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Lead Left Interview – Doug Cruikshank & Rafael Castro (Part 2)

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This week we continue our conversation with Doug Cruikshank, Managing Partner and Rafael Castro, Director, Enhanced Capital. Enhanced Capital is a small business investment firm focused on established lower middle market companies often overlooked by traditional sources of capital due to location or size.

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The Lead Left: What are sponsors attitudes to this type of lending? My experience is that guaranties are a bright line they rarely allow lenders to cross over.

Rafael Castro: They love it. First, thanks to the credit crisis, hold periods for their investments have gone up, It's delayed take-outs to over six years. 40% of all companies owned by 2005-2008 vintage funds are still held by the PE firm. That means the fund is outside its reinvestment period.

Doug Cruikshank: But they still need to keep the capital invested, despite the fact that the fund is out of dry powder. These are pivotal companies that may be in disfavored industries. It helps, for example, that we don't need a quality of earnings report. We frankly don't care about the portfolio company as much. And we move very quickly. We've closed deals in as little as 20 days. That's because it's all about the sponsor.

TLL: And how many portfolio companies do you now have?

RC: In the current fund we have ten companies across six different sponsors and one high net worth individual. Plus there are 5-10 other sponsors we're currently working with on deals. These are household names, not zombie funds. Many are successful but can't cross funds. So sometimes they'll have a great Fund One and Three, but need to support a company in Fund Two.

TLL: Have you done any non-guaranteed deals?

DC: No, our mandate is guaranties only. We could do a cash collateralized deal without a guaranty.

TLL: Really? A sponsor would do to that?

DC: You'd be surprised. We've done it, and gotten paid 11-12%!

TLL: You do straight cash flow lending out of your mezz fund, correct?

RC: Yes, there we can go unguaranteed and have done so in our SBIC mezz fund run by Barry Osherow.

TLL: Could you give us an example of something you're working on?

RC: One down-the-middle-of-the-fairway example is a Texas-based GP with three funds. Fund Two has ten remaining portfolio companies – a mix of growth private equity and traditional LBOs – with NAV of $350 million. Two companies needed a combined $10 million of financing, both had negative ebitda.

DC: The first was frozen by its lender so couldn't borrow, and the second had a loan from a bank backed by uncalled LP capital, so their money was tied up. We provided 11-12% debt, no warrants or dilution which freed up the uncalled capital. Since then, the GP has raised a larger fund.

TLL: Would you characterize what you do as distressed lending?

DC: It could be a tool for that, but many of our borrowers are good companies. One of the ones we mentioned had tripled its revenues in two years, but the situation is taking time to resolve. Because of the nature of the guaranty, these opportunities tend to self-select. The sponsor has already made the decision to support the business.

RC: We'd rather finance that deal than one from which the GP has decided to step away, handing the keys to the bank. Two-thirds of our portfolio borrowers are growth equity stories.

TLL: Interesting.

DC: Another way we can help is where the GP has put half their investment in as equity and the other half mezz. We can provide 5-10% of the financing at the holding company to give the sponsor the ability to skinny back their equity check. We care less about the borrower, than the sponsor.

TLL: What's been the biggest surprise about your experience at Enhanced?

DC: It's two-fold. First, how hard it is to get in front of the sponsor to talk to them about our strategy. Second, once it clicks with them, how easy the sale is. As someone once told me, I can explain it to you, I just can't understand it for you!

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