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Outlook remains favorable for 2022, but risks abound

Middle-market PE and private debt markets saw record deal volume in 2021 as M&A activity soared in the face of robust earnings and real GDP growth. Based on Refinitiv LPC data, sponsored middle-market loan volume rocketed to $196 billion, up 82% versus 2020 levels and up 7% from the prior 2018 peak. Accounting for 70% of the 2021 total, M&A activity was the main driver, with leveraged buyout (LBO) loan volume up 113% and add-ons up 74%. Volume was particularly strong in Q4, at a record $72 billion.

So far in 2022, PE deal activity has taken a bit of a breather following Q4 2021's frenetic pace, but recent surveys and investment banker feedback suggest activity is poised to strengthen in the months ahead. Positive drivers include expectations of continued robust—if slower—earnings and GDP growth, favorable financing conditions/liquidity, ebbing pandemic fallout, and high PE dry powder. However, inflation remains high, the Fed is increasingly hawkish, volatility is up, markets are down and geopolitical risks are running hot, with news breaking at the time of this writing regarding the invasion of Ukraine. While there is reason to be optimistic, there is also plenty of reason for concern.

Timothy Lyne
Chief Executive Officer
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Timothy is a founding partner of Antares. He is a member of Antares' Investment Committee and Antares' Board of Directors. Previous roles include chief operating officer and head of Asset Management for Antares.

Q&A with Timothy Lyne, CEO of Antares Capital

What are the credit implications of high inflation and Fed tightening in 2022? Are you seeing any signs of worry in your portfolio? What about the impact on M&A/PE activity?

High inflation followed by Fed tightening has been a classic precursor of past recessions, so concern is warranted. However, in most past cycles, the beginning of Fed policy tightening has actually been a sign of a firming recovery rather than imminent recession. Also, even recently raised expectations of as much as 175 basis points in hikes in 2022 look rather middling when compared to other hiking cycles since the 1960s. Of course, if inflation isn't tamed in 2022 and the yield curve inverts, the risk of a recession in 2023 or 2024 will rise.

As far as credit concerns, many existing loans have 0.75% to 1.0% LIBOR floors, so borrowers on those loans won't feel an impact until LIBOR exceeds those floors. Meanwhile, interest coverage ratios look healthy, with the S&P/LSTA leverage loan index median interest coverage at 4.76x as of Q3 2021—its highest level on record in 20 years. Thus, there appears to be significant cushion, particularly if EBITDA continues to grow as expected. Default rates, which are currently at rock bottom levels, could rise some but are expected to remain low during 2022.

Regarding our portfolio, our latest supply chain/inflation analysis indicates most credits are managing well. While almost a quarter of the portfolio anticipates some gross margin compression over the next six months, the majority expect it to be temporary. Of course, war in Ukraine could exacerbate supply chain disruptions and inflationary pressures and will warrant close monitoring in the months ahead.

Finally, regarding M&A and PE activity, the impact of inflation and rising rates is unclear. To the degree that we see some multiple compression due to higher interest rates, some may see this as a buying opportunity, while others may hold off selling in hopes of a better price later on. Of course, if inflation and interest rates rise to the point of being a harbinger of recession, deal activity would probably decline. For now, surveys and investment banker sentiment suggest reason to be optimistic about activity in the months ahead.

2021 was a record year for direct lending fundraising. Do you think it has been excessive?

According to Refinitiv LPC data, US middle-market loan fundraising rose sharply in 2021, to $180 billion, but that is still well below the year's $410 billion of US PE "buyout and generalist" fundraising. As such, it would appear that private debt fundraising isn't out of step. In fact, if you look at the dry powder of North American-focused direct lenders as measured by Preqin at the end of 2021, it is only about 20% of the total dry powder of North American-focused PE funds. Some of the discrepancy can be explained by PE funds aimed at mega-larger deals that are normally syndicated, but lately, direct lending has been increasingly penetrating deals in the "jumbo" $1 billion-plus deal size range. According to Direct Lending Deals (DLD), since September 2019, there have been over $50 billion in jumbo unitranche loans including a record sized $3.4 billion loan to Galway Insurance led by Antares Capital. About 60%, or more than $770 billion of the S&P LCD/LSTA Leveraged Loan Index, is comprised of loans in the $1 billion to $5 billion range, thus suggesting room for further growth.

How about growth prospects for PE and private debt in the middle market? Are they still favorable in the long term?

In a word, yes. The middle market remains our core focus. According to the National Center for the Middle Market (NCMM), middle-market companies saw robust revenue growth of 12.3% in 2021 and are projected to see 9.9% growth in 2022. Middle-market employment growth of 10.8% in 2021 exceeded both small businesses, at 5.2%, and large businesses, at 4.4%. While tight labor markets and supply chain disruptions continue to pose challenges, middle-market companies have proven to be agile and resilient.

The latest US census data available (2017) shows 223,000 middle-market companies in the US with revenue ranging from $10 million to $1 billion. We estimate PE penetration of companies in the $100 million to $1 billion range to be 10% to 12%, which suggests there is still plenty of room for growth. Also, new business formation surged during the pandemic and remains strong, according to findings by the National Bureau of Economic Research. Such entrepreneurial seedlings should bolster the future crop of investment opportunities for PE AUM, which is expected to more than double by 2026, according to the latest projections from Preqin.

How has the LIBOR transition to SOFR gone?

Over the last two years, we have diligently prepared to arrange and lend in SOFR, and today, all our new direct originations—or new deals—are being quoted in SOFR. For existing borrowers with incremental debt needs, Antares will initially quote terms in SOFR, but we will work with the borrower and PE sponsor to determine the most appropriate base rate for each situation.

What role does ESG play in private debt versus PE, and how do you see things developing?

To date, PE investors have been more deeply involved in driving ESG adoption at companies, given their ownership and control positions. However, private debt providers are a critical source of capital, too, and have an important and developing role to play.

As a lender, we believe many aspects of ESG are simply fundamental to proper due diligence. We believe it's critical to get things right up front and that investing in borrowers with lower ESG risk factors will ultimately lead to better outcomes for our investments and stakeholders. Key to development of the lenders' role in driving ESG will be further progress in ESG-related transparency and standardization.

On the climate change transparency and standardization fronts, our parent company, CPP Investments—a founding PRI signatory and the first pension fund to issue a green bond—recently published "The Future of Climate Change Transition Reporting" and "Investing in the Path to Net Zero." For more information on Antares Capital's ESG policy and approach: https://www.antares.com/responsibility