PE Hub

By: Mary Kathleen Flynn
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Monroe's Ted Koenig: Direct lenders' certainty of execution and tailored financing can't be matched by banks

Certainty is valued by sponsors 'never more so than during periods of market volatility when banks are less willing to put their balance sheets at risk.'

PE Hub's Q&A series with private equity leaders reflecting on highlights from 2022 and sharing their outlooks for 2023 continues with Ted Koenig, chairman and CEO of Monroe Capital. Headquartered in Chicago and founded in 2004, Monroe is a boutique asset management firm specializing in private credit markets, including direct lending, asset-based lending, specialty finance, opportunistic and structured credit and equity. The firm had $14.1 billion of committed and managed capital, as of October 1, 2022. Koenig shares his perspective on the rise of private credit.

Ted Koenig, Monroe Capital

Q Why will private credit be stronger in 2023 than it was in 2022?

In our view, private credit's role has shifted over the years to the go-to source of debt financing for companies of all sizes in all industries. Direct lenders' ability to provide borrowers with certainty of execution, and custom and tailored financing solutions, cannot be matched by the traditional bank underwriting and syndication process. Certainty is always highly valued by sponsors, but never more so than during periods of market volatility when banks are less willing to put their balance sheets at risk and when new issuance for collateralized loan obligations, the primary buyer of leveraged loans, slows. The second half of 2022 demonstrated the valuable role that private credit can and will play keeping the M&A market functioning and liquid, even in periods of uncertainty. As we head into an uncertain and likely recessionary environment, this will further accelerate private credit's importance to M&A in 2023.

Q What were the most important trends in dealmaking in 2022?

There were a few interesting trends this past year: The return of take-privates made possible by the public equity sell-off. Monroe has seen this in the large-cap market, increasingly in the mid-market, and we would expect to see a lot more public-to-private M&A across the size spectrum in 2023.

Monroe continues to see sponsors focused on making new add-ons to existing platforms. In periods of volatility and valuation uncertainty, private equity and private credit firms alike can still deploy ample capital and generate attractive returns in a lower risk manner by prioritizing incremental inorganic growth with existing portfolio companies.

The growing specialization of sponsors and direct lenders alike in complex areas, including high-growth software, specialty finance, real estate, media, entertainment, sports finance, venture lending, among others, is driving greater efficiency in capital markets and the ability to complete LBOs in segments of the market that previously would have required larger equity contributions because we believe traditional banks were unfamiliar with these areas.

Q What was the biggest challenge to completing deals in 2022?

Valuation uncertainty. The sell-off in public equities, the recessionary environment concerns, and the rapid escalation in interest rates has made it more challenging for buyers and sellers alike to come to a meeting of the minds

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on market clearing valuation. LBO models are hard to predict with certainty in this environment. Many industries have been challenged with labor and supply chain shortages. However, Monroe has seen resilience in areas such as enterprise software, where high gross margins, low capital intensity, and recurring revenue streams from diversified customer bases result in less cyclicality risk.

Q How do you expect the first six months of PE dealmaking in 2023 to compare with the last six months of 2022?

Unfortunately, Jerome Powell will have a lot to say about that. We are clearly in line for further interest rate increases in early 2023 which we believe should dampen PE activity. However, market consensus seems to be that the Fed will be able to engineer a soft landing, with inflation coming back down to earth without pushing the US economy into a significant decline. If monthly CPI reports continue to show deceleration and consensus continues to grow that interest rates may be cut in the latter half of 2023, the PE dealmaking market should show some good signs of life in the first half of the year. If, on the other hand, a hard landing becomes the expectation, Monroe believes we will likely see a further slowdown in dealmaking as valuations decline and interest rates continue to climb.

Q What will be the most important trends affecting dealmaking in 2023?

Public-to-private LBOs will continue to accelerate as a share of the overall PE landscape. There are a lot of solid public companies trading at attractive valuations across the size spectrum. The dislocated de-SPAC market, in particular, could become a fertile hunting ground for more growth oriented and opportunistic private equity firms. Monroe also believes we should see more opportunistic deal flow from specialized players focused on segments of the market that are less correlated to the broader economy, as well as attractive opportunities in the secondary market for investors who need liquidity.

Q What should the private equity industry be most worried about?

If the rate of inflation continues to stay stubbornly high, equity valuations will become more challenged, reducing the ability to exit existing portfolio companies and making price discovery more challenging. Monroe believes that perhaps the bigger issue for the industry, however, could come from the "denominator effect." Alternatives have become a sizable share of most institutional investors' portfolios, and as other asset classes see declines, it's harder for investors to increase their allocations or commitments to new illiquid funds. Furthermore, the returns offered by "safer" asset classes, such as credit, could become more compelling on a relative value basis.

Q What should PE folks be most excited about for 2023?

After successfully navigating a once-in-a-hundred-years pandemic and a 400+ percent increase in the risk-free rate over the past few years, it's hard to imagine what 2023 could throw at us that would be more unexpected. While higher interest rates and a recession may be in the cards, the skills necessary to succeed and drive growth in that environment are well within the time-tested PE toolkit. And when we get to the other side, those firms that perform well should find it easier to differentiate versus peers and see an opportunity for accelerated growth. ■

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