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Antares: Keynote and Q&A

Light at the end of the tunnel…

Markets and the economy continued to heal in Q3 2020 as US real GDP growth rebounded more sharply than most expected, rising 33.1% after having plummeted 31.4% in Q2. The S&P 500 followed suit with EPS surging 75% and the index rising 9% vs. Q2 2020. Loan markets likewise continued their ascent, with the S&P/LSTA Leverage Loan Index rising 3% during Q3.

Of course, the real light at the end of the tunnel has come with the November news of no less than three new COVID-19 vaccines developed by Pfizer, Moderna, and AstraZeneca—at least two of which claim efficacy rates above 90%.

… but winter is coming

While vaccine development is clearly wonderful news, vaccines don't prevent virus spread—vaccinations do—and we still need to get from here to there. It will take some time for approvals, production, and distribution to ramp up, with widespread availability not expected until perhaps April. In the meantime, COVID-19 cases, hospitalization rates, and business shutdowns have been resurging in the face of a pullback in emergency loan support by the U.S. Treasury and potential gridlock over other stimulus efforts.

Life after COVID… preparing for the next virus

Hopefully, we can all bask in the warmth of better times by the summer of 2021, but as a lender, we always prepare for the worst. While the Fed appears likely to be successful in bridging markets to a post-COVID-19 world, an increased populace of "zombie" companies on the other side are likely to remain vulnerable to unforeseen shocks. Defaults could remain above average for some time. Maintaining financial strength, diversification, seniority in the capital structure, meticulous underwriting, ESG mindfulness, and an alignment with strong PE sponsors and management teams will prove to be as critical as ever.

As a lender, we look forward to working closely with all stakeholders in helping finance a recovery and sustainable long-term growth—whatever other twists and turns the future may bring.

David M. Brackett

CEO, Antares Capital

Dave is a member of Antares' Investment Committee as well as Antares' Board of Directors. Previously, Dave served as president and CEO for GE Antares. He was a founding partner when Antares was formed in 1996. Prior to starting Antares, Dave was a senior executive with Heller Financial.

Q&A

How has Antares and direct lending generally weathered the pandemic thus far?

We have been very pleased at how our teams, borrowers, and PE sponsors have delivered through the crisis thus far, and I would say direct lending as an asset class also seems to have performed well. As of September 30, 2020, approximately 1% of our borrowers were in payment default, and year-to-date specific loan impairments net of recoveries were less than 0.5% of our average loan portfolio outstanding. Looking at leveraged loans more broadly, the S&P/LSTA Index trailing 12 months (TTM) default rate appears to have stabilized in recent months at near 4% as measured by LCD. On the public BDC front, results have varied, but on average non-accruals actually declined slightly in Q3 2020 vs Q2 to about 5.5%. Of course, we are not out of the woods yet, but these results are encouraging.

Has the pandemic changed your thinking at all about how you assess borrower risk? What implications has COVID-19 had for adoption of environment, social, and governance (ESG) criteria from a private debt perspective?

COVID-19 has been a "stress test" like no other in modern history—an event of great human tragedy that shut down large swaths of the economy seemingly in an instant. While the virus' epitaph has yet to be written, we feel the experience thus far has vindicated our preference for lending to sponsor backed companies,

being highly diversified across borrowers and industries, and being senior secured first-lien focused.

Clearly, we didn't get all of our underwriting assumptions right. Nobody did. Lenders generally can't underwrite to such sweeping "black swan" events, or they will quickly find themselves out of business for lack of deal flow. That is why we take great comfort in having high-quality sponsors beneath us in the capital structure that are adept at managing through challenging situations and contributing equity when needed. In hindsight, we were also well served by avoiding significant direct exposure to certain highly cyclical segments such as retail, restaurants, hotels, and oil & gas—although, admittedly, this had little to do with us foreseeing the fallout of a global pandemic.

Looking forward, we continue to view rigorous underwriting as a critical driver of superior performance as a lender, and here, ESG plays an important role. Consideration of material ESG risks are really nothing new in one sense. It goes without saying that risks like environmental mismanagement, fraud, workplace safety issues, product liability issues, or cyber security breaches are all garden variety risks a lender will look to mitigate or avoid altogether. However, what has become increasingly apparent and underscored during the COVID-19 pandemic is that companies that are focused on managing ESG tend to be more resilient, well-managed companies. Happily, it turns out that doing well as a PE investor and a lender is well aligned with doing good! As such, we have become increasingly mindful of ESG throughout our investment process. This is another reason we value our sponsor relationships since we can piggyback on their ESG-related due diligence and their influence as equity owners aimed at creating long term value. Lenders have limitations as to how much they can influence management.

Of course, there are also aspirational aims for PE firms and lenders in terms of how we manage ourselves. For example, it's no secret that financial services lags behind other industries around diversity, equity, and inclusion. At Antares, we believe that a more diverse company with disparate voices, where we explore different options and hear different things, is a better company, a more profitable company. We're making strides—with good diversity on our board and a D&I Council that I chair with our CHRO. In addition, we have six affinity groups to represent our employees' voices. Ultimately, we're looking to create a strong culture of inclusion and belonging because we think it's the right thing to do from a societal perspective and will lead to long-term success.

What are your expectations for what lies ahead?

With the recent announcement of very high efficacy vaccines and the resolution of election-related uncertainty of late, it is clear the markets have been justified in looking over the valley to more normal times ahead—perhaps by H2 2021. We have seen a surge in our deal pipeline, which is up over 20% YoY as of the end of November. Much of this is add-on activity, but LBO activity has also picked up sharply.

Of course, in the near term, the COVID-19 resurgence remains a threat. Already, the pace of retail sales growth appears to be losing steam (up only 0.3% MoM in October), consumer confidence is waning (down slightly in October), and jobs growth is slowing. Indeed, defaults probably haven't peaked yet, with LCD's late Q3 survey of US leverage loan portfolio managers suggesting the TTM U.S. leverage loan default rate will peak at 6.6% in 2021. However, it should be noted that this peak rate forecast—along with other credit rating agency forecasts—is down roughly 1% from expectations only a few months ago. Also, while loan markets continue to be bifurcated between COVID-19-sensitive and COVID-19-remote sectors, as time passes, the gap will probably continue to narrow as the end of the pandemic gets closer—at which point we could actually see quite a pent up resurgence in travel and other such activity.

Clearly, there are still risks on the horizon, some of which seem to be ever-present, but we are cautiously optimistic that 2021 will be a year of further recovery and repair despite the near-term headwinds.

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