

## A WORD FROM ANTARES CAPITAL

# On an even keel in choppy waters

### Direct lending displays relative stability in H1 2022

The first half of 2022 saw a surge in volatility in the wake of geopolitical strife, a lingering pandemic, supply chain disruptions, high inflation, rising interest rates, and a hawkish Federal Reserve. Economists surveyed by the Wall Street Journal boosted their estimates of the odds of a recession in the next 12 months from just 18% in January to 49% in July.<sup>5</sup> Along the way, the S&P 500 fell into a bear market, dropping about 25% from a peak at the end of 2021 to a trough in May 2022.

The loan markets were also affected but saw significant divergence between private/direct and public/syndicated market performance. The average bid on syndicated loans in the S&P/LSTA Leveraged Loan Index fell from 98.6 at the end of 2021 to 92.1 by the end of Q2 2022, with the percentage of “distressed” loans trading below 80 rising from 1.6% in December 2021 to 4.0% by July 2022. Banks, which hold underwritten buyout loans for a short period before syndicating them, were left to sell into weakness and take significant write-downs. In contrast, the more “buy and hold”-oriented direct lending market exhibited greater stability, which enabled direct lending’s share of the US-sponsored middle market to grow from 56% in H1 2021 to 70% in H1 2022. In the large corporate market, jumbo unitranche direct lending deals continued to take share, with volume almost doubling to \$40 billion in H1 2022 from \$21 billion in H1 2021, according to Refinitiv LPC.

### Fair winds and following seas?

So far in early Q3 2022, there are signs that the waters are calming, with inflation showing signs of ebbing, earnings holding up better than expected, and the stock market recovering about half its losses. However, with Fed interest rate hikes still yet to bite, it remains to be seen whether the tempest has passed or if we are just in the eye of the storm. No doubt challenges and opportunities lay ahead, but as former President Franklin D. Roosevelt once said, “A smooth sea never made a skilled sailor.”



### Tyler Lindblad

Chief Investment Officer  
Antares Capital

*Tyler is Chief Investment Officer for Antares Capital. Previously, he was senior credit executive for GE Capital’s commercial lending business in North*

*America, where he led the underwriting, account management, portfolio management, and risk management processes. Before this role, he was the CRO of specialized finance and CCO of Telecommunications, Media & Technology. Prior to GE Capital, he held roles at Heller Financial, Inc. and was a founding member of Antares.*

## Q&A with Tyler Lindblad, Chief Investment Officer of Antares Capital

### With all the market turmoil, can you give us a view from your portfolio on how well companies are handling inflation, supply chain issues, and rising interest rates?

We have a portfolio team that diligently tracks the impact of issues on our diverse portfolio of over 475 companies, and on the whole, our portfolio has been performing quite well.

On the inflation front, as of our end-of-July reading, only 5% of our portfolio was deemed to have high inflation risk exposure—up only slightly from a 4% reading at the end of Q1 2022. Cost inflation pressures tend to overlap with supply chain issues by driving up input costs, but supply chain constraints can also limit output and revenues. Most of our portfolio companies have been able to pass through prices to cover inflation, with some actually seeing net benefits; however, some industries are facing margin headwinds. Sectors with the most exposure include food and beverage, aerospace and defense, and restaurants. In any case, given the strong cash flow profiles of our borrowers, we do not believe modest margin compression will result in any material principal risk.

<sup>5</sup>: “About the Wall Street Journal Economic Forecasting Survey,” The Wall Street Journal, Anthony DeBarros, July 17, 2022.

On the interest rate side, base one-month secured overnight financing rates are currently near 2.8% and are expected to peak near 4% in early/mid-2023 based on the forward curve as of mid-September. Granted such a rise and assuming flat EBITDA, interest coverage would remain healthy for the vast majority of our borrowers, with our modeling suggesting only very slight incremental net losses. Of greater concern is what happens to EBITDA. While there may be some margin pressures in some sectors, when looking at the absolute level of EBITDA, revenues have also been growing as an offset. Our portfolio has been seeing solid double-digit revenue growth YTD, and this has been the case for most sectors within our portfolio. Looking forward, the National Center for the Middle Market's mid-year 2022 survey shows middle-market company revenue growth of 12.2% in Q2 2022 projected to be at 9.1% growth in Q2 2023.<sup>6</sup> Middle-market company revenue growth is thus expected to continue to outpace growth of 11% in 2022 and 4% in 2023 for the S&P 500 revenues based on a consensus of estimates as of mid-August.

All told, while default rates have started to rise, they are generally projected to remain relatively benign. According to S&P Global as of September 1, the trailing 12-month Morningstar LSTA Leveraged Loan Index default rate is expected to rise from 0.43% in July 2022 to 2.0% by June 2023 in its baseline forecast, but this remains slightly below the long-term average of 2.1%. Even its pessimistic case forecast of 4.25% remains below the late-2020 COVID-19 peak of 4.6%—a “stress test” period through which private debt generally performed well. Also, on the positive side, terms and conditions for loans have become more lender-friendly, with wider spreads, less leverage, tighter EBITDA definitions, increased call protection, and tighter baskets.

**What have you been seeing in terms of deal flow, and what is the outlook? Has your deployment strategy changed in the face of higher recession risk?**

We are seeing a slower pace of activity compared with near-record-high levels at this time last year, with leveraged buyout activity down. However, add-on activity remains

very robust and is actually up pretty sharply for us on a volume basis YTD, in part reflecting larger average deal sizes. Being able to mine our portfolio for incumbent deal flow among credits we like and know well is an advantage that comes with having one of the largest middle-market portfolios in the business. It also allows us to remain selective when deploying capital to new borrowers. YTD July, 78% of our deals by count have come from our portfolio.

Looking forward, Refinitiv LPC's Q3 2022 direct lender survey shows 45% of lenders expecting a moderate decrease in middle-market M&A activity in H2 2022 and 32% foreseeing a moderate increase. Our crystal ball on M&A activity is a bit cloudy, but our expectation is that 2022 will be down modestly from booming 2021 levels but will still be a pretty solid year, with capital deployment opportunities remaining favorable given continued add-on acquisition activity and ongoing dislocation in the broadly syndicated market.

As far as our capital deployment strategy, we continue to look for leading companies with strong cash flow and pricing power and continue to favor growing, less-cyclical sectors such as software, business and financial services, and healthcare. We don't really try to time the cycle by doing sector rotation or stretching our credit box. We always underwrite to a bad case/recession scenario. Our strategy really hasn't changed much for more than 25 years, and it has served us quite well through many cycles. Upside appreciation is limited as a lender (in contrast to equity), and thus we believe alpha among lenders is generated primarily by loss avoidance. As such, we believe it is critical to have: 1) strong originations and a large, diversified portfolio of lead-managed incumbent opportunities that allows for selectivity among the best credits; 2) a first lien focus with strong private equity sponsor support; 3) strong credit discipline, portfolio management, and experience through multiple cycles; and 4) a dedicated and experienced workout team to maximize recoveries.

<sup>6</sup>: "Mid-Year 2022 Middle Market Indicator," National Center for the Middle Market, n.d., accessed September 9, 2022.