Many Opportunities Yet to Come in Private Debt

Undeterred by the pandemic, the private lending market is seeing new possibilities emerge and a strong future taking shape.

The question of the year for 2021 is "How did [fill in the blank] do during the pandemic?" Few asset classes have a better story to tell than private debt, which displayed resilience that set it up to seize opportunity as it emerged. That has especially been the case at Antares Capital, which specializes in the middle market. II recently spoke with the firm's COO, Tim Lyne, who is slated to take on the role of CEO in January, about the road recently traveled, and opportunities yet to come.

How do you think private debt handled the height of the Covid pandemic and the slow transition toward something resembling normalcy?

Tim Lyne: In retrospect, I can say private debt has been incredibly strong for the entirety of the Covid-related challenge. We felt all along it would be, but it was a new scenario for everyone. Across the board, however – in terms portfolio performance, the sector, and returns – it was strong.

We saw incredible resilience among borrowers in their ability to very quickly transform their businesses to operate in the new normal. And private equity sponsors showed tremendous and timely support for their companies, not only financially – which is critically important – but in terms of providing best practices and marshaling resources for those borrowers so they could adopt those best practices.

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Did any concerns arise along the way?

Tim Lyne: Yes, but only a small percentage of our portfolio is in sectors that really had a hard time of it, such as travel, hospitality, fitness, and aerospace. Overall, the businesses we're invested in have performed incredibly well. There was a real question mark around sponsors and what we'd see in terms of covenants – concern regarding how they might delay in taking action. In the end, we discovered sponsors have so much at risk in terms of driving returns that they can't sit on their hands and wait to see how things play out. Instead, they took a very proactive and collaborative approach, and everyone contributed to working out solutions.

What's the current state of play in the private lending market?

Tim Lyne: We've had very low losses and very favorable risk return dynamics. Demand tells a big part of the story. Years ago, banks comprised the bulk of the market. Today, private debt providers comprised the bulk of the market. What has made that so dynamic is the growth of private equity sponsors over time. As they've learned more about their own businesses, they've realized they want to work with a shorter list of solution providers who can deliver under any circumstances, good or bad. We can now commit to larger and larger dollar amounts because of the capital our space has attracted. In our space, there are a dozen players that can commit and hold more than $400 million in a transaction. Previously, that loan size would have been more broadly syndicated. Right now, there are record

amounts of dry powder in private capital waiting to be deployed.

What are the upsides to that for sponsors?

Tim Lyne: They can avoid worrying about the timing of going to market and potential leaks of confidential information. In addition, sponsors like the speed of execution in private transactions that don't require roadshows and ratings and related uncertainties around execution.

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Are you seeing a shift in priorities for borrowers and sponsors?

Tim Lyne: In the early days of the pandemic and as it extended, there was a focus by borrowers and sponsors on being able to keep businesses operating – to make sure there was ample liquidity to keep things running. Toward late summer of 2020, that view shifted to acknowledge there was opportunity emerging, and how to take advantage of it. That's reflective of the maturation of the private equity space and the robust pipelines that they had in place before the crisis. They dove right back into those pipelines to take advantage of acquiring companies that had an opportunity to extend their products or markets – and doing so when those companies were at a much more favorable price. That's the value creation story that we've seen evolve.

Another thing we witnessed was a tremendous increase in activity overall in terms of new platforms. As such, it has been a great time for us to lend and for PE sponsors to invest in companies that survived and thrived in terms of performance during the litmus test of the pandemic. Admittedly, they were in largely insulated sectors like software, business services, or healthcare – but these were very strong and resilient companies that helped lead the shift from crisis mode to opportunity mode.

Everyone is talking about inflation. Is Antares doing anything specific to address it?

Tim Lyne: We focus on high margin companies that are price setters rather than price takers. We've been fine through inflation cycles in the past, and with higher interest rates – so we're confident we will be resilient in an inflationary environment.

That said, inflation isn't an entirely bad thing. It's a sign of a growing and robust economy. And frankly, bottlenecks were inevitable as the economy snapped back so quickly. The expectation with the companies we've financed is that the impact should eventually dissipate.

Are you more concerned about stagflation than inflation?

Tim Lyne: As lenders, we must be prepared for anything – to expect the unexpected. Bad things are going to happen, and I'm proud to say that we've managed our businesses successfully for 25 years through multiple cycles. We didn't have a crystal ball on Covid, but we were up to the challenge based on experience and where we play in the capital structure. We work with private equity sponsors that have proven to be good partners through multiple cycles as well, and together we find solutions in challenging scenarios.

Let's look ahead briefly. How do you see the private debt space growing?

Tim Lyne: We estimate private equity firms have penetrated less than 12% of companies with revenues from $100 million to $1 billion. I think it's reasonable to expect we'll see an increase in that percentage, and that should provide a lot of opportunity to provide capital in good transactions. The future scenario does not appear to be one of too many dollars chasing too few deals. I think the industry in on solid footing with nice tailwinds and robust deal activity. There will be more aggressive terms and leverage will increase. For us as a firm, it will come down to continuing to pick the right companies with the right sponsors.