Q+A

Monroe Capital

A Q&A session with CEO Ted Koenig

Private credit has become very competitive, what differentiates Monroe and why has it achieved success where others have struggled? Does Monroe benefit from its focus on the lower end of the middle market in particular?

That's a great question, particularly as so many new entrants have moved into the asset class over the past few years. One of the critical differentiators for Monroe has been our 12-year track record and its history in the business. We founded the firm in 2004 and our focus has remained fixed on middle-market and lower-middle-market companies in the $3 million to $30 million EBITDA range. We work with both equity sponsors and companies that haven't yet partnered with private equity, so we can bring a flexible solution to fund future growth or provide appropriate leverage. We are one of the non-bank lenders with experience lending through a number of economic cycles, having worked with companies and sponsors prior to the financial crisis and then following the credit dislocation caused by the financial crisis. This history has allowed us to prove out our value proposition as a reliable and steady source of capital.

Another differentiator is our reach across the US and into Canada. Monroe manages approximately $3.6 billion and has eight offices throughout North America. This allows us to develop a consistent platform with many of our national and regional referral partners, and our deep-seeded relationships in cities has proven to be a unique source of deal flow.

Beyond focusing on the lower middle market we have dedicated expertise across several verticals, such as healthcare, technology, media, retail; and we recently launched a specialty finance vertical. If borrowers are focused on price or the amount of leverage they can get, this may not resonate quite as much, but more often we're finding that clients appreciate the kind of expertise we can bring to the table and this domain knowledge helps us stand apart.

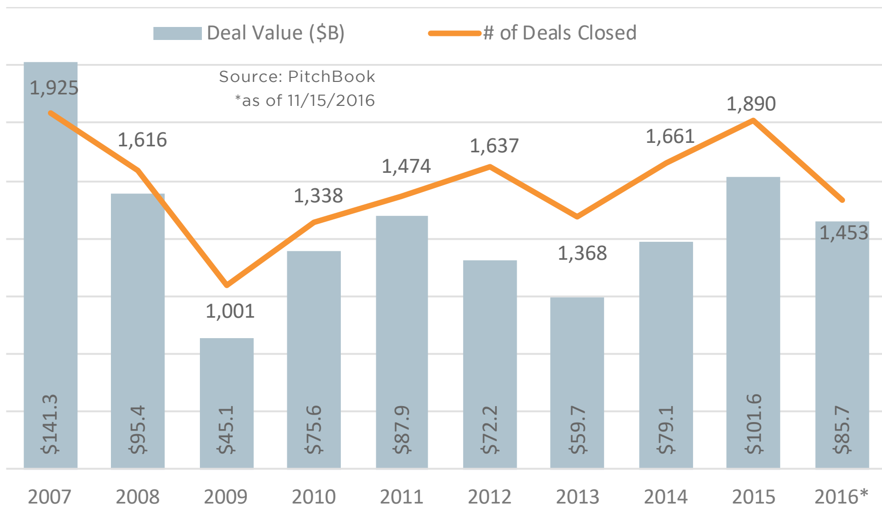
Liquidity is always a primary concern. What's your take on the current state of regulated banks' role in the financing market and also, with regard to supplying money to firms such as yours?

Liquidity is always going to be the primary concern in finance. The financial crisis taught us that most regulated banks and other finance firms don't necessarily fail because of bad loans; they fail because they do not have the liquidity or staying power to survive an extended economic downturn. We saw many of our competitors close because they chose to operate their businesses through a hedge fund-style structure that exposed themselves to redemptions. Others chose to leverage themselves with cheap mark-to-market debt, which magnified the impact of the crisis.

All of our funds are long-term in nature, effectively mirroring the structure used by PE firms with lockups to ensure alignment between our investors and the businesses we're backing. All of our debt facilities are multiyear, matched facilities and face no mark-to-market risk.

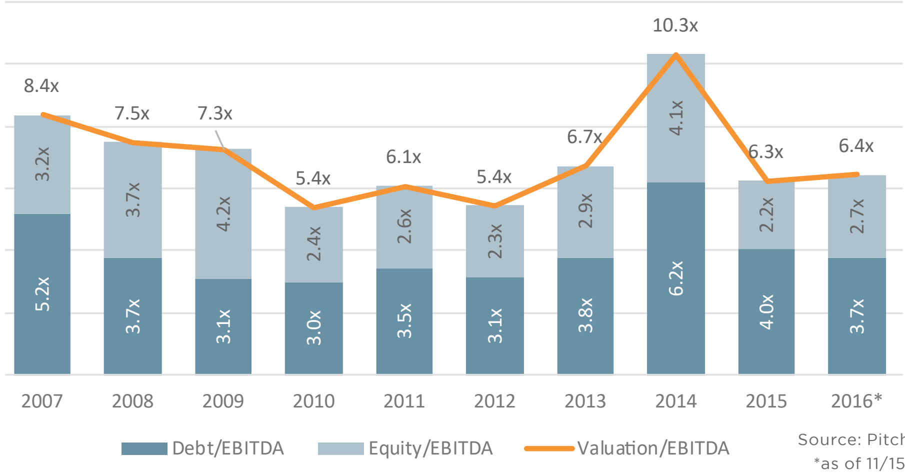
The banks, meanwhile, are far stronger than they were five years ago, largely due to the improving economy, but federal regulators have also required banks to maintain a higher amount of capital on hand than at any other point in time. The Fed and the OCC also guided the banks to impose a debt ceiling of 6x EBITDA for LBOs, which has served as a governor at the individual credit level and has probably served to curb

Middle-market deal activity by year



***Middle-market transactions are defined as those between $3 million and $100 million or those involving businesses with revenues between $10 million and $50 million.*

EBITDA ratios for middle-market deals by year



Source: PitchBook
*as of 11/15/2016

purchase prices here at the later stages of the credit cycle. This is important as firms like ours rely to some extent on the health and stability of these regulated banks to provide us with credit facilities, which, in turn, modestly leverage our own LP commitments.

Explain why the trend toward segmentation of the middle market is so important and why it's showing no signs of stopping; where do you think it will end up?

What you're seeing is that the investment world has become much more sophisticated today and is segmenting the private credit market. Just as LPs are looking to find very specific allocations within private equity, they are also looking to deploy capital in private credit across the market to build diverse investment portfolios. I think one of the drivers is that LPs want to allocate more dollars to the asset class so they're adjusting their models to optimize goals around alpha generation.

In terms of how they're segmenting the space, at one end of the spectrum, they are seeking lenders that work with larger companies, EBITDA of $25 million and up. Several firms fit into this category and really do a good job covering that part of the market. In the lower part of the market (EBITDA of between $5 million and $25 million), the LPs might be penciling higher total returns as the credit quality is just as attractive, although the pricing tends to be far more favorable. The challenge for institutional investors is that there's a limited capacity of how much capital can be committed to the lower middle market because the overall investable asset pool is not as great as the larger company size market.

What do you foresee as the most pressing risks looking into 2017?

I think there are really two primary concerns heading into next year and then a host of minor considerations that are no less important. First, it's all about individual loan performance. In this business, asset managers need to be all over their portfolios. We monitor all of our credits vigilantly, and seek to work with borrowers proactively to get ahead of any potential stress. I think this is one of the factors that has contributed to the struggles among many business development companies, as they fell victim to lax portfolio surveillance practices and poor credit underwriting and, today, are trading at less than 80% of their NAVs. As a result, they're actively reducing and cutting their dividends, which is probably a red flag for borrowers.

My second concern relates to liquidity. As we discussed, most financial firms do not fail because of losses, they fail due to a lack of liquidity. As a result, I'm very focused on what the banks are able to do in the leverage lending area to firms like ours.

In terms of the other concerns heading into next year, they all revolve around taking care of our people. Our business is people and I count on every member of our team to originate, execute and monitor deals. I am proud to say that we have nearly all of the same senior people in place at our firm since our inception 12 years ago. In a relationship business like this, that is critical.

What are the key benefits and challenges to Monroe operating two separate business lines—the direct & agented loan origination versus the creation of high-quality club investment opportunities with other asset managers?

We have the direct and agented loan-origination business, which I've disclosed above, but we also operate a "flow" business. The flow business takes advantage of our ability to originate and distribute loans to others by creating high-quality club investment opportunities for us with other asset managers. Those deals are proprietary relationship loans that we back with other credit focused managers. The flow business, which we're working to expand, is about being a good partner to other managers. We have issued several CLOs over the last couple of years and seen a lot of enthusiasm for these products both from investors and other credit managers.