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PARTNERS
Non-Control Capital for the Middle Market

Cyprium Capital Markets Perspectives

Selection Bias
All Capital Is Not Created Equal

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My colleagues and I came together seventeen years ago to form the core investment team of Cyprium Investment Partners. Our guiding investment philosophy since our founding has been to make long-term, illiquid, non-controlling investments directly alongside entrepreneurs and families to facilitate the continued growth of their lower middle market businesses. This philosophy allows the owners to achieve their strategic and/or financial objectives without yielding economic or voting control. We are joined in this pursuit by a handful of other independent, similarly focused competitors. It has been a very rewarding business model as our firms are typically the first institutional investor in our portfolio companies and thus we have the pleasure of working with the folks whose sparks of inspiration and years of perspiration have driven their businesses to the current stage of success. Our goal is to be a constructive investor, one which as a partner brings resources and experience to bear for the benefit of our portfolio companies, their shareholders and their executive leadership teams. Cyprium's particular model is labor intensive as we seek to underwrite each investment with the curiosity and diligence of a control investor. My colleagues and I also seek to maintain an active ongoing dialog with our management teams such that we are prepared to quickly and intelligently work to take advantage of unanticipated opportunities or dispassionately respond to unforeseen challenges.

Given the sustained increase in capital supplied to mostly unregulated credit providers since 2012, it is reasonable to query whether there is still demand for this approach which is often referred to as sponsorless mezzanine. Why would an issuer choose to pay more than a market clearing price for their capital? Indeed why give up any equity ownership at all particularly given the aggressive lending terms available as credit purveyors with an excess of capital over demand enter competitive bids to provide debt financing?

The answer is embedded in the philosophy of the issuer (i.e., private company owner). While many of our family owners and entrepreneurs are optimists by nature, the majority of their net worth is illiquid, tied up in the retained earnings of their privately held enterprises. Primary influencers on the decision regarding the selection of the firms to provide the required financing as well as the nature of the capital to be provided are evident in the dialog that we often encounter in a capital raising exercise. What is the risk tolerance with respect to that illiquid net worth? Does the issuer believe they can create more value by focusing on profitably growing their business or through financial engineering? Clearly the discussions entail more nuance than suggested above but they often do boil down to a simple weighting of perspectives on risk tolerance and the perceived path towards future value creation.

We have observed that issuers with a higher risk tolerance tend towards financial engineering solutions which bias towards maximizing leverage while minimizing the corresponding cost of that capital. These solutions have historically incorporated higher leverage levels than we would recommend or with which we would be comfortable. Credit centric with such solutions, there is a strong potential for lack of alignment with the shareholders.

An issuer choosing a capital partner such as a sponsorless mezzanine firm is effectively expressing interest in identifying the balance between cost of capital and long term alignment. While aware that less expensive capital alternatives are available, these companies are focused on value creation opportunities driven mostly through organic or acquired growth of the enterprise. As such they are looking for a partner that can deliver resources and/or advice as needed to enhance their ability to achieve their potential. The higher cost of capital is justified by a combination of the partnering mindset and the experience and value that the investor is able to contribute. These latter attributes are critical and the company will almost always seek to validate the value-add potential through reference calls to former portfolio company shareholders and executives. My partners and I at Cyprium are confident of our bona fides in this regard as our firm has completed 75 investments since 1998. In addition to our own experience and similar to control PE firms we have both an Advisory Council as well as a roster comprised of experienced executives to provide input and/or act as mentors to our portfolio company management teams.

As an example, in 2010, Cyprium was introduced into an investment banking process where the banker was retained to raise non-controlling capital for a market-leading Canadian company. The owners were a husband and wife team; self-described serial entrepreneurs. The owners were raising capital to build out a new factory that would provide them with first mover advantage in the manufacture, using 100% recycled material, of their packaging material. Cyprium won the day due to its packaging experience, successful minority investment history and track record with Canadian companies.

Due to our capital flexibility, we were able to change the investment from preferred stock to junior subordinated debt during our diligence, based on the owners' request. Fast forward four years later, as our sub-debt was about to mature, the company had continued its growth trajectory and had a need for additional capital. At this point, the company was quite sizable and had many financing options open to it. Instead, the owners elected to renew Cyprium's investment and continue our relationship for another five years. Again, this company was presented with a wide variety of capital options but the strategic and financial partnership they had formed with Cyprium, and the counsel and expertise we had been able to provide, won the day over cheaper but less value-added investors.

There is a definitive selection bias in most of the investment opportunities that cross our threshold. On an anecdotal basis we know that the management/shareholders are looking for a partner when their first question is 'how can you help me' rather than 'how much is it going to cost'. Similarly they want our first question to be 'what keeps you up at night' as opposed to 'what will the coverage ratios look like'. As long as such companies continue to seek an informed partner rather than a credit source, firms like Cyprium will find sufficient demand for our capital and our team members will continue to have the privilege of supporting the families and entrepreneurs that drive value creation and employment in lower middle market companies.