EXPERT Q&A

In an environment of high interest rates and limited capital, one strategy is poised to outperform, according to Aaron Peck and Kyle Asher, managing directors and co-heads of Monroe Capital's Opportunistic Private Credit Group

Where asset-backed opportunistic credit thrives

A rising rate environment and uncertainty about the global economy have contributed to a capital vacuum that has increased investment opportunities for opportunistic credit investors. Monroe's Aaron Peck and Kyle Asher explain how market participants are employing novel structures to mitigate risk and why, with a disciplined approach to credit, the industry may be seeing the best opportunities in over a decade.

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Q The Federal Reserve has been busy trying to mitigate inflation and has not signalled any signs of pulling back. How has the market changed in this high interest rate environment?

Aaron Peck: The high-rate environment creates opportunities, both in private credit and special situations, to generate higher returns on deals. Higher interest rates mean higher borrowing costs and put pressure on borrowers' cashflows, leading to more opportunity. Higher rates also set the expected returns and cost of borrowing at an elevated level.

In this market, higher rates have put pressure on valuations across public and liquid markets: this means there is now a lack of supply of capital. People are concerned about where we are in the economic cycle. It is creating a bit of a capital vacuum, which allows lenders with flexible capital the opportunity to come in and find an abundance of less risky deals. It is not just the high-rate environment itself, but it's as much about the economic environment, uncertainty which creates this opportunity set.

Kyle Asher: For seasoned opportunistic credit investors, this may prove to be one of the best environments in over a decade. What you are seeing is a liquidity mismatch related to declines

Q What should we expect in the deal environment over the next 12 months?

KA: The broader economy is still absorbing the impact of higher borrowing costs after a protracted period of artificially low interest rates and distorted valuations in a wide range of assets. Today, we are seeing the early stages of a recalibration of risk that has spurred a retreat by some traditional providers of credit.

That pullback in liquidity is more notable in certain segments or subsets of the economy, such as real estate, but institutions with a nimble and credit-focused strategy with seasoned investment teams will be the beneficiaries. Those who manage risk with creative approaches to providing credit will unearth remarkable opportunities. The current environment is one of the best opportunity sets we have seen in a long time, and these conditions likely will persist for at least 18 to 24 months.

AP: Veteran opportunistic credit specialists are typically agnostic about the rate environment and the economy's wellbeing because their mindset when providing liquidity focuses on mitigating downside risk. Over the next 12 to 24 months, opportunistic credit strategies will offer bespoke solutions that call for creativity and flexibility, and some will tap overlooked assets as collateral to manage risk. These underlying themes allow us to approach the high-rate market and take advantage of complex opportunities we believe will generate enhanced returns. It will take some time for the current market to normalise but we expect that during this period of transition in the availability and cost of capital, opportunistic credit providers will find novel opportunities to generate value.

we have seen in equity markets. Investors are holding back and there is less capital in the markets. There's a liquidity squeeze. It is important to note, though, deals put together in periods with heightened liquidity pressure often end up being some of the best vintages for investors. We're extremely bullish about opportunistic credit, regardless of economic cycle. But in this environment, we believe the returns can increase significantly.

Q What does this mean for dealflow? What kinds of opportunities are investors seeing in the market?

AP: The increase in rates impacts various deals and industries in vastly different ways. For example, high absolute interest rates create a challenge for people who want to buy homes. While higher rates typically create a downtrend in home prices, increased mortgage costs associated with higher rates keep the market unaffordable for most consumers. This results in significant demand for rental properties in both the multifamily apartment as well as the single-family home rental spaces.

The opportunistic strategy invests in areas which seek to benefit from these tailwinds, including investing up and down the capital stack in the single-family home rental space, as well as further investment in the multifamily apartment market.

There are geographic markets where you would not consider financing office space because of lingering challenges related to the pandemic, while other regions may offer pockets of opportunity. For example, you could finance a multi-use office property with a strong tenant base in Florida or other high-growth states in the Sun Belt, which have seen massive migration from other states, particularly since the pandemic.

KA: Investors now have opportunities in corporate special situations, real estate and speciality finance. Each one of those is driven by its own dynamics. For example, banks have pulled back substantially from different segments of capital markets, resulting in broken primary loan deals. They may have

> *"In periods of reduced liquidity, you can often find a few pearls that are overlooked"*
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> **AARON PECK**

committed to a primary issuance with the aim of syndicating it to different funds – CLOs and mutual funds – but in the current market environment, where spreads have widened, buyers have pulled back and command a higher return.

As a result, investors have seen an opportunity to buy certain new-issue credits from healthy and high-quality companies off bank balance sheets at significant discounts to par. We really haven't seen that opportunity at scale in many years. You'd have to go back over a decade to have seen a regular flow of these types of deals from large companies in great industries offering discounted new issue senior secured debt.

Q Banks and other lenders have pulled back and this has enabled opportunistic credit investors to step in during a liquidity vacuum. How are these new sources of liquidity showing up in the market?

AP: Businesses that are not fully stabilised with uncertain cashflows, those that may have significant execution risk, and those in more challenged industries are the types of deals that are facing a lack of liquidity in the lending marketplace. Opportunistic lenders that are primarily focused on a borrower's assets to structure transactions can underwrite deals with significant downside protection with strong deal terms, pricing and investor protections. Credit providers want to be sure an asset used as collateral has high and sustainable value, and they'll look to identify risks to ensure there is no possibility of value leakage.

Deals are being structured to enable lenders to step in quickly, mitigate threats to an asset and, if needed, monetise it. In some cases, credit investors will be creative and employ other collateral outside the original borrower group to mitigate risk. Certain structures allow that excess collateral to be passed back to a sponsor once the lender's risk is mitigated. In periods of reduced liquidity, we're finding if you scrub all of these opportunities you can often find a few pearls that are overlooked.

> *"Investors likely will enjoy the benefits of this dislocated market for at least 18 to 24 months"*
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> KYLE ASHER

KA: Experienced, thoughtful and well-capitalised lending institutions are looking to protect capital and increase returns in periods of dislocation. In overly aggressive markets with excess capital, many lenders end up taking equity risk to generate debt returns and may have very weak credit documents. It is the lenders with robust origination and structuring expertise that succeed in these markets.

In today's market, even lenders without robust origination can find bountiful opportunities that can offer equity-like returns for debt-like risk. Documentation is also exceptionally lender-friendly. Given the high cost and scarcity of equity capital, borrowers in need of funding may find debt capital is a better solution.

For example, a multifamily real estate borrower looking to raise $100 million of equity may not get the best execution in a period of reduced liquidity. In that case, some lenders may arrange a mezzanine loan or preferred equity. The lender will earn a high coupon that bridges the borrower until the market improves and the borrower can refinance at lower rates. This concept of bridge finance can be a very desirable option for a lot of sponsors in the real estate world.

AP: It works really well in a market like this because the senior lenders are also less aggressive. Banks and first mortgage lenders are not pushing as deep as they once did. That means there's excess collateral coverage for speciality lenders willing to do mezzanine financing or a preferred equity financing in real estate.

Q What other opportunities are out there for investors looking to put money to work?

KA: While we have not seen an abundance of rescue financings yet, lenders likely will see an increased need for rescue financings in the future and can find opportunities in areas such as discounted notes, non-performing loans in the real estate space, and debt-or-in-possession loans.

In addition, borrowers likely will need loan financings to fund non-standard M&A transactions. Early this year, two of the largest tech-enabled real estate services companies in the country closed a merger that provided opportunistic investors the opportunity to fund the transaction with both senior debt and preferred equity co-investment at very attractive market terms.

AP: DIP loans are great space to be in. There are only select opportunities for an outside lender to provide a priming DIP loan over an existing lender group, as most times the existing lender group chooses to provide the DIP themselves. In cases where existing lender groups can't invest more capital to provide the DIP financing, there is a great opportunity to step in and provide low risk capital. Situations like this can provide some of the best risk-return available in the market due to the position in the capital stack. ■