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Recovery gathers pace, but risks still loom

Antares Capital Keynote

US recovery gathers pace, driving deal activity up and default rates and spreads down

After a brief respite following a year-end 2020 deal activity boom, our open pipeline of PE deal flow has picked up steadily through Q1 2021 and well into Q2. Activity has been buoyed of late by a confluence of factors including 1) a recovering economy, with rising consensus 2021 US GDP growth expectations currently at a robust 6%+ as vaccine distribution proceeds and restrictions are eased; 2) continued significant fiscal and monetary stimulus; 3) related rising revenue and EBITDA growth prospects across most sectors, with Q1 2021 results beating expectations at a high rate; 4) very favorable capital market and private debt financing conditions; 5) potential for a rise in capital gains tax rates; and 6) high levels of PE dry powder. The recovery has also been broadening across industries, with even some of the spaces most severely affected by COVID-19—such as aerospace, travel & hospitality, and fitness—starting to see some signs of improvement.

As a result of these favorable trends, default rates have continued to plummet, with the S&P LSTA Leveraged Loan Index LTM default rate by amount down to as low as 1.73% as of May—well below the 2.9% long-term historical average (since 1999). Looking forward, as per S&P LCD: "without a fresh wave of bankruptcies and payment misses, the loan default rate could fall to less than 1% by the end of July." Declining default rates have also been evident in direct lending markets, as reported by Proskauer, and in the continued fall in average reported business development companies' (BDC) non-accrual rates in Q1.

Lower default rates have in turn led to a narrowing of "all in" spreads back to lows not seen since H2 2017. Based on data in Refinitiv's LPC Middle Market Weekly from May 14, syndicated middle-market 1st Lien term loan yields have narrowed from an average of 6.6% in Q4 2020 to 6.0% so far in May 2021 (albeit up from 5.7% Q1 2021 level). In comparison, syndicated Large Corporate 1st Lien term loan yields have narrowed from an average of about 5.3% in Q4 2020 to about 4.7% so far in May 2021

Dave Brackett

Chief Executive Officer
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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.

(also up slightly from Q1 2021). On balance though, the institutional middle-market yield premium of 1.3% (as of mid-May) remains attractive.

Keep your eyes on the road

Although the markets broadly appear to have adopted a "risk-on" posture, risks of inflation, malware/cyber breaches, geopolitical strife and lagging emerging market vaccination/variant risks continue to loom. While the COVID-19 pandemic recedes in the rear-view mirror (at least in the US), lenders would be well-advised to remain vigilant in looking for potholes in the road ahead.

Q&A with Dave Brackett

With spreads falling, are loan markets still attractive?

In a word, yes. We are still seeing attractive opportunities to put money to work, though being selective and credit-disciplined across the broadest set of opportunities available in the market is ever more critical.

Capital has been attracted to loan markets, reflecting a continued hunger for yield, falling default rates, and rising concerns over inflation and a potential related rise in interest rates (with loans offering a natural hedge against inflation via floating rate terms). The asset class's appeal has also benefited from solid performance through the COVID-19 crisis and continues to appear attractive on a risk-adjusted basis relative to many other asset classes. As a result, money is flowing in. Collateralized loan obligation

(CLO) issuance has surged to over $59 billion as of May 20th, according to S&P LCD—the highest level seen for this period since 2005. Meanwhile, retail loan mutual fund and ETFs have seen net inflows of about $16.3 billion through late May versus approximately $19 billion of outflows during all of 2020. Such inflows have put pressure on spreads, though some spread contraction is justified by falling default rates, and institutional and direct lending middle-market yield premiums remain attractive.

What are the implications of still-rising LBO purchase price multiples?

Middle-market purchase price multiples (PPMs) remained high in Q1 2021 at a little over 12x EBITDA across deals financed in both syndicated and direct markets, according to Refinitv LPC data. This figure was up from 11.8x in Q4 2020 and closer to 11x for all of 2020, but it remains below over 13.5x for the large corporate market. This reflects multiple expansion more broadly across markets (for example, the S&P 500 total enterprise value to EBITDA in Q1 averaged 17.6x versus 14.5x on average for all of 2020, according to Capital IQ) as well as a higher share of high-multiple tech deals in the mix of LBOs. From a lender point of view, rising enterprise valuations aren't a bad thing from a loan-to-value perspective, and although leverage has risen along with PPMs, middle-market equity contributions remain high at 57% in Q1.

With that said, competition among acquirers remains fierce, and PE buyers must find new ways to create value to maintain their returns. This is driving increased investment holding periods and add-on activity to build on existing platforms and create value. This trend should continue to favor incumbent lenders with large portfolios.

Are you worried about inflation? What is Antares doing to protect itself?

Clearly this is a hot topic of debate. From a macro perspective, some transitory inflation and a steepening yield curve is a welcome sign of an entrenching recovery. The US 10-year bond yield has come off its March high of nearly 1.8% and is now back down to 1.6% as of late-May, which suggests the bond market isn't too concerned about inflation—at least not yet. However, recent incoming inflation data, including a 4.2% headline rise in the consumer price index (CPI) in April, has continued to surprise significantly on the upside, giving fuel to those arguing that fiscal and central bank stimulus is excessive.

We know that "price allocates resource," so the real debate is how high the price (inflation intensity) and for how long (inflation duration). An analysis of all the moving parts is complex, and we are in somewhat unchartered waters. Labor market tightness has surprised some, and asset inflation may yet make its way into CPI. For example, significant inflation in housing prices (median single-family home prices were up 20% YoY in April) doesn't show in CPI. Meanwhile, rent inflation, which makes up about a quarter of CPI, has dropped sharply over the past year to only 1.8%. Could increasingly unaffordable homes drive up rental costs? How much impact might there be from commercial real estate converting to residential as post-pandemic work-from-home trends settle in? Will productivity gains offset inflationary pressures?

For our part, we believe shortages tend to be "short ages," and that inflation will prove to be transitory; however, that doesn't mean we should dismiss the potential risks/consequences (for example, talk of tapering could drive market volatility, and so on). Inflation intensity won't be uniform across inputs, and could be painful to some. Of course, from a company perspective, inflation pain for some (such as raw material and labor costs) may actually be pleasure for others (revenue/margin gains). While we view a long-lasting, pernicious upward wage/price spiral as unlikely, as a lender, you have to be prepared for unwanted scenarios.

As far as protecting our portfolio from inflation, this mostly revolves around underwriting borrowers with 1) leading positions and pricing power, 2) supply chain diversity to avoid bottlenecks and promote competition, and 3) favorable labor force dynamics (such as the ability to hire from a diverse set of prospects and improve productivity). We also have a dedicated portfolio management team that monitors developments closely.

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