KEYNOTE ADDRESS
- Ted Koenig, **Monroe Capital**

Ryan Flanders: Your firm has historically been focused on the lower middle market, targeting companies with less than $30mn in EBITDA. Why is that and have there ever been thoughts of moving upstream?
Ted Koenig: Over the past 14 years, we have built our platform to focus on the lower middle market and it has proven to be a place where we generate "alpha" for our investors. With so many other direct lenders chasing after a finite number of loan assets in the large end of the market, we have chosen to focus on the sub $30mn EBITDA segment, which is significantly more fragmented and inefficient than the upper middle-market. The market inefficiency allows us to find value as opposed to being a "price taker" as many direct lending firms have become in the current market environment. The challenge, however, is that investing in the lower middle market requires significant infrastructure in terms of originations, underwriting and portfolio management than is required to buy into a club or syndicated loans at the upper middle market, where there is significant competition and direct lenders are much more commoditized.

There is a structural void for established lower-middle-market companies looking for debt-based expansion capital and enterprise-value-based transaction financing. Many of the direct lenders are targeting borrowers with EBITDA of $50mn and above. This supply and demand imbalance in the sub-$50mn EBITDA company loan space results in attractive investment terms; which includes higher contractual coupon with more conservative transaction structures, and in some instances, the ability to obtain warrants and equity co-investments. Additionally, according to S&P LSTA data, default rates over a 20-year measurement period are considerably lower and recovery rates are higher in the lower-middle-market private loan space (sub-$100mn loan size). This is also confirmed by our own experience and our track record.

Although the lower middle market has significant benefits, it takes a strong brand and a talented, experienced team to source and execute investment transactions. Monroe Capital is among the largest and most recognized players in the lower middle market with approximately 100 employees, 300 portfolio company borrowers and over $5bn of AUM. Approximately 25% of Monroe Capital's employees are focused solely on sourcing and originating investment ideas. Over the last 14 years, the originations team has developed long term and lasting relationships throughout the lower middle market. The firm has offices in New York, Boston, Chicago, Los Angeles, San Francisco, Atlanta and Dallas. In addition, the firm has an industry sector focus with experienced professionals covering healthcare, specialty finance, media, retail and consumer goods, and technology. We believe that these two approaches to cover the market – geography and industry – are the best way to generate deal flow for the firm.

RF: Founded in 2004, Monroe Capital has had the fortune (or misfortune) of experiencing a down credit cycle. There are many firms that launched post-Global Financial Crisis, taking advantage of regulatory changes, which have not seen a more turbulent credit market. What has this done to the supply dynamic and the direct lending landscape as a whole?
TK: As you have pointed out, the direct lending space has attracted significant capital since the financial crisis, with over $54bn focused on the direct lending opportunity raised in 2017. However, much of this capital, although focused on direct lending, does not compete in our primary market, which we have defined as borrowers with less than $30mn of EBITDA. The newer entrants are often asset managers focusing on the larger middle market, targeting private equity sponsored borrowers with $50mn of EBITDA and greater. The increase in supply of capital in that part of the market has created an ultra-competitive environment and this competition has caused a loosening of terms, elimination of loan covenants and borrower-friendly terms that we are not seeing to the same extent in our target market. Although we have seen minor spread compression and a more competitive landscape, we are still able to find attractive risk adjusted return transactions. By continuing to be diligent with a "credit first, zero loss" credit focus, our bottom-up investment approach allows us to prudently invest on behalf of our limited partners.

RF: What does origination mean to you?
TK: Origination is probably one of the most misunderstood concepts in direct lending. Every direct lending asset manager "originates" loans. However, to us, origination means that we directly source the investment opportunity and transaction through our proprietary network of regional banks, investment banks, private equity sponsors, other private debt providers, accountants, lawyers, financial advisors etc. Approximately 90% of the time, we are also the sole agent in the transaction, meaning that we structure, underwrite, execute, monitor and portfolio manage the investment transaction for the exclusive benefit of our limited partner investors. It is surprising to see how few direct lending asset management firms actually source, agent and manage their own investment transactions. Many just purchase club participations in someone else's deal and rely on the agent to structure and manage the credit.

RF: The LP community often discusses advantages and disadvantages of sponsored versus non-sponsored deal sourcing. Given Monroe Capital does both, what are your thoughts?
TK: Historically, Monroe Capital has

invested in approximately 65% sponsored and 35% non-sponsored transactions. Depending on market conditions, business cycle and/or merger and acquisition volume, Monroe Capital has a unique, diverse source of investment opportunities so not to be solely reliant on private equity-sponsored transactions. Non-sponsored transactions usually generate greater risk-adjusted returns for our limited partners because they are less heavily negotiated and proprietary in nature.

Since 2004, Monroe Capital has developed a referral network of over 15,000 firms and key individuals throughout the US and Canada. Very few direct lending firms can match this record of longevity and brand awareness. As such, we are fortunate to have deep relationships with many middle-market companies, CEOs, CFOs and private equity firms. We have found that regional and local financial institutions, such as banks, financial sponsors, investment banks, money management firms, attorneys, and accountants have all been a strong source of proprietary deal flow. This results in Monroe Capital reviewing over 2,000 deals annually and the ability for us to select the very best opportunities that allow us to enjoy attractive pricing and more conservative capital structures.

The private equity-sponsored transactions come with the advantage of being able to build off the due diligence conducted by the private equity sponsor. But that is just one part of our process. Each potential investment is scrutinized in the same manner by our team of underwriters. For non-sponsored deals, we conduct the same level of diligence as a private equity sponsor led transaction. Given the size and tenure of our platform, we are comfortable running that process, although it generally takes a bit longer to complete a non-sponsored transaction.

RF: **The definition of senior lending has seemed to evolve over the past few years, with more second lien and unitranche being classified as senior. How does Monroe Capital approach the capital structure as a direct lender?**
TK: In the current environment, the lenders focusing on the traditional and upper-middle-market are experiencing an increase in transactional debt leverage – up to 6x and even 7x EBITDA in many cases. Those firms are utilizing the unitranche transaction to win those deals and stretch themselves to these debt levels. We believe that we are in extra innings of an economic cycle. Historically, when a slowdown occurs, we have found that our limited partners value Monroe Capital for (i) being less leveraged at the fund level, (ii) having more conservative loan-to-value on our investments with lower last dollar attachment points, (iii) requiring full covenant packages for borrowers, (iv) having fixed and variable amortization on our loans, (v) serving as the sole or lead agent on our transactions with the ability to enforce our credit documents, and (vi) having better risk-adjusted returns.

With the increased overall leverage in the space generally, this leads us to believe that other firms are using financial engineering and additional fund-level leverage to increase their returns, which is a levered beta approach to investing and may be riskier given the late stage of the credit cycle.

Our average leverage in our loan portfolios is generally less than 4x (through our last dollar of investment). Many others in the industry start there and continue much higher. We have found many firms to be stretching the concept of unitranche, especially recently. A first lien loan at the top of the capital structure historically had robust covenant protections and financial maintenance covenants. We still have those characteristics in our market, but oftentimes they are non-existent with borrowers, above $30-40mn of EBITDA.

Lastly, we use over 30 bank partners for our own internal credit facilities. This means that in a credit down cycle, we are not overly concentrated with one credit provider who may change their view of the market or the industry, much like what occurred in the 2007-2009 time period, and caused many private credit firms and their respective limited partners operational challenges and losses.

RF: **Monroe Capital has recently looked towards a more opportunistic and special situations strategy adding new personnel and launching a fund focused on the opportunity. What motivated this decision?**
TK: CEOs, business owners, investment banks, financial advisors, financial brokers and many other borrowers seek out Monroe Capital's assistance in crafting creative solutions for their financing needs. In large part, this is a result of Monroe Capital being a consistent presence in providing stable and reliable capital since 2004, irrespective of business cycles. Lately, we have been seeing a lot more opportunities where Monroe Capital can provide financing on an opportunistic basis because of speed, complexity, or perceived risk of the unique situation. We embrace complex circumstances where competition is less intense but where financial structuring acumen and deep knowledge of the company and the industry sector is required. As a result, we are seeing deal flow that is more asset focused and well collateralized. We believe that we are now at the right inflection point in the cycle to launch a dedicated special situations, asset-focused, secured lending strategy, leveraging Monroe Capital's robust origination, underwriting and asset management platform. We have been making these opportunistic investments as part of our overall private credit strategy since the formation of the firm.

Recently, Monroe Capital completed a transaction where we provided a $100mn loan to a real estate development firm secured on a portfolio of very high-quality real estate assets. The portfolio consisted of approximately 20 individual real estate properties with complex operating agreements and ownership structures, which required an intricate level of structuring to navigate each underlying asset-level entity and perfecting security. We moved quickly and solved for what the borrower needed, unlocking additional growth and value creation for the borrower, resulting in a win-win partnership.

We are uniquely positioned to provide liquidity quickly in situations where pockets of dislocation occur across sectors and opportunities as economic conditions warrant. This adaptability allows us to seek out inefficiencies and mispricings in markets and in investment areas where there is a shortage of financing options. Like our core funds, these investments are generally structured with significant downside protections and collateralized to minimize the potential for losses. Adding this synergistic area of special situations investing to our core business is a way to offer our limited partners unique and differentiated alpha in the entire spectrum of private credit solutions.

RF: What poses the biggest risk to the private credit market in the near and longer term? How is Monroe Capital preparing itself for the inevitable downturn?

TK: There is a very high cost to building the proper direct lending infrastructure to successfully source, underwrite, execute, monitor and manage private credit investments. Many direct lending firms existed prior to the financial crisis in 2007-2009 and most of those firms were fatally impacted by market conditions during the financial crisis because they were ill-prepared and not equipped to deal with the challenges of a market downturn at that time. We believe limited partner investors should underwrite the firm platform, the management team's history in working together through credit cycles, and their experience in handling workouts and turnarounds. We have seen many firms enter the direct lending space after 2009 who are currently "buying into the market" as an asset gathering exercise in order to build scale for their firm. We see this as risky, especially for a team inexperienced in operating during an economic downturn or not having a strong expertise in workouts and turnarounds. Our experience has shown that private credit lending requires discipline and the ability to say "no" much more often than "yes". The firms that have a long track record of success in a variety of economic cycles are the ones that will provide their investors with the stable long-term returns they desire. We have seen these market conditions before and we are preparing our firm in the same manner we did in 2007, which was the last time we witnessed similar conditions of excessive leverage, loosening of documentation and lender rights, and excessive liquidity in the credit markets.

MONROE CAPITAL

Monroe Capital LLC ("Monroe") is a private credit asset management firm specializing in direct lending and special situations investing. Since 2004, the firm has provided private credit solutions to borrowers in the US and Canada. Monroe's middle-market lending platform provides senior and junior debt financing to businesses, special situations borrowers and private equity sponsors. Investment types include unitranche financings; cash flow, asset-based and enterprise value-based loans; and equity co-investments. Monroe is committed to being a value-added and user-friendly partner to business owners, senior management and private equity sponsors. The firm is headquartered in Chicago and maintains offices in Atlanta, Boston, Dallas, Los Angeles, New York, and San Francisco. Monroe has been recognized by Global M&A Network as the 2017 Small Middle Markets Lender of the Year; Private Debt Investor as the 2016 Lower Mid-Market Lender of the Year; M&A Advisor as the 2016 Lender Firm of the Year; and the U.S. Small Business Administration as the 2015 Small Business Investment Company (SBIC) of the Year.

www.monroecap.com