MONROE CAPITAL

OPPORTUNISTIC CREDIT FORECAST: CLOUDS WON'T OVERSHADOW INVESTMENT OPPORTUNITY

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OPPORTUNISTIC CREDIT FORECAST: CLOUDS WON'T OVERSHADOW INVESTMENT OPPORTUNITY

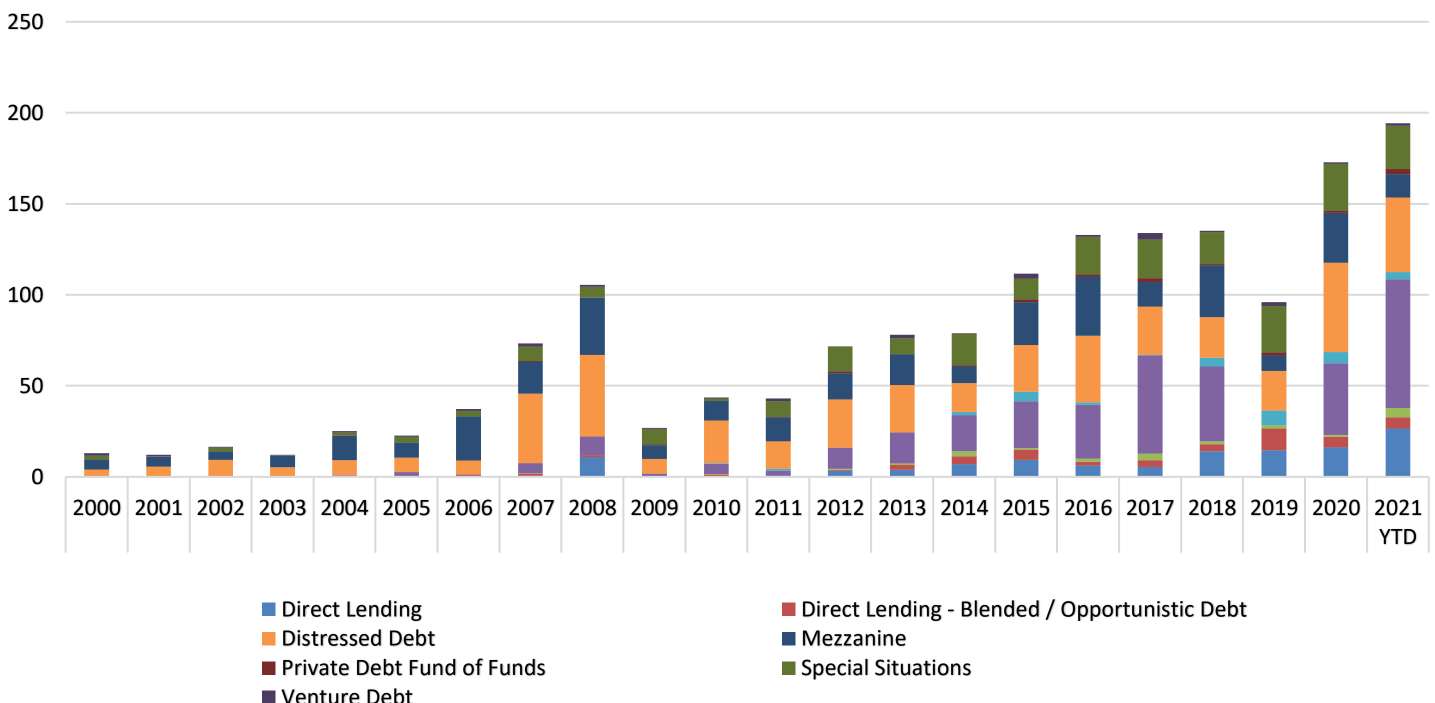
Special situation and opportunistic credit can be an "all weather" strategy for private lenders who chase complexity versus a changing credit cycle.

The past two years have provided a case study around the value of an all-weather investment strategy. The floor fell out from under the market in 2020, as the pandemic helped trigger the biggest decline in U.S. GDP since World War II. 2021, on the other hand, is expected to see the economy accelerate at its fastest pace since 1984, which kicked off what economists refer to as the Great Moderation. While nobody is quite sure what will happen in 2022, The Daily summed up the overriding sentiment succinctly in a podcast that asked, "The economy is good, so why do we feel so terrible about it?"

If investors were uncertain about the inflationary picture in 2021, entering 2022 the worry revolves around the definition of "transitory," as inflation hit a 30-year high in November. Fed Chair Jerome Powell in testimony before the Senate actually retired the word "transitory" as a qualifier to describe inflation, but he implied that it should moderate when the supply chain crisis is resolved. However, rising prices remain an issue for both business owners and consumers, and represents the answer to the question that explains the escalating anxiety currently muting any inclination to celebrate economic growth or record highs in the public markets.

It's against this backdrop that flexibility has never been more appreciated among institutional investors. In fact, J.P. Morgan Asset Management, in its 2022 Long-Term Capital Market Assumptions report cited both its optimism for modestly higher global growth and the ongoing risk of inflation to proclaim that "despite low return expectations in the public markets, investors can find ample risk premia to harvest if they're prepared to look beyond traditional asset classes."

INVESTORS' ALLOCATIONS TO PRIVATE CREDIT REMAIN RELATIVELY HIGH



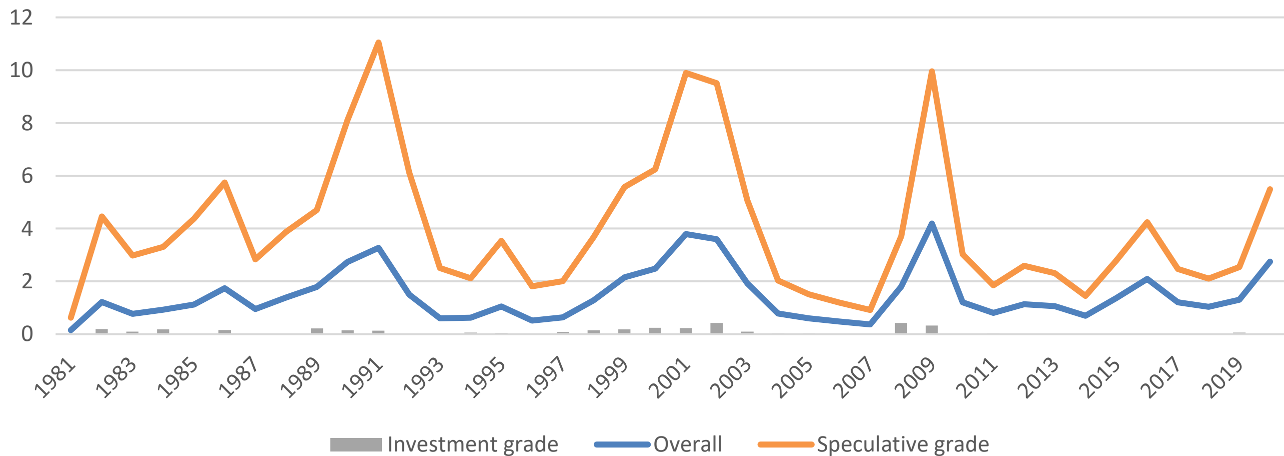
Source: Preqin. Data as of December 17, 2021 for global private credit.

Enter opportunistic credit. Investors have historically equated flexibility in the debt market with event-driven strategies, designed to step in during economic dislocations, acquire distressed debt at significant discounts, and make directional bets on the economy and the markets. As was demonstrated during 2020 – marked by extremes to both downside and upside scenarios – traditional "opportunistic" strategies no longer provide the flexibility required by investors in such a dynamic environment, not with the increasingly abbreviated investment windows or extended bull markets aided by interventionist monetary policies. But among select managers, the "opportunistic" playbook now embraces an "all-weather" strategy that can deliver consistent uncorrelated returns across any market environment.

THE "OPPORTUNISTIC" RORSCHACH TEST

To a certain degree, opportunistic strategies, given their inherent and necessary flexibility, can mean different things to different lenders. For Monroe, we launched our opportunistic strategy to take advantage of an underwriting skillset already in place to focus on high-quality assets whose value is often masked by collateral complexity, nuance around existing credit structures, or restricted access to more traditional capital markets. As such, the strategy focuses on specialty finance, such as SPV financings or structured products; asset-heavy corporate debt, including DIP loans, NAV lending or corporate special situations; highly structured real estate across property types; and other asset-rich areas, from royalty streams to litigation finance.

Window for Distressed-Oriented "Opportunistic" Strategies Gets Narrower As Credit Cycles Becomes Elongated



Source: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro, 2020 Annual Global Corporate Default and Rating Transition Study

Unlike most "opportunistic" strategies, however, our funds avoid deep distress and loan-to-own situations, which typically require an operational turnaround. And while the thesis is enabled by deep underwriting, most investments tend to fall outside of the market's more traditional ABL or direct-lending archetype. It's a niche that historically had been dominated by sharp-elbowed hedge funds, with uncertain intentions. This lends to a massive gap that exists in the market, as most private equity firms and high-quality borrowers are remiss to obtain loans from these lenders of last resort.

From the perspective of fund investors, the upshot is that the strategy is geared around non-traditional credits that can be sourced and realized during any market environment. For instance, “typical” for Monroe’s opportunistic strategy is best characterized by “atypical” investments with bespoke structures and high complexity. These targeted segments provide a steady pipeline of deal flow and prevent capital from sitting on the sidelines, where it would otherwise create a drag on returns amid an indefinite wait for the next cyclical shift.

Institutional investors tend to be drawn to the immediate yield available through credit strategies that can put capital to work quickly, which helps to moderate the “J curve” often associated with other private market allocations. And by targeting “difficult,” not distressed, credits, the strategy offers higher yields compared to traditional middle-market private debt. Rather than representing a bet on the cycle, like most opportunistic strategies, Monroe’s approach seeks to provide protection against the cycle through asset coverage and the opportunity for enhanced yields in the event liquidity dries up.

A key differentiator for Monroe, besides the underwriting skillset to navigate the complexity, is an ability to move quickly. This is especially the case during periods of change. The events of 2020, for instance, highlighted the nimbleness of the strategy as the markets and the opportunity set quickly changed over the course of the year. For instance, when the flood of rescue financings and secondary market investments dried up, the strategy was able to quickly transition to highly structured real estate, asset-heavy corporate credit, and specialty finance investments. In 2021, meanwhile, the pivot was less pronounced, but no less expedient in finding the corners of the market in need of capital – areas that traditional private debt strategies typically can’t accommodate.

OCCUPYING A ‘PROBLEM SOLVER’ NICHE

SPECIALTY FINANCE

- **Bespoke SPV Financings, Portfolio Purchases, Structured Products**
- Portfolios of **asset-backed financial instruments** and receivables
- **Renewed focus on efficient asset classes that have become dislocated as well as historically uncorrelated and niche asset types**

ASSET HEAVY CORPORATE CREDIT

- **DIP Loans, Rescue Financing, NAV Lending, Stressed Portfolio Purchases and Corporate Special Situations**
- Companies with unpredictable cash flows and questionable enterprise value but **asset rich**
- Idiosyncratic risk tied to assets; less susceptible to macro conditions

HIGHLY STRUCTURED REAL ESTATE LENDING

- **NPL Purchases, Portfolio –Level Loans, Structured Financings, B Piece Lending**
- Bespoke structures often with high complexity
- Multiple asset types across industrial, multi-family, residential, and others

SECONDARY INVESTMENT

- **Focus on performing first lien middle market and syndicated paper**
- Invest capital in the secondary markets **when appropriate; we believe current market conditions are favorable**
- Opportunities created by illiquidity, ratings driven selling, and various fundamental and technical factors

Consider the slowdown in the market for special purpose acquisition companies, or SPACs. Despite a run of successful transactions that brought several high-profile companies onto the public markets, the activity hit a speed bump in the second quarter of 2021. According to S&P Global Market Intelligence, SPAC IPOs saw quarterly proceeds from new listings plummet from $88 billion in the first quarter to just $16 billion in the second quarter, while the number of "deSPAC" deals – in which the blank-check companies secure an acquisition – fell by 37% over the same time period.

The slowdown, rather than reflecting a material weakness in the market, provided an opportunity to step in as a valuable source of liquidity as sponsors behind the blank-check companies solicited extensions of their closing dates and high-growth targets required "insurance" liquidity as the time to closing was extended. For instance, in one deal, Monroe's opportunistic fund provided a bridge loan to a deSPAC target, as the closing of its merger endured delays. From the borrower's perspective, the financing provided additional liquidity to continue its strong growth trajectory, without any disruption as the company waited to complete the deSPAC transaction. Monroe's funds, meanwhile, were able to secure an attractive credit, underwritten against a very conservative loan-to-value ratio, at a yield well in excess of traditional private debt.

In other instances, in 2021, Monroe's opportunistic strategy developed a concept to provide "fund loans" to private equity firms seeking to extend the investment periods of assets in their portfolio. Without the capital infusion, the GPs would either be forced to sell a company to recycle the capital back into their portfolio or approach their LPs for an extension to the follow-on investment period. Beyond just helping GPs avoid a challenging request, fund loans – secured against the underlying portfolio and priced in the high single digits – can also augment IRRs, not unlike subscription financing arrangements that have become quite common in recent years.

DEFINING "OPPORTUNISTIC" IN REAL ESTATE

At the core of the strategy, we endeavor to finance the highest quality assets and borrowers in spaces where there likely is less capital and less competition. As the saying goes, we "skate to where the puck is going to be, not to where it has been." Some areas for us, such as litigation finance tend to reside off the beaten path, representing a less trafficked pool of assets, whose inefficiency can translate into attractive returns for investors able to evaluate and de-risk the investments. Other areas, however, might seem more traditional, such as real estate credit, although the flexibility of the strategy allows us to create solutions for borrowers not available through other lenders.

Given the appreciation in home prices, for instance, we're seeing a compelling opportunity to back proven investors building single-family rental properties. The thesis is augmented by the unique dynamics currently characterizing the housing market, in which it's cheaper to build a house than buy an existing property in many high-growth markets. This is creating an insatiable demand from families who can't afford to buy a house in these geographies. It was the nimbleness of our opportunistic strategy that helps make Monroe a capital provider of choice in this market.

Alternatively, we're also seeing other opportunities that are more indicative of the distress in certain pockets of real estate, which is masking the value of the underlying assets. For example, we recently backed an investment in an office property located in West Palm Beach, Florida. Given the near-term uncertainty of work-from-home trends as well as portfolio struggles facing traditional real estate lenders, we were able to step in quickly and gain comfort in the location, the specific asset, the equity investor, and a deal structure that protects against the downside.

Our underwriting skillset also attracts the less "cookie cutter" deals traditional lenders avoid. We recently invested in an emerging specialty finance company that revolves around real estate commissions. The platform, headed by a veteran of the life insurance settlements niche, is effectively investing in the right to be the listing agent for single-family properties – paying an upfront fee to homeowners for exclusivity to list the houses for the standard commission. Future agent fees are then pooled to create a collateralized investment that offers high spreads and predictable distributions. It's very similar to the strategies behind litigation finance or insurance settlements, where conviction can be found through fundamental analysis and a large, diversified pool of assets.

Our reputation in working with our investment partners to bring deep underwriting insights also makes us a preferred partner for more special situation investments involving high-profile properties, marked more by external complications than undue investment risk.

Real Estate: Underwriting Skillset Creates Opportunity When Traditional Lenders Pullback

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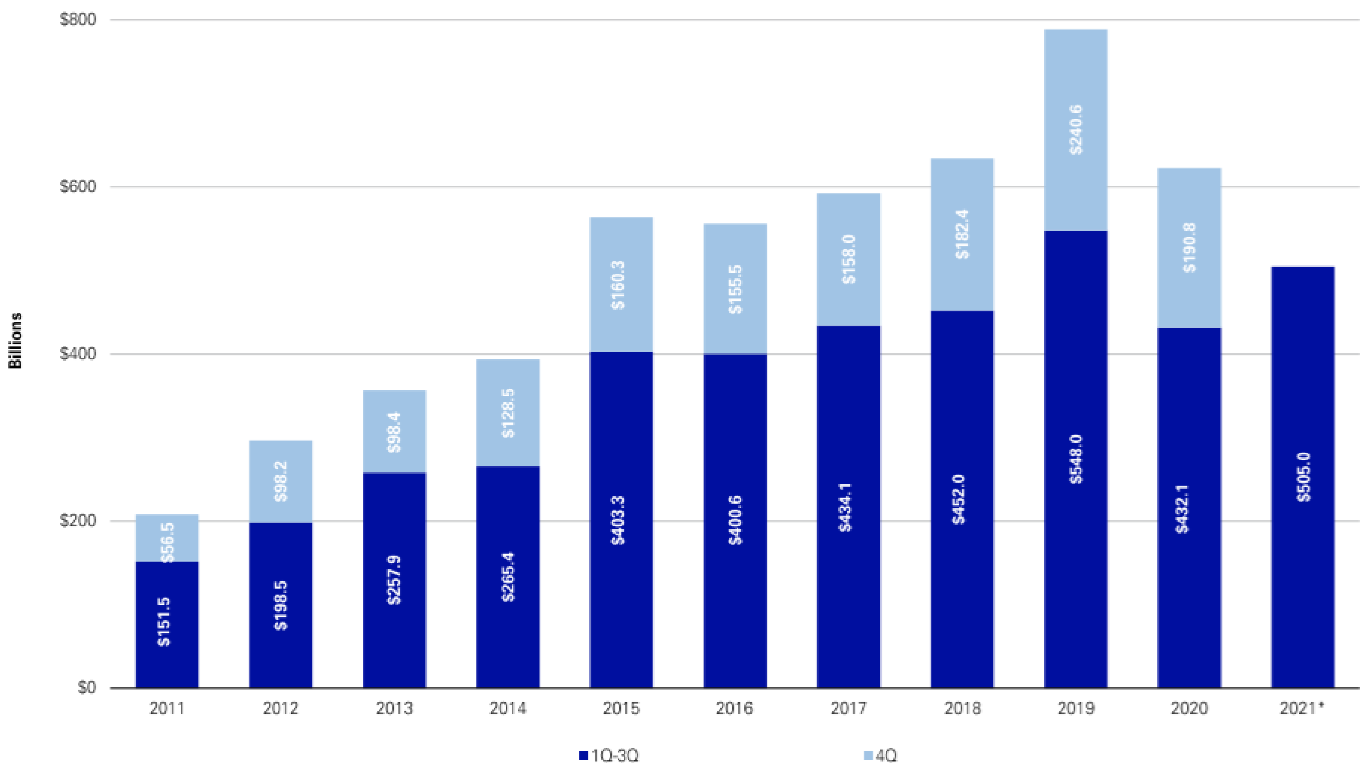
U.S. TOTAL ORIGINATION VOLUME

ACQUISITION, CONSTRUCTION AND REFINANCING IN REAL ESTATE SECTOR



*Preliminary
Source: Newmark Research, Real Capital Analytics, 3Q2021 Capital Markets Report

OPPORTUNISTIC IN ACTION

The distinguishing characteristic is that no two deals are ever identical, yet all share the common threads of deep underwriting marked by bottom-up analysis. Downside protection is also a prerequisite via structures that mitigate risk through advance rate, cash traps, diversity, eligibility and by other means. Sometimes, new credits may even resemble traditional financing arrangements, but are far more complex under the surface.

In July, Monroe Capital backed the acquisition of a transit-oriented development site located in Miami led by real estate development and investment firm Witkoff. The site sits adjacent to Brightline's MiamiCentral Station, which will connect Florida's largest economic center as the region transforms and becomes a southern hub for the financial services, technology and media industries. It's the type of special situation transaction that lends itself to an underwriting skillset to gain comfort quickly and keep pace with the buyers on a fast-moving transaction.

Other deals, however, may be better characterized by their complexity. Monroe helped back a merger between Vertical Bridge REIT and Eco-Site. Vertical Bridge is the country's largest private owner and operator of wireless infrastructure, with over 20,000 owned and master-leased tower sites and an entire portfolio of more than 290,000 sites across the U.S. Beyond just the unique collateral, the transaction had to be completed under a tight timeframe – no small feat considering tower deals historically involve nuanced zoning rights, sale-leaseback arrangements and other considerations. It's a heavy lift from an underwriting perspective, albeit risk averse to those who understand the industry dynamics and intrinsic value of the underlying assets.

The deal is a perfect example of our value proposition to borrowers, who seek us out when they need speed and certainty. Among investors, though, the primary draw is the alpha found through embracing complex credits, coupled with the hedging characteristics of an all-weather strategy.

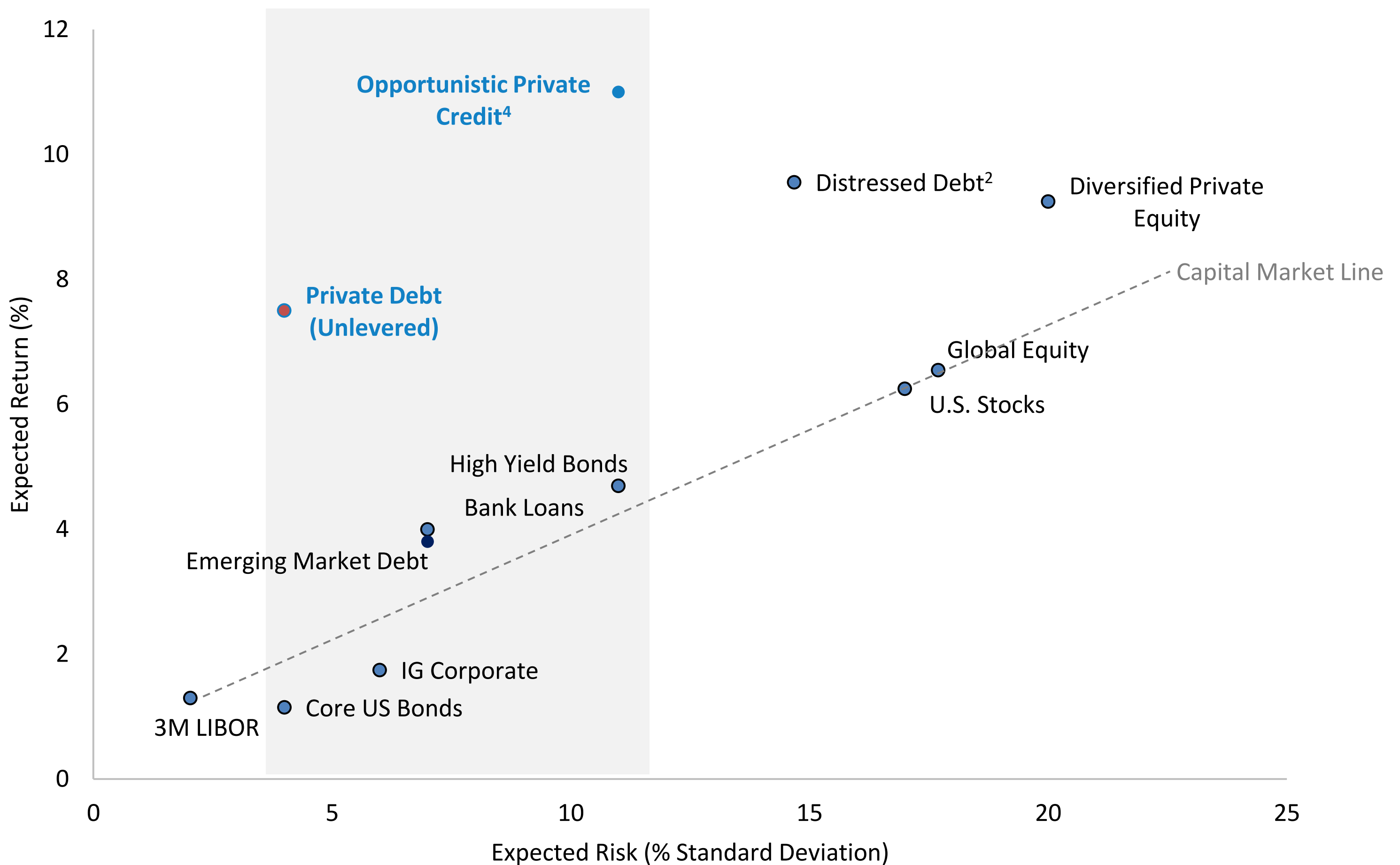
This is particularly the case given the overriding questions facing asset owners today. The uncorrelated nature of Monroe's opportunistic investments, for instance, can provide a natural hedge against inflation that's only amplified by exposure to areas such as real estate. The floating-rate terms of most credits can also augment current yields in the event of rising rates, while the value of underlying collateral offers further comfort in the event that recent inflation becomes more permanent. Meanwhile, even as supply chain bottlenecks are creating acute challenges across much of the economy, the resulting liquidity crunch in many cases in many sectors creates demand for a proven lender adept at underwriting non-traditional credits.

Indeed, "special situations" do not have to imply high risk or lender of last resort, and exposures to opportunistic strategies can be a return enhancer within an alternatives allocation that offers both the income of private credit with equity-like returns.

To us, the appeal is that we don't have to sweat the cycle, because it's an all-weather strategy that not only is protected against economic shifts, but allows us to stay active in any market.

Opportunistic Private Credit Provides a Better Risk Return And Has Low Correlation To Other Asset Classes

10-YEAR EXPECTED ASSET CLASS RETURN AND RISK [1,3]



The 'Capital Market Line' represents the tradeoff between expected return and risk.

1. Source: Cliffwater 2021 Asset Allocation Report, January 19, 2021. Private Debt (Unlevered) returns have been adjusted to reflect Monroe's expectations of future returns as currently projected for Monroe's Fund IV strategy at the current time. Certain returns herein are presented on a gross of fees basis by investment. Such returns would be reduced by certain fees and expenses, including Monroe's manager fee, as is more fully described in the applicable Private Fund's confidential private offering memorandum, partnership/memorandum or articles of association (as applicable), and Monroe's Form ADV Part 2A.
2. Source: Preqin. The information presented is the average historical return and risk from all 2010-2020 vintage funds identified as Distressed Debt. Monroe assumes that future returns will be similar with past returns, but please see footnote 3.
3. There can be no assurance that any expected rates of return or risk will be achieved. Expected rates of return and risk may be based upon assumptions regarding future events and conditions that prove to be inaccurate. Expected rates of return and risk should not be relied upon as an indication of future performance and should not form the primary basis for an investment decision. The index returns are provided for information only. Reference to an index does not imply that a portfolio will achieve returns, volatility, or other results similar to the index. Please see additional disclosures at the end of this report.
4. Monroe Capital LLC Proprietary Research reflects our current estimate of gross returns for this strategy. See footnote 1 for description of difference between gross and net returns.

APPENDIX

THEODORE L. KOENIG, CHAIRMAN & CEO

Mr. Koenig is the Chairman, CEO and Founder of Monroe Capital. He is responsible for executive management, strategic initiatives, and company direction and policy, and is a member of Monroe's Investment Committee. He also serves as the Chairman, President and CEO of Monroe Capital Corporation, a publicly traded business development company (BDC). Mr. Koenig has over 30 years of experience in structuring, negotiating and closing transactions on behalf of asset-based lenders, commercial finance companies, financial institutions and private equity investors. Prior to founding Monroe in 2004, Mr. Koenig was President and CEO of Hilco Capital LP, a junior secured/mezzanine debt fund established in 2000. Mr. Koenig spent the previous 13 years at the Chicago-based law firm of Holleb & Coff as partner and co-chair of the firm's Corporate Law, Mergers & Acquisitions and Business Finance groups. Mr. Koenig earned his J.D. with Honors from Chicago-Kent College of Law and his B.S. in Accounting with High Honors from Indiana University Kelley School of Business. He also successfully passed the Certified Public Accounting Exam. Mr. Koenig is a Director of the Commercial Finance Association, and a member of the Turnaround Management Association and the Association for Corporate Growth.

AARON PECK, MD, CO-HEAD OPPORTUNISTIC PRIVATE CREDIT

Mr. Peck is a Managing Director, Portfolio Manager and Co-Head of Monroe Capital's Opportunistic Private Credit investment vehicles. He is also Portfolio Manager for Monroe's retail and high net worth investment funds including serving as the Chief Financial Officer and Chief Investment Officer of Monroe Capital Corporation's publicly held business development company (NASDAQ:MRCC). He joined the firm in 2012 and is a member of Monroe's Investment Committee. Mr. Peck has over 25 years of experience in credit, lending, high yield, distressed credit and public company operations and investor relations. Prior to Monroe, Mr. Peck was Chief Investment Officer at Deerfield Capital Management and was responsible for the investment teams at Deerfield including syndicated and middle market loan teams which managed over $5 billion in assets. Mr. Peck was also chief portfolio manager for Deerfield's publicly-traded specialty finance mortgage REIT and in that capacity, was the key point of contact for all institutional and retail investors, investment banking research analysts, lenders and investment bankers. Prior to Deerfield, he worked in leveraged credit at several investment firms including AEG Investors, Black Diamond Capital, Salomon Smith Barney, and ESL Investments. Mr. Peck earned his M.B.A. with Honors from The University of Chicago Graduate School of Business and his B.S. in Commerce from The University of Virginia, McIntire School of Commerce.

KYLE ASHER, MD, CO-HEAD OPPORTUNISTIC PRIVATE CREDIT

Mr. Asher is a Managing Director and Co-Head of Monroe Capital's Opportunistic Private Credit investment vehicles, and also Head of Underwriting & Structuring. He is responsible for deal origination, structuring, and portfolio management, as well as managing the underwriting team. He joined the firm in 2009 and is a member of the Opportunistic Private Credit Fund's Investment Committee. Mr. Asher has over 10 years of investment experience and has led the underwriting of over $2 billion of debt and equity transactions, across a variety of opportunistic private credit investments. Prior to Monroe, he was an Analyst with Chicago-based Calder Capital Partners, a direct and fund-of-funds private equity firm partly owned by Goldman Sachs and Ares Capital (formerly Allied Capital), where he performed due diligence on various direct and fund-of-fund investments, sourced transactions and assisted in capital raising. Mr. Asher began his career as an Equity Analyst for MindShare Capital, an institutional money-manager where he focused on the valuation and trading patterns of small-cap growth companies. Mr. Asher earned his M.B.A. in Finance and International Business from Northwestern University and his B.A. in Philosophy and Political Science from Northwestern University.

R. SEAN DUFF, MD, HEAD OF MARKETING & INVESTOR RELATIONS

Mr. Duff is a Managing Director, Marketing & Investor Relations of Monroe Capital. He is responsible for all aspects of marketing and investor relations. He has over 20 years of experience in the alternative investment business including capital raising, investing in alternative investments, institutional investors coverage, and investment talent sourcing. Prior to Monroe, Mr. Duff was a Director at Deutsche Bank within their Global Prime Finance group responsible for covering institutional investors and consultants in the U.S. and Canada. He also served as Director of Marketing at Onex Credit Partners, has spent time investing at hedge funds at Trout Trading Management and SAC Capital, and at investment banking firms Morgan Stanley and Merrill Lynch. Mr. Duff earned his B.B.A. with a concentration in Finance from The College of William and Mary.

ABOUT MONROE CAPITAL

Monroe Capital LLC ("Monroe") is a premier boutique asset management firm specializing in private credit markets across various strategies, including direct lending, asset-based lending, specialty finance, opportunistic and structured credit, and equity. Since 2004, the firm has been successfully providing capital solutions to clients in the U.S. and Canada. Monroe prides itself on being a value-added and user-friendly partner to business owners, management, and both private equity and independent sponsors. Monroe's platform offers a wide variety of investment products for both institutional and high net worth investors with a focus on generating high quality "alpha" returns irrespective of business or economic cycles. The firm is headquartered in Chicago and maintains offices in Atlanta, Boston, Los Angeles, Naples, New York, San Francisco, and Seoul. For more information, please visit www.monroecap.com.