A WORD FROM ANTARES CAPITAL

Private debt, an all-weather friend

A perfect storm?

So far, 2022 has proven to be a harsh reminder that the world we live in is unpredictable and fraught with risk. A perfect storm of war in Ukraine and renewed COVID-19 lockdowns in China have stressed supply chains and stoked already high inflation, leaving the Fed an ever-narrower path to negotiate a soft landing. Recession risks are rising.

Of course, the risks are far more profound than purely economic considerations. There have been many conflicts with their fair share of atrocities since WWII, but few match the sheer scale of the war in Ukraine in terms of troops engaged, horror, and human tragedy, or the potential for escalation. Not since the Cuban missile crisis has the specter of nuclear conflict loomed so large in a collective psyche that has already been traumatized by waves of COVID-19 and high inflation (with gas prices recently hitting an all-time high). Yet on the positive side, there is reason for hope. NATO has never been more united, and the unexpected success and grit of the Ukrainian resistance has been inspiring. Long live Ukraine!

Private debt—safe harbor

Faced with such uncertainty, investors have been challenged in today's market in finding a relatively safe haven with attractive real risk-adjusted returns. Indeed, there has been much ink in the press of late on the failure of bonds to offer ballast in a traditional 60/40 asset allocation YTD, as stocks have fallen. Interestingly, in a May 2022 research paper from investment and research firm Cliffwater on the topic of lessons learned from US stagflation experienced in 1973-1982, the firm notes that, "Credit, apart from interest rate duration, was largely unaffected, perhaps because inflation deflates debt obligations." Given private debt's limited interest rate duration risk due to floating interest rates, the paper goes on to recommend a high 20% portfolio allocation to private debt in its "Stagflation Portfolio"—a portfolio designed to offer inflation protected asset allocation with high inflation beta and high expected risk-adjusted returns. It is notable that this 20% allocation to private debt is tied with US stocks for the highest allocation among various asset classes.

Timothy Lyne

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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.

Private debt demonstrated its resilience through the shock of COVID-19 in 2020-2021. Hopefully, a new stagflation stress test is not in the making, but if so, private debt may prove itself to yet again be an all-weather friend.

Q&A with Timothy Lyne, CEO Antares Capital

What impact do you see in your portfolio and private credit more broadly from the war in Ukraine and/or China's COVID-19 lockdowns?

For starters, let me just say how sad we are to see the devastation in Ukraine caused by the Russian invasion. Our hearts go out to all the people who are suffering as a result of this senseless violence.

As far as our portfolio, we have minimal direct exposure to Russia or Ukraine. We have four software deals in our portfolio with some operations (e.g., coders) in the region, but management has successfully moved those resources, with overall business risk now deemed to be low. We have no borrowers with direct customer or supplier exposure to Russia or Ukraine, and only a very small portion have indirect exposure via indirect reliance on major export items or financial markets in the region. Exposure to China is somewhat larger but still relatively moderate, with only a single digit percentage of our portfolio deemed to have "high" exposure, primarily driven by supplier exposure. While it's hard to speak for private debt more generally, our belief is

that the direct lending asset class in the US is likely to have a similar exposure profile, though of course this will vary by lender.

So, what about inflation and rising interest rates? Do you expect a recession ahead and if so, are companies overleveraged? What do you see happening to default rates?

CPI has been running near 8% of late but is expected to trend back toward 3-4% by mid-2023 based on the mean of the Wall Street Journal's April 2022 survey of economist forecasts. Mid-2023 is also the point at which SOFR rates are currently expected to top out at near 3%. Assuming these assumptions pan out, we believe the prospects remain favorable from a credit perspective. At approximately 3% SOFR, interest coverage in our portfolio is still quite manageable on average, all else equal. Of course, consensus expectations could prove to be wrong about inflation and interest rates and "all else" might not end up "being equal." While we are still not convinced a recession is inevitable in 2023, clearly the risks have risen (e.g., the Wall Street Journal April survey puts the mean odds of recession in the next 12 months at 28%, up from 18% in January). We believe a mild recession that tames inflation is clearly a possibility but would not be the end of the world.

Another scenario increasingly discussed is stagflation with near zero growth, but still high inflation. In Fitch's estimation per its April 27 report: "Our top-down stagflation stress case analysis for the US leveraged finance market produces a hypothetical default rate of 5%." This compares with a default rate of near 9% in 2009 for "B" category global corporate issuers, a 1.25-1.75% default rate range forecast for 2022-2023, and an average default rate of 2.3% from 1990 through 2021. It is worth noting that Fitch sees risks of rising defaults in a stagflation stress case scenario as highest for certain sectors such as airlines, autos, gaming, lodging, and leisure—areas where we have relatively limited exposure.

What is the outlook for private equity (PE) and related private debt deal activity? Is private debt still a good place to invest?

Our pipeline of deals has picked up since its lows in January that had followed a blow-out year end 2021, but activity still modestly lags its year-ago pace. High volatility, falling stock markets in the face of war, and heighted economic uncertainty have no doubt rattled confidence for dealmaking. However, on the positive side, earnings results for companies in the S&P 500 have surprised on the upside in Q1 2022. Also, while an increasing percentage of forward guidance has become negative, with inflation a hot topic of concern, earnings are still forecast to grow almost 10% in 2022 as of mid-May, according to FactSet. Meanwhile, public market valuations are becoming more attractive, which could spill over into private markets where PE is looking to invest high levels of dry powder. Supply chains, which have been a source of pain, are increasingly becoming a source of PE investment opportunity. In short, we believe conditions look ripe for a renewed pick up in M&A activity should volatility abate.

As far as attractiveness of private debt, we believe the asset class tends to shine best during times of uncertainty, owing to some of its key attributes such as lower volatility (e.g., versus broadly syndicated loans and high yield); limited downside risk at the top of the capital structure with low LTVs; floating interest rates that limit duration risk while offering higher yields should rates climb, and floors (typically) on the downside should rates fall; and significant yield premium at a comparable level of credit risk versus more liquid debt.

Of course, performance can vary significantly among lenders, particularly during times of stress. We believe having: 1) strong originations and a very large, diversified portfolio of lead-managed incumbent opportunities that allows for selectivity among the best credits; 2) a first lien focus with strong PE sponsor support; 3) strong credit discipline, portfolio management, and experience through multiple cycles; and 4) a dedicated and experienced workout team to maximize recoveries—are all critical to favorable outcomes.