EXPERT Q&A

To thrive over the next decade, fund managers will need to demonstrate their strategy and execution expertise, says Ted Koenig, chairman and CEO of Monroe Capital

Differentiation is key to creating strong performance

Q Let's discuss the elephant in the room. Private credit has grown so much since the last real default cycle. How is it going to change in the next default cycle?

The next default cycle is going to highlight why manager selection is vital in private credit. This is an active management investment strategy. Experienced teams that have navigated difficult times have a distinct advantage. Most of the asset managers in private credit were formed since the last default cycle and the market has become much more commoditised as a result.

SPONSOR

MONROE CAPITAL

As Warren Buffet has said: "You never know who's swimming naked until the tide goes out."

Since the last default cycle, a rising tide has benefited all managers, including those that were perhaps more focused on deployment than underwriting. Managers that have the operational capabilities required for executing workouts and portfolio management, and have the infrastructure necessary to support those activities, will be the ones that can take advantage of an economic downturn and create alpha during the next default cycle.

Q What do you see in the next decade as the asset class is growing and continues to mature?

I think we will see consolidation in the industry. The space will continue to become increasingly commoditised as well. Many institutional investors perceive all private credit as the same and it is not.

In an economic downturn, undifferentiated private credit will be

correlated with a number of other asset classes that are tied more directly to the broader financial markets. The advantage that private credit provided in the last economic downturn was that it was much less correlated to other asset classes.

Today, many "beta" private credit managers built portfolios that not only overlap with one another, but are also now much more correlated to the broader public credit markets and that is a risk many investors may not be fully aware of.

As this distinction plays out in the next downturn, I think one of the consequences will be more manager consolidation in the market.

Q When investors are evaluating managers of private credit, what are the most important capabilities and characteristics they should look for that are going to succeed in the next 10 years?

The number one differentiator of managers is the team; complementary skill sets, expertise and experience on the investment side and a deep bench is important. Longevity in terms of how long the team has been working together is often the most overlooked and least appreciated attribute of a successful private credit asset manager. Further, over the 20 years we have been in business, our proprietary sourcing has been a big advantage for us.

The team's ability to underwrite, work out of transactions, have dedicated in-house industry expertise, analytics and specialisations is key to generating attractive risk-adjusted returns consistently over time.

What institutional investors do not sometimes fully appreciate is that private credit investments are made over a continuum of a fund's life. Good asset managers must manage through deployment, repayment and sometimes, the workout of transactions. Over a six- to eight-year period, the best managers can do all of that, but it requires a team with size, scale and expertise. It's much easier to scale a private credit firm as a "beta" investor by taking pieces of larger club transactions than to do the labour-intensive work of originating your own deals, conducting bottom-up due diligence, and managing those deals closely post-close.

Q What are some of those areas of expertise?

Industry expertise is number one. Each industry has its own idiosyncrasies, particularly when there is a downturn. There are areas of expertise that are more value added, such as non-sponsored versus private equity-sponsored markets and specific capital structure strategies, such as independent sponsor deals with a hybrid of debt and preferred equity. There are specialist areas like software and technology, healthcare, opportunistic credit, real estate and asset-backed credit.

We are anticipating growth in venture debt, life sciences and royalty lending. All require deep industry expertise and add a tremendous amount of diversification, protection and, ultimately, resiliency in a private credit portfolio.

Portfolio management and workout experience are equally important. Team members should have the ability to work out of transactions and understand the complexities and nuances of what happens when a workout occurs. The key is to be proactive in these situations versus reactive.

Q What will be the biggest challenges for mid-market lenders in the next decade?

Differentiation and retention of talent are going to be the biggest challenges for asset managers.

Q What are your views on artificial intelligence and how it can impact the global economy? Are there factors when making investments today?

We need to be very thoughtful and build knowledge around how AI could impact company market, operations and competitors. Leveraging our in-house software and technology industry expertise and when needed hiring outside experts, we are positioning ourselves to be on the forefront of the use of AI. We are in the early stages of examining how AI will be useful in the asset management industry and things are moving quickly.

AI will play a role in data analytics and predicting outcomes in portfolio management. It will be a resource that portfolio managers will use to continue to monitor and stay abreast of changes or challenges in their investment portfolios.

Many asset managers look similar. Adding value for institutional investors is going to be important, so asset managers are going to have to figure out how they can differentiate and how they become more solution providers.

One of the most successful ways of doing that is the people side, which relies on the ability of firms to recruit and retain management and staff. That is going to be paramount in the next 10 years because of the proliferation of players in the industry. It says a lot about a firm if they have had low turnover rates and senior management has stayed together over an extended period of time.

> *"Diversification is ultimately what protects you when there are challenges in the economy"*

Q Why would an investor want specific allocation to niche areas, such as non-sponsor deals or speciality finance?

It all comes down to diversification. As an investor, you want a diversified pool of public market stocks, a diversified pool of real estate, and you should want a diversified pool of private credit. Those areas can be sponsored or non-sponsored markets, and independent sponsor (a hybrid debt/equity), software and technology, or opportunistic credit – specifically areas of specialty finance, or corporate credit. Diversification is ultimately what protects you when there are challenges in the economy or when private equity dealmaking is off.

Just like other asset classes, investors are starting to realise that diversification in private credit is just as important. Now that the asset class is more mature, it becomes critical.

Q Monroe often refers to opportunistic credit as an "all-weather" strategy. How does that look for the next decade?

Opportunistic credit is going to be a much more important element of the investment portfolio for institutional investors going forward. That is because financial market volatility is going to occur much more often and for shorter durations than in the past. We have had a long period of very low interest rates but, because of macro factors that the US capital markets can no longer control, outside influences are going to have a greater impact on the US economy than they have before.

Because of this, it is going to be more important to focus on investment strategies that are asset-orientated, which is how we see opportunistic credit. In times of market volatility, asset valuations are going to be more easily determinable than projected cashflow. Having a nimble asset-centric and backed investment product allows asset managers to take advantage of dislocation in the market or volatility in certain segments.

Q What is the opportunity you see in venture debt?

We are excited about the venture debt opportunity. It is an area that has been growing for years as a sub-specialisation within private credit. Historically, it has been an attractive business, but highly concentrated among just a few players. With the demise of Silicon Valley Bank and the other regional banks that had a significant market share in venture debt, this market has fundamentally shifted and changed from a supply-side basis. Success in venture debt lending relies on the same thoughtful, analytic underwriting, with industry expertise and portfolio management monitoring techniques, that good traditional private credit players bring to best practice.

Q Monroe Capital has grown and evolved over time. Why have you chosen these strategies and areas for new product development?

Monroe leverages our core competencies and understanding of investing in areas where there are inefficiencies in the market. Our core focus is the US lower mid-market because we believe we can create "alpha" in both sourcing and portfolio management. We have a deep and dynamic sourcing bench with a strong direct originations footprint, that includes geographic coverage and a variety of specialised industry vertical expertise. From a differentiation standpoint, we target a number of specific investment niche areas to grow and build deep relationships and understandings within those markets.

We believe our "bottoms-up" philosophy in underwriting and high-touch investment management and monitoring, coupled with our differentiated sourcing techniques, creates better and more compelling investment returns over the long term.

Ultimately, we want to play in areas where we can create an investment edge because of our expertise and platform. We want to provide and offer our investors unique access to markets and investment opportunities that are more compelling, less competitive, and have a higher degree of safety and security. We want to do this with the goal of delivering superior risk-adjusted returns. With our nearly 20 years of firm history and experience, we plan to continue to maintain the same approach of providing best in class differentiated private credit allocations to our investors. ■