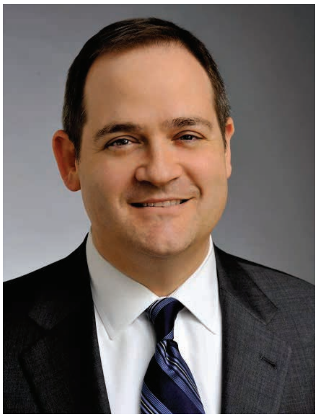
E X P E R T Q & A

Monroe Capital's Aaron Peck and Kyle Asher discuss why speciality finance is a good option for private credit exposure that can deliver exceptional, uncorrelated risk-adjusted returns



Speciality finance: A strategy for multiple rate environments

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Q How does Monroe Capital view speciality finance?

Aaron Peck: Speciality finance is a significant opportunity in the US. Market experts have estimated it is a $20 trillion opportunity that is four times the size of the US and European leveraged finance and private corporate direct lending markets.

Due to regulation, the volume of bank asset-backed commercial securities outstanding has declined sharply after the global finance crisis, creating a huge opportunity for non-banks. Simply put, we view speciality finance as lending on an advance rate basis against pooled assets, in a highly structured manner, rather than more typical single asset or company loans.

Kyle Asher: As a speciality finance loan is covered by a collection of assets, it typically has a borrowing base and other structural protections. Structures are very similar to securitisations but without the volatility of rating agencies and the complexity of multiple rated tranches.

Speciality finance borrows the techniques of securitisations, which allows for lower risk because you are tied to a formula that advances against individual assets. The structure isolates those assets from a variety of company-specific risks such as their cashflows as a result of performance of the company.

AP: Another way of saying that is you set an eligibility requirement for assets to receive an advance on the credit line, and if an asset becomes ineligible due to underperformance or an increase in risk, the structure is set up to self-correct the overall risk so that asset would no longer receive an advance. If the structures are set up correctly, which is largely learned through experience, it tends to have large self-moderating element of risk along the way.

Q Could you outline the kinds of assets or verticals that are a good fit for a speciality finance structure?

AP: We have done a variety of transactions including litigation finance, fund finance, equipment leasing, royalty streams and small business lending, among others.

KA: Another compelling investment opportunity we have seen in the last 12-18 months is the acquisition of speciality finance loans from counterparties. Banks that require liquidity are selling off speciality finance portfolios, often at an attractive discount.

Q How do you price risk in when providing speciality finance?

AP: Pricing risk is an art form, and it takes experience and a lot of time in the market to develop expertise. It's like any muscle, the more you work it, the stronger it gets. It is a skill that benefits from repetition, seeing deals play out and learning what creates risk. It's one of the areas we excel at, because we've been doing this for decades.

When you are investing in mainstream assets, the differentiation ultimately becomes lower pricing, but in the spaces where we focus, it's more about trying to be thoughtful with your approach and thinking about downside risk and protection.

Q Speciality finance is one of the legs of Monroe's opportunistic credit platform. How does it complement other opportunistic strategies?

KA: The way we have set out our opportunistic credit platform gives us the ability to toggle between the different areas, and that enables us to compete more effectively, particularly when transactions involve investment targets that straddle the different areas. This is where we really have historically excelled – in areas where everything isn't always bucketed neatly. Hybrid areas include telecoms, digital infrastructure and single-family rental.

Q What impact has the cycle of rising inflation and interest rates had on speciality finance, and does market dislocation make this an appropriate time to build exposure to speciality finance?

AP: It is important to be clear that speciality finance is a long-term strategy that has delivered strong returns for investors across an entire investment cycle. That said, inflationary and interest rate headwinds have created opportunities, and it is fair to say that speciality finance thrives in times of market dislocation.

In our experience, market dislocation has seen banks pull back from certain opportunities, including speciality finance deals they would have pursued a year or two ago. That opens opportunities for us.

Asset-covered speciality finance structures provide us comfort in an uncertain environment. Speciality finance is a great strategy that often has modest correlation to the broader economy, and has the ability to drive higher returns during times of dislocation.

KA: We tend to focus on assets with high excess spread. These assets have the headroom to absorb material increases in interest rates or various changes in loss rates. That doesn't suggest that these assets aren't impacted by rate hikes, which create higher debt servicing costs, but for us as a lender, it doesn't necessarily stress the equation very much.

We believe there is a distinction to be drawn between market dislocation and market distress, which are terms that sometimes are conflated. At an individual borrower level, a dislocation is more of a market fracture – even in a market dislocation, underlying borrowers can still be perfectly healthy and not experiencing distress. These are the situations that we seek – opportunities where the underlying asset is not distressed and is less impacted by what's going on in the macro sense.

If I look at litigation finance, for example, where we have done numerous deals, the investment cycle is not going to stop lawsuits from proceeding and settlements from being paid. That illustrates what kind of assets we like to build into a portfolio – assets that tend to be less susceptible to the overall economy.

Q Even though speciality finance has built-in protection against downside risk, it is also able to generate alpha. What is the secret to selecting assets that are perceived as high risk but present lower actual risk?

AP: The secret is simply hard work. It is very easy take a cursory review of something and throw it away. One of the common themes about opportunistic private credit is that we don't read a book by its cover.

We tend to go the extra mile to figure out the actual risk versus perceived risk. It is where we thrive. I always say that the worse a deal sounds, the more likely I am to spend some time on it to see if there is an angle that is worth consideration. Now, nine times out of 10, there isn't a better angle, and your first instinct was correct. That one time out of 10, you'll find there's really an interesting opportunity that didn't sound as great at first, which can only be determined with experience.

KA: Given that we are not dealing with conventional situations where everything is neatly packaged, our skillset needs to be specialised. In speciality finance, structures are more complex and take more time to pull together, but with the right experience and skill set you can secure some highly attractive margins on loans that are in fact less risky. It is also important to point out that we are always dealing with assets – many of which are financial assets that create cashflows (which not all hard assets do) and are generally easier to monetise. ■

Aaron Peck and Kyle Asher are co-heads of opportunistic credit at Monroe Capital