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## CUTTING EDGE CAPITAL MARKETS

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# Monroe takes middle-market lead in risk retention

Collateralised loan obligations that pool loans to smaller middle-market companies generally play second fiddle to the larger broadly-syndicated CLO market. But in a bid to widen the transatlantic appeal of its CLOs, middle-market lender Monroe Capital is taking a lead in tackling new regulation, writes **Will Caiger-Smith**.

NOT MANY games in the US offer comebacks as fast-paced and electrifying as basketball. As a serious aficionado of the sport — he met many of his business contacts while playing in his law firm’s championship team in Chicago — Ted Koenig, CEO of Monroe Capital, has seen his fair share of those. But when it came to making its comeback to the CLO market, his firm took a more measured approach.

It was no less impressive, though. Monroe Capital CLO 2014-1, which was priced in the penultimate week of August, notched up two milestones: not only was it the firm’s first CLO since 2006, it was also the first US middle-market CLO to comply with European risk retention rules.

The US is yet to finalise its version of those rules. But as European investors increasingly look to the booming US CLO market to pick up yield, making it possible for them to buy deals by ensuring they comply with Europe’s skin-in-the-game rules is becoming more and more of a priority for managers.

“It allowed us to access not only US investors but also the European market,” says Koenig. “That is significant because the broadly syndicated market is much deeper than the middle market from an investor standpoint.

“We have a number of high quality European investors that would not have been able to invest with us, so we structured the transaction in the manner we did to accommodate those European investors. We think it was a good business decision. I think it may have also had a positive impact on pricing as well.”

## The structure

Other US CLOs have complied with European risk retention rules — Onex Credit Partners and American Capital both issued broadly-syndi-

cated deals in May this year that did so. Most, though, have done so by the collateral manager simply retaining a 5% stake in the deal.

That is costly, though, and there is another way. Working with Deutsche Bank as arranger, Monroe complied with the rules by partnering with a third party, Orchard Global Asset Management.

AO Funding Ltd, an originator vehicle set up and managed by Orchard, accumulated assets for the CLO and will contribute at least 50% of the loans in the CLO portfolio. AO Funding then purchased CLO equity totaling 5% of the transaction — the skin-in-the-game part of the deal.

Because two asset managers are required to assemble transactions of this type, the process is complicated. But it offers a way to comply with the rules without the CLO manager itself having to stump up costly extra capital to retain a stake in the CLO.

“There is a threshold issue, because the third-party originator has to be a substantive entity with a proper business plan,” says a CLO lawyer familiar with the structure. “But if you are an issuer planning multiple deals it would make sense to think about this.”

## Next stop US

After the Securities and Exchange Commission finally adopted Reg AB II at the end of August, risk retention is now the next goal for US regulators. It has fuelled a boom in CLO issuance as managers try to ramp up assets under management before they are forced to buy stakes in their own deals.

Some smaller managers may be forced out of the market by the rules, but Monroe is in a good position to continue issuing when the regulation finally bites, says Koenig.

“We are trying to be thoughtful

about the structure of this deal, not only in complying with the European risk retention rules but also in preparing for any domestic US risk retention rules,” he says. “We have some very good business partners and good counsel on structure.”

Other firms, such as Fair Oaks Capital and GSO/Blackstone, have sought to comply with risk retention rules in Europe by floating public funds to invest in CLOs.

Other CLO managers in the broadly-syndicated sector, like Onex Credit Partners, have used the 50% third-party originator structure, but the third party is often an affiliate. By keeping very much within the letter of the rules, Monroe’s approach is more transparent, says Koenig.

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Ted Koenig,  
Monroe Capital

“Everyone, it seems, does it their own way,” he says. “We have taken a more transparent view of compliance. We have not tried to skirt the corners.”

That strategy clearly paid off, bringing hungry European investors into Monroe’s deal. In the close-knit community that is the middle market, it seems, taking a conservative view of new regulations and setting a rock-solid precedent with your interpretation of the rules can only be a good thing. It might mean taking slightly longer to make your long-awaited comeback, but at least people know you’re there to stay. ▲