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Lead Left Interview – Doug Cruikshank & Rafael Castro

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This week we speak 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.

The Lead Left: Gents, not many people may have heard of Enhanced Capital, but you've actually been around for a while. Tell us a bit about the history of the company.

Doug Cruikshank: Thanks, Randy. Our firm was started in 1999 by Andy Paul, a former managing partner at Welsh Carson. His practice was primarily healthcare, and he invested $2 billion of capital during his time there. He left Welsh Carson and founded the Enhanced Equity Fund with $200 million.

Rafael Castro: Andy's focus again was healthcare, but more on lower middle market transactions. That first fund was separate from Enhanced Capital which is our lending fund.

TLL: I see from your website you've grown considerably in terms of your national presence since then.

DC: Yes we have offices in sixteen states.

TLL: How did you get started on your current lending strategy?

RC: In 2012 we raised an SBIC fund with the track record we had built over the previous decade. Our support came from a family office as well as other private investors. There's $110 million of LP equity with $50 million of leverage for $160 million total capital. About 50% of that fund is deployed today.

DC: That was primarily a lower middle market mezzanine fund. As we were originating for that fund, we came across a private equity owned company that was a bit of a challenge from a credit perspective. Our capital was going to look a lot like equity, so we told the sponsor we needed a back-stop. We discovered, somewhat surprisingly, there was quite a bit of appetite for this type of approach.

TLL: Meaning that you could get a guaranty from the GP.

RC: That's right. So in December 2012, we talked to Hamilton Lane about raising a fund for us dedicated to this approach. We started investing about a year later and held our final close this past December.

DC: We've financed 12-15 companies since we raised that fund. The thesis is that some deals can't get done without sponsor support, so our capital is structured as debt so to be non-dilutive to the equity.

TLL: Has your strategy – deals supported by GP support – been a challenge in terms of fundraising?

DC: At first the LPs didn't understand the nature of the debt. They were coming at the questions from the wrong angle. Is it sub debt? Is it senior? First lien? Second lien? The real way to think about our strategy is to ask what the net asset value of our GP fund guaranties is versus the debt. That answer is 15.5x the debt, so we're 14.5x covered!

RC: We did ten loans in year one from the new fund, with one already realized. Our expected yield is about 12.25%, including cash and PIK.

TLL: What's the average loan size?

RC: The average is $5 million. We could do $20 million, but our preferred hold is $10-15 million.

TLL: Talk to us about your origination strategy.

RC: It's very simple, actually. There's a finite world of PE firms. We look at market research data bases – like Prequin, PitchBook, and Capital IQ – looking for funds in the 2005-2010 vintage. Ideally $100-800 of million AUM with multiple funds. But you need to engage partners in a conversation. It's usually taboo to talk about GP guaranties, but we'll do some unnatural things. For example, other than a minimum cash balance test, we don't require financial covenants on the borrower.

TLL: That gets their attention.

DC: We will be a first lien lender to a negative ebitda company. We'll go five years in tenor – which compares favorably to working capital lines or equity. Our key differentiator is that we look to the NAV. Our loan is an unsecured obligation of the fund.

TLL: So it's not always a GP guaranty.

RC: Sometimes, not always. We view it as a "fox-hole" guaranty – to make sure there's a moral impetus and everyone's incented alike. For the sponsor it's a low risk since we're not changing fund economics.

TLL: How have your results been? Have you ever had to call on a guaranty?

DC: We've never lost a dime. We've only had to call a guaranty twice. Both times we were paid in full.

To be continued the week of April 13

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