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Lead Left Interview – Justin Kaplan Part 2

THE LEAD | June 4, 2014

This week we continue our conversation with Justin Kaplan, Partner, Balance Point Capital Partners, a lower-middle market investment firm with offices in Westport, CT and Hartford, CT. Second of two parts – View part one

The Lead Left: *Cov-lite? For a $5 million ebitda business?*

Justin Kaplan: When I say "cov-lite," I mean that mezz investors usually get three or four covenants, but instead now they're getting one.

TLL: *OK, that's better. I was about to throw in the towel.*

JK: Well, it's very tough to compete. BDCs, SBICs and other non-bank lenders, are all very aggressive right now.

TLL: *What kind of industries are you focused on?*

JK: We like service businesses, particularly business services, defense, healthcare, and media.In healthcare we've looked at revenue cycle management deals and toxicology/lab testing companies.

TLL: *These sectors do seem to come in waves, for some reason. Last year it seemed like every seller was a dental practice. There were six of them out there at one point!*

JK: I wish we could look at six dental practice deals. It's an attractive sector with many characteristics that we look for in a company – strong margins, limited capital expenditures and revenue visibility.

TLL: *Where are we in the business cycle? Are we close to a downturn, given all this financing froth?*

JK: Great question. If the 9th inning is the bubble bursting, I would say we're in the 6th inning. What do you think?

TLL: *With the Fed continue to provide the punch bowl it's hard to not see this going extra innings. Maybe this is the 7th inning stretch. So what kind of pricing are you getting?*

JK: For mezz it's still decent yields, especially for non-sponsored deals. Certainly 13%, with maybe 1-2% less for sponsored paper. For sponsored unitranche, it's in the 7-9% range; probably 10-12%, non-sponsored. We can also do non-dilutive paper, like preferred with a PIK component.

TLL: *Is that at the holdco?*

JK: Yes, with about a 17-20% return. The challenge is, if the company is not a growth business, with the PIK compounding at a double-digit pace, the common can get crushed.

***TLL:** What's been your biggest surprise this year?*

JK: Another great question. I'm surprised at the proliferation of credit funds in the lower middle market. There are many BDCs in registration! That activity has just ballooned. I'm surprised that the market can support it. But deals are getting done so investors seem to think there's room for everyone.

***TLL:** So there's no real survival of the fittest yet.*

JK: No, although that is proving out on the PE side, i.e. funds are dropping out as they fail to raise money. But two other things to watch that are in the "surprise" category are, first, the fact that the fundless sponsor market seems to be gaining more traction and credibility. And there's a growing interest from family offices in smaller deals. Those are trends for your readers to watch closely.

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