Lead Left Interview – David Petrucco, Ed Cerny, and Mark Gudis (Part 2)

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This week we continue our conversation with David Petrucco, Ed Cerny, and Mark Gudis – founding partners of Backcast Partners Management. Backcast is a recently formed venture that focuses on providing direct debt and equity capital to middle market companies across industries. ***Second of two parts – View part one***

The Lead Left: So Mark, you're in charge of sourcing. Tell me how you're planning to manage that?

Mark Gudis: I see four main avenues, but all have one common denominator: being highly proactive. First, the traditional private equity route from a variety of firms we've done business with in the past, who not only trust our ability to deliver as promised, but also who understand how we behave at certain inflection points during the lifespan of an investment. We work on plenty of "middle of the fairway" sponsored investments and compete well, aided by our ability to work on investments that require more thought and time. Secondly, through financial intermediaries such as Houlihan Lokey, Baird, Blair, Duff & Phelps, Ray Jay and countless other smaller boutiques. The latter include one to two person spinouts from larger brand name firms, and successful execution is so important for this sub-set. Third, we've been doing this a long time, and often collaborate with our banking and club lender partner friends when it's a win-win. Finally, our COPs are spread out across the U.S. and are always seeing attractive opportunities in their own areas of expertise, in addition to Centre which sources thousands of opportunities, not all of which are ideally suited for a control equity buyout, meaning our capital might be helpful.

We also expect to see off-the-run transactions, for example, companies that need growth capital, but may want to avoid leverage. In these scenarios, we're often happy to invest in convertible notes or preferred equity, especially when there is limited debt ahead of us. This can matter for companies looking to complete an IPO, or which are required to share balance sheet leverage information with customers or suppliers. This is where we really pride ourselves on our ability to construct unique solutions. We try to be flexible investors who focus more on specific risk-adjusted assessments, rather than more arbitrary, broad fund level investment requirements. It's this fund mandate flexibility that enables us to more quickly achieve the kind of portfolio balance we're looking for.

People say the middle market is crowded. We find competition always exists, but it's always less crowded in the traditional middle market. We've found over two-plus decades of investing, that right-sizing funds, offering unique value and being flexible investors, we have always had a steady and abundant stream of investment opportunities. As an example of flexibility, let's say you have a 10-11x purchase price multiple on an LBO today. The buyer may feel the need to put 6x+ leverage on that business to make their model work, but history shows us that such leverage can increase risk, and create a tension among lenders from the outset. We say, why not consider a structure with lower leverage, but with preferred equity tranche behind the debt, and we can provide that debt/preferred mix. That type of structure keeps the sponsor's common equity check down, but tends to keep lenders calmer in downside scenarios, and can literally save companies and affect investment outcomes.

The other really important thing to note is that we have a lot of senior bandwidth and experience at Backcast, we have a tremendous working and personal relationship with each other, and this really enables us to think out of the box, be very responsive and creative to our clients, and constantly be in the market looking for and closing transactions.

TLL: What are the kinds of credit risks you're taking? It's certainly a higher yield approach.

Ed Cerny: The bulk of what we do focuses on a company's ability to deliver cash flows, and obviously the stickier those flows, the better. When cash flow stability is more obvious, companies can find capital in more places, but sometimes these assessments take more time and effort. Because we have the resources and are willing to invest the time, we often find companies that are willing to pay more for structures that aren't always well suited to more simplistic syndicated or "clubbed" executions.

David Petrucco: The greater the "story," the more likely our COPs will be involved. We can better check the veracity of the story and act more deliberately with the COPs' assistance. We've found that not as many firms are willing to do this hard work, maybe because they don't share our resources, maybe because it can take a lot of time. It's funny, when we go to meet companies as part of a process these days, we usually find ourselves to be the oldest financing folks in the room. It seems like as competitors get bigger, their teams get younger, or maybe we are just getting older. Either way, we are the decision makers. Lots of experience and having industry insiders is key.

TLL: What kind of industries do you favor? And those you don't.

MG: We cover most, but avoid real estate, financial services or industries that have their own language if we can't speak it. Our favorite businesses are those that don't fit neatly into any one category; they are nichey. The assessment focuses more on barriers to entry and whether people will care if this business goes away? If customers care, companies tend to endure.

TLL: Do you care about hard asset protection?

EC: We'll lend to companies with less-certain cash flows if the assets or valuations work, but most of what we do is cash flow driven. We are probably more focused on expected future cash flows and less focused on historical cash flows than your average lender.

MG: We also like non-traditional assets such as royalty streams or even intellectual property. We are creative about finding value and again this is where the COPs get involved.

TLL: What about healthcare?

DP: Healthcare is about 15% of what we've done historically. It's really an insider's industry. When someone tells you there's no reimbursement risk, that's probably baloney. Eighty percent of healthcare has some reimbursement risk. If the Company's model is off the fairway, and if we don't have COPs dedicated to the space, then we're not going to play; there's no middle of the fairway in healthcare. This is also an industry where Centre has extensive experience and resources.

TLL: I'd like to ask each of you to describe your biggest career lesson with regard to investing.

MG: Control your destiny from both a fund and an investment perspective. At Backcast, the partners own the majority of the fund, so we aren't subject to larger firm events that don't specifically affect us and our investors, not to mention that if we want to do a certain deal, we can. Controlling our destiny from a transaction origination perspective allows us to be highly selective, which affects investment outcomes. Over our history, because of our strong deal-flow, we've closed less than 5% of what we've originated, which really puts us in a nice position of selecting the right investments, and it takes away pressure to do the deals immediately in front of you because you know from experience that next week will bring more transactions to consider.

EC: Always question your investment thesis multiple times before making an investment, and then re-question it throughout the life of the investment. Take appropriate action, don't be afraid to act, don't panic. Good companies can make it through the cycle; you just need to stick to your guns if you still believe in them.

DP: If you want to be taken seriously, your reputation is everything. You need to be thoughtful about your decisions, and always find ways to bring value that's unique to your customers. And make sure you enjoy what you are doing.

TLL: Finally, inquiring minds want to know: where does the term "Backcast" come from? Sounds fishy to us.

DP: We love fishing! Ed and Mark love the fly rods, I'm more of an ocean guy. In all forms of fishing, casting is critical. The success of the cast is determined by the right positioning at the outset, or the backcast.

In economic planning, backcasting is the opposite of forecasting. Forecasting asks where historical trends will take you in the future. Backcasting is asking, where do you want to be in the future, say five years? Then work backwards from there to figure out how to get there from where you are today, what kind of capital and what resources do you need? Our goal at Backcast is to help our clients reach these goals. It took a while to find a fishing word that also described how we do business but when we hit on Backcast we knew we had a keeper.

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