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# A lender's view of a heated market

Monroe Capital's **Ted Koenig** outlines the catalysts that will keep the deal and credit markets humming in 2019

Monroe Capital president and chief executive Ted Koenig explains why deal activity should remain robust this year, while focusing on areas he's tracking that could foreshadow a slowdown in the event that conditions change. Monroe has over $7 billion of assets under management – across several private credit funds and managed accounts, a public BDC and CLOs.

**Q The credit markets, along with the rest of the economy, seem to defy gravity. How are you viewing the market and what are the catalysts that have been supporting activity over the last few years?**

Debt is the fuel that drives M&A, so whenever the M&A market is this hot, you can probably assume that there's also a lot of liquidity in the credit markets.

The persistence and strength of the credit cycle, though, is due to a number of factors. From the "supply" side, we've seen a rush of new capital enter the private debt space over the past few years as well as increasing allocations to this sector from large pension funds and other institutional investors. The primary reason for this is that against a backdrop of easy monetary policy and aggressive quantitative easing (QE) programmes globally, institutional investors have struggled to find yield. Pervasive and lasting low interest rates, or even negative interest rates in some parts of the world, have certainly helped stimulate business activity, which has driven performance in public equities and also driven prices of real assets to all-time highs. But, at the same time, low rates have made yield tough to find for institutional investors.

"GEOPOLITICAL RISKS ARE CERTAINLY PRESENT AND, AS INTEREST RATES HAVE CLIMBED, WE'VE SEEN THE PUBLIC MARKETS BECOME MORE VOLATILE"
**Ted Koenig**

This can create some real challenges. Pensions, for instance, need current yield to fund employee health and welfare benefits, whereas endowments, foundations and universities depend on it to fund their day-to-day operations. The World Economic Forum predicted that by 2050, there will be a $400 trillion funding gap, underscoring the scope of the challenge facing global pensions. Given this kind of demand for yield and coupled with the appealing risk/return profile of private debt, this asset class has been among the fastest growing of all institutional investment categories in recent years and should continue to grow.

**Q You mentioned the M&A market as a driver on the demand side. Do you see anything on the horizon that could alter the level of deal activity or slow it down?**

Not really; at least, not in the near term. Geopolitical risks are certainly present and, as interest rates have climbed, we've seen the public markets become more volatile. But the M&A environment is arguably as dynamic as it has ever been over the last few economic cycles. Purchase price multiples are at all-time highs; credit is readily available at borrower-friendly terms; and private equity dry powder exceeds $1 trillion.

The game-changer has been the re-emergence of the corporate acquirer. Much of this stems from the 2017 tax legislation in the US, which cut the "headline" corporate tax rate from 35 percent to 21 percent and included provisions around accelerated depreciation. The net effect of these tax changes was increased net cashflow to US corporates. As a result, corporate strategic buyers are sitting on record amounts

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Monroe Capital LLC is a private credit asset management firm specializing in direct lending and opportunistic private credit investing. Since 2004, the firm has provided private credit solutions to borrowers in the U.S. and Canada. Monroe's middle market lending platform provides debt financing to businesses, special situation borrowers, and private equity sponsors. Investment types include cash flow, enterprise value and asset-based loans; unitranche financings; and equity co-investments. Monroe is committed to being a value-added and user-friendly partner to business owners, senior management, and private equity and independent sponsors.

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# MARKET CONDITIONS

of cash. And, once again, they're a credible force in the M&A market.

This marks a shift. Financial sponsors, for the past few years, have been paying significantly more than strategic buyers. But we've seen a number of transactions recently that demonstrate a willingness among corporate acquirers to pay well above the market rate for assets with a distinct strategic value. It's the old "buy versus build" question. The IBM/Red Hat deal provides a great example of that. So the return of the corporate buyer to the M&A process only adds another catalyst to an already dynamic environment.

**Q If institutional capital continues to flow unabated into private debt and the M&A market is showing no signs of let up, is there anything that could surprise the debt market in 2019?**

Company performance is always the most important factor that impacts our portfolio. This is something we monitor closely. It has now been a year since the tax legislation was implemented in the US. That means most companies will be comparing 2019 operating results and earnings with those from 2018, which benefitted from the earnings acceleration attributable to the first year of the more favourable tax regime. I would expect to see either decelerating or declining earnings growth in 2019. That being said, cashflows remain quite strong and we remain optimistic around the trajectory of performance.

Finally, we're also cognisant that other factors could come into play. I'd argue that this is one of the toughest periods over the past 20 years to find clarity around what these "other factors" will be and how they will impact corporate growth. For instance, the geopolitical risk, while tougher to quantify, has escalated. In the US, we have an unpredictable and erratic foreign policy and it's been some time since the government has been this divided. There is also ongoing uncertainty regarding trade, tariffs, foreign sales, and imports. When you throw in questions about the direction of interest rates and currency volatility, it can become incredibly difficult for companies to map out long- or medium-term strategic plans, not to mention deal with the potential for unexpected surprises in the near term.

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**Q Have these concerns had any impact on the types of deals that are getting financed today?**

Not in the US middle market, where it seems like *all* deals are getting financed. Healthier deals – involving good companies that generate consistent cashflow – will always generate interest. In particular, we're seeing a lot of activity in business services, enterprise software, healthcare, consumer staples and food, as well as new digital-media businesses. Even out-of-favour sectors, like traditional brick-and-mortar retail, are showing no shortage of lender interest, although this area tends to attract asset-based lenders and inventory liquidation firms. Still, the competition to participate in the recent Sears DIP financing and exit package demonstrates the liquidity available in this sector.

**Q So it sounds like you remain optimistic, albeit with an eye on potential risks. How are you guarding against a potential downturn?**

We are always thinking about a "down" credit cycle. In a competitive landscape, like we're facing today, it can be even more difficult. The influx of money in the asset class has attracted newcomers who haven't experienced a downturn before. They're being particularly ravenous in competing for new sponsor-backed financings, for instance. It just makes it that much more important for lenders to sharpen their pencils around underwriting and due diligence.

At Monroe, we're maintaining our lending standards and increasing our selectivity of our borrowers in cyclical industries. We are also providing more scrutiny to any EBITDA adjustments that may seem overly aggressive and are very cautious around valuations today. We also believe that the market is more aggressive on covenants, loan documentation and EBITDA adjustments, so you have to be more attentive to the risks and consider all the different scenarios that could affect a credit.

The difference between the longer-tenured players and the newcomers, though, is that those of us who have gone through cycles in the past recognise and appreciate that each of these items will factor into the recovery rates of defaulted credits. It happened in 2008 and 2009 and it will happen again.

All that being said, we're still quite bullish. M&A activity is strong and the economy continues to provide optimism. We've used this opportunity to expand the depth of our product offering and add industry expertise across each of our verticals. In a crowded market, this allows us to differentiate ourselves as a true value-added partner. We want to be the first and last call a borrower makes, and it's the strength of our relationships that excites me most about our business today. ■

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