

Roaring like the '20s but hints of the '70s loom

Antares Capital Keynote

As 2021 comes to a close, earnings growth and M&A activity continue to boom. Consensus forecasts show real GDP growth reaccelerating from more tepid growth in Q3 2021 to a 4% to 5% range in Q4 2021. Also, profit growth trends have continued to outpace expectations—82% of the 95% of S&P 500 companies that have reported thus far in Q3 2021 have seen earnings per share upside surprises, with 75% seeing upside revenue surprises, according to FactSet. Meanwhile, middle-market M&A activity continues to surge with LBO and add-on loan volume up 82% YTD Q3 2021 from the same period in 2020 and up 15% from the same pre-COVID-19 period in 2019. According to Refinitiv LPC's Q321 Sponsored Middle Market Private Deals Analysis and the LPC Loan Connector Daily Analytic, total US LBO loan volume YTD November 2021 has already well surpassed the previous annual record high of \$208 billion in 2007.

Looking forward, despite risks and headwinds looming, consensus 2022 forecasts remain healthy, at 3.6% for US real GDP growth and at 8% for S&P 500 earnings per share, aided by trillions of dollars of increased money supply, new infrastructure spending, and low interest rates. However, the persistence of high inflation has dented consumer confidence and fueled concerns that the Fed may be behind the curve and that some companies could increasingly face margin pressure. While there are some signs of easing bottlenecks, new COVID-19 waves, perhaps including the more pernicious Omicron variant that hit the news as of this writing, could lead to more lockdowns and continue to plague supply chains through the winter months and well into 2022. Meanwhile, signs of stickier inflation have also been developing on the wage front, with some worried John Deere's new United Auto Workers (UAW) labor contract with sharp wage/benefit increases and cost of living adjustments (COLA) that are reminiscent of the 1970s could be a harbinger of things to come.



Tim Lyne

Chief Operating Officer
Antares Capital

Tim is a founding partner of Antares. He is responsible for leading the company's sponsor coverage and capital markets activities, operations and technology functions, as well as marketing and enterprise risk. Tim is a member of Antares' Investment Committee. He has been appointed to succeed David Brackett as Antares Capital's CEO in January 2022.

With the 10-year treasury bond yield near 1.5%, markets appear to remain sanguine about inflation prospects—at least in the longer term. Nevertheless, markets could see further turbulence ahead as the tides of monetary policy turn, especially if COVID-19, geopolitical risks, or other risks come to the fore. As a lender, prudence necessitates that economics remains a dismal science.

Q&A with Tim Lyne, COO

What are your expectations for middle-market PE M&A activity? What are you hearing from your borrowers and sponsors?

Strong economic and profit growth, abundant liquidity, and record PE dry powder remain potent forces that are likely to drive continued high levels of M&A activity into 2022. However, factors on the negative side include high valuation multiples, inflation and labor shortage concerns, potential new COVID-19 waves, and rising tax rates. On balance, we expect LBO and add-on activity to remain robust. Interestingly, based on an informal survey of our borrowers at a recent Antares-hosted event, 62% expect M&A to be more active in 2022 than in 2021, with only 10% expecting M&A to be less active. This perspective also appears to be consistent with other recent M&A outlook surveys we've seen. Still, there was also acknowledgement that auctions are getting very competitive with outsized multiples, making integration excellence and lower multiple add-ons all the more critical in achieving target returns.

Q&A: Antares Capital

With purchase price multiples reaching new heights, how are lenders and fund managers responding tactically to the risks associated with high valuations?

First, as a lender, to the degree that higher purchase price multiples are funded with higher equity contributions, this lowers loan-to-value ratios and is favorable to lenders in that it implies more “cushion” below the debt in the capital structure. It’s really higher debt leverage levels that are more the concern, though these haven’t risen as much. Refinitiv LPC’s data shows sponsored middle-market purchase price multiples (PPMs)—for institutional and private deals combined—climbing to a new high of 12.5x in Q3 2021 and comprised of a total debt multiple at 5.3x and an equity multiple at 7.2x. By comparison, if you look at the pre-COVID-19 Q3 2019, the PPM was 11.5x, the total debt multiple was 5.2x, and the equity multiple was 5.9x. So as you can see, leverage hasn’t risen all that much relative to the equity multiple over the last two years. If you go back several years, debt leverage is up about a turn, but the equity multiple is up three turns. Of course, it is important in today’s market to be sure in underwriting deals that true debt leverage is not too severely understated by questionable EBITDA add-backs.

Secondly, while the 12.5x middle-market LBO PPM in Q3 2021 may be a new high, it compares to a 16.9x total enterprise value to EBITDA multiple for the S&P 500 in Q3 2021—a multiple that has likewise been rising to new heights over the last several years. Of course, one can debate whether markets generally are in an asset bubble and whether the Fed tightening and raising interest rates will cause multiple compression (versus rising earnings, which could be a source of favorable multiple compression), but such questions are not specific to private debt as an asset class. In fact, if rates do rise, and valuations fall, being in a first lien position with floating interest rates is probably not a bad place to be, at least on a relative basis.

Thus far, how has inflation been impacting borrowers in your portfolio, and how as a lender do you mitigate inflation risk?

Our portfolio management team actively monitors and assesses risks such as those related to COVID-19 and supply chain/inflation. Across our portfolio, labor shortages and wage inflation are the most prevalent

concerns, followed by increased raw material costs/shortages and supply chain disruptions. About a quarter of borrowers expect some gross margin compression over the next six months, but the majority expect it to be temporary, based on their ability to pass through costs, albeit with lag. Also, some borrowers actually expect to see a positive impact from inflation. As of late October, less than 5% of our total portfolio by count was assessed as having high supply chain/inflation-related risk, with these borrowers sprinkled across industries such as automotive, aerospace and defense, chemicals, manufacturing, and capital equipment, as well as retail and consumer goods & services, food & beverage and restaurants, and containers & packaging.

As to the question of how a lender mitigates inflation risk, this entails 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.

What other challenges and opportunities do you see ahead for the middle market? Do you expect defaults to rise?

COVID-19 fallout—perhaps rekindled by Omicron or other new variants—labor shortages (recruitment and retention), supply chain disruptions, and raw material cost inflation are the top challenges, but cybersecurity is another. The unfortunate reality is that cyber attackers are getting more sophisticated in their approach and companies need to continually monitor and update hardware and software to help combat attacks. In our informal borrower offsite survey, cybersecurity ranked highest among environmental, social, and governance (ESG) risk-related topics of interest.

Clearly, middle-market companies face many challenges and there will be winners and losers, but we expect them to continue to prove themselves to be an agile and a dynamic engine of the US economy, especially with strong sponsor support. Default rates may tick up a bit, given how low they are at present (0.29% in November for the S&P/LSTA Leveraged Loan Index); however, we expect them to remain low, and to the degree they do rise, spreads may also rise and/or terms tighten, which might not be a bad thing for lenders and private debt investors.