Lead Left Interview – Theodore L. Koenig (Part 2)

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This week we continue our conversation with Ted Koenig, president and CEO, Monroe Capital. Monroe is and has been a leading provider of senior and junior debt to middle market companies in the U.S. for the last 14 years. ***Second of two parts – View part one***

The Lead Left: Monroe has two different businesses, correct?

Ted Koenig: Yes, we have the direct and agented loan origination business I've just described and we have a "flow" business. The flow business takes advantage of our ability to originate and distribute to others by creating high quality club investment opportunities with other high quality asset managers. Those deals are proprietary relationship loans that we do with other like minded credit focused managers. We create alpha in that business by utilizing those proprietary club transactions and then sprinkling in some of our own "home cooking" Monroe agented deals.

TLL: How much of your business is PE sponsor-backed?

TK: It varies a little from year to year, but we like to keep it around 60-70% PE sponsored and 30-40% non-sponsored. By doing high quality non-sponsored transactions with generally better pricing and lower leverage, we can pick up 200-300 basis points annually of net LP returns. The PE sponsored deal market is more competitive and sophisticated.

TLL: What's the largest check you can write?

TK: We can write a $150 million check across our platform today. However, the biggest check we have actually written is around $110 million. The average size for us in the portfolio today is about $55 million for our directly originated and agented deals.

TLL: What about the flow business?

TK: That's our club business that we developed from our origination business. It's easy to create scale there. However, if we can't create alpha, I really don't want to scale that business. We can't hold everything; diversification is critical. We want to sell certain assets and when we do, that creates reciprocation from others. The flow business for us is about being a good partner to other managers. We're working to develop our flow business; we have issued several CLOs over the last couple of years. We have a strong loyal following of CLO investors, particularly in Europe. Everything we do in that area is both U.S. and European risk retention compliant.

TLL: How are you able to maintain and reward your people as your growth has been very impressive?

TK: As I mentioned earlier, we have not and are not going to grow for growth sake. That being said, we have grown our firm at a 28% CAGR since the financial crisis in 2008. That growth is a direct result of increasing our market share in our space at a time when the traditional regulated financial institutions have largely left the market. This has allowed us to attract the best talent from many of those same financial institutions we used to compete against in the early and mid 2000s. I think it is critical to create opportunities for career development for our employees and staff. It's important for our firm to help our people succeed – professionally, personally and financially. For example, last year in 2015, we closed on two separate funds totaling around $1 billion of LP commitments or about $2 billion of total buying power after considering leverage. 56 people in our firm have been allocated carry with those two funds. That's pretty atypical in our industry.

TLL: Ted, what keeps you up at night?

TK: Two primary concerns, and then a host of other minor ones that are no less important. First, it's all about the portfolio. In this business, asset managers need to be all over their portfolios. If you take your eye off things, and don't monitor borrowers properly and proactively, problems will occur.   This is true in both the larger and more traditional middle market as well as the lower part of the middle market where we play. Just look at the BDC market for evidence of this. Many BDCs fell victim to lax portfolio surveillance practices and poor credit underwriting. Those same BDCs are now trading at less than 80% of their NAVs and are actively reducing or cutting their dividends. Early detection of problems and early intervention are keys to not losing money.   In our business, not losing money means we are creating alpha and generating high risk adjusted absolute returns for our investors. We have 25 people on portfolio surveillance, actively monitoring our borrowers. The private credit middle market allows us to receive lots of information, almost an unlimited amount about our borrowers on a timely basis. The important thing is to utilize that information.

My second concern relates to liquidity.   Most financial firms don't fail because of losses, they fail due to a lack of liquidity. That is what the financial crisis taught us. Leverage, albeit a modest amount, is an important part of our business in generating returns. We are non-regulated but indirectly, we get some of our money from regulated banks in warehouse leverage loan facilities.   I'm very focused on what the banks are able to do in the leverage lending area to firms like ours.

My third, fourth and fifth concerns all revolve around taking care of our people and compensating them properly. Our business is people. People execute and generate deal flow and returns. I am proud to say that we have most all of the same senior people from the start still together over our 14 years.

TLL: What does the future hold for the business?

TK: I think the future is bright for the private debt space. Investors need yield. Pension funds continue to grow. Regional banks are on the sidelines for transactional lending. There will always be middle market deal flow. The middle market represents 60-70% of all U.S. deal flow. There will always be deals generated from family transfers of ownership among privately held companies. And there will always be private equity sponsors buying from middle market businesses from other private equity firms.

TLL: What has been the biggest difference in the last 10 years?

TK: Eighty percent of the middle market loans made back in the mid 2000s were made by regulated financial institutions. Today that number is 20% which means that, 80% are being made and managed by firms like Monroe.

The asset class will continue to be a mainstream element of an investor's portfolio. But unless managers continue to generate alpha, they risk that they will become irrelevant. The amount of data available to investors today is much improved vs. ten years ago. Like with private equity, LPs want to invest in top tier performance rated funds. Institutional LPs will have their choice and they will choose alpha over beta in this space.

Segmentation of the market will continue. Ultimately, investors will want to invest in all segments of the market: companies with less than $25 million of EBITDA, those that have greater than $25 million of EBITDA but less than $100 million, and finally, those companies with greater than $100 million of EBITDA. Like private equity, institutional investors will want the best in class asset managers for each market segment. That creates diversity of managers and is a thoughtful way to construct an institutional investment portfolio of private credit today.

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