Called in the experts

Arrowpoint managing directors Michael Novoseller and Vipul Shah explain why, with the right experience and research-driven process, the mid-market can be a source of considerable opportunity.

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ounded in 2007, Arrowpoint Partners is a Denver, Colorado-based investment manager with $10 billion in credit and equity assets, focused on fundamentally-driven strategies in less efficient markets. In an interview with Michael Novoseller and Vipul Shah, who help lead the firm’s efforts in mid-market lending and specialty finance, we find out more about their origination process, how they evaluate risk, the keys to working in partnership with management teams, and more.

Q Could you tell us a little about the background of the team?

Vipul Shah: Our team has diverse and unique backgrounds which set the foundation of our strategy and the nature of the relationships we build with our portfolio companies. Within our team we have people who have founded and run small businesses, as well as those who have career-long private credit and equity backgrounds. The level of empathy and advice we can offer small and medium-sized businesses as a result of our actual experience as business operators is very inviting for the companies with whom we partner.

Q What is your investment focus and how do you go about originating deals?

Michael Novoseller: In recent years, institutional capital has been flowing into the market to replace the cash flow lending activities of banks, which have been largely regulated out of the market. However, most of the money raised by mid-market direct lending firms is focused on supporting private equity sponsor LBO activity. There was a time when there was not much difference between how sponsored and non-sponsored (family owned) businesses raised capital. But in today’s environment of supply/demand imbalance and for the foreseeable future, non-sponsored companies pay a higher price for what is frequently less risky capital. Banks moving out of the market has left a hole that we have moved into. That’s the backdrop.

How we source and originate in the non-sponsored market is very different from sourcing and originating sponsored investments. Other firms have teams of “sponsor coverage” originators, separate execution teams, and an investment committee that’s removed from day-to-day transaction execution. Our staffing model, on the other hand, resembles that of private equity firms, with the collective team finding and executing deals. Like the partners at private equity firms, our investment committee is intricately involved in granular day-to-day investment analysis and execution.

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VS: It’s hard enough to find good companies with great management in industries you understand. Once you have found that, in order to deliver differentiated investment outcomes, you need to optimise risk/reward through flexible financing solutions that maximise relative value across the capital structure. We believe there is much more value to be had on the non-sponsored side financing growth companies.

We use a framework to explain how you can deliver differentiated alpha-generating outcomes without sacrificing the need to protect capital. The mid-market involves high-touch, medium-touch and low-touch approaches. We believe that the more high-touch sourcing and execution you can do, the more likely you are to get paid a premium without taking additional risk.

Medium-touch is when you source from a private equity sponsor. That approach takes away a lot of the work but it also reduces your compensation and ability to manage risk. Low-touch is simply buying from another lender, such as you would in the syndicated loan market. Most competition currently resides within the medium- and low-touch markets. We focus on high-touch investing by sourcing investments directly,
and leading due diligence and structuring. The result of this approach allows our LPs to receive a premium in exchange for the extra work we do.

Q Some businesses see debt as an amplification of risk. How do you assuage those concerns?

MN: Small businesses often have a fear of debt and that’s a positive for us because we take time to go through an education process and ultimately finance capital structures that are more conservative than what would be financed in a sponsor-backed LBO. We are able to understand a business owner’s fears because we’ve been in their shoes as entrepreneurs and operators. We have deep domain knowledge and expertise and what rightfully comes across to the entrepreneur is that Arrowpoint knows his/her industry really well.

Additionally, we invest both debt and equity, which means we are able to deliver comprehensive solutions rather than saying ‘this is what we’re selling and it’s what you need’. We say ‘tell us what you want and we’ll see if we can create a solution’.

VS: We’re focused on investment performance not assets under management, so we don’t force a minimum deal size. We often hear from portfolio companies that they were pleased we did not try to force capital that they didn’t need. The quantum of capital required by the business will change over time and our companies know they don’t need to go elsewhere for capital as they grow.

Q Where do you think we are in the cycle, and how are current market conditions likely to impact the fortunes of mid-market companies?

MN: We don’t know where we are in the cycle, but we always underwrite as if we are in the ninth inning.

The key determinant of success in a downturn is how much leverage portfolio companies have. If the portfolio is filled with sponsor-backed LBOs and sponsor-backed dividend recaps, you will struggle in a downturn. With non-sponsored businesses, our starting point is a lower leverage level, which gives us strong downside protection. We focus on appropriately-capitalised companies. We use leverage but less so than others do.

Additionally, in the credit selection process, we focus on businesses that control their own economic destinies. We like recurring revenues and strong, long-term customer relationships. We focus on non-cyclical areas within the market. You won’t see us back consumer retail or energy, but we will invest in the likes of tech-enabled businesses, healthcare IT and established franchises.

We’re content to miss a few good deals as long as we stay true to our credit process and avoid the bad one that comes along. If your mind-set is that you need to book a growing business, over 30 percent a year, you will struggle in a downturn. With non-sponsored businesses, our starting point is a lower leverage level, which gives us strong downside protection. We focus on appropriately-capitalised companies. We use leverage but less so than others do.

Q What do you feel are the key concerns and priorities of investors?

VS: The need for yield has not gone away simply because traditional sources of yield no longer deliver as they once did. Most investors do not see excess risk as a viable compromise to meet return objectives and have become increasingly comfortable pursuing new approaches that go beyond the old style box.

We typically see investors allocate from two perspectives. If it is a fixed income allocation, private credit is definitely helping to enhance returns within unlevered vehicles. For the alternatives and private markets allocation, which typically has a lot of private equity exposure, our approach helps deliver a risk/return profile that is uncorrelated to market beta and has coupon-generated income to dampen volatility.

MN: Hedge funds have been underperforming and private equity has not been delivering on its yield promise. Investors are continuously gaining an appreciation of the more nuanced segments within private credit. We offer the added value of being able to source opportunities directly from business owners in the lower mid-market and clients view us as a valuable complement to their existing core or alternative allocations.

Q Could you pinpoint a deal that captures the Arrowpoint approach?

VS: We had a long-term relationship with a board member of a growing company, which put the business on our radar. They had a management team we liked in an industry we viewed favourably. In early 2016, we invested in the business and partnered with the management team and its family office shareholders.

It was a well-funded business that had been nurtured through the years and we understood their market. It was a fast-growing business, over 30 percent a year, and its growth capital needs exceeded its leverage capacity.

We worked with the management team to structure a 1st lien senior secured loan plus structured equity financing solution. We leveraged the business at only 2.5 times and provided a structured equity return with significant downside protection in exchange for some upside. It’s a business with a re-occurring revenue model, strong Fortune 1000 customer relationships, and meaningful barriers to entry.