

COMMENT

Broader basket better market fit

Penfund Capital III spans entire capital structure



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John Bradlow, Barry Yontef, Richard Bradlow and Adam Breslin are, as the old saying goes, like kids in a candy store. The four are in this enviable position thanks to the closing of their third fund, Penfund Capital Fund III — a closing that ended up with \$240-million in the kitty. And the new fund, which will close with proceeds of \$250-million, has a broader mandate than Penfund's first two funds.

"This fund is different from the two predecessor funds in that it can invest across the whole capital structure," said Bradlow. "That basically means we can provide all the forms of capital that a company may need in a given situation," he added, noting that the firm's first two funds (which together raised \$154-million) were restricted to investing in subordinated debt securities, a hybrid that features an interest rate plus an equity participation.

Bradlow said Penfund opted for a broader basket of securities in which to invest for a couple of reasons:

■ **Market reality.** The past few years have been "tough" for all providers of capital, because there is a veritable "glut of liquidity generally in the financial system and specifically in the private equity system of which we are part," he said. As a result, risk has been driven upwards while price — the ability of capital providers to generate returns — has been driven downwards.

Bradlow said one manifestation of this situation "is a dramatic climb" in so-called leverage ratios, meaning that transactions are completed with more debt and less equity than in the recent past.

Another manifestation is a dramatic fall in pricing. "You look at spreads in the U.S.-dollar high-yield market and they are virtually at an all-time low," said Bradlow, who added that with defaults at low levels, market participants "think that nothing can go wrong. As a result, the risk envelope is being pushed all the time." Another result: a 300-basis point drop in the return an investment likely will generate.

■ **The need to be a one-stop shop for clients.** Bradlow said the limited options available to Penfund in its first two funds meant "it was more and more difficult to do quality transactions, particularly when we had a very limited product line, namely mezzanine finance. "There are so many situations where a company may need more than just mezzanine financing and we are not in a position to address those needs," he said, adding the current fund can offer high-yield debt, equity (either for a control stake or a minority position), bridge facilities, standby lines, underwritten facilities and financial guarantees — in addition to mezzanine finance.

Bradlow said Penfund has the product range of a large financial institution, "which we hope to combine with the dynamic entrepreneurialism of a private equity firm where we can move quickly."

The broader product line comes when there has been an increase in the types of capital provided. In the good old days there was equity, mezzanine finance and senior debt. Now the balance sheet can also include high-yield, Tranche B and Second Lien securities.

The effect is a capital structure with multiple layers and much more potential for conflicts between the capital providers. The result has been a rise in one-stop shopping (in which one provider can provide all the capital required) and an increase in the number of specialist, niche providers, many of which are from the United States.

Bradlow and Yontef have been running Penfund since they bought the fund manager from CIBC in 2000. (Penfund was formed in 1979 by Hugh Rorison. It is generally regarded as the first manager to source and manage debt investments, mostly private placements, for institutional investors.)

At the time the two were managing Private Equity Management Corp., which managed contracts owned previously by Canadian Corporate Funding Limited. In due course they raised their first fund that was focused on making subordinated debt investments. The pair rounded up \$48-million from institutional investors, investing between 2000 and 2003. The fund's target price — a mixture of yield and the equity participation — was in the range of 18%-22%. Investments in the first fund were made in Access Flower Trading (an online auction site for flowers); Maddocks Systems (which makes software products for the trucking industry); Footmaxx Holdings (which makes prescription foot orthotics); TDS Automotive Canada (a sub-assembler of automotive components) and Canadian Home Income Plan (which provides reverse mortgages).

About 95% of those investments have been liquidated with returns (net of fees and carried interest) above 17%.

In 2003 with most of the first fund invested, the two set out to raise their second fund: a few months later they had scooped

MULTIPLE LAYERS RAISE RISK OF CONFLICT BETWEEN CAPITAL PROVIDERS

up \$106-million. That was invested from 2003 to 2007 with the fund's target return in the range of 14%-18%. Investments have been made in a variety of companies including Gesco Industries (a distributor of floor coverings); Goodlife Fitness Centres (which operates a national chain of fitness centres); Ingenia Polymers (a processor of thermoplastic resins and additives); Wakefield Canada (the exclusive Canadian distributor of Castrol motor oil) and Normerica Capital (a manufacturer of cat litter and dog treats.) About 60% of those investments have been harvested.

Refinancings, in which a financial institution provides cheaper capital, have been the most common way that Penfund has realized on its investments. (Sales to other private equity funds also provide exits.)

Bradlow expects to make two or three investments a year, but only after looking at 150 opportunities.

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