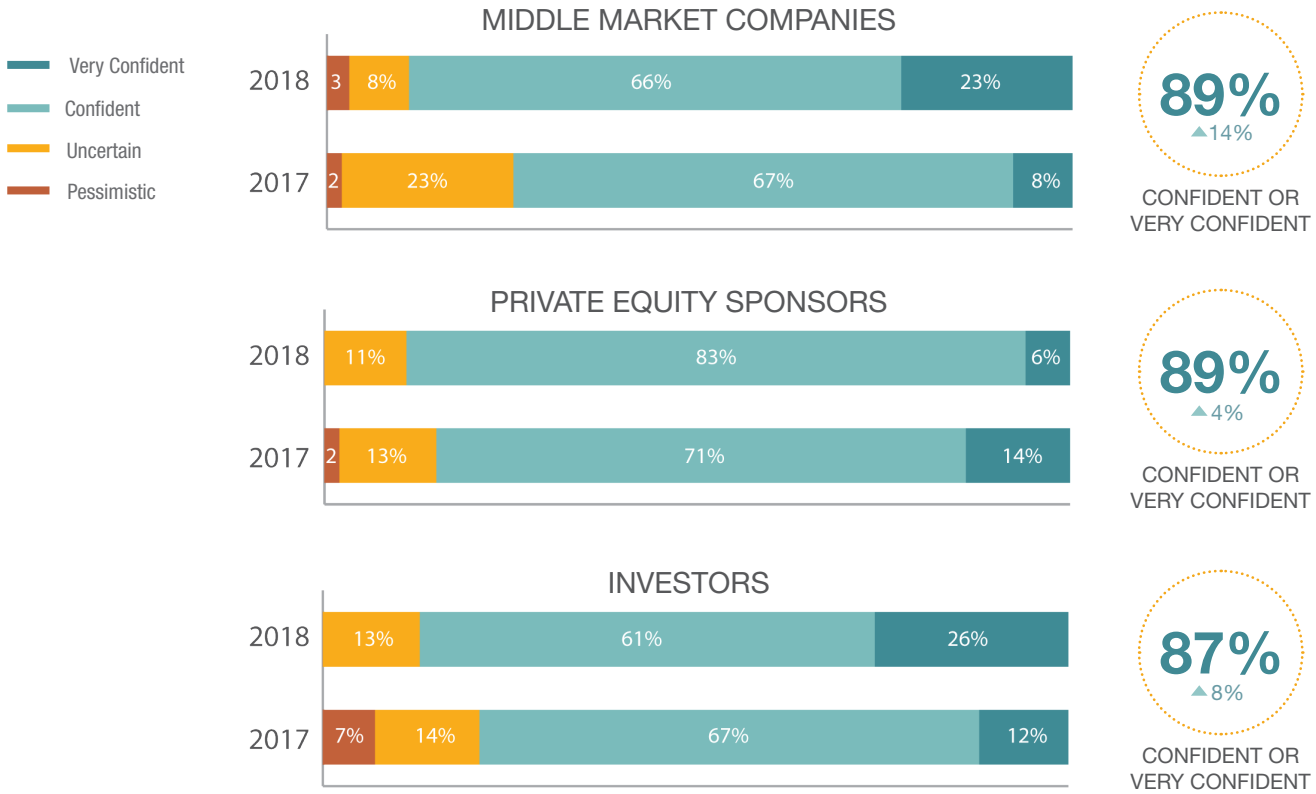
The clouds of uncertainty over the global economy have cleared since our inaugural survey launched post election in January 2017. Meanwhile, optimism over the U.S. economy, which had already been high, has only gained steam. The vast majority believe a recession is unlikely or very unlikely to occur in the next 12 months and default rates are expected to remain low. Companies are forecasting strong revenue and EBITDA growth ahead and are accelerating their hiring. M&A/LBO activity is expected to remain high.

Increased optimism is well founded but can breed complacency as evidenced by rising leverage, lower spreads and looser terms. While middle market loans remain an attractive asset class, credit discipline has become all the more critical.

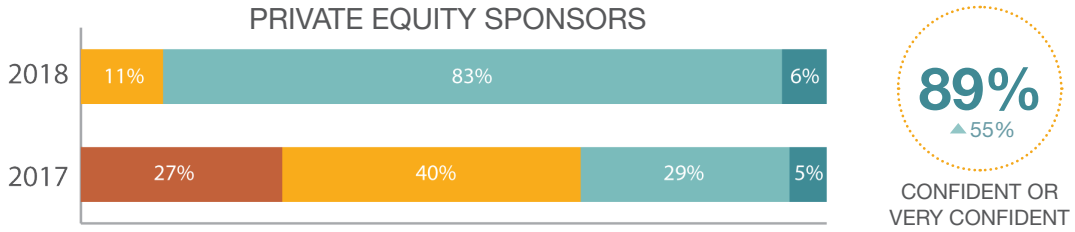
Dave Brackett John Martin

Managing Partners and Co-CEOs

Over the next 12 months, how confident are you in the U.S economy?



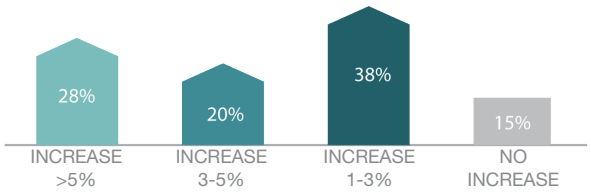
Over the next 12 months, how confident are you in the global economy?



Optimism Strengthens

PE-owned middle market companies are even more bullish about the U.S. economy in the next 12 months than they were a year ago, with almost 90% currently "confident" or "very confident." About three in four see growth in their respective industries versus last year, but the percent seeing "high growth" has risen to 13% vs. 2% a year ago.

Turning inward, companies also are more optimistic about their own financial prospects, with 92% seeing moderate to strong revenue growth and 87% for EBITDA growth vs. 82% and 74% respectively a year ago. However, whether such optimism is realistic vs. aspirational remains to be seen, with 46% having fallen short of LTM budget targets in 2017 and the majority citing competition as their top external challenge.



How do you project hiring will impact your company's workforce in the next 12 months?

Hiring also is anticipated to be a driver of growth this upcoming year — alongside marketing investments — as 85% of companies surveyed expect to grow their workforce in the next 12 months (vs. 62% a year ago). Surprisingly, wage inflation did not rank high on the list of companies' foreseen challenges.

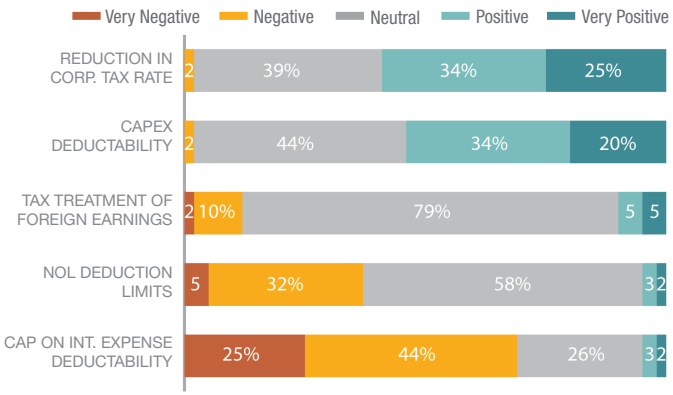
see "strong" 5%+ growth for sales & EBITDA over the next 12 months

Growth in sales to new and existing customers remains the top driver of anticipated EBITDA growth, fueled in part by acquisitions and capex (the #1 and #2 cited uses of excess cash flow). Interestingly, these factors also were listed as top business challenges in the year ahead along with acquisition integration.

Top 5 areas where companies plan to spend excess cash flow (ECF) in the next 12 months:

	ECF Spend	Distributor	Manuf.	Service Provider
1	Acquisitions	21%	25%	22%
2	Capital Equipment	11%	28%	12%
3	Sales & Marketing	26%	10%	20%
4	Hiring Employees	5%	5%	13%
5	IT	5%	3%	10%

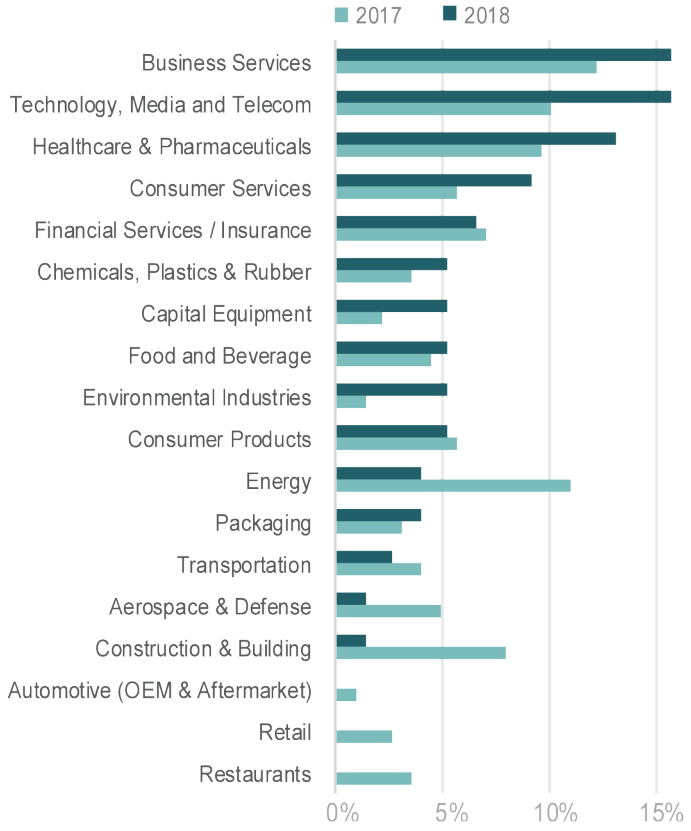
What impact will tax reform have on your company's incremental cash flow over the next two years?



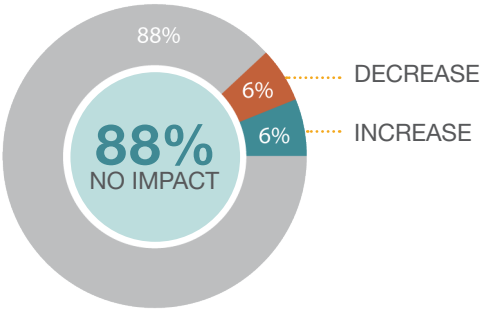
LBOs Seem Unabated

89% of PE sponsors surveyed are confident in the U.S. economic outlook and 83% see a recession as unlikely over the next 12 months – largely unchanged from a year ago. Where views have swung dramatically has been on the global economy, with 83% now confident and 0% pessimistic about the outlook vs. only 29% confident and 27% pessimistic a year ago. Interestingly, even with interest rates rising, 37% plan to leave their portfolio unhedged – flat vs. a year ago.

Which industries do you think will experience the most growth over the next 12 months?



On the industry front, business services, TMT and healthcare remain in the top 5 out of 18 segments with energy and construction falling down the list vs. a year ago. This industry mix aligns closely to Antares' LBO volume growth over the last 12 months.



Do you expect the tax reform to impact LBO activity in 2018?

A majority of sponsors see the new tax law as having little to no impact on aggregate LBO activity, with some commenting that tax cuts may extend the cycle. Most see M&A activity as flat with only 6% seeing M&A as "more active" vs. 21% a year ago. Two-thirds expect to sell either the same or more businesses from their portfolios over the next 12 months. Both financing availability and valuations moved up as key forces driving M&A activity with dry powder ranking as less of a factor vs. a year ago. (Note: 94% view their levels of dry powder to be in line with expectations.)

Which strategies does your firm use to distinguish itself in an auction process?

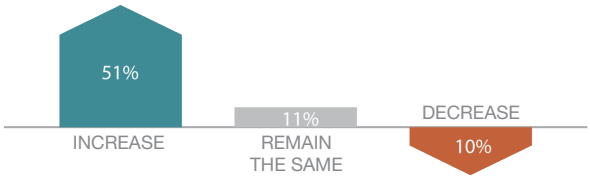
(Respondents select all that apply ≠100%)

Internal industry expertise (past/current investments)	27%
Avoid auctions - look for proprietary opportunities	18%
Pre-empt process with a commit with no diligence outs	15%
Leverage operating partners	13%
Valuation strategy	10%
Partner with another PE firm	8%
Fund level revolvers, bid with all equity	6%

Likely More of the Same

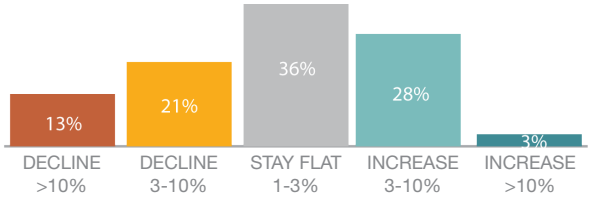
Investors surveyed continue to remain confident about prospects for the U.S. economy over the next 12 months with 87% either confident or very confident (vs. 79% a year ago), and with the percentage of very confident rising to 26% vs. 12% a year ago. Similarly, 92% see odds of a recession as unlikely or highly unlikely over the next 12 months vs. 86% a year ago.

Turning to the loan markets, most (36%) see volume holding flat, with 28% seeing a 3-10% increase and 21% seeing a 3-10% decrease. This compares to 47% seeing a 3-10% increase last year. However, 51% see M&A/LBO activity increasing over the next 12 months – up slightly versus a year ago.



Over the next 12 months, what do you expect of M&A/LBO activity?

On the pricing front, 62% see middle market spreads holding roughly flat vs. 45% a year ago and 51% for broadly syndicated loans. However, 36% still see potential for a further spread erosion (vs. 30% a year ago). Meanwhile, 41% see further loosening of terms in the broadly syndicated market (about flat vs. a year ago).



In the next 12 months, how do you expect U.S. leveraged loan volume to change compared to the last 12 months?

With the economy strengthening, 74% of respondents expect LIBOR to creep into the 2-3% range by the end of 2018. Leverage levels are a rising area of concern, with 95% seeing total debt-to-EBITDA as “high” or “very high” vs. 77% a year ago; however, most (51%) expect default rates to remain low at ~2% while 41% see defaults inching up into the still low 2-3% range by the end of 2018.

Survey Notes

This second annual edition of Antares Compass features information collected from over 100 respondents. Surveys were sent to borrowers, private equity sponsors and investors in January 2018.

Middle Market Companies:

- 77% have <$50MM of EBITDA
- Utilize one of the following business models: distributor, manufacturer, retail or service provider
- Span 17 unique industries & 19 end markets

Private Equity Sponsors:

- 83% with a current fund size >$1B
- 61% (majority) with AUM between $1B – $7B

Investors:

- Identified as one of the following institution/investor types: bank, BDC, CLO, insurance, non-bank leader or other fund

What's in store for 2018

"So, as we look into 2018, we really don't see any change in the momentum that built up throughout the course of 2017. Certainly in the last half of 2017. There is, again, significant levels of capital that private equity sponsors have to deploy. There is an abundant amount of liquidity to provide leverage for those acquisitions.

And I think one of the things that is in place now is economic momentum. So you see GDP growth that is closing in on 3 percent in the U.S. You look around the globe, and you see basically every area of the globe is growing right now."

– John Martin

"I spent the last couple of years educating investors about the middle market space. I think initially investors wanted exposure to a floating rate instrument given the prospect of rates rising. However, I think when they dug in a little bit more, they were delighted to find the middle market loan market is a space where you can get more yield without taking incrementally more credit risk. You give up some liquidity but when you've got a lot of money to put to work, making that sort of trade, I think, made sense for a lot of investors in '17 and I think they're going to continue to want to make that trade in '18."

– Vivek Mathew

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