TALKING POINTS

Deals are getting done, asset prices are escalating and the market is heating up. So why does something not feel right about this recovery? Monroe Capital's Tom Aronson, Michael Egan and Zia Uddin explain why now is not the time to let the guard down

Proceed with caution

Q Entering 2021, a sense of hope has enveloped the market, particularly after a fourth quarter in which M&A volume rebounded so significantly. How would you characterise the deals that are getting done?

Zia Uddin: It's pretty simple, at least from a credit perspective. It's the same deals that historically get done with top-tier lenders: companies with high free cashflows, a track record of customer retention and strong management teams. Even with a macro backdrop in flux, the fundamentals don't change.

Tom Aronson: There was a push at the end of 2020 to make up for the prior six months after many private equity firms put deals on hold in the immediate aftermath of covid. There continues to be momentum at the beginning of 2021.

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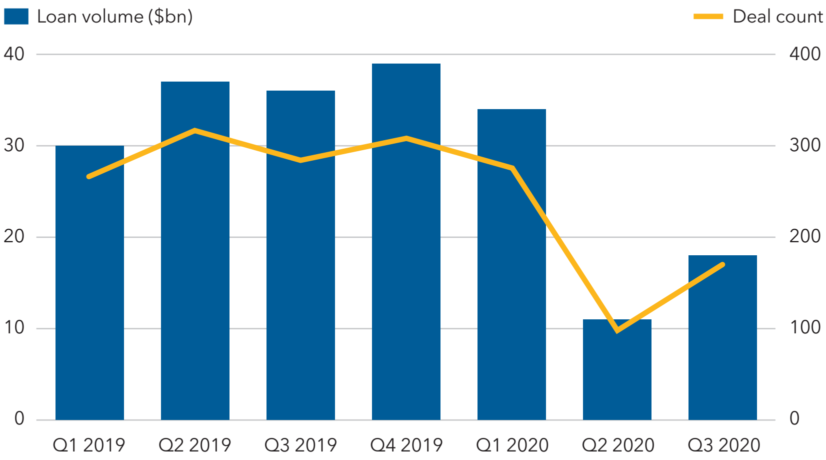
At Monroe, we've now experienced three down cycles. As we emerge from the crisis, many private equity firms have a renewed appreciation for the value of an experienced lender, like Monroe. We proved to be responsible and worked constructively with our borrowers to help them find liquidity and manage through the uncertainty of covid. Fast forward 10 months, and borrowers are again prioritising good lender relationships over merely choosing the cheapest source of financing at the friendliest terms.

Michael Egan: I'm going to challenge the conventional wisdom that the worst is behind us. We're hearing a narrative develop, as vaccines are rolling out, that there's a light at the end of the tunnel. Yet here we are, in the first quarter, and much of Europe is going back into lockdown; and many industries are still dealing with shifts in the business landscape as digital transformation, automation, and evolving consumption patterns are forcing companies to evolve in real time. There's a sense, too, that while the pandemic technically

Mid-market sponsored loan volume



Source: Refinitiv LPC

triggered an economic recession, this didn't feel like a true downturn marking the end of the cycle. The depth of our pipeline affords us the luxury of staying disciplined, discerning between the haves and have nots. We're scrutinising prospective credits and our funnel has narrowed in what we consider to be a still-uncertain economic environment.

Q Are there any takeaways from 2020 that are informing investments, in terms of which sectors are most appealing, how companies are financing, or new threats?

ZU: There's a widening gulf between the haves and have nots. In some cases, such as retail, the pandemic reinforced existing trends; on the flip side, you saw it accelerate digital transformation, with implications for virtually every company and industry. Historically, we've focused on three major industries: business services, healthcare, and technology and software. This served us well as they're traditionally recession-resistant segments of the economy, but these areas also represented the bulk of deal volume last year. In terms of how companies are using their financing, in the immediate wake of the lockdowns, it was 'preservational' in nature. Now companies are beginning to play offence.

ME: Regarding the threats, though, this is a challenging environment for underwriting. Initially, when liquidity dried up, you saw pricing and terms improve, even for the best credits. But that was temporary. And while the market has started to normalise, there's a lot of variables that add complexity and risk. Stimulus money, for instance, pulled forward demand and discretionary spending in certain cases that aren't sustainable. And some industries are still dealing with supply chain issues.

TA: The pandemic allowed us to witness the value of a strong management team as well as evaluate which private equity sponsors supported their portfolio companies. This is extremely valuable underwriting knowledge as we continue to invest in 2021 and beyond. As Zia mentioned, this is an area we scrutinise, but a 10-year bull market provided cover for many shortcomings that became evident when the environment changed.

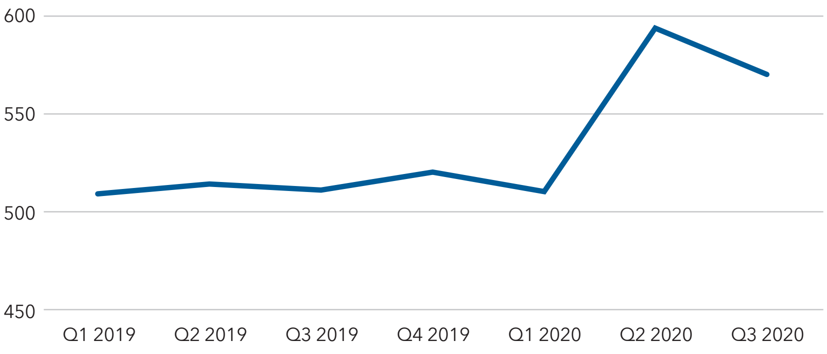
> *"A 10-year bull market provided cover for many shortcomings that became evident when the environment changed"*
>
> TOM ARONSON

Q Regarding the sectors, the past year has provided a test case for software as a service. Can you talk a bit about how recurring revenues held up?

ZU: If you look across private equity deals in 2020, approximately one out of every three deals was in the software space. It wasn't that long ago that the sector was confined to specialists willing to take on tech and R&D risk. We have been lending into the space for many years and have continued to add to our team and strengthen our industry expertise in order to underwrite and monitor these assets, which have a number of unique attributes – including that they revolve around annual recurring revenues versus traditional EBITDA metrics. Successfully lending into the space requires deep industry specialisation, particularly to understand where these companies fit in their respective value chains and how much cashflow they can generate when growth rates normalise. But one of the takeaways from the past year was that covid-19 has accelerated the digital transformation and enhanced the value of mission-critical software solutions, validating our longstanding commitment to the space and thesis that these companies would prove to be highly defensive. Now you're seeing a covid premium in software and more participation by generalists. Part of our underwriting going forward requires that we assess to what extent these deals truly possess the key attributes we're looking for in a software company.

Q Given your experience, how would you characterise the competitive set today? It seems like private

Mid-market direct lending: first lien term loan spread (bps)



Source: Refinitiv LPC

debt has grown considerably over the last few years. Is that creating pressure on returns, especially following a year in which dealflow seemed to shrink?

ZU: Much of the growth has come at the expense of the traditional bank lenders, who used to play a much larger role financing M&A. But if you look at the breakdown between the current overhang in private equity and the fundraising figures in private debt, there is a lot of runway left before lenders start to run out of opportunities.

Even in a year like 2020, we saw nearly $110 billion raised in private debt. If you look at the PE dry powder overhang, which eclipsed $725 billion, and assume a very conservative 50/50 debt-to-equity split, the amount of private credit funding currently available is barely one tenth of what will be required to finance future PE investments. This is one of the several reasons why forecasts project that private debt will become a $1.5 trillion asset class by 2025. While the numbers may vary by source, directionally the gap is important.

TA: We have a dedicated originations team that generates significant non-sponsored dealflow. This is important because it provides a countercyclical source of dealflow. When private equity M&A volume slows, the non-sponsored financing requests tend to increase. These non-sponsor borrowers tend to be more opportunistic, in that they'll wait for dislocations to find value in M&A. From a portfolio management perspective, non-sponsored credits can also enhance risk-adjusted returns, as the marketplace isn't nearly as efficient.

Q To that point, can you talk about the market for private equity sponsored dealflow in terms of pricing, leverage and protections? As dealflow has picked up again, are you seeing private equity firms becoming more aggressive?

ZU: This is what we love about the lower middle market. Although spreads have started to normalise, pricing in our market remains attractive, especially compared with the larger deal realm. At the same time, leverage levels are more moderate, generally below 5x EBITDA, while covenant-lite loans remain non-existent for us. We're starting to see some signs of greater supply of capital in the market in the form of dividend recaps, funding for acquisitions without strong collateral and documentation, and looser definitions of EBITDA.

ME: Run-rate EBITDA definitions are not new, but some PE sponsors can be particularly creative when it comes to documentation. We're seeing companies that may have experienced a lift in the last few months try to extrapolate that out to project 12-month adjusted earnings.

TA: The covid addbacks have also become very aggressive. We expect to see a request for addbacks to adjusted EBITDA related to layoffs, for instance, but PE sponsors are increasingly trying to take a very liberal approach to their requests. We're even seeing requests for lost revenue addbacks to normalise the business, as if covid didn't happen. It underscores the need to dig in and understand the fundamentals of each business to determine which companies will survive post-pandemic.

Q So given everything, what's the overriding theme that will characterise 2021?

TA: Proceed with caution. I think as extraordinary as 2020 was in every sense, and as happy as everyone is to put last year behind us, it's not unreasonable to think there could still be some kind of market correction.

ZU: You can probably count on two hands the number of private debt firms that have gone through three credit cycles. Our experience tells us this is not the time to put your guard down. Luckily, lenders like us, that have been together for over 17 years, have processes in place to manage through the noise and take advantage of market opportunities.

ME: Make no mistake, we're looking forward to the next sustained upturn. But through discipline, we stay aligned with our borrowers and LPs, and our experience tells us that it's during these periods of uncertainty that we can forge stronger relationships as a dependable source of financing, whatever the market may bring. ■

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