Lead Left Interview – Theodore L. Koenig

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This week we chat 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.

The Lead Left: Ted, it's been a while since you've done an interview with us. What's going on in the world of private credit?

Ted Koenig: What's happening is that the investment world has become much more sophisticated and is segmenting the market. Limited partners are looking to deploy capital in the private credit space across the market in order to build diverse investment portfolios and allocate more dollars to the space just as they have been doing for years with private equity. In the public or liquid credit space, mostly company EBITDA size of $100 million and up, there are lots of investment alternatives with liquid loan funds. At the middle market larger EBITDA company size, say starting at $25 million and up to $100 million, firms like Ares, Antares, Cerberus, Golub, GSO and Madison Capital do a good job covering that part of the direct lending market. For club and participation transactions in that same middle market, firms like yours (Churchill) and a several other large name brand asset managers offer an alternative product. In the lower part of the middle market, EBITDA company size of $5-$25 million, we at Monroe I think have built the best in class direct lending alternative. Investors need access to all of these market segments in constructing thoughtful private credit investment portfolios.

TLL: So investors are figuring it out? Or are they driving change?

TK: The sophistication level of investors is increasing thanks to the consulting community. Over the last five years, the asset class has come into its own. Post-crisis, beginning in 2011 and 2012, things began opening up. In 2008-2009, it was mostly distressed private credit investing. We were one of the first private credit firms post-crisis to raise a fund in 2010. We had a good track record coming out of the financial crisis. Investors believed that if we were able to generate solid returns in the 2008-10 time period in an uncertain and difficult credit environment, then we should do very well for them in a more benign time.

TLL: What were the lessons you learned from that period?

TK: Those that were able to raise money in 2010-12 learned that we needed to diversify our funding base. That was one of the most important lessons I learned in the financial crisis. What almost brought us down and actually brought many of our competitors down at the time was having too concentrated a funding base, with (in our case) two large financial institutions, both of which locked up during the financial crisis and failed. We were fortunate however; we had solid performance and long term locked up capital in one of our funds. That long term capital allowed us to be buyers when the entire market were sellers.

TLL: How did you diversify those sources?

TK: In 2009-10, we put a lot of new business on the books, mostly buying from hedge funds that dabbled in private debt but got caught with massive redemptions or mark to market short term financing. We raised a new private equity style, long term locked up LP fund in 2010. Then in 2012, we did an IPO for our BDC (MRCC).

Then in 2013 and 2014, we raised additional long term LP funds, and several large single investor managed accounts. All during that time period, we issued CLOs, both middle market and broadly syndicated. So we developed a deep diversified pool of capital to deploy in self originated, middle market private credit.

TLL: How about the last few years?

TK: The market has continued to mature. By 2013, we had established a solid ten year plus track record. Then, the consultants began to focus heavily on the space. They dug in and determined which firms were actually creating alpha as opposed to beta by buying the market. As luck would have it, the world was experiencing unprecedented prolonged low interest rates. That created a perfect storm for private credit.

On the other side of the equation, pension funds need yield to pay their bills. That is a fundamental fact. They found themselves with significant amounts of assets to deploy and no place to generate acceptable fixed income yield. They also dramatically increased their allocations in the private credit space from non existent or low single digits to up to 10%. Again, the perfect storm. Once the sophisticated LP investors segmented the space, it changed the game. Management teams from firms that blew up during the financial crisis were looking for new homes, and hooked up with institutions eager to take advantage of the macro asset management trends and get into private credit. Case in point, ten new private debt platforms have been created in the U.S. within the last 12 months. Also, most all of the large brand name private equity asset managers now have dedicated credit teams amassing assets under management.

TLL: Isn't it a huge challenge to differentiate between asset managers?

TK: Yes, it's a huge challenge for LPs. Today there are over 50 private credit firms operating in the U.S. and counting. The consultants help but differentiating is difficult without understanding the fundamental dynamics of the firms such as how much of the loan product is being directly originated and agented vs. how much is being bought from others; how much is subject to full and complete credit underwriting vs. how much is participated and/or clubbed with another agent; who is actually driving the bus in terms of setting and waiving covenants, defaults, dealing in loan collateral; how much of the product is PE sponsor backed vs. non sponsored; and, what size EBITDA companies are actually being financed and for what purposes. All of these questions are relevant for differentiation among asset management firms in the private credit space today.

TLL: What is your thesis relative to the newer players who are raising money in the space today?

TK: I think the more recent and new entrants are going to be surprised at how difficult it is to originate and find good credits to invest in. The European asset managers in private credit are finding that out now. It's not like the liquid markets where you can accumulate loan assets easily by pushing numbers on a Bloomberg terminal. We have 18 origination professionals spread across 8 offices in the U.S. and Canada. We reviewed over 1,700 deals last year just to do 64. This is very much a relationship business and we have been working with our deal referral sources and private equity firm clients for over 20 years and have been executing loan transactions with them over a very long period of time. Reliability and certainty of close is critical in this space. New entrants are going to have a hard time displacing the industry standard firms. The way to really break into this space today is with lower interest rates and looser credit structures – both of which are recipes for long term failure.

TLL: Why has your firm been so successful in fundraising over the last several years?

TK: I like to think it is because we are best in class in our space and we consistently generate "alpha." I do not believe that we should grow our AUMs simply for the sake of generating more scale and management fees. We seek to generate alpha with each fund that we raise and with each product that we offer to our LPs in our various private funds and to our shareholders in our public BDC. The results speak for themselves. Our firm is 100% owned by senior management; no pension funds, private equity firms, hedge funds or insurance companies. We are completely aligned with our LP investors and our public shareholders to create safe and stable long term absolute returns. We are focused on proprietary, self-originated and agented loan transactions for companies with between $5-$25 million of EBITDA. I would put our ten year track record of generating returns up against anyone in the private credit business, anywhere.

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