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PRIVATE EQUITY PERSPECTIVES PODCAST

EPISODE 5: DEERPATH CAPITAL & CIP CAPITAL TALK LEVERAGE AT ACG INTERGROWTH 2018

INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

Todd Kinney: Hi, this is Todd Kinney, I'm a director in BDO's Private Equity Practice and I want to welcome you to another episode of BDO's PErspectives Podcast. I'm very excited to announce, I've got two guests today. Two good friends, two good clients of the firm. Bobby Kelly with CIP Capital and Orin Port with Deerpath Capital. We're all sitting in San Diego today for the kickoff of day one of ACG InterGrowth. A lot of investors, bankers, lenders, lawyers here in the middle market. A lot of excitement and I know you guys have a busy meeting schedule over the next couple of days, so we appreciate your time. So maybe we could kick things off, and Bobby, I'll throw it to you first. I always like to give our guests an opportunity to tell our listeners a bit about your firm's strategy and investment focus.

INVESTMENT STRATEGIES [1:07 – 2:50]

Bobby Kelly: Great. So CIP Capital is a sector-focused and growth-focused private equity firm. We play in what we call the business information and tech-enabled services sector, so we're looking to partner with companies that offer value added outsource services, must-have information content, and data-driven insights. We also focus on growth, so we look to partner with companies that are platforms that ultimately are looking to scale and dramatically impact their business from a broad range of revenue enhancing initiatives. It could be expanding your solution offering, could be expanding into a new geographic market, whether that's regional to national, national to international, and it could be expanding into a new end market. And as far as the size of companies we play in, we're considered a lower middle-market investor, so typically looking to partner with companies in the $20 to $100 million revenue range initially and then look to dramatically scale that during our partnership.

Kinney: Gotcha. Orin, how about Deerpath?

Orin Port: Deerpath Capital is a private equity fund that focuses on senior debt. We're a private debt fund. We look at businesses from $10 million of revenue to about $100 million

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of revenue. We look at ourselves as an alternative lender to a bank. We've been around for about 10 years. Focusing on the cash flow part of lending to lower middle market companies. We're industry agnostic with a primary focus on service companies, asset light, cash flow rich, so we are very active in healthcare, technology, consumer retail, niche manufacturing, distribution. We started 10 years ago, so we're in our tenth year. And we partner with funded sponsors, independent sponsors, and we do some direct lending to companies. We can do small equity co-investment, but our core focus is the senior part of the cap structure, focusing kind of on first lien debt.

2018 DEAL FLOW [2:50 – 4:44]

Kinney: Gotcha, gotcha. All right, well, let's jump into it here. I think with Q1 in the rearview mirror, our listeners would certainly like to get your sense for deal activity, how it's looking so far, is it just as competitive, valuations still high? Maybe Orin, we'll start with you on this one.

Port: Yeah, Q1 and through the end of April, deal volume from our perspective has been up considerably. We found the quality a little less stellar than it had been in the previous years. Competitive-wise with other lenders that have come into the market via banks, via other direct lenders, we're seeing more competition that ever, so deal winning has been tougher this year in the first quarter. We've been very active. Like I said, deal flow has picked up. We continue to look at other industries that we might not have looked at in the past. We've had some businesses and logistics and other sectors that have been pretty hot. Healthcare, technology. But I think from our end, we've been pretty excited with the amount of deals we've seen this year.

Kelly: We have a similar vantage point as well. I think our deal flow was up about 10% year over year in the first quarter for 2018. Competition's still there. There's no shortage of funds, chasing the same deals and despite us having a sector-focused strategy, we'll run into different competitors on every deal we look at, so there's always new funds that we're bumping up against. And then from a valuation perspective, the market's definitely reverting differentiated, growing businesses with premium multiples, and that's probably even up from where it was last year.

Port: And also, we've been seeing leverage levels tick up in combination with valuations going sky high, as we've seen. So, a lot of people, a lot of funds are putting on more leverage than historically they might have put. And we're seeing banks infringe a lot in areas that they might not have done several years ago.

SOURCING DEALS [4:44 – 5:34]

Kinney: Great. So I don't want either of you to kind of give away your secret sauce, but really, with such a crowded and competitive market, Bobby, maybe we'll start with you, how are you guys finding investment opportunities?

Kelly: It's a great question, and we maintain that the sector-focused strategy within business information and tech-enabled services, so we're trying to find-- we gravitate toward certain business model themes and that enables us to be a lot more efficient in our minds from a sourcing perspective. So if you take a couple themes we spend a lot of time on, whether that's human capital management or data-driven marketing services. We spend a lot of time doing deep dives in the market. Getting to know industry executives, helping us to get up to speed on trends and themes so when we ultimately get to sit down with an executive, we know that market and we can really differentiate to a CEO and a founder that we can be a value-added partner to them to help them scale their business.

Kinney: Very compelling. Orin?

Port: We've been seeing competition increase over the last couple years. When we first started about ten years ago, there weren't a lot of independent direct lenders. We'd been seeing a lot of capital going to that asset allocation these days, so competition has been tough. But we look at ourselves differentiating for other factors than just coupon. We've been in business for ten years, we're a very flexible lender. We tailor each of our credits to that specific sponsor and to that company so I think being flexible with credit terms, being able to have a timely approval process through our committee has really helped us win deals over the last couple of years. And I think that's really been kind of our secret sauce in the market.

INCREASED LEVERAGE FOR BDCS [6:18 – 7:10]

Kinney: Good. Good stuff. Maybe Bobby, I'll ask you about BDCs, I think recently they've been given the green light to increase the leverage from one to two times. I'm just curious if you think this will prove beneficial to lower middle-market companies seeking capital?

Kelly: Yeah, I definitely think this will be, brought, increased capital into the market. And this market is all about speed and certainty. You hit on the competitive nature of this market. So if a firm has more capital to offer, they might be now in a position to be a true one-stop provider for a transaction to a company, whereas otherwise they might have to partner up with one or two people. So that increase in their capital base would enable such a lender to be a lot more competitive in my mind and that's a unique angle to have in this market where you can come in with one capital provider to ultimately show that you can deliver on that speed and certainty aspect to ultimately get something over the finish line.

INCREASED FUND LIMITS FOR SBICS [7:10 – 8:41]

Kinney: Definitely can be a nice differentiator, right? Orin, how about on the SBICs, the fund limit was recently increased

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to 175 from 150 million, right? What are your thoughts on this and the potential impact for the lower middle market?

Port: Speaking for Deerpath, we're actually investing out of our third SBIC fund, so as far as the platform for the SBIC, it's been a really great source of capital for us to go out, raise equity and have the debt component from the SBIC to support our transactions. I think it's a good number at this point and I think you'll see more applications to be an SBIC fund. We've been very happy and like I said, we're on our third SBIC fund. The process is long and arduous, and we got in right under the last administration so that worked out well for us. But it's a great program, great platform and we look forward to utilizing it in the future going forward.

Kinney: I had heard about a pretty substantial backlog in the whole application process. Has that worked itself out or it's still…?

Port: From what I hear, it's still a backlog, even though we were on our third, it still took several months and a lot of hard work from our team to get the paperwork done and the process done. But like I said, it's a real nice source of capital for both on the direct lending side and other capital providers to utilize. Once you're in, it's a really good platform.

LEVERAGE TRENDS [8:41 – 10:10]

Kinney: Yeah. Good stuff, good stuff. Well, maybe I'll throw this one out to both of you. According to PitchBook, an industry resource, debt multiples hit about 5.6 times median in the US PE middle market last year. I'm wondering if you guys can kind of provide an overview of leverage trends you're seeing in the lower middle market, specifically. Maybe Bobby, you want to take this first?

Kelly: Yeah, I'd say lower middle market, which I'll define as less than $20 million of EBITDA, you're definitely seeing more borrower friendly terms just given the availability of capital on the market. I think compared to maybe the upper end of the middle market, it's still below what you're seeing as far as leverage levels, as far as pricing, and even covenants or lack thereof when you get a little bit bigger, so it's definitely more borrower friendly, but not, I think, quite as robust as you're seeing a little bit, in the step above where we play.

Kinney: Appreciate that. Orin?

Port: Yeah, I would second that. I mean, in the lower end of the middle market, as Bobby mentioned, we are seeing leverage tick up, but not to the levels where we're seeing in the bigger part of the middle market. From our perspective that's another piece of the competitive market. There are certain firms that will provide more leverage. We have our levels that we're comfortable per deal, so we don't kind of lend in a box. But you have seen other lenders come into the market that-- potentially to win deals, they've increased leverage. But definitely not as high as what we're seeing in the broader market at this point.

PREPARING PORTFOLIOS FOR RISING INTEREST RATES [10:10 – 11:02]

Kinney: Certainly as interest rates are rising, debt is becoming more expensive. I guess Bobby I'll ask you. What is your firm doing to prepare? Maybe especially at the portfolio level.

Kelly: Yeah. We look at it across our entire portfolio. I'd say we're typically modest users of leverage, we haven't pushed the envelope, historically. We want to make sure we have sustainable cash flows to reinvest in our businesses for growth. That being said, as rates are rising, we need to look every year at our budgets and what that makes to our interest expense levels. I think because of our approach, we feel good about the portfolio company level. It's definitely impacting how you look at a new deal. Take the same leverage multiple you're putting on before, your interest expense is just going to be higher, not zero like it used to be. So it definitely impacts how we have to look at the market.

TAX REFORM'S LIMITATIONS ON INTEREST DEDUCTIBILITY [11:02 – 11:50]

Kinney: Gotcha. On the topic of the limitation of interest rate deductibility, I guess just curious again with you Bobby. Do you think it's going to have an impact on lower middle market borrowers? Or is it too early to tell?

Kelly: I think it has to, broadly, on the market. The new law you're referring to is the interest deduction, interest expense deduction is now limited to 30% of EBITDA levels. Whereas before, there was no cap. From our fund, we don't use leverage as a primary means of value creation, so it's going to have a limited impact on how we view our deals. But ultimately, over time, it has to have an impact on the market. I think that people will not see that tax advantage nature of it that's of extra leverage that you had before. Ultimately that should lead to lower leverage levels that at some point should trickle down to the enterprise value side as well.

OUTLOOK FOR 2018 [11:50 – 14:26]

Kinney: Gotcha, gotcha. Well, we always love to wrap the podcast with the crystal ball question. So, I'm going to throw it to Orin first, but maybe give me your thoughts on kind of deal activity through the end of 2018 and maybe beyond as much as you want to want to go out on a limb.

Port: I think activity will continue to be stronger than it has in past years. Even deals that have not been signed up by sponsors, we're seeing a lot of opportunities. For us, focusing on different sectors, we're seeing a lot of activity in healthcare, technology. I mentioned consumer retail. So I think those opportunities are still out there for sponsors to acquire these businesses. I think what we're also seeing is a lot of smaller deals getting done as platforms for sponsors. And we're very supportive of those early-stage deals, because what we like to do is we like to scale along with a sponsor

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to build their portfolio out through additional debt going forward. I think the quality will hopefully improve. Quantity is definitely out there and just speaking with people today at InterGrowth, there's definitely a lot of deals that are out there. A lot that are going to be coming to markets. So I think we'll continue to see the increase of deal volume and hopefully the quality will continue to improve as well over the year.

Kinney: So Bobby, do you share Orin's positivity?

Kelly: I'll let you know after my final set of meetings tomorrow at the conference, how it's going to look. But no, we expect it to be busy. I think there's-- with the capital out there on the market, that excess capital is driving actual deal flow. So we're going to see deal flow from both a new platform perspective and then a follow-on, tuck-in perspective as well. As Orin mentioned, our strategies continue to support our companies and do multiple follow-on deals. So we're going to be busy. I think from everyone I'm speaking to this week, it sounds like pipelines are starting to fill up again, so we had a good start to the year and expect it to continue.

Kinney: Good stuff. Good stuff. We had a bunch of meetings earlier today and everyone seems pretty upbeat and positive and optimistic, so good to hear more of that. So want to thank you both for joining us today. Again, for our listeners, Bobby Kelly with CIP Capital and Orin Port with Deerpath Capital, you guys are both friends of the firm, we appreciate the relationship that we have. Strongly encourage our listeners to go out there and look at your websites and get an understanding of what CIP and Deerpath are doing and hopefully we can drive some traffic your way. And with that, thank you to the listeners and we look forward to catching up with you next month. Thanks so much.

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