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Benefits of Senior Secured Direct Lending

- Senior direct loans have demonstrated resilience throughout market cycles and have shown to be insulated from periods of public market volatility.
- Amidst tightening credit conditions and rising default expectations, being senior in the capital structure provides relative safety without having to sacrifice performance.
- Adding senior secured direct loans to a portfolio has historically provided downside protection and increased investor's risk-adjusted returns.
- Managers with the scale, experience and stress-tested underwriting processes are best positioned to navigate the current investment landscape.

Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

FALL 2023

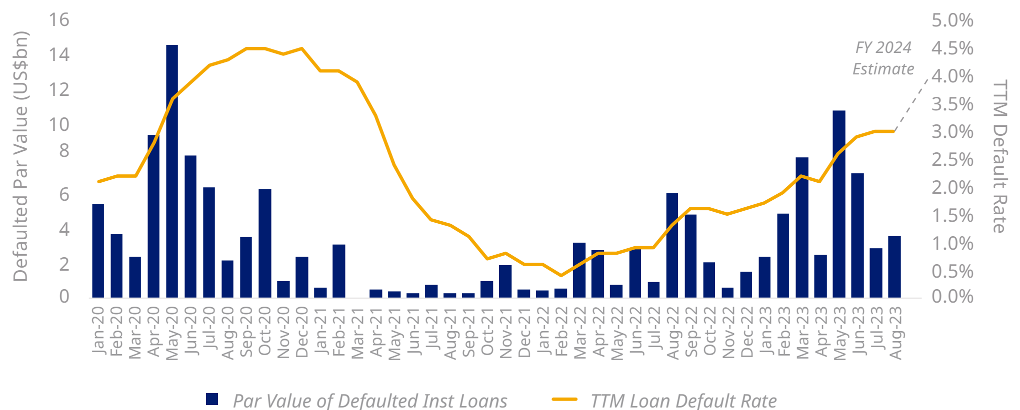
SAFETY AT THE TOP

To tame rampant inflation, the Fed has embarked on the fastest rate hiking cycle since the early 1980s, leaving many investors guessing regarding the economic implications of tighter monetary policy and the future path for risk assets. In the wake of continued economic uncertainty, investors should consider how allocating to senior secured direct lending can provide downside protection to a portfolio. Furthermore, it's important to understand how historical performance compares to similar traditional fixed income investments, such as broadly syndicated loans (BSL) or high yield (HY).

Senior direct loans are considered "senior" because they sit at the top of the capital structure. In the event of a default, investors' claims are paid out first, ahead of bondholders more junior in the capital structure. As higher financing costs further pressure companies' balance sheets, defaults will continue to rise. According to Fitch, institutional leveraged loan defaults are forecasted to rise from 3% in August 2023 to 3.5% to 4.5% for full year 2024 (*Figure 1*). Therefore, now is the time for investors to be employing a more defensive posture and consider the benefits of moving up in the capital stack to the relative safety of first-lien position.

FIGURE 1

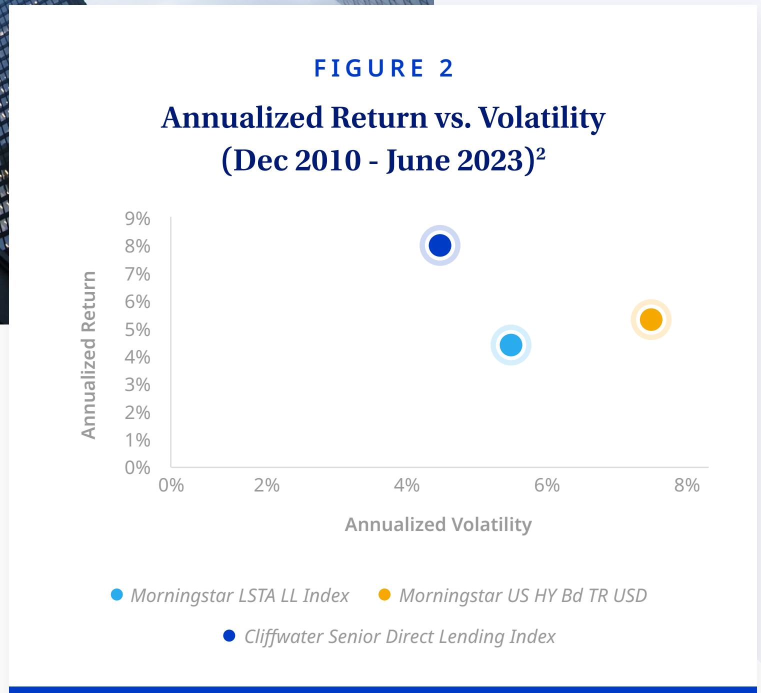
Institutional Leveraged Loan Defaults[1]



While the current tightening cycle may be nearing an end, with core inflation remaining entrenched, the Fed appears likely to keep rates elevated for an extended period. As a result, companies unable to generate enough profit to manage increased interest expenses could be at risk of default. Consequently, investors should be looking to upgrade their position in the capital structure and evaluate how the attractive risk-adjusted return profile of senior private credit strategies can potentially enhance portfolio performance.

1 Fitch Ratings. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

Historically, senior direct lending strategies, as represented by the Cliffwater Senior Direct Lending Index (CDLI - S), have proven resilient, providing investors with higher returns and lower volatility than both HY and BSL (*Figure 2*).



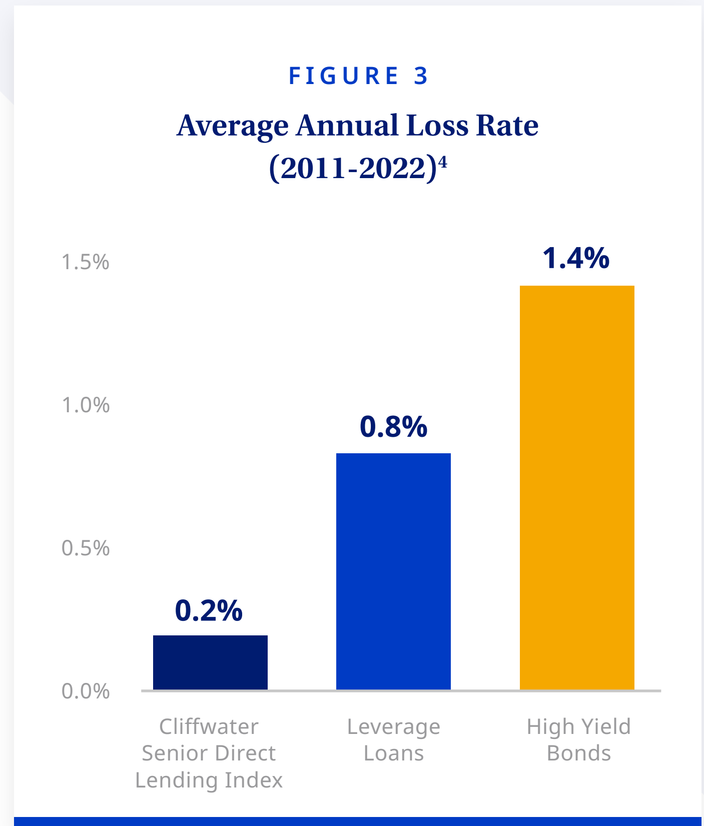
These strong risk-adjusted returns are derived from the structural features of senior private credit:

1	**Higher Seniority**	In first-lien position, the senior credit is above more junior debt and equity, the last security to be adversely impacted in the event of a default.
2	**Floating Rate**	Most direct loans have floating rate coupons that increase in-line with the reference rate as well as floors to protect lenders as rates decline.
3	**Sector Focus**	Private credit typically focuses on companies in non-cyclical industries with stable cash flows and proven business models.
4	**Small Club of Lenders**	Most transactions are negotiated on a bilateral basis and lenders typically have greater access to companies both before and after the deal.
5	**Sponsor Support**	Most financing is provided to companies backed by private equity sponsors who can provide equity infusions to support companies through challenging environments.
6	**Lender Protection**	Lenders are able to negotiate strong covenants and call protections to ensure borrowers meet certain requirements and reduce the potential impact if a borrower decides to pay before maturity.
7	**Credit Selection**	Private credit managers have deep sector expertise and borrower familiarity which can lead to higher quality underwriting.

2 Pitchbook and Cliffwater LLC. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

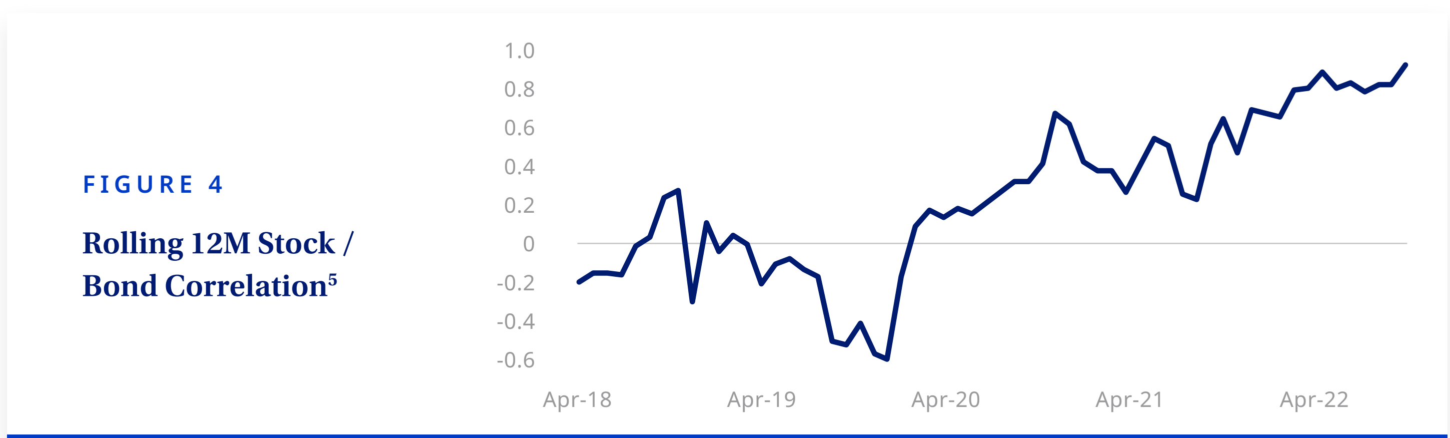
In the current investment environment, with so many conflicting factors clouding the economic outlook, it's prudent that investors evaluate the portfolio benefits of investments like senior direct lending. Having historically weathered default cycles and outperformed in periods of both rising and falling rates, senior private credit can reduce portfolio volatility and potentially enhance risk-adjusted returns.

Despite a resilient economy in the first half of 2023, there are indications that borrowers' capacity to service their debt is deteriorating. For example, interest coverage ratios, which tend to be a good leading indicator of future default potential have dropped for new issue leverage loans to the lowest levels since 2007[3]. With the expectation that the cost of capital is likely to remain higher for longer, now is not the time for investors to get too far out on the risk curve. In this environment, investors should consider asset classes desensitized to inflation and look to upgrade their position in the capital structure.



Across public and private debt markets loss rates can vary significantly. Senior private credit has historically had lower loss and higher recovery rates than both HY and BSL (*Figure 3*). Compared to BSL or HY, private credit loans have tighter documentation with more idiosyncratic provisions, allowing for lenders to be more proactive in monitoring borrower health. Lenders can intervene, individually or with the sponsor to amend terms and ensure the structure of the transaction supports the borrower's capacity to meet its debt obligations.

Typically, investors have viewed public debt markets as a source of income generation and portfolio diversification. However, in recent years fixed income correlation to equities has risen (*Figure 4*), enticing investors to allocate to private markets to achieve the portfolio diversification benefits traditional fixed income has normally provided.



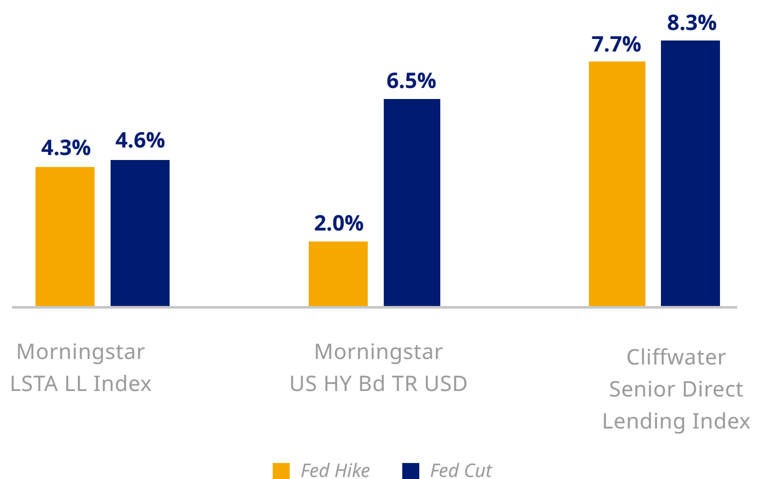
3 LCD as of March 31, 2023. 4 Cliffwater LLC and Fitch. 5 Bloomberg. Correlation is between the S&P 500 and the Bloomberg Bond Agg. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

Looking at past performance, senior direct loans act as an all-weather investment in a portfolio, outperforming both HY and BSL during Fed rate hiking and cutting cycles (*Figure 5*). As depicted below, senior direct loans not only have provided investors with higher total returns during periods when the Fed is raising rates, but also better performance when the Fed is lowering rates, a period which tends to be a more favorable environment for higher beta risk assets.

In taking on illiquidity, investors in senior direct loans can access higher yields and more stable asset values compared to traditional fixed income investments. Moreover, because the investments are not marked-to-market, the volatility profile tends to be lower. The credit selection capabilities of private credit managers combined with the fact that most managers typically focus on non-cyclical industries creates a quality bias. This translates to portfolios being less exposed to companies' whose balance sheets are more susceptible to deterioration in a higher rate, lower growth environment. In lending to high-quality companies at more beneficial terms than BSL or HY, direct lenders can construct resilient portfolios that have the potential to deliver better risk-adjusted returns than could be achievable in public debt markets.

FIGURE 5

Average Annualized Performance During Fed Hiking and Cutting Cycles (Dec 2010 – Jun 2023)[6]



6Pitchbook, and Cliffwater LLC. Periods for cutting are Dec 2010 - Nov 2015 and Jan 19 - Feb 22 and periods for hiking are Dec 15 - Dec 18 and Mar 22 – Jun 23. Note: Unless otherwise stated, statements above reflects Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

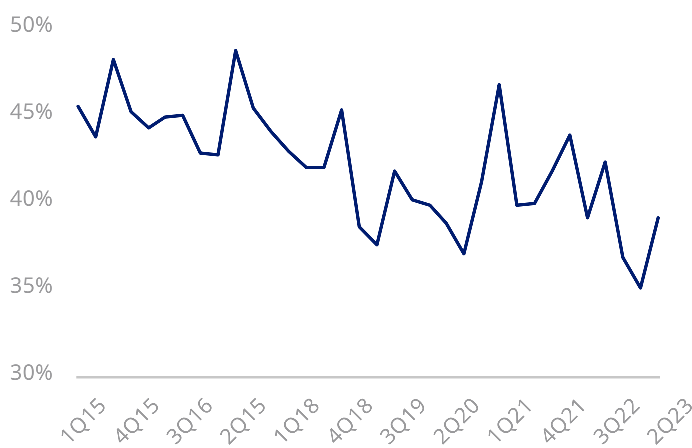
Current fundamentals present an attractive opportunity to allocate to senior direct lending. The higher illiquidity premiums investors can obtain provide a unique opportunity to get paid to go up in credit quality. With middle market first-lien spreads vs. BSL continuing to widen over the last few quarters (*Figure 6*) and spread per unit of leverage for first-lien middle market direct lending deals at 141bps, near the highest level in seven years, investors are being well compensated relative to the risks.

FIGURE 6

Middle Market 1st Lien Yield Spread vs BSL[7]

FIGURE 7

Loan to Value for Senior MM LBOs[8]



Additionally, as direct lenders continue to take share from banks and public market financing activity remains anemic, loans terms have continued to shift in favor of lenders. This provides additional downside protection for investors should macro economic conditions deteriorate. Recent deals are being underwritten with lower leverage, higher equity contributions, tighter documentation and at better valuations. With loan-to-values for senior middle market LBOs near the lowest level on record dating back to 2015 (*Figure 7*), managers can underwrite good companies with strong equity cushions that more than compensates for the increased default risk.

7 Refinitiv LPC data as of June 30, 2023. 8 Refinitiv LPC data as of June 30, 2023. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

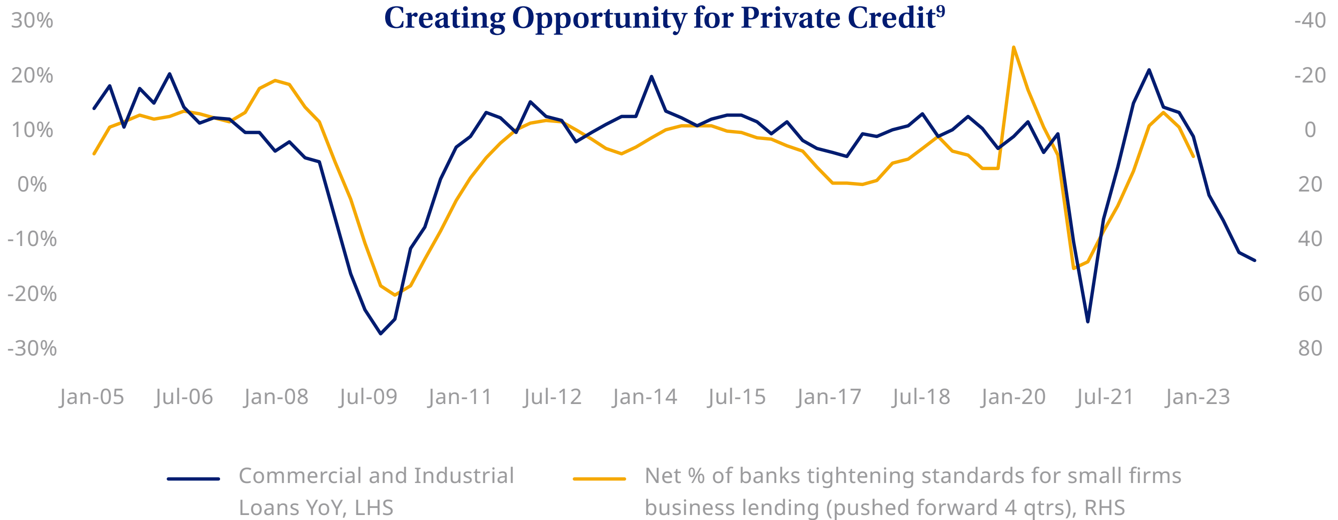
Given these underlying fundamentals, there remains strong potential for direct lending to continue its track record of outperformance vs. public debt markets and weather future periods of market volatility.

With credit conditions already tightening ahead of recent stress in the banking system (*Figure 8*), it would be surprising if loan growth did not slow further, allowing direct lenders to continue to take share. This will result in significant opportunities ahead for direct lenders to prudently deploy capital as banks scale back originating new loans.

In summary, the strong structural protections of senior direct loans and historical outperformance independent of the overall market environment present investors with an attractive tool to increase risk-adjusted returns. However, there can be a wide dispersion of performance amongst credit managers, and those with scale, experience and stress-tested underwriting processes are well-positioned to navigate the current credit cycle.

FIGURE 8

Bank Loan Growth Set To Further Contract, Creating Opportunity for Private Credit[9]



9 Refinitiv LPC data as of June 30, 2023. Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

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