SPECIAL SITUATIONS

A strategy for all seasons

Not all special situations strategies are focused on distressed investing. Managing directors **Aaron Peck** and **Cesar Gueikian**, co-portfolio managers of Monroe Capital's Opportunistic Private Credit strategies, highlight how opportunistic private credit differs from more traditional distressed strategies

Q What are your thoughts around opportunistic investing and how is it different from other special situations strategies?

Aaron Peck: We have been investing in the opportunistic credit markets at Monroe Capital for many years. Our investment focus has been on asset value and providing loans to companies and asset owners based on the value of their assets on a loan-to-value basis. We believe this creates optimal risk-adjusted returns for our limited partners.

It is important to make the distinction between what we are doing in special situations and more traditional distressed debt investing. To be sure, we will buy discounted senior secured loan portfolios amid market dislocations. We are not traditional distressed debt investors. Occasionally our borrowers may encounter some stress in their businesses, but we are focused on the value of their corporate assets rather than the enterprise value of the business.

Since we have seven offices and 20 origination professionals located throughout the US focused exclusively on identifying the very best investment opportunities, we can invest in asset-backed transactions with attractive collateral as well as cashflow-based leveraged loans. Over the last few years, we have recognised the considerable market opportunity that has emerged in this asset-heavy lending area.

Cesar Gueikian: When you think about lending against assets as a strategy, it is a relatively broad opportunity set. For us, assets may include real estate, accounts receivable, intellectual property or a music library generating royalties. We could be lending against pools of financial assets, including small business loans, litigation finance claims and medical receivables where we are lending on an advance-rate basis. Alternatively, it could be a strategic corporate asset, such as wireless spectrum or a power plant. We will also look

at opportunities such as sports franchises, aircraft and infrastructure assets. The key theme is that if there is a core asset that has verifiable collateral value, we can provide a loan against that asset and maintain downside protection for our investors.

Q When lending against assets rather than cashflows, what are the key considerations?

AP: When we think about asset value, we think about the present asset value and the asset value in a downside scenario. To lend against an asset, you must consider what a realisation might look like in a worst-case scenario. Our plan going into a loan is to experience no losses even in a default scenario.

CG: It has to do with balancing our views around the going-concern value and the liquidation value of the asset. We also consider whether there is somebody for which the assets we are lending against have strategic value – in which case we potentially have a strategic bid in the event of a foreclosure.

Considerations around the jurisdiction are also important, given how legally intensive our strategy can be. It is very important to operate in jurisdictions where asset transfers can occur in a relatively short period of time. That comes also with some structuring elements. There are certain jurisdictions in which the process is protracted, even if we have a mortgage or lien. Therefore, we will take into consideration certain structuring enhancements to gain control of the asset and decide as to what we want to do with it in the event of a default.

Q Do you favour specific sectors or do you try to diversify? Are there certain types of assets that you will avoid financing?

AP: We don't want our funds investing primarily in one type of asset so we run a relatively diversified portfolio. Having said that, this strategy is not as diversified as our traditional lower mid-market lending strategy, where we might have 70 borrowers in our portfolio. In the opportunistic strategy, we might have closer to 20 borrowers. So our portfolio will be more concentrated, but we will have strategic diversification in the categories of assets we finance. We don't intend for this fund to be 100 percent real estate, for instance, and we don't intend for it to be 100 percent specialty-finance lending targeting a variety of different assets. It is an opportunistic strategy, so we will invest opportunistically in assets with significant downside protection coupled with attractive valuations, and where we can generate solid risk-adjusted returns for our investors.

"IF COMPANIES ARE EXPERIENCING CASHFLOW ISSUES IN TIMES OF DISTRESS, OFTEN THEIR CORE ASSETS ARE THE MOST VALUABLE AND LEVERAGEABLE PART OF THEIR BUSINESS"
Aaron Peck

CG: We will lend against any asset if we are not taking on certain untenable risks, like commodity risk. At the end of the day, it is important that we believe an asset has significant value in all scenarios and that we can attach ourselves to the asset in an efficient way to realise the valuation.

Q Even when it's not a typical distressed strategy, might stressed situations still present possible opportunities?

AP: There will be opportunities to invest in stressed situations. If companies are experiencing cashflow issues in times of distress, often their core assets are the most valuable and leverageable part of their business. One can envision a scenario in which a company has publicly traded bonds that are unsecured and has valuable assets that have not been pledged

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to another lender. The company may be struggling and experiencing cashflow deterioration, so they will seek to unlock the value of those assets – this is a scenario we would consider lending into. We will lend to distressed companies, but our strategy is not to buy distressed loans or bonds with an eye to owning the restructured equity on the backend. That is a more traditional distressed-for-control or loan-to-own strategy in which multiple parties angle to own the fulcrum security and it typically involves more execution risk than we will take on.

CG: When there is more stress in the marketplace, it is not uncommon to see the opportunity set expand for asset heavy lenders like us. This is because leveraging those assets is often the only way for companies experiencing stress to borrow money. As well, during these cyclical downturns, the marketplace will often encounter liquidity issues that are often amplified by fund redemptions that force certain lenders to liquidate good, high-quality assets. When this happens, we become liquidity providers buying loans at discounts. Effectively, we become secured lenders to companies that would never borrow from us in the private market.

Fund liquidations can occur in any market. In October 2015 and during the first several months of 2016, for instance, there was a run of hedge fund liquidations that presented opportunities to buy high-quality assets at a discount.

Q How do current market conditions help or hinder this strategy?

AP: To be sure, we believe opportunities exist in our strategy across the market cycle, particularly when compared to traditional distressed funds, whose opportunity set is more cyclical. The senior team at Monroe Capital is very experienced and we have found sustained windows to invest profitably for our LPs in all different market conditions and through multiple economic cycles.

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Cesar Gueikian

Q What questions do LPs typically have around this type of strategy?

AP: LPs are typically focused on the risk, how much leverage we employ, and how market conditions impact the strategy, among other things. Our LPs seem to appreciate that we're running a "current return" strategy, whereas many other special situations fund managers pursue more of a total return strategy. In the case of the latter, much of the return is coming from price appreciation. For us, some portion of our return might come from upside, fees or price appreciation, but most of the returns we generate come from current return, in which we are lending money, receiving income and paying out that income to investors.

Q What will be the likely key factors that will impact the market over the coming months and years?

CG: We look at the interest rate environment, as that will always have an impact on our portfolio. We must be mindful to manage the additional default risk that accompanies a rising-rate environment, as it will impact our borrowers' debt-service coverage. But we mitigate as many risks as possible and we closely monitor the direction of rates and its potential impact on the credits we back. In some instances, we may require our borrowers to purchase LIBOR caps to mitigate this risk. But I'd just highlight that the opportunistic nature of our strategy provides a margin of safety through the value we seek to uncover.

AP: Clearly when you are lending against certain types of assets, like real estate, there are cyclical elements to how loans can be repaid. For example, if a borrower defaults on a real estate loan during a weakening real estate cycle, it can present a challenge. This is where active management and a track record operating across market cycles really works to our advantage. In this example we might have to take a more aggressive strategy to monetise an asset if the borrower is unable to service our debt or meet covenants.

The key to success, however, is careful credit underwriting when entering a loan and a conservative approach to valuations to ensure a cushion is available during a downturn. Based on the deals we have done in the past, we believe our opportunistic loans are structured to maximise the possibility that our funds will receive a full recovery even if our downside case materialises. It's in managing these risks that we're able to find such an attractive alpha proposition for our investors. ■