ISSUE 38 | NOVEMBER 2016
PRIVATEDEBTINVESTOR.COM

PEI Alternative Insight

PRIVATE DEBT INVESTOR

FOR THE WORLD'S ALTERNATIVE ASSET CLASSES

OFF THE BEATEN TRACK

WHY MONROE TARGETS SECOND-TIER CITIES

PLUS: THE RISE OF THE MARKETPLACE | BDCS UNDER THE SPOTLIGHT | SENIOR DEBT'S PREDICTABLE ALLURE | WHAT BREXIT MEANS IN ASIA | AND MORE…

MONROE CAPITAL

From left: Thomas Aronson; Michael Egan; Ted Koenig; Zia Uddin

Reaching out

US fund manager Monroe Capital spreads itself far and wide in the quest to build relationships with small to mid-sized companies. With a new fund freshly raised, *PDI* talks to its senior leadership to find out more about the firm's origination efforts and how it runs the rule over prospective investments

If making money were easy, we'd presumably all be rich. Which is why Ted Koenig, joined in conversation by three senior executive colleagues at the Chicago headquarters of lower mid-market fund manager Monroe Capital, likes to avoid taking the straightforward option.

For example, the Monroe president and chief executive describes the due diligence process for a typical sponsored private debt transaction as follows: "The private equity firms present us with a deal and most of the diligence information is tied up in a nice neat package with a bow on it. We open up the package and go through the information. Then to the extent we have questions, we have the opportunity to ask follow up questions and do additional due diligence."

It's an easy and well-trodden path, the downside of which is that it leads almost inevitably to aggressive competition for the deal. Koenig is not in any way dismissive of sponsored transactions: indeed, Monroe does many of its deals alongside private equity firms, and there are good opportunities to be had outside of fiercely fought-over auctions.

Nonetheless, the firm has carved out a niche as one of the leading proponents of the sponsorless market, where the path to deal completion has a more demanding gradient – together with the promise

of less competition and more lucrative rewards.

"In non-sponsored transactions, we have to create the package," he says. "Our people dig in and retain the third-party due diligence providers and we do the work to assemble the various diligence items. It's a lot more work for us and a lot more employee hours. We can add real 'alpha' in those situations by working harder. Our leverage attachment points tend to be lower in those deals and our pricing tends to be a bit higher. In those non-sponsored deals, we can add another 250 basis points of net yield per year for our LPs, and that's a pretty significant differential."

The message appears to be well received by institutional investors, as Monroe has just closed its 11th investment vehicle, its 2016 Private Credit Fund II, at $800 million of LP commitments, beating its $600 million target. Together with committed credit facilities, this new fund provides Monroe up to $1.5 billion of new lending firepower.

CAREER CHANGE

Koenig is a certified public accountant by education who went on to law school and worked as a mid-market M&A and finance attorney. He left the legal profession in 1998 – having worked as an associate at Winston & Strawn and risen to partner at Chicago based Holleb & Coff – in 1998 in order to launch a finance business known as Hilco Capital, which raised what he describes as a "small" distressed credit investing fund in 1999.

Joining Koenig on the Hilco team were Michael Egan and Tom Aronson – now two of the eight senior Monroe executives who make up the firm's leadership team. Then as now, Egan was the head of credit and Aronson the head of new business originations. Alex Franky, an underwriting specialist not present for this interview, was also part of the initial Hilco Capital team and joined Monroe at the very beginning in 2004. Franky is head of direct deal underwriting at Monroe.

From 1999 to 2004, Hilco Capital made investments in mostly junior debt, mezzanine and distressed debt until "the market became frothy and the returns were no longer compelling from a risk/reward basis", according to Koenig. "We did a lot of deals during that time period where we were trying to add 'intelligent capital' to underperforming companies and provide them with additional liquidity. Once the multi-strategy hedge funds found this space en masse in the early 2000s, we could no longer find a way to provide these underperforming companies with intelligent capital."

THE EARLY DAYS

In recent years, Monroe has developed a strong fundraising franchise but in the early days, it relied for capital on strategic relationships with partners that Hilco Capital had invested with and built solid

Koenig: 'In those non-sponsored deals, we can add another 250 basis points of net yield per year for our LPs'

MONROE AT A GLANCE

Founded: 2004

Focus: US mid-market and lower mid-market

Number of professionals: 80, including 45 investment professionals

Committed and managed capital under management: $3.6bn

Newest fund: $1.5bn total investable capital for 2016 private credit fund

Amount invested since inception in 2004: $5bn (in more than 900 deals)

Offices: Chicago, New York, Los Angeles, San Francisco, Atlanta, Boston, Dallas, Toronto

Source: Monroe Capital

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relationships with, such as Fortress Investment Group, Citibank and Goldman Sachs.

In 2006, Monroe found another strategic partner in NorthStar Realty Finance, a New York-based Real Estate Investment Trust (REIT). The plan was for NorthStar to back Monroe in building a CLO issuance business in the mid-market. At that time, NorthStar took a 49 percent stake in Monroe and agreed to provide a significant limited partner capital commitment, initially for two CLOs that were backed by warehouse facilities from Wachovia Bank.

The first of these CLOs was completed in late 2006 and, according to Koenig, was one of the leading performers in the market through its call date, generating better than a 23 percent net IRR. But amid market turbulence in late 2007 and early 2008, the second CLO which was fully ramped at the time, and which had a one-year tenor, could not proceed without a restructuring including fresh capital. That was at the height of the financial credit crisis and the CLO market was hit especially hard.

Uddin: 'Our companies tend to be second-, third-, or fourth-generation family-owned'

Financing difficulties such as these were not uncommon during that period; as one competitor said of the Monroe/NorthStar vehicle that had its credit line pulled by Wachovia Bank: "This happened to them and 100 other guys."

NorthStar could not fund the additional capital needed at the time and Monroe ended up taking back the 49 percent equity stake from NorthStar, with NorthStar rolling over its existing commitment into a restructured vehicle managed by Garrison Investment Group. Garrison, NorthStar and Wells Fargo, which later purchased Wachovia, declined to comment.

Koenig says that the experience taught him a number of important lessons, including the need to have lengthier tenors on its credit facilities and reduce its reliance on single LPs for equity commitments. He says that this CLO experience forced him to change his thinking and greatly diversify both his debt and his LP capital raising efforts.

Since then, Monroe has indeed embarked on the fundraising trail, diversifying its sources of capital supply in the process, as well as the types of investment vehicles that it manages.

The recent close of Private Credit Fund II included commitments from US pension funds the Orange County Employees Retirement System, New Hampshire Retirement System and Chicago Policemen's Annuity & Benefits Fund.

The fund is targeting a net IRR of 8-10 percent unlevered and 12-14 percent levered, according to public documents from the City of Fresno Retirement Board. Its predecessor, Private Credit Fund I, raised $500 million in 2014 and was showing a net IRR of 14.2 percent levered and an

PUBLIC FACE

Monroe Capital has a business development company called Monroe Capital Corp (MRCC), which was listed on Nasdaq in late 2012. Research by financial services firm Raymond James & Associates at the end of June 2016 estimated, on a fair value basis, that its portfolio comprised 58.6 percent first lien senior secured loans, 19.0 percent junior secured debt, 15.7 percent unitranche loans, and 6.7 percent equity investments.

According to MRCC filings and Raymond James research, MRCC's industry concentration as at August 2016 was: consumer 50 percent; healthcare 13 percent; manufacturing 12 percent; industrial services 9 percent; financial services 7 percent; energy 5 percent; technology 5 percent.

MRCC's dividend coverage is currently well above the industry mean of 100.3 percent. This places it fourth out of 47 BDCs listed by Raymond James in its September 2016 *BDC Industry Investment Banking Weekly Newsletter*:

Dividend coverage	
MVC Capital (1st out of 47)	163.0%
Monroe Capital Corp (4th)	122.9%
Mean	100.3%
Median	100.0%

Source: Raymond James, 30 September 2016

annualised cash-on-cash return of 16.3 percent in 2015, according to public documents from the City of Dallas Police and Fire Pension System, another Monroe investor.

As well as senior debt and unitranche debt, Monroe also has a CLO strategy headed by Jeremy VanDerMeid. The firm closed its third CLO in the last two years in July on $305 million, secured by Monroe's mid-market senior secured loans and with a four-year reinvestment period.

OCCUPYING THE SPACE

From the beginning, Monroe sought to reach as far as it could into the vast swathe of lower mid-market companies across the US. It recognised that the only way to do this effectively would be to reach into what Aronson describes as the "white space" – the huge potential market that other managers were not penetrating effectively.

"In order to bring in new business, it's all about relationships," asserts Aronson. "I affectionately say you can't do our business by having two people sit in a cube in New York looking at each other and dialling for dollars. You need to be out on the street."

Aronson spearheads the deal origination effort, with 18 origination professionals and offices in New York, Los Angeles, San Francisco, Atlanta, Boston, Dallas and Toronto. The firm seeks opportunities to lend to companies with EBITDA typically ranging from $3 million to $25 million.

The zeal that Aronson brings to the conversation is notable: "We want people out there, we want them networking. We want them in the local chapter meetings. We want them not only in the first-tier cities, the Chicagos, the New Yorks, the LAs; we want them in second-tier cities like Indianapolis, Cleveland, Minneapolis, Kansas City, St Louis and Milwaukee."

It's an approach that appears to be bearing fruit, at least in terms of dealflow, with around 1,750 possible transactions

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Thomas Aronson

coming Monroe's way last year, according to Aronson (41 of which were actually completed). A material proportion of deals, he notes, comes from banks referring their non-sponsored clients – particularly in the second-tier cities.

"A banker might call us up and say, 'I've got an opportunity for you to work with my customer. He wants to buy out his partner.' It's a good supplement to our business to have our originators calling in these second-tier cities and getting opportunities that may not be shopped around the country," says Aronson.

That is the "edge" and the additional value that Monroe brings to its LP relationships according to Aronson; high-quality investment opportunities that they cannot get from competitors and other asset managers.

SECTOR SPECIALISTS

He insists the firm is helped by having sector specialists aiding the origination effort, citing the example of healthcare: "You need someone who knows the lingo and the regulatory landscape on a daily basis, who can go into a meeting and talk about Obamacare and offer views on Medicare and Medicaid. It would be tough for me to walk into a healthcare conference and give someone a high degree of confidence that I really know the space.

"But Matt Evans, who co-heads our healthcare group, can go in there and tell everyone what he's seeing and what the leading healthcare providers are doing today to stay ahead of the curve. From an origination standpoint, we like to bring that expertise and understanding to our prospective clients."

Michael Egan, the firm's chief credit officer, acknowledges that his understanding of risk is also assisted by having smart people in industry verticals (he cites technology and media as well as healthcare). But ultimately "we all come together as a group, we all make sure we understand

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the risks of a business and then decide as a group if we should move forward on it."

"We have an investment committee of eight individuals averaging over 25 years of private credit experience per person with very impressive backgrounds. That team works on a unanimous basis. So you can imagine that each of our deals get vetted pretty hard. The system has proved it works well over the last 16 years."

Asked to describe Monroe's philosophy when it comes to assessing credit, Egan replies: "I think what you'll find is that we're very deep-dive, heavy due diligence, [we] dig in, understand businesses very well and then select the ones that we really like with the best business models, the best management teams and the most stable cashflows."

Are there any companies, or sectors, that the firm would rule out? "We tend to stay away from companies that are highly cyclical, where we are not confident of their performance in a down cycle. Companies that don't have a real differentiated product or service advantage or that do not have staying power to make it through a down economic cycle," says Egan.

He refers specifically to oil and gas firms: "I don't think it's fair to say we won't do any oil and gas company investments, but to date, we have had a very hard time underwriting the commodity price risk involved, which is why we have completely avoided this sector and all the carnage that our competitors have had to deal with."

Egan says that the firm keeps a keen eye out for any signs of stress in the portfolio – and has what he describes as a "proactive early intervention philosophy" – although he also insists that deals are structured in a way that allows companies to ride out storms. "We include all the bells and whistles of a highly monitored, highly scrutinised deal. As a result, we don't have to change anything when the credit cycle becomes difficult because we've already done what was required three or four years previously. For example, we use both

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quantitative and qualitative covenants to capture both EBITDA numbers but also EBITDA drivers. That is crucial for doing business in the middle market. It provides us with early EBITDA driver concerns far before they actually affect EBITDA."

He adds: "My background is in asset-based lending. I spent a significant part of my career as a credit guy with CIT in the 1980s and 1990s focused on closely watching our middle-market asset-based loan portfolio. When you're an asset-based lender, you're into very day-to-day, week-to-week, month-to-month monitoring of credit and credit statistics as well as liquidity and availability. You really get to know your borrowers and their business cycles."

Nonetheless, some market sources have claimed they've passed on some of the deals Monroe ended up doing – citing the level of risk as the key factor.

Aronson responds: "A lot of the deals we might do, the perceived risk is much different from the actual risk involved."

He points out that the firm may use less leverage than competitors would have done or include more covenant or collateral protections. "We work a deal to shape it to the risk-return and credit profile that we think fits Monroe Capital," he adds.

"People see a deal announcement from us, but in many instances, the deal we structured and closed was completely different from the deal that was shopped around initially and shown to our competitors. We

FUNDS INCLUDE

2016: **Monroe Capital Opportunistic Private Credit Fund LP** (in market)
2016: **Monroe Capital Private Credit Fund II** ($800m)
2016: **Monroe Capital MML CLO 2016-1** ($305m)
2015: **Monroe Capital BSL CLO 2015** ($412m)
2014: **Monroe Capital MML CLO 2014** ($358m)
2013: **Monroe Capital Senior Secured Direct Loan Fund** ($500m)
2013: **Monroe Private Credit Fund A LP** ($515m)
2012: **Monroe Capital Corporation IPO** (Nasdaq: MRCC) ($350m)
2011: **Monroe Capital Partners Fund I LP** ($250m)

Source: PDI

try to provide custom-tailored solutions to each of our borrowers that also fits into our own Monroe credit box."

Egan is asked about the firm's apparent enthusiasm for non-sponsored deals, given the rigorous private equity-led scrutiny applied to sponsored deals. Is gaining comfort in non-sponsored businesses more of a challenge?

"The sponsored transactions provide a certain level of expertise and sometimes even financial sophistication, which is nice," says Egan. "But you'd be surprised at some of the non-sponsored deals we do. They have very sophisticated management teams and they are very well-run companies. These managers will run through a wall for their company and for us."

"IN NON-SPONSORED TRANSACTIONS, WE HAVE TO CREATE THE PACKAGE. OUR PEOPLE DIG IN AND RETAIN THE THIRD-PARTY DUE DILIGENCE PROVIDERS AND WE DO THE WORK TO ASSEMBLE THE VARIOUS DILIGENCE ITEMS. IT'S A LOT MORE WORK FOR US. WE CAN ADD REAL 'ALPHA' IN THOSE SITUATIONS BY WORKING HARDER"
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END OF THE CYCLE?

This prompts consideration of whether there will be any running through walls to be done in the near future. The point is often made, by those both within the asset class and outside, that private debt has had a smooth run since the crisis – as a result of which, it's getting tougher to discern the best from the rest. But is this about to change?

"Everyone uses the baseball analogy," notes Zia Uddin, a managing director as well as portfolio manager and head of special situations. "They say we're in the seventh or eighth inning of the credit cycle. I have no idea. In our space (the sub $30 million EBITDA-size company), my view is that the highs are not as high and the lows are not as low. This market is much more insulated from the broader syndicated larger cap market. Our companies tend to be second-, third- or fourth-generation family-owned businesses and in secure parts of the market food chain."

He also does not think the growing appetite to invest in private debt will create too much competitive pressure. "People see a bunch of money flowing into the private credit space today, but that's typically all at the higher end of the market or the 'traditional middle market' with companies with $25 million-$100 million of EBITDA," says Uddin.

"That market is much more of a club market where an agent lender will arrange a $150 million-$400 million and upwards credit facility and then sell it to a number of other participant lenders. Being a participant in those deals is pretty easy as the agents do a good job of underwriting and structuring these loans today.

"Unfortunately, it's hard to add much value or 'alpha' to your LPs as a participant in those deals as the pricing and leverage metrics are not great," he adds.

"Not many people want to roll up their sleeves the way we do at Monroe and underwrite a large number of $5 million-$20 million EBITDA-size companies. That is a lot of work, and that is also where we can add a ton of value for our LPs."

It's not the easy route to success, but whatever results end up being delivered, the easy route is not the one Monroe chooses. ■