Lead Left Interview – Art Penn (Part 2)

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This week we continue our conversation with Art Penn, Founder and Managing Partner, PennantPark. PennantPark Investment Advisers– founded in 2007 – is a leading investment firm focused on partnering with middle-market companies to provide them with creative and flexible capital. *Second of two parts* – *View part one*.

The Lead Left: *You're among the few managers I've heard who've accomplished that.*

Art Penn: It took quite a while to achieve and requires ongoing adherence to guidelines which protect our BDC shareholders and LP investors.

TLL: *Where do you want to be today in capital structures?*

AP: It's really deal dependent. First-lien is a good place to be. Second-lien is good with the right lenders above you and strong sponsors beneath you. Stretch senior/unitranche investments can often be allocated across our platform. At the end of the day, we are in the business of providing financing solutions for our private equity clients and different risk/rewards to investor clients.

TLL: *How would you characterize the competition?*

AP: There is a massive opportunity in the middle market driven by the banks exiting. The middle market lending community is usually fairly rational. That said, at different times when the broadly syndicated market gets overly ebullient, that sentiment can spill down to the small and mid-sized middle market making risk/reward more challenging. The market we're seeing today is attractive.

TLL: *Are we overbanked?*

AP: I don't think so. The banks have largely exited lending to small and mid-sized middle market companies due to capital and regulatory constraints. At the same time, the broadly syndicated market has been volatile and not always open to sub-$50 million ebitda companies. I feel like the supply/demand dynamics today are favorable for where we operate.

TLL: *What about industries? Which ones do you like? Not crazy about?*

AP: We're cautious on apparel, retail, and restaurants. We also generally don't lend to companies in highly cyclical industries such as airlines or pulp and paper. We like issuers with high free cash flow conversion rates and low capex.

TLL: *What's your view on energy related borrowers?*

AP: PennantPark has had an excellent track record over a long period of time in the energy sector. Today, PNNT's energy exposure is mostly first-lien secured by real assets. That said, no question that it's a challenging energy market now.

TLL: *Do you think oil prices have bottomed out?*

AP: Over the longer term, it seems so. That's not to say we don't expect continued volatility related to short term supply/demand news which could see it down to $30 or so at some point. We don't think it will go back to the $20s for a sustained period. At $60 or so, we think we have a good shot of getting our capital back, and there will be some debt to equity conversions along the way.

TLL: *What is your exposure to energy?*

AP: It differs by investment mandate. As of 12/31, on a market value basis, our senior-focused BDC, PFLT had about 1.5% whereas our subordinated-focused funds had about 10%.

TLL: *How do you originate loans?*

AP: From our long-term relationships with over 150 sponsors. They've known our senior people for decades. Long term trusted partnerships are our goal.

TLL: *How large is your target borrower?*

AP: We generally focus on companies with EBITDA between $10-50 million. Our guiding principles remain the Three C's of Credit: Cash flow, Collateral and Character – with Character being the most important. Our past body of work really helps. Because we've been in deals together- in different kinds of companies, in different kinds of markets- we can handicap the behavior of our sponsor/borrower clients and they know what to expect from us.

TLL: *How many offices and employees do you have now?*

AP: Besides headquarters in New York we have offices in Los Angeles, Chicago, Houston, and London, with a total of nearly 40 people. We'll be celebrating our tenth anniversary next year.

TLL: *Congratulations on that, Art. Given that experience, what has surprised you most today?*

AP: I would say the increased acceptance of alternative lenders in the investment world. Many of us come from classic middle market backgrounds, so it's gratifying to see growth coming from non-banks. Jimmy Lee invented the syndicated loan selling to funds. Now it's the reverse. Some of our lending peers have hired sales people to syndicate their deals. The buy-side has become the sell-side!

TLL: *It's back to the future.*

AP: My first deal as a first year Associate at Drexel Burnham was in 1986. I was sent on a road show all around the country for a $15 million public high-yield bond for Gundle Environmental. That company is still around and PFLT financed it!

TLL: *And you've built an excellent business over nearly ten years.*

AP: We're proud of our track record: As of 12/31, only 11 non-accruals on nearly $5 billion in loans across nearly 400 deals. And we have recovered over 70 cents on the dollar on those tough situations. The firm has invested through cycles, and thanks to our strong relationships, we continue to find excellent companies in which to invest. We're proud of that reputation and happy to have peers like Churchill to do business with.

TLL: *Would you consider additional mergers like MCG?*

AP: We would consider it but those deals are hard to do. Between the process of agreeing to buy a public company and getting retail investors to vote, it’s a challenge. Plus you’re re-underwriting someone else’s portfolio. It’s often difficult to agree on price as you don’t want to buy someone else’s problems. Our main focus continues to be finding great risk/reward in order to preserve and grow the capital our investors have entrusted in us.

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