THE Lead Left
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Lead Left Spotlight - Robert Gefaell

This week we chat with Robert Gefaell, co-founder and partner, Plexus Capital. Plexus focuses on subordinated debt investments in middle market companies, with a total of $550 million under management across three funds.

PLEXUS CAPITAL

***The Lead Left:** Robert, you and your partners got started together at the old Centura Bank, correct?*

Robert Gefaell: That's right, Randy. We all worked for Centura Bank from the mid '90s through 2002. In 1995, Bob Anders – at the request of then bank President Kel Landis – was successful in establishing Centura's first licensed SBIC named Centura Capital. Ultimately Bob hired me, Michael Painter, and Mike Becker. That's how it all started.

***TLL:** And when did you all found Plexus Capital.*

RG: Well, in 2001 RBC acquired Centura Bank and named Kel the first CEO of RBC in the U.S. Unfortunately in 2002 it was determined by RBC to harvest Centura Capital's portfolio which we successfully did yielding a net return to the bank of 14% over the 9 year period. Ultimately Michael, Mike, and I left and all joined other SBIC's in NC, but ultimately found our way back together with Bob and Kel (after they took early retirement from RBC) in the summer of 2005 for the formation of Plexus – we got the band back together!

***TLL:** I'm very familiar with the strategy of bringing bands back together.*

RG: We then got our first SBIC license under the Plexus name, raised $27 million of private capital from 20 banks and 40 individuals, and ultimately funded our first transaction on December 30, 2005. With 2 tiers of leverage from the SBA, Fund I had $81 million of investable capital which was used to finance 28 companies over a 4 year period.

***TLL:** When did your second fund close?*

RG: That was in 2010. We raised just north of $58 million, so with leverage we had a $175 million fund from which to invest. It also had, coincidentally, 28 companies in its portfolio. 2 years ago in May of 2013 we raised our third fund – we raised $150 million in private capital and plan on taking $150 million in leverage. To date we have invested $154 million of Fund III in 18 companies.

***TLL:** Because the SBIC caps leverage at a maximum of $150 million?*

RG: That's correct. We are leveraging our Fund III capital calls on a 2 to 1 basis currently until such point we hit the cap on the leverage. Our LP's are still deriving attractive return enhancements from the leverage as we deploy capital in companies coast to coast.

***TLL:** How do you define the kind of companies you look for?*

RG: We seek later stage, growth oriented businesses that have reached an inflection point in their life cycle where outside capital is needed. These companies typically have a great relationship with their existing senior lender, but have simply maxed out their ability to attract any more debt – that's when mezzanine debt most often comes into play.

***TLL:** I assume most of these companies are private.*

RG: Correct, however; two of our existing portfolio companies are actually public. We target companies with revenues under $100 million and EBITDA under $20 million. Most importantly to us though is management: management, management, management! I would rather have an A-rated management team with a C-rated product/service then the inverse – products/services can be fixed, typically people cannot.

TLL: *Most of your investments are in the form of subordinated debt?*

RG: The vast majority for sure. Some unitranche and some equity as long as it's in concert with a larger mezz check from us.

TLL: *Do you get upside with your mezz?*

RG: Out of our 74 investments since inception, we have upside in all but 2, primarily through penny warrants, but also through equity co-invests.

TLL: *How many companies are backed by private equity sponsors?*

RG: Only 20% of our deals are sponsored-backed. While we like to see PEG deal flow, purchase multiples sponsors are paying today are incredibly high and we tend to get uncomfortable when being asked to get aggressive on leverage and frankly beat-up on pricing to levels that fall below our risk/return profile.

TLL*: How aggressive are they being?*

RG: I've seen deals where the purchase multiples are north of 9x EBITDA (with EBITDA in the $5MM range), pro-forma capital structures suggesting leverage through the mezz of 4x+, and all-in pricing in the 10%-11% range. If leverage is above 4x it's likely not a deal for Plexus. We feel much more comfortable with all-in leverage through our debt of 3.0x to 3.5x and pricing commensurate with the risk. And no, this is not a unicorn! We pride ourselves on staying in front of referral sources, staying relevant in the market, logging serious hours in cars, planes, and trains in order to turn over far more rocks then our competitors. We are not afraid of taking the road less traveled to find the best opportunities for the benefit of our investors.

TLL*: How do you target opportunities?*

RG: We look for entrepreneurially run companies, most of which have never changed hands, that have a growing business where the owner a) wants to take the company to the next level and needs capital to do so; or b) is seeking a liquidity event for all or a portion of their ownership – we can help them take some chips off the table.

TLL: *That's pretty typical of smaller companies.*

RG: You bet – most owners are looking for help in strengthening their balance sheet and their management depth in a growth scenario, while others are seeking to begin the succession planning process with the end goal of liquidity. We can help them in all these scenarios.

TLL: *What kind of industries do you favor? Or not.*

RG: We're agnostic. We like businesses we can understand – business services, light manufacturing, healthcare, distribution, etc. We are precluded from investing in real estate, re-lenders of capital, and project based financings per the SBA regulations – although it is rare we encounter businesses operating in these industries.

TLL: *Any concerns about where we are in the cycle?*

RG: Candidly, the large purchase multiples and increased leverage multiples in the market today give me pause. Pretty much reminds me of where the market was in the years leading up to the meltdown in 2008 – unfortunately there are groups out there who haven't listened to their rearview mirror – "Warning – objects may be closer than they appear!".

TLL: *How much competition are you seeing in the mezz arena?*

RG: We're certainly seeing it – lots of money chasing deals. Mezz funds, BDC's, unitranche funds, and senior debt funds are feeling pressure to deploy capital to keep their investors content. In a crowded market like we are in, this typically results in aggressive leverage profiles with squeezed pricing. It is imperative to Plexus' success we remain disciplined, first and foremost, on credit underwriting, and secondarily on risk appropriate pricing. We believe we are doing this well.

TLL: *So your pricing is above market?*

RG: That is one way to look at it, although I prefer to look at it as appropriate pricing for the market we serve. We aren't the cheapest capital in the market, but we aren't the most expensive either.

TLL: *Fund I started before the Great Recession, so you experienced the full downturn. How has your track record held up?*

RG: You're right, we invested right through the recession. We're quite proud of our track record for Fund I having generated to date (with two assets remaining in Fund I) a 10.3% net IRR, and a 1.7x cash-on-cash return. Fund II is 100% invested, but as Fund I was artificially low due to the recession, one might argue Fund II returns will be artificially high given the attractive investment window we had on the heels of the recession – we estimate an 18-20% IRR and 2.0x COC for Fund II given the returns realized to date and the status of our remaining investments. Fund III should be on target with our stated goal of a net IRR of 12-17% to our investors.

***TLL:** How do you view the economic backdrop?*

RG: It appears relatively healthy, and I hope it stays that way, but I just can't help feel there is something around the corner – what, where, and how soon I don't know – but my gut is telling me something and to me that screams remain disciplined and remain alert.

***TLL:** What economic factors could be most vulnerable?*

RG: I think the rate environment is potentially at risk. While I don't see the Fed doing anything drastic anytime soon, when rates go up it's definitely going to have an impact on those companies sporting larger-than-prudent leverage levels. Cash will get tighter, covenants will start to trigger, and lenders, specifically senior lenders with jittery credit officers, will most certainly get their antennas up with one finger on the panic button.

***TLL:** You've mentioned some SBA regulations impacting you. What are some others?*

RG: The SBA is a great partner and gives us a lot of room to maneuver. The only other regulation worth mentioning is we are precluded from investing in foreign entities. It is rare we encounter this, but we have certainly seen a handful.

***TLL:** Anything else to mention about your track record?*

RG: I'm proud to say Plexus was named the 2013 SBIC of the year by the SBA out of over 300 SBIC's across the country. I think that speaks to the wonderful team of 18 people we have assembled. I know it sounds clichés-ish, but we truly are a family with a lot of respect and trust in each other.

***TLL:** Congrats! So what's been your biggest surprise?*

RG: I would say I'm still shocked by the precipitous fall of the economy and what transpired in 2008 and 2009. It really showed us that backing the right management teams and having conservative capital structures in place at close of a transaction paid off. We had a few issues, but the portfolio held up and we were able to ride through it.

***TLL:** Give us an example of the "few issues"?*

RG: Well, we had an investment in a high-end door and millwork manufacturer in Florida focused on the residential building market…not sure I need to say anything else!

***TLL:** You said it well…no you don't. Thank you for your time.*

RG: Thank you Randy.

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